

BUYING A RHINO: A CASE STUDY IN THE INSURANCE M & A GAME

PLEASE READ PRIOR TO PRESENTATION

As a means to better understand the dynamics of doing a deal in the insurance industry, I thought it would be useful to discuss the opportunities and hurdles of an actual transaction to see if you, as a group, can arrive at a workable valuation and financing plan, and protect the buyer from the major risks of the deal. Presented below are short overviews of the specific industry, the target and the buyer (using pseudonyms) involved in one insurance M&A deal in which Insurance Partners was recently involved. During our session, I'd like to answer the following questions:

- How would you value the Target?
 - What financial statistics are insurance companies priced off of?
 - What should you consider in applying a discount or premium to the relevant transaction multiples?
 - What are typical pitfalls to look for when evaluating the balance sheet of an insurer?
- How would you finance the transaction?
 - What are the potential financing options in the public and private markets?
 - What are the limitations on leverage in the insurance industry?
 - What constituencies should be considered in the financing structure?
- What are the primary financial risks of the transaction/Target and how do you protect the Buyer from them?
- What are the primary business/integration risks of the transaction and how do you protect the Buyer from them?

I will be calling on you to help fit together the pieces of this M&A puzzle, so please be creative and thoughtful in using the information provided below. Once we've come up with some potential solutions, I'll walk you through the thought process we used in creating the structure ultimately used to get the deal done.

THE CALIFORNIA WORKERS' COMPENSATION MARKET

Overview of Industry

Workers' compensation is a no-fault statutory system under which an employer is required to provide its employees with medical care or other specified benefits for work-related injuries or diseases. There are four types of benefits payable under workers' compensation policies: disability, vocational rehabilitation, medical and death benefits. The amounts of benefits payable for various types of claims are established by statute and vary with the nature and severity of the injury or disease; wages; occupation; and age of the employee. While no dollar limitations are set for medical benefits and limited dollar amounts are set for vocational rehabilitation benefits, reinsurance typically covers liability in excess of a specified dollar amount.

Insurers must compensate policyholders' employees injured in the course and scope of their employment, even though the injuries may have resulted from the negligence or wrongs of any person (including the employee). Subrogation procedures exist however, which allow an insurer to recover from third parties in certain instances all or a portion of the benefits the insurer has paid. The amount of premiums charged for workers' compensation insurance is dependent on the size of an employer's payroll and the type of business.

California Marketplace

California is the country's largest workers' compensation insurance market, with total direct premiums written of \$5.0 billion in 1996. The California market is composed of (i) the State Fund, (ii) companies that write workers' compensation insurance in California but have significant writings in other lines of business and/or in other states ("Multi-Line, Multi-State Writers"), and (iii) one private sector company that writes exclusively workers' compensation insurance specifically focused in California. The State Fund, which is obligated to write workers' compensation insurance for any applicant, including those turned down by the private sector carriers, is the largest underwriter of workers' compensation insurance in California, accounting for approximately 19% of the direct premiums written in California in 1996. Because the State Fund must accept all risks, its combined ratios have historically been much higher than those of the private sector carriers. Although the State Fund regularly competes with private insurers for profitable underwriting business, the State Fund's role as the insurer of last resort is generally viewed as a significant benefit because it eliminates the need to create an assigned risk plan in which other insurers conducting business in California would be required to participate.

Pricing

Prior to January 1, 1995, the Department on Insurance (the "DOI") set minimum premium rates for workers' compensation insurance in order to provide a stable environment for the pricing of such insurance. On January 1, 1995, the State of California formally converted to a system of "open rating" for workers' compensation insurance written within the state. Insurance companies now file and use their own actuarially defensible rates. Following the introduction of open rating, total direct written premiums in the California market decreased from \$9.0 billion in 1993 to \$5.0 billion in 1996 as many carriers engaged in price competition.

Under open rating, the DOI sets “pure premium” (effectively, the estimated claim and allocated claim adjustment expense) rates for each employment classification. Carriers then apply their own multipliers to the pure premium rate to adjust for that carrier’s anticipated unallocated claim adjustment and underwriting expenses. These rates are then subject to further adjustment on a policyholder by policyholder basis to account for historical loss experience, the presence of stricter safety programs, differing dividend and commission plans, and other factors.

Recent Developments

While competitive pressures in the California’s workers’ compensation market increased with the implementation of open rating in January 1995, certain fundamentals of the workers’ compensation market have recently improved. In 1996, the total direct workers’ compensation premiums written in California leveled out at approximately \$5.0 billion as compared to \$9.0 billion in 1993, as the market began to experience rate stabilization. This trend has continued into 1997, as demonstrated by a slight improvement in premium pricing of 0.5% for the year ended December 31, 1997 over 1996. Additionally, anti-fraud legislation passed by the State of California in 1993 continues to have a positive effect on the market’s losses by controlling fraudulent claims and medical and legal expense levels. These improvements have resulted in a reduction in the frequency of claims in the California workers’ compensation market. However, during 1997, there appears to have been an increase in claims severity marketwide for injuries sustained in 1995 and thereafter.

