Inside P&C

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Q3 BROKERS REVIEW. MISSION: IMPOSSIBLE

Arthur J. Gallagher

> *The rates being requested in many instances make a lot of sense*
> ***- CEO Pat Gallagher***

MARSH & McLENNAN COMPANIES

> *I expect upward pricing pressure to continue throughout next year*
> ***- CEO of Marsh John Doyle***

Last quarter, we pointed out how the (re)insurance intermediaries gravitated towards talking down the market pricing due to the inherent tensions in their stakeholder communications. Though better insurance pricing is good for investors, brokerage clients are unlikely to be happy about gleeful pricing commentary. Furthermore, junior brokers are likely to take any sign of surrender from leadership as permission to cave in negotiations, and underwriters are likely to take any hot takes as ammunition.

Understandably then, brokers have been on a mission for the past two quarters of trying to pour cold water on growing sense of a rapidly transitioning market. However, there was a material shift in their framing of the market in Q3.

The brokers' key message of talking down the breadth and depth of price increases is now turning to "managing stakeholders". The timing of the inflection point in brokers' rhetoric makes sense to us. Now the price firming is not just a talking point but a strong trend with fundamental causes (social inflation, higher loss picks and reserve true-ups).

In many ways this is understandable. Insurance is an intermediated market, with price discovery led by, and controlled by, brokers – with limited price transparency on order flow by market participants. As in other financial markets, participant psychology can be an important factor in the short-run, and this can be manipulated with spin and other tactics (or "good broking" as it is known). Who controls the data, wins.

The old joke among investors is that in the short run the stock market is a voting machine but in the long run it is a weighing machine. So too in insurance. "FOMO" can manage supply-side factors in the short-run, but ultimately if fundamental forces mean supply is not there to meet the buyers "ask price", the market will move.

It was a valiant effort, but keeping clients away from the tide of price increases is an impossible mission in this market.

Another notable trend was an overall negative reaction of the broker stocks to the strong Q3 stats, in line with our view that the high expectations is a major broker problem today. This was particularly evident when near-perfectly neutral results by Willis Towers Watson initiated a pullback in the stocks.

Speaking of the results, the public brokers came up with upbeat operating results in another quarter awash with tailwinds.

Some of the highlights include:

- **Aon's** largest segment had second highest organic growth in 7+ years.
- **Marsh & McLennan** reported strong organic growth of 5% despite revenue headwinds from JLT integration.
- **Willis Towers Watson's** risk & broking grew organically 7%.
- **AJ Gallagher's** organic sales up 6% both in brokerage and risk management.
- **Brown & Brown's** wholesale organic revenues up +11%.

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Index	QTD	YTD
Large Cap	(5.2)%	21.5%
Regional	(3.9)%	8.3%
Specialty	(0.6)%	27.6%
Personal	(5.0)%	16.0%
Bermuda	(4.4)%	32.3%
Florida	0.1%	(16.6)%
Brokers	1.5%	29.6%
IPC Select	(3.1)%	11.0%
S&P 500	3.7%	23.1%
S&P Fin.	5.9%	24.6%

Source: S&P Global, Inside P&C

BROKERS Q3 WRAP

- ***Brokers' (re)insurance Q3 composite organic revenue up 5.8%, highest in more than 5 years***
- ***Operating margins expanded by 80bps YoY on average, 20bps on rolling 4Q basis***
- ***Higher rates aided growth and margins, outlook generally bullish***
- ***Impact on stocks varied substantially as brokers that started with lower expectations enjoyed highest upward revaluations***

The benign operating environment that insurance brokers benefited from through the first half of 2019 stretched into another quarter. The consensus among insurance brokers, carriers and other industry professionals is that individuals' and businesses' exposures to various risks continues to rise, demand for professional advice heightened, the economic expansion is still solid, and insurance pricing increase is accelerating – all forming a strong tailwind for the brokers' businesses.

