Deutsche Bank Depositary Receipts Virtual Investor Conference

Company Participants

- Mark J. Gregory
- Unverified Participant

MANAGEMENT DISCUSSION SECTION

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Welcome to the Deutsche Bank Depositary Receipts Virtual Investor Conference, DB VIC. My name is Zafar Aziz, Head of DR Market Solutions at Deutsche Bank's Depositary Receipts team. I'm pleased to announce our next presentation will be from Legal & General from the UK.

Before I introduce our speaker, a few points to note. During the presentation, please submit questions in the ask-a-question box along the bottom of your screen. There's no need to wait until the end of the presentation to type in your questions. Please remember that after the presentation and the Q&A session lasting around 30 minutes in total don't log out. You'll automatically be transferred to Legal & General booth where you can continue the conversation via the chat screen and access additional investor material. On a final note, all of today's presentations will be recorded and can be accessed via the Deutsche Bank website, adr.db.com.

At this point, I'm very pleased to welcome Mark Gregory, Chief Financial Officer from Legal & General. Over to your, Mark.

Mark J. Gregory {BIO 15486337 <GO>}

Thank you. Good afternoon, everyone, from here in London, good morning to you all stateside. Thank you for the opportunity to make this visual presentation about Legal & General. Delighted to have the chance to connect this way with our various shareholders.

Here are the usual forward-looking statements.

Unverified Participant

Yeah.

Mark J. Gregory {BIO 15486337 <GO>}

That's it. So on Tuesday, we announced another terrific set of results from L&G. Net cash up 14% at £1.3 billion. Operating cash up 11% at £1.2 billion. Operating profit up 14% at £1.5 billion. Earnings per share up 11% at £0.185. And return on equity of 17.7% for the year and a recommended full-year dividend of £0.134, which is up 19% year-on-year. So growth in the teens across all our key financial metrics, it's a major success for our business.

We can deliver these results because we have two things, a clear and consistent strategy as well as the ability to execute well.

Our five key growth drivers, aging populations, globalized asset markets, the need to create new real assets, welfare reform and digitalization; these are long term, persistent and operate across economic cycles.

We are a resilient growth business. We don't just float along passively waiting for the rise and tide to lift your boats. We have positioned ourselves in a fast-moving water. And here's how we've done it. In pension de-risking, we are winning mandates and becoming a top UK lifetime mortgage provider. We're winning investment management mandates in the UK, the U.S. and Asia, achieving further big scheme wins in open enrollment, moving insurance towards a digital direct model and investing in long-term assets that capture a liquidity premium and drive economic growth.

The 2015 results are part of a consistent medium-term trend. Over four years, our compound annual growth rate for net cash has been 10% while for EPS, it's been 11%, a dividend per share of 20% and return on equity has grown to 17.7%. Total shareholder return of three and five years has been 114% and 259% respectively.

We've accelerated the evolution of L&G from a divisional life office for an integrated asset model, asset gathering, asset management and asset creation whilst retaining our market leading expertise in insurance risk management. We've de-cluttered and refocused on our core capabilities, exited the noncore and sub-scale and positioned ourselves in new growth markets, including liability-driven investments, real assets, housing, urban regeneration, workplace pensions and lifetime mortgages whilst retaining our consistent focus on efficiency and unit cost reduction.

We have a strong balance sheet. The Solvency II basis for capital had just become live at the start of 2016 and our Solvency II capital surplus at year-end was £5.5 billion, a coverage ratio of 169%.

Our economic capital surplus at year-end was £7.6 billion, a coverage ratio of 230%. The only new business effect for us in Solvency II is in L&G retirement in the UK which we had in any case already move to, to be more capital-efficient and more risk-efficient.

About three quarters of our risk capital arises from market risk, both in the Solvency II and on economic capital models, reflecting the fact the we are more of an asset company than an insurance company. Solvency II has not materially changed our strategy. And moreover, we believe there will be further helpful changes to Solvency II as the EU reviews its post-credit crisis legislation, potentially including a reworking of the risk margin for longevity within Solvency II.

