

HCC Insurance Holdings, Inc.

Another Good Quarter; Results Boosted by Continued Favorable Development

- Third-quarter operating EPS increased 38%, to \$0.83, compared with our \$0.75 estimate and consensus of \$0.74. The outperformance relative to our estimate was principally driven by higher favorable loss reserve development (\$0.10-per-share benefit relative to our estimate).
- Net written premium was flat during the quarter at \$493 million, compared with our 5% growth estimate. Production in the quarter was driven by modest growth within its diversified financial products line, which includes directors' and officers' liability coverage—an area of the market that has shown the greatest rate increase to date and has been going through dramatic change. Pricing remains under pressure, and we do not expect a sharper recovery until underlying profitability for the industry begins to deteriorate. Given that HCC's medical stop loss business is nearly 40% of total company premium, the company is not experiencing the same pricing pressure as most of its specialty lines peers.
- The combined ratio was 82.7%, compared with our 84.8% estimate—\$25.4 million of favorable loss reserve development subtracted 4.9 percentage points from the loss ratio (compared with \$16 million favorable development and a 3.2 percentage point benefit last quarter). The loss ratio was 58.4%, compared with our estimate of 59.8%—our estimate included \$7.5 million of favorable loss reserve development, a 1.5-percentage-point benefit to our loss ratio estimate. The higher accident-year loss ratio seems to be mix driven, with some volatility in smaller lines of business.
- Realized investment gains totaled \$864,000, compared with \$933,000 of gains last quarter. Credit quality remains generally high for HCC and most of the commercial property-casualty insurance industry, and we do not see credit as a serious concern. Diluted book value per share increased 6.0% during the quarter, to \$26.46, given the recovery in credit markets.
- We are increasing our 2009 EPS estimate to \$3.12 from \$3.05 given the outperformance this quarter offset by a slightly more conservative growth expectation for the fourth quarter. We are lowering our 2010 EPS estimate to \$3.00 from \$3.10, consistent with the reduction we are seeing across our coverage universe given more competitive pricing.

Financial | Commercial P/C Insurance

November 04, 2009

Stock Rating: **Market Perform**
Company Profile: **Core Growth**

Symbol: HCC (NYSE)
Price: \$26.28 (52-Wk.: \$19-\$29)
Market Value (mil.): \$2,951
Fiscal Year End: December
Long-Term EPS Growth Rate: 15%
Dividend/Yield: \$0.52/2.0%

	2008A	2009E	2010E
Estimates			
EPS Q1	\$0.70	A\$0.73	NA
Q2	\$0.81	A\$0.82	NA
Q3	\$0.61	A\$0.83	NA
Q4	\$0.69	\$0.74	NA
FY	\$2.80	\$3.12	\$3.00
CY		\$3.12	\$3.00

Valuation

FY P/E	9.4x	8.4x	8.8x
CY P/E		8.4x	8.8x

Trading Data (Thomson Financial)

Shares Outstanding (mil.)	112
Float (mil.)	NA
Average Daily Volume	657,662

Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	12.6
Book Value Per Share (MRQ)	21.9
Enterprise Value (mil.)	3,194.8
EBITDA (TTM)	477.2
Enterprise Value/EBITDA (TTM)	6.7x
Return on Equity (TTM)	10.9

Two-Year Price Performance Chart



Source: Thomson Financial, William Blair & Company estimates

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- Our rating remains Market Perform. We view HCC as a high-quality, stable underwriter that should continue to benefit from a flight to quality as one of only two double-A-rated commercial property-casualty insurance companies in the United States. The shares trade at about 1.0 times third quarter 2009 diluted book value per share of \$26.46, and while we view this as very attractive on an absolute basis, we see more relative value within the space.

Another Solid Quarter, EPS Upside Driven by Favorable Development

Third-quarter operating EPS increased 38% to \$0.83, compared with our \$0.75 estimate and consensus of \$0.74. The outperformance relative to our estimate was principally driven by higher favorable loss reserve development (\$0.10-per-share benefit relative to our estimate). Operating EPS exclude \$0.01 per share of realized investment gains. The operating ROE was a respectable 13.0% in the third quarter and roughly 12.4% for the first nine months of the year.

Flat Premium Growth Not Surprising, Continued Growth in D&O

Net written premium was flat during the quarter at \$493 million, compared with our 5% growth estimate. Production in the quarter was driven by modest growth within its diversified financial products line, which includes directors' and officers' liability coverage—an area of the market that has shown the greatest rate increase to date and is going through dramatic changes with the capital pressures and employee departures at AIG (AIG \$36.20), Hartford (HIG \$24.44), and XL Capital (XL \$16.17), three major players in D&O. The London market account was particularly weak, and aviation and other specialty lines also declined during the quarter.

