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Aon Plc (AON)

Q4 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and thank you for holding. Welcome to Aon plc's Fourth Quarter and Full Year 2017 Earnings Conference Call. At this time, all parties will be in a listen-only mode until the question-and-answer portion of today's call. If anyone has an objection, you may disconnect your line at this time.

I would also like to remind all parties that this call is being recorded and that it is important to note that some of the comments in today's call may constitute certain statements that are forward-looking in nature as defined by the Private Securities Reform Act of 1995 (sic) [Private Securities Litigation Reform Act of 1995] (00:35). Such statements are subject to certain risk and uncertainties that could cause actual results to differ materially from historical results or those anticipated. Information concerning risk factors that could cause such differences are described in the press release covering our fourth quarter and full year 2017 results as well as having been posted on our website.

Now, it is my pleasure to turn the call over to Greg Case, President and CEO of Aon plc.

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

Thank you, and good morning, everyone. Welcome to our fourth quarter and full-year 2017 conference call. Joining me here today is our CFO, Christa Davies. For your reference, I would note that there are slides available on our website for you to follow along with our commentary today.

Before we discuss the financial results of the quarter, I'd like to reflect on Aon overall in 2017 and the efforts of my colleagues to further strengthen our firm, consistent with Aon's record of value creation. This year was a pivotal year for Aon as we completed significant steps to reinforce and build upon a decade-long strategy to be the leading global professional services firm, delivering a broad range of risk, retirement and health solutions, enabled by proprietary data and analytics.

Earlier this year, we completed the divestiture of our outsourcing platform, a meaningful acceleration of our strategy and a tremendous accomplishment, made possible by the tireless united efforts of our colleagues around the globe. The divestiture provided a further catalyst for our strategy and actions to deliver shareholder value as it reinforced our focus to provide advice and solutions and further align Aon's portfolio around our clients' highest priorities.

It generated significant capital to accelerate investment in emerging client needs and in our firm, noting over $1 billion invested on high growth areas of M&A, again, in 2017. It provided a catalyst to further unite our firm under one operating model, creating greater efficiency and operating leverage across the firm. And finally, the divestiture reinforces our return-on-invested capital, decision-making priority and emphasis on delivering double-digit free cash flow growth over the long-term, highlighted by a record amount of capital return to shareholders through share repurchase and dividends.

Overall, our optimism is built through conviction that the actions we're undertaking will substantially strengthen our firm on the heels of a decade of improvement in innovation for our clients and shareholders. With this momentum, we're already seeing improvement in our growth profile, driven by new investment in high growth, high margin areas across our portfolio. Organic revenue growth has increased from 3% in both 2014 and 2015 to 4% in 2016 and 2017, and noting that we end the year with four of our five major revenue lines, delivering 5% or greater organic revenue growth for the fourth quarter.

Again, I'd like to acknowledge my Aon colleagues who achieved these results while addressing many challenges, including working with our value market partners to assist clients and navigating through one of the most challenging loss years in recent memory.

Now, turning the quarter on page 5 of the presentation. Consistent with previous quarters, I'd like to cover two areas before turning the call over to Christa for further financial review. First is our performance against key metrics we commit to shareholders. Second is overall organic growth performance, including continued areas of strategic investments.

On the first topic, our performance versus key metrics. Each quarter, we measure our performance against the key metrics we focus on achieving over the course of the year. Grow organically, expand margins, increase earnings per share, and deliver free cash flow growth. In the fourth quarter, organic revenue growth was 6% overall, highlighted by strong growth in every major revenue line, including double-digit growth in Data & Analytic Services.

Operating margin increased 200 basis points, primarily reflecting core operational improvement and savings from investments in our Aon United operating model. EPS increased 18% to $2.35, reflecting both strong operating performance and effective capital management, partially offset by a higher effective tax rate and a loss from the disposal of the business.

If we turn to the year, organic revenue growth was 4% overall, including growth in every major revenue line, highlighted by strong growth in areas of continued strategic investment. Operating margin increased 180 basis points. EPS increased 17% to $6.52. And finally, free cash flow decreased $1.2 billion, primarily reflecting tax payments related to the divestiture of our outsourcing business and investments in our operating model.

Overall, a strong finish to the year with results for both the fourth quarter and full year, reflecting strong organic revenue growth, core operational improvement, and substantial progress in the first year of our Aon United operating model initiative and effective capital management, highlighted by a record return of capital for the full year.

Turning to slide 7, on the second topic of organic growth and strategic investments. Organic revenue growth was 6% overall in the fourth quarter. Further, four of our five revenue lines delivered organic growth of 5% or greater with particular strength in Data & Analytic Services, Reinsurance, and Health Solutions, reflecting on each of our core growth platforms.

In Commercial Risk Solutions, organic revenue growth was 5%, an acceleration from flat in the prior-year quarter. On average globally, exposures were modestly positive, and impact from pricing was marginally negative, resulting in a relatively stable market impact overall. Our results in the quarter primarily reflect strong growth in U.S. retail, driven by double-digit new business generation and strong management of our renewal book portfolio.

Internationally, we saw continued solid growth, led by both Asia and Pacific regions. Results also include strong growth in our Captive Management business, driven by multiple new client wins in the quarter, reflecting our leadership position in the space as we leverage our diverse risk-consulting expertise to help clients develop a successful risk management program.

In Reinsurance Solutions, organic revenue growth was 8%, an acceleration from 1% in the prior-year quarter. I would note this is the highest level of organic revenue growth achieved in our Reinsurance business in over a decade. Results reflect growth across every major category including treaty placements, facultative placements, and capital market transactions. Market impact was neutral to results in the quarter, reflecting both a continuation of moderating pricing as well as a modest upward pressure to loss-exposed geographies.

We saw particular strength in treaty placements, driven by another quarter of record net new business generation. Results also reflect a modest non-recurring benefit from reinstatement premiums as clients purchased more cover following the catastrophic events earlier in the year.

Overall, this was a tremendous year of growth for our Reinsurance business, reflecting our leadership and unmatched level of investment in Data & Analytics, our record level of cap on issuance, and additional revenues from cat-driven reinstatement premiums.

In Retirement Solutions, organic revenue growth was 4%, acceleration from minus 2% in the prior year quarter. Results reflect growth across all major businesses and geographies. We saw particular strength in our Talent, Rewards and Performance practice, primarily Rewards as well as assessment services. Results also reflect strong growth in investment consulting, including double-digit growth in delegated investment management solutions, reflecting an increase in client demand for Aon's tailored solutions and objective advice as well as increase in performance fees for outperforming benchmark returns.

Assets under management and delegated investment management continue to trend upward, increasing from $118 billion in the third quarter of 2017 to $134 billion in the fourth quarter, driven primarily by client wins. With the recent close of the Townsend Group acquisition, our total assets under management headed into 2018 are now approximately $150 billion, up more than 60% compared to the prior year quarter.

In Health Solutions, organic revenue growth was 6% against a strong comparable 30% in the prior year quarter. We saw strong growth globally in health and benefits brokerage, reflecting continued strength in the U.S. and double-digit growth in Canada, Latin America, EMEA and Asia. In healthcare exchanges, we saw solid growth in our active exchange while results in retiree exchange were impacted by certain project-related work that benefited the prior year quarter.

