Inside P&C by The Insurance Insider

October 25, 2019

BROKERS BEGIN TO CHANGE THE MOOD MUSIC AS AJG SAYS RATE INCREASES "MAKE A LOT OF SENSE"

AJ Gallagher pricing commentary

	Q2:19	Q3:19
US retail	4%	5%
US wholesale	5-6%	Approaching 6%
UK retail	3%	3% (but higher QoQ)
UK wholesale	8%	Approaching double-digits

Arthur J. Gallagher reported results and held its Q3 earnings call Thursday evening, providing a significant new lens and data points on the state of the market, particularly as one of the most bearish voices in Q2.

AJG's results beat analyst estimates in Q3, reporting .80/sh vs. the .79/sh consensus, off of $1.79B in revenue and producing $286M in EBITDAC, compared with $1.74B and $239M in 3Q18.

Organic revenue growth came in at 5.8%, in line with Q2, offering a glimpse into a market where broker organic growth remains strong. Net earnings margin improved by 78bps, whereas EBITDAC margin expanded by 66bps, boosted by slower hiring.

On the market, the data released by AJG shows a market that continues to firm, though management continues to caveat operating conditions as not truly a "hard market".

Recall, last quarter we wrote about the inherent tension brokers have in their stakeholder communications, needing to both excite investors with bullish growth drivers while remaining disciplined on messaging to protect clients' interests ("Caught Between a Soft and a Hard Place")

Still, accelerating rate increases of +5% "in the aggregate" suggests firming conditions, in line with other data we've seen. Indeed, management noted rates are "increasing at a higher rate than earlier this year".

Perhaps most significantly, what stands out to us is brokers are no longer resisting rate increases, but, further to what we've heard during conference season, brokers are focused on prepping clients for rate increases and training staff selling those rate rises. As Pat Gallagher put it:

> *"Our job is to mitigate [rate increases] for our clients. So number one, we're training our people across the globe, get out in front of this and explain to your clients that in fact in many instances we can show you that your rates are lower today than they were in 2005, so if you had a very good run, this is not a knee-jerk [reaction]; the rates that are being requested in many instances make a lot of sense, but it certainly not a message that anybody wants to hear."* – **CEO, Pat Gallagher**

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Arthur J. Gallagher, Key Statistics

Market Cap ($mn)	**16,774**
Share price	**91.2**
MTD	**1.8%**
YTD	**23.8%**
1-YR	**27.8%**
3-YR	**87.9%**
Div Yield	**1.9%**
Price / Earnings	**24.6 x**
Price / Book	**3.4 x**

Source: S&P Global, Inside P&C

Still, AJG attempted to walk the line and reiterated earlier comments that played down the firming across the market. Comparing current conditions to the market following 9/11, when the "door slam shut" and policies were being "cancelled left and right", AJG made a point that the cycle is a long way from a hard market.

> *"This is not a hard market. It's getting firmer, there's no question about it that when you get into some higher end property stuff and catastrophe exposed or places where there been losses, our people are working very hard to place those. Some of the stuff is getting done at the last minute, it takes more effort, more submissions to E&S markets to get it completed. We're seeing excess casually take a little more effort and cost more money as well. But this is not 2001, 2002 by any means. There is still plenty of capacity. Deals are getting done."* – **CEO, Pat Gallagher**

The company also announced that it completed 14 "tuck-in" mergers worth $85M in annualized revenue, bringing the total number of acquisitions YTD to 38 and a total of $351 in acquired revenue.

AJG also sounded off on the social inflation that is increasingly getting the industry's attention.