Net written premiums within diversified financial products overall increased 2%, to \$220 million—the company's D&O product line increased 9% year-over-year, and its other professional liability line increased 5%. HCC could take huge share in the D&O business if the company has the appetite, given that it is now of only two double-A-rated publicly traded insurance companies (the other is Chubb Group [CB \$48.65]). Life, accident, and health net written premium was up 1% in the quarter to \$198 million (38% of total), as pressure on exposure growth from the weak economy continues; however, pricing continues to run modestly in excess of trend according to management, which is unique within the broader industry. Aviation declined 6% in the quarter to \$35 million, and the London Market Account (offshore energy, marine, and property), as mentioned above, was particularly weak, decreasing 25%, to \$13 million, with energy down 58% year-over-year, which is a bit surprising given that offshore energy is one area in which pricing has increased significantly.

While pricing, in the aggregate, remains under significant pressure, management stated that approximately half of its business is experiencing rate increases, although this is due to disciplined underwriting and HCC's business mix, particularly medical stop loss, as opposed to an indication of a change in the cycle. HCC is seeing continued rate increases in financial institution professional liability, energy, credit, medical stop-loss, and international aviation. Our basic view on commercial property-casualty insurance pricing since mid-September 2009 has been that underlying underwriting margins were still too high for the commercial property-casualty insurance industry to push for price increases aggressively despite capital pressures, which we believe has been generally accurate. Therefore, we believe the primary catalyst toward a further push in pricing is further deterioration in underlying margins and profitability after more than four consecutive years of price declines.

While the pricing environment and economic headwinds remain challenging, management has made several key hires over the past 18 months and stated that it is in active talks with several other teams at present, to drive growth despite the difficult operating environment. Management stated that new team recruitment will be a core element of the company's growth strategy in 2010. Management also observed that pricing for acquisitions is becoming more reasonable and it continues to actively review potential bolt-on acquisitions that could grow the business while also maintaining the company's low expense ratio.

Underwriting Profitability Remains Strong; Continued Benefit From Favorable Development

The combined ratio was 82.7%, compared with our 84.8% estimate—\$25.4 million of favorable loss reserve development subtracted 4.9 percentage points from the loss ratio (compared with \$16 million favorable development and a 3.2-percentage-point benefit last quarter). The expense ratio was 24.3%, compared with our 25.0% estimate. The favorable development year-to-date is primarily from the 2006 and prior accident-years' reserves, with roughly two-thirds of the development coming from the U.K.

professional indemnity business, surety, and aviation businesses, with the balance scattered from several different areas. The loss ratio was 58.4%, compared with our estimate of 59.8%—our estimate included \$7.5 million of favorable loss reserve development, a 1.5-percentage-point benefit to our loss ratio estimate. Excluding favorable loss reserve development, the loss ratio was 63.3%, compared with our 61.3% estimate. The higher accident-year loss ratio seems to be mix driven, with some volatility in smaller lines of business. No detail was given regarding any D&O loss reserve movement, although the number of claims is rising only at a measured pace. In certain quarters over the past year, the company has taken up current accident-year loss reserves within D&O, offsetting favorable development in earlier years. We expect continued favorable loss reserve development in 2009, with continued pressure on accident-year loss ratios by line of business in the aggregate.

Realized Investment Losses Minimal, Capital Not an Issue

Realized investment gains totaled \$864,000, compared with \$933,000 of gains last quarter. The company also had \$380,000 of other-than-temporary impairment losses in the quarter, of which only \$312,000 flowed through earnings. We would not be surprised by some additional small, realized losses over the next few quarters, but credit quality remains generally high for HCC and most of the commercial property-casualty insurance industry and we do not see credit as a serious concern. HCC has significantly derisked its investment portfolio over the past 15 months, exiting its remaining equity and equity-related investments at the end of first quarter 2009. Diluted book value per share increased 6.0% during the quarter, to \$26.46, given the recovery in credit markets. HCC is one of the few companies in the space that continued to buy back stock during market weakness early in the year given its high financial flexibility, repurchasing \$35 million of stock in the first quarter. Consistent with its conservative capital management stance, management has stated in the past that it would not repurchase shares at levels greater than book value.

