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ProAssurance Corp.

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ProAssurance Corp.

Major Rating Factors

Counterparty Credit Rating
Local Currency
BBB/Stable/--

Strengths:
- Strong competitive position, supported by further geographic diversification.
- Strong operating performance, though prices for professional liability insurance continue to decline.
- Strong financial flexibility and low financial leverage.

Weaknesses:
- Modest geographic concentration by state.
- Business concentration in medical professional liability (MPL) niche.
- Potentially inadequate reserves and capital as a result of recent acquisitions.

Rationale

The counterparty credit rating on ProAssurance Corp. (PRA) reflects the company's strong competitive position; strong operating performance, though premiums continue to decline as favorable loss experience has resulted in lower filed rates in many states; strong financial flexibility; and low financial leverage ratio of less than 5% at year-end 2009. Standard & Poor's Ratings Services expects that PRA will maintain its financial leverage at the current rating level. In addition, PRA's recent acquisitions and planned acquisition of American Physicians Service Group (AMPH) have further diversified the company geographically, which supports its competitive position. Partially offsetting these positive factors is PRA's modest geographic concentration by state, though the company is nationally diversified. In addition, PRA has a business concentration in the MPL niche (though it's slowly diversifying). So, regulatory reforms and changing trends in this market could have a significant impact on the company's underwriting results. An additional business risk is that PRA's reserves could prove inadequate and that capital adequacy could be an issue as a result of recent acquisitions, though we do not expect this to be a significant issue.

PRA's competitive position is strong. It is one of the few monoline MPL companies with broad national coverage. Strong claims defense is a key factor that differentiates the company from its peers. The company has grown mostly through selective mergers and acquisitions. PRA is one of the top three MPL writers in each of its top five states, which supports its strong competitive position. Its top five states are Alabama (which contributed 17% of gross premiums written in 2009), Ohio (13%), Florida (6%), Indiana (6%), and Michigan (6%). The acquisition of AMPH will likely add another 10% in premiums to the top line and make PRA the second-largest MPL writer in Texas. Standard & Poor's views the acquisition as favorable to PRA's competitive position because it increases business in a favorably regulated state and it adds scale. We also expect that the concentration in the top five states will decrease slightly.

The company's operating performance was strong in the past five years (2005 to 2009). PRA reported a GAAP combined ratio of 69.1% in 2009 and 83.8% in the first six months of 2010, compared with 67.8% in 2008. The company's reserve releases, primarily related to accident years 2003 to 2007, continued to bolster its combined ratios as it experienced claims severity that was below its initial expectations for the 2004 to 2008 accident years.

PRA recognized favorable loss development of $207.3 million in 2009 (about 8.7% of year-end 2008 reserves) and $62.5 million in the first six months of 2010 (about 2.5% of reserves at year-end 2009). The developments lowered the company's combined ratio by 25.1 percentage points and 41.7 percentage points, respectively, which brought the combined ratios to 83.8% for the first six months of 2010 and 69.9% for full-year 2009. (Lower combined ratios indicate better profitability. A combined ratio of greater than 100% signifies an underwriting loss.) We believe PRA's reserve practice is consistent and conservative year over year. We do not believe these favorable reserve releases will be sustainable unless PRA continues to book its initial reserves conservatively. The holding company has maintained its fixed-charge coverage ratio at more than 20x since 2007. The company's financial leverage ratio improved to less than 5% as of June 30, 2010, from 11% at year-end 2007.

PRA's geographic and business concentrations--which led to pre-2004 earnings that were volatile but slightly better than those of some of its peers--are weaknesses to the rating. PRA is essentially a monoline company, with the majority of its total direct premiums written coming from the MPL segment, principally in the mid-Atlantic, Midwest, and Southeast, as well as a small book of legal professional liability. Because of this, the company is more vulnerable to adverse industry conditions in the MPL segment resulting from a soft market cycle. The positive correlation between PRA's performance and the pricing, frequency, and severity trends of the MPL industry limits the rating. Standard & Poor's views MPL as a high-risk line of business because of its state-specific regulatory constraints, potentially volatile earnings, and long-tail reserve risk. The business concentration makes PRA vulnerable to systematic risks as a result of changing industry trends and regulatory reforms, which could significantly affect PRA's loss costs.

