



# **Hallmark Financial Services, Inc.**

*Presentation for*

## **Southwest IDEAS Investor Conference**

*November 15, 2012*

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# Forward-Looking Statements

**This presentation contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created thereby. These statements include the plans and objectives of management for future operations, including plans and objectives relating to future growth of our business activities and availability of funds. The forward-looking statements included herein are based on current expectations that involve numerous risks and uncertainties. Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, competitive and market conditions, regulatory framework, weather-related events and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this presentation will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by any person that our objectives and plans will be achieved.**

**More information about forward-looking statements and the risk factors associated with our company are included in our annual, quarterly and other reports filed with the Securities and Exchange Commission.**

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# Strategic Overview

**Mark Schwarz**

*Executive Chairman*

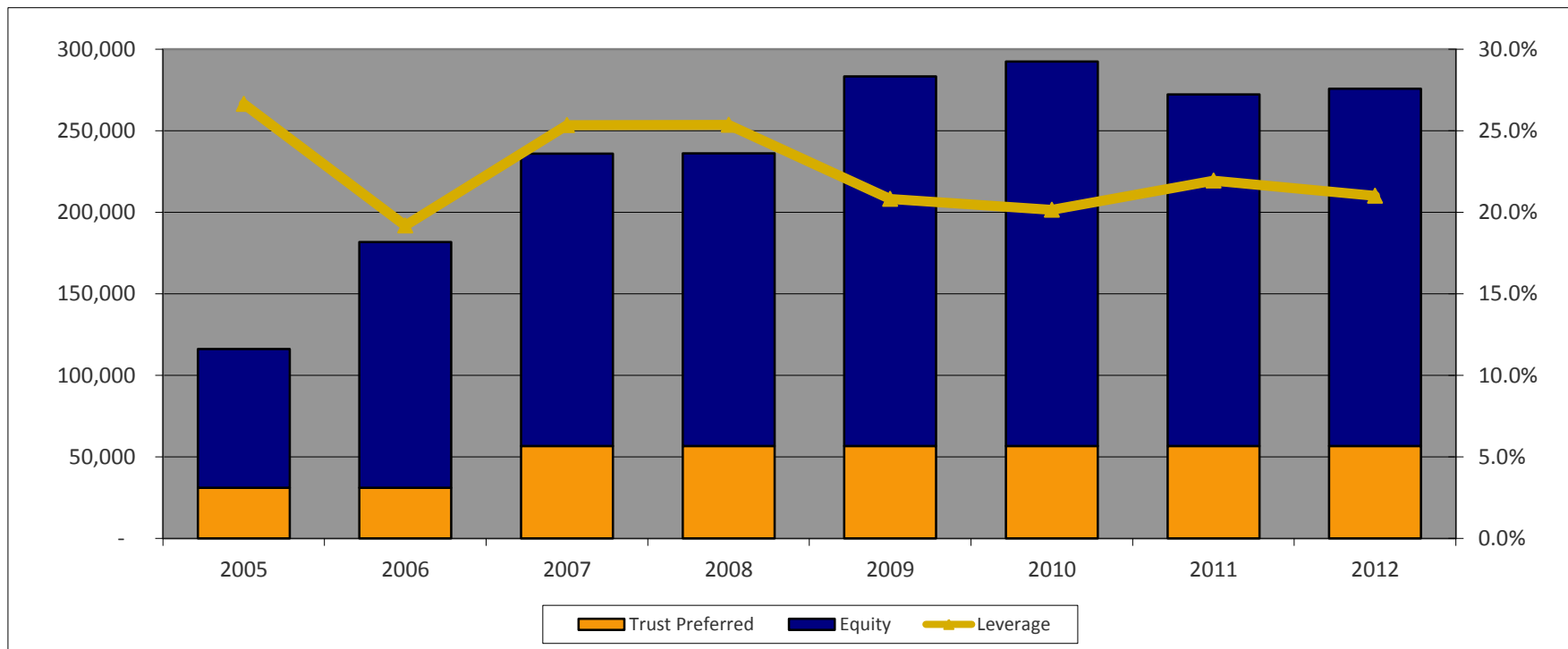


## Who We Are

- ✓ Diversified specialty property/casualty insurer with operating units in Dallas-Fort Worth, Austin and San Antonio, Texas
- ✓ Market, underwrite and service nearly \$400 million of commercial and personal insurance in selected markets
  - Focused on underserved sectors, mostly short-tailed lines
  - Operate in diversified, sustainable niche markets
- ✓ Focus on disciplined underwriting and bottom line profitability
- ✓ Proven track record of strong underwriting performance
- ✓ Demonstrated ability to identify and acquire profitable, niche businesses
- ✓ "A-" (Excellent) A.M. Best Financial Strength Rating
- ✓ Combined Statutory Surplus of \$174 million as of September 2012

## Who We Are

- ✓ Market capitalization of \$153 million, with 19.3 million shares outstanding (\$7.93 market value per share) as of Nov. 6, 2012
- ✓ Consolidated Shareholders' Equity of \$219 million as of Sept. 30, 2012 (\$11.37 per share)
- ✓ Total capitalization of \$277 million as of Sept. 30, 2012, including \$57 million of subordinated trust preferred debt securities that mature in 2035.



