Inside P&C by The Insurance Insider

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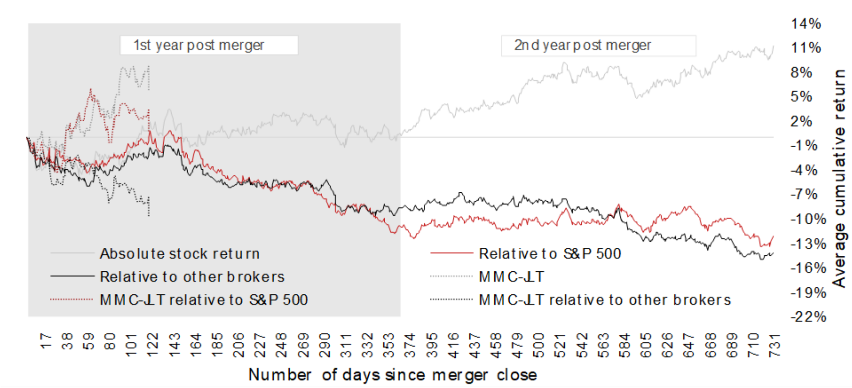
CLOSING THE MARGIN GAP > REVENUE HEADWINDS

Expect a messy first year at MMC post-JLT. But longer term, the opportunity to close the margin gap on acquired and retained revenues is huge relative to earnings on likely lost revenue.



Since the close of the **JLT** transaction in the 1st of April **MMC** has underperformed average peers' stock performance by almost 10%. This is perhaps not surprising. Major broker M&A has historically been followed by lower relative stock returns (see chart above). In this sense, a messy first year is entirely in line with the base case.

As such, Marsh's "choppy" Q2 was in line with lowered expectations, albeit with some surprises in it. For us, there are three major takeaways:

- Despite strong industry tailwinds, organic growth was hit by dis-synergies from the JLT transaction (among other things)
- However, bottom line growth was sustained through margin expansion, as management wields the expense lever.
- And…the above model of expense saves offsetting revenue headwinds will be the story for some time to come as management works its way through integration by making each dollar of acquired revenue sweat a little harder.

Ultimately, for all the attention on revenue leakage, there has been less focus on two crucial factors. First, lost revenue also carries costs, so cost synergies only has to offset the impact of lost *earnings*, not lost *revenue*. Second, given the huge margin gap of ~600bps between acquired JLT revenues and MMC margins, the simple math is that closing that gap is a powerful lever that would be hard for lost revenue to offset.

Against that, wielding these expense levers can come with morale problems, management distraction, and talent leakage = all can have a longer-term impact on culture and capabilities (the people are the assets). This is where leadership comes in, and is less simple than making the numbers work. Management has all the levers it needs to deliver the synergies and earnings accretion it has pledged its external stakeholders. However, the harder challenge may be managing the internal stakeholders, and making sure near-term noise doesn't distract from building the future of the franchise.

Quick Hits: **Allstate: a big beat, and improved guidance**

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Index	QTD	YTD
Large Cap	2.8%	24.7%
Regional	0.8%	12.4%
Specialty	3.6%	23.6%
Personal	0.2%	22.9%
Bermuda	3.4%	29.6%
Florida	(11.9)%	(26.9)%
IPC Select	(0.6)%	9.7%
S&P 500	2.4%	20.2%
S&P Fin.	2.7%	19.1%

Source: S&P Global, Inside P&C

MMC: CLOSING THE MARGIN GAP > REVENUE HEADWINDS

- ***Organic growth slows to 4% as JLT drags on top-line***
- ***Most notable at Guy Carpenter, 800bps decline to negative 3% organic***
- ***P&C rate commentary notably more bullish than other brokers***

This week Marsh & McLennan (MMC) reported its first earnings that include JLT operations following the merger close on April 1. For us, there are three major takeaways from the results:

