Business Update Call

Company Participants

- Adrian Gore, Chief Executive Officer

Other Participants

- Francois du Toit, Analyst
- Larissa van Deventer, Analyst
- Michael Christelis, Analyst
- Risto Ketola, Analyst

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Discovery Corporate Announcements Teleconference. All participants will be in listen-only mode and there will be an opportunity to ask questions after today's presentation. (Operator Instructions) Please note that this conference is being recorded.

I would now like to turn the conference over to Discovery's Chief Executive Officer, Adrian Gore. Please go ahead, sir.

Adrian Gore {BIO 3068929 <GO>}

(Technical Difficulty) and good morning everybody. Thank you for dialing in and thank you for the time. This call is in relation to the strange announcement we did just 50 minutes or so ago, and I'll speaking I guess about 15 to 20 minutes or thereabout, and as you've heard, we'll be very pleased to have questions if there'd by any.

We have put out a slide show online and I am (Technical Difficulty) page two, and just talk about the number of pages, I only expect to do the too complex and (inaudible) this is an important day for us. We are announcing that Discovery has acquired the outstanding 25% of our British business from the Prudential. The purchase price is GBP155 million and the partnership takes largely the formula on which the put and call options that are enshrined in the shareholder agreement (Technical Difficulty).

(inaudible) just going to turn to slide number two and make the point that I think the joint venture has been a remarkable partnership between us and the Prudential. It really was gained in 2007 with both health and protection entering into the market. I think the seminal moment in the evolution of the joint venture is 2010 when we effectively acquired

Standard Life Healthcare, and in return for that, grew our shareholding in a joint venture from 50% to 75%, as you can see, in the middle of slide number two.

As part of that transaction, because the Prudential became a minority, it became important to give them some flexibility and so we agreed upon a call and a put call and put that was to happen in 2015, in which we would have the ability to call the 25% and although we have the ability to put the 25% to us. It is important to say that since that the evolution of the joint venture, I think has exceeded the expectations I think for both parties, it's bigger and it's more complex. I think the relationship has been excellent between the parties and it is fundamental that both of us felt that to work for the put it call option to trigger in 2015 given the nature of the relationship and the (Technical Difficulty) doesn't make sense.

So over the last year or so, we have been negotiating and working with the Prudential in order to get the right Life path going forward. If they decide that in that process, we consider the number of different alternatives, not just the put in the cone in fact, the Prudential considered by us in the joint venture that based on our aspirations ultimately we say from opposite line up by the outstanding 25%. And that's exactly what has taken place. So this in the sense happens now and not in terms of the put and call agreements.

Let me move to the next slide and just to make the pace of what we are trying to do here now. I will be brief, but it is worthwhile saying that we do believe the UK offers the considerable opportunity for Discovery and for our specific business model. And as you know, it's a fairly fundamental part of our strategy that's taken primary marketing and we have that confidence that (Technical Difficulty) in the UK market.

As you can (Technical Difficulty) like any developed markets that is suffering from complete demographics and the social implications of that placing social (Technical Difficulty) under pressure. People are living longer, they're living longer in PruHealth (inaudible) continues to rise about general price inflation and some even great complexities that make insurance, health and life and other forms frankly a central part of society.

Having said that, you can see that the insurance system hadn't responded to serving the really macro trends affecting the market the fact that, millennials have different expectations of institutions and these are a very different sense of institutional power of our financial crisis et cetera. But I think the core thing for us and I think if you follow that you will notice that, our strong belief in the fact that insurance systems done the fact that the nature of risk has changed. That today the developed market is 80% of risk is still by behavioral, last half choices that lead to non-communicable disease, it's more than 50% of the driver of mortality is on that course.

At the same time, because behavioral, we know that people are rational in terms of how they make choices and to the extent there is very little response in the insurance industries around that. Our very strong belief is that the Discovery model, the use of incentives and behavior change and passing that into (inaudible) life and health insurance offers a unique opportunity and a unique business model. And as our last time reviews I think in the context of the UK, we see great receptivity of the model, and to an extent going forward, there has been a lot of work within in the Discovery organization around, disciplined process of netting out what is really a shared value model. The idea of using incentives to get change, the actual surplus from that better behavior being clawed back into incentives and (inaudible) to shareholder et cetera and getting really a pure shared value cycle.

