Close Brothers Group

Tuesday 10th March 2015

Interim Results

Preben Prebensen, Chief Executive

Good morning and welcome to the presentation of our 2015 Interim Results.

As usual, Jonathan will take you through the Group's financial performance and I'll provide an update on our businesses and the future opportunities we see for each of them.

We're also joined by our business heads seated here on the front row, Stephen Hodges from Banking, Julian Palfreyman from Winterflood, and Martin Andrew from Asset Management, and they will assist you with any questions you have after the presentation as well.

As we announced in January, Julian will retire from his position as Chief Executive of Winterflood at the end of the current financial year, so this will be his last Results Presentation. And we also have Philip Yarrow here, who will be taking over from Julian in August.

Before I hand over to Jonathan, I'd just like to share the highlights of our performance in the first half of the year.

The Group, as a whole, continues to deliver good performance with adjusted operating profit growth of 16% to £109m. This reflects strong performance in Banking and continued progress in Asset Management, although Securities was affected by difficult trading conditions.

Adjusted earnings per share improved by 19% to 58.2 pence. Importantly, we're delivering these positive results while maintaining our simple and transparent balance sheet and strong capital position. Both the common equity tier 1 capital ratio and leverage ratio improved in the period to 13.6% and 9.9% respectively.

As a result of this good performance, our return on equity remains strong at 19% and we've entered our fifth consecutive year of dividend growth with a 9% increase in the interim dividend to 18 pence per share.

Overall, these results demonstrate the ability of our proven business model to deliver good results in a variety of market conditions.

I'll now hand over to Jonathan

Jonathan Howell, Finance Director

Good morning everyone and thank you, Preben.

I'm pleased to report that we have continued our good performance in the first half. As Preben has said, we achieved good growth in operating profit, up 16% to £109m. And adjusted earnings per share increased 19% to 58 pence, reflecting the reducing corporation tax rates.

We've declared an interim dividend of 18 pence per share. This is a 9% increase on last year, demonstrating our commitment to a progressive dividend policy.

The Banking division continued to generate strong profit growth with operating profit up 19% to £106m. Securities was affected by more difficult trading conditions and profit reduced to £10m.

Asset Management continued to make steady progress and increased profit to £5m.

And finally, central group costs were broadly unchanged at £13m.

Looking now at the income statement in more detail.

Revenue increased 8% to £330m. This was driven by higher income in Banking and Asset Management, although Winterflood's income reduced.

Expenses increased 7% to £203m. This reflects higher staff costs in the banking division and continued investment in systems and infrastructure. Overall, the expense income ratio improved slightly to 61%.

Bad debt charges continued to reduce, to £19m, supporting the strong profit growth in the period.

In January, we completed the disposal of Seydler, the German Securities business, which has been treated as a discontinued operation. This resulted in a £10m profit on disposal.

Turning now to funding and the balance sheets, which as you can see, has changed very little. We've maintained a strong funding position with £7.2bn of funding covering 132% of the loan book. We accessed diverse sources of funding, giving us flexibility to optimise cost and maturity. And there is no change to our prudent maturity profile, with term funding covering over 70% of the loan book.

We have a simple and transparent balance sheet where the loan book and our treasury assets make up over 85% of total assets.

And we have a strong liquidity position, with over £1 billion of liquid assets substantially all on deposit with the Bank of England.

In recent years, our prudent approach to capital has allowed us to grow the loan book and, at the same time, meet increasing regulatory requirements. Our capital ratios have improved further in the first half. The common equity tier 1 ratio increased to 13.6% and the leverage ratio increased to 9.9%. Tier 1 capital increased 6%, reflecting strong profitability, but risk-weighted assets increased only 2%, reflecting lower market risk following the disposal of Seydler.

We are committed to maintaining a strong and prudent capital position and we'll continue to manage our capital resources carefully.

In Banking, we achieved another strong performance and returns continued to improve. Income was £245m, up 12% year-on-year, in line with loan book growth. Expenses were up 13%, reflecting higher staff and IT costs, as we continued to invest in our service-led business model.

As a result, the expense income ratio was broadly stable at 49%. The bad debt charge has reduced steadily for several years now, and this continued in the first half.

