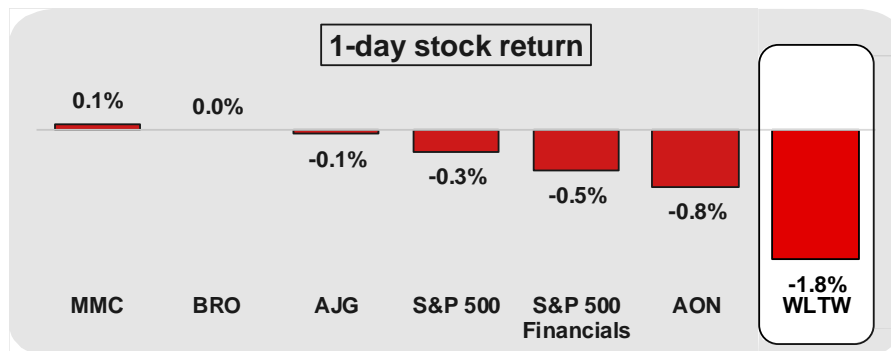


November 1, 2019

WILLIS: GOOD ENOUGH IS NOT ENOUGH



Following the quarter that included Tranzact results for the first time, management and analysts understandably spent most of the time discussing human capital, benefits and administrative solutions - businesses that are more tangential than central to our coverage. There was not a single mention of P&C pricing and social inflation – the trendiest P&C topics of Q3.

More generally, there was hardly any new disclosure that added material new information to the mix in today's Willis Towers Watson's Q3 report. The broker is typically good at communicating expectations on future performance and Q3 was largely in line with the existing guidance, as well as analyst estimates.

In its typically least informative quarter in the year (Q3 is the broker's seasonally lowest on sales, least profitable and cash-poor period), Willis printed nearly a match versus consensus and approximately flat EPS YoY. The lack surprises does not end here. The broker reported organic growth within the widely expected range of 5-6% and a margin expansion of 120bps continuing the upward trend of the trailing-four-quarters, as expected. Furthermore, there were no changes to the guidance whatsoever as the growth, margin and free cash flow outlooks were all untouched. Furthermore, there were no adjustments to the view on future borrowing, and no change in rhetoric related to future buybacks and dividends.

But as trite as it may sound, the absence of new information can sometimes be a data point in itself. For us, Willis' in-line print provided a perfect opportunity to test the extent to which the elevated market expectations on brokers' operating performance we have emphasizing for some time are actually the case. If there is a company and a quarter that are perfect to collate investor expectations against Wall Street sell-side expectations then it is Willis Towers Watson in Q3:19.

And the stock did not do well. On the trading day following the neutral earnings release, Willis Towers Watson stock slid 1.8% versus negative 0.4% for the S&P 500 and flat to 0.5% for peer brokers. We view the pattern as a confirmation of our thesis that the "[expectations escalator](#)" is a major problem currently facing the insurance intermediaries as only absurdly blowout results seem to be able to push the valuations beyond these highs. And sooner or later, one or more of the [accommodative tailwinds](#) in their operating environment will mean revert. As such, risks seem skewed to the downside.

Turning to the results, Willis Towers Watson reported adjusted EPS of \$1.31/sh, broadly in line with consensus and Q3:18. Organic growth was up 6% versus 5% in Q3:18 led by risk & broking growth of 7%. The adjusted operating margin expanded 120bps led by higher profitability across all segments ([more earnings details below](#)).

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Willis Towers Watson, Key Statistics

Market Cap (\$mn)	24,455
Share price	186.9
MTD	(3.1)%
YTD	23.1%
1-YR	30.6%
3-YR	48.5%
Div Yield	1.3%
Price / Earnings	29.4 x
Forward Price / Earnings	17.0 x

Source: S&P Global, Inside P&C

WILLIS TOWERS WATSON: EARNINGS SUMMARY

- ❖ **Adjusted EPS of \$1.31/sh (nearly flat YoY) marginally beating consensus of \$1.30/sh.**
- ❖ **Organic growth +6% (from 5% in Q3:18) led by Corporate Risk & Broking at 7%.**
- ❖ **Adjusted operating margin up 120bps to 11.6%.**

In its seasonally lowest sales and profitability quarter, **Willis Towers Watson** announced adjusted EPS of \$1.31/sh with 0.8% positive surprise against consensus estimate and 0.8% higher YoY.

