MOODY'S
INVESTORS SERVICE

Credit Opinion: Harleysville Group Inc.

Global Credit Research - 29 Jun 2010

Harleysville, Pennsylvania, United States

Ratings

Category	Moody's Rating
Rating Outlook	STA
Senior Unsecured	Baa2
Harleysville Mutual Insurance Company	
Rating Outlook	STA
Insurance Financial Strength	A3
Rated Intercompany Pool Members	
Rating Outlook	STA
Insurance Financial Strength	A3

Contacts

Analyst	Phone
Alan Murray/New York	1.212.553.1653
Pano Karambelas/New York	
Robert Riegel/New York	
Benjamin Goldberg/New York	

Key Indicators

Harleysville Group Inc.[1]

	2009	2008	2007	2006	2005
Total Assets ($ Mil.)	$ 3,302	$ 3,155	$ 3,072	$ 2,991	$ 2,905
Equity ($ Mil.)	$ 773	$ 653	$ 759	$ 712	$ 614
Net Income ($ Mil.)	$ 86	$ 42	$ 100	$ 111	$ 61
Gross Premiums Written ($ Mil.)	$ 968	$ 1,057	$ 930	$ 926	$ 934
Net Premiums Written ($ Mil.)	$ 852	$ 950	$ 838	$ 839	$ 839
High Risk Assets % Shareholders' Equity	24.4%	15.6%	10.1%	10.0%	29.3%
Reinsurance Recoverables % Shareholders' Equity	35.6%	38.9%	27.2%	28.7%	46.1%
Goodwill & Intangibles % Shareholders' Equity	14.5%	16.9%	13.4%	14.4%	17.0%
Gross Underwriting Leverage	3.6x	4.4x	3.3x	3.4x	4.0x
Return on Capital (1 yr.)	10.4%	5.1%	11.7%	14.2%	8.5%
Sharpe Ratio of ROC (5 yr.)	291.6%	246.6%	---	---	---
Adv/(Fav) Dev. % Beg. Reserves (1 yr.)	-2.3%	-2.3%	-1.7%	-1.5%	-1.5%
Adjusted Financial Leverage	20.9%	25.0%	16.8%	19.2%	23.0%
Total Leverage	20.9%	25.0%	16.8%	19.2%	23.0%
Earnings Coverage (1 yr.)	11.9x	5.0x	17.0x	17.3x	9.4x
Cashflow Coverage (1 yr.)	14.7x	9.0x	15.8x	16.9x	9.4x

[1] Information based on GAAP financial statements

Opinion

SUMMARY RATING RATIONALE

Moody's A3 insurance financial strength ratings on members of the Harleysville Insurance intercompany pool and Baa2 rating on the senior debt of Harleysville Group Inc. (HGIC) consider Harleysville's established regional presence in small business commercial lines insurance, its strong reserve position, its high-quality investment portfolio and good cash flows, as well as its conservative financial leverage. Additionally, HGIC has a good geographic spread of risk, which has been achieved over time through a combination of internal growth and acquisitions. The company's application of predictive modeling, especially to its small business customer segment, also has contributed to improved underwriting performance and risk selection. These strengths are tempered by an intensely competitive environment in business insurance which is likely to continue to constrain profitability, the company's relatively high expense ratio, by its relatively limited scale in personal lines, and by above-average regional exposures to losses arising from natural catastrophes - primarily North Atlantic windstorms. HGIC writes a broad range of standard commercial lines (approximately four-fifths of net premiums written) and personal lines coverages through independent agents in the eastern and midwestern US. Approximately half of Harleysville's commercial insurance operations pertain to the middle-market segment, which comprises somewhat larger accounts that tend to be subject to a higher degree of market price competition.

