Interview transcript

22 May 2014

YEAR END RESULTS

Stephen Koseff

Good morning everybody. Welcome to our annual results presentation. If we look at the year we've just been through we would regard it as an improving operating environment, particularly as you're seeing a lot of strength in the UK economy and an improved situation in the developed world. Clearly on the South African side life has been a lot tougher generally speaking, and that is clearly reflected in the currency. The Pound Sterling was particularly strong against all other operating currencies, and that would have had a big impact on these results because our reporting currency is Sterling.

We have seen good equity markets and we have continued to see very benign interest rates. So overall we would consider it to be an improving operating environment. Clearly we do believe we have a diverse business model with decent revenue diversity. We're seeing a good mix of income coming from our non-banking activities. And that generated about 46% of operating profit between the two of them, which is our Wealth & Investment business and our Asset Management business against our Specialist Banking business at 54%. If you look at that pre financial crisis that was 80/20. So we have done a lot to change our business model over the last while.

On the geographic mix still South Africa makes up the largest contribution. The UK did show quite a lot of improved results; however we did go through the significant restructure in Australia. So in neutral currency you did see continued growth in our key earnings drivers. Obviously in Pounds some of these were affected by the exchange rate. So our third-party assets under management did increase 8.9%. However, they were down 7% in Pounds. Our customer accounts, which are deposits, increased by 6.2% and our loans and advances by 7.9%. Both of those numbers were down approximately 7% in Sterling.

If you look at operating income in neutral currency it was about 5.6%. In Sterling it wad down 2.9%. So again neutral currency is really home currently, so we did manage to grow the top line. Obviously improved economic conditions and the fact that we were well provisioned in prior years has seen a significant drop-off in impairments. South African impairments were down in Rands just under 24%. UK impairments on our core book were down 17%, and if we include Kensington in the number, down 39%. So you are seeing the impairment line normalise. Already at September we told you we had some extra impairments in Australia, and that was pretty modest for the second half for the year. Most of this was reflected in the first half of the year. So overall impairments were down significantly.

Our fixed costs were marginally up. Our cost to income ratio did weaken, and that is partly a consequence of the exchange rate as the mix of income goes more to the developed world. Our South African cost to income ratio actually improved to about 52%, so almost in line with where we want to be. Still work to do on the UK Specialist Bank. If you look at Investec Asset Management their operating margins remains steady at 34.7%, which is around about where we expect them for that business.

We saw a big improvement in operating margins in our Wealth business down from 20.3% to 22.9%. Still not normal yet, but on the way there. And then the Specialist Bank had a deterioration in operating margin, and part of that was obviously the issues in Australia. South Africa did see an improvement, as I said earlier, in the Specialist Bank's operating margin. And in the UK we still have work to do to reshape, but we are well on the way on that, as we will talk about later.

When you look at overall results in Sterling – and I will also give you the Rand results – you can see they were up 20% in neutral currency, approximately 6% in Pounds. Dividend up 5.6% in Pounds, up 27% in Rands. And so some of you guys sitting here in South Africa shouldn't really complain. Net asset value per share up 9% in neutral currency, down 2.2% in Sterling.

So if you look at the Rand performance, operating profit before tax up 28%, earnings per share up 24.7%, dividend per share up 27%, net asset value per share up 23%. And you can see if you look at the graph at the bottom there has been a fairly strong recovery from our results post the crisis. So we are almost getting back to normal.

We did make some progress on our financial targets. We are still way off on return on equity, so we went up to 10.1%. Our EPS growth where our target is 10% above the UK retail index price index, clearly we were below that at 5.3%, but if we look at it in neutral currency we were up 19.7%. And our cost to income ratio is outside the target, and we will deal with that a bit later on. Our dividend cover was within target.

If you look at our capital we've got a very stable capital position. Post the Australian transaction you will see the UK core ratio move to above our target level. But I think you've always got to look at common equity against leverage. We're a lowly leveraged organisation with a leverage ratio in the 7% mark against the minimum requirement of 3%. I think you would have noted a lot of global banks had to do capital raising to improve their leverage ratios.

