Close Brothers
Modern Merchant Banking

Interim Results

Tuesday, 14th March 2017

Preben Prebensen, Chief Executive

Good morning and welcome to the presentation of our 2017 first half results. As usual Jonathan Howell will take you through our financial performance and I'll then provide an update on the Group and each of our businesses.

We also have several colleagues here today, Philip Yarrow from Winterflood, Martin Andrew who runs Asset Management and Adrian Sainsbury who's the Managing Director of the Banking Division. And as usual we'll be happy to take your questions after the formal presentation.

I'm pleased to say that we've delivered a strong first half performance with profit increasing in all business segments. The Banking division achieved a strong performance with continued strong margins and historically low bad debts.

And profit increased in all three of our Banking segments: Retail Finance; Commercial and Property Finance.

Loan book growth was slightly lower in this period as we focused on our lending discipline, prudent underwriting and returns. However the growth rate also reflects seasonality and higher repayments in the second quarter and the pipeline remains strong.

Both Securities and Asset Management also delivered higher profit supported by favourable market conditions. We delivered good growth in earnings and continued growth in the dividend in line with our progressive policy.

Clearly we're very pleased with our performance in the first half when conditions have been favourable. And as always our priority remains to protect, sustain and invest in our business for the longer-term.

I'll now hand over to Jonathan who will take you through the first half performance in more detail.

Jonathan Howell, Finance Director

Good morning everyone and thank you, Preben.

As Preben has said this has been a strong first half with good performance across all our businesses.

Overall adjusted operating profit increased 21% to £134m. Earnings per share increased 9% to 67p and return on equity remains strong at 18%.

We maintained a good capital position with common equity tier 1 ratio of 12.6% and total capital at 15.3%. And we are pleased to declare an interim dividend of 20 pence, up 5% on last year. This reflects our commitment to progressive and sustainable dividend growth whilst maintaining a prudent level of cover.

This slide looks at the operating profits by segment. For the first time we are reporting profit for the three business segments in the Banking division. As you can see each of these makes a significant contribution to group profits and all three increased in the first half.

Retail Finance profits increased 3% to £40m reflecting continued loan book growth. In Commercial Finance profits increased 9% to £37m driven by higher income. And finally Property Finance had a particularly good first half with profit up 29% to £46m benefiting from strong business performance as well as bad debt provision releases.

Securities and Asset Management also performed well, supported by good market conditions. Profit at Winterflood more than doubled to £14m. And Asset Management increased profits by 8% to £9m, reflecting organic growth as well as higher market levels.

Turning now to the income statement, operating income increased 14% to some £380m benefiting from higher lending income, as well as increased trading revenue from Winterflood.

Costs increased 11% to £227m. This reflects higher variable costs at Winterflood which drove around half of the increase, as well as continued investment in our Banking division. Impairment losses remained stable, and overall operating profit increased significantly, up 21% to £134m.

The tax rate increased to 26% reflecting the first full year impact of the banking tax surcharge. Despite this adjusted EPS increased 9% to 67p and ROE remained unchanged at 18% reflecting the strong profit growth in the period.

As you know we have a simple and transparent balance sheet where the majority of assets and liabilities relate to our lending activities. Consistent underwriting and strict lending criteria ensure we maintain a high quality loan book. It is predominantly secured, diverse and short-term with an average maturity of 14 months. We also have £1.3bn of Treasury assets, principally on deposit with the Bank of England.

On the funding side our position remains strong with total funding of £8.7bn covering 133% of the loan book.

We continue to have good access to a diverse range of funding markets. In the first half we issued both a £250m senior bond and £175m of subordinated debt, or tier 2 capital. And we continue to borrow long and lend short with over 75% of the loan book covered by term funding at the balance sheet date.

We have a good capital position underpinned by our high return business which supports strong organic capital generation. This has allowed us to grow the loan book, invest in our business and pay a good dividend over many years now.

In the first half CET1 capital continued to grow, up 4% to £940m. However we had a one-off increase in risk-weighted assets following new guidance from the EBA which risk-weights all property development loans at 150% under the standardised approach.

As a result our CET1 ratio reduced to 12.6% at the end of January. This ratio maintains significant headroom to regulatory requirements.

