The Plymouth Rock Company

695 Atlantic Avenue
Boston, Massachusetts 02111

Chairman's Letter

February 28, 1997

To Our Shareholders:

No prior year has dealt us such unpleasant operating results or, ironically, such an enhancement of our long term prospects. The good news and the bad news both qualify for the headlines. At Plymouth Rock Assurance Corporation, our Massachusetts automobile insurance writer, 1996 was a tough year indeed. The tidings from our other companies are all positive; and our relationship with the newly formed Direct Response Corporation gives us a depth, a spread and a potential for value far beyond anything we have had before.

The picture having changed substantially in recent years, it is useful here to step back and review the landscape of the Plymouth Rock enterprises. Two years ago this letter reported that Plymouth Rock Assurance Corporation accounted for too much of the group's revenues and nearly all of its profits. That situation was already destined for change, because it gave the Company too great a dependence on a single line in a single state, a market insufficient to provide the stability and growth opportunities we seek. I compared the handsome returns in Massachusetts auto insurance at that time to an unsustainable speculative bubble and suggested that we would accept a downturn "with equanimity". Last year's letter stated that a price war had begun in Massachusetts auto insurance and that net income would be down as a consequence. I also reported that we were then exploring an ambitious new venture, which would require substantial financing and would take us into those parts of the United States where Plymouth Rock does no business.

The fine results of a few years ago were indeed unsustained, and the price war in Massachusetts automobile insurance is severe enough to test the equanimity I promised. Our consolidated profits are down by 66% to $4.2 million, the entire decline attributable to the price war and unusual weather in our home state. The gross revenues of Plymouth Rock Assurance Corporation now account for slightly more than half of the total revenues received for operating management by the Plymouth Rock Companies. The Massachusetts automobile insurer's contribution to the group profits in 1996 was two-thirds of the total. Seeing that company's profit account for a smaller share of the group

income has been a target of mine for some years. I had hardly hoped, however, to achieve it by shrinking the profits nearly $10 million. The rise in net income of the other profitable companies in the group, from less than half a million dollars in 1995 to almost two million in 1996, is some consolation. And, every bit as important though scarcely reflected yet in the financials, we did in fact broaden Plymouth Rock's area of interest to the entire United States by launching Direct Response Corporation, which will write automobile insurance from New York to California. In April of 1996, The Plymouth Rock Company, Peter Wood and I (together the common shareholders of Direct Response) completed a preferred stock offering which should capitalize the new company at $215 million. Peter, one of the best insurance executives of our generation, continues as chief executive of the Direct Line Group, which he founded and is the largest writer of automobile coverage in the United Kingdom. He also serves now as vice chairman of both The Plymouth Rock Company and Direct Response Corporation.

Plymouth Rock Assurance Corporation is not beyond its arduous trials. The price war is continuing into 1997 and will likely last longer than that. Few, if any, in the industry really want it, but such is the nature of price wars. Consumers pay less, at least in the short run, while we are lucky if we can stay in the black. The rates in the early 1990's turned out to exceed costs by more than anyone could have imagined. Contributing factors to this surprise included reduced auto thefts which followed a much-celebrated national downturn in crime, diminished societal and judicial tolerance for drunk driving, a welcome abatement of health care price increases that may be related to managed care, a slowdown with respect to tort inflation, and dividends from two wise public policy initiatives that permitted companies to negotiate directly with preferred body shops and depopulated the residual market pool. A methodological error in the companies' favor apparently affected the state-set rates since 1991 as well. One overreaction seems to have led to another. A large and influential carrier, concerned that its market share would fall as exuberant competitors began offering group discount plans, offered a 10% discount off the state-made rates to all members of an emergency road service club. Other companies, threatened by loss of recently profitable volume as customers weighed joining the service club's "open group", responded by providing discounts for all drivers with sufficient safe-driver credits. Soon, concurrent group discounts and safe-driver discounts were available from a wide variety of companies, giving some drivers prices 19% lower than the Commissioner's promulgated rates, which were slashed each year as well. Whatever margin was present in the premium rates of the early 1990's was returned to the public, and then some.