# Our Corporate Strategy

***To be a "Best in Class" Specialty Insurance Company Focused on: (1) Underwriting Profitability; and (2) Superior Investment Returns:***

- ✓ Strong management team has interests aligned with shareholders
- ✓ Focus on specialty insurance niches with customized products by competing on service and coverage, not price
- ✓ Diversification through multiple business lines
- ✓ Selectively and opportunistically acquire well positioned businesses with strong underwriting and operating management
- ✓ Balance Sheet based on strong investment, reinsurance and reserving practices
- ✓ Performance measurement based on long-term growth in book value per share

# The Hallmark Track Record

***Aggregates & Averages Through the Third Quarter of 2012 Highlight Hallmark's Successful Expansion and Diversification into Specialty Lines of Business.***

	<b>Gross Premiums Produced</b>	<b>Investment Income</b>	<b>Operating Income</b>	<b>GAAP Equity</b>		<b>GAAP BVPS</b>		<b>Year End Stock Price</b>	
			(1)		ROAE	(2)	% Chg	(2)	% Chg
<b>2004</b>	\$ 119,305	\$ 1,386	\$ 8,602	\$ 32,656	20%	\$ 5.37		\$ 7.20	
<b>2005</b>	\$ 118,066	\$ 3,836	\$ 13,468	\$ 85,188	16%	\$ 5.89	10%	\$ 8.16	13%
<b>2006</b>	\$ 293,304	\$ 10,461	\$ 23,950	\$ 150,731	13%	\$ 7.26	23%	\$ 9.91	21%
<b>2007</b>	\$ 297,904	\$ 13,180	\$ 41,769	\$ 179,621	17%	\$ 8.65	19%	\$ 15.86	60%
<b>2008</b>	\$ 287,081	\$ 16,049	\$ 21,124	\$ 179,412	7%	\$ 8.61	0%	\$ 8.77	-45%
<b>2009</b>	\$ 288,450	\$ 14,947	\$ 33,257	\$ 226,517	12%	\$ 11.26	31%	\$ 7.96	-9%
<b>2010</b>	\$ 314,857	\$ 14,849	\$ 8,264	\$ 235,763	3%	\$ 11.72	4%	\$ 9.10	14%
<b>2011</b> (3)	\$ 344,379	\$ 15,880	\$ (19,788)	\$ 215,572	-7%	\$ 11.19	-5%	\$ 6.99	-23%
<b>Last 8 Years (2004-2011).....</b>									
<b>TOTAL</b>	\$ 2,063,346	\$ 90,588	\$ 130,646						
<b>CAGR</b>	<b>16%</b>	<b>42%</b>	<b>NM</b>	<b>31%</b>		<b>11%</b>		<b>0%</b>	
<b>YTD 2012</b>	\$ 293,428	\$ 11,573	\$ 1,087	\$ 219,108		\$ 11.37		\$ 8.14	

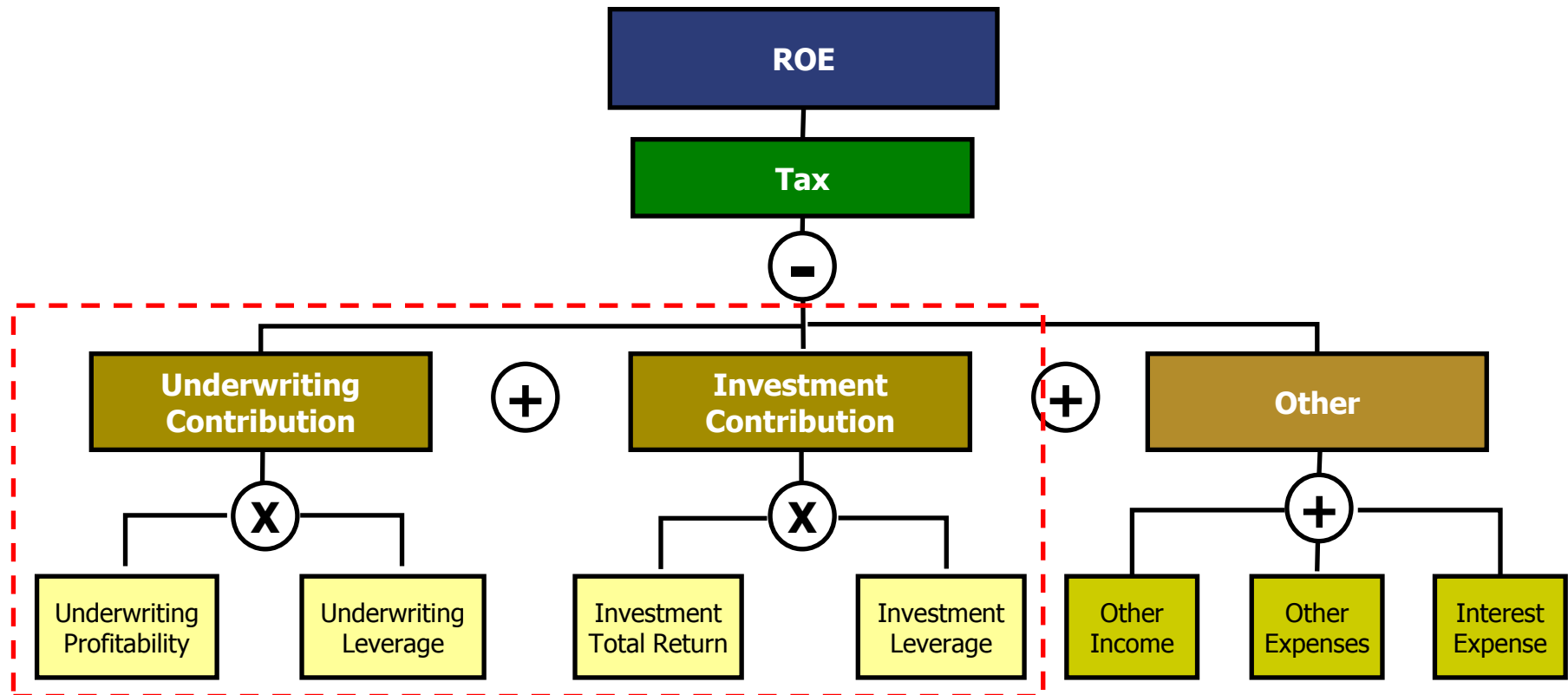
(1) Operating income is income before noncash interest expense from amortization of deemed discount on convertible notes, income tax and non-controlling interest.

(2) Stock prices and BVPS prior to 2006 have been adjusted for the one for six stock split which took place during the Q3 2006. 2012 stock price is as of September 28, 2012.

(3) 2011 Operating income, equity and BVPS have been restated for change in accounting principal related to deferred acquisition costs.