In Data & Analytic Services, organic revenue growth was 12%, an acceleration from 4% in the prior year quarter. Results primarily reflect continued growth in our Affinity business with particular strength in the U.S. Growth in U.S. Affinity was highlighted by continued strong performance in pet and travel solutions.

Lastly, following significant catastrophic flooding events in the second half of the year, we also saw an increase in certain non-recurring revenue related to claims processing activity and our flood business during the quarter.

Turning to slide 8 to discuss areas of strategic investment. Clients continue to navigate an increasingly volatile world with 2017 being the costliest year on record for weather-related disasters at an estimated $344 billion of economic losses. Weather-related disasters combined with economic, demographic, geopolitical forces and the exponential piece of technology change are all converging to create challenging new realities for our businesses and clients.

Aon has a strong track record of allocating capital to developing innovative first-to-market solutions to help solve problems and create differentiated value in response to specific client needs. Driven by strong operating performance, underlying free cash flow growth and transaction-related proceeds, we deployed more than $1 billion of capital to attractive M&A in both 2016 and 2017. These strategic investments in high growth areas are improving the firm's long-term growth profile and increasing operating leverage across the portfolio.

We're investing organically and through M&A across our portfolio in areas such as Data & Analytics in our InPoint and ReView businesses; in cyber risk advisory; in health and elective benefits brokerage through the acquisitions of Admix in Latin America and Univers; in healthcare exchanges where we offer the broadest set of solutions in health, geographically with the acquisitions of UMG and Henderson, reinforcing our industry leading position in the Netherlands and the UK; and finally, in delegated and investment management solutions, a business with rapidly growing client demand with the acquisition of the Townsend Group.

The addition of Townsend significantly expands our investment capabilities by bringing greater depth of expertise in real estate and real estate assets to Aon's distribution scale, and furthers our ability to provide more attractive alternative private market asset capabilities to clients.

In summary, we finished the year with a strong performance in the fourth quarter, reflecting 5% or greater organic growth across major revenue lines, substantial operational improvement including significant progress in the first year of our Aon United operating model initiative and effective capital management, highlighted by the return of a record amount of capital to shareholders in 2017.

Looking forward, we head into 2018 with continued momentum. The growth profile of the firm is improving, amplified by an unmatched level of investment as we continue to focus the portfolio around our highest value solutions and our clients' greatest needs. Combined with core operational improvement and savings from the Aon United operating model, we believe we're on track to exceed $7.97 of earnings per share in 2018 and deliver double-digit free cash flow growth over the long term, driving the next wave of substantial value creation for shareholders.

I'm now pleased to turn the call over to Christa for further financial review. Christa?

Christa Davies

Chief Financial Officer & Executive Vice President, Aon Plc

Thank you so much, Greg, and good morning, everyone. As Greg noted, our results reflect a strong performance in the fourth quarter and a solid year of progress in 2017. During such a pivotal year for the firm, we delivered strong organic revenue growth, substantial operational improvement, and underlying free cash flow growth while continuing to take significant strengths, steps to increase the effectiveness and efficiency of our operating model. In addition, we deployed $3.8 billion of capital in 2017, including the return of a record $2.8 billion to shareholders through share repurchase and dividends, and $1 billion in acquisitions in high growth, high margin areas of our portfolio.

Turning to slide 10 of the presentation. Our core EPS from continuing operations excluding certain items increased 18% to $2.35 per share for the fourth quarter compared to $2 in the prior year quarter. Included in the result was a $0.06 per share favorable impact related to foreign currency translation due primarily to a weaker U.S. dollar. In addition, we incurred a $0.06 per share unfavorable impact, recognized through other expense from the sales of certain businesses in the quarter and losses on the remeasurements of assets and liabilities in non-functional currencies. If currency would remain stable at today's rate, we would expect foreign currency translation to have a similar favorable impact in the first quarter of 2018.

For the full year, EPS included a $0.13 per share unfavorable impact recognized through other expense primarily for losses on the remeasurement of assets and liabilities in non-functional currencies partially offset by an $0.08 favorable impact on EPS from foreign currency translation.

Certain items that were adjusted for in the core EPS performance and highlighted in the schedules on page 11 of the press release include non-cash intangible asset amortization, non-cash restructuring charges, non-cash expenses related to pension settlements, certain tax related impacts due to changes in statutory legislation, and $14 million reduction in charges related to certain UK regulatory and compliance matters upon further review as we believe our UK regulatory risk is less than previously anticipated. The prior quarter also included transaction costs related to the sale of the outsourcing businesses.

Turning to the next slide to discuss our strong operational performance. Operating income increased $123 million or 18% with more than half of $1 increase year-over-year driven by core operational improvement. Operating margin improved 200 basis points to 27.5% compared to the prior year quarter. Operating margin improvement reflects $56 million or 190 basis points of savings from restructuring savings and other operational improvements before any reinvestment. This was partially offset by $3 million or minus 10 basis points of transaction costs related to recent acquisitions. FX translation had an immaterial impact to margin in the quarter.

For the full year, operating income increased 15% and operating margin improved 180 basis points compared to the prior year. Operating margin includes a 20-basis point favorable impact from FX translation, offset by a minus

10-basis point impact for transaction costs related to acquisitions completed within the year, and then a minus 10-basis point unfavorable impact from lower non-cash income from pension and post-retirement benefits.

From the dollar standpoint, operating income increased $306 million with $165 million driven by savings before reimbursement and $141 million driven by solid organic revenue growth and core operational improvement, a strong performance operationally in the first year of execution against our multi-year investment in the firm).

Before turning to the next slide, I want to spend a moment discussing the accounting changes that Aon will adopt, beginning in the first quarter of 2018. There is new accounting guidance related to the treatment of revenue from contracts with customers and new accounting guidance related to the presentation of costs associated with pension and other post-retirement benefits. Ultimately, these changes will have an immaterial impact on our full year results. However, there will be a shift of certain revenues between quarters, most notably in our reinsurance business.

In order to help you understand the impact of these changes and to easily update your model, the company has released unaudited pro forma financials for the last eight quarters that present the retrospective impact of both of these standards on 2016 and 2017 results. These schedules can be found on page 15 to 21 of the press release as well as an Excel format on the Investor Relations area of our website.

Moving on to page 12. I'd like to spend a few moments discussing the investments we're making to create the next-generation global business services model that allows better scalability, flexibility, and enhance colleague and client experience. These investments are intended to create one operating model with increased operating leverage.

Our primary investment areas are across IT, real estate, and people. In IT, we expect to create greater insight from data center optimization, application management, and strategic vendor consolidation. In real estate, we expect to drive greater collaboration and engagement through real estate portfolio optimization. And in people, we expect to create greater scalability of operations and activity, including the use of centers of excellence and third party providers.