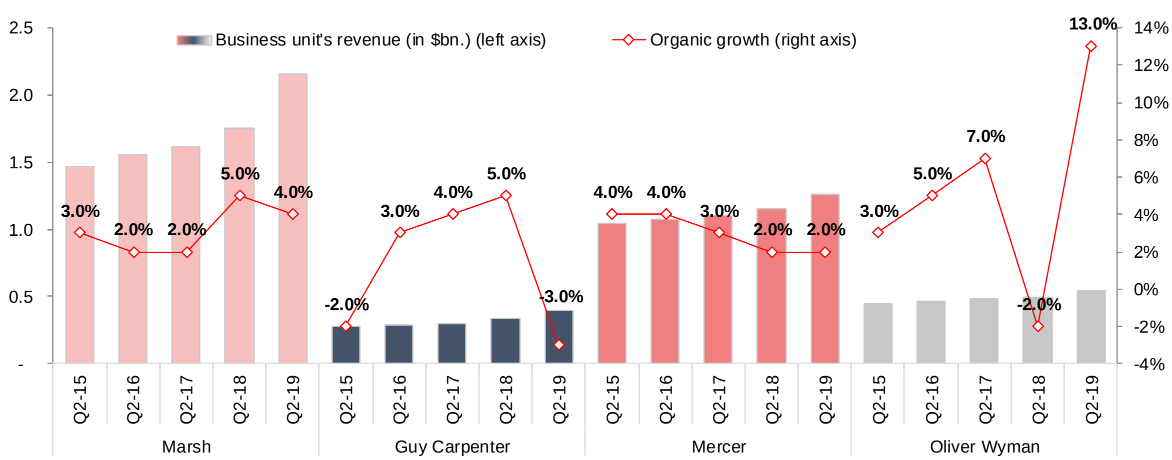
- Despite strong industry tailwinds, organic growth was hit by dis-synergies from the JLT transaction (among other things), as expected and in line with management messaging in Q1.
- However, bottom line growth was sustained through margin expansion, as management wields the expense lever.
- And…the above model of expense saves offsetting revenue headwinds will be the story for some time to come as management works its way through integration by making each dollar of acquired revenue sweat a little harder.

Recall, our view has been the economics of the JLT transaction are similar to a leveraged re-capitalisation (e.g. using debt to buy back stock) of a conservatively capitalised company with a stable cash flow. However, instead of buying back its own shares, MMC is buying a faster-growing earnings stream, re-weighting its geographic mix, and adding strategic capabilities.

But put simply, the capabilities, strategic aspects, and possible longer-term revenue synergies of the deal are really just “nice-to-haves”. What makes the transaction compelling is the margin gap on JLT revenues to MMC due to operational inefficiencies. It is becoming clear that MMC intends to sweat each dollar of revenue harder, and in that respect, the firm can afford to lose a lot of revenue and still make the deal highly accretive.

EXHIBIT: MMC ORGANIC GROWTH BY BUSINESS UNITS

Source: Company reports, Inside P&C



Overall in Q2, MMC grew 4% organically, as Guy Carpenter underwent organic contraction, Marsh's growth slowed, Mercer was flat and Oliver Wyman was the only bright spot with 13% organic growth, up from 2% contraction in last year's Q2. Recall, Oliver Wyman revenue can be lumpy. Growth by segment above.