Overall, this resulted in strong profit growth of 19% to £106m, and a return on net loan book of 4%.

The loan book was up 3.2% in the first half, and although this was slightly below the 4.5% last year, we continue to see growth opportunities across our markets.

In Retail, the loan book increased 1.8%. This reflects modest growth in Motor Finance, where we have seen strong price competition in the first half. The Premium Finance business also grew slightly.

Commercial increased 2.4%, the asset finance loan book continued to grow by 4%, with good new business across all sectors. This more than offset a normal seasonal decline in invoice finance.

Property continued to grow strongly at just over 7%, reflecting continued good demand for residential development finance.

Our lending continues to generate strong returns, reflecting strict underwriting discipline. We've maintained a strong net interest margin at 8.8%. The bad debt ratio continued to improve, reaching a new low of 0.7%. This reflects our ongoing focus on credit quality, supported by a favourable economic and interest rates environment. This resulted in an excellent return on loan book of 4%.

Winterflood's results was impacted by particularly difficult trading conditions in the first half. Operating profit reduced 23% to £10m, which includes some £3m related to the disposal of shares in our longstanding investment. Retail investor risk appetite was low throughout the period and, in addition, there were periods of sharply increased volatility. This resulted in ten trading lost days compared to only one last year.

Overall, average bargains increased slightly to £55,000, due to growth in high volume international trading. However, income per bargain reduced to £5. This reflects the difficult trading conditions and an increased share of low margin international volumes.

Overall, income reduced 13%, but expenses also reduced, reflecting Winterflood's largely variable cost structure. And as a result, Winterflood remained profitable while maintaining our market-leading position.

And turning finally to Asset Management, where we continue to make steady progress. Income increased 7% to £43m, driven by good growth in investment management, which was up 15%.

However, advice income was broadly stable and overall the revenue margin was stable at 86 basis points.

Expenses increased modestly, reflecting the operating leverage in the business with a predominantly fixed cost base, as a result profit increased to £5m. This corresponds to an improved operating margin at 12%.

Looking now at AuM, new business remains strong across advice and investment management with over £700m of gross inflows, some 7% of opening AuM. Net inflows in the core business were solid, however due to an outflow of a large legacy mandate overall net inflows were around £120m. We also benefited from positive market movements of almost £400m. And overall we achieved good growth in the first half with AuM up 5% to £10.2bn.

So we are pleased with our progress in the first half and now I'll hand you back to Preben. Thank you.

Preben Prebensen

Thank you, Jonathan. We continue to execute our strategy which remains unchanged and continues to deliver good results as you see here today. Through our expertise and service we build long lasting client relationships and leading positions in specialist markets. We do this by being there for our customers in all market conditions. We also maintain our strict lending criteria and prudent approach to funding and capital. This strategy allows us to generate strong returns throughout the economic cycle. As the charts on the slide demonstrate, since 2011 first half profits have increased at an average of 14% per year and RoE has increased from 13% to 19%.

This in turn has allowed us to deliver progressive increases in the dividend having held it flat during the financial crisis, whilst still maintaining our strong capital position. It’s important to note that we’ve delivered these improvements in profitability and returns while at the same time investing in our business, in our people and in our infrastructure.

So let’s look at what this means for each of our businesses.

In Banking we’re specialists in our markets, focusing on strong customer relationships and high levels of service. We offer direct lending services through our dedicated sales force of over 500 people and our network of specialist intermediaries which includes motor dealers and insurance brokers. Our business model is built on the expertise of our people and our disciplined approach to credit underwriting. This supports our long term track record of growth and profitability.

The last five years have been characterised by constrained credit supply and economic recovery which has allowed us to grow our loan book strongly. At the same time bad debts have reached historic lows leading to increasingly strong returns. Today we’re seeing a steady increase in competition from both traditional and the newer banking groups, but we continue to see solid demand for our products.

In this environment our priority is to maintain our tried and tested business model and prudent underwriting which will ensure we maintain our returns and continue to price risk appropriately through the cycle. At the same time we continue to see opportunities for future growth and will actively seek out opportunities that fit with our model. This includes expanding our offering to include new products and services; for example, we’re developing a new point of sale finance offering with specialist retailers, and our alternative energy team is now fully up and running and producing interesting opportunities. We’ll also continue to invest in people and technology to improve and expand our distribution capabilities.