Our initial estimates were to invest $900 million of cash over a three-year period to deliver $400 million of annual estimated savings in 2019. After evaluating the current progress of the program and identifying further opportunities to improve our operating model, the program estimates have been updated to reflect an increase of $50 million in total expected savings for 2019. We now expect to invest an estimated $1.175 billion in total cash over a three-year period.

These investments include an estimated $975 million of cash charges. We have incurred $497 million of expense and spent $280 million of cash to-date. Future cash outlay is expected to increase modestly in 2018, then expected to decline each year thereafter, and an estimated $200 million of incremental CapEx investment with $27 million incurred in 2017, and approximately $100 million expected in 2018, and $70 million expected in 2019. There is an additional estimated $50 million of non-cash charges included as part of asset impairments. Overall, we now expect these investments and other expense discipline initiatives to deliver $450 million of estimated annual savings in 2019 before any potential reinvestments.

Further, we've been investing the balance of the transaction proceeds to the highest return on capital opportunities. As Greg mentioned, we returned a record $2.8 billion to shareholders in 2017 through share repurchases and dividends, and we deployed over $1 billion of capital in acquisitions in high growth, high margin areas across the portfolio.

Turning to the next page. In the fourth quarter, we incurred $96 million of restructuring-related charges relating primarily to workforce production and other general initiatives. Year-to-date, we've incurred $497 million of restructuring-related charges, representing 48% of the updated total program estimate. The cash impact in 2017 was an outflow of $280 million. We recognized $56 million of savings in the fourth quarter and $165 million of savings for the full year, representing 37% of the expected $450 million total program savings.

Now, let me discuss a few of the line items outside of operations on slide 14. Interest income increased $4 million to $7 million for Q4 compared to the prior quarter, reflecting additional income earned on the balance of proceeds from the sale of the outsourcing business. As I noted last quarter, higher cash balances in the short-term have resulted in additional interest income, but balances are coming down through the deployment of capital such that we would not expect the same level of interest income going forward.

Interest expense increased $1 million to $71 million in Q4. Other expense of $19 million primarily includes a loss on the sale of certain businesses and losses due to the unfavorable impact of exchange rates on the remeasurement of assets and liabilities in non-functional currencies. The prior year quarter reflects $9 million of income, primarily including gains due to the favorable impact of exchange rates and the remeasurement of assets and liabilities in non-functional currencies.

Further, as I noted earlier, beginning in Q1 of 2018, we will adopt a new accounting standard that will shift the financial components of net periodic pension expense and net periodic post-retirement benefit cost from above the line in compensation and benefit expense to below the line in other income expense. You could see the historical impact in our restated pro forma financials for 2016 and 2017 on pages 15 to 21 of the press release schedules or in Appendix D of the presentation.

Based on current assumptions, we believe that approximately $10 million per quarter is the right run rate to model for other income expense in 2018, excluding all other items we do not forecast that could be favorable or unfavorable in any given period.

Turning to taxes. The adjusted effective tax rate on net income from continuing operations excluding the applicable tax impact associated with certain non-GAAP adjustments increased to 15.5% compared to 12% in the prior-year quarter. The adjusted effective tax rate in both periods reflects a net favorable impact from certain discrete items. The underlying operating rate was 17.9% based on geographic mix of income in the fourth quarter of 2017.

I would note that this quarter includes $345 million of additional tax expense on GAAP earnings that was adjusted from the non-GAAP effective tax rate in the fourth quarter. This amount represents the provisional estimate of the impact of U.S. tax reform based on Aon's initial analysis of the Tax Cuts and Jobs Act and may be adjusted in future periods.

Approximately $260 million of additional expense was incurred as a result of the transition tax related to repatriation of accumulated foreign earnings, and we would expect the cash associated with this expense to be paid out over the course of eight years. The balance of expense occurred in fourth quarter primarily relates to the write-down of deferred tax assets due to the reduction in the U.S. statutory tax rate. We expect that U.S. tax reform will have a modest upward pressure on our effective tax rates. Based on initial interpretation of changes in U.S. legislation, current assumptions of geographic mix of income and impact of discrete items, we believe the best estimate of our full year non-GAAP effective tax rate to be approximately 19%. This legislation is very new and it is possible that there will be further guidance from the U.S. Treasury and others on interpretational application of the new rules. This could result in adjustments to our estimate.

Lastly, weighted average diluted shares outstanding decreased 5% to 254.5 million in the fourth quarter, compared to 268.3 million in the prior-year quarter as we effectively allocate capital. The company repurchased 3.5 million Class A ordinary shares for approximately $500 million in the quarter, and a record 2.4 billion of shares for the full year. The company has approximately $5.4 billion of remaining authorization under its share repurchase program.

Actual shares outstanding on December 31 were 247.6 million and there are approximately 4.5 million additional dilutive equivalents. Estimated Q1 2018 beginning dilutive share count is approximately 252 million subject to share price movement, share issuance and share repurchase.

Now, let me turn to the next slide to discuss our solid balance sheet and financial flexibility. At December 31, 2017, cash and short-term investments decreased to $1.3 billion, including the completion of both the Townsend and UMG acquisitions in the fourth quarter. Total debt outstanding was similar at $6 billion and totaled debt-to-EBITDA on a GAAP basis for continuing operations decreased modestly, 3.2 times. As discussed previously, while debt-to-EBITDA will be initially elevated as a result of the sale of the outsourcing business, we expect to return back to the 2 to 2.5 times range by the end of 2018, driven by operational improvement.

Cash flow from operations for the full-year decreased $1.2 billion to $669 million, primarily driven by $940 million of cash tax payments associated with the divestiture of the outsourcing business, $280 million of cash restructuring charges, and $45 million of transaction costs related to the divestiture of the outsourcing business, partially offset by operational improvement. Free cash flow as defined by cash flow from operations less CapEx decreased $1.2 billion to $486 million, driven by a decline in cash flow from operations and a $27 million increase in CapEx, including investments to deliver our Aon United operating model.

Excluding the tax payments and transaction costs associated with the divestiture as well as the investments in restructuring activities resulting from the divestiture, underlying free cash flow growth was 6% for the full-year 2017. Given the strong organic revenue growth reported in the fourth quarter, higher receivable balances increased working capital in the near-term.

Turning to the next slide to discuss our free cash flow growth over the longer-term. We value the firm based on free cash flow and allocate capital to maximize free cash flow return. This disciplined capital management approach is focused on a decision-making process that maximizes return on invested capital, which we've consistently improved each year since 2010, increasing 610 basis points to 17.8% in 2017. We've also taken significant steps to maximize the translation of each dollar of revenue into the highest amount of free cash flow, including working capital initiatives and actions to manage our cash pension contributions.

Since 2010, we've increased our free cash flow margin by nearly 1,000 basis points. In 2017, free cash flow margin on an underlying basis excluding the impact of the divestiture was 17.8%. Looking forward, we expect two main drivers to contribute to free cash flow growth over the long-term. The first is continued operational improvement driven by organic revenue growth and margin expansion. The second is working capital improvements as we focus on closing the gap between receivables and payables. We expect working capital to contribute to free cash flow by over $500 million over the long-term.