# ROE Decomposition & Summary Analysis

***Return on Equity and Growth in Book Value per Share are Primarily Driven by Two Major Elements: (1) Underwriting Income and (2) Total Investment Return***





# Underwriting Contribution to ROE

## *Low Loss Ratios and Expense Management result in a Strong Underwriting Contribution to ROE.*

- ✓ Profitable underwriting produces significant ROE contribution
- ✓ Softening market conditions since 2006 have caused margin pressure across most all lines of business
- ✓ Personal Lines losses in Florida have severely impacted recent results

	Loss Ratio	Expense Ratio	Combined Ratio	(1 - CR%) Underwriting Margin	Underwriting Leverage	Underwriting Contribution
2005	57.1%	30.8%	87.9%	12.1%	1.8	21.9%
2006	57.3%	28.7%	86.0%	14.0%	1.8	25.0%
2007	58.8%	29.1%	87.9%	12.1%	1.5	18.1%
2008	61.0%	30.6%	91.6%	8.4%	1.3	11.1%
2009	61.2%	30.5%	91.7%	8.3%	1.4	11.6%
2010	72.8%	29.6%	102.4%	-2.4%	1.2	-2.9%
2011	81.6%	30.8%	112.4%	-12.4%	1.2	-15.4%
<b>7 Yr Avg</b>	<b>64.3%</b>	<b>30.0%</b>	<b>94.3%</b>	<b>5.7%</b>	<b>1.5</b>	<b>9.9%</b>

# Investment Contribution to ROE

## *Total Investment Return includes Interest, Dividends, Realized and Unrealized Gains*

- ✓ Superior total returns: Outperform market averages
- ✓ Significant outperformance in since 2008
- ✓ Increasing investment leverage magnifies contribution to ROE

	Total Investment Return	Beginning Invested Assets	Investment Leverage	Investment Contribution
2005	3.6%	51,531	1.6	5.7%
2006	6.2%	153,374	1.8	11.3%
2007	5.7%	268,000	1.8	10.1%
2008	-2.8%	427,787	2.4	-6.6%
2009	15.7%	360,683	2.0	31.6%
2010	7.7%	327,677	1.4	11.1%
2011	3.7%	432,441	1.8	6.8%
<b>7 Yr Avg</b>	<b>5.7%</b>	<b>288,785</b>	<b>1.8</b>	<b>10.0%</b>

# Hallmark's Seven-Year Track Record

***ROE Calculation Utilizing Comprehensive Income is Equivalent to Change in Book Value per Share (after adjustment for changes in equity capitalization)***

- ✓ Over the seven-year period below, Hallmark produces significant contribution to ROE from both underwriting and investments

	Underwriting	Investment	Debt	Other	Comp Pre-Tax ROBE	Tax	Comp After-Tax ROBE	Treasury Repurchase	Stock Compensation	Stock Issuances	Minority Interest	BVPS Growth
2005	22%	6%	-4%	9%	33%	31%	22%	NA	0.4%	-13%	NA	10%
2006	25%	11%	-7%	-12%	17%	36%	11%	NA	0.2%	12%	NA	23%
2007	18%	10%	-3%	3%	28%	33%	19%	NA	0.2%	NA	NA	19%
2008	11%	-7%	-3%	-1%	1%	268%	-1%	NA	0.6%	NA	-0.1%	-1%
2009	12%	32%	-3%	1%	41%	31%	29%	2%	0.8%	NA	-0.2%	31%
2010	-3%	11%	-2%	-2%	4%	14%	4%	NA	0.5%	NA	-0.1%	4%
2011	-15%	7%	-2%	0%	-10%	43%	-6%	1%	0.4%	NA	0.0%	-4%
<b>7-YR Avg</b>	<b>10%</b>	<b>10%</b>	<b>-3%</b>	<b>0%</b>	<b>16%</b>	<b>32%</b>	<b>11%</b>	<b>NM</b>	<b>0.4%</b>	<b>NM</b>	<b>NM</b>	<b>12%</b>

# Performance Measured on Growth in Book Value

## *Why Measure an Insurance Company's Performance on its Growth in Book Value per Share?*

- ✓ Standard ROE calculation fails to capture Total Return on investment — an important component on insurance company profitability:
  - Standard ROE calculation excludes changes in unrealized gains or losses
  - Analysts typically adjust ROE calculation to further exclude realized gains
- ✓ The period-to-period change in Book Value per Share captures all elements of insurance company profitability:
  - Underwriting income
  - Total investment return
  - Changes in share capitalization and other items

# Growth in BVPS Compared to “Best in Class” Peers

***Through 2011, Hallmark’s Seven-Year Average Growth in Book Value per Share Compares Favorably to the Performance of “Best in Class” Specialty Insurance Companies.***

- ✓ Average Growth in Book Value per Share for Hallmark Substantially Exceeds the 7-Year Performance of the S&P 500 Index.

	SELECT LEADING SPECIALTY P/C INSURERS						
	HALL	HCC	WRB	RLI	MKL	BRK	S&P
2005	10%	18%	21%	10%	4%	6%	5%
2006	23%	20%	29%	15%	32%	18%	16%
2007	19%	16%	15%	12%	15%	11%	6%
2008	-1%	10%	-5%	-6%	-16%	-10%	-37%
2009	31%	14%	22%	19%	27%	20%	27%
2010	4%	8%	14%	-4%	16%	13%	15%
2011	-4%	10%	11%	2%	8%	5%	2%
<b>7-YR Average</b>	<b>12%</b>	<b>14%</b>	<b>15%</b>	<b>7%</b>	<b>12%</b>	<b>9%</b>	<b>5%</b>