This is a chart that many of you have seen before but which we think is more relevant than ever as market dynamics continue to evolve. Here you can see the strong track record of our lending business over the long term. Throughout this 25 year period we’ve done what we always do, we’ve stuck to our specialist markets and maintained our robust and prudent lending model. The chart illustrates the benefit of the recent period of constrained credit supply which has supported a 17% average loan book growth over the past five years.

More importantly looking longer term over the last ten years we’ve delivered 12% average loan book growth and 20% average return on equity. And over an even longer period such as the last 25 years we’ve been able to remain profitable and grow sustainably despite two recessions, a stock market bubble and an easy credit bubble in that period. As we enter a period of potentially more moderate growth we remain confident that our model supports strong returns in all market conditions.

Moving on to Securities. As a market maker Winterflood is committed to providing continuous liquidity for our clients in all conditions. The last six months have been difficult but our core strengths, the expertise of our staff and strong technology have ensured the business continues to trade profitably and we maintained our leading position. Market conditions have been challenging so far this year, political uncertainty has caused lower levels of retail investor activity while wider economic factors such as falling oil prices and exchange rate movements have caused periods of sharp volatility.

As you know there's been a strong correlation between retail trading activity and Winterflood's performance. In recent years first half adjusted operating profit has ranged between £7m in 2013 and £28m in 2010. In this first half retail investor activity remained subdued and combined with sharp periods of volatility, particularly in October means that underlying profitability is more in line with the levels seen in 2012 and '13. In this environment we continue to focus on maximising trading opportunities in all market conditions and remain well positioned to take advantage of any opportunities.

Finally, on to Asset Management. We positioned this business to benefit from the demographic and regulatory changes which are driving increased demand for financial advice and wealth management solutions. Our strategy is clear, we focus on building long term personal relationships with our clients offering them a full range of high quality financial planning advice and investment management services. This strategy is working as we continue to see good demand for our propositions as illustrated by strong underlying inflows.

The business continues to make steady progress. Putting the last six months into some context, over the past three years total AuM has increased 18% and the value of assets that we manage has grown 33%. Most importantly the assets which are both advised and managed by us and therefore provide a greater revenue opportunity have increased 54% which has helped drive a steady improvement in profitability.

Looking ahead our priority remains to continue to build the business and the assets that we advise and manage. To do this we continue to invest in training and development for our advisers as well as our internal systems and processes to maximise adviser productivity and support client service. We'll also look at opportunities to support our organic growth potential with infill acquisitions and selective hiring of advisers or portfolio managers.

Overall we expect to see further improvements in profitability as the scale of the business increases.

To conclude, we're in a strong position and will remain focused on meeting the needs of our clients, on executing our strategy and delivering ongoing shareholder value. In Banking we continue to see growth opportunities and will maintain our disciplined approach to risk and returns.

Winterflood remains sensitive to current market conditions but is well positioned. And in Asset Management we expect steady growth in assets and increasing profitability. So overall we remain confident in the outlook for the current financial year.

We now look forward to answering any questions that you may have and as usual, please state your name and company before asking a question.

Q&A Session

Question 1

Gary Greenwood, Shore Capital

Hi, it's Gary Greenwood at Shore Capital. I've got a question on Asset Management and one on Winterflood as well. On Asset Management I remember a few years ago you set targets for 2015, I think it was a hundred basis point revenue margin and a 15% operating margin. You're tracking below those targets at the moment so maybe if you could just update us as to what's been different versus your expectations and whether those targets remain valid?

Then on Winterflood, if you could just give us an update on how trading has performed since period end?

Preben Prebensen

The Winterflood question, I think since period end it's really a question of February and early March, and things are a bit better actually, there's a little bit more retail demand, there's a bit more interest in the AIM market, so things are a bit better. We look at this as a daily trading business, that's what it is, and so as conditions improve, as I said, we'll make the most of those conditions.