In summary, we finished the year in a position of strength with momentum behind us as we head into 2018. We delivered strong operational improvement and double-digit earnings growth of 17% while continuing to make substantial steps to strengthen our firm over the longer-term, including investments in high-growth areas and in our Aon United operating model.

We believe that continued operational improvement combined with significant financial flexibility and underlying free cash flow generation position the firm to deliver on our near-term goal of exceeding $7.97 adjusted earnings per share in 2018. More importantly, we believe this reinforces our ability to deliver double-digit annual growth in free cash flow over the long-term, reflecting what we believe is the next significant value creation opportunity for shareholders.

With that, I'd like to turn the call back over to the operator for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Dave Styblo of Jefferies. You may now ask your question.

David Styblo
Analyst, Jefferies LLC
Q

Hi there. Good morning, guys. How are you?

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc
A

Hey, good, Dave.

David Styblo
Analyst, Jefferies LLC
Q

Good. So this is arguably the best organic growth quarter you've had in several years, not only from a total 6% standpoint, but also from a well-balanced view, where all the segments are contributing strong performance. And as always, I can appreciate the margin profile and those puts-and-takes but they were up 200 basis points in 4Q and that seems to be almost entirely driven by restructuring savings. And I know you guys have talked about reinvesting some of those savings at certain points. So I guess the question is, did you do that in a material way this quarter? And if not, then why didn't margins expand more given the strong organic growth?

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc
A

Maybe, Dave, a couple of things. We'll hit the growth piece first and then sort of talk about the overall expansion as we think about improving the business overall, which includes restructuring and core. And Christa can talk about that a bit.

First, on the organic side, you're absolutely right, we feel very good. Not just about the quarter, but really about across the year in terms of where we are. And while we don't give specific guidance on expected levels of organic growth, if you look at our history and actual performance to put in perspective, we think that's pretty interesting. To go back and look at – from 2014 and 2015, we were growing at roughly 3% across the board. Now, in 2016 and 2017, that's elevated to 4% and we're doing so in a way as Christa described by investing in higher growth, higher margin areas in M&A and organically as well as improving operating leverage of the firm and that fundamentally is what's going to drive margin improvement overall.

And you're seeing that actually play out. And it's played in 2017, played out in 2016. And we would say, as you go forward and think about organic growth, you're going to see that measured progression into 2018 and 2019. Now, in terms of overall economic leverage and the operations we get out of it, Christa maybe you can talk about the tradeoff between the two.

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc

A

Yeah, and Dave, we're absolutely thrilled with the operational performance in 2017. 15% operating income growth, we're very, very pleased with. As we think about that, 8% operating income growth driven by restructuring savings and 7% growth driven by core operational improvement. As we think about the growth in operating income and margin going forward, it's really going to be a blend of core improvements in operations, restructuring savings, and a return on the investments we've made in M&A because we've really invested over $2 billion in M&A in the last two years.

And so we're driving up operating leverage on a sustainable basis, and you can see that through the accelerated revenue growth that Greg described, so improved top line which is really leading to a much stronger bottom line performance. And you can see that historically accelerating as well. So we're very pleased with 2017, and we believe that we are very well-positioned for a very strong 2018.

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

A

It really does, Dave, put you on track to think about the platform now, higher organic growth, higher margin, higher operating income growth across the board, and we think 2017 proves that out and 2018 will show the same.

David Styblo
Analyst, Jefferies LLC

Q

Okay. Great. And then how do you guys think about the go/no-go decisions for payoffs when you're generating incremental savings from restructuring plans versus making more restructuring investments? And kind of if I take a step back and look at your additional $900 million investment looks like, that was about a two-year – just over a two-year payback from the $400 million of savings. And now, you're spending about another $275 million. It looks like that's going to generate $50 million of incremental run rate savings, so that's more like a – seems like more like a five- to six-year payoff. So can you just help me understand how you guys think through that process of whether to invest and when not to invest for the savings?

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc

A

Yeah, and Dave, it's a great question because we really do think about this as we think about all forms of cash usage on a return on capital basis, cash on cash return. And so, whether we're spending money on share repurchase which is really our highest return on capital opportunity, we spent $2.4 billion on that this year, or its M&A where we spent $1 billion on that. And to spend money on M&A, you've really got to get a higher return on capital than share repurchase which we have across that range of terrific opportunities we've invested in this year or on the restructuring program where we're generating a great return for shareholders.

And so it's a blend of all of these that gets us to return on capital as you can see for the firm at 17.8% in 2017. And so we're driving overall return on capital. And as we think about that restructuring range of initiatives, we're very excited that we found incremental opportunities to generate more savings, overall a $450 million savings outcome in 2019 against $1.175 billion in cash. That's a great return across that portfolio of activities.

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

A

And again, in essence, if you think about sort of where we anticipate ending 2018, as you pull all these together, the operating engine of the platform that Christa described and what we're doing with the operating model, we'll end 2018 again with an engine called Aon with a higher organic growth profile, higher margin, higher operating income growth, higher return on invested capital. And that really is sort of the reason that we undertook all the activities post the divestiture of our outsourcing business to really reinvest and strengthen the firm. So the catalyst we talked about in June is really playing out we think quite effectively as we move into 2018. And we want you think about sort of what we look like at the end of 2018 when we get all these completed.

David Styblo
Analyst, Jefferies LLC

Q

Okay. Thanks. And then just real quick on tax rates, I know you talked about 19% for this year. Previously you talked about perhaps being able to have that drift lower over time. Is there still an opportunity in 2019 and beyond to see that tax rate possibly nudge down a little bit?

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc

A

What we would say is our underlying effective rate was 17.5% for 2017 and we do expect modest upward pressure based on U.S. tax reform. And what we would say is based on what we estimate so far, our best estimate of full year non-GAAP for 2018 is 19%. And we'll always look for opportunities, whether that's tax rates coming down due to statutory tax reductions across the world, and we are very fortunate to be domicile in the UK with a territorial system and a global capital structure where we manage all of that capital and cash on a global basis.

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

A

One of the things, if you look at the punch line for tax rate overall and our history and some of our capabilities in that arena, like the punch line for us is really this is a marginal event overall as you think about all that's written about it.

It doesn't change our views on what we're going to achieve for 2018 as Christa described. It's $7.97 plus. It doesn't change what we're doing from an operational improvement standpoint, all the things we're doing. It really is a marginal event overall in terms of what we're trying to accomplish. And the free cash flow generation of the firm, nothing's changed in the context of any this as we push forward.

David Styblo
Analyst, Jefferies LLC

Q

Right. Got it. Thank you.

Operator: Thank you. Our next question comes from the line of Sarah DeWitt of JPMorgan. Your line is now open.

Sarah E. DeWitt
Analyst, JPMorgan Securities LLC
Q

Hi, good morning.

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc
A

Hi, Sarah.

Sarah E. DeWitt
Analyst, JPMorgan Securities LLC
Q

The increase in the expense savings target, could you just talk about what areas drove that?

And then secondly, at $450 million, it's still only about 6% of cost. So, to what extent do you think there could potentially going to be some more room for further upside?