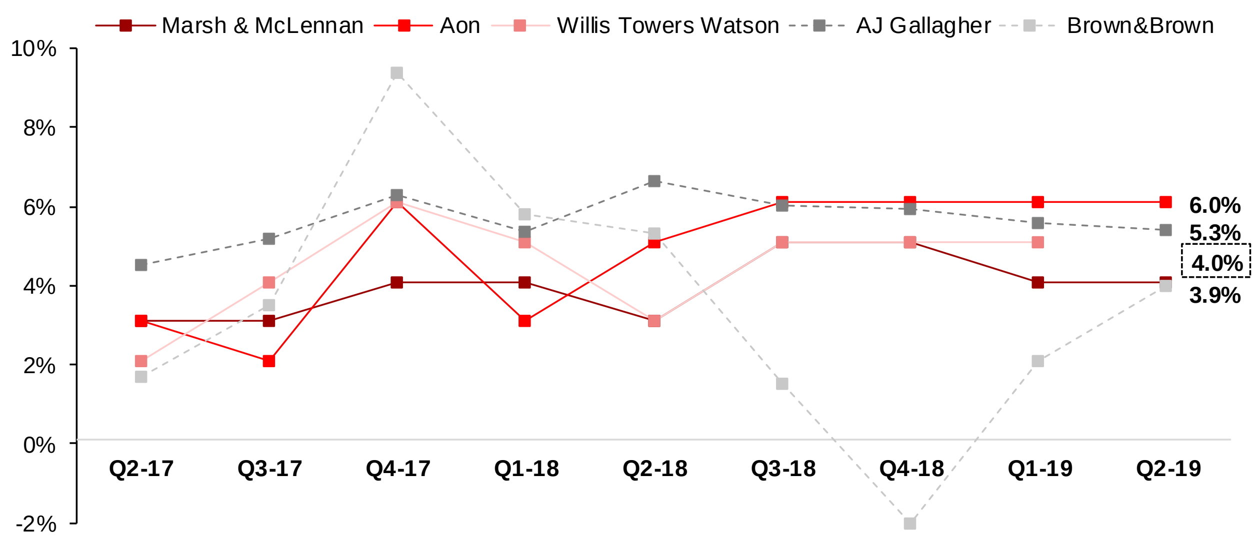
However, it is worth noting that the gloomy reception to the growth reported is not so much about the absolute levels of growth, which are in line with longer term targets, but the slowing growth in the context of an improving insurance market where peers are largely showing improving organic growth in insurance.

MMC reported the 2nd slowest organic growth among peers, only 10bpsmore than Brown & Brown that is facing headwinds due to specifics of the business.

Aon and AJ Gallagher reported numbers that exceed MMC's organic growth by 100-200 basis points, BB&T's insurance unit reported stellar 11.7% organic and Willis Towers Watson's organic is expected to exceed 4% by analysts. See chart.

EXHIBIT: BROKERS' ORGANIC GROWTH

Source: Company reports, Inside P&C



Guy Carpenter headwinds: Likely not just JLT

The most noticeable hit on organic growth was at reinsurance broker Guy Carpenter, with organic revenues down 3% versus 5% growth in Q2:18. Most of the discussions during the yesterday's call around Guy Carpenter's organic dip were centered on the JLT impact, though we suspect this is likely only part of the story.

Summarizing the discussions, management expects the JLT headwinds to persist for approximately two years while it will focus on delivering improved bottom-line results, i.e. levering expenses and closing the margin gap on acquired revenues.

However, one important data point that would help us better understand the dynamics behind Guy Carpenter's top-line but was not addressed on the call is the impact of Markel CatCo's. An exclusive distribution relationship has been extremely lucrative to Guy Carp, and we expect some part of the revenue headwinds may be due to the ILS fund's runoff.

Going forward, we view Guy Carpenter's underlying revenue growth trend to be subject to how the following concerns unfold:

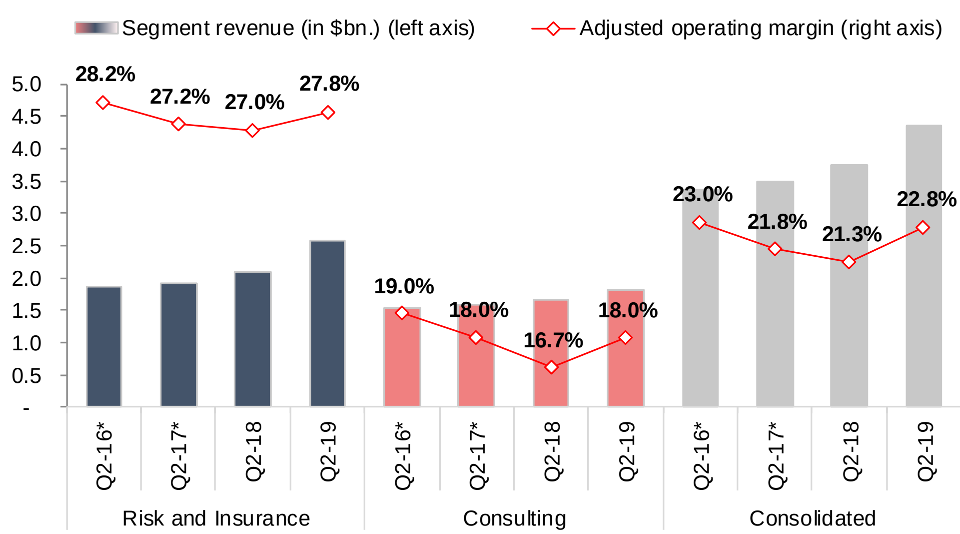
- While the effect of the interruption of new business pipeline will likely persist through the next number of quarters, **existing business retention** will take more time to play out and is the important determinant of potential growth. The firm's institutional relationships are strong, but the competitive attack is multi-faceted.
- Pressures from competitors and talent leakage outside of JLT departures, especially competition from Lockton Re. Recall, the company is facing a leadership transition in the US following the departure of CEO Tim Gardner, who will likely target key "house accounts" at his new post at Lockton Re. Note sister-publication *The Insurance Insider* reported just yesterday the departure of hybrid solutions head Jeff Flemming to Aon, who was understood to control a lot of revenue.

