

Equity Research

**FINANCIAL**  
Insurance

October 29, 2007  
**Research Note**

Ticker: ACE  
Market: NYSE  
Price: \$61.46  
52-week: (\$53-\$64)

Stock Rating:  
**Outperform**

Company Profile:  
**Core Growth**

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# ACE Limited

## Third Quarter—Very Solid Results, Managing Business for the Long Term

### FINANCIAL SUMMARY

Fiscal Year Ends:	December	Dividend/Yield:	\$1.08/1.8%
Long-term EPS Growth Rate:	14%	Market Value (mil.):	\$19,958

FISCAL YEAR	2006A	2007E	2008E
<b>ESTIMATES *</b>			
Earnings Per Share	\$7.25	\$7.97	\$7.25
<b>VALUATION</b>			
Price/Earnings Ratio	8.5x	7.7x	8.5x

\* Estimates reflect the adoption of FAS 123R.

### Highlights

> Third-quarter operating EPS increased 5%, to \$2.06, and were ahead of our \$1.85 estimate and consensus of \$1.81. The upside relative to our estimate was broad-based with modestly higher underwriting margins, higher net investment income, and better results within the life insurance segment. The quality of results was excellent, although pricing continues to erode and underlying profitability remains under modest pressure.

> Gross written premium growth within property-casualty of 3% was slightly above our no-growth estimate, as better-than-expected production in North America and international accident and health offset greater-than-expected weakness within reinsurance and the commercial property-casualty insurance overseas.

> The combined ratio within property-casualty underwriting was 88.5%, compared with our 89.3% estimate, driven principally by favorable loss reserve development (lowered loss ratio by 2.3 percentage points).

> We do not expect any share repurchase activity from ACE, as we have seen increasingly with other companies in the space. Management continues to believe its capital levels are relatively balanced and appears to be interested in building excess capital to further improve financial flexibility, in our opinion. We expect ACE to become more acquisitive at some point.

> We are increasing our 2007 EPS estimate to \$7.97 from \$7.76 to reflect the outperformance this quarter and are maintaining our 2008 operating EPS estimate of \$7.25. Management expects to provide 2008 EPS guidance in December.

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> Our rating remains Outperform. We continue to remain cautious overall regarding the property-casualty insurance space, but believe ACE should be the core name in the space among the larger companies that can be owned at this point in the cycle given its strong execution, emerging global franchise, and improving financial flexibility and risk profile. We find valuation very reasonable at about 1.3 times book value, with an expected 14% to 15% return on equity (ROE) next year.

## **Discussion**

### **Solid Results, Earnings Upside Broad-Based**

Third-quarter operating EPS of \$2.06 came in ahead of our \$1.85 estimate and consensus of \$1.81. This marks the **seventh** consecutive quarter that ACE has exceeded consensus estimates, and there were no surprises during the quarter, in our opinion. The upside relative to our estimate was broad-based with better-than-expected results including modestly higher underwriting margins, higher net investment income, and better results within the life insurance segment. ACE's ROE in the quarter was solid at 18.0%, and operating EPS excluded \$0.11 per share of realized losses on investments.

### **Top Line Growth a Bit Better Than Expectations, Aided by North America and International A&H**

Gross written premium growth within property-casualty of 3% was slightly above our no-growth estimate, as better-than-expected production in North America and international accident and health offset greater-than-expected weakness within reinsurance and the commercial property-casualty insurance overseas. Strong client retention levels contributed to the growth, which is very respectable relative to large peers. Net written premium declined 1%, although the decline in the average underwriting retention rate (net written premium to gross written premium) is being driven by product mix changes (e.g., faster growth in the low retention crop business in the United States) and not any major change in reinsurance buying.

Net written premium within property-casualty declined 3%, but was more than offset by 19% growth in personal accident and health (A&H). The accident and health business was actually almost twice as large as the global reinsurance business this quarter, which we view very positively. Property lines were up given the residual benefits from increasing catastrophe property prices over the last 12 months (although prices are now falling after a favorable hurricane season) and casualty lines were down. The international A&H business is a very attractive, unique franchise and does not face any of the same cyclical challenges as the property-casualty insurance business. Management stated that it expects growth in the A&H segment to potentially accelerate in the near term, driven by continued above-average growth in Latin America and Asia, as distribution and product breadth continues to expand. Growth with global reinsurance was negative 24% and continues to run well below expectations. Management stated that it remains committed to the reinsurance business, but it has no issues with letting the business shrink considerably further if market conditions remain more challenging (less than 10% of net written premium in the quarter).

