WHEN TIMING IS EVERYTHING

RAISING EQUITY IN A TURBULENT MARKET WAS A BRAVE STEP FOR LEGAL & GENERAL, EXPLAINS **JOHN WHORWOOD**, THE COMPANY'S GROUP TREASURER. SHEELAGH KILLEN INTERVIEWED HIM.

These are difficult days for the insurance sector. Over the past few years, general insurers' results have been hit by a number of issues ranging from the effects of global warming and climate change to the costs of longtail liabilities such as asbestos claims. The increased threat of terrorist activity has also greatly affected the industry. Many general insurers have reported underwriting losses and the insurance cycle is now set firmly in a 'hard market' of increased premiums.

The life business, which looks set to benefit from an ageing population and decreased reliance on state retirement provision, has been beset by low interest rates, adverse publicity surrounding 'with profits' products and a third consecutive year of devastating falls in the equity market. Why then would Legal & General (L&G) choose September 2002 to approach its shareholders with a substantial rights issue? Hardly, one would think, perfect timing. Yet timing, according to Group Treasurer, John Whorwood, was one of the key drivers in the decision to launch the issue.

CAPITAL GROWTH. The L&G management team had recognised some time previously that, as many of its competitors adopted defensive strategies to weather the storm of adverse market conditions, the company's relative financial strength (it maintains a AAA long-term rating) meant it was well placed to use its capital to increase its market share and write more highly profitable business. For some years, the group had been positioning for above market growth with new marketing initiatives, not least strategic distribution partnerships with Barclays and Alliance & Leicester, and planning for this continued expansion indicated that a significant inflow of capital would be required within the next five years. Accordingly, there was strong commitment to an ongoing funding programme to underpin this strategy.

SENIOR CLASS. L&G's previous issuance programme had been primarily centred on senior debt, including a £525m senior convertible bond issue in November 2001. The company was the first insurer to launch a global medium term note (MTN) programme in 1992 and, at the end of 2000, chose this to raise further funds. L&G selected senior debt at that time because, according to Whorwood, the company "had capacity to do that whilst still staying within our rating and it was the lowest cost". Thereafter, sterling senior debt issuance continued in long-dated tenors (out to 30 or 40 years) on an "opportunistic basis" against a fixed rate target. The debt was raised in the group holding company with a view to the resulting proceeds being passed down to the operating company by way of subordinated debt. This structure

BOX 1

John Whorwood - Career Overview

1975 -79

Graduate development programme (degree in metallurgy) – Air Products
Qualified CIMA
Treasury Manager, Air Products
Joined Association of Corporate Treasurers (MCT)

1979 -86

Assistant Treasurer, Rio Tinto
Secondment to CRA, Melbourne (Australian mining subsidiary of Rio Tinto)

1986 - 1987

Deputy Treasurer, Rio Tinto

1987 to date

Group Treasurer, Legal & General

BOX 2
Rights issue – deal summary

Issuer	Amount	Type	No of shares	Offer price	Pricing date	Record date	Exchange	Advisors and principal underwriters
Legal & General	£804m	Rights offer (13 for 50)	Up to 1,341,575,618	60p	9 September 2002	19 September 2002	LSE	UBS Warburg, Dresdner Kleinwort Wasserstein
Legal & General	£75.2m	Sale of rump	71.6m	£1.05	23 October 2002	-	LSE	UBS Warburg, Dresdner Kleinwort Wasserstein

BOX 3
Legal & General. Key treasury facts

- FTSE top 50 company with 7,800 employees and 3.6 million customers
- £120bn of funds under management worldwide in June 2002, 60% for external clients
- $2bn ECP progamme
- £2bn Euro MTN programme
- Legal & General Group Plc rated by S&P AA long term and A-1+ short term counterparty credit (outlook negative) as at 29 January 2003
- Legal & General Assurance Society (LGAS) rated by S&P AAA long-term counterparty credit and insurer financial strength (outlook negative) as at 29 January 2003
- Estimated gearing at 31 December 2002, 25%

satisfied regulatory capital criteria in the operating subsidiary. However, by the spring of 2002, the group was reaching the regulators' limit at that time on the amount of capital which could be structured in this way (although a higher figure now applies). This resulted in the group being obliged to look at raising some form of hybrid capital.