It is our stock of business which drives our cash generation. And in terms of the stock of business, there are two particular great areas to highlight in 2015. First, the 8% growth in LGIM assets under management, now £746 billion and driven by almost £38 billion of external net flows. A record year and a fantastic performance across all product areas, geographies and client segments.

And the second is a 22% growth in direct investments, now at £7 billion across the group. This growth reflects that the shares (5:30) we're having in originating and developing assets on which we expect to enhance the risk-adjusted returns for shareholders.

This line shows how our business stocks have progressed over the medium term, 11% combined annual growth rate in LGIM assets under management. LGIM is now the 15th largest global firm manager, but still represents only just under 1% of global market share, so plenty of headroom to grow. Our insurance premiums have grown by compound annual growth rate of 8%, now it's £3.1 billion. And bear in mind, we're the largest player in the UK protection market with a retail market share of around 25%. And of course, our growing annuity back book in L&G Retirement is expected to provide predictable releases for very many years to come.

Turning now to our individual business divisions. And it's worth noting that today, L&G is substantially an asset gatherer, asset manager and asset originator. The asset businesses, LGIM, LGR and LGC collectively delivered operating profits of £1.227 billion in 2015, more than 3 times the £376 million operating profit achieved by the insurance businesses in UK, U.S. and Asia.

Expertise and scale in the insurance markets is an important component. It is a combination of asset management and insurance risk expertise which gives us clear leadership position in pensions de-risking.

Moving now to the business divisions, and I'll start with L&G Retirement. This is a growing business. And operational cash generation was up 27% , £372 million in 2015. Net cash generation benefited from a new business surplus of £45 million within which the longevity reinsurance in respect of new business contributed £55 million post-tax, or £69 million pre-tax. And operating profit of £639 million was up 49%.

As UK individual annuities declined following the abolition of (07:33) and utilization two years ago, we are moving into lifetime mortgages as an alternative means of funding retirement. For an outstanding (7:41) start at the end of Q1, we wrote £201 million of lifetime mortgages in 2015. Volumes continue to grow through the year with £99 million being completed in Q4, very definitely, a growth business to L&G.

L&G Retirement has nine sources of profit, and we are pushing forward on all of them. Optimizing the cash generation from the back book, internationalizing new business with deals now completed in the U.S. and the Netherlands and setting a higher £500 million target for lifetime mortgages business in 2016. Meanwhile, the back book generation will remain a source of material (8:18) profits for many years. Our £1.2 billion Lucida transaction in 2013 was a model of a back book acquisitions. No people, no systems, no property. This is a market with further potential as players consolidate or exit.

Turning to LGIM, L&G Investment Management, 2015 was an outstanding year with external net inflows of £37.7 billion. Revenues were up by 8% at £193 million, the cost income ratio was a very competitive 48% and operating profit from our asset management business was £359 million, up 7%.

In the UK, the National Grid Pension mandate delivered £12 billion of inflows. We're expanding workplace savings, which now has £14.7 billion of assets under administration and continue to win significant new mandates, including John Lewis and Tesco, which we believe to be the largest corporate pension scheme in Europe by a number of members.

Total defined contribution assets, including investment only, rose 13% to £46 billion. Our retail offering is also growing. 2015 was a record year for inflows, and we are now ranked at number six for retail flows in the UK when we were outside the top 20 in 2014. And real assets also performed well, with assets up 26% at £18.3 billion. And LGIM worked closely with LGC and LGR to launch three urban regeneration schemes in the UK in Salford, Leeds and Cardiff.

Our assets under management has more than tripled in the last decade, a compound annual growth rate of 14%. And scale has been accompanied by diversification with growth across products and client segments as well as geographies.