In terms of asset management, we set those targets back in 2012, and we wanted to give you a sense that we were restructuring the business and that that business would reach a sensible level of profitability within a sensible timeframe. So targets were only a point in time. Our ambitions for the business are beyond that 15% pre-tax operating margin that we set for 2015, and it is only a point in time, and that's important to remember and not to become too focused on it.

Having said that, we will be kind of there or thereabouts in terms of the 15% pre-tax operating profit margin. We were 12% in this half versus 8% in the same period of last year. We tend to have a stronger second half than first half, and so you'll see additional progress in that.

We also indicated the revenue margin target, but I think we pointed out to you back in September that we were tracking a little below that. The point there is that that's all a function of mix. The more that we can advise and manage, which is substantially above 100 basis points, the more that that margin will improve. These things never go up in a straight line. We have three major channels in terms of AuM. This was a period where the investment management channel managed assets went up more quickly than the advised and managed channel. So we will continue to see an improvement in net revenue margin, we're happy with the progress that we're making, but it won't be in a straight line, I think, and it will take some time. So that's what I would say to that.

Gary Greenwood

Is the 100 basis points still a valid target then?

Preben Prebensen

We're not hooked on it. We will have continued to improve as the mix changes. It was only ever meant to be an indication of the direction and is only ever meant to be a point in time.

So I think we'll make progress towards it. As I say, the advised and managed business is well above 100 basis points, purely managed business is more in the 70s, so it really just depends on the pace of the change in that mix. We'll continue to pursue all of our major channels rather than trying to direct ourselves in order to reach that target kind of artificially. I think that's not in the interests of the business.

Question 2

Gurjit Kambo, JP Morgan

Just in terms of the competitive landscape in the banking area, either from existing competitors or new competitors, if you could just provide any sort of update there it would be helpful.

Preben Prebensen

Sure. Let me make two comments and then I might invite Stephen to add anything that he might. We are seeing more credit supply, no question, and that supply is coming both from the larger banks that are providing more unsecured credit generally, and also from one or two of the new banking groups.

In terms of where we see that, I think we see it evidently in the motor business from the larger banks, and they're clearly making more credit available there, they are keen on price, and that as I think we have described to you in the past, comes in with the big dealers and then kind of filters its way down to the mid-size motor dealers. We, if you like, start at the small dealers and work our way up through the mid-size dealers, and our market share tends to move with the amount of credit that the large banks are supplying there. At the height of the crisis, if you like, our market share went up to around 11/12%. It's back down in the 7s now. We tend to protect our margins and our returns in the business rather than chasing share or chasing growth. But that's an example of where we are seeing more competition from the larger banking groups in particular in Motor.

I think the other one that I would point to is in asset finance where there's a lot of focus on the emerging challenger banks, and that is where we would see them. It's important to note that we have a different business model, so we go direct as well as through brokers. We have 200 people on the ground in asset finance as well as going through the brokers, so that's an important difference. Then it's also important to note that we don't overlap with them in very much. They have big mortgage businesses in residential and commercial, we don't do that, so we're really focused. The overlap is in asset finance and invoice finance. But it's a big market. Our share of the asset finance market is about 7%. It's risen during the last five years. There's plenty of opportunity. We're seeing good demand. We're seeing a pick up in demand if anything in a few of our sectors. So the backdrop is important. Stephen, do you want to add anything?

Stephen Hodges, Managing Director and Banking CEO

I think you've covered the main points. In each of our businesses we have a different competitive landscape. In some, as Preben has referred to, clearly in motor it's a more vanilla business, it's the area you would expect to see more competitors coming into earlier in the cycle. But our branch network, our service and our specialisation protect us, and we're very clear that we're going to stick to that model regardless of the competitive pressure.

In other areas our particular approach gives us greater protection. I think in Asset and in Property in particular we're focused as much on what's happening on the demand side of the equation as we are on the supply. There is clearly growth in the UK economy at the moment and that has lead, I think, to an increase in investment by SMEs generally. We expect to see that waiver a bit as we get towards the Election because political uncertainty will make people postpone their investment plans. But underneath it all the outlook for the UK economy is good for the foreseeable future, and we do expect that to be reflected in increased investment from our customers.

