Zurich Insurance Group AG to Aquire ANZ's Life Insurance Businesses in Australia Conference Call

Company Participants

- George Quinn, Group CFO and Regional Chairman of Europe, Middle East & Africa
- Mario Greco, Group CEO
- Richard Burden, Head of IR

Other Participants

- Andrew Hughes, Insurance Analyst
- Arjan van Veen, Executive Director and Equity Research Analyst of Insurance
- Dhruv Gahlaut, Analyst
- Farooq Hanif, Head of Insurance Research in Europe
- James Austin Shuck, Director
- Johnny Vo, MD
- Michael Igor Huttner, Senior Analyst
- Niccolo Cornelis Modesto Dalla-Palma, Research Analyst
- Nick Holmes, Equity Analyst
- Peter Eliot, Head of Insurance Sector Research
- Thomas Seidl, Senior Analyst
- Vinit Malhotra, Banca di credito finanziario S.p.A., Research Division

Presentation

Operator

Ladies and gentlemen, good morning, or good afternoon. Welcome to the Zurich enters agreement to acquire ANZ's life insurance businesses in Australia conference call. I'm Sarah, the Chorus Call operator. (Operator Instructions)

At this time, it's my pleasure to hand over to Mr. Richard Burden, Head of Investor Relations and Rating Agency Management. Please go ahead, sir.

Richard Burden {BIO 1809244 <GO>}

Good afternoon. Good morning, ladies and gentlemen. Thank you very much for making yourselves available at relatively short notice today for this Q&A session on the acquisition of ANZ's life business that we announced last evening. We will have to run fairly promptly today. And so I would ask you just to ask one question. And we'll probably have to take any other questions offline through the IR team later on today.

On today's call, we have our Group CEO, Mario Greco; and our Group CFO, George Quinn.

Before moving on to your questions, though, I'll just hand over to Mario for some introductory remarks on the transaction.

Mario Greco {BIO 1754408 <GO>}

Thank you, Richard. Good afternoon, everyone. And thanks again for being on the call on such a short notice.

The transaction is fairly simple. It fits perfectly with our strategy and with our past decisions. It's a bancassurance deal. And we've been fairly successful in the past years in bancassurance deals. So we know what it takes. And we can give value to the banks basing on what we learn from the past experiences. The portfolio that we acquire and the portfolio that the bank use to distribute is a portfolio of products that we're extremely familiar with and products that we like and where, again, we have lots of skills how to manage them.

The bank is an excellent partnership for us. It's a very strong Australian institution, high reputation, well managed, extremely stable, not involving customers' issues. So that was another very good point in this transaction. And on the financials of the deal, it's a cash-generative deal. And it's both accretive. The profile of the returns is extremely interesting, as George will later tell you. So we thought even the financials were extremely interesting and fair.

So all in all, it fits with the strategy. It balances very well the portfolio of Zurich and adding products that we know and we like and will make Australia one of our top countries, which, again, I think, is a positive thing after the Macquarie acquisition and the Cover-More acquisition. This concludes our growth in Australia and bring us to the position that we wanted to achieve there.

I would stop here. And we go directly to Q&A? Yes. So it's back to you guys.

Questions And Answers

Operator

(Operator Instructions) The first question is Peter Eliot from Kepler Cheuvreux.

Q - Peter Eliot {BIO 7556214 <GO>}

I'm limited to one. I might just ask on the reinsurance financials. You show on Slide three of your presentation $70 million sort of expected impacts. I'm just wondering if you can sort of explain a little bit about the finances and how you get to that. And I guess specifically, ANZ seemed to be pointing to a lower foregoing of profits. So I was just wondering if you could reconcile the figures.

