Inside P&C by The Insurance Insider

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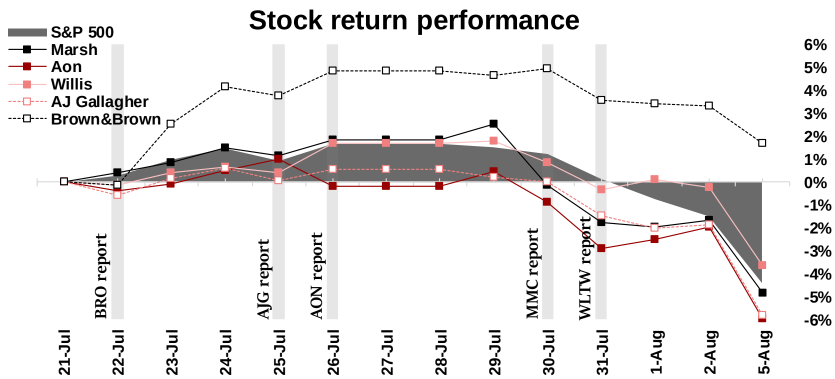
BROKERS: CLIMATE CHANGE DENIAL?

Insurance brokers reported strong Q2 results, with organic growth tailwinds helping both top and bottom lines. But with expectations already elevated, and valuations near highs, strong results appear to be merely table stakes.



The first half of 2019 provided a benign operating environment for insurance brokers, with dual tailwinds from economic expansion and accelerating pricing. As we explore below, this resulted in both strong top and bottom line expansion across the group. With the full contingent now reported, on a composite basis, organic growth at the public insurance brokers was **+5.2%** versus a historical average of **3.5%.**

Notable data points included a decade-plus high growth rate in reinsurance at **Aon**, and similar strong results at **Willis Re**. On the other hand, unsurprisingly, **MMC's** growth headwinds due to the integration of **JLT** was the anomaly among the group.

As we have noted before, the brokers face a challenging balancing act. Though rate is a positive tailwind to growth and earnings, the firms' job is to deliver the best possible combination of coverage, price, terms, and conditions. Managements seem willing to acknowledge the tailwinds to growth, and have promulgated a positive outlook for H2. Yet this has largely been balanced with a bit of cold-water on general market commentary.

Perhaps this balance explains the muted stock reaction to a strong set of earnings, with the group outperforming the S&P 500 on average by just 1%, almost exclusively due to Brown & Brown. With expectations already elevated, and valuations near cyclical highs (see below), the group has set itself a high bar to jump over just to hold to current valuations.

Quick Hits: **Kemper: Specialty lines push helps Q2 beat**

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Index	QTD	YTD
Large Cap	(0.8)%	20.3%
Regional	(1.5)%	10.0%
Specialty	0.4%	19.7%
Personal	(4.9)%	16.6%
Bermuda	1.0%	26.5%
Florida	(11.5)%	(26.7)%
IPC Select	(3.1)%	6.4%
S&P 500	(3.3)%	13.5%
S&P Fin.	(3.5)%	11.8%

Source: S&P Global, Inside P&C

BROKERS Q2 WRAP: CLIMATE CHANGE DENIAL?

- ***Brokerage composite organic revenue up 5.2% versus ~3.5% historical average, consolidated incl. non-brokerage up 4.9% versus ~3.75% average***
- ***Results benefited from firming rates; brokers' outlook on rates remain fairly neutral***
- ***Average adj. operating margins expanded by 130bps, 30bps on rolling 4Q basis***
- ***Impact on corporate valuations neutral to slightly positive for publicly listed firms***

The first half of 2019 provided a benign operating environment for insurance brokers, with dual tailwinds from economic expansion and accelerating pricing.

The favorable brokerage operating environment is evident from the Q2 reported organic growth numbers:

- **Aon's** commercial risk - 6%, including a decade+ high 12% in reinsurance.
- **Willis Towers Watson's** investment, risk & reinsurance segment - 8%.
- **AJ Gallagher's** brokerage segment – 5.8%.
- **Brown & Brown's** retail segment – 5.6%, wholesale segment – 7.0%.

However, despite the positive results, brokers have largely restrained from a bullish tone on the market, in contrast to more optimistic comments from carriers.

We view this as reasonable given brokers' position in the industry's value chain, predicated on delivering the best possible terms and conditions to clients.

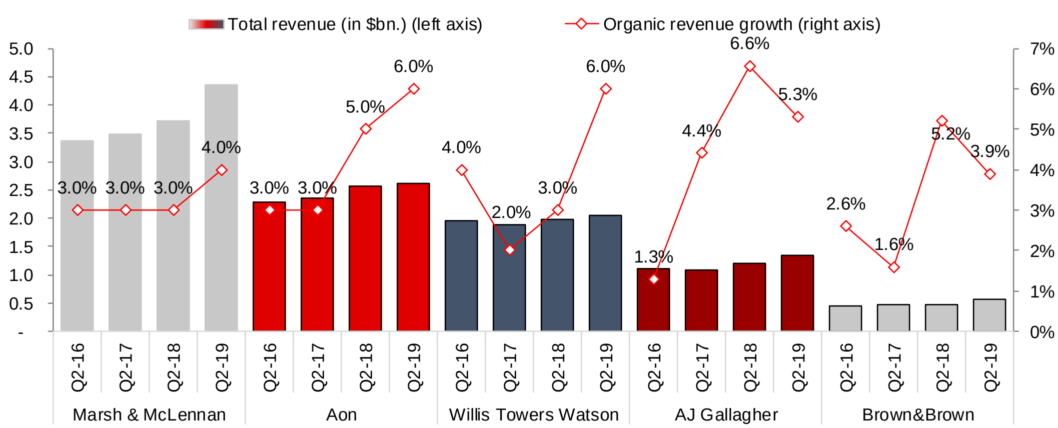
However, the "rate-wind" does appear to be blowing on the brokers' backs, and there seems to be at least tacit acknowledgement that part of growth is due to the firming market…and in the bullish outlook on the growth given for H2.