> *"There is no doubt. We're seeing are seeing tort inflation across our book of business, in in particular, areas like transportation, sexual misconduct and D&O, in places like that. Our liability book and severity -- even in the liability book in Gallagher Bassett, it's both up in terms of numbers of claims as well as the settlement amounts that are being paid to close. There's clearly tort inflation."*

EXHIBIT: AJ GALLAGHER PRICING DISCLOSURE

Source: Company report, Inside P&C

<table>
<tr><th></th><th>Q2-18</th><th>Q3-18</th><th>Q4-18</th><th>Q1-19</th><th>Q2-19</th><th>Q3-19</th></tr>
<tr><td colspan="7">US retail</td></tr>
<tr><td>Commercial auto</td><td>5%</td><td>4%</td><td>5%</td><td>5%+</td><td rowspan="4">4%
on average</td><td rowspan="4">5%
overall</td></tr>
<tr><td>Property</td><td>5%</td><td>3%</td><td>5%</td><td>5%+</td></tr>
<tr><td>Workers comp</td><td>-1%</td><td>-1%</td><td>-1%</td><td></td></tr>
<tr><td>US casualty & specialty</td><td>0-2%</td><td></td><td></td><td>2%</td></tr>
<tr><td colspan="7">US wholesale</td></tr>
<tr><td>Commercial auto</td><td></td><td></td><td>4%</td><td>4%+</td><td rowspan="4">5-6%
(many in property 10%+)</td><td rowspan="4">Approaching 6%</td></tr>
<tr><td>Property</td><td>7%</td><td>5%</td><td>4%</td><td>4%+</td></tr>
<tr><td>Casualty</td><td>2 - 4%</td><td>2%</td><td>3%</td><td>3%+</td></tr>
<tr><td>Workers comp</td><td></td><td><-1%</td><td><-3%</td><td></td></tr>
<tr><td colspan="7">UK retail</td></tr>
<tr><td>Overall retail</td><td>1.5%</td><td></td><td>Flat+</td><td>3%</td><td>3%</td><td>3% (higher QoQ)</td></tr>
<tr><td>Professional liability</td><td></td><td></td><td>5.0%</td><td>5%+</td><td rowspan="5">3%</td><td rowspan="5">3% (a touch higher QoQ)</td></tr>
<tr><td>Property</td><td>Flat</td><td>2%+</td><td rowspan="4">Flat+</td><td rowspan="4">1-2%
for most lines</td></tr>
<tr><td>Marine</td><td></td><td>2%+</td></tr>
<tr><td>Commercial auto</td><td></td><td>2%+</td></tr>
<tr><td>Casualty</td><td>2 - 3%</td><td><2%</td></tr>
<tr><td>London Specialty Operations</td><td></td><td></td><td></td><td>5%
(10%+ in cat exposed)</td><td>8% (more in D&O, E&O and property)</td><td>Appoaching double-digits</td></tr>
</table>

EXHIBIT: AJ GALLAGHER PRICING DISCLOSURE (CONTINUED)

Source: Company report, Inside P&C

	Q2-18	Q3-18	Q4-18	Q1-19	Q2-19	Q3-19
Canada						
Property		3%	4%		7-9%	8% (property more than 10%)
Commercial Auto			<4%		7-9%	
Professional Lines		1%				
Casualty		1%	<4%		0%+	
Australia & NZ						
Casualty & Specialty	4 - 6%	5.0%	5%+	4-6%	7%	5-6%
Property	8 - 9%	7%	9%			

Earnings highlights

AJ Gallagher reported organic growth of 5.8%, slightly slower than 5.9% in Q3:18 but higher than 5.3% in Q2:19. Brokerage revenue grew organically by 5.8%, slower against 6.3% YoY and balanced against same growth rate sequentially.

On the bottom line, the broker reported Q3 earnings of $0.80 per share, edging over the consensus estimate of $0.79 and last year's Q3 EPS of $0.78.

