

Top 50 Insurance Institution at 66% Discount to Book Value

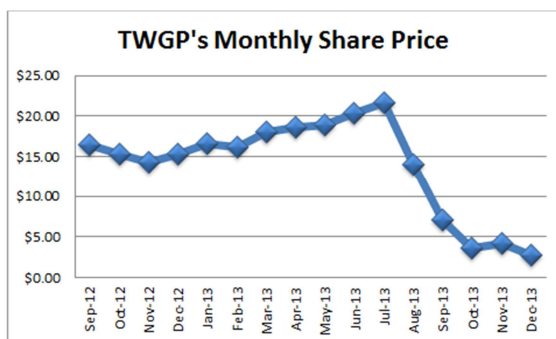
[Accumulate](#)

We are [maintaining our Accumulate](#) rating on Tower Group International (TWGP). We like that its share price is at a 66% discount to its book value. However, we are aware of its insurance reserve related issues and that is why we have not rated it as a Strong Buy even though its share price is at a 66% discount to its book value.

RECOMMENDATION

We have an Accumulate rating on Tower Group's common stock. Although its \$2.75 share price represents a 66% discount to its \$8.09 estimated book value per share and a 42.67% discount to its \$5.39 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 in Q2 2013 and \$75M-\$105M in estimated charges for Q3 2013 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

UPDATES:

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. We were intrigued with investing Tower Group as a potential distressed, special situations investment. Tower Group's recent troubles resulted in its share price dropping by 80% from its 52-week high of \$22.30 in July to \$4.16 in November because it incurred \$578M in charges in Q2 2013 to strengthen its loss reserves.

We previously thought that Tower Group's share price "reached rock-bottom" based on those charges. We initially began researching Tower Group in October before it announced the \$578M in charges to strengthen its loss reserves and to write off acquisitions that did not work out. We were relieved that we avoided the 50% decline in Tower Group's share price after it announced its big bath charges. We considered buying shares in Tower Group but ended voting not to take action in Tower Group at that time.

SALE OF CANOPIUS GROUP SHARES

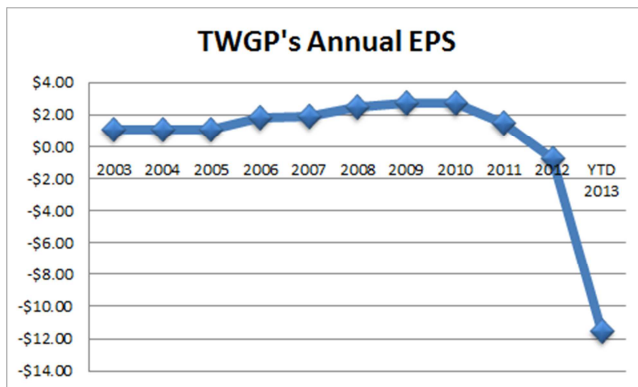
On December 17, Tower Group announced that it sold its 10.7% stake in Canopus Group to an investment fund managed by Bregal Capital LLP. Bregal paid £42.5M (\$US 69.7M) to Tower Group, which is slightly below the US\$71.5M Tower Group paid for its Canopus stake. With proceeds from the sale, Tower has paid in full the \$70.0M outstanding on its credit facility led by Bank of America, N.A., and Tower terminated the credit facility. The sale of the Canopus shares permits Tower's Board to continue its strategic evaluation of various alternatives without any current liquidity concerns arising from its former bank credit facility, while also permitting Tower to participate in any future transaction involving the sale of Canopus that occurs within the next six months.

As part of Tower's agreement to sell its shares, if a legally binding contract for the sale or other transfer of shares representing a majority of the voting power of Canopus is entered into within six months after the date of the Purchase Agreement, a further cash payment would be made by Bregal to Tower. This additional cash payment would be equivalent to the excess, if any, of (1) one third of the difference between the amount in GBP paid for the shares previously owned by Tower in such sale and £40.6M (plus Tower's share of expenses of such sale) minus (2) £1.95M. This provision worked out well for Tower Group because on December 18, the Japanese insurance group [Sompo Japan announced](#) that it agreed to a deal to acquire Canopus Group for £594M, which represents a 1.5x multiple based on Canopus's unaudited

tangible net asset value at Q2 2013. This price will be adjusted to reflect Canopiuss's audited TNAV at Q4 2013. We believe that this enables Tower Group to potentially harvest an additional £21M for its Canopiuss stake once Sompoo Japan acquires Canopiuss.

