Investec

Conference call transcript

15 November 2012

RESULTS FOR THE SIX MONTHS ENDED 30th SEPTEMBER 2012

Stephen Koseff
Right. I will get going. Welcome everybody. I think we've been saying this for a while now, but I think the environment has been a fairly difficult environment. I think we have seen good growth in equity markets in South Africa and a bit of a recovery in the UK and Australia, but certainly in the last six months part of it was quite choppy with the recovery at the back end of the period. Interest rates have remained low. We saw interest rate cuts in South Africa and Australia. And I think a big feature in the past six months was the average exchange rate of the Rand against the Sterling in which the Rand depreciated 15% against Sterling against the equivalent period last year, which did have quite a substantial impact on these results.

I think overall if we look at the negatives the environment was still difficult, but at the back end the environment did start to improve. I think the Rand depreciation as I mentioned. We did have lower investment income in the UK business. And overall we had a 2.5% drop in revenues in Sterling, which was about a 2.5% increase in revenues in stable currencies. We did see revenues grow in each of our geographies, but clearly when we converted them back to Sterling they declined.

On the positive side we continued to see solid net inflows into our Asset Management and Wealth Management businesses. We did have moderate line growth in the various geographies. Our recurring income was just under 70% of our revenue. We did see an improvement in the South African business with growth in both revenue and costs held at below inflation, and a significant improvement in Australia as a consequence of the reversal of impairments. We took a lot of hits last year and impairments were significantly down this year.

As a consequence of that operating profit before tax by business, 40% came from Wealth Management and Asset Management, and the balance from Specialist Banking. And the mix between the South African business and the rest of the world was about 58% to 42%, which is a shift from where we were at the end of March.

I think as I mentioned we did see good growth in third-party funds under management. In stable currency they were up 6.7% with net inflows of £2 billion. We saw customer deposits up in stable currency of 2.3% and loans and advances up 2.5% in stable currency. Very clearly our loan deposit ratio is at about 67% or 68% and we are sitting on a big surplus pool of cash which does create some kind of a drag on revenue. That's something that we're obviously something we're starting to look at as the system becomes more stable.

I think impairments improved significantly. A big falloff in impairments in Australia. South Africa slightly up in Rand, which was more in the corporate space. We saw them down in our private client space but up slightly in our corporate space. That is just one or two transactions that we need to make provision

for. And the UK was flattish relative to the first half of last year but down quite substantially on the second half of last year.

Impairments overall are down 19% on the first half and 36% on the second half, which is reflected in this graph. You can see that they were the lowest they have been since the first half of 2009. If you look at Australia, we cleaned out the book at the end of last year and that was reflected. The problem loan portfolio is now about 1.3% of total loans and the impairment charge was down to a miniscule number from £32 million to about £6 million in this period. I think we have seen progress on defaults on all fronts and the overall impairment charges of core loans and advances did come down from 1.12% to 0.85%. Hopefully that trend will continue if the world economy continues to show signs of life.

Head count was stable. It was only two small acquisitions that we made that would have affected head count during the period, which was aligned to equipment financing Australia, which is an equipment finance broking business, part of building our equipment or asset finance business. NCD Holdings is primarily a corporate finance boutique together with a wealth management business. Those are the only acquisitions, and that was where the head count came from. In South Africa head count was fairly flat, in the UK marginally up and in Australia up as a consequence of that acquisition.

Then costs overall are slightly up, 1.9%, but largely due to acquisitions. They would have been down if you excluded the acquisitions. I think in South Africa they were up 4.8%, which is just below inflation. I know it is more recently running at about 6%, but it was running at the mid-5%.

If you look at each business unit our costs are still too high. These are things that we will deal with over the next couple of years as we get a lot more coordination and a lot more synergy across the group and all the acquisitions get integrated. The Asset Management cost base is running within its range of 63% to 65%, its cost to income ratio.

