Phoenix Group plc 2011 Q3 Interim Management Statement

Tuesday 8th November 2011

Clive Bannister, Chief Executive Officer, Phoenix Group

Good morning everybody. My name is Clive Bannister, and I welcome you all to our Q3 Interim Management Statement call. I'm the Group Chief Executive of the Phoenix Group. And I'm joined here today by Jonathan Yates, our Group Finance Director, and Lorraine Rees, Head of Investor Relations.

Jonathan and I will 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 statement, which we released earlier this morning.

I'm very pleased to report the Group demonstrated real resilience in the third quarter, and we expect to deliver on all our 2011 financial targets, namely cash flow, MCEV uplift and organic deleveraging.

First on cash generation. Cash generation at the Holding Company level and the free surplus within the Life Company are important metrics for the Phoenix Group. We recognise cash when it has been passed up from the Operating Companies to the Holding Companies. The free surplus within the Life Companies is consistent with the £750 million to £850 million full-year target for cash generation that we have published before. Holding Company cash receipts totalled £503 million by the third quarter; the same number last year was £364 million. This is an increment of over £139 million, or a 40% uplift.

As we speak today we have remitted a further £100 million from the Life Companies up to the Holding Companies subsequent to 30th September, taking the total year-to-date cash generation to £603 million. This £100 million cashflow includes a further £89 million from cash flow acceleration, from management actions – split equally between risk management activities and operational management activities. We continue to have a strong pipeline of cashflow acceleration management actions which will emerge in the rest of Q4 and into 2012. In total closing cash in the Holding Companies was more than doubled to £691 million from the same period last year.

Second, I also want to take this opportunity to reiterate that we are on track to meet our £100 million target for MCEV enhancements through management actions by the year end. Again, I am looking at a strong pipeline of actions, which gives me confidence on this point for the full year.

Third, de-gearing remains a key focus for us. We have already achieved our target of reducing our gearing ratio below 50% by year end at the interim stage; and this position has been maintained. The final tranche of the 2012 mandatory payments on the bank facilities of £62.5 million was paid in October.

In the current environment I am particularly pleased at the resilience of our balance sheet. This has been proven again. Both our estimated IGD surplus and headroom were unchanged from the interims, at £1.1 billion and £300 million respectively. This is a direct result of the de-risking we have done over the past few years, and is absolutely in line with the IGD sensitivities that we have previously disclosed, which showed both these measures to be relatively insensitive to volatile markets.

Ignis, our fund management company, sustained its assets under management at just over £68 billion. The asset mix meant that there were no severe negative impacts for market movements in the period, as increases in fixed income offset the fall in equities.

Net new money of £1.1 billion was up 10% over the same period last year, and reflected strong inflows in the liquidity business in particular, and has largely offset the natural run-off in our life book.

Over the period in question our exposure to Peripheral European sovereign and financial institutions was down from £480 million to £189 million; a decrease of £282 million or nearly 60%.

We recently ran an investor day on Ignis which provided more details on each of the individual business units, and this is of course on our website.

The Phoenix Group is more than a balance sheet; it's a business. And the Group has continued to deliver operationally, bringing policyholder and shareholder benefits. The systems transformation is progressing well, with over 200 million live policies now transferred from legacy administration platforms to a modern bespoke platform we call BaNCS. All Pearl policies have now been transferred. The benefits of the IT transformation programme were outlined in the Phoenix Life investor presentation which we did in June, and again this is commented on in our website.

We are pleased that our approach to estate distribution has meant that we are being able to increase payouts by around 3% to 10% for certain customers. TCF, Treating Customers Fairly, is crucial to our modus operandi.

As we said at our full-year results for 2010, and we repeat it at the interims, the Phoenix Group is on a journey: from private equity ownership through our premium listing of a year ago it is a progressive journey of normalisation. Our third quarter, these third quarter interim results, mark another important step on that road; a solid set of results, demonstrating the resilience of our balance sheet, Ignis' performance and the continued operational delivery of our business. And we can say that we expect to meet all our financial targets in 2011.

At this point I'd like to finish. And if we may, Lloyd, can we move on to a question and answer session where Jonathan and I stand by to answer all your enquires. Thank very much.

Question & Answers

Question 1

Jon Hocking, Morgan Stanley

I've got three questions if I may. Firstly, the cashflow target of £750-850 million for this year, you obviously seem very on course to hit that; I wonder if you could talk a little bit about the range we might expect for 2012.

Secondly, you mentioned there's £62.5 million on the mandatory debt repayments that is paid in October; are you going to make any voluntary payments on the debt in the remainder of 2011?

