Inside P&C by The Insurance Insider

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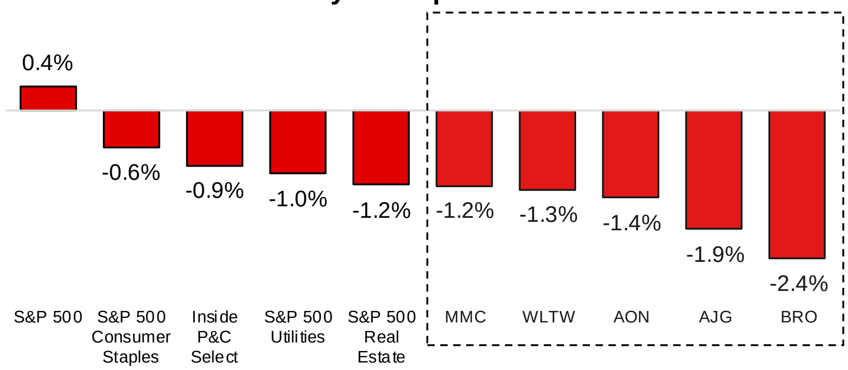
BROKERS: THE EXPECTATIONS ESCALATOR

1-day stock performance



Insurance broker stocks traded down Friday as the broader market rallied, despite strong results by AJ Gallagher and Aon that both beat estimates and included strong organic growth and margin expansion.

On the day, every public broker stock underperformed the worst performing S&P 500 sectors, as well as P&C stocks. Although we are conscious some of the movement may be due to the rotation into cyclical stocks, the relative performance suggests there were hardly any positive surprises for investors.

As we noted in our Q3 earnings preview, in a firming market with strong organic growth tailwinds, elevated expectations have made broking stocks vulnerable when turning in anything other than stellar results. Now, Aon's results had plenty of good news, including +355bps of margin improvement and 7% organic growth in Commercial Risk Services. Details below.

But taking a step back, the dynamic facing brokers appears clear. On the one hand, they have been operating with their wind at their back for some time. Organic growth has been supported by economic expansion and improved pricing, while inorganic growth has been possible due to the financial arbitrage available from multiples on bolt-on private transactions.

Simultaneously, margin improvement has been sustained by addressing long run inefficiencies with more investment in technology, reducing back office expenses = a shift towards more fixed costs, and less variable expense with every dollar of new revenue. (And some tax "efficiencies" ☺)

On the other hand, these tailwinds have led to an expectations escalator that appears to only be accelerating. With every blow-out quarter, the bar keeps getting lifted, making it harder for even good results to impress stakeholders.

In the long-run, this can be a toxic cocktail for management. Eventually conditions will reverse, or the marginal returns to technology investments will diminish. If expectations are not well managed (read: lowered), this can lead to pressures to manage results through margin initiatives (= less investment in the business), resulting in lower quality earnings.

Ultimately we are probably a long way from fundamental headwinds. Environmental conditions appear likely to be accommodative for the near to near term, and investments in technology are likely to provide margin support for the medium term. The problem really boils down to expectation management. Once you get priced for perfection, the risks simply become skewed to the downside – for managements and investors alike. And the share price reactions Friday suggest we are not a million miles from that.

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Aon, Key Statistics

Market Cap ($mn)	**45,126**
Share price	**188.7**
MTD	**(2.5)%**
YTD	**29.8%**
1-YR	**25.8%**
3-YR	**75.0%**
Div Yield	**0.9%**
Price / Earnings	**32.7 x**
Forward Price / Earnings	**19.6 x**

Source: S&P Global, Inside P&C

Aon: Earnings summary

Aon's earnings came in at $1.45 per share, an increase of 10.7% YoY and slightly higher than consensus estimate of $1.43. The result was driven by continued organic growth and margin expansion above historical pace as the restructuring initiatives continued aiding profitability. Aon reported adjusted op. margin of 22.0%, a 355bps expansion versus 18.5% YoY.

