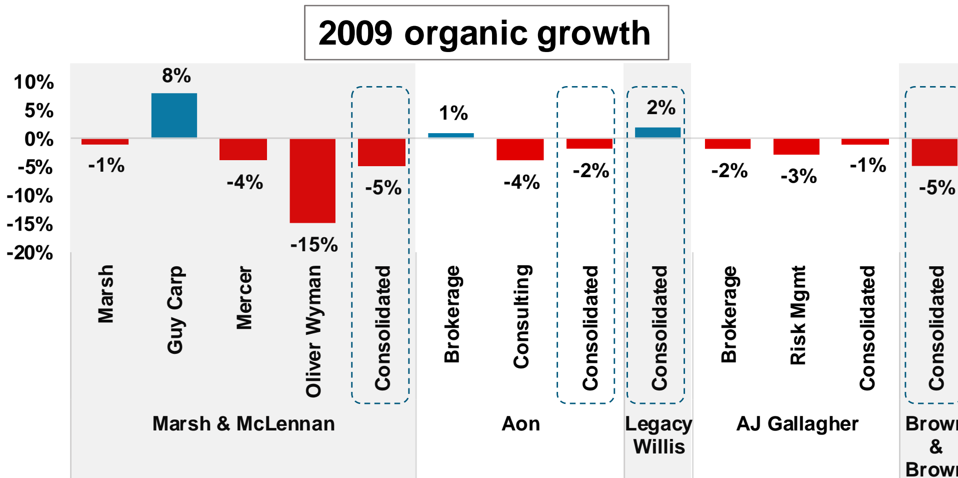
Brokers: You Can't Have Your Rate And Eat It Too



The first quarter likely marked the end of the 2-year long broker bonanza when the industry, supported by countless tailwinds, posted remarkable streaks of organic growth and margin expansions.

Insurance brokers delivered a 4.2% composite organic growth in Q1, the slowest in seven quarters but still substantially higher than the nearly flat Q1 YoY economic expansions in the US and EU (QoQ comparisons showed 4.8% and 3.5% contractions, respectively).

However, for brokers that correlate with the economy (albeit fractionally), the quarter was all about the outlook for the coming quarters where the US is expected to contract at a record pace. Almost all economists are currently expecting Q2 US GDP contraction deep into double digits with some estimates reaching negative forties.

Although we maintain our positive long-term view on the industry, the Covid-19 crisis poses a substantial short-term headwind for the sector – beyond what we think most external analysts, the market, and some management teams appear to be expecting. This is particularly true for highly-levered brokers that are programmed to operate at a constant cash inflow with access to low-cost debt refinancing, as we discussed last month. However, Covid-19 will likely leave scars on even big and relatively under-leveraged public brokers that were priced for an extended period of above-average growth and margin expansion heading into the crisis.

In our view, the coronavirus marked the beginning of a year of big trade-offs for the insurance intermediaries. And Q1 already gave some early clues on the challenges, as well as increasingly binary and costly trade-offs facing brokers.

Below are our four takeaways from the brokers' Q1 results.

First, several brokers praised high rates, recognizing the firming market as a significant tailwind that may cushion the recession impact - unlike the great recession years that hit the industry amid soft pricing cycle.

This comes as a contrast to the brokers' mainstream rhetoric from the last couple of years when they largely preferred to endorse other factors including exposure

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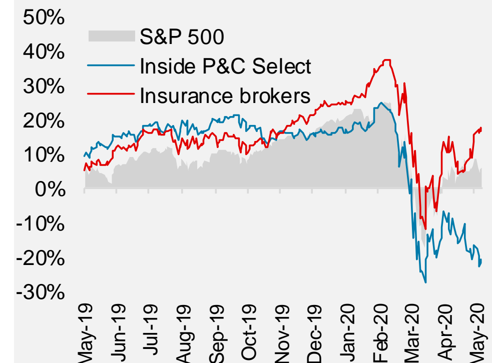
Composite	YTD px chg.	P/B
Large comm.	(40.2)%	0.7x
Regional	(45.3)%	1.1x
Specialty	(33.4)%	1.3x
Personal	(6.3)%	1.9x
Bermuda	(38.2)%	0.9x
Florida	(30.3)%	0.9x
Brokers	(6.1)%	-
IPC Select	(32.1)%	1.0x
S&P 500 Fin.	(31.8)%	-
S&P 500	(11.4)%	-

Top performer on the day UFCS +6.6%
Bottom performer on the day CINF -2.4%

1YR Price Performance



growth and product enhancements as the main drivers behind the strong underlying revenue expansion.

