Top 50 Insurance Institution at 58% Discount to Book Value

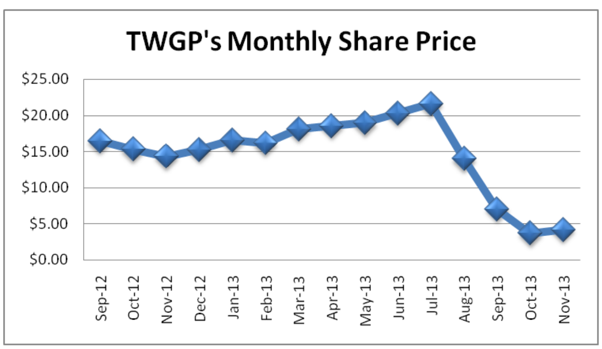
Accumulate

We have initiated coverage on Tower Group International (TWGP) as an Accumulate. We like that its share price is at a 58.25% discount to its book value. However, we are aware of its insurance reserve related issues.

RECOMMENDATION

We have an Accumulate rating on Tower Group's common stock. Although its $4.14share price represents a 58.25% discount to its $9.92estimated book value per share and a 42.67% discount to its $7.22 per share tangible book value, we are rating it as an Accumulate instead of a Strong Buy for three reasons:

- Its insurance loss reserve related issues, which resulted in a $364M charge against its earnings due to under reserving against expected insurance losses.
- We are concerned that the company is suffering from acquisition-indigestion based on its recent $214M goodwill impairment.
- Tower Group may have to dilute its shareholders in order to shore up its capital base



Source: Morningstar Direct

COMPANY OVERVIEW

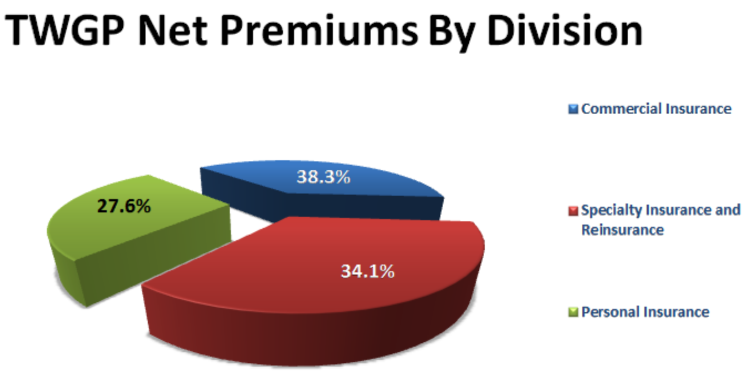
Tower Group International is a Top 50 property/casualty insurance institution. Michael Lee, who is still serving as its CEO, founded Tower Group in New York City in 1990. Tower Group reincorporated in Bermuda in 2013 once it acquired Canopius Holdings. Tower Group acquired Canopius in order to gain access to the Bermuda platform, which would provide competitive advantage to support growth opportunities in U.S. and international markets. Tower Group previously presents its business results through three business segments: Commercial Insurance, Personal Insurance and Insurance Services. Beginning with Q2 2013, Tower Group realigned its business segments into three different business segments: Commercial Insurance, Personal Insurance and Specialty Insurance and Reinsurance.

- **Commercial Insurance:** Tower Group's Commercial Insurance segment offers property and casualty insurance products through several business units that serve customers in general commercial and specialty commercial markets. Tower Group's Commercial Insurance product portfolio consists of commercial package, general liability, workers' compensation, commercial automobile, fire and allied, inland marine and commercial umbrella policies to businesses across different industries. These products are underwritten and serviced through its 20 offices and distributed through approximately 900 retail agents, approximately 220 wholesale agents and 15 program-underwriting agents ("PUA"). Although Tower Group has made efforts to expand its geographic footprint, approximately 55% of the direct premiums written by the Commercial Insurance segment in 2012 were from the northeastern United States.

- **Personal Insurance**: Tower Group's Commercial Insurance segment offers a broad range of personal lines products including package, mono line homeowners, mono line automobile insurance, and ancillary personal lines coverage (renters, condominium, dwelling fire, scheduled articles, umbrella and boats). Package policies include homeowners and auto and may include ancillary coverage. Tower Group distributes its Personal Insurance products through a network of approximately 500 retail agents, wholesale agents, national brokers and other insurance companies. Our customers are concentrated in the northeastern United States with 86% of the premium volume produced by agents in this region, including NY (41%), NJ (15%), and MA (11%). Mono line homeowners in CA make up 8.4% of our premium. Personal lines include the business written in the Reciprocal Exchanges and Tower stock companies.