Lastly, because PRA actively acquires other MPL companies to expand its footprint, the company could face unexpected business risks, such as inadequate reserves or capital of the acquired companies. In addition, there is the potential that PRA may improperly evaluate the acquired entities' business risks--such as reserve and capital adequacy and potential litigation liability. Miscalculating acquired entities' business risks could hurt PRA's earnings and capitalization. We expect that PRA will continue conducting careful due diligence prior to any other acquisitions.

Liquidity

PRA's liquidity is strong. Consolidated cash flows from operations totaled $76 million in the first six months of 2010, compared with $13 million in the same period in 2009. The net increase in operating cash flow of $63 million was primarily a result of higher premium receipts, a decrease in paid losses, an increase in reinsurance recoveries, and a decline in federal and state income tax payments. Cash and cash equivalents increased to $45.3 million as of June 30, 2010, from $40.6 million as of Dec. 31, 2009. We do not expect PRA will have any liquidity constraints to meet its obligations in the next two years because of its expected cash flow stream from its investment portfolio and dividend capacity from the insurance operating subsidiaries. In 2010, PRA's subsidiaries can pay PRA approximately $228 million in dividends without regulatory approval. In addition, as of June 30, 2010, the company had $360 million in cash and investments held outside the operating subsidiaries that it can use without regulatory approval.

The weighted average effective duration of PRA's fixed-maturity securities and short-term securities was 3.8 years (4.1 years when excluding short-term securities) as of June 30, 2010, longer than its three-year average duration. About 87% ($3.5 billion) of the company's investments were available-for-sale fixed-maturity securities, with an average income yield (including Podiatry Insurance Co. of America, or PICA) of 4.4%. As of June 30, 2010, the company's investments--excluding cash and cash equivalents--comprised 7% U.S. treasury and agency bonds, 33% state and municipal bonds, 29% corporate bonds, 14% residential mortgage-backed securities, 3% commercial mortgage-backed securities, and 14% other investments, which includes other asset-backed securities, equities, and short-term investments. Most of the fixed-income portfolio, 97%, was investment grade. Average ratings on the corporate bonds, state and municipal bonds, and asset-backed securities were 'A', 'AA', and 'AA+', respectively.

In the first half of 2010, the company recorded about $12.4 million in other-than-temporary impairments related to its investments in residential mortgage-backed securities, equity interest in a private investment fund, and high-yield asset-backed securities. We viewed this as neutral to the rating because we consider PRA's investment portfolio to be diverse and conservative. The company has been transparent in disclosing its holdings and closely monitoring its portfolio performance. Its investment committee meets quarterly to review portfolio performance against internal benchmarks and to discuss general market conditions. We expect PRA will maintain its liquidity through a high-quality, conservative investment portfolio and strong earnings.

Outlook

The stable outlook is based on our view that PRA has demonstrated a sustainable and strong financial profile while maintaining its strong financial leverage metrics, strong operating performance, and adequate reserves. The company also has enhanced its competitive position and diversified its geographic and specialty coverage through selective acquisitions.

We expect that PRA will maintain its strong competitive position, further diversify its business through the acquisition of AMPH, and maintain strong operating performance and capitalization and low financial leverage ratios. PRA's top line will likely increase by about 10% in 2011 as a result of the acquisition of AMPH, assuming PRA doesn't experience any further rate reductions. We also expect that PRA will have a combined ratio of no more than 95% as of year-end 2010 and 2011 (with the benefit of potential reserve releases related to prior accident years) and a current accident-year combined ratio of 105% to 110% in 2010 and 2011.

We believe it's likely that PRA will perform better than its MPL insurance peers because of its disciplined underwriting and claims management as well as its strong competitive position. Although PRA might increase its use of debt opportunistically in light of favorable interest rates, we do not expect that the company's debt-to-capital ratio will increase to more than 20% or that its interest coverage will fall to less than 6x.

The rating could come under pressure if the integration with AMPH does not proceed smoothly and if the acquisition detracts from PRA's operating performance, or if PRA is unable to maintain a strong competitive position, underwriting discipline, strong earnings, and adequate reserves. We do not expect to raise the rating again within the next two years because of the company's business concentration.

