Investec

# Interview transcript

20 March 2015

## PRE-CLOSE BRIEFING

**Stephen Koseff**
Good morning everybody. Good morning to Johannesburg as well. Good morning to the people in Johannesburg. Morning in London. Welcome to our traditional pre-close briefing. I will go into it straight away. I think if we look at what has happened over the past year a lot of strategic change has happened in our group. We've made quite a lot of disposals. And that obviously changed the balance sheet and the income statement quite significantly. I think if we look at what we expect to happen for this financial year in Wealth and Asset Management we do expect to report results ahead of the prior year. I think both divisions have benefited from higher average funds under management supported by net inflows of £2.6 billion and £2.4 billion respectively.

The Specialist Banking business is also expected to report results ahead of the prior year. The South African side is expected to report results substantially ahead of the prior year, where the UK bank will report results slightly behind the prior year. Overall I think clearly we have been impacted by the Rand exchange rate which on average depreciated by about 11%. But at operating profit level it is up at operating profit level. We expect to be ahead of the prior year in Sterling, and that will also result in a solid increase in Rands.

Revenue because of the sales will be marginally lower than the prior year. And what we will do in the year is make a very clear differentiation between ongoing and our statutory, because I think it is going to be quite difficult with the movement and the change for people to understand if it is statutory. So for this year and probably going forward until all the legacy is gone we will differentiate between ongoing and statutory. As I said, revenue if it wasn't for the sales would be ahead of the prior year if we look at it on an ongoing basis.

What is important in these results is recurring revenue is expected to be about 76% of operating revenue. I think that is probably the highest we have been in our history. If you have been investors over many years we have had a lot of income from investment activities, or what we would classify as non-recurring. I think this number has grown and grown as our business model has shifted and it is now by far the major portion of our operating income.

I think we do expect expenses to be lower, again as a consequence of the sale. And if we adjust for the strategic disposal they are more or less in line with the prior year.

So overall third-party assets are up 12%. That's at the end of Feb. March is still not finished and we could still see another movement in that exchange rate and we still expect some inflows into Asset Management and Wealth Management. Customer accounts flat. If you adjust for disposals, up about 7%. Loans and advances down 1%. Adjusted for disposals, up 13%. So we have seen quite strong growth in loans and advances in our core businesses both in South Africa and in the UK.



Our balance sheet is very liquid. Clearly we still have to deploy the cash from the sale of Kensington. And we are working on how to utilise that. It is mainly running off some liabilities, but overall we need to deploy that cash. We have seen a decrease in cost of funds in the UK, but we have seen a moderate increase in cost of funds in South Africa as banks compete with what we would call LVR friendly deposits. Our loan to deposit ratio is 73%. In March it was 72% so still very well covered. We would probably want that slightly higher so we utilise that cash a lot more.

On capital we are still slightly below our target of 10%. Bearing in mind we are still under a standardised approach. We expect to get to that target. I think the UK may make it this year. South Africa will be slightly behind. Our leverage ratios are still above our minimum internal target of 6% on a fully loaded basis.

On impairments we expect impairments overall to be about 17% lower. We've seen a normalisation in trend in South Africa. We still have some elevation in the UK on our legacy portfolio. As we said in September we are trying to clear that quicker. And I will talk a little bit about it at the back end of this presentation. So we expect the credit loss ratio to be between 0.65% and 0.7% which is similar to last year. You can see how our expenses are trending. Still slightly elevated in the UK and Ireland but obviously significantly off the peaks that we saw in 2011.

If we look at our divisional performance I think Asset Management net inflows for the year are £2.4 billion. We have seen some outflows generally speaking in South Africa on money fund mainly as a consequence of the failure of African Bank. Quite a lot of money did leave money fund, and we were one of the firms that had quite a big money fund, so we lost money in that area. So we do expect this number to still improve because there are some expected inflows for the full year, but that we will talk about in May. Earnings are still growing, but at a relatively modest rate at this point. Overall funds under management are up 11% since March 2014 to just under £76 billion.

If we look at our Wealth business it is performing ahead of the prior year. Average funds under management have been much higher and we have seen very good net inflows, £2.6 billion to the end of Feb. we see a slight improvement in operating margin as we get more efficient and as we complete all the integration work that we've done over the past while. We still have a couple of businesses within the Wealth platform that are below scale. Our Irish business is doing well but still below scale, and we have the bank in Switzerland which is still marginally loss-making from an operational point of view. But the UK business is now getting to its efficient level and it has been taking in new funds as well as making investments in senior investment professionals.