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc
A

Yeah, so Sarah, as we think about it, we're creating the next-generation global business services model really driven by running Aon as one firm, Aon United, and it's going to drive better scalability, flexibility, and really operating leverage for the firm because we're building in productivity savings as we scale the business going forward.

And really, as we looked across this operating model across the firm, it's really the same three areas that were driving the increased savings in, its IT, its real estate, and its people. And as we bring Aon together really out of the two segments we used to operate in in 2016 into one Aon operating model under Aon United, we're really identifying further savings.

$450 million is our current estimate of savings and that will be delivered in 2019 and we don't see further upside at this time, Sarah. But we'll continue to optimize the model and we're very excited about the progress so far.

Sarah E. DeWitt
Analyst, JPMorgan Securities LLC
Q

Okay. Great. Thank you.

Operator: Thank you. Our next question comes from the line of Adam Klauber of William Blair. You may now ask your question.

Adam Klauber
Analyst, William Blair & Co. LLC
Q

Thanks. Amazon had a big announcement obviously in the health industry. One, are any of those companies your clients? And two, how do you think that will – just on broad strokes, how will that impact the industry over the, like, next five years or so?

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

A

Adam, from our standpoint, we don't talk about clients specifically, although I would say we're in a very privileged position in terms of who we serve across the world. And in terms of sort of what was announced, there's not a lot of clarity on it, but we love the spirit of it. We just absolutely love the spirit of it. You know how much we love this category. It's just such a monumental opportunity, and it's driven out of a set of needs both for companies and their employees which is so high. I mean, you know the statistics.

Overall, health is challenged, bringing the cost of healthcare is going up. The 150 million Americans that we addressed, and this is really a U.S. story principally, although for us it's a global opportunity. But for the 150 million Americans and employee-sponsored plans, there's just substantial pressure everywhere. And our whole mantra, our whole approach has been when you can create greater alignment between employers and employees, greater transparency and give them choice, it leads to better decisions, healthier employees, and lower costs. And we are absolutely excited and in favor of anything that moves in that direction because this opportunity is so massive.

And we've invested very, very heavily and innovated around active employees as well as retirees. And we're, we believe, in a very, very unique position to help shape this outcome and see any movement by companies taking initiative in this arena is just absolutely terrific. So looking forward to seeing how this evolves.

Adam Klauber
Analyst, William Blair & Co. LLC

Q

Great. And then Data & Analytics had clearly a strong quarter. Could you give just one or two examples of the type of wins that drove that very positive number?

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

A

Well, actually, Adam, it really comes across the board. So the Data & Analytics business particularly on the Affinity side has had some exceptional, exceptional wins with clients. And again this is where we're taking segments of clients, understanding sort of overall needs, aggregating those needs, and coming up with very innovative solutions to address those needs. And we've seen great examples of that across the board on the Affinity side.

We also have a business, InPoint is in this category as well. We're actually helping insurers and broader companies think about more holistically how they think about their risk management needs. This is outside the placement. And the consulting and advisory basis have done exceptionally well in that. And as we highlighted before, we also benefited a bit given the activity in the second half of the year on the flood side. So really this is for us – we love this category. There's obviously a category we're breaking out Data & Analytic Services. We want to put a spotlight on it. It will be variable. Sometimes up a lot, sometimes up a little bit. Over time, we think up a lot. And it's an area of substantial investment we're going to make over time. And we think it's going to be beneficial for Aon, for our clients and for our shareholders.

Adam Klauber
Analyst, William Blair & Co. LLC

Q

Okay. And then thanks. Finally for Christa, operating cash at roughly $2.3 billion, $2.2 billion, $2.3 billion in 2016. You're investing the business in 2017, you're investing in 2018. So, by 2019, do you think we get back to those levels or could we possibly exceed those levels by 2019?

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc

A

Yeah, look, we certainly think that's true, Adam. And what we would say is our goal is really double-digit free cash flow growth over the long-term. And we're obviously driving improved return on capital on a cash-on-cash basis driven by strong operational improvement, restructuring savings and the return on the investments we're making in M&A. And so we feel all three of those are going to contribute to strong free cash flow growth, combined with working capital improvements which are going to be substantial, over $500 million over the long-term.

Adam Klauber
Analyst, William Blair & Co. LLC

Q

Okay. Great. Thank you.

Operator: Thank you. Next question comes from the line of Yaron Kinar of Goldman Sachs. You may now ask your question.

Yaron Kinar
Analyst, Goldman Sachs & Co. LLC

Q

Good morning, everybody, and thanks for taking my call. So my first question is with regards to the reiteration of the $7.97 EPS target for 2018, the adjusted EPS. And I guess if I look at the net impact of tax reform and the $50 million of additional cost saves, not all of which I'd expect to flow through in 2018, I think it gets a net negative impact between the two. So I'm just trying to better understand what else is driving you to feel so comfortable in that $7.97 or exceeding $7.97 target.

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc

A

Yeah, it's a great question, Yaron. And what we would say is we delivered 17% EPS growth in 2017 including a headwind from both a higher effective tax rate and significant onetime impacts in other expense year-over-year. Our underlying effective tax rate was 17.5% for 2017. So you've got a modest upward pressure based on unforeseen changes in U.S. tax reform. But despite the modestly higher tax rate of 19%, we believe strong operational performance, savings from our Aon United operating model, returns on the investments we've been making in high growth, high margin M&A areas will continue to reinforce our confidence in exceeding $7.97 per share in 2018 and delivering double-digit free cash flow growth over the long-term.

Yaron Kinar
Analyst, Goldman Sachs & Co. LLC

Q

Okay. So it sounds like it's maybe more of a margin improvement story given the investments you've undertaken?

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc

A

Absolutely. I mean it's operating income growth and it's operating income growth coming from the core, coming from restructuring, and coming from the M&A investments we've made in high growth, high margin areas.

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

A

Understand as well what we're doing on the One Aon approach on the operating side that Christa described is creating operating leverage in our business. This isn't just about a dollar tax save, this creates greater operating leverage. So, as we grow organically, we get disproportionate benefit from that. And then, if you think about sort of the investments and acquisitions and higher growth, higher margin areas, all of these things come together to give us the confidence that Christa described.

Yaron Kinar
Analyst, Goldman Sachs & Co. LLC

Q

Okay. And then with regards to free cash flow generation, so you have a long-term target of double-digit growth. If I think of, let's say, the next year, do you think it's reasonable to expect that level of growth in 2018 on an underlying basis?

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc

A

Yeah, I mean, what we would say, Yaron, is we're looking at double-digit free cash flow growth over the long-term, so that's every year over the next couple of years. And what we would say is it's driven by – 2018 is absolutely going to improve. I mean, you saw 6% underlying free cash flow growth in 2017. And really, it was actually looking much higher and really driven by very strong organic growth. In Q4, we had slightly higher working capital. And so you can see that you're generating then even in 2017 with everything going on, and we think 2018 will improve. And 2019, 2020, and 2021 will continue to accelerate from there.

Yaron Kinar
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Got it. And one final question. Just you have very strong growth in the reinsurance brokerage business, can you maybe walk us through your thoughts as to the ILS market in 2018? I think we've seen a lot of replenishment of capital over the last quarter and a bit. How do you see that market develop over the course of this year?

