

Aon Corporation

First Quarter—Softer All Around, but Not Disaster; Lowering Estimates, Rating Remains Market Perform

Highlights

- Adjusted EPS from continuing operations increased 9%, to \$0.76, \$0.08 below our estimate and \$0.12 below consensus (based on management's definition). The shortfall relative to our estimate was driven principally by lower organic revenue growth and a lower operating margin within insurance brokerage. The impact from foreign currency translations decreased EPS by \$0.04, although this was largely included in our estimate.
- Organic revenue growth within insurance brokerage (about 85% of earnings) was 1%, compared with 2% in each of the past several quarters and our 3% estimate. Growth is being hampered by continued competitive pressure on commercial property-casualty insurance pricing (about two-thirds of revenue is commissions) and the weaker economy. We expect modest organic growth in 2009, although now at slightly lower levels, despite the economic headwinds, given Aon's ability to take share and more stable insurance pricing. In general we expect the weaker economy to continue to offset any impact from the benefits from stabilization in pricing.
- The adjusted insurance brokerage operating margin was 20.7% compared with 19.7% in first quarter 2008 and our 21.0% estimate. The improvement compared with the prior year was driven by cost savings from the 2007 restructuring program, the Benfield Group acquisition (closed fourth quarter 2008), and continued good expense management away from that. We expect margins to move higher in 2009 versus 2008 for the balance of the year as well, despite significant headwinds, although slightly lower than previously forecast.
- The company maintained its estimated cumulative expense savings from its 2007 restructuring plan of \$370 million, realized by year-end 2010. The Benfield acquisition is estimated to deliver cumulative expense savings of \$122 million by year-end 2011.
- The company did not repurchase any shares during the quarter, and refrained from providing a timetable for completion of its share-repurchase program given continued increased conservatism due to the extreme volatility of financial markets and uncertainty surrounding the health of the economy. That said, management stated that it was still committed to the program and maintains \$850 million of outstanding share-repurchase authorization.

Financial | Commercial P/C Insurance

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Stock Rating: **Market Perform**
Company Profile: **Core Growth**

Symbol: AOC (NYSE)
Price: \$36.00 (52-Wk.: \$33-\$50)
Market Value (mil.): \$11,333
Fiscal Year End: December
Long-Term EPS Growth Rate: 12%
Dividend/Yield: \$0.63/1.8%

	2008A	2009E	2010E
Estimates			
EPS Q1	\$0.71	A\$0.76	NA
Q2	\$0.71	\$0.75	NA
Q3	\$0.69	\$0.65	NA
Q4	\$0.81	\$0.85	NA
FY	\$2.90	\$3.00	\$3.40
CY		\$3.00	\$3.40
Valuation			
FY P/E	12.4x	12.0x	10.6x
CY P/E		12.0x	10.6x

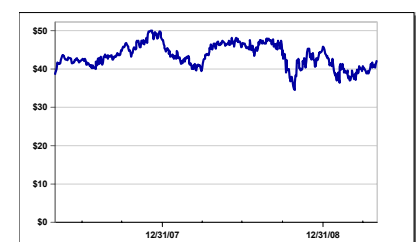
Trading Data (Thomson Financial)

Shares Outstanding (mil.)	274
Float (mil.)	256
Average Daily Volume	4,363,699

Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	25.0
Book Value Per Share (MRQ)	21.2
Enterprise Value (mil.)	13,060.4
EBITDA (TTM)	1,254.0
Enterprise Value/EBITDA (TTM)	10.4x
Return on Equity (TTM)	28.1

Two-Year Price Performance Chart



Source: Thomson Financial, William Blair & Company estimates

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- We are lowering our 2009 EPS estimate to \$3.00 from \$3.20 and are lowering our 2010 EPS estimate to \$3.40 from \$3.55, reflecting more of the softness seen this quarter.
- We are maintaining our Market Perform rating. We have been cautious on Aon, as it was a beneficiary of a flight to quality in 2008 and multiples were pushed up because of the anticipation from pricing improvements within commercial property-casualty insurance from the pressure in financial markets. We tend to hold a more negative view than consensus on both the prospects for price improvements and the likely adverse impact on growth from the weak economy—both putting pressure on organic growth and margins this year.

