

Marsh & McLennan Companies, Inc.

Good Second Quarter, but Growth Remains a Question Mark

Summary

Marsh & McLennan had a strong quarter, with core business trends—particularly margin improvements—suggesting potential for additional upside down the road. EPS came in at \$0.50, compared with consensus of \$0.48 and our estimate of \$0.49. However, underlying results were even better than the EPS outperformance would indicate. Excluding the effects of the reverse in investment income, a higher share base, and a higher tax rate, EPS would have been closer to \$0.55 to \$0.56, 10% to 15% above estimates. Brokerage margins are a definite plus, particularly if the expansion is sustainable. Lack of acquisitions, however, is mitigating impressive organic performance.

Estimate Revisions:

We are increasing our adjusted operating EPS estimates for 2011 from \$1.88 to \$1.91 and for 2012 from \$2.17 to \$2.24, primarily as a result of additional margin expansion.

Factors to Watch:

Stronger margin trends. Margin expansion, particularly in the RIS segment, was stronger than expected, at 21.7%, a 100-basis-point improvement from second quarter 2010 and above our estimate of 20.8% despite pension and foreign-exchange headwinds of roughly 150 basis points. We are increasing our estimates for brokerage margin from 18.9% to 19.2% in 2011 and from 19.4% to 19.7% in 2012 as business conditions appear favorable for additional margin expansion.

The consulting margin was 11.7%, compared with our estimate of 11.5%. Our current estimates already assume strong margin expansion for the consulting segment, with growth from 11.4% in 2010 to 12.6% in 2012, but upside is possible.

Top-line growth flattening for risk insurance services. Although organic growth remained strong in the second quarter, overall revenue growth excluding the exchange rate impact was 7%, versus the previous-four-quarter average of 9.5%. The decline in revenue from acquisitions is the only real disconcerting conclusion from an otherwise standout quarter. The full year 2010 and first quarter 2011 acquisition growth rates were 6%, but that slowed dramatically during the second quarter to 2% as many of the acquisitions completed in the first half of last year began to run off. We are slightly disappointed by the lack of acquisition activity, as it is forcing overall revenue growth to flatten, mitigating the strong organic improvements noted above. Market conditions remain competitive for acquisitions, so it will be important to monitor progress on this front going forward.

Financial Services | Insurance Brokers

August 03, 2011

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

Symbol: MMC (NYSE)
Price: \$28.49 (52-Wk.: \$23-\$32)
Market Value (mil.): \$15,900
Fiscal Year End: December
Long-Term EPS Growth Rate: 10%
Dividend/Yield: \$0.88/3.1%

	2010A	2011E	2012E
Estimates			
EPS Q1	\$0.50	A\$0.56	\$0.64
Q2	\$0.46	A\$0.50	\$0.63
Q3	\$0.28	\$0.35	\$0.40
Q4	\$0.41	\$0.49	\$0.57
FY	\$1.66	\$1.91	\$2.24
CY		\$1.91	\$2.24
Valuation			
FY P/E	17.2x	14.9x	12.7x
CY P/E		14.9x	12.7x

Trading Data (Thomson Financial)

Shares Outstanding (mil.)	548
Float (mil.)	541
Average Daily Volume	3,079,803

Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	32.5
Book Value Per Share (MRQ)	14.7
Enterprise Value (mil.)	17,078.2
EBITDA (TTM)	1,494.0
Enterprise Value/EBITDA (TTM)	11.4x
Return on Equity (TTM)	14.0

Two-Year Price Performance Chart



Source: Thomson Financial, William Blair & Company estimates

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Brokerage organic of 5% is the top so far for the brokers, and much stronger than major competitor Aon (AON \$47.08; Outperform) at 2%. The biggest drivers were international (Latin America 18% and Asia 6%) and reinsurance (5%), as Marsh is benefiting from strong positions in growing insurance markets, but also appears to be taking market share. Given the strength observed, we are raising our estimate for organic from 3.8% in 2011 to 4.3% and from 3.8% in 2012 to 4.7%. Top-line growth for the quarter also benefited from a weaker dollar, which drove 5% upside to revenues for the quarter, but had a negligible to slightly negative effect on margins.