The favorable operating environment is evident from the brokers' Q3 results from the top to bottom. Some of the highlights include:

- **BB&T's** insurance unit reported 8.7% organic growth early in the earnings season presaging another strong quarter for brokers.
- In **Aon's** largest segment - commercial risk - organic revenue was up 7%, the second highest in 7+ years. Adj. operating margin expanded by 355bps.
- **Marsh & McLennan** reported strong organic growth of 5% despite revenue headwinds from the JLT integration. Notably, Guy Carpenter grew organically 11%, repeating Q3:18's decade+ high print.
- **Willis Towers Watson's** organic growth was 6% led by 7% in risk & broking. Margins expanded 120bps.
- **AJ Gallagher's** organic revenue 6% both in brokerage and risk management. Margins expanded 70 bps.
- **Brown & Brown's** retail segment +3%, wholesale segment +11%.

In a divergence from prior quarter comments, brokers threw in the towel on the pricing environment, admitting that loss cost trends may keep pressuring prices upwards into the future.

The only exception perhaps was Brown & Brown that continued to walk a fine line between self-reported quarterly rate acceleration and a limited outlook on future rate increases. Ironically, the concession comes at a time when the market no longer needs confirmation from brokers, who shielded the clients' insurance contracts from the rising tide of pricing sentiment for as long as it made any sense, and perhaps a little beyond. The market dislocation is real in many segments of the market, becoming more wide-spread geographically and across businesses, and appears to still be accelerating.

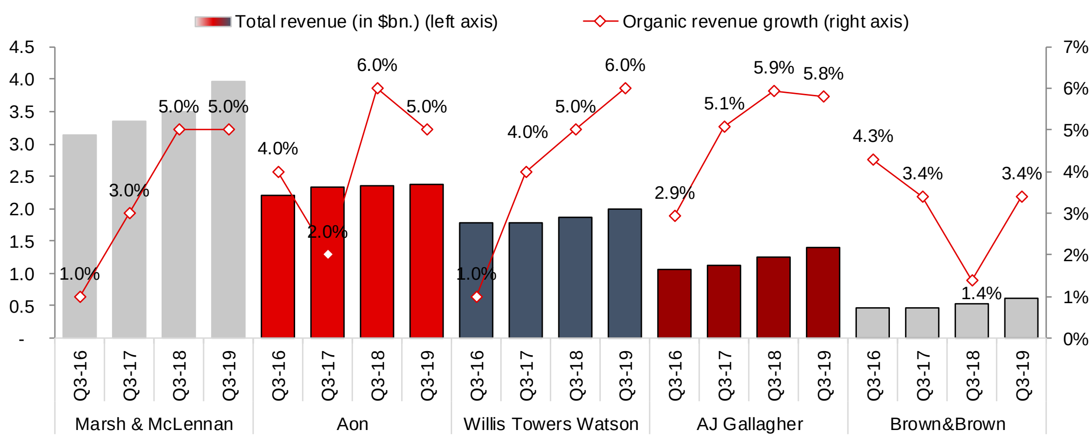
Despite decidedly positive results, the brokers' stock reaction to earnings was mixed, and stocks tended to underperform the broader market, getting stuck on what we referred to as "the expectation escalator". With every strong quarter accompanied by sustained tailwinds, the bar for brokers keeps getting higher, making it increasingly hard for even very good results to impress investors in a way that pushes valuations further up. The stock performance pattern through this earnings season supported the thesis, as the insurance intermediaries that had lower expectations heading into the earnings season outperformed peers (details in a later section).

Organic revenues outrun trend growth for eight consecutive quarters. MMC restores optimism on JLT.

Insurance brokers' all-in top-line organic growth numbers in Q3 were strong as both their (re)insurance brokerage and consulting businesses experienced strong tailwinds we discussed above.