And then finally on the IGD, you've got this obviously £0.3 billion of headroom; given the environment is there an opportunity to increase that headroom or is that headroom likely to be stable? And is there anything underlying the IGD which looks a little bit more stressed than the stable headline number?

Thank you.

Answer: Clive Bannister

Jon, thank you for those questions. Jonathan, I'll answer the first; and then will you take the debt one and deal with the IGD headroom? That would be very kind.

As we said we are on track to hit between our £750 and £850 million. And I think at this time it's appropriate simply to give you that clear guidance and repeat it, because that is how we see the state of play.

So, Jonathan, why don't you tackle the debt?

Answer: Jonathan Yates, Finance Director

Thanks, Clive. In terms of discretionary debt payments, we're not expecting to make any further payments this year. Next year maybe, it's quite possible that we will look to accelerate; but in terms of what we're looking to pay this year it will be the mandatory amounts.

In terms of the sorts of targets that we will be setting for things like cashflow, MCEV sort of accretion, things like that, we'll probably come out with those early in the New Year, as we did last year. I think we'd actually announce them with our full-year results, and we'd expect to carry on that pattern for next year.

And finally on the issue of IGD headroom, obviously we are particularly pleased with the way in which our IGD headroom has actually held up over the last three months in the period since the half-year. Obviously these are very challenging times, and other companies have found it very difficult. But I think one think about Phoenix is that we've spent the last two and a half years or so really de-risking its balance sheet, and I think we're really seeing the benefits of that now. That is very much what you're seeing here: IGD surplus and the headroom over our capital policy, maintaining the level that we had previously, in spite of the market conditions. It didn't happen sort of just by chance; there were management actions that we were able to push through to keep it up at the existing levels. But I think, of course, management actions are part of what we use to manage our balance sheet through challenging circumstances. So, personally I was extremely satisfied with our performance in that regard.

<u>Question 2</u>

Toby Langley, Barclays Capital

One question on refinancing. I'm wondering if you can give us some sense as to what your bankers have indicated to you would be the interest rate you would incur were you to refinance at the current time.

Then separately, I was talking about this with Lorraine earlier, the disclosure was only on actual cash movements and I'm just wondering if you can give us some sense as to the free surplus generation that's been produced in the year. That would be really helpful, thank you.

Answer: Clive Bannister

Well, Toby, thank you very much indeed. I'm going to tackle the first question; I'll ask Jonathan to tackle the second.

Our interest rates are weighted at the moment at about 195 basis points. No, we have not had any indication from our banks because we are not asking for a refinancing. As you know well, Toby, it's not an issue in our mind of quantity of debt; it's a question of the terming of the debt and the obligations that we have for repayment in '14, '15 and '16.

What I'm very happy to say is that we continue to have very cordial relationships with our banks, who are immensely supportive. We outline in our full annual report the nature of our future debt costs and charges, and so that is what we expect and that's where we are at the moment.

Jonathan, do you want to talk about the surplus?

Answer: Jonathan Yates

Yes. I can't be hugely helpful in this regard, I'm afraid. But what I can say is that clearly we monitor our solvency continuously, so daily solvency monitoring for surplus within the Life Company. And pretty much like I was saying on IGD, these have been very challenging times; you've seen a combination of falling equity markets, rising credit spreads, and falling yields. That combination is just about the worst possible combination for Pillar 2 surplus. And so what we've seen is Pillar 2 surplus put under quite severe stress. But, having said that, I come back to the point I made before which, through a combination of previous de-risking that we've undertaken, plus the management actions that we've had at our disposal, we've actually been able to sustain the level of free surplus at a level which means that we do still expect to be able to deliver cash generation and to the Life Companies from that free surplus, sufficient to meet the targets that we set for the year – in other words £750-850 million.

Further Question

Can I ask a follow up question? What kind of yield are you able to achieve on cash generation and then held in stock, if you like, at the moment?

Answer: Jonathan Yates

Good question. What we do typically is the cash which we bring it effectively it goes into long-term liquidity. But with the Holding Company we broadly look to hold sufficient cash to meet our cash requirements, our outgoing requirements for another 18 months or so. So, very strong cashflow for us. What we do is we look to invest in the light of the term of our

liabilities. So, typically what we'd be to doing is looking to invest in liquidity funds which are run by all the various banks; and of course Ignis – Ignis has probably the UK's leading liquidity fund, and we actually put a significant amount of our cash in there. And typically the duration of that fund would be something like getting on for perhaps a month maybe, something of that nature, at the most; probably more likely less than a week in many cases. So, very short dated and typical yields on those are of the order of 85 basis points.

