FirstRand

ceo's
report

for the year ended 30 June 2023

ALAN PULLINGER *Chief executive officer*

FirstRand's normalised earnings for the year ended 30 June 2023 **increased 12% to R36.7 billion.** These strong results are a direct outcome of key decisions taken at the beginning of the current macroeconomic cycle. The credit performance stands out, with the credit loss ratio below the group's through-the-cycle (TTC) range. This is testament to the post-pandemic origination approach, and particularly pleasing given the higher-than-expected interest rate and inflationary cycles experienced across all jurisdictions.

The quality of the group's operating businesses, FNB, RMB, WesBank and Aldermore, is captured in their resilient operational performances, underpinned by healthy topline growth from solid new loan origination and impressive deposit gathering. Executing on the strategy to deliver more to customers has remained a cornerstone of the group's success.

Discipline in the deployment of financial resources supported the group's normalised return on equity (ROE) of 21.2% (2022: 20.6%), which remained at the upper end of its stated range. The group produced R12 billion of economic profit (2022: R10.1 billion), or net income after cost of capital (NIACC), which is its key performance measure.

Despite the record dividend payout for the year ended 30 June 2022, net asset value (NAV) grew 10% year-on-year. A significant portion (51% or R8 billion) of NAV accretion resulted from currency movements in the capital deployed in the UK operations.

Given the high return profile, the group remained capital generative, with the Common Equity Tier 1 (CET1) ratio at 13.2% (2022: 13.9%) notwithstanding the impact of the special dividend declared in the prior year. Taking into account this strong capital level, the board was comfortable to keep the dividend cover unchanged at 1.7 times. This translated into an annual ordinary dividend of 384 cents per share, up 12% year-on-year.

A detailed explanation of the group's financial performance is provided in the *CFO's report* which can be found at https://www.firstrand.co.za/investors/integrated-reporting-hub/directors-reports/. Comprehensive financial and operating reviews of the underlying businesses are included in the group's *Analysis of financial results for the year ended 30 June 2023*, available at https://www.firstrand.co.za/investors/integrated-reporting-hub/financial-reporting/.

This report provides an overview of the group's strategic framework and unpacks the financial performance against the specific strategies that the group has been executing.

Strategic framework

FirstRand Limited is a portfolio of integrated financial services businesses operating in South Africa, certain markets in sub-Saharan Africa and the UK. Many of these businesses are leaders in their respective segments and markets, and offer a broad range of transactional, lending, investment and insurance products and services.

Captured in the group's strategic framework in the following schematic, FirstRand's consistent execution on its focused regional strategies, enabling digital platforms, disciplined financial resource management (FRM) and people philosophy continue to underpin its distinctive investment proposition, and long track record of delivering growth and superior returns.

FirstRand commits to building a future of **SHARED PROSPERITY** through enriching the lives of its customers, employees and the societies it serves. This is the foundation to a sustainable future and will preserve the group's enduring promise to create long-term value and superior returns for its shareholders.

Diversified portfolio with unique strategies:

SOUTH AFRICA	BROADER AFRICA	UK
Platform-enabled integrated financial services providing ecosystems that create long-term value for clients and shareholders	Build competitive advantage and scale to deliver economic profit and dividends	Modernise, digitise and scale to a more valuable UK business that delivers economic profit and dividends

Enabled by digital platforms

Disciplined management of financial resources (capital, funding, liquidity and risk capacity) to deliver on financial commitments

Committed, accountable and empowered people key to delivering continued outperformance

Purpose

FirstRand's purpose statement, to build a future of shared prosperity, reflects a deep commitment to deliver both financial value and positive social outcomes for multiple stakeholders. This is increasingly achievable as the group intentionally uses core business activities, including its role in allocating capital to the economy, to add value to society – profitably and at scale.

There are already multiple examples of the operating businesses intentionally tackling a wide array of societal challenges through innovative product and distribution strategies, whilst remaining relentlessly focused on driving economic growth and superior returns for shareholders. These two ambitions are mutually inclusive and distinctive, and have the potential to create new sources of value. As such, they form the foundation for a sustainable future and the group is working hard to rigorously measure and ultimately report progress on purpose.

Geographic strategies

FirstRand's earnings remain tilted towards South Africa, which represents 80% of total earnings, mainly generated by its large lending, transactional and deposit franchises, which have resulted in deep and loyal customer bases. These domestic banking operations are mature and systemically important. Against the prevailing backdrop of weak macroeconomic growth and given the group's size, any aspiration to outperform requires strategic distinction combined with sound execution. The key growth imperatives in the domestic businesses are to grow customer numbers, do more business with customers, and do this more efficiently. The group is also investing in building capital-light revenues in adjacent activities such as insurance, and investment and asset management.