We are now active in solutions, fixed income, real assets, work-based pensions and UK retail, where we were largely invisible for several years, but where we have the benefit of a strong brand and 10 million existing customers. 2015 saw a very strong inflows and international mandate accounted for £9.5 billion of external inflows.

In Asia, LGIM won further mandates in China and new ones in Korea, Japan and Taiwan. And the U.S. business continues to grow strongly. We're (10:35) as well as having a market leading LDI proposition, we won our first multibillion dollar U.S. index mandate. Distribution is working effectively. Our brand travels brilliantly, and our basic premise of scale, value and customer service is winning mandates for us even where we have little or no infrastructure.

Barriers to entry in local markets are coming down and we are on the way to becoming genuinely global. Globalization for us means moving towards a three-hub manufacturing model in the UK, U.S. and Asia. We're no longer a monoline asset manager providing index products for UK defined benefit pensions. That was the old model.

International AUM inflows were strong in 2015. But what I think is really striking here is not the 43% compound annual growth rate, but the amount of headroom for growth. As I said, we're the 15th largest global asset manager but our global asset market share is less than 1%. And we have the ambition to more than double that share.

L&G Capital delivered strong net cash, £187 million compared to £162 million in 2014. Operating profit was up 15% to £233 million. LGC has been actively managing and diversifying its portfolio with a particular focus on direct investments in housing, urban regeneration, energy and alternative finance.

Direct investments in LGC now account for £867 million, not just using our balance sheet size and duration to capture liquidity premium, but also driving synergy gains across the business. LGC has four areas of focus for direct investment, urban regeneration, housing, alternative finance and clean energy. These are marketplaces with a clear funding gap where supply and demand are out of balance and where we can deploy our large long-dated balance sheet effectively, often partnering with sector specialists.

We're already leading the way in building an impressive real estate portfolio. We have momentum and are accelerating delivery and are always exploring ways to maximize return which is our new investment in modular housing which allows us to access fast, cost-efficient building. This is asset creation for the whole group. And today, LGC has generated a terrific return on capital by creating assets to L&G Retirement and LGIM.

This slide illustrates how we do it. I don't think we've communicated the multiple drivers of value within LGC well enough. We invest as a principal using shareholder money, we invest as a direct investor to back the annuity book and we invest as an agent through LGIM and its institutional family and friends. The assets we create can be tailored in terms of maturity, cash flow, index linking and so on, and we can choose between LGIM, LGR and LGC to best deliver our strategy.

The synergies across LGC, LGR and LGIM enable us to enhance earnings per shareholders directly, optimize cash flows and annuity back book and create new asset classes for LGIM and its clients. This delivers economically and socially useful outcomes, but is also a real win for L&G to have this capability. We've been leading this institutional sector by doing this for three years now. The political world is catching up as they realized the investment in real assets is the way to improve productivity and growth.

For our Insurance division, UK Protection gross written premiums were up by 3% to £1.442 billion in 2015, as a result of strong sales and good retention. Retail Protection premiums were up by 5% with a particular emphasis on growing the direct sales channel, which now accounts for 18% of new business sales. Protection purchases are frequently aligned with mortgage and house buying. Our Mortgage Club last year facilitated over £46 billion of mortgages, which is 20% of the entire UK mortgage market.

Insurance net cash was up by 6% to £348 million. Although operating profit was down to £293 million from £370 million as a result of changes to our modeling of reinsurance for our Protection business in the UK. The impact of these changes was to reduce operating profit by £93 million in 2015 and change the shape of the potential margins which will have the effect of deferring emergence of future cash.

The General Insurance business saw operating profit reduced by £8 million in 2015 to £51 million. This includes a £15 million impact from the UK floods in December. The combined operating ratio for our UK GI business in 2015 was 89% compared to 87% in the prior year.

The digital disruption which we've seen across all industries; media, music, retail, and so on, is coming to insurance. We've already seen the effect of regulatory change on intermediated and advised sales in financial services. But the combination of big data, digital communications and the Internet of Things will have an even bigger effect. Our challenge is to ride that wave and we've made a decent start. The back office in our Insurance business is already highly automated and digital and delivers competitive unit costs.

