

## PoleStar Investment Research LLC

One Market Steuart Tower  
Suite 1642  
San Francisco, CA 94105  
(415) 546 1500

Security transactions through Samuels Chase & Co., Inc., registered broker-dealer, member NASD/SIPC; Clearing Firm – Bear Stearns & Co., Inc.

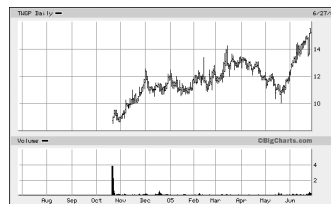
### Tower Group, Inc. (TWGP; \$15.30) – Buy

June 29, 2005

**Excellent Insurer with solid underwriting, conservative management and a unique and highly profitable business model is undervalued despite its strong growth prospects and its relative lack of sensitivity to insurance cycles.**

#### Key Data (\$M except per share data)

Share Price	15.3	Gross Prem ('04)	177.0
52 Wk Hi-Lo	8.50/15.3	Gross Prem ('05)	279.7
Mkt. Cap	307.53	Rev ('04)	108.0
		Rev ('05)	221.8
		U/W Mgn (5-yr avg.)	11.70%
		U/W Mgn (Industry avg.)	-6.80%
Debt	47	U/W Mgn ('05)	12.85%
Total Investments	283	P/E ('05)	15.3x
Book Value/Share	6.45	P/E ('06)	9.9x
ROE ('04)	24.91%	P/Bk ('05)	2.1x
ROE ('05)	12.85%	P/Bk ('06)	1.7x



We had originally launched TWGP at \$10.28 on 11/23/04 at a prior firm. Though we recognize that Tower's stock price has outperformed the market significantly in the last six or so months, we continue to believe that TWGP is likely to trade north of \$20 in the next 12-18 months as it delivers solid results. Tower is a typical name that fits very well on PoleStar's independent platform of extremely well-run companies that are relatively undiscovered or undervalued. We recommend original investors to continue holding this premier insurer and recommend investors wishing to commit fresh funds to TWGP to spread their capital commitment over some time given the illiquid nature of the stock.

Tower Group, Inc. (TWGP) is a unique P&C insurer that primarily serves small and medium businesses in the New York State and the surrounding tri-state area. It has a highly profitable, demand-driven; business model that has shown underwriting margins far exceeding the P&C insurance industry in the last decade. It recently came public (October 2004) and raised \$109M amidst a tough time for the insurance industry. With an A.M. Best upgrade to A-, Tower is now in the process of solid top and bottom-line growth for the next several years. We believe Tower currently suffers from an unsupportive investor perception fostered by the Elliot Spitzer allegations on the entire insurance industry and from a declining EPS (FY04 to FY05) due to its sizable IPO dilution despite an expected doubling of its top and bottom line. We believe Tower is undiscovered and undervalued at 15.3x FY05 P/E (and 9.9x FY06 P/E) and 1.7x P/Book, given its top-notch performance, high insider ownership, consistently profitable underwriting and robust growth prospects. As Tower executes on its profitable growth plans through 2005 and subsequently guides to a much higher and growing EPS, investors should take notice. While some comparable top-notch insurers trade at multiples closer to 20x P/E and 2x Price /Book, we believe TWGP should trade at a similar premier valuation implying a stock price in the \$18-20 range within the next 12-18 months.

- **Unique business model in a large underserved market with limited competition.** Tower offers a wide range of products for low-risk residents and small businesses in the New York and tri-state area. The company targets short-tail, low-severity risks with no exposure to complex deals, giving Tower more control over pricing than its larger peers. TWGP targets only demand-driven markets that it can foresee profitable underwriting for several years. Given the small- policy amounts it writes, it typically finds no competition from big players.
- **Experienced, invested management.** Michael Lee and his senior management team are seasoned and experienced in profitable niche underwriting. Their unique focus on efficient claims management yields above-average margins. We like the high level of insider ownership (greater than 22%) and recent insider buying. We are impressed by Tower focus on benchmarking its performance to industry leaders and to best practices among the top corporate performers in general.
- **Highly profitable underwriting and claims department.** Tower underwrites profitably (U/W margins above 20% for years) and also stands out in its high level of claims efficiency. With a seasoned in-house legal team, it vigorously manages the claims process with its third parties. Tower has outperformed, on an average, its P&C peers by 19 percentage points in underwriting margins over the last 5 years. Though its margins would now come down from the mid 20s to the mid-teens due to a business model change to

**Raj Sharma**

(415) 546-1500

rsharma@polestarresearch.com Page 1 of 10

## PoleStar Investment Research LLC

One Market Steuart Tower  
Suite 1642  
San Francisco, CA 94105  
(415) 546 1500

Security transactions through Samuels Chase & Co., Inc., registered broker-dealer, member NASD/SIPC; Clearing Firm – Bear Stearns & Co., Inc.