In the broader Africa portfolio, which represents 11% of earnings, FirstRand remains focused on growing its presence and offerings in certain key markets where it believes it can build competitive advantage and scale over time. The group's expansion strategy has been largely organic, complemented where possible by bolt-on acquisitions. There is a strong focus on building in-country customer and deposit franchises.

Contributing 9% to earnings, the group's UK operations represent long-term growth opportunities decoupled from South Africa and broader Africa, with the UK market offering attractive risk-adjusted returns through the cycle. The diversification is already supporting group NAV accretion.

As a specialist lender, Aldermore's business model targets the credit needs of individuals and entities which are underserved by mainstream providers. These customer pools in the UK market are large and growing. They also represent quality risk that is not catered for by the large incumbent players as it requires a bespoke approach to structuring and underwriting.

The group remains confident the UK business can grow at a higher rate than the domestic franchise given its presence in large profit pools, and given that UK system growth is expected to be stronger than current SA projections for GDP. The UK management team is executing on strategies to grow market share in core product sets where it has strong value propositions, modernise its platforms to achieve scale and efficiencies, and build a more diversified and sustainable funding franchise.

Operating environment in the year under review

The operating environment, both globally and domestically, was characterised by persistently high inflation and rising interest rates.

The resultant slowdown in global economic activity translated into lower commodity prices and a reduction in the terms of trade tailwind enjoyed by commodity producing countries, including South Africa.

This gave rise to pressure for households in South Africa, causing lower demand for retail credit, particularly in the second half as interest rates lifted higher than initially expected. Corporate and commercial lending remained robust as the private sector increased investment in replacement infrastructure and sustainable energy generation. Whilst the pick-up in loadshedding during the winter months was ultimately less intense than expected, the ongoing need to stabilise energy supply and improve energy access remains an important macroeconomic challenge.

Employment data suggests that private sector employment and wage growth began to slow but still provided some support to household income in certain sectors. Conversely employment and wage growth in the public sector remained under pressure after more than a decade of above-inflation increases. The rising interest rates and inflation meant household debt service levels remained high, although still within historical averages.

In the UK, sticky inflation meant that policy rates continued to rise and the outlook for households remained divided between those with sufficient savings to manage the increase in prices and those without. This dynamic necessitated ongoing government fiscal support to households facing financial strain.

In the broader Africa portfolio, the most noteworthy developments were in Ghana and Nigeria. Ghana experienced a sovereign debt crisis and high inflation. In Nigeria, the beginning of an economic and financial market reform process sparked significant currency weakness and added to inflation pressures.

FirstRand's shareholder value creation thesis

Sustainable shareholder value creation in a universal bank boils down to four fundamental themes, which are listed in order of importance below:

- gathering deposits;
- optimising for the risk capital emanating from lending activities;
- generating revenues from activities that require less or no risk capital; and
- to a much smaller degree, being cost efficient.

1	Liabilities	• High-quality revenue • Quality of customer franchise • Trust • Ease of fulfilment, product development
2	Risk-weighted asset (RWA) optimisation	• Discerning origination – credit outcomes through the cycle • Advances mix, return on assets • Diversification (asset class, collateral, geography)
3	Capital-light/ non-bank revenues	• Customer franchise strength • Mix – diversification • Sustainability
4	Costs	• Capture platform investment benefits • Drive efficiencies

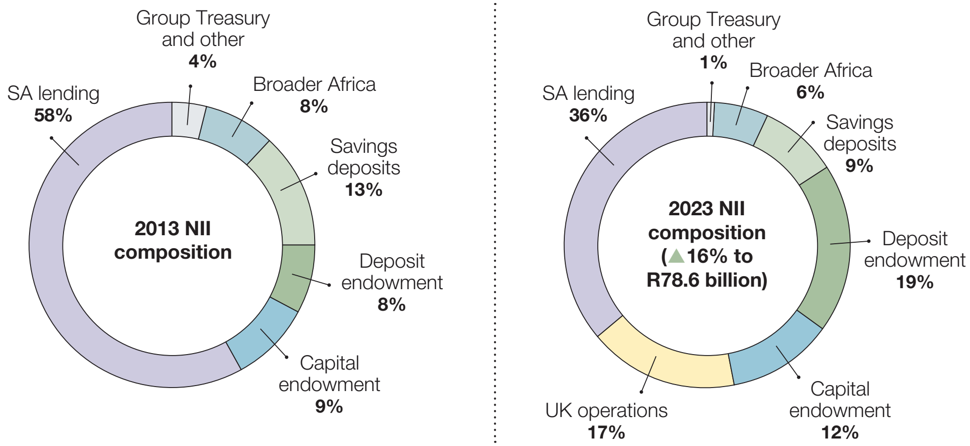
These themes profoundly impact return on assets (ROA), the amount of capital used to generate the ROA, and ultimately shareholder returns. Delivering on these themes is how a more valuable bank is built.