Organic growth outruns historical average for seven quarters

Insurance brokers' top-line consolidated organic growth numbers in Q2 were strong as both their brokerage and non-brokerage businesses experienced strong tailwinds we discussed above.

EXHIBIT: BROKERS' COMPANYWIDE ORGANIC GROWTH

Source: S&P Global, Inside P&C

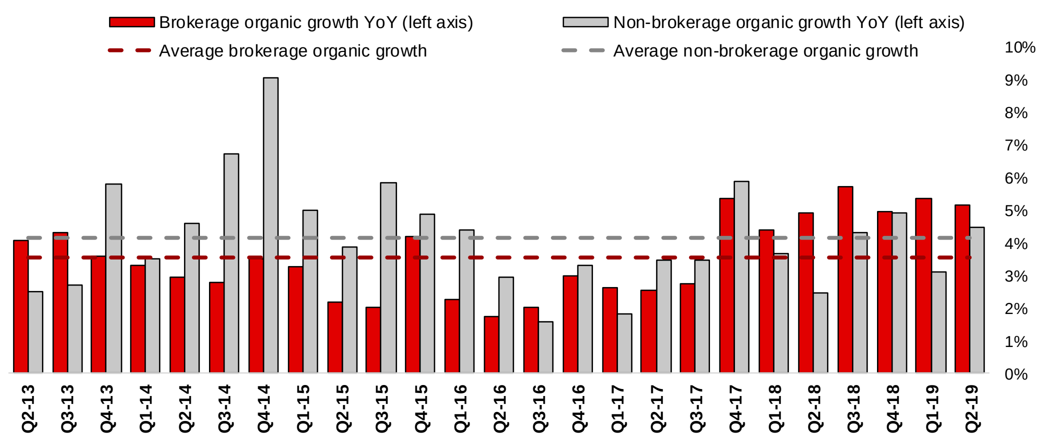


On brokerage, firms continued outpacing the historical average organic growth rate of 3-4% in Q2, i.e. at levels that generally allow brokers to expand margins.

The (re)insurance brokerage composite organic growth of public firm in Q2 was 5.2%, the 7th straight quarter of 4%+ growth. See chart below.

EXHIBIT: INSURANCE BROKERS' COMPOSITE ORGANIC GROWTH

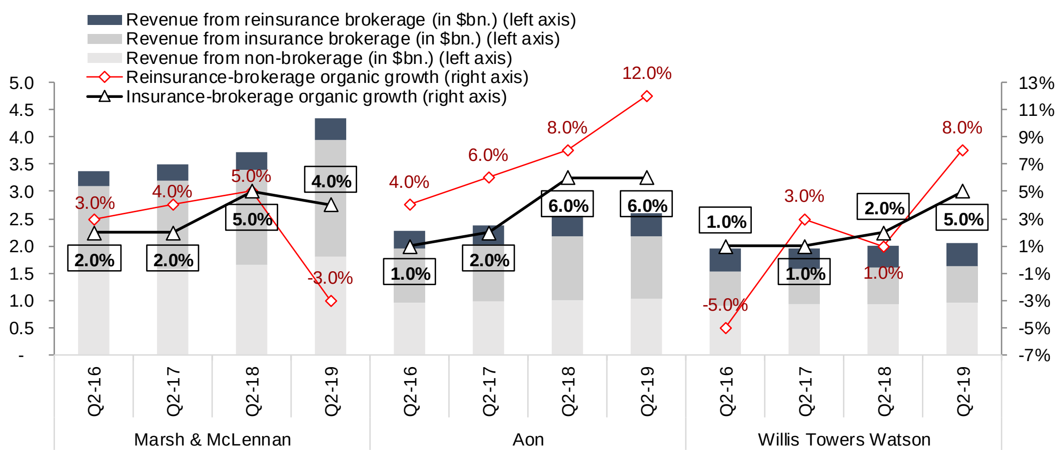
Source: S&P Global, Inside P&C



Within brokerage, perhaps the most notable data points was the dramatic acceleration of organic growth in reinsurance units at **Aon** (up 12% vs 8% YoY) and **WLTW** (up 8% vs 1% YoY). In sharp contrast, MMC's **Guy Carpenter** contracted 3% organically, only the second quarterly decline in a decade.