EXHIBIT: WILLIS TOWERS WATSON RESULTS SUMMARY

Source: Company reports, Inside P&C

Willis Towers Watson						
	Q3-18	Q4-18	Q1-19	Q2-19	Q3-19	YoY var.
Revenue (\$mn)						
Consolidated	1,859	2,372	2,312	2,048	1,989	7.0%
Human Capital & Benefits	778	843	829	797	807	3.7%
Corporate Risk & Broking	622	816	728	690	651	4.7%
Investment, Risk & Reinsurance	317	280	589	409	325	2.5%
Benefits Delivery & Administration	127	390	135	126	179	40.9%
Organic growth						
Consolidated	5%	5%	5%	6%	6%	100bps
Human Capital & Benefits	2%	4%	3%	5%	6%	400bps
Corporate Risk & Broking	4%	5%	4%	5%	7%	300bps
Investment, Risk & Reinsurance	9%	8%	5%	8%	3%	(600bps)
Benefits Delivery & Administration	10%	8%	10%	6%	2%	(800bps)
Adjusted operating margin						
Consolidated	10.4%	27.4%	21.3%	14.6%	11.6%	118bps
Human Capital & Benefits	24.9%	30.0%	24.6%	21.2%	26.5%	158bps
Corporate Risk & Broking	10.6%	29.4%	17.4%	15.1%	12.4%	183bps
Investment, Risk & Reinsurance	9.1%	1.8%	42.8%	26.7%	9.5%	39bps
Benefits Delivery & Administration	-26.0%	61.5%	-15.6%	-19.8%	-11.7%	1425bps
Adj. EPS analyst estimate	1.13	4.05	3.02	1.75	1.30	-1.5%
Adj. EPS actual	1.32	4.00	2.98	1.78	1.31	-0.8%
Surprise	↑ 16.8%	↓ -1.2%	↓ -1.3%	↑ 1.7%	↑ 0.8%	-

Organic growth

The results included 6% organic growth, higher than 5% in Q3:18. Below the headline number, Corporate Risk & Broking grew the most by 7%, followed by Human Capital & Benefits (+6%), Investment, Risk & Reinsurance (+3%) and Benefits Delivery & Administration (+2%).

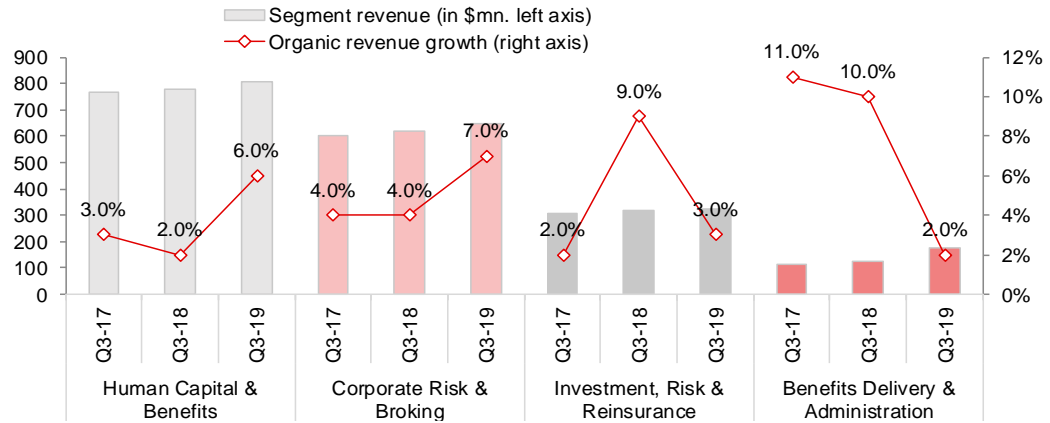
Notably, the broker's reinsurance organic growth of 3% is slower than a year ago (+9%) and last quarter (+8%), as well as relative to Big-3 peers' reinsurance units (Guy Carpenter +11%, Aon Reinsurance segment +5%). Management noted that there is nothing out of ordinary in the business and it is better looked at over longer periods of time.

“The third quarter is one of our lower quarters for the [reinsurance] business overall. So we're not uncomfortable with what's happened in terms of looking at that. I think you got to really look at the business on an annual basis. And when you look at it year-to-date standpoint, we're at 5%, and we continue to believe in [Investment, Risk & Reinsurance] in terms of where it is”. – CFO Michael Burwell.

Elsewhere, Corporate Risk & Broking organic growth of 7% was largely driven by 9% revenue expansion in North America.

EXHIBIT: MMC ORGANIC GROWTH BY BUSINESS UNITS

Source: Company reports, Inside P&C



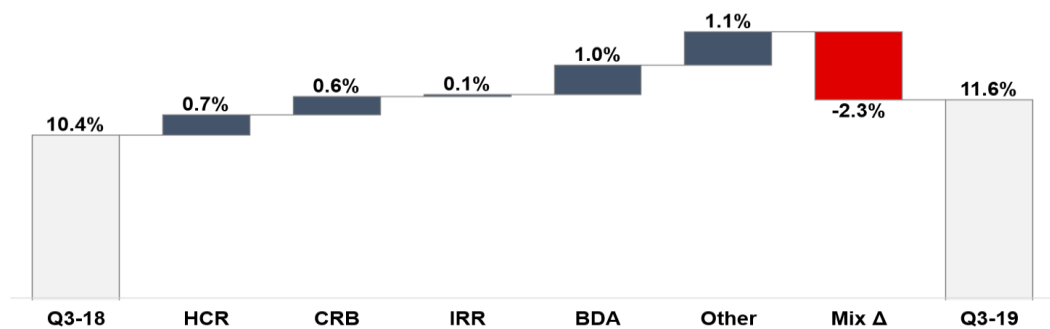
Margins

On profitability, the broker reported 120bps expansion on adjusted operating margin to 11.6%. The margins were up across all individual segments reflecting organic revenue growth and operating leverage, according to management commentary.