The group's performance is unpacked below under these themes.

Liability gathering

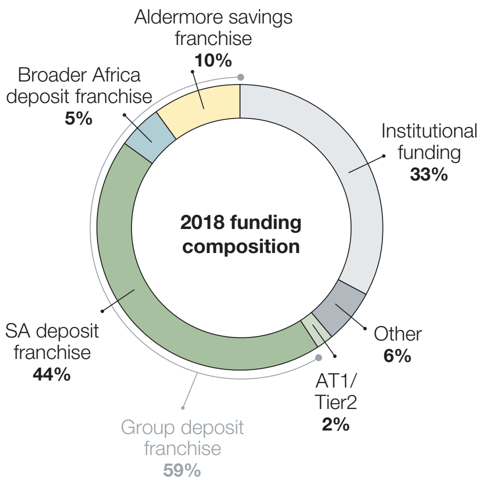
First, and foremost, banks are the custodians of the savings in a country. It's about trust. This is why the technical name for a bank is a deposit-taking institution. There are very few areas in banking where one can truly declare an almost unlimited appetite for growth. Well-sourced and well-priced liabilities generate non-risk interest income. However, deposit gathering is not a short-term game. Apart from rewarding customers competitively, it requires a strong, and growing customer franchise with good propositions that are easy for customers to secure.

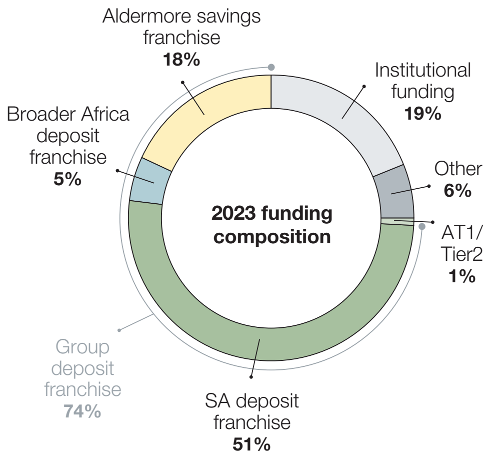
The following chart shows how the group's balance sheet evolution over the past decade has resulted in a shift in the net interest income (NII) composition, resulting in both an improved risk-adjusted margin and greater diversification.



The change in the group's funding mix over the past five years (depicted below) reveals a material increase in the group deposits component, from 59% to 74%, which has been a key underpin to the group's superior return profile. Year-on-year, the deposit franchise grew 14% to R1.44 trillion.

The sustained outperformance from the deposit franchise has enabled a significant decline in the institutional funding component from 33% at 30 June 2018 to 19% at 30 June 2023.





RWA optimisation

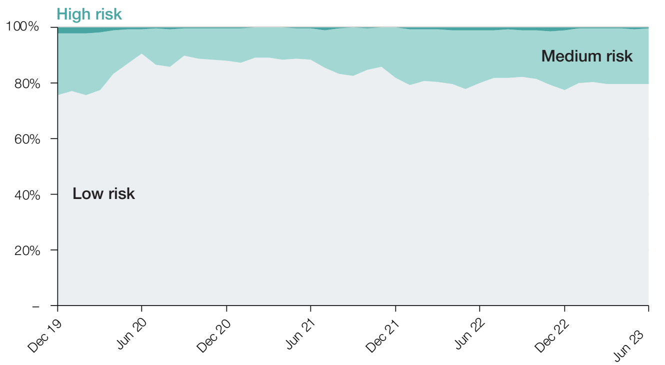
Optimising for the risk associated with lending, investment and markets activities is another imperative. These activities have to be backed by capital and it is credit risk from lending that consumes the bulk of the group's risk capital. Lending judiciously to the right counterparties, in the right asset classes and geographies has a material impact on ROA.

