PHOENIX GROUP

Phoenix Group Holdings

Q3 2015 Interim Management Statement

Thursday, 22nd October 2015

Clive Bannister, Group Chief Executive

Good morning everybody. I'm here with Jim McConville, the Group's Chief Financial Officer, and also Sam Perowne, who looks after Investor Relations.

Well, thank you for attending today's call. We would be very happy to answer your questions in a few minutes, but first I would like to take you through the highlights of our third quarter announcement which we released this morning.

First, cash generation. Cash, remitted by the operating companies, continues to be the metric which we think is most useful in helping investors understand the long-term value and predictability of our business. I'm pleased to report the company has generated a total of £137m of cash from the operating companies as at 30th September. And we have also generated a further £18m of cash in October. Thus our total year-to-date cash generation totals £155m.

We expect the cash generation for the full year will be within our target range of £200m to £250m, and we remain on track to meet all of the financial targets we set for 2015 and beyond, and that includes our statement of £2.8bn between 2014 and 2019.

And after our normal cash outflows and dividend payments in the third quarter we had £809m of cash at the holding companies as of 30th September.

Now, turning to capital. We currently report our Group solvency position on two bases: IGD and PLHL ICA. However, the existing Group capital measures will no longer be regulatory measures from 1st January 2016, and the Group is therefore focused on optimising the capital position under Solvency II rather than the current metrics.

Our IGD surplus and IGD headroom have both reduced by £200m since the half year, at £1.4bn and £0.6bn respectively. This decline is due to the financing costs incurred in the third quarter, including pension contributions and the payment of the interim dividend. And our PLHL ICA surplus and headroom also reduced at £0.6bn and £0.5bn respectively as of 30th September due to the impact of market movements and actions taken to optimise the Solvency II balance sheet.

And finally, from an individual life company perspective, we report the Phoenix Life free surplus. The position was £294m as at 30th September, which represents the excess capital over and above the life companies' own strong capital policies on a Solvency I basis.

Next a quick update on Solvency II. We continue to work with the PRA towards the approval of our Internal Model, and expect to be notified of the outcome in early December. As we stated at the time of the first half results in August the Group expects to be well capitalised under the Solvency II capital regime, with the Group position expected to be in excess of the current PLHL ICA surplus, subject to regulatory approval.

Finally I would like to touch on the M&A environment. We continue to believe that Solvency II and other regulatory changes will result in further consolidation in the UK, and that there will be a number of potential acquisition and consolidation opportunities in the UK. Phoenix's specialist operating model and our recent achievement of an investment grade rating positions us to take advantage of this opportunity.

And so to conclude. I'm delighted by the progress we continue to make and look forward to the introduction of Solvency II and Phoenix's participation in the future consolidation of the closed life funds.

At this point in time I'd like to finish and move on to questions and answers. As I've said before, I'll do the easy ones and I'll ask Jim to do the difficult ones.

<u>Q&A sessions</u>

<u>Question 1</u>

Ming Zhu, Canaccord

Just two questions please. First your comment on the Solvency II capital has always been sort of in excess of your current ICA, and I think now your ICA has come down. Does that mean that Solvency II capital is coming down with it, or is it still as it was when it was announced full year?

Second question is: could you please provide some outlook or clarity on the timeline for M&A please? Thank you.

Clive Bannister

Jim, would you do the first? And then I will talk about M&A second. Thank you.

Jim McConville, Group Finance Director

I think Ming, what you've rightly said is we have consistently said our Solvency II expected position will be in excess of our PLHL ICA. The reduction in the PLHL ICA from the half year 2015 position is a reflection of the dividend and financing costs which were expected during that period, which were countered by the benefit of management actions and the BAU surplus, and the impact of the market movements which were negative.

The one thing in the ICA which was slightly unusual was the Solvency II impact of management actions, and this is where we are taking action to optimise our balance sheet from a Solvency II perspective. So, why don't we just spend a minute or two on that, and then I'll come back to your question.

So we've done a number of key things in relation to preparing the balance sheet over the course of the last year or two. First of all we got the consent for the Tier II debt, which meant that that debt was Solvency II compliant; and then you'll recall at the beginning of this year we did the exchange offer for the new Tier II debt, which again resulted in that debt being Solvency II compliant. And following the completion of the bank restructurings we completed a corporate restructuring, which improved the efficiency of the balance sheet.

The final element of optimising the Solvency II balance sheet is we are taking some action to convert from gilts to swaps, so that has had a slightly negative impact on our ICA position during this quarter, but it's not a significant amount.

Our expectation for the Solvency II surplus position has not changed since we last spoke at the half year.

