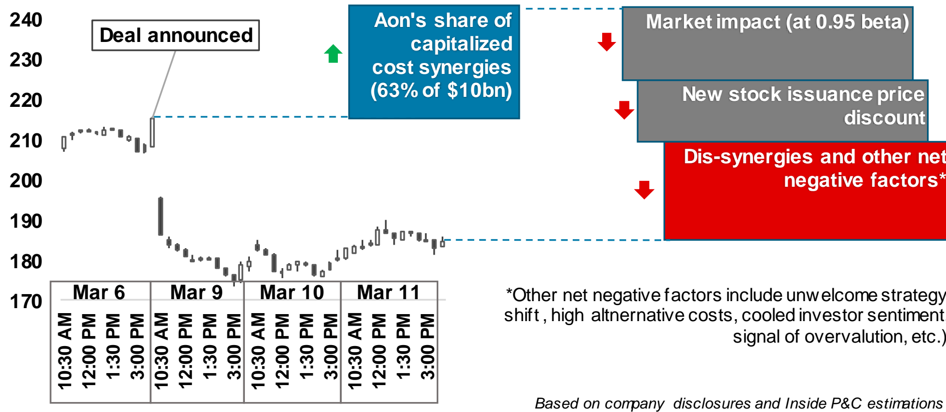
Aon-Willis: A strategic coup, but an unfair price



The merger between Aon and Willis has been pitched by both managements as a “highly complementary” strategic tie-up that opens significant strategic opportunities before the combined organization with a potential to accelerate growth, innovation and address unmet client demand.

This somewhat aligns with our long-term vision on the broker industry where the market power is rapidly concentrating with a potential to transform into a paragon of hyper-competition that sweeps inefficient players and leaves space for only highly innovative, resource and data-rich businesses, replicating the trends in the tech industry of the 21st century.

The deal also seems perfectly reasonable from the financial perspective involving distinct opportunities for elimination of duplicate resources to extract synergies, as well as a substantial opportunity for Aon to drive margins up at Willis in line with its own high corporate cost efficiency standards. Moreover, it is a convenient opportunity for Aon to take advantage of its equity currency reflected in the substantially higher valuation multiple.

In spite of the initial share price response, the initial reaction of the industry to the merger seems to convey these distinctly positive financial and strategic aspects of the deal with mainstream opinion concentrated around Aon getting a great deal.

In fact, Aon having to pay a higher premium or finding other ways to sweeten the deal for Willis was not an unpopular opinion given the “unique” nature of the asset as one of the “big-3 brokers”. Partly, this was due to the poor price performance of Willis’ stock after the announcement that followed a long-anticipated and amply priced-in probability of an M&A proposal.

However, if we disengage from these likely yet uncertain deal prospects, there is a lot to be frustrated about in this value proposition if you are an Aon shareholder.

Taking a step back, we have Aon on one hand and Willis on the other. One is a highly cost-conscious well-oiled brokerage and consulting machine with a proven track record of shareholder value creation, outperformance on benchmark metrics, delivering and surpassing on its core strategic proposals. The other one is a less efficient enterprise that is facing an uncertainty surrounding succession issues and that consistently failed to deliver on working capital management and aligning margins to peers’ level, both of paramount importance for a broker’s success.

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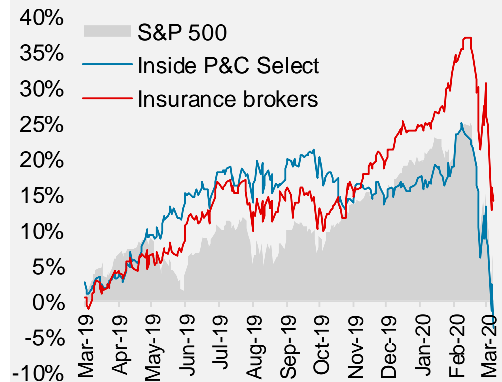
Composite	YTD px chg.	P/B
Large comm.	(22.2)%	0.8x
Regional	(17.3)%	1.4x
Specialty	(13.7)%	1.5x
Personal	(6.8)%	1.9x
Bermuda	(17.9)%	1.2x
Florida	(24.2)%	1.0x
Brokers	(8.1)%	-
IPC Select	(17.3)%	1.1x
S&P 500 Fin.	(26.2)%	-
S&P 500	(15.1)%	-

Top performer on the day **FNHC +3.8%**
Bottom performer on the day **WRB -7.9%**

1YR Price Peformance



Against this backdrop, one would expect Aon shareholders to have the best hand and negotiation power over Willis. But paradoxically, Willis shareholders are the ones to get better share in the combined company per current shareholding. To add some precision, Willis shareholders are offered 1.08 shares of the combined firm per their own while each Aon share is entitled 1 share in the combined firm, which automatically discounts existing Aon shares by 7.5%. And Aon has locked in this deal with a billion-dollar breakup fee.

