Q4 2017 Earnings Call

Company Participants

- David Louis Richardson, Group Deputy Chief Executive Officer & Managing Director-UK Corporate Business
- Rodney Malcolm Cook, Group Chief Executive Office & Director
- Simon George Thomas, Group Chief Financial Officer & Director

Other Participants

- Alan Devlin, Analyst
- Andrew J. Crean, Analyst
- Angel Kansagra, Analyst
- Barrie Cornes, Analyst
- Charlie Beeching, Analyst
- Gordon Aitken, Analyst
- Marcus Barnard, Analyst

MANAGEMENT DISCUSSION SECTION

Rodney Malcolm Cook {BIO 14008420 <GO>}

Right. Good morning, everyone. I am Rodney Cook, CEO of the Just Group. And this morning I'm joined by David Richardson on my right, who is Deputy CEO of Just; and Simon Thomas, our Group CFO. I'd like to thank Nomura for the use of their conference facilities and welcome all of you today and also those on the webcast. We do really appreciate your continued interest.

As usual, I'll start off by giving you a brief update on how we see the business. Simon will then go into the details on the numbers, and David will talk fully about our capital position. And after that, we will take some questions.

Now, please note in the presentation that unless otherwise stated, all of the comparative figures are presented as if our merger had completed at the start of 2016 rather than in April. So, finally, as you know, it's a busy reporting day with other companies. We aim to finish promptly at 11:00 so that you can get to the next analyst presentation in time.

Before I jump into the results highlights, I'd like to just take a quick moment to restate why we do, what we do at Just. David, Simon and I this morning are going to spend a lot of time talking about the what, so let me start by briefly adding in the why.

So, as you know, we believe everyone deserves a full, fair, fulfilling and secure retirement. Now, we focus our attention and we deploy our resources to improve the lives of people in later life. And in order to make this happen, we positively disrupt markets, as you've seen in the past. We campaign and we make our case to politicians and to the regulators in order to improve competition in the market and to protect consumers. We innovate and we solve problems for our customers.

Our mission is to help people achieve a better later life, both directly but also importantly indirectly through our distribution and corporate partners. Just to be clear, that purpose motivates over 1,000 of colleagues at Just every day.

So, moving on to the results highlights, you'll see that the main operating highlight today is the 9% new business margin. This is up from just under 7% in 2016 and reflects our continued focus on pricing discipline. And that focus on margin over volume has driven a 37% increase in new business operating profit and helped also to deliver the 35% increase in total operating profit.

We're today announcing that we've achieved £52 million in synergy run rate savings, and that is 30% higher than the announced original target in 2015. And we have, in fact, delivered that a year ahead of schedule. Now that the merger is completed, effectively, we will give our full attention to how we can further disrupt markets, diversify our business model and we will be focusing our investment on innovation rather than integration.

Simon is going to make sure that the level of investment is both affordable, it's within our profit expectations and it also delivers suitable returns. But we think our markets are ready for further change, customers are demanding it and we want to be at the forefront.

You'll see that we have significantly improved during the year our capital structure and our financial flexibility. You might recall in July, we agreed a £200 million revolving credit facility at twice the level of our previous senior term facility and on significantly better terms. Then, in August, we announced inaugural single A and single A+ credit ratings for certain group entities. And last month, we put our new credit rating to work and issued a £230 million Tier 3 subordinated bond at 3.5% coupon, which would, as you see, have taken our capital position under Solvency II to 156% on a pro forma basis.

Embedded value per share up 4% to £2.28. Tangible IFRS net asset value at £1.65 at the end of December. So, overall, we see a lot of positives and we are well positioned for 2018. The board of Just is expressing its confidence via another 6% dividend increase, and that takes the total for the year's dividend at £0.0372.

Now, can I move on and remind you of the attractive growth markets in which we operate. However, talking about growth markets, I would want to remind you that our strategy has been and will continue to be growing profit rather than headline sales. And we have used those growing and expanding markets in order to take the most attractive risks. That gets easier the more you have to choose from.

So, on slide 5 is the depiction of our three product segments and you'll be familiar with the seminars that we run on each of those in 2017. At that time, we also detailed our leadership positioning in each of those sectors which are quite exciting markets in financial services. As a retirement specialist, we have differentiated ourselves through continuous product innovation, exemplary customer service and unparalleled distribution reach. And this means that our market leading propositions are making a real difference to help our customers achieve a better later life.

So, firstly, the top-left chart, Defined Benefit momentum continues to be strong with LCP estimating the 2017 market would exceed £12 billion, and of course, that doesn't include comments on such as the Prudential deal announced yesterday, of course. Can I say that the industry pipeline we're experiencing is as strong as it has ever been, and that includes our small to medium-sized segment. You know that we concentrate on transactions up to around £250 million.

Recent high profiled DB pension scheme issues are expected to result in a renewed focus on deficits in companies. Even perhaps at the expense of dividend payments to shareholders of sponsoring employers. Just to remind you Hymans Robertson's research suggest that the DB de-risking market will continue to grow substantially during the next decade and they forecast £700 billion of de-risking opportunities through to 2031. Now that implies around £45 billion per annum, which is of course well ahead of any historic level achieved. So, I'll leave DB there, but suffice it to say, we remain very positive about that market and our participation in it.

On the top right-hand side you'll see Guaranteed Income for Life or GIfL where the outlook is also positive. That chart indicates that the open market GIfL volumes increased by around 11% over the year. Now that growth is significantly higher than the growth of overall market, and just to remind you we participate only in the open market. It says there that open market sales represented 48% of the total volume and that is the highest level achieved post Pension Freedoms.