However, with the pandemic extinguishing these other tailwinds that were distilled in the brokers' stock valuations, companies are now keen to play up the revenue impact of these pricing trends previously dismissed as insignificant. The reality check question of us is, can you have your rate and eat it too? (More details below).

On 2020 guidance, MMC's, AJ Gallagher's and Brown & Brown's organic revenue expectations ranged between modestly negative and slightly positive for the full year with a reservation for significant inclinations should the crisis diverge from the base-case pattern, which we feel brokers view as a U-shaped recovery with recessionary conditions persisting for 12-15 months followed by a bounce in 2021. Aon and Willis Towers Watson pulled their guidance altogether citing high uncertainty.

Second, notwithstanding the mood music throughout broker conference calls, there are signs of more meaningful challenges facing the group in this crisis than commonly understood.

Pointing to that are the expansions of the revolver facilities at MMC and Brown & Brown by $1bn and $250mn, respectively, both implying a corresponding 14% increase in the debt funding (followed by steps by MMC to term out its short term debt in recent days).

But the most significant by far was Aon going nuclear with almost firm-wide salary cuts that seem potentially like a canary in the coal mine. Aon is currently one of only three financial firms in the list of biggest 3000 US public companies that implemented a broad executive and other employee base pay cuts since March 1 (next to two much smaller leasing and consumer lending firms), according to data from The Conference Board. As of now, the database is mostly populated by the hardest hit sectors including consumer discretionary, industrials and energy.

Third, brokers seem to be universally determined to protect margins, albeit at a different cost from firm to firm.

In Q1, every broker sounded enthusiastic about its ability to control margins through expense levers. At the least, all brokers cut discretionary expenses to protect margins and cash flows and conveyed an ability and willingness to implement further cuts should circumstances necessitate.

However, we would warn that each of the levers directed to manage short-term margins may have significant long-run costs. In particular, cutting compensation risks staff motivation, retention, and long-run talent leakage. Deferred cap-ex on mission critical technology and capabilities can weaken competitive positioning relative to peers at a time of increasingly Darwinian market forces. Some companies may see their hands tied on margins by commitments to preserve jobs – potentially restricting even pre-planned headcount reductions or integration synergies based on an operating model assuming pre-pandemic peak revenue.

On the other hand, allowing margins to contract but cutting dividends, buybacks, or increasing borrowings (including revolver) increases cost of capital. In short, there's no easy way out, and we'd expect these trade-offs to be the most topical agenda in the broker boardrooms and town halls for many months to come.

Lastly, the trade-off between "happy" clients and higher rates just got harder for brokers.

Recall, last quarter we pointed out how 2020 was going to be a somewhat challenging year for brokers that were facing an environment of growing "friction" from carriers on claims and a growing sense of unhappy clients, both potentially leading to divergent client outcomes and subsequent account wins and losses.

Now that rates are not just one out of multiple tailwinds but the only game in town, the balancing act between "harvesting" rates and reaching the best possible outcome for clients gets even more challenging.

Our view is that it reinforces the potential for performance de-coupling to favor brokers with higher ability to tolerate headwinds to suit stakeholder interests.

Perhaps more importantly, in the current climate that somewhat blurs the boundaries between coverable and uncoverable events and that provides incentives for carriers to delay or reject claims, the flight to quality brokers able to get better clients outcomes on claims may further intensify. Indeed, it may well prove a "proof of concept" moment one way or another for the market power of scale.

Recall, this is in line with our initial reaction to the Covid-19 crisis as a catalyst for a "flight to quality" that we first expressed in March.

In summary, we view this crisis as having two somewhat contradictory effects.

Longer term, we expect the result to be heightened demand for high quality risk management advice, an increased willingness to outsource this complex function akin to investment banking, and the potential for growth from unaddressed but latent risks (pandemic, cyber, climate change, supply chain).

That said, in the near term, we expect the group to be put squarely in an environment of intensive natural selection – stress testing their financial strength, liquidity, and ability to deliver better outcomes for clients than competitors under extraordinarily challenging circumstances. Let the hunger games begin.

Read below for more details on takeaways from Q1 broker results.