Consulting continued to show strong organic growth trends and came in at 5% for the second quarter, versus 3% for the whole of 2010. Rewards, talents and communications, investment consulting and management, and health benefits had average organic growth of 9.3%, and continue to drive overall consulting revenues. Despite a struggling domestic economy, the segment is benefiting from a snap back in demand post-recession for value-added services, strong international performance, and also an expanding client base.

More aggressive capital management could provide upside. Marsh bought back 8 million shares during the quarter worth \$235 million. It continues to have a strong balance sheet with net debt to EBITDA around 0.6 times, far more conservative than the majority of public brokers. Management reiterated that it wanted to maintain a flexible capital structure to position itself opportunistically, but we expect that the company could be more active in managing capital over the next 12 to 18 months. Ideally, a combination of share repurchases and more aggressive acquisition activity should help bolster the bottom line. We estimate an additional 15 million to 20 million shares will be repurchased through 2012.

Bottom Line:

Margin expansion and best-in-class organic are paramount to improving our view of the company. While we view the recent trends favorably, we would like to see a few more quarters of improvement in those metrics, as well as some pick-up in acquisition activity, before getting more excited about the stock. In addition, at current valuation levels (the stock is trading at 14.3 times projected 2011 cash EPS and 12.2 times projected 2012 cash EPS), we believe there are better values in the sector.

Insurance Brokers
Valuation Comparison

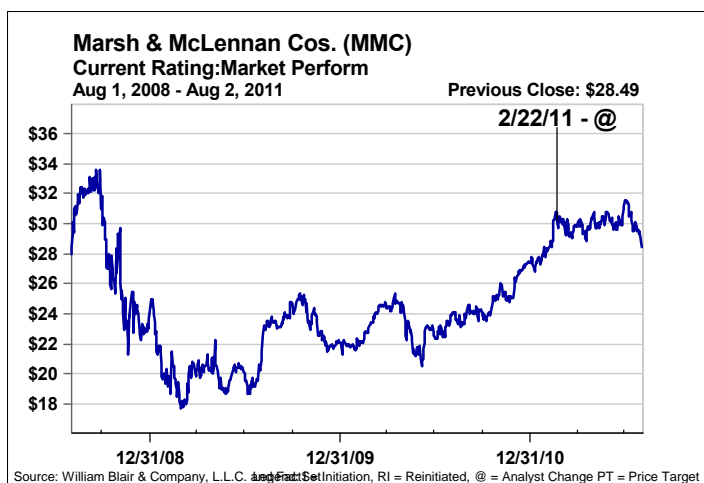
Ticker	Rating	Price	GAAP EPS			GAAP P/E			Cash P/E			EV / EBITDA		
			2010	2011E	2012E	2010	2011E	2012E	2010	2011E	2012E	2010	2011E	2012E
AON	O	47.08	\$3.07	\$3.38	\$3.97	15.3x	13.9x	11.9x	14.3x	12.7x	9.6x	9.3x	6.9x	6.3x
AJG	M	28.11	\$1.36	\$1.33	\$1.68	20.6x	21.1x	16.8x	15.1x	16.0x	13.2x	11.0x	9.1x	7.6x
BRO	M	21.25	\$1.13	\$1.10	\$1.18	18.8x	19.3x	18.0x	14.3x	14.4x	13.4x	8.7x	8.8x	8.3x
MMC	M	28.49	\$1.66	\$1.91	\$2.24	17.2x	14.9x	12.7x	16.5x	14.3x	12.2x	9.3x	8.5x	7.8x
WSH	O	39.86	\$2.69	\$2.83	\$3.58	14.8x	14.1x	11.1x	13.1x	19.7x	10.2x	9.7x	9.5x	8.0x
Average						17.4x	16.7x	14.1x	14.7x	15.4x	11.7x	9.6x	8.6x	7.6x
Median						17.2x	14.9x	12.7x	14.3x	14.4x	12.2x	9.3x	8.8x	7.8x

