OLD MUTUAL WEALTH ACQUISITION OF QUILTER CHEVIOT

TRANSCRIPT

17 October 2014

Julian Roberts: Good morning, ladies and gentlemen. Thank you for joining us on this call, which as you've just heard is also a WebEx. I think roughly half of you have – are using those facilities. So you should be able to view the slides of the presentation on your computer as I talk through the acquisition of Quilter Cheviot and how it will transform significantly our wealth business. Details of the WebEx are on page 3 of the press releases, if you still want to follow the presentation that way. With me in the room I've got Ingrid Johnson, our group finance director, Paul Hanratty, the Group Chief Operating Officer, and Paul Feeney, Old Mutual Wealth Chief Executive. We'll be happy to answer your questions at the end of this presentation.

You will have had the chance by now to read, I hope, our announcement that we're acquiring Quilter Cheviot, a leading discretionary investment manager, the final piece in the jigsaw that is needed to build a vertically integrated wealth management business. Before I explain the acquisition in detail, I'd like to remind you of the group's strategy and achievements over the past five years. In 2010 we set out a number of targets for the group which we have since achieved. We've streamlined and simplified our business through the disposal of assets which were not core, or were outside our risk appetite. We strengthened our balance sheet significantly through the repayment of £1.7 billion of debt, and we've returned £1 billion to shareholders via a special dividend. We have a clear vision of being our customers' most trusted partner, helping them achieve their lifetime financial goals, and the acquisition today helps our wealth business do just that.

Two years ago we decided to fundamentally transform Old Mutual Wealth, when we took the decision to build a modern capital light business, based on our core high growth, high margin UK and cross border operations. We remain on track to deliver the £270 million profit goal from the existing businesses in 2015. We've said we want to transform our wealth earnings profile, and in the last 12 months we have sold or are in the process of selling the non-core European assets of Poland, Germany, Austria, France, Luxembourg and Liechtenstein for a combined £245 million. We closely monitored the developments regarding the retail distribution review, or, as it is colloquially known, RDR, and anticipated how it would affect the UK market. We said that RDR would encourage financial advisors to switch from independent to restricted advice. We acquired Intrinsic, one of the UK's largest distribution networks, with 3,000 financial advisors to capitalise on this opportunity, and we are already seeing this shift to restricted advice. We also set an objective to manage more of our clients' money ourselves, and have strengthened our capabilities in Old Mutual Global Investors. To achieve this, we have hired UK equity, Asian equity, pan European small company, and fixed income absolute return asset management capabilities. We are now managing more of our clients' money. At the half year, over 30% of all UK platform sales were into Global Investors funds. This includes some internal transfers in the period. As part of the Intrinsic transaction, we're also buying Cirilium.

We are increasingly seeing a trend for financial advisors to direct their top end clients' money into discretionary investment management. As an example, our Intrinsic advisors use three other discretionary investment management firms. We are confident the acquisition of Quilter Cheviot will immediately strengthen the value proposition for Old Mutual Wealth and Intrinsic clients.

The consideration of £585 million will be financed from the gross £300 million cash proceeds from the Old Mutual Asset Management IPO, and pre IPO dividend, and the £245 million gross proceeds from the sale of the non-core European businesses. We are redeploying capital from businesses that have delivered a return on historic investment of 5% and 8% respectively into a business that will deliver return on investment of more than 12%. We are doing this while maintaining our low gearing, improving our interest cover, and with an FGD surplus targeted around 150%.

I'll now move on to the transaction rationale. Quite simply, Quilter Cheviot is a high quality asset, which, combined with our existing business, will create the UK's leading vertically integrated wealth manager, with £92 billion of funds under management. It will provide us with a significant discretionary investment management capability, or DIM as I will refer to it, in the affluent and high net worth segment, which is a large and growing market. For those of you not familiar, let me explain what the discretionary service is. DIM allows clients to hand over the day-to-day management of their portfolio to an investment manager who will monitor that portfolio and make investment decisions on their clients' behalf. It is a bespoke service, and as such can charge premium fees. It is highly complementary to the Old Mutual Wealth strategy, meets our return on equity target of 12% to 15%, and will deliver £9 million of run rate cost and margin synergies, with potential to deliver significant revenue synergies. Additionally, it will replace heritage insurance profits with high quality, high margin new world earnings.