EXHIBIT: BIG 3 BROKERS' INSURANCE AND REINSURANCE ORGANIC GROWTH

Source: S&P Global, Inside P&C



That hints to a possible (and understandable) rearrangement in market share following the MMC-JLT transaction. Confirming the thesis using only data from public brokers is close to impossible, though JLT Re's portfolio always seemed one of the most vulnerable to dis-synergies from the merger (and was likely expected by the acquirer).

However, Aon's and WLTW's tones on the conference call Q&A sessions hinted that some of their "wins" may be the result of the M&A involving their largest competitor. For example:

- **WLTW CFO Michael Burwell** answered whether there were market share wins from MMC-JLT transaction: "*We have seen our reinsurance business being very strong … at 10% overall, and so part of that is coming from continued wins and strong market conditions that we've seen out there. So I think it's encapsulated in those numbers*".
- **Aon CFO Christa Davies** answered what part of the 13% reinsurance growth is coming from new solution versus share wins: "*As it features in our win/loss, it is actually kind of hard for us to tell candidly … but our win rates are at all-time highs across the firm, across commercial risk, and our top 10 countries, and across reinsurance*".

On insurance brokerage, key data points included: MMC's Marsh was up 4% (vs 5% YoY), which trailed the results by Aon (up 6% flat YoY); WLTW (up 5% vs 2% YoY) and AJ Gallagher (up 5.8% vs 5.9% YoY).

MMC noted that JLT dis-synergies impacted Marsh growth too, albeit to a less extent than reinsurance.

Lower rates – better broker

One of the most significant takeaways from early Q2 reports has been the bullishness among insurance carriers that the nascent firming market in P&C is accelerating, spreading to more lines and territories, and is sustainable.

However, perhaps unsurprisingly, public commentaries from the brokers were rather mixed as some brokers appeared less willing to whole-heartedly endorse this view, with an apparent concern to not give away too much ammunition and leverage by conceding a market framing inuring to the benefit of carriers at the expense of clients.

For example, Aon and AJ Gallagher, as well as Brown & Brown, downplayed the thesis of an accelerating market, putting clear daylight between them and the "mood music" emanating from leading insurance carriers that has persisted for two quarters in a row now. For example:

- **AJ Gallagher** CEO Patrick Gallagher: *"While I am pleased that we have a bit of a tailwind, I would not get extra bullish on the rate environment".*
- **Aon CEO** Gregory Case: *"The impact from pricing was modest for the quarter and for the first half of the year".*
- **Brown & Brown** CEO J Powell Brown: "*There's still a lot of capital that needs to get put to work and therefore we do not believe there's going to be large swings in pricing in the near future*."

On the other hand, unlike their peers MMC and WLTW seemed more bullish on the rate trends they observed in the quarter and understandably restrained on the outlook:

- **MMC** CEO Daniel Glaser: "*Ultimately, we can't predict the mid to long-term outlook for pricing, but the current conditions are firmer almost across the board*".
- **WLTW** CEO John Haley: "*This is a better environment than we've had for a while*".

One other notable comment was from Guy Carpenter CEO Peter Hearn: "I think the other thing that's important to note too is that insurance and reinsurance pricing are sort of moving in synchronicity. It isn't the top-down reinsurance pricing being forced on the primary business, it is primary rates rising as reinsurance rates respond to the underlying growth of premiums as well".

Among the public brokers only AJ Gallagher discloses rate changes more or less consistently, but still not perfectly, across periods. We summarized the data points below.

EXHIBIT: AJ GALLAGHER RATE CHANGE DISCLOSURES

Source: Company reports

	Q2-18	Q3-18	Q4-18	Q1-19	Q2-19
US retail					
Commercial auto	5%	4%	5%	5%+	4% on average
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%+)
Property	7%	5%	4%	4%+	
Casualty	2 - 4%	2%	3%	3%+	
Workers comp		<-1%	<-3%		
UK retail					
Overall retail	1.5%		Flat+	3%	3%
Professional liability			5.0%	5%+	3%
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)

	Q2-18	Q3-18	Q4-18	Q1-19	Q2-19
Canada					
Property		3%	4%		7-9%
Commercial Auto			<4%		7-9%
Professional Lines		1%			
Casualty		1%	<4%		0%+
Australia & NZ					
Casualty & Specialty	4 - 6%	5.0%	5%+	4-6%	7%
Property	8 - 9%	7%	9%		

Despite the balanced commentary on the state of the market, some brokers were willing to give more credit to higher rates when explaining their own solid Q2 top-line growth numbers. Note, improving growth and margins is good for brokers stocks. For example:

- **AJ Gallagher** noted 2 points in Q2 organic growth was due to exposure and rate increase versus the benchmark of 1 point, seen in Q1.

- Similarly, **Brown & Brown** listed rate increases among the factors that drove organic growth in retail and wholesale brokerage segments, for the first time in a long time.

Brokers mostly bullish on growth

Brokers were also mostly bullish on the growth environment going forward as most management teams expressed expectations for 5% or more organic growth for the remainder of the year.

A clear exception was MMC, whose tone appears to imply organic contraction on its reinsurance unit Guy Carpenter for the next several quarters.

Beyond that, the impression is that MMC's management expects the dis-synergies will remain a headwind for about two years.

We view firming rates environment as a significant tailwind to the brokerage organic growth numbers in Q2, as well as going forward into 2H:19.