It's good to see the drivers we have described to you many times in the past actually translating integrated propensity for people to shop around. And we see no reason why the open market can't eventually exceed 80% of the total, up from that 48%, driven by continued regulatory pressure for people to shop around.

So, adding that up, we think by 2021, the open market could represent £2.9 billion per annum, up from last year's £2.1 billion, and that would represent compound annual growth of 11%. But if things go well, the upside could be considerably more.

And then thirdly, to the area that we operate principally as an asset for those two other businesses, lifetime mortgage market is developing particularly favorably at present. Shown in the bottom left-hand chart, you'll see that the market grew 42%, and that's on top of 34% the prior year. So very substantial growth in the last few years.

At our LTM seminar last year, our estimate was that the market could more than double to £6.6 billion in 2021. Obviously, that market has been growing faster than either of the DB or GIfL segments above, and that's what funds our mortgage advances. That has been meant that we have been able to achieve all of the mortgage volumes we require at attractive spreads, helping our positive overall margin story which I've already pointed out to you.

Now, new capacity is entering the lifetime mortgage market, we fully acknowledge that. But that has been fully met by stronger and increasing demand. And we have maintained our disciplined approach to pricing and LTM selection.

As we've shown and demonstrated, lifetime mortgages offer a very attractive risk-adjusted yield as well as being very suitable for duration matching particularly for Defined Benefit. So, all in all, we continue to be excited by our strong positioning and distribution capability in each of these growing markets.

So, with that, I'll hand over to Simon, who will take you through the details on the numbers. Simon?

Simon George Thomas {BIO 15219564 <GO>}

Thanks, Rodney. I am Simon Thomas, Group CFO, and I'd like to welcome all of you here today. Today's numbers show that our strategy is delivering real benefits to our shareholders. We've had an impressive year and are proud of the progress that we've made, but there's plenty more to do.

So, if I go straight into the summary IFRS results, this slide shows the overall summary results, and I'll provide some more color on the key lines. Our adjusted pre-tax operating profit grew by 35%, and the underlying operating profit by 21%. Both of these were driven by the 37% increase in new business profit. This is a real vindication of our disciplined pricing approach with the benefits of the cost synergies making an impact.

I'll go into a bit more detail on new business and in-force operating profit in a moment. Operating experience and assumption changes were unusually large for us. The starting point here is the £52 million run rate of merger cost savings. Although this mostly relates to new business, some relates to in-force book and given clear evidence that our per policy costs are below our pre-synergy reserving assumptions, we've released some of the expense reserves.

We've also decided that it's time to strengthen our mortgage mortality assumptions, but still reporting a net positive P&L benefits of £35 million in relation to operating experience variances and assumption changes. I'll go into this detail in just shortly.

The other group companies mainly – result mainly includes our continued investments in HUB, our corporate solutions and distribution business, and our Central costs. As Rodney said, we'll be investing in our business during 2018, and this could add as much as £10 million to this line next year or in 2018, should I say. The increase in the reinsurance and finance costs, reflect the full-year cost of our £250 million Tier 2 debt issued in October 2016.

Now looking at sales in a little more detail. Retirement Income sales were up 4%, driven by solid performance in both DB and GIfL product lines. We've already touched on the long-term growth drivers in these areas, and I'd echo Rodney's enthusiasm for the exciting DB de-risking growth market. DB sales were up 6% on improved margins, as we maintained our disciplined pricing approach. We remain focused on relatively smaller transactions, where our asset liability management works best, and where our medical underwriting can add most value. We completed 22 transactions during the year.

For 2018 and beyond, we're already benefiting from our track record of product innovation, with the launch of our DB Choice proposition in November, which has been positively received by EBCs. The trend towards writing business later in the year, may become less pronounced in 2018, as the market is uncharacteristically – has been uncharacteristically busy for the time of year.

Our pipeline is robust with multiple potential transactions of various sizes in our target segment. GIfL sales were up 5%, again, reflecting our disciplined pricing approach and rigorous risk selection. The open market is slowly gaining traction. Our own distribution company hub and others like it are establishing panels to help retirees purchase a better value GIfL from a wide choice of providers.

Previously, they may have just defaulted to the company that happened to help them save for retirement. As for mortgages, despite the strong market background we have managed advances to take a risk based approach towards our mortgage appetite. We use the longer duration characteristics to these assets to provide an optimum backing ratio relative to the shape of the liabilities we write during the particular period.

This reduction in mortgage volumes is a reflection of our pricing discipline and reselection. And spreads have remained satisfactory. Mortgages exemplified our strategy of controlling volumes to optimize profit during 2017. Now, turning to new business margins. Our 2017 new business margin of 9% was a further significant improvement on the 6.8% margin achieved in 2016.

We were able to maintain firm pricing discipline during H2 and have improved margins beyond recognition from the low points of about 3% after the Pensions Freedoms. Combined with Retirement Income sales of 4%, this margin expansion led to a 37% increase in new business profitability in 2017. This margin expansion was driven by the same key drives that we discussed at the interims.

First, we've been particularly selective in 2017 in our GIfL and DB business actively choosing more profitable even if it's meant a lower market share. I flag that general market pricing discipline has also been maintained.

Second, margins were helped by continued attractive mortgage yields. Demand for mortgage yields has significantly increased in the market as a whole, but our own appetite is a function of our own DB and GIfL volumes and their duration. We're therefore being more selective on mortgage pricing enabling us to broadly maintain our mortgage spread even if it's meant lower mortgage market share.