And as I said our common equity ratio is on standardised approach so we are targeting 10% by March 2016 based on a fully loaded Basel III – or CRD IV which they call it in the UK – regulation. So as I said post the Australian transaction the UK Investec Plc will be aligned, and we are comfortable that the South African business will get there by 2016. We are also moving the South African business in time from standardised to advanced, which will also add a percent to our core ratio.

Looking at our individual businesses, I think you're all aware that we did complete a sale of a percentage of the Asset Management business to management in July. I think overall we did benefit from higher funds under management with net inflows of about £2.6 billion. Our investment performance is very strong in the long term, a bit weak in the short term, but still very competitive. And our funds under management in Sterling did decline from £69.8 billion to £68 billion. However, if you look at it in Rand it went from R1.7 trillion to just under R2 trillion. So this business is well positioned, has good momentum.

It did have some headwinds during the course of last year the minute the Feds starts tapering talk. You clearly had money flow away from emerging markets or money that was earmarked for emerging markets not going in. we do manage a lot of money in emerging markets. However, that seems to have subsided and we are starting to see good momentum again. So we believe that momentum is positive.

Our priorities are to deepen and widen our investment strategy and to focus on further diversifying our client base.

And we are also expanding a range of private market strategies and trying to increase penetration in Asia, Europe and the Americas. We have recently opened up a Singapore office, and we will also start manufacturing some products in Singapore. At the moment we manufacture primarily in Cape Town and London.

So I think if you look at the key drivers, as I mentioned the operating margin was stable. The net inflows were lower than the last few years, but that was also partly to do with what was happening in emerging markets. And our average income as a percentage of funds under management came down marginally, but still at the 0.6 times level.

Our Wealth & Investment business really had a very strong performance. I think the benefit of integration of the acquisitions, good markets and a very strong positioning and performance across the spectrum. We have benefited from higher average funds under management. We did see net inflows and an improvement in operating margin, as I mentioned. And overall up 30.5% operating profit.

I think the UK business has expanded across the geography in the UK. It has been investing in infrastructure. It has been investing in talent. And it is getting into a pretty good space. I think our South African business has benefited from a strong alignment with the Private Bank in terms of marketing to our private client base. And a lot of progress in working together with the international counterparts on leveraging our global investment platform.

So I think we have made a lot of investment in this business and we continue to make a lot of investment. We're building our online and digital capability to make it easier for clients to transact with us, those that wish to use that sort of channel. And we hope that through those initiatives we will improve our efficiencies, our infrastructure costs and also improve revenue at the same time. So a very strong performance from this business.

I think if you look at the operating margin I mentioned it did improve to 22.5%. We did see good net inflows. And our average income as a percentage of funds under management did also improve as we get the benefits of the integration of the businesses in the UK.

On the Specialist Banking side we had very strong performance from South Africa. It grew 29%. I think we benefited from an increase in corporate activity, corporate fees, good increase in income from customer flow. Our unlisted private equity business performed well. We are seeing very good growth in attraction of clients in the Private Banking business. And our investment in property trading portfolios although last year they had a phenomenal year this year they had a reasonable year. So they delivered a sound performance.

Overall I think the Specialist Bank in South Africa is doing particularly well. There is still a little bit of legacy, but that is starting to run off completely. And if we eliminate the legacy we would have done even better than this.

The UK grew 30%. I think we had strong performance from our principle investment activity. We had good growth in our professional and asset finance loan portfolios. We are seeing a big improvement in the quality of income. But it is clearly a place where we still have a lot of work to do. And that is part of the reshaping that has been going on over the past while.

Australia reported a loss, as you would be aware. I think we have come to the end of the reshaping of Australia. Our people there have done an excellent job in terms of navigating the business to where we want it to be. And our sale with the Bank of Queensland is only subject to regulatory approval now, so they have raised all the money they wanted to raise. They have good support from the market for the transaction. The fact that we were able to sell it at an A$200 million premium to book reflects the fact that there was a proper business there that had a proper traction, had a proper client base. However, someone else could make a lot more money from it than we could because of scale issues that we were facing in that market.