Margins save the day

Despite the revenue pressures, MMC's report included YoY improvement in adjusted operating margins in both its risk and consulting segments despite the fact the result consolidated JLT's financials which have historically showed lower margins. Management pointed to the 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.

EXHIBIT: MMC ADJUSTED OPERATING MARGINS BY SEGMENTS

Source: Company reports, Inside P&C



**unadjusted for the effects of ASC 606 revenue standard*

Note, the JLT acquisition heightened the seasonality of MMC results which may favor Q2 and Q4 margins and put relative downward pressure on Q1 and Q3.

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

- Contrary to other brokers to have reported to date, **MMC's rate commentary was skewed more bullish**. The broker reported an increase of the Marsh global insurance market index, that tracks commercial insurance renewal pricing changes on mostly large risks, to 6% from 3% QoQ with property lines up 8-10%, casualty lines up for the first time since 2013 (+1%), financial and professional lines up 10%.
- **Oliver Wyman** 13% organic growth improved due to new projects, easy YoY comparison; recall, the business is volatile in nature and management does not expect the pace will recur.

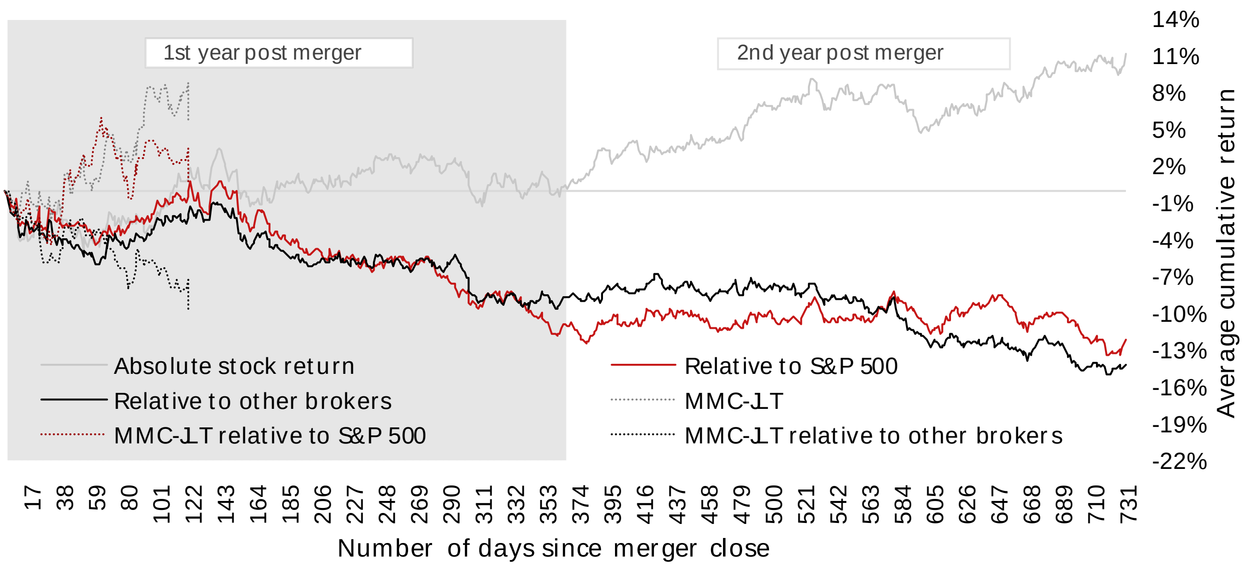
Broker M&A's has historically been followed by lower relative stock returns