In 2012 new world earnings made up 35% of Old Mutual's wealth profits. By 2017, we estimate these will represent 85%. This represents a true transformation of the business' source of earnings.

The consideration, as I've already indicated, is £585 million. This includes a contingent consideration of £42 million in equity that is dependent on business performance, and is deferred for three and four years. This will closely align Quilter Cheviot's management interests with our shareholders'. We expect the transaction to close by the end of the first quarter 2015, subject to customary regulatory approvals.

The following chart highlights Quilter Cheviot's attractive footprint in a segment of the UK market, the upper end of the affluent and high net worth segments. Quilter Cheviot gives us immediate critical mass in this market. These segments are sizeable, with high net worth constituting 29% of the UK's wealth at £900 billion, and affluent 55% of the UK's wealth at £1.7 trillion.

I'm now on a slide, if you've printed them off, slide 8: 'UK discretionary market is large and growing'. The growth of the wealth management market in the UK, which in 2013 was worth £524 billion, is supported by a number of long term structural trends. It will benefit from regulatory development, including RDR as previously discussed, and the recent radical annuity reform. An aging population, higher savings rates, and a responsibility for savings being transferred to the individual are also important factors. As you can see from the chart in the top right, discretionary investment management, the dark green part of the column, has comprised two thirds of the UK wealth management market over the past four years. The total wealth management market is expected to grow at around 6% to 2018. Significantly, as shown in the chart in the bottom right, funds sourced from financial advisors are expected to be the biggest driver of growth, at 15% CAGR, a function in large part due to RDR.

Quilter Cheviot is the leading player of size in the highly fragmented UK discretionary market. On this page you can see how the £13.2 billion of discretionary funds under management that Quilter Cheviot manages are compared to its peers, and the industry is highly fragmented. So the acquisition of Quilter Cheviot will place Old Mutual Wealth in the top five, in the top tier. This chart sets out the top 20 discretionary managers. The tail of the industry is considerable, with the next 20 firms managing an aggregate of around £20 billion.

This slide will be familiar to most of you. You can see Quilter Cheviot as new capabilities and opportunities, strengthening Old Mutual's wealth market position. We have added percentages in this chart to show how we see our business in 2017. We expect that direct channels brought by Quilter Cheviot to bring 5% to 10% of our client base directly. We can provide products not currently offered by Quilter Cheviot to their customers if appropriate. International bonds, for example. We believe that by 2017, about half of clients' money will either be in managed portfolio services or in discretionary investment management, rather than managed by financial advisors. We also see the opportunity to bring more of the management of funds inside the group, now either with Old Mutual Global Investors or discretionary investment management.

Old Mutual Wealth's access to the full wealth management value chain': we used this chart a few weeks ago when Paul Feeney updated you on Old Mutual Wealth, showing how the individual parts of the wealth management business contributed to potential margin. Here we have shown that the industry can charge up to 300 basis points at the highest levels. Quilter Cheviot will sit neatly in the investment management section, and will allow us to earn more revenue by managing more money from within the group.

Quilter Cheviot has an attractive, competitive position. I now want to unpick the Quilter Cheviot business model, to show you how it earns its revenues. As you can see from the figures on this slide, it is a high quality asset with a strong competitive position. It is focused on growing funds under management through a range of distribution channels, including financial advisors, existing client referrals, professional bodies, as well as by its own direct sales team. It took £1.1 billion of net new money in 2013, which is 9% of opening funds under management. It maintains strong relationships with financial advisors, and has strong end client advocacy. It has high productivity, with the average number of clients per investment manager at 229, and net flows per investment manager are strong, at £6.8 million. Its operating margin is 29% and has revenue margins of between 85 and 90 basis points. DIM generates those margins from two streams of revenue: fees on funds under management, and fees from commissions driven by portfolio turnover. This mix of revenue streams means that it is less susceptible to market movements.