### Tower Group, Inc. (TWGP; \$15.30) – Buy

June 29, 2005

writing less agency business and retaining more risk, Tower should still be able to outperform its peers on a consistent basis.

- **New Capital and recent A.M. Best upgrade to generate substantial growth.** A capital infusion of \$108M and a subsequent A.M. Best rating upgrade to A– should allow Tower to write more premiums, retain more risk, and earn higher investment income while being conservative in its underwriting discipline.
- **Conservative Reserves and Reinsurance Management.** Tower's reserves to surplus ratio now stands at 20%, far below many of its peers. Tower writes and reserves against short-tailed business and has not had any adverse development in the last 8 quarters. Tower's reinsurance recoverables' are very manageable since it collateralizes close to 60% of their recoverables' balance.

### Key Competitive Advantages

**Innovative product development and marketing.** Traditional insurance companies develop products based on their own predefined underwriting criteria and then market those products. Tower's strategy is to first identify the market need and then expand the product line by segmenting the insurance market, identifying the profitable segments, and then marketing its products within those profitable segments. Having gained the reputation of being responsive to the needs of its chosen market, Tower concentrates on developing the underwriting criteria to produce underwriting profits.

**Large, underserved market.** New York City alone represents total premiums of \$14B, of which Tower's direct addressable market is close to \$3.5B. In addition, surrounding states represent a market of \$33B in premiums that Tower can now address.

**Opportunistic capital allocation.** Tower keeps an eye on different market segments and develops products in those segments with the best opportunity for underwriting gain based on market conditions. Tower expands its product lines in those profitable segments with significant premium volume and opportunity for market penetration, and maintain the product line but reduce premiums in segments where underwriting profits would get tough to come by.

**Cost-effective and profitable underwriting.** Using technology, efficient business processes, and economies of scale, Tower is able to reduce underwriting expense and succeed in the small-premium-size segment (under \$25,000) where other companies are unable to successfully compete. Tower exploits its flexible operating platform to shift its focus as market conditions change.

#### Tower Group, Inc.

Financial Snapshot	(\$ in millions except per-share data and percentages)					
	2001	2002	2003	2004	2005E	2006E
Gross Written Premiums	57.0	105.3	133.3	177.0	279.7	349.6
Net Earned Premiums	5.6	25.4	22.4	45.1	160.2	236.0
Total Revenues	32.9	62.7	74.7	108.0	221.8	311.8
Net income (loss)	0.4	5.6	6.3	8.9	20.1	31.0
Diluted EPS	0.01	0.94	1.09	1.06	1.00	1.55
FD Shares O/S	4.6	5.8	5.7	8.5	20.1	20.1
Cash and CE	13.2	3.4	20.9	55.2		
Total Investments	17.8	39.6	66.1	230.0	300.0	325.0
Reinsurance Recoverables	33.1	55.1	84.8	101.2		
LT Debt (incl. Deb & Pref)	0.0	3.0	28.6	47.4		
Surplus Capital	3.3	9.1	13.1	129.4	149.5	180.5
Loss Ratio	76.6%	62.9%	65.7%	59.0%	61.3%	61.0%
Expense Ratio	25.7%	18.5%	4.4%	16.1%	25.8%	25.0%
Combined Ratio	102.2%	81.4%	70.1%	75.1%	87.2%	86.0%
Underwriting Margin	-2.2%	18.6%	29.9%	24.9%	12.8%	14.0%
Book Value Per Share (EOY)	0.7	1.6	2.3	6.3	7.5	9.0
ROE	1.3%	81.2%	56.3%	24.7%	14.6%	22.0%
Leverage (Earned Prem/Avg Surplus)	1.7	4.1	2.0	0.6	1.1	2.6
A.M. Best Rating	B+	B+	B++	A-	A-	A-

Sources: PoleStar Estimates and company reports

**An in-house claims and legal staff** enables Tower to defend against frivolous claims, maintain prompt

**Raj Sharma**

(415) 546-1500

rsharma@polestarresearch.com Page 2 of 10

## PoleStar Investment Research LLC

One Market Steuart Tower  
Suite 1642  
San Francisco, CA 94105  
(415) 546 1500

*Security transactions through Samuels Chase & Co., Inc., registered broker-dealer, member NASD/SIPC; Clearing Firm – Bear Stearns & Co., Inc.*

### **Tower Group, Inc. (TWGP; \$15.30) – Buy**

**June 29, 2005**

response to the needs of policyholders, and control loss adjustment expenses. Tower's reputation in claims administration has opened opportunities to act as third-party claims administrator for other insurance companies.

