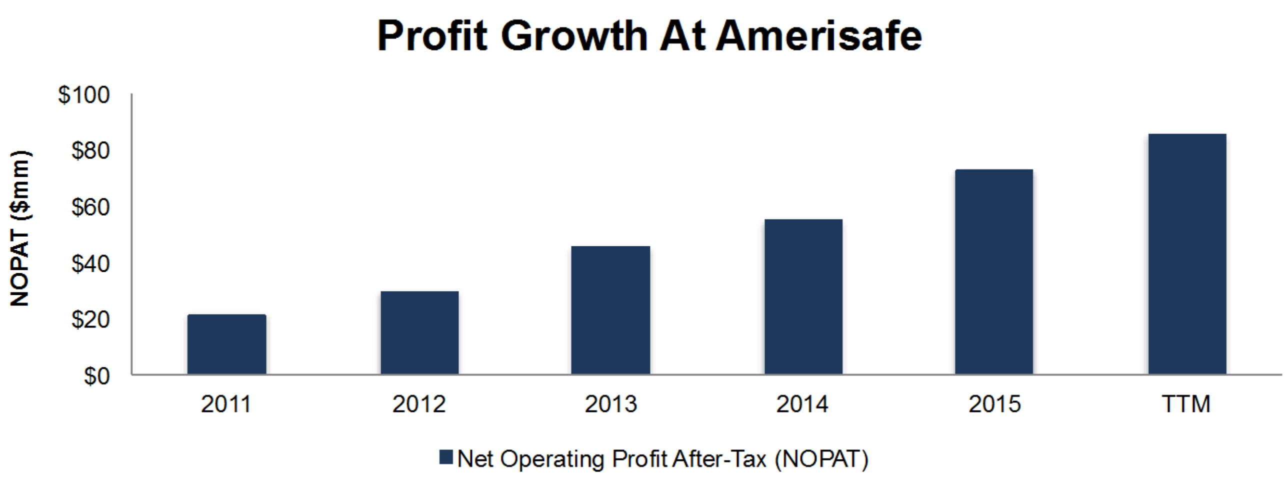
Long Idea: Amerisafe Inc. (AMSF)

This insurance provider has sold workers compensation insurance to companies engaged in hazardous industries for more than three decades. Impressive profit growth, prudent underwriting, and an undervalued share price have earned Amerisafe (AMSF: $60/share) a spot on September's Most Attractive Stocks list and make it this week's Long Idea.

Impressive Profit Growth Achieved At Amerisafe

Since 2011, Amerisafe has grown after-tax profit (NOPAT) by 36% compounded annually to $73 million in 2015 and to $85 million over the last twelve months, per Figure 1. The company has grown NOPAT by 28% compounded annually over the past decade.

Figure 1: Amerisafe Increasing Profits



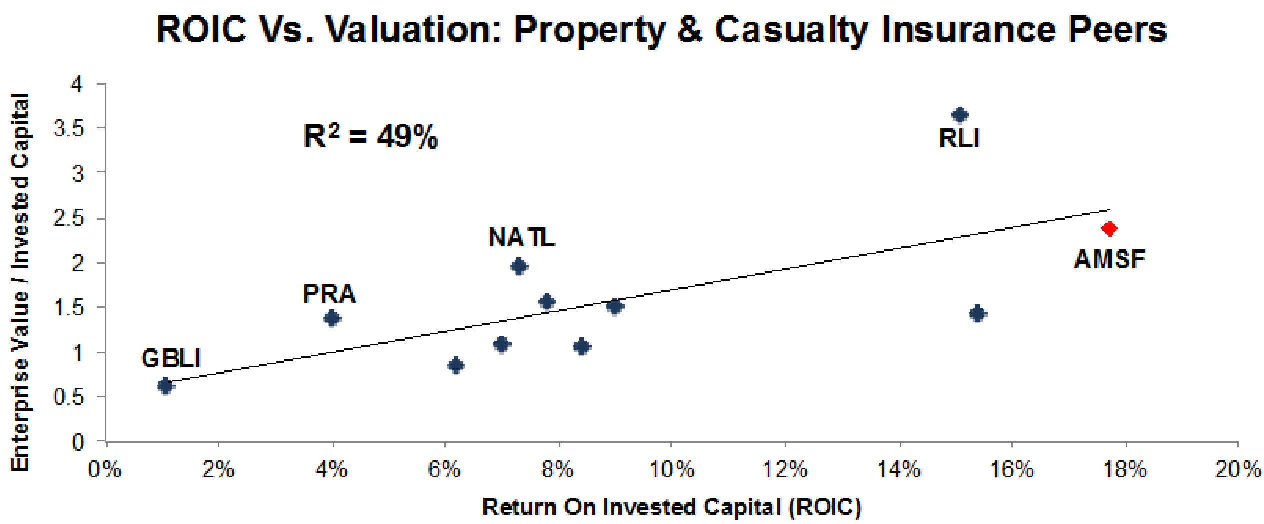
Sources: New Constructs, LLC and company filings