The addition of tier 2 capital increased our total capital position to 15.3% at the half year. And our leverage ratio remains very strong at over 10%.

Overall therefore our ratios remain comfortably ahead of minimum regulatory requirements and we maintain flexibility to continue supporting business growth for the longer-term.

Turning now to the Banking division. We had a strong first half with income up 10%, with growth across all lending areas. This reflects good loan book growth over the last 12 months with a broadly stable net interest margin at 8.2%.

Costs increased 8% as we continue to focus on cost control, investing in new business initiatives and strengthening our infrastructure. Our of the total £10m increase around half related directly to this investment.

Bad debts were broadly flat at £17m with the bad debt ratio at 0.5%. This reflects both good credit performance as well as provision releases in the period. Overall profits in the Banking division increased 13% to £123m and return on net loan book remains ahead of the long-term average at 3.7%.

Loan book growth was slower than last year as we continued to apply the same disciplined approach to our lending. Although competition continues to impact some businesses others continued to achieve good growth.

Firstly, in Retail Finance the loan book increased 2% overall to £2.6bn with growth driven by premium finance which achieved a number of new broker wins in the period. In the Motor Finance business the UK market remains competitive although we saw some good growth in Ireland.

Secondly, the Commercial Finance loan book was flat reflecting ongoing competition particularly in the broker market. However we continue to see good business volumes in the more specialist areas.

And finally Property Finance grew at 3.3% with good demand, partly offset by higher repayments towards the period end.

Looking now at the three operating segments in the Banking division. As you can see all three are performing well and generating strong profitability. The net interest margin is strong and broadly consistent across our businesses, ranging from 7.8% in Property to 8.7% in Retail Finance.

Bad debts remain low across the book although the bad debt ratio increased slightly in Retail it remains below historical levels. And in Property Finance we reported a net recovery reflecting a release of provisions in relation to historical loans.

And finally, as you can see, the expense income ratio was flat or down in all our businesses, despite ongoing investment in both Retail and Commercial Finance.

Turning now to Winterflood, which achieved a strong trading result with an increase in retail trading activity and rising equity markets. Income increased over 50% to £54m, benefiting from higher trading profit across all sectors, and particularly in AIM. Volumes increased and trading was consistently profitable with no loss days in the period. Expenses increased, reflecting the improved trading performance. And overall profit more than doubled to £14m.

A strong performance which demonstrates Winterflood's ability to make the most of improved market conditions.

And finally Asset Management where we made good progress in the first half, supported by favourable market conditions. Adjusted operating profit increased 8% to £9m, this includes £2m in relation to the profit on disposal of OLIM. Excluding OLIM and the corporate business which we sold last year, underlying AOP increased 26% to £7m. Managed assets grew organically by over £300m, including net inflows of £125m and around £200m of market movements. But overall they were broadly stable at £8bn, reflecting the disposal of OLIM.

In the period we also bought two IFA businesses, adding £400m of advised client assets. As a result total client assets increased to over £10bn.

Thank you.

Preben Prebensen

Thank you, Jonathan.

Conditions in the first half have been favourable, however we always manage our business for the long term. And we remain focused on the consistent execution of our strategy and business model which have underpinned our performance for many years.

Our shared values of Expertise, Service and Relationships define every part of our business. This allows us to build leading positions in the specialist markets we operate in, which in turn generate strong profits, allowing us to reinvest and grow our business while delivering good returns for shareholders.

Our Group consists of five business segments, all of which operate in their own specialist markets. However, we apply the same disciplined approach, prudent risk management and customer focus across all of them.

The three banking segments share a focus on specialist markets, maintaining our prudent underwriting and achieving strong and sustainable returns throughout the cycle. But each provides a different range of products and serves a different set of customers.

Retail Finance provides intermediated finance through our large network of motor dealers and insurance brokers to both individuals and small businesses. Commercial Finance focuses on specialist secured lending to the SME market.

And Property Finance provides a specialist residential development finance to well-established professional developers in the UK.

Winterflood is the leading market maker in the UK providing trading services for retail brokers and institutions.

And finally our Asset Management division offers financial advice and investment management to private clients in the UK.

All our businesses provide specialist solutions serving a wide range of clients, and each remains well positioned in its particular market.

