Insurance Brokers

Downside Scenario Given Potential Economic Weakening

Organic Revenue Growth Correlated to Economy. U.S. organic revenue growth has demonstrated a definite relationship with economic factors going in and coming out of the last recession. Declines in business activity have correlated to lower organic levels. As payrolls and manufacturing dropped during 2009, organic revenue declined by -1.4%.

Limited Downside for the Stocks. Our negative scenario analysis suggests that sector stocks have the potential to decline by roughly another 10%. This assumes material reductions in our forecast 2012 organic revenue growth rates and margins and depressed P/E multiples (similar to 2009).

Bearish Growth Scenario. To simulate a downside scenario for the brokers, we took our 2012 organic revenue growth estimates to 0% versus our current forecast of 4%. We also reduced gross margin assumptions by roughly 5% to 7% (on a percentage basis, not an absolute basis).

Greater Divergence Among Brokers. We expect material economic weakness to widen the divergence among the global brokers (Aon, Willis, and Marsh & McLennan) and the mainly U.S. middle-market brokers (Brown & Brown and Arthur J. Gallagher). A number of factors should disproportionately help the global brokers, including strong international growth, better reinsurance brokerage conditions, and some revenue diversification with the consulting businesses.

Attractive Investments. We continue to believe that Aon and Willis are the top picks in the sector due to margin expansion, cost-saving efforts, and revenue diversification. Aon and Willis are also the most attractive on a valuation basis, trading at 11.6 times and 10.7 times our 2012 EPS estimates. Our bearish scenario suggests that the stocks would have roughly 10% more downside, but a return to historical valuation levels could translate into 30% upside.

2012 Broker Downside Projections

Ticker	Rating	Current Price	Current 2012 EPS	Current 2012 P/E	Downside EPS Target	Downside Price Projection With Depressed Multiple	% Downside
AON	O	$46.02	$3.97	11.6x	$3.61	$41.85	-9%
AJG	M	$27.27	$1.68	16.2x	$1.54	$25.00	-8%
BRO	M	$20.88	$1.18	17.7x	$1.05	$18.58	-11%
MMC	M	$28.62	$2.24	12.8x	$1.97	$25.17	-12%
WSH	O	$37.87	$3.55	10.7x	$3.11	$33.18	-12%

Sources: Company reports, Thomson One, and William Blair & Company L.L.C.

Financial Services | Insurance Brokers

August 05, 2011

Aon Corporation
Stock Rating: **Outperform**
Company Profile: **Established Growth**
Symbol: AON (NYSE)
Price: $45.00 (52-Wk.: $36-$55)

Willis Group Holdings Public Limited Company
Stock Rating: **Outperform**
Company Profile: **Established Growth**
Symbol: WSH (NYSE)
Price: $37.87 (52-Wk.: $29-$42)

Marsh & McLennan Companies, Inc.
Stock Rating: **Market Perform**
Company Profile: **Established Growth**
Symbol: MMC (NYSE)
Price: $28.62 (52-Wk.: $23-$32)

Brown & Brown, Inc.
Stock Rating: **Market Perform**
Company Profile: **Established Growth**
Symbol: BRO (NYSE)
Price: $20.88 (52-Wk.: $19-$27)

Arthur J. Gallagher & Co.
Stock Rating: **Market Perform**
Company Profile: **Established Growth**
Symbol: AJG (NYSE)
Price: $27.27 (52-Wk.: $24-$32)

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Summary

We examined the potential downside for the public brokers given concerns over the economic recovery and the potential for a double-dip recession. Our bear-case scenario analysis suggests that sector stocks have the potential to decline by roughly another 10%. This assumes material reductions in our forecast 2012 organic revenue growth rates and margins and depressed P/E multiples (similar to 2009). The analysis clearly shows that the brokers have economic risk; however, given already-depressed trading levels, we believe the brokers as a whole represent a fairly conservative investment. Aon and Willis continue to represent attractive investments, especially given that the majority of their near-term earnings growth is tied to expanding margin leverage.

2012 Broker Downside Projections

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AON	O	$46.02	$3.97	11.6x	$3.61	$41.85	-9%
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BRO	M	$20.88	$1.18	17.7x	$1.05	$18.58	-11%
MMC	M	$28.62	$2.24	12.8x	$1.97	$25.17	-12%
WSH	O	$37.87	$3.55	10.7x	$3.11	$33.18	-12%

Sources: Company reports, Thomson One, and William Blair & Company L.L.C.