Thirdly, as we discussed in September, we allocated more mortgages as part of the asset mix, you'll recall that we previously target a 25% ratio of mortgage advances through Retirement Income sales. We now use a dynamic approach based on the shape of the liabilities that we write, and in 2017, the LTM Retirement Income backing ratio for new business rose to the upper 20%, allowing us to capture higher spreads across the portfolio. And the final driver of the margin is the synergy benefits, which naturally are now being felt to a greater extent than in 2016.

Looking ahead to 2018, we're seeing and hearing about more mortgage supply and competition, therefore coming into the market. However, our markets are constructive and on that basis, I probably expect to see our margin to be in excess of 8% for 2018.

Now turning to our in-force result, in-force profit fell by £4 million from £75 million in 2016 to £71 million in 2017. Here the impact of higher opening actuarial reserves was mainly offset by continued tightening of corporate bond spreads, and lower earnings on our surplus assets. In 2017, bond spreads continued the trend seen in 2016, and tightened by about a further 35 basis points, which led to a reduction in the in-force earnings of about £5 million and therefore represented the main reason for the reduction in this caption.

As I have said before, I'd flag that we don't lose this benefit, as the capitalized impact of the spread tightening on defaults is captured in the investment and economic variances line. This year, we have seen a benefit of £34 million created by the spread tightening and it's recognized in this investment variance line, which I'll come back to in a couple of slides.

The other factor affecting the in-force margin relates to earnings on surplus assets. Wherein 2016, we had higher number of mortgages in surplus and over the last two years, this amount has reduced therefore reducing the earnings on surplus by about £2 million.

Looking ahead, and subject of course to spread developments, I'd expect the in-force profit to get back on track, more closely following the growth in reserves. Next, given their size, I wanted to talk through the operating experience variances and assumption changes. You will see that we reported positive operating experience variances and assumption changes of £35 million. This is the net result of some larger movements. Firstly, a £90 million release in reserves captured from the integration expense synergies. Rodney highlighted that we're at a run rate savings of £52 million at the end of 2017. Now although most – this mostly relates to new business, some of it relates to the in-force book. And given clear evidence that the per-policy costs are below our reserving assumptions, we've released some expense reserves.

The £90 million represents the capitalized effect and along with the improvements in the new business margins is another tangible benefit of the merger. However, conversely, the first half trend of higher-than-expected mortgage mortality continued in the second half. This was the main driver of the £15 million negative operating experienced at variance.

In the light of that experience, we decided to strengthen our mortgage longevity assumptions, which was partly offset by releases from our standard underwritten DB book, resulting in a net £30 million increase in reserves. As part of the year-end basis review, we've generally moved to the new CMI mortality improvement tables for our standard underwritten books. We do not generally medically underwrite the licensed Lifetime Mortgages and the borrowers, and we've therefore seen the impact of the lower mortality improvements on our mortgagees. This has prompted us to prudently strengthen our assumptions by assuming that we'll accrue interest on these mortgages for approximately one year less and get repaid sooner. We then conservatively assume that the proceeds are held in cash rather than put back to work.

Similarly, we've looked at our mortality reserves for our standard underwritten DB business and found that this book is exhibiting similar characteristics. This means that reserves here can be reduced, partly offsetting the effect of the mortgage changes. And this is a practical example of the hedge that we have between our Lifetime Mortgages and our GIfL in DB liabilities.

Now moving onto medically underwritten business, primarily the individual GIfL, but also the rest of the DB book, it's important here to consider the interaction between the mortality of people we've medically underwritten and general population data. We're doing this as part of the process of integrating our IP from both the Just Retirement and the Partnership sides of the business. We expect to complete this in 2018. Our analysis so far supports the existing medically underwritten basis which we have therefore not changed. Overall, we're comfortable that our reserves continue to remain prudent following these changes.

Now, next, I just wanted to look at our statutory result specifically the non-operating items. This is the only slide in the pack where the comparative figures are shown on a statutory basis including 18 months of Just Retirement and 9 months of Partnership. I want to highlight a few areas.

First, non-recurring and project expenditure of £12 million was down from £21 million. The main costs here include the cost of the combination and reorganization of JRS and TOMAS to form the HUB group, IFRS 17, and a continued but reduced charge for Solvency II work.

The Investments and economic profit line has made a net positive contribution of £23 million. This was the line that benefited from the tightening of credit spreads to the tune of £34 million, which as I explained earlier represents the capitalized amount of the spread tightening and the reduction of the in-force operating profit result by about £5 million. This line also includes the negative effects of slightly rising interest rates on our surplus assets and the other changes to our economic assumptions.

Merger integration costs of £26 million were incurred as the integration program came to a conclusion. Further integration efficiency gains will come, but these will be captured via normal BAU activity. The total investment of £67 million of integration costs has released £52 million of run rate savings which confirms the success of the deal. And finally, the cost of amortization of intangible assets is flat over the year.

Now moving to our Tier 3 bond issuance after the year-end in February; our credit story improved significantly over the last year or so, especially since we achieved an investment grade credit rating, Together with favorable market conditions, this allowed us last month to issue £230 million of seven-year Tier 3 capital with a 3.5% coupon.

Our year-end gearing level at 16% was lower than our sector peers but our pro forma leverage ratio would now be in the middle of the pack at 25%, a position we're comfortable with. Fitch has confirmed our existing A/A+ plus ratings with a stable outlook.

The support feels like a real vote of confidence in our model and we'll use the debt proceeds to strengthen our capital position so that we can invest in the business and take advantage of profitable growth opportunities. You will also recall that in July, we announced a five-year revolving credit facility. This gives us flexible access to liquidity at interest rates broadly 100 basis points less than the previous senior term facility. The facility remains undrawn and gives us up to £200 million worth of liquidity if need be.

