Investec

Interview transcript

22 September 2014

PRE-CLOSE BRIEFING

Stephen Koseff
Good morning everybody. Welcome to our traditional pre-close briefing. I think over the past year we've made an announcement to shareholders that we were going to go through significant reshaping of our specialist banking business, and the aim was to improve returns and simplify our business model. I think that decision was taken around about October / November last year. And we spent most of the period up until the other day when you saw some announcements executing on that particular strategy.

So you are all well versed of the fact that the Australian bank which incorporated professional finance and asset finance business was sold to Bank of Queensland. That was completed on 31st July and paid for on that date.

You saw more recently we announced on 9th September the sale of the UK Kensington business to Blackstone and Texas Pacific Group. That is still subject to regulatory approval and some other conditions, but they have paid a forfeitable deposit and we expect that transaction to conclude over the next four to five months, depending on how long it takes to get regulatory approval.

We also sold the Irish piece of our mortgage business called Start. The sale of the UK business wasn't only Kensington. It was all the other non-core mortgage activities that we had conducted over the years. Similarly the Irish business came from Kensington and some mortgage activities that we conducted pre-crisis. Post-crisis we stopped doing it, but we still had to collect and manage the book. We sold that to Lone Star last Friday. That is also still subject to regulatory approval. And they also paid quite a significant forfeitable deposit in the event that the transaction doesn't happen.

Having concluded these transactions obviously we still have to complete on two of them. If these transactions had been done by the end of March 2014 our core tier one ratio would have gone up from 8.8% to 11.1%. In the UK we would have seen a significant improvement in our leverage ratio from 7.4% to 8.9%. Our legacy book which we have disclosed to you and is in run-off mode would have been reduced by £1.5 billion. And our total assets – those are balance sheet assets which include securitised assets – would have dropped off by £6 billion. So quite a significant change to the shape of the balance sheet, and that gives us a lot more scope to build our core business in our core target markets.

I think if we look at the expected results for the period to the end of September we've seen again quite good growth in the wealth and investment business, and we've seen growth in the asset management business. Both divisions have benefited from higher average funds under management. We have seen quite good inflows into those businesses, £800 million in the wealth business and £2.7 billion into the asset management business up to the end of August.

I think that the specialist banking business will also report results ahead of the prior year. The South African business has done very well and will be substantially ahead of the prior year. The UK business still had legacy and could be marginally behind the prior year. Australia we will no longer report separately. It still recorded a loss for the period, but that was as a result of a final level of impairments which we don't expect in the future. So overall the specialist bank will show an improved set of results.

I think that clearly the Rand has been a big factor again, not on the balance sheet although with yesterday's news it went walking again, but more on the effect on the income statement with the average exchange rate being 19% weaker the Rand against the Pound Sterling for the similar reported period. That does have an impact on operating results, and we do expect operating profit to be ahead of the prior year in Sterling, which would be a substantial increase in Rand.

Revenue is expected to be marginally ahead of the prior year in Sterling. And recurring income as a percentage of operating revenue has improved to 74% as we continue to build out our franchise businesses. We also see expenses marginally ahead of the prior year. So overall one can say we're still trying to drive revenue but we are seeing some improvement on that front. We are building out some units, so there is some new expense coming into the system, but overall one would expect the expenses to be pretty stable going forward, particularly when you start taking out the business that has been sold. But that is not really reflected in these results yet.

So again with the new money coming in plus a reasonable performance from markets during this period you're seeing that third party funds under management has grown to just under £120 billion. That was at the end of August. We saw a decrease in customer deposits if you include Australia in March. If you exclude Australia you would have seen that they would have increased by 4% for the remaining banking businesses. Similarly on core loans and advances, a decrease overall which is Australia moving off, but an increase if you exclude that number of 7%. So we are seeing some lending activity both in the UK and in South Africa.

On the balance sheet, I think the balance sheets are very sound. Even before the sale I think we are quite liquid, but we have seen quite a big increase in demand for credit in the UK. And you've seen a slight shift in our loan deposit ratio of 74% at the end of August. Again that is partially affected by Australia moving off, but also partially affected by the fact that there was increased demand for credit.