Increasing Estimates, Rating Remains Market Perform—Quality Franchise, but See More Opportunity for Upside Elsewhere in the Space

We are increasing our 2009 EPS estimate to \$3.12 from \$3.05 given the outperformance this quarter, partly offset by a slightly more conservative growth expectation for the fourth quarter. We are lowering our 2010 EPS estimate to \$3.00 from \$3.10, consistent with the reduction we are seeing across our coverage universe given more competitive pricing.

Our rating remains Market Perform. We view HCC as a high-quality, stable underwriter that should continue to benefit from a flight to quality as one of only two double-A-rated commercial property-casualty insurance companies in the United States. The shares trade at roughly 1.0 times third quarter 2009 diluted book value per share of \$26.46, and while we view this as very attractive on an absolute basis, we see more relative value within the space. While we remain selective in the space given what we view as an imminent deterioration in industrywide profitability due to nearly five consecutive years of price declines, we view valuation near trough historical valuation levels for the group as limiting downside.

HCC Insurance Holdings, Inc.
Condensed Income Statement Comparison
(\$ in millions, except per share data)

	1Q08	2Q08	3Q08	4Q08	2008 Actual	1Q09	2Q09	3Q09	4Q09E	2009 Estimate	2010 Estimate
Gross written premium	\$582,999	\$691,593	\$612,964	\$611,207	\$2,498,763	\$602,387	\$681,317	\$620,382	\$628,776	\$2,532,862	\$2,628,422
% change annual	-3%	4%	3%	3%	2%	3%	-1%	1%	3%	1%	4%
Net written premium	\$493,647	\$567,150	\$495,585	\$504,236	\$2,060,618	\$491,250	\$543,352	\$493,287	\$521,055	\$2,048,944	\$2,148,266
% change annual	-1%	6%	6%	4%	4%	0%	-4%	0%	3%	-1%	5%
% gross written premium	85%	82%	81%	82%	82%	82%	80%	80%	83%	81%	82%
Premiums earned	\$493,546	\$506,610	\$504,972	\$502,646	\$2,007,774	\$502,388	\$501,978	\$520,059	\$497,634	\$2,022,059	\$2,048,605
% change annual	-1%	2%	2%	0%	1%	2%	-1%	3%	-1%	1%	1%
Losses and LAE incurred	\$293,026	\$302,901	\$324,506	\$291,440	\$1,211,873	\$315,566	\$292,570	\$303,808	\$301,068	\$1,213,012	\$1,251,698
% premiums earned	59.4%	59.8%	64.3%	58.0%	60.4%	62.8%	58.3%	58.4%	60.5%	60.0%	61.1%
Favorable/(unfavorable) reserve development	\$5,100	\$9,300	\$44,000	\$24,000	\$82,400	(\$4,700)	\$16,000	\$25,400	\$7,500	\$44,200	\$25,000
% premiums earned	1.0%	1.8%	8.7%	4.8%	4.1%	-0.9%	3.2%	4.9%	1.5%	2.2%	1.2%
Policy acquisition costs	\$92,268	\$95,845	\$96,582	\$96,746	\$381,441	\$88,692	\$90,248	\$92,418	\$90,569	\$361,927	\$372,846
% premiums earned	18.7%	18.9%	19.1%	19.2%	19.0%	17.7%	18.0%	17.8%	18.2%	17.9%	18.2%
Underwriting expense	\$59,204	\$57,514	\$57,702	\$59,089	\$233,509	\$68,998	\$61,526	\$64,985	\$55,425	\$250,934	\$234,052
% of operating revenue less NII	11.4%	10.5%	10.5%	11.2%	10.9%	12.4%	11.5%	11.7%	10.6%	11.6%	10.8%
Expense ratio	24.3%	24.3%	23.7%	27.0%	25.0%	24.5%	25.5%	24.3%	24.7%	24.7%	24.7%
Underwriting income	\$49,048	\$50,350	\$26,182	\$55,371	\$180,951	\$29,132	\$57,634	\$58,848	\$50,571	\$196,185	\$190,009
% change annual	-3%	-4%	-56%	81%	-6%	-41%	14%	125%	-9%	8%	-3%
Underwriting margin	23.7%	23.1%	17.9%	19.8%	21.1%	19.9%	23.6%	24.3%	22.4%	22.6%	22.0%