Brokers Q1 wrap

- ***Broker composite organic growth slowed in Q1 to 4.2%, the lowest in 7 quarters***
- ***FY 2020 organic growth guidance ranged between light contraction and light expansion, excluding Aon and Willis that cited inability to form an outlook***
- ***Operating margins expanded by an average of 200bps YoY as most brokers cited ability to protect margins in the crisis***
- ***Brown & Brown and MMC expanded revolvers as a cautionary measure***
- ***Comments on premium rates remained bullish across the board***

Insurance brokers posted another solid quarter with 4-6% organic growth and margin expansions across the board.

According to commentary from conference calls, Covid-19 had a limited impact on the firms' performance in the quarter. That excludes a 1.5% negative impact on Brown & Brown's and 3.2% impact on AJ Gallagher's organic revenues, due to re-evaluation of the existing contract values (the legacy of ASC 606).

However, it's been a long time since past results mattered this little. The Covid-19 crisis bears unprecedented risks under unprecedented circumstances with an immense potential to shift the habits in consumers and to cause paradigm shifts across industries.

To an extent, it reinforces an insurance brokers' value proposition. Old solutions may no longer work and risks from across an organization may no longer average out, demanding businesses to respond with a sensible and measured risk management approach. Business models will have to adjust to address the needs and habits of the post-pandemic world. These developments will serve as an accelerant to the trends that have been bolstering insurance brokers' value proposition and strategic vision.

Of course, any enterprise in the world of humans is highly path-dependent and a future plentiful of opportunities does not guarantee success. That is the reason equity investors become extremely myopic on the doorstep of recessions. In brokers case, we feel that frontloading the Covid-19 risks is not unreasonable as well.

As we have discussed before, we see building short-term issues for brokers stemming from:

a) **Revenue** pressures from declining economic activity that is certain to be deepest in living memory, coupled with pressures from the rebasing of premium exposures through renewals and mid-term endorsements – likely well beyond levels seen in any "in sample" recessionary period.

(b) **Cash flow** issues from explicit reversals of paid commissions through rebates and endorsements and grace periods on payments and bad debts, depending on how carriers treat the commission reversals.

(c) **Margin** pressures from slowed organic expansion (3% being conventionally understood as the first threshold that leads to a material margin expansion) and from the suspension of "on-going" head count reduction plans, which interferes with synergy and integration work (a significant source of value-creation for brokers). This limits not only the ability to offset incremental revenue headwinds with cost saving measures but prevents even the base-case reductions planned on peak revenue.

The broker actions to date on the expenses and cash flow are reflective of these challenges. Brokers universally cut discretionary expenses, reduced capex and implemented various other measures including pay and hiring freezes, buyback suspensions, limited dividend growth and planned for possible furloughs.

Although most of these measures reflect the actions taken throughout the Western corporate world, few of them stood out to us as repeating trends in the most distressed parts of the economy. One of them is significant revolver facility expansions at Brown & Brown and MMC that imply up to 15% more debt funding for these brokers. Notably, MMC also pre-funded in 2020 debt maturity and took steps to term out its nearer term debt following earnings.

Exhibit: Changes to brokers' 2020 outlooks; cash flow and expense actions

Source: Company reports

Company	2020 outlook: organic rev.	2020 outlook: op. margin	Cash flow actions
Marsh & McLennan	**Q4**: Up 3-5% ↓ **Q1**: Modest decline	**Q4**: Expand ↓ **Q1**: Likely stable	- Increased revolver capacity by $1 billion on top of existing $1.8bn with $0.8 unused capacity - Cut "nonessential" expenses, but pay cuts are "unnecessary" - Reduced capex - Suspended buyback program - Slower dividend growth
Willis Towers Watson	**Q4**: Up 4-5% ↓ **Q1**: Withdrew	**Q4**: Up 20bps ↓ **Q1**: Withdrew	- Restrictions on discretionary spending, T&E - Hiring freeze - Reduced capex - Still no buybacks due to pending combination with Aon
Aon	**Q4**: Expansion ↓ **Q1**: Withdrew	**Q4**: Up 70bps+ ↓ **Q1**: Withdrew	- Cut base salaries for management by 50%, for most other employees by 20% - Reduced spending on contractor and third-party vendors - Reduced all discretionary expense unrelated to client service - Suspended buyback program
AJ Gallagher	**Q4**: Up 5.5-6% ↓ **Q1**: NA, but flat to negative in Q2 and Q3	**Q4**: Up 50bps+ ↓ **Q1**: Flat to slightly up	- Restrictions on discretionary spending, T&E - Limited use of consultants - Freeze pay raises - Planning furloughs on less than 4% of workforce - Total quarterly expense cut capacity - $50-75mn - Suspended buyback program
Brown & Brown	**Q4**: NA ↓ **Q1**: Mid single-digit contraction to low single-digit growth	**Q4**: "No headwinds" ↓ **Q1**: Likely down	- Plans drawing down $250mn from revolver out of $700mn available - Stuff and salary decisions remain in discretion of individual business units

