Brokers Q1 wrap: A brokerage super-cycle

The pandemic has been an event of enormous tragic scope. However, on the way out of the mass trauma it is becoming increasingly apparent that humanity and the global economy are rising stronger, as well as more adaptive, cognizant, and efficient - much like in the aftermath of most disasters of the past.

Large insurance brokers may find themselves at the epicenter of these changes. The pandemic, as well as the other events of 2020 and early 2021, reinforced their value proposition in many aspects.

To start with, it increased global risk awareness and demand for advice around unaddressed but latent risks like cyber, pandemic, climate change, supply chain etc. These are the areas that require scale, resources and inventiveness – the sweet spot of large insurance brokers.

In addition to the heightened demand for insurance and risk management due to the increased risk appreciation, the pandemic also reinforced corporates' propensity for risk transfer, as tail events feel more tangible now.

Not only did the pandemic educate executives about risk, it also acted as its promoter. The accelerated digital adoption and the highly supportive economic policies turned risk into the key performance enabler. As risk-taking behavior grows pervasive, it requires more risk for incumbents to hold on to their share and for new market entrants to disrupt an industry.

Against this backdrop, risk management, consulting services and data analytics – important areas of the brokers' vertical expansion – grow in importance too.

Now, large insurance brokers seem to be entering this environment at a great time. Their brokerage revenues are still benefitting from high insurance rates with unit exposure growth now adding to the strong performance. Their more cyclical revenues – HR, benefits and consulting – are quickly rebounding on the back of the buoyant recovery.

The strong organic growth and high margins provide for solid free cash flow – the fuel brokers will need to invest in their businesses.

Furthermore, they still have some safety valves in the form of a combination of low financial leverage, high creditworthiness, and the low cost of debt.

To borrow the commodity market jargon, with these structural tailwinds the industry has a chance to turn the macro-driven boom into a super-cycle. Intermediaries that maintain and improve their relevancy in this environment will win.

Turning to their most recent results, all five brokers beat EPS estimates by an average of 13% in the first quarter. The results suggested that the industry is already growing above the pre-pandemic mid-single digit pace, at least one quarter earlier than anticipated.

Notably, the high growth number came in despite the challenging comparison against Q1:20 where economic activity was only partly impacted by the pandemic.

The peer group composite organic revenues grew by 5.6% in the quarter, above the pre-pandemic eight-quarter average of 4.6%, driven by the remarkable 6.8% organic growth in P&C operations.

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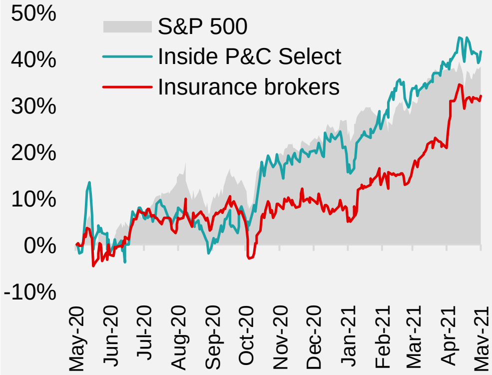
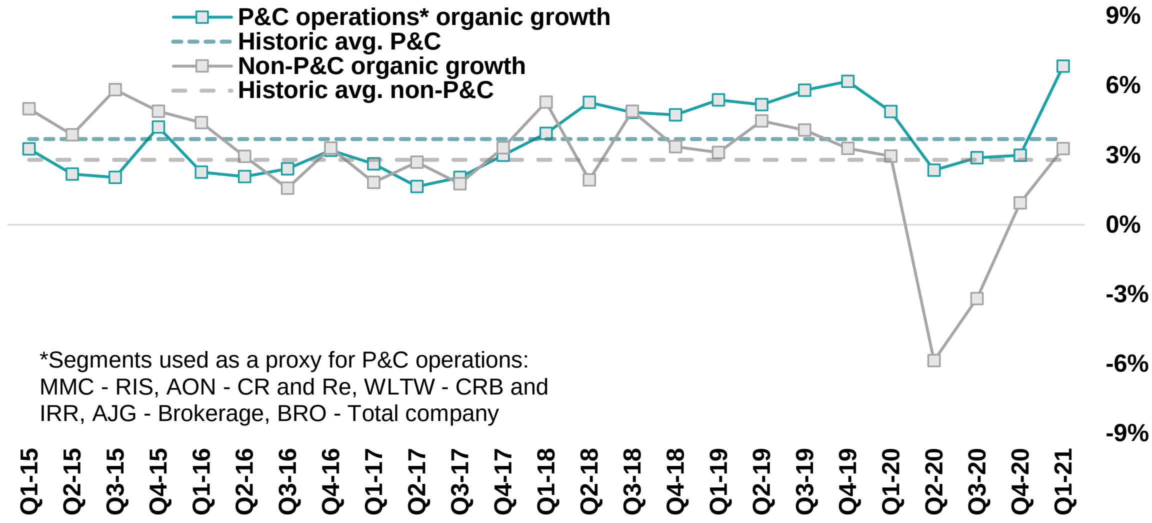
Composite	YTD px chg.	P/B
Large comm.	**19.9%**	**1.1x**
Regional	**28.7%**	**1.6x**
Specialty	**22.6%**	**1.7x**
Personal	**8.5%**	**2.2x**
Bermuda	**5.8%**	**1.1x**
Florida	**6.7%**	**1.0x**
Brokers	**18.8%**	**-**
IPC Select	**16.1%**	**1.3x**
S&P 500 Fin.	**26.9%**	**-**
S&P 500	**11.8%**	**-**