Question 3

Kevin Ryan, Investec

I was just wondering about the additional £100 million of cash which emerged since the quarter end. Is that a sort of regular amount you'd expect? And could you give us a feel for the dynamics of the cash emerging in the group and whether this is likely to change going forward? Thanks

Answer: Clive Bannister

Thank you very much for that question about the £100 million which emerged, and I think I said how the £89 million had emerged, but I'll let Jonathan answer it. And then you've asked about future cash and the timing thereof.

Answer: Jonathan Yates

Yes, it's a good question. The reason the £100 million came up is because it was identified as being surplus. We had a Life Company board meeting and then the board was happy to approve the payment of that money up to the holding companies. So that payment was made for that reason, it just happened to be the amount that was identified and the board was comfortable to transfer at that time. It's not what we would expect to form part of a regular pattern of £100 million (inaudible) up on a periodic basis, it just happens to be where we were. In terms of looking forward we can't really give predictions as to the precise timing of cash generation but of course we do look to set the cash generation targets for the calendar year, and the precise timing within the calendar year is really hard to pin down.

Question 4

James Pearce, UBS

Two questions, first of all could you explain whether the fall in peripheral sovereign etc is because of sales, impairments, market movements or what? And then second, on the debt restructuring, can you talk a little bit more about why we haven't seen more progress? It's been a couple of years now and I thought this was somewhat more urgent that it appears to be, in that it would allow the full integration of the two silos of the life business.

Answer: Clive Bannister

James, thank you for those questions. The first point is that we have consciously, this is Ignis, has managed these assets and so it's not due to a write-down but these have been due to sales, and as I said a few minutes ago our exposure here to financial institutions and sovereign debt on behalf of the shareholder and the non-profit funds has moved from £480 to £189 million, which is a decrease of just over 60%. So this is conscious, and it's a way of managing our risk against the benchmarks that have been set within the Life Company.

Then on your second question, which was regarding the debt restructuring, it's a very good question and it's a slightly moot point. We have very good value debt, and the debt supports our capital structure well, and it behoves us to work on behalf of the shareholders to re-term that debt on terms which are advantageous to us, and of course fair to our banks who are a critical partner in our story going forward. You've mentioned one of the concomitant benefits of such a re-terming which would allow us to bring silos together, but that has to be balanced against the timing and the appropriateness of whatever re-terming we are discussing with our banks. So it's not a question of if, it's more a question of when, and to do that at a time which is propitious for our shareholders, and so there's nothing untoward in this, and so I go back to my earlier comments. But as you can see from our balance sheet the value of this debt is obvious to our shareholders and retaining that is sensible until such a time we get the right re-terming arrangements.

Question 5

Oliver Steel, Deutsche Bank

I've got three questions. First, following up from James' question on peripheral sovereign debt, where are you reinvesting this money, and does that have any implication for future cash flows to shareholders? The second question surrounds the furore over liquidity swaps, and again does this have any implication for future cash flows? And the third question is whether you're seeing any greater scrutiny or greater intervention by the FSA in terms of your ability to dividend up cash from the life companies.

Answer: Clive Bannister

I'm going to answer those in reverse order. We never comment on relationships with the FSA, who continue as always to be our lead regulator and looks after us and we continue to have very good relationships with them.

Let me take second your first question, I can't tell you, and I don't think it would be right, to go into what we've done by selling down on the peripherals, where that has been invested. We have a broad range, we are 85% fixed income, 15% in equities, these are in crude terms, 5%, 4.5%, in property, and then we have some others. So we would have to get back to you, Oliver, for more precise detail, but I think that might have to wait for the year end.

And then I think on your second question about liquidity swaps and how that affects cash flow, I'm looking at Jonathan.

Answer: Jonathan Yates

I think it's been fairly well known that we have looked at liquidity swaps in quite some detail over the last 18 months, so it goes back quite some considerable time. Now we consider it a very attractive lesson for us, we would like to look to use the gilts that we hold, and capture the liquidity premium that's available to us by doing transactions with banks. We think the security that the banks are capable of offering us is extremely good and the risk return dynamic is very attractive, certainly when you compare it with the alternatives such as investing in corporate bonds or indeed covered bonds. We think that obviously there's a lower return but the risk profile is very much better suited to our business. So we'd be very keen to do this as soon as the FSA has completed its consultation and decides that it's prepared to actually countenance these transactions going ahead.

Further question

So you still think that potentially there is some sort of deal that can be done here?