As a result of the significant upheaval in the California workers’ compensation market since the advent of open rating, a large number of competitors have exited the market, been acquired, taken over by the California Department of Insurance or are rumored to be for sale. Of the five California workers’ compensation companies owned by major managed care companies, three are reportedly for sale, including BIG (owned by Foundation Health), Great States Insurance Co. (owned by FHP), and Unicare (owned by Wellpoint Health Networks). CII Financial, which was acquired in 1995 by Nevada-based Sierra Health Services, has been targeting its parent’s health insureds outside of California, as Sierra does not have a significant presence in California. The last of the five, CareAmerica Compensation & Liability Insurance Co., was acquired in 1987 by C.E. Heath and subsequently sold to CareAmerica Health Plans in 1994. In 1996, the company was reacquired by C.E. Heath at a substantial discount from the original purchase price and is expected to be used as an expansion platform into workers’ compensation in all of North and South America.

Of the other specialists or major writers of California workers’ compensation insurance, three have been acquired (Pac Rim, Industrial Indemnity and Citation Insurance Co.), one has been taken over by the California Department of Insurance and subsequently acquired by Liberty Mutual (Golden Eagle), three have exited the California workers’ compensation market (California Casualty, National American Insurance Co. of California, and ULICO), and three are rumored to be for sale (Argonaut, Zenith National, and Alistar).

THE TARGET

History

Target Insurance Group, Inc. was purchased in 1988 by its current senior management team. The company was subsequently acquired in 1993 by a predecessor of Managed Care Systems, Inc. ("MCS"). Target currently conducts its insurance operations through four wholly owned insurance subsidiaries as listed below:

California Insurance Company: The largest of the Company's subsidiaries and licensed in 12 states, it primarily writes workers' compensation insurance in California.

USA Insurance Company: Acquired in February 1995 and licensed in 49 states. USA Insurance Company writes workers' compensation insurance primarily in states other than California.

Combined Benefit Insurance Company: Acquired in January 1995 to write an integrated 24-hour employee group health and workers' compensation product in California.

Shell Insurance Company: A shell insurer with licenses in 40 states was acquired in May 1997 in order to create a broader range of products and pricing plans.

Under the ownership of MCS, and during the extremely competitive environment of "open rating" in California, Target grew to become the largest private writer of workers' compensation insurance in California. Between 1992 and 1997, the company grew its gross premiums written from \$300 million to \$669 million, during a period when the U.S. and California workers' compensation markets declined approximately 20% and 45%, respectively. These gains were largely achieved through Target's strategy of under pricing its competitors, while reporting significant profits through under reserving. As a result of this strategy, Target was forced to increase reserves by \$75 million pre-tax in 1997 and begin to dramatically increase its pricing on new and renewal business to stem further losses. In the first quarter of 1998, Target's direct written premium in California decreased by \$15.0 million, as compared to the three-month period ended March 31, 1997, precipitated by this change in Target's underwriting and pricing criteria implemented in 1998. Additional factors responsible for the decline were uncertainties created by the sale process and the recent downgrade of Target's rating by A.M. Best from "A-" to "B++".

Reason for Sale

Target Insurance Group is a wholly owned subsidiary of Managed Care Systems, Inc. The company was purchased by the predecessor company to MCS, Care Systems Corporation, in 1993, with the intention of creating and marketing a 24-hour care product which would integrate workers' compensation insurance with managed care primary health services. The companies jointly pursued this strategy, but found that the product was largely unsuccessful. In April 1997, Care Systems completed a merger of equals with Managed Care, Inc., creating Managed Care Systems, Inc., Target's current parent. Since the merger, the management team of Managed Care has dominated the ongoing operations of MCS and has decided not to pursue the previous 24-hour care strategy purported by the Care Systems management team. At the same time, as a

result of very rapid growth in the brutally competitive “open-rating” workers’ comp market, Target was forced to increase reserves in 1997 and begin to dramatically increase its pricing on new and renewal business. These events further shook MCS’ confidence in Target management and contributed to the decision by MCS to hire an investment bank to conduct an auction of Target. MCS is seeking to accomplish a sale of the company for all cash and as part of a purchase agreement, requires certainty of the ability of the Buyer to finance the transaction.

