VIVA AVIVA

AVIVA
£1.2bn equivalent hybrid debt, 14 November 2001

CORPORATE PROFILE
Aviva is the world's seventh-largest insurance group, the largest insurer in the UK and one of the top five life companies in Europe. Its main activities are long-term savings, fund management and general insurance. It has worldwide premium income and investment sales of £28bn from continuing operations and more than £200bn of assets under management.
www.aviva.com

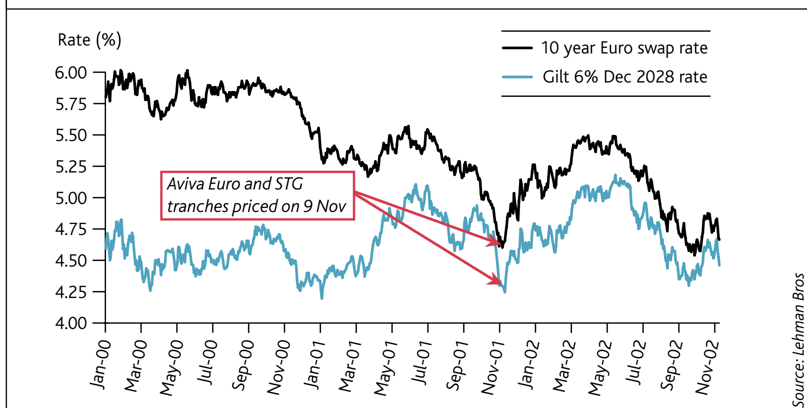
On 14 November 2001, CGNU, since renamed Aviva, priced a £1.2bn (equivalent) hybrid capital issue re-opening the market for insurance companies after the events of 11 September. The dual currency issue of £700m and €800m was the largest UK insurance financing to date and the largest sterling-denominated subordinated issue ever. The two tranches each received 100% equity credit from both the rating agencies and insurance regulator. The transaction enabled Aviva to successfully add a second (hybrid) tier of capital to its balance sheet and reach a whole new group of investors.

SPOTLIGHT ON GROWTH. Unlike many of the deals in the equity and debt capital markets in the past 12 months Aviva did not need to do this deal in November 2001. John Westby, Group Treasurer at Aviva, said "Our objective was to further enhance the group's capital position to support ongoing growth but it was not an imperative per se to raise money at that time." He went on to stress that the rationale behind the merger between CGU and Norwich Union in 2000, was that each group could grow faster by getting together with the spotlight on growth, not cost-cutting. The capital base had been predominately equity with a small proportion of senior debt and nothing in between up to this point (see *Table 1*).

With sound half-year results behind it, Aviva started working on the transaction with its structuring adviser Lehman Brothers. Westby said: "Things were going smoothly with a view to launching at the end of September when the terrorists struck. Credit spreads moved out and the markets became very volatile for a few weeks. Spreads then started to recover and we decided to proceed given the quality of the credit and the internal momentum that had already been built up."

Eamonn Price, Co-Head of Financial Institutions at Lehman Brothers Debt Capital Markets said: "The destabilised market conditions after the tragic events of 11 September made it very difficult for any issuer to launch a transaction. The credit market was disrupted, with insurance company spreads particularly affected. As a result, we decided to sit out of the market for a few weeks and wait until conditions stabilised, spreads tightened and investor confidence returned. Subsequently, the market improved and together with Aviva we decided to proceed. The transaction was very successful and Aviva's market leadership paved the way for other European insurance companies to access the subordinated debt market thereafter."

FIGURE 1
REFERENCE INTEREST RATES



TURNING POINT. Aviva mandated four bookrunners to sell the deal: Lehman Brothers, the co-ordinator and structuring adviser; Barclays Capital for its strength in UK distribution; Merrill Lynch for its pan-European reach; and Société Générale for its access to French investors, where Aviva has a strong local operation. This broad based distribution strategy clearly worked and, of course, gave the banks a great opportunity to go out and re-open the hybrid securities market with a leading blue chip name. It was good for all market participants that the deal was such a storming success, as it proved to be a turning point for the market.

Standard & Poor's and Moody's rated the issue A and Aa3 respectively – the

transaction's high credit ratings were valuable to continental investors unfamiliar with the new name. Both agencies confirmed the bonds standing for equity credit. The Standard & Poor's research report assigning the A rating stated: "The bonds are equity-like for the following reasons: the subordination process provides loss absorption for senior creditors; it is management's intention that these bonds will be a long-term feature of CGNU's capital structure; the management can defer interest and principal if no dividend is paid on equity or no interest is paid on more junior capital." These features are essential for equity credit.