A - George Quinn {BIO 15159240 <GO>}

Peter, it's George. I'll take that question. So the reinsurance element of the transaction is something that we've agreed to do together, one to allows us to get an exposure to the earnings more rapidly and, of course, for ANZ to allow them to release capital more quickly. From a reinsurance perspective, I mean, we targeted part of the portfolio that's acquired so it becomes part of what we acquire when the transaction itself closes, it's priced at a level that we think is close to market and it reflects, I mean, what we see traditionally in the reinsurance market. I mean, given we expected this, I mean, somewhere around $1 billion of capital in that part of the transaction, I mean, this, from an after-tax or pretax perspective, given the period that's involved is roughly, I think, what we expect to see. As far as, I mean, reconciling to the Australian view, I mean, it's tricky to do it on this particular part of the deal. I mean, obviously, you'll see comparisons, I mean, both from our view of, I mean, what we anticipate the operating profit will be, say, in 2019 versus the level that we've seen from the business locally on an Australian basis. I think the important things to have in mind are, of course, the number that we've given for '19, of course, is pretax. I think everyone has probably noticed that. And the figure that you're aware of from the OnePath business is post-tax. Second, a couple of issues. I mean, we have been working on a DI issue, I mean, we've watched them reprice as we've worked alongside them on the transaction. So of course, the benefits of that are reflected in what we anticipate for the 2019. And of course, I mean, given that the transaction process itself has been running for some time, I mean, well, we think the organization is actually, I mean, very well managed with some very strong talent, I mean, the process itself is bound to have some impact on production over that period. And we've allowed for that in our view of future expected operating profit.

Operator

The next question is from Johnny Vo from Goldman Sachs.

Q - Johnny Vo {BIO 5509843 <GO>}

Just a quick question in terms of like your reconciling this transaction with the ongoing balance sheet strength of the group, i.e., does this transaction limit your capital flexibility in terms of capital returns? Because when I look at this transaction on a pro forma basis, your leverage ratio still remains under 30%. Given that you're buying this business for about market consistent and better value, it won't change your Z-ECM much. You may consume some central liquidity. But it looks like your financial flexibility is in place. So can you give us some view of how this financial flexibility is impacted by this transaction and what this means for capital distributions going forward?

A - George Quinn {BIO 15159240 <GO>}

Thank you. So maybe I can answer actually 2 questions in the course of trying to answer this one. So I mean, I think your summary is, I mean, almost spot on. I mean, from an economic perspective, I don't expect it to have any significant negative impact on the economic capital ratios. It will consume some S&P capital. Most of the S&P model is different, in particular, the discount around VIF. And if you look at it from an S&P perspective, I mean, we expect to consume somewhere around $800 million of S&P capital as part of this transaction. I mean net-net, all of that means that, I mean, post the transaction, the group continues to be very strongly capitalized. And this will only have a modest impact. On the cash topic, I mean, we can, in fact, fully fund it from our existing resources. I mean, to the extent that we do use senior, I mean, that will really be a, I mean, a foreign currency hedging mechanism for us in the end rather than an unnecessary funding mechanism. But from a capital perspective, obviously it has some impact on S&P but very modest on all the key economic capital metrics.

Operator

The next question is from James Shuck from Citi.

Q - James Austin Shuck {BIO 3680082 <GO>}

My one question is just to try and get some insight into the track record on the earnings profile please, because you showed the $300 million BOP number by 2019. I'm just keen to know the trajectory of earnings over, say, the last five years or so because I think you -- for the industry as a whole, you show the inflows and the maturities and surrenders in the appendix, which, absent the indexation, shows that the business is actually in decline. So I'm just keen to get an understanding of how that earnings -- the earnings have actually trended over time and what the kind of key performance metrics are that you look at. Because it seems like you're making about $225 million on about $1.1 billion of premium, which is a pretax margin of about 20%. So that suggests a combined ratio of maybe around 85%. If you could just comment on that for the outlook there, that'd be helpful, please.