Overall, following the recent Tier 3 issuance our capital and funding base is significantly more efficient than at IPO, and we've made real progress on the cost of debt.

Now, I'll hand over to David to take you through our capital position.

David Louis Richardson {BIO 18045016 <GO>}

Good morning, everyone and I'm going to focus on the capital position before handing back to Rodney for concluding remarks. So, first of all, our Solvency II capital coverage ratio was 141% at the end of 2017, and that compared to 148% at the prior year-end. To enable a like-for-like comparison, we've restated the year-end 2016 figure, assuming a TMTP recalculation at that date even though it was only recalculated at year-end 2017. The reduction in coverage ratio we saw during 2017 was expected, and I'll take you through the moving parts on the next slide.

You'll see in the chart in the bottom left that we have added an extra column to show the position as if the new Tier 3 debt had been in place at year-end, increasing the pro forma Solvency II coverage ratio to 156%. The board remains comfortable with both the level of surplus and the coverage ratio. Economic movement since the year-end reporting data have actually meant solvency has improved so far in 2018, but we'll wait until the interim results to update you on that. Until then, you can use the sensitivities provided later to inform your own estimates.

As you can see from the chart on the bottom right, our capital structure is now taking advantage of more of the features available to us under Solvency II. We have utilized some of the hybrid capital capacity available to us, making our Solvency capital structure less equity-dependent and as a result more efficient, that being said, 117% of the SCR continues to be covered by unrestricted Tier 1 own funds.

The economic capital ratio at year-end was 238%. This further demonstrates the significant capital strength of our balance sheet. This is much higher than our Solvency II capital ratio as it reflects our true economic view and does not contain the more onerous elements of Solvency II, such as the risk margin or inefficiencies introduced by the structuring required to make lifetime mortgages eligible for matching adjustment treatment under Solvency II.

You'll notice that during 2017, our economic capital ratio increased by 22%, even as the Solvency II coverage ratio fell by 7%. As we lay around more new business under the Solvency II regime, don't be surprised if the gap between economic capital and Solvency II continues to widen.

The board has proposed a final dividend of £0.0255 per share, a 6% increase on the prior year. Added to the interim dividend, this makes a full-year dividend of £0.0372 per share, also up 6%. The dividend is supported by our resilient capital position. Now the payout ratio is not something we intend to change significantly in the short term, however, it is intended to be progressive, subject to continued earnings growth, opportunities to invest in the business, and of course, the satisfactory capital position.

Now moving to the next slide, I'll take you through the change in the Solvency II surplus during the year. So for those of you online, we're now on slide 16. This chart shows the development in our Solvency II surplus over 2017. I'll step through each component and how we expect them to develop in the future. And please note that all the figures here are net of tax.

First of all to compare like-with-like, the waterfall we've shown here starts with the year-end 2016 position, as if the TMTP had been recalculated then. This gives a starting Solvency II coverage ratio of 148% and a surplus figure of £666 million.

Over the period, in-force surplus was £128 million, a little higher than my original guidance at last year's full-year results. This represents the gradual release of all the prudent margins in Solvency II, including risk margin and SCR, and it allows for 12 months amortization of transitionals. Looking forward, we expect this figure to grow by around 15% per annum over the next few years.

New business strain over the period loaded for post-synergy cost levels was £105 million. On £1.9 billion of new business premiums that represents a strain of around 5.5% of premium. This is in line with our mid-single-digit percentage of premium guidance and this remains our expectation for the future. We also continue to expect to achieve a mid-teen return on shareholder capital deployed in new business and indeed exceeded that during 2017. As we've previously explained, the amount of new business strain and the IRR are subject to a number of variables including business mix, customer rates, the level of mortgage spreads, risk-free rates and other economic variables.

The dividend and interest cost captures the dividends paid during 2017 and also includes the full 12 months of coupon on the Tier 2 debt issued by us in October 2016. For 2018, full-year interest costs are expected to be £40 million pre-tax which you can net down for taxing your projections and add that to your forecast of dividends.

Now, Simon explained, we've made great progress in achieving £52 million of run rate merger expense synergies, however, there is a lag in converting those to actual cash savings. During 2017, there was a £22 million cost overrun versus the expected 2018 cost base, which was in line with our expectations in addition to £21 million of merger integration costs.

And finally, there was a positive benefit of £76 million from other items during the year. The largest single component of this was the impact of the merger expense synergies that Simon explained earlier. This led to an increase in Solvency II expense reserves of just over £60 million post tax. Adding all that up, that means an aggregate on a like-for-like basis we achieved a stable surplus in pound terms during 2017.

Now, looking forward, the growth opportunities in the DB de-risking market are exciting. And our recent Tier 3 debt raise will allow us to target a high level of growth. In addition, we've decided to invest in our business to grow in new areas and diversify our sources of revenue. As a result of these decisions, we expect the business will reach a capital neutral point in pound terms during 2020. We expect the Solvency II coverage ratio to reach its low point in 2020 and to remain above the board's capital risk appetite throughout that time. Of course, there are lots of variables which will affect the actual capital ratio development over time, but that is our base level expectation, and is consistent with the five-year business plan approved by our board.

Now, let's move on to the Solvency II sensitivities. The chart on slide 17 shows the sensitivity of our capital position to the key risks that our balance sheet is exposed to. Overall, the picture is one of a resilient balance sheet with scope to absorb various stress scenarios and still support the growth of the business. Note that these sensitivities are on a pro forma basis including the Tier 3 debt issued in February. They make no allowance for any potential management actions to mitigate the impact of the scenarios modeled.