- **Specialty Insurance and Reinsurance**: Tower Group's Specialty Insurance and Reinsurance segment includes its specialty business and assumed reinsurance previously reported in the Commercial Insurance segment.

- **Insurance Services:** Tower Group folded its former Insurance Services segment into its Personal Insurance segment. This segment generated fees from performing various aspects of insurance company functions for other insurance companies, including underwriting, claims administration, operational and technology services. Tower Group Insurance Services provides these services through its managing general agencies and management companies. This segment's primary source of fee income is from the Reciprocal Exchanges for which it manages the day-to-day operations in exchange for a management fee. This model allows Tower Group to use capital more efficiently and provides the company with a steady flow of fee income.



Source: [Tower Group's Q2 2013 Earnings Release]

Management: Michael H. Lee founded Tower Group's first insurance subsidiary (Tower Insurance Company of New York in 1990 and serves as Tower Group's Chairman, President and Chief Executive Officer. Before founding the Predecessor Company's first insurance subsidiary in 1990, Mr. Lee was an attorney in private practice specializing in advising entrepreneurs on the acquisition, sale and formation of businesses in various industries. Mr. Lee also served as Chairman, President and Chief Executive Officer of CastlePoint Holdings, Ltd. from its formation in 2006 until its merger into the Predecessor Company in February 2009.

Institutional Ownership: Tower Group's largest shareholder as of Q2 2013 was Ralph Wanger's old shop Columbia Wanger Asset Management. CWAM had4.06M shares of Tower Group and that represented7% of Tower Group's outstanding shares but CWAM liquidated its position in Q3 2013. Other well-known managers that previously owned Tower Group but sold out in Q3 2013 or Q4 2013 included Vaughan Nelson (1.87M shares representing 3.25% ownership of Tower Group) and Century Capital Management (1.3M shares representing 2.29% ownership in

Tower Group). Other well-known asset managers that currently own shares of Tower Group include Private Management Group (2.8M shares representing 4.8% of Tower Group), LSV Asset Management (2M shares representing 3.5% ownership of Tower Group) and Roumell Asset Management (1M shares representing 1.7% ownership of Tower Group).

Insider Ownership: We sum up Tower Group's insider ownership as a classic case of good news, bad news and ugly news.

- The good news is that its CEO Michael Lee still owns 2.3M shares of Tower Group's common stock plus 608.5K shares issuable upon the exercise of employee stock options which represents ~5% of Tower Group's outstanding shares.
- The bad news is that he had to dispose of 1.2M shares of Tower Group in order to satisfy a margin call.
- The ugly news is that the other executives and board members own very few shares of Tower Group stock and the shares that they own are primarily from stock options and restricted stock grants.

SUMMARY OF OBSERVATIONS

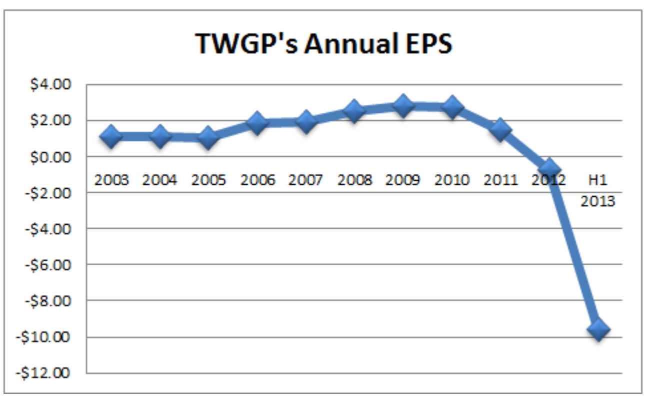
The property/casualty insurance industry is an industry that does not benefit from favorable competitive positions. Industry competition is fierce and the products are essentially commodities. Furthermore, participants do not know their cost of goods sold for a number of years, allowing them to underprice policies without knowing it. Firms have a large incentive to chase growth without regard for profitability, a cycle that repeats itself as competition forces insurers to match artificially low prices or risk losing business. We do not see the property/casualty insurance business as offering the opportunity for above average returns on equity or the opportunity for the stocks to trade at a significant premium to book value due to the need to maintain a liquid balance sheet. However, Tower Group's recent troubles have resulted in its share price dropping by 80% from its 52-week high of $22.30 in July and because we believe that its $578M in charges incurred recently have resulted in the company "reaching rock-bottom".