So I think we have reshaped this business almost completely. We believe that we are very well positioned to benefit from any improvement in economic conditions going forward. It has been a very tough period particularly in places like the UK for this business. But if you look at the UK economic stats you can see that they are moving into a totally different plane. We are really hopeful that as life continues to improve so we get a lot more traction. We have clearly articulated what the legacy book is, and I will talk in a moment about where we are with that legacy book and the progress that we are making. Our ongoing businesses are starting to perform well.

If you look at the mix of income, net interest income would have been up. The margin in stable currency did grow on average by 6% or 7% in stable currency. In Pound Sterling they were down. Our fees and commissions again were up a little bit in stable currency. And our investment and trading income was up in both stable and Sterling. Still, as I said, work to do. Costs were up marginally in neutral currency and down in Pounds. And as I said to you, impairments were down significantly in this period.

So the areas that we have work to do on is on cost to income ratio and ROE. ROE is still nowhere near where it needs to be. And that is partially a consequence of very low interest rates. Your re-investment rate on your cash is almost zero in the developed world. And partially a consequence of the reshaping. Once we complete the reshaping and get rid of the legacy the ROE starts to normalise.

We have managed to grow our core loans. You can see over the period the growth in risk weighted asset, not quite linked to growth in core loans. That is a change in regulation that has come at us over the period. And our credit loss ratio is starting to normalise. It is still not quite normal, but it is down from a peak of 1.28% to 0.68%. And I guess that normal for us would be probably closer to 0.5%.

I think if you look at the legacy there are two elements to it. There is legacy in the bank and legacy in Kensington. I think in the bank you can see that it has come down from £2.6 billion at the end of March last year to just under £2.2 billion. Of that legacy the bulk of it is performing. There is £387 million that is not performing that is in work-out mode. The balance is performing. And I will give you an idea of the expected run-off in a moment.

On Kensington we’ve got £1.2 billion of Kensington warehouse lines left. The rest is in a securitised pool. We have told you that we are in the process of trying to sell Kensington. And we are making quite good progress. We’ve had a lot of interest. We will be able to say something probably within the next six weeks, depending.

So in these results our legacy would have cost us £83 million after tax, a bit more than we would have expected when we sat here and originally articulated the legacy. We are trying to accelerate the clearance of it. So we will make some calls on clearing stuff, and sometimes when you make those calls you do accelerate the loss that you were anticipating to make. However I think we are making good progress. As economies improve it gets easier and easier, but it is still something we have to navigate out of our system over the next while.

If you look at the ongoing business it is getting a very good ROE. Cost to income ratio is still a little bit high at 70%. We do load the Specialist Bank with all the head office costs and all the marketing costs, so that is probably not a very fair reflection. But it is still where we are. It also gets the benefit of the capital, but you're earning nothing on the capital.

If you look at the legacy this is our expected run-off. So it will take us another four years to clear it. Clearly if we sell Kensington then this run-off won't exist next year. So that obviously is what we're trying to do, accelerate the clearance of the legacy so you can see us in a normalised way.

If you look at our strategic priorities from a year ago we said that there were a number of things that we were going to do as a firm. I'm going to concentrate on the one that is simplify the Specialist Banking business model. It had become very complex and we were trying to do too many things pre the crisis. Obviously we had to navigate the crisis, and now we see clarity we have to move forward.

We believe that what we said we would do we have made good progress in doing. We've done a lot to simplify and de-clutter. If you look at what we've done in the UK, we sold our [unclear] business. We sold Lease Direct Finance. We've integrated the investment bank and the securities business into our corporate. We have positioned ourselves as a mid-corporate specialist. So we have integrated that, so we are offering a lot more to a corporate as opposed to just advice. We are offering treasury services. We are offering debt advice. We are offering all sorts of other things into that corporate market, including M&A and including broking. And we have commenced the process of the sale of the Kensington business.

I think the second thing obviously is Australia. We have sold the professional finance, asset finance and leasing business subject to regulatory approval. But that means we've sold the bank in Australia. That means we can run Australia as a non-bank financial services company. We can't take any deposits in that environment. We are not longer supervised by APRA. We are supervised by AFEC [?] which is a different level of supervision. And it eliminates a whole layer of cost and infrastructure.