Since the close of the JLT transaction in the 1st of April MMC underperformed average peers' stock performance by almost 10%.

Notably, the aftermath of broker M&As since 2000 were on average disadvantageous to the acquirers' stockholders when either peers' stock performance or S&P 500 index is used as a benchmark. Our post-M&A stock performance analysis shows that acquirers' stocks on average underperformed both peers and S&P 500 index for two years following an M&A close (see charts below).

EXHIBIT: BROKERS' STOCK PERFORMANCE POST MERGERS SINCE 2000

Source: Company reports, Inside P&C



				One-year			Two-year		
Acquirer	**Target**	**Value**	**Transactions closed**	**Stock return**	**Relative to S&P**	**Relative to peers**	**Stock return**	**Relative to S&P**	**Relative to peers**
Willis Group	Towers Watson	$18bn	5-Jan-16	0.1%	-12.4%	-30.3%	21.0%	-15.0%	-34.6%
AJ Gallagher	1) Noraxis Capital 2) Oval	$0.64bn combined	1) 2-Jul-14* 2) 1-Apr-14	2.1%	-3.1%	-7.1%	2.6%	-3.9%	-18.0%
Brown & Brown	Wright Insurance	$0.64bn	1-May-14	6.9%	-5.0%	-6.5%	17.9%	8.2%	1.2%
AJ Gallagher	1) Giles Group 2) Bollinger	$0.7bn combined	1) 14-Nov-13* 2) 1-Aug-13	-0.8%	-14.7%	-6.1%	-10.7%	-23.6%	-16.9%
Brown & Brown	Beecher Carlson	$0.5bn	1-Jul-13	-5.0%	-27.2%	-25.4%	1.8%	-26.9%	-27.3%
Brown & Brown	Arrowhead Corp.	$0.6bn	9-Jan-12	16.7%	2.6%	8.5%	40.3%	-3.2%	-9.4%
Aon	Hewitt Associates	$4.9bn	1-Oct-10	6.9%	8.2%	4.2%	35.7%	9.6%	3.4%
Aon	Benfield Group	$1.36bn	1-Dec-08	-10.4%	-46.3%	-14.7%	-4.1%	-51.9%	-32.5%
WTW	Hilb Rogal & Hobbs	$2.1bn	1-Oct-08	-12.1%	-0.8%	-1.1%	-3.4%	-2.1%	5.6%

** transactions combined to avoid duplicated effect. The latter transaction used as a starting point for perfomance tracking period*

ALLSTATE: A BIG BEAT, AND IMPROVED GUIDANCE

- ***Auto benefits from continued lower accident frequency***
- ***Homeowners hit with higher claims severity***

Allstate grew its adjusted operating EPS by 9% to $2.18, beating analyst estimates of $1.54 by 41%. However, the firm saw a 19.3% decline in its underwriting income to $367mn due to higher catastrophe losses. Allstate's auto and homeowners' segments continued to benefit from lower accident frequency, but both businesses were hit by catastrophes and increased claim severity in Q2:19. Notably, the firm also improved its guidance on its 2019 underlying combined ratio by 1.5 points to 84.5-86.5%