EXHIBIT: BROKERS' COMPANYWIDE ORGANIC GROWTH

Source: Company reports, Inside P&C

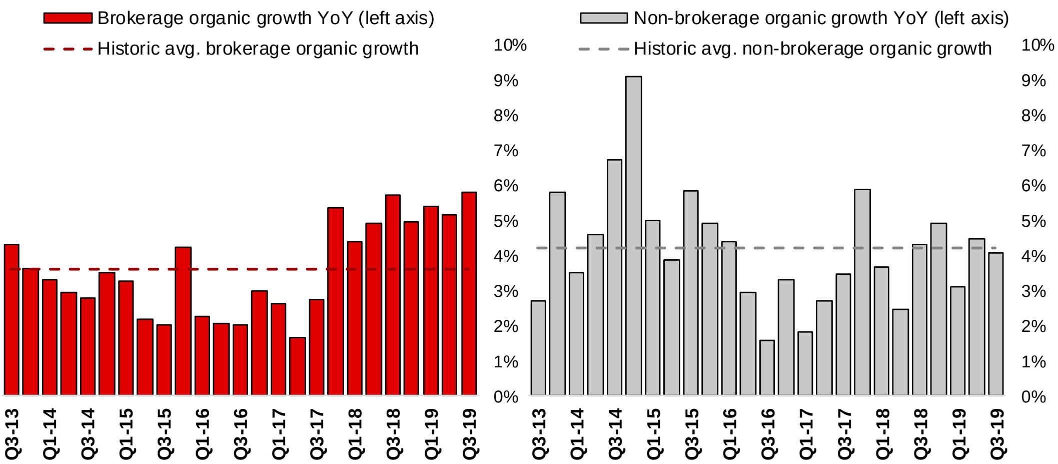


On brokerage business, the firms continued outpacing the historical average organic growth rate of 3-4% in Q3, i.e. at levels that typically allow brokers to expand margins.

The (re)insurance brokerage composite organic growth in Q3 was 5.8% (see chart below), the highest in at least six years, which is as far back as we can reasonably track the composite's brokerage business separately from consulting.

EXHIBIT: PUBLIC BROKERS' COMPOSITE ORGANIC GROWTH

Source: Company reports, Inside P&C



Among growth stories, Guy Carpenter putting up 11% organic revenue increase was perhaps the most notable industry data point in the earnings season.

The MMC's reinsurance unit reported organic contraction of 3% a mere quarter ago due to the revenue leakage associated with the JLT integration, the headwind that's been expected to persist for a number of quarters, as voiced by the management in Q1 and Q2.

It is worth noting that 6pts of the Q3 growth came from existing long-term contract true-ups, as management noted. However, even with this impact ruled out, the change is still substantial considering the amount of noise the firm is going through, as well as the tough comparison against Q3:18 when it reported the same 11% underlying revenue expansion.

To give a perspective, sell-side analysts projected negative to positive low single-digit growth into the release.

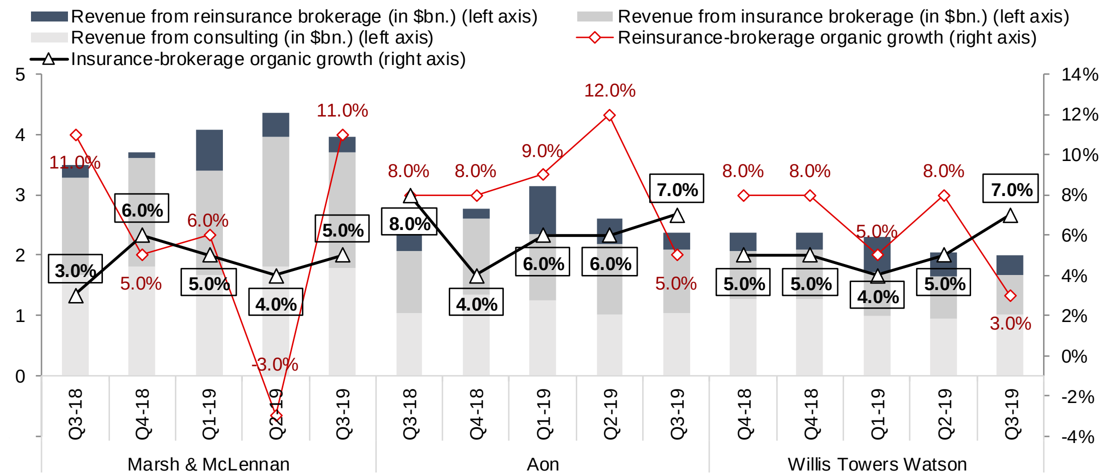
Of note, management has not changed its outlook on the JLT-related dis-synergies. It will still be a noise factor for few future quarters.

