Broker Thursday. Unsurprisingly surprising

"I am nowhere near as pessimistic as I was"
- CEO John Haley

"We now expect to generate modest EPS growth for the year"
- CEO Dan Glaser

"Nearly every metric we are monitoring is trending better"
- CEO Pat Gallagher

Thursday saw an avalanche of broker data points with Q2 reports and conference calls of Marsh & McLennan, Willis Towers Watson and AJ Gallagher all held on the same day.

Although brokers beat consensus expectations on most of the key performance metrics from the top to bottom line, the positive "surprises" were hardly surprising. Heading to the earnings season most analysts conservatively maintained existing estimates despite clear signals for the upward surprise bias.

As we covered before, the reversal of pay cuts at Aon and AJ Gallagher investor day, more recently followed by positive Q2 results from Truist and Brown & Brown, all contributed to the shifted consensus.

All broker reports yesterday beat Wall Street on EPS, organic growth, and margins. Insurance brokerage underlying growth was positive across the board, as rate increases exceeding exposure declines was a dominant observation. However, consulting, benefits and HR-related revenues were all down due to their more discretionary nature.

Overall, forward-looking rhetoric turned more sanguine from what felt a few months ago like a deeply pessimistic environment, and in some cases, a five-alarm fire. Improved guidance, the revival of M&A ambitions, and plans on reversing some of the expense cuts were commonplace.

However, we would warn against getting too complacent about brokers' performance in the short term. The way this crisis developed to date shows its consequences may be less front-loaded but dispersed over longer period, which may force brokers to experience a longer phase of slow growth and keep expenses pressured to deliver higher profits.

This brings us back to the trade-off risk we discussed at large after Q1 and more recently heading into Q2 earnings season. The extension of this period where brokers are in the chronic position to find compromises between short term reputation and long term growth reinforces the risk. It is particularly acute against the backdrop of tech disruptors enjoying access to capital at unprecedented scales and a surge in interest in the business community.

At the same time, there may well be an opportunity to grasp the nettle and accelerate efforts to tackle pre-existing inefficiencies, that are no doubt present at every industry and every business.

Perhaps most conspicuously it was discussed at AJ Gallagher's conference call where executives shared that they are "learning a lot" about their own

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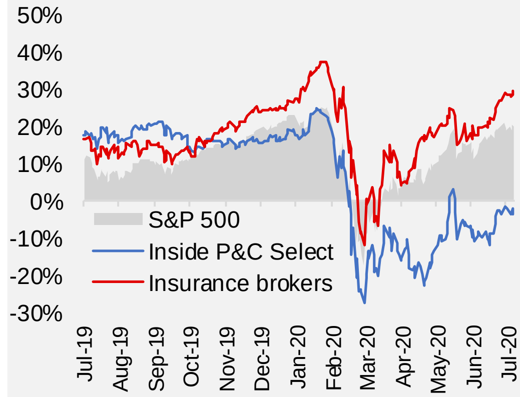
Composite	YTD px chg.	P/B
Large comm.	(24.1)%	0.8x
Regional	(24.7)%	1.3x
Specialty	(16.6)%	1.5x
Personal	2.6%	2.0x
Bermuda	(22.7)%	1.1x
Florida	(29.2)%	0.9x
Brokers	4.4%	-
IPC Select	(17.2)%	1.1x
S&P 500 Fin.	(22.0)%	-
S&P 500	0.5%	-

1YR Price Peformance



businesses and facing opportunities to do things differently because of the shifts in clients' habits and demands.

Lastly, although the "unsurprisingly surprising" results provided few implications for the industry beyond what has already become a mainstream view, it provided another interesting accompaniment to Aon-Willis merger.

MMC called the impending historic merger "not good for clients and for the industry". It also announced that it proceeded with its annual pay raises, just as its next biggest competitor reversed pay cuts.

Having gone through hell and high water of the JLT merger, it seems the reigning biggest broker is making it clear the preparations of the new battleground for clients and talents are well underway at MMC.

Read more on MMC, WTW and AJ Gallagher Q2 earnings below.