This is not meant to present this deal as one that stands out, there are plenty of anomalies and paradoxes in the ego-driven world of M&A. But as an Aon shareholder there is little point in that Aon currency can afford less than WLTW.

In a similar and highly relevant transaction back in 2015, Towers Watson shareholders were proposed to merge with the P&C broking giant Willis Group in a deal that implied discounting their shares. The proposal was rejected, and the design of the new proposal suggested improved terms.

Is Aon-Willis a good deal? Likely. The deal provides appealing cost synergies and more importantly implies a market power growth in the increasingly attractive industry that rewards resource and data-rich businesses.

But is it a fair deal? Not exactly. It is clear that Aon had a desperate, hard-to-hide desire to acquire Willis following MMC-s acquisition of JLT, and it may result in Aon shareholders leaving more on the table. As much as this is contrarian against the view prevalent in the industry, it is perfectly aligned with common sense.

For better or worse, it is not shareholders but managements who has negotiated the deal which may change rather soon as shareholders get their say in the upcoming proxy vote. We see potential for shareholder dissent over the deal terms on Aon's side. Ultimately, we see the deal has a high likelihood of being closed given the strategic and financial opportunities that it has to offer. However, it may require a sweetener to get Aon shareholders' nod. After all, it is the negative reaction of Aon shareholders and impact to its stock that has dragged down Willis' shares and initiated the speculation of a sweetener to Willis. For us, our analysis of the deal suggests this logic is backwards.

On stock performance, we expect Aon's stock to remain pressured for the period preceding the M&A close and at least a year after as short-term headwinds, typical for the large-scale broker integrations, will likely cool investor sentiment driving the underperformance relative to peers. That is something observed at MMC following JLT acquisition, as well as at the most recent large broker M&As (details below).

Exhibit: Historical broker post-M&A stock performance stat

Source: SNL, FactSet, Inside P&C

Acquirer	Target	Value	Transactions closed	Stock return	Relative to S&P	Relative to peers	Stock return	Relative to S&P	Relative to peers
Marsh & McLennan	JLT	$5.6bn	1-Apr-19	11.5%	7.8%	-17.6%	-	-	-
Willis Group	Towers Watson	$18bn	5-Jan-16	0.1%	-12.4%	-30.3%	21.0%	-15.0%	-34.6%
AJ Gallagher	1) Noraxis Capital 2) Oval	$0.64bn combined	1) 2-Jul-14* 2) 1-Apr-14	2.1%	-3.1%	-7.1%	2.6%	-3.9%	-18.0%
Brown & Brown	Wright Insurance	$0.64bn	1-May-14	6.9%	-5.0%	-6.5%	17.9%	8.2%	1.2%
AJ Gallagher	1) Giles Group 2) Bollinger	$0.7bn combined	1) 14-Nov-13* 2) 1-Aug-13	-0.8%	-14.7%	-6.1%	-10.7%	-23.6%	-16.9%
Brown & Brown	Beecher Carlson	$0.5bn	1-Jul-13	-5.0%	-27.2%	-25.4%	1.8%	-26.9%	-27.3%
Brown & Brown	Arrowhead Corp.	$0.6bn	9-Jan-12	16.7%	2.6%	8.5%	40.3%	-3.2%	-9.4%
Aon	Hewitt Associates	$4.9bn	1-Oct-10	6.9%	8.2%	4.2%	35.7%	9.6%	3.4%
Aon	Benfield Group	$1.36bn	1-Dec-08	-10.4%	-46.3%	-14.7%	-4.1%	-51.9%	-32.5%
Willis Group	Hilb Rogal & Hobbs	$2.1bn	1-Oct-08	-12.1%	-0.8%	-1.1%	-3.4%	-2.1%	5.6%

** transactions combined to avoid duplicate effect. The latter transaction used as a starting point for perfomance tracking period*

Bigger is better

It is hard to imagine that the trends of the today's world do not reinforce insurance brokers' value proposition. Risk continues to become more complex and therefore professional advice more demanded as tech innovations threaten traditional business models. Political views in developed countries continue to become more polarized, with geopolitical tensions adding to the uncertainty, and complicating the strategic decision-making process.

