EUREKA*report*

AXA SA bonds worth a look

By Elizabeth Moran
April 11, 2011

PORTFOLIO POINT: Solid but relatively boring revenue and profit figures, and a huge balance sheet mean AXA's tier-one securities offer compelling value.

Keen followers of bond markets will have seen spreads contract in recent months and if you had invested more than a year ago, your portfolio should be looking quite healthy right now. It is getting harder to find value in part of the fixed interest market, but there are always opportunities.

International insurers AXA SA and Swiss Re have issued Australian dollar-denominated securities and, perhaps due to a string of horrific natural disasters, these securities have not kept pace with the rest of the market. Both securities are available in small parcels of $100,000 from specialist brokers and both still have a yield of over 10% – assuming they are called at first opportunity – as we expect.

I've been meaning for some time to go into more detail about AXA SA tier-one securities, as I bought them back in September 2010 as a part of my $1 million portfolio (click **here**). When I originally allocated my portfolio, I chose to incorporate the securities to provide:

- Capital stability.
- Increased diversification (AXA SA is the French parent of the global insurance giant).
- Increased overall return (the securities had a yield to first call of 11.423% when I bought them).

Since I bought them for our nominal portfolio, their price has risen and the yield has declined, so there is the possibility of a small capital gain if I chose to sell them this week. The question we should be asking ourselves is: how many securities pay a return of more than 10% in this market? AXA SA tier-one securities offer a fixed return and remain good value, so for now I'll hang on to them.

It's precisely when big negative stories break and prices fall as investors panic that it's worth reassessing the risk/reward continuum. The week after the Japanese earthquake, AXA SA issued the statement: "Based on the preliminary information available, at this stage and recognising that the situation is evolving rapidly, AXA Group currently expects no material direct financial impact because of the profile of its Japanese operations." AXA SA's dominant insurance market is Life Insurance (see graphs below), which is less susceptible to natural disasters. By contrast, Swiss Re, one of the world's largest reinsurers, will take a hit from Japan and other natural disasters to the tune of $US2.4 billion this year.

Investors need to remember that insurers generally know and understand the risks and make allowances for them. In a big event year, it's possible the company will incur a loss, but this shouldn't impact the ongoing nature of the business.

The AXA SA tier-one securities

The AXA SA tier-one security, while issued by a leading international insurance company, is considered higher risk than AXA SA's senior debt and thus has a lower credit rating (but is still investment-grade) because it sits further down the capital structure. The security is a tier-one or hybrid security (sitting just above equity). The security is perpetual but benefits from a "first call date" in October 2016, when we would expect the securities will be repaid.

The securities are essentially the same as bank tier-one securities: they can have their coupons deferred or cancelled, but this is very unlikely as it would mean stopping the dividends the company pays on its shares, which would put offside equity investors, both retail and institutional.

Capital structure – insurance company (simplified)

Source: FIIG Securities

I should also explain that the securities contribute to tier-one capital – which is required under Basel II regulation – so has an additional important function.

AXA SA Tier 1 Securities	
Coupon	7.5% fixed
Yield to first call	10.50%
Running yield	over 8.5%
Credit spread	around 500 bps
First call	26 October 2016
Source: FIIG Securities Ltd	

AXA SA senior and subordinated debt credit default swaps (CDS), a proxy for credit spreads in the market, have contracted substantially since the beginning of the year, yet spreads for the physical tier-one securities have not contracted enough compared to senior and subordinated debt in our view. We expect the tier-one securities still have some way to contract, meaning we expect the prices of the securities will also rise (remember the inverse relationship between price and yield) offering an opportunity to investors.

So, the securities pay a better return than AXA SA's senior debt, which is currently around 130 basis points (based on five-year CDS) and subordinated debt of approximately 170 basis points. Although the tier-one securities are higher risk and there is a premium required for the risk of non-call, the credit spread of about 500 basis points more than compensates for the risk involved. The significant pick-up of more than 300 basis points for what we view as only a small increase in risk, presents an attractive opportunity.

Strengths of tier-one securities

- AXA SA is one of the world's largest insurers, with a very strong brand name and highly regarded management.
- AXA has 96 million customers worldwide.
- AXA is considered to be a market leader and in a stronger, more stable position than many of its European/global peers. As a leading global wealth manager who earns fees based on funds under management, the rapid improvement in investment markets has been a welcome development.