Tower Group is a broken growth company. Michael Lee founded Tower Insurance in 1990 with $2M in capital, according to *The Wall Street Journal*. Prior to founding Tower Insurance, Michael Lee was an attorney. Lee told Investor's Business Daily in 2005 that he initially targeted tiny businesses as customers because "not many big players want to compete there," Lee said.

Tower Group became more ambitious after an initial public offering in 2004 that raised $116 million. In the 2004 annual report, Mr. Lee said he felt "unbridled excitement" for the "greater range of opportunities" ahead.

From 2005 to this year, Tower Group acquired six companies or units of them. It expanded geographically, took on bigger customers and even began selling policies to other insurers. Tower moved into the top 50 of U.S. insurers, with $1.76 billion of premiums in 2012, according to Fitch Ratings.

After a merger in March, Tower Group moved its headquarters to Bermuda. The deal triggered a customary review by its outside auditors of its internal financial controls, according to an August regulatory filing. This, in turn, led to the hiring of an independent actuarial firm to review loss reserves and resulted in the $364M loss reserve addition charge and the $214M goodwill impairment charge. Tower Group’s need to boost reserves "primarily emanates from business acquired" in its$107M acquisition of Specialty Underwriters’ Alliance in 2009, according to Fitch, which also downgraded Tower. Before Tower announced its “big-bath charges”, it announced that it struck three reinsurance agreements to cede portions of its business and enhance financial flexibility.



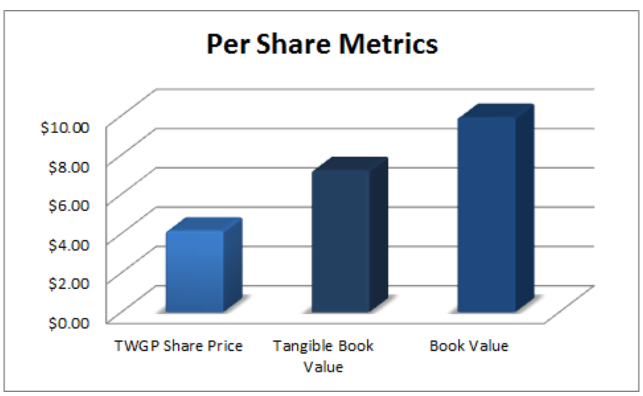
Source: Morningstar Direct

VALUATION AND PROJECTIONS

Tower Group’s share price of $4.14 is at a significant discount (58.25%) to its per share book value of $9.92 even after taking into account the $578M in charges that it incurred in Q2 2013. Tower Group announced in October that it completed a comprehensive review of its loss reserves as of June 2013. Because of this review, Tower Group incurred $364M in charges to strengthen its loss reserves in Q4 2012 and Q2 2013. These additional loss reserve charges are primarily attributable to accident years 2008 through 2011 in commercial insurance lines of business, including workers' compensation, commercial multi-peril, commercial auto and other liability lines. The reserve strengthening reflects adverse loss emergence, coupled with changes in judgment, including actuarial factors. Since 2010, Tower has been shifting its business mix, significantly de-emphasizing the lines that contributed to the reserve strengthening and modifying its book of commercial lines business.

Tower Group also incurred a non-cash goodwill impairment charge of $214 million for the second quarter of 2013, representing all goodwill associated with its commercial and specialty and reinsurance segments. Tower Group is completing its evaluation of other intangible assets associated with its commercial and specialty and reinsurance segments, as well as the goodwill associated with its personal lines segment. We assumed a worst-case scenario in our financial model in which Tower Group would write off its remaining $55.5M in goodwill attributed to its personal lines segment as well as the $99.5M in acquisition related intangible assets.

Tower Group's U.S. insurance subsidiaries continue to maintain risk based capital levels in excess of those required by their respective domiciliary states. Tower Group will release its full financial results for Q2 2013 promptly upon the conclusion of management's evaluation of the results of the results. Tower Group also announced that the Company's Board of Directors is reviewing a range of strategic options with its lead financial advisor, JP Morgan Securities LLC. We believe that investors have lost confidence and trust in Tower Group's management and that explains why its share price is trading at a 42.7% discount to its tangible per share book value as well as 58.25% discount to its per share book value.



