Property Casualty Intelligence Briefing

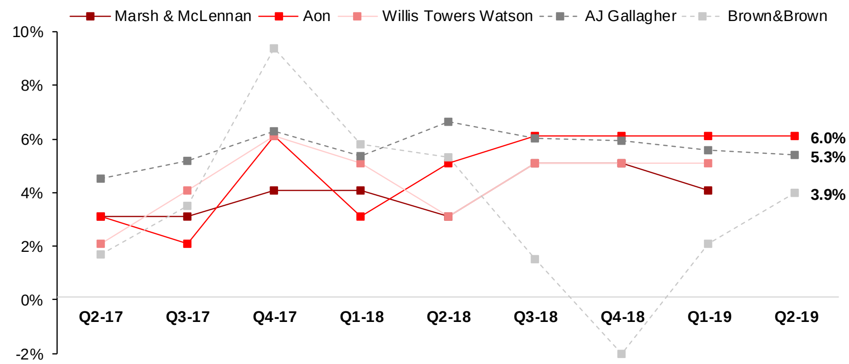
Inside P&C

by The Insurance Insider

July 29, 2019

CAUGHT BETWEEN A SOFT AND A HARD PLACE

Intermediaries appear caught between the competing pressures of results that speak to an improving market (good for their stocks) and a concern to manage market expectations to the benefit of clients.



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

However, perhaps unsurprisingly, public commentary from the brokers appears 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.

Of course, while brokers' growth and financials benefit somewhat from rate increases, there is a natural tension in the fact that it's not exactly their job to talk up the market. Their role is to get the best price for clients, who have their own budgets and internal expectations to manage.

Below, we outline the inherent tension between these two conflicting incentives, with the brokers' financials and market data pointing to an improving market (good for investors), but management commentary that appears intended to not let expectations get too carried away in a way that could ultimately be bad for clients.

Quick Hits:

- **Aon: Highest reinsurance organic growth since early 2000s**
- **AJ Gallagher Q2 organic growth 5.3%, risk management slows**
- **Next broker data points likely to be less clean**

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Index	QTD	YTD
Large Cap	3.8%	25.9%
Regional	0.3%	12.1%
Specialty	3.7%	23.6%
Personal	2.4%	25.6%
Bermuda	4.0%	30.2%
Florida	(11.4)%	(26.5)%
IPC Select	(0.3)%	10.2%
S&P 500	2.9%	20.7%
S&P Fin.	3.7%	20.3%

Source: S&P Global, Inside P&C

OUR JOB IS TO MITIGATE RATES MOVING HIGHER - AJG

❖ ***Brokers try to re-frame the debate away from a run-away hard market but also seeing the benefits from rate = trying to walk the line***

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

However, perhaps unsurprisingly, public commentary from the brokers appears 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, both Aon and AJ Gallagher last week, as well as Brown & Brown's the week before, down played 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*."

That said, we continue to find the brokers commentary somewhat at odds with the data they are disclosing – including the more granular data outlined below.

- For example, **AJ Gallagher** noted that 75% of their surveyed producers recorded around 5% rate increase and another 15% communicated a surge to 10%. "Very few" indicated that 10% level of increase last year.
- Similarly**, Brown & Brown** reported rate increases in auto, employee benefits, general liability and property, with an acceleration in coastal property where the rate jumped to 5-10% from 0-5% in Q1. The company also said it expected further upward rate pressure in H2.

Of course, we should note up front that, while brokers' growth and financials benefit from rate increases, there is a natural tension in the fact that it's not exactly their job to talk up the market. Their role is to get the best price for clients, who have their own budgets and internal expectations to manage.

Per **Pat Gallagher**: "*Our people go out every day and try to figure out with their clients how to make sure that these rate increases don't hit them…so at 5%, you're sitting across from a client that's getting a reduction in the workers' compensation. They can tweak their deductibles up. They can drop a line of cover. There's a bunch of things they can do to mitigate the impact of that."*

= along with an attempt to re-frame the market narrative, a hint that too much action on rate increases will lead to a change in risk appetite from original insureds too, and re-set the market's demand and supply equilibrium.