A - George Quinn {BIO 15159240 <GO>}

So James, it's George again. So from a -- so if we look at our recent experience. So again, just a comment on the '17 experience. There is some correction around the DI book reflected in the figures. I mean, there is some impact of what we believe -- at least it's our opinion rather than fact there's some impact of the transaction on some of the new business flows. I think if you look at this business over long periods, it has been well managed. I think, I mean, it hasn't entirely avoided the market issues which, I mean, even our own business in Australia has suffered from. But in general, a bit like our own business, it has managed and used the mechanism in the Australian market, which, I mean, one of the reasons why we like it is its ability to reprice and respond to profitability trends that were different from the ones were anticipated at pricing. I mean, it's one of the things that does make Australia an attractive market for us. I mean, if we look at this over -- I mean, either going backwards or going forward, I mean, we see a, I mean, a relatively stable business. The DI business has had the challenges that, I mean, you've seen elsewhere in the market. They've addressed them promptly. They haven't seen some of the significant volatility you've seen more on the group products because it's obviously a much smaller player. I mean, we look at this actually as a high-quality life business with a good track record and one that we would expect to continue into the future. Sorry, on the combined ratio topic. So I mean look, I haven't looked at this from a combined ratio metric. I mean, we've looked at the -- I mean, more the economic and ordinary accounting profit figures this thing throws off. Given it's a protection business, I mean, you could do that combined ratio measure. But, I mean, I haven't tried to do that as part of our review of the transaction. I mean, for us, I mean, the most important things here are the, I mean, the forward trajectory around earnings, how we allocate the value and the transaction between the various products that we rate. And I mean, it won't be a huge surprise, I mean, given the market profitability characteristics, that the lump sum of the term mortality product is by far the most important, that's where we attach, I mean, the vast proportion of the profitability. But I mean, from a traditional perspective, it's about operating profit trajectory and, in particular, their cash. So I mean, the thing -- given it has a relatively significant in-force component, it does chew off lots of cash. But the cash characteristics and the operating profit characteristics are 2 of the factors that we focus on most.

Operator

The next question is from the Farooq Hanif from Credit Suisse.

Q - Farooq Hanif {BIO 4780978 <GO>}

Could you please talk about the drivers of the $40 million synergy that you've talked about? And talk also about the kind of the strategic synergy, I guess, with Cover-More as well as Macquarie.

A - George Quinn {BIO 15159240 <GO>}

Yes. So on the synergy topic. So I mean, in fact, we've literally just -- well, not literally just. I mean, 2 weeks ago, we've switched over on the Macquarie acquisition from the Macquarie systems to a single system. It would be our intention to take those same things. So we've moved from the OnePath system environment to a single-target environment. And that's probably, I mean, a large part of, I mean, what we expect to achieve by way of cost reduction. I mean, there will be some overlap in terms of resources. I mean, this is a well-run business and, I mean, there's some great talent inside OnePath. We need to look carefully at both OnePath and the Zurich organization and bring together the combination of both. But that system component is a significant driver of the cost benefits. In terms of the broader benefits of the combination of what we have in Australia. So I mean, for us, it actually starts with neither Macquarie nor OnePath. I mean, we felt that we had a good team in Australia prior to the Macquarie deal. We felt they had managed the business they had well, they were positioned well. And Macquarie was a chance for them to step up. I think they've demonstrated through the success they've had with, I mean, both the business and the success of the integration that they can do that effectively. And in fact, given they just finished one process, I think they can have some break for the Australian summer. But then they can come back. And they've got good experience that they can deploy on this topic. On Cover-More, we certainly discussed with ANZ ways in which we can bring some of those products to ANZ clients. And that's certainly something we'll focus on more as the transaction goes on. But I mean, obviously the market positioning that this gives us, as Mario said, powerful, well-run distribution partner, I mean, these are the reasons why we do this. And the fact that we have the scale and expertise on the ground in our own business gives us the confidence to allocate capital in this way.

Operator

Your next question is from Michael Huttner from JPMorgan.

Q - Michael Igor Huttner {BIO 1556863 <GO>}

It's assumed we can only do one question. But -- and I understand and it's very efficient. On the cash, I think 2 numbers. So one is the all-in Australian dollars of $ 300 million which would be accretive, if I've got the right numbers, in your 2017 to '19 period. Then there's a bigger number of $1.4 billion. Now the $1.4 billion is so much bigger than the $300 million. I'm just wondering whether it's a decent portfolio. Maybe you're saying one is VIF benefit. And I just wondered if you could explain a little bit more or share a bit more on the cash flow profile you're expecting.