EXHIBIT: AON Q3 RESULTS SUMMARY

Source: Company reports, S&P Global, Inside P&C

Aon	Q3-18	Q4-18	Q1-19	Q2-19	Q3-19	YoY var.
Revenue ($mn)						
Total consolidated	2,349	2,770	3,143	2,606	2,379	1.3%
Commercial Risk	1,029	1,273	1,118	1,167	1,057	2.7%
Reinsurance	279	162	788	420	291	4.3%
Retirement	501	509	420	419	484	-3.4%
Health	278	558	486	317	279	0.4%
Data & Analytic Services	263	271	336	286	271	3.0%
Organic growth						
Total consolidated	6%	6%	6%	6%	5%	(100bps)
Commercial Risk	8%	4%	6%	6%	7%	(100bps)
Reinsurance	8%	8%	9%	12%	5%	(300bps)
Retirement	2%	4%	2%	1%	3%	100bps
Health	8%	8%	5%	6%	2%	(600bps)
Data & Analytic Services	5%	9%	5%	4%	3%	(200bps)
Adj. operating income ($mn)	434	716	1060	637	524	20.7%
Adj. operating margin	18.5%	25.8%	33.7%	24.4%	22.0%	355bps
Adj. EPS estimate	1.22	2.13	3.30	1.87	1.43	9.2%
Adj. EPS actual	1.31	2.16	3.31	1.87	1.45	10.7%
Surprise	7.4%	1.4%	0.3%	0.0%	1.4%	-

The organic growth of 5% in Q3 and 6% YTD was largely driven by insurance-related businesses. Aon's commercial risk grew 7% in Q3 (6% YTD) and reinsurance solutions grew 5% in Q3 (9% YTD). This is compared with 2-3% Q3 growth in other segments (2-5% YTD).

Explaining the growth, Aon admitted "modestly positive" tailwind from rate increases but emphasized overall operating efficiency.

> *"When you think about Aon overall, something around half of our world operates completely independent of any insurance pricing cycle. And within our risk business, 1/3 of it is fee-based".*
> *"So for us, overall, modestly positive impact to results and our view is highly client-centric approach is one of the reasons we've got new business generation and retention levels at an all-time high.*
> **- CEO Greg Case**

On reinsurance growth, following the highest quarterly organic growth print since early 2000s in Q2 of 12%, Aon reported some 5% for Q3. However, management refused to call it a slowdown and explained that the sequential quarterly numbers are hardly comparable.

> *"The reality is we have not seen a slowdown on it. The composition of the book is different in the second half of the year. The first half is pretty heavily loaded towards the treaty business. The second half as much more facultative and capital markets. Yes, that that business is a little bit of lumpy based on how and when the clients need to cover. And so I would say we are continuing to be pretty strong in that space. It's a double-digit growth business for us, especially the business and we continue to see that going forward."*
> - **Co-President Eric Andersen**

Other notable items included:

- Going forward, Aon sees 70-80bps margin expansion annually after the end of its restructuring period which ends next quarter, which has accelerated margin expansion in recent periods.
- Q3 margin expansion of 355bps was aided by leveraging compensation expenses and other G&A expenses (see chart below).
- Free cash flow to firm (FCFF) grew 25% to $996mn from $792mn for the 9 months of 2019 primarily driven by improved operational performance.
- Maintained restructuring-related cost savings guidance for 2019 at $510mn (upgraded in Q2 from $500mn announced in Q1 and $450mn announced in Q4:18); maintained guidance for 2020 - $535mn.