With Quilter Cheviot we're buying a business where 165 investment managers individually manage funds for 38,000 clients. To help those of you who are less familiar with this market, Rathbones is the largest quoted peer, and has market capitalisation of around £900 million, and on a 2014 forward PE of 18.1 according to Bloomberg. Quilter has a track record of strong financial performance. It has demonstrated significant growth in the past four years, with funds under management increasing to £15.8 billion at the end of 2014. It has generated 40% CAGR in EBITDA from £20 million in 2011 to £39 million in full year 2013, and maintained stable fee generating margins. Significantly for Old Mutual Wealth, the majority of net new money in the past 18 months, around 60%, has come via financial advisors. We estimate Quilter Cheviot's EBITDA to be £45 million for the 2014 full year.

Now let's go into a bit more detail on how this acquisition will enhance value for Old Mutual Wealth. We will deliver Old Mutual Global Investor funds and capabilities to Quilter Cheviot's clients, and extend advice on tax-efficient, international solutions to the Quilter Cheviot clients seeking them. For the top end Intrinsic clients, there is the opportunity to offer Quilter Cheviot services. All of these activities lead us to expect to generate revenue synergies on top of the £9 million per annum of run rate cost and margin synergies.

You can see in the top right hand chart we've included our familiar matrix to show how the mix of funds under management and margins affect our profitability. In the bottom right hand chart, we use the same technique for Quilter Cheviot for 2017, including the cost and margin synergies. You can see that, if the business maintains its current margins, delivers only the cost and margin synergies target and experiences around £2 million per annum growth of funds under management, we will reach our 12% return on investment criteria. It is important to note that these figures exclude the revenue synergies and utilise the group tax losses available.

So let me summarise. The acquisition of Quilter Cheviot supports Old Mutual's vision, and is in line with our stated strategy to build the UK's leading wealth management business. It is a high quality asset that brings immediate critical mass in the strategically important area of discretionary investment management. The structure of the deal aligns Quilter Cheviot's management with our shareholders' interests, and delivers operational and strategic synergies with our existing asset management and distribution capabilities. Critically, it well exceeds our cost of capital, and in 2017 meets our group return on equity target.

Before I finish, let me say that we are very conscious of the current volatility in the markets, but we are comfortable that even in these conditions we're making the right decision and building long-term value creation for the group. We have considered very seriously all options for the cash received from the IPO and the sale of our non-core European businesses, including share buybacks and paying down additional debt, and firmly believe that this is the best use of the cash. By reinvesting the proceeds in this growth opportunity, we are building this business for the long-term. We are clear that deploying the cash from assets that have been generating an ROI in single digits to a business that will deliver an ROI of over 12% is the best way for us to deliver long-term sustainable value to our shareholders. We are confident that we can achieve significant synergies, and we have an integration plan which will be part of the management team's remuneration structure. Paul Hanratty and Paul Feeney will oversee this process and, as I mentioned earlier, are with me in the room and will be available to answer questions.

We will be speaking again in a few weeks' time when we report our third quarter sales figures, but any current trading questions on the rest of the group will have to wait until then. With that, I will hand back to the operator who will open up the line for any of your questions. Thank you.

Blair Stewart: Thanks everyone, it's Blair Stewart here. A couple of questions. Firstly, Quilter's ownership by an insurance company, what is the view within Quilter of that? Is there a potential concern over conflicts of interests, etc., from their perspective? And secondly on that point, you talked about extending the Intrinsic financial advisory service to some of the Quilter customers. Would that potentially conflict with the IFA relationships that they have with other IFAs already providing those services, and therefore not be best pleased with you trying to cross-sell into it? That's the first question just around conflicts of interest.

And the second question, if I may, just on the – I think you've talked about there being a capital review in progress with Ingrid coming on board. What's the timeframe for that, please, Julian, and the scope? And you've given some detail on the hard interest cover has actually gone up to five times, I'm just wondering to what extent that plays into all that.

