Johan Burger

ceo's report

INTRODUCTION

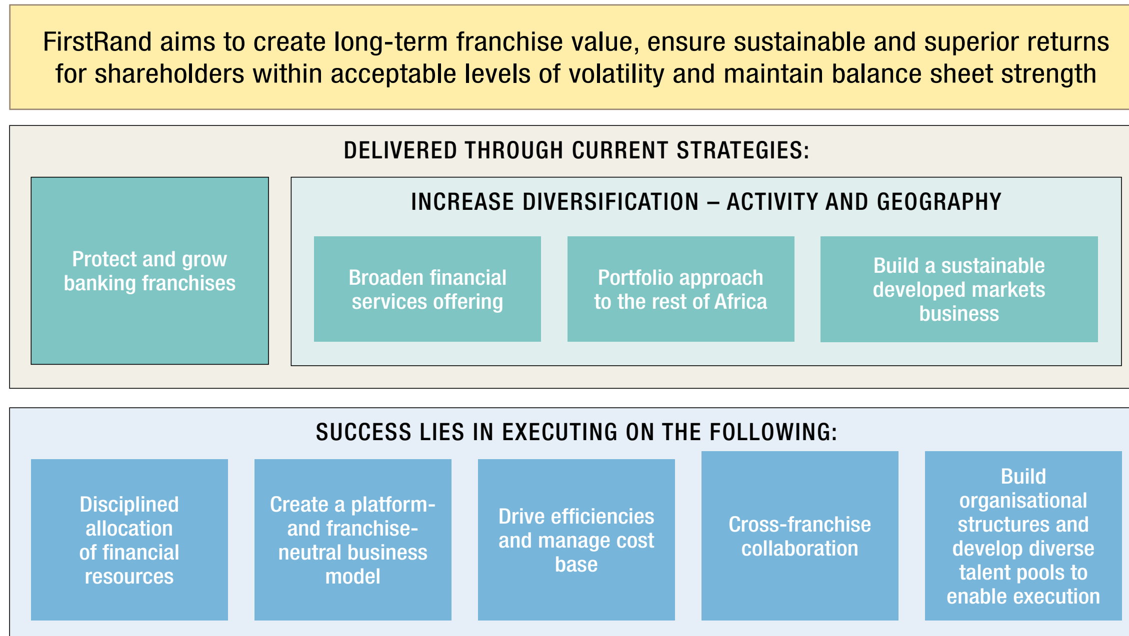
The group continues to operate in an extremely uncertain and challenging operating environment. Most macro issues remain material and have, in fact, heightened over the past twelve months. These include:

- further downward pressure on revenues given low GDP growth in South Africa;
- political and policy uncertainty which could lead to a local currency rating downgrade;
- increasing cost and scarcity of financial resources;
- ongoing introduction of new regulations and legislation (particularly in banking activities), which will impact profitability over the medium to long term;
- intensifying competition in banking profit pools from non-traditional disruptors (specifically those with low cost infrastructures) and insurance players; and
- rising regulatory and macro risks in the rest of Africa.

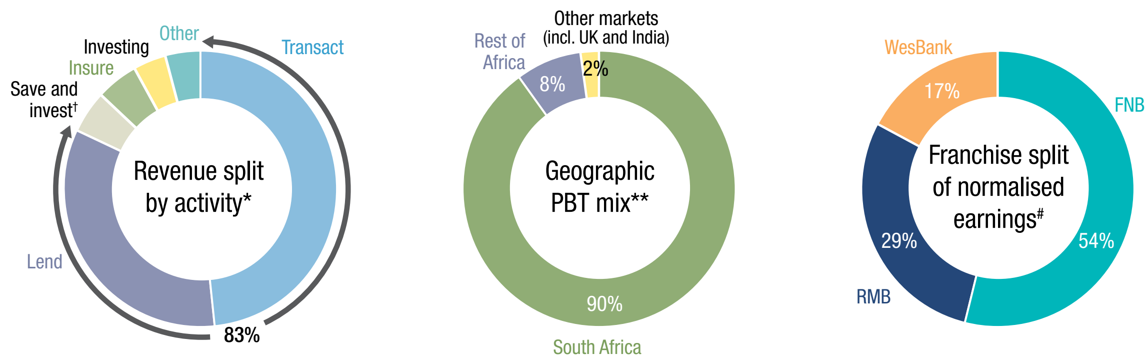
As stated in last year's CEO's report, the group fundamentally believes these pressures are structural rather than cyclical in nature and will prevail for some time. In order to continue to deliver on commitments to stakeholders, the group believes it must diversify its portfolio to deliver both growth and returns going forward.