**Proven management capability.** Tower's senior management has an average insurance industry experience of over 20 years. The management has an enviable track record of successfully developing and implementing strategies that have allowed Tower to prosper during both hard and soft markets. Despite its limited capital at inception, it was able to grow its premium base and gain market share from other insurance companies with greater financial resources and higher ratings.

#### **Company Description**

Tower Group, Inc. (TWGP) is a highly profitable P&C insurer with a growing residential and commercial business in New York and the Tri-State area. Significant insider ownership and a unique business model drives Tower's premium growth and low operating costs. With \$109 million of new capital from the recent IPO and an A.M. Best upgrade to A-, we believe Tower now has the capacity to grow its gross written premiums by at least double the current rate over the next 18 months.

Tower Group, Inc. has grown its core P&C insurance business at 41% annually since 1999 and improved its impressive 27.4% underwriting margin in 1999 to an even better 29.9% in 2003. Following a change in business model to less agency and more risk retention, its underwriting margins will come down to around 13% going forward – a margin still significantly ahead of its peers. From modest beginnings in 1990 with \$2.1 million of statutory surplus, Tower has grown steadily over the ensuing fourteen years to achieve a total policyholder surplus of \$126.0 million by the end of 2004 – a compounded annual growth rate of 31%.

Tower serves a vast underserved market segment in residential and commercial areas of New York City and avoids properties that might be subject to potential terrorism risk. It has been mandatory for insurers to offer terrorism coverage to New York residents and businesses as a result of 9/11. This has kept most insurers away while creating an opportunity for Tower to cover (very profitably) simple, short-tailed, and low severity risks in most areas except downtown and commercial areas of Manhattan. Tower also has an efficient claims management process mostly handled by an in-house legal team. In the last few years, Tower has been constrained in writing a significantly higher level of premiums because of its A.M. Best rating of B++ (Very Good) and its shareholders' capital base. With the recent IPO (October 2004) and an upgrade from A.M. Best to A- (Excellent), Tower should be able to write substantially more premiums and be able to retain more (reinsure or cede less) of the premiums. Also the new acquisition of (and rights to) OneBeacon's premiums of up to \$100 million should allow Tower to write within other areas in upstate NY.

We believe Tower's superior growth prospects and its highly profitable business model are relatively undiscovered on the Street. With an FY06 Price/Book valuation at 1.7x and an FY06 Price/Earnings multiple of 9.9x, TWGP trades at a discount to other top-notch insurers trading. We believe Tower's valuation should benefit from a) an increase in the overall valuation multiples of the P&C industry relative to the market (as most P&C stocks currently trade at the low to mid-end of their five year P/E ranges); and b) increased recognition of Tower's efficiency and growth within the P&C sector. With outsized growth prospects and a uniquely profitable and seasoned business model, we believe Tower should show significant share price appreciation over the next 18 months, as we expect the company to report solid growth and profitability metrics for FY05.

#### **What Does Tower Do?**

Tower Group, Inc. is a specialty property and casualty insurer that has a unique business model of profitably underwriting in niche markets and creating leverage through earning fees by placing insurance and reinsurance with third-party insurers. It operates through two subsidiaries: Tower Insurance Company of New York (TICNY) and Tower Risk Management (TRM). The TICNY insurance and reinsurance segment underwrites policies and insure against risks for "Main Street" customers like grocery stores, apartment dwellers, real-estate units, and the like while the TRM services segment places insurance and reinsurance for other insurers. On the overall gross-premium basis, TICNY and TRM placed a total of \$177 million of premiums in 2004.

**Raj Sharma**

(415) 546-1500

rsharma@polestarresearch.com Page 3 of 10

## PoleStar Investment Research LLC

One Market Steuart Tower  
Suite 1642  
San Francisco, CA 94105  
(415) 546 1500

*Security transactions through Samuels Chase & Co., Inc., registered broker-dealer, member NASD/SIPC; Clearing Firm – Bear Stearns & Co., Inc.*

### **Tower Group, Inc. (TWGP; \$15.30) – Buy**

**June 29, 2005**

The TICNY insurance segment provides personal and commercial lines insurance to individuals and businesses. Personal lines include homeowners, dwelling, and other liability policies. Commercial lines include property, general liability, workers' compensation, automobile, and commercial umbrella coverage for mercantile and service, restaurant, construction and real estate industries throughout New York State. The TICNY reinsurance segment provides reinsurance coverage directly or indirectly for TRM's issuing companies.