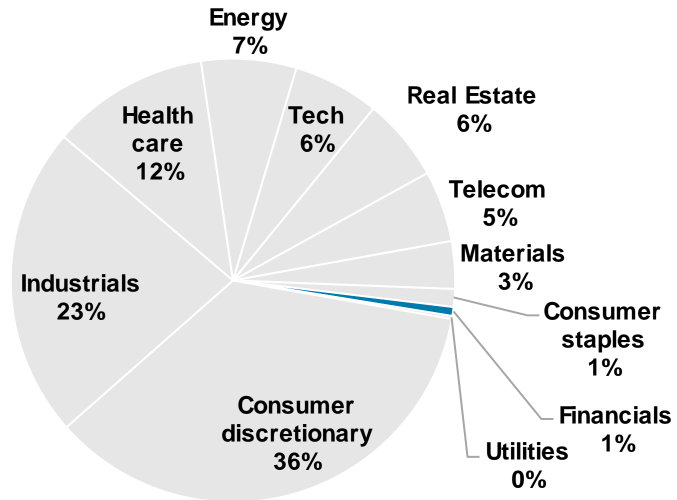
Another one is a panic-like action by Aon directed at implementing pay cuts for 70% of its workforce.

Of note, according to data from The Conference Board, 462 firms in the Russell 3000 index (=3000 biggest US public companies) implemented salary cuts in one form or

another since March 1. Only three of them represent financial services sector, including Aon.

Exhibit: Companies that cut salaries since March 1 broken down by GICS sectors

Source: The Conference Board



Organic growth: Rates to the rescue

Macroeconomic conditions are typically the first financial risk listed in the brokers' annual reports, also known as 10-Ks. Indeed, lower economic activity implies lower buying, selling, renting and investing in businesses and individuals that lead to a decline in insurable risk events. Although there are many stationary insurable risks that persist regardless of macroeconomic conditions, a meaningful portion of P&C risks remain a function of business activities.

For example, a smaller number of employed population leads to less workers' comp coverages (~8% of 2019 US P&C DPW), less trade and purchased goods involve less shipping and less demand for commercial auto coverage (~6%), less private construction works lead to less surety bond insurance (~1%), etc.

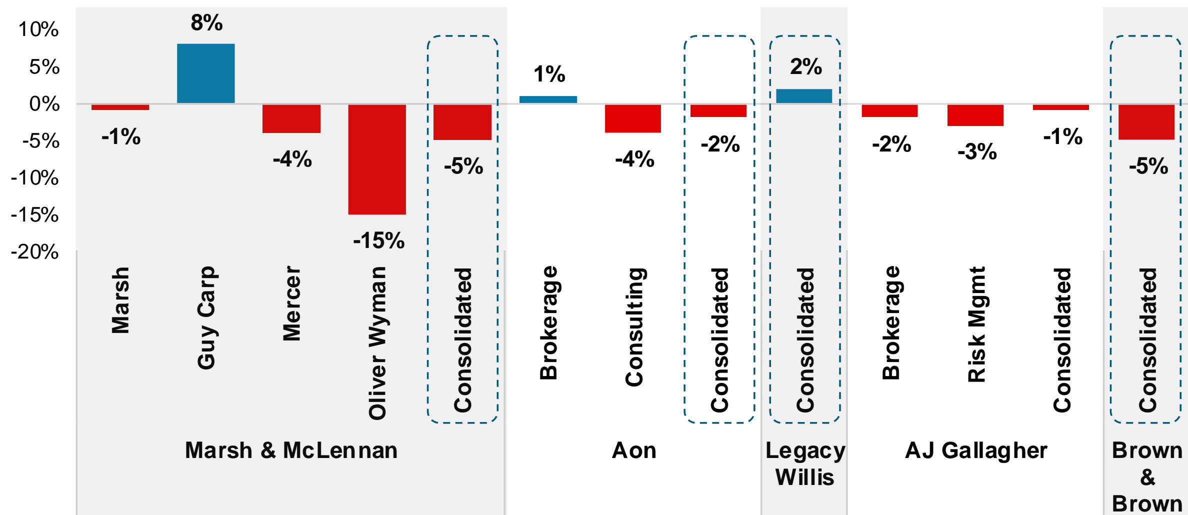
Furthermore, recessions are associated with lower contract values, lower revenues, lower payrolls, and lower asset prices, which lead to reductions in exposure units, which have been responsible for a significant part of the industry's organic growth in recent years.