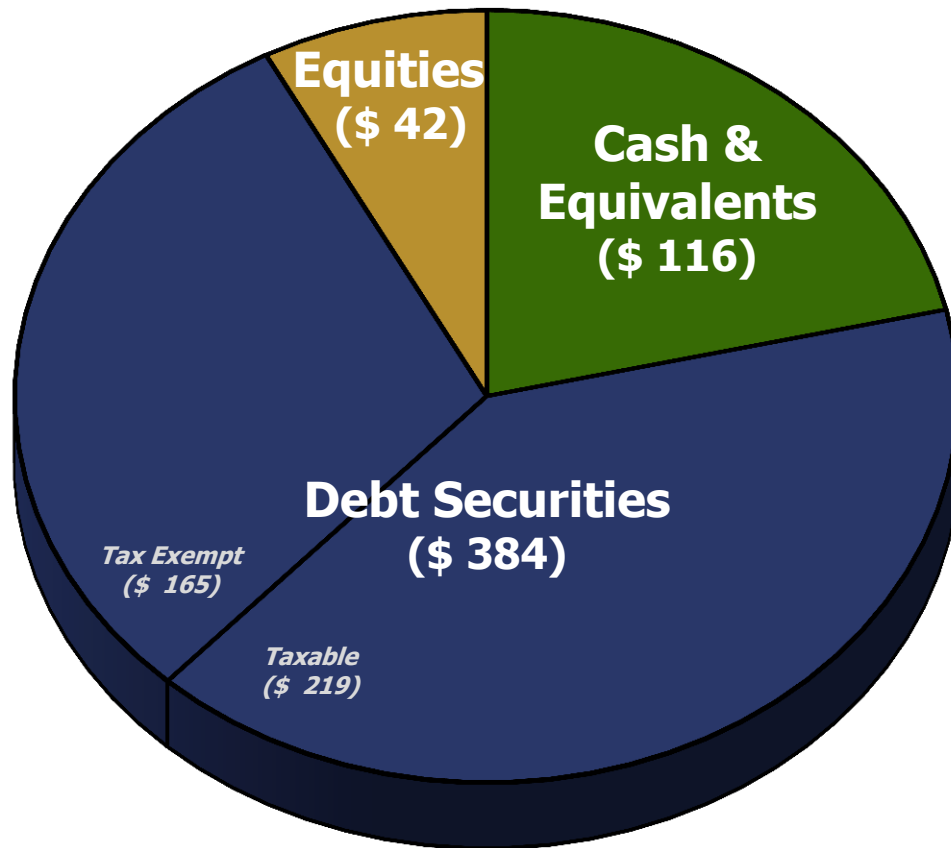
# Investment Strategy

***Hallmark views Investment Operations as a Core Competency. Hallmark has achieved above average results and expense savings through internal management of its investments.***

- ✓ Employ a disciplined, value-based investment strategy
- ✓ Investment process focuses on individual security selection
- ✓ Seek to outperform market benchmarks on average vs. consistently beating the market ever year
- ✓ Total return approach values all components of investment return equally, whether reported as interest and dividends on the income statement or recognized as comprehensive income on the balance sheet
- ✓ Seek to maximize total return on an after-tax basis through investment in tax-exempt securities and compounding of unrealized gains.

# Investment Portfolio

**As of September 30, 2012**  
(\$ in millions)



***Total Cash & Investments***  
***\$542 million, or Approximately***  
***\$28 per Share.***

- ✓ Cash \$116 million
- ✓ Total Investments \$426 million
- ✓ Investment grade portfolio, marketable securities
- ✓ No hedge fund or private equity investments
- ✓ 10% invested in equities
- ✓ Book tax equivalent yield of approximately 4.8%
- ✓ Weighted-average duration of 2.6 years

