AON: RESTRUCTURING FOR GROWTH

GETTING THE BEST OUT OF CHANGE & CATASTROPHE

Greg Case, president and CEO, Aon Corporation. Photograph kindly supplied by Aon Corporation, December 2007.

The global insurance industry faces something of a market paradox. A period of relative respite in catastrophe losses through 2007, and stronger than expected property and casualty insurance sales, are factors expected to boost the insurance sector outlook in 2008 and 2009. Moreover, the crossover between insurance and the global capital markets will become even stronger through the coming twelve months. Even so, insurance mavens appear to expect flat—even negative—premium growth for the year. How timely then that in 2005 global insurance major Aon Corporation embarked upon a comprehensive three year makeover programme to help prepare the firm to best leverage impending changes in the global financial markets. The corporation's third quarter 2007 results show a revenue uptick of 92% year on year. Clever planning? Prescience, or sheer good luck? Francesca Carnevale went to Chicago to find out.

AS BENJAMIN DISRAELI repeatedly noted: "change is inevitable." The Chicago headquartered Aon Corporation took Disraeli's favourite chestnut to heart in late 2005, embarking on a three year restructuring programme involving the rationalisation of its 43,000 strong workforce, the sale of no longer core assets and a refocusing of its business sales and development model. It appears to be working. After a lacklustre 2006, Aon's 2007 performance improved in proverbial leaps and bounds, culminating in a third-quarter 2007 profit increase of 92%. The uptick in Aon's revenue is due to not only cost cutting, but also organic growth, with the company reporting an improvement of margins across the board, helped by growth in brokerage and insurance underwriting premiums and higher consulting fees. According to the corporation's third quarter 2007 financials, net income rose to $204m (or 64 cents per share), from $106m, (32 cents a share) on the same quarter in 2006. Profit from continuing operations more than doubled to $188m. Greg Case, Aon Corp's president and chief executive officer explains the context. "The need to restructure was no one's fault, rather it was a product of how Aon had been constructed over the years. You cannot always build and integrate at the same time. We understood clearly therefore that we had to reduce frictional costs. It was hard, yes, but we had a single focus, around which colleagues could begin to serve clients more effectively. That focus has allowed us to unleash the commercial energy in the firm."

The corporation's restructuring was propelled by three considerations: a belief that the firm's risk management expertise would finally come into its own; an understanding that premium income would come under pressure for the near future; and a deliberate and strong focus on customer benefit. Over the last three years, Aon's restructuring programme has involved the consolidation of functions such as personnel, finance and its worldwide information technology systems, as well as the streamlining of its real estate structure. The programme itself— though a constant process—has been carried out in two bulk rounds. The first began in November 2005, and involved the cutting of 3,600 jobs, incurring a $365m restructuring charge and resulting in

$280m in annual savings as of the end of 2007. The second round was announced in the fall of last year, when Aon announced plans to cut 2,700 jobs (about 6.3% of its work force) in predominantly non-client facing roles, including the outsourcing of more than 1000 jobs. Aon expects savings of between $50m and $70m are achievable in 2008, rising to $175m to $200m next year and then $240m by 2010; though it will incur associated costs of $360m pre tax.

Some industry mavens posited that this latest round of restructuring was inevitable, as the company was not growing business fast enough to achieve significant margin expansion and Aon had to take aggressive action in the last quarter of 2007 to protect income over the medium term. That may well have been the case. Even so, the corporation appears to be moving in the right direction. Aon's stated aim has been to seek brokerage margins of at least 20% and while the July through September is a seasonally weak quarter, on an adjusted basis the corporation posted margins of 17.5%.

It is understandable that market watchers would take the latest round of restructuring to signal that Aon needed to continue to seek efficiencies to keep margins aloft. Through 2006 and 2007, the reasons for increased efficiency continued to be writ large.

Through 2006 and 2007, the insurance market itself appeared unremittingly softer than expected. Like New York-based Marsh & McLennan Co. Inc, its main insurance brokerage rival, Aon has been trying to sustain commissions as property and casualty insurance rates have fallen during the last two years. There were other problems as well to face. Although the corporation's first quarter 2007 results showed an 8% uptick in its Brokerage Americas unit on the same period a year before, first quarter 2006 had included a special charge of $6m related contingent commissions, which Aon's brokers had received from insurers for steering business to them—in 2005, Aon had agreed to stop accepting contingent commissions as part of a regulatory settlement with the then New York Attorney General Eliot Spitzer.

In May 2007, Case told journalists that he expected insurance rates for products his brokers handle to decline between 10% and 20% through the year. As the largest insurance broker in the world, Aon helps companies find property and casualty insurance, reinsurance and legal liability coverage. Its business is dependent, in part, on commissions from these sales. The lower the rates, the smaller the commissions. Case noted that rates initially declined in casualty insurance, which covers companies against lawsuits, but were also down in property and catastrophe coverage. Moreover, he noted that directors and officers insurance, which protects top company officials against shareholder suits for errors of judgment and wrongful acts, was becoming increasing competitive, with rates dropping by 20%.