Question 3

Robin Savage, Cannacord

Further to that question, I wonder whether Stephen and Preben, you could explain the areas which you really won't go into in terms of lending, and perhaps talk about your attitude towards point-of-sale finance you seem to be talking about. How does that fit with the idea that it's actually secured lending if you're lending now on point-of-sale on retail purchases?

Preben Prebensen

I think the first answer, where we will not go, we're not in the mortgage market either residentially or commercially, so that's a very large part of other banks' business but it's not part of our business. That's the most obvious. We're already in a point-of-sale market. Very substantially our entire motor business is a point-of-sale business, as is our premium business. So two of our large businesses are already point-of-sale businesses that we originate through motor dealers or insurance brokers. So we are a point-of-sale lender. In fact, in terms of our retail lending business it's entirely point-of-sale.

The reference I made to where else we might apply that point-of-sale lending, is that we're just in the early stages of exploring providing point-of-sale financing to specialist retailers. There I think the important thing would be that it's a specialist market. It shares a lot of the attributes with our other businesses. It's kind of niche like, it's specialist. It's something that they're not getting from the large banks or not getting with the kinds of service proposition that they would like. It allows them to do things that they otherwise couldn't do in terms of providing sales campaigns and things like that. And it's potentially interesting to us. But it's in the very early stages.

Question 4

James Hamilton, Numis

Given that your return on the net loan book is so strong by historical standards, and obviously your return on equity is also exceptionally good by historical standards, why aren't you growing more rapidly in the Bank? And on that point could you comment on the flow RoE that you expect? I could understand a slowdown in balance sheet growth if the flow RoEs were not high enough; but even by your standards I would have thought in the market place at the moment if you cut your pricing you could swamp the balance sheet with assets generating returns on equity maybe 24% rather than 28% and we'd all be very happy.

Preben Prebensen

It's an understandable question. We think it's incredibly important that we stick to our model and it's served us so well for 25 or 30 years. That model doesn't target growth. The model is applied to the circumstances of the market, and growth is an output. So our model is all about high service, flexibility, speed and those quite important things for which we charge an appropriate price.

Trying to reduce those price points in order to drive volume periodically would start us down a path that would make us look too much like everybody else; it would accentuate the cyclicality of the business.

Banks are very good at creating their own credit cycles by reducing their return and reducing their loan standards in order to chase growth. We've never done that and we never will, and it's served us pretty well.

Stephen Hodges

Can I just add a couple of points to that? The first is that one of the contributing factors to the high return on the net loan book that you refer to is a very, very low charge currently for bad debt. Now that's partly down to our credit underwriting, but it's also partly down to the fact that the market as a whole is seeing low levels of defaults at the moment – that's not particular to us. Now we don't believe that's a permanent state of affairs. So for us and for the market as a whole at some point the bad debt will get back into its normal range; and that's really where we are pricing our product to cater for that if and when that happens.

On the growth point I think the point to make is that our year-on-year growth, our rolling 12-month growth rate in the loan book is 12.5%. So, yes, we have some good quarters and some bad quarters, but the underlying rate of growth is still acceptable.

Jonathan Howell

Can I just add on top of what Stephen said? In terms of the position on bad debt, Stephen's absolutely right: as we go through the cycle we would expect the bad debt charge to go back into the middle of the range, and then ultimately in full recession to the top of the range.

I just want to stress though that in the short term, over the next three to six months, we're not in this announcement calling any sort of uptick in bad debts or downtick. As far as we can see it at the moment we can't see a trend in either direction.

I know over the last 12 to 18 months we've consistently said we can't see it getting any better and it has got better. This time we're calling the end in terms of that guidance.

James Hamilton

Can I just quickly follow up? The duration of your book is short and obviously the impairment charge is very cyclical, and clearly after recession you've washed away most of the junk and this is survivorship biased. Are you guiding that over the average duration of your book you don't think that adjusting the price to take account of the low impairment charge is appropriate, and that the normalised returns aren't available over the duration of your book?

Jonathan Howell

Yes, I think over the duration of the book that will move according to the cycle. What we're saying is that over the short term, the short duration book, we're not anticipating a too material change in that bad debt charge, either up nor down.