Digging deeper: Granular disclosures by brokers

AJ Gallagher is one of the most transparent among brokers and carriers in terms of reporting the pricing changes by lines of business. However, it is unfortunately oftentimes difficult to use their rate disclosures to track the changes QoQ on an apples-to-apples basis due to inconsistent disclosures. Just as with carriers, we are conscious of a selective disclosure problem when pricing data is disclosed inconsistently.

However, we attempted to structure the data in a granular way, which seems to us to imply to us a bit of acceleration (see chart below). Similar to other disclosures we have seen, wholesale seems to be ahead of retail.

Key highlights include.

- **US Retail rates were up 4%** led by commercial auto, property and umbrella. Casualty lines are “flat to up a few points, with workers’ comp down 3%.
- **US Wholesale rates were up 5-6%,** driven by double digit increases on large or loss-impacted property. Other lines cited at “above 5%” included med-mal, GL, and umbrella. Workers comp, casualty, and “some professional lines” are “closer to flat”.
- **UK business pricing up 5% overall,** with different environments in retail and wholesale. UK retail pricing was up 3% but wholesale up almost 8%. The latter increases are being driven by “casualty-oriented lines”, including D&O, E&O, GL, as well as property.

EXHIBIT: AJ GALLAGHER RATE CHANGE DISCLOSURES

Source: Company reports, Inside P&C

<table>
<tr><th></th><th>Q2-18</th><th>Q3-18</th><th>Q4-18</th><th>Q1-19</th><th>Q2-19</th></tr>
<tr><td colspan="6">US retail</td></tr>
<tr><td>Commercial auto</td><td>5%</td><td>4%</td><td>5%</td><td>5%+</td><td rowspan="4">4%
on average</td></tr>
<tr><td>Property</td><td>5%</td><td>3%</td><td>5%</td><td>5%+</td></tr>
<tr><td>Workers comp</td><td>-1%</td><td>-1%</td><td>-1%</td><td></td></tr>
<tr><td>US casualty & specialty</td><td>0-2%</td><td></td><td></td><td>2%</td></tr>
<tr><td colspan="6">US wholesale</td></tr>
<tr><td>Commercial auto</td><td></td><td></td><td>4%</td><td>4%+</td><td rowspan="4">5-6%
(many in property 10%+)</td></tr>
<tr><td>Property</td><td>7%</td><td>5%</td><td>4%</td><td>4%+</td></tr>
<tr><td>Casualty</td><td>2 - 4%</td><td>2%</td><td>3%</td><td>3%+</td></tr>
<tr><td>Workers comp</td><td></td><td><-1%</td><td><-3%</td><td></td></tr>
<tr><td colspan="6">UK retail</td></tr>
<tr><td>Overall retail</td><td>1.5%</td><td></td><td>Flat+</td><td>3%</td><td>3%</td></tr>
<tr><td>Professional liability</td><td></td><td></td><td>5.0%</td><td>5%+</td><td rowspan="5">3%</td></tr>
<tr><td>Property</td><td>Flat</td><td>2%+</td><td rowspan="4">Flat+</td><td rowspan="4">1-2%
for most lines</td></tr>
<tr><td>Marine</td><td></td><td>2%+</td></tr>
<tr><td>Commercial auto</td><td></td><td>2%+</td></tr>
<tr><td>Casualty</td><td>2 - 3%</td><td><2%</td></tr>
<tr><td>London Specialty Operations</td><td></td><td></td><td></td><td>5%
(10%+ in cat exposed)</td><td>8% (more in D&O, E&O and property)</td></tr>
</table>