Credit Strengths

- Established regional presence with strong agency network in the small business commercial insurance market

- Geographic diversification has improved through internal growth and acquisitions

- High-quality investment portfolio, with strong liquidity and operating cash flows

- Very good capitalization with conservative parent company leverage

Credit Challenges

- Limited scale in an increasingly competitive environment in small business commercial and personal lines

- Exposures to natural catastrophe losses arising from regional underwriting concentrations

- Relatively lagging - though improving - core earnings and underwriting performance, in recent years, when compared to peer group

Rating Outlook

The outlook for the insurance financial strength ratings of the members of the Harleysville intercompany pool and the debt ratings of HGIC is stable. Moody's also expects that the company will continue to deliver sustained improvement in operating results and achieve an overall combined ratio of below 100% in the medium term.

What Could Change the Rating - Up

The following could lead to a rating upgrade:

- Enhanced scale and market presence in the company's chosen agency-based small business and personal lines insurance markets;

- Reduced gross and net catastrophe underwriting exposure profile, relative to total capitalization;

- Sustained underwriting profitability (e.g. combined ratios around 100% or better through the cycle), with improved underwriting margins in the group's flagship business insurance segment;

- A sustained reduction in the company's expense ratio (e.g. to approximately 30%), contributing to improved efficiency;

- Adjusted financial leverage below 20%.

What Could Change the Rating - Down

The following could lead to a rating downgrade

- Combined ratios of 105% or greater;

- A decrease in capitalization of 10% or more over a 1-year period resulting from catastrophe losses and/or adverse loss reserve development;

- Adjusted financial leverage in excess of 30%;

- Operating leverage (NPW to surplus) in excess of 2 times;

- Interest coverage in the low single-digit range.

Notching Considerations

Harleysville Mutual Insurance Company owns approximately 53% of publicly-traded HGIC. The mutual ownership structure provides additional financial flexibility to HGIC, which is reflected in the two notch spread between the insurance financial strength and senior debt ratings, rather than the customary three-notch spread for insurers and their holding companies. Harleysville Mutual's relationship with HGIC also includes participation in the group's intercompany pooling agreement.

Recent Results and Developments

For the first quarter of 2010, Harleysville report net income of $8.1 million and net premiums earned of $209 million, as compared to $17.3 million and $218 million, respectively for the same period in 2009. The decline in quarterly earnings primarily reflected significant 1Q2010 winter and rain storm losses, particularly in the Northeastern states. In 2009, Harleysville reported GAAP net income of $86.3 million, as compared with income of $42.3 million in 2008. Results in 2009 included an overall combined ratio of approximately 100%, with personal and commercial lines contributing combined ratios of approximately 97% and 101%, respectively. The group's statutory underwriting expense ratio, at just over 34% in 2009, remains essentially unchanged. Client retention trends appear to remain stable. Unlike many of its industry peers, Harleysville Group has reported only very nominal investment-related impairments during the recent credit crisis, reflecting the very high quality of its investment portfolio.

DETAILED RATING CONSIDERATIONS

Moody's rates Harleysville Mutual Insurance Company and members of its inter-company pool A3 for insurance financial strength, which is in line with the adjusted rating indicated by the Moody's insurance financial strength rating scorecard.

Insurance Financial Strength Rating

Factor 1: Market Position, Brand and Distribution: Baa

HGIC has a strong regional franchise in eastern and midwestern states with good brand recognition among its independent agents, notwithstanding its relatively small overall market share, which is the basis of our view of the company's overall franchise position being consistent with expectations for Baa-rated insurers. The company had strategically shifted its focus toward small to medium-sized commercial lines business and away from what had been its less profitable personal lines business several years ago. In the most recent years, the company's personal lines business has grown somewhat through targeted expansion with the improved profitability of that business. One of HGIC's key competitive advantages is its established relationships with independent agents, which it continues to strengthen through significant investments in technology to standardize underwriting processes and improve agents' ease of doing business with the company.