The Wealth business was 80%, and I think that was primarily as a consequence of the Evolution acquisition where a lot of work is being done to integrate that business. The business was integrated successfully at the end of August this year. One will start seeing that cost base align. Our aim is a cost to income ratio in the Wealth business down to about 75% in the UK and 67% in South Africa over the next three years, which gives you an average of 70% to 72% from the 80%.

In Specialist Bank we're running at 61%. That number also is too high. That number needs to be brought down to about 55%. It is partially a revenue issue and an activity issue, but there is also a cost issue in terms of the work we need to do in terms of the work we need to do on integration of systems and processes and rationalisation which we are currently well down the path of to create the single bank structure.

So overall our cost to income ratio did rise, and again that is partially due to acquisitions and partially due to revenue growth being a bit muted. But nevertheless it is something we think we can still do quite a bit about and that we will start tracking towards the bottom end of our cost to income ratio target of 65%. Clearly we want to get it as close to 60% for the overall group as possible. Hopefully by 2015 we can get there.

If you look at geography we were at 68% in the UK. We need that down to about 60%. And 56.6% in South Africa, it was flattish and we need that down below 55%. And then in Australia we're at 80% and we need that down to 65%. So overall we are trying to get the cost to income ratio down to between 60% and 62%.

As a consequence of all this we would regard this as a stable performance. Operating profit was up 2.6%. In stable currency it is up quite a lot more. Again if we look at adjusted earnings they were up 3.5% from £162 million to £168 million. And adjusted EPS was down 4.4% because we have more shares in issue as a consequence of the Evolution deal. Dividend is held flat in Sterling at 8p. And the net tangible asset value per share declined by 2.9%, again mainly because of the weakness of the Rand. That obviously has had a fairly large impact.

So for the South African shareholder base I think because we report in Sterling our results are not always looked at from the right perspective. If we were reporting in Rand our operating profit would have been up 14.7%. Adjusted earnings would have been up 19% and adjusted earnings per share up just under 10%. And the dividend would have been up 8.7%. So I think that depending on where you are in the world and depending on how you look at these results you would get quite a different perspective because of the impact of the currency.

Looking at our financial targets, our actual ROE was 10.1% which was the same as the previous equivalent period but significantly better than the full year last year, which was 7.8%. We know that that is not acceptable and this is an area of substantial concentration. So on a rolling five year period we were at 12.8%, but that has come down from 14.3% of the equivalent period last year. Now, very clearly we need to get the actual ROE back to the target range, and hopefully that is not too far away from us.

Adjusted EPS growth we've mentioned is down 4.4%, but obviously we try to grow that by 10% plus UK inflation. The cost to income ratio is just inside our target. Dividend cover is in the middle of the range at 2.5 relative to a range of 1.7 to 3.5. Capital adequacy in all balance sheets is within our target range. Clearly with Basel III we have to manage that, but we do not have a big jump in risk weighted assets as a consequence of Basel III. Basel 2.5 brought in a very extra risk weighted assets, but Basel III will hardly do anything to our level of risk weighted assets. Obviously there are certain instruments that get phased out over time. So we feel fairly comfortable with where our capital position is.

I think if you look at the three core businesses you will see that all of them are marginally up at an operating profit level in Sterling. Again, the group as we said was marginally up at an operating profit level. The Asset Management business continued to perform well. It did well in the South African side and was stable in the UK side. It had higher average funds under management. It saw further positive net inflows of £1.5 billion and still has a very competitive investment performance. As we can see from here the costs were reasonably under control, within their target range. We did see growth in funds under management of 1.3% to £62.4 billion. That also was affected by the Rand.

I think there has been positive momentum in this business, but I guess that if markets remain pretty flat and the uncertainty that is out there continues that will obviously be one of the challenges. But our strategy remains unchanged. We continue to drive this business organically. We have well-established platforms on the global stage and I think this business is in a very sound position. I think it is also reflected in the fact that Hendrick du Toit, who runs it, was anointed European Fund Manager of the Year this past period, which I think is a very big achievement for someone coming from the bottom of Africa to build a global asset management firm.