So the South African business has benefited a lot from its marketing effort and integration with the Private Bank. We've got this concept called One Place and that is working very well in South Africa. There will be a time when we're able to roll it out in the UK. So overall this business continues to perform well.

If we look at the Specialist Bank overall it is performing ahead of last year. We've seen good loan growth of about 13%, a little bit above where we would normally target loan growth. But there have been opportunities to expand in our core areas of activity. We've seen relatively stable lending margins and we've seen a cost of fund reduction in the UK. So in the UK and in South Africa we've seen an increase in non-interest income.

The one area where we would have seen a decrease in the UK would have been in our investment and trading income. We mentioned to you at the half year in our Hong Kong portfolio we had some falling in prices of some of our investments which are listed. And that created a negative performance in that portfolio, whereas we've had a strong performance in our South African portfolio and a very good performance from our UK unlisted portfolio. We also saw lower customer gross [?] trading income in this particular period and volatility was low for this particular year. So that would also have an impact. So overall investment income up in South Africa and in the UK down, mainly because of Hong Kong.

If you look at fees and commissions I think we've seen good flows in our private client transactional and professional finance activities. We've had a very good performance from our UK corporate finance, corporate treasury and prime broking businesses. Corporate fees are expected to be higher than the prior year in the UK and South Africa more or less in line with the prior year. And then South African costs in line with inflation in Rand. That would make them down a bit in Sterling. And UK costs slightly higher than the prior year if we look at the cost from an ongoing business perspective.

So if we look at the UK bank in particular, I just want to give you some colour there. I think if we look at the ongoing business we expect to report results slightly behind the prior year, mainly as the result of the performance in the Hong Kong investment portfolio. If we look at what we've done on legacy, we've gone from £6.9 billion in March 2008 down to £750 million now. So we were £1.750 at September and we were £3.5 billion at the end of March. Obviously the drop from £3.5 billion to £1.750 is partly Kensington going and partly sales of assets and clearance of some assets. But you can see we have come down by a further £1 billion. Some of that is migration of portfolio from legacy back to [unclear]. We have spread it right and we've realigned that portfolio. And then we have a residual portfolio that we have to deal with now.

We have, as we said in September, tried to accelerate the clearance of some of that portfolio. It will still take us the full year to clear it completely. But that would have resulted in an increase in impairments in these assets. The overall legacy we expect to report a moderately larger loss than the prior year overall. We just wanted to give you colour. We have made very strong progress in dealing with this. This is the last of the pre-crisis stuff that we have to deal with. And we will show you a separation of the ongoing business from the statutory business. So you've got a lot of colour on what this business will look like on an ongoing basis going forward.

Other information, we've got the effective tax rate approximately 19%. We do incur a deconsolidation loss as Kensington was sold. There were a whole lot of instruments that we held that were Kensington-related that had to be carried at par and we will suffer a loss on deconsolidation of that. It is basically the Kensington bond portfolio that we have to mark down to what we paid for them. And that would come through in this particular year as another below-the-line, non-operating item. Other non-operating items would be largely in line with the half year. We couldn't do that at the half year because Kensington had to be sold, and we had just marked it for sale at the half year.

Other non-controlling interests of approximately £32 million which relate to the minority interest in Asset Management, that hedge accounting, that euro instrument which has really caused nonsense in our income statement. It either comes through or gets taken out of our top line and comes out of the bottom line. It doesn't really affect anything. It's neutral. But it does cause a bit of aberration in accounting. And then the property fund which we consolidate, clearly we don't own the majority of those shares so there is a minority charge on that. And then we expect shares in issue to be about 863 million, which is not too different from prior years.



I think in summary there has been a lot of change that has taken place over the last year. Everything we said we would do from a strategic perspective we have now done. I think we have a much more simple business. I think that will provide stakeholders with a much clearer view of our underlying drivers going forward. It is obviously also a lot easier for us to run the firm because it is a lot simpler. I think our focus now remains on clearing the legacy once and for all and driving our core franchise businesses alongside our specialist activities.