In the first half all our businesses delivered growth in profit, building on our long track record of profitability. Conditions for lenders remain benign, with good access to funding and historically low bad debts, and that continues to attract competition into our markets.

Notwithstanding this all three banking segments performed well with strong profits and continued loan book growth.

As you know we don't set growth targets, and growth is an output of our prudent business model. Our focus is on maintaining consistent and disciplined lending criteria without having to adjust our pricing or underwriting as market conditions change.

Winterflood made the most of the improved market conditions and delivered a strong performance in the period. And Asset Management made good progress with positive net flows and an increase in total assets.

Overall profit increased 21%, continuing our long track record of profitable growth which supports the generation of strong returns and dividends throughout the cycle. We have a good capital position which supports our growth and continued investment. And the RoE, which now includes the full effect of the tax surcharge, remains strong at 18%.

Now turning to look in more detail at each of our lending businesses.

In Retail Finance we have a nationwide network of 7,000 motor dealers and 1,700 insurance brokers who distribute our finance products to small businesses and individuals. We have strong relationships with these intermediaries who value our fast and flexible underwriting and personal service.

The UK motor finance market remains one of the most competitive markets we operate in as both large banks and more specialist providers have re-entered this market in recent years. In this environment we continue to focus on our margins and the quality of our underwriting rather than chasing market share, and continuing to develop our service offering to motor dealers. At the same time we're continuing to grow our motor finance loan book in Ireland.

Our Premium Finance business continues to grow strongly, driven by a number of new broker wins, as well as higher volumes from our existing brokers. We're continuing to invest in this area to upgrade our infrastructure and improve our proposition to insurance brokers.

Commercial Finance, which includes asset and invoice finance, provides secured lending solutions to around 25,000 small businesses across the UK. We have a large nationwide direct salesforce with over 200 sales people, who are experts in their specific asset classes.

This direct distribution network, the expertise of our lenders and their local underwriting authority means we can provide fast decisions and a high level of service, allowing us to build long-lasting relationships with the small businesses we lend to.

Overall we achieved solid performance from the Commercial Finance in this period with good profit growth and a stable loan book.

While we're continuing to see competitive pressure, particularly in the broker distributed market, we also continued to see growth in more specialist areas and are pursuing a number of new initiatives. This includes our green energy business which again grew strongly in the first half. More recently we launched our technology leasing service which provides IT procurement and financing solutions, focusing on medium-sized business. And we recently agreed to acquire a specialist provider of secured finance to law firms and their clients.

Our Property Finance business focuses on specialist residential development lending to experienced property developers. We have a long and established track record in this business with many years' experience of lending successfully at all stages in the property cycle. This reflects our deep sector expertise and the ongoing prudent and consistent application of our lending criteria.

To remind you, we only lend to established developers with successful projects behind them. We lend at conservative loan to values, typically 50% to 60% of developed value. We focus on mid-range properties with a typical unit price of £500,000 so have minimal exposure to foreign buyers and the London super prime market. We do not lend to the buy-to-let sector and nor do we provide residential or commercial mortgages.

We continue to see a good demand for residential development and shorter-term refurbishment finance in London and the Southeast, and increasingly in our regional markets. And our Property Finance business is generating significant profit at this stage in the cycle with historically low bad debts. However, our consistent margins and prudent underwriting ensure that we can lend profitably across all stages of the cycle as we've demonstrated over many years.

Moving on to Winterflood, which is the leading market maker to retail stockbrokers in the UK with a long track record of trading successfully in all market conditions, supported by the expertise of its traders and proprietary market-leading technology. In the first half performance improved significantly and profits increased to £14m. This reflects more favourable market conditions with higher retail trading activity supported by both political events and rising equity markets.

Retail trading volumes in the market were up 63% year-on-year. In this environment Winterflood achieved a strong trading performance with higher income across all sectors and no loss days. As a daily trading business Winterflood is always sensitive to changes in market conditions, but as these results clearly demonstrate it remains well positioned to benefit from any increase in trading activity.

And finally on to Asset Management. As you can see the adjusted operating profit has increased significantly over the last five years, and we continue to make good progress in the first half of this year. We achieved positive net flows of £125m, with a particularly strong contribution from our own advisers. Total managed assets have increased over the year to £7.9bn, notwithstanding several recent disposals. And total client assets currently stand at £10.2bn.