1YR Price Peformance



Source: SNL, Inside P&C

Brokers' P&C and non-P&C organic growth
Source: Company reports, Inside P&C

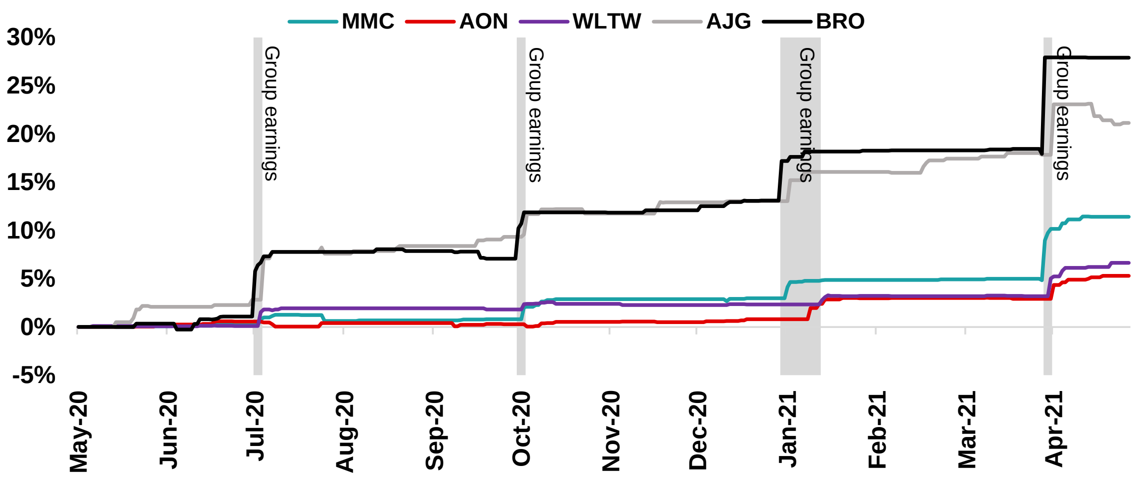


The quarter was rich for record-breaking prints in insurance brokerage operations. Examples include the 17-year high quarterly organic growth of 9% in Aon's commercial risk segment, 18-year high organic growth of 8% at Marsh and 19-year high growth of 10% at Brown & Brown's retail brokerage.

Furthermore, brokers continued to raise their heads above water on the more discretionary revenue sources. Their non-P&C operations – mostly involving consulting, HR and benefits – grew 3.3%, up from 0.9% last quarter.

This resulted in a flurry of positive post-earnings revisions in the industry for a fourth back-to-back quarter following the gloom and doom of March and April of 2020.

Exhibit. FY 2021 EPS estimate changes over TTM
Source: FactSet



All brokers with existing organic growth guidance improved outlooks. The growth is now expected to be at or above mid-single digits.

Recall, in Q4 we highlighted that the Street and company organic growth outlooks were somewhat pressured. Even with the Q1 upgrades, we believe the current 2021 growth expectations of 5% to 6% are still largely conservative and hence entail some upward surprise bias.

Lastly, despite the all-round great news on the Q1 results, the Aon-Willis merger was a more dominant theme, as the parties announced highly anticipated divestitures to AJ Gallagher long-trailed by ***Inside P&C's*** news team.