Our very strong completion is on slide number four that that has the opportunity to change the market by offering lower prices, achieving better selection, creating good behavior and driving both better value for our customers, and importantly, better value for shareholders as we illustrate on slide four.

Turning to slide five, ignoring the macro trend, at a micro level, we have a strong belief that the strong opportunity to get superior profits and return on capital from both the health and life insurance market. In the context of health insurance or PMIs, as it's called in the UK, it's relatively lighter on capital. It is an industry that wrecks around (inaudible) that is robust, about 7 million people that are covered in that market with a market growth that is not (Technical Difficulty) and our concern is to gain market share. We only have 500,000 or so lives and makes this considerable space to grow into.

But I think what is exciting is that if you get better selection, better pricing, dynamic underwriting et cetera, you have the ability to get (inaudible) effect on the return on capital. So the slide number five, on the left hand side, illustrates that a 1% reduction in claims draws a 5% increase in return on capital. We think that the ability to have superior returns on capital is present in the health market.

In the context of life insurance or protection, as it's called, the opportunities are vast. It is a very, very large market. As you can see from the slide, on the right hand side, the UK is third large market .Globally at the same time it's a market that is largely commoditized and therefore, if you can achieve better price points, differentiated value propositions, we believe we can see opportunities (Technical Difficulty) superior profits and growth is real. So at sort of a micro level, I think (Technical Difficulty) very strongly in what we set out to do in the evidence over the last number of years.

Turning to slide number six, I think it is important to give you a sense of the confidence we are building of what are going to achieve in the UK. I have made the point that the last number of years have been important for us. Illustrating that on the slide, you can see the strong new business growth, you can see the operating profit emerging just after 2011.

But importantly, you can see the quality of the business, and I think that reflects the quality of the business model. We managed to bring loss ratios down and lapse rates down in the context of PruHealth's lows in the industry. You can see a similar trend in the context of PruProtect in terms of claims levels and lapse rates. And I think very importantly, over the last few years, we've managed to really get Vitality into a position of strength, visibility and considerable engagement as we've tried to illustrate through the bottom of slide number six.

Just two specific comments on each of the business lines. In the context of PruHealth, I've just made the point, you can see it on the left-hand side, that the market clearly has a fairly long tail, but it's fairly -- that's kind of a strong oligopoly at the top end. There is considerable market share for us to grow into, as you can see.

As I've just mentioned, we've done, I think, very good work on the quality of the business. But on the right-hand side, we've made this comment in a number of our results announcements, we really have been laboring under a number of administrative systems and structures. We acquired Standard Life Healthcare, taken us a number of years to roll through into different technology (inaudible) change blocks of business et cetera.

But as you can see from the chart from now through the next year and to the following 2016 year, we will be on to one administrative system, considerable amount of expenses will drop off, and therefore we expect by 2015 to 2016, 100 million to 150 million of additional profitability to merge from really the removal of this burden of a number of technology layers. And so essentially [ph] the PruHealth was a differentiated product offering with the quality of the business that it had and with a far more efficient chassis that has great potential to make significant profits.

In the case of PruProtect, turning to slide number eight, I would say that our confidence levels are very higher, the ability to disrupt the market. On the left-hand side, we have followed a different distribution strategy to many of our competitors. And I do believe that that is because of the 12 face to face distribution channel that now touches 8,000 brokers, that together with the differentiated product offering (Technical Difficulty) not just excellent distribution, but some of the really powerful networks that offer great potential for growth going forward.

But I think the seminal issue for the PruProtect business is on the right-hand side. Late last year, so approximately one year ago, we rolled out the, what we call the Vitality Optimiser, really the dynamic underwriting and dynamic pricing model that has driven Discovery Life. It has taken us some time, as I think I mentioned in our result presentation, to get us to what it needs to be in a foreign market. It required codifying mortality curves, moving them to reinsurance structures et cetera.

But really what it gives us in a market that is commoditized, as you can see on the right-hand side, with lower price points, really pricing selection, that really prices in the better lives, creates the right kind of behavior and brings down lapse rates for the better lives. And to an extent, it reverses the very dynamics that take place in the traditional life book where you tend to latch for the better lives (Technical Difficulty).