MMC	*"JLT is going to continue to be a drag to underlying revenue growth as Carpenter rebuilds the new business pipeline. That's something that takes multiple quarters to do, but that effort is already underway, and so it's not going to last for years. It's temporary".* ***- CEO Daniel Glaser***

This also puts a damper on the speculations around market share rearrangements in favor of the other Big-3 firms, as reinsurance organic growth at Willis and Aon came down to normal levels following the blowout Q2 (see chart below).

EXHIBIT: BIG 3 BROKERS' INSURANCE AND REINSURANCE ORGANIC GROWTH

Source: Company reports, Inside P&C



As we <u>discussed</u> immediately following the report, the positive news on the growth revived some optimism around growth prospects of the MMC-JLT combination. Furthermore, MMC announced that the JLT cost synergies are ahead of schedule and the broker is likely to revise the cost savings outlook upward in Q4. Recall, MMC's current outlook includes $75mn cost savings in 2019, $175mn in 2020 and $250mn in 2021 and beyond.

The growth print on insurance brokerage was not so hot for MMC on the relative basis. Marsh was up 5% (vs 3% YoY), which trailed the results by Aon (up 7% vs 8% YoY), Willis (up 7% vs 5% YoY) and AJ Gallagher (up 5.8% vs 6.3% YoY). This is in line with the Q2 trends when MMC's insurance brokerage growth fell short of the peers', as JLT dis-synergies continued putting a drag on Marsh's growth.

Joining the bull herd

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 ("<u>Caught Between a Soft and a Hard Place</u>").

That cross turned unbearable for brokers in Q3. Under the weight of social inflation noise, the string of carrier reported reserve charges and importantly self-disclosed rate acceleration, the brokers' Q3 pricing rhetoric was more in sync with what we've been hearing from carriers of all stripes ever since Q1.

Yet, it is a credit to the insurance intermediaries, who shielded the clients' insurance contracts from significant price increases for as long as it made any sense, and perhaps a little beyond.

Below is a collection of some Q3 broker pricing comments:

AJG	*"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."* *"There is no doubt. We're seeing are seeing tort inflation across our book of business".* **- CEO Pat Gallagher**
MMC	*"The underwriting community is clearly concerned about rising loss cost trends".* *"We, of course, again, are trying to get the best outcome for our clients. And we'll find solutions no matter where they might be in the world. But I do expect upward pricing pressure to continue throughout next year"* **- Marsh CEO John Doyle**
BBT	*"You have tightening of capacity in the market such that there is a still upward pressure on pricing. It's hard to know exactly sort of how long that lasts. But certainly, fourth quarter, we expect it to hold possibly, even push up a bit depending on how the reinsurance renewals go in January. I think you also could see some further commitment to that pressure".* **- COO Chris Henson**

However, perhaps more important than the exact description of the market was more transparency from management teams that their work is becoming more oriented around managing clients' expectations and coaching a generation of broking talent with limited firming market experience to navigate negotiations.

AJG	*"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".* **- CEO Pat Gallagher**

The market dislocation is real in many segments of the market, becoming more wide-spread geographically and across businesses, and appears to still be accelerating. Notably, the only unique Q3 voice was still perhaps Brown & Brown that keeps walking an increasingly thin line between self-reported rate outlooks that keep getting higher every quarter, and still talking down the market.