Source: Morningstar Direct and Saibus Research Estimates

Here are our estimate inputs for our valuation model:

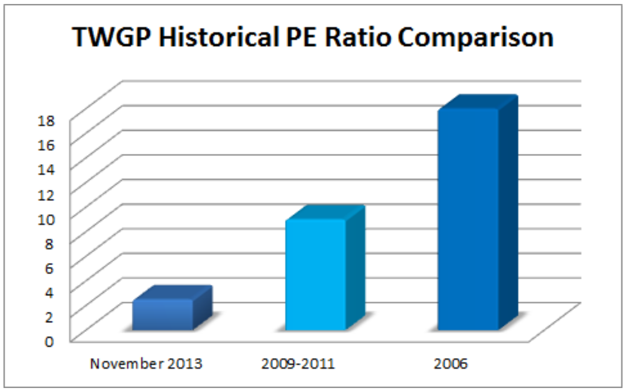
- We assumed that the company's core EPS for Q3 2013 & Q4 2013 would be $0, which is well below the $.40 that analysts are projecting these quarterly periods.
- We assumed that the company would maintain its $.165/share dividend payments for Q3 2013but suspend its dividend until it restores its profitability and resolves its reporting issues.
- We accounted for the $214M goodwill impairment charge and the $364M loss reserves additions charge in our model before it finally released its reported results. This charge led its analysts to withdraw their Q2 2013 EPS estimates.
- Although Tower Group's EPS estimates have declined drastically for FY 2013 and FY 2014, the company is still expected to generate $1.64/share in core EPS in FY 2014
- If we assume that Tower Group will at least meet that minimum standard, Tower Group would be trading at an implied PE of 2.5X forward EPS.
- For purposes of conservatism, we assumed that the company would have to write-off its remaining goodwill and intangible assets

Because analysts were expecting Tower Group's loss reserve charges to come in at $200M or less, Tower Group endured a series of analyst downgrades. Keefe, Bruyette and Woods slashed its target share price from $21 to $7.50 once Tower Group announced its charges. Fitch cuts Tower Group's credit rating from BBB to B, which means that Fitch no longer considers Tower Group as an investment grade credit. A.M. Best downgraded the company's financial strength rating late Tuesday to "B++," considered its "good" rating, from "A-," its "excellent" rating. A.M. Best said that the once well-regarded company might struggle to restore shareholder confidence after its reserve charges came in so much higher than anticipated.

KEYS TO INVESTMENT THESIS

Tower Group's share price is trading at a sharp discount to its book value per share. Tower Group's share price is $4.14 whereas its estimated book value per share is $9.92 and its tangible book value per share is $7.22. Tower Group's share price is at a 58.25% relative to its book value and 42.7% relative to its tangible book value.

Tower Group's shares are trading at 2.5X its expected forward EPS. Even with Tower Group's declining EPS projections and recent charges against earnings, a Forward PE of 2.5X is still dirt-cheap. We do not expect it to reach the 18X that it was trading at in 2006 but we think that it should eventually come back to the 8X-10X level that it traded at from April 2009 to 2011.



Source: Morningstar Direct

Tower Group hired J.P. Morgan to help it explore strategic alternatives. Deloitte Consulting is predicting an increase in insurance industry mergers and acquisitions activity because other growth opportunities are limited. Tower Group has a strong presence in insuring small businesses and may be an attractive niche for a larger company.

RISKS THAT WOULD PREVENT TOWER GROUP FROM REACHING ITS FAIR VALUE TARGET PRICE

- Interest rate shocks resulting in sharp declines in its general investment account
- Inability to reach a deal to sell all or part of the company at a fair price
- Another major weather-related event just like with Superstorm Sandy last year
- Additional "big-bath" charges that wipe out more of its capital base
- Ratings declines resulting in clients transferring their policies to other firms
- Ratings declines prompting insurance agents to persuade their clients to transfer their policies to other firms
- Issuing stock at an unfavorable price
- Potential price wars with larger, deep-pocked competitors