Earnings Downside Projections

Potential recessionary conditions should affect earnings estimates on two key fronts: lower organic revenue growth levels and declining margins. To simulate a downside scenario for the brokers, we took our 2012 organic revenue growth estimates to 0% versus our current forecast of 4%. We also reduced gross margin assumptions by roughly 5% to 7% (on a percentage basis, not an absolute basis). Even with a modest decline in our organic revenue growth estimates, gross margins should not be overly harmed given that a good portion of expenses is tied to revenue performance and are thus somewhat scalable based on economic conditions. Overall, we expect roughly 10% downside from our current 2012 estimates should economic headwinds strengthen over the next several quarters. In lieu of organic revenue growth, acquisition activity levels will be a key metric to monitor to determine whether the brokers can find an alternative path to top-line growth.

Additionally, we expect any economic weakness to continue propagating the divergence among the global brokers (Aon, Willis, and Marsh & McLennan) and the mainly U.S. middle-market brokers (Brown & Brown and Arthur J. Gallagher). A number of factors should disproportionately help the global brokers, including strong international growth, better reinsurance brokerage conditions, and some revenue diversification with the consulting businesses. At the bottom of the last recession (2009), the global brokers averaged 1% organic revenue growth compared with -4% for the middle-market brokers (Brown & Brown's growth was the lowest).

2012 Broker Bearish Growth Scenario

Ticker	Current 2012 EPS Estimate	Effect of Lower Organic	Effect of Lower Margins	Combined Effect	Downside EPS Target	% Downside
AON	$3.97	$0.14	$0.22	$0.36	$3.61	-9%
AJG	$1.68	$0.05	$0.09	$0.14	$1.54	-8%
BRO	$1.18	$0.07	$0.06	$0.13	$1.05	-11%
MMC	$2.24	$0.14	$0.13	$0.27	$1.97	-12%
WSH	$3.55	$0.26	$0.18	$0.45	$3.11	-12%

Sources: Company reports, Thomson One, and William Blair & Company L.L.C.

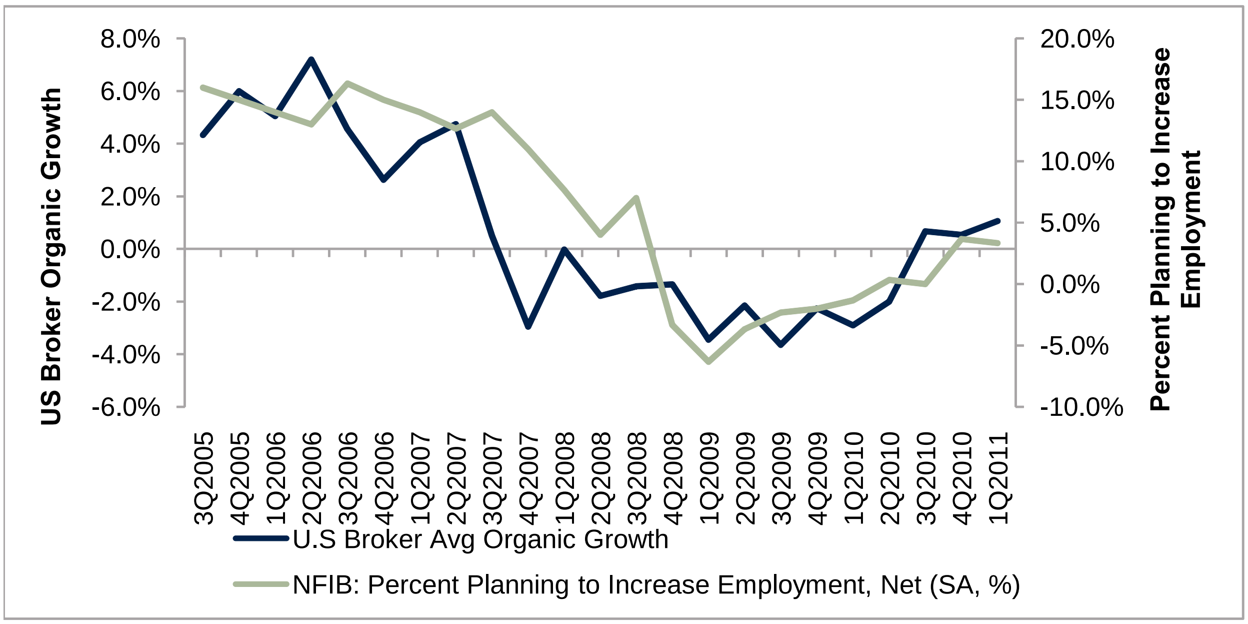
Organic Revenue Growth Correlated to the Economy