MMC: “We now expect to generate modest EPS growth for the year”

- ***Q2 all in all organic revenue was down 2% with (re)insurance brokerage up 2% and consulting down 6%***
- ***Expects small contraction in 2020 and slightly more challenging second-half for most businesses***
- ***Adj. operating margin expanded by 265bps reflecting cost cuts***
- ***FY2020 EPS outlook upgraded to “higher” from “flat or higher”***

Marsh & McLennan reported Q2 results with better organic revenue than expected for both (re)insurance and consulting businesses.

The consolidated organic revenue was down 2%, one to three percentage points better than anticipated by most Wall Street analysts. However, management said H2 can be more challenging on the topline as there is a lag in how some revenue headwinds are reflected in the income statement.

Overall, following a relatively worrisome tone in Q1, the language turned more optimistic in Q2.

MMC	*Our actions include maintaining jobs in the thick of the pandemic as well as proceeding with our annual salary increases, avoiding a hiring freeze and continuing to make strategic hires in the face of industry dislocation, and moving forward with several acquisitions so far this year in M&A as we continue to pursue inorganic growth.* ***- CEO Dan Glaser***

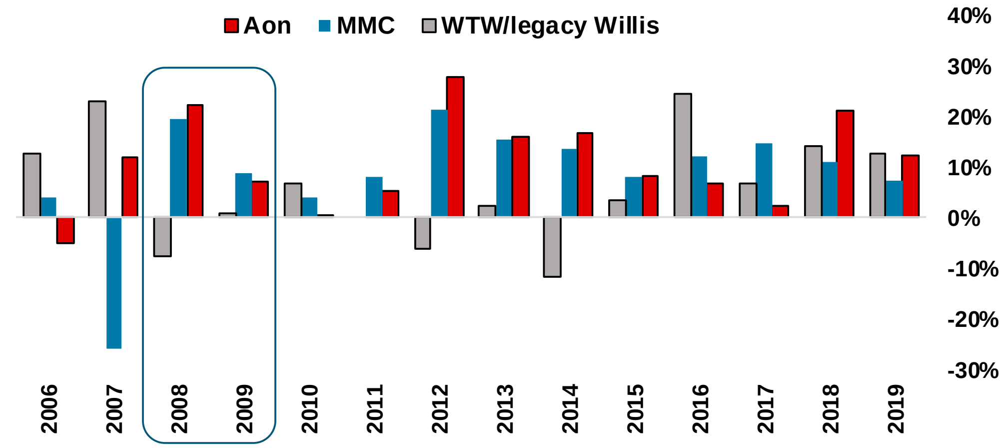
Despite the revenue headwinds, the firm remains committed to margin expansion through implementing expense cuts necessary to deliver a strong bottom line performance, something that most brokers expressed commitments to achieve.

Although MMC did not change the language around 2020 full year organic growth outlook, it upgraded its EPS forecast for the year, as it is now looking at “higher” EPS versus “flat or higher” telegraphed last quarter.

Of note, the industry’s resiliency to economic recessions is a known phenomenon. Most big public brokers managed to grow adjusted earnings during the 2008-2009 recession years. This period also has the benefit of additional rate momentum that has been absent in recent recessionary environments.

Exhibit: Adjusted EPS growth history for “Big-3” public brokers

Source: FactSet



Beneath the headline numbers, the broker's outlook for its individual business units was relatively unchanged. Detailed breakdown of the firm's 2020 guidance on included:

- **Marsh** to show "positive" organic growth with "more challenging" H2.
- **Guy Carpenter** to grow at mid single-digit for the year but may slow in H2 (Q3 and Q4 are relatively small quarters for Guy Carp).
- **Mercer** and **Oliver Wyman** to be down for 2020. Recall, in Q1 management announced that Oliver Wyman might see a bigger drop than during the financial crisis. Note, Oliver Wyman saw an organic revenue drop of 2% in 2008, a negative 15% in 2009 and is down 7% year-to-date.

On leverage, the broker reduced overall debt by $439mn or by 3% through reduction in the amount owed on revolver credits, partly offset by the new $750mn 10-year senior notes issued in May. MMC announced that it expects to de-lever in 2020. Note, following the debt-financed acquisition of JLT, MMC became the highest levered broker among the five big public brokers.

Recall, last quarter some carriers including MMC and Brown & Brown announced additional drawdowns from revolver credit facilities which raised some cashflow concerns surrounding brokers.

Speaking of the results in more detail, Marsh & McLennan reported adjusted EPS of $1.32, a beat against analyst consensus of $1.13 and a YoY growth of 11.9%.