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# Operations Overview

**Mark Morrison**

*President & Chief Executive Officer*





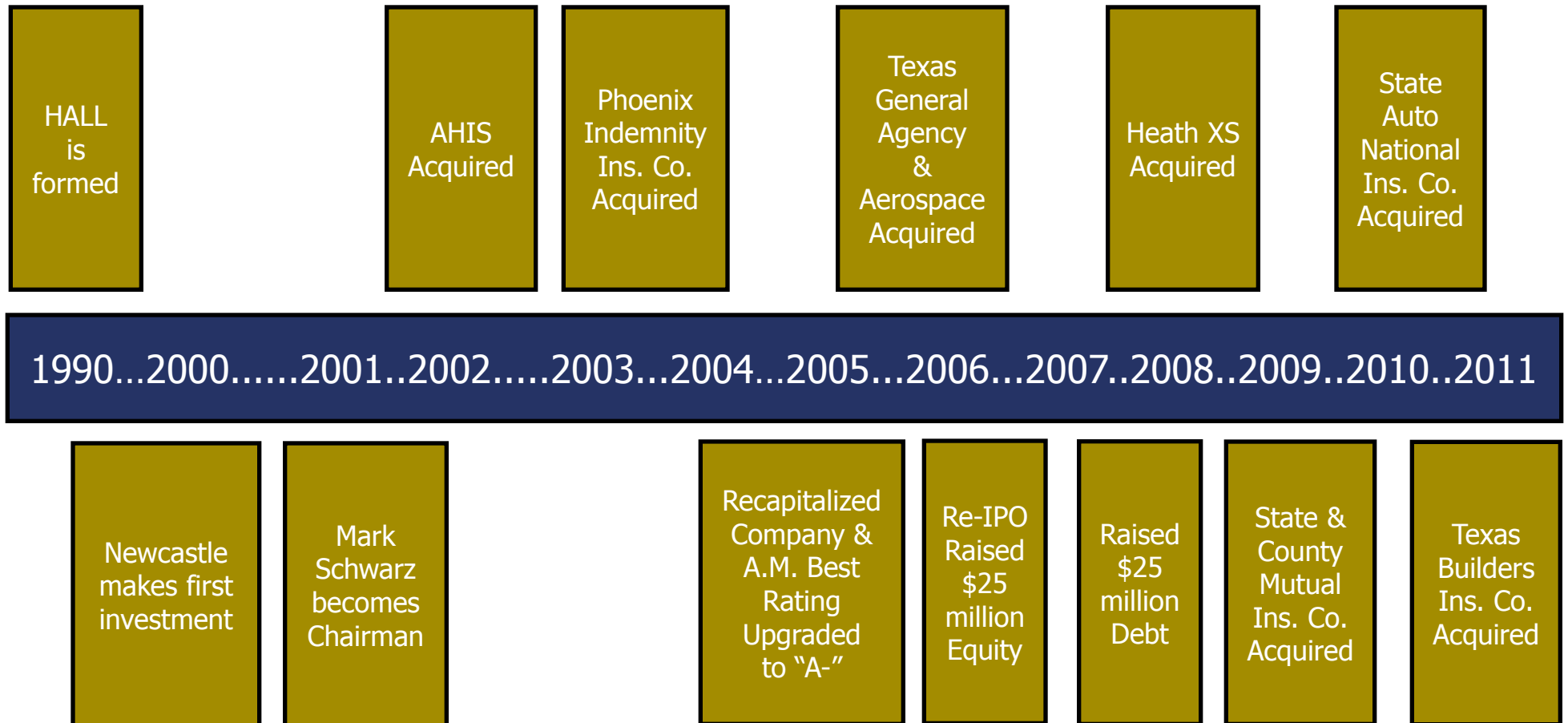
# Underwriting Strategy

## Disciplined Underwriting Strategy in Specialty Niche Market Segments:

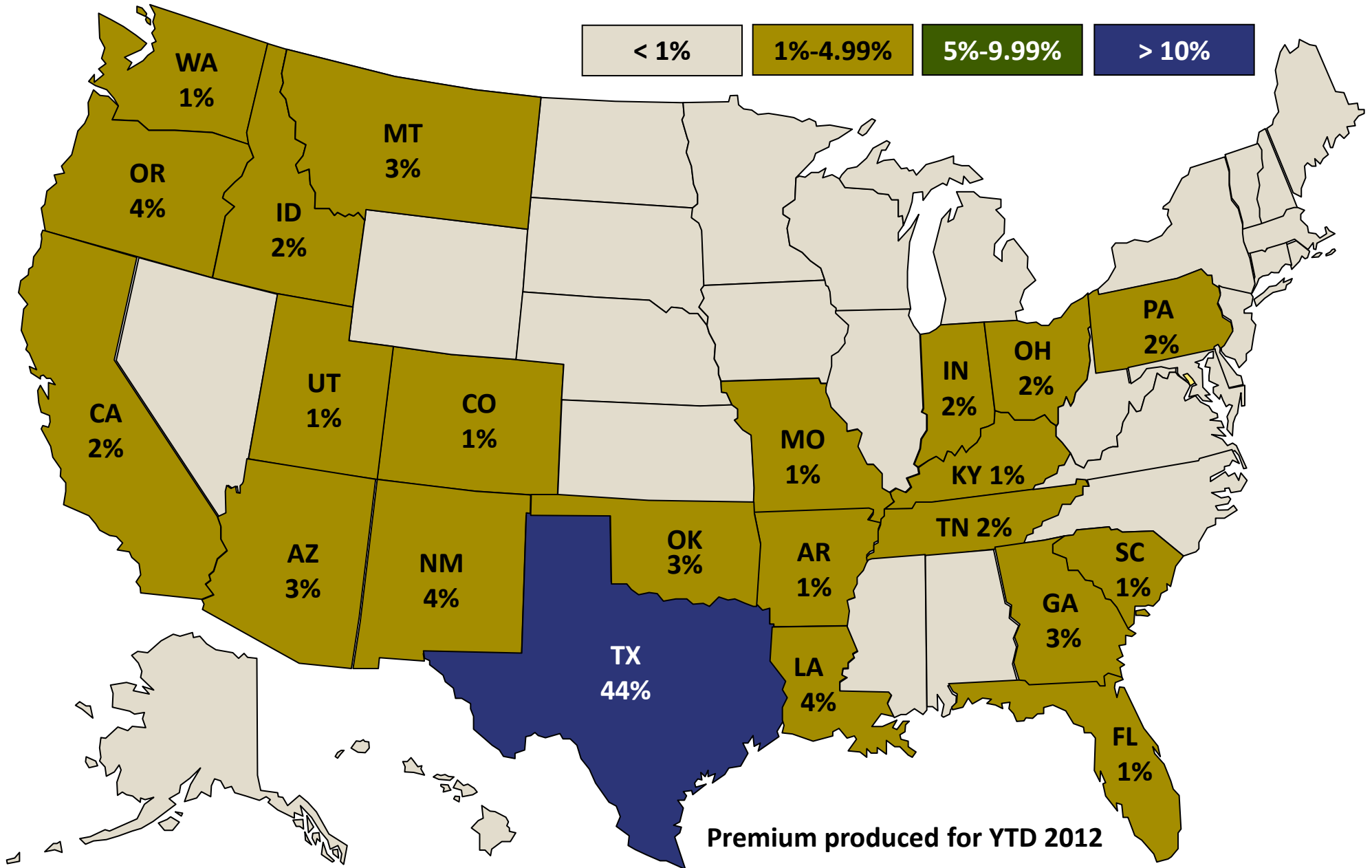
- ✓ Underserved markets – limited competition
- ✓ Highly customized products to meet unique needs of insureds
- ✓ Low price sensitivity
- ✓ Mostly low-severity and/or short-tailed exposures
- ✓ Underwriting expertise critical: Underwriters have an average of 15 years of experience
- ✓ Underwriters' bonuses based on underwriting performance—emphasizes bottom-line profitability over top-line growth
- ✓ Sustain strong, consistent underwriting performance
- ✓ Reinsurance used to reduce operating volatility and to protect shareholders capital

# How We Got to Where We Are Today

***Hallmark Began in 1990 as a Texas-only, Mono-line Company. In 2002, New Management Begins Transformation into a Diversified, Specialty Lines Focused Property/Casualty Insurer.***