EXHIBIT: ALLSTATE Q2:19 EARNINGS RESULTS

Source: Allstate, Inside P&C

	ALL Consolidated					
$mn	**Q2:18**	**Q3:18**	**Q4:18**	**Q1:19**	**Q2:19**	**VAR**
Operating EPS.	**$ 2.00**	**$ 2.16**	**$ 1.59**	**$ 2.30**	**$ 2.18**	**9.0%**
PL NWP	8,541	8,800	8,370	8,327	9,043	5.9%
NII	824	844	786	648	942	14.3%
Loss and LAE	(5,689)	(5,717)	(5,991)	(5,730)	(6,272)	10.2%
Operating expenses	(2,045)	(2,096)	(2,145)	(2,077)	(2,042)	-0.1%
U/W income	455	507	286	700	367	-19.3%
AY loss ratio	60.0%	61.0%	60.8%	59.8%	60.9%	0.9pts
Cat pts.	11.1%	7.5%	11.4%	8.0%	12.3%	1.2pts
PPD pts.	(1.7%)	0.2%	(1.1%)	(0.4%)	(0.9%)	0.8pts
Loss ratio	69.4%	68.7%	71.1%	67.4%	72.3%	2.9pts
Expense ratio	25.0%	25.2%	25.5%	24.4%	23.5%	(1.5)pts
Combined ratio	94.4%	93.9%	96.6%	91.8%	95.8%	1.4pts

EXHIBIT: ALLSTATE SEGMENT HIGHLIGHTS

Source: Allstate, Inside P&C

Allstate brand auto	o NWP up 5% o 2.5% increase in PIF YoY o Higher average premium o 92.8% headlined CR, up 0.3pts o 91.1% underling CR, 1.2pts lower o Lower operating expenses o Lower accident frequency o Increased claim severity
Allstate brand home	o NWP up 6.5% o 5.6% increase in average premiums o 1.6% growth in PIF YoY o 104.3% combined, up 6.4pts o 62.1% underlying combined, down 0.8pts o Elevated cat losses o Lower operating expenses o Lower frequency o Increased claim severity
Esurance brand	o NWP up 9.6% o PIF increased 8.4% YoY o 100.6% combined, down 1.3 pts o 96.2% underlying combined, up 0.3pts o Increased claim severity
Encompass brand	o NWP up 1.1% o Higher average premiums o 0.5% decline in PIF o 97.2% combined, down 0.8pts o 89.8% underlying combined, up 4.6pts o Lower cats o Higher non-cat losses

PIF Growth: Overall, the firm grew its policies in force to roughly 130mn, a 5.1% sequential growth rate. Management credits SquareTrade's exceptional growth of 7.8% to 84mn PIF to the overall PIF growth. Allstate brand saw 0.6% PIF growth to 31mn, driven by auto with grew at 0.8%. Esurance brand grew PIF by 0.2% 1.7mn. Encompass's PIF continue to decline, but at a slower rate of 0.5%. Last year, the segment saw a 2% decline in its PIF.