Other things being equal, we expect the peer group, ex. MMC, to deliver strong (5%+) YoY brokerage organic growth in the remainder of the year despite tough comparison with Q3:18, particularly on reinsurance business.

For Guy Carpenter, the comparison may become a significant challenge as it saw 11% organic in Q3:18 with strong growth across all of its three treaty businesses, as well as facultative business, i.e. new quarterly lows on organic may be coming for Guy Carp.

Brown & Brown may hit growth below our 5% target, even absent large account renewal timing issues normal for the broker, due to its lender-placed insurance headwind.

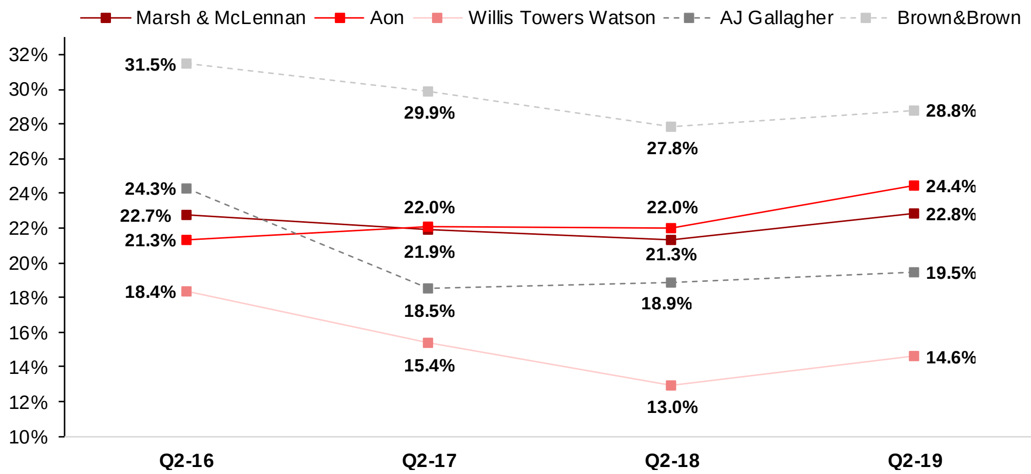
Contrary to expectations, the lender-placed business was less of a hurdle for Brown & Brown in Q2. However, though the economy appears to be slowing, the counter-cyclicality of the lender placed business would likely take some time to play out, especially with consumers seen as reasonably strongly positioned. As such, we view the business to remain a significant headwind for at least the balance of the year.

Margins improve across the board

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

EXHIBIT: BROKERS' Q2 ADJUSTED OPERATING MARGINS

Source: Company reports, Inside P&C



Perhaps, the most notable topic is the fact MMC posted a 150bps expansion YoY of its adjusted operating margin despite all the headwinds the company is facing surrounding the JLT integration. Additionally, and perhaps more interestingly, this comes in spite of the fact that JLT as a stand-alone organization historically had lower margins than MMC. In fact, it is MMC's first margin expansion in Q2 for 3 years.

MMC's management pointed to some cost synergies with JLT, improved operational performance, as well as the presence of many non-recurring items that impacted the margins, which they did not specify.

Other margin stories in Q2 included:

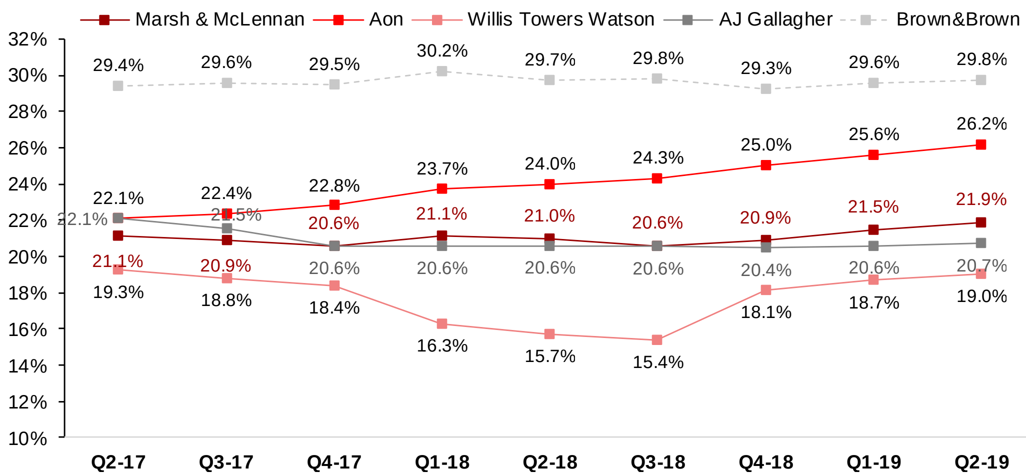
- **Aon** demonstrated the most prominent margin expansion among the peers of 242bps. The expansion is driven by accelerating organic growth and a shift of revenue to higher growth and margin areas, the company noted.
- **WLTW** reported margin expansion of 160bps reflecting margin growth in every segments. This was driven by a combination of top-line growth and cost management efforts, according to the comments.
- **AJ Gallagher** posted 49bps EBITDAC margin expansion and 60bps adjusted operating margin expansion (our standardized margin metric), which is in line with the firm's telegraphed goal of 50bps on 5% organic growth.
- **Brown & Brown's** EBITDAC margin improved by 20bps as the improvements in wholesale brokerage, services segment and a large expansion in national programs was offset by a large margin contraction in its retail segment. Our standardized adjusted operating margin indicated a bigger improvement of 100bps due to larger negative estimated acquisition earn-out payables that we typically eliminate from the nominator of our standardized margin metric.