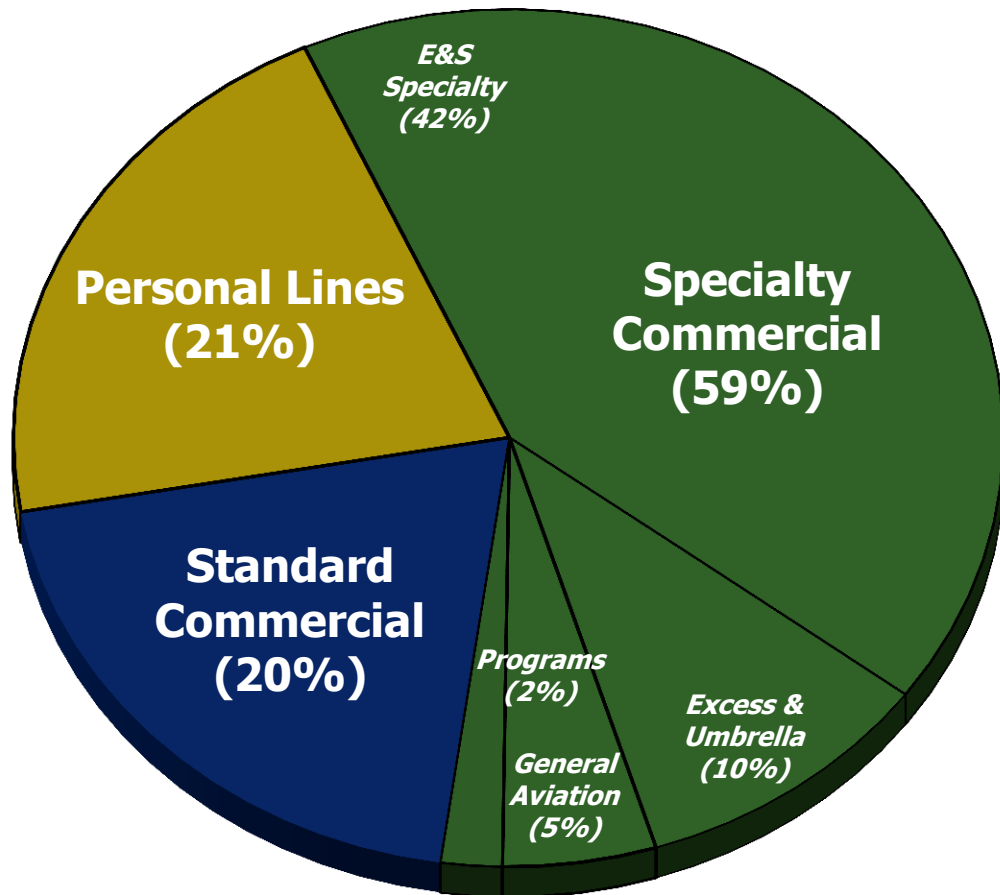


# Geographic Spread of Premiums Produced



# Hallmark Operations Overview

## Gross Premiums Produced *By Operating Unit*



*YTD 2012 Gross Premium Produced of \$293 million*

## Three Reporting Segments:

### ▪ **Specialty Commercial:**

- ✓ E&S Specialty: Difficult-to-place accounts, primarily commercial auto and small, stand-alone general liability policies.
- ✓ Excess & Umbrella: Middle market, mostly transportation fleet accounts.
- ✓ General Aviation: Small airports, small planes focused on new/old/transitional pilots and older aircraft.

### ▪ **Standard Commercial:**

- ✓ Small accounts, low hazard standard commercial package policies.
- ✓ In 2011, workers comp coverage through independent agents in Texas.

### ▪ **Personal Lines:**

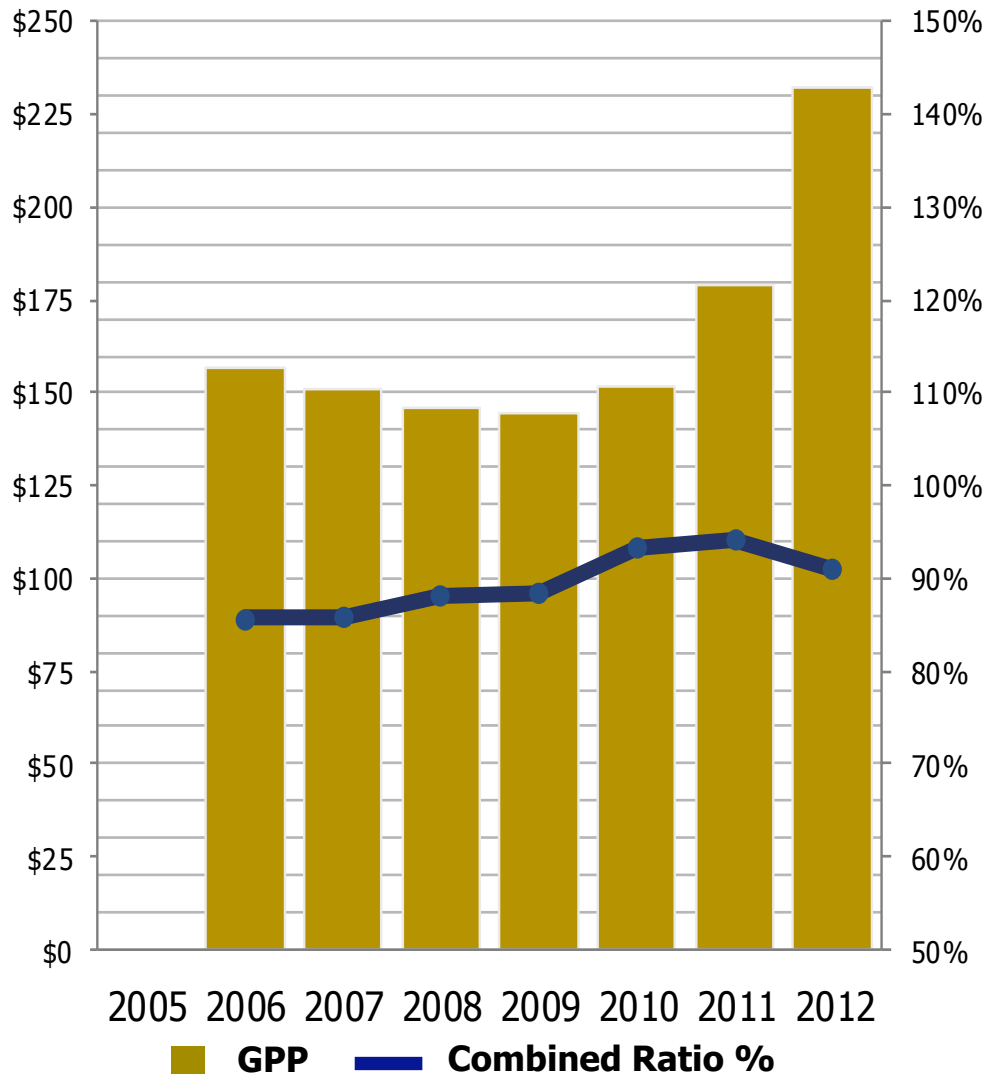
- ✓ Non-standard automobile coupled with other niche personal line products.