Like we discussed in our follow-up notes to the announcement, the deal is still attractive to Aon despite the meaningful value migration to AJ Gallagher.

There is a potential for further value migration to other brokers from revenue dis-synergies at both Aon and Gallagher. The signed non-compete agreement between the firms means the staff and clients that leave AJ Gallagher will not have that many options to choose from.

Marsh McLennan will likely be the #1 candidate for these dropouts. The firm reported that it had already hired hundreds of employees from the merging parties by April, and there will be more to come.

Taking a step back, the whole merger saga is reminiscent of natural selection with more efficient players tearing apart the underperforming peer. Size, data, and resources are highly complementary to brokers' value proposition. This is particularly true given the industry dynamics we discussed above. Therefore, we remain constructive about the Aon-Willis combination, as well as AJ Gallagher's prospects following the integration of Willis assets.

In summary, we view the post-pandemic period as highly advantageous for brokers both in the near term and more fundamentally into the long term.

We should see more correlation between organic growth and broker valuations in 2021 as the market's attention continues to divert to revenue expansion, and away from expense management where they face tough comparison's to the pandemic year. It is all about growth again for brokers.

Further down the road, in an environment where elevated risk-taking is needed and encouraged, brokers may find a unique opportunity to evolve into more valuable risk management partners.

In the quickly changing risk landscape, the creation of new strategies and innovative solutions will be key for the industry players to maintain their relevancy and drive long term revenue potential.

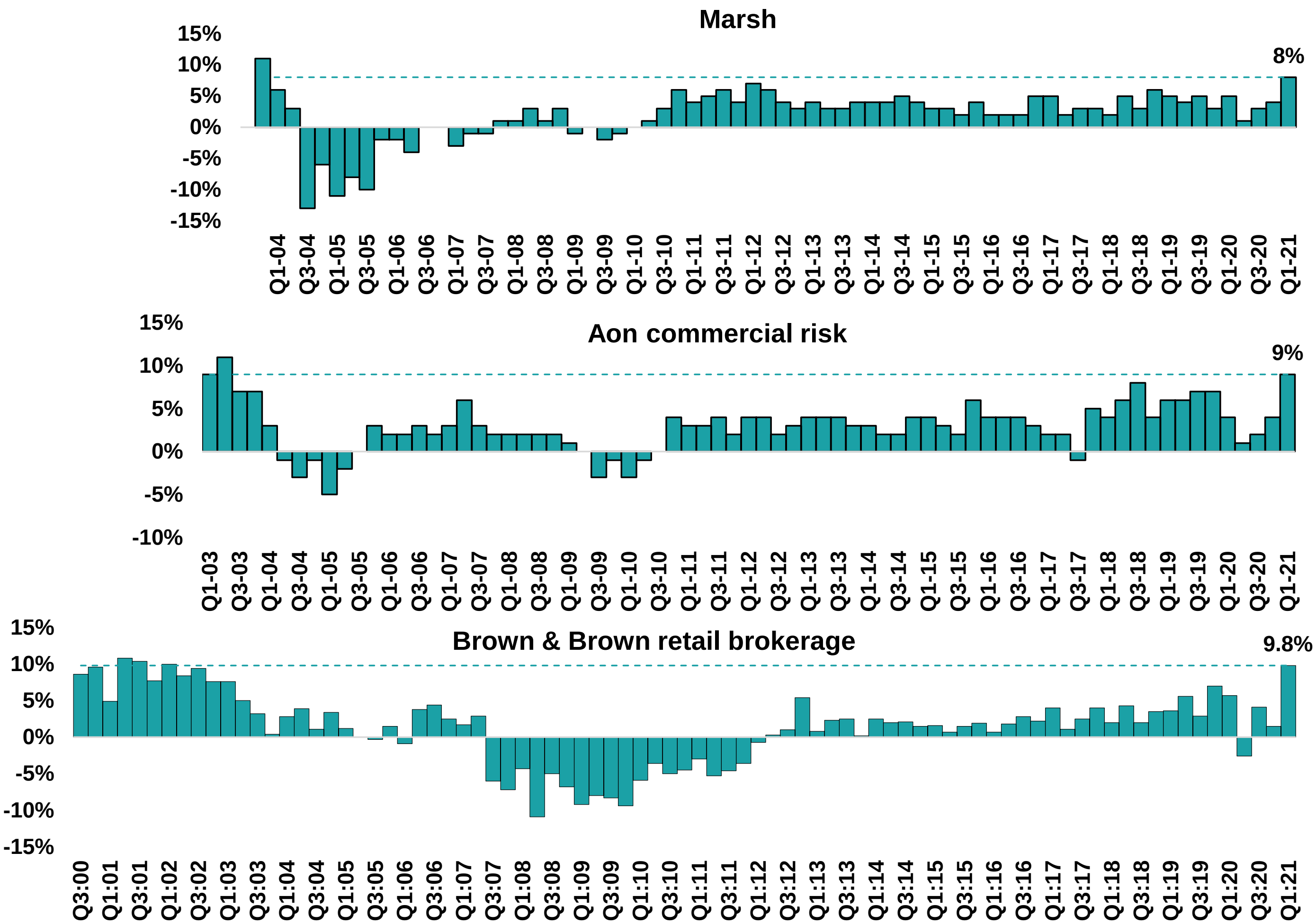
Read more on brokers earnings review below.