The TRM insurance services segment serves as a managing general agency and provides insurance services to other insurance companies. TRM underwrites business on behalf of other highly rated insurance companies, called issuing companies, including risks that TICNY is unable to insure (in the past) due to its rating, size or geographical limitations. TRM is a non-risk bearing entity and generates revenues purely from commissions and fees. In 2004, TRM generated revenues of \$16.4 million or 15.2% of revenues. Tower contracts with an outside money manager, Hyperion Capital to manage its investments conservatively. Net investment income for the company was \$5.1 million (4.7% of total revenue) for 2004.

### **Key Business Attributes and the Competitive Landscape**

Tower writes insurance primarily for small and mid-size businesses in urban and residential areas. Policies cover real estate, both retail and wholesale, and small businesses and modest dwellings of residents in Manhattan and the surrounding boroughs. Competition is not that significant, in our opinion, as most of the big insurers choose not to insure low-hazard and low-premium policies. On the commercial side, Tower faces competition primarily from some local mutual companies like Greater New York Mutual Insurance and the Magna Carta Companies in addition to Travelers. On the personal side, it competes with Allstate, State Farm, and St. Paul, though it goes head on only with some local mutuals like Commercial Mutual and Otsego Mutual.

Since premium face amounts are relatively small – average annual premium amount of \$3,091 per policy for commercial lines and \$899 for personal lines, pricing is also far less prone to cyclicity as evidenced by larger face-amount policies written by other insurers.

While servicing its customers in a quick, customer-friendly, and efficient manner, Tower employs its experienced in-house legal team to vigorously defend claims from third parties. Tower has developed a reputation in the market for its hard stance on questionable claims from third parties. Tower is also unique in inspecting each risk and property in person before the company covers the risk and writes a policy. Physical inspection is typically not done by other insurers before they cover a risk and write a policy.

Tower's approach to selecting a market is unique because of its inherent demand-driven nature. Tower enters a market very selectively and only does so upon extensively studying the market for its low penetration and profitable underwriting characteristics. Once it enters a market, Tower should continue to service it at a scale that is appropriate for its profitability and competition levels. Like other insurers, it does not feel compelled to mitigate declining profitability levels with increasing volumes. Tower may choose to exit a market or sustain existing levels of premium volumes as long it continues to believe that the segment is profitable.

We believe Tower has proven itself a shrewd underwriter with underwriting margins on an average of 11.7% for the last 5 years, ahead of the industry average by at least 18% points. We believe Tower's superior underwriting results are a product of its pricing power, favorable competitive dynamics, efficient claims management process, and its focused management.

### **Growth Potential**

Tower completed its IPO of 13 million shares of common stock on October 20, 2004, and received net cash proceeds of \$108 million from the IPO and the concurrent private placement of 500,000 shares. On October 26, 2004, Tower added \$98 million of new capital to TICNY, Tower's insurance arm. The infusion of new capital should allow Tower to grow its gross written premium base, retain more of the premium it generates, and add significantly to its bottom line.

### **Raj Sharma**

(415) 546-1500  
rsharma@polestarresearch.com Page 4 of 10

## PoleStar Investment Research LLC

One Market Steuart Tower  
Suite 1642  
San Francisco, CA 94105  
(415) 546 1500

*Security transactions through Samuels Chase & Co., Inc., registered broker-dealer, member NASD/SIPC; Clearing Firm – Bear Stearns & Co., Inc.*

### **Tower Group, Inc. (TWGP; \$15.30) – Buy**

**June 29, 2005**

Following the new capital infusion, A.M. Best upgraded Tower's rating from "B++" (Very Good) to "A- " (Excellent). The higher A.M. Best rating and the new capital will allow Tower's insurance arm, TICNY, to penetrate rating-sensitive market segments, which were formerly inaccessible to the company. With the new capital infusion, the ceding percentage (insurance reinsured through other carriers with give-up of premiums) should also go lower (from 64% ceded in the first nine months of 2004 to only 25% ceded in Q4 -04 and in FY05). A lower ceding percentage should equate to a higher level of risk bearing, higher earned premiums and higher current profits.