Julian Roberts: Yes, let me take that one first, and then I'll hand over to Paul Feeney. The review that we've been doing on capital, as you know there's a very important ingredient on capital which is Solvency II, and also SAM in South Africa. We believe that we will have clarity on that by the time of our prelims at the beginning of March. So the capital review will be over, and we'll be updating on our capital position then.

Let me answer the first one on Quilter. Part of the process that we've been going through is quite clearly talking to management as we've gone through the due diligence process, and meeting many of the investment managers there. It is very clear that there's been a degree of uncertainty in this business owned by a private equity house, and therefore now their future has been sorted out, and the feedback that we've got is that they are delighted to be part of the Old Mutual Wealth business, they fully understand and see the synergies and the benefits of being part of that business, and they have the stability moving forward that they haven't had for a period of years, and therefore they can focus totally on their customers. You mentioned the advisory services point.

Paul Feeney: Sure. First of all, hi Blair, it's Paul Feeney. I fully endorse what Julian's just said and if you spoke to Martin Baines who is the Chief Executive of Quilter Cheviot, he would also endorse that, that our joint vision is to be the UK's leading vertically integrated wealth management business. And we've shared that view for some time.

In terms of Intrinsic, I think it's important to understand that of about £16 billion under management in Quilter Cheviot, around £9 billion is unadvised, so it has come directly over the years. So a financial advisor has not introduced that business, and does not have the financial advisor attached. It's that book particularly that we will clearly align with Intrinsic's top end financial planners. So we don't see any conflict there at all, and at the same time we certainly wouldn't do so for IFA introduced business. And it's also the opportunity to not only provide advice from Intrinsic to Quilter Cheviot, but also for Intrinsic to introduce clients to Quilter Cheviot for the discretionary investment management service.

Blair Stewart: Okay, just to follow up on that if I can, Paul? Do you think the – you talked about a lot of the business, a lot of the flow of business, coming in from IFAs now for Quilter. Do you think those IFAs would be more reluctant to place business with Quilter, given that it's now part of a group that has – that owns an IFA?

Paul Feeney: Not in the least. I mean, we had this argument when we purchased Intrinsic. All the IFAs will abandon you, and – not one [did]. The issue is to continue to provide a top class service to the open financial advisory market, and any business introduced for financial advisor in the open market to Quilter Cheviot will be sacrosanct. And, you know, the first time that anybody then tries to re-broke that business will be the last time that they try that. So no it is not the case at all. It hasn't proven to be the case with Intrinsic, we don't believe for a second it will prove to be the case here, and I think the days where everybody had to exist in their own little silos in this market are gone.

Blair Stewart: Okay, thank you.

William Elderkin: First of all, can you just talk about the sustainability of the revenue margins within Quilter? You touched on it in your speech, but if you could just give it a little more colour of why those margins remain robust. Second, could you give me a few more concrete examples of how you're going to integrate this business within the broader vertical strategy that you've set out? And finally, can we take it that this completes your UK strategic ambitions from an acquisition angle?

Julian Roberts: Paul, do you want to take this one?

Paul Feeney: Certainly. Well, the margins are good, sustainable margins in Quilter Cheviot, and if you look at those margins over time, they've been incredibly stable. It's also very much a service and relationship-led proposition, and a discretionary investment management proposition. Also, at the same time, when we bring Quilter into the Old Mutual Wealth group, we can also use our own buying power – you know, £90 billion of buying power – to help secure funds in the market at a lower price. And that will go back to customers. So if anything, we'll be adding more value there, which I also think will help to underpin the margins. So we haven't seen any real margin compression, it's a service-led proposition, and I think we'll actually be able to, if anything, add more value to clients on that.

In terms of integration, yes, our strategy is a vertically integrated strategy. I think there's three clear initial areas of, if you like, integrative synergy, and one is the provision of Old Mutual Global Investors' funds to the Quilter Cheviot base, so of the £16 billion in Quilter Cheviot, only about £50 million is privately invested with Old Mutual Global Investors. Don't forget, we've actually built Old Mutual Global Investors over the last two years, through what is now £17-odd billion, probably around £19 billion by the end of the year. That's a great opportunity.