Getting a subordinated issue away for an insurance company adds value because the sub-notes count towards the all-important solvency ratios, whereas senior debt does not. In addition, unlike equity, hybrid debt is tax deductible. The structure was also ground breaking in that it was the first UK holding company to achieve solvency credit under the EU Insurance Groups Directive (IGD) introduced at the end of 2001.

In short, the new rules require solvency to be measured on a group basis to eliminate double leverage that could be achieved through raising debt at holding company level and injecting it as equity into operating subsidiaries. Specific language had to be incorporated to deal with the IGD in consultation with the Financial Services Authority (FSA).

GREAT RECEPTION. Aviva was looking to raise the equivalent of £1bn equally from the long-dated sterling and euro markets but created overwhelming interest particularly in the sterling book. The sterling notes were increased by £200m to a final take of £700m, the maturity was extended from 30 to 35 years, yet the margin tightened by 5bp to 185bp over gilts. A great reception for a debut issue. The euro portion was also in hot demand, coming in twice oversubscribed, but Aviva resisted the temptation to increase the size keeping it at €800m for 20 years at a slimmer rate of 112bp over mid-euro swaps, three points in from the talk (see *Table 2*). The overall funding cost came in just under 6%. Westby said: "Getting an after tax cost of capital at just over 4% was a very satisfying result."

The bonds both have non-call periods, 10 years for the euro and 25 years for the sterling tranche and at these two points 10 years before maturity the coupons step up 100bp. Who knows where markets and rates will be then, but surely the sterling call will not be on Westby's radar screen.

Aviva got its timing right for more than one reason. The level of demand waiting to back a good story was boosted by a wave of fixed income redemptions, meaning there was lots of money around. And not only did the company manage a benchmark issue in each currency with its newly merged identity, it was first off the block re-opening the market for others. But take a look at the reference interest rates in *Figure 1* and see where Aviva priced the euro and sterling deal.

COMMITMENT FROM THE TOP. Two teams comprising the CEO, CFO, Westby and David Butler, the Deputy Group Treasurer, simultaneously took the roadshow to London, Scotland, the Netherlands, France, Germany, Denmark and Italy in five-man days through to the Wednesday. The presence of the big guns was particularly well received by investors and turned the heat up for pricing before the books opened on Thursday, closing Friday, 16 November. It was unusual at that time for such senior management to go out on the road. Price said: "Aviva again demonstrated its market leadership by showing the highest level of commitment to fixed income investors."

The roadshow had two distinct flavours, although the presentation material and disclosures were identical. Westby said: "We take differential disclosure very seriously." In the UK, Aviva was presenting to its peers – life companies with a natural appetite for -dated sterling assets and, of course, it has a good understanding of the nature of the business and the credit.

Westby said: "Today, investors are more sophisticated. Rather than thinking they shouldn't help a competitor through purchasing hybrid securities, they now focus on grasping the opportunity to book a quality credit."

Across the water there was more to achieve in selling the name and explaining the business since the UK notion of 'with profits' is not well understood. The presentations obviously did the job, as the final distribution proves and more than 170 quality orders were received between the two tranches. Aviva said it has no immediate plans to return to the hybrid market but with such a successful debut it must surely be up for more.

TABLE 1
PRINCIPAL TERMS OF THE NOTES

Amount	Term	Marketed at	Margin	Fixed coupon
700m	35 years (non-call 25 yrs)	190bp for 30 yrs	185bp > gilts	6.13%
€800m	20 years (non-call 10yrs)	115bp	112bp > mid swaps	5.75%

Bookrunners: Barclays Capital, Societe Generale, Lehman Bros, Merrill Lynch

TABLE 2
AVIVA'S CAPITALISATION AS AT 30 JUNE 2002

	£m	%	%
Shareholders' funds	12,140	78%	91%
Subordinated notes	1,185	8%	9%
Total capital, reserves and subordinated notes	13,325		100%
Long term borrowings	2,254	14%	
Total capitalisation	15,579	100%	

JOHN WESTBY'S RECOLLECTIONS.

- Discovering on the roadshow that the group's UK household insurance division buys enough carpet each year to cover the Isle of Wight!
- Establishing two benchmark deals for our newly merged group, now called Aviva.
- There were few precedents for using four bookrunners. The way they worked together as a team throughout the whole process from structuring to execution, exceeded our expectations.