The results were driven by the 2% organic contraction, which on the way to the bottom line was more than offset by lower expenses. Management shared that the expense containment efforts included reductions in T&E, capex, hiring, overtimes, temporary workers and contractors.

Exhibit: Marsh & McLennan earnings summary

Source: Company reports

Marsh & McLennan						
	Q2-19	Q3-19	Q4-19	Q1-20	Q2-20	YoY var.
Revenue ($mn)						
Consolidated	4,349	3,968	4,264	4,651	4,189	-3.7%
Marsh	2,156	1,902	2,219	2,061	2,161	0.2%
Guy Carpenter	392	273	152	827	433	10.5%
Mercer	1,260	1,280	1,326	1,251	1,149	-8.8%
Oliver Wyman	540	505	559	511	467	-13.5%
Organic growth						
Consolidated	4.0%	5.0%	3.0%	5.0%	-2.0%	(600bps)
Marsh	4.0%	5.0%	3.0%	5.0%	1.0%	(300bps)
Guy Carpenter	-3.0%	11.0%	10.0%	7.0%	9.0%	1200bps
Mercer	2.0%	3.0%	4.0%	5.0%	-3.0%	(500bps)
Oliver Wyman	13.0%	7.0%	-2.0%	0.0%	-13.0%	(2600bps)
Adjusted operating margin						
Consolidated	22.8%	16.9%	21.9%	27.0%	25.5%	265bps
Risk & Insurance	27.8%	17.4%	25.7%	34.5%	32.1%	430bps
Consulting	18.0%	18.7%	19.7%	17.2%	17.3%	(70bps)
Adj. EPS analyst estimate	1.13	0.70	1.18	1.57	1.13	-4.2%
Adj. EPS actual	1.18	0.77	1.19	1.64	1.32	11.9%
Surprise	4.4%	10.0%	0.8%	4.5%	16.8%	-

The tandem of (re)insurance brokerage businesses were up 2% and consulting was down 6%.

The organic revenue also included a $36mn downward adjustment (mostly Marsh) from existing contracts due to anticipated Covid-related exposure declines. Excluding this impact Marsh's organic growth was up around 3% (otherwise 1%).

On operating margins, the broker expanded its consolidated margins by 265bps on the adjusted basis, driven by the stronger profitability in risk and insurance operations (+430bps) versus weaker margins in consulting (-70bps) due to revenue headwinds.

On capital return, the buyback program is not expected to recommence in 2020. Recall, in Q4 MMC reported that it was not planning to buyback shares in 1H:2020 due to deleveraging initiatives and recent acquisitions. Also, in Q1 MMC announced it may not grow dividends by double-digit percents in 2020, like in recent years.

The JLT synergy guidelines are unchanged. The cost synergy guidance is still $350mn (upgraded in Q4 from the initially estimated $250mn) with total associated costs of $625mn plus $75mn noncash charges (from initially estimated $375mn). In Q2, MMC incurred $57mn integration costs bringing the total to $472mn.

Elsewhere, the conference call included interesting remarks on the merger between MMC's two biggest competitors Aon and Willis.

MMC	*I don't think the AON-Willis combination is good for clients or good for the market. But I do think it's good for Marsh & McLennan. I mean, come on, the big 3 becomes the big 2, how could that not be a benefit to us?* ***- CEO Dan Glaser***

Willis: "Nowhere near as pessimistic"

- ***Q2 all in all organic growth was flat***
- ***2-4% organic expansion in (re)insurance operations and investments was offset by 2-3% contraction in benefits and HR businesses***
- ***Operating margin was down 60bps***
- ***No updates on withdrawn guidance but more optimistic rhetoric***
- ***Q2 FCF was up due to improvement in receivables collection***
- ***No meaningful increase in debt***

Willis Towers Watson reported Q2 results that included flat organic growth, 60bp contraction on adjusted operating margin, as well as improved free cashflow and cash conversion. The report marks the second quarter in a row with improved cash flow metrics since disappointing Q4 that reinforced the broker's long-drawn-out issue of slow cash collection.

The firm's Q2:20 free cashflow came in at $593mn versus $287mn in Q2:19. The improvement was driven by better cash processing and working capital management (an important focus areas for the year), as well as expense cuts.