# Specialty Commercial Operating Trends

## Gross Premiums Produced

*\$ in millions*

*2012 GPP is SEPT YTD Annualized*



## Market Conditions in 2012 have Improved, Allowing for near Double-Digit Rate Increases

- ✓ Standard markets appear to be more selective in writing marginal risks and classes of business
- ✓ Increases in insured exposures suggest stabilizing economic conditions

## Recent Additions of Specialty Underwriting Teams to Provide Product Expansion

- ✓ Experienced underwriters in Medical Professional Liability, Space & Satellite, and Oil & Gas added since 2010

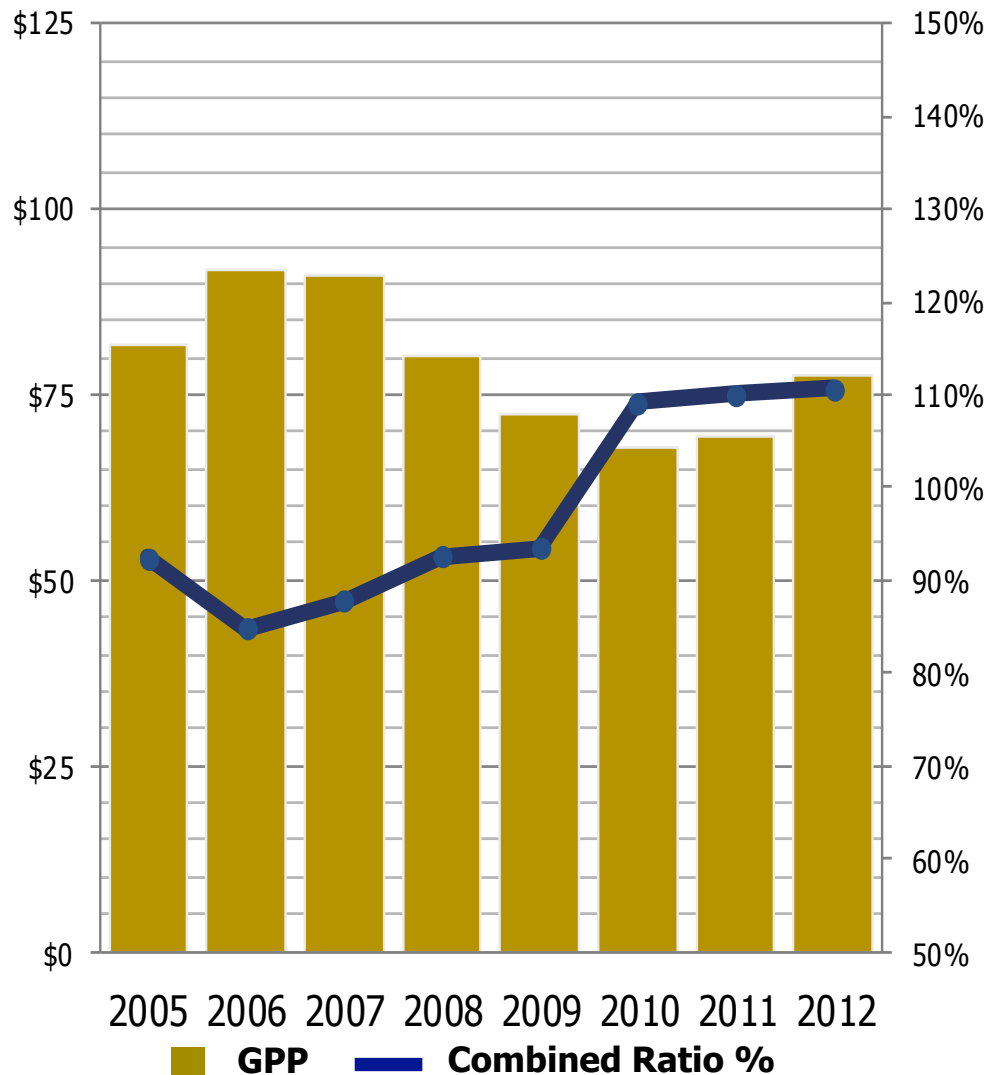
## Underwriting Discipline has helped to Maintain Healthy Margins

# Standard Commercial Operating Trends

## Gross Premiums Produced

*\$ in millions*

*2012 GPP is SEPT YTD Annualized*



## **Disciplined Underwriting in Prolonged Soft Market has Significantly Reduced Size of Book of Business**

- ✓ Reduced book increases underwriting volatility driven by large losses

## **Results since 2010 have been Adversely Impacted by High Level of Large Property Losses**

- ✓ Despite consistent underwriting, an unprecedented level of large property losses incurred as a result of natural catastrophes and arson related losses