I think we've seen a lot of progress in building our core franchise businesses, and we are quite comfortable with where we are in the building out and development of those businesses and with the underlying performance from some of the work that we've been doing over the past few years. We think the business model is a lot more balanced than it would have been five or six years ago, and I think that has created a material improvement in our revenue mix. As I said, our annuity income is now 76% of our operating income. That makes our business a lot more defensible and well positioned for future growth and development.

I think you would also note that we are starting to see potential rating uplifts in the UK. Moody's announced yesterday that we could get an upgrade on our senior debt instruments and our depositor rating of two notches. So we are starting to see a recognition of this in the financial community. So overall I would say a successful year because we have implemented and done a lot to get our business into the kind of shape that we wish to be in. we will see you again in May with the actual facts. This is just to give you some guidance on where we are going. So thank you very much. I will start off with questions. I will let the South Africans ask first. I'm more used to doing the pre-close briefing in South Africa. Any questions in South Africa? David, who is there?

**Hannah**
It's Hannah from Moneyweb. I wondered if you could give any indication as to the outflows from your money market funds because of ABL. Thanks.

**Stephen Koseff**
I don't know the exact number. We lost about 10% to 15% of the fund. That is the whole industry. And then some of the money came back direct to the bank. So we saw outflow from the money fund investors and depositors and an inflow from our private clients and institutional and corporate.

**David [?]**
Stephen, that's it. No other questions from Jo'burg.

**Stephen Koseff**
Okay. London.

**Male speaker**
Steve, good morning. On the Asset Management mix shift has there been a shift in the yield on assets? And similarly in the bank you guided that asset margins are broadly stable. Has there been a shift in mix and is that broadly stable by product line or broadly stable for the overall group NIM?

**Stephen Koseff**
I think we meant a shift in product lines. I think clearly you're seeing pressure on the gross margin but you're also seeing cost of money come down. But overall it is broadly stable, a slight improvement in

the UK. So cost of money has come down. On new business written you've got some downdraft on gross margin, but it is made up on the cost of money side. So at the moment it is slightly improved. But in South Africa on the other hand you've seen a rising cost of money, and it is quite competitive on the other side. So we have to watch margins quite carefully. We are managing to hold them, but it is competitive. There is very moderate demand for credit. So overall, no, we are not getting margin expansion and you can end up with some margin compression. But at the moment we're managing okay. I don't understand the other question.

**Male speaker**
…lower yield [overtalking] that at a group level or is it offset by margin compression in other funds that you have?

**Stephen Koseff**
No, you may not be aware that there was a bank sale in South Africa where money funds had to take a haircut of 10% on their deposits. And that meant that their yields were negative for a month in the money fund. That meant people shifted out of money funds direct to the banking sector. And that flow was 10% to 15%. But it is as you say very low yield. So I don't think there is any shift in other areas. Alan, you were late.

**Alan**
Thank you. I have a couple. Let's do one by one. In terms of loan growth in the UK you've done 6% year on year. I just wondered what are the products that are seeing demand and what are you pushing in this market?

**Stephen Koseff**
Look, we have seen strong growth in our corporate specialist activity. There are a whole host of areas that we are seeing demand in as corporate activity picks up. On the sale of Kensington some of that activity would have been regarded as professional finance. The non-professional mortgages we sold, so you would have seen a drop in that stuff. But we stripped that out to give you some clearer picture. It has really been on the corporate side. And going forward we are going to start growing the private client and professional finance activities. But it is still early days on that.

**Alan**
On the cost to income ratio for the UK it was up. Was there anything specific there, and is there a target that you want to run the business at?

**Stephen Koseff**
Are you talking the bank specifically? I think we've got a lot of work to get… If you strip out legacy then you start seeing the cost to income ratio come down. But there is work to do to get it into the low 60s. That is where we would like to get it to ultimately. But we've still got work to do to get there.

**Alan**
The last one was on the shifting of the assets between non-core to what you now define as core. How much of the £1 billion that has gone out of the £1.7 billion has actually shifted into core? And is that because you were able to re-price it to sensible margins?

**Stephen Koseff**
The margins are not perfect, but they are sensible enough. And the credit quality is fine. The residual legacy we want to deal with in a separate way. We take it away from the operating divisions. So we don't want the operating manager to worry about the legacy. We have created a special team that will look after that legacy; otherwise it takes away their focus. I don't have the exact number. We hope to give you some colour on that at the end.

**Alan**
Thank you.

**Stephen Koseff**
Any other questions? Nothing. Thank you for attending and we will see you in May.

END OF TRANSCRIPT