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

A

Yaron, well, first of all, we had a remarkable year in reinsurance. Our colleagues just have done a terrific job sort of in that category. As you know, we are number one in treaty. We're number one in fac. We're number one in ILS and make another additional investment sort of outside that set of arena. So it really was a remarkable year, and we actually had progress on the organic side in all categories. It wasn't just one category. And we also continue to make substantial sort of investments across the board to sort of strengthen our Data & Analytics in the context of that.

So, against that backdrop, and when you think about sort of the ILS market, number one in that marketplace, that performed exceptionally well. If we look at it now, there's about $600 billion in global reinsurance capital overall, and alternative capital increased to about $82 billion, give or take. So it's kind of 14%, 15% of the overall global reinsurance capital pool and we saw a terrific performance there.

And again, our colleagues were just absolutely remarkable in both the level and quality of work they did throughout 2017 and actually into 2018 as we watch capital come back in, the ILS market come back in and replenish losses. So you're right. It just was a remarkable year for us on the reinsurance side across the board included in the ILS world.

Yaron Kinar
Analyst, Goldman Sachs & Co. LLC

Q

And do you have any thoughts with regards to how that continues to develop in 2018?

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

A

Well, listen, if you think about growth overall for us in 2018 and you mentioned growth at the beginning, and I would sort of stay sort of in that context, we're going to continue to make progress. As I mentioned, we had some small benefit in terms of sort of the reinstatements that happened sort of at the end of the year. So there was a bit there, but we really saw growth in all the different areas I described before. You'll see a continuation of growth across Aon. I think we always think about it from an Aon standpoint, 3% in 2014 and 2015, 4% in 2016 and 2017, and you'll see that trend continue as we move into 2018.

Yaron Kinar
Analyst, Goldman Sachs & Co. LLC

Q

Thank you. I appreciate all the color.

Operator: Thank you. Next question comes from the line of Meyer Shields of KBW. Your line is now open.

Meyer Shields
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks, good morning.

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

A

Hi, Meyer.

Meyer Shields
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Sort of a snowball question. When you've got reinstatement premiums driving, to a limited extent, reinsurance organic growth, are there any expenses offsetting those incremental revenues?

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

A

There are some. I mean, again, I would think about this more holistically. We've got the level of service required and the complexity of what went on sort of at the end of the year is just absolutely astronomical. So the things that caused those, so there's an ecosystem that sort of comes together in sort of the service of the client, the payment of claims, the movement of service overall.

So, for us, this kind of all blends together, so there's a little bit of potentially some upward pressure or upward benefit on the margin side. But I wouldn't overplay that, nor would I overplay the impact of the reinstatements. They were there. They were real. But when you think about performance overall, it was really driven by fundamentals on the reinsurance side.

Meyer Shields
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Okay. That's helpful. And then I guess this is for Christa. Can you walk us through, I guess, directionally how changes in interest rates affect or interact with the new pension accounting?

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc
A

I'm not sure. Meyer, just say a little bit more about your question because, obviously, interest rates, if interest rates were to rise, they have a positive benefit to our pension on funded liability and pension contributions over time. A 100-basis point increase in the discount rate, which is really equivalent to AA corporate bond rate, reduces our pension on funded liability by about $400 million. And so, I mean, I don't know if that's helpful or what you were looking for.

Meyer Shields
Analyst, Keefe, Bruyette & Woods, Inc.
Q

It is. I just want to put that into context of the new standards, I mean above the line versus the below the line items.

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc
A

Sorry. There's no impact on the above the line, below the line. It's just a movement in the location of the P&L. It used to be in comp and benefits. It's now in other income and expense. There's no change to the absolute dollars on the P&L and we have given guidance that what you should expect in other income and expense on that pension-specific item is about $10 million in expense a quarter.

Meyer Shields
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Right. Pardon me, so just to close the loop, if interest rates continue to rise, then obviously – or I'm asking, not obviously, that would benefit the expenses going forward.

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc
A

Yes, it would.

Meyer Shields
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Okay. Thank you very much.

Operator: Thank you. Next question comes from the line of Elyse Greenspan of Wells Fargo. You may now ask your question.

Elyse B. Greenspan
Analyst, Wells Fargo Securities LLC
Q

Hi, good morning. My first question, you guys saw a pretty strong pickup in growth in commercial risk. I think there was some timing move from the third quarter. If you could just give us kind of a little bit of an outlook in that business and would you expect you guys pointed to a stable market impact overall in the fourth quarter. Would you expect exposures and prices to move when we think about the market impact for 2018?

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

A

Yeah, so Elyse, a couple of perspectives. First on commercial risk and again, remember, we're breaking out commercial risk differently than anyone else. So we used to have all these together, now we're breaking up this specifically. We'd encourage you to look at that over the course of the year and you see 2017 is continuing to progress over 2016. Our colleagues did a terrific job. Net new business generation was at record levels, so really terrific on the commercial risk side.

And from a pricing standpoint, to your question, we would say, look, all in, as we look at our overall book and we calculated down to the individual risk, exposures were modestly positive as we described. Pricing was marginally negative still, marginally negative leading to relatively stable market impact overall. I would observe, as we said before, insured values are what's most important. They drive more of the economic impact than anything else. And as we observe the global economic environments, we believe it looks slightly better in 2018 than it is in 2017 which has positive implications.

But I would emphasize as we continue to do our work and make our investments in Data & Analytics, it means we're evaluating risks at a very detailed micro client level, which we believe enables much better outcomes in pricing in terms of conditions for our clients and ends up being much less about the state of the market and more about individual client dynamics so that that drives sort of what happens for us overall. And there's no better example for us than Aon Client Treaty and sort of what we've done there. The investments in these kinds of capabilities, we think, create great outcomes for clients. Again, analyze at the individual level and Aon Client Treaty as an example has got 1,800 clients. So there are now 3,800 placements. The clients are up 25% and was probably totally their choice. They're seeing an outcome and an opportunity which is much better for them.

And so it's less about the overall market and where they are specifically. We even had a client, an energy client, a Caribbean energy client that, frankly, had undergone some trauma, was worried about literally where they were going to come out in the overall process through Aon Client Treaty and other analytics. They end up actually at roughly stable pricing with very strong terms and conditions and absolutely thrilled sort of with the overall outcome. So I just want to put in perspective on how we think about sort of the overall market environments, much more client than market.

Elyse B. Greenspan
Analyst, Wells Fargo Securities LLC

Q

Okay. Thank you. And then in terms of the tax rate outlook on the 19% going forward. Does that – Christa, does – I know in the first quarter of last year, there was obviously a benefit from stock comp. So, when we think about the 19%, is that excluding if we can see any kind of benefit from the stock comp accounting in the first quarter and kind of ex any other discrete items?

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc

A

At this stage, Elyse, it is all encompassing. What we would say is it's based on our initial interpretation of changes in U.S. legislation, current assumptions of geographic mix and impact of discretes. And therefore, that's our full-year non-GAAP effective rate at 2019. And then based on what we see during the year, discretes could be up or down.