STRATEGIC FRAMEWORK

Last year's CEO's report explained the process management went through to identify new growth and diversification opportunities. Over the past 12 months, the focus has been on execution. The framework for that execution is depicted in the schematic below.



The chart below provides a point-in-time analysis of the group's portfolio and it is clear that the lending and transactional (banking) activities remain the largest contributors to revenue at 83%. The group also remains heavily concentrated in South Africa, with the domestic business accounting for 90% of pre-tax profits.



* Based on gross revenue excluding consolidation adjustments.

** Based on PBT (including GTSY), excluding FCC, FirstRand company, consolidation adjustments and NCNR preference dividend.

\# Excludes FCC (including GTSY), FirstRand company, consolidation adjustments and NCNR preference dividend.

† Includes deposit taking and investment management.

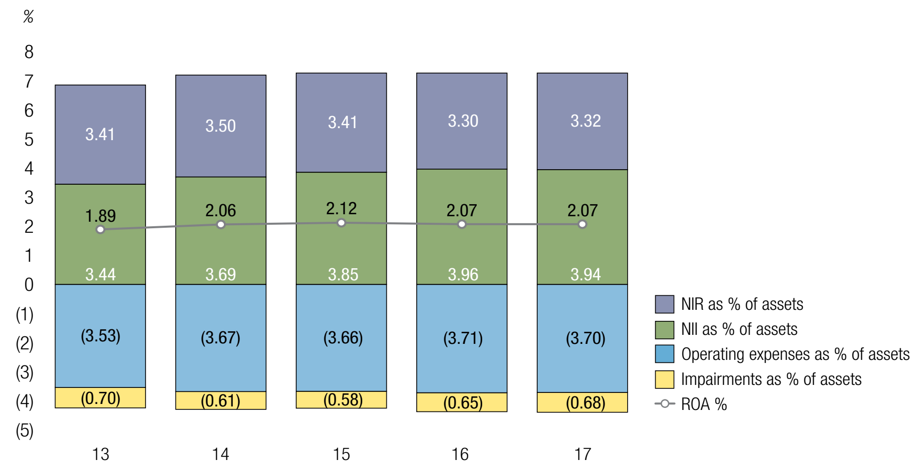
UNPACKING EXECUTION ON STRATEGIES TO PROTECT AND GROW BANKING FRANCHISES

The lending and transactional franchises have delivered sustained growth since 2010 resulting from the acquisition of a deep and loyal customer base. The group's results for the year to June 2017 demonstrate that FirstRand has continued to grow and protect these franchises. The high quality topline growth generated from these activities was achieved on the back of the following deliverables:

- Acquisition of core transactional customers across retail, commercial and corporate segments and the resultant increase in transactional volumes and deposit growth.
- Ongoing momentum in cross-sell.
- Segment focus delivered appropriate advances growth given the cycle and pricing anchored to protecting returns.
- Leveraged market-leading advisory and structuring franchises (RMB).
- Maintained balance sheet prudency.
- Focus on efficiencies resulted in positive jaws.

The quality of the topline growth and sources of revenue is also demonstrated in the following chart, which unpacks the group's ROA which has been above 2% since 2014.

ROA decomposition



The group's ROA is structurally higher than the South African sector as result of its portfolio mix and certain strategic choices, such as:

- The relative size of the group's transactional franchise (49% of gross revenue and 78% of NIR).
- The group's relative advances mix delivers higher risk-adjusted margins:
  - VAF (37% of retail advances, average margin 4.34%).
  - Unsecured (16% of retail advances, average margin 12.31%).
  - Lower relative market share of lower-margin, lower-risk lending business (i.e. mortgages 47% of retail advances with average margin of 1.67%).
  - Discipline in generating appropriate returns in corporate lending.
- Credit underwriting and pricing anchored to preserve the return profile.
- Disciplined allocation and pricing of capital, funding and liquidity, and risk capacity.
- Market-leading private equity franchise has remained consistent generator of high returns.
- Incremental benefit of insurance, and save and invest franchises.
- Lowest cost-to-income ratio in the peer group.