A - George Quinn {BIO 15159240 <GO>}

Yes, okay. Thanks, Michael. So the reason for this, I mean, the seeming contradiction is that the USD 225 million or the AUD 300 million is the, I mean, the actual cash remittance for '17 through '19. So that's overlapping with the current target period we're in. But given that we don't own the business until the end of '18, the only cash flows that we really have in there are one year of their ownership plus the impact of the reinsurance. I think if you look at this from a, I mean, a pro forma and ongoing perspective, I mean, you see on the next page of the presentation we're anticipating pretax operating profit around the $300 million mark. I mean, cash generation is very high. So I mean, you could assume here that the cash generation is, I mean, very much in line with the expected after-tax profit. And that's really what takes you back to that view over the first five years. So I mean, we pay $2.85 billion up front. And we anticipate that in the first five years of the ownership of the business, we'll get back about half of that. But the difference between the $300 million and the $1.4 billion is at that timing issue. We don't own it until actually quite late in that period.

Operator

Your next question is from Andy Hughes from Macquarie.

Q - Andrew Hughes {BIO 1540569 <GO>}

Just trying to get my head around the 3 different metrics of the cash at ECM and S&P metrics. So George, when you said there was a $1 billion of capital going to be used for the reinsurance, did you mean that? Because obviously, the Z-ECM impact is quite small as the reinsurance sort of relatively capital efficient. And I guess what I'm trying to do is say, well, the Z-ECM impact of the deal isn't very big, then presumably there's ECM cash generation -- or yes, the capital generation on an ECM basis isn't very big either. And so maybe you can kind of break it down by the 3 metrics in terms of kind of what's going on.

A - George Quinn {BIO 15159240 <GO>}

Yes. So on the first one, you've got me. I confess I've used the cash and liquidity a bit carelessly. So the $1 billion is cash. If you look at the total transaction, the expected impacts from an S&P perspective, we estimate around $800 million. I mean, the reason that figure is important is, of course, that's the number that you need to use for the buyback comparison. As far as the cash and the Z-ECM side of it, maybe I didn't understand the question correctly. But I mean, let me try and answer. If I get it wrong, you can come back and ask me again. So I mean, cash itself is -- I mean, it's not so important from an economic perspective. So if the economic asset is there, I mean, it's effective available financial resources as far as the capital calculation is concerned. I mean, cash is obviously extremely important to us because we want to make sure that, I mean, as we make this investment today, we don't need to wait for five years before we see real cash returns. And again, one of the things that makes this thing so attractive is that the cash flow is, I mean, as I answered in the question that Michael asked. I mean, over the first five years, I mean, we'll see, I mean, almost half the purchase price back. So and it's also important for that ECM and it's very important for the overall proposition behind the transaction. And the cash flows are extremely strong.

Q - Andrew Hughes {BIO 1540569 <GO>}

Yes, I guess the question I was trying to ask was what was the -- what would the Z-ECM capital generation be? Presumably, it's a lot smaller than the AUD 300 million a year. But I was just wondering what the incremental benefit the Z-ECM capital generation would be.

A - George Quinn {BIO 15159240 <GO>}

So the -- I mean, given the nature of the business. So -- I mean, in spite of that conversation we had, I think, again -- I think that's, again, a question that Michael asked around Q2. So you need to look at the economic value of the business, the new business that you write. And that's really the economic capital accretion. I mean, given the nature of the product that we write, I mean, it's not quite a short duration at some of the businesses given the protection bias that it has in it. But at the same time, I mean, this product has a step-up feature. I mean. So the new business values, I mean, can be significant. So I mean, I would expect to see something close to, if not higher than the figures that you're seeing here from an operating -- post-tax operating profit perspective. So I think as we own it, I mean, it will have a positive impact on available capital in Z-ECM.

Operator

Your next question is from Niccolo Dalla-Palma from Exane BNP.