The two quarters with positive news on the cashflow front may be an emerging sign of the sustained trend, which is included in most analysts' bull case scenarios.

On Covid-19 response, WTW doubled down on the expense cuts, saying that cost reduction initiatives are the firm's "high priority" as it overcomes the revenue pressures. Recall, last quarter management described its intentions in relation to expense cuts as willing to "cut to the bone".

In line with other broker executives, Willis' management skewed more optimistic during the quarter notwithstanding the persisting uncertainty.

WLTW	*"The one caution I would give to that is the situation is a little bit uncertain with potential second waves, and a return to some of the lockdowns. So, we are still a little uncertain, but I am nowhere near as pessimistic as I was, or at least I don't worry about the downside as much as I did 3 months ago".* ***- CEO John Haley***

However, they remained unwilling to provide more quantified impact across its financials. WTW did not update its guidance that was pulled away last quarter. Notably, this contrasts with the other broker reports in the quarter, all of which provided quantified outlooks of some sort. Perhaps most distinctly, MMC provided the most granular guidance on its businesses.

WLTW	*" We continue to be unable to predict the extent of the impact of COVID-19 pandemic. The company will reassess this position once we have a clear understanding of the depth, duration and geographic reach of the pandemic* ***- CFO Mike Burwell***

On the business combination with Aon, Willis still expects to complete the transaction in H1 2021 despite the elevated speculations that it may take longer for some pending M&A's to adhere to planned timelines due to Covid-19 resulting in slower regulatory processing.

WLTW	*"We're still planning to submit all of our required filings in the various jurisdictions, and we expect to have clearances in the first half of 2021. I will say this is a complex undertaking. But there's nothing that has happened so far that has been any surprise to us, and we are continuing to work with the regulators cooperatively."* ***- CEO John Haley***

Recall, earlier we listed obstacles hindering the biggest-ever industry merger as market continues pricing some likelihood of no-deal. However, during the last quarter the stock movements partly closed the gap between actual and transaction-implied prices indicating growing market belief in the eventual deal.

More substantively on Q2 results, WTW reported adjusted EPS of $1.80, a 1% increase from last year, and beating consensus estimate by 10%.

The flat all in all organic growth was driven by 2% to 4% growth in (re)insurance brokerage and investment operations, offset by 2% to 3% contraction within benefits and HR businesses.

Exhibit: WTW earnings summary

Source: Company reports

Willis Towers Watson						
	Q2-19	Q3-19	Q4-19	Q1-20	Q2-20	YoY var.
Revenue ($mn)						
Consolidated	2,048	1,989	2,690	2,466	2,113	3.2%
Human Capital & Benefits	797	807	865	850	767	-3.8%
Corporate Risk & Broking	690	651	877	739	701	1.6%
Investment, Risk & Reinsurance	409	325	314	615	413	1.0%
Benefits Delivery & Administration	126	179	595	231	209	65.9%
Organic growth						
Consolidated	6%	6%	6%	4%	0%	(600bps)
Human Capital & Benefits	5%	6%	4%	4%	-2%	(700bps)
Corporate Risk & Broking	5%	7%	9%	4%	4%	(100bps)
Investment, Risk & Reinsurance	8%	3%	12%	5%	2%	(600bps)
Benefits Delivery & Administration	6%	2%	3%	1%	-3%	(900bps)
Adjusted operating margin						
Consolidated	14.6%	11.6%	30.1%	21.3%	14.0%	(59bps)
Human Capital & Benefits	21.1%	27.0%	30.1%	25.0%	20.9%	(20bps)
Corporate Risk & Broking	15.2%	12.0%	30.3%	17.2%	19.2%	400bps
Investment Risk & Reinsurance	26.9%	9.3%	9.1%	45.1%	28.7%	180bps
Benefits Delivery & Administration	-20.1%	-12.0%	52.4%	-4.7%	-4.2%	1590bps
Adj. EPS analyst estimate	1.75	1.31	4.86	3.13	1.63	-8.4%
Adj. EPS actual	1.78	1.31	4.90	3.34	1.80	1.1%
Surprise	1.7%	0.0%	0.8%	6.7%	10.4%	-

On margins, all segments had solid adjusted operating margin expansions except Human Capital & Benefits, where the margin was flat. However, all in all margin was down 60bps, as corporate items more than offset the operating segments' results.