So, first of all, we can absorb falls in interest rates. A 50 basis point fall from end 2017 levels would have left the Solvency II coverage ratio 19 percentage points lower. For falls bigger than 50 basis points, we have positioned the balance sheet so that the effect on the coverage ratio is dampened to changing risk-free rates after TMTP recalculation.

And to be clear, a 50 basis point fall does not automatically trigger a recalculation of the transitionals, and as per the previous slide, the TMTP was recalculated at the end of 2017. Thus far, in 2018, rates have actually risen, which is a positive for our balance sheet, and the sensitivities shown here allow you to estimate the impact of market movements, both pre and post TMTP recalculation.

You can see that credit spread expansion is manageable in a Solvency II world, and a 10% increase in lifetime mortgage early redemptions would be a net positive for our Solvency II position, in contrast to IFRS, because the associated risk capital is released earlier than expected when you get those elevated redemptions. Our principal balance sheet risks, otherwise, remain property and longevity. Our exposure to property risk primarily relates to our no-negative equity guarantee on Lifetime Mortgages. The property stress represents a 10% permanent fall below our assumed long-term trend for property prices and assumes no subsequent recovery of that fall. In other words, it's a permanent step down below the long-term trend with no subsequent mean reversion. Now, this stress would have reduced the Solvency II coverage ratio by 12 percentage points.

Current property price trends are not uniform across the country, and this is where we benefit from a geographically-diversified lifetime mortgage portfolio with a low initial loan-to-value ratio. As for longevity, trends are actually favorable. The latest CMI analysis shows that the rate of improvement has continued to fall. People are living longer than ever before, however, the incremental gains are harder to come by and the rate of improvement has slowed down to a crawl. You can see a good depiction of this on slide 25 in the appendix to this presentation. There is now general agreement in the industry that has slowed down in the rate of mortality improvement that we've seen in recent years now reflects a trend as opposed to a blip.

The 5% uniform increase in longevity shown here would represent material surprise to the business given the credibility of our accumulated mortality intellectual property. But again this is a risk we could absorb should current trends dramatically reverse.

And with that back to Rodney for his concluding remarks.

Rodney Malcolm Cook {BIO 14008420 <GO>}

Thanks, David. I'd like to just quickly restate our equity stories so we can move on to questions. It hasn't changed; firstly, our markets our growing and profitable. We've been maximizing profits as you've seen through risk selection rather than pursuing headline sales growth and we expect that growth and process to continue.

We have sustainable competitive advantages in these markets driven by our medical underwriting, our extensive distribution franchises, and importantly, our mortgage origination capability. These advantages power our risk selection and are translating into higher profits. The third one, these improving returns mean we remain confident of achieving a self-sustaining capital position, our balance sheet is now stronger and more efficient than it was a year-ago, and we expect to be capital neutral in 2020 as David said. And fourthly, the merger has now delivered synergies well beyond our expectations, and it isn't a coincidence that margins have therefore expanded following the integration.

So moving on to conclusions, quick recap on the achievements of 2017, and how we can kick on into 2018 and beyond. The model really did deliver the goods. Last year, the 37% increase in new business profit, a huge pride for us all, and it delivered on the promises that we made with respect to the merger. We're already achieving an internal rate of return on new business above our 2018 target, as David said.

Last year, we exceeded the mid-teens return and that is our ambition with respect to the deployment of new business capital. We've also significantly improved our balance sheet strength, as mentioned, and it's flexibility over the last year. Although our business will remain capital consumptive for another couple of years, we are starting from a good position, and I think we've earned credibility here and significantly lowered that cost of capital. There's more to come as we have focused on improving our returns, and we'll do this partly by doing more of the same as you've seen given supportive marketplace and sound capital, but we're also intending to invest in innovation and renewal.

So, we have renewed our five-year business plan to invest in strategic priorities. This includes digitizing the group to help us deliver market leading customer experience and to drive operational savings as well. We're actually relishing the shift from integration to investment and innovation. As we diversify and grow our business, we will have further product launches this year and service innovations aimed at the millions of middle Britons who currently don't have access to help in managing their retirement finances. So, adding it all up, we think our model is delivering and more importantly will continue to do so.

So, could I take our first question from the room? And given the short time, will you please limit it to two questions maximum. If you could state your name and company, please.

Q&A

Q - Alan Devlin {BIO 5936254 <GO>}

Thanks. Alan Devlin from Barclays. I have two questions, please. First of all, on the – obviously, your margins expanded significantly this year driving earnings growth, and you focused on value over volume, but your market share did decline. Do you think going forward, can you keep your margins at 8% level by maintaining the current market share or would you expect the market share to lag the growing market, and the future as well?

And then, the second question on investing the £230 million of debt proceeds into bulk annuities. On the 5.5% new business stream with a lighter rate, an incremental of £4 billion, if my math is correct, business, even if we did it over a full-year period, that would still be a significant increase in (00:43:04) doubling your bulk annuity sales. Is that kind of the opportunity you foresee given (00:43:10) the market, their pipeline increase from £12 billion to £17 billion, so that the market is growing, is that what we can kind of expect or what – or how are you going to invest that £230 million?

A - David Louis Richardson {BIO 18045016 <GO>}

Right. So I'm going to tackle question on margin. Just to be clear as I think the pipeline in our area of the DB market is stronger than we've ever seen it before. But we certainly wouldn't be deploying the whole of the £230 million in one year, and then having sales collapse back. So the investment is to have continuous growth, Alan.

Simon, on margins...