Combined ratio	83.7%	84.1%	88.0%	85.6%	85.3%	87.3%	83.8%	82.7%	85.2%	84.7%	85.8%
Fees and commissions	\$30,999	\$30,764	\$37,795	\$25,643	\$125,201	\$30,294	\$26,132	\$31,687	\$23,079	\$111,192	\$100,073
% change annual	-4%	-1%	-12%	-25%	-11%	-2%	-15%	-16%	-10%	-11%	-10%
Noninsurance company expenses	\$31,540	\$30,253	\$34,606	\$17,105	\$113,503	\$34,605	\$23,770	\$31,029	\$23,079	\$112,482	\$100,073
% change annual	8%	11%	-1%	-61%	-16%	10%	-21%	-10%	35%	-1%	-11%
Fee-based income	(\$541)	\$511	\$3,189	\$8,538	\$11,698	(\$4,311)	\$2,362	\$658	(\$0)	(\$1,291)	(\$0)
% change annual	-119%	-87%	-59%	-184%	167%	696%	362%	-79%	-100%	-111%	-100%
Fee-based margin	-2.1%	1.2%	7.5%	34.9%	8.7%	-8.1%	7.5%	2.0%	0.0%	-0.9%	0.0%
Net investment income	\$47,621	\$47,249	\$35,962	\$33,919	\$164,751	\$45,218	\$48,411	\$48,111	\$48,487	\$190,227	\$205,377
% change annual	-4%	-3%	-28%	-42%	-20%	-5%	2%	34%	43%	15%	8%
Other income	(\$4,946)	\$10,947	\$4,828	(\$1,191)	\$9,638	\$22,896	\$5,523	\$1,405	\$3,000	\$32,824	\$14,750
Total operating revenues	\$567,220	\$595,570	\$583,557	\$561,017	\$2,307,364	\$600,796	\$582,044	\$601,262	\$572,200	\$2,356,302	\$2,368,805
% change annual	-5%	0%	0%	-7%	-3%	6%	-2%	3%	2%	2%	1%
Pretax operating margin	21.0%	22.3%	14.2%	17.8%	18.8%	20.4%	22.9%	22.8%	21.2%	21.8%	20.9%
Interest expense	\$3,959	\$4,826	\$4,768	\$4,771	\$18,324	\$4,639	\$3,628	\$3,549	\$3,600	\$15,416	\$14,400
Income before income taxes	\$118,931	\$132,764	\$82,761	\$99,820	\$434,276	\$122,843	\$133,164	\$137,041	\$121,537	\$514,585	\$495,809
Provision for income taxes	\$37,482	\$41,089	\$24,370	\$27,543	\$130,484	\$39,673	\$41,579	\$42,720	\$38,284	\$162,256	\$156,676
Effective tax rate	31.5%	30.9%	29.4%	27.6%	30.0%	32.3%	31.2%	31.2%	31.5%	31.5%	31.6%
Net income	\$81,449	\$91,675	\$58,391	\$72,277	\$303,792	\$83,170	\$91,585	\$94,321	\$83,253	\$352,329	\$339,133
% change annual	-16%	-9%	-40%	-27%	-23%	2%	0%	62%	15%	16%	-4%
Operating income after tax ¹	\$81,340	\$92,793	\$69,596	\$78,225	\$321,954	\$83,208	\$92,175	\$93,971	\$83,253	\$352,606	\$339,133
% change annual	-16%	-8%	-29%	-14%	-17%	2%	-1%	35%	6%	10%	-4%
Operating earnings per share	\$0.70	\$0.80	\$0.60	\$0.69	\$2.79	\$0.73	\$0.82	\$0.83	\$0.74	\$3.12	\$3.00
% change annual	-16%	-7%	-28%	-11%	-16%	5%	2%	38%	7%	12%	-4%
Average diluted shares	116,372	116,075	115,418	114,111	115,494	113,300	112,500	112,900	113,000	112,925	113,000
Return on equity—operating basis	13.1%	14.6%	10.7%	11.9%	12.5%	12.5%	13.4%	13.0%	11.0%	12.4%	10.5%
Book value per share—diluted	\$21.67	\$22.09	\$22.85	\$23.14	\$23.14	\$23.87	\$24.97	\$26.46	\$27.17	\$27.17	\$30.18

¹Income before net realized capital gains/losses and excluding discontinued operations.
Source: Company reports and William Blair & Company L.L.C. estimates

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Additional information is available upon request.



Current Rating Distribution (as of 10/31/09)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	64	Outperform (Buy)	3
Market Perform (Hold)	36	Market Perform (Hold)	0
Underperform (Sell)	0	Underperform (Sell)	0

*Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

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