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GLOBAL IDEAS

Aviva - Viva! for a 7% dividend yield

Aviva PLC provides life insurance, general insurance and asset management services worldwide but with a focus on the UK and Europe. The group has 43mn customers globally and is the UK's second-biggest insurer.

Aviva's metrics are as follows:

Spot (GBp)	362.70
MKT Cap (GBPmn)	10 682.92
12M fwd P/E	7.70
10 Average P/E	12.8
10 Average DY	6.42
FYE	31-Dec
P/Book Ratio	0.92
12M trailing DY	7.99
12M fwd DY	7.03

Source: Bloomberg, Anchor Capital

The past few years have been difficult for the company and in FY11 it reported a total pre-tax profit of only GBP87mn for the year (vs GBP2,440mn in FY10). Early in 2012 shareholder outrage over his remuneration saw Aviva's CEO Andrew Moss resigning while an extremely difficult operating environment put immense pressure on the company.

In May this year John McFarlane took the helm as chairman and has been in day-to-day control of the company since Moss quit. McFarlane set out a radical restructuring plan in July with the aim of improving the capital and financial strength of the group as well as its financial performance. The restructuring plan included the sale or winding down of 16 underperforming businesses (approximately a third of the group's operations) and improving the performance of 27 other business units. A review of Aviva's 58 divisions identified the 16 weak performers which included the group's bulk annuities business in the UK.

Aviva's US life and annuities arm was also on the chopping block and in November the company warned it would take a big loss on the sale of this division. With the value of the US arm already written down by GBP876mn in August, it was expected to sell for little more than GBP1bn, but the sale would also free up north of GBP1bn in capital, according to consensus estimates.

Aviva also pulled out of Sri Lanka, South Korea and its smaller Italian partnerships, and sold down its stake (initially 25mn shares were to be sold but then increased to 37mn shares) in Dutch insurer, Delta Lloyd. The company is planning on selling a further eight businesses in 2013 and taking what Aviva calls "radical action" in five of its other divisions, including taking capital out or winding down these businesses. The idea behind the restructuring exercise is that Aviva would free up billions to invest in its faster-growing, more resilient divisions by getting rid of the weaker, underperforming assets.

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We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watchlist, which is continually reviewed and updated.

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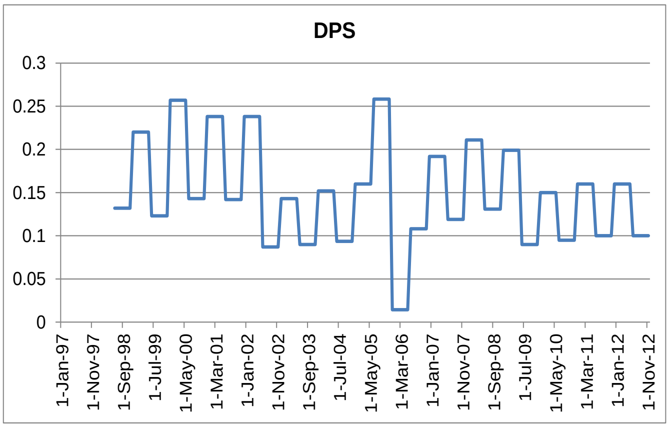
These disposals were seen as bolstering Aviva's capital reserves in order to counteract concern that the company's focus on mainland Europe had made it vulnerable to losses on its holdings of distressed eurozone sovereign debt. Between July and September 2011 the group's regulatory capital buffer dropped by a third due to the escalating euro area crisis which resulted in sharp falls in the value of bonds issued by heavily indebted governments. Aviva said it sold EUR2bn of Italian sovereign debt in June, thereby reducing its holding to EUR5bn, and it also flagged up to GBP400mn of cost cuts to be achieved in part by a culling of middle management.



Source: Bloomberg, Anchor Capital

Aviva's new strategic plan:

Aviva's so-called **new strategic plan** has three main objectives: first, to narrow the company's focus to fewer business segments which can produce better returns; second, to improve their economic capital ratios to be in line with industry peers and third, to improve their financial performance. We discuss each of these objectives in more detail below.