Secondly, basically providing financial planning, retirement planning services into the non-advised part of the Quilter Cheviot base, and also technically selling or distributing the discretionary investment management service of Quilter, not just through the Intrinsic network but also through our international network. As we said here today, we don't actually have any discretionary investment management proposition across Old Mutual Wealth's whole international network, and that's a huge opportunity. And I think just in terms of structure, Martin will join my executive committee and report to me, so there's opportunities all around alignment, so aligning our financial planning with our investment management, with our asset management, all delivered across one high quality, efficient IT investment platform.

Julian Roberts: And you asked does this complete it. Yes, there'll be no more material acquisitions in this business. We've got all the bits we need. Clearly, we may add and will continue to grow the advisors in Intrinsic, and we will continue to add more strategies I'm sure over time in asset management, but no, we've now got the foundation and the businesses that we want.

William Elderkin: Okay, thank you.

Greig Patterson: Morning, gentlemen.

Julian Roberts: Hi Greig.

Greig Patterson: Just three questions. One is, excuse me for bringing it up, but Capel-Cure Myers and Albert E Sharpe, bought over a decade ago, was a similar strategy, and eventually, I think it was actually a similar cost, £700 to £800 million pounds, and eventually Old Mutual had to exit that, because it wasn't successful. I was just wondering, how can you compare and contrast this with the previous situation? And what sort of lessons have been learnt when dealing with them? The other one, there's two sort of other ones, I was wondering if you'd just remind us at the half year, there's no forecast, what the useable tax losses were within the group? And second of all, I was wondering, at the half year, what's the run rate in your opinion after the adjustment for the rand in terms of dividend versus true underlying capital generation, when you've stripped out all the one offs, is it one and a half, is it one, is it 1.3? What sort of number do you have in your mind?

Julian Roberts: Thanks, Greig. I'm going to ask Paul Hanratty to comment on the first question you asked.

Paul Hanratty: Hi Greig. I think two things I would say about the contrast between Quilter Cheviot and some of the earlier acquisitions which eventually got bundled up into one business called Gerrard. I think the first thing is that this industry, this discretionary investment or discretionary fund management industry has changed a great deal in the UK over the last 10 or 15 years. It's become a much more professional industry than it was back then, and I think its role in providing advice to clients has been fundamentally changed by the retail distribution review. So, yes, that factor alone I think makes the market context very different to the period back then.

And then I think, the problem that we had with some of those businesses that you referred to, and there were quite a number of them, they were small businesses, they were bought, and there was a huge period of trying to integrate them. Here we're buying one business, which does not need lots of integration. It is the standout business in this sector if you look at its financial performance and efficiency. I think if you go to the charts there, we show there the productivity of the investment managers is extremely high. The clients are very happy with that. The operational performance of the business has been really, really strong. So it's a quality business, a quality business which doesn't need to be integrated, and very importantly as Paul Feeney mentioned, a management team who believe that the future direction of the market is different, and they do believe that an integrated offering for the high net worth client is essential. So they don't have an ambition to remain independent in this value chain.

Ingrid Johnson: And just to – it's Ingrid Johnson. Just to answer the second question about the usage of tax losses: firstly, we don't recognise this as a deferred tax asset in our balance sheet. However what this acquisition does do, it generates profits in Old Mutual Wealth, and as a consequence of that it would result in us being able to actually use the tax loss provided it exceeds the debt and centre costs that we would be incurring.

Greig Patterson: So is it – hello, can you hear me?

Julian Roberts: Yes.

Greig Patterson: Is it that it's really, it's not losses; it's current unutilised expenses that you're knocking off against those head office expenses?

Ingrid Johnson: And historic asset losses.

Greig Patterson: What would be the number for historic asset losses?

Ingrid Johnson: We've [not] given a number – we've not publically disclosed but we are now £250 million.