And more into the Optimiser, turning to slide number nine, that has been pretty fundamental in the evolution of PruProtect. In the left-hand slide of chart number nine, although it's a discounted premium, it starts out lower, but irony is the average premium that our policyholders are buying is 30% higher than we've had on the traditional. The number of ancillary benefit (inaudible) which drives a lot of profitability is 20% higher. You can see on the bottom left-hand corner that now maybe 44% of the business is in fact is integrated to Vitality through the Optimizer.

And then on middle part of the chart, which I think is important, you can see the rapid market share gain that PruProtect has managed to achieve. And so while, a number of units that we were kind of languishing in the tail of the market today, we are the third largest writer in the IFA channel and we are quite close to the second and the considerable growth opportunity.

On the right-hand side, I think you can see graphically the rapid and exponential growth in the number of policyholders of PruProtect. And I think we believe the business really is embryonic. This is one playout of the product and there is a long way to go. And so, combination of the two has given us great confidence about what PruProtect can do.

On slide number 10, I'm not going to dwell on this, but it is important to make the point that our business supported very substantial Vitality chassis besides the technology and the methodologies and the pricing. (Technical Difficulty) version and many, many companies in the UK, we developed a very, very powerful Vitality chassis and network that really bodes well for a lot of things that we'd be doing, and in the process of next week we'll be rolling our additional products as part of the launch of the new brand and the launch of the new products that are really pivotal on the Vitality capable (Technical Difficulty).

So what I am trying to make we are developing [ph] for both is just to make the point that the Discovery composite model Vitality linked to both health and life. I think is taking shape very, very well in the UK. And that has given us the confidence to drive in terms of what we try to achieve there.

Turning to the slide number 11, it is important to say that one of the critical things going forward is building brand equity, the close part of this transaction that we will be changing the brand away from the Prudential. Over the last 18 months or so, we have worked hard in terms of building the Vitality brand. You will probably notice that in some of the certain things like Britain's healthiest company that we've done those kinds of things. but we've been lot more visible about the line, the Vitality and that sort of strategy (Technical Difficulty) et cetera has worked remarkably well. We stepped up the pace quite a bit with going with the premiership and that poses a whole bunch of opportunities and not only just in terms of visibility, but in terms of our DTC campaigns et cetera.

And so, the research we've seen has meant with the -- has allowed us to conclude that the Vitality brand and what it stands for it has achieved considerable cut through in the UK market, and that too has given us not only confidence on the way forward, but an important brand, an important brand pillar upon which we intend to build.

I will turn to slide number 12, just as important to talk about strategic thinking. And it really talks to the question of why from our perspective we moved quicker than the call and the put is laid down in the shareholders' agreement. As I said at the offset, there are negotiations and instructions between ourselves and Prudential have been remarkably good, and therefore the discussions have been about how both parties should go forward and get the right kind of like path [ph].

From our perspective, our reasoning is essentially the sooner we do, the deals are better. And the four distinct things I thought I would mention, the first is brand. Of course, the Prudential brand is an incredibly powerful asset and it's a remarkable brand, but in reality, for us hiding behind it is not a long-term solution. As we're so cut through in the Vitality brand, it became clear that trying to brand Vitality with the Prudential in a sense is inefficient, and to an extent, given the amazing cut-through that Vitality is getting, the longer (Technical Difficulty) inextricably linked to the power of the Prudential, and that would remove our ability forever to really get away from it. So the important asset of Vitality and its brand potential means that sooner, we do it the better.

The second point is the balance sheet. While PruHealth is written -- the health insurance is written on a license inside the joint venture, we've written the protection business inside the Prudential's balance sheet, on the Prudential's license. What this has meant in practice it's really a bifurcation of the balance sheets of the joint venture where in effect, all of the protection business, product approval, its governance, its reserving basis et cetera, are determined by the Prudential because it's on their balance sheet. Now while that I think worked in a start-up phase, the truth is that's not really fit-for-purpose for an institution building on its own. And so bifurcation of the balance sheet had to be addressed sooner than later.