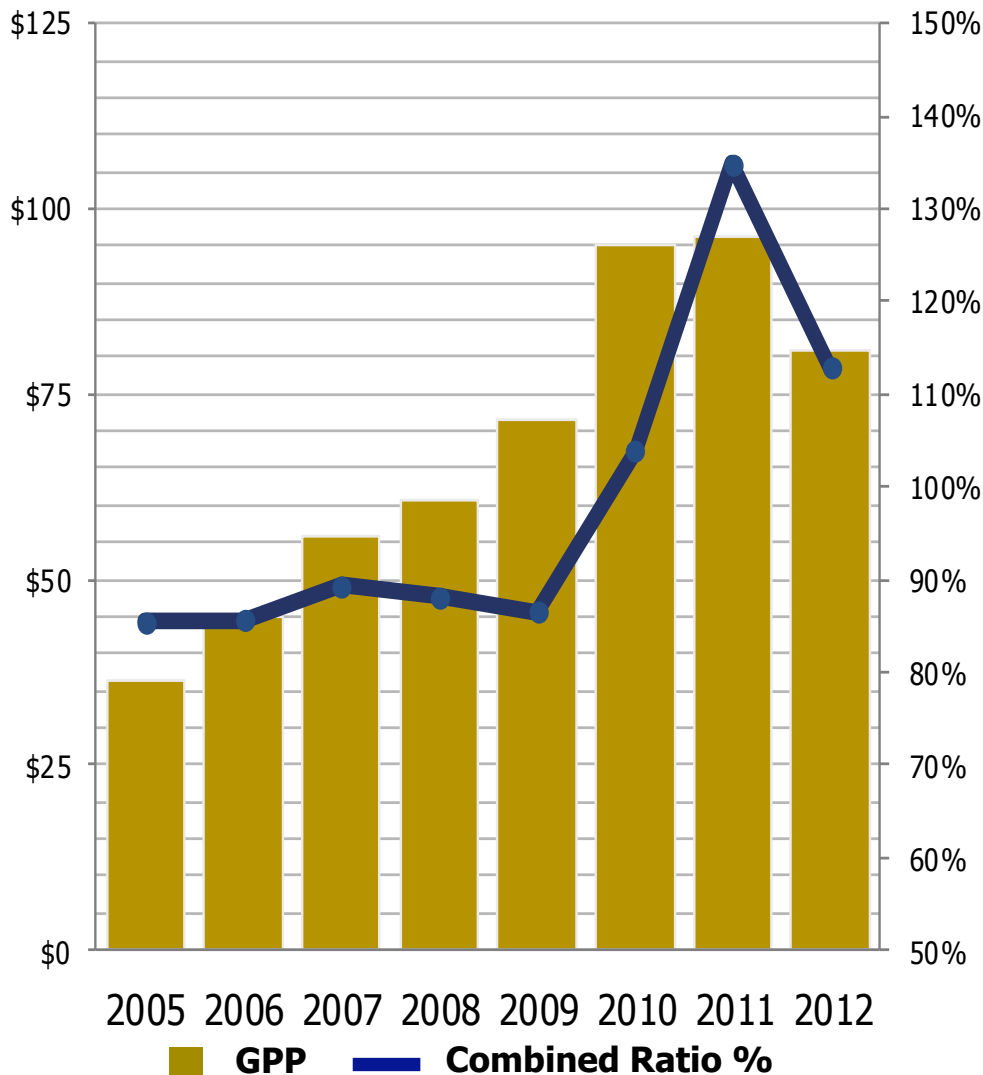
## **Initiated Rate Increases and Reduced Large Property Driven Accounts starting in mid 2011**

# Personal Lines Operating Trends

## Gross Premiums Produced

*\$ in millions*

*2012 GPP is SEPT YTD Annualized*



## **Loss Ratio Slammed by PIP Fraud with 2009 Expansion into Florida Personal Auto Market**

- ✓ Aggressive measures taken in 2011 to mitigate losses and exit Florida

## **Re-Focused Business to Target Mature, less Volatile States and Simplified Product Lines**

- ✓ Exiting 11 unprofitable states and streamlined product offerings
- ✓ Significant rate increases taken in underperforming markets/products
- ✓ Focusing resources towards 22 ongoing states
- ✓ Increased use of point of sale underwriting and underwriting tools

## **Highly Efficient Operating Platform with Expense Ratio in mid 20%'s**

- ✓ Efficiency via technology

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# Financial Overview





# Select Financial Highlights

***Since 2003, Hallmark's Specialty Focus, Underwriting Discipline And Opportunistic Acquisitions Have Driven "Best In Class" Results. Misstep into Florida's Personal Auto Market Blemishes this Record.***

	Year Ended December 31										4-YR CAGR	Nine Months Ended June 30		
	2007		2008		2009		2010		2011			2011	2012	
Gross Premiums Written	↑	249,472	↓	243,849	↑	287,558	↑	320,973	↑	354,881	9%	270,834	↑	297,658
Net Premiums Earned	↑	225,971	↑	236,320	↑	251,072	↑	278,271	↑	293,041	7%	216,759	↑	235,938
Total Revenues	↑	275,166	↓	268,690	↑	287,039	↑	307,060	↑	322,771	4%	239,669	↑	253,177
Net Earnings <sup>(1)</sup>	↑	27,863	↓	12,899	↑	24,575	↓	7,334	↓	(10,821)	NM	(11,202)	↑	1,741
Loss Ratio (GAAP)	↑	58.8%	↑	61.0%	↑	61.2%	↑	72.8%	↑	81.6%		83.9%	↓	71.6%
Expense Ratio (GAAP)	↑	29.1%	↑	30.6%	↓	30.5%	↓	29.6%	↑	30.8%		31.3%	↓	30.4%
Combined Ratio (GAAP)	↑	87.9%	↑	91.6%	↑	91.7%	↑	102.4%	↑	112.4%		115.2%	↓	102.0%
EPS - Basic	↑	\$ 1.34	↓	\$ 0.62	↑	\$ 1.19	↓	\$ 0.36	↓	\$ (0.55)	NM	\$ (0.57)	↑	\$ 0.09
EPS - Diluted	↑	\$ 1.34	↓	\$ 0.62	↑	\$ 1.19	↓	\$ 0.36	↓	\$ (0.55)	NM	\$ (0.57)	↑	\$ 0.09
Return on Average Equity	↑	17%	↓	7%	↑	12%	↓	3%	↓	-5%		-7%	↑	1%
Book Value Per Share	↑	\$ 8.65	↓	\$ 8.61	↑	\$ 11.26	↑	\$ 11.72	↓	\$ 11.22	7%	\$ 10.96	↑	\$ 11.37

(1) Net earnings is defined as net income attributable to Hallmark Financial Services, Inc. as reported in our consolidated statements of operations.



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**NASDAQ: HALL**