Insurance brokerage is firing on all cylinders

In the fourth quarter, broker top lines continued to benefit from stable P&C brokerage results. P&C rates remained high, albeit the increases moderated sequentially. Exposure units also increased leading insurance brokerage expansion numbers to nearly two-decade highs at several brokers.

Exhibit. Selected broker segment organic growth

Source: Company reports



The composite peer group organic growth was 5.6%, higher than the pre-pandemic eight-quarter average of 4.6%. P&C revenues led the way with 6.8% organic growth. Consulting revenues saw a significant tick up too at 3.3% (-5.9% in Q2, -3.2% in Q3 and 0.9% in Q4) as businesses seem to have grown more willing to resume discretionary spending.

In P&C brokerage, the outlook is still sanguine, with rates expected to climb throughout 2021, despite some moderation. However, clients' purchasing behavior will remain the wild card in short term.

Despite projections that economic activity will continue to recover, some brokers shared their expectations for pressured insurance purchasing due to elevated rates and tightening underwriting terms and conditions.

Over the longer term, we believe corporates will grow more willing to transfer risk as the events of 2020 and early 2021 reinforced the global risk awareness, revealed under-covered areas, and bolstered risk-taking.

Consulting, HR and benefits revenues should see continued pickup and potentially exceed mid-single-digit growth as the industry begins to compare the results versus the 2020 contractions.

The bounce back in consulting revenues is particularly encouraging for the "Big Three" with high exposure to more discretionary revenues