Adding to that is the fact that today's brokers pushed the envelope of the regular functions to include risk, benefits, HR and analytical consulting. These services typically fall in the clients' "wants" category rather than "needs" and thus represent a much more cyclical revenue source for the intermediaries. Many of these services are "cross sold" leading to concentration risk by clients. A similar argument can be made for ancillary P&C services such as market data "products".

In 2009, in their worst year of the great recession organic growth figures reported by insurance brokers ranged between 5% contraction and 2% expansion, with a low single-digit to flat expansion of brokerage revenues and a mid-single digit contraction or worse in consulting revenues.

Exhibit: FY 2009 organic growth for brokers, selected business units and segments

Source: Company reports



Brokers' Q1 rhetoric was framed around the businesses being positioned defensively enough to weather the crisis. In their base cases, MMC, AJ Gallagher and Brown & Brown expect to have flat to mid single-digit losses on the organic revenue. Aon and Willis Towers Watson pulled their guidance altogether but emphasized their defensive positioning on the top line.

To support the point, the executives underscored the highly recurring nature of their revenues.

MMC	*"Our current view is that we could see a modest decline in underlying revenue for the full year."* ***- CFO Mark McGivney***
AON	*"80% of our business is core. Core revenues tend to be highly recurring and nondiscretionary and include things like property and casualty or directors' and officer's insurance placements, cyber remediation, treaty reinsurance, required actuarial work on pension programs and health and benefits brokerage. Many of these services are regulated, required or necessary cost of doing business."* ***- CFO Christa Davies***
WLTW	*"We have large recurring revenues, 80% to 85% of our revenues, we pretty much know before we start the year. So that's a big help."* ***- CEO John Haley***
AJG	*"It's very hard to predict, but we are prepared for the possibility that organic may go flat or even a bit negative for a couple of quarters. But I see that reverting to organic growth levels like we saw in 2019 during 2021."* ***- CEO Pat Gallagher***
BRO	*"Our best estimate is that the full year organic growth could be slightly positive or down low to mid-single digits."* ***- CEO Powell Brown***

Notably, what stood out to us is that a number of brokers candidly endorsed the high premium rates acknowledging it as a meaningful tailwind that will help weather Covid storm.

This comes as a bit of contrast to the brokers' mainstream rhetoric from 2019 quarters when they largely preferred to endorse other factors including exposure growth and product enhancements as main drivers behind the strong underlying revenue expansion, referring to the premiums rates as a "slight" or "not material" in justifying organic expansion.

<table>
<tr><td>MMC</td><td>Q3: "Maybe we have a mild tailwind today, but it's not material to the overall performance of the company."

Q4: "I think it's a modest tailwind at the moment."

Q1: "And the exposure decline may be more significant than they were in the global financial crisis. But on the other hand, at that point in time, rates were generally going down, and now rates are generally going up."</td></tr>
<tr><td>BRO</td><td>Q3: "What we've historically said is 2/3 to 3/4 of the impact [on organic growth] is exposure units. So those could be increases in existing customers and/or new business wins. The 1/3 to 1/4 would be rate."

Q4: "The Retail business, not unlike the overall business, is a low to mid-single-digit organic growth business in a steady state economy that could be positively impacted slightly by other impacts, i.e. rates increasing in the area where we are today."