In the first half of the year we acquired two IFA businesses, strengthening our presence in London and the Midlands. The Asset Management division provides an attractive proposition to clients with an integrated advice and investment management offering, and we continue to see significant growth potential for our services. We're pleased with the progress in the first half, and continue to focus on growing this business both organically, through our business development efforts, selective hiring of advisers and fund managers, and if appropriate small complementary acquisitions.

So to summarise. Our service driven model and the consistent execution of our strategy underpin our long track record of profitability throughout the cycle. This allows us to deliver both an attractive proposition for our clients, and long-term value to our shareholders. Overall, we've achieved a strong performance in the first half of the year, and are confident in delivering a good result for the full year.

Thank you, and we'll now be happy to take any questions you may have.

Q&A SESSION

Question 1

Philip Middleton, Merrill Lynch

When you look at your new business growth, are you losing business to competitors on pricing? How does that whole dynamic work because obviously your growth has slowed, other have risen, and you are known to be fairly strict with your lending criteria. What actual behaviour are you seeing from your competitors and how do you think that's panning out over the next few months?

Preben Prebensen

I'll just repeat the question actually in case it wasn't heard by everyone. The question was around the new business growth and process, and whether we're losing business to the competition on price, or indeed on underwriting standards, and where we see that at the moment.

So on loan book growth, I might just make one or two comments about that because as we have said today, and as you know, it's an output and it's not something we target. At this point in the cycle we are in a more moderate phase. But having said that, the first half remember includes August and December, which are structurally kind of weaker months in the calendar, and there are therefore seasonal factors and we had some pre-payments. So don't extrapolate from the first half to the second. That would be the first point.

I think on the question of pricing and underwriting standards, obviously as the credit cycle moves through its normal path, we see more supply of credit from both large banks and small banks. The larger banks affect us in certain areas more than in others, motor finance would be an example of that. Whereas the smaller lenders affect us more, for example in the broker channel of asset finance. As that credit supply comes back it clearly comes back at lower prices than we require, and our competitors do lend at significantly lower net interest margins than we do. Our business model is based on service and it's based on speed and it's based on managing repeat business levels which are very high. We're intensely local and delegate authority. So we have a slightly different business model. But in answer to your question, absolutely pricing is a factor, and we will maintain our returns in the face of price competition.

Underwriting standards are also a factor. We have very consistent loan to value criteria for our business; and in fact if you look at those criteria across the Bank they are not very different from the criteria that I saw when I first joined in 2009. So over the last eight years much has happened, but our loan to value ratios that we lend out are really the same. Other people will do different things. So we see the kind of price competition, we also see different underwriting standards. And that's exactly what we would expect at this point in the cycle.

Question 2

Gurjit Kambo, JP Morgan

Just a few questions. Firstly, you refer to the cycle. What are the key characteristics of the cycle you're currently seeing? Just so we can understand how the business is behaving. That's the first question.

The second one is, in terms of the loss days of Winterflood, obviously zero loss there is a great achievement, and also at the same time you've managed to increase the profitability there. Is that just the market backdrop, or have you tweaked anything within Winterflood?

Then the final question is just on Asset Management in terms of potential strategic acquisitions. Would that be more biased towards wealth management or assessment management?

Preben Prebensen

In terms of the cycle, just to give you a little bit more colour, I think it probably makes sense to go down to the business unit level, because the different businesses do have different characteristics, and they do have different competitive dynamics. So if you look at one end of our business, Motor Finance, we do business with smaller to medium sized dealers, and we have a local branch network, and as I say we base a lot of what we do on that service proposition. As the credit cycle comes back, large lenders come into that market, it has a relatively straightforward distribution network for them, and they can come in through the larger dealers and they work their way down to the mid-size dealers. So we kind of ebb and flow in market share based on the amount of credit supply.

Before the credit crisis we had about 7% share of point of sale used car finance. It went up to about 11% I think, or even 12% in around 2011, and it's back at kind of 6'ish now. We don't target market share, we protect our returns. So that's the kind of dynamic that we're seeing there. The underlying demand for new and used cars has been very strong though so our business continues to grow a bit notwithstanding that competitor dynamic.