- Inability to restore its dividend
- Firm going into run-off mode

PROPERTY/CASUALTY INSURANCE INDUSTRY OUTLOOK

The property/casualty (P/C) insurance industry's business model is about managing and sharing risk. In the event of a loss, insurance is a means by which the burden of that loss—whether related to the destruction of property or an incurred liability—is shared by the policyholders. The two types of ownership structures in the (P/C) industry (as well as the life/health industry) are mutual ownership and stock ownership. Mutual insurance companies are owned by its policyholders, and its ownership capital is policyholders' surplus. State Farm Group is the largest P/C insurer in the United States, based on premium volume and it is still a mutual insurance company after 90+ years of operation. The second largest P/C insurer, Allstate, is a stock insurance company. Investors buy shares of stock in Allstate, and its ownership capital is shareholders' equity.

In 1911, The General Court of Massachusetts overhauled workers' compensation, chartering the Massachusetts Employers Insurance Association to mitigate the hazards faced by ordinary workers. MEIA changed its name in 1917 to Liberty Mutual and is now the third largest P/C insurer in the U.S. Liberty acquired Safeco Corporation in 2008 and investors have speculated whether Liberty Mutual will demutualize itself. As the Commonwealth of Massachusetts imposed heavy regulations on the Massachusetts automobile insurer industry until 2008, Massachusetts had numerous small mutual P/C companies operating within the state. Massachusetts also has two well-known life insurance companies with a significant operating presence within the state. The first was John Hancock and the second was MassMutual. John Hancock demutualized in 2000 and Canadian life insurer Manulife acquired it in 2004. MassMutual is located in the Western Massachusetts city of Springfield, acquired three global asset management boutiques in the last 20 years and acquired the Springfield Civic Center's naming rights in 2005 (now known as the MassMutual Center).

Insurers collect payments in the form of premiums from people who face similar risks. A portion of those payments is set aside to cover policyholders' losses. Therefore, earned premiums are typically an insurer's primary revenue source. When an insurance company issues an insurance policy, it records the policy on the insurer's books as a written premium. Then, over the life of the policy, the premium is "earned," or recognized as revenue, on a fractional basis. GAAP classify these premiums as deferred revenues for accounting purposes and assigned to an unearned premium reserve, which is a liability on an insurer's financial statement. There is usually a lag of about 12 months between when an insurer writes a policy and the time an insurer recognizes the full premium as revenue. For example, a $600 premium for a year of auto insurance coverage would be "earned" by the insurer at the rate of $50 a month for 12 months.

After premiums, the second largest component of insurer revenues is investment income. Insurers earn investment income from investing the funds set aside for loss reserves and unearned premium reserves and from policyholders' surplus or shareholders' equity. The third and usually smallest revenue component is realized investment gains; this component is the most volatile and hardest to predict. Realized investment gains arise from the sale of securities (usually stocks and bonds) in an insurer's investment portfolio. Because the timing and magnitude of the gains depend on conditions in the securities markets, which are by their nature dynamic, it is difficult to forecast realized investment gains.

The majority of property-casualty insurers reported improved profitability and generally favorable underwriting results in Q2 2013. P/C Insurance pricing continues its upward momentum, policy retention rates slipped for some insurers in the wake of recent price hikes and higher interest rates negatively affected insurance company book value. Although net written premium growth has gradually trended upward—rising 2.9% in 2011, 3.4% in 2012, and 4.5% in the first three months of 2013—we would not characterize market conditions as "hard." We would characterize the insurance pricing environment as "improving," with a number of lines of business achieving rate adequacy (i.e., premiums are covering loss costs). Major insurance institutions reported Q2 2013 year-over-year net written premium growth of between less than 1% to upwards of 9%.

The P/C industry had its strongest underwriting performance in 2006, one year after Hurricane Katrina's impact. The Insurance Services Office reported that P/C insurers generated $31B in net underwriting gains in 2006 as well as $52.3B in net investment income. However, underwriting gains declined to $19B in 2007 and then the industry suffered five straight years of underwriting losses before generating $4.64B in net underwriting gains in Q1 2013. Furthermore, P/C industry net investment income has sagged from $52.3B in 2006 to an estimated $45B in 2013.