As much as YoY margin comparison is useful to track the period-to-period changes for an individual company, it becomes less useful when comparing peers since there are quarterly seasonalities that are inconsistent among brokers.

We use rolling-four-quarters margins to overcome the seasonality issue and perform peer-to-peer comparison (see chart below).

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

Source: Company reports, Inside P&C



On a rolling-four-quarter basis, Aon continued steady margin expansion and further narrowed the margin gap with Brown & Brown that has historically been operating at by far the highest margins among public brokers. At its current pace of improvement, Aon would take at least two years for the gap to close, conditional on stable margins at Brown & Brown and Aon's sustained ability to reap the benefits of its "united" strategy and restructuring initiatives.

WLTW successfully continued its catch-up race to the peers' margins. The broker is now 170bps behind second last AJ Gallagher, versus ~500bps a year ago.

Recall, margins are viewed as highly important performance indicator by investors evident from the high alignment of them with valuation multiples (illustrated by charts in a later section).

Stocks and valuations

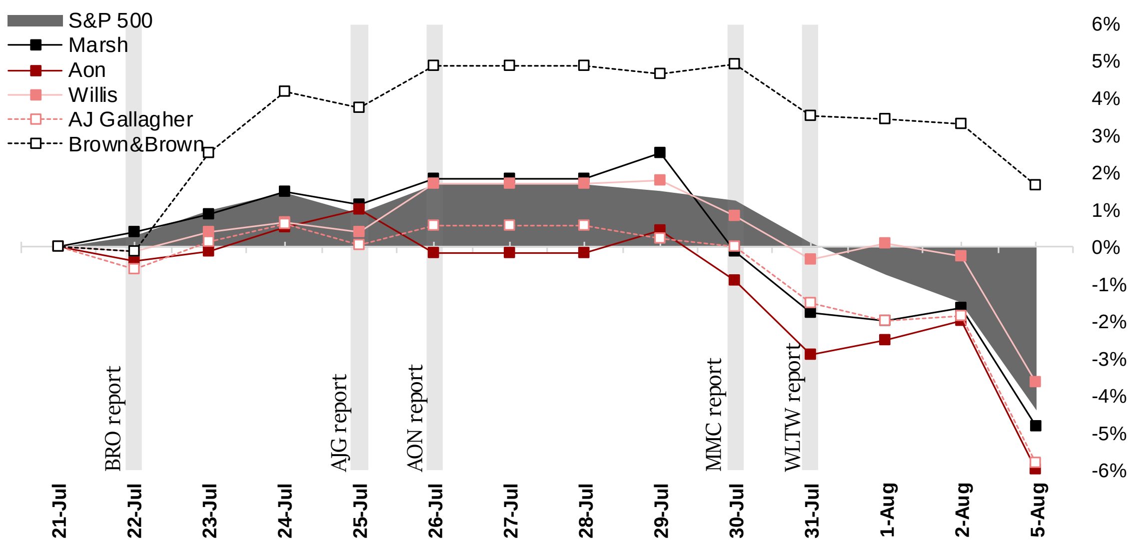
Insurance broker stocks had a generally muted reaction to Q2 earnings releases, broadly following the market movements.

The only clear exception was Brown & Brown. The stock rallied over 4% in two days following its earnings release on July, 22. As of the last week's Friday close, the stock was up 3.3% since earnings. This is compared with -0.3% to -2.0% percent downward price movement on the peers' stock for the same period and -1.5% drop on S&P 500 index (see chart below).

In our opinion, Brown & Brown outperformed both market and peers during the earnings season due to higher than expected organic growth within national programs segment as the headwinds from lender-placed business appeared less significant than anticipated, combined with stronger retail performance.

EXHIBIT: BROKERS' STOCK PERFORMANCE THROUGH Q2 EARNINGS SEASON

Source: S&P Global, Inside P&C



Notably, prior to WLTW earnings release, brokers had generally underperformed the market since earnings season kickoff. The impact of WLTW's solid report spilled over to the peer group which resulted in ~2% relative outperformance over two days following the announcement.

Overall, the stock price movements implied to us that investors' assessment of the brokers' Q2 reports was neutral suggesting the elevated performance was in line with the market's high expectations that we highlighted in our Q2 earnings preview. Of note, the peer group outperformed S&P 500 on average by 1.0% during the two-week broker earnings season, and only by 0.1% excluding Brown & Brown that skewed the average performance due to significantly higher outperformance relative to both S&P and the peer group (see chart above).