In terms of funding, one of the (Technical Difficulty) of the initial joint venture was that the Prudential, through its balance sheet, funded the start-up acquisition cost of the (Technical Difficulty) at the outset, that was of course a very important asset. Having said that, given the tax changes, a lowering of interest rates, the funding is not -- is not that efficient and we replaced at a lower cost. At the same time, the scale and success of the JV has meant that it has its own ability to raise funding from other sources like FINRI [PH] et cetera that presented a lower cost to the existing funding. And so to an extent, the funding became something that was not necessary going forward.

And then the fourth point I think I would like to mention is just potential expansion going forward. The joint venture as it was structured had a fairly restricted scope of business, only life -- only protection and PMI and really restrict any other scope of business. So if you think of the Discovery composite business, all other areas like long-term savings and other that we may go into over time.

And essentially when you go through, it became clear that in essence the current structure had to change. I would also say the last point on slide number 12. It's an important one, is that the price of the 25% is formula driven, and of course the bigger the business gets, the higher that price tends to -- the higher that price is. And (Technical Difficulty) the rate of growth of the business that exceeds the cost of funding. So the sooner the purchase is done, based on this formula, of course, the better it is for us in that respect.

And so I would say in conclusion that we felt that given our aspiration and given the structures that were there that it makes sense for us to acquire the 25% and move forward.

Turning to slide number 13, this is a very important point I would like to get (Technical Difficulty) the Prudential on transition of the platform [ph] going forward. The business is hugely complex and both parties felt that we need a very smooth, careful transition to make sure that shareholder value is maintained, and of course, policyholders and other stakeholders are treated properly. So there are a number of facets to the transition, all of them required close collaboration with the Prudential and I think that's scoring the very good (Technical Difficulty) we have with the Prudential.

On the brand itself, we will be transitioning immediately essentially from the Prudential brand that will take place next week from the 17th in London. You will see more of it going forward, but we have made the strategic decision to use the Discovery brand at the corporate level, but in fact, the insurance entities will be branding Vitality, Vitality Life and Vitality Health. This has been based on a lot of research that we have done over the last number of months and I think some of the smartest thinking people in the UK around the cut-through of Vitality, the centrality of the mechanism and the message that Vitality is not just a program anymore, but in fact the entire insurance products really revolve around how Vitality works with pricing and makes it different.

On the balance sheet itself, we will continue to use the Prudential balance sheet while the licensing takes place for the life insurance business in in the JV. So what will happen is that new business will continue to be written on the Prudential balance sheet and over time when that licensing processes is done, we will then start writing new business on the new license and then over time we'll shift the existing block that sits on the Prudential balance sheet, over time we anticipate that in the three to five year period to shift on to the Vitality business in the UK.

From a funding perspective, the Prudential will continue to provide funding for the existing block of business and that will only be transferred once the entire existing block is transferred into the Vitality business in the UK. So to an extent, the Prudential will support the existing business in the UK and Discovery through our resources, FINRI and other structures will (inaudible) that funding as required as the business grows.

I think the strength of the life part is that it makes sure that things are done properly and appropriately, all stakeholders are taken care of, but I think critically, given the rapid growth of the business, it doesn't interfere with anything on the ground. Bear in mind that operationally and from a management standpoint, it's an entirely stand-alone business controlled by Discovery. So these very (inaudible) behind the scenes is essentially business as usual on the ground. So I think what we managed to achieve with the Pru is a process that's good for all parties and I think that is important.

I am going to wrap up with slide number 14, just very briefly, the economics. As I've said acquired the outstanding 25% meaning that going forward, Discovery on 100% of the businesses in the UK. We paid GPB155 million. From our plans, we estimate that only GBP155 million -- we should return between 15 -- we should earn between 15 and 20% return on the capital, but of course, the real aim of acquiring that is to liberate other 75% that we own already and to really to drive that going forward.

From a capital perspective, we are funding the purchase price and the regulatory capital out of existing resources and some debt, but and we are comfortable that we do not need to raise capital for this particular transaction. I must point out that Discovery is involved in a number of growth initiatives and over time we'll continue to revaluate that capital plan. And then finally, just to make the point on earnings itself, the business is growing rapidly. We anticipate by 2016, we estimate that the business can generate in excess of ZAR1 billion of profitability.