ADDITIONAL LOSS RESERVE CHARGES

Investors asked us why Tower Group's share price declined by 30% on December 18 after it announced the sale of its Canopiuss Group shares. By itself, Tower Group selling its Canopiuss Group shares and paying off its line of credit should not have negatively influenced its share price. Unfortunately, many of these investors did not realize that Tower Group also announced in its press released that it incurred an addition \$75M-\$105M in loss reserve addition charges in Q3 2013 in its workers' compensation, commercial multi-peril liability, other liability and commercial auto liability lines of businesses. Tower Group expects its U.S. combined statutory surplus, net of cessions to its Bermuda affiliate, to decrease from \$374M as of Q2 2013 to an amount between \$315M and \$335M as of Q3 2013. Tower further stated it is still in the process of preparing its statutory financial filings, but it anticipates filing its statutory financial statements for Q3 2013 by the end of 2013.



Source: Morningstar Direct

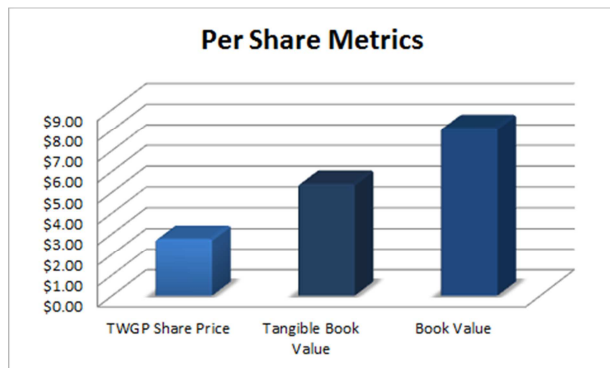
VALUATION AND PROJECTIONS

Tower Group's share price of \$2.75 is at a significant discount (66%) to its per share book value of \$8.09 even after taking into account the \$653-683M in charges that it incurred in Q2 2013 and Q3 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 and \$75M-\$105M in Q3 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 \$214M for Q2 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 still assume 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 seeks to release its full financial results for Q3 2013 before the end of December. We previously discussed that Tower Group 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 reiterate that investors have lost confidence and trust in Tower Group's management and that explains why its share price is trading at a 49% discount to its tangible per share book value as well as 66% discount to its per share book value.

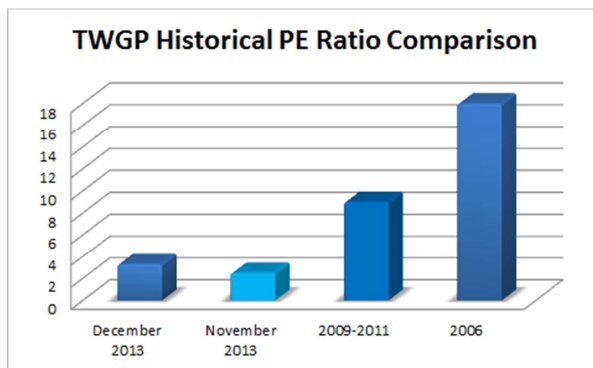


Source: Morningstar Direct and [Saibus Research Estimates](#)

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. Analysts previously projected \$.40 for these quarters in October but reduced their estimates to \$.26 for Q3 2013 and \$.22 for Q4 2013.

- We assumed that the company would pay its \$.165/share dividend payments for Q3 2013 but suspend its dividend until it restores its profitability and resolves its reporting issues.
- Regarding the \$75M-\$105M in loss reserve charges for Q3 2013, we assumed that the eventual charge would be \$105M rather than \$75M.
- Although Tower Group's EPS estimates have declined drastically for FY 2013 and FY 2014, the company is still expected to generate \$0.84/share in core EPS in FY 2014. However, this represented a sharp 67% decline relative to the \$2.51 in EPS that analysts projected Tower Group would earn 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 3.3X forward EPS.
- For purposes of conservatism, we assumed that the company would have to write-off its remaining goodwill and intangible assets



Source: Morningstar Direct

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 \$2.75 whereas its estimated book value per share is \$8.09 and its tangible book value per share is \$5.39. Tower Group's share price is at a 66% discount relative to its book value and a 49% discount relative to its tangible book value.

Tower Group's shares are trading at 3.3X its expected forward EPS. Even with Tower Group's declining EPS projections and recent charges against earnings, a Forward PE of 3.3X

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.

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

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 |
| Estimated Core Q4 2013 Earnings | \$0 |
| Q3 2013 Loss Reserve Charges | -\$105,000 |
| Q3 2013 Book Value (est) | \$464,758 |
| Outstanding Share Count | 57,429 |
| Q3 2013 Book Value per Share (est) | \$8.09 |
| Remaining Goodwill | \$55,540 |
| Intangible Assets from Acquisitions | \$99,507 |
| Q3 2013 Tangible Book Value | \$309,711 |
| Outstanding Share Count | 57,429 |
| Q3 2013 Tangible Book Value per Share (est) | \$5.39 |
| Market Price | \$2.75 |
| Discount to Tangible Book Value | 49.01% |

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 expected 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

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