EXHIBIT: AON ADJUSTED OPERATING MARGIN CHANGE ATTRIBUTION

Source: Company reports, S&P Global, Inside P&C

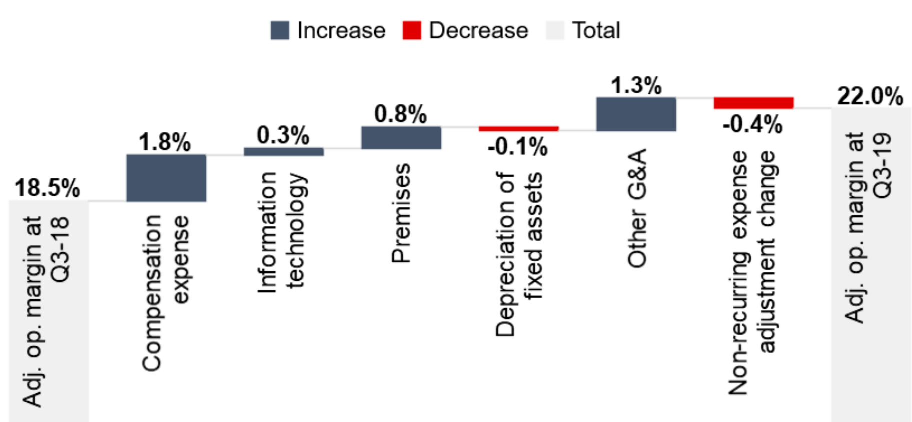


EXHIBIT: INSURANCE BROKERS' ORGANIC GROWTH

Source: Company reports, Inside P&C

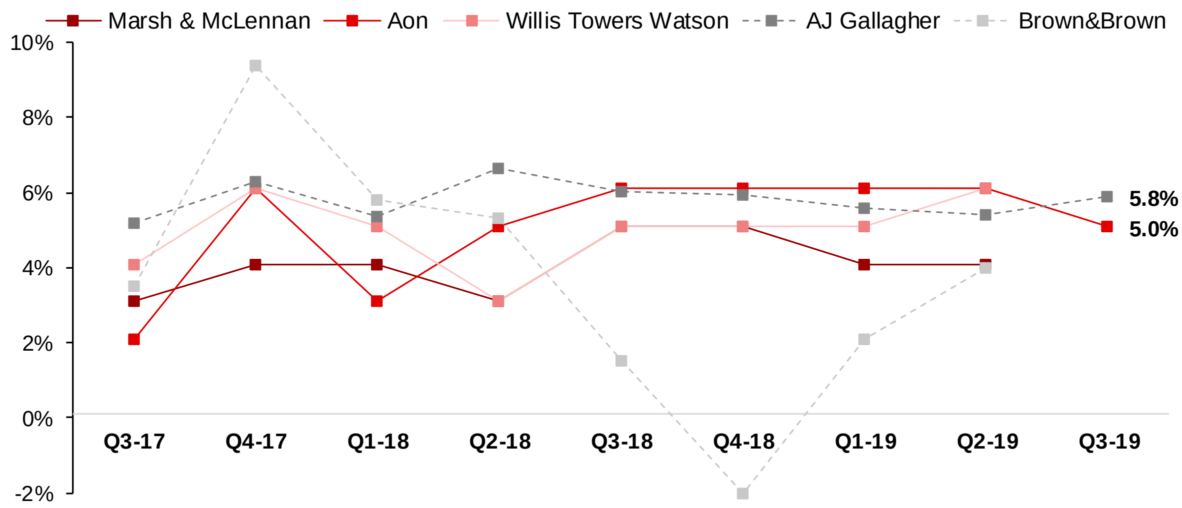
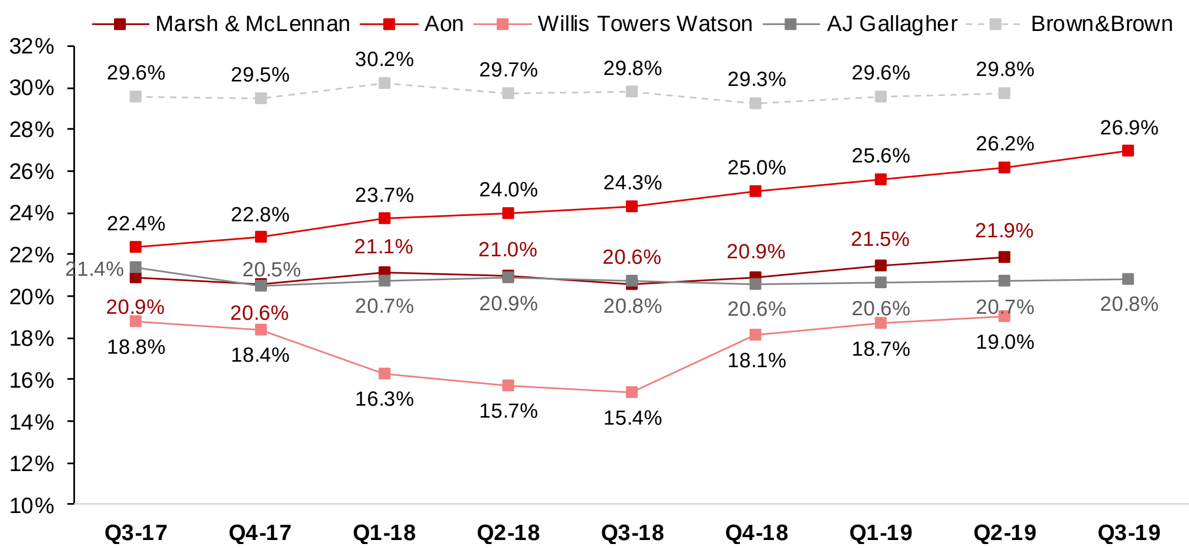


EXHIBIT: ROLLING 4-QUARTERS ADJUSTED OPERATING MARGINS

Source: Company reports, Inside P&C



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