A - Simon George Thomas {BIO 15219564 <GO>}

Yeah. On the margins, obviously, I went through the factors that drove the margin this year and there was a pickup from 6.8% up to 8% and there were three or four items that we talked about earlier. I think most of those are sustainable. The one area that flagged though going forward is mortgage competition. And this year, we've benefited by the fact that the mortgage market has grown by about 40-odd percent, which I think surprised everybody frankly. But we are hearing and seeing people coming into the market place. We're seeing for people like Nationwide. Canada with retirement advantage will be starting there as well, and one or two reinsurance companies, I won't mention their names, but there are rumors in the market that they're coming in.

And that's why I'm looking forward. I think I'm being a little bit more cautious about the market conditions potentially into 2018, and guiding it, I think it will start (00:44:34) going forward. In terms of looking further ahead, well, it's difficult. I think the structural aspects of what we have now as a business, I think there are good reasons to suggest that we've got some solidity around that. But again, it does – we are in a competitive market, and that's one thing I would flag clearly on all our products.

A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Just to be clear, the mortgage market has started off very well this year. So we're very comfortable with our position, and also the spreads, but you're always looking for a forward-looking statement, and we need to be conservative.

Do you have just a quick word on your approach to DB this year, David?

A - David Louis Richardson {BIO 18045016 <GO>}

Yeah. As Rodney says we're not planning to blow it all in one year. And so it is about...

Q - Alan Devlin {BIO 5936254 <GO>}

(00:45:17)

A - David Louis Richardson {BIO 18045016 <GO>}

...it is about sustainable growth. And what we are seeing in the DB market is very exciting, really strong pipeline of opportunities, and what I'd call high quality credible opportunities. So, what we're finding is that the EBCs are working very closely with the trustees of the pension schemes now. And when they bring opportunities to the market there, what you might call deal-ready, more deal-ready than they were in the past. So I think the extra capital, stronger base gives us the opportunity to go after that really strong pipeline.

A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Right. Next Christian, Gordon.

Q - Gordon Aitken {BIO 3846728 <GO>}

Thanks. Gordon Aitken from RBC. Couple of questions, one on mortality, one illiquid assets, so the mortgage mortality assumptions, you said you reduced life expectancy assumptions by a year. And you said that was prudent. It really is incredibly prudent given all the updates we've had each year on – see it from the CMI reduce more life expectancy by a couple of months at most. And just maybe you can give us some sensitivity for the group as a whole. So, if you were to say one month reduction life expectancy across all your product lines, you gain on the annuity reserves. I mean, would you lose on mortgages because you gained on the (00:46:29) but you'd lose on the interest received? So just what's the net effect of a one-month reduction across the whole operating profit for the group?

And the second question is, illiquid assets as a proportion of assets-backed annuities, I mean, you have the 25% target, you said 2017 was high-20s. Maybe talk about total illiquid assets because I know you're doing a little bit more than just Lifetime Mortgages. But Aviva said they're happy to be at 50%. So why aren't you, given the regulators (00:46:57) also talking about a move to 40%?

A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Aviva, happy to take 50% of what...

Q - Gordon Aitken {BIO 3846728 <GO>}

Of their assets backing...

A - David Louis Richardson {BIO 18045016 <GO>}

Iliquids.

A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Right. So just very quickly, David is incredibly smart, but he doesn't have the entire Solvency II model, and he said that he is going to press a button and answer the moving parts of (00:47:19) and so on. Just to be clear, the alteration in the mortgage profile is early redemptions in combination with mortality. So, what we're seeing is that the assessment in the total portfolio is that we expect the propositions to last for one year shorter than we have previously assumed. And we think that's conservative but proper.

As you know, in this particular year, getting the proceeds earlier, we have reinvested them at almost higher spreads but you can't guarantee that, Gordon, going forward.

Q - Gordon Aitken {BIO 3846728 <GO>}

David, that interaction between all of those (00:48:02) annuities?

A - David Louis Richardson {BIO 18045016 <GO>}

Yeah. So, the sensitivities we show, Gordon, on slide 17, the 5% drop in mortality rates. That is across all the annuitant portfolios, and the LTM business. So, that is a combined impact you're seeing there. And very, very, very rough, just this 5% mortality might be about half a year of life expectancy. So this'll be actually the opposite direction. This would be adding to life expectancy about a half year. Of course, in reality, the two don't move precisely. That's the thing. But this is a uniform change so to give you a kind of a flavor for that.

A - Rodney Malcolm Cook {BIO 14008420 <GO>}

And remember our book of annuitants is still much younger than some of our larger and longer serving competitors who've got annuities for the last 40 years, where the majority of our business has been written in the last five years. So, it's not saying that we won't see the trends. But also, it is a mark of the medical underwriting assessment that we don't see our customer bases reflecting the general population. The 50% in illiquid assets; remember we have to hold very substantial liquidity.

A - David Louis Richardson {BIO 18045016 <GO>}

We do yes. So, and you're obviously right, Gordon, we reinvest more than just Lifetime Mortgages, so we've also gradually started to invest in infrastructure, in private placements, and in commercial real estate mortgages. And we give a split at the back there you'll see for example the other asset classes are still very low percentage of the back book, it's still very heavily weighted towards Lifetime Mortgages.

And our approach to this is purely risk based, we look at the profile of the liabilities that we're writing and DB GIfL, and we look at the profile of the assets that we can use to back those liability cash flows. And we make sure we leave plenty of margin for variability in the cash flow, so you need a certain amount of liquidities as Rodney said.

So, we don't actually set a fixed percentage in terms of limit on this, it's going to depend on the mix of the assets, and the mix of liabilities that are available. But overall, as a general theme we're looking to diversify our investment portfolio and to make it less dependent on LTMs.

A - Rodney Malcolm Cook {BIO 14008420 <GO>}

There was a question there that I missed before.