The key is the relationship with economic factors. Exposure units reflect the amount of insurance purchased by existing customers. The measure excludes the impact of premium rates and is based on insurable coverages—this typically includes payroll levels (workers' compensation coverage), physical property, plant and vehicles (commercial multiple peril, fire, and commercial auto coverages), and business/sales volumes (general liability and other liability coverages).

U.S. organic revenue growth is showing a definite relationship with economic factors going in and coming out of the last recession. Declines in business activity have correlated with lower organic levels. As payrolls and manufacturing dropped in 2009, organic revenue declined by -1.4%. The relationship is also working on the way up. Payrolls stabilized in the back half of 2009, and manufacturing had an average increase of 7.3% in 2010 compared with 2009. On a corresponding basis, U.S. organic revenue growth went from -3% in the back half of 2009 to +1% in the second half of 2010.

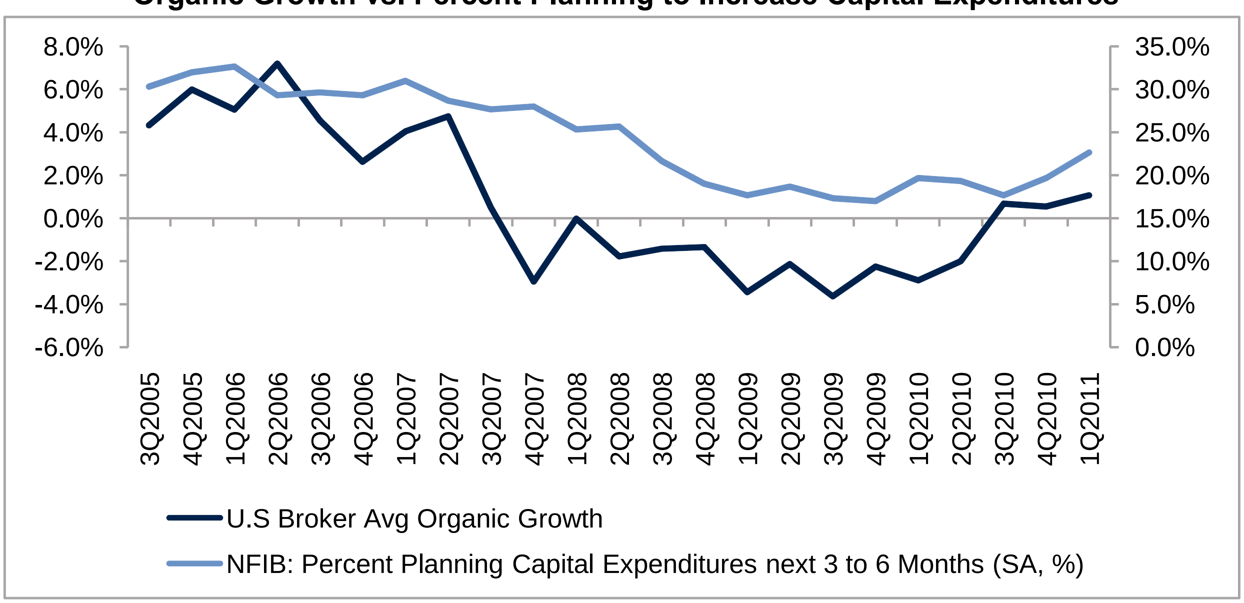
The relationship between the economy and organic revenue growth is why we are cognizant that any economic weakening in the second half of 2011 and into 2012 will have a modestly negative impact on the brokers. Assuming the correlation holds, should GDP growth flatten in 2012, it is likely that broker organic revenue growth will be closer to zero versus our current estimate of 4% organic revenue growth for 2012.