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

	2009	Q1'10	Q2'10	Q3'10	Q4'10	2010	Q1'11	Q2'11	Q3'11E	Q4'11E	2011E	2012E
INCOME STATEMENT												
Insurance Services Revenues	\$5,284.0	\$1,492.0	\$1,459.0	\$1,327.0	\$1,486.0	\$5,764.0	\$1,634.0	\$1,620.0	\$1,403.6	\$1,572.6	\$6,230.2	\$6,623.5
% Change	-3%	9%	9%	8%	11%	9%	10%	11%	6%	6%	8%	6%
Risk Consulting and Technology	\$687.0	\$162.0	\$0.0	\$0.0	\$0.0	\$162.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
% Change	-31%	-13%	-100%	-100%	-100%	-76%	-100%	#DIV/0!	#DIV/0!	#DIV/0!	-100%	0%
Consulting Services Revenues	\$4,609.0	\$1,155.0	\$1,168.0	\$1,203.0	\$1,309.0	\$4,835.0	\$1,261.0	\$1,319.0	\$1,284.4	\$1,402.6	\$5,267.0	\$5,649.0
% Change	-11%	7%	2%	5%	6%	5%	9%	13%	7%	7%	9%	7%
Interest Income	\$17.0	\$4.0	\$3.0	\$6.0	\$7.0	\$20.0	\$7.0	\$5.0	\$5.0	\$5.0	\$22.0	\$24.0
Investment Income	(\$2.0)	\$8.0	\$18.0	(\$2.0)	\$19.0	\$43.0	\$19.0	(\$6.0)	(\$5.0)	\$10.0	\$18.0	\$40.0
Corporate Eliminations	(\$68.0)	(\$14.0)	(\$21.0)	(\$6.0)	(\$10.0)	(\$51.0)	(\$11.0)	(\$11.0)	(\$11.0)	(\$11.0)	(\$44.0)	(\$48.0)
Corporate Eliminations % Revenue	-0.6%	-0.5%	-0.8%	-0.2%	-0.4%	-0.5%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%
Total Revenues	\$10,527.0	\$2,807.0	\$2,627.0	\$2,528.0	\$2,811.0	\$10,773.0	\$2,910.0	\$2,927.0	\$2,677.0	\$2,979.2	\$11,493.3	\$12,288.5
% Change	-9%	7%	1%	-1%	2%	2%	4%	11%	6%	6%	7%	7%
Salaries & Benefits	\$6,240.0	\$1,650.0	\$1,614.0	\$1,586.0	\$1,690.0	\$6,540.0	\$1,721.0	\$1,728.0	\$1,686.9	\$1,798.9	\$6,934.7	\$7,352.4
% Change	-10%	7%	5%	2%	5%	5%	4%	7%	6%	6%	6%	6%
Amortization of Intangibles	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
% Change												
Operating Expenses	\$2,941.0	\$706.0	\$1,042.0	\$699.0	\$770.0	\$3,217.0	\$691.0	\$735.0	\$783.1	\$835.1	\$3,044.2	\$3,413.3
% Change	-14%	1%	38%	0%	-2%	9%	-2%	-29%	12%	8%	-5%	12%
Interest Expense	\$241.0	\$60.0	\$60.0	\$60.0	\$53.0	\$233.0	\$51.0	\$49.0	\$48.0	\$48.0	\$196.0	\$192.0
Total Operating Expenses	\$9,422.0	\$2,416.0	\$2,273.0	\$2,315.0	\$2,459.0	\$9,463.0	\$2,462.0	\$2,512.0	\$2,422.0	\$2,586.0	\$9,981.9	\$10,573.7
% Change	-11%	5%	-3%	0%	0%	0%	2%	11%	5%	5%		
PT Operating Income	\$1,105.0	\$391.0	\$354.0	\$213.0	\$352.0	\$1,310.0	\$447.0	\$415.0	\$255.1	\$393.3	\$1,510.3	\$1,714.8
Pretax Operating Margin	10.5%	13.9%	13.5%	8.4%	12.5%	12.2%	15.4%	14.2%	9.5%	13.2%	13.1%	14.0%
Special Items	(\$791.0)	\$0.0	\$443.0	\$0.0	\$0.0	\$443.0	\$0.0	\$0.0	(\$73.0)	\$0.0	\$886.0	\$813.0