The drive is now on to expand the front office digital direct channels. Direct customers and sales grew at an impressive rate in 2015, and L&G Direct now accounts for 18% of Insurance new business sales. We're investing in the direct channel, in the customer journey, and experience in marketing direct, and in mobile optimization. This is vital for UK markets and to internationalize in a high-value way.

Belgium is a good digital model. $1 trillion assets under management, managed by 1,800 employees. Insurance and Savings are fast followers. IndiaFirst, our JV with Bank of Baroda and Andhra Bank in India, has been a pathfinder, working closely with the Indian government, which has a strong digital program to deliver basic mass market products to improve financial resilience. We sold 2 million policies in just three months in 2015.

The next steps will be to take - will be to take experience and reimport it to the UK. We intend to introduce a highly affordable, entry-level protection product which will be a significant disruptor to the UK insurance market. Our aim at L&G is to be our own active disruptor, not a passive disruptee.

Legal & General America had a good year in 2015. Net cash generation, that is their dividend of the Group, was up by 9% at $83 million and operating profit increased by - from $93 million to $125 million. The ordinary dividend for 2016 of $88 million has already been paid. L&G America is moreover an important component of our expansion in the U.S. We're using its balance sheet for U.S. bulk purchase annuity transactions and is also providing back-office support to L&G Retirement and LGIM in America.

As well as Insurance, L&G America gives us a terrific base in the U.S. from which to write pension risk transfer business and to support LGIM America.

The U.S. is our second most important market after the UK, and our strategy will mirror what we do in the UK into the U.S. We have made good strides there, but we haven't maximize our synergies yet. But we are focused intently on a market that is underpinned by a strong economy and where our brand is really well received.

The strength of the business has enabled us to announce a full-year recommended dividend for 2015 of £0.134, an increase of 19%. And this week, we also announced a new dividend policy. Going forward, we will have a progressive dividend policy reflecting the group's medium-term underlying business growth, including net cash generation and operating earnings.

Legal & General has evolved rapidly over the last few years and we have come a long way. 15 years ago, we were a traditional UK life office with a small investment management business, dull but worthy. We have decluttered, aligned our strategy to five macro drivers, set growth businesses in motion and are moving successfully towards a more digital asset management business.

Our businesses today are focused on those areas where we can operate at industrial scale, providing the best products, service and best value through tight cost control and economies of scale. The five growth drivers create a world of opportunities for Legal & General over the next decade. Aging populations and a rapid rise in population of over 60s means we can aspire the international leadership in pensions derisking.

As an asset gatherer, we are operating in a $76 trillion global asset market, that is almost borderless and becoming ever more global. It is realistic to double our sub 1% market share. We will continue to use what I believe to be unique synergies to capture illiquidity premium and grow our real asset portfolio. And Defined Contribution pension saving will grow across the world over the next decade as it becomes a favorite solution in the U.S., Europe and Asia. We'll leverage our DC and Workplace experience to become international leaders in providing private sector solutions by shrinking welfare states. And we will continue to disrupt ourselves and our markets to drive the digital agenda going forward.

Not at least (20:10) in insurance which on a medium or perhaps even short-term view will change beyond recognition. L&G has come a long way in a few years but it is still work in progress. We take a long view but we have already started to make the changes that will drive us forward over the next 5 and 10 years. We'll make that change positive for our customers, employees and our shareholders.

And with that, any questions? So, first question on my screen here is – it's come down, one, so with pension reform, will annuity sales experience a sustained period of decline?

I just said we operate in two annuity market. We operate in the bulk market which is where our corporate defined benefit pension scheme has passed their risks to us through both bridges of transaction and in individual market where customers transfer their pension pots into a guaranteed income for life through an annuity. And it's very much the latter one has been impacted by the changes in the budget from George Osborne two years ago where he removed the need essentially for compulsory annuitization of pension pots.