Credit

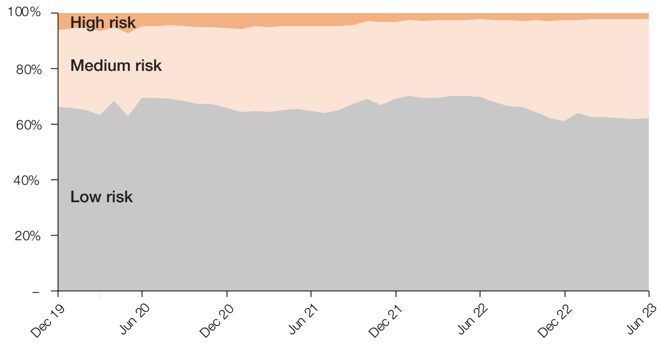
FirstRand continues to employ a judicious and tactical approach to lending, supporting its customer franchises whilst protecting the balance sheet and return profile. This is a necessary balancing act given the operating environment, which is currently characterised by high inflation and interest rates, combined with sluggish system growth and competitive behaviour. The credit performance for the year was in line with expectations and is a direct outcome of the group's origination strategy from mid-2020 to late 2021, as the country emerged from the Covid-19 pandemic. The decision to tilt origination to low- and medium-risk customers has resulted in a credit loss ratio below the group's TTC range, despite a higher interest rate and inflation cycle than initially anticipated. Over the past 18 months, the group has gradually lifted origination back to pre-pandemic appetite, and core lending advances growth of 15% year-on-year reflected continued momentum in new business origination across all large lending portfolios.

As illustrated in the following charts, front-book retail lending in FNB and WesBank continued to reflect the tilt towards low and medium risk customers. This better-rated customer group has more sustainability to withstand the affordability pressure of high interest rates and high inflation. The bottom two risk distribution graphs reveal how the total retail lending books have migrated over the past 3.5 years, a risk shift that is better positioned for the current consumer environment.

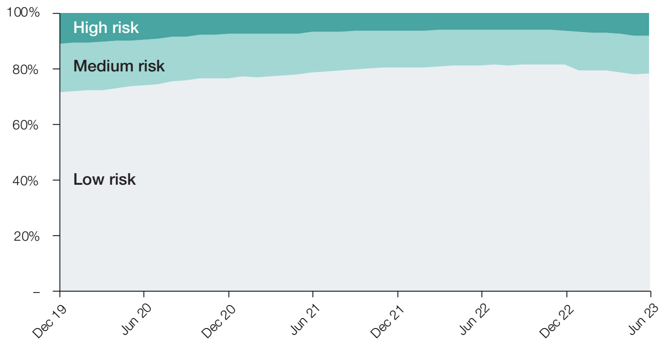
FNB retail new business risk distribution