EXHIBIT: AJ GALLAGHER Q3 RESULTS SUMMARY

Source: Company Reports, Inside P&C

AJ Gallagher	Q3-18	Q4-18	Q1-19	Q2-19	Q3-19	YoY var.
Revenue ($mn)						
Consolidated	1,741	1,623	1,958	1,625	1,791	2.8%
Brokerage	1,049	1,002	1,382	1,131	1,196	14.0%
Risk management	199	202	203	209	212	6.3%
Corporate	493	419	372	285	383	-22.3%
Organic growth						
Consolidated	5.9%	5.8%	5.5%	5.3%	5.8%	(14bps)
Brokerage	6.3%	5.6%	5.7%	5.8%	5.8%	(50bps)
Risk management	4.0%	6.7%	4.1%	3.0%	5.7%	170bps
Adjusted EBITDAC margin						
Consolidated	25.1%	21.6%	33.1%	25.0%	25.8%	66bps
Brokerage	26.5%	22.5%	35.6%	26.4%	27.2%	70bps
Risk management	17.9%	17.3%	17.0%	17.5%	18.0%	10bps
Adj. operating income ($mn)	244.8	189.9	417.2	261.0	285.4	16.6%
Adj. operating margin	19.6%	15.8%	26.3%	19.5%	20.3%	72bps
Adj. EPS analyst estimate	0.77	0.52	1.61	0.61	0.79	1.3%
Adj. EPS actual	0.78	0.53	1.63	0.65	0.80	2.6%
Surprise	1.3%	1.9%	1.2%	6.6%	1.3%	-

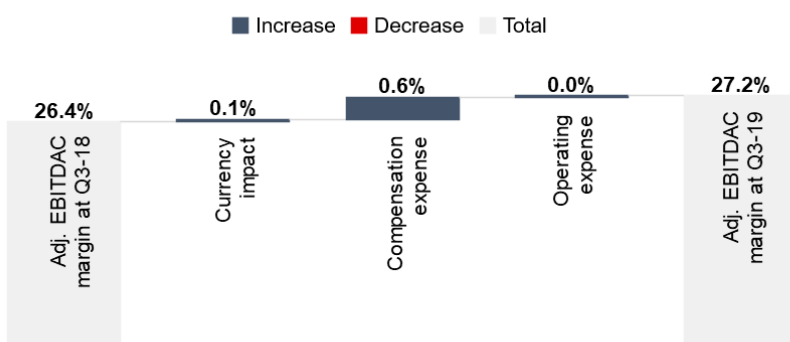
On margins, the broker outpaced its own outlook as Brokerage adjusted EBITDAC margin expanded by 70bps versus 50bps guidance and Risk Management expanded to 18.0% versus 17.0-17.5% guidance.

Management noted that less aggressive hiring aided margins.

"I think the biggest answer is the team did a really nice job. We kind of put a clamps on hiring. And when you're hiring 350 people a month, you can kind of control your corporation a little bit by just putting the brakes on it a little bit. We're coming into the end of the year, we didn't want to get too aggressive in our hiring. That's probably delivering most of it in the quarter. Typically, we don't do that until the fourth quarter so I think the team just got ahead of a little bit".

"I think that you're really seeing some of the economies scale coming through. But also, we're just getting good results by utilization of our Offshore Centers of Excellence. We're getting good results through our technology list".
– CEO, Pat Gallagher

EXHIBIT: BROKERAGE ADJ. EBITDAC MARGIN CHANGE ATTRIBUTION
Source: Company reports, Inside P&C



<u>Other notable items from the company's report included:</u>

- Reiterated 50bps brokerage margin expansion for future quarters assuming 5% organic growth.
- Risk management organic growth guidance for Q4 5.5% up from 5.0% for H2:19 communicated in Q2, adjusted EBITDAC margin for Q4 and full year 17-17.5%, in line with Q2 guidance.

There is more to come

The strong Q3 results by AJ Gallagher and BB&T Insurance Holdings provide a strong signal for the overall industry's results.

However, more meaningful data points are still to come, with Aon reporting today before the bell, as well as the other two big brokers and Brown & Brown also yet to report.

In particular, increased attention will be on Guy Carpenter's organic growth following 3% contraction last quarter, only the second contraction in over a decade. The consensus among analysts points to another contraction in Q3 for the Marsh's reinsurance unit.

Some outcomes of Willis Towers Watson's efforts to catch up with the peers' margins will also be topical.

Q2 earnings schedule for the remaining brokers is as follows:

- **Aon –** Friday 25th October before the bell.
- **Brown & Brown** - Monday 28th October after the bell.
- **Marsh & McLennan –** Tuesday 29th October before the bell.
- **Willis Towers Watson –** Thursday 31st October before the bell.