<u>Question 5</u>

Philip Middleton, Merrill Lynch

Just very quickly. On Winterflood I quite understand why you had more loss days than normal. Could you give us some idea on how much of an impact that was on the profitability? Did that just offset the year in ex-sale or was it much more than that? How do you think about that?

Preben Prebensen

We don't break that out. But to give you a sense of it, it's roughly of that magnitude, yes. If you look at what we benefited from in terms of that sale and the cumulative impact of the loss days it's not very far away.

Philip Middleton

Thanks. I look forward to the bad debt ratio coming in even lower next time.

Preben Prebensen

Just to add my two-pennyworth on that: conditions are very benign right now and we don't expect those very benign conditions to change based on anything that we can see going out and we can see months out but we can't see very much further out than that. So we really don't want you to go away and think that the bad debt number is going to change any time soon.

It's just that we're very cognisant of the ten-year average of bad debts being 1.5%, and the range we always quoted, until about a year ago, was between 1% and 2.6%. And we find ourselves at 0.7%. So those are the facts. And we all know that these conditions are exceptional.

<u>Question 6</u>

Unnamed Analyst

A couple of quick follow-ups. First on Winterflood. I heard you were saying that it was a cyclical issue rather than a structural issue. I'm just wondering on the income to bargain that dropped down is that entirely attributable to a mixed shift away from AIM; i.e. is the income per bargain in AIM and in large cap stocks the same as it has been?

Preben Prebensen

I would say that very broadly what you should look at there is that this is a poor period for AIM and a period which included ten loss days. So obviously if you just look at income per bargain, income is affected by both of those things. And at the same time we signalled that we are doing more volume in international stocks, and that's at the larger cap, smaller margin end. So those are things that all contributed to that change in income per bargain.

We're not saying that this period of six months is signalling any kind of structural change in our ability to make money in the AIM market or in the margins that are available in large cap stocks. AIM is a high margin business and large cap stocks is a low margin business – that continues to be broadly true.

Unnamed Analyst

The second one: you mentioned alternative energy as an opportunity for the Bank. I'm wondering if you could maybe characterise that opportunity in a bit more numbers and potential market share and ((those 0:37:37?)) other markets?

Preben Prebensen

We don't break down the sub divisions to that level. This is a team of people that we told you we hired from the Co-op that had a good alternative energy team. They've now been here for a while and they're up and running so the deal flow is starting to become interesting; but it will always be a relatively small business in the context of the whole bank rather than becoming a large business in the context of the whole bank.

It's more that it's an example of another specialist niche that we could acquire which sits appropriately alongside the other things that we do.

Unnamed Analyst

But it's a business where we would expect to see long-term sustainable growth.

Preben Prebensen

Yes.

<u>Question 7</u>

Robin Savage, Cannacord

Just on the way the board looks at the dividend at the end of the year, I just wondered whether you can list the various factors which would be taken into account.

Preben Prebensen

This is Jonathan's specialist subject, so I'll let him answer this.

Jonathan Howell

Well, first of all, as you can see Robin, a 9% increase in the first half; and that follows on from 10% for last year's full dividend. As we've been saying now for five years, as we've grown the dividend and grown the cover at the same time, those are the two considerations that the Board will have. And what we've been in the fortunate position over the last five years of increase is to be able to move the dividend forward whilst removing the cover.

And to give you a guide around the sort of endpoint of what we consider to be appropriate cover for a well-capitalised and well-run bank through the cycle, that's in a range of 2% to 2.5%. And I can just point you to one data point, which is at the end of last financial year we were on a dividend cover of 2.1%.

Question 8

Gurjit Kambo, JP Morgan

Just in terms of infill acquisitions in asset managing business, where do you see opportunities? Is it from changes from the regulatory side and RDR; or is it potentially from pension fund changes which are going on and how you want to position yourself for that?

Preben Prebensen

I think in terms of infill acquisitions we would be looking for things that add to our model. And our model, as you know, is providing advice and investment management services. So we've hired portfolio managers that go directly into the investment management side of the business; and we've made small IFA acquisitions which go directly into the advice side of the business. We've done both of those things. And we would continue to look on both sides of that business actually. That is a function of all of the change that's going on, and the fact that ours is an integrated model which includes both of those.

Any other questions? Thank you for coming.