Current Business Focus

Target, through its four wholly-owned insurance subsidiaries, specializes in providing workers’ compensation insurance to a wide range of businesses and trade associations nationwide. The company ranks as the second largest private writer of workers’ compensation in California (previously first until Liberty Mutual’s acquisition of Golden Eagle). Prior to 1995, Target was exclusively a California insurer and the company’s business continues to be concentrated in California, accounting for approximately 68.2% of inforce estimated annual premiums as of March 31, 1998. However, in anticipation of regulatory reforms and the elimination of minimum rate laws in 1995, the company began to pursue national growth opportunities, and currently writes business in 42 states through a network of 37 regional and branch offices. Target is licensed in 49 states and the District of Columbia. Through March 31, 1998 approximately 31.8% of Target’s premium was written outside of the state of California. The company has historically written policies with average annual premium greater than those of Buyer’s, as demonstrated by an average annual premium per policy of approximately \$16,200 versus \$8,300 for Buyer. The large account business has generally been the most competitive market in California workers’ compensation, generating the greatest potential for under pricing and losses. Accounts with premiums greater than \$50,000 represented 60.9% of Target’s business as of September 30, 1997.

Premium Stratification by Size as of September 30, 1997
(\$ in millions)

<u>Premium Range</u>	<u>EAP</u> ⁽¹⁾	<u>% of Total</u>	<u># of Policies</u> ⁽¹⁾	<u>% of Total</u>
Under \$25,000	\$141.6	24.0%	29,809	85.0%
\$25,001-\$50,000	89.1	15.1	2,569	7.3
\$50,001-\$100,000	108.9	18.5	1,569	4.5
\$100,001-\$200,000	103.4	17.5	754	2.2
\$200,001-\$500,000	82.6	14.0	288	0.8
Over \$500,000	<u>64.0</u>	<u>10.9</u>	<u>76</u>	<u>0.2</u>
	<u>\$589.6</u>	<u>100.0%</u>	<u>35,065</u>	<u>100.0%</u>

⁽¹⁾ – Excludes health insurance included in Combined.

The Company primarily offers traditional monoline workers’ compensation insurance, comprising 69% of earned annual premium. The Company also offers numerous other related products as set forth in the following table:

Product Distribution in EAP
(\$ in millions)

	<u>September 30, 1997</u>	<u>Policy Count</u>
Monoline Workers' Comp	\$413.7	11,241
Trade Associations/Groups	82.7	20,815
Captive Programs	33.5	486
Retrospective Rating	25.8	1,128
Small/Large Deductibles	23.2	480
Combined Care	15.3	649
Qwik Comp	4.0	311
Totals	<u>\$598.2</u>	<u>35,110</u>

Marketing

The Company has been pursuing strategic national expansion since 1995. Today the Company distributes its products in 42 states, and with the exception of Michigan, is operating in every state in which it wishes to compete. The Company has filed an application with the state of Michigan and expects to receive its license in 1998.

Estimated Annual Premiums/Policies in Force by Region*
(\$ in millions)

	<u>1993</u>		<u>1994</u>		<u>1995</u>		<u>1996</u>		<u>Sept. 30, 1997</u>	
<u>Region</u>	<u>EAP</u>	<u># of Policies</u>	<u>EAP</u>	<u># of Policies</u>	<u>EAP</u>	<u># of Policies</u>	<u>EAP</u>	<u># of Policies</u>	<u>EAP</u>	<u># of Policies</u>
California	\$317.9	6,757	\$379.8	12,288	\$414.9	21,803	\$475.2	26,820	\$421.4	26,252
Western	--	--	--	--	12.2	504	36.7	2,254	39.8	3,667
Central	--	--	0.9	24	32.4	888	91.6	3,062	93.3	3,806
Eastern	--	--	--	--	9.1	169	37.7	850	35.1	1,340
Total	<u>\$317.9</u>	<u>6,757</u>	<u>\$380.7</u>	<u>12,312</u>	<u>\$468.6</u>	<u>23,364</u>	<u>\$641.2</u>	<u>32,986</u>	<u>\$589.6</u>	<u>35,065</u>
% California	100.0%		100.0%		88.5%		74.1%		71.5%	

* Excludes health insurance included in Combined.

The Company has grown nationally into a decentralized network of 16 regional offices and 21 branch offices (8 regional offices and 2 branch offices in California). The organization is structured so that the Company benefits from the close customer relationships that are maintained by the regional and branch personnel.

The Company typically has low start-up costs when opening a new branch office. The Company expands into new regions by establishing a branch office with three employees specializing in marketing, underwriting and loss control. As a branch office grows and there is a demonstrated need for further infrastructure to support growth, resources are added and the branch is made a

regional office. Regional offices have additional local management and support the growth of additional branch offices. Target has developed an extensive network of offices throughout the U.S. and currently employs a staff of 270 outside of California.

Target markets its products through a distribution network of approximately 1,700 independent brokers. Of these, over 1,300 are located in California, and approximately 400 are outside California. The Company markets its policies through major national brokers as well as through small-to medium-sized producers focusing on regional customers. The top ten producers accounted for 18.5% of direct written premium in fiscal 1997.