If we look at our Wealth business the performance was stable. We just had higher average funds under management. We had net inflows of £0.6 billion, which is running at the target of 5% per annum. We did include Williams de Broë and NCB for the first time. Clearly we have not yet even started any kind of integration of NCB, but Williams de Broë we believe we're well down the road for full integration having migrated the business across onto all the Investec platforms and changed all their offices to Investec offices.

The challenge in the business right now is to get the cost to income ratio down to the right kind of level. Rensburg was at 75%. Now the combination of Rensburg and Williams de Broë is a much higher level at this point in time, and clearly the target is to get that down to 75% over the next two years. The South African business was at around 68%. They are almost where they need to be, but they believe they can get it down to 67%. So I think that we believe that the medium-term prospects for this business are pretty good. There is a lot going on on the ground and there are a lot of opportunities for us to broaden our customer base integration between the Wealth business and our Private Banking client channel. And there is a lot of effort that is taking place as an organisation on that front. As you can see UK funds under management are up 7.3% and South African funds under management were up 12.5% during this period.

Then very clearly the area that we still have most to do is in the Specialist Bank. I think earnings were up again in Sterling by 2.3% at an operating profit level. The cost to income ratio did rise a bit, and I think that is partially reflective of some of the acquisitions and a difficult revenue environment because the operating profit clearly comes from a drop-off in impairments. The ROE is still far too low overall at 9.3% and on tangible just under 10%. That is where the work needs to take place.

We did in South Africa see an increase in net interest income as our lending books did grow. We also have slightly larger fixed income portfolios. We also had a reasonable performance from our principle investment and investment property portfolios. They are not where they should be. We have pretty good portfolios there and we think you will see a lot of profitability come out of them in the next couple of years, but still reasonable performance. I think in the UK we had a slightly wider margin but flattish books, and we saw an increase in fees and commissions in the corporate advisory business, but our investment income was slightly lower. And then as we mentioned, in Australia impairments are significantly down.

The outlook for this business we think is positive, but the operating environment is still challenging, which we will talk about in a moment. There is a bit more activity than we have seen for a while. We saw reasonable growth in our core earnings drivers, but certainly the world is still not in the space where you can put a foot on the accelerator.

So if you look at net interest income, net interest income was slightly down in Sterling and up in stable currency. It has been static at just around about the 208 level as a firm. It dipped down when the crisis hit, but we rebuilt it up, and then obviously the Rand took away quite a bit of that in this particular year. As I said, we have to be careful. The world is not quite out of the woods, although it does look like it is in a much better state.

Fees and commissions is based on activity levels, and we have seen activity levels relatively moderate. They're a lot better than they were in 2009, but certainly not where they were in the 2007-2008 period. But it is starting to improve. Again, in stable currency you can see fees and commissions were a little bit higher or flattish on last year.

And the trading and investment income, that was pretty much in line with the previous trading period. The year September 2009 where we had that big jump was the debt repurchase which we still had some of in September 2010. We are trading and getting investment income at a similar level to where we were previously, and hopefully as conditions in the world improve this number can start improving. We have got very moderate trading and investment income and trading and investment risk.

I've mentioned impairments. Compared to last September they are down 19%, and compared to the second half down 36%.

Costs in the Specialist Bank were down in Pounds and down in stable currency. And that is a consequence of some of the work we're doing to improve efficiencies and combine systems and processes. It's an area that we will continue to concentrate on as a firm.

If you look overall we believe that we are now quite balanced between capital-light revenue and capital-intensive revenue. This is very different from where we were perhaps in 2008 and 2009. I think that we believe that our business has a reasonable degree of balance at the moment. As far as we are concerned it is appropriately re-aligned.