HGIC was an early adopter of predictive modeling technology, enabling it to develop the expertise for refined risk segmentation and pricing ahead of other regional carriers - a significant competitive advantage in the small commercial lines market. Although Moody's believes HGIC will be challenged to compete effectively over the longer term against the better-scale efficiencies and superior technology of several larger competitors, the company's focus and established position in the regional small business insurance segment, its long-standing agency relationships and its favorable regional underwriting presence should help sustain its competitive position in the near term.

HGIC's expense ratio is slightly higher relative to similarly rated peers mainly because of the company's focus on providing a high level of customized services, especially to its middle-market commercial lines customers. Going forward, as the company rolls out its agent portal and other tools for integrating and automating the production process, we expect some improvement in the expense ratio.

Factor 2: Product Risk and Diversification: A

HGIC has good product diversification and fairly broad geographic diversification across the eastern and mid-western states. The company's three largest segments are commercial multi-peril, commercial automobile and workers' compensation, which together account for more than three-quarters of net premiums written. A potential source of earnings volatility is HGIC's dependence on medium-sized commercial accounts, which comprise a significant proportion of commercial lines net premiums written. Personal lines insurance provides an important element of diversification against the more volatile long-tail commercial lines business and the company has been gradually increasing its presence in personal lines in recent years as it has improved the quality and profitability of its overall business.

HGIC's product diversification benefits are somewhat tempered by the geographic concentration of over half of its business being in New York, New Jersey and Pennsylvania, the first two of which have challenging regulatory and legal environments.

Factor 3: Asset Quality: Aa

HGIC has a very high-quality investment portfolio comprised primarily of investment grade, fixed-income securities, as reflected in the fact that high-risk assets, as defined by Moody's accounted for less than 8% of invested assets at year-end 2009. Equity securities, comprising 7% of the portfolio as of year-end 2009, should enhance long-term capital appreciation without adding undue volatility to the group's capitalization. Harleysville's credit exposures to sub-prime and other distressed asset classes is modest, primarily reflecting the company's focus on underwriting profitability as the source of most of its internal capital generation, together with maintaining a high quality and liquid investment portfolio to support its insurance and reinsurance liabilities.

The group's conservative use of reinsurance is a further credit strength, and with over 90% of its reinsurers rated excellent or better, HGIC's recoverables are generally of very good credit quality. There are no intangible assets associated with goodwill. Overall, Moody's views the company's overall asset quality indication as being more consistent with a Aa-rated insurer, reflecting some degree of credit and market risk in its investment portfolio.

Factor 4: Capital Adequacy: A

HGIC's capital adequacy is supported by modest GAAP gross underwriting leverage of 3.6 times at year-end 2009, and good risk-adjusted capitalization, as measured by Moody's Risk-Adjusted Capital model. HGIC has exposure to catastrophe losses primarily hurricanes, tornadoes and hailstorms, and to a lesser degree, earthquakes. The company manages its catastrophe exposures through the use of sophisticated modeling tools, policy limits on coastal business and the use of reinsurance.

The company seeks to limit the after-tax net impact to a one-in-250-year event to no more than 40% of policyholders' surplus. Notwithstanding Harleysville's solid risk-adjusted capitalization, Moody's considers this benchmark to be somewhat high for an A-rated insurer, and it - together with gross catastrophe exposures that are likewise outsized relative to similarly-rated peers - is therefore a meaningful consideration in the group's overall rating profile. We also note that the impact of unrealized investment losses on Harleysville's capital at year-end 2008 and 2009 was nominal, reflecting the group's very conservative investment profile.

Factor 5: Profitability: A

With a five-year average return on capital of 10.0% and some volatility in earnings growth due to adverse loss development in prior years, Moody's considers HGIC's historical profitability track record to be on par with expectations for A-rated competitors, notwithstanding the group's break-even combined ratios. In recent years, HGIC's underwriting profitability for both personal and commercial lines has demonstrated improvement, driven by favorable reserve development, renewed underwriting discipline and management efforts to improve operational efficiency and performance. Consequently, we expect the company to perform consistently with expectations for A-rated insurers on a go-forward basis. We expect that HGIC will maintain its underwriting discipline and strong relationships with agents, although underwriting margins will likely narrow.