Underwriting

Target's underwriting decisions are generally left in the hands of independently operating branch offices. Target's Home Office periodically attempted to direct the field operations in new, higher priced directions, but was unable to prevail on the branch offices to execute Home Office plans. Until quite recently, branch executives were encouraged to generate new premium with relatively little emphasis being placed on underwriting profitability. Target's management paid little attention to industry pricing, or pricing guidelines established by the rating agencies, and in the extremely competitive open rating environment these were deadly oversights. Target's size generated economies of scale that permitted high loss ratios relative to most industry players, but even the high 60 to low 70 percent ratios booked by Target were insufficient, resulting in a fourth quarter charge that shook MCS' confidence in Target and its management, resulting in Target's sale.

Claims

The Company follows a team-based, customer-driven claims approach that emphasizes managing the work place injury, not simply processing a claim. The Company believes that immediate medical intervention is an important catalyst for controlling medical costs, promptly returning injured employees to work, and minimizing litigation expenses. By commencing medical care as soon as possible, medical costs and recovery time can be substantially reduced. In order to execute its claims management strategy, the Company has made a significant commitment to employee training. Entry level claims trainees participate in an intensive, six week training program held at the Company's training facility in San Jose, California.

In 1992, the Company developed the Special Investigations Unit. This group is responsible for developing potentially fraudulent cases and referring them to the Department of Insurance and District Attorney's offices. The group also serves as a training resource for employees and customers in areas of fraud recognition, trends and legal updates. The group consists of former law enforcement officials and medical and claims experts who are qualified to handle potentially fraudulent situations. Through 1997, the unit has been responsible for 241 referrals to insurance departments and District Attorney's offices, 80 criminal cases filed, 23 arrests and 14 convictions.

Ratings

Target is currently rated “B++” (Very Good) by A.M. Best, a rating it was assigned in February 1998. The “B++” rating marks a downgrade from the “A-” (Excellent) rating Target had held from 1993 to 1998. The following factors were relevant in A.M. Best’s decision to downgrade the rating: Target’s projected 1997 underwriting loss and reduced capital position following the announcement that it would increase loss reserves in response to adverse loss development on its most recent accident years, the continued uncertainty related to the pricing environment in Target’s core California market, Target’s aggressive premium growth over the past few years, the potential for further adverse loss development impacting future earnings (i.e. Target may still be under reserved), the capital position of Target, and the uncertainty regarding Target’s future ownership. In February 1998, the “B++” rating was placed under review by A.M. Best with negative implications.

A.M. Best’s ratings are based upon the evaluation of an insurer’s: (i) financial strength (leverage/capitalization, capital structure/holding company, quality and appropriateness of reinsurance program, adequacy of loss reserves, quality and diversification of assets, and liquidity); (ii) operating performance (profitability, revenue composition, and management experience and objectives; and (iii) market profile (market risk, competitive market position, spread of risk and event risk).

One factor in an insurer’s ability to compete effectively is its A.M. Best rating because some customers and insurance brokers require certain ratings as a prerequisite for writing business with an insurance company. The reduction of Target’s A.M. Best rating in February 1998 may have had an adverse effect on Target’s competitive position in the nationwide workers’ compensation insurance market.

Investments

As of December 31, 1997, approximately 98% of Target’s investment portfolio was held in fixed income securities, of which 93% are rated A or better and 89% are invested in municipal securities. The Company maintains a minimum rating requirement of BBB. As of December 31, 1997, the average duration of Target’s portfolio was 3.88 years. At the same date, the market value of the portfolio was \$617.7 million and its book value was \$610.0 million.

TARGET HISTORICAL FINANCIAL INFORMATION

Summarized below are Target's audited results for the previous five years.

Historical Target Income Statement (\$ in thousands)

GAAP	1993	1994	1995	1996	1997
Gross Premiums Written	\$332,772	\$364,466	\$421,422	\$641,113	\$668,906
Net Premiums Written	240,991	343,006	397,077	490,367	526,925
Net Premiums Earned	233,341	340,097	390,974	480,828	515,272
Investment Income	13,711	16,146	24,005	33,317	37,548
Net capital gains	2,539	(61)	1,667	892	7,176
Other Income	0	96	248	2,823	3,512
Total Revenues	249,591	356,278	416,894	517,860	563,508
Loss and LAE	169,828	218,240	245,522	381,897	443,204
Other Underwriting Expenses	49,262	75,364	114,918	107,640	168,187
Policyholder Dividends	24,487	11,176	5,494	(5,250)	793
Interest Expense	946	-	-	4,330	8,326
Total Expenses	244,698	304,926	366,190	489,526	621,772
Income from Continuing Operations	4,893	51,352	50,704	28,334	(58,264)
FIT (Benefit)	(1,461)	13,832	12,952	2,934	(28,847)
Net Income	\$6,354	\$37,520	\$37,752	\$25,400	\$(29,417)
Net Income Excluding Realized Gains	4,704	37,560	36,668	24,820	(34,081)
Loss Ratio	72.8%	64.2%	62.8%	79.4%	86.0%
Expense Ratio	31.6%	25.4%	30.8%	21.3%	32.8%
Combined Ratio	104.4%	89.6%	93.6%	100.7%	118.8%