Greig Patterson: At 250, all right, sure. And then I was just wondering, after the rand depreciated, what do you think your capital generation is? And also, I mean, if I'm not mistaken you've earmarked a third of the South African capital generation for the rest of Africa exposure, I wonder if you could bring that into the discussion as well? The reason I'm asking is just in terms of the central cash buffer and the rest of the dividend and stuff, that's what interests me.

Ingrid Johnson: If we look at our overall cash, we've looked very carefully at what we need for the different businesses, as well as the capital availability from an FGD perspective, and what's very interesting is, when you look at the growth proceeds that emanate out of the US and continental Europe, it is sufficient to fund this particular transaction. Clearly we would also in time understand the green shoe outcome, which we can't speak about now, and in South Africa, in terms of the rest of Africa strategy, we certainly have sufficient in terms of capital and liquidity to be able to fund those acquisitions. So the careful orchestration of the resources across the group ensures that we can grow in all of our chosen markets.

Julian Roberts: Greig, part of your question you're going to have to wait until February when Ingrid's finished the capital review pulling everything together, because that – that really sets out in detail where we are and what the surpluses are and where the dividend ability is coming from.

Greig Patterson: Perfect, all right, thanks very much.

Brian Mushonga: Morning guys. Just a quick question from an earnings point of view. You've given EBITDA numbers; do you actually have a bottom line number for Quilter Cheviot that we could maybe use as a multiple? Could you also talk about branding? Are you going to keep the Quilter Cheviot branding or are you going to change that to Old Mutual Wealth?

Julian Roberts: Okay, let me just pick up those two questions. That's really why we are mentioning the tax situation. Because of the tax position we've got, effectively, EBITDA and the post-tax number are the same. When you come to branding, you know, this is a quality brand that's known in its own right in the market, you know, it's taken us just eight years to change the Skandia brand to Old Mutual, so there are no plans to do anything with the branding currently.

Brian Mushonga: And just a follow-up question, I suppose. You mentioned, sort of, you hinted at an uncertain outlook within the business given its previous ownership. What's your sense of your ability to retain all the investment managers within Quilter?

Julian Roberts: That's been, as you would expect, a key part of the work we're doing. The investment managers are, and again this actually quite surprised us. They're really quite young, they're not people who are about to retire and go into their retirement. So we are pretty confident that we have structured with a significant, the majority of the incentive to management deferred that there is a good carrot for them to continue, and quite clearly, you know, they are signed up to continue with us.

Paul Hanratty: Julian, I wonder if it's worth adding, Brian, that of the management shareholding, actually they were all 60%, and it's contingent on business performance going forward, so that's Julian's point. But secondly, the employment contracts that all these people have are extremely onerous on leaving and actually, historically, even through four changes of ownership, they haven't actually lost more than I think one person in all those years. They're highly paid, we know they're at the top end of this industry in terms of pay, so they've got some incentive to stay as well as some shackles, and we've added very onerous restrictive covenants on the top people as part of the terms of the deal. So in addition to the normal service contracts, they now have non-compete and non-solicitation on leaving, which are very extensive and effectively would rule them out of employment if they leave.

Julian Roberts: I'm not sure, for those on the call from South Africa, whether the law is the same, but in the UK when people receive consideration, the restrictive covenants are far tougher and really bite, and so therefore we've taken the opportunity to do so.

Brian Mushonga: Okay, thank you.

Julian Roberts: So thank you very much for joining us on the call. As you see with the group, we've made some significant strides over recent weeks, Nedbank's purchase of a 20% stake in ETI, the IPO of US Asset Management, and the purchase of Quilter Cheviot. You know, our strategy is quite clear: we are growing an African-based financial services group, and that strategy is clear, and we want to build the UK's leading vertically integrated wealth management business. The addition of Quilter Cheviot really helps us in the UK achieve that aim, and, most importantly, with a 12% ROI, it adds value for shareholders, it exceeds our return on equity target. Management are on side, and they have a quality management team that we're delighted to add this business to the group. Thanks very much.