Regarding the first objective – **a narrower focus** - Aviva completed a detailed performance analysis earlier this year of the various divisions, or cells, comprising their business. They identified 58 separate cells and, after comparing each one's return on capital with its cost of capital, divided them into three baskets according to whether they are exceeding (c. 25% of the cells), just making (c. 50% of the cells) or not achieving (c. 25%) their return benchmarks. Part of the company's new strategy is to exit underperforming cells. They also aim to improve or "turn around" those businesses which are only just achieving their return benchmarks. There was general scepticism amongst analysts regarding the company's ability to execute an exit from these underperforming businesses in current market conditions and the company acknowledged this difficulty but nevertheless expressed some confidence in their ability to at least partially succeed in this objective.

Their second objective, **building financial strength**, is expressed in specific targets relating to capital levels, leverage and capital volatility. In August, with the release of the company's interim results McFarlane noted that the company aims to achieve economic capital levels of 160%-175% (i.e. to have a larger capital surplus based on its own internal capital management policies). Aviva also aims to reduce leverage and capital volatility. These financial strength targets raised concerns that the dividend would be cut. Although Aviva agreed such a cut would aid the achievement of this target they communicated an awareness of the importance of the dividend to shareholders and in August indicated it was their desire to hold the dividend.

There are a number of layers to the strategic objective of **improved financial performance** but one striking announcement was for an additional GBP400mn in expense and productivity savings (c. 15% of 2011 operating profit). This is part of a broader strategy to simplify the group structure and make it less bureaucratic.

Through its asset portfolios, Aviva is exposed to various financial market variables. The most significant of these are credit spreads (c. 40% of the credit spread sensitivity is to US credit, while the remainder relates to the UK and Europe). Investors who find credit spreads attractive at present may consider getting this exposure indirectly through Aviva as opposed to buying it directly. Of course this is less 'pure' credit exposure but it comes with a good quality business and a hefty discount to NAV.

Aviva's results and interim management statement

In August, Aviva released its first half results which were dominated by the GBP876mn write-down in the value of its US operations. However, this move was largely expected by the market and seen as the company's commitment to selling the US unit. Operating profit after restructuring costs was 10% down to GBP935mn due to the sale of the RAC (its roadside assistance business), unfavourable FX, the impact of adverse weather in the UK and higher restructuring costs related to the implementation of the strategic plan. It held its dividend at GBp10/share, with the company saying there would be no need to raise equity or cut the dividend provided economic conditions did not deteriorate and adding that the insurer would prefer to sell assets if they did.

In November, Aviva released its 3Q interim management statement (for the nine months to end September 2012) which showed the operating profit trend was broadly in line with that of the half-year results. Operationally the business seems to be performing well in a difficult market with management describing the results as strong.

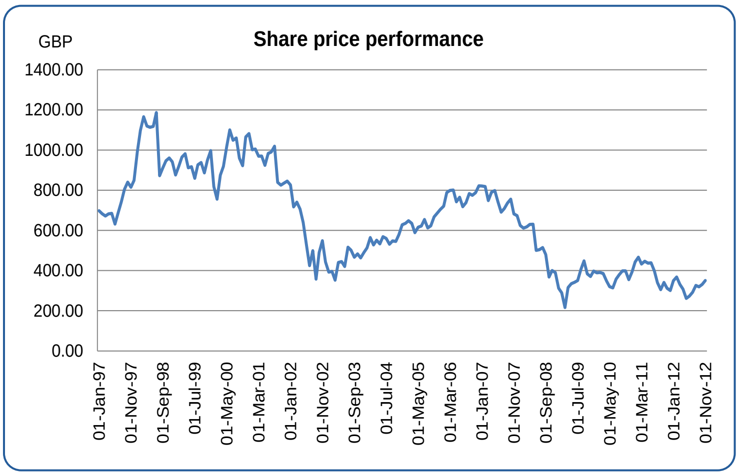
Total life and annuity sales grew c. 8%, based on present value of new business premium or PVNBP while individual annuity sales increased c. 2% YoY but were below 2Q's results. The company has been aggressive about the restructuring (with major headcount reductions and divestments taking place in the past few years and IRR's on new business high and strengthening). Aviva also said it was close to selling its US business (Aviva USA).

The company's economic capital surplus ((The economic capital surplus represents an estimated position based on Aviva's own internal assessment and capital management policies.) is ahead of full-year 2011, helped by the further disposal of Delta Lloyd and hedging transactions while Aviva has reiterated that achieving an economic target ratio of 160%-175% was a priority. However, the company also indicated that the external operating environment remains challenging and 2H12 is likely to remain tough. Nevertheless the execution of its strategic plan is on track and expected to make further progress this year with the strategic and transformational programmes enabling Aviva to improve its financial performance and value.