I think our recurring income base is pretty solid at just on 70% of revenue. Clearly the average since 2003 has been 66%. If you get a better trading season that number normally drops because you get more lumpy fees and commissions and you also make good money on deals. But we're not in that kind of environment so our core driver was to build that recurring revenue base.

Our ROE has been a particular challenge, and if we go back in time our ROEs were very high in certain jurisdictions and reasonable in others. This is where we really have to get our work done. I think the heyday of getting 30% ROEs in South Africa one can forget about. And certainly it is achievable for us to get back into the mid-teens pre-tax in the UK and Australia. We just need a little bit of time to deal with some of our legacy issues and get a better environment.

So I think the drag from legacy books is quite substantial. We've got about £500 million of capital supporting legacy activity that we break even on or make a small loss on. And that's because even though the loans may be good they are written at the wrong price. That will run off over time. Only over time will this issue be resolved, and so we expect it to moderate over the next five years and work its way out of our system in the next five years. But it is still there and it is still dragging ROE.

The next thing is low interest rates have had a significant impact on endowment. If you look at our net interest earned as a percentage of interest-earnings assets net of cash it has dropped from about 3% to about 2.5%. That is a consequence of two things. One, we have a lot of cash and we're not making money on some of the cash. The second thing is that interest rates are particularly low, so we have no income on our free cash. Those are the two big factors. And then obviously we still have some of the legacy book which we are funding at a different cost of funds. But things have started to improve from March this year, and this is where there will be a lot of concentration taken to make sure that we start eliminating some of the drag in the surplus cash.

I think scale in Australia is still an issue for us. The type of business that we were doing historically in Australia we paid a big price for. You can see they had quite a decent cost to income ratio back in 2009 and 2010 as they never really had the crisis that you had in the world. But then things started blowing up and we had to take big write-offs. We have restructured that business totally. We do not do the mezzanine-type finance that we were doing in the early days that paid nice margins. The core areas of activity have been very clearly defined. Two-thirds of our book is lending money to doctors and accountants. I think our bad debt defaults on that book are 0.3 or 0.4 and your bad debt charge is about 0.2. So it is a very safe book and it's a reasonable margin book, but we still have to get the revenues and activity levels up and build the scale.

Our focus there is really where we can find an opportunistic small acquisition that is not very good will orientated, or where we can get people to fill gaps we do that. I think the brand there is pretty strong and we've got quite a decent presence. We now just have to get the scale right.

I think overall there have been low levels of activity in our industry, which I've mentioned. The UK was in recession not so long ago. It is just coming out of it right now. South Africa was going okay, and then we had the labour issues so the economy is fairly week. And in Australia the mining side of the economy has come off, and hopefully the other side of the economy, which was muted when the mining economy was booming, will start gaining some traction. But you are in an environment where activity levels are low and where people are still scared to invest.

The impact of Basel III doesn't matter that it is phased in over ten years. Rating agencies, analysts, everyone is expecting us to already be at the kinds of levels that we need to be. We have to prepare for this in advance. We can't wait till 2019 to prepare for this, so therefore we have much higher capital ratio requirements. We have to be mindful of that in how we conduct our business activities. So that has an impact.

Those are the things that caused some of the drag. But if we get back to the core strategic focus of each business unit, in our Asset Management business we're not looking for acquisitions. It wants to drive itself organically. It has got a solid platform in place and will continue to focus on the increasing funds under management and maintaining the momentum that has built up over the last few years. The Wealth and Investment business is really an integration story now. It is broadening its product set, making sure the business is more global, working with the private banking channel to offer our product set to a broader customer base.

And I think we have a very good domestic platform in the UK. We're getting rid of the excess costs which came from the acquisition. And we can see ourselves building a very good international Wealth and Investment business through the broadening of our client base and greater cooperation between the different geographies.

I think the strategy in the Specialist Banking business has been reshaped and optimised. I think we will continue to strive to improve efficiencies and eliminate duplication. We have just launched them in Australia. We will be launching them in the UK in the not-too-distant future, and we try and scale up our Corporate and Institutional Banking businesses.