Answer: Jonathan Yates

Oh yes, very much so. I don't want to sort of quote... well I did actually have a quote from somebody fairly senior at the FSA who made the comment, well where else are the banks going to get their funding from if not from the insurance companies and the pension schemes? And this is a very attractive form for us to actually provide that funding. At the moment we provide our funding in the form of unsecured corporate bonds. More than 50% of the iTraxx Index is comprised of financials. I'd much rather lend in a secured form than in an unsecured form, which is historically what's been the case, and I think the idea of actually doing it, as I say, there is a lower return on secured funding in this way, but actually the risk profile is so much better and so much better suited to a company like us, which is obviously here to meet... we hold the money to meet policy holder guarantees. I think it's an extremely attractive opportunity for us, which is not to say we want to invest 100% of our assets in that form, but it certainly gives us a very interesting opportunity for diversification, away from unsecured funding.

<u>Question 6</u>

Marcus Rivaldi, Morgan Stanley

I've got two questions please. First a follow-up from the liquidity swaps debate, and I guess we are slightly in the dark here, given no disclosure about maybe what security you might be looking at, but can you give some sort of flavour about what banks are proposing for security here, and to give some sort of sense about what skill set you have internally to be properly managing from a risk perspective, those sort of... that security. And then secondly, just a second point on your fund merger programme you flag up NPI Ltd today, could you maybe just highlight what other funds might be available for you to carry on merging in Phoenix Life without resolution around... long term resolution on your bank facilities?

Answer: Clive Bannister

I'm very happy to answer the second part of that question, the first part I think hand it back to Jonathan. Jonathan, do you want to deal with the banks and liquidity?

Answer: Jonathan Yates

Yes, sure. In terms of what the banks offer by way of security, I mean we've had conversations with a number of banks who approached us with a view to doing transactions of this type, and each was offering different types of security, reflecting the sort of assets that they had on their balance sheet. So, without being specific in relation to individual banks, it's everything from residential mortgage bank securities to PFI type assets. And those kind of assets, you're absolutely right, I mean obviously the bank is managing the asset up until the point in which the bank fails and all of a sudden your collateral becomes your asset. And in that situation obviously you do need the capacity to manage it, which is one of the things that the FSA has highlighted as part of its consultation. And we're in a particularly strong position in that regard in that obviously we in Ignis are in a sort of asset management company and that gives us the ability to actually manage these assets and we have the confidence to do it, not least because we're already managing assets of this type. So this would just be more of the same. So the quality of the collateral that we're getting would be exceptionally high in that situation.

Answer: Clive Bannister

Jonathan, thank you very much indeed. We talked about this, Marcus, at our June day so happy to come back in greater detail there. But as you know we seek to get value from benefits in our life business, risk management, restructuring, operational management, outsourcing, and you've asked specifically about the restructuring. So currently we have five funds in the UK and five life companies in the UK, and one in Ireland. It is our objective next year, probably in the second half, to bring two more together and then that will bring additional benefits. And of course it is those structural things, not exclusively but those structural things, that allow us to drive what we call management actions, which in the normal course of our business allows us to drive forward and accelerate and release cash flow.

Further question

Sorry, what were those two funds, sorry I missed it in the middle of the year, but the two you're targeting maybe for the second half of next year?

Answer: Clive Bannister

Pearl and PLF

Question 7

Duncan Russell, J P Morgan

Just one question really, which is the free surplus generation phrase, just to be clear, is that the same basis as the £199 million you reported for the first half of 2011, i.e. includes investment variances?

Answer: Clive Bannister

Investment variances included, we're just checking back on the £199 million as you speak.

Answer: Jonathan Yates

In terms of the free surplus generation you're absolutely right, that was the surplus generation within the life funds, and what we're saying is that the surplus which is within the life funds and the surplus which continues to be generated should be sufficient to enable us to meet our target for cash generation for the whole year.

Further question

Okay, because at the half year that was designed as the total movement in the free surplus excluding the cash upstreamed. So it strikes me if that's the same definition then that's quite positive.

Answer: Jonathan Yates

Yes.

Concluding comments: Clive Bannister

I'm going to wrap up in literally 20 seconds, but these are strong, solid results and we've delivered resilient financial and operational performance. So as the UK's largest specialist

closed life consolidator we are happy at the generation of £603 million of cash from the operating companies, and despite the difficult market conditions the Life Company free surplus generation is consistent with a full year result of within the £750 and £850 million of cash generation target that we've given before. We're also proud that we have maintained our IGD surplus at £1.1 billion and that the assets under management for this business have remained stable at £68.3 billion. And those are the sorts of results that make us happy to talk about strong and resilient. Thank you very much indeed.

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