Amerisafe's NOPAT margin has improved from 2% in 2005 to 21% over the last twelve months (TTM). Its return on invested capital (ROIC) improved from 9% to a top-quintile 18% over the same time. The company generated cumulative $95 million in free cash flow over (FCF) the past five years and FCF is $60 million TTM. Across all facets of the business, Amerisafe's fundamentals impress.

ROICs Correlation With Improving Shareholder Value

Amerisafe's 18% ROIC is well above the 9% average of the 11 Property & Casualty insurance companies listed as peers in its most recent proxy statement. Better yet, the average ROIC of the 47 Property & Casualty Insurance companies under coverage is even lower, at 8%. Companies with a top-quintile ROIC tend to have wider moats and, on average, premium valuations. However, AMSF has not been awarded a premium valuation. Figure 2 shows that ROIC explains 49% of the changes in market valuation for the 11 Property & Casualty Insurance peers and that, given the company's top ROIC, AMSF is undervalued relative to these peers.

Figure 2: ROIC Explains 49% Of Valuation for Property & Casualty Insurance Peers



Sources: New Constructs, LLC and company filings

Amerisafe's Leading Profitability Provides Competitive Advantage

As a specialty provider of workers' compensation insurance to businesses engaged in hazardous industries, Amerisafe faces a broad range of competitors from broad based providers offering multiple products to more specialized providers. From AMSF's proxy statement, its peer group consists of RLI Corporation (RLI), Baldwin & Lyons (BWINB), Donegal Group (DGICA) and Employers Holdings (EIG), among others listed below. Per Figure 3, Amerisafe not only earns the highest ROIC of the group, but also the highest NOPAT margin. Amerisafe's increased profitability provides the company with a competitive advantage, particularly AMSF is better positioned to withstand price cuts from competitors and still grow profits. This advantage is not lost on management, as per the 2Q16 earnings call, when Amerisafe's CEO noted that when faced with competitive pressures "We will protect the underwriting margin. We are trying to be as responsive as we can to the market and only add what we're willing to accept." Being selective about underwriting is much easier when your firm is the most profitable. Amerisafe does not have to chase bad deals just to prop up the top line.

Figure 3: Amerisafe's Leading Profitability

Company	Ticker	NOPAT Margin	Return On Invested Capital
Amerisafe	AMSF	21%	18%
RLI Corporation	RLI	16%	15%
Employers Holdings	EIG	14%	15%
ProAssurance Corp	PRA	11%	4%
Baldwin & Lyons	BWINB	11%	8%
United Fire Group	UFCS	7%	9%
Safety Insurance Group	SAFT	7%	8%
Donegal Group	DGICA	4%	7%
Hallmark Financial Services	HALL	4%	6%
National Interstate Corp	NATL	4%	7%
Global Indemnity	GBLI	2%	1%

Sources: New Constructs, LLC and company filings.