<table>
<tr><th></th><th>Q2-18</th><th>Q3-18</th><th>Q4-18</th><th>Q1-19</th><th>Q2-19</th></tr>
<tr><td colspan="6">Canada</td></tr>
<tr><td>Property</td><td></td><td>3%</td><td>4%</td><td></td><td>7-9%</td></tr>
<tr><td>Commercial Auto</td><td></td><td></td><td><4%</td><td></td><td>7-9%</td></tr>
<tr><td>Professional Lines</td><td></td><td>1%</td><td></td><td></td><td></td></tr>
<tr><td>Casualty</td><td></td><td>1%</td><td><4%</td><td></td><td>0%+</td></tr>
<tr><td colspan="6">Australia & NZ</td></tr>
<tr><td>Casualty & Specialty</td><td>4 - 6%</td><td>5.0%</td><td>5%+</td><td rowspan="2">4-6%</td><td rowspan="2">7%</td></tr>
<tr><td>Property</td><td>8 - 9%</td><td>7%</td><td>9%</td></tr>
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Despite the balanced commentary on the state of the market, some brokers were willing to give more credit to higher rates when explaining 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, a week earlier, **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.

Does re-framing the debate matter?

In summary, our view is that data points provided by the brokers are somewhat more bullish than their market framing, tone and body language. Perhaps the most notable in this regard was AJ Gallagher CEO Pat Gallagher, who went to great lengths to re-frame the terms of the debate as in terms of “not a hard market”, and is worth quoting at length.

> “*This is really important. Do not overemphasize this as a hard market. This is not a hard market. We're getting the accounts quoted, we're not having accounts canceled in a wholesale fashion, we're working through a little bit of increase here…You go back to 2001, our organic growth was 19%, the market rates were up an average of over 20%, and many accounts never could get the cover they wanted. They couldn't fill out their lines. That was a hard market. So let's not get crazy here looking at this as a hard market.”*
> **- AJ Gallagher CEO Path Gallagher**

Fair enough. We concede that it is not exactly the job of a broker to talk up the market and provide ammunition for carriers to quote in their negotiations with placing brokers. And we respect the argument as valid in how it is framed.

However, our view is both that a) nobody really seems to be arguing that there is a hard market anyway and, more importantly, b) this binary “hard/soft” framework is not a helpful model to understand the market most of the time.

The P&C business has changed. Hard markets are likely to be the very rare exception – absolutely still possible, just not part of a normal cycle. In fact, we would argue that there are multiple pockets of P&C where the market is hard as classically defined. And given their loss histories and return adequacies, this is a symptom of a rational and well-functioning market. However you describe it.

AON REPORTS HIGHEST REINSURANCE ORGANIC GROWTH SINCE EARLY 2000S

Aon's earnings came in at $1.87 per share, an increase of 9.4% YoY and in line with analyst estimates. The result was driven by organic growth of 6% versus 5% YoY and adjusted op. margin of 24.4%, a 242bps expansion versus 22.0% YoY.

EXHIBIT: AON Q2 RESULTS

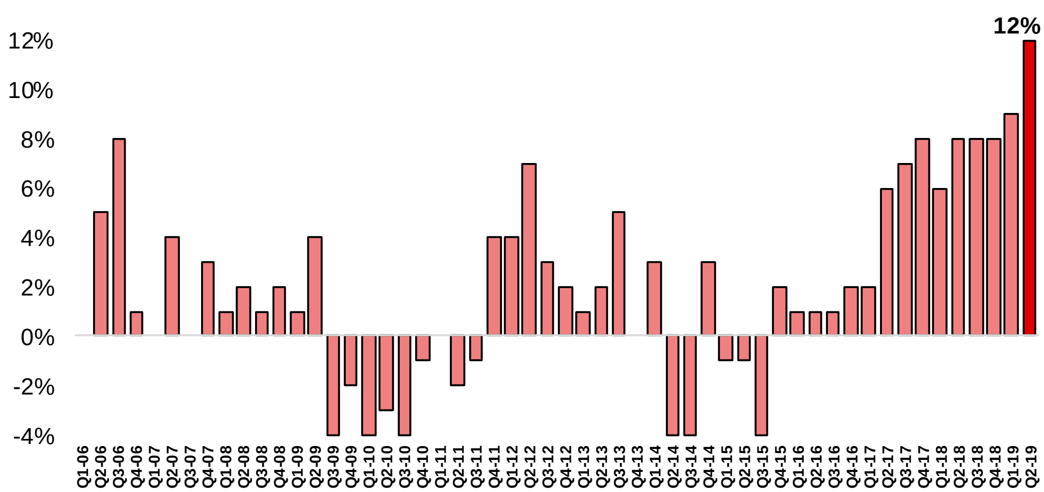
Source: Company reports, S&P Global, Inside P&C