Exhibit. Composite broker organic growth by revenue source: P&C vs non-P&C

Source: Company reports

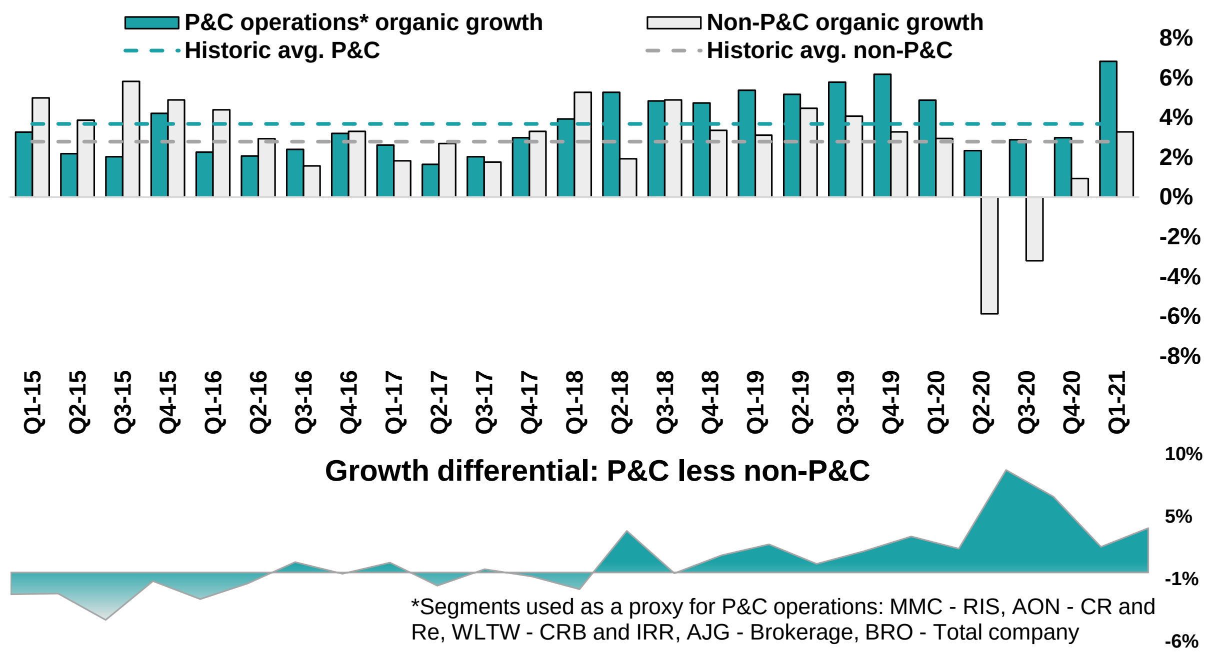
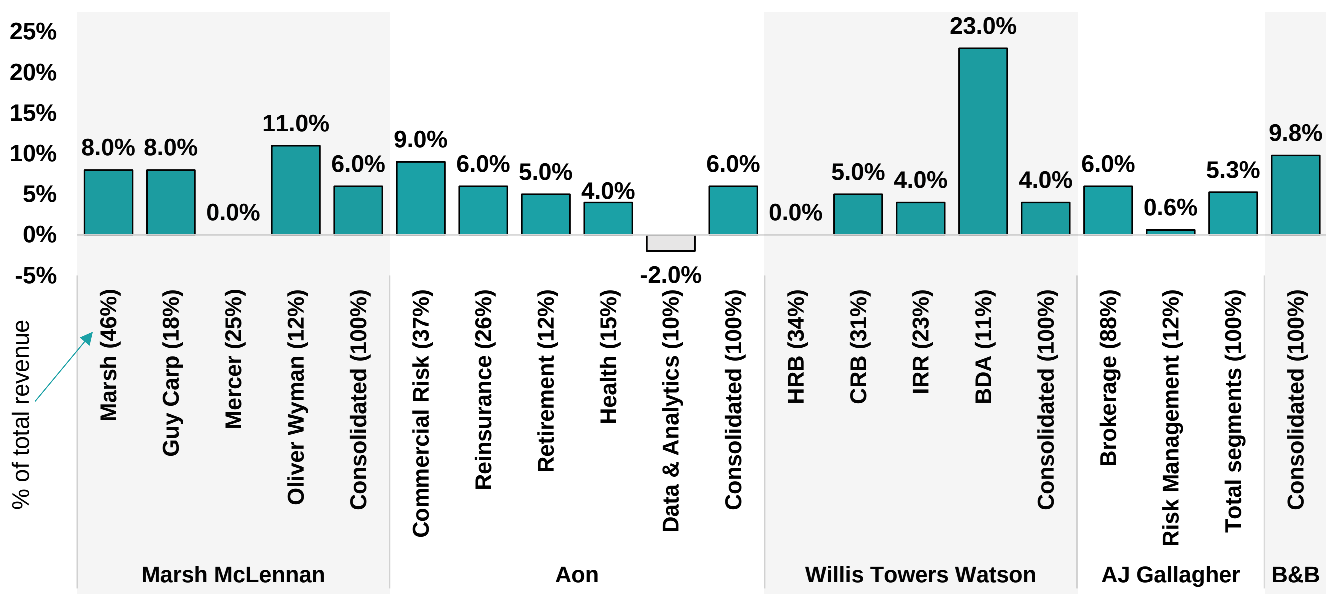


Exhibit. Q1:21 organic by broker segments

Source: Company reports



Optimistic on future results, capital return and M&A activity

On forward guidance, executives grew more optimistic on 2021 growth and margins. Most brokers maintained the Q4 wording for the full year 2021 growth guidance except that they added "higher" or "above" next to it.

Similarly, on margin guidance broking executives grew incrementally more confident in their ability to expand margins on the back of the strong organic growth expectations.

Marsh McLennan, Aon, and AJ Gallagher upgraded their growth expectations to mid-single digits or higher. Executives also started dropping the reservation for uncertainty around the economic recovery trajectory from their scripts.