And we can still originate debt as we will continue to do in the corporate space. We have some fund management activities; principally we have a property fund that is listed in Johannesburg. We have an aircraft fund that is a private fund both in Australia and in Hong Kong that is partially supported by our team on the ground in Australia. And we also have an asset management capability, mainly a sales team. We don't manage any money there for Investec Asset Management. So we go down from 500 people to about 90 odd. And much leaner, much fitter hopefully and with much less infrastructure going forward.

The other thing that we're trying to do in the UK going forward is trying to drive our private banking capability. We've developed a transactional capability. We've launched our product in February this year focussing on professionals in the UK and our South African client base that wish to open up accounts in the UK. We did launch our voyage account some time last year to more high net worth individuals and high net income individuals. We continue to try and grow our specialised lending to high net worth clients. We do still have a niche property business, a lot more focussed than it used to be.

And then we are leveraging a link between the Wealth businesses, which has a lot more clients than the Private Bank at this point in time. It's the opposite of South Africa. South Africa has a lot of clients in the Private Bank and less in the Wealth business. In the UK we've got a lot of clients in the Wealth business and less in the Private Bank. We are trying to offer both products and services to that client base.

I think if we look at what we're doing in the corporate space we've got a very strong small ticket asset finance business grown from £20 million to £660 million over the last eight years. We've got a strong treasury and products business which deals in the mid-corporate space, from nothing to 1,360 clients and £10.6 billion of volume. We have the aviation finance business that we've now got a number of funds, debt funds and equity funds with third-party money that is linked into that business. We have very strong capability there. And we have very strong infrastructure finance business. These are in addition to our normal day to day activities.

On the Specialist Bank side in South Africa I think we are focussing on offering our clients a much more integrated service. I think we have a good franchise here. We're doing a lot of collaboration between the Private Bank and the Wealth business and we are seeing the benefit of that in terms of flows into the Wealth business. We are also looking at the corporates from a holistic perspective as opposed to a product perspective and trying to offer them much broader service, and we have a very good offering into the South African corporate market.

We have progressed the rollout of an African strategy. We are not going to be retail in Africa. We are not going to open up banks in Africa. But we will open up offices. Our product offering is really asset management, corporate banking and wealth management to the higher end individuals in that market.

So we believe that the performance of the Specialist Bank will be driven by two factors. One is managing down the legacy portfolio, and importantly growing the business organically with efficiency and balance sheet optimisation. So we really believe that we are back in terms of growing this business organically. And it is something we've tried to do since the crisis, make sure we deal with the underlying businesses while we deal with all the clutter that was created from whatever happened.

I think in Asset Management we built this business mostly organically. We haven't made acquisitions in this business since we bought Guinness Flight in 1998. That's the whole strategy. Continue to drive it organically. The business is always affected by cycles and price movements in the short term, but we are investing in building for the next phase of growth in line with a clear long-term strategy. We have a very stable and experienced management team and they are focussing on investment performance and growing the client base. As we said before, we manufacture it in Cape Town and London, but we distribute it all around the world in all geographies.

And then for our Wealth business I think the important thing is to continue to build critical mass in our future growth areas. We are a client-driven business. We are not a product pusher. We try and service our clients by managing their portfolios according to their needs. We have developed our offshore offering now, and we are building our private office service to high net worth type clients. We are continuing to leverage off the group's private client platform around the world and also the group's global investment platform.

So again we are driving this business organically. We are also making sure that we have an integrated solution to our private clients. Whether you are a client on the wealth side or the private bank there is an integrated offering, one gate into Investec. In time we are able to deal within geographies across banking and wealth management products. And these are things that we have been busy on, a lot of effort going into it. And we have made significant progress on this front in the past year through the building of a very sound digital platform.

So I think in closing you can see we have a very balanced business model. 32% now coming from capital light. If I went back to 2008 it was 40/60. Now it is 52/48. Clearly as interest rates start rising and we start seeing an improvement in general economic conditions you might see some improvement in capital-intensive type revenue streams. But certainly we've got the business into a nice degree of balance. 70% of our income is annuity.

We are very client-focussed. We are building a client franchise business. Alongside the client franchise business, which is Private Banking, our corporate banking advisory business, our Wealth & Investment business and our Asset Management business, we have some specialist activities which would be aircraft finance, asset finance, project finance, resource finance, private equity and our property activities. And that gives us the entrepreneurial capability because we are either highly specialised or very client-driven.