Financial Profile

PRA is one of the largest monoline MPL writers in the U.S, covering 49 jurisdictions. It focuses on providing medical liability insurance to physicians and surgeons, dentists, hospitals, and others involved in the delivery of health care through its nine underwriting offices and 17 claims offices. PRA conducts business regionally, with a national footprint ranging from the Midwest to the Southeastern U.S. and covering 64,000 policyholders, of which 78% are physicians and dentists, 10% are attorneys, 7% are ancillary health care and facilities, and 5% are other, non-healthcare risks that PRA is non-renewing throughout 2010 and 2011. The company has a track record of growth through selective acquisitions. It was formed when Medical Assurance Inc. and Professionals Group Inc. merged in 2001, though its core businesses were originally founded in the 1970s. The company has grown through active acquisitions, and with the recent announcement of the AMPH acquisition, we expect PRA will further increase its market shares in key states, such as Texas, Oklahoma, and Arkansas. The company also added some meaningful business in attorney's liability with the acquisition of Georgia Lawyers Insurance Co. (GLIC) in 2009.

Competition has been somewhat aggressive as the MPL sector experiences large favorable loss developments because of favorable frequency and severity trends for prior accident years. In response to these loss trends, PRA has been reducing rates since late 2006 and continues to face downward pressure on pricing, although the pressure has slightly abated in 2010. In the first six months of 2010, the renewal rate reduction moderated slightly to an average rate decline of 1%, compared with an average rate reduction of 3% in the same period of 2009. Throughout the first nine months of 2010, the average renewal rate was flat, while retention remained healthy at 89%. In full-year 2009, PICA contributed $70.3 million of net premiums earned to the group. Excluding PICA, PRA's net premiums earned declined by 7%, primarily because of rate reductions stemming from improved loss trends. However, the retention rate for physicians remained stable at 89% in full-year 2009 versus 88% in 2008. (The retention rate for PICA is about 93%.) Although writing new business was challenging in 2009, PRA successfully wrote about $22 million in new business--which was unrelated to acquisitions--compared with $12 million in 2008. The company is implementing retention programs in long-term markets to meet the targeted return on equity (ROE) of 12% to 14%. PRA's focus on profitability rather than top-line volume is a strength to the rating.

After analyzing its competitive position versus its peers', PRA implemented a new branding strategy in 2008. We believe this, along with PRA's advantage in claims defense, will help the company to better differentiate itself in the market.

PRA's distribution channels are direct marketing and independent agents. About 300 independent agents generated 65% of the company's 2009 gross premiums written. No single agent or agency accounts for more than 10% of the company's total direct premiums written.

PRA's management team is well seasoned, with an average tenure of 13 years at PRA and 25 years of industry experience. Given the breadth of the state coverage, we believe that management is highly knowledgeable about the MPL industry. Claims management is a competitive advantage for PRA. The company tries more claims than its peers, and it's willing to defend its clients' claims to the extent permitted under the laws and legal system of each state. This not only leads to a lower loss ratio for PRA, but it also helps to retain clients and prevent PRA's products from becoming commodities. As a result of this approach, legal expenses are higher, though indemnity payments are lower. PRA's strong and exclusive relationship with lawyers makes it difficult for companies to enter states where PRA already has dominant market positions.

PRA's capitalization at the operating company level remains strong and redundant at the current rating level, based on our enhanced capital model as of year-end 2009. As of June 30, 2010, PRA's financial leverage ratio was less than 5%, which is slightly higher than year-end 2008 because of the debt that PRA assumed with the recent acquisitions. We also consider the quality of PRA's capital to be strong because about 92% of shareholders' equity ($1.5 billion) is tangible, and goodwill increased to $130 million as a result of the recent acquisitions. The ratio of gross premiums written to shareholders' equity was about 32.4% as of year-end 2009. These metrics are strong for the rating category. However, we expect that capital adequacy will decline--though remain redundant at the current rating level--following the acquisition of AMPH.