While L&G considered its options and entered into discussions with its regulator, the Financial Services Authority (FSA), and the rating agencies, conditions in the debt markets moved against the company. The volatility in equities raised credit concerns surrounding the insurance industry and spreads ballooned out. Standard Life, by continuing to issue at these increased spread levels, set a comparative benchmark for insurance company hybrid debt which would have made an issue by L&G appear just too expensive when analysing "the historic normalised differential between senior and subordinated debt", according to John.

Attention then turned to the possibility of equity issuance. As John explained, projections for growth indicated that the full amount of required capital could not be raised from hybrid sources and that, although L&G's capacity for senior debt would increase with business growth, there would still be a need for an equity injection in the medium term. An equity issuance would also further bolster the financial strength of L&G at a time when creditworthiness was potentially a valuable corporate differentiator in new business acquisition. As it was clear that the company would need to raise equity finance at some point, "the question was," he says, "do that first, or later."

CARPE DIEM. This is where timing became a major factor. If the decline in equity prices was to continue, there was the possibility that less well-capitalised insurers might be driven to the equity markets in attempts to shore up their solvency positions. L&G therefore felt that an early move to tap the equity market would both guard against erosion of investor demand for the insurance sector and clearly differentiate L&G's strategic growth proposition from any subsequent sector issuance motivated by financial distress.

While recognising the slightly higher costs associated with the use of equity finance against subordinated debt, a rights issue appeared justified, bearing in mind these market-driven issues and both the commercial flexibility and subsequent increase in low-cost senior debt capacity which it offered. As Whorwood explains: "We would move to fill capacity in various forms of [hybrid] capital at some stage, but why not pick off this now to actually give us the greatest flexibility? Our thinking was 'let's get the equity under our belt before others who are in a more desperate state come to the market and set the tone and pricing for what we want to do'."

DIFFERENT STROKES. Once the decision to undertake the rights issue had been made, differentiating L&G's proposition from that of less secure insurers was a key element of the company's message to shareholders. The company offered evidence of impressive revenue growth (sales of its individual life, pensions and investment products were up 11% in the July and August immediately preceding the announcement of the issue), whilst demonstrating its readiness for the challenges of the simplified, low margin products, which the Sandler Report sees as crucial in closing the UK savings gap. The group has made significant investment in technologies and systems to support its business and has taken action to streamline its cost base. The split of L&G's business between general and life insurance also favours longer-term growth, with more than 90% of revenues derived from more stable life products. The general insurance division is focused on personal lines and is designed to complement the life business by offering clients a comprehensive product range.

‘THERE WERE ONLY ABOUT “TWO WEEKS FROM DECISION TO GO”, WHICH GIVES AN INDICATION OF THE EFFICIENCY WITH WHICH THE RIGHTS ISSUE WAS PUT TOGETHER’

L&G has also adopted a conservative approach to fund asset allocations, in particular, by avoiding exotic instruments, and was able to point to positive indications from a Standard & Poors’ review of the asset quality of its fund investments in February 2002. Underpinning these factors was a solid free asset ratio (one of the principle measures of an insurance company’s financial strength), which was maintained even before adjustment for so-called ‘quasi’ assets included by some insurers in computing their ratios.

SAFETY ISSUE. The reasoning behind L&G’s decision to launch the rights issue was generally well received by the market. However, there was some discussion in the press about the size and pricing of the issue. Whorwood confirms that the decision to raise £804m was based on striking a balance between the projected capital requirements of the company’s business strategy with the perceived appetite for the issue in the market. While the possibility existed to either marginally increase or decrease the issue size, in consultation with the company’s advisers, it was felt that the 13 for 50 issue would achieve an optimum reception among shareholders.