Plymouth Rock Assurance has been a follower, not a leader, in this sequence. Its goal has been to reduce prices just enough to hold its high quality business, and add to its book those, but only those, carefully selected customers it actually wants to keep for the long run. This has proved a realistic strategy, but certainly not costless. The company suffered a relatively small net decline in volume during 1996, about 3% of the total unit

count, but we were hit harder by the unavoidably lower prices. Price cuts removed 7% from the top line, so our total auto insurance revenues fell by nearly 9%. This is every bit as bad as it sounds for the 1996 financials, but not so bad for the longer term. Because we zealously hewed to our tight underwriting standards, we were able to replace some lost business with risks of even higher quality, and it now appears that the unit count has started upward again.

The price war alone would have been painful enough, but 1996's woes didn't stop there. Massachusetts had a horrendous winter, with the greatest snowfall in Boston's recorded history. Since Bunker Hill Insurance Company, our new homeowners subsidiary, had not yet begun accepting business, Plymouth Rock Assurance carried most of the burden. Additional auto skids and the leakage through ice-dammed roofs produced over $7 million in claims and loss adjustment costs that an ordinary winter would not have seen. Plymouth Rock Assurance Corporation lost $3.7 million in the first quarter, the first time it has had a red-inked net income in ten years. By yearend there was some improvement, but not all the damage could be made up. That company's combined ratio for the year was well over one hundred, a symbolic barrier it had stayed below for a decade. Plymouth Rock Assurance's 1996 results would have been worse still had they not benefited from favorable development of claim reserves and residual market assessment set-asides in prior years.

As we enter 1997, the winter weather looks to be favorable. The same can not be said of the rate situation. The Commissioner, at the end of January, announced a 6.2% decrease in the average statewide premium rate. The largest insurers, who should see this third-in-a-row cut as a sign to lay down arms, are instead continuing to war over increasingly unprofitable market share. Included in the announced decrease is a provision for retroactive adjustment of the calculation error that had favored the industry. The Commissioner noted that the 1998 and 1999 rates will also contain a downward component contributing further to the correction of the error. Retroactive adjustment seems a bit harsh to the industry (which is appealing the decision) since no one seriously believes that an error in the other direction would have been corrected and because the companies have, in effect, already returned the excess gains in unprecedented voluntary discounts below the state-made rates. More important than the correction factor, there is little hope at this time for an immediate break in the price war. The best one can wish for is that the direction of momentum has at least been reversed. Even if this is the case, expect the impact of the price reductions and discounts on our results to worsen in 1997. There is no way it can do otherwise.

We performed this year a careful and systematic study of the operating results of Plymouth Rock Assurance Corporation and its domestic competitors. The study suggests that over the past three years Plymouth Rock averaged about five points better than the mean of our peers in loss ratio and about two points higher in expense ratio. This makes

logical sense. Our loss ratio advantage derives from a superior agency force and superior underwriting mathematics. Among the contributors to our expense ratio handicap are our emphasis on the best service, maintenance of a managerial corps capable of running a larger company, and slightly higher agency commissions and agency automation expenses than most companies incur. Since our combined ratios are generally a few points better than our peers, results near break-even after removal of non-repeating events at Plymouth Rock translate into fairly serious losses for the industry as a whole. Others, too, may have had some reserves left to carry forward from the good years, but next year's industry results will be naked and, I suspect, not very pretty. Suspicion may be the proper response to any Massachusetts auto insurer who suggests that it isn't hurting in 1996 and 1997.

The many challenges of this period coincided with a change in the operating structure of Plymouth Rock Assurance Corporation. As the scope of the Plymouth Rock group has widened, it has become impractical to have the daily operational decisions of any one of its components depend on my input. The kind of hands-on management which I have performed at our flagship subsidiary for over thirteen years has always been a source of enjoyment and never seemed a burden. It is with a sense of loss, not relief, therefore, that I am beginning to move away from the front line. My efforts now are spread too widely over the group's activities to be involved in everything I once touched at Plymouth Rock Assurance, so this year Keith Rodney was elected that company's president while I remain as its chairman. Keith runs the company with the support of a talented operating committee, whose members are Ray Moore, Paula Gold, and Maria Walsh, who replaced Bill Kelley as claims vice president in mid-year. There is a search in progress for a fourth member, in the position of vice president for underwriting and marketing.