Other Income	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
Pretax Income	\$314.0	\$391.0	\$797.0	\$213.0	\$352.0	\$1,753.0	\$447.0	\$415.0	\$182.1	\$393.3	\$1,437.3	\$1,714.8
% Change	297%	47%	-805%	18%	-1860%	458%	14%	-48%	-15%	12%	-18%	19%
Taxes	\$53.0	\$117.0	(\$60.0)	\$55.0	\$106.0	\$218.0	\$128.0	\$129.0	\$56.4	\$121.9	\$435.4	\$890.5
Tax Rate	16.9%	29.9%	-7.5%	25.8%	30.1%	12.4%	28.6%	31.1%	31.0%	31.0%	30.3%	51.9%
Taxes Adj	\$241.0	\$117.0	\$95.1	\$55.0	\$122.0	\$389.1	\$128.0	\$129.0	\$56.4	\$121.9	\$435.4	\$514.5
Tax Rate Adj	21.8%	29.9%	26.9%	25.8%	34.7%	29.7%	28.6%	31.1%	31.0%	31.0%	28.8%	30.0%
Minority Interest (net of tax)	\$15.0	\$4.0	\$6.0	\$3.0	\$3.0	\$16.0	\$6.0	\$7.0	\$7.0	\$7.0	\$27.0	\$12.0
Participating securities adj.	\$19.0	\$0.0	\$3.0	\$0.0	\$0.0	\$3.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$6.0
A-T Adjusted Income	\$830.0	\$270.0	\$250.0	\$155.0	\$227.0	\$902.0	\$313.0	\$279.0	\$191.6	\$264.4	\$1,048.0	\$1,188.4
% Change	10%	31%	45%	-38%	13%	9%	16%	12%	24%	16%	16%	13%
Adjustments Net	(\$444.0)	(\$22.0)	\$271.0	\$43.0	\$0.0	\$292.0	\$12.0	\$3.0	(\$73.0)	\$0.0	(\$58.0)	\$0.0
A-T Net Income Con. Ops	\$386.0	\$248.0	\$521.0	\$198.0	\$227.0	\$1,194.0	\$325.0	\$282.0	\$118.6	\$264.4	\$990.0	\$1,188.4
A-T Net Income Without Minority	\$252.0	\$252.0	\$527.0	\$201.0	\$230.0	\$902.0	\$331.0	\$289.0	\$125.6	\$271.4	\$1,017.0	\$1,188.4
Operating Earnings	\$830.0	\$270.0	\$241.8	\$146.1	\$243.4	\$901.3	\$306.9	\$283.5	\$171.5	\$268.3	\$1,030.2	\$1,188.4
Net EPS - Cont Ops	\$0.74	\$0.46	\$0.96	\$0.36	\$0.41	\$2.19	\$0.59	\$0.51	\$0.22	\$0.49	\$1.80	\$2.24
% Change	-656%	36%	-406%	-10%	36%	197%	27%	-47%	-40%	18%	-18%	24%
Adjusted Operating EPS	\$1.59	\$0.50	\$0.46	\$0.28	\$0.41	\$1.66	\$0.56	\$0.50	\$0.35	\$0.49	\$1.91	\$2.24
% Change	9%	26%	39%	-41%	9%	4%	12%	10%	24%	18%	15%	17%
Adjusted EPS (Normalized)	\$1.41	\$0.50	\$0.44	\$0.27	\$0.44	\$1.65	\$0.55	\$0.51	\$0.36	\$0.50	\$1.88	\$2.24
% Change	1%	19%	40%	-11%	17%	17%	10%	17%	34%	12%	14%	19%
Amortization Expense Per Share	\$0.08	\$0.02	\$0.02	\$0.02	\$0.02	\$0.08	\$0.03	\$0.03	\$0.03	\$0.03	\$0.10	\$0.11
Adjusted Cash EPS	\$1.49	\$0.48	\$0.97	\$0.38	\$0.43	\$1.72	\$0.61	\$0.53	\$0.24	\$0.52	\$1.98	\$2.34
% Change	0%	9%	192%	19%	9%	15%	27%	-45%	-36%	19%	15%	18%

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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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