Prior to initiating a formal sale process for Target, MCS retained an actuarial firm to evaluate the reserve adequacy of the insurance subsidiaries of Target. Based upon the results of this reserve study, Target put up additional pre-tax reserves of \$75.2 million for the year ended December 31, 1997, bringing the reserves of Target's insurance subsidiaries up to the adequacy level suggested by the outside actuary. This was the primary component of Target's loss of \$29.4 million in 1997.

Selected Historical Target Balance Sheet Items
(\$ in thousands)

GAAP					
<u>Assets</u>	1993	1994	1995	1996	1997
Total investments	\$362,133	\$419,053	\$529,515	\$754,652	\$763,171
Reinsurance receivables	119,050	104,573	81,545	136,109	229,521
Other assets	120,840	104,229	138,044	203,012	229,714
Total assets	\$602,023	\$627,855	\$749,104	\$1,093,773	\$1,222,406
<u>Liabilities</u>					
Loss and loss adjustment expense reserves	386,194	412,666	443,600	590,595	728,421
Long-term debt (Intercompany to parent)	-	-	-	128,250	121,250
Other liabilities	79,945	66,877	64,641	107,036	120,389
Total liabilities	466,139	479,543	508,241	825,881	970,060
<u>Stockholders' equity</u>					
Common Equity	135,884	148,312	240,890	267,892	252,346
Total liabilities and stockholders' equity	\$602,023	\$627,855	\$749,104	\$1,093,773	\$1,222,406
Statutory					
Statutory Surplus		\$126,687	\$151,652	\$286,048	\$258,110

THE BUYER

Buyer is a publicly traded insurance holding company, which through its insurance subsidiaries, writes workers' compensation insurance in California and Arizona. The Company is currently the eighth largest private writer of workers' compensation insurance in California with a market capitalization of approximately \$158 million, based on fully diluted shares outstanding.

History

Buyer was formed in 1985 to write primarily workers' compensation insurance in California and capitalized with \$11.1 million raised in a private common stock offering (including \$3.3 million from insurance brokers). A second private offering in 1987 raised an additional \$4.3 million.

From the Company's formation in 1985 through 1991, Buyer experienced significant growth. Workers' compensation premiums grew from \$17 million in 1986 to \$104 million in 1991. Beginning in 1987, the Company expanded its writings into general property and casualty lines. These lines proved to be very unprofitable. Although the Company remained profitable overall during this time period, results were bolstered by a financial reinsurance transaction with North American Re, which allowed the Company to spread its losses over a period of years. In 1991, California insurance regulators became increasingly uncomfortable with the Company's capital position. These concerns were exacerbated by concern over the Company's financial reinsurance with North American Re because the treaty did not involve any real risk transfer.

Financial Restructuring

In 1991, the Company commenced a financial restructuring program which included an aggregate excess of loss reinsurance contract with Centre Re and an investment by International Insurance Investors, L.P. ("III"), a partnership controlled by Centre Re and Bob Spass. On June 30, 1991 the Company entered into an excess of loss reinsurance contract with Centre Re in which it purchased \$87.5 million in coverage for a premium of \$50 million. Additionally, on March 31, 1992, Buyer issued approximately \$10.4 million of 14.5% Subordinated Notes to III. Attached to the notes were Warrants to purchase approximately 1.5 million shares of Buyer common stock at a price of \$4 per share. These Notes were repaid June 30, 1994. In addition, the Company issued to III \$30,000 of Voting Notes that gave III the ability to vote in the election of directors of the Company. Since this date III has had three representatives serve on Buyer's board of directors. Two of those representatives, Bob Spass and Brad Cooper, have management responsibilities related to Insurance Partners, L.P. ("IP") and Insurance Partners II, L.P. ("IP2"). IP and IP2 are investment partnerships formed for the purpose of making investments in securities of a diversified global portfolio of insurance, financial services, and healthcare services companies and other related businesses. Formed in 1994, IP had total committed capital of \$540 million and to date has achieved a net IRR in excess of 70%. IP2 is currently in the process of being formed and is expected to have committed capital in excess of \$1.75 billion. Major partners will include the Zurich Group and The Chase Manhattan Bank.