Exhibit. Company outlooks on 2021 growth and margin

	2021 growth outlook as of Q4	2021 growth outlook as of Q1:21	2021 margin outlook as of Q4	2021 margin outlook as of Q1:21
Marsh McLennan	3%-5% growth	3%-5% growth or above	Expansion	Expansion
Aon	Mid-single digit	Mid-single digit or higher	Expansion	Expansion
Willis Towers Watson	None	None	None	None
AJ Gallagher	3-4% in Q1, 4-5% in H2	Back to or slighter higher than 2019 (=~6%)	Maybe flat	Flat or up
Brown & Brown	None	None	Flat or up slightly	Flat or up slightly, but think up

Willis maintained radio silence on guidance, alluding to the elevated economic uncertainty. Brown & Brown traditionally provides no guidance on growth, though it referred to its low to mid-single target organic growth as a reference point for the firm's growth in a steady-state economy.

Margins will be mixed for brokers in 2021. The challenging comparison against the 2020 quarters that included substantial savings, and the need to innovate and invest at the time of ever more complicated corporate risk profiles and a changing risk landscape, will pressure margins. On the other hand, strong organic growth should support margins through expense leverage.

On capital return, management rhetoric suggested that the capital return propensity in the industry increased. However, in the first quarter all brokers except for Brown & Brown remained restrained on the buybacks.

Brown & Brown repurchased 0.9% of its average common shares outstanding, Marsh McLennan repurchased 0.2%, while the rest of the group repurchased negligible amounts.

Exhibit. Total shares repurchased as a % of average common shares outstanding (quarterly data)

Source: SNL

Firms/Index	Q1:16	Q2:16	Q3:16	Q4:16	Q1:17	Q2:17	Q3:17	Q4:17	Q1:18	Q2:18	Q3:18	Q4:18	Q1:19	Q2:19	Q3:19	Q4:19	Q1:20	Q2:20	Q3:20	Q4:20	Q1:21
MMC	0.7%	0.7%	0.6%	0.4%	0.5%	0.5%	0.5%	0.7%	0.6%	0.6%	0.4%	0.0%	0.0%	0.2%	0.4%	0.4%	0.0%	0.0%	0.0%	0.0%	0.2%
AON	2.9%	0.0%	1.0%	0.7%	0.4%	3.1%	2.1%	1.4%	1.6%	1.2%	0.9%	0.5%	0.3%	2.4%	0.8%	1.0%	0.9%	0.0%	1.1%	1.7%	0.1%
WLTW	0.0%	0.2%	1.1%	1.0%	0.9%	0.7%	0.8%	0.3%	0.0%	1.3%	0.7%	1.0%	0.0%	0.2%	0.4%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
AJG	0.6%	1.0%	0.0%	0.0%	0.2%	0.0%	0.0%	0.2%	0.1%	0.0%	0.0%	0.0%	0.1%	0.1%	0.0%	0.0%	0.1%	0.0%	0.0%	0.0%	0.1%
BRO	0.3%	0.1%	0.0%	0.2%	0.1%	0.2%	0.8%	0.9%	0.2%	0.0%	0.1%	1.0%	0.1%	0.2%	0.1%	0.3%	0.1%	0.0%	0.3%	0.4%	0.9%
S&P 500 L&H avg	1.3%	1.1%	0.9%	0.9%	1.2%	0.9%	0.8%	0.8%	1.2%	1.3%	0.8%	1.6%	1.3%	1.1%	1.4%	1.1%	1.3%	0.1%	0.5%	0.9%	1.2%
S&P 500 P&C avg	1.5%	1.3%	1.4%	1.2%	1.1%	1.0%	0.5%	0.5%	0.3%	0.5%	0.4%	0.8%	0.3%	0.3%	0.4%	0.5%	1.3%	0.3%	0.3%	0.4%	0.7%
S&P 500 Banks avg	0.7%	0.6%	1.0%	0.8%	0.8%	0.7%	1.5%	1.2%	1.0%	0.9%	2.0%	2.0%	1.7%	1.6%	2.1%	1.7%	1.3%	0.0%	0.0%	0.0%	0.5%

For perspective, brokers' peers within the broader financial sector were more active at returning capital to investors. S&P 500 life & health firms returned capital equivalent to 1.2% of shares, S&P 500 P&C carriers returned 0.7% and banks returned 0.5% in the quarter.

On M&A, all brokers were bullish on industry M&A activity, although they noticed a slowdown in Q1.

Marsh McLennan is still budgeting $2bn of capital for M&A and buybacks with a bias towards acquisitions. AJ Gallagher management telegraphed that the firm will not pause its tuck-in acquisition strategy despite the pending acquisition of Willis assets. Brown & Brown reported a "good" M&A pipeline.