Please remember as you see the painful consequences of the price war that they reflect no lack of excellence on the part of the new team. It was on my watch that the price war began, and on my watch too that we formulated our early responses to it. Keith and the other key executives are just completing their first annual budget. They are also working on a longer term plan, intended to widen the combined ratio advantage we hold with respect to our average domestic competitor. It will take several years before there can be a fair test of the new team's stewardship.

The closest siblings to Plymouth Rock Assurance are Bunker Hill Insurance Company, our Massachusetts homeowners carrier, and Mt Washington Assurance Corporation in New Hampshire. Both are wholly owned subsidiaries of The Plymouth Rock Company, and both are underwriters of personal lines business distributing their products through independent agents. Bunker Hill, located in a stately, National Historical Register building we purchased at a bargain price in downtown Boston, is in its first year. It is managed under contract by Pilgrim Insurance, our insurance service company. Vin Nieroda, who runs Pilgrim Insurance, serves simultaneously as president of Bunker Hill.

He and his team are beginning to take an independent look at the economics of the homeowners business, viewing it not just as an adjunct product to automobile insurance. Bunker Hill had a small loss this year, but the results carry little significance since the premiums and expenses began moving over from Plymouth Rock Assurance at uneven rates. Its revenues, when all the business is finally transferred in June of 1997, will be about $25 million. Most of the expenses have moved already. By the end of next year, Bunker Hill's results should conform to its actual profitability.

Bill Kelley, after ten years as the head of claims for Plymouth Rock Assurance, is now the president of Mt Washington, working with chairman Ray Moore to expand our presence in New Hampshire. Bill is leaving his life-long claims specialty, having built a department of which he can be rightfully proud, to try his hand at the full range of executive challenges. First among them is to increase the scale of Mt Washington, which wrote about $7.2 million in 1996 at a small net profit for the year. It has been close to the breakeven line, on one side or the other, for four years in a row. We have all recognized since it began that Mt Washington will need about $25 million in premiums to reach a reasonable economy of scale point. This is, of course, easier said than done in as small a state as New Hampshire. Bill, however, is a man of unusual perseverance. He has established as a goal that, without extending beyond the three northern New England states, he will break the economy of scale barrier and earn an annual return on capital every bit as healthy as those of the larger insurers in the Plymouth Rock group.

After Plymouth Rock Assurance, the largest insurer in the Plymouth Rock family is now Palisades Safety and Insurance Association, the reciprocal automobile insurer our group manages in New Jersey. Under Hal Belodoff's fine leadership, the management company and the reciprocal together earned more than $1.1 million dollars on reciprocal premium of over $45 million. The management company alone earned just over half a million dollars, its first significant profit since inception. Although some unusual events helped contribute to success in 1996, we consider the prospects for the future in New Jersey quite promising. New Jersey never had the boom years that recently led to financial whipsaw in Massachusetts, and its long term regulatory history has been unnerving to insurers. As a consequence, competition there is only so intense. More companies still want to reduce their volume in New Jersey than increase it, and few of our competitors in that state have spent the time and money required to develop excellence in customer service.

The loss ratio at the reciprocal, estimated at 62% for the 1996 calendar year, remains several points superior to that of the New Jersey industry. The gross expense ratio for the management company and the reciprocal, taken together and including both loss adjustment expenses and investment expenses, is around 39%. This is a few points worse than industry norms, but economies of scale in the next few years should help significantly to close the gap. As a minor historical footnote, it is interesting to remember

that, over five years ago, when we first conferred with the New Jersey Insurance Department on entering the state, the Commissioner asked what premium level would be required for sufficient scale economies to complete the start-up phase. My guess at the time was $40 million, half again the equivalent number in New Hampshire, and it has not changed. Palisades passed its mark this year. As Palisades continues to grow, it will try to achieve a sustainable combined ratio advantage over its peers. Because New Jersey is a state that some companies are still paying to exit, Hal envisions Palisades as a $200 million company. This would correspond to about a 4% market share in New Jersey, similar to what Plymouth Rock Assurance already has in Massachusetts. The volume and combined ratio goals would add up to a big success, but they look rather realistic from here. I am certain that Keith Rodney, as Palisades' chairman, would be thrilled to see the New Jersey kid catch its older sibling in size and strength.