Q - Niccolo Cornelis Modesto Dalla-Palma

I just want to check what the expected drag is from earnings from the runoff portfolio from 2020 onwards. And if I should read my -- into your comment about stable profitability going forward, is that an effect of the business underlying growing but the runoff of the legacy business offsetting that growth and that leading to stable earnings outlook?

A - George Quinn {BIO 15159240 <GO>}

Correct. I mean, that's the important thing here. You see that on Slide seven in the investor presentation. So again, I mean, it's something that, I mean, we don't see so often in others markets. I mean, this business has a step-up feature. So I mean, step-ups in lapses. I mean, I think traditionally, if you look across the entire market, I mean, probably there's some smaller runoff of the book. But the characteristic of the bank book is very different from what we see in either Western Europe or North America. I mean, here, I mean, you actually expect to find some growth in the bank book. So you don't have that same feature, Niccolo.

Operator

Your next question is from Thomas Seidl from Bernstein.

Q - Thomas Seidl {BIO 17755912 <GO>}

It's about the business mix on Slide 7. So the Australian protection market is actually quite volatile, has been loss making in 2 quarters over the last 3, four years. And the main driver has been, as we all know, disability and group risk, which make up more than 50% of the book. So I wonder how you would think about the risk and return profile of disability and the group risk part of this transaction.

A - George Quinn {BIO 15159240 <GO>}

Yes, I mean it's a good question. I think, I mean, you're absolutely right, Thomas. If you look over the, I mean, the history of the markets, I mean, group DI, also individual DI, I mean, have been challenging, I guess, would be the best way to put it. I think if you look at the thing that we've acquired today, I mean, the vast bulk of what we're acquiring is term life. That's certainly how we allocate the value of the purchase price that we pay in the transaction. And if you look across the market in general, I mean, that's where the profitability is strongest. I think this book is no different. I think, I mean, you point to a risk factor that exists in the market more generally. I think our perspective on it is that, I mean, again, I won't repeat the things I said earlier about the repricing capabilities that the market offers. I think we see in OnePath, I mean, again, a very effective manager of the in-force. I mean, we've had the benefit of watching what they've been doing around some of the challenges they've seen on DI. I mean, DI, I don't think we'll see as something that becomes the most profitable part of the book given the nature of that part of the market. Now, of course it's an important feature for the distribution channels. And it helps drive sales of term life product. But I mean, the vast bulk of what you see in this transaction today. And at least today the vast bulk of what we anticipate in the future, comes from the term life. And that's characteristic of the market in general.

Q - Thomas Seidl {BIO 17755912 <GO>}

Okay. But you'll need to sell the disability in order to get the term life. Is that (inaudible).

A - George Quinn {BIO 15159240 <GO>}

So I mean, not entirely. But it's an important feature of the offering for the distribution. So I think you can only sell one and sell one none of the other. It would be a bit optimistic.

Q - Thomas Seidl {BIO 17755912 <GO>}

Yes, because disability is loss making 4 year in a row now, though there's no repricing going on, obviously.

A - George Quinn {BIO 15159240 <GO>}

Oh, no, there is. So I mean, I think it obviously depends on which part of the market you look in. I mean, if I look at our own book, which, of course, we know extremely well, we went through this exercise already in 2015. We saw the target do this the earlier part of this year. I mean. So -- I mean, it's not a theoretical possibility of the market, it's something that is done regularly.

Operator

The next question is from Nick Holmes from Societe Generale.

Q - Nick Holmes {BIO 3387435 <GO>}

Just a question on business mix. The (inaudible) about 30% of group earnings are life insurance. Is this acquisition a sign that you want to move this more to life 50-50 or embrace the composite model more than you do?