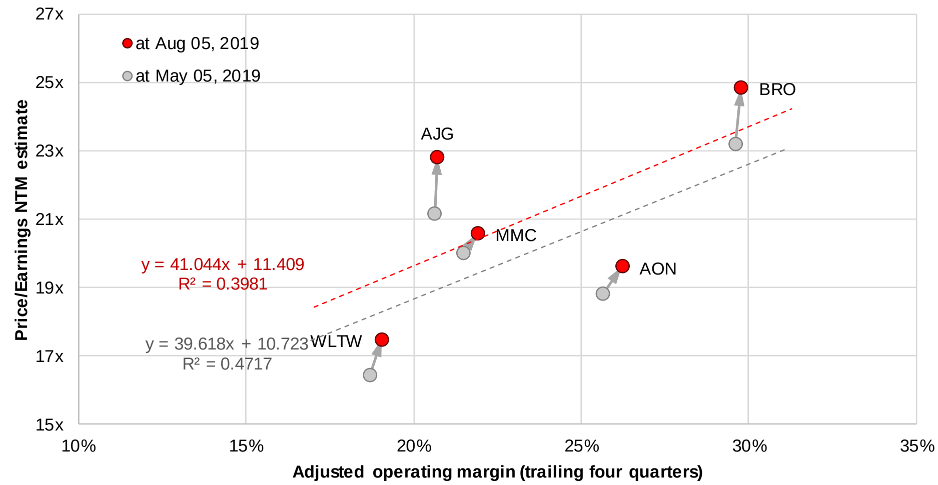
Ultimately, the brokers' lofty valuations may demand for further acceleration in performance to justify further upward repricing relative to the broader market.

For context, on a forward P/E basis, the brokers were generally revalued upward since the Q1:19 earnings season, except for MMC as investors likely continued to assess the revenue breakage. AJ Gallagher and Brown & Brown had highest revaluations as both stocks gained ~2 turns on the forward P/E.

Interestingly, the biggest upward re-ratings, that included AJ Gallagher and Brown & Brown, were not accompanied by substantial trailing operating margin improvements (see chart below). Recall, rolling-four-quarters operating margins explain over 40% of broker valuations, evident by the regression function in the chart below.

PRICE-TO-FORWARD-EARNINGS VERSUS TRAILING 4Q ADJ. OPERATING MARGINS

Source: S&P Global, Inside P&C



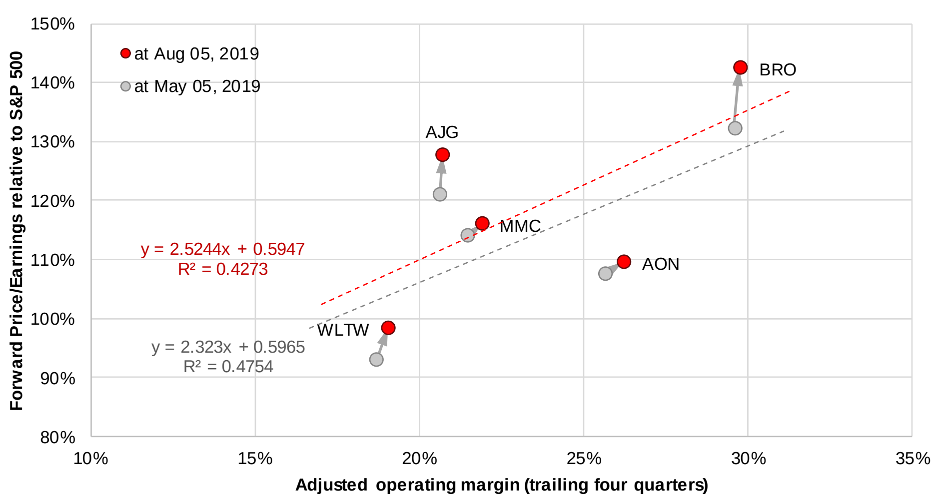
An upward re-rating of a broker's stock, absent margin improvement, may be due to a myriad of possible reasons, but the major reasons that we highlight are:

- Increased expectations about the future operational performance, and/or
- Realized improvement (against expectations) in performance indicators other than operating margin, and/or
- Increased expectations of a firm being targeted for M&A, and/or
- Market-wide upward revaluation that lifts all boats.

We can eliminate the market-effect by replacing forward P/E with **relative** forward P/E which results in the chart below.

PRICE-TO-FORWARD-EARNINGS VERSUS TRAILING 4Q ADJ. OPERATING MARGINS

Source: S&P Global, Inside P&C

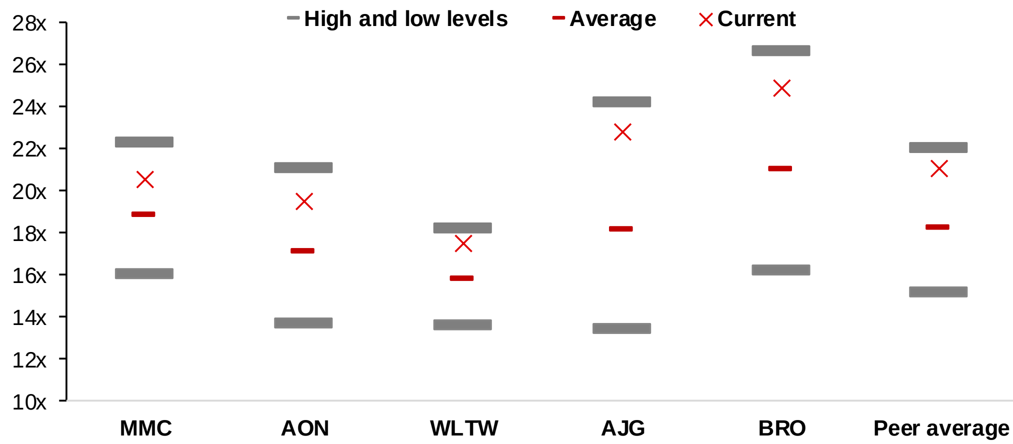


This still results in a substantial non-market related revaluation, but dealing with the remaining three factors requires judgment. Our inclination is to weigh this as expectations of improving margins from the operating leverage provided by growth.