Rates were also down for Aon Re, which helps property insurers get back up coverage in case of natural catastrophes, by as much as 20%, particularly for home coverage.

Aon made up the loss of commission revenue by retaining more of its clients and performing additional work for them, explains Case (Aon consults, for instance, for many of its clients). Additionally, Aon began focusing on its financial risk management expertise. The rationale was obvious. "The top 20% of our client base are typically multinational, with a broad range of businesses and exposures and with captive insurance operations. These global clients are financially sophisticated and rely on Aon to design risk management programmes that utilise their capital efficiently," notes Steve McGill, CEO of Aon Risk Services Americas and CEO of Aon Global. "Over the last decade, clients have demonstrated greater interest in our actuarial and risk modelling capabilities, which are valuable in helping those clients balance risk transfer with risk retention. Over the next 10 years, new risks will emerge, particularly in areas like reputational risk and in risks tied to outsourcing and/or investments again in emerging markets," he adds.

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Case acknowledges the drivers. For one, he says, "the insurance world is incredibly competitive and the client has substantial choice in its approach to insurance." Moreover, Aon's clients are increasingly focused on risk management as the global markets become more complex. "Look who is in our space," notes Case, "private equity, the world's biggest banks and financial institutions. We touch at least one third of what you see: one third of the global economy and so that market impact means something. We don't change it, but we are in the business of helping our clients perform better." The beauty is in the simplicity and cost effectiveness of building market share in the sector. "There are no barriers

to entry," notes Case. "What is important is understanding what our clients require and being really useful to them. That means putting teams of people at the disposal of key clients, or individuals within a firm if necessary. You can then imagine how the business evolves."

In the case of Aon, this also means offering human capital consulting to organizations around the world. Aon Consulting Worldwide develops retirement, health care, talent management programs and the like that are aligned with an organization's business goals and drive toward productivity. Andrew Appel joined Aon Consulting Worldwide as CEO in July 2005, and is leading the charge to deliver truly distinctive client value. "We are embedding value and innovation in every service we provide, which we believe gives us a significant advantage over our competition," said Appel. "Additionally, we're developing a culture where this type of value-based thinking is prevalent as we serve and grow our existing client base and work to secure new business."

In growing its overall market share, Case acknowledges that current market volatility plays into the corporation's long term business aspirations. Managing risk will be a key note through this year and next, "The way we bring capability to our clients is evolving, though delivering value is at the core of every one of our activities," stresses Case. "The overarching strategy is to build globally and then deliver locally."

The application of that strategy is exemplified by its UK business, where Aon is relying on organic growth after two less than shining years. Aon's UK unit was hit hard by the contingent commissions agreement with Spitzer; performance of its local unit—the group's third largest regional business –suffered a downdraft. The unit has been brought back on track by slashing costs, including cutting hundreds of jobs and targeting new areas of business, such as high net-worth individuals, and which is among the corporation's fastest-growing businesses. Intermediary services and risk management advice to UK-based global corporates, a market in which it has a 20%-plus market share is also on the rise. Small and medium-sized construction, media and technology firms "are key areas of growth", while insurance services to affinity groups, such as unions, employer groups and hobby associations are also on the rise. "Our plan focuses on our competitive positioning; our growth levers; organisational effectiveness; performance management; and, leadership and behaviours," notes Peter Harmer, CEO of Aon's UK operations. "Our growth strategy has been very simple: we are very focused on ensuring we understand our clients' risk-based needs in the context of their overall business objectives," adds Harmer.

Roelof Hendricks, Aon's CEO for Europe, Middle East and Africa is clear on what will create more value for its clients, commenting, "Our new business approach comprises three elements: winning new clients, cross-selling services to existing clients and innovating new products and services for the market."

Perhaps the strongest single reminder of Aon's new focus came in mid-December 2007, when the corporation announced that it had signed definite agreements on the sale of Combined Insurance Company of America (CICA) to ACE Limited for $2.4bn and Sterling Life Insurance Company (Sterling) to the Munich Re Group for $352m. [Additionally, Aon will enjoy a one-time cash dividend of $325m from CICA prior to the close of the transaction. Aon Capital Markets, Credit Suisse Securities (USA) LLC and Merrill Lynch & Co. acted as advisors on the separate transactions.]

The sale of Glenview, Illinois-based CICA is the largest of a US life insurer since Aviva Plc bought AmerUs Group Co. for $2.9bn in 2006. CICA has 4m policyholders and almost 7,000 sales agents and the deal will probably close by the end of the second quarter. ``We had tremendous interest across the board," notes Case.

In effecting the sale, Aon is giving up the last vestige of its origins, which trace to W Clement Stone, a door-to-door insurance salesman who founded Combined Registry Co. in Chicago in 1922 with $100 in cash. Patrick Ryan, who succeeded Stone as chief executive officer in 1982 and now is Aon's executive chairman, built the company into one of the world's largest insurance brokerages through a rapid and comprehensive succession of acquisitions. When Case left McKinsey & Co to take over from Ryan in 2005, he rapidly sold or closed some of Aon's insurer units, including ones that sold auto warranties and liability protection for construction projects in an effort to simplify the corporation's global structure and exit the lower-margin and more capital-intensive insurance underwriting business. The current sell offs continue in that same strategic vein. As Case explains it, "Our core assets will now be more strategically aligned as we expand our capabilities to better serve our risk brokerage and consulting clients."