Now, I'd say probably that market has – we've seen the market reduce by about 75% from what it was before those changes. I think probably – that's probably the end of that decline. I don't think people will go much slower now (21:44). There still is a need and a use for annuities in the retail market. And I would say with the advent, if one can believe, of higher interest rates in the future, the apparent value of an annuity as a guaranteed source of income will improve with that. So, I would take the view that if you can believe the world (22:01) where interest rates could go higher then we might well see something of a bounce back in the volume of annuity but not where they were before the changes introduced two year ago, but nevertheless, higher than perhaps we see in the market as of today.

Another question. What can the company do to increase capital buffers? Well, I would say, first of all, we do have a very strong capital balance sheet in the first place. So, we are at 159% (22:23) of our Solvency II coverage ratio, which is £5.5 billion in excess of what the regulatory says we need to hold. And I have to say regulators are not known to be racy. They have a natural conservative mindset themselves. So, in fact, we hold £5.5 billion more than they think we need to hold in itself (22:40) you we have a very, very robust balance sheet.

But I would say there was a lot of work went on (22:45) last year to make sure we had all our applications for Solvency II approved entirely. And it's fair to say that in so doing, we didn't really optimize all the features and, more importantly, to get the applications approved then fine tune down to the last pounds. And there's definitely a list of things in our to-do list during the course of this year and next year, just to make sure now we have the rules all agreed, just to make sure we can more fully optimize at the sake of our balance sheet going forward. We don't need to do that. Our balance sheet is perfectly strong. It can deliver our strategy and growth going forward. But clearly, if we can improve the balance sheet, we will definitely do so.

It's quite a long question. I'll read it out though. So, what would L&G's Solvency II ratio be by excluding the benefit of matching adjustment, the volatility of the transitionals, some of the various features of Solvency II, what is the outlook for the year-on-year change in the pre-solvency surplus pre-dividends (23:48)? What is LGIM's measure of free cash flow? What metrics are used in management incentive compensation? (23:56) Dave (23:56) will be in here all day reading the question out.

So, on the question mark on what the ratio would be excluding the various features within Solvency II, we haven't disclosed that number nor of any of our peers in the UK. I think the reason we haven't done it is they actually (24:11), you have to take the Solvency II balance sheet in and out. And I know it's kind of tempting to go and pick away various bits of it, but it is a package of metrics and balance sheet operates as one feature, so we haven't disclosed matching adjustments, all the benefit of transitionals.

Now – so today, we are not alone in doing that. All of our peers have done – taken out the same approach. And the key thing to remember and I'll say is actually to (24:36) it is one balance sheet and it's incorrect to think about picking up each bit in our installation. The matching adjustment is a permanent feature of our Solvency II balance sheet. The transitionals, the regulatory rates here in the UK, that transitionals are Tier 1 capital. Any things like dividend debates could consider transitionals to be Tier 1 capital in that regard. So, again, we don't see any great need to split out the individual components of the Solvency II – of the solvency balance sheet.

The outlook for – sorry, a couple more other questions here. The outlook for the year-on-year change in the free surplus, Solvency II surplus, pre-dividends. I did actually disclose a slide in my main presentation on (25:16) when we did the preliminary results announcement, and that showed a growing free surplus generation year-on-year.

The key message here is that we had fully expected to be enough surplus generated each year to fund, one, the amortization of our transitional benefits; two, to fund the investment in new business; three, to fund the progressive dividend policy, and four, to retain enough surplus to make sure the capital base is sizeable at the business itself and the balance sheet grows. So we're very confident we have enough surplus emerging each year to fund all the needs and all the mouths it needs to feed from one year to the next.