We are also coordinating our investment bank a lot more globally. We have combined our resource capability in each geography into a single global team and we are starting to see a reasonable flow from that exercise. The big thing is to optimise liquidity, capital and our costs. And that is really where we concentrate. A lot of hard grind work is taking place.

I think our franchise has demonstrated that it is standing the test of time. We have received a lot of recognition in some of the geographies we operate in. We're the Best Business Bank in South Africa, Best Discretionary Service Wealth Management in the UK, Excellence in Institutional Asset Management, and Hendrik du Toit, as I mentioned, was CEO of the year in Europe, emerging markets manager of the year in South Africa nine years out of the last 11. We have the highest domestic approval rate for our credit card from a service and quality perspective. And Middle East and Africa Financier of the Year in the airline space. I know all banks can brag about them, but we do have good positioning in our market place.

I think if we come back to where the world is, different commentators have different views, but it does appear to us that the cliff risk in the financial sector that was hanging over the world has subsided quite significantly over the last period as global banking systems have stabilised. I think if you look at the leverage in various geographies like the US you can see your highest leveraged institution in 2008 was 100 times leveraged. And the average was 40-something times. Now around about between 12 and 14 times leveraged. Europe likewise has come down from in some areas 80 times to between 20 and 30 times leveraged. And the UK from 60 times to 20 to 25 times. The South African banks they never had a crisis because they were 14 times leveraged when the crisis hit, and now they are 12 times leveraged. We likewise were 14 times leveraged both in the UK and 12.8 when the crisis his, and we are now 10.5 in the UK and 12 times in South Africa.

So if you look at what has happened with leverage in the system it has come down quite dramatically through a de-leveraging process and a capital raising process. We believe that is starting to be reflected in financial markets, and that is what has started happening in the past few months. You saw strong support from Mr Draghi for Europe and some of the major systemic banks are dealing with their capital issues. I was reading an article today about Jim O'Neill talking about green shoots back in America and China. The IMF does expect growth to pick up over the next few years. We hope they are right. And certainly some of the commentators are supporting that.

But on the other side there are still the big macro risks. We understand the fiscal cliff issue. We understand the [unclear] crisis. We understand what is going on in the Middle East with Iran. There is always noise coming out of that part of the world. And is China going to grow at the right kind of level or not? Jim O'Neill was saying China is going to grow, as is the US. We hope that they are right, because confidence still remains low and activity levels are only going to pick up when confidence at a macro level starts picking up.

So for us the outlook is that the world is still volatile. There are still vulnerabilities out there. It feels a lot better. We are seeing the cost of liabilities starting to come in. I go to the IMF every year for the last 20 years. This is the first year that you have really seen the banks calm as opposed to outright panic on their face. The one time they were all called home because the world was about to fall off a cliff. We've come a long way from that time. I think we have re-aligned our business model and our focus is on consolidating the gains that we've made in our Asset Management business, broadening the distribution of our wealth capability and continue to make progress in dealing with legacy issues and at the same time driving our Specialist Banking business.

So we believe given a decent environment we are well placed to start benefiting. For my friend there in Cape Town, Mr Neville Chester [?], he writes an email to my colleague Andy Leith. He said to him this morning: Jam yesterday, jam tomorrow but no jam today. I think there is some jam floating around in these numbers. If you look at them in Rand there is certainly jam. In Sterling obviously the Rand took away all our jam. But we as a firm believe our job over the last five years was to re-align our business model, make sure we're ready for the world when it starts picking up, and start improving our returns to our shareholders. That is what we're concentrating on doing. So hopefully, Neville, the promise of jam is not too far away. Thank you. Can I start off with questions in South Africa?

Louis Venter [?]
I see your cash is burning you.

Stephen Koseff
You're back, hey? Where did you disappear all these years, Louis?

Louis Venter
I'm wetting my toes here.