Discussion

Softer Results; Not Disastrous Given Challenging Environment

Aon reported softer, but not disastrous first-quarter results given the challenging environment, with management's definition of adjusted EPS from continuing operations increasing 9%, to \$0.76, \$0.08 below our estimate and \$0.12 below consensus. The shortfall relative to our estimate was driven principally by lower organic revenue growth and a lower operating margin within insurance brokerage. The impact from foreign currency translations decreased EPS by \$0.04, although this was largely included in our estimate. The quality of results this quarter is what we expected to see last quarter. EPS from continuing operations including restructuring charges were \$0.80, compared with \$0.55 in the year-ago period. GAAP EPS were \$0.97, compared with \$0.68 in first quarter 2008, including \$0.17 per share from discontinued operations (a gain on the sale of a business).

Organic Growth Feeling Impact From Economy—Although Still Remains Positive

Organic revenue growth within insurance brokerage (about 85% of earnings) was 1%—the 15th consecutive quarter of positive organic growth—compared with 2% in each of the past several quarters and our 3% estimate, outperforming peers Brown & Brown (BRO \$19.46) with 2.2% negative organic growth and Arthur J. Gallagher & Company (AJG \$22.48) with 1.4% negative organic number, but underperforming competitor Willis Group Holdings' (WSH \$27.51) 2.0% organic growth reported early in the week. Marsh & McLennan (MMC \$21.09) is scheduled to report its first-quarter results before the open on Wednesday, May 6, 2009. Growth is being hampered by continued competitive pressure on commercial property-casualty insurance pricing (about two-thirds of revenue is commissions) and the weaker economy that is limiting exposure growth in a material way and increasing clients' resistance to price increases. Pricing for the quarter on average was flat to down in the low single digits, according to management—retail was flat to down low single digits, and reinsurance was flat to up low single digits. This represents a very modest improvement from fourth quarter 2008 when prices overall were down low single digits, but management stated that the adverse impact from conservative client behavior limiting exposure growth more than offset any minimal benefit from pricing—a significant reason reinsurance organic growth was not stronger in the quarter.

Management's view on the prospects for commercial property-casualty insurance pricing appears to remain less optimistic than the "party line" from the underwriters, although we believe that the consensus view may be beginning to come off its own optimism a bit. It is clear that in addition to a persistent soft market, management is shifting its concern to the adverse impact on client behavior from the recession. Exposure growth concerns appear to trump pricing woes at this stage in the cycle, in our view. That said, we expect modest organic growth in 2009 despite the economic headwinds given Aon's ability to take share with some pace of stabilization in pricing continuing, albeit at a much more gradual rate. Our basic view since mid-September 2009 has been that underlying underwriting margins were still too high for the commercial property-casualty insurance industry to push for price increases aggressively despite capital pressures, which we believe has been generally accurate. Therefore, we believe the primary catalyst toward a further push in pricing is further deterioration in underlying margins and profitability after more than four consecutive years of price declines.

Regionally, the Americas experienced 2% organic growth, compared with 1% in the year-ago period, driven by strong production in Latin America and Canada. The U.K. saw the greatest decline in organic growth of negative 5% compared with negative 1% a year ago, highlighting the U.K. economy's dependence on financial, construction, and energy sectors—all significantly impaired

during the current recession. While China and New Zealand markets performed well, Japan and Thailand more than offset any growth, leading to an overall negative 2% organic growth for the region.

Brokerage Operating Margin—Restructuring Benefits Counteracting Significant Headwinds

The adjusted insurance brokerage operating margin was 20.7% compared with 19.7% in first quarter 2008 and our 21.0% estimate. The first quarter is a seasonally weaker quarter for profitability for Aon, and this marks the first time in several years that the company has been able to exceed a 20% margin in the first quarter. The improvement compared with the prior year was driven by cost savings from the 2007 restructuring program (\$41 million), Benfield Group acquisition savings of \$4 million (closed fourth quarter 2008), and continued good expense management away from that. These benefits were offset by three significant headwinds that, in the aggregate, resulted in 220 basis points of adverse impact in the quarter—investment income (declined 41%, or \$21 million, with an 110-basis-point adverse impact), increased intangible amortization and depreciation expenses associated with the Benfield merger (increased \$9 million with a 60-basis-point adverse impact), and pension expense (increased \$7 million, a 50-basis-point adverse impact). We expect margins to move higher in 2009 despite foreign exchange, investment income, and pension expense headwinds given the ongoing benefit from the company's restructuring plans, which management has done an excellent job of realizing expenses savings from the past few years. In general, management expects to invest about 20% of the savings into growth initiatives.