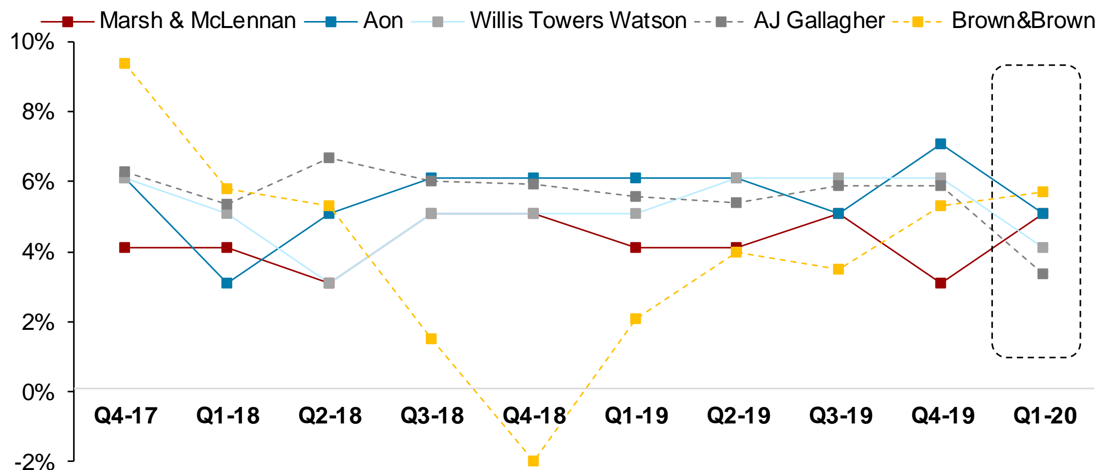
Q1: "Here's the thing that, I think, is very important for everybody to consider on this telephone call. In 2008 through 2011, you had a period of time where exposure units were going down and rates were going down. Today, you have a different dynamic. You have exposure units going down and rates going up."</td></tr>
</table>

As we have been pointing out since [Q2:19 broker earnings], we view firming rates environment (that is likely to accelerate due to the pandemic) as a significant tailwind for the brokerage organic growth numbers of the recent past and 2020 quarters. Hence, the pivot towards the market firming as a strong foothold heading into the crisis is a valid talking point and we expect it to continue in the future quarters.

That said, it should put the prior commentary in new light. We understand the brokers' desire to de-couple their narrative from a cyclical and unfavored sector. But you can't have your rate and eat it too, and this should be remembered in the next "good" market.

Exhibit: Brokers' organic growth

Source: Company reports



Margins: “We won’t give that one up easily”

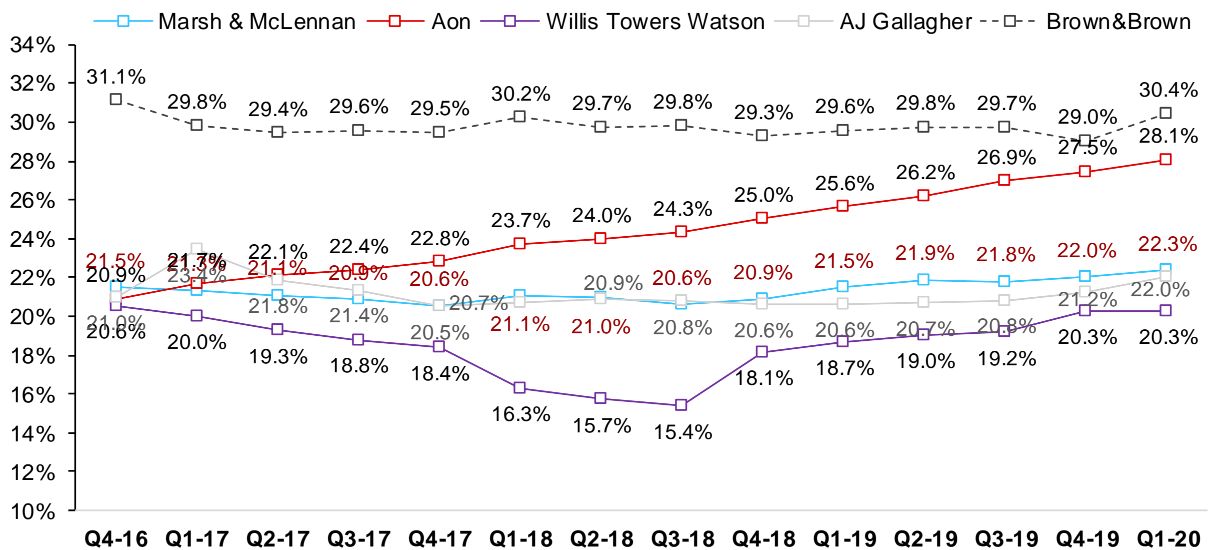
In a traditional sense, insurance brokerage is a mature industry and its growth should thus mean revert to the global nominal GDP. However, for many years the industry managed to successfully persuade the market that it can return more than the global economy due to the continuous operating margin expansion through higher operating leverage and improving operating efficiency.

That’s the reason the broker margins are closely watched, and brokers put up ambitious margin expansion targets that typically range between 30-70bps of adjusted operating margin expansion annually.