Hal is supported in his New Jersey chores by two first rate officers. Frank Arment, who took over the Palisades claims function after a long and successful career at the Hartford Insurance Group, has guided Palisades in building a claims force whose performance and competence belie the company's recent origins. He is a fine example of how much we can benefit from other carriers' early retirement programs. Karen Murdock oversees Palisades' marketing and underwriting operations, and has successfully established Palisades' reputation for first class service. An additional word on Karen is befitting here, since Karen, Maria Walsh and John Delano, Karen's counterpart at Pilgrim, became the first Plymouth Rock employees to become officers of a Plymouth Rock company through internal promotion. It is a welcome sign of a maturing organization that outside searches are no longer necessary in filling some key jobs. I hope we are moving toward a healthy balance of internal advances, which build morale and strengthen corporate culture, and outside searches, which add new ideas and prevent taking the familiar for granted. In any event, Palisades, Plymouth Rock Assurance and Pilgrim could not have done better no matter how or where the searches were conducted.

Vin Nieroda, who runs our insurance services company, Pilgrim Insurance, also had a fine year, and, as a consequence of his success, he has been given some weighty new responsibilities. Pilgrim brought more than a million dollars to the bottom line from gross fee revenues of just over $10 million and $21 million in managed premium volume. Vin and I had agreed for some years that there were two goals he should set as president of a Plymouth Rock operating subsidiary: proving marketplace acceptance by earning at least a million dollars a year after taxes on a continuing basis, and establishing an enterprise in which every involved person took pride from their association. Pilgrim Insurance now meets both tests. As a sign of the board's confidence in Vin, he has not only been given responsibility, under contract, for Bunker Hill Insurance, but also Boston Risk Management Corporation, which has become a subsidiary of Pilgrim. Boston Risk, our brokerage and consulting subsidiary, has not yet crossed the threshold into profitability, but Bob Barrese and Fred Church are continuing their efforts to cure this by

launching a very long-awaited workers compensation project, with a major health care company as a partner. All of us think the new project under discussion can prove worthy of its lengthy gestation period.

Direct Response Corporation was financed in April, when a group of highly prestigious investors led by Morgan Stanley Capital Partners subscribed to a $210 million preferred stock issue. The Plymouth Rock Company will put in $5 million to complete the company's capitalization. The first $31.5 million arrived at the closing. The next tranche of $91.6 million arrives this coming April, contingent only on the continued participation of Peter and me. The final $91.6 million is scheduled for April of 1998, though the investors have the right to delay the final subscription if Direct Response has not met certain hurdles and operating benchmarks by that time. Only if Direct Response misses the benchmarks every year until 2001 do the investors have the right to opt out of the final round. Direct Response has set out an objective worthy of its impressive stake. To consider itself a success in ten years, it will have to be profitably providing automobile insurance to over a million customers around the country. It will need all the mathematical analysis and regulatory focus that has characterized Plymouth Rock, marketing talent and information technology skills comparable to those at Direct Line, and household-level recognition for customer service a noticeable cut above the norm for its industry.