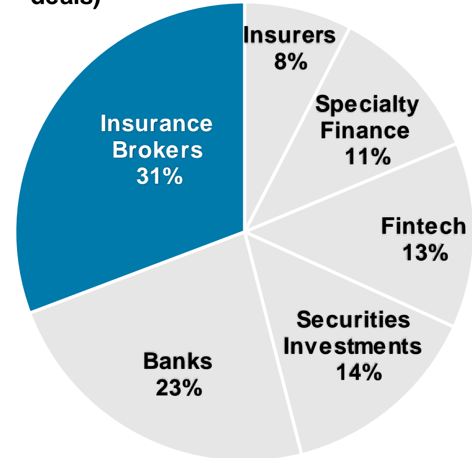
The mere fact that the world is at a later phase of the business cycle and the governments continue to stimulate economies by pumping up more liquidity into the system to extend the expansion and hardly addressing structural issues leads to a magnified vulnerability and fragility across entire economic system. This leads to decisions by corporates and individuals to have extreme binary outcomes. A number of tail-risks are increasing as tails are becoming fatter. In turn, this reasonably leads to an enhanced risk-awareness in corporates and individuals, that are willing to address the new risks and re-assess old ones.

This is the heyday of the insurance brokerage industry and that is unlikely to change due to the growing virus and oil-related macroeconomic headwinds of late that may or may not end up being short-term.

Against this backdrop, it is hardly a secret that the bigger companies, with more resources, more data, deeper specialization, political clout and prestige for talent attraction, have substantial competitive advantages in this industry.

It is due to the combination of these very reasons (plus, the old stewardship demographics of the industry and cheap debt) that the industry is one of the fastest consolidating, far surpassing any other financial sub-sector by the number of M&A deals.

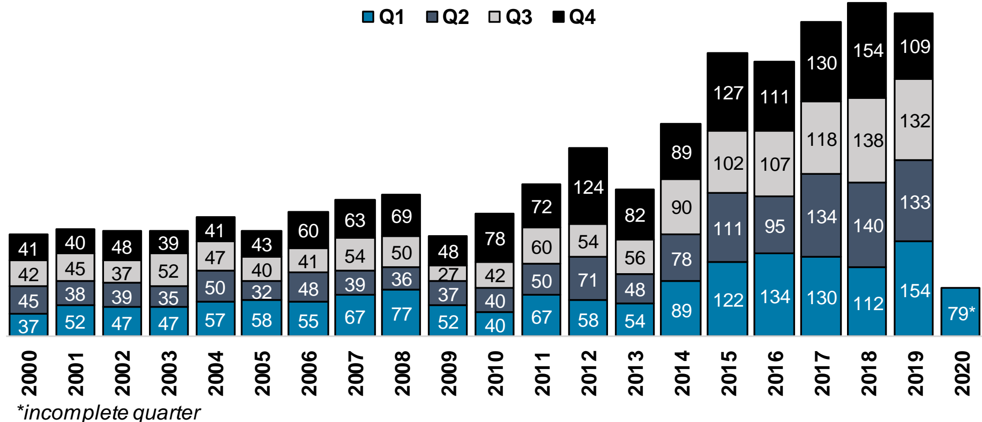
Exhibit: M&A transactions in financial services industry since 2010 (using # of deals)



Source: SNL, Inside P&C Select

Exhibit: Quarterly number of broker M&A's since 2000

Source: SNL, Inside P&C



Sound financial rationale

Aon is making a leap in a booming industry with significant potential to leverage on key advantages and lead the industry transformation, redefining and reinforcing its place in the risk management services value chain - as we discussed earlier in the report and immediately following the announcement in “Dual shock threatens paradigm shift in P&C”. These strategic aspects of the deal sound appealing.

However, let’s not forget that the economies of scale are a significant motivator behind most horizontal mergers, and serve as an important offsetting factor for the elevated short-term volatility on the acquirer’s stock.