EXHIBIT: ALLSTATE TOTAL PIF GROWTH, SEQUENTIAL

Source: Allstate, Inside P&C

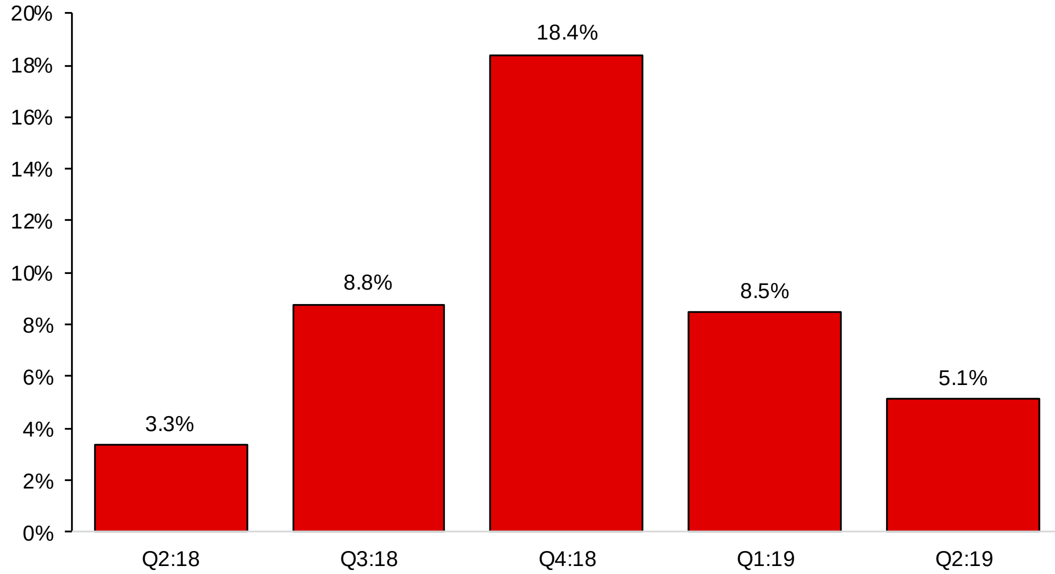
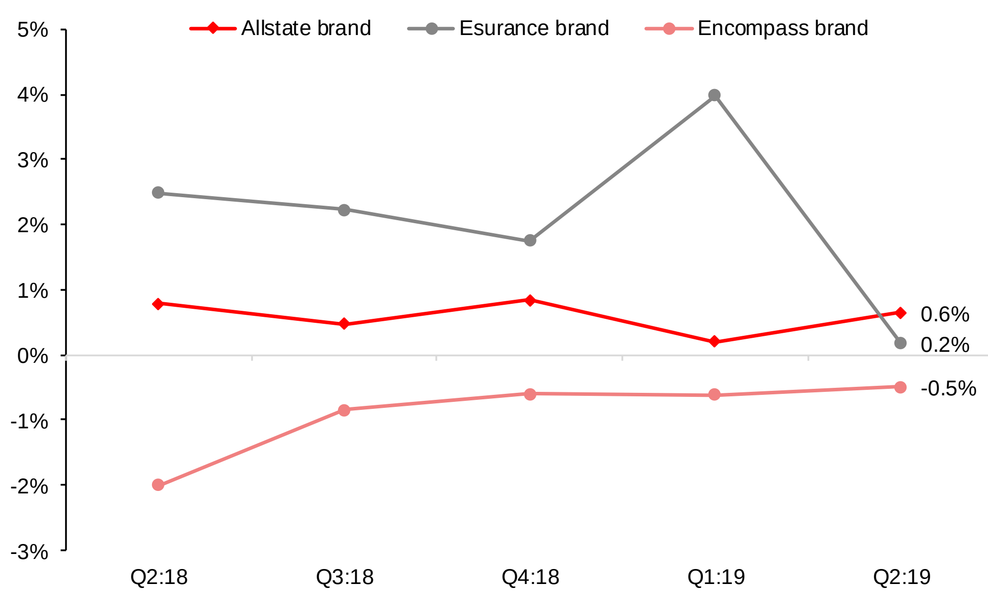


EXHIBIT: ALLSATE & ESURANCE BRAND PIF GROWTH

Source: Allstate, Inside P&C



Property liability results (PL)

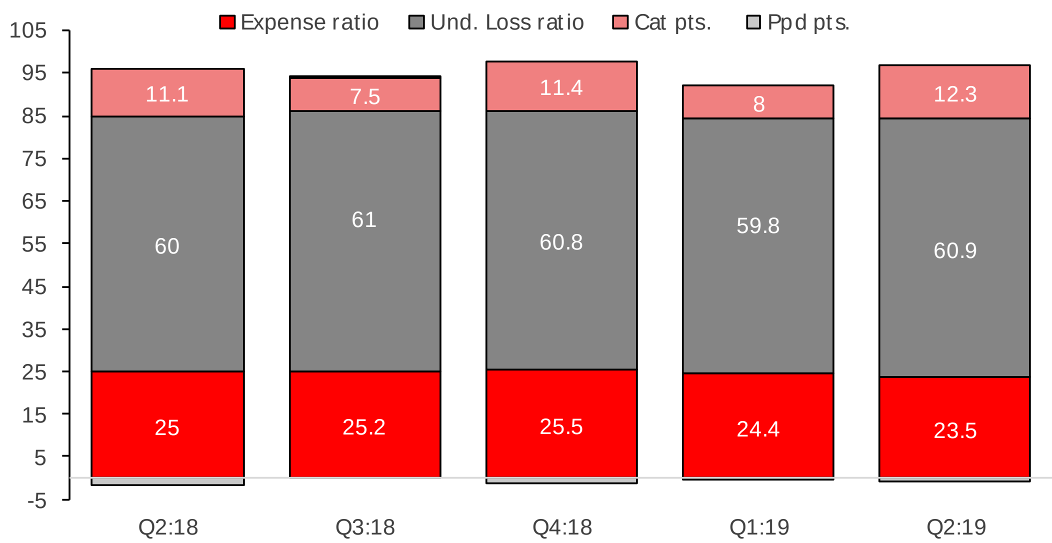
Property liability underwriting income was down $88mn to 367mn as a result of higher catastrophe losses of $1.1bn, contributing 12.3 points to the firms Q2:19 combined ratio of 95.8%. This compared to $900mn of catastrophe losses in Q2:18 which represented 11.1pts on the combined.