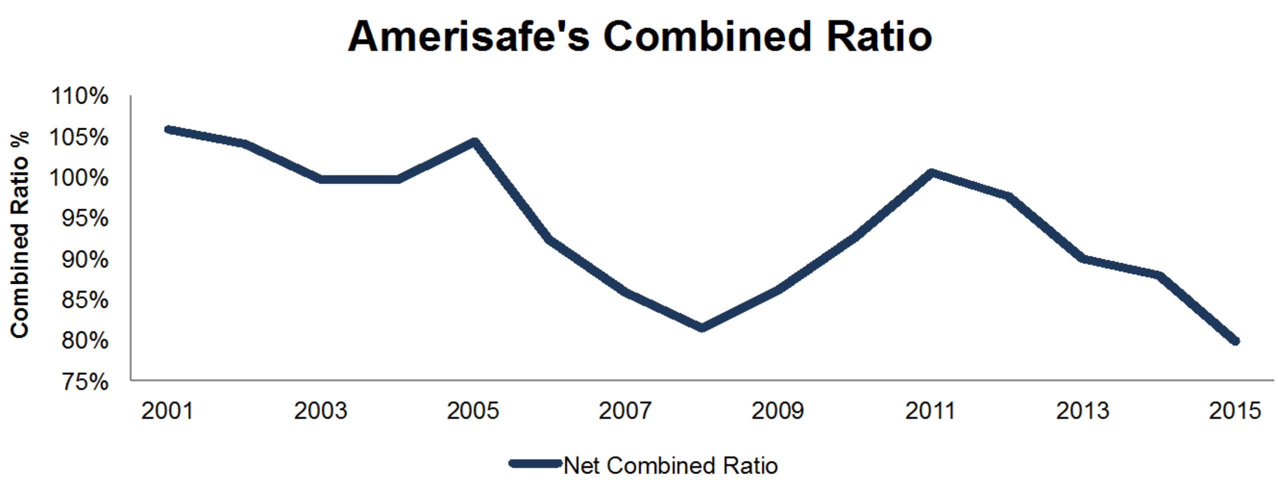
Bear Concerns Ignore Amerisafe's Profitability Throughout History

The largest concern regarding most insurance companies revolves around its ability to underwrite profitable policies and the constant risk of a large catastrophe resulting in large claims. Amerisafe's focus on underwriting policies to employers in hazardous industries, such as construction, manufacturing, and oil & gas may remove the firm from the unpredictability of natural disaster, but the risks of human error and injury cannot be avoided.

These concerns seem less alarming given Amerisafe's focus on proactively ensuring employee safety standards are maintained and improved at most companies that hold a policy with AMSF. To ensure safety standards are upheld, Amerisafe provides proactive safety reviews of worksites to ensure safer workplaces and minimize the risk of claims. In 2015, nearly 90% of new voluntary policyholders were subject to pre-quote safety inspections, and, in addition, Amerisafe performs periodic on-site safety surveys on all voluntary policyholders. Maximizing safety in hazardous industries minimizes the risk of injury, which directly impacts Amerisafe's bottom line.

The steps taken above directly translate to Amerisafe's success in profitable underwriting. Per Figure 4, the company's combined ratio, which measures premiums received vs. losses paid, has consistently been below 100. A ratio below 100 means that Amerisafe collects more in premium than it pays out in losses. 2011 is the only year over the past decade that Amerisafe's combined ratio was not below 100. In fact, since 2001, Amerisafe's combined ratio has been below 100 in 11 of the 15 years, a testament to the firms underwriting success. Amerisafe's combined ratio was 80% in 2015 and is 76% through the first half of 2016.

Figure 4: Combined Ratio's Continual Improvement



Sources: New Constructs, LLC and company filings.

Not only is Amerisafe profitably underwriting insurance, it is doing so more effectively than its competition. Per Figure 5, Amerisafe has the lowest (best) combined ratio of its peer group, not only in 2015, but also through the first six months of 2016.

Figure 5: Combined Ratio Peer Comparison

Company	Ticker	Combined Ratio (2015)	Combined Ratio (First Half 2016)
Amerisafe	AMSF	80%	76%
RLI Corporation	RLI	85%	87%
Baldwin & Lyons	BWINB	91%	91%
ProAssurance Corp	PRA	91%	93%
Employers Holdings	EIG	94%	95%
Safety Insurance Group	SAFT	112%	95%
Donegal Group	DGICA	99%	96%
Hallmark Financial Services	HALL	94%	96%
National Interstate Corp	NATL	100%	97%
United Fire Group	UFCS	92%	99%
Global Indemnity	GBLI	95%	102%

Sources: New Constructs, LLC and company filings.

Valuation Implies Permanent Profit Decline

Despite impressive share price performance this year, up 20% year-to-date, AMSF is still priced for a permanent decline in profits. At its current price of $60/share, Amerisafe has a price to economic book value (PEBV) ratio of 0.9. This ratio means that the market expects Amerisafe's NOPAT to permanently decline 10% from current levels. This expectation runs contrary to the company's profit growth since 2005.

If Amerisafe can maintain TTM NOPAT margins of 21% and grow NOPAT by just 5% compounded annually for the next decade, the stock is worth $75/share today – a 23% upside. This expectation assumes AMSF can grow revenue by 3% compounded annually, which is slightly below the 4% average over the past decade.

This scenario also assumes that Amerisafe's spending on working capital and fixed assets will average 8% of revenue, which is the average change in invested capital as a percent of revenue over the past five years. The low market expectations embedded in AMSF offer investors low risk/high reward exposure to the P&C industry.