So let me end there and just say that it is an important day for us, a lot of work and planning over last year has taken place to get here, and to express gratitude to our team and certainly to the Prudential for a process that I think has gone very, very well.

I am going to end then. If there are questions, we are very, very happy to take them.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Michael Christelis from UBS.

Q - Michael Christelis {BIO 15233664 <GO>}

Hi, guys. So it's just three questions. I apologize, the line was pretty bad, I am not sure if I misheard or if you perhaps already said this. I mean, is there a period of time over which new business will continue to be written on the pre-balance sheet? That's my first question. The second question, just in terms of accounting for this transaction, the value is significantly lower from what I can see than your puttable interest value in your balance sheet. Can you maybe just talk a little about the impact that, that has on the current year's reported earnings number?

And then just in terms of product expansion, you touched on, I think. I mean, are you looking to launch things like Invest and Insure into that market or what could we expect in the near-term as far as new products in that space? Thanks.

A - Adrian Gore {BIO 3068929 <GO>}

Michael, thanks for the questions. Yeah, you are correct, in the case of new business, we will continue to write new business on the Prudential license while the Life Insurance license is being obtained for the business. Once that license is obtained, we expect it to be 12 to 15 months or thereabout. Once the license is there, we will then write new business on the new license obviously. The new business that has been written on the Prudential business will essentially from the part of the existing block that will then be transferred over time on to the license.

The second question is on the accounting. You are correct, the put option and the accounting treatment, all that took into account the long-term projection of how the business might play out, and it does create some distortions because of the value that we are paying is lower than -- that determined inside that put option calculation. So it will show us some excess earnings this year, but in fact, I'm pretty sure we are set up to reveal a proper normalized earnings that will allow in the complete [ph] comparison year-on-year.

The third point is really just at this stage I think largely epidemic. I think we have all real opportunities for some of our other products in Invest and Insure that come to play out in different ways in the UK. There are a number of, I think, opportunities in different ways that we can think about, but at this stage, it's a point just to make clear that before we're completely restricted to follow it and I think given that we have that now opening the opportunities will present themselves, but there's nothing planned immediately for that.

Q - Michael Christelis {BIO 15233664 <GO>}

Are the Pru restricted from launching new protection products or not?

A - Adrian Gore {BIO 3068929 <GO>}

The Pru cannot use its brand in the protection space for a year. So what they'll do is up to them and that follows from the transaction.

Q - Michael Christelis {BIO 15233664 <GO>}

Perfect. Thanks, Adrian.

Operator

Our next question comes from Risto Ketola from Standard Bank.

Q - Risto Ketola {BIO 4929572 <GO>}

Yeah, good morning, Adrian. I'll also ask maybe three questions. First of all, in terms of funding this ZAR2.8 billion, can you give me some indication of how much will be from internal cash resources and how much will be new debt issued and maybe whether you're going to be using the preference share in South Africa or are you going to raise debt offshore?

The second question is that ZAR1 billion of earnings you showed in the last slide. Is that pre-tax for the UK combined operations or net earnings? Maybe just a little bit more clarity on what the ZAR1 billion refers to? And then the last question it sort of follows up on Michael's question, because Prudential mentions in its release that they will be looking at re-entering the protection market, so it's basically the use of the brand for one year to only non-compete in place?

A - Adrian Gore {BIO 3068929 <GO>}

Yeah, thanks. The first one is, I think, approximately 50-50 on funding of the 2.8 billion debt and internal resources. We continue to look how best to go forward on that, but at this stage, it's about 50-50 between the two and it's entirely onshore at this stage.

Second point is the estimate of profitability is really the operating profit, I was illustrating, and then the third point, the only restriction on the Prudential is -- the two restrictions that can't use the PruProtect name in the protection space, because it's a name that we built up with them and they can't use their brand in the protection space for 12 months. Those would be the only protections essentially that we have.

Q - Risto Ketola {BIO 4929572 <GO>}

Thank you.

Operator

Our next question comes from Larissa van Deventer from Barclays. Please go ahead.