On January 1, 1993 the Company entered into a separate excess of loss reinsurance contract with Centre Re in which they agreed to cede \$15 million of premium annually for varying amounts of cover. This contract was terminated by Buyer on January 1, 1996. Buyer maintains a quota share contract with Zurich Reinsurance Centre entered into on January 1, 1994. Pursuant to this contract the Company ceded 20% of its premium in 1994 and 5% in 1995 and 1996. Effective January 1, 1997, the terms of the contract were amended whereby ZRNA increased its participation to 6.5%.

In June of 1994, the Company further strengthened its financial position by selling \$20 million of preferred stock to an affiliate of Centre Re. Attached to the preferred stock were Warrants to purchase 579,357 shares of Buyer common stock at \$5.20 per share. The preferred stock was redeemed in connection with the acquisition of Pac Rim.

Acquisition of Pac Rim

In April 1997, the Company acquired Pac Rim Holding Corporation, the parent company of The Pacific Rim Assurance Company (subsequently renamed Buyer Casualty Corporation), partially financed with a \$16 million common equity investment by IP. BCC historically underwrote larger accounts than Buyer Insurance Company ("BIC"), and in a more limited range of risk classification codes. In addition, BCC's Southern California operations complement BIC's historical focus on Central and Northern California. As a result of the acquisition of BCC, the Company is the eighth largest California workers' compensation insurer overall, based upon 1996 direct premiums written (and excluding the State Fund).

In connection with the acquisition, the Company agreed with the California Department of Insurance that BCC would operate in “run-off” and that all new or renewal business would be written only by BIC. As a result, the Company has been integrating BCC’s pre-acquisition operations into BIC’s operations and has substantially completed the process. The acquisition has enabled the Company to increase its book of California workers’ compensation business and generate significant expense savings through the consolidation of the back office operations of the two companies. In addition, since BCC’s acquisition, the Company has been re-underwriting BCC’s book of business at policy renewal dates in conformity with BIC’s historic underwriting standards and pricing guidelines. BCC’s average policy size has declined significantly, standing at approximately \$17,000 for the policy year ended December 31, 1997 versus approximately \$20,300 for the policy year ended December 31, 1996. Management believes that the re-underwriting of BCC’s business will produce a new book of business mirroring BIC’s historical book of business, both as to the size and range of risk classifications, by the end of 1998.

Current Ownership Structure

The Company is publicly traded on the Nasdaq, with approximately 8,298,000 shares outstanding on a fully diluted basis. The latest closing price of the Company’s common stock was \$19 per share. The Company’s current ownership profile is shown in the table below:

Shareholder	Shares Held	% of Total
Insurance Partners	2,124	25.6%
Centre Re Warrants	579	7.0
III Warrants	1,243	15.0
Management/Other Warrants	328	4.0
Management Options	289	3.5
Public Shareholders	3,735	45.0
Total	8,298	100.0%

Current Business Focus

Buyer markets and underwrites workers’ compensation insurance principally in California through its two wholly-owned insurance subsidiaries, Buyer Insurance Company and Buyer Casualty Company. The Company traditionally has focused its marketing efforts on policies with annual premium under \$50,000, primarily to avoid the extreme price competition usually associated with larger accounts, and it also has a cost advantage due to SWAMI and related systems. However, Buyer has recently begun to dramatically increase the number of accounts with premium over \$100,000 as the Company entered into a quota share reinsurance agreement under which it cedes 100% of the accounts greater than \$100,000 to a reinsurer and receives a fee (ceding commission) equal to 35% of the premiums ceded. This commission is significantly in excess of what it costs the Buyer to write the premium. Therefore, the quota share contract effectively places the Company in the position of an intermediary collecting a fee for producing large account business for the reinsurance market. This strategy makes sense given the price competition taking place in the large account segment of the California comp market, and further, leaves control of the large account business in Buyer’s hands until such time that the market hardens.

Although the Company writes over 400 of the approximately 500 employment classifications established by the Workers' Compensation Insurance Bureau (the "WCIRB"), it targets specific classifications that the Company believes to be profitable, in particular classifications including office and clerical, hospitality, agricultural, garment and health care workers. Buyer primarily distributes through approximately 250 small to medium-sized producers located throughout California and Arizona. In addition to California, the Company is also licensed to write business in 18 other states and the District of Columbia. However, virtually all of Buyer's premium is generated in California (94%) and Arizona (6%).

Premium Stratification by Size as of March 31, 1998
(\$ in millions)

<u>Premium Range</u>	<u>EAP</u>	<u>% of Total</u>	<u># of Policies</u>	<u>% of Total</u>
Under \$25,001	\$63.0	42.4%	15,450	93.6%
\$25,001-\$50,000	19.8	13.4	568	3.4
\$50,001-\$100,000	21.1	14.2	306	1.9
\$100,001-\$200,000	15.5	10.4	112	0.7
\$200,001-\$500,000	16.7	11.3	58	0.4
Over \$500,000	<u>12.3</u>	<u>8.3</u>	<u>12</u>	<u>0.1</u>
	<u>\$148.5</u>	<u>100.0%</u>	<u>16,506</u>	<u>100.0%</u>

BIC is currently rated "BBB" by Standard and Poor's and "B+" (Very Good) by A.M. Best, a rating it has held since 1995.