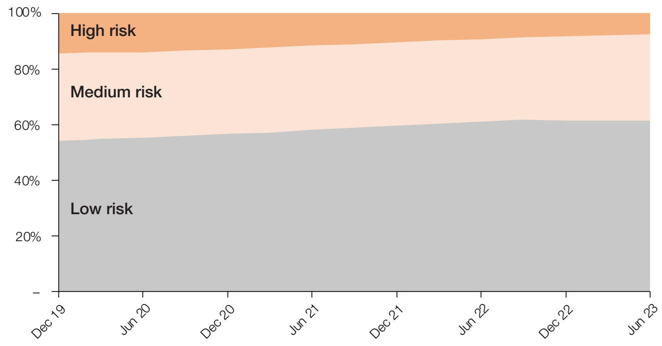
WesBank new business risk distribution



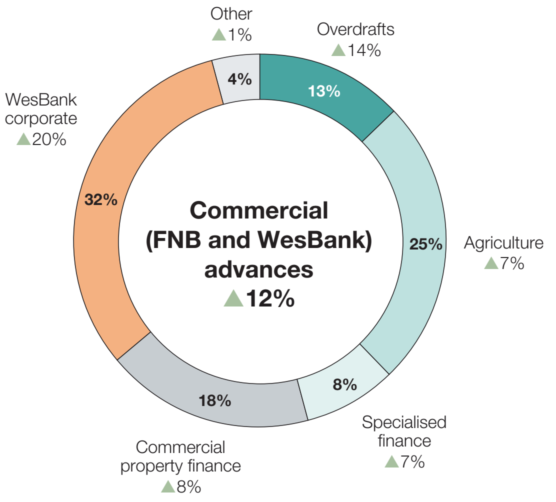
FNB retail total book risk distribution



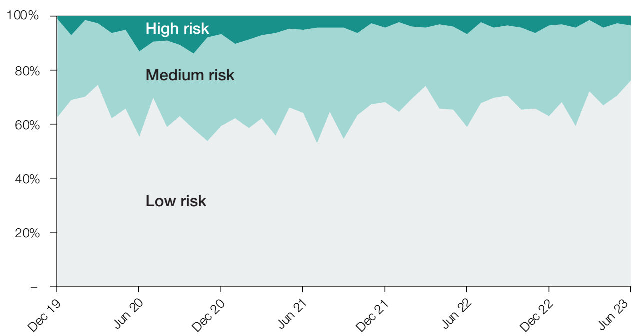
WesBank total book risk distribution



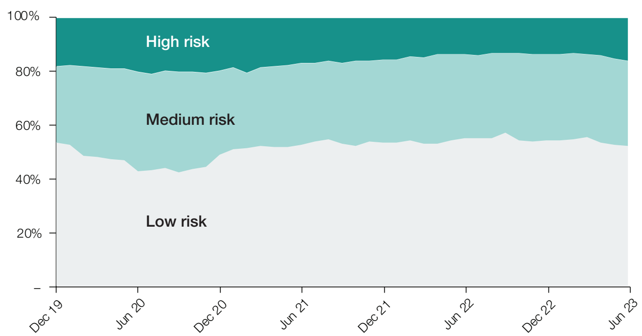
There was strong growth in commercial advances at FNB and WesBank. Advances increased 20% in WesBank's asset-based lending business, evidence of the replacement cycle under way in the business sector. FNB commercial's front book origination and the in-force book also reflect a pleasing risk picture.



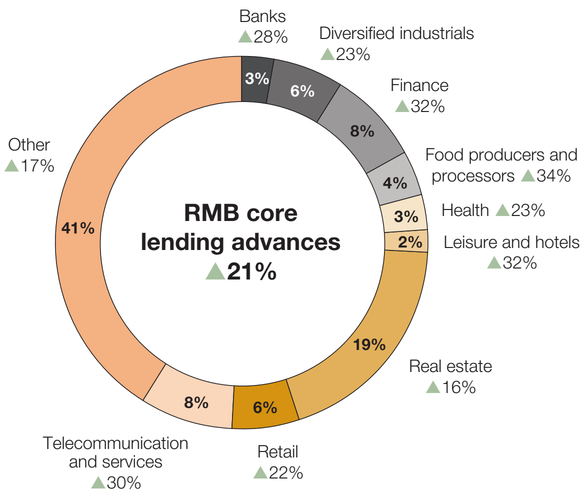
FNB commercial new business risk distribution



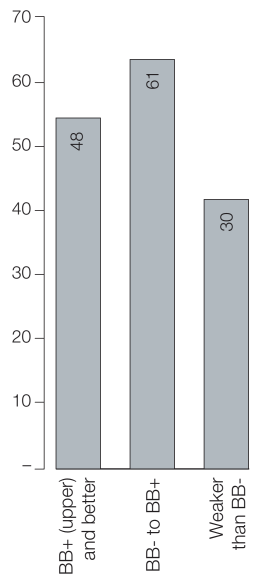
FNB commercial total book risk distribution



RMB's growth slowed from the half year, although it still ended the year up strongly at 21% (with the SA book growing 16% and the broader Africa book growing 39%). Growth was well distributed across sectors. The front book risk distribution again reflects a well-balanced risk picture, as shown below.



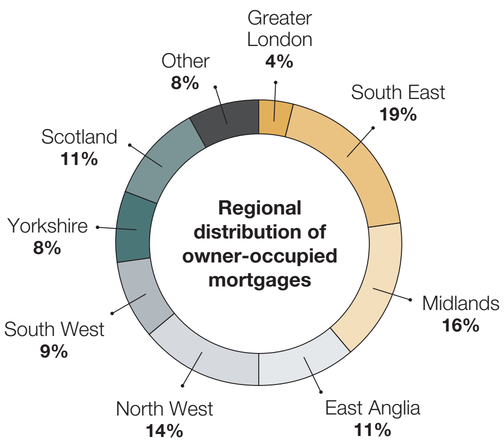
New origination – EAD by rating distribution
(R billion)

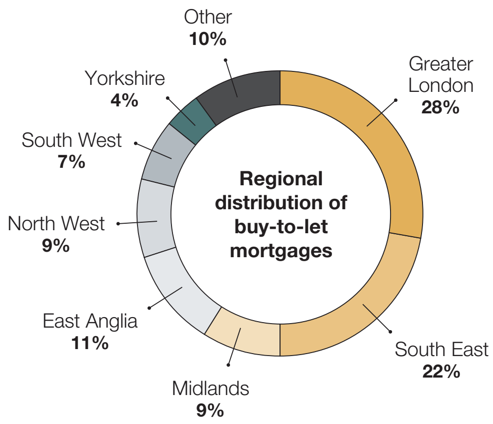


Advances in the UK operations grew 2% in pound terms, driven by buy-to-let mortgages and motor finance. The owner-occupied mortgage book (c. £2 billion) contracted slightly over the year given the material rise in borrowing costs in addition to the cost-of-living squeeze on consumers. The average loan-to-value (LTV) of the uninsured owner-occupied book was 53% with almost all balances with LTVs above 85% being insured. The buy-to-let portfolio grew 7% to c. £5 billion. This business lends to mainly professional landlords, often on a portfolio basis, with lower LTVs than owner-occupied mortgages.