As one would expect there will be a significant amount of duplicate resources ready to get eliminated between Aon and Willis, particularly on the administration and support functions of the combined organization.

Aon announced $800mn annual run rate cost synergies with $267mn realized in year, $600mn in year 2 and the full amount in year 3 and thereafter. The associated one-off integration costs are estimated at $1.4bn, with one-half incurred in year 1 and the remainder in the two years that follow. In addition, the retention costs of $400 million will be incurred evenly over the three years. The present value of expected synergies is estimated at $10bn implying 6.5% return on Aon shares using the price of the last close prior to the announcement.

The comparison to both peers’ and Aon’s own past deal assumptions indicates that there is a healthy conservativism in them (see chart below). In addition, Aon has a track record of beating its own guidance, including costs savings from the recent restructuring initiatives. However, we would warn for that no two deals are same, particularly when juxtaposing against the deal of this size.

Exhibit: Synergy comparison with selected M&A deals

Source: Company reports, Inside P&C

	Aon WTW	MMC JLT	MMC JLT (upd. Q4-19)	WTW MoE	Aon Hewitt	Aon Benfield
Date of announcement	Mar-20	Sep-18	Sep-18	Jun-15	Jul-10	Nov-08
Cost synergies	$800mn	$250mn	$350mn	$125mn	$355mn	$122mn
As a % of target's expense base	**11.5%**	**17.2%**	**24.1%**	**4.1%**	**13.5%**	**27.6%**
One-off costs	1800	375	625	NA	325	185
Per dollar of cost synergies	**2.25x**	**1.50x**	**1.79x**	**NA**	**0.92x**	**1.52x**
Revenue synergies	Undisclosed	Dis-synergy	Dis-synergy	$375-675mn	None	None

On the revenue side, Aon is restricted by the Irish regulation to disclose revenue (dis)synergies but our view is that it is unlikely that Aon would not face talent and revenue leakage. There will be an employee runaway involving key producers who will be picked up at another brokers, much like at Marsh & McLennan following JLT acquisition. The revenue leakage may also be exacerbated by the longer gestation period till the deal closure that may stretch to over 12 months versus the period of 6 to 8 months for most M&As. For instance, MMC closed the JLT deal within slightly over 6 months.

Aon will have to defend its revenues from rivals post-deal and a legal strategy will have to be developed. The combined firm will have to institutionalize the orphaned businesses following the key producers’ departure, all posing a certain degree of disruption and distraction to the firm.

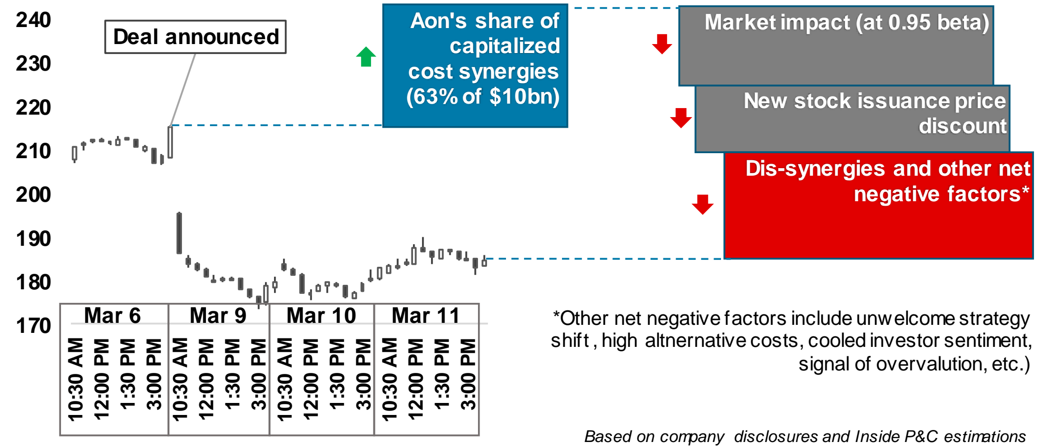
Aon’s share price movement since the announcement and as of Wednesday close implies revenue dis-synergies of $9.0bn for the combined firm with $5.7bn allocated to Aon’s shareholders. The cost synergies of $10bn estimated by Aon implies the net

capitalized value of synergies of $1.0bn, with $0.6bn allocated to current Aon shareholders (see chart below for illustration).