Q - Charlie Beeching {BIO 21296314 <GO>}

Yeah. Charlie Beeching, KBW. Actually a follow-on from the Lifetime Mortgage question. I guess it'd be beneficial for you to increase the percentage of the LTM book that is medically underwritten or in terms of new business. Is that an experienced thing? Is it possible to do so in terms of increasing the medical underwriting and?

A - Rodney Malcolm Cook {BIO 14008420 <GO>}

So, just quickly, we do medical underwriting, we think we're the only Lifetime Mortgage provider that said – that's only a small percentage and that's where people are uniquely seeking a higher LTV than would normally be available and we will medically underwrite those in that case. But it's not a – there's so much standard business just to be clear. There hasn't been a need to pursue that, but it is one of our small competitive advantages. Andrew...

Q - Andrew J. Crean {BIO 16513202 <GO>}

Good morning. It's Andrew Crean from Autonomous. Can we stay on this slide? Firstly, could you give us - I've asked this a number of times, the sensitivity to credit migration. And also, you said, I think, that the interest rate sensitivity was relatively symmetric, but the property sensitivity is not symmetric. At what point does the cracking point really begin to hurt on that in terms of the (00:52:03) because I think it's around 25%, 30%. It can be really deleterious.

And finally, can you give us - what are the costs and what are the expenses in the operation, and how do they split between new business and the in-force?

A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Okay. So, David, if you can take the first one. Just to be clear, in addition to this under our current Solvency II reserving, we hold a 9% downturn in the market already built into our figure. So, in the base Solvency II, we assume that property prices in the UK are damaged by 9%, and then, the - this would be an additional one.

David?

A - David Louis Richardson {BIO 18045016 <GO>}

Yes, the question. Yes there was a couple - so, we'll take away the request on credit migration and see what would be useful there. And on more extreme property price falls, and it is not quite symmetric or linear for the first - for a bit more than what we've shown here, but it's not far off.

And what happens when you start getting into more severe falls like say more than 20%, you then need to start asking yourself, well, how I would recalibrate my internal model. So how would I recalibrate the stress events that you apply to the balance sheet. And that would have a probably dampening effect on the stress as you get more and more extreme. Because if you see, say, you have a 25% full, would it be appropriate in your risk models to assume a further 30% fall over a 12-month horizon.

So they're the type of interactions which make actually more extreme scenarios more difficult to model. But the key thing I'd emphasize here is, it's not what happens to property prices over the next 12 to 24 or even 36 months. So what happens to house price trends over the next 15, 20 years, because that's where the kind of the main and neg exposure is. With an average loan-to-value ratio of 29%, a significant fall in house prices are going to translate into significant net costs in the next couple of years.

A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Just to be clear, Andrew, our computer systems are updating index values on a monthly basis. So we are automatically upping or reducing the no-negative-equity reserving that we have on a monthly basis in indexation. Simon, there was a cost question.

A - Simon George Thomas {BIO 15219564 <GO>}

Yeah. I mean, if you're looking specifically, the actual costs (00:54:27) here is £238 million of costs in the noted accounts. In there you have got amortization of £25 million and acquisition integration costs of £25 million. And also investment expenses of about £11 million. So that probably takes you down to about sort of...

Q - Andrew J. Crean {BIO 16513202 <GO>}

Can you give the...

A - Simon George Thomas {BIO 15219564 <GO>}

...£170 million.

(00:54:45)

Q - Andrew J. Crean {BIO 16513202 <GO>}

...it's in the RMS (00:54:46).

A - Simon George Thomas {BIO 15219564 <GO>}

No file at RMS (00:54:47).

A - David Louis Richardson {BIO 18045016 <GO>}

It's basically the cost within the (00:54:49).

A - Simon George Thomas {BIO 15219564 <GO>}

Yeah. Yeah. And then within that, of course, the costs associated with the HUB companies, the group companies. So we don't give a breakdown down to that level. What accounts, Andrew, is that clearly with the integration costs and the integration process. We have clearly gone through a substantial process to save these costs coming through the £52 million, that's included losing 300 roles, 300 roles in the business. It's included losing two floors of the property (00:55:19), it's included losing the property at Redhill. Integration of systems has come through as well. Renegotiation of contracts with our suppliers and renegotiation of contracts with our relationships where partnership and Just Retirement will have the same ones. So that's the £52 million.

Now, if you take out the trading cost savings in that, let me you just give you a bit of breakdown which might help. That's about £7 million, so it gets you down to £45 million. So that's £45 million of management expenses that we save from the original companies, when the two were separate as such. And that's what you're seeing coming through the new business margin. And the capitalized amount, that's coming through the management reserves.

Q - Andrew J. Crean {BIO 16513202 <GO>}

(00:55:55-00:56:00)

A - Simon George Thomas {BIO 15219564 <GO>}

I don't know (00:56:01) in there. But breaking it down further, it's...

A - David Louis Richardson {BIO 18045016 <GO>}

Well, perhaps if we can do that offline. I promise (00:56:08) tried five times to get a question.

Q - Andrew J. Crean {BIO 16513202 <GO>}

Okay.

Q - Barrie Cornes {BIO 2389115 <GO>}

Good morning. It's Barrie Cornes at Panmure Gordon. Couple of questions, one for David. David, just wondered if there's much potential for change in the regulatory capital requirements? I think, there's a paragraph in the press release, just wondering if you could expand on that, please.

And second one, perhaps for Simon, there is much of a breakdown in EEV operating profit, Simon, just wondered if I've missed it or is it a metric you're perhaps looking to phase out? Thank you.