In the last two years brokers managed to pull margins up significantly driven by the solid organic growth (3% of growth being conventionally understood as the first threshold that leads to a material margin expansion).

Exhibit: TTM adjusted operating margins

Source: Company reports



With organic growth expected to flatten or turn negative, the legitimate concern is that the industry would experience a period of margin compression.

However, brokers remained optimistic on margins and in places even shared a hefty amount of bullishness, with an exception of Brown & Brown that struggled to give a direction on the margin impact.

MMC	*“We've had 12 in a row of margin expansion. And so we won't give that one up so easily.”* ***- CEO Dan Glaser***
WLTW	*“We're prepared to take swift actions as necessary to help mitigate adverse consequences and preserve our margins in the event that we might sustain a prolonged negative impact to our operations.”* ***- CEO John Haley***
AON	*“We would expect that if there are any reductions in revenue, that we would reduce expenses proportionately to match.”* ***- CFO Christa Davies***

AJG	*"Even if we end up in a flat environment for a couple of quarters with the expense saves that we are seeing, we should easily hold EBITDAC margins at historical levels and actually can probably increase them."* ***- CFO Doug Howell***

BRO	*"Wouldn't be surprising if there's some downward pressure on the margins on the full year."* ***- CFO Andrew Watts***

There are currently many levers for mastering margins at brokers' disposal. Brokers do not disclose travel and entertainment expenses (T&E), but according to various estimates such expenses at broker firms can vary between 4% and 10% of operating expenses.

A meaningful part of these expenses will likely be cut anyways for most of the balance of the year due to the extensive social distancing measures and the changes in people's behavior for at least some time in the post-lockdown world (=get out of jail free card).

Other available but much less popular options may include cutting base or variable employee compensations.

The brokers' optimism on margins are justified by these get out of jail free card expense cuts under the assumption of flat to slightly negative base-case organic growth.

That said, it's important to note that should the crisis have farther-reaching consequences, or the recessionary conditions persist in 2021, brokers will face increasingly tough trade-offs involving stakeholder and shareholder gains and losses.

This complicates an already long list of trade-offs the industry has been facing including inward focus vs outward expansion, high rates and unhappy clients, high vs managed expectations, more debt vs less debt and integration work vs market share growth.

More bullish on rates

On pricing, brokers reported rate increases broadly in Q1 and maintained a view for more rate increases in Q2.

Notably, there is a growing sense of possibility for more acceleration in the rate increase driven by the pandemic.

MMC	*"Small and middle market insurance pricing increased more modestly in the mid single-digit range. Given the losses from the pandemic, pricing trends globally are likely to continue."* ***- CEO Dan Glaser***

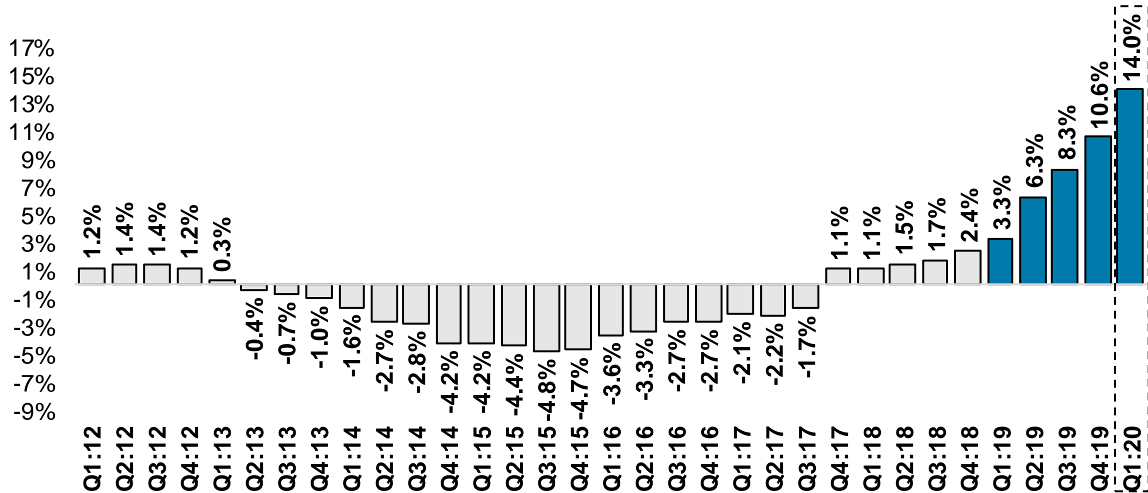
AJG	*"Even before Covid, losses were deteriorating and now this crisis could cause further loss deterioration, causing the underwriters to need even more rate. I wouldn't call it a hard market, but I would call it becoming a more difficult rate and conditions market."* ***- CEO Pat Gallagher***

