

Equity Research

**FINANCIAL**  
Insurance

May 02, 2008  
**Research Note**

Ticker: AOC  
Market: NYSE  
Price: \$47.20  
52-week: (\$38-\$51)

Stock Rating:  
**Market Perform**

Company Profile:  
**Aggressive Growth**

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# Aon Corporation

## First-Quarter Highlights—Executing Well; Good Margin Upside, Weak Dollar Big Benefit

### FINANCIAL SUMMARY

Fiscal Year Ends:	December	Dividend/Yield:	\$0.60/1.3%
Long-term EPS Growth Rate:	12%	Market Value (mil.):	\$14,238

### ESTIMATES\*

FYE	Q1	Q2	Q3	Q4	Annual	P/E
2007A	\$0.57	\$0.57	\$0.52	\$0.69	\$2.35	20.1x
2008E	\$0.71 A	\$0.70	\$0.66	\$0.94	\$3.00	15.7x
2009E	NA	NA	NA	NA	\$3.70	12.8x
Cal2008					\$3.00	15.7x
Cal2009					\$3.70	12.8x

\* Estimates reflect the adoption of FAS 123R.

### Highlights

> Aon reported solid first-quarter results, with adjusted EPS from continuing operations increasing 25%, to \$0.71, \$0.11 above our estimate and \$0.09 ahead of consensus, given higher operating margins within insurance brokerage and consulting relative to our expectations. However, a lower tax rate added \$0.02 per share and foreign currency translation added \$0.08 per share and contributed to higher reported operating margins. In addition, management's characterization of adjusted earnings is too subjective, in our opinion. EPS from continuing operations excluding restructuring charges were \$0.69, EPS from continuing operations including restructuring charges were \$0.56 per share, and GAAP EPS were \$0.68 including discontinued operations (underwriting businesses were sold on April 1) and restructuring charges.

> Organic revenue growth within insurance brokerage was 2%, compared with 2% last quarter, and should be consistent or slightly better relative to peers. Growth is being hampered by continued competitive pressure on commercial property-casualty insurance pricing (about two-thirds of revenue is commissions), which is affecting all of Aon's insurance brokerage peers and we expect to continue for the next several quarters. Aon has invested a lot of the last few years to drive higher organic growth and management maintains that organic growth has not seen the benefits from these investments, but it does not provide much detail to assess how these investments may affect growth in the aggregate and we do not see the benefits in reported results yet.

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> The adjusted insurance brokerage operating margin was 19.5% compared with 18.5% in first quarter 2008 and was ahead of our estimate. The improvement was driven by cost savings from restructuring (1.3 percentage points), lower pension expense, and the positive impact from foreign currency translations (at least 1.0 percentage point). These factors allowed the company to continue to invest in the future growth of its business. The adjusted insurance brokerage operating margin in 2007 was 18.2% compared with 17.2% in 2006. Management's goal is to drive the operating margin well above 20% over time. In 2007, we estimate that the cost savings from restructuring and lower pension aided the margin by more than 500 basis points.

> The adjusted consulting operating margin was an eye-popping 19.2% compared with 14.9% in first quarter 2008 and was well ahead of our estimate. The improvement was driven by a number of factors, including cost savings from restructuring, lower pension expense, and the positive impact from foreign currency translations. In addition, management stated there were some other nonquantified benefits that would not likely continue, and it believes the consulting business remains a midteens margin business over the long term. Organic revenue growth excluding the small and shrinking outsourcing business was 4%. We believe this business has greater economic sensitivity than the insurance brokerage business, given it is more dependent on headcount growth and certain specialty practices include higher discretionary spending, in our opinion. Results within consulting have been volatile the past several quarters, but we are encouraged by the underlying trend and we do not see a need for Aon to remain in the HR outsourcing business. We also believe that consulting is the segment that can benefit the most from a more substantial acquisition.

> The company remains on track to recognize the \$45 million of cost savings from the 2005 restructuring program in 2008 (\$22 million this quarter), \$50 million to \$70 million of cost savings from the 2007 restructuring plan in 2008, \$125 million to \$130 million in 2009, and \$50 million to \$55 million in 2010. Savings from these programs is the only way Aon will be able to expand margins in the near term within the current industry environment, in our opinion.

> Aon repurchased \$860 million, or 19.8 million shares, of common stock year-to-date, including 10.0 million shares in the first quarter. On December 17, 2007, Aon announced agreements to sell Combined Insurance Co. (CICA) for \$2.4 billion to ACE Limited (ACE \$61.28) and Sterling Life Insurance for \$352 million to Munich Re Group. Aon received about \$2.7 billion in after-tax proceeds and dividends, with the primary use of funds directed at share repurchase. The Sterling and Combined Insurance deals closed ahead of schedule on April 1 and our estimates include the vast majority of net proceeds directed at share repurchase this year. Aon repurchased about 19.1 million shares in 2007 after repurchasing more than 28.0 million shares in 2006.

> We are increasing our 2008 EPS estimate to \$3.00 from \$2.75 given the outperformance this quarter, a lower ongoing tax rate, and further margin expansion. We are moving our 2009 EPS estimate to \$3.70 from \$3.65 due to a lower tax rate. The growth rate in continuing operating EPS in 2008 is overstated because the positive contribution from the underwriting business is eliminated from continuing operations in 2007, but the benefits from the use of the net proceeds significantly enhance earnings growth in 2008 (more than 100%)—less of a positive impact in 2009.

> Aon continues to accomplish a lot: the sale of the underwriting businesses establishes Aon as a pure professional services firm, the company continues to manage capital very aggressively, it is working to manage expenses aggressively, and management continues to make substantial investments for future growth. Our rating remains Market Perform, as we see valuation as relatively full at current levels at roughly a market multiple within the context of more challenging industry fundamentals. Our primary concerns have been the adverse impact on organic growth from the cyclical pressure on commercial property-casualty insurance pricing coupled with valuation. Our view on valuation could be wrong if Aon can drive higher organic revenue growth, which would result in greater-than-expected margin expansion, or recognize additional expense savings from the most recently announced restructuring plan.

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Additional information is available upon request.



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Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	59	Outperform (Buy)	12
Market Perform (Hold)	40	Market Perform (Hold)	6
Underperform (Sell)	1	Underperform (Sell)	1

\*Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

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