EXHIBIT: INSURANCE BROKERS' ORGANIC GROWTH

Source: Company reports, Inside P&C

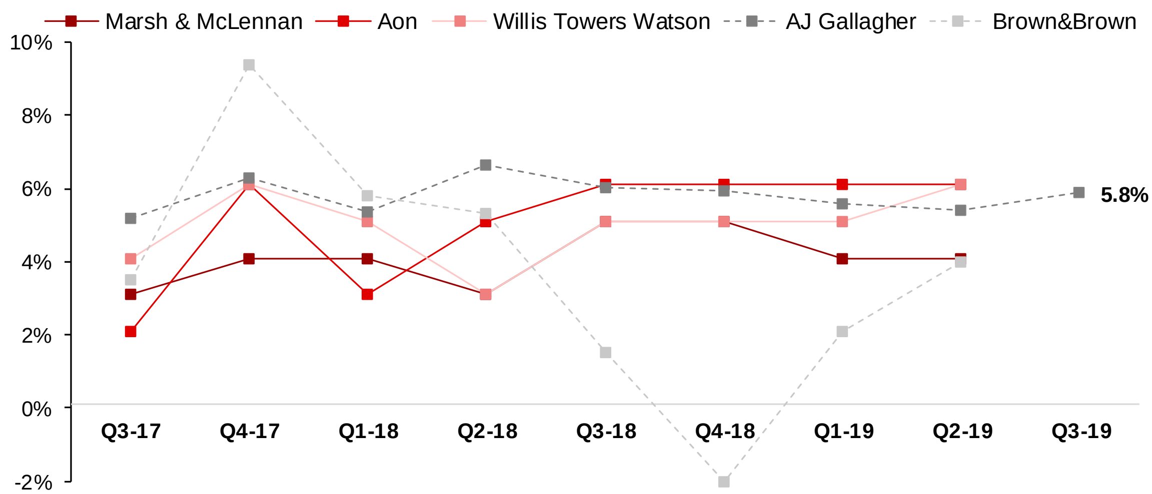
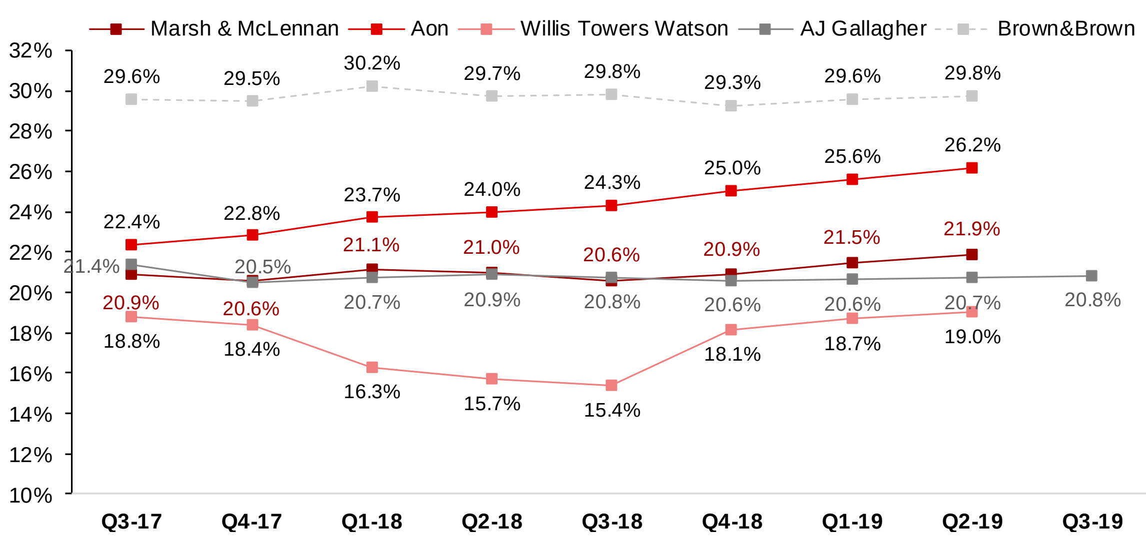


EXHIBIT: ROLLING 4-QUARTERS ADJUSTED OPERATING MARGINS

Source: Company reports, Inside P&C



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