Whilst most mortgages in the UK are fixed rate, these are relatively short in duration and fixed-rate mortgages have reset at materially higher variable rates at the end of the fixed term. This mortgage market refinance in the UK still has some way to go and is expected to extend into 2024. The portfolio is being monitored closely for signs of stress.

The charts below show the regional distribution of the owner-occupied and buy-to-let portfolios.





ALM strategy

FirstRand's approach to managing the endowment profile (its asset-liability management (ALM) strategy) has resulted in positive outcomes for shareholders since implementation in 2017, through the pandemic and to date. The principles of ALM are a cornerstone of the group's FRM process and aligned to the group's objective to optimise TTC returns to shareholders.

Rather than take a passive position (i.e. overnight) with regard to the impact of the rate cycle on its endowment profile, the group's overarching objective is to actively manage the profile to protect and enhance earnings through the cycle, and earn the structural term premium for shareholders by investing along the yield curve over and above the repo rate.

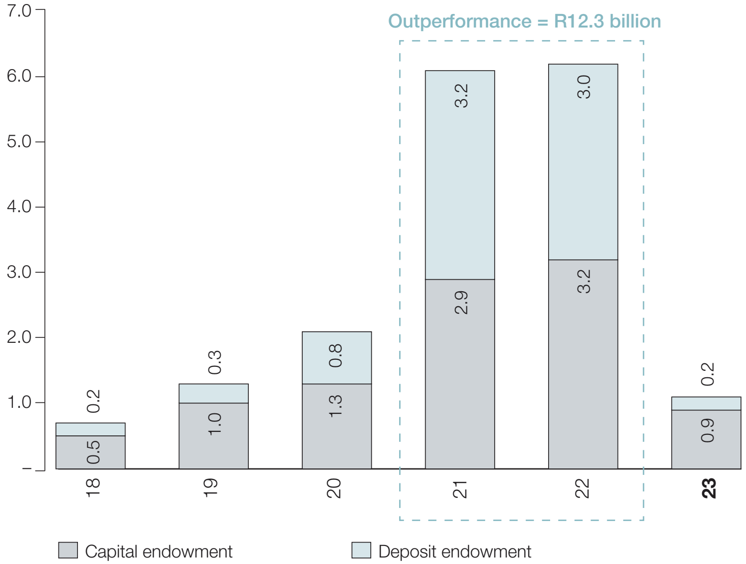
This active ALM strategy is managed by Group Treasury according to the following underlying principles:

- do not add to the natural risk profile in aggregate;
- consistently apply investment philosophy;
- be countercyclical to operating businesses;
- reduce the natural earnings volatility introduced by the interest rate cycle;
- optimise for capital allocation and risk-adjusted return; and
- take cognizance of accounting and regulatory requirements.

The absolute year-on-year rate of growth in the group's endowment NII for the current financial year will therefore not reflect the full extent of the rise in interest rates. However, the converse was true in previous periods when rates were lower, as the endowment was protected and optimised by the ALM strategy.

The outcomes for shareholders of this approach should be assessed on a TTC basis. The chart below shows the additional endowment NII earned from the group's ALM strategies in excess of an overnight (repo) investment profile.

Additional endowment NII from ALM strategies relative to overnight (repo) profile
(R billion)

