

## Philadelphia Indemnity Insurance Co. And Philadelphia Insurance Co.

### ***Rationale***

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

The GAAP financial data in this report includes the following companies: Philadelphia Indemnity Insurance Co., Philadelphia Insurance Co., Liberty American Select Insurance Co., and Liberty American Insurance Co. (collectively referred to as PHLY).

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

Tokio Marine's acquisition of PHLY was consistent with its long-term strategy of expanding

### ***Local Currency***

Credit Rating:  
AA-/Negative/—

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revenues and profits from international markets. Given its limited growth potential in the domestic Japanese nonlife insurance market, Tokio Marine has been pursuing an international expansion strategy to achieve business growth and strengthen profitability. The PHLY acquisition will play a vital and strategic role in the group's strategy, enabling it to establish a significant presence in the U.S., the world's largest insurance market. The acquisition also will enable Tokio Marine to create a well-balanced global portfolio, including domestic, developed, and emerging markets. Therefore, we view PHLY as a strategically important subsidiary of TMNF.

PHLY constitutes a significant proportion of Tokio Marine's pro forma consolidated position. As of year-end 2008, PHLY accounted for about 7% of the group's pro forma net premiums written and about 11% of its pro forma capital position. More importantly, its net income represented about 39% of the group's pro forma total.

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 this competitive advantage into strong underwriting results, as it targets niches (such as nonprofit and religious organizations) with specialized areas of expertise. This enables PHLY to offer customized coverage and solutions rather than competing solely on price. The company also benefits from a diverse multichannel distribution platform with a national footprint.

PHLY's operating performance has been consistently strong, with an average combined ratio of 79.9% over the past five years (2004-2008). In the first nine months of 2009, its underwriting performance remained strong, although it declined from the prior-year period. Adjusting the operating metrics to exclude merger-related items (refer to the Accounting section, below), the company had a combined ratio of 88.8% and pretax operating income of \$263 million, compared with 84.5% and \$274 million, respectively, in the prior-year period. Results were hampered by \$47 million of catastrophe losses resulting from a number of small events, a higher-than-expected frequency of losses across its commercial package products, and declining premium rates (a 1.7% average rate decrease during the first nine months of 2009). However, this was partially offset by \$34 million of favorable reserve development. PHLY continues to generate robust earnings that have supported its very strong and redundant risk-adjusted capital base (which includes an estimated property catastrophe charge incorporating its net aggregate probable maximum loss based on the one-in-250-year return period).

In the past five years, the company has been growing its top line aggressively. Gross premiums written (GPW) increased at a 13% compound annual growth rate, reaching \$1.89 billion in 2008 versus \$1.17 billion in 2004. Similarly, in the first nine months of 2009, GPW rose 8% year-over year, to \$1.56 billion. To implement its growth strategy, PHLY is relying on its experienced management team and strong relationships with its key agents to generate new business opportunities. PHLY added a significant number of new products and wrote a significant amount of new business, including about \$350 million of GPW during the first nine months of 2009 (22% of GPW). The company does extensive research prior to introducing a new product and focuses on the coverage needs within each niche. However, PHLY 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 chief operating officer) prior to the acquisition had been held by the Maguire family, which constitutes a key-men risk. James Maguire Jr., president and CEO, became chairman following the retirement of James Maguire (the founder of PHLY) effective Jan. 1, 2010. Nevertheless, the prior three executives had owned about 20% of Philadelphia Consolidated's common shares prior to its acquisition by Tokio Marine. Given their financial payouts, 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 (set to expire Jan. 1, 2012) and retention bonuses vested over time. In addition, PHLY's top five executives invested about \$23 million in Tokio Marine's common stock.

PHLY's gross property catastrophe exposure is high compared with its capital base. However, 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.

### ***Outlook***

The outlook on PHLY is negative, reflecting the negative outlook on its parent, TMNF. Standard & Poor's revised the outlook on TMNF to negative following the outlook revision on the long-term sovereign credit ratings on Japan (AA/Negative/A-1+) to negative from stable. (See Standard & Poor's article entitled "Outlooks On Three Japanese Insurers To Negative Following Sovereign Outlook Revision," published Jan. 26, 2010, on RatingsDirect.)

Standard & Poor's expects PHLY's GPW to grow by about 5% to 10% in 2009 and by about 5% in 2010. We are somewhat concerned about the company's growth in a weak pricing environment, which could affect its operating results. Nevertheless, we expect PHLY's competitive position to remain strong, and we anticipate that the company will continue to emphasize underwriting discipline. PHLY should generate strong underwriting results in 2009 and 2010, in line with its historical results. We believe that the company will report an adjusted combined ratio (excluding merger-related items) of about 88% in 2009, despite the soft pricing environment.

In our opinion, PHLY's capitalization is likely to remain strong, redundant, and supportive of the ratings in 2009 and 2010. We expect TMNF to support PHLY's capitalization and financial flexibility, if necessary, and believe PHLY will 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 during 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 lower the ratings on PHLY if its operating performance were to deteriorate significantly, thereby affecting its financial profile.

***Related Research***

- “Outlooks On Three Japanese Insurers To Negative Following Sovereign Outlook Revision,” Jan. 26, 2010
- “Tokio Marine & Nichido Fire Insurance Co. Ltd.,” June 29, 2009
- “Group Methodology,” April 22, 2009

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