John also admits that volatility in the stock markets led the group to take a ‘belt and braces’ approach to ensuring that the rights issue was successful. This involved deciding both to have the rights fully underwritten and to offer a substantial discount in the rights price. The new shares were offered at 60p per share, which represented a 46.8% discount to the middle-market price of the shares on 9 September 2002 (at 112.75p). While there was confidence that L&G had an appealing rationale for issuing the rights, it was accepted that the discount offered should not theoretically affect the value attributable to existing shareholders provided they took up their rights. The offer of a slightly more generous discount also served to facilitate the underwriting of the issue in what was an exceptionally volatile market. In the event, L&G’s somewhat conservative ambitions in securing the rights issue paid off, with 95% of the issue being initially taken up and the sale of the rump being three times subscribed.

SETTING THE PACE. A desire for confidentiality fuelled the pace at which the issue was prepared. Whorwood estimates that there were only about “two weeks from decision to go”, which gives an indication of the efficiency with which the rights issue was put together. The group benefited from regulatory exemptions enjoyed by insurers, which meant the working capital exercise required by most companies to support a rights prospectus was not required. John recalls with some satisfaction that he was therefore spared the intensive few weeks that had accompanied a pre-rights issue working capital review at his former employer, Rio Tinto.

Preparation of the prospectus document itself was the responsibility of the finance function, but the Treasury Department was involved in negotiating some of the terms of the deal, particularly in respect of the underwriting agreements. Here, John offers a word of advice to fellow treasurers, urging them to make

BOX 4
Legal & General – corporate milestones

1800s

Society formed in 1836, Society assets reached £4m by turn of century

1920s to 1960s

Commenced writing Fire & Accident insurance
Expanded into the US and Australia
Asset value £1bn by end of the 1960s

1970s to 1980s

Writing of index-linked and unit linked policies
Legal & General Group established
Legal & General Mortgage Services incorporated
Expansion into continental Europe
Initial diversification into estate agency
Asset value exceeded £2.5bn by end of the 1970s

1990-1995

Creation of Legal & General Direct
Joint venture with the Woolwich Building Society
Assets under management in excess of £82bn

1996-1999

LGAS articles amended to allow distribution to be made which better reflected to shareholders’ interest in the UK long-term fund
Sale of commercial lines general insurance business to Guardian Insurance
Legal & General Bank offers deposit accounts; deposits soon total £942m
Website launched

2000 -2001

Assets under management exceed £100bn
First fully online life assurance product application
Entered partnership with Barclays Bank and Alliance & Leicester

2002

Purchased Alliance & Leicester Life Assurance Company
Legal & General Bank Ltd, Legal & General Mortgage Services Ltd sold to Northern Rock
Legal & General launches £804m rights Issue

> 'THE TREASURY DEPARTMENT OPERATES AS A COST SAVING CENTRE AND WHORWOOD DESCRIBES RISK-TAKING IN TREASURY AS "LIMITED AND VERY TIGHTLY CONTROLLED"'

sure to impress on their advisers the need to finalise negotiations in good time and to avoid midnight drafting sessions.

TAKING ADVICE. L&G's advisers and principal underwriters in respect of the rights issue were UBS Warburg and Dresdner Kleinwort Wasserstein. Both banks act as L&G's corporate stockbrokers and Whorwood noted the benefit of such a relationship in bringing an equity issue to market.He admits that, in prospective debt issuance, there is merit in tendering for 'bookrunners' advisers through the now proverbial 'beauty parade'. However, for significant M&A or equity activity, he believes that confidentiality once again is key and that a company is well advised to keep the allocation of business "fairly tight to your closest advisers".