Total after-tax cash proceeds and dividends are expected to be some $2.6bn, subject to final transaction costs. The funds are to be used, depending on "prevailing market conditions" to bolster an authorised share repurchase programme, worth $2.78bn. Aon had already repurchased 48.1m shares through 2006 and 2007, worth $1.82bn under a $2bn share repurchasing programme that had been authorised in November 2005 and increased a year later. The Sterling transaction is expected to be completed by the end of March, while CICA's sale should complete by June. "At the same time, the increased share repurchase programme reflects our ongoing belief in the underlying positive momentum of the business," adds Case.

The move is also in line with wider market trends, where the vast majority of the industry's profits in 2007 look to be reinvested back into the business. There is excess capital in the insurance industry today—estimated by some analysts to be as much as $100bn that is driving down returns on equity. Aon, like its insurance counterparts, in an effort to manage this impact is returning capital to shareholders in the form of increased dividend and share repurchases. In the wider context, analysts note that share repurchase activity in 2007 will shatter all previous records and could constitute a return of 4.5% to 5% of the industry's capital to owners. [In fact, through the third quarter of 2007, $17.4bn in share repurchases had been transacted, a figure that is

already 133% above the previous record of $7.1bn for all of 2006 and it is likely total share repurchases will have exceeded $20bn by the end of 2007.]

Profits continue to bolster the industry's policyholder surplus —a measure of claims paying capacity, or capital—providing an additional buffer against any natural catastrophes that may lie ahead. An improved capital position also helps insurers meet the higher capital requirements imposed on them by ratings agencies in the wake of Hurricane Katrina—requirements that oblige insurers to demonstrate an ability to pay claims arising from more than one major catastrophe per year in order to maintain and improve financial strength ratings. Actually, 2006 was a hurricane-free year, and there is now, reportedly an abundance of capital in the insurance industry. Catastrophe bonds and "sidecars," which insurers use to get additional capacity, has added $8bn of liquidity to the market. Moreover, Florida's Hurricane Catastrophe Fund, a state-backed fund that increases property insurers' access to reinsurance coverage at below-market rates, freed up $14bn worth of reinsurance. "We have seen a block of new capital come into the reinsurance market and in such a climate as it, insurers will generally find sufficient capacity at the right terms," says Ted Devine, chief executive of Aon Re.

"This is a cyclical market and will always have cyclical characteristics. But I think the nature of the cycles have changed and will change going forward," notes Case. The future looks much brighter from where Case sits in Chicago, casually mulling over industry trends. Further consolidation in the reinsurance industry is a given, he thinks, though is quiet in terms of how that may play out. Aon currently is a rising star among the four major players in the reinsurance broking industry, namely Aon Corp, Marsh, Willis Group Holdings and Benfield; though only Benfield has been recently mooted as a possible acquisition target by either another reinsurer or a private equity player.

Analysts meantime expect the wider insurance industry's profitability to continue in 2008, albeit with an underwriting performance that will generate a moderately smaller underwriting profit, according to the results of the Insurance Information Institute's Earlybird Forecast 2008. Each year the survey reviews the prospects for the industry. This latest report moots that the continuing respite in catastrophe losses in 2007 combined with strong performances in virtually all major lines of property and casualty (P/C) insurance will propel the industry to another best performing year. The survey also shows that analysts uniformly expect premium growth in 2007 to come in below expectations while the outlook for 2008 remains completely flat to slightly negative. This apparent paradox of strong profits but stagnant premium growth is a reminder of the highly cyclical nature of the property/casualty business and the fact that the industry's financial fortunes are determined by a myriad of factors.

Aon has been setting a pace for restructuring and a more rigorous market approach. Market players attribute this new discipline not only to the quality of leadership in the firm, but also to a number of external factors, including savvier investors, better technology and data to understand exposures as well as greater scrutiny from investors, analysts and regulators. Credit rating agencies, for instance, which play a crucial role in the insurance and reinsurance businesses, are also seen as having taken a far more active role in monitoring company behaviour, industry players say.

The industry is also facing some regulatory risks. In the US, for instance, some states continue to attack the right of insurers to use certain well-established underwriting criteria.

That said, insurers such as Aon will need to come to carefully manage a variety of challenges unrelated to catastrophe losses, including increasing price pressure, slow growth and the legal, legislative and regulatory environments, all of which could erode underwriting performance and profitability in the year ahead. For the time being Case is sanguine. "Much of what we have invested in over the last three years is value accretion. That's because our business ultimately rests on the value of our team and what they can bring in terms of real benefit to our client. I am not talking about the Chicago team, but our global team. The great thing about Aon is the tremendous opportunity that it is providing to our clients and shareholders, particularly with a market that is now playing to our strengths."

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