We believe PRA's reserve practice is consistent and conservative year over year and that its reserves are adequate. The company conducts a detailed analysis of reserves by coverage type, geography, layer of coverage, and accident year. It receives semiannual independent reserve reviews from Tillinghast and an annual review from Ernst & Young. In the past five years, PRA's reserve estimates were higher than those of Tillinghast and Ernst & Young's. The company has been booking its initial accident-year reserve at a loss ratio of about 85%. This practice has contributed to favorable loss developments in the past three years. The accident-year loss ratios were 84.3% in the first six months of 2010 and 88.1% in 2009 as PRA continued to reserve for the current accident year at eight to 10 percentage points above the expected losses embedded in its rates.

Because of its strong capital position, the company has chosen not to use a large amount of reinsurance coverage, and it doesn't have a significant reinsurance recoverability issue. The reinsurance utilization ratio (premiums ceded to gross premiums written) was less than 10% as of June 30, 2010. The primary uses of reinsurance are to provide capacity to write larger limits of liability and to protect against losses in excess of policy limits.

PRA's financial flexibility is strong, as its success in raising capital demonstrates. The company converted $107.6 million in convertible debentures due in 2023 to equity in 2008, and it issued $45 million in trust preferred securities in August 2004. It also issued $107.6 million in senior convertible debentures in a private offering in July 2003, and it issued another $46.7 million through a stock offering in late 2002. As of year-end 2009 and June 30, 2010, its financial leverage was less than 5% and its fixed-charge coverage (excluding realized capital gains) was more than 20x. These are strengths to the rating.

Enterprise Risk Management

Standard & Poor's views PRA's enterprise risk management (ERM) as adequate. PRA has an adequate risk-management process in place to manage key underwriting, pricing, reserves, and acquisitions risks. The board of directors has designated its chairman and chief executive officer as its chief risk officer, and we believe the company has an adequate understanding of the various types of risks that it is facing and has adequate practices in place to manage and control these risks. Its local presence enhances long-term customer relationships and deepens its understanding of the legal environment. The company's close ties to medical communities help it to understand critical underwriting issues and prepare for emerging trends. Corporate strategy is implemented locally, though the underwriting and claims functions are performed through a centralized system. Because business varies by state, the company monitors the political and regulatory climates in each state closely and participates in regulatory discussions. This also helps PRA to better prepare itself for the emerging regulatory changes. The company has a strong claims-management culture and aggressively defends claims that it views as having no merit. A committee, led by the CEO, reviews claims once every two weeks. The audit committee monitors the liabilities on the balance sheet, and the board and the investment committee oversee the asset risks. PRA has mitigated reserve risk through semiannual reserve reviews by Tillinghast and annual reviews by Ernst & Young.

Accounting

PRA reports its financials on both GAAP and statutory bases. The company has filed its reports on time, and Standard & Poor's is unaware of any adverse opinion from the auditor. We analyze PRA's audited and unaudited financial reports.

PRA conducts an annual assessment of goodwill impairments. The company recorded no goodwill impairments as of June 30, 2010, and goodwill and intangible assets totaled $131 million, an increase from $72 million at year-end 2008 as a result of the three acquisitions in 2009. We included a three-year discount credit in our capital model, and we didn't make an adjustment for reserve adequacy because we viewed the company as adequately reserved. The Financial Accounting Standards Board issued various accounting changes in 2009 and 2010. We do not expect that these will have a significant impact on the rating in 2010.

ProAssurance Corp./GAAP Financial Statistics

	--Six months ended June 30--	--Year ended Dec. 31--			
	2010	**2009**	**2008**	**2007**	**2006**
Debt leverage (%)	2.9	3.2	2.6	1.0	9.3
Financial leverage (%)	2.9	3.2	2.6	10.5	14.1
GAAP interest coverage (EBIT) (x)	61.3	75.3	41.4	161.3	51.3
GAAP fixed-charge coverage (EBIT) (x)	61.3	75.3	41.4	20.5	25.9
Statutory interest coverage (x)	N.A.	45.4	20.6	114.6	13.9
Statutory fixed-charge coverage (x)	N.A.	45.4	20.6	14.6	7.0

N.A.--Not available.

Ratings Detail (As Of November 30, 2010)*

ProAssurance Corp.		
Counterparty Credit Rating		
Local Currency		BBB/Stable/--
Counterparty Credit Ratings History		
09-Nov-2010	*Local Currency*	BBB/Stable/--
09-Nov-2009		BBB-/Positive/--
23-Jan-2007		BBB-/Stable/--

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.