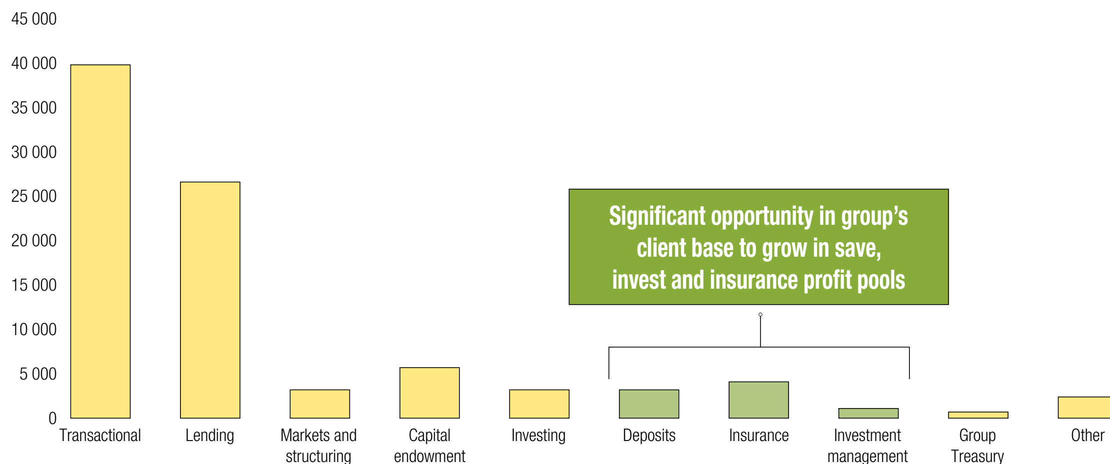
UNPACKING EXECUTION AND PERFORMANCE OF DIVERSIFICATION STRATEGIES

Broadening financial services offerings

The group believes that through the utilisation of the origination capabilities and distribution networks of the banking franchises, it can diversify through capturing a larger share of profits from savings, insurance and investment products within its existing customer base. As depicted in the chart below, broader financial services activities remain small contributors to overall group revenue, however, FirstRand has all the capabilities to grow them faster than the transactional and lending activities.

*Gross revenue**

R million



* *Excludes consolidation adjustments.*

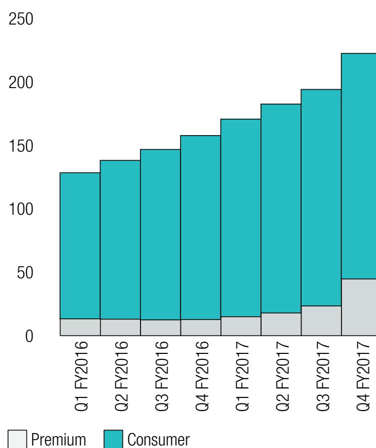
The annual flows from FNB's customer base to other providers of these products are very significant, so it's clear the group's customers want these products. Therefore, the group intends to use its model to participate in the full value chain presented by the manufacture and sale of its own best-of-breed financial services products and services. Full ownership of this value chain will allow the group to build differentiated value propositions for customers. Capturing a larger share of the profit pools available will, over time, generate new and potentially significant revenue streams for the group.

To date, progress looks promising and FirstRand is incrementally increasing its share of the insurance profit pools that exist within its own customer base. For example, the following charts show that FNB has achieved good traction in the penetration of insurance products to existing customers utilising all its channels, although branches still contribute the bulk of sales. The embedded value of the insurance business in FNB is now R3.5 billion.

Penetration

In-force annualised premium on standalone life products

R million



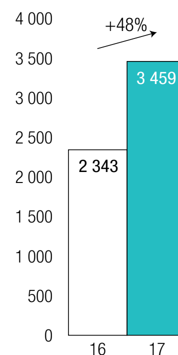
Sales channels

Channel	% of sales
Branch	75
Call centres	13
Digital	8
Other	4

Value creation

Embedded value – life products

R million

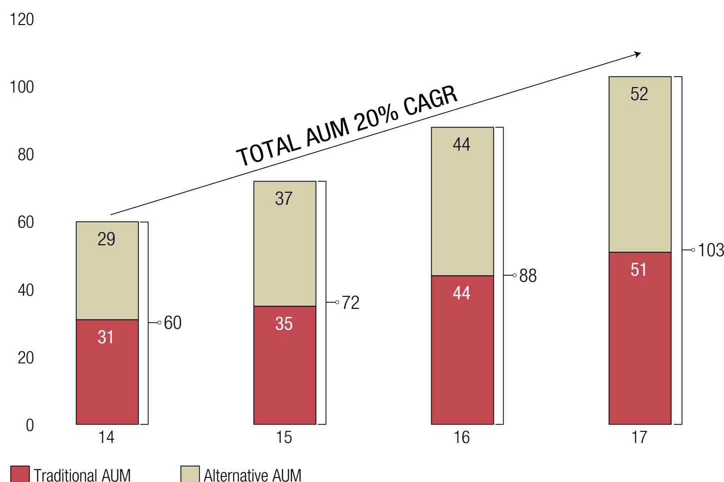


In terms of the save and invest profit pools the group has an organic strategy to grow its asset management, and wealth and investment management (WIM) activities.