A - David Louis Richardson {BIO 18045016 <GO>}

Yeah. So there's obviously been a lot of commentary around potential reductions in the risk margin, which would be beneficial for us, both in terms of our back book and also new business capital strain. But we put our comment in there, Barrie, just to bring a bit of balance to the perception, because everyone is talking about the risk margin, there's a number of other areas, the regulator is consulting on at the moment. So, they have issued a number of consultation papers and supervisory statements relating to things like the (00:57:14) the treatment of the liquid assets, how the matching adjustments should be calculated and internal model processes.

All of which could and I say could impact us either positively or negatively. So, we just wanted to paint a picture, does a number of changes potentially coming down the line as the PRA continues to refine its thinking on the application Solvency II. But that's too early, frankly, to call any of them.

Q - Barrie Cornes {BIO 2389115 <GO>}

Was there a second?

A - Simon George Thomas {BIO 15219564 <GO>}

EEV, I think it was, Barrie, no, you haven't missed it. We've done greater the level of disclosure on EEV this year, frankly, Barrie. I think, we felt that with the level of disclosures related to Solvency II that's been a big pick up, frankly, in terms of the efforts and resourcing on that. And also the number of questions that we got on EEV has dropped and indeed a number of other companies have also downgraded their disclosures or in fact many of them aren't disclosing it at all. I think, we're going to keep it though at this high summarized level because we think it is a relevant metric, but it's not as quite as detailed as before Barrie.

A - Rodney Malcolm Cook {BIO 14008420 <GO>}

(00:58:14).

Q - Angel Kansagra {BIO 19712659 <GO>}

Thanks. Angel Kansagra from HSBC. Just a quick one actually. In your five-year forecast, David, so as your equity base grows you want to write more new business. Would you assume more debt to feel that growth because in the absence of it your ratio might trend down to 140 or less, like mathematically.

So, in couple of years' time can we expect some debt coming through. And the second one is for Simon, why wouldn't the new business margins stay at 9% because the £52 million of cost sales which you have achieved by the end, you would get the benefit, some of it next year. And then you have higher new business sales where your cost will be spread across a bigger base. Wouldn't those two actually enough to offset compressing in LTM spreads?

A - David Louis Richardson {BIO 18045016 <GO>}

The answer is no to the second question. So, the first question on a capital, yeah. So, if we think about a shape, sorry, this is a translation on the line but what we're trailing and what we've trailed in prior periods as well is that whatever your starting point, you can expect our capital coverage ratio to come down for a few years as the balance sheet expands and we're saying until it reaches the low point in 2020. And then start to increase even allowing for what I call a healthy level of new business growth. So that's our baseline expectation.

And based on our current business plans, our expectation is that as you go through that journey you will remain above our capital risk appetite without further accessing the capital markets. So, does not make any sense, but what we will and won't do but that's just what the baseline projection shows.

A - Rodney Malcolm Cook {BIO 14008420 <GO>}

So, we're not going to show our capital policy that the board might have over the next five years at this point. The fundamental about the spread is as interest rates rise that also impacts on the spread of lifetime mortgages. So, Simon has to take a complete view of what might be achieved from the assets and the yields. Do you want just – because we'll have to conclude?

A - Simon George Thomas {BIO 15219564 <GO>}

You're quite right, there's multiple things going on here. We will get some benefits coming through from the synergistic benefits, the role forward of the £52 million and some if we're putting more business through there'll be a gearing effect coming through on that. But as Rodney said, we talked about the competition coming into the marketplace which we've seen and we are hearing about.

And certainly if interest rates rise and they did rise in the first couple of months, actually interestingly, people did behave economically, so actually the prices went up which is great, but that's - interest rate rises (01:00:56) for a long-time, so that's another risk potentially that could happen, I guess. But so from a cautious perspective, I think, (01:01:03) is where I'm guessing at the moment.

A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Steve (01:01:06), do we need to conclude or - Marcus, this will have to be the last.

Q - Marcus Barnard {BIO 2103471 <GO>}

Okay. Marcus Barnard from Numis. Can you give us some indication of how quickly and how much you expect to see the new investment impact your new business? So I think you've talked about the DB and you've talked about quote activities, I think, in GIfL. I just wonder what we should be thinking about in terms of growth going forward. Can you help us on that one?

A - Simon George Thomas {BIO 15219564 <GO>}

So, with respect to DB, we're not going to give specific guidance. But, I think, what we're pointing to here is a strong market backdrop. We are seeing good opportunities for DB growth, whilst maintaining our pricing discipline and getting that mid-teen return on capital. So, that element of kind of the growth is something which should emerge in the very short term. I don't know if you want to comment on the kind of the broader investment in...

A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Well, Simon, you were very clear that we will have one-off investments still, but the investment that will impact above the line, we expect £10 million. So, could you just explain that?

A - Simon George Thomas {BIO 15219564 <GO>}

Yeah. Yeah, I mean, clearly, we're moving out of the integration phase more to an investment phase now. And, I think, there are certain areas that we are going to be looking which obviously includes - we're still doing all the regularity stuff, so the IFRS 17, GDPR, more on Solvency II, I'm sure that's still coming through. But also, operational efficiencies, we'll be looking at, but also investing in the core business.

And, I think, you might have attended the GIfL seminar, where we talked about the GIfL plug-in, for example. That's one thing where we're developing the core business and that's something that will be within that £10 million, for example, there. So, it's those sorts of investments that we're starting to look forward a little bit more rather than just sorting out and putting two companies back together.

A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Right. Thank you very much for your interest and I hope a safe trip to your next meeting.

A - David Louis Richardson {BIO 18045016 <GO>}

Thank you.