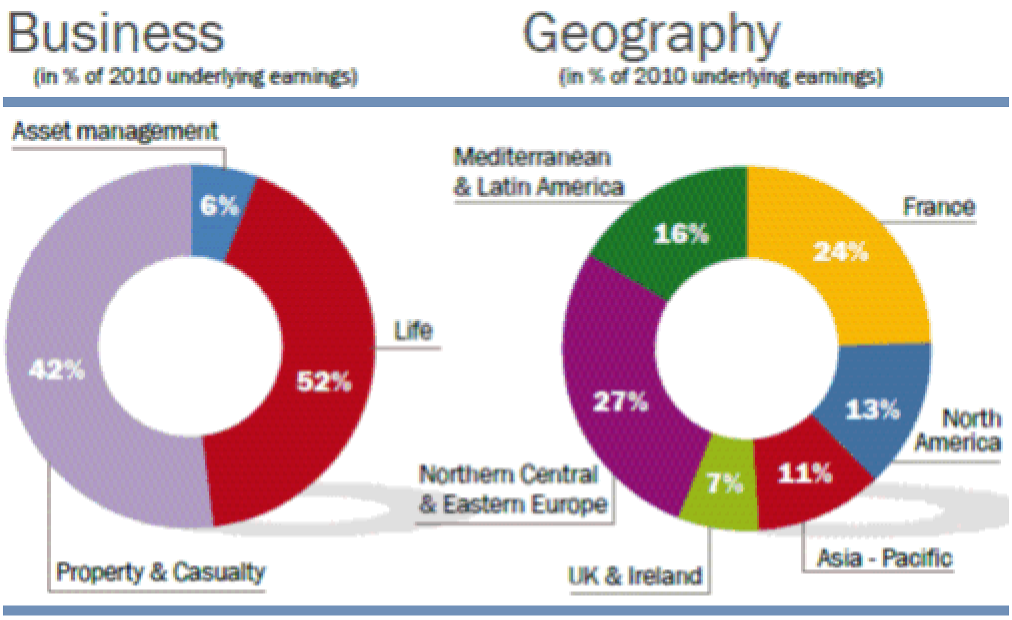
Risks

- Possibility of coupon deferral, although this risk is considered very remote given strong profitability and shareholders' equity.
- Possibility of non-call at the first opportunity, although this is also thought to be very unlikely given AXA SA's call history.

Overview of AXA SA

AXA Group (the French parent, not AXA Asia Pacific, which was recently sold to AMP) is a one of the world's largest insurers and wealth managers with a very strong brand name and highly regarded management. AXA SA's operations are diverse geographically, with major operations in Europe, North America and the Asia/Pacific area.

It has five main divisions: Life & Savings; Property & Casualty; International Insurance; Asset Management; and Banking. The most significant division in terms of revenue is Life & Savings, which contributed about 60% of total revenue for the financial year, to December 31, 2010. However, Property & Casualty generated the highest net income for the year, of €1.75 billion. AXA had €1103 billion in assets under management as of December 31, 2010. It has more than 96 million clients, 216,000 employees and a market capitalisation of €36.23 billion as at April 8, 2011.



Source: AXA SA

Latest financial results

The latest results, for the six months and year to December 31, continued the recent trend of relatively flat revenue and underlying profit figures. While equity investors may have some concern with the lack of growth, the boring nature of AXA SA's recent results and absence of any material surprises is a positive for bond holders.

Net profit for the year was €2.75 billion, slightly below the consensus estimate of €2.87 billion. The full-year result was well down on net profit of €3.61 billion from a year earlier. However, the one-off loss of €1.64 billion from the recent sale of AXA SA's UK Life business is a major contributor to the decline in the bottom line. Excluding one-off factors, the net profit figure was actually 18% up year on year.

AXA SA intends to combat low revenue growth by continuing to rationalise investments and operations in developed markets and to concentrate on further acquisitions in emerging markets such as Asia. The sale of AXA Asia-Pacific to AMP has seen AXA SA exit the Australian market but significantly increase its stake in Asia.

AXA SA continues to report solid but relatively boring revenue and profit figures. As we often say in fixed income, however, "boring is good". With a huge balance sheet, almost €50 billion in shareholders' equity and a relatively strong solvency ratio of 182%, AXA debt holders, including tier-one security investors, are well placed.

At current spreads, the AXA tier-one securities continue to offer compelling value.

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