Ashburton Investments represents the pure asset management activities of the group and the following chart shows that it has achieved 20% compound annual growth in assets under management to R103 billion since 2014 which is a good outcome considering that market returns were less than 1% over the same period. The growth in AUM reflects new flows on the back of good take-up in the fixed income and multi-asset credit funds and a solid investment performance.

*Assets under management**

R billion



* *AUM excludes conduits, and is shown for pure asset management business.*

With regard to the WIM strategy, this was reviewed during the year and the decision was taken to restructure the WIM business to be fully integrated into FNB's customer ecosystem of products, channels and rewards. The group believes this step will significantly increase the penetration of investment products into the existing client base to grow the save and invest revenue streams.

GROWING THE OPERATIONS IN THE REST OF AFRICA

The group's rest of Africa portfolio currently represents 8% of pre-tax profits.

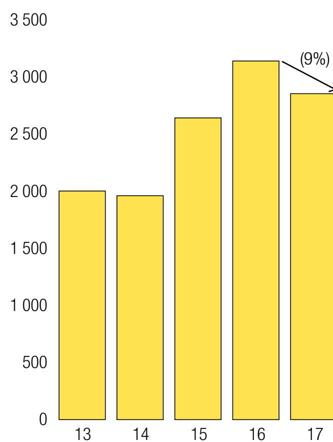
The group remains committed to the long-term opportunity in the rest of Africa and follows a fundamentally organic approach, which means the strategy has a long-term payoff profile.

It continues to focus on scaling and better leveraging its existing portfolio of businesses with a stronger focus on corporate, commercial and investment banking (CCIB) activities. In the markets where the group has mature businesses, it is looking to broaden its financial services offering, organically or through bolt-on acquisitions. For example, in the year under review, Namibia acquired Pointbreak, a local asset management franchise.

The following chart shows the performance of the group's rest of Africa portfolio.

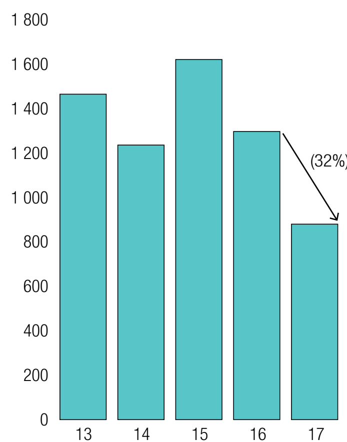
*Group rest of Africa PBT**

R million



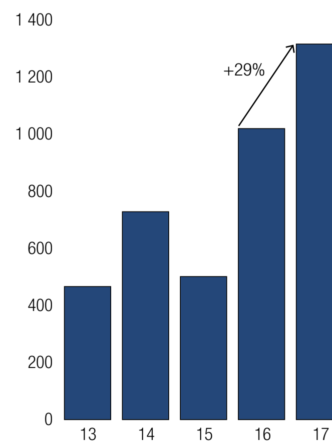
*FNB rest of Africa PBT**

R million



*RMB rest of Africa PBT**

R million



Overall subsidiaries ROE 12.0%, mature subsidiaries ROE** 21.7%**

* *Strategy view – includes in-country and cross-border activities. Includes GTSY, but excludes FCC, FirstRand company, consolidation adjustments and NCNR preference dividend. GTSY profits were included in FNB numbers for years prior to 2015. FNB includes India.*

** *ROE based on legal entity (in-country) view.*

Note: RMB and consequently group comparatives have been restated for refinement in cross-border cost allocation methodology.

Pre-tax profits from FNB's businesses (retail and commercial) were down 32% reflecting macros, regulatory pressures and continued investment drag. The performance of the mature businesses, namely Namibia, Botswana and Swaziland, reflects good operational performances from Namibia and Botswana. These were, however, impacted by the investment/costs incurred in building regulatory capacity in Namibia and the legislated removal of cash deposit fees in Swaziland. The emerging and start-up businesses' results reflect investment drag on the back of the group's organic strategy and higher bad debts due to tough macros, particularly in Mozambique.