Share Buyback & Dividend Could Provide 3% Yield

Amerisafe has $25 million remaining under its current repurchase authorization, which unless reauthorized, will expire at the end of 2016. Amerisafe has repurchased $22 million (2% of current market cap) in stock since the beginning of the repurchase plan, which first began in 2010. Amerisafe made no share repurchases in 2015 or through the first six months of 2016. If Amerisafe were to repurchase the remaining $25 million under its current authorization by the end of the year, it would represent 2% of AMSF's current market cap. When combined with Amerisafe's dividend, the potential buyback could provide investors just over a 3% yield. If Amerisafe chooses not to repurchase its remaining authorization, investors would still receive a dividend yield of just over 1%.

Increased Employment Leads To Increased Premiums

By providing workers compensation insurance, Amerisafe's success is tied to a robust job market, as more hires will lead to increased demand for insurance policies and/or larger policies as companies expand operations. More specifically, increased employment in the construction, trucking, and manufacturing industries provides increased opportunities for Amerisafe. As such, it's worth noting that these industries have seen strong employment growth in recent years and the uptrend has continued through the first half of 2016.

- From 2010-2015, construction employment grew 3% compounded annually to 6.4 million employees, and through August 2016, monthly average employment totaled 6.6 million.
- From 2010-2015, trucking employment grew by 3% compounded annually to 1.45 million employees, and through August 2016, monthly average employment totaled 1.46 million.

Furthermore, monthly average manufacturing employment is still 15% below its historical 20-year average and the decline in oil prices in 2014/2015 led many oil firms to cut back on hiring and/or undergo layoffs. A strong employment market, as shown through the consistent growth in the industries above, coupled with the growth possibilities in manufacturing and oil & gas provide excellent profit growth opportunities for Amerisafe.

Insider Trends/ Short Sales Raise No Red Flags

Over the past 12 months, insiders have purchased 103 thousand shares and sold 152 thousand shares for a net effect of 49 thousand insider shares sold. This amount represents less than 1% of shares outstanding. Additionally, short interest sits at just 279 thousand shares, or just over 1% of shares outstanding.

Executive Compensation Relies Upon GAAP Metrics

Amerisafe's executive compensation plan, which includes cash incentives and long-term equity awards, is tied largely to multiple GAAP metrics, including GAAP loss ratio, GAAP expense ratio, GAAP gross premiums written, and GAAP return on average equity. While GAAP metrics have their inherent flaws, Amerisafe's executive compensation plan is much better than those that focus on non-GAAP metrics, which allow management significant leeway in determining "success." By using standard GAAP metrics, management is held accountable to common, comparable, and accepted metrics in the insurance business. In fact, these incentives have led to significant shareholder value creation, as economic earnings have grown from less than $1 million in 2005 to $53 million TTM. We would much rather see Amerisafe tie its executive compensation to ROIC, as there is a strong correlation between ROIC and shareholder value, but as it stands, AMSF's executive compensation plan raises no red flags.

Impact of Footnotes Adjustments and Forensic Accounting

In order to derive the true recurring cash flows, an accurate invested capital, and a real shareholder value, we made the following adjustments to Amerisafe 2015 10-K:

Income Statement: we made $2 million of adjustments with a net effect of removing $2 million in non-operating expenses (<1% of revenue). We removed $2 million related to non-operating expenses and there were no adjustments related to non-operating income. See all adjustments made to AMSF's income statement here.

Balance Sheet: we made $38 million of adjustments to calculate invested capital with a net decrease of $36 million. One notable adjustment was $30 million (7% of net assets) related to deferred tax assets. See all adjustments to AMSF's balance sheet here.

Valuation: we made $4 million of adjustments with a net effect of decreasing shareholder value by $4 million. Despite this decrease in shareholder value, AMSF remains undervalued. The largest adjustment to shareholder value was the removal of $3 million in outstanding employee stock options. This adjustment represents <1% of AMSF's market cap.

Attractive Funds That Hold AMSF

The following funds receive our Attractive-or-better rating and allocate significantly to Amerisafe.

1. Aberdeen US Small Cap Equity Fund (GSXCX) – 2.1% allocation and Attractive rating.
2. 1919 Financial Services Fund (LMRIX) – 1.9% allocation and Attractive rating.

This report originally published here on September 23, 2016.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.

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Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

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ANSWER: They should not.

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