Clive Bannister

Ming, your second question was about the outlook for M&A. Very hard for me to look into the future I don't possess a crystal ball. But what I said a year and a half ago is that I did think the uncertainty around the Solvency II regulatory capital regime would inhibit transactions. I think it was an accurate statement then. And I think that the converse is true, that when we know what Solvency II looks like, i.e. the treatment of capital from both the vendors' point of view but also from us from an acquisition point of view, it will make things easier to calibrate.

I don't think there will be a starting gun that starts on 1st January 2016 but I do think it is fair to expect further consolidation in this industry, and that there will be more transactions in the years 2016 and 2017. We think that there is still a good pool or sizeable pool of closed businesses or businesses that are virtually closed; these are owned by banks, by UK insurance companies and foreign insurance companies. I think there is a level of vendor motivation because of trapped capital, high administrative costs, close regulatory scrutiny of these businesses, which for some owners, particularly since the annuity changes of a year and a half ago, mean that the economics are not what they used to be and therefore you can either own these businesses and run them yourself or put them up for sale. Clearly we're interested in the latter. And that I believe that we as a firm, particularly having got the investment grade rating, are well-positioned to play a role in future industry consolidation.

Question 2

Garvin Peoples, Kames Capital

Apologies if this question has already been asked; I just dialled in a bit late. Looking at your solvency numbers, I was interested in – I appreciate you can't say the exact numbers that you expect under Solvency II – I was interested in whether you were talking about the surplus under Solvency II being the same as an absolute amount or as a percentage, because the denominator will change.

Jim McConville

What we are talking about when we make this statement that we expect the Solvency II surplus to be in excess of our existing PLHL ICA surplus we are talking about the absolute amount. And we have not given any indication on ratios thus far.

Question 3

Oliver Steel, Deutsche Bank

Two questions. First of all on a couple of the regulatory comments you've made, so the long-term customers and also the exit charges: has anything changed in your mind on either of those two fronts? You've always tended to be quite reassuring about them in the past, but I thought the statements today were just a little bit more open.

The second question, coming back to Ming's question on M&A. Obviously the UK regulator has got an awful lot of companies to approve, and certainly for internal models I think some of them are not planning to get their internal models approved until later in 2016. Do you feel that you will have enough information about potential targets, Solvency II positions or about what they could then look like on an internal model basis as early as January, February 2016? Or do you think in practice that sort of becomes clearer as we go through the year?

Clive Bannister

Okay, so we have two questions, let's deal with the regulatory one, Oliver. There are two points: first of all we are still waiting for the FCA industry legacy review, legacy industry review, I beg your pardon, it is our expectation, I had thought that it would be delivered in the first half of this year, I think it will be delivered in the second half of this year before we all go home for Christmas. I don't think it will happen before the Autumn Statement because the new news is of course the Chancellor's interest in exit charges.

So there were three parts of the work being looked at by the FCA, the first was the quality of our communication with clients, the second was the degree of cross-subsidisation between open and closed books and the third was looking at exit charges. I don't think our position has changed so I don't think you should infer if our vocabulary has become any more tense about this. We can always do better as an industry in terms of communication, and we expect that there will be an appropriate focus on ensuring that vesting annuitants know that they don't have to acquire their annuity from the business, i.e. our business from where the vesting has taken place; and we have about £500m a year vesting annuities so that will matter to us, and obviously there will be renewed emphasis on letting people know about product riders and also the existence of enhanced annuities for those people who may have health issues. So I don't think that attaches itself to shareholder value but I think those are important possible outcomes from this review.

The second is on the open and closed cross subsidisation, we don't have an open business so it won't affect us, it may affect others and you have seen some people sort of starting to ring-fence some of their businesses or separate their legacy businesses from their open businesses.

Then the third one is on exit charges, so I have no doubt that there will be comments on this. We are robust in the fact that exit charges have not inhibited our customers' behaviour, so since A-Day in April of this year we've had about 27,000 clients do encashment of their funds, albeit slightly smaller amounts of money than our average fund holders, and neither the tax charge if they have to pay, nor the exit charges, have inhibited their actions. And on balance, on average I should say, our average unit linked fund has a 1% exit charge which works out at about £150. So I don't think that is an amount of money that will allow anybody to declare war, though I think there will be comments about exit charges and that these should not inhibit client actions; but obviously we wait to see what the regulator, and I think importantly the Chancellor, may say in his Autumn Statement.

Then your second question is a very interesting one about M&A and IMAP and when will we know enough about targets. So let's just take a step back. At the beginning of this year we were told by the PRA that there were 45 companies going through an IMAP process, we went through a commitment panel in April, we then learned there would be about 25 companies going through IMAP and I think that number has probably come down to a slightly smaller number of around 20. As Andrew Bailey said very clearly, it's not just IMAP, we then had partial IMAP and standard formula. What is clear is that all firms need to know where they are in a capital sense by this year end.