A - George Quinn {BIO 15159240 <GO>}

I mean, I don't think we think of it in terms of there's a target mix between life and P&C. I think this is more that -- I mean, where do we have the capabilities, where do the markets offer the rate conditions for us to be successful and how do we want to allocate the capital. I think you've seen from us over the course of the last 18 months that, I mean, we've been pretty active. Again, at the Investor Day, we demonstrated that we've taken now about $1.7 billion of capital. We've put back in, in a way that concentrates the focus of the group in markets we believe we have strength about that $1.8 billion number. We've gone now further. And last night, I mean this, as a process, both inbound and outbound, is something you can expect to see continue. It's just part of good portfolio management. But there's no target mix of what are you trying to achieve.

Operator

The next question is from Arjan van Veen from UBS.

Q - Arjan van Veen {BIO 5197778 <GO>}

Just a quick question on term life. At least one of your peers there has an issue with an older portfolio and hence having some lapse issues as the CPI or the automatic increases come through. So just curious, well, what is the average age of the portfolio at ANZ and whether they've had any lapse issues in recent years?

A - George Quinn {BIO 15159240 <GO>}

Thanks. I don't have the average age at my fingertips. But I mean, I do know the lapse rates. The lapse rates have been very consistent, I mean, at or around the same number for several years for OnePath now. So I mean, we haven't seen significant volatility in their persistency.

Operator

The next question is from Dhruv Gahlaut with HSBC.

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

Just one question on the legacy portfolio. Could you say what is the capital employed within the legacy or the runoff book? And what's the book size currently?

A - George Quinn {BIO 15159240 <GO>}

So the -- I think the total funds under management in the legacy part of the book are about $2.5 billion, $2.6 billion. From a capital perspective, I mean, given that the total consumption overall is about $800 million, I mean, the proportion here will be quite small. I mean there are some -- there's a small part of the portfolio with legacy guarantees. But I mean, I suspect that we're talking about low triple digits, very triple digits, Dhruv.

Operator

The next question is from Vinit Malhotra from Mediobanca.

Q - Vinit Malhotra {BIO 16184491 <GO>}

So I was just curious, George, about the Slide three and the data on OnePath balance sheet here. I mean, there are a few things. Kind of one is the life investment liability of $1.8 billion. Probably that is the legacy assets. But equally, there's a very large amount of cash on this balance sheet, $2 billion for a $5.6 billion balance sheet. And even the ceded life insurance liabilities of $700 million. I mean, is ceding portion also part of the synergies? Apologies if it looks like 3 questions but basically just trying to understand the balance sheet.

A - George Quinn {BIO 15159240 <GO>}

Yes, no problem, Vinit. So thank you for the question. The -- so I mean, you're right to point out as a -- I mean, the -- you see this legacy investment component, both on the liability side and of course, the combination of what's in cash and what's in other financial assets. And there's quite a bit in cash in this book. I mean, I think certainly, as we price, I mean, we haven't made an assumption that we would extract some alpha return out of this component. I think that's not something that we would see as, of course, the right core competence. And in fact, I mean, here, I mean we expect as part of the transaction that OnePath -- in fact, the one that ANZ has already announced was IOOF, that IOOF will continue to manage this on behalf of policyholders. So don't anticipate seeing a significant synergy out of that component. On the reinsurance side, I mean, I think in common with a number of Australian portfolios, I mean, there is -- I mean, re with significant regions already in place, I mean, we talked about DI here already. I mean, they have, I mean, quite a bit of reinsurance around some of the older DI part of the portfolio, say, 2015 and prior. Again here, I mean this is not an area where we've assumed that we would drive significant value through recapture or something that would fundamentally change the risk profile of the business. I mean, as we look at it, we think it has a good track record. We think it's been well managed. We think the balance sheet is in good shape. And certainly, from a Zurich perspective, I mean, I'm not anticipating that we will make any radical changes here.

A - Richard Burden {BIO 1809244 <GO>}

Thank you, everybody. There are currently no more questions on the call. But obviously, if you do have further follow-up questions, feel free to give the IR team a call during the course of the afternoon or over the next couple of days. And with that, I wish you all a happy holiday season.

A - George Quinn {BIO 15159240 <GO>}

Yes, Merry Christmas.

Operator

Ladies and gentlemen, this concludes today's Q&A session. Thank you for participating and wish you a good rest of the day. Goodbye.