BRO	*"Let's not forget, there's still an inordinate amount of capital sitting out there. And so I believe that at any time, optimistic or new capital, however you want to classify it, can come swooping in and do some things".* **- CEO Powell Brown**

On numeric pricing disclosures, the broker reports on Q3 price changes were largely in sync, as all of them logged rate uptick across many lines of business. Some of the highlights included:

- **Marsh's** proprietary pricing index increased by 8% (from 6% in Q2 and 3% in Q1)
- **Brown & Brown's** coastal property rates are up 5-15% (from 5-10% in Q2), personal lines are up 5-20% (from 5-15% in Q2), other property lines up 3-5% (from 0-3%), professional lines down 0-5% (from down 3-5%).

- **AJ Gallagher**, who discloses rate changes consistently (albeit not always apples-to-apples), reported uptick across many lines as shown in the consolidated rate disclosure in the table below.

EXHIBIT: AJ GALLAGHER RATE CHANGE DISCLOSURES

Source: Company reports

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

	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%			

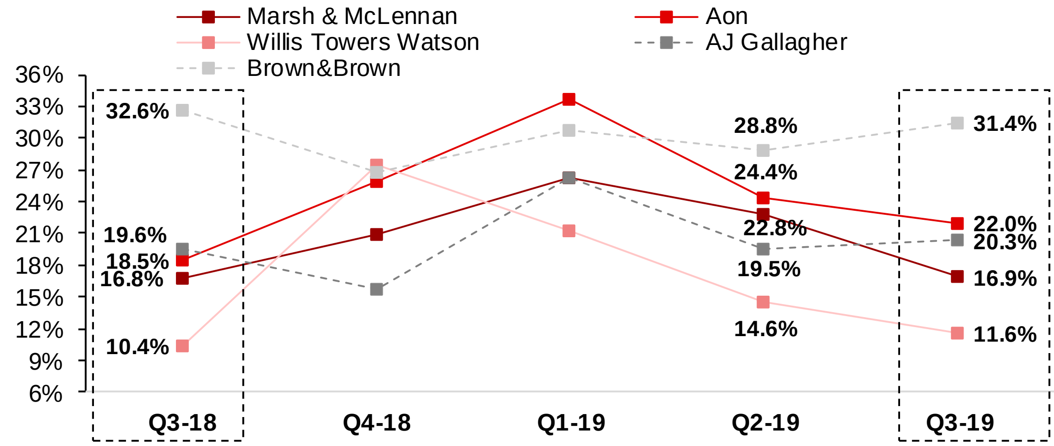
Margins are moderately higher but slowed by integrations

Most of the brokers reported significant YoY margin expansions, which comes as no surprise given the above-trend growth figures, including solid growth in the high-margin reinsurance business.

The slowest expansions occurred at the brokers with an undergoing integrations, Marsh & McLennan (+3bps) and Brown & Brown (-120bps). Both experienced an adverse seasonality effect from their acquired targets JLT and Hays respectively. In contrast, Willis Towers Watson (+120bps) integration with the digital health insurance broker Tranzact was accretive to the margin in Q3 (see chart below).