Going forward into 2016 it doesn't really matter if we were acquiring a firm whether they are IMAP, standard formula or partial IMAP, what we understand very clearly is that any firm we acquire would have to be harmonised into our way of doing things, i.e. onto our IMAP. So it is extremely helpful for us to know by year end, as we will do, what our IMAP situation is, or what our capital is under Solvency II as a consequence of IMAP. And that means that floating issues which are still out there, matching adjustments, the impact on transitionals and the final capital management policies which will be applied to our firm will all be done; so therefore one end of the quadratic equation will be solved, and then anything that we look at we know we will have to harmonise with those known facts. At the moment there are unknown knowns, we have an estimate on where we are on matching adjustments and capital management policies and that's why we make the statements we do about where we think we'll be under Solvency II.

So my sense is irrespective of what we're looking at, the fact that we know the capital card is in our hands - that will be helpful to us in taking forward future transactions because it removes a layer of uncertainty.

<u>Question 4</u>

Atif Ali, Citadel Investment Group

Post newspaper reports linking Guardian to Phoenix, can you give us an update on the possible deal sizes you are considering, along with financing strategy? Any plans to issue further subordinated bonds to boost capital?

Clive Bannister

So Atif, thank you very much for your question, it comes in two parts about deal size which I will answer and then Jim will talk about our financing strategy, and obviously the optionality we have, particularly in the light of having got the investment grade. I think size is a lot less important than the type of acquisition or the type of book of business, or books of business that we have the option to look at. The size of the Swiss Re Guardian deal was £1.6bn so that's at one end of a spectrum, and I think at the other end of the spectrum there are deals that are relatively small that don't warrant our focus and time and attention and that would be deals sub £100m of EV.

However, there's a very big range between £100bn and £1.6bn and what is really important to us is that a transaction delivers three things. The first is that it is accretive to our shareholders; the second is that it protects and enhances our retention and maintenance of our investment grade rating; and then finally, enormously important, that we protect or improve our dividend.

And so those are the criteria and therefore we look at the types of businesses, we're very strong and very able in the area of with profits, that is a pretty difficult business to administer, we're very happy with unit linked, of course we have annuities, a substantial annuity book at around about £8bn, and of course a pensions book. So we look at the quality of an acquisition in the light of how well it will fulfil the first three criteria that I've described, so size is secondary to the fulfilment of those criteria.

Jim, do you want to talk about our financing options?

Jim McConville

Yes, so obviously as I think you're all aware we achieved earlier this year an investment grade rating, that was important to us because it lowered the cost of our debt and clearly opened us up to a potential wider pool of investors for any future debt transactions. The strategy that we have for our debt going forward is no different from what we said at our half year announcement; roughly half of our debt is in the form of senior bank debt and over time we would look to reduce the proportion of senior bank debt relative to bonds by taking advantage of further market opportunities to issue traded debt. However, there is no immediate financing requirement upon us and we would just look to do any transactions in due course when we thought markets were conducive and so on. So there are no immediate plans for any debt issues and we'll continue to monitor the market with the overall direction of travel being to reduce our proportion obviously of bank debt.

<u>Question 5</u>

Alan Devlin, Barclays

Hi, thanks guys, it's just one question from me. I wonder if you could comment on the impact of the PRA's guidance that transitional measures won't necessarily be transferred in M&A, that you need to apply for them to be transferred. Do you think that will impact the M&A market in any way or is it not that significant, given the businesses you're looking for?

Clive Bannister

Alan, I'm going to give you my top line and then look to Jim. Nice to have you on the call. Any transaction requires a change of control which is given by our regulator, and the two regulators on the capital side with the PRA and of course on the conduct side from the FCA. So I think that would only be one item which would be a factor in a sandwich that has to be thought about which has multiple layers and clearly transitionals and their treatment is a part of how our balance sheet looks. So it doesn't surprise me what they said, it is a component in what is quite a complex set of conversations with a regulator when you're doing M&A.

Jim, I don't know…?

Jim McConville

Yes, I mean I think you've captured it, any discussion on M&A we would need to satisfy the regulator that we had an appropriate capital structure in place, and whilst I don't think they are saying that you transfer the transitional measures across into the acquiring entity, clearly that is a factor that'll be part of the wider discussions on the capital structure of any transaction.

Concluding Comments: Clive Bannister

Thank you everybody for listening to our third quarter IMS. As we said, it's steady as it goes, we're on track to meet our £200m to £250m annual target having delivered £155m and we're comfortable with the £2.8bn that we put out there for the 2014 to 2019 target. Thank you very much indeed, have a good day.