	Q2-18	Q3-18	Q4-18	Q1-19	Q2-19	YoY var.
Revenue ($mn)						
Total consolidated	2,561	2,349	2,770	3,143	2,606	1.8%
Commercial Risk	1,166	1,029	1,273	1,118	1,167	0.1%
Reinsurance	380	279	162	788	420	10.5%
Retirement	431	501	509	420	419	-2.8%
Health	309	278	558	486	317	2.6%
Data & Analytic Services	277	263	271	336	286	3.2%
Organic growth						
Total consolidated	5%	6%	6%	6%	6%	100bps
Commercial Risk	6%	8%	4%	6%	6%	0bps
Reinsurance	8%	8%	8%	9%	12%	400bps
Retirement	3%	2%	4%	2%	1%	(200bps)
Health	7%	8%	8%	5%	6%	(100bps)
Data & Analytic Services	-4%	5%	9%	5%	4%	800bps
Adj. operating income ($mn)	564	434	716	1060	637	12.9%
Adj. operating margin	22.0%	18.5%	25.8%	33.7%	24.4%	242bps
Adj. EPS estimate	1.64	1.22	2.13	3.30	1.87	9.4%
Adj. EPS actual	1.71	1.31	2.16	3.31	1.87	9.4%
Surprise	4.3%	7.4%	1.4%	0.3%	0.0%	-

The organic growth was driven by 6% growth in commercial risk and health segments and a decade+ high organic expansion of 12% for reinsurance.

EXHIBIT: AON REINSURANCE SOLUTIONS ORGANIC GROWTH

Source: Company reports, Inside P&C



Other notable items included:

- The adjusted operating margin expansion of 242 basis points is the most prominent among the peers that have reported to date. The expansion is driven by accelerating organic growth and a shift of revenue to higher growth and margin areas, the company noted.
- Free cash flow to firm (FCFF) declined 15.6% to $255mn from $302mn as $85mn legacy litigation claims more than offset benefits from improved operational performance and lower restructuring costs in the quarter. The company remains committed to the double-digit FCFF annual growth goal.
- The company increased restructuring-related cost savings guidance for 2019 to $510mn from $500mn announced in Q1:19 and $450mn announced in Q4:18; set guidance for 2020 - $535mn.

AJ GALLAGHER Q2 ORGANIC GROWTH IS AT 5.3%, RISK MANAGEMENT SLOWS

AJ Gallagher reported organic growth of 5.3% versus 6.6% YoY, as brokerage growth of 5.8% was offset by a smaller growth of 3.0% in risk management.

This growth picture transferred to margins as brokerage adjusted EBITDAC margin expanded by about 50 basis points which was slightly offset by risk management margin contraction of 10 basis points.

The broker reported Q2 earnings of $0.65 per share, an increase of 4.8% YoY versus the 1.6% decrease expected by analysts.