EXHIBIT: BROKERS' Q3 ADJUSTED OPERATING MARGINS

Source: Company reports, Inside P&C

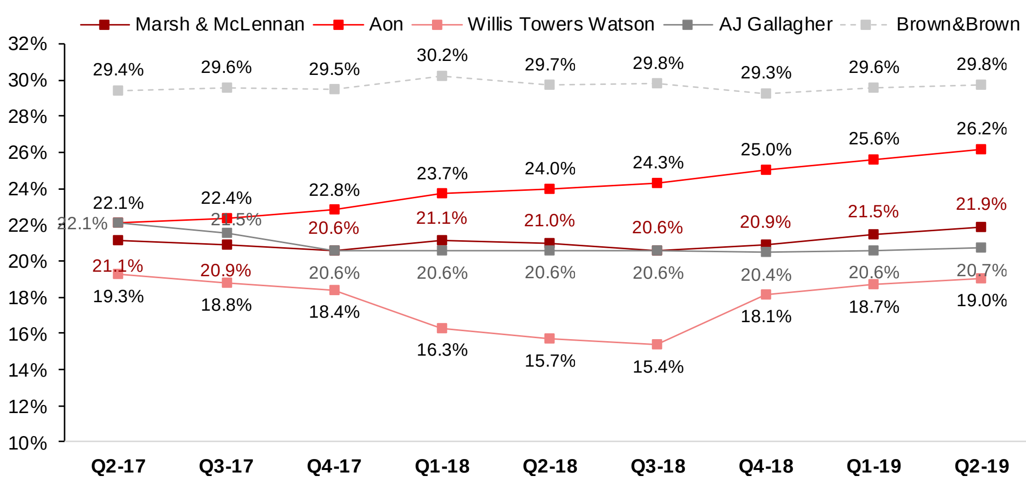


Elsewhere, Aon (+355bps) continued posting the highest margin expansion in the peer group thanks to a restructuring program. AJ Gallagher increased margins by +70bps due to expense leverage that included lower hiring in the quarter.

To acquire a better feel on how brokers rank relative to each other on margins, it is better to look at smoothed margins on the rolling-four-quarters basis that eliminates the seasonality effect observable in the chart above.

On the rolling-four-quarter basis, Aon continued steady margin expansion and further narrowed the margin gap with Brown & Brown that has historically operated at by far superior margins relative to the peers. At its current pace of improvement, it would take Aon at least two years to close the margin gap, conditional on stable margins at the Brown & Brown and Aon's sustained ability to reap the benefits of "United" strategy and restructuring initiatives.

EXHIBIT: BROKERS' ADJUSTED OPERATING MARGINS ON THE ROLLING-FOUR-QUARTERS BASIS



Willis Towers Watson progressed on its catch-up race to its peers' margins. The broker is now 170bps behind second-to-last AJ Gallagher, versus ~500bps a year ago.

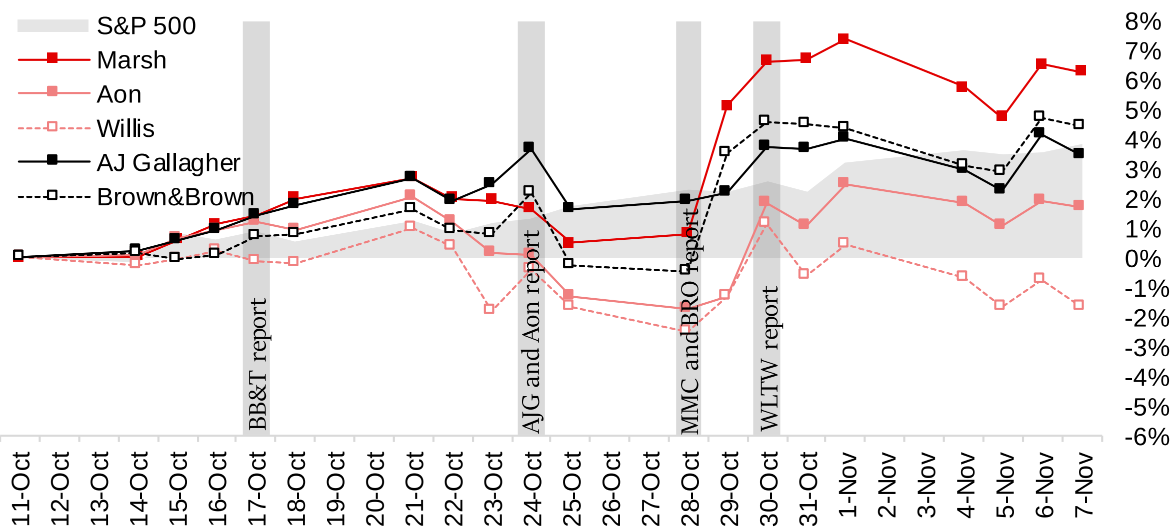
Recall, margins are viewed as highly important broker performance indicator by investors as evident from the consistency between margins and valuation multiples.