Regarding Aon's pension plan, the company expects to increase 2009 pension contributions by 65%, to \$400 million. Pension expense for 2009 is estimated to increase by \$40 million to \$50 million, or approximately 55% to 70%, to between \$112 million and \$122 million. Total pension liabilities in the quarter declined by nearly \$250 million due to foreign exchange movements and the company's contribution to the plan.

Regarding the 2007 restructuring program, Aon incurred \$34 million of charges in the quarter and achieved roughly \$41 million of savings—principally in the brokerage segment through a reduction in headcount. The company maintains its expectations for the cumulative expense savings from its 2007 restructuring plan of \$370 million to be achieved by the end of 2010. To date, roughly \$118 million, or 32%, of restructuring savings have been achieved from the 2007 restructuring program. The Aon Benfield restructuring program incurred \$9 million of charges in the quarter and achieved roughly \$4 million of savings, and is still expected to result in ultimate cumulative savings of \$122 million achieved by the end of 2011.

Consulting Under Pressure as Well

Organic growth within consulting was 2%, organic growth in the core business was up 2% after 4% last quarter and 8% in third quarter 2008. Adjusted consulting margin declined to 16.9% from a record high 19.3% in the year-ago period. Roughly \$6 million, or 160 basis points of margin decline, was attributed to the human capital segment, which is the most sensitive to economic weakness. Overall, consulting in general 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. Management characterizes this as a midteens business, and continues to expect margins to decline in 2009, given headwinds that the company faces from a weakening economy.

Reducing Estimates—Maintain Market Perform Rating

We are lowering our 2009 EPS estimate to \$3.00 from \$3.20 and are lowering our 2010 EPS estimate to \$3.40 from \$3.55, reflecting more of the softness seen this quarter. The company did not repurchase any shares during the quarter—\$850 million of share repurchase authorization remains, and management once again refrained from providing a timetable for completion of its share-repurchase program given the extreme volatility of financial markets and uncertainty surrounding the health of the economy.

We are maintaining our Market Perform rating. We have been cautious on Aon as it was a beneficiary of a flight-to-quality in 2008 and multiples were pushed up because of the anticipation from pricing improvements within commercial property-casualty insurance from the pressure in financial markets. We tend to have a more negative view than consensus on both the prospects for price improvements and the likely adverse impact on growth from the weak economy—both putting pressure on organic

growth and margins this year. That said, Aon has no balance sheet risk, no business model risk, and potential for stabilization in pricing, albeit at a gradual pace. The shares trade at about 12 times our 2009 EPS estimate and we have viewed a 10 to 12 multiple range as a more attractive entry point.

Aon Corporation
Condensed Income Statement Comparison
(\$ in millions, except per share data)