If you look at Asset Finance, we have two different stories there. One is the broker channel where new banks can move in, and based on price can go through the broker channel to the SMEs relatively straightforwardly and take business on price. So that happens every cycle and it's absolutely happened in the last year or two. On the direct side, we're more protected by that salesforce that I talked about, so that we can get very locally to very small businesses. But even there obviously an increase in supply and an increase in competition does affect us. In certain asset classes, transport for example, it's more particular than in some others because it's less specialised. So that's at one end of our spectrum.

At the other end of the spectrum we have businesses that have higher barriers even at this point in the cycle, and those barriers are based on expertise in property for example. We have real deep expertise in residential property lending, and that is hard to replicate, and we have very strong relationships and a very strong market position, so I would say that's a well protected business. Premium Finance is another example of that, where we've won brokers, where the barriers include systems investment, long-term relationships with brokers, and so that would be a more protective, more defensible sector.

So you really have to look at it business by business actually rather than just looking at it in the round. Then you can cast your mind back over a long period of time over many cycles, and you can see that that business model does provide long-term, actually double digit growth. But there are periods when it's very high and periods when it's more moderate.

Your two other questions, loss days and Wins. It's much more the market than anything else. In markets like this time last year when we had lots of dislocation and low volumes and low participation by retail, it's much harder for our traders. And markets like this where you've got rising levels but much more importantly rising participation and sentiment, it's more straightforward for our traders. There's nothing that I would point to structurally, I think, beyond that. Phil, would you ...?

Philip Yarrow, Winterflood Securities

We haven't tweaked anything structurally in terms of risk limit at all. The only thing I would add is obviously market volatility is obviously at much lower levels given the business right now.

Preben Prebensen

Yeah. So better environment. Then finally, in terms of M&A, we signalled that we will have and will continue to make small acquisitions that incrementally add to our business. Those have tended to be IFAs, but we would equally look at adding to the high net worth side of our business if something came along. And indeed there are legal entity acquisitions, there are people acquisitions that bring clients, and that could be either in the discretionary investment management side, i.e., high net worth, or in the advice side of the business.

<u>Question 3</u>

James Hamilton, Numis

Couple if I may. Firstly, you mentioned secure finance law firms. These things invariable have no net tangible assets whatsoever. Would that be something like post-settlement finance, and if so could you run through the thinking behind that?

Adrian Sainsbury

Yes, James, it's an established business that's been running for four or five years now that we're acquiring. It's due to close in April, the transactions, just to be clear. The predominance of the funding is contested law cases, family law cases, contested divorce, and it's funding the disbursements of those cases. There's an assessment done of the two individuals involved in the divorce, the asset base that they have and the lending is a very low proportion of that. The structure behind that then, if there isn't a big asset base, is it's lending against the insurance product, so that is the structure.

Preben Prebensen

So we like the risk profile of that business.

James Hamilton

The second is on the capital stack, I mean obviously its mix has changed very substantially in the period, I was just wondering if you could give us a feeling as to how you feel about the current sort of balance sheet structure, really sort of talking between CET1 and tier 2 capital, is this sort of a bit too much sort of tier 2 for you and gradually it'll move back the other way? Are you happy with the change, etc, etc?

Preben Prebensen

Sure. Jonathan, do you want to take that?

Jonathan Howell

Yes. And, James thank you for that. First of all, as you say we've got a CET1 ratio now of 12.6% and a total capital ratio of 15.3%. We're in a good position, we're happy with where we sit in terms of the capital stack. The first thing to note about Close Brothers, and this is a consistent part of the model which actually we've been discussing earlier on, is that we generate high levels of organic capital each year, each period, and that has continued, and that is driven by the high NIM and the high RoE, we're running a bank with an RoE of over 20%.

There are two particular one-offs so to speak during the course of this first six months of the year, the first was the increase in risk weighting assets of the property development loan book by the EBA, which applied to all banks within the EU and increased that from 100% to 150%, notwithstanding the high quality of our underlying assets in that part of the business, and that took 1.2% off the CET1 ratio.