Elyse B. Greenspan
Analyst, Wells Fargo Securities LLC

Q

Okay. Okay. Great. And then another question, in terms of you guys raised the savings program by $50 million this quarter, but the cash charges did go up by $275 million. I'm just trying to understand, if we think about those two numbers together, why is it taking $275 million of additional charges to yield $50 million of additional saves and basically reducing the yield on the charges of the entire program? What kind of drove, really drove the higher cost with the $50 million this quarter?

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc

A

So, Elyse, we don't really think about it that way. We think about it as an overall portfolio of the program. And therefore, we think about $1.175 billion in cash driving $450 million in savings, which is a terrific return on investment. As I said earlier on restructuring, we do really think about restructuring, share repurchase, M&A, any kind of cash investment on a return on invested capital basis cash-on-cash return. And so we're looking at this cash-on-cash return and saying that is an exceptional return and we identified further savings and we thought that it made sense to deliver those savings. And so that's really how we're managing this on an overall portfolio basis as opposed to the incremental way in which you described it.

Elyse B. Greenspan
Analyst, Wells Fargo Securities LLC

Q

Okay. Great. And then one last question. The share repurchase, obviously, it's been volatile a bit this year just given some of the acquisitions and when they closed, how should we think about the level of share repurchase going forward for 2018?

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc

A

So, first of all, we don't give guidance on share repurchase. What we can say is we've got a strong balance sheet, cash and short-term investments, $1.3 billion at year end 2017. We're generating strong free cash flow growth due to operating income growth and working capital improvements as we said. And we look at allocating capital based on the highest return on capital. And share repurchase remains the highest return on capital activity across Aon, which is why you saw us do $2.4 billion of share repurchase in 2017, and we expect to continue share repurchase 2018.

Elyse B. Greenspan
Analyst, Wells Fargo Securities LLC

Q

Okay. Thank you very much. I appreciate the color.

Operator: Thank you. Next question comes from the line of Kai Pan of Morgan Stanley. Your line is now open.

Kai Pan
Analyst, Morgan Stanley & Co. LLC

Q

Thank you, and good morning. So just a follow-up Elyse's question on the share buybacks, and just working through my math about the 2018 free cash flow, is that like you adding back the $940 million of onetime, like, tax payments? In 2017, we got $1.4 billion. Is that run rate – like a baseline run rate, is that correct way to look at it?

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc

A

I mean, they're obviously from onetime cash outlays, Kai, in 2017. The two biggest ones were the $940 million of cash taxes, as you said, and the restructuring charges. And so, look, what I would say is you saw underlying free cash flow growth of 6% in 2017. There were some onetime items that you should back out to get your run rate, and then we do expect strong free cash flow growth in 2018, driven by strong operational performance in the core, restructuring savings, return on the investments we've made from M&A, and improvements in working capital.

Kai Pan
Analyst, Morgan Stanley & Co. LLC

Q

Okay. So, if we do the math, so the all-important four starting points, you're going to spend similar amount or we'll leave it even more, a little bit more on the restructuring cost, then you grow double-digit on that, and then you take out $400 million dividends, how about more than – a little bit more than $1 billion spend between acquisition and buybacks, which will be significantly less than what have you seen in 2017.

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc

A

Kai, I'm not going to give guidance on free cash flow for 2018 because we don't give out that number. What I can say is we do expect strong free cash flow growth in 2018. We do have elevated cash and short-term investments on the balance sheet $1.3 billion leftover from the cash in the transaction. Obviously, we expect to generate substantial free cash flow in addition to the cash and short-term investments we have on the balance sheet to drive overall deployable cash in 2018. We believe the highest return on capital activity to use that cash is share repurchase. And what we expect obviously to look at M&A, we've got a terrific M&A pipeline and to continue organic investments as we have in 2017 in high growth areas of the business.

Kai Pan
Analyst, Morgan Stanley & Co. LLC

Q

Okay. That's great. My follow-up is on a different topic on the FCA investigation. If I heard it correctly, you mentioned that there is some reduction in term of regulatory-related costs in the quarter. Could you explain a bit what's behind that? And also, do you have any updates on the FCA investigations? Thanks.

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

A

Why don't I start just overall and Christa can talk specifically about sort of what we did in the quarter because I think it's an indication of sort of how we feel about the process overall at this point. First, we would highlight, we welcome the opportunity to assess ways to make our industry more effective and responsive to clients. Fundamentally, that's what this is all about. I would observe three things sort of in the context of this.

One is around the client imperative and what this all means. The second is kind of the size of our work in this area, Aon's work in this area because it seems the numbers don't quite make sense to us. And then overall profitability and the impact that this might have in London, that's been written about too, which also don't seem to square. We told you the facts.

But the most important piece of this is the clients. In all aspects of what we do, have to focus on client value and client centricity. Really, it's the reason our industry exists and why Aon exists. And we invest in huge amount in this area to innovate for our clients. [indiscernible] s58:48) got to drive value for our clients, be fully transparent to them in our approach, and also be optional in every respect. They've got to be able to decide whether they want to be in the approach or out of the approach.

And as I described before, Aon Client Treaty is a great example. We spent years developing the analytics behind it and we're able now to look at our book of business risk by risk, then aggregate it to the portfolio level. This creates enormous benefit for our clients, and by the way, 1,800 have opted into this, their choice. It's grown by 25% in 2017, coming up on 4,000 placements, I think 3,800 placements.

Let me give you the example of the Caribbean energy company. I kid you not, this company was in a situation where it was really struggling in terms of what the risk program was going to look like going forward and to be able to take advantage of Aon Client Treaty, 20% guaranteed capacity, literally fully set on followed price, followed form, followed claims from a lead carrier, it was incredibly helpful even more so maybe a lifesaver in terms of how they thought about it. So very, very positive and would highlight what we do there is a lot of service, a lot of activity underwriters used to do. So we do the underwriting, the policy issuance, the administration, et cetera. And so the carrier doesn't bear that cost, we do. What I'm really trying to highlight is one point around the client imperative of this.

And the second is just the size of our work in this area, I'll just highlight for the perspective on this call. I'll put everything into this category called facilities although we would argue Aon Client Treaty is a long way from a classic facility. And the amount we placed in the London Market amounts to less than $40 million in revenue just for reference which is sort of a lot of stuff has been written but that's the facts.

And then finally, the one I find most interesting is sort of that the overall profitability is impacting the London Market operating costs. Just for reference just not factually correct, if you look at sort of – so everything in, our overall benefit, what we get paid is we place premium in the London Market, that yield, so numerator over denominator, very straightforward, everything in including the cost of Aon Client Treaty, everything, it's basically been flat for the last five or six years. So there's no kind of supernormal return here when you put everything together and anything we get extra sort of on the Client Treaty piece, again, we're investing heavily to actually do services that underwriters used to do.

So, for us, the most important piece to this whole thing is where I started was we just see such great value for clients and getting our risk placed and getting our claims paid, this is an area of substantial investment for us. And we absolutely welcome the opportunity to assess how we can make our industry more competitive on these fronts.