Our capital ratios are all within our target capital adequacy ranges. We do expect our core tier one ratio to be slightly below the 10% that we're targeting by 2016. Clearly with the Kensington and Start sale that would change in the UK and that would go somewhere around 11%. But in South Africa we will probably be 0.1% or 0.2% below the 10% target. We are confident of getting there reasonably comfortably. Again we have very sound leverage ratios on a Basel III fully loaded basis. The UK is going to track up to almost close to 9% and South Africa will be on 7%, which are both very good ratios.

On impairments the picture is starting to look okay. You can see the trend, and this is September over September over the last seven or eight years. We have just got below 2008 level in impairments. And clearly we've seen a normalisation of impairments in South Africa. We expect it for the period to be 12% lower than the prior year. And we are still seeing some elevation in impairments as we try and clear the UK legacy portfolio. So the credit loss ratio is expected to be about 0.71%. That includes Australia, which is similar to what it was in September last year, and 0.62% if you exclude Australia. What we lose is Australian assets, but we still had some impairment. That's why that other ratio is a little bit elevated.

Clearly I think we are probably at the bottom end of an impairment cycle now. In South Africa the economy is quite weak and we haven't seen the impact of these mining strikes and the very weak economy on our clients. They all seem to be performing okay. But we have had a weak economy and as I said we are probably at the bottom of that cycle. It's the lowest it has been for a long time.

Looking at different divisions, I think asset management again saw quite good growth in its total funds under management, 9%. It had good inflows and it has maintained a competitive long-term investment performance. And we believe they will be ahead of the similar period last year notwithstanding the exchange rate. So still performing at a reasonable level.

I think wealth is performing well ahead of last year. We've seen higher funds under management, we've seen good inflows, we've seen a continuation of the improvement in operating margin as we continue to benefit from the integration of the business that we acquired. We are now expanding the business by hiring in select investment professionals. And I think that the South African business has benefited quite a lot from a closer alignment with the private bank. And you have seen more recently the launch of a philosophy called One Place which allows our clients to come into one place to deal with Investec. That is starting to work quite well and we are seeing a lot of cross-pollination between the two.

Now that we don't have to deal with all that rubbish we can concentrate again on growing our franchise, innovating, and I think you are starting to see a fair amount of innovation coming back from our group and trying to build our brand globally.

I think in the specialist bank we're seeing good loan growth, relatively stable lending margins. We have seen a continuation of reduction of cost of funds in the UK, and I think as a firm we are clearly very liquid. We have seen an increase in net interest income during this period. In investment and trading income we saw an increase in South Africa and a slight decline in the UK.

So we have had a good performance from our South African and UK unlisted investment portfolio and a weaker performance from our Hong Kong portfolio. We have seen lower customer trading income really because of low levels of volatility that has been experienced in particular the interest rate and forex markets.

We are seeing good fees and commissions in our target client transactional and professional finance activities. We are seeing very good performance from our UK corporate finance business. That has been very active. And we've been seeing good corporate fees in the UK, with South Africa's more or less in line with the prior year.

And then on the cost front, as I said earlier South African costs are running in line with inflation, or marginally ahead but not far. And in the UK fixed costs we expect to be slightly higher than the prior period. That's in the specialist bank. And that ignores some of the businesses that are being sold because they will still be in our hands at the end of September with the exception of Australia.

So if we look at additional aspects, our tax rate is expected to be between 19% and 20%. The gain on the sale of our subsidiaries is flat. And that is really a decent gain in Australia offset by losses on the sale of in particular the Irish subsidiary. We made a call that we wanted to clear that and we didn't want to hang around waiting for better times. You see the Irish economy improving, but it was still a call that we made strategically to clear that business, and that was the deal that we saw last Friday.

Goodwill write-offs both on Australia and Kensington. The bulk of that item would be Kensington. And then in Australia we had to pay tax on our gain and we had to revert to deferred tax asset because the visibility of the kind of profits we require to absorb that deferred tax asset would take too long for us to carry the debit. So we have reverted the deferred tax asset and recognised tax on the profit of sale, and that would be a £33 million charge.