EXHIBIT: AJ GALLAGHER Q2 RESULTS

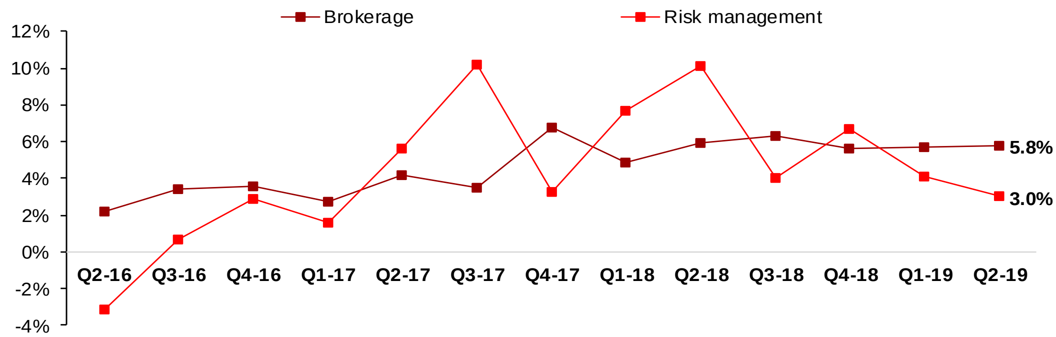
Source: Company reports, Inside P&C

	Q2-18	Q3-18	Q4-18	Q1-19	Q2-19	YoY var.
Revenue ($mn)						
Consolidated	1,625	1,741	1,623	1,958	1,625	0.0%
Brokerage	1,000	1,049	1,002	1,382	1,131	13.1%
Risk management	202	199	202	203	209	3.6%
Corporate	423	493	419	372	285	-32.7%
Organic growth						
Consolidated	6.6%	5.9%	5.8%	5.5%	5.3%	(127bps)
Brokerage	5.9%	6.3%	5.6%	5.7%	5.8%	(10bps)
Risk management	10.1%	4.0%	6.7%	4.1%	3.0%	(710bps)
Adjusted EBITDAC margin						
Consolidated	24.5%	25.1%	21.6%	33.1%	25.0%	49bps
Brokerage	25.9%	26.4%	22.5%	35.6%	26.4%	50bps
Risk management	17.6%	18.0%	17.3%	17.0%	17.5%	(10bps)
Adj. operating income ($mn)	227.0	244.8	189.9	417.2	261.0	15.0%
Adj. operating margin	18.9%	19.6%	15.8%	26.3%	19.5%	60bps
Adj. EPS estimate	0.63	0.77	0.52	1.61	0.61	-1.6%
Adj. EPS actual	0.62	0.78	0.53	1.63	0.65	4.8%
Surprise	-1.6%	1.3%	1.9%	1.2%	6.6%	-

Management noted no specific headwinds that slowed the risk management consulting business in the quarter and hinted at normal variability of the segment's results by highlighting that Q2:18 10.1% organic growth complicated the YoY comparison this year.

EXHIBIT: AJ GALLAGHER ORGANIC GROWTH BY SEGMENTS

Source: Company reports, Inside P&C



<u>Other notable items from the company's report included:</u>

- The impact of a rate firming tailwind was 2 points versus 1 point in Q1 and historically.
- Brokerage organic growth guidance for Q3:19 is 5% due to tough comparison with solid Q3:18 that recorded 6.3% growth (prior year includes lumpiness from multi-year surety bonds).
- Brokerage margin expansion of 50 basis points is a base case guidance for future quarters assuming 5% organic growth.
- Risk management organic growth guidance for H2:19 is 5% with adjusted EBITDAC margin above 17%.

Next broker data points likely to be less clean

While two of the big three insurance brokers are yet to report the results, the data points released to date point to another solid quarter for the group.

That said, the Q2 results of Marsh & McLennan and Willis Towers Watson, set to release this week, will likely face scrutiny on a number of fronts.

In particular, increased attention will be on MMC's organic growth following the acquisition of JLT. As the broker shared on its Q1 earnings call, the firm is expecting noise from possible dis-synergies.