The rest of the decline on the stock since the deal announcement is caused by the new stock issuance price discount of 7.5% and the beta factor driven by the recent market crash.

Exhibit: Aon stock price change attribution analysis (interpretive)

Source: Company report, FactSet, Inside P&C

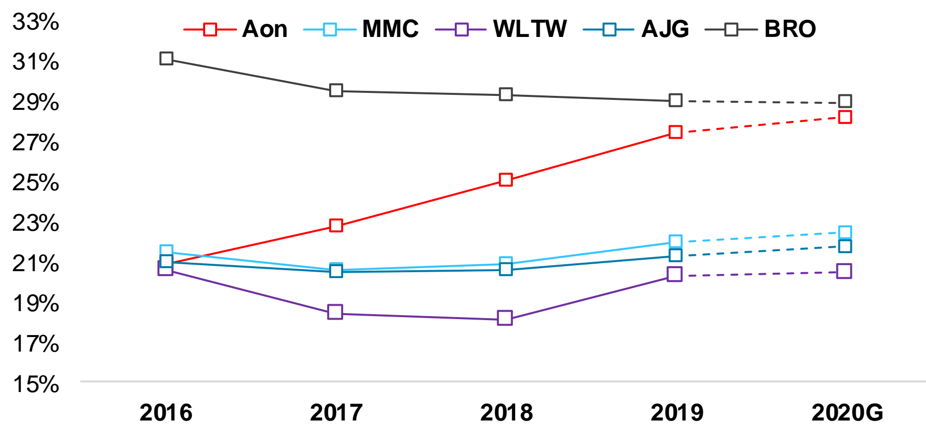


An additional potential lever for value creation for Aon comes from fixing Willis' margins beyond mere deal synergies.

Willis has struggled to align its margins to the industry standard since its formation following the merger of equals between Willis Group and Towers Watson in January 2016. The combined firm trailed its public peers by at least 200bps in 2017 and 2018 before catching up in 2019 at 100bps gap but announcing 2020 guidance that fell short of margin expansion outlooks at peers (see chart below).

Exhibit: Broker adjusted operating margins

Source: Company report, Inside P&C



As such, there appears to be substantial opportunity for Aon to drive efficiencies at Willis in line with its own corporate best practice, whether from back-office efficiencies, better technology and systems through economies of scale, or more efficiently capturing more dollars in revenue for every dollar of premium that passes through the organization.

Using 2020 margin projections announced by the firms on Q4 conference calls and a 5% revenue expansion assumption, it takes ~$750mn in operating cost cuts on Willis'

income statement to eliminate the 770bps estimated margin gap between the firms. In this light, the projection of $800mn annual run rate cost synergies indicate that in the lapse of three years post-merger the combined company will have higher margin than the stand-alone Aon would have in 2020, absent accompanying revenue dis-synergies.

Of course, the assumption that Aon would be able to fix Willis' margins involves a lot of uncertainty and non-trivial risks hidden from an outside observer. For example, there is an additional risk from the cash flow problem that received elevated scrutiny on Willis' Q4 conference call earlier in the year, as well as in "Show me the money, Willis". It remains to be seen whether the working capital issues are a Willis problem or a counter-party problem – the information hidden from our eyes as external analysts. The former is fixable, but the latter may point to bigger and more serious problems, with exposure on earnings quality and margins in an extreme case.

Not exactly a fair shake

As is typical with all-stock M&As of this size, the problem with trying to value the deal arises from the very fact that what the bidder is paying to merge with the target is an unobserved variable. It is tempting to conclude that Aon is paying its own stock to purchase the target, and it is technically correct but potentially misleading inference that may work with small acquisitions but not mergers of this size. Following the merger, Willis contribution to the mix of the combined firm's total revenue will pro-forma be 45%. Aon will not be the same company after the business combination. After Willis shareholders are compensated with newly issued Aon shares, they will become share owners of Aon and Willis and whatever the synergies and dis-synergies of such business combination, as well as an "epsilon" that encompasses everything else.

As such, let's make it clear, there is no dollar amount of premium in the all-in-equity deal where the target shareholders receive acquirer's shares at a fixed ratio but at an unfixed dollar price.