	1Q08	2Q08	3Q08	4Q08	2008 Actual	1Q09E	2Q09E	3Q09E	4Q09E	2009 Estimate	2010 Estimate
Revenue:											
Insurance brokerage	\$1,566	\$1,610	\$1,473	\$1,581	\$6,230	\$1,550	\$1,592	\$1,473	\$1,692	\$6,307	\$6,618
% change	10%	8%	4%	-3%	5%	-1%	-1%	0%	7%	1%	5%
% organic growth	2%	2%	2%	2%	2%	1%	1%	2%	2%	1%	4%
Americas	\$493	\$588	\$557	\$642	\$2,280	\$477	\$576	\$546	\$648	\$2,248	\$2,337
% change	3%	1%	2%	-1%	1%	-3%	-2%	-2%	1%	-1%	4%
% organic growth	1%	-1%	1%	3%	0%	2%	1%	2%	2%	2%	4%
International	\$766	\$725	\$616	\$648	\$2,755	\$648	\$616	\$524	\$661	\$2,449	\$2,540
% change	15%	14%	7%	-9%	6%	-15%	-15%	-15%	2%	-11%	4%
% organic growth	2%	2%	2%	2%	2%	1%	1%	2%	2%	1%	4%
Reinsurance brokerage	\$256	\$248	\$252	\$247	\$1,003	\$395	\$372	\$378	\$358	\$1,503	\$1,608
% change	7%	13%	9%	18%	11%	54%	50%	50%	45%	50%	7%
% organic growth	1%	2%	1%	2%	1%	1%	3%	3%	3%	3%	6%
Net investment income	\$51	\$49	\$48	\$44	\$192	\$30	\$28	\$26	\$24	\$108	\$132
% change	13%	-8%	-14%	-14%	-6%	-41%	-43%	-46%	-45%	-44%	22%
Consulting services	\$342	\$335	\$335	\$341	\$1,353	\$308	\$301	\$307	\$336	\$1,253	\$1,295
% change	4%	5%	3%	-8%	1%	-10%	-10%	-8%	-2%	-7%	3%
% organic growth	0%	2%	6%	3%	3%	2%	2%	2%	2%	2%	4%
Total operating segment revenue	\$1,908	\$1,945	\$1,808	\$1,922	\$7,583	\$1,858	\$1,894	\$1,781	\$2,027	\$7,560	\$7,914
% change	9%	8%	4%	-4%	4%	-3%	-3%	-1%	5%	0%	5%
Corporate and other	\$5	\$18	\$41	\$6	\$70	\$1	\$5	\$5	\$5	\$16	\$26
Intersegment revenue	(\$9)	(\$7)	(\$4)	(\$5)	(\$25)	(\$6)	(\$6)	(\$7)	(\$7)	(\$25)	(\$28)
Total revenue	\$1,904	\$1,956	\$1,845	\$1,923	\$7,628	\$1,853	\$1,893	\$1,779	\$2,026	\$7,551	\$7,912
% change	8%	7%	6%	-4%	4%	-3%	-3%	-4%	5%	-1%	5%
Pretax income from continuing operations¹											
Insurance brokerage	\$309	\$292	\$247	\$314	\$1,162	\$321	\$315	\$273	\$350	\$1,259	\$1,368
% change	17%	11%	1%	5%	9%	4%	8%	10%	12%	8%	9%
% total revenue	19.7%	18.1%	16.8%	19.9%	18.7%	20.7%	19.8%	18.5%	20.7%	20.3%	21.1%
Consulting services	\$66	\$47	\$53	\$65	\$231	\$52	\$44	\$45	\$52	\$192	\$207
% change	35%	-2%	36%	2%	16%	-21%	-7%	-16%	-20%	-17%	8%
% total revenue	19.3%	14.0%	15.8%	19.1%	17.1%	16.9%	14.5%	14.5%	15.5%	15.4%	16.0%
Total operating segment revenue	\$375	\$339	\$300	\$379	\$1,393	\$373	\$359	\$317	\$402	\$1,451	\$1,575
% change	20%	9%	6%	4%	10%	-1%	6%	6%	6%	4%	9%
% total revenue	19.7%	17.3%	16.3%	19.7%	18.3%	20.1%	19.0%	17.8%	19.9%	19.2%	19.9%
Corporate and other	(\$48)	(\$52)	(\$22)	(\$54)	(\$176)	(\$59)	(\$55)	(\$55)	(\$55)	(\$224)	(\$208)
Total pretax income	\$327	\$287	\$278	\$325	\$1,217	\$314	\$304	\$262	\$347	\$1,227	\$1,367
% change	24%	6%	16%	5%	12%	-4%	6%	-6%	7%	1%	11%
% total revenue	21.6%	18.4%	19.5%	21.1%	20.2%	20.7%	19.4%	18.1%	20.8%	19.8%	21.1%
Provision for income taxes	\$102	\$71	\$78	\$93	\$343	\$108	\$88	\$76	\$101	\$372	\$395
Effective tax rate	31.2%	24.7%	28.1%	28.6%	28.2%	31.5%	28.9%	28.9%	29.0%	29.6%	28.9%
Adjusted operating earnings	\$225	\$216	\$200	\$232	\$874	\$230	\$216	\$186	\$247	\$879	\$973
% change	22%	18%	19%	4%	15%	-3%	0%	-7%	6%	-1%	12%
Operating earnings per share¹	\$0.70	\$0.71	\$0.69	\$0.81	\$2.90	\$0.76	\$0.75	\$0.65	\$0.85	\$3.00	\$3.40
% change	23%	24%	32%	19%	24%	8%	6%	-6%	6%	3%	13%
Average diluted shares	319.8	305.3	290.3	288.1	300.9	288.8	289.0	289.0	289.0	289.0	286.5
% change	-1%	-5%	-10%	-11%	-7%	-10%	-5%	0%	0%	-4%	-1%

¹Excludes restructuring charges, other nonrecurring gains/losses, and discontinued operations

Source: Company reports and William Blair & Company estimates

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Current Rating Distribution (as of 04/30/09)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	57	Outperform (Buy)	3
Market Perform (Hold)	42	Market Perform (Hold)	1
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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