Factor 6: Reserve Adequacy: A

HGIC benefits from strong reserve adequacy, as evidenced by favorable reserve development over the past three years. Moody's believes that core reserves are within a reasonable range. We expect HGIC's current reserve cushion to diminish going forward, as market conditions deteriorate and pricing competition intensifies.

Although HGIC has some exposure to A&E claims, its focus on small commercial risks significantly lessens the likelihood of large judgments against the group. Furthermore, since the intercompany pooling agreement pertains to post-1986 business, the group has not incurred significant A&E losses. Consequently, we view exposure to latent liabilities as not being a meaningful consideration with respect to the group's overall credit profile.

Factor 7: Financial Flexibility: A

HGIC's 21% adjusted financial leverage ratio is relatively low in comparison with similarly rated peers. Included in the debt figure is approximately $118.5 million debt securities issued, as well as other adjustments for pension underfunding (about $60 million at year-end 2009) and lease obligations. Additionally, the company's very strong cash flow coverage and good earnings coverage of interest expense underscore its strong earnings and liquidity position, which are at levels that are characteristic of Aa-rated insurers. HGIC's publicly traded status provides the company with access to both debt and equity capital. However, Moody's believes the mutual holding company structure and majority ownership by Harleysville Mutual effectively places limits on the group's financial flexibility, relative to larger and entirely publicly-held companies, hence we consider HGIC's financial flexibility to be a positive credit factor, but at a level commensurate with expectations for A-rated insurers.

Earnings and cash flow coverage metrics have been likewise strong, reflecting the healthy dividend capacity of the group's principal subsidiaries (approximately $91 million for 2010, without prior approval, based on capital as reported on December 31, 2009) as well as modest holding company fixed charges.

Rating Factors

Harleysville Group Inc.[1]

Financial Strength Rating Scorecard	**Aaa**	**Aa**	**A**	**Baa**	**Ba**	**B**	**Caa**	**Score**	[2]**Adjusted Score**
Business Profile								**Baa**	**Baa**
Market Position, Brand and Distribution (25%)								**Baa**	**Baa**
Relative Market Share Ratio				**X**					
Underwriting Expense Ratio % Net Premiums Written					**X**				
Product Risk and Diversification (10%)								**Aa**	**A**
Product Risk		**X**							
P&C Insurance Product Diversification			**X**						
Geographic Diversification		**X**							
Financial Profile								**Aa**	**A**
Asset Quality (10%)								**Aaa**	**Aa**
High Risk Assets % Shareholders' Equity	**24.4%**								
Reinsurance Recoverables % Shareholders' Equity		**35.6%**							
Goodwill & Intangibles % Shareholders' Equity	**14.5%**								
Capital Adequacy (15%)								**A**	**A**
Gross Underwriting Leverage			**3.6x**						
Profitability (15%)								**Aa**	**A**
Return on Capital (5 yr. avg)		**10.0%**							
Sharpe Ratio of ROC (5 yr. avg)			**291.6%**						
Reserve Adequacy (10%)								**Aaa**	**A**
Adv./(Fav.) Loss Dev. % Beg. Reserves (5 yr. avg.)	**-2.0%**								
Financial Flexibility (15%)								**Aa**	**A**
Adjusted Financial Leverage		**20.9%**							
Total Leverage		**20.9%**							
Earnings Coverage (5 yr. avg.)	**12.1x**								
Cashflow Coverage (5 yr. avg.)	**13.2x**								
Operating Environment (0%)								**Aaa - A**	**Aaa - A**
Aggregate Profile								**A1**	**A3**

[1] Information based on GAAP financial statements [2] The Scorecard rating is an important component of the company's published rating, reflecting the stand-alone financial strength before other considerations (discussed above) are incorporated into the analysis