We are not all things to all people. We never want to be all things to all people. At the end of the day we want to deliver appropriate returns to our shareholders. We also want to build very strong relationships with our core client base so that we can offer them not just one product but a broad spectrum of services.

So where we believe we are is we're building Investec into a high-quality, client-driven organisation that is relevant in its core markets. It's no good being in a place where you're not relevant. We have navigated very troubled waters that have reminded us about who we are and what we stand for as a firm. Our focus over the next year will be to execute on our strategic initiatives. We have already done the one thing, which is Australia. So going forward we are recognised as an agile, innovative, service-driven organisation providing great products and services to our clients, above-average returns to our shareholders, and a significant contributor to growth and development of our people, our communities and broader society. So we believe we have an important role to play as a firm.

I think if we get to outlook you have economic conditions that have continued to improve. Particularly where we operate, the UK economy has gained a lot of momentum and that is evident in the increased levels of activity that we are starting to experience on the ground. I think it goes without saying that the South African economy is going through a period of weakness. Obviously we've had a lot of noise on the labour front. We've had elections. We are hopeful that we will have a cabinet that can help implement the NDP so that the economy can really start moving forward.

For our type of client base we are still seeing encouraging levels of activity. And remember we're not in the consumer space, so we are in the upper end of the market where you have had very good equity markets, decent asset prices and there has been opportunity for entrepreneurial endeavour. So our clients seem to have faired quite well in the last year, but overall the economy is limping.

I think the significant restructuring effort that has taken over the past year together with the ongoing strategic initiatives should enable us to benefit from any upturn in global conditions and start showing the kinds of returns that our shareholders expect of us. So that's our story. A lot of work has gone into reshaping our firm. A lot of people have made considerable effort around the world. Our people have really stood up to the challenge, so I thank them all for what they've done and the effort that they've all made. I don't want to single any individuals out. I think it has been a big team effort. And I really think that we are in a much better space than we've been for a long time. So I thank you all for attending and I'm available for questions. I will start in Jo'burg. Ruby, I said no questions from you today.

Ruby Rosenberg
What can I do, Mr Koseff? Mr Koseff, I want to refer to fixed costs featured on page eight. I will start with the Specialist Bank. We are informed that the head count is down 144 people. Yet the cost to income ratio has gone up. Now why is that?

Stephen Koseff
I think there will be a number of reasons. Firstly obviously you're looking in Sterling, so there is an impact. If it was in neutral currency the cost to income ratio would be for the group about a percent lower, Specialist Bank probably 1.5% to 2% lower. So we had inflationary adjustments in our fixed cost. As some businesses do better there would be an increase in variable costs. And we had the costs of reshaping. You have to pay the people that have to be retrenched. You're paying costs for retrenchment. You're doing all sorts of things in there that would cause a lot of noise in the income statement. So until we've finished reshaping you're going to have this kind of noise. But yes, we have to get that cost to income ratio down. Where we didn't have a lot of noise was in South Africa. The cost to income ratio came down from 54% to 52%.

Ruby Rosenberg
Let's have a look at the other two divisions, Wealth & Investment and the centre first of all. Head count was up 51 persons, and as expected operating costs are up 11.9%. And pleasingly operating income is 15.7%. So happy with that division. Let's bear that in mind and look at the Asset Management. Head count is up 200 people. Operating costs are only up 1.3%. Disappointingly operating income is only up 1.7%. In other words, the effect of the additional 200 people hasn't yet been shown in the operating income increase.

Stephen Koseff
I think unfortunately you're looking at it a little bit wrong, because a lot of those 200 people are in an admin unit called Silica which provides admin services to most of the South African unit trusts and investment firms. And they have a lot of people because it is an admin intensive business. So that's where a lot of that head count would be coming from. Some of the head count is hiring professionals to help us grow and develop, but a lot of that head count would come from that admin infrastructure.

Ruby Rosenberg
Am I correct, the Silica department is the one that pays out commissions?

Stephen Koseff
I don't know if it pays out commissions. It is the one that administers unit trusts.

Ruby Rosenberg
Okay, all right.