Recall, MMC has experienced a notable executive and front-line broking departures following the acquisition, though we expect the company will downplay the persistent news-flow as noise, and continue to express confidence in earnings accretion due to the expense levers it has to pull to offset any revenue leakage.

Some outcomes of WLTW's efforts to catch up with the peers' margins will also be topical.

Q2 earnings schedule for the remaining brokers is as follows:

- MMC – Tuesday 30th July before the bell.
- WLTW - Wednesday 31st July before the bell.

EXHIBIT: BROKERS' ADJUSTED OPERATING MARGINS

Source: Company reports, Inside P&C

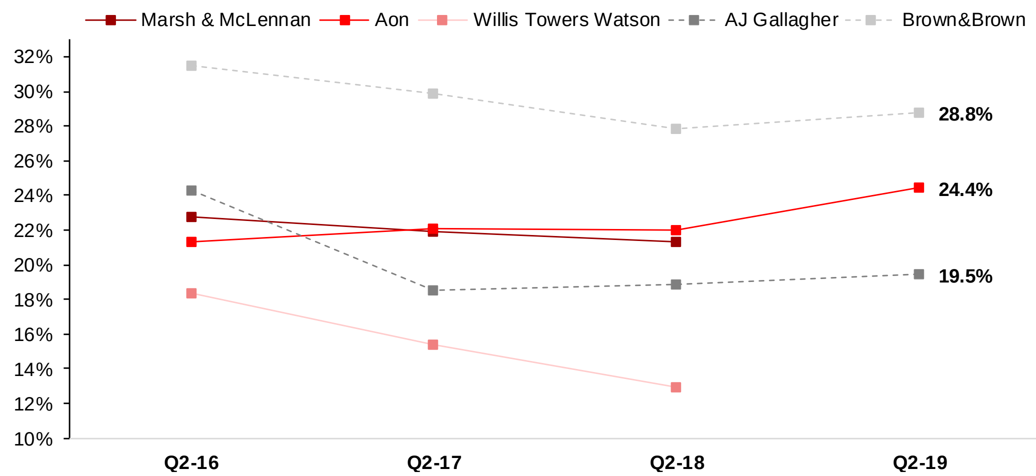
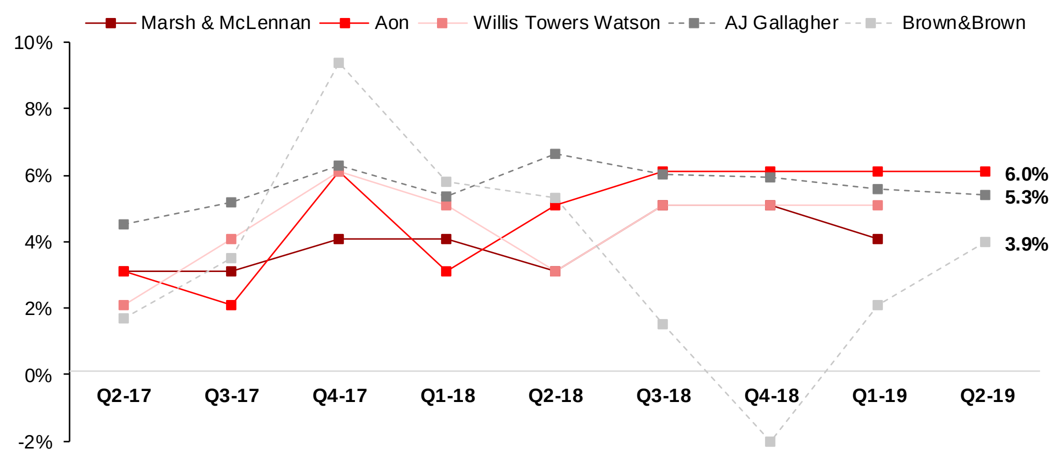


EXHIBIT: BROKERS' ADJUSTED ORGANIC GROWTH

Source: Company reports, Inside P&C



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