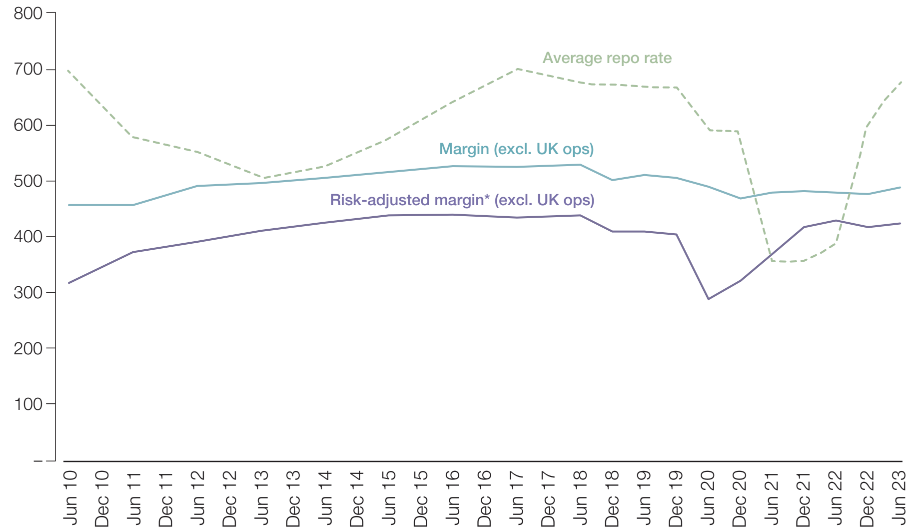


This demonstrates that the group outperformed in the 2021 and 2022 financial years due to the cumulative additional NII generated by the ALM strategy, totalling R12.3 billion over this period. This performance more than offset the relatively lower growth in the current year.

In addition, this outperformance in earnings growth translated into superior shareholder value creation, captured in a further structural underpin to the ROE and significant NAV accretion.

One of the outcomes of investing a portion of the endowment is a smoothing out of interest income that would otherwise follow a more volatile path of policy rates. The graph below illustrates the point well. The added degree of stability allows management to follow a TTC origination approach when it comes to lending. The chart also reflects the recent narrowing of the gap between the pre- and post-credit cost margin.

Basis points



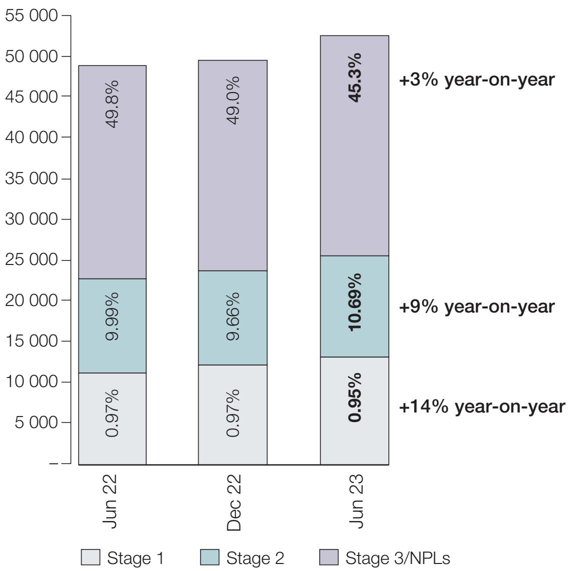
* *After impairments.*

This leads us to consider credit quality. In South Africa, the combination of higher rates for longer, persistent inflation, lower growth, loadshedding and sovereign risks are impacting consumer and business health. Despite the operating environment, the group credit loss ratio ended the year at 78 bps, marginally below the group's TTC range of 80 – 110 bps, reflecting the origination tilt over the past few years.

Nevertheless, better-rated customers (and the older back book) are not immune to these macroeconomic pressures. The second half of the financial year saw an increase in payment strain, debt counselling cases and new non-performing loan (NPL) formation, particularly in retail. Increased consumer strain is evident at an industry level. Strain is also noticeable in the self-employed and juristic space. Looking forward, credit loss ratios are expected to move well into the TTC ranges, with retail expected to lead the rise.

Impairment coverage remains well positioned. As expected, given the growth in advances, total provisions increased over the year (up 7% to R51.1 billion) and stage distributions deteriorated off a low base, as illustrated in the following chart.

Total provisions *(R million)* **and coverage** *(% of core lending advances)*



Capital-light/non-bank revenues

The relative size and quality of the transactional franchise allows the group to achieve high levels of capital-light earnings growth, translating into superior returns to shareholders.

FNB's focus on gaining more customers, and doing more business with customers played out well this past year. The business grew customers across all segments and geographies (up 5% in total). Transactional volumes increased 12%. The ongoing fee givebacks continued this year, amounting to c. R380 million.

RMB's corporate transactional franchise continued to onboard new clients and grew the number of primary-banked clients. Merchant card acquiring grew strongly off the back of higher consumer spend and inflation, with a 62% increase in volumes, and turnover up 54%. RMB's fee generation also grew meaningfully as a result of the strong balance sheet activity, whilst knowledge-based fees were also healthy.