Note, the margins expanded despite the inclusion of Tranzact in the Q3 income statement that increased the weight of Benefit Delivery & Administration segment in the mix - typically unprofitable business in Q3 (see chart below).

EXHIBIT: ADJUSTED OPERATING MARGIN CHANGE ATTRIBUTION

Source: Company reports, Inside P&C



Free cash flow

Free cash flow - a highly watched metric in insurance intermediaries – was down 12% to \$445mn versus prior year on YTD basis. Management attributed the change to higher cash taxes resulted from US and global tax reforms, higher bonus compensation in 2019 and changes in working capital.

Going into Q4, management expects to offset the gap and estimates to grow free cash flow by 10-20% year-to-year.

On other items, the firm maintains guidance communicated in Q2, including 4-5% organic growth, revenue growth ex. FX changes of 7-8%, adjusted operating margin of ~20% and effective tax rate of 22%.

EXHIBIT: ROLLING 4-QUARTERS ADJUSTED OPERATING MARGINS

Source: Company reports, Inside P&C

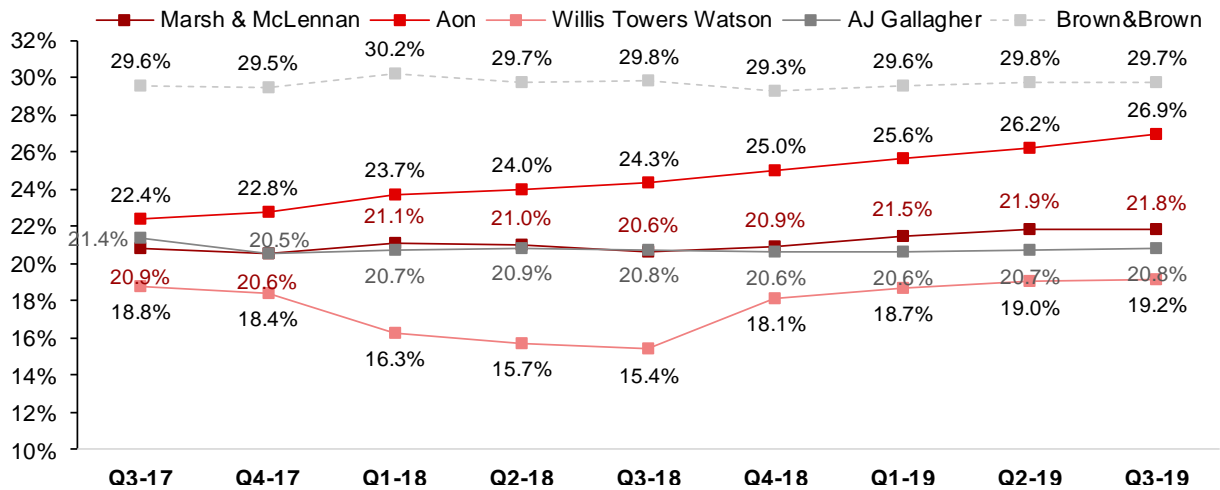
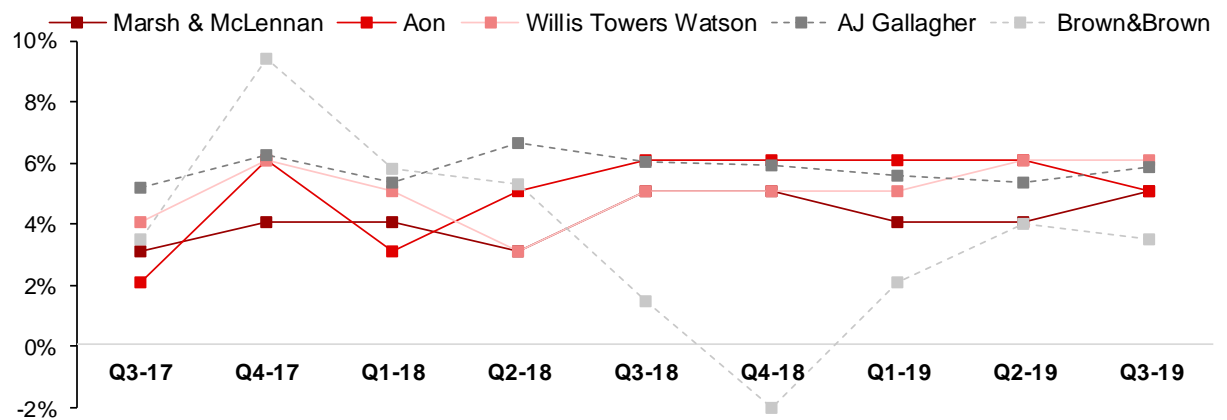


EXHIBIT: INSURANCE BROKERS' ORGANIC GROWTH

Source: Company reports, Inside P&C



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

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