The theme this quarter within the space is nearly identical to last quarter: pressure on premium growth from further pressure on pricing—it is global and pervasive in all lines of business, although particularly within casualty lines of business. Renewal pricing globally is down roughly 5 to 15 percentage points depending on the line of business. New business remains much more under pressure than renewal pricing—at least another 5 to 10 percentage points lower depending on the line of business. Terms and conditions also continue to erode steadily, in our view, which will affect profitability more slowly over time. Given record profitability in the industry in 2006 and again in 2007, including the benefits from favorable loss reserve development, we see no reasonable scenario in which pricing will not be under pressure over the next few years.

### **Underwriting Margins Remain Solid and Ahead of Our Expectations**

The combined ratio within property-casualty underwriting was 88.5%, compared with our 89.3% estimate, driven principally by favorable loss reserve development (lowered loss ratio by 2.3 percentage points). Catastrophe losses were only \$21 million and expense management was excellent, with the expense ratio remaining stable at 26.7% compared with third quarter 2006.

Management stated that, everything else equal, it is booking its accident year loss ratios about 1.5 percentage points higher relative to 2007. While pricing continues to come under pressure, underwriting margins have held up much better than general expectations at this point in the pricing cycle given continued prior-year reserve redundancies and benign claims inflation. While claims inflation should pick up at some point, it is difficult to estimate the timing of any change, and therefore earnings visibility should remain good in the near term despite a pretty competitive pricing environment.

**Management Comfortable With Capital Position, No Actions Likely—Frustrating to Many**

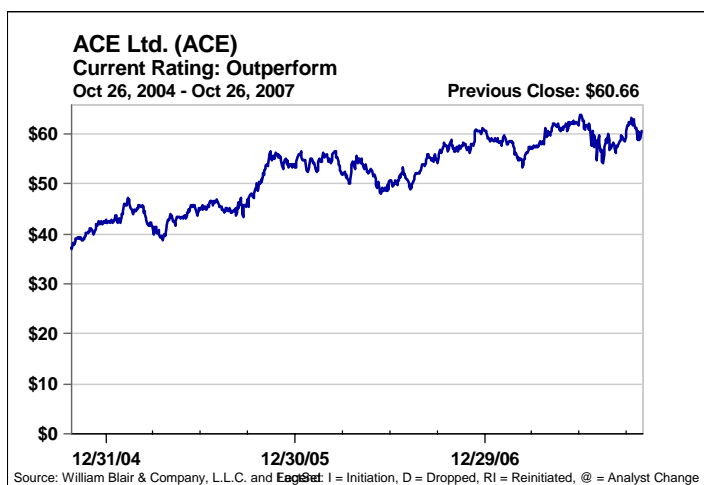
We do not expect any share repurchase activity from ACE, as we have seen increasingly with other companies in the space. Despite raising \$1.5 billion in late 2005, the market not developing as robustly as initially expected in late 2005, and ACE generating record results in 2006 and 2007 with no major catastrophe losses, management continues to believe its capital levels are relatively balanced and appears to be interested in building excess capital to improve financial flexibility further, in our opinion. We expect ACE to become more acquisitive at some point. We believe any potential acquisition would have significant international exposure or potentially be a non-risk-bearing service business with recurring fee income.

**No Change to Estimates Outside of Upside This Quarter—Rating Remains Outperform**

We are increasing our 2007 EPS estimate to \$7.97 from \$7.76 to reflect the outperformance this quarter and maintaining our 2008 operating EPS estimate of \$7.25. Management stated it expects very little in the way of losses related to the California wildfires and does not expect any major impact from the meltdown within the subprime RMBS market, stressing that ACE is really not a major player in financial lines and its investment portfolio is rather conservative. Management expects to provide 2008 EPS guidance in December. Our expectation is for premium growth to decline modestly in 2008, continued modest favorable loss reserve development, and accident year loss ratios to increase at least 200 basis points excluding catastrophe losses. Favorable loss reserve development or lower catastrophe losses could drive upside relative to our expectations. We include about \$350 million of catastrophe losses in our 2008 estimate, or about \$0.85 per share at a 20% effective tax rate.

We continue to remain cautious overall regarding the property-casualty insurance space, but believe ACE should be the core name in the space among the larger companies that can be owned at this point in the cycle given its strong execution, emerging global franchise, and improving financial flexibility and risk profile. Importantly, execution has been excellent the past few years, which gives us a high level of conviction in management's ability to continue to create value, and historical concerns such as asbestos or reinsurance recoverables are at the lowest level in the last seven to eight years. We find valuation very reasonable at just about 1.3 times book value, with an expected 14% to 15% ROE next year.

Additional information is available upon request.



**Current Rating Distribution (as of 10/1/2007)**

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	60	Outperform (Buy)	12
Market Perform (Hold)	39	Market Perform (Hold)	5
Underperform (Sell)	1	Underperform (Sell)	1

\*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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