That is really the effect of all the strategic initiatives we have taken. You've got a very moderate effect on tangible net worth. That £33 million would be the effect. None of it qualified for regulatory because a deferred tax asset doesn't rank as regulatory. So zero effect on regulatory capital. And we've dropped our risk-weighted assets quite substantially as a consequence. That's why you are seeing the build-up in capital.

And there is no real effect on net income because we were making some profits in Kensington UK offset by losses in Ireland, and Australia as it was last year was loss-making. So the whole effect of the restructuring has been neutral on income and giving us a lot more capital and liquidity to build our business, and taking away stuff that clearly defocuses the group.

This is the first period where we had to put in the effect for the full period of the sale of the minority interest in asset management. And you've got that other forex hedge and we also have minorities because we have to consolidate the property fund. So that is £11 million that would come out of our income.

And our weighted number of shares is down a little bit, and that is really because we need to buy in shares for our staff share scheme and the like. That is what that represents, that small drop in number of shares in issue.

So I think in conclusion we've completed now the bulk of our restructuring and reshaping. That does significantly simplify our day to day operations and does strengthen our financial capability quite substantially. I think there are still some legacy assets that we have to deal with in the UK, but those things we are dealing with. And as we said to you previously it will take us about three to four years to actually clear them completely, and that also depends on economic conditions. But they are becoming a smaller and smaller part of our lives.

So we believe that our focus going forward will be to grow and build our franchise in our core areas of activity. We're back to understanding who the clients are that we need to serve and what products and services we want to offer those clients. And hopefully all of this will enable us to improve our returns to our shareholders, which as we know is what you guys want. So that's really an update on where we are in life. And we will see you in November to unpack the detail. Questions. We will start in South Africa.

Male speaker
Hi Stephen. What could those remaining legacy assets realise potentially?

Stephen Koseff
Well, we hope our carrying value. They're loans. No, there is a huge schedule which you can look in the book last year, and you will get an update on exactly what it is. I can't give you the exact number today. They are loans. Some are non-performing portfolio, some are performing. They are just clients which were outside of our target client base or alternatively loans in default that we're on a recovery

process on. You can get the exact details up till March. We told you it dropped by £1.5 billion. So it's a loan portfolio of various types of loans. As I've said, most of it is not in default, but defaulted loans do live in there. Any other questions? Nothing. Okay, we go to London. Bernard, are there any questions?

Aaron
[Unclear].

Stephen Koseff
You are going to have to ask that whole question again because we couldn't hear a word you said.

Aaron
...South Africa.

Stephen Koseff
Can you hear me, Aaron?

Aaron
See if you can hear me now.

Stephen Koseff
You'll have to ask that whole question again.

Aaron
Let's try again. Congratulations on your restructuring. The question I had was on surplus capital. I wondered if you felt there was surplus capital in the group given where the leverage ratio is and where the core tier one sits at. And what are your ideas for what you would do with the surplus capital? Do you think that shareholders will benefit from upside to where the dividend payment ratio is now? Thank you.

Stephen Koseff
I think we want to grow out our core franchise in the UK. Our private banking franchise is nowhere yet. And we are seeing a lot of activity in the UK, which is where the surplus capital would really live. Sorry? No, you've gone again. Can you hear?

Aaron
Yes.

Stephen Koseff
So at this stage we are going to keep that surplus capital and try and deploy it in building our core franchise. You know I don't want to talk dividend policy. We've got a dividend policy. Our range is between two and three, and we will live within that range. We've got a wider range, but that's really the key range.

Aaron
Let's just come back to it in another way. Then given the risk weighted intensity of the assets that are coming off balance sheet are you able to grow the core franchise because your assets in bulk don't need as much RWAs to grow the profit stream? Are you able to allocate as much assets in the speciality bank as you would to absorb those coming off restructuring?