The company's debt remained unchanged. None of the revolver capacity of $1.25bn was utilized.

AJ Gallagher: Nearly every metric is trending better

- ***Q2 all-in-all organic growth was 0.3% with brokerage up 2.1% and Gallagher Bassett down 9.6%***
- ***Brokerage EBITDAC margin up 630bps and risk management up 10bps***
- ***Organic in both segments is expected to gradually improve on second half***

AJ Gallagher's Q2 included little new data points, following the early clues on the quarter's results provided by the firm on its investor day back in late June.

Organic growth by segments was almost perfectly in line with the guidance. Brokerage is up 2.1% and risk management down 9.6%.

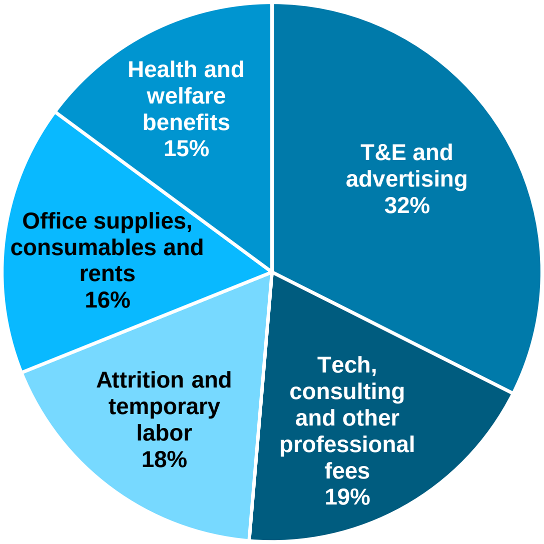
Coming out of Q2, the broker shared even more optimism as it sees "nearly every metric" improve entering the next quarter. Q3 brokerage organic growth is expected to sequentially stay same or slightly improve and likely pickup further in Q4.

Although the broker did not provide quantified guidance for risk management segment, it is looking like an improvement on the back half of the year is the base case scenario, given the broker's data points on the higher claims count in recent months.

AJ Gallagher achieved $74mn cost savings in Q2, in line with the guidance. Notably, it is the only broker to have provided itemized detailing of the expense reductions.

Exhibit: WTW earnings summary

Source: Company reports



Going forward, the expense savings are expected to decrease gradually - $65-70mn in Q3, $60-70 in Q4 and likely half of that thereafter.

The adjusted EPS of $0.94 increased by 45% relative to prior year period, beating consensus estimate of $0.72. The bottom line growth was driven by the cost savings discussed above.

Brokerage adjusted EBITDAC margin expanded by 630bps and by more than 100bps excluding cost savings. Margin in risk management stayed flat.

Exhibit: AJ Gallagher earnings summary

Source: Company reports

AJ Gallagher	Q2-19	Q3-19	Q4-19	Q1-20	Q2-20	YoY var.
Revenue ($mn)						
Consolidated	1,625	1,791	1,684	1,829	1,552	-4.5%
Brokerage	1,131	1,196	1,193	1,436	1,201	6.2%
Risk management	209	212	215	212	191	-8.8%
Corporate	285	383	277	182	160	-43.9%
Organic growth						
Total segments	5.3%	5.8%	5.8%	3.3%	0.3%	(504bps)
Brokerage	5.8%	5.8%	6.1%	3.1%	2.1%	(370bps)
Risk management	3.0%	5.7%	4.7%	4.1%	-9.6%	(1260bps)
Adjusted EBITDAC margin						
Total segments	24.9%	25.8%	23.0%	32.2%	30.5%	567bps
Brokerage	26.3%	27.2%	24.1%	34.5%	32.6%	630bps
Risk management	17.5%	18.0%	17.1%	16.7%	17.6%	10bps
Adj. operating income ($mn)	261.0	285.4	255.7	474.3	357.0	36.8%
Adj. operating margin	19.5%	20.4%	18.3%	28.8%	25.6%	617bps
Adj. EPS analyst estimate	0.61	0.79	0.53	1.83	0.72	10.8%
Adj. EPS actual	0.65	0.80	0.58	1.83	0.94	44.6%
Surprise	6.6%	1.3%	9.4%	0.0%	30.6%	-

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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