Strategy

The key facets of Buyer's strategy are the following: (i) focus on selected policy sizes and employment classifications that management believes provide the greatest opportunity for profitability; (ii) maintain consistently stringent underwriting policies in order to maintain gross profit margins; (iii) develop and maintain strong relationships with small to medium-sized independent insurance producers; and (iv) capitalize on the competitive advantage provided by its proprietary information technology system which enhances the effectiveness of employees' underwriting, policy administration and claims activities, provides detailed, real-time and near real-time information to management for control and administrative purposes and provides marketing benefits through improved customer service.

Rationale for the Acquisition

The Buyer has a number of reasons for desiring to acquire Target. Included among them are the following:

- Buyer will grow from the eighth largest workers' compensation carrier in California to the largest private sector workers' compensation carrier in California, based on available data on 1997 direct premiums written.
- While increasing its presence in California, the Buyer will also diversify geographically by acquiring Target's non-California book of business, thereby lessening its dependence on the California market for workers' compensation insurance.
- The Company will have the opportunity to improve Target's financial performance by implementing Buyer's underwriting policies and applying its expertise in information systems.
- The Company will benefit from economies of scale over a period of years, potentially realizing cost savings as a result.

Distribution

Buyer distributes its products through approximately 250 small to medium-sized producers located throughout California and Arizona. Because these producers also represent one or more competing insurance companies, the Company views the producers as its marketing target and delivers service that the Company believes surpasses normal industry levels. Buyer's percentage of business with each of its producers, in terms of premium volume, has a significant effect on a producer's efforts, because management believes companies that represent a significant volume of a producer's business typically receive the highest quality business. The Company is one of the primary underwriters of workers' compensation insurance for most of its producers. During the year ended December 31, 1997, no single producer controlled more than 5.0% of premium in force.

Buyer's proprietary computer system allows the Company to carefully monitor the volume and profitability of business of each producer, canceling producers who consistently write unprofitable business or fall below the minimum annual premium guidelines.

The marketing staff, along with the branch office managers and the underwriting, loss control, and regional claims staffs, work closely with producers and frequently make joint presentations with producers to potential workers' compensation policyholders. Buyer conducts its marketing by territory to enable its marketing representatives to better address the specific types of accounts located in each region.

Producer commissions are generally determined by negotiation and are dependent on the size and profit potential of the producer's accounts. Buyer's average direct commission rate was 11.1% for the years ended December 31, 1997, and 1996 and 12.0% in 1995. The Company believes the stabilization in the average direct commission rate for 1997 was due primarily to a combination of firming prices and a greater use by larger policyholders of fee-based arrangements (as opposed to traditional commission arrangements) with their insurance brokers. Buyer's producers are not permitted to bind the Company with respect to any account. All new and renewal policyholder applications must be submitted to the Company for approval.

Underwriting

Prior to insuring an account, Buyer's underwriting department reviews the employer's prior loss experience and safety record; premium payment and credit history; operations; geographic location; and employment classifications. In many instances, the Company verifies employment classifications through its own on-site surveys of the employer's place of business. If the underwriting department determines that Buyer may be willing to insure an account, a Company loss control consultant generally reviews the employer's prior loss patterns and consults with the policyholder to assess the extent to which losses may be prevented and the policyholder's commitment to safety in the workplace.

The SWAMI system is an integral part of underwriting at the Company. The system is a fully-integrated rating, quoting, and policy issuance system for use both internally and remotely from producers' offices. The system contains edit and blocking features that prohibit underwriters from issuing policies associated with business that is deemed inappropriate or undesirable by management, or that may be inappropriately priced. The system permits management to evaluate commissions, in force business, collections activity and producer pricing in detail, utilizing information that is no more than 24 hours old.

Buyer conducts its underwriting activities through branch offices. Branch offices are typically allowed to write accounts; however, accounts with estimated annual premiums of greater than \$250,000 or in certain higher risk classifications must be approved by Buyer's principal underwriting officer.

Systems

The Company's computer systems are among the best in the insurance industry. The SWAMI system enables the Company to compete more effectively through enhanced policyholder services, efficient underwriting, more effective claim support systems, reduced processing costs and timely management information. One of the Company's key strategic initiatives is the maintenance of a creative, flexible and dynamic data processing capability.

The Company began to upgrade its data processing operations in late 1991, and in 1997 spent or capitalized 3% of direct premiums written annually on these operations. In 1998, this figure is expected to decline to 2%. The Company developed the proprietary SWAMI software system internally. The system is operated on off-the-shelf computer hardware, including a commercial local area network communications system. The Company's personal computer technology approach provides flexibility at low cost, and the structure of the system makes it expandable well beyond the Company's current needs.