I'm going to move on to one, two other question. Our lives are in danger just doing all that. So I've got a question here. Are the net inflows in LGIM a result of the popularity of passive investments? I think we are definitely seeing a move towards better - more of a kind of apparent value-for-money mindset within asset management. I think more generally not in the UK. And we are all seeing certainly attractive fund managers, quite a lot of fee pressure. Therefore, I think the very obvious value for money of index passive funds is going to the (26:26). That's been true for institutional investors for a very long time.

We're definitely seeing that also begin to emerge more in the retail space here in the UK. In the past, one would often see a bundled charge picking up both the product wrapper at the cost of the platform, the advisory fee and the cost of the underlying fund or when the implications of the retail distribution review which was two and a half years ago now. And once you strip out each of those components in isolation, therefore, one can very easily see the cost of the actual fund rather than just being lost in a bundled fund charge. And therefore, we definitely are seeing a significant move in the UK from the retail space more towards passive fund.

This clearly accounts for about 10% of all retail funds in the market here in the UK, whereas institutional business is about 30% of all funds are invested in passive. So there's still quite a big gap between institutional appetite for passive and where the retail market is stuck to. Again, we do see there has been a big increase in trend going forward, and clearly LGIM, as a big index fund manager, is very, very well placed to take advantage of that trend.

So, what is your target for lifetime mortgages? We said we did just over £200 million of lifetime mortgages in our first year. In fact, it wasn't really a year, it was only nine months in 2015. We set an initial target in 2016 to grow that to £500 million. It's a very, very good asset class for us. In fact, our annuity business - because again, if people live longer, so the lifetime mortgage is worth more to us. That's a very good hedge against any natural longevity risk in our annuity book.

And we like the market a lot, which took a lot of years to decide (27:59) enter it or not, given previous compliance. A conduct rate issues in that market. Nothing to do with that (28:04) but it's not been - always been the very best market from a conduct point of view. But that is now being sorted out. The FCA, the regulator over here, has ensured that the standards are way, way higher and we make sure there's a legal process involved in any lifetime mortgage as well.

So we like that market. The market last year grew to about £1.6 billion in the UK. We're going to see that market growing quite (28:28) going forward because – a lot of people do regard their home is being part of their pension fund and the lifetime mortgage is a very, very easy way of converting that value had held in equity into an income stream that they can use.

So we like the market and we've entered it, we've very good value products, though our headline product comes in at less than 5% which is very comparable to the more normal retail mortgage market in the UK. So plenty of room for progress in that regard.

A question I've got, what are the drivers that likely increase in flows of asset into LGIM? I think I've covered it quite a bit during my speech. But obviously, international was a big part to that £38 billion of inflows last year which just over a quarter came from international mandates. In the UK, we saw a decent increase across the board, both in defined contribution pension assets, in retail funds as well in some big defined benefit mandate wins such as the National Grid scheme which brought £12 billion of assets with it.

So really could diversify growth across product sets, across geographies and across segments. So we're very, very content with the progress that LGIM is making. That's certainly an area we want to grow more into the future.

How is L&G gearing up to competition from online aggregators? What do you (29:53) offer any competition. They're just providing a different marketplace for people to choose insurance products. And again, I would say, now of course, we tend to operate at the good value end of the market and we're very happy for that process to continue.

So as I said in my comments and for example, in our retail protection, our life insurance business here in the UK, 18% of our business came in direct in 2015 and a lot of that did come by the aggregator site. So again, I think we take the view that's an efficient marketplace. And if people want to access our products and services through that sort of medium, then we're very happy to do so, and we are sure that we can compete very actively in that space.

Likewise for General Insurance, again we get a lot of General Insurance premium via the aggregator site. So, again provided one has a clean proposition and a very evident good value for money, then the bigger the marketplace, the better we feel about it. So no concerns from our perspective.

Okay. So, with that, I'll say thanks for your time today and happy to take any further questions. If you wish to do so, please contact the Investor Relations team here at L&G and we'll answer your questions in due course. So thank you for listening and thank you for your support.