RMB's rest of Africa business now represents 13% of its pre-tax profits and is increasingly key to RMB's growth strategy. Rest of Africa profits increased 29% year-on-year, driven by:

- investment banking and advisory activities (+8%) benefited from balance sheet growth and conservative credit provisioning in prior periods;
- corporate and transactional banking growth (+26%) reflects increased demand for working capital and trade finance, and good deposit growth; and
- markets and structuring results were supported by market volatility and strong growth in structuring fees.

BUILDING A SUSTAINABLE BUSINESS IN THE UK

The group is focusing on leveraging its current operations in the UK to generate new revenue streams and create the building blocks for a more sustainable developed markets business. This will provide greater diversification to the group's earnings profile on a potentially better risk-return basis and should extend the group's track record of shareholder value creation. By way of example, meaningful growth opportunities could be unlocked from further scaling the MotoNovo platform through product and segment diversification and longer term through leveraging FNB's capabilities in certain segments of the market.

The group, however, needs to create a long-term sustainable funding model for its UK businesses through access to a hard-currency deposit franchise. The group also requires access to hard-currency funding to meet cross-border client needs.

FirstRand is in the process of assessing the most appropriate way of addressing this, either through organic build or acquisition of a local deposit franchise.

MANAGEMENT OF FINANCIAL RESOURCES

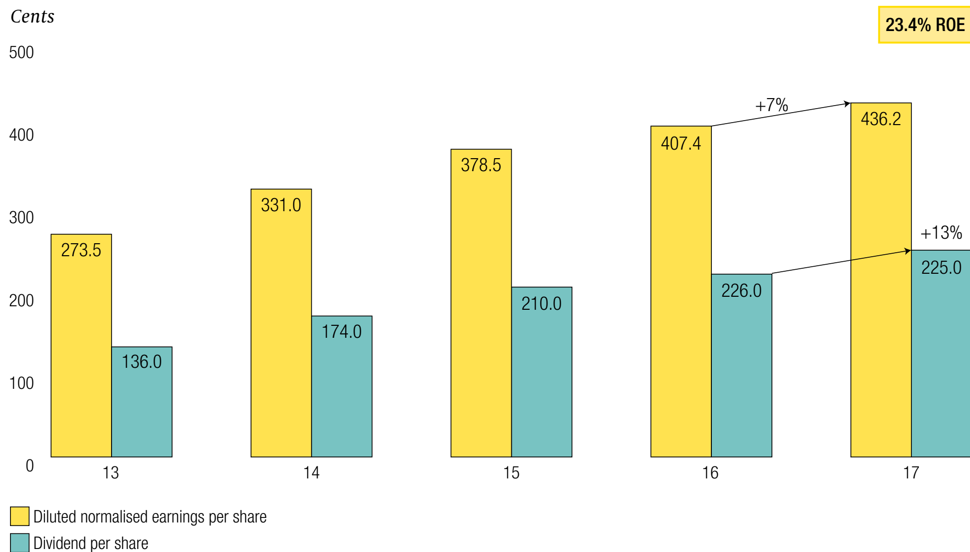
The management of the group's financial resources (FRM), which it defines as capital, funding and liquidity, and risk capacity, is critical to successful execution of the group's objectives and supportive to the achievement of FirstRand's stated growth and return targets.

FRM is executed through Group Treasury and is independent of the operating franchises. This ensures the required level of discipline is applied in the allocation of financial resources and pricing of these resources. This also ensures that Group Treasury's mandate is aligned with the operating franchises' growth, return and volatility targets, to deliver shareholder value.