Stephen Koseff
They take in a lot of new clients in South Africa because they seem to be the flagship administrator of unit trusts.

Ruby Rosenberg
Just finally, those additional 200 people, are they going to have a positive effect in the year to come on operating income?

Stephen Koseff
Well, it is an admin business so you don't get a lot of margin on that kind of stuff. It helps us keep our admin costs low because we are sharing resources with other third parties.

Ruby Rosenberg
Thank you, Mr Koseff.

Stephen Koseff
I wouldn't bet on that. Yes, Mr Levy. You're brave to talk today.

Mr Levy
Congratulations. Well done. You're right. If I can just ask on slide 23. Thank you very much for the detail. The question I have relates to the cost to income ratio and the legacy. What happens to that if you get Kensington away?

Stephen Koseff
Obviously this number will be totally different once Kensington is gone. There is one profitable element to Kensington and one unprofitable element to it. We'd have to come back to you on that number. I haven't got it in my head.

Mr Levy
Thank you. The ongoing 71.1% cost to income, you've mentioned you've had some revenue pressures there. Where do you see that as a target medium term, and what is the strategic path to getting there?

Stephen Koseff
We hope in time we can get it into the low 60s. But because we are not highly leveraged and some of our stuff is service-driven – that includes the investment banking, advisory, securities type businesses – probably mid-60s is where we can get it to. If you strip that out and just had a pure banking business then it would be lower. But it is a lot of services and advisory type stuff, which in that part of the world have much higher cost to income ratios.

Mr Levy
Thank you.

Stephen Koseff
More questions here? Okay, can we go to London? Dave. Anyone going to ask questions?

Dave
There aren't any questions here. One question here.

Male speaker
A couple of questions. I had one on Asset and Wealth Management. Given all the investment you're making, what is your expectation of net flows as a percentage of AUM [?] in terms of guidance? Would you be able to give some guidance there? It has largely been 3% to 4% in the past.

Stephen Koseff
Wealth we target at 5%. Asset Management will depend on the season. There are years they have done 16% and this year they were 4%. It just depends on the direction of markets and where people are investing.

Male speaker
What are you happy with?

Stephen Koseff
As much as possible. We would like it at about 5% but [overtalking]...

Male speaker
I was wondering what...

Stephen Koseff
Ja, I'm listening to you. You've gone on the blink.

Male speaker
The second question was the South African impairment. I was wondering what your guidance was on the 50 BIPS [?] for the group. How much of it have you baked in? Have you baked in any rises for impairments as the rate rises or the economy deteriorates further?

Stephen Koseff
I'm saying normal for us is that. South Africa was at 41 or 40 basis points. With the type of clients we deal with it is only every now and then we get hit by a lump that could push that number out. It should be between 0.3 and 0.4 for the type of clients we deal with. Obviously some of the stuff that caught us in the past we don't deal with any more. If you had sharp rate rises I suppose that number could go up. Where we are at the moment we think that number is sustainable. Our net defaults as a percentage of our core capital is only 9% from a peak of 20%.

Male speaker
Thank you. You have still not given us the asset yield and behavioural maturity to be able to work out whether your trajectory is right or wrong, or how much of it you are able to achieve going forward. Would you be able to disclose something on that? Or if not, would you be able to talk a little bit about where you think the marks might be were you to undertake some kind of opportunistic sale in certain elements of that business? I'm talking about the UK legacy business ex-Kensington. Thank you.

Stephen Koseff
I think the UK legacy business ex-Kensington is well provisioned. It is something that is just going to take time to manage out. So there is always one or two binding outcomes where you could get all your money back or lose all your money, but I don't think those numbers are big. So we give you details in the book on the actual growth in the level of impairment against that book. It has got a high level of

impairment against that book. So obviously there is cost to manage this out which you incur as you go along. And you have a weaker negative margin. Although with cost of money coming maybe that will improve slightly, but I can't give you the detail. You will have to ask offline for what you're not getting. But I think you get a lot of detail.

Male speaker
All I wanted was the asset yield. If you could give us that, that would be great.

Stephen Koseff
Okay.

Dave
Any other questions here? No more questions from here, Stephen.

Stephen Koseff
Okay. Well, that's it. Thank you for all attending.

END OF TRANSCRIPT