Q - Larissa van Deventer {BIO 20764470 <GO>}

Thank you. Good morning. Just one question from my side. You previously had the use of Prudential's balance sheets and license until 2020. You mentioned 12 to 15 months to get the new license in place. Any related financing arrangements and anything else? Will that all end at the end of the 12 to 15 months as well or do you have alternative measures in place that will have play out in 2020?

A - Adrian Gore {BIO 3068929 <GO>}

Larissa, I hope I am interpreting the question correctly. We will continue to use the balance sheet for the existing block for a number of years. So there is two pieces in place. One is, once the license is approved, we can then transact new business on our own license, but the existing block will probably stay with (inaudible) transfer for a number of years, we expect three to five years. So I am not sure I'm answering the question. In effect, it's actually quite simple, I think. The existing block (inaudible) by the time we get our license stays there for a number of years and is transferred. A new business starts in our own license from the time that the license is approved.

Q - Larissa van Deventer {BIO 20764470 <GO>}

And any loans that you have between, yourselves and Prudential?

A - Adrian Gore {BIO 3068929 <GO>}

Well, the main issue is that the Prudential has funded the acquisition costs of the -- that's part of using their balance sheet in effect, but they had inside the reserve structure funding for the existing block of business. That will remain in place, so essentially, that funding will continue to support the business. And at the point of the transfer to our license, whatever funding is left or whatever funding hasn't unwound by that stage, will need to be paid back, but in fact on our calculations, it's probably very negligible. It's likely that that funding will have run down by that stage.

Q - Larissa van Deventer {BIO 20764470 <GO>}

Okay. Thank you very much.

Operator

(Operator Instructions) Our next question comes from Francois du Toit from JP Morgan. Please go ahead.

Q - Francois du Toit {BIO 16128719 <GO>}

Hi guys. Sorry, I'm -- can I ask you a question that I think has been asked? So the 4.7 billion Prudential policyholder debt or negative reserve funding, that will effectively need to be repaid when your license gets into place. And is that -- am I understanding that correctly? Or if not, are there any events that could force the early repayment of that debt?

A - Adrian Gore {BIO 3068929 <GO>}

No, Francois, let me explain that. The 4.7 million -- the 4.7 billion negative reserve effectively is the acquisition cost funding of the existing block that's been built to-date, right? That will not -- what happens is that will only need to be repaid once that existing block is transferred on to the new license. So even though our license hopefully will come particularly next year or so. Then debt transfers likely take three to five years, right? As you know, if you look at that existing block on its own, those negative reserves unwound part [ph] which is certainly in the UK and therefore if it's four to five years out, it's unlikely that much of that 4.7 billion will still be there. And so the 4.7 billion funding will remain, but it's likely to run down. So on our projections, it's unlikely that any of debt needs to be paid from Discovery resources.

Q - Francois du Toit {BIO 16128719 <GO>}

Okay. It's a fairly big amount of debt that's increasing through ongoing funding. I would just maybe request that some disclosure around the payback period for that gets disclosed as -- similar to the sort of disclosure you give after a negative reserve payback in the annual report, I think that'd be very useful.

A - Adrian Gore {BIO 3068929 <GO>}

Yeah.

Q - Francois du Toit {BIO 16128719 <GO>}

Just also on the -- can you maybe disclose or will you put out some announcement maybe what the financial impact on your TNAV and your NAV and earnings at some point in time?

A - Adrian Gore {BIO 3068929 <GO>}

Yes. (inaudible) and Ricky Farber will be giving you detail on that quite soon, on all these issues.

Q - Francois du Toit {BIO 16128719 <GO>}

Okay. Thank you.

A - Adrian Gore {BIO 3068929 <GO>}

Thank you.

Operator

Thank you, sir. Adrian, at this time, there were no further questions. Do you have any closing comments?

A - Adrian Gore {BIO 3068929 <GO>}

Just maybe to again thank you for dialing in and listening. And just like -- a lot of detail on these [ph] what I've said, I hope that's clear that will be available from our teams as we move forward. Maybe just to end with, it is an important step for us and one we are very excited by and let me thank you for listening once again. Thank you.

Operator

Ladies and gentlemen, on behalf of Discovery, that concludes today's conference. Thank you for joining us and you may now disconnect your lines.