John also casts an interesting perspective on the question of banking relationships for insurers. As insurance companies have traditionally had more limited reliance on banks' balance sheets (L&G, for example, only relies on bank lending capacity for its committed liquidity facilities) and have also been, through their investment management businesses, a significant source of income for banks, they have, to an extent, "pulled the strings" in relationships with banking partners. While insurers now place an increasing emphasis on the equitable allocation of fee-based corporate-related business among the banks, the interests of policyholders dictate that, at least in relation to fund services, the use of banking services still tends to be transaction driven. This means that insurers' bank relationships, taken as a whole, tend to flow from a coincidence of benefit, rather than the reliance of one party on the other.

A DEVELOPING WORLD. Indeed, the changing tone of banking relationships is just one of the developments which Whorwood has seen in the corporate treasury function within the insurance sector. In the late 1980s, when insurance treasury functions were predominantly centred around the investment function, it was easier for general insurers to align the interests/investments of policyholders' funds with shareholders' interests. This resulted in a stronger emphasis on performance and return to shareholders within composite insurance companies. The life business however was more problematic because of the long term nature of the products sold and, accordingly, the interests of shareholders and policyholders arguably had to be treated separately, even though both were long term participants in the business. When John joined L&G in 1987, the concept of managing shareholder value in life companies as rigorously as policyholder value was in its nascence. L&G's first finance director had only recently been appointed and Whorwood was brought on board as the first corporate treasurer.

Since then, John has been part of a changing panorama. In the years of high returns, life companies with their considerable investment funds prospered and their capital base expanded considerably. It became apparent that many companies operating in this relatively mature, low-risk business were holding capital far in excess of what was required to write the levels of business available to them through organic growth. This fuelled both merger activity, as companies seeking new markets invested cash in acquisitions, and also diversification of insurers into new product areas, particularly banking. L&G itself became involved in mortgage lending business and developed the Legal & General Bank, which has now been sold to one of its long-time business partners, Northern Rock. At that time, capital raising was largely restricted to the bankrolling of M&A strategies. In fact, several life companies were so capital-rich that, far from going to the markets for further funding, enhancement of shareholder value became synonymous with plans to return excess capital to investors. There were also highly publicised attempts to reallocate 'orphaned' fund assets to shareholders. All a far cry from the solvency concerns of today.

TREASURY TODAY. Yet against this ever-shifting background, the corporate treasury function at L&G has continued to consolidate and add value to the business. John now heads a team of seven, comprising two dealers, a settlement manager and assistant, a treasury controller and two treasury accountants. The treasury department operates as a cost saving centre and Whorwood describes risk-taking in treasury as "limited and very tightly controlled". The approach to delivering value is one of proactively seeking opportunities to outperform on core treasury activities. For example, John explains: "We might issue ahead of the game in terms of paper, invest cash until it needs to go out for dividend service or any other commitment and so on."

The function is assessed against a variety of benchmarks, including a cost of debt objective, a target figure for return on surplus funds and both interest rate and foreign exchange management guidelines. The use of derivatives is mainly restricted to managing interest rate risk and, while the company continues to regularly examine derivative-based structures to enhance fund returns, this is at present not part of the company's investment strategy. All debt issuance and funding is centred on treasury, with investment managers not permitted to fund positions direct from the markets.

LOOKING AHEAD. One area in which treasury is hoping to add additional value to the business, going forward, is in applying knowledge of regulatory processes. With the transfer of insurance regulation to the FSA, it is widely believed that insurance regulation will become more closely aligned with banking regulation. This will mean operational changes for insurers, as reporting of capital adequacy and exposures become more detailed and demanding. From their experience in supporting L&G's banking business, the team will be able to offer some insight into issues such as regulatory capital usage, limits monitoring and control over regulatory risks. That said, Whorwood is aware that the task will to an extent involve attempting to apply "a simple model based around a straightforward lending and deposit-taking operation to a highly complex investment business oriented on actuarial analysis". It seems that there are still challenges ahead for John and the L&G Treasury Department.

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