One of management's primary goals in improving its systems was to enhance the quality, quantity and timeliness of information available to management to: 1) monitor the Company's operations and 2) feed back corrections to personnel. Management believes that most insurance companies monitor their operations and feed back corrections to their staff quarterly, a large minority annually and a small minority monthly. At Buyer, management views quarterly monitoring and feedback as insufficient. With the SWAMI system, management monitors operations and gives feedback at least weekly and often daily. Management believes this is

necessary due to the information intensive nature of the insurance business - lack of information constitutes a major underwriting risk.

The SWAMI system allows management to review claim frequency and severity by line components; and paid, reported and ultimate losses by producing office, claims servicing office, agent and underwriter. The system also gives immediate access to details behind the numbers in a format that is easily understandable to non-actuarial and data processing personnel. SWAMI has rendered obsolete virtually all of the data processing generated paper reports historically used by the Company. The Company is continually examining ways to improve the system and how it is used. During the past year, the Company implemented a proprietary document imaging system that combined with sophisticated workflow protocols, improves the productivity of the Company's claims staff. The Company has comprehensive physical and virtual safeguards for its information and processing systems. Disaster recovery programs and back-up procedures include nightly back-up storage of all transactions and changes to the system's database. This information is transferred to off-site storage daily.

Investments

The Company's portfolio consisted almost entirely of fixed income securities as of December 31, 1997, and 91% of the portfolio was rated AA or better.

HISTORICAL BUYER FINANCIAL INFORMATION

Historical Income Statement **(\$ in thousands)**

GAAP	1993	1994	1995	1996	1997
Gross Premiums Written	\$157,986	\$134,769	\$97,084	\$99,282	\$159,352
Net Premiums Written	154,431	105,946	89,139	87,715	136,929
Net Premiums Earned ⁽¹⁾	153,585	110,418	89,735	88,648	140,920
Investment Income	8,481	9,014	10,309	7,738	12,630
Net Capital Gains	1,069	35	(525)	31	44
Other Income	(743)	(340)	(536)	186	(817)
Total Revenues	162,392	119,127	98,983	96,603	152,777
Loss and LAE	113,817	78,761	53,970	55,638	90,447
Underwriting Expenses	28,779	21,660	29,447	34,138	37,695
Other Expenses	18,335	14,049	4,413	1,414	8,191
Total Expenses	160,931	114,470	87,830	91,190	136,333
Pre-Tax Income Before Extra., Pfd Div.	2,204	4,997	11,689	5,227	17,261
FIT (Benefit)	530	1,398	(12)	1,597	6,437
Net Income from Continuing Operations	2,734	3,599	11,701	3,630	10,824
Net Income Excluding Realized Gains	2,039	2,576	12,042	3,610	10,795
Basic EPS	\$0.80	\$1.05	\$3.41	\$1.06	\$2.06
Diluted EPS	\$0.58	\$0.70	\$2.97	\$0.75	\$1.54

Historical Balance Sheet
(\$ in thousands)

GAAP				
Assets	1994	1995	1996	1997
Total investments	\$ 174,345	\$165,408	\$149,440	\$242,116
Reinsurance recoverable	66,166	38,051	25,274	53,082
Deferred policy acquisition costs	2,905	2,780	3,042	5,879
Deferred taxes	5,645	10,085	9,520	12,200
Receivable from reinsurer	0	0	93,266	0
Goodwill (1)	0	0	0	35,887
Other assets	37,715	28,018	26,027	67,405
Total assets	\$286,776	\$244,342	\$306,569	\$416,569
Liabilities				
Loss and loss adjustment expense reserves	\$171,258	\$140,774	\$115,529	\$201,255
Unearned premiums	10,728	10,220	9,702	12,913
Long-term debt	9,730	8,530	98,961	30
Other liabilities	35,906	20,293	13,615	41,276
Total liabilities	227,622	179,817	237,807	255,474
Preferred Securities				
Preferred securities issued by affiliate(2)	0	0	23,571	0
Company-Obligated Trust Preferred(3)	0	0	0	101,277
Stockholders' equity				
Common Equity	40,364	43,480	45,191	59,818
Total liabilities, preferred securities stockholders' equity	\$286,776	\$244,342	\$306,569	\$416,569
Statutory				
Statutory Surplus(1)	\$65,526	\$51,894	\$51,998	\$102,205

(1) Related to the acquisition of Pac Rim.

(2) Utilizing proceeds from the issuance of Senior Subordinated Notes in connection with the Trust Preferred Issuance, Buyer redeemed this preferred stock issued by an affiliate of Buyer to an affiliate of the Zurich.

(3) Related to the issuance of the Trust Preferred Securities.