Aviva also announced the appointment of its new CEO, Mark Wilson in November. Wilson comes to Aviva from Asian life insurance company, AIA Group, where he was credited with steering the firm through the financial crisis and preparing it for a stock market listing in 2010. He will start on 1 January 2013.

Dividend and NAV

In our view the major cause of the share price weakness earlier in the year was concern in the market that Aviva would have a repeat of its FY11 results. However, the shake-up at Aviva was clearly aimed at regaining flailing investor confidence and so far the strategy seems to be slowly paying off with the share price retracing some of the losses experienced in the first six months of this year. A substantial rebound in the share price was seen in August and currently the share price is up over 18% YTD.



Source: Bloomberg, Anchor Capital

Two important variables that we believe will drive investor returns in the stock are the dividend and the future of the NAV discount. If the dividend is maintained and the stock returns to a NAV premium then investors could make sizeable returns. What are the prospects for these two variables going forward?

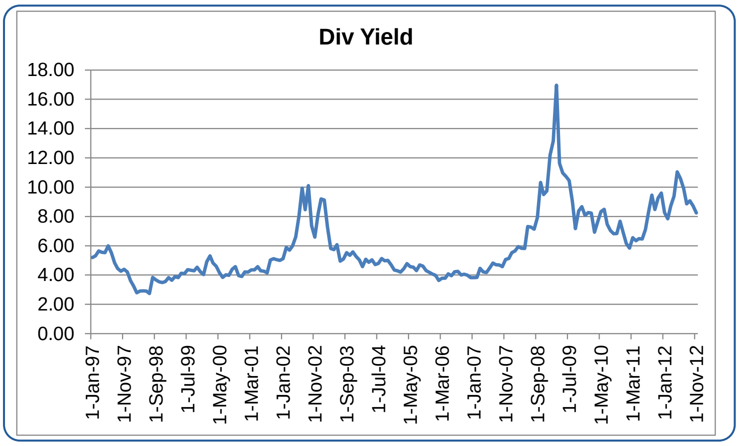
Although Aviva did not express any firm guarantee to keeping the **dividend** at current levels, they did express an intention to do so in various ways. Given that the dividend level is ultimately a management choice it is harder to analyse this any further. However, they do appear to have the financial ability to maintain the dividend, but whether such a choice is eventually made remains to be seen. Our view is that the dividend will be maintained.

What of the **NAV discount**? Among Aviva's peer group there is a pattern between the NAV discount and the returns generated in the underlying business (predictably, high-return businesses trade at a NAV premium, low return businesses at a NAV discount). Aviva is generating a lower ROE than many of its peers and, in an already depressed market environment; this underperformance goes a long way to explaining the NAV discount. If the company is successful in its new corporate strategy then it may well be on the road to achieving much higher ROEs and this would almost certainly result in a rerating of the stock.

Net Asset Value per share	IFRS	MCEV
Opening NAV per share at December 2011	435p	441p
Profit and investment variances	9p	29p
Dividends net of scrip	(16)p	(16)p
Pension fund	2p	2p
Goodwill write down	(30)p	(30)p
Foreign exchange and other movements	(5)p	(5)p
Closing NAV per share at June 2012	**395p**	**421p**

Source: Aviva

It is still early days for the new strategy though and it remains to be seen how this will be delivered. Nevertheless, even if we put little hope in management's ability to successfully execute their new strategy, we still think the stock looks attractive. If the dividend is indeed retained then it represents outstanding value and a great source of income in an environment of low yields.



Source: Bloomberg, Anchor Capital

Conclusion

We believe Aviva stands out as it trades at a very high dividend yield (7.0%) and a sizeable discount to its NAV (c. 17%). Operationally the business seems to be performing well in a difficult market. The company has also been aggressive about restructuring (major headcount reductions and divestments have taken place in the past few years and IRR's on new business are high and strengthening).

The nature of this business means company profits and corporate strength are significantly dependant on financial market performance so earnings may continue to be under pressure in the short term. However, we feel it is cheap at the current price level (7.7x P/E on forward earnings) and the 7.0% DY, together with the strong upside potential (when problems in Europe subside), makes Aviva a good share to have in your portfolio for the long term.

Blake Allen

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