BRO	*“We think most rates will increase slightly in the second quarter, but it's unknown what will happen to rates in the second half of the year until more is known about the impact of Covid-19.”* ***- CEO Powell Brown***

Briefly turning to the numeric depiction of the rates trend, brokers’ pricing disclosures pointed to another quarter of rate acceleration (unsurprisingly). Marsh and McLennan composite pricing index, that skews to large risk, indicated an acceleration deeper into the teens. The broker noted that middle and small accounts, less captured by the index, are experiencing price increases as well.

Exhibit: Marsh Global Composite Pricing index change

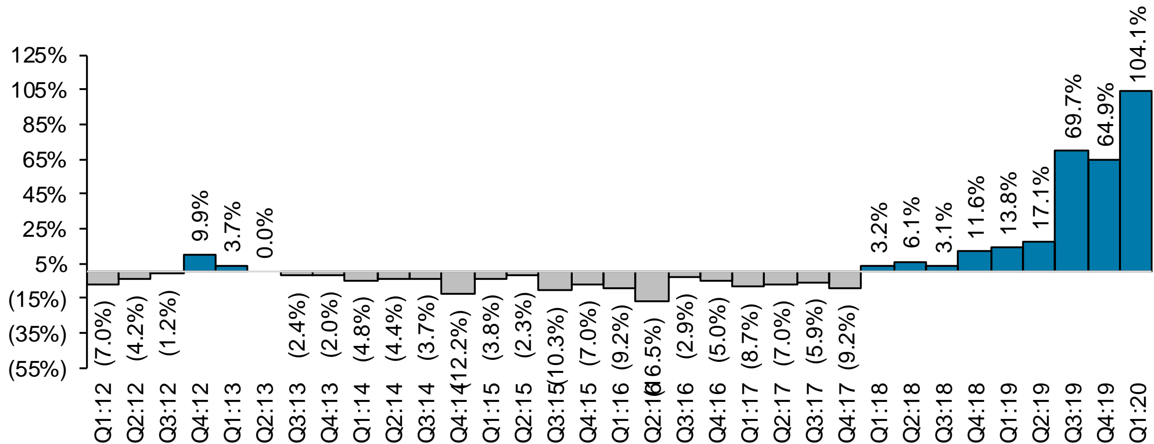
Source: Marsh & McLennan



Aon’s D&O report in Q1 showed “pricing” up ~104% on a simple price-per-mil basis, with primary coverages up 26%, which was enough for us to call it a true hard market.

Exhibit: Aon D&O pricing change

Source: Aon



With more focus on the small and middle markets, Brown & Brown’s rates disclosures showed a continuation for high rates, particularly in professional lines.

Exhibit: Brown & Brown pricing disclosure

Source: Brown & Brown conference calls

Brown & Brown rate disclosures				
	Q2:19	Q3:19	Q4:19	Q1:20
Most lines	+1% to +5%	+1% to +5%	+1% to +5%	+1% to +5%
Coastal property	+5% to +10%	+5% to +15%	+5% to +20%	+5% to +15%
Other property	0% to +3%	+3% to +5%	+5% to +10%	+5% to +10%
Professional lines	-3% to -5%	0% to -5%	-5% to +5%	+5% to +10%

and carriers alike suggest continued momentum into April, though we would note that this type of inconsistent disclosure inevitably invites selective disclosure biases.

Additionally, insurance is a slow-moving industry with a long lead time on negotiations in some parts of the market. Any reaction to a fast-moving and rapidly changing crisis is likely to be slow and prolonged, and play out over quarters not weeks.

There remain many known unknowns around the length and depth of economic slump which could impact insureds' ability to pay, and may change their behavioural responses to increased pricing (e.g. by restructuring and buying less or seeking alternative risk transfers).

Reduced economic activity and therefore lower frequency may also put pressure on rate in some lines as well as exposures. Though the "need" for pricing is indisputable, the willingness and ability to pay is less clear.

That said, commentary at our recent Insider US conference last week pointed to expectations from intermediaries and carriers a like that price increases would accelerate.

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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