On September 13, 2004, Tower acquired renewal rights from OneBeacon Insurance Group for a block of commercial lines' insurance policies for up to total gross premiums of \$100 million in gross written premiums in 2003. Tower also opened two new branches and contracted with 280 agents from OneBeacon. We believe Tower is likely to write about \$43-45 million in gross premiums from OneBeacon's rights this year, which should translate into earned premiums of \$28 million for FY05. OneBeacon's clients are more geographically diverse than Tower's and should allow Tower to expand its markets to areas such as Long Island and upstate regions of NY.

Tower intends to use part of its IPO proceeds to acquire a shell, multi-state insurance company that should allow Tower to expand its P&C book of business to New Jersey and Pennsylvania. With fresh new capital of close to \$108 million, an A- rating from A.M. Best and higher retention rates, Tower should be able to write annual gross premiums of up to \$280 million and net earned premiums of up to \$176 million for FY05. We believe Tower should be able to "put" its overall capital to use throughout FY05 and achieve gross premiums of \$365 million in FY06 from \$177 million in FY04. We expect total revenues to increase to \$296 million in FY06 from \$108 million in FY04.

### **Financial Strength**

Tower made gross premiums of close to \$134.5 million in 2003, of which it earned net premiums, after reinsurance outflows, of \$29 million. In FY04, with higher risk and premium retention, Tower did net written premiums of \$98.4 million, representing growth of 240% from FY03. Tower has grown its gross premiums at an annual rate of 41% in the last five years. It achieved an underwriting margin of 29.9% in 2003 and looks to achieve 22.4% in FY04. Growth over the years has come from rate increases and new business. Growth in the coming years should come from rate increases, new business and higher risk-retention. Tower should also yield investment income from the higher level of investable assets that it has post-IPO. Tower's investment portfolio of \$284 million is invested primarily in fixed maturity and short-term securities and has yielded healthy 5+% returns for each of the last three years.

Tower has reinsurance recoverable of \$138 million. With \$72M or 52% of this recoverable being collateralized, we believe risk from the reinsurance recoverables' balance is manageable.

### **Management**

**Michael H. Lee** (Chairman, President, and CEO) was a founder of TICNY in 1989. He has extensive knowledge of the insurance industry and its operations. Mr. Lee has instituted a strict regimen of conservative, low cost and efficient claims management at the company. He is also considerably invested, owning approximately 15% of the company.

**Steven G. Fauth** (Senior Vice President, General Counsel, Secretary, and Director) joined Tower in 1993 and held the above positions since 1993. Before Tower, he was a trial lawyer and he specialized in commercial litigation. His duties at Tower include oversight of the Claims and Legal Divisions.

**Francis M. Colalucci** (Senior Vice President, Chief Financial Officer, Treasurer and Director) joined Tower in February 2002 and held the above positions since February 2002. Prior to Tower, he was an EVP and CFO of Empire Insurance Group, a property and casualty company competitor from which Tower acquired renewal rights to a book of business in 2001.

### **Raj Sharma**

(415) 546-1500  
rsharma@polestarresearch.com Page 5 of 10

## PoleStar Investment Research LLC

One Market Steuart Tower  
Suite 1642  
San Francisco, CA 94105  
(415) 546 1500

*Security transactions through Samuels Chase & Co., Inc., registered broker-dealer, member NASD/SIPC; Clearing Firm – Bear Stearns & Co., Inc.*

**Tower Group, Inc. (TWGP; \$15.30) – Buy**

**June 29, 2005**

### Investment Risks

**Geographic concentration** in the New York area exposes Tower to losses should a catastrophic event, such as a terrorist attack, hit New York City or the surrounding areas. Although the Terrorism Risk Insurance Act of 2002 is to reimburse Tower up to 90% of losses due to terrorism in excess of a 10% deductible, this federal assistance is set to expire at the end of 2005 unless extended by Congress. Tower's strong propensity to stay clear of ultra-urban and commercial areas of New York City also mitigate the possibility of a catastrophic event to some degree.

**Reinsurers may not pay losses or may not pay promptly.** Although Tower has arranged for its reinsurance recoverable and prepaid premiums to be collateralized or held on a "funds-withheld" basis since October 2003, Tower has substantial amounts recoverable from reinsurance contracts before October 2003 that were uncollateralized. Should a reinsurer holding an uncollateralized contract become insolvent or refuse to pay, or refuse to pay promptly a covered loss, Tower's financial results and stock price could be adversely affected. However, Tower's recent capital infusion of \$108M mitigates the negative impact of a reinsurer insolvency.

### Summary and Valuation

Tower Group, Inc. (TWGP) is a highly profitable P&C insurer with a growing residential and commercial business in New York and Tri-State area. Significant insider ownership and a unique business model drives Tower's premium growth and low operating costs. With \$109 million of new capital from the recent IPO and an A.M. Best upgrade to A-, Tower now has the capacity to grow its revenues by at least 90% over the next year or so.