Good enough results are no longer enough

The reaction of the insurance broker stocks to Q3 results significantly varied. Generally, the stocks tended to trade down (on the relative-to-market basis), even following the upbeat earnings releases (see chart below).

EXHIBIT: BROKERS' STOCK PERFORMANCE THROUGH Q3 EARNINGS SEASON

Source: S&P Global, Inside P&C



Following blowout results from BB&T, the broker stocks universally rallied until the releases by Aon and AJ Gallagher. Those results dragged all broker stocks down, despite both firms beating earnings expectations and reported strong improvements on the top and bottom lines.

Interestingly, four days later, strong results by Marsh & McLennan and Brown & Brown—where expectations had been lowered due to recent headwinds—produced a wave of optimism as the stocks rallied 2-7% across the board amid fairly flat market.

The uniquely neutral results by Willis Towers Watson – typically the last reporter in a quarter – pulled stocks back again.

Despite the significant synchronization between the stocks, brokers going into earnings season with higher expectations (Aon, Willis Towers Watson and AJ Gallagher) underperformed the peers that are facing headwinds, i.e. Marsh &

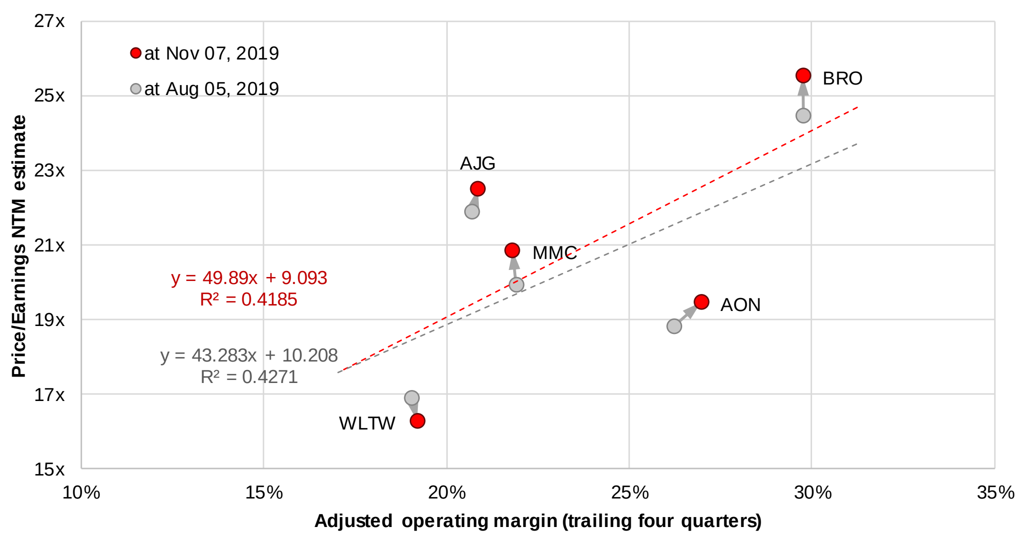
McLennan (JLT integration) and Brown & Brown (Hays margin impact, Social Security advocacy business completion and counter-cyclicality of lender-placed business).

Of note, the peer group underperformed S&P 500 on average by 1% during the period under consideration[1] with the individual relative performances ranging from -5.5% (Willis Towers Watson) to +2.4% (MMC).

Although we are conscious that during Q3 earnings season the market rotated from defensive to cyclical stocks (in a defensive-cyclical spectrum brokers arguably slightly lean to the former), the overall stock price pattern implies to us that upbeat earnings are struggling to play a catalyst to push valuations beyond current levels, i.e. brokers are priced into perfection or believed so by the investors.

PRICE-TO-FORWARD-EARNINGS VERSUS TRAILING 4Q ADJ. OPERATING MARGINS: POST-Q2 VS POST-Q3.

Source: S&P Global, Inside P&C



[1] The 27-day period from October 11 to November 7, covering the earnings dates plus one week prior to the first reporter BB&T and one week following the last reporter Willis Towers Watson

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