Stephen Koseff
Because we had an increased Rand dividend, hey?

Louis Venter
The thing is, we need the shoes.

Stephen Koseff
Your grandchildren need shoes.

Louis Venter
It is starting to look up.

Stephen Koseff
Now where has Louis gone? We lost you, Louis. Louis deserted us for a couple of years. He will go and buy Coronation and got a better dividend. He made a good call at the time. Any questions here? I don't want people to miss out on the questions.

[Power failure; Background chat]

Stephen Koseff
We didn't hear the end of Louis' question.

Male speaker
You couldn't hear us for a while.

Stephen Koseff
The power failed apparently. I don't know if our generator kicked in. But we spent a lot of money. A generator was put in about four years ago. And this is the first time we've had to use it. Are you back?

Louis Venter
Can you hear me now, Mr Koseff?

Stephen Koseff
Welcome back. You see what you did? You caused the power to fail.

Louis Venter
Can you hear me?

Stephen Koseff
Ja, we can hear you now.

Louis Venter
Can you hear me now?

Stephen Koseff
Yes.

Louis Venter
Since [inaudible segment].

Stephen Koseff
I know. Then you deserted us.

Louis Venter
I'm coming back. Now I'm coming back I need those shoes for my grandchildren. Dividends.

Stephen Koseff
You got an increase in dividends, Louis. In Rand.

Louis Venter
The Rand is looking terrible today.

Stephen Koseff
I know.

Louis Venter
It's not looking good.

Stephen Koseff
Who else has got questions?

Jo Foster
I'm Jo Foster from [unclear]. Usually I listen to you on the phone because I'm based in London. I happened to be passing through Jo'burg today and I thought I'd come and see you in the flesh. I usually cover you from a debt perspective and talk about your capital raising. I know you are a regular visitor to the London markets, raising Euro bonds and also you're in the syndicated loan market. I wanted to see what your debt raising plans were for the next 12 months, both in the Rand market an in the international market.

Stephen Koseff
We don't have any... Is it gone again? *[Background chat].* You asked about the debt raising plans. We don't have any specific debt raising plans. I mean we have done some issues both in South Africa and

the UK over the last few months. It is part of our overall liability management process, and we will continue to. We are primarily funded out of customer deposits and we have a lot of cash, but some of the longer liabilities we tend to go to the debt markets for. So no, we will look at opportunities when they arise, but we don't have any specific plans. Did you get that answer? *[Long pause]*. No more questions there? Okay, then I will come to London. Any questions?

Male speaker
Morning. Firstly the £500 million of capital that you've got supporting what looks like no operating profit [inaudible segment] profit. Can you give us the duration on that? How long does it take and when [inaudible segment] that block of assets you've got there?

Stephen Koseff
Only amortised over five or six years probably.

Male speaker
Okay. When was it originated then?

Stephen Koseff
Legacy books were all originated prior to 2008. The back end of 2008 would have been the last time. We saw that between 2008 and 2009 there was an uptick in our book. That was pipeline coming through. So it would all be pre-September 2008 originated stuff or committed stuff. No, it will amortise from here out over about five years.

Male speaker
[Inaudible segment] the excess liquidity you've got. I appreciate your point about impairment and about efficiency and all that, but if you could just shed a few billion in excess deposits it would have a monumental impact on your PNL even if you didn't lend the money. Even [unclear] doesn't operate with the liquidity that you guys have got, and they think they've got far too much. Can you give us an indication if you're doing anything about it? I know you said in the past the loan to deposit ratio isn't quite where you'd like it.

Stephen Koseff
Look, I think we believe that the financial industry macro risks have subsided, and therefore we would be probably amenable to having some of that liquidity reduced. And that is really one of our core strategies in our liability management area, managing the costs of that money down over the next two years. And that means being prepared to let some go. We really have strategies in place to do that. Any other questions? Is that it? Okay. Thanks very much and we will see you guys around. Thank you.

END OF TRANSCRIPT