Now, against that backdrop, the punch line of that is, if you ask us, how do we assess our risk, is it going up or down, Christa, maybe you can talk about the action we took in the quarter.

Christa Davies — A
Chief Financial Officer & Executive Vice President, Aon Plc

Yeah. And so what you saw in the quarter, Kai, was that we took a reduction of $14 million in charges related to certain UK regulatory and compliance matters as we believe our UK regulatory risk is less than we previously anticipated.

Kai Pan — A
Analyst, Morgan Stanley & Co. LLC

Really appreciate all the colors.

Operator: Thank you. Next question comes from the line of Paul Newsome of Sandler O'Neill. You may now ask your question.

Jon Paul Newsome
Analyst, Sandler O'Neill & Partners LP

Q

Just wanted to see if you could give us a little bit of color about the margin impact on the acquisitions that you've made, whether or not we should see a little compression or a little expansion related to the acquisitions themselves and if those impacts would change over time. One of your peers talked about sort of margin compression because of that.

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc

A

Paul, that is exactly right. I think what we observed in the first year of an acquisition is margin compression. And you saw in the quarter, we closed two fantastic acquisitions, the Townsend Group and UMG. And we certainly saw margin compression in Q4 due to acquiring those businesses. And so what you usually see is margin compression in the first year and then they contribute to margin expansion and operating income growth in the years thereafter. And really, the reason for that margin compression in the first year is just the transaction cost to close the acquisition.

Jon Paul Newsome
Analyst, Sandler O'Neill & Partners LP

Q

So, if it's just acquisition costs, presumably, you're essentially putting businesses on that the – that have this underlying same margin as opposed to trying to buy something that you're going to expand the margins on.

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc

A

Yes, and we are obviously investing in higher growth, higher margin opportunity areas. And we certainly see that that was the case in 2016 and 2017. And then as you bring them into Aon, we can really scale those businesses to expand margins over time.

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

A

One of the realities, Paul, for us is as you think about the foundation of the return on invested capital approach that Christa described, and we take, in every investment of capital we make, we don't invest just to get bigger. Ours has to be, we're bringing in content that we can scale. And in doing so, we create we think superior economic value. Christa was describing the transition cost of doing that, and what you've got the fees, et cetera, up front. But there's no business we bring in to sort of say we're just going to continue to have a performance that's performed. We're taking their business and scaling it across Aon or finding ways to improve that business based on Aon assets. And that fundamentally drives the return on invested capital approach we take. Otherwise, we don't make the acquisition because buyback looks better.

Jon Paul Newsome
Analyst, Sandler O'Neill & Partners LP

Q

Fantastic. Congrats on the quarter.

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc
A

Thanks.

Operator: Thank you. Our last question comes from the line of Brian Meredith of UBS. You may now ask your question.

Brian Meredith
Analyst, UBS Securities LLC
Q

Hey, thanks. A couple of quick ones here for you. First, Christa, just I believe you give what your kind of free cash flow baseline for 2017 is in the presentation. That's like $1.8 billion. Is that correct? Appendix G give us $1.778 billion.

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc
A

Yes, that's right.

Brian Meredith
Analyst, UBS Securities LLC
Q

Okay. So that's what we should kind of use as a baseline here kind of as we're looking forward, okay.

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc
A

Yeah.

Brian Meredith
Analyst, UBS Securities LLC
Q

Second quick question. I'm just curious when you think about the expense saves and stuff kind of going forward, the kind of benefits, what are you thinking about, Greg, as far as wage inflation because we're definitely seeing some upward pressure on that going forward?

Christa Davies
Chief Financial Officer & Executive Vice President, Aon Plc
A

Yeah, Brian, one of the things we would say is, we normally expect wage inflation, let's call it, 2% on your biggest expense base called people. What we would say though is we're obviously investing a significant amount of money $1.175 billion in the Aon United operating model. And the reason we're investing that kind of money to drive $450 million of savings is because we're trying to get better operating leverage throughout our business and improve productivity going forward. And so we expect the investments we're making in the operating model to offset some portion of that wage inflation to give us greater operating leverage in our business going forward.

Brian Meredith
Analyst, UBS Securities LLC
Q

Okay. Great. And then last question, Greg and Christa, could you talk a little bit about Stroz Friedberg. How has that kind of performed for you since you bought it? And then also, I know you were looking to kind of develop a bunch of insurance products around cyber with Stroz Friedberg. Can you talk about progress there? How is the market accepting it, et cetera?

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

A

Brian, for us, we love this investment and it really just speaks to what innovation means and how one pursues it. Again, if you step back and think about the overall cyber marketplace just for reference, pick your number $2.5 billion, $3 billion of premium in 2017 give or take. By the way, going up substantially so the industry is celebrating, we've got a category, it's new, it's going up, it's terrific. By the way, Aon places as much or more than anybody in the marketplace. We've got an incredible group of colleagues who've driven this and led this.

Having said that, our colleagues will be the first to say, look, when you think about client need, client need and our ability to meet their increasing needs on cyber, take your number, it's $450 billion of loss connected to related to cyber in 2017. So, think about it, Brian, $2.5 billion to $3 billion in premium, $450 billion in reported loss connected thereof. And by the way, just for reference that includes roughly zero for Europe because they didn't require you to report cyber losses.

That obviously changes in May, June of this year when GDPR kicks in and the regulations require cyber loss reporting, which means cyber loss on a global scale is going to $1 trillion and yet where is our industry. And by the way, we're the leader. Our industry is $2.5 billion to $3 billion. We're not meeting the needs of our clients. So we said, listen, what's the root cause of that? How do we understand that? And that's why we brought in Stroz Friedberg. This was not a set of colleagues who knew insurance, but they knew cyber better than anyone in the world. They do cyber remediation, identification. They work with boards extensively. They've got a database of 45,000 cyber events and growing every day.

So, if we could actually help capital underwriters understand where and how to address cyber, we would end up with a much better set of products on behalf of our clients. And we're seeing great uptake in terms of sort of that. It's going to take time, no doubt. It's not an easy thing to do. But watch the press and you'll see some announcements over the coming bit of time that we think will be interesting in terms of sort of innovations. But it will be steps at a time, Brian. It'll be progress.

One thing is for sure. If we, as an industry, don't innovate on behalf of our clients in the topic of cyber, they will leave us behind. And so, we have got to be on front of it, and Stroz Friedberg is a great example of how you get out in front of it as well as bringing in other capabilities that we have around the firm. So we're excited about it. It will take time. It will take energy. But a credit to my Aon colleagues who really sort of embraced that challenge and are working it through and we're excited about it for our clients.

Brian Meredith
Analyst, UBS Securities LLC

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Great. Thanks.

Operator: Thank you. I would now like to turn the call back over to Greg Case for closing remarks.

Gregory C. Case
President, Chief Executive Officer & Executive Director, Aon Plc

Just wanted to say thanks to everybody for taking part today. We look forward to the discussion next quarter. Thanks very much.

Operator: Thank you. That concludes today's conference. Thank you for participating. You may now disconnect.