We believe Tower's superior growth prospects and its highly profitable business model are relatively undiscovered on the Street. With an FY06 Price/Book valuation at 1.7x and an FY06 Price/Earnings multiple of 9.9x, TWGP trades at a discount to other top-notch insurers. We believe Tower's valuation multiple should increase on two accounts: an overall increase in the P&C multiples (as most insurers currently trade at the low to mid-end of their five year P/E ranges) and due to an increased recognition of its premier insurer status within its group. With outsized growth prospects and a uniquely profitable and seasoned business model, we believe Tower should show significant share price appreciation over the next 18 months, as we expect the company to report solid growth and profitability metrics for FY05 and FY06.

**Raj Sharma**

(415) 546-1500

rsharma@polestarresearch.com Page 6 of 10

# PoleStar Investment Research LLC

One Market Steuart Tower  
Suite 1642  
San Francisco, CA 94105  
(415) 546 1500

Security transactions through Samuels Chase & Co., Inc., registered broker-dealer, member NASD/SIPC; Clearing Firm – Bear Stearns & Co., Inc.

## Tower Group, Inc. (TWGP; \$15.30) – Buy

June 29, 2005

### Tower Group, Inc. Yearly Financials (Historical and Projected)

(All Figures in \$ millions, except per share and % data)

	1999	2000	2001	2002	2003A	2004E	2005E	2006E	2007E
<b>Income Statement</b>									
<b>Revenue:</b>									
Net Premiums Written	4.8	5.4	11.3	27.3	29.0	98.4	203.3	263.8	316.7
Net Earned Premium	4.8	5.9	7.0	26.0	22.9	45.9	160.9	236.9	284.4
TICNY Fee and Commission Income	7.3	6.4	10.6	22.2	36.2	40.7	30.2	38.9	46.7
TRM Revenue	23.7	19.0	14.4	12.4	12.8	16.4	17.2	19.7	22.3
Net Investment Income	0.5	0.7	0.9	2.0	2.8	5.1	13.5	16.3	18.0
<b>Total Revenue</b>	<b>36.2</b>	<b>32.0</b>	<b>32.9</b>	<b>62.7</b>	<b>74.7</b>	<b>108.0</b>	<b>221.8</b>	<b>311.8</b>	<b>371.5</b>
<i>y-o-y growth</i>		-11.6%	2.8%	90.7%	19.1%	44.6%	105.4%	40.6%	19.1%
<b>Expenses:</b>									
Loss and loss adjustment expense	3.7	4.7	5.3	16.4	15.1	27.1	98.7	146.9	176.3
Insurance Underwriting Expense		14.0	11.3	26.6	37.0	47.9	71.5	97.9	117.5
Reinsurance Underwriting Expense			1.1	0.5	0.2	0.2	0.2	0.2	0.3
Total Underwriting Expense			12.4	27.1	37.2	48.1	71.7	98.2	117.8
TRM Insurance Services Expense			14.5	9.4	11.3	14.5	15.6	17.7	20.1
Corporate Expense			(0.0)	0.0	0.0	0.2	0.4	0.3	0.4
Interest Expense	0.0	0.1	0.1	0.1	1.5	3.1	2.4	1.0	1.0
<b>Total Expenses</b>	<b>32.6</b>	<b>33.6</b>	<b>32.3</b>	<b>52.9</b>	<b>65.0</b>	<b>92.9</b>	<b>191.0</b>	<b>264.1</b>	<b>315.6</b>
Pretax Income	3.5	(1.6)	0.5	9.8	9.7	14.6	31.4	47.7	55.8
Taxes	1.2	(0.4)	0.2	4.1	3.4	5.7	11.3	16.7	19.5
<b>Tax Rate</b>	<b>35.2%</b>	<b>24.5%</b>	<b>34.4%</b>	<b>42.3%</b>	<b>34.9%</b>	<b>39.0%</b>	<b>36.0%</b>	<b>35.0%</b>	<b>35.0%</b>
<b>Net Income (loss)</b>	<b>2.3</b>	<b>(1.2)</b>	<b>0.4</b>	<b>5.6</b>	<b>6.3</b>	<b>8.9</b>	<b>20.1</b>	<b>31.0</b>	<b>36.3</b>
Preferred Dividends	0.3	0.3	0.3	0.3	0.2	0.0			
<b>Net Income available to common</b>	<b>2.0</b>	<b>(1.6)</b>	<b>0.0</b>	<b>5.3</b>	<b>6.1</b>	<b>8.9</b>	<b>20.1</b>	<b>31.0</b>	<b>36.3</b>
<b>EPS (Diluted)</b>	<b>\$ 0.41</b>	<b>\$ (0.35)</b>	<b>\$ 0.01</b>	<b>\$ 0.94</b>	<b>\$ 1.09</b>	<b>\$ 1.06</b>	<b>\$ 1.00</b>	<b>\$ 1.55</b>	<b>\$ 1.81</b>
EPS Growth		-184%	-103%	9343%	16%	-2%	-6%	54%	17%
Avg. Diluted Shares O/S	5.5	4.5	4.6	5.8	5.7	<b>8.5</b>	20.1	20.1	20.1
Loss Ratio (1)	77.1%	79.4%	76.6%	62.9%	65.7%	59.0%	61.3%	61.0%	61.0%
Expense Ratio (2)	-4.5%	32.6%	25.7%	18.5%	4.4%	16.1%	25.8%	25.0%	24.5%
Combined Ratio (1+2)	72.6%	112.0%	102.2%	81.4%	70.1%	75.1%	87.2%	86.0%	85.5%
<b>Underwriting Margin</b>	<b>27.4%</b>	<b>-12.0%</b>	<b>-2.2%</b>	<b>18.6%</b>	<b>29.9%</b>	<b>24.9%</b>	<b>12.8%</b>	<b>14.0%</b>	<b>14.5%</b>