Stephen Koseff
We were a little bit below where we needed to be. There has been a lot of change in terms of what regulators expect you to have and what rating agencies expect you to have compared to pre-crisis. So we've had to build our capital to get to new levels. We gave you a target of minimum core tier one of 10% and leverage ratio of 6%, and we are way above the leverage ratio. This is something we will have to manage. If we are generating a lot of surplus capital because the mix our activities is weighted towards the wealth and the asset management area and we can't deploy the capital effectively then we will move to the lower end of the dividend cover range. So if we are unable to we have to move to the middle or where we've been living over the last while. At the start of the financial crisis we went to the high end of the cover range. I think our cover range is wide enough to pay the appropriate dividend. But we think that we can deploy the capital in building our core client franchise. If that proves to be not the case then we'll have to rethink our capital planning. And at the moment we think we have the right capital to be able to grow our core franchise. And we will not be changing our dividend policy at this point in time. We still have to execute all these deals, so it is early days. You've still got a few more months. We've got to complete, I mean.

Bernard
Another question, Stephen.

Neil Welch
Hi this is Neil Welch from Macquarie. Two questions actually. The first is you referred to the beginning of an impairment cycle within South Africa with impairments of around 62 basis points for the group on an underlying basis. Perhaps you can give an idea of what the sensitivity would be for a full impairment cycle for South Africa for the group impairment ratio. The second question was on the asset and wealth management businesses. I was wondering whether you were seeing any asset management business operating margin headwinds, particularly over the next two years, particularly in the European part of the business, and in the wealth management business whether revenue margins have now stabilised or continue to fall.

Stephen Koseff
That is about seven questions in one. You may have to repeat some of them if I forget, but I will start off with the impairments. Our South African impairments in this period are down to about 0.3%. In a normalised environment that's where we would expect them to be. But the economy has been weak, so I don't know what is going to come. In our client base we haven't really felt that yet, but we don't know what is to come. In the UK as I said we're still elevated because we've got legacy. Pre-crisis our impairment levels in the UK were negligible. Clearly as the legacy runs off so the impairment charge in the UK is going to come off. Living at around between 0.5% and 0.6% should be the number. We peaked at 0.75% in South Africa. We peaked at much higher in the UK as a result of the financial crisis. So I still think that for the group impairments can still come down from where they were because we won't have Australia anymore. They were elevated in Australia and we've cleaned that out. South Africa is low at the moment. It may pick up if the economy remains as weak as it has been. And in the UK one would expect them to come down going forward into the future as we clear the legacy. Your second question was around margin in the asset management business. The margins have sustained themselves during this period. And it's hard to answer whether they are going to come under pressure or not. At the moment they are sustaining themselves. If we move to the wealth business, we do expect to see a continuation in improvement of margins as we deal with the tail of some of the acquisitions we've made. So the area of greater potential improvement is greater integration of our Irish wealth

business which is still below scale. We've had to carry the...are they gone there, Greg? We've got half a question to answer. No, I know the answer.

Male speaker
...in terms of you changing your business model. Presumably your philosophy going ahead as you've been talking about now is going to also be a capital light expansion programme.

Stephen Koseff
We still need to build scale in some of our banking businesses. So the big area that you will use capital in is rolling out the private bank franchise in the UK. And we still use capital. But we're now 50/50 from being 80/20 in 2007. That's a big shift. What we've cut out was up to 2008 we had this originate and distribute concept. That we've cut out. When we lend money it is to a core client, and what else can we do with that client as opposed to just lending money? That's the big shift in philosophy in the last seven years, as opposed to originate, package, sell. So that's [unclear] banks. Let them do that stuff. You've got to lend money there to build the client franchise. Are we connected again to London?

Male speaker
[Inaudible segment].

Stephen Koseff
Any other questions? He hasn't answered. I'm not going to have him hanging around to answer that question. He thinks I deliberately cut him, that guy from Macquarie. Greg, are you going to get it up or not? No, I'm not going on a conference call. The oak can speak to me later. Then it doesn't answer. I don't know if the uncle had more questions. Tell him to phone me. Okay, any other questions here? No. He doesn't answer. Thank you for attending and I hope you have a good day. Cheers.

END OF TRANSCRIPT