PROPERTY-CASUALTY OPERATING RESULTS
(In millions of dollars)

YEAR	NET UNDERWRITING GAIN (LOSS)	NET INVESTMENT INCOME	PRETAX OPERATING INCOME
2013*	4,640	11,385	15,885
2012*	(144)	11,657	11,873
2012	(16,679)	47,708	33,323
2011	(36,229)	49,194	15,428
2010	(10,514)	47,567	38,170
2009	(2,981)	47,057	44,983
2008	(21,173)	51,466	30,645
2007	19,304	55,052	73,363
2006	31,115	52,309	84,607
2005	(5,612)	49,729	45,145
2004	4,263	39,966	43,963
2003	(4,853)	38,648	33,752

*Three months.
Source: Insurance Services Office.

Source: S&P NetAdvantage

Property-casualty insurers in the ISO study reported consolidated net surplus (or net worth) of $607.7 billion as of March 31, 2013. This measure of the industry's capital was up 3.6% from year-end 2012, when surplus totaled $586.9 billion, and 5.9% above the March 31, 2012, level of $573.9 billion. Because insurers leverage their surplus to write business, the ratio of net written premiums to policyholders' surplus is a good way to measure industry leverage (or lack thereof). The premium-to-surplus ratio stood at 0.76-to-1 at March 31, 2013, down slightly from 0.77-to-1 as of March 31, 2012. In other words, insurers, on average, at March 31, 2013, were writing $0.76 worth of premiums for every $1.00 of capital. According to the ISO study, the 0.75 premium-to-surplus ratio at March 31, 2011, was a record low, looking at the quarterly data dating back to the fourth quarter of 1986, when the ratio stood at 1.88.

To put this in perspective, if we assume insurers would "typically" (and at this juncture, theoretically) leverage their surplus two times, we estimate the industry had more than $375 billion of excess underwriting capacity at March 31, 2013, a factor that may limit the degree to which premium rates rise for most lines of coverage. We calculate this so-called excess underwriting capacity by using the following 2013 data points: the $461.6 billion in net written premiums for the 12 months ended March 31, 2013, and the $607.7 billion surplus at March 31, 2013. The actual amount of surplus required to support the industry's existing level of written premiums is approximately $230.8 billion, according to our estimates. Subtracting this minimum level of surplus from actual surplus leaves us with more than $375 billion in surplus that, for purposes of this exercise, can be deemed "excess." This so-called excess capital could support $750 billion or so of written premiums, much more than the industry is currently writing.

Overall, we see the industry as fairly valued and its risk adjusted return would be in line with what we expect for the overall S&P 500. We do not see any catalysts that will enable P/C insurance institutions to generate shareholder returns in excess of the market though aggressive investors may want to look at AIG and Tower Group since both firms are trading at deep discounts to its book value.

VALUATION ANALYSIS

P/B Model Summary	$Ks
Q2 2013 Book Value	$579,234
Estimated Q3 2013 Dividend	$9,476
Estimated Core Q3 2013 Earnings	0
Q3 2013 Book Value (est)	**$569,758**
Outstanding Share Count	**57,429**
Q3 2013 Book Value per Share (est)	**$9.92**
Remaining Goodwill	$55,540
Intangible Assets from Acquisitions	$99,507
Q3 2013 Tangible Book Value	**$414,711**
Outstanding Share Count	**57,429**
Q3 2013 Tangible Book Value per Share (est)	**$7.22**
Market Price	**$4.14**
Discount to Tangible Book Value	**42.67%**

DISCLOSURES

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Disclosure:* *Analyst(s) covering this company does not own shares of TWGP

RECOMMENDATION SCALE

INVESTMENT RATING	DEFINITION
STRONG BUY	Stocks expected to be 20% underpriced relative to its intrinsic value and whose total return is expected to significantly exceed the market index benchmarks.
ACCUMULATE	Stocks expected to be at least 10% underpriced relative to its intrinsic value and whose total return is expect to exceed the market index benchmarks.
NEUTRAL	Stocks expected to be fairly priced relative to its intrinsic value and whose total return is expected to closely track the market index benchmarks.
AVOID	Stocks expected to be slightly overpriced and to either potentially see a small, incremental decline in its price to converge with its intrinsic value or expected to appreciate at a slower pace relative to the market index benchmarks.
STRONG SELL	Stocks expected to be strongly overpriced and to potentially see a rapid decline in price to converge with its intrinsic value or expected to significantly underperform relative to the market index benchmarks.

Relevant benchmarks: In North America, the relevant benchmark is the S&P 500 Index