Raj Sharma

(415) 546-1500

rsharma@polestarresearch.com Page 7 of 10

# PoleStar Investment Research LLC

One Market Steuart Tower  
Suite 1642  
San Francisco, CA 94105  
(415) 546 1500

Security transactions through Samuels Chase & Co., Inc., registered broker-dealer, member NASD/SIPC; Clearing Firm – Bear Stearns & Co., Inc.

## Tower Group, Inc. (TWGP; \$15.30) – Buy

June 29, 2005

### Tower Group, Inc. Quarterly Financials (Historical)

	Q1A	Q2A	Q3A	Q4A	2004	Q1	Q2E	Q3E	Q4E	2005E
<b>Income Statement</b>										
Revenue:										
Net Earned Premium	7.9	9.5	12.1	16.0	45.9	30.0	36.7	40.3	53.9	160.9
TICNY Fee and Commission Income	10.5	10.9	9.5	9.7	40.7	5.9	6.8	7.5	9.9	30.2
TRM Revenue	2.5	4.7	3.6	5.6	16.4	3.8	6.5	3.6	4.1	17.2
Net Investment Income	0.8	1.1	1.3	2.0	5.1	3.0	3.3	3.5	3.8	13.5
Total Revenue	21.7	26.2	26.4	33.3	108.0	42.7	53.2	54.8	71.7	221.8
<i>q-o-q growth</i>	29.2%	45.9%	28.7%	71.7%		96.8%	103.3%	107.4%	114.9%	105.4%
Expenses:										
Loss and LAE	5.0	5.9	7.4	8.7	27.1	18.1	22.7	24.9	33.1	98.7
Insurance Underwriting Expense	11.8	11.8	11.2	13.1	47.9	14.4	16.0	17.7	23.4	71.5
Reinsurance Underwriting Expense	0.0	0.1	0.0	0.0	0.2	0.1	0.1	0.0	0.0	0.2
Total Underwriting Expense	11.8	11.9	11.3	13.1	48.1	14.5	16.1	17.7	23.4	71.7
TRM Insurance Services Expense	2.1	4.4	3.4	4.8	14.5	2.8	5.9	3.3	3.7	15.6
Corporate Expense	0.0	0.0	0.0	0.1	0.2	0.0	0.1	0.1	0.1	0.4
Interest Expense	0.7	0.7	0.8	1.0	3.1	1.2	1.2	1.2	1.2	2.4
Total Expenses	19.5	22.9	22.8	27.7	92.9	36.5	45.9	47.1	61.5	191.0
Pretax Income	2.2	3.3	3.6	5.6	14.6	6.2	7.3	7.7	10.1	31.4
Taxes	0.9	1.3	1.2	2.4	5.7	2.5	2.6	2.7	3.5	11.3
Tax Rate	39.6%	39.0%	32.0%	43.2%	39.0%	40.0%	35.0%	35.0%	35.0%	36.0%
Net Income	1.3	2.0	2.5	3.2	8.9	3.7	4.8	5.0	6.6	20.1
Preferred Dividends										
Basic Shares	4.4	4.4	4.5	16.1	7.3	19.5	19.5	19.5	19.5	19.3
Diluted Shares	5.8	5.8	5.9	16.9	8.5	20.1	20.1	20.1	20.1	20.1
Basic EPS	0.30	0.45	0.55	0.20	1.22	0.19	0.24	0.26	0.34	1.04
Diluted EPS	0.23	0.35	0.43	0.19	1.06	0.19	0.24	0.25	0.33	1.00
Consolidated Ratios										
Loss Ratio (1)	63.3%	61.9%	61.3%	62.0%	59.0%	62.0%	61.8%	61.8%	61.5%	61.3%
Expense Ratio (2)	16.5%	10.2%	14.7%	20.0%	16.1%	26.0%	25.5%	25.5%	25.0%	25.5%
Combined Ratio (1+2)	79.8%	72.1%	76.0%	82.0%	75.1%	88.0%	87.3%	87.3%	86.5%	86.8%
Underwriting Margin	20.2%	27.9%	24.0%	18.0%	24.9%	12.0%	12.8%	12.8%	13.5%	13.2%

