

Equity Research

FINANCIAL
Insurance

February 14, 2008
Research Note

Ticker: AGII
Market: NASDAQ
Price: \$38.55
52-week: (\$37-\$53)

Stock Rating:
Outperform

Company Profile:
Aggressive Growth

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Argo Group International Holdings, Ltd.

Fourth-Quarter Results: In the Penalty Box Until Tangible Merger Benefits Emerge

FINANCIAL SUMMARY

Fiscal Year Ends:	December	Dividend/Yield:	\$0.00/0.0%
Long-term EPS Growth Rate:	12%	Market Value (mil.):	\$1,227

FISCAL YEAR	2006A	2007E	2008E
ESTIMATES *			
Earnings Per Share	NA	NA	\$3.80
VALUATION			
Price/Earnings Ratio	NA	NA	10.1x

* Estimates reflect the adoption of FAS 123R.

- We estimate that operating EPS were \$0.73, excluding realized investment gains of \$0.03 per share; the result compared with our \$0.90 per share estimate. Results continue to be a bit difficult to interpret given the PXRE merger (closed August 2007) and segment reporting changes, and it will take a few quarters for the tangible benefits of the deal to be seen in financial results, in our opinion. We estimate that a nonrecurring higher tax rate related to the PXRE merger was worth \$0.07 per share and a realized loss from the sale of PXRE catastrophe bond was worth \$0.07 per share. Comparisons to prior periods are not that useful given the distortions associated with the reverse merger and reverse stock split.
- Gross written premium declined 11%, to \$284 million, given further pricing pressure in all lines of business, as underwriters get more aggressive after generating record profitability for the past two years. Growth was about 2% for 2007 and E&S was down 2%. We expect competition to continue to be intense in the near term, although management stated that its new international specialty segment met production expectations on January 1 and it continues to pursue several new business opportunities. Management expects the new international specialty group to write about \$100 million of gross written premium this year. Our companywide estimate is \$1.2 billion of gross written premium, down about 1% with the benefit of the new segment.

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- The combined ratio was about 95.2%, compared with 92.3% in fourth quarter 2006 and about 95.4% last quarter excluding the A&E loss reserve charge and merger-related expenses. The higher combined ratio related compared with last year is the result of higher expenses in the near term related to the PXRE merger. The loss ratio was stable year-over-year and both periods included significant loss reserve releases from prior years (\$35.3 million, or 15.8 percentage points of combined ratio) and significant upward estimates of current accident year loss ratios, which we view as a conservative recognition of current year results. Management states that, everything else equal, accident year loss ratios in 2007 were about 1 or 2 points higher than what 2006 accident year loss ratios were recognized at in 2006—relatively consistent with actions taken across the industry in casualty lines of business.
- More aggressive capital management and expense management are key catalysts for the stock over the next few quarters and management expects to announce the hiring of a new chief financial officer over the next few weeks. Management seems to be intent on allocating excess capital, which we believe could be over \$300 million, to new business opportunities and acquisitions, although stated the board has also authorized a \$150 million share repurchase authorization. The company has had a successful acquisition history and management states that sellers are becoming more realistic about pricing as underlying profitability comes under further pressure. Given the competitive dynamics of the business currently and a stock trading at a 15% discount to book value per share, stock repurchase would be highly accretive to book value per share and EPS and some share repurchase at these levels would seem to make sense. Given the stock price, management should continue to get pressure from shareholders to repurchase stock, but we believe management will wait for new business and acquisition opportunities to develop more fully in the near term before more aggressively repurchasing stock, in our opinion.
- We are lowering our 2008 EPS estimate to \$3.80 from \$4.00 and establishing a 2009 EPS estimate of \$4.35, the latter of which represents an ROE of around 9%. Management states that during 2008 it will become clearer regarding Argo Group's ability to achieve a midteens ROE over time. We are highly skeptical regarding the company's ability to generate a midteens ROE anytime soon, although we believe it is not necessary to achieve a midteens ROE for the stock to Outperform from these levels.
- We reiterate our Outperform rating. While we continue to remain selective within the commercial property-casualty underwriting space overall given deteriorating underlying profitability, we view Argo Group as an opportunistic and undervalued investment idea (15% discount to diluted book value per share), and believe the recent merger with PXRE creates significant financial and strategic value that is currently being overshadowed by the complexity of the merger and management's inability to lay out a path toward higher profitability over the next several quarters.

William Blair & Company, L.L.C. is a market maker in the security of Argo Group International Holdings, Ltd. and may have a long or short position.

Additional information is available upon request.



Current Rating Distribution (as of 2/1/2008)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	59	Outperform (Buy)	13
Market Perform (Hold)	40	Market Perform (Hold)	6
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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