

Philadelphia Indemnity Insurance Co. And Philadelphia Insurance Co. Assigned 'AA-' Ratings; Outlook Stable

Rationale

On Feb. 4, 2009, Standard & Poor's Ratings Services assigned its 'AA-' counterparty credit and financial strength ratings to Philadelphia Indemnity Insurance Co. and its sister company, Philadelphia Insurance Co. (collectively referred to as PHLY). The outlook on both of these companies is stable.

The supported ratings on both companies are based on their strategic importance to Tokio Marine & Nichido Fire Insurance Co. Ltd. (TMNF; AA/Stable/A-1+) and therefore receive an uplift in the ratings. According to our criteria, these ratings are capped at one notch below the ratings assigned to core group members. PHLY's stand-alone characteristics include its strong competitive position, strong operating performance, and very strong capitalization. Offsetting these strengths are the company's aggressive growth strategy (including the introduction of new products in a difficult insurance cycle), key-men risk, and relatively high gross property catastrophe exposure.

On July 23, 2008, Tokio Marine Holdings Inc. (Tokio Marine; the parent company of TMNF) and Philadelphia Consolidated Holding Corp. (the parent company of PHLY) entered into an agreement under which Tokio Marine will acquire all outstanding shares of Philadelphia Consolidated for \$61.50/share in cash, a 73% premium to Philadelphia's closing price of \$35.50. The total transaction value was approximately \$4.73 billion and was completed on Dec. 1, 2008.

The acquisition of PHLY is consistent with Tokio Marine's strategy of expanding revenues and profits from international markets in the medium and long term. With limited growth potential in the domestic Japanese nonlife insurance market, Tokio Marine has been

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pursuing an international expansion strategy to achieve business growth and strengthen profitability. Therefore, the PHL Y acquisition plays a vital and strategic role in the group's strategy, allowing it to establish a significant presence in the U.S., the world's largest insurance market. The acquisition will also let Tokio Marine create a well-balanced global portfolio, including domestic, developed, and emerging markets. Therefore, we view PHL Y as a strategically important subsidiary of TMNF.

PHLY constitutes a significant proportion of Tokio Marine's pro forma consolidated position. For year-end 2007, PHL Y's figures were about 6% of the group's pro forma net premiums written and about 5% of the group's pro forma capital position. More importantly, PHL Y's net income was about 23% of the group's pro forma figure.

PHLY has a strong competitive position as a specialty insurer with an underwriting focus on value-added coverage and services for select markets. The company has translated its competitive advantage into strong underwriting results as it targets niches (such as nonprofit and religious organizations) with specialized areas of expertise, enabling PHL Y to compete by offering customized coverage and solutions rather than competing solely on price. The company also benefits from a diverse multi-channel distribution platform with a national footprint.

PHLY's operating performance has been consistently strong, with an average combined ratio of 80.6% over the past five years (2003-2007). In the first nine months of 2008, pretax operating income declined, though underwriting performance remained strong. For this period, PHL Y reported pretax operating income of \$274 million and a combined ratio of 84.5% compared with \$351 million and 73.3%, respectively, for the same period in 2007. For the first nine months of 2008, underwriting results were affected by \$22 million in net losses from Hurricane Ike (a \$120 million gross loss), \$21 million in losses from Midwestern storms in the U.S., and declining premium rates (year-to-date average rate decreases on renewed business of 4.8% for commercial and 2.3% for specialty lines), offset by \$37 million in favorable reserve development. Also hurting profitability were \$42 million in other-than-temporary-impairments in the equity investment portfolio. The robust earnings strengthened the very strong and redundant risk-adjusted capital base, including an estimated property catastrophe charge incorporating the company's net aggregate probable maximum loss based on the 1-in-250-year return period.

In the past five years, the company has been growing its top line aggressively. Gross premiums written grew at a 17% compound annual growth rate to reach \$1.69 billion in 2007 from \$906 million in 2003. Similarly, in the first nine months of 2008, gross premiums written grew by 11.2% to \$1.44 billion compared with the prior-year period. To implement its growth strategy, PHL Y is relying on its experienced management team and strong relationships with its key agents to generate new business opportunities. Furthermore, over the same timeframe, PHL Y added a significant number of new products, which contributed \$133 million (about 9% of 2007 gross premiums written). The company does extensive research prior to entering a new line of business and focuses on slippage in the ISO policy form. However, the company has a short track record in some of these new businesses, and its ability to execute an overall profitable growth strategy—especially in a challenging environment—remains somewhat unproven and risky.

The company has a strong and experienced management team consisting of financially motivated owners/managers. The top three executive positions (chairman, CEO, and COO) within PHL Y are held by the Maguire family, which constitutes a key-men risk. Collectively, these three executives owned about 20% of PHL Y's common shares prior to the acquisition by Tokio Marine.

Given their financial payout, there are concerns about their long-term plans with the company. However, as a mitigating factor, TMNF has retained PHLY's executive management team through three-year employment contracts and retention bonuses vested over time. In addition, PHLY's top five executives have invested about \$108 million in Tokio Marine's common stock.

PHLY's gross property catastrophe exposure is high compared with its capital base. As a mitigating factor, the company has a good reinsurance program in place that significantly reduces its net exposure. To minimize the counterparty credit risk, PHLY's reinsurance structure is well-diversified among highly rated carriers. Moreover, following the acquisition, PHLY is expected to use Tokio Marine's financial strength by ceding some of its business within the group rather than to third parties.

Outlook

Standard & Poor's expects that PHLY's gross premiums written will grow by about 10% in 2008. This growth strategy in a weak pricing environment is concerning and could affect future operating results. We expect that the company's competitive position will remain strong following the acquisition. Despite soft pricing and catastrophe losses, operating performance will likely remain strong in 2008, with a combined ratio of 86%-88%. We expect that PHLY will continue to emphasize underwriting discipline and generate strong underwriting results in 2009 in line with historical results. Furthermore, capitalization will likely remain very strong, redundant, and supportive of the ratings in 2009.

We expect TMNF to support PHLY's capitalization and financial flexibility if needed, and we expect PHLY to maintain its strategically important status within TMNF. As a result, the ratings and outlook on PHLY should move in tandem with those on TMNF.

If PHLY is successfully integrated, establishes itself as a cornerstone within the group, and materially contributes to the group's turnover and earnings over the next two to three years, we might decide to view PHLY as core to TMNF. If that were to happen, we would then align the ratings on PHLY with those on the other core group members. Alternatively, we could revise the outlook to negative or lower the ratings on PHLY if its operating performance were to deteriorate significantly and affect its financial profile.

Ratings List

New Ratings

Philadelphia Indemnity Insurance Co.

Philadelphia Insurance Co.

Counterparty Credit Rating

Local Currency AA-/Stable/—

Financial Strength Rating

Local Currency AA-/Stable

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