Raj Sharma

(415) 546-1500

rsharma@polestarresearch.com Page 8 of 10

## PoleStar Investment Research LLC

One Market Steuart Tower  
Suite 1642  
San Francisco, CA 94105  
(415) 546 1500

Security transactions through Samuels Chase & Co., Inc., registered broker-dealer, member NASD/SIPC; Clearing Firm – Bear Stearns & Co., Inc.

### Tower Group, Inc. (TWGP; \$15.30) – Buy

June 29, 2005

#### Tower Group, Inc. Discounted Cash Flow Model

(All Figures in \$ millions, except per share and % data)

	2003A	2004A	2005E	2006E	2007E	2008E
Free Cash Flow (FCF)	5.11	7.69	18.88	29.81	35.09	41.28
FCF per Share	\$0.89	\$0.90	\$0.94	\$1.49	\$1.75	\$2.06
Discount Rate	20.0% <i>Unusually high discount rate to account for an unforeseen catastrophe</i> <i>Normally use a 10% discount rate</i>					
Factor		1.00	0.83	0.69	0.58	0.48
Discounted FCF per Share		0.90	0.78	1.03	1.01	0.99
Total Discounted FCFs per Share	4.7					
FCF per Share in 2008	2.06	2.06	2.06			
<i>Estimated Terminal Multiple</i>	13	15	17			
Residual Value of Stub	26.7	30.9	35.0			
Discounted Value of Stub	12.9	14.9	16.9			
Total Value of FCFs/Share	17.6	19.6	21.6			
Plus Cash per Share	2.8	2.8	2.8			
Less LT Debt per Share	0.0	0.0	0.0			
Total Intrinsic Value per Share	20.4	22.4	24.3			
Current Price	15	15	15			
Discount to Intrinsic Value	26%	33%	38%			

Raj Sharma

(415) 546-1500

rsharma@polestarresearch.com Page 9 of 10

## **PoleStar Investment Research LLC**

One Market Steuart Tower  
Suite 1642  
San Francisco, CA 94105  
(415) 546 1500

*Security transactions through Samuels Chase & Co., Inc., registered broker-dealer, member NASD/SIPC; Clearing Firm – Bear Stearns & Co., Inc.*

**Tower Group, Inc. (TWGP; \$15.30) – Buy**

**June 29, 2005**

*The information contained herein has been obtained from sources believed reliable but is not necessarily complete and accuracy is not guaranteed. Opinions expressed are subject to change without notice. This research is only meant for institutional investors. PoleStar Investment Research LLC, their partners and employees (collectively PoleStar) may hold positions in or options on the securities discussed. PoleStar and affiliates do not conduct corporate finance activities in the stocks we cover, and do not plan to in the foreseeable future. Within this report we have attempted to examine industry dynamics, threats or cyclical factors, which may impose risk upon our clients. PoleStar has no investment-banking conflicts on its research. The analysts responsible for this report own stock in the securities of this company. Outside of this ownership, the analysts are not aware of any material conflict of interest. PoleStar Investment Research LLC does not make a market in any securities. Neither the analysts responsible for this report nor any related household members are officers, directors, or advisory board members of the subject company. The views expressed herein accurately reflect personal views of analysts who write these reports. PoleStar Investment Research LLC conducts its securities transactions through Samuels Chase & Co., Inc., registered broker-dealer, member NASD/SIPC that clears through Bear Stearns & Co., Inc.*

**Raj Sharma**

(415) 546-1500

rsharma@polestarresearch.com Page 10 of 10