Moreover, the dollar premium will never become observable because both Willis and Aon shares are heavily pricing in the tie-up since Monday's open and can no longer serve as a proxy for either organization's stand-alone performance. In fact, the closer to the deal and the less uncertainty around its successful completion, the more the sync between Willis and Aon shares will be and they will trade at an approximately 1.08x WLTW-to-AON ratio.

While it is virtually impossible to say whether this is a win or lose for the shareholders of both firms without having a view on the future performance of the combined firm in a highly speculative and assumption-heavy exercise, it is easier to form a view on whether the deal is fair or not since the values of the respective firms immediately preceding the announcement are known parameters. And based on those stock prices Willis shares should have been discounted by approximately 7%, not Aon's.

There are some parallels with Willis Group and Towers Watson merger-of-equals back in June 2015. Then Willis Group was a P&C brokerage focused firm facing operating headwinds with both contracting top and bottom lines, diversifying into professional services, consulting, risk management and IT services through the merger with Towers Watson, a profitable growth story with superior stock performance track record.

However, using the pre-announcement closing prices, the deal involved premium to Willis Group shareholders at the expense of Towers Watson shareholders. This was followed by a rejection of the merger proposal by the unhappy Towers Watson shareholders. Subsequently, managements sweetened the deal by increasing the special dividend by 105% which made the shareholder to approve the deal. The economics of the updated deal still favored Willis Group shareholders at the expense of Towers Watson. Regardless, it is a good demonstration that a passive agreement

with a management crafted deal may involve substantial costs for investors, and the shareholder involvement turn the costs manageable.

To an extent, Aon-Willis is a similar merger story where shareholdings of a better company are to be diluted and discounted in management's pursuit of merging with an inferior company. A curious observation is that the implied discount (derived using pre-announcement closing price and implied inverse exchange ratio) for Aon is even lower than what Towers Watson shareholder received in the initial proposal. Similarly, Aon shares tanked 9.1% (ex market-beta) on the announcement day, an exact match to how Towers Watson shareholder priced their initial proposal (see chart below).

Exhibit: Premium analysis Willis Group-Towers Watson and Aon-WLTW

Source: Company reports, FactSet, Inside P&C

	Towers Watson	Willis Group
Closing price before announcement	$137.98	$45.40
Exchange ratio (# of merging party's shares per own share)	2.649x	0.38x*
One-time cash dividend	$4.87	$0.00
Premium (using pre-announcement closing prices)	**-9.3%**	**10.7%**
Increased one-time cash dividend	$10.00	$0.00
New premium	**-5.6%**	**6.4%**
Closing price after announcement	$125.80	$46.90
1-day price return	-8.8%	3.3%
1-day price return ex. market beta	**-9.1%**	**3.0%**

	Aon	WLTW
Closing price before announcement	$214.81	$199.71
Exchange ratio (# of merging party's shares per own share)	0.93x*	1.08x
Premium (using pre-announcement closing prices)	**-13.9%**	**16.2%**
Closing price after announcement	$178.93	$184.74
1-day price return	-16.7%	-7.5%
1-day price return ex. market beta	**-9.1%**	**0.1%**

**implied inverse exchange ratio*

This makes us believe that Willis shareholders are offered an excessive premium at the expense of Aon investors.

A likely counter argument to that may be that Aon pushed on strings to boost the stock price prior to the offer thus having more room to negotiate and offer a premium. Indeed, all-in-equity mergers often send a signal to the shareholders that management views the company's stock as overvalued, albeit this enters into a sharp contrast with Aon's consistently communicated view that the stock buybacks represent the best ROIC across all available opportunities before Aon.

We admit that the prospects of the deal are attractive enough to offer a premium if Willis' board does not buy into the value creation narrative of the proposed combination or simply did a great job at jacking up the price for the bidder that is openly euphoric about the next strategic move. In which case, we view one-for-one exchange ratio as an okay deal which would imply 7.5% premium for Willis investors using pre-announcement stock prices.

But 16% premium is too much of a cost. With all its charms, the deal is far from a guaranteed success. The deal is distinctly riskier for Aon's shareholders as opposed to Willis'.

We see a potential for a pushback from Aon investors on the upcoming shareholder meeting.

Ultimately, we see the deal close as highly likely given the strategic and financial opportunities that it has to offer. However, it may require a sweetener to get Aon shareholders' nod.

This research report was written by Insider Publishing's Research team which includes Gavin Davis, James Thaler, Gianluca Casapietra, and Dan Lukpanov.

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