At a Morgan Stanley Capital Partners conference in July, Peter and I spelled out our specific goals for 1996 as these: (1) attain licensed carrier status in all major states; (2) recruit a first rate executive team; (3) select and begin implementing the company's data processing systems; and (4) formulate both a marketing philosophy and a plan for getting the first $100 million in written premium. I am pleased to say that we were on target when the new year began. Direct Response bought from John Hancock Mutual Life Insurance a virtually inactive property and casualty subsidiary, which was licensed for auto insurance in over 40 states. The top level operating team, led by Chuck Bryan, a former president of the Casualty Actuarial Society and a former chief financial officer and chief actuary of USAA (the largest direct writer of personal lines in this country), is mostly complete. Jane Dickson, until recently an officer of Direct Line, has moved to the United States and taken over the company's legal and human resources functions. Eric Gottheim, an actuary we first met when he was at GEICO, will head up the risk selection effort. Kathy Gleeson, also trained at GEICO, will manage customer services. Peter Graham, formerly the second in command in the data processing department at Direct Line in the U.K., joined us and has assembled a team to meld a system licensed from a vendor with our own proprietary systems elements. And, Dennis Robich, an energetic former officer of Allstate, has begun the marketing effort, which will take us simultaneously into general market advertising and partnerships with carefully selected affinity groups. No one pretends it will be easy to build the United States' best billion dollar insurer within ten years, but we are hard at the attempt.

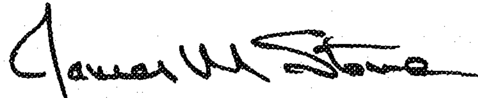
Our investments, which have long prospered under the management of Jim Bailey and Rick Childs, had another strong year. In fixed income investments, where we have purposely avoided speculation on interest rates, our results were comparable to those of the relevant indices (which declined moderately as rates rose). That is all we expect. On the equity side, where we explicitly accept the risks inherent in a non-diversified portfolio in exchange for extra returns when our analysis is better than that of the market, we had a splendid year. Our portfolio of marketable equities was up by 39%, versus a gain of 23% in the Standard and Poor's Index. Our marketable equity portfolio has now risen by 160% in three years, which is more than twice the increase for the bull market as a whole. Since our non-marketable equity investments are not all appraised on a regular basis, their performance is a bit harder to calibrate. It appears, however, that these have done about as well as the marketable equities. This means that there have probably been some gains in our net worth that can not be reflected on the balance sheet until the underlying investments have readily determinable market values.

The only disquieting element to the investment picture is that the domestic stock markets are at dizzying levels, and it is ever harder to find a bargain. Since we have no interest in trading, we must live on our perceptions of long term undervaluation by others. Even in generally strong markets, some companies are undervalued, but in boom times there is less and less to choose from. That may force us more into alternative equity vehicles, such as real estate (that's ownership, not mortgages to developers), venture funds, and occasional foreign equities. I would feel more comfortable about the advantages of systematic fundamental analysis in more normal times, when our equity selections could be principally from among domestic stocks.

A warm welcome is due to our newest Plymouth Rock director, Chuck Chokel, whose principal responsibility is as the chief financial officer of the Progressive Insurance Companies in Cleveland. Progressive has long been a supportive and constructive shareholder of Plymouth Rock. Chuck is proving all of that and more as a director.

I hardly need to dwell on next year's challenges. Just staying the course for those parts of the business that are presently meeting expectations is one task. Threats and turmoil can arise from the most unexpected places, especially when the businesses are all still at entrepreneurial scale. Guiding Plymouth Rock Assurance Corporation through its raging waters, and making sure that it is poised to emerge from the price war with an enhanced competitive advantage, is a top agenda item for half a dozen of your officers. If their strategy is sound and its execution steady, we may still be able to make lemonade out of the current barrage of lemons. Completing the management transition at Plymouth Rock Assurance is another essential task. Direct Response Corporation will go live sometime in 1997 and sell its first policies in New York State before the year ends. Peter and I will be satisfied only if its first customers recognize right from the inception the high standard for policyholder service which will become the company's signature. At the same time,

Jim Bailey and I have come to a shared awareness that we must give even more emphasis to the investment side of the business. Before long we should be handling half a billion dollars in investment assets, and, as Direct Response takes off, that number can only grow. These are big changes, but they are welcome. Your senior team is relieved beyond measure that Plymouth Rock's activities were broadened before the cycle in Massachusetts automobile insurance headed for its anticipated and inevitable, though presumably temporary, drought. We do not see our overall endeavor as weakened by the dry spell, and, in fact, there has never been a time of challenges more worthwhile or opportunities more appealing.



James M. Stone