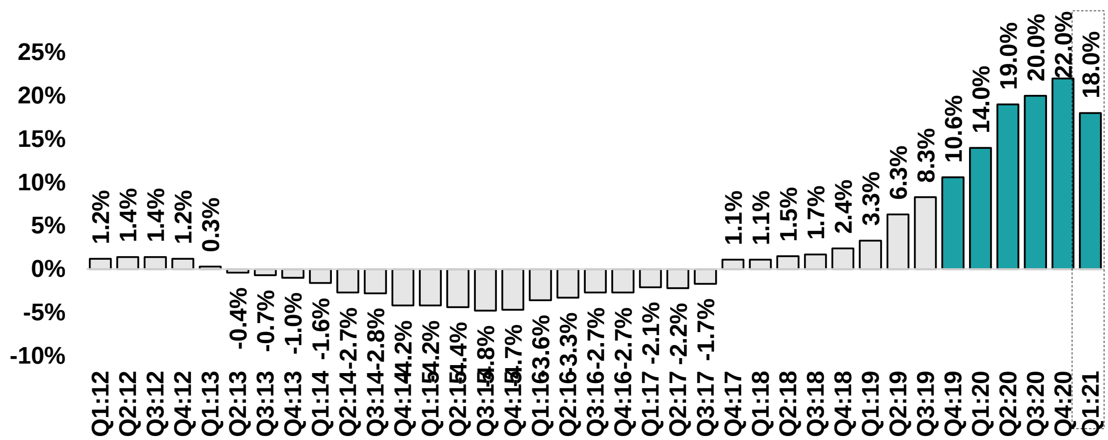
Rate rises are moderating but prices are still advancing

With the market registering rate-on-rate-on-rate, the Q1 broker pricing disclosures confirmed the signs that began in Q4 that rate rises are tapering down in some areas.

Marsh's proprietary pricing index indicated that rate increases tapered to 18% from 22% in Q4.

Exhibit: Marsh pricing index

Source: Company reports



Similarly, AJ Gallagher's pricing disclosures with more exposure on middle market accounts displayed deceleration in selected lines and geographies.

Exhibit: AJ Gallagher pricing disclosure

Source: Company reports

	Q1-20	Q2-20	Q3-20	Q4-20	Q1-21
By geography					
Globally	NA	5% or greater	7%	8%	NA
US	NA	7%	8%	8%	7%
Canada	NA	8%	9%	12%	Double-digits
UK inc. London specialty	NA	6%	6%	5%	5%
Australia and New Zealand	NA	2%-3%	3%	low single-digit	low single-digit
By lines of business					
Property	10%	10%	12%	12%	16%*
Professional liability	NA	7%	10%	12%	10%*
Other casualty	5%	5%-10%	5%-10%	5%-10%	9%*
Workers' comp	0%	0%-2%	Flat	Modestly positive	1%*

**April investor day disclosure*

Lastly, Brown & Brown's bucket-style pricing disclosure implied stable rate increases across most lines.

Exhibit: Brown & Brown pricing disclosure

Source: Company reports

Brown & Brown rate disclosures					
	Q1:20	Q2:20	Q3:20	Q4:20	Q1:21
Most retail lines	+1% to +5%	+2% to +7%	+3% to +7%	+3% to +7%	+3% to +7%
Coastal property	+5% to +15%	+15% to +25%	+15% to +25%	+15% to +20%	+15% to +20%
Other property	+5% to +10%	+10% to +15%	+10% to +20%	+10% to +20%	NA
Professional lines	+5% to +10%	+10% to +20%	+10% to +25%	+10% to +25%	+10% to +25%

In summary**,** we view the post-pandemic period as highly advantageous for brokers both in the near term and more fundamentally into the long term.

We should see more correlation between organic growth and broker valuations in 2021 as the market's attention continues to divert from the expense management to revenue expansion. It is becoming all about growth again for brokers.

Further down the road, in an environment where elevated risk-taking is needed and encouraged, brokers may see a unique opportunity to evolve into more valuable risk management partners for their clients.

In the quickly changing risk landscape, creation of new response strategies and innovative solutions will be key for the industry players to maintain their relevancy and drive long-term revenue potential.

This research report was written by Insider Publishing's Research team which includes Amit Kumar, Dan Lukpanov and Ella Soltz.

The content of this report includes opinions based on publicly disclosed financials and management commentary.