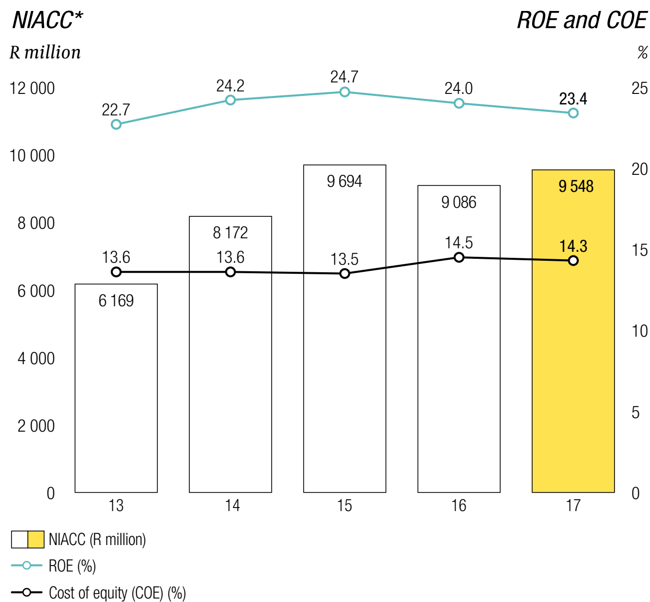
The group continues to monitor and proactively manage a fast-changing regulatory environment and ongoing macroeconomic challenges. Prior to the downgrade of the South African sovereign to sub-investment grade on a foreign currency basis, through the establishment of FirstRand Securities Limited, the group became a member of the interest rate derivatives clearing service, SwapClear, one of the clearing platforms provided by multi-national clearing house LCH. This was an important step to protect and enhance FirstRand's counterparty status in international funding markets. Participation in clearing interest rate derivatives through SwapClear will mitigate risk and reduce trading costs for both the group and its clients and provides the group with enhanced international access to financial market infrastructure as well as to greater liquidity pools.

FINANCIAL PERFORMANCE

The group continued its track record of delivering real growth in earnings and a superior return profile.



As illustrated in the following chart, the sustained high return profile resulted in continued growth in NIACC to R9.6 billion (2016: R9.1 billion), which the group believes is the true measure of shareholder value creation.



* *Net income after cost of capital.*

The CFO's report on pages 30 to 50 provides a detailed overview of the group's financial performance.

Capital and dividend

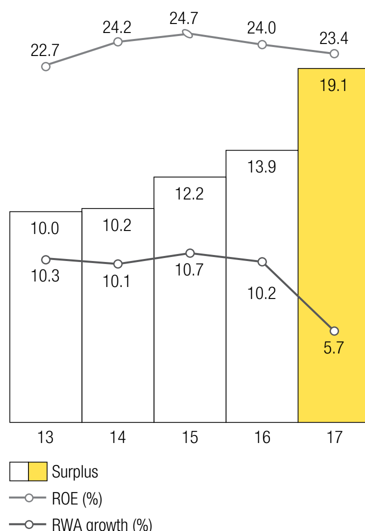
After a long period of sustained earnings growth outperformance relative to the macros and the peer group, FirstRand has entered a period of relatively lower growth due to:

- a deterioration in the nominal GDP growth outlook;
- deliberate decisions not to chase earnings growth at the expense of ROE to protect the return profile; and
- the heavy investment cycle in future growth initiatives (to ensure outperformance over the longer term).

FirstRand's capital position post the rating downgrade during the year under review remains prudent and the group continues to generate surpluses which are adding to its excess capital position. The strong capital generation reflects the group's high return on capital and this combined with the lower demand for RWA and the group's discipline in allocation, are shown in the chart below.

Surplus

R billion



Post the global financial crisis the group's dividend strategy has been anchored to a sustainable payout ratio which has, over the past decade, grown in line with earnings. FirstRand continues to balance that sustainability with ensuring sufficient firepower to execute on strategy and at the same time cater for Basel 3 and anticipated accounting changes (IFRS9).

However, given the group's sustained high return profile and solid operational performance, combined with its strong capital position, the board took the decision to grow the dividend above normalised earnings. The board decided not to adjust the group's stated long-run cover range which remains 1.8x to 2.2x, however, it believes that the current higher payout ratio is sustainable over the short to medium term.

APPROPRIATE BALANCE BETWEEN RISK, RETURN AND GROWTH

To conclude, when assessing FirstRand's performance, it is important to analyse multi-dimensionally. When considering the year to June 2017, despite five years of outperformance, the group continued to show real growth in earnings off a very high base and, given all the economic and regulatory headwinds, 7% growth in earnings per share and a 23.4% ROE was a very good outcome. This performance was also achieved whilst the group is investing heavily in future growth strategies that it believes will ensure outperformance over the longer term.

All of this demonstrates the quality of the group's portfolio of businesses, combined with its ability to allocate financial resources to maximise shareholder returns.

The group has consistently stated that it will not chase earnings growth at the expense of ROE and these results strike an appropriate balance between growth, prudent risk management and investment for the future, whilst ensuring sustainable, premium returns.

JOHAN BURGER
CEO: FirstRand