And the second thing to note, as you identified, was that during the course of the year a planned, we've been planning to do it for a window of a year or 18 months or so, we brought forward the issue of a tier 2 bond of £175m, that sort of rounded out our capital stack to prepare us for the fully loaded Basel III CRD full requirements of FY19 in our case.

So if you take that all together we've got a strong return business with high RoE and that will remain and that is the bedrock of the business. Secondly, we've got underlying confidence in the quality of that asset base that that capital is supporting and that hasn't changed and we sit in a position where we feel comfortable that we've got the flexibility to grow the loan book to invest in the business and to continue to pay good dividends to our shareholders. So all in all we feel comfortable where we're sitting at the moment.

<u>Question 4</u>

Arun Melmane, Macquarie

Can I ask a question on NIM? So when you look at sort of capital structure and what you're doing in terms of the tiering of capital and the intensity of risk weights how do you manage your NIM to be flat into next year; is that largely a product mix decision or are you thinking of doing something on the asset side, given your liability durations also increasing and you're raising more sort of liability structure in some senses?

Preben Prebensen

So we clearly keep an eye on overall NIM but it's really an aggregate of what's going on in all of the businesses. The segmental reporting we've done now gives you a sense that it's not that different across those three segments, and we don't set an absolute hard NIM target or limit for any of the businesses, we tend to look at the RoEs and have hurdle rates for the businesses in an RoE sense and we look at our historic experience with those businesses and we look at the product of where that all might leave us. But it's not a kind of overarching command and control, we're happy that we are in a high NIM environment in what we do and we want to continue to be in a high NIM environment in what we do.

Arun Melmane

And just the write back of impairments that you took in the property division, what were they exactly and what's the sort of logic behind that?

Preben Prebensen

These are legacy positions, we have what is now really a tiny bit left of our legacy property book which we have actually managed our way out of and in a few cases the management of that right at the end of that tail has actually resulted in write-backs, but this is a very small tail at this stage.

Jonathan Howell

So in broad terms just to help you on the numbers on that, the write-backs were about £5m or £6m in aggregate, principally in the Property division and then if you strip that out instead of the underlying bad debt charge for the first half being at a 0.5% that would just increase it marginally to 0.6-0.7%. So all things said and done, the overall bad debt charge for the whole of last year is more or less in line with where we are now, just marginally up.

Arun Melmane

Can I just ask a last one? On the asset management side of things what is the strategy for the business on a sort of a three or a five year outlook, I mean what do you want to see the assets look like or the structure?

Preben Prebensen

Well again, we're wary of setting absolute targets for growth or AUM levels; actually instead we'd look at the business model which is an integrated advice and investment management model, we like that model, we think that there is a strong demand for that integrated proposition. In terms of our strategy for the execution of that model we want to focus on our ability to grow that organically and then to supplement that with attracting additional people or the odd small acquisition. So we think it fits very well with the brand and it has a long-term place, but the highest value proposition for us is to grow that business over time.

<u>Question 5</u>

Shailesh Raikundlia, Panmure Gordon

Actually just one question related to the NIM again, just on the liability side, I mean we obviously have the term funding scheme which you haven't really talked about, whether you're going to participate in it or not, given it's over a four year term. I mean that would allow you to sort of be a bit more competitive in the market on the asset side as well and sort of maintain your NIMs as well. So I was just wondering whether that changes your dynamics in terms of how you're going to try to sort of manage the competition going forward?

Preben Prebensen

So the easy answer is that we will participate in it, we are participating in it, but it's very small. So we're talking about a few hundred million out of the total loan book funding that we have with a £6.5bn loan book. It's a marginal impact for us.

Jonathan Howell

I mean the total funding that we have is about £8.7bn, and we're in both of the funding schemes with the Bank of England up to about £400m at the moment. But don't forget in terms of our flexibility, in terms of financing, our model is to borrow long and then short and as you can see from the numbers we've reported today some 76% of the loan book is covered by term funding of more than 12 months. And that's against an average term on the loan book of 14 months. And the average term on that funding is 39 months. That is the way we fund ourselves, it is a very secure, very safe, very long-term funding model that we hold at all points of the cycle. So that means that short term, relatively small changes in immediate marginal funding costs don't really impact our overall NIM.

Preben Prebensen

Thank you very much.