The RMB markets business fared much better in broader Africa than domestically. The domestic PBT performance was down year-on-year. This was driven by:

- Equities decreasing 50% on the prior year, reflecting lower volumes from both local and international clients due to unfavourable macros and reduced funding spreads on the back of the implementation of the monetary policy implementation framework (MPIF) in South Africa, also impacted by the high base in the prior year.
- Commodities also declining 50% year-on-year, due to reduced client hedging activities from the energy sector. MPIF also impacted funding spreads.
- The fixed income performance was flat following three years of successive outperformance.
- The foreign exchange (FX) business continuing to deliver double digit growth (for the third successive year) benefiting from additional client hedging activities across all sectors.

There was a large realisation in RMB private equity and the equity-accounted earnings from the remainder of the portfolio remained strong.

The insurance business continues to scale and is providing pleasing non-interest revenue (NIR) diversification. FNB Life now insures 7.3 million customers and is the third-largest insurer by debit order in FNB's retail customer base. The business is already a meaningful contributor to total group NIR (c. 10%).

The 17% growth in life premium income over the past year (15% compound annual growth rate (CAGR) since 2018) is an outcome of healthy sales volume and solid growth in the in-force book. The short-term insurance business is also scaling fast (penetration has doubled since 2018) and is delivering ahead of business case expectations. Premium growth and new business volumes more than doubled (189%), on the back of sales of homeowners cover and car insurance products.

In-force annual premium equivalent of R6.8 billion for life and c. R900 million for short-term insurance bodes well for future income growth. In 2023, the value of new business increased 54% to R1 billion, with a return on embedded value of 34.8%.

Costs

The final component of the shareholder value creation thesis relates to operating efficiency. It also matters to the overall value creation thesis.

This year, group operating costs were elevated. FirstRand is confident that the rate of growth in costs will be arrested in the coming year. Furthermore, now that the bulk of the architecture and plumbing for the contextual, data-driven platform has been laid, the group believes that operating cost efficiencies from this investment will begin to be noticeable.

Financial resource management underpins the group's commitment to value creation

The themes unpacked in this report do not represent new insights – they have always been part of the group's FRM philosophies and practices which have been followed for many years. These principles are also embedded in the performance management framework. FRM is one of the group's important pillars that make FirstRand distinctive.

Prospects

Looking ahead, the macroeconomic environment should start to show signs of recovery next year. The worldwide disinflation process has progressed sufficiently for the major global central banks to consider pausing the current tight monetary policy cycle and begin to contemplate rate cuts in the second half of the 2024 calendar year. The outlook for the global economy remains uncertain.

The South African Reserve Bank and central banks in most of the broader Africa jurisdictions where the group operates, are likely to follow suit. Policy rates appear to have peaked, with cuts in rates expected late in 2024. The UK may lag somewhat, with policy rates likely to lift further over the next few months.

As domestic inflation and interest rates trend lower, this will slowly provide real income relief to households and those businesses that cannot pass on input price pressures. This will support South Africa's tertiary sector and help lift economic activity in the outer years.

Beyond the cycle, ongoing investment by South African businesses and households in energy capacity provides an underpin for credit extension and some upside to production capacity, GDP growth, and overall business and consumer confidence.

The outlook for the countries in broader Africa where the group operates will benefit from improved mining production, but this is expected to be offset by inflation pressures in some jurisdictions with weaker fiscal positions continuing to weigh on growth.

In South Africa, corporate advances growth will moderate from current levels but remain resilient. Retail portfolios will probably soften on the back of lower demand, however, commercial lending is expected to maintain current growth trends. The momentum from the deposit franchise should continue, supporting overall NII growth.

Against this backdrop, the group believes the quality of its operating businesses means it will continue to capture a growing share of profitable growth opportunities in all the segments and markets where it operates.

The broader Africa portfolio is also expected to maintain current levels of growth in advances and deposits. Modest advances growth is anticipated from the UK operations in the year ahead.

NIR is likely to benefit from ongoing customer growth and commensurate volume increases. This will be partially offset by some contraction in customer spend as disposable income remains under pressure.

The group's credit loss ratio in the coming year is expected to marginally exceed the mid point of the group's TTC range. The group believes the credit cycle will be close to peak levels by the end of the financial year. The expected upward trend is a result of origination strain from written advances over the past 18 months, and the weak macroeconomic outlook.

Growth in earnings is expected to land within the group's long-term target band of real GDP plus CPI plus >0% to 3%.

FirstRand expects its ROE to remain at the upper end of its stated range of 18% to 22%.

ALAN PULLINGER
CEO

FirstRand

www.firstrand.co.za