The headline result is 1.4pts higher than Q2:18's 94.4% combined ratio. The increase stems from a 1.2pt increase in the firm's cat ratio, a 0.9pt increase in the underlying loss ratio, a 1.5pt improvement in the expense ratio, and a 0.8pt decrease in the PL favorable development ratio.

The firm's underlying loss ratio deteriorated due to increased claim severity.

EXHIBIT: ALLSTATE PROPERTY LIABILITY COMBINED RATIO

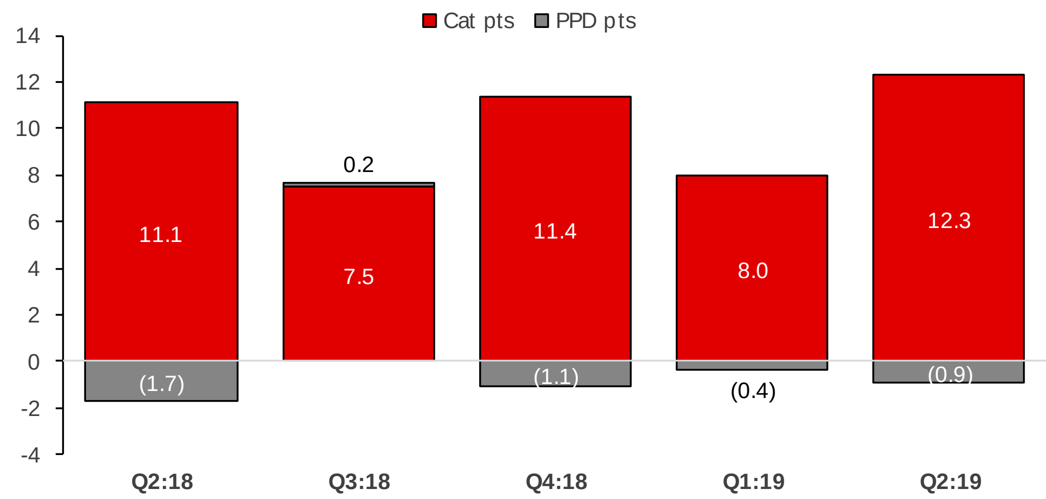
Source: Allstate, Inside P&C



Q2:19's catastrophe losses largely stem from the Allstate brand homeowners business which saw $781mn in cats, a 24% increase from the segment's Q2:18 result of $627mn. While the total cat losses of $1.1bn are higher than last year's total of $900mn, the effect on the combined still sits below the quarter's 10-year average 14pts.

EXHIBIT: ALLSTATE CAT & PPD POINTS ON THE COMBINED

Source: Allstate, Inside P&C



CEO Tom Wilson commentary: "*The strategy of increasing market share in Property-Liability products and expanding into other protection products is gaining momentum. This is supported by excellent operating results which have led us to improve our outlook for the 2019 Property-Liability underlying combined ratio* by 1.5 points to 84.5 to 86.5. Importantly, overall results generated a 13.5% adjusted net income return on equity. Shareholders have also been provided strong cash returns with $643 million of common shareholder dividends and $1.8 billion of common share repurchases (5.6% of outstanding shares) over the last 12 months."*

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