On the relative (to S&P 500) forward P/E basis, stock are now placed above 5-year averages and just below the 5-year highs.

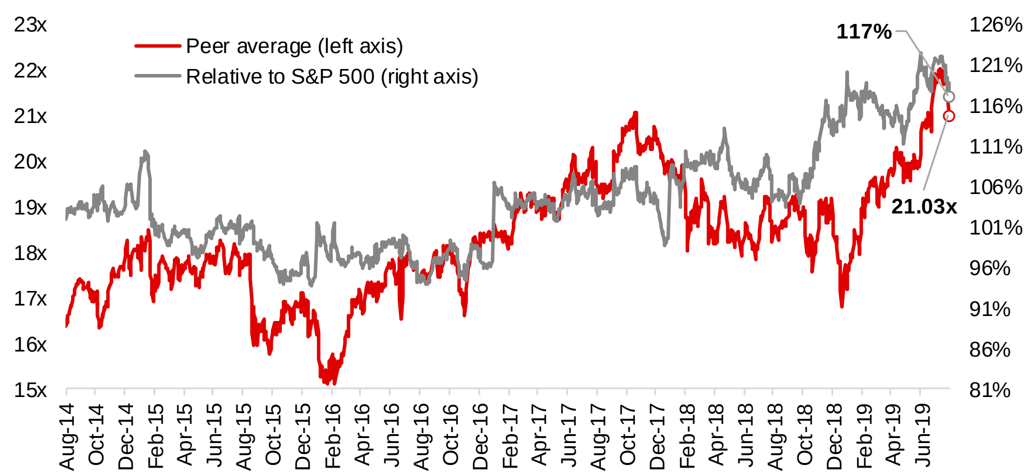
RELATIVE (TO S&P 500) PRICE-TO-FORWARD-EARNINGS AGAINST 5-YEAR AVERAGE, HIGH AND LOW

Source: S&P Global, Inside P&C



PEER AVERAGE PRICE-TO-FORWARD-EARNINGS AND RELATIVE PRICE-TO-FORWARD EARNINGS

Source: S&P Global, Inside P&C



QUICK HIT: SPECIALTY LINES PUSH HELPS Q2 BEAT

- ***Operating EPS up 97% to $1.38***
- ***EPS beats consensus of $1.33 by 3.8%***

Kemper reported an operating eps of $1.38 per share, up 97% from last year's $0.70 a share. The result stems from continued profitable growth in the specialty P&C segment.

The firm's specialty segment grew written premiums by 137% to $805mn YoY, while the firm's preferred P&C segment grew by 2.1% to $123.4mn. The jump in premiums was a result of Kemper's July 2018 acquisition of Infinity P&C, a specialty auto insurer, as it aims to reposition itself in the specialty lines business.

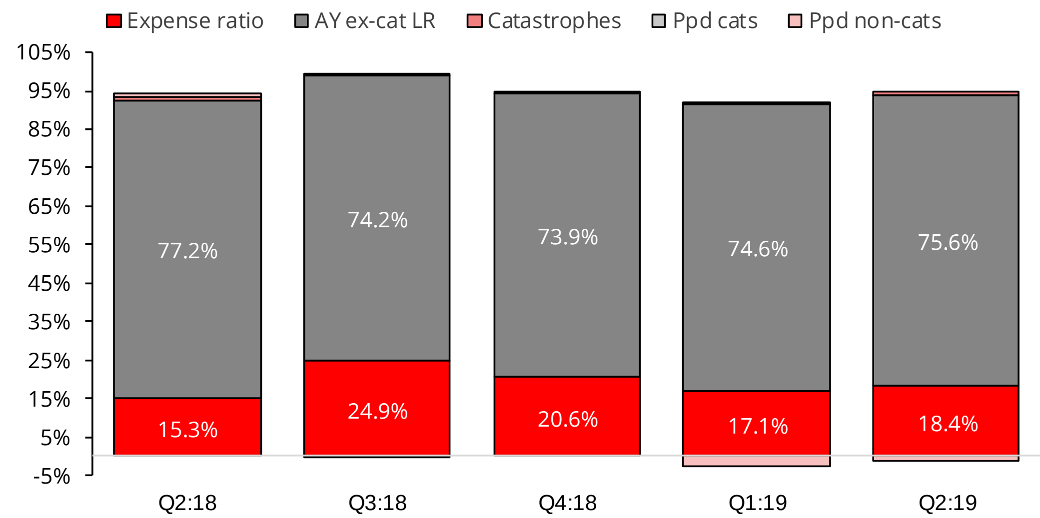
The firm's net investment income grew 22.4% to $96mn, largely a result of the 25% jump in total investments following the acquisition of Infinity P&C.