Insurance Brokers
Organic Growth vs. Percent Planning to Increase Employment



Sources: National Federation of Independent Businesses and William Blair & Company L.L.C.

Insurance Brokers
Organic Growth vs. Percent Planning to Increase Capital Expenditures



Sources: National Federation of Independent Businesses and William Blair & Company L.L.C.

Insurance Brokers
Average Quarterly Broker Organic Revenue Correlations
3Q'05 - 1Q'11

	NFIB: Percent Planning to Increase Employment, Net (SA, %)	NFIB: Percent Planning Capital Expenditures next 3 to 6 Months (SA, %)
Correlation	80.3%	80.0%

Source: Company reports, National Federation of Independent Businesses, and William Blair & Company L.L.C.

Valuation Levels

Current P/E valuation levels for the brokers appear in line with historic ranges, and we do not currently expect severe multiple deterioration, even with worsening economic conditions. Our downside price targets will come into play should GDP or employment conditions worsen dramatically over the next 12-18 months. However, as mentioned above, we believe the brokers represent something of a safe haven in turbulent market conditions given their conservative business models and the inherent underlying demand for insurance from their clients.

We continue to believe that Aon and Willis are the top picks in the sector due to strong growth, margin expansion, cost-saving efforts, and revenue diversification. Aon and Willis are also the most attractive on a valuation basis, trading at 11.6 times and 10.7 times our 2012 EPS estimates. We view the recent weakness in the stocks as a potential buying opportunity and remain confident in the company's ability to navigate the potentially worsening economic environment. Our bearish scenario suggests that the stocks would have roughly 10% more downside, but a return to historical valuation levels (15 times for Aon and 14 times for Willis) could translate into 30% upside.

Insurance Brokers
Valuation Comparison

			GAAP EPS			GAAP P/E			Cash P/E			EV / EBITDA		
Ticker	Rating	Price	2010	2011E	2012E	2010	2011E	2012E	2010	2011E	2012E	2010	2011E	2012E
AON	O	46.02	$3.07	$3.38	$3.97	15.0x	13.6x	11.6x	13.9x	12.4x	9.4x	9.2x	6.8x	6.2x
AJG	M	27.27	$1.36	$1.33	$1.68	20.0x	20.5x	16.3x	14.7x	15.5x	12.8x	10.7x	8.9x	7.4x
BRO	M	20.88	$1.13	$1.10	$1.18	18.5x	19.0x	17.7x	14.0x	14.1x	13.2x	8.6x	8.7x	8.2x
MMC	M	28.62	$1.66	$1.91	$2.24	17.3x	15.0x	12.8x	16.6x	14.4x	12.2x	9.3x	8.5x	7.8x
WSH	O	37.87	$2.69	$2.83	$3.55	14.1x	13.4x	10.7x	12.4x	19.9x	9.8x	9.4x	9.0x	7.7x
Average						17.0x	16.3x	13.8x	14.3x	15.3x	11.5x	9.4x	8.4x	7.5x
Median						17.3x	15.0x	12.8x	14.0x	14.4x	12.2x	9.3x	8.7x	7.7x

Sources: Company reports, Thomson One, and William Blair & Company L.L.C.

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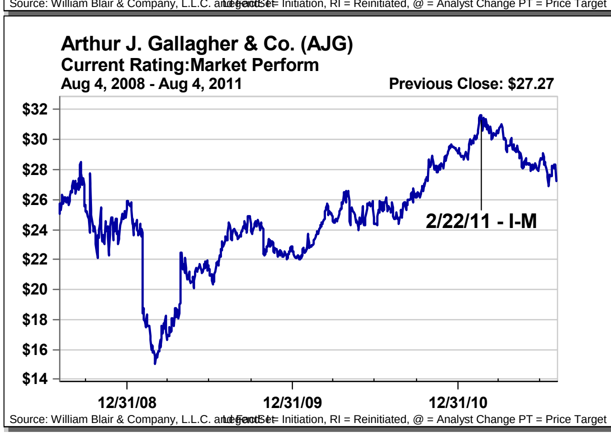
Additional information is available upon request.



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Coverage Universe	**Percent**	**Inv. Banking Relationships***	**Percent**
Outperform (Buy)	59	Outperform (Buy)	8
Market Perform (Hold)	31	Market Perform (Hold)	1
Underperform (Sell)	1	Underperform (Sell)	0

*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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