	Kemper (KMPR)					
$mn	**Q2:18**	**Q3:18**	**Q4:18**	**Q1:19**	**Q2:19**	**VAR**
Operating EPS.	**$ 0.70**	**$ 1.59**	**$ 0.91**	**$ 1.50**	**$ 1.38**	**97.1%**
NEP	658.1	1,052.9	1,063.6	1,074.8	1,116.6	69.7%
NII	78.4	92.0	91.3	82.7	96.0	22.4%
Loss and LAE	499.5	757.3	772.8	765.4	825.4	65.2%
Operating expenses	171.2	296.0	273.2	234.8	263.5	53.9%
Adj. net operating income	36.5	104.5	59.9	98.9	91.5	150.7%
Preferred P&C						
AY ex-cat LR	59.5%	63.4%	64.0%	65.1%	63.2%	3.7pts
Catastrophes	22.3%	9.9%	11.3%	8.9%	12.0%	(10.3)pts
Ppd cats	(1.0%)	(0.1%)	(0.4%)	0.5%	(0.5%)	0.5pts
Ppd non-cats	0.3%	(1.0%)	(1.6%)	(2.7%)	(2.3%)	(2.6)pts
Loss ratio	81.1%	72.2%	73.3%	71.8%	72.4%	(8.7)pts
Expense ratio	31.4%	31.1%	30.6%	30.9%	30.7%	(0.7)pts
Combined ratio	112.5%	103.3%	103.9%	102.7%	103.1%	(9.4)pts
Preferred P&C						
AY ex-cat LR	77.2%	74.2%	73.9%	74.6%	75.6%	(1.6)pts
Catastrophes	0.7%	0.2%	0.1%	0.1%	0.6%	(0.1)pts
Ppd cats	-	-	-	-	-	0.0pts
Ppd non-cats	1.3%	(0.2%)	-	(2.5%)	(1.1%)	(2.4)pts
Loss ratio	79.2%	74.2%	74.0%	72.2%	75.1%	(4.1)pts
Expense ratio	15.3%	24.9%	20.6%	17.1%	18.4%	3.1pts
Combined ratio	94.5%	99.1%	94.6%	89.3%	93.5%	(1.0)pts

Kemper's specialty segment improved its combined ratio 1pt to 93.5%. While the firm's loss ratio improved 4.1pts to 75.1%, the firm's expense ratio deteriorated 3.1pts to 18.4%, acting as an offset.

EXHIBIT: KEMPER SPECIALTY COMBINED RATIO BREAKDOWN

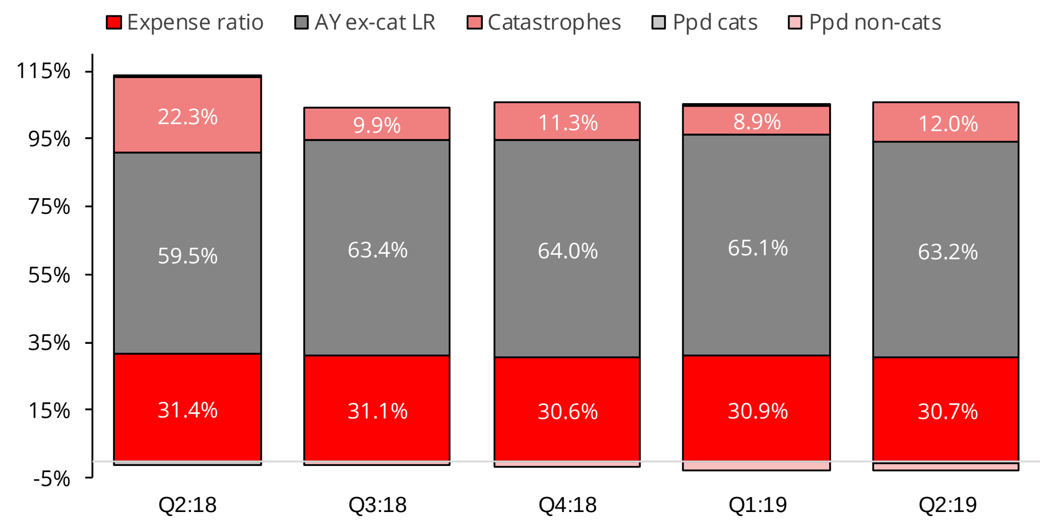
Source: Kemper, Inside P&C



Kemper's preferred P&C segment improved its combed ratio by 9.4pts to 103.1%. The result stems from a 10.3pt drop in catastrophe losses, and 2.3pts worth of favorable development. The segment's underlying loss ratio deteriorated by 3.7 points, a result of adverse intra-year development of Q1 non-catastrophe large losses in its homeowners business.

EXHIBIT: KEMPER PREFERRED P&C COMBINED BREAKDOWN

Source: Kemper, Inside P&C



CEO Joseph Lacher mentioned in the firm's press release that "Our results this quarter demonstrate meaningful gains in specialty auto, and continued stability in our life and health segment," and that "the consistent strength of our balance sheet and disciplined approach to strategy execution again produced revenue growth, solid earnings, and shareholder returns. Our strategy and business model continues to perform, expanding Kemper's reach to specialty markets with easy-to-use, affordable and appropriate insurance and financial solutions."

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