



chairman's report

Roger Jardine

“Someone is sitting in the shade today because someone planted a tree a long time ago.”

So said Warren Buffett, “the sage of Omaha”, a man of world renown who has demonstrated over many decades an expansive and highly successful vision for his business. But he is just as famous for his folksy and seemingly simple style when commenting on his strategy (as anyone would know when reading his annual letter to shareholders). Buffett’s style should not, however, distract us from the profound nature of his insight.

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As I sit here today, writing my first statement as chairman of FirstRand, the quote above resonates with me. I consider myself very fortunate to follow in the footsteps of two founders of FirstRand, GT Ferreira and Laurie Dippenaar. Along with Paul Harris, the third member of the founding trio, GT and Laurie have been instrumental in creating what is arguably today one of the most well-regarded financial institutions in South Africa. They planted many “trees” that were the enduring foundations of this business. The combination of long-term thinking, sustainable business practices and great people operating in a unique corporate culture that fostered an enduring entrepreneurial mindset, have all resulted in a powerful heritage. I look forward to playing my part, together with the board and the management team of FirstRand, in writing another chapter of this legacy.

I take over this role at a time when the business is in excellent shape, as demonstrated in the results for the year to June 2018 covered later in this report, however, it is an extremely challenging time for our country.

POLICY UNCERTAINTY REMAINS A CONSTRAINT TO CONFIDENCE AND GROWTH

Slow economic growth over the last ten years, alongside ever increasing public spending, has resulted in a fiscus that is under enormous strain, with government debt still accumulating rapidly and unemployment at unacceptable levels. In addition, government has embarked on a number of populist policies which the South African balance sheet simply cannot afford: higher public-sector wages, a questionable approach to higher education funding and, more recently, the proposed process for the introduction of National Health Insurance. Also, with regard to the land debate, the government is seeking constitutional amendments that, if implemented poorly, run the risk of compromising the property rights of South African citizens.

This unfortunately paints a rather bleak picture and is negative for investor and business confidence, both of which are required for the country to attract much needed further investment. The government must drive major structural reform for South Africa to return to a growth path and deliver the positive outcome this country and its people, particularly our youth, so sorely needs. Structural reform is, however, painful and unpopular. It requires strong leadership and a unified government to make the tough decisions.

The election of Cyril Ramaphosa as president of South Africa earlier this year marked a significant shift away from nearly a decade of a very poor local and international narrative about the country characterised by state capture, looting and a general breakdown in public sector governance and trust.

We have seen some early signs of positive change. Certainly, the new boards at the large state-owned enterprises (SOEs) are welcomed and have been well received by investors and rating agencies. The importance of these changes should not be underestimated, as some of the larger entities continue to place risk on the country's balance sheet.

We have seen early signs of positive change

Whilst the tackling of broken balance sheets and business models at the systemic SOEs does seem to be top of mind for government, I also believe

we must shape a view on the less systemic enterprises. For instance, we need to ask ourselves if South Africa really requires a national carrier that costs the country billions of rand a year when the vast majority of our citizens do not use its services. How can it make sense, in a country with thousands of chronically underfunded state schools and hospitals, that tax monies continue to flow to SAA and SA Express, particularly as both businesses are incurring material operational losses? The banks can step in with short-term liquidity, but this is just "kicking the can down the road" and it is not sustainable. If there are strong business cases in support of tourism and business revenues, then perhaps government needs to make a shareholder decision to accelerate the process of finding strategic equity partners for these assets. Fiscal resources of the magnitude required to keep these SOEs going can be used elsewhere for the benefit of a much larger proportion of our population. Questions of ideology around the ownership of "state assets" cannot and should not prevail when children are drowning in pit toilets.

Another policy topic I want to touch on is land reform, which is certainly one of the most important issues facing the country and, whilst the debate is not idiosyncratic to South Africa, it is relevant to developing economies with large Gini coefficients.

South Africa's Gini coefficient currently stands at 0.68, which makes us one of the most unequal countries in the world.

Interestingly, Brazil's Gini coefficient was very similar to South Africa's in 1994. Since then, however, inequality in Brazil has fallen on the back of strong economic growth and, in addition, the country has experienced a significant rise in secondary school enrolments and graduations.

South Africa on the other hand, over the same period, experienced low economic growth, a moderate reduction in poverty levels, but a sharp rise in income inequality. The obvious question is why does South Africa remain such an unequal country 24 years after democracy? Why did Brazil do better?

There are many reasons, one of which is that ours is an economy that is both skills-intensive and capital-intensive and does not generate a sufficient number of blue collar jobs, which is critical to reducing unemployment and inequality. Circling back to the land reform debate, however, the World Bank

and other institutions have also identified that the skewed distribution of land and productive assets is a key constraint to South Africa's economic growth potential.

There is tremendous upside potential should property rights evolve to be more inclusive of SA's real economy

Best estimates suggest that more than half of South Africans occupy land without their property rights being recorded in the deeds registry, leaving them outside of the formal economy and unable to put these assets to productive work within it. This is why land reform is back on the table in a real way. There is tremendous upside potential should property rights evolve to be more inclusive of South Africa's real economy.

However, if land reform is done in a way that prejudices property rights, the downside risk potential is equally significant. So far, the Presidency is navigating this issue well. The process is transparent and designed to be inclusive of all views, but, the assertion that mortgaged private property assets can be expropriated without compensation (and the banks will just have to absorb the loss) is a ludicrous and dangerous fallacy. The Banking Association of South Africa estimates that the current total exposure that banks have to property assets is approximately R1.6 trillion. Most importantly, these loans are funded by depositors' money – that's yours and mine.

The earlier point about the improvement in Brazil's education system should not be forgotten. The political economist Thomas Piketty argues that good schooling and a healthy educational pipeline play a crucial role in an economy's long-run growth trajectory and is critical

for reducing inequality. This is why the private sector is fully committed to partnering with government to address the education crisis. In fact, our own foundations have aligned their funding strategies to systemic interventions in education and this year alone contributed R243 million to education initiatives.

It is encouraging that the economic stimulus package announced by President Ramaphosa recognised that the South African economy is in dire need of supply-side reforms rather than an increase in government spending. In fact, a plan to increase government spending would have led to further sovereign downgrades, rising cost of capital and further long-term economic malaise.

Instead, by announcing initiatives that should provide more policy clarity, increase the stock of capital in the country and reduce the cost of doing business, the stimulus plan could represent a few important steps down the path of structural reforms that the South African economy so desperately needs.

The success of the plan will, however, depend on its implementation and the extent that it is followed by other initiatives that will improve South Africa's production capacity. I therefore hope the government will make use of the offers from the private sector to get involved in the management and implementation of some aspects of the government's reform initiatives. PPPs will be key to unlocking the potential of this country and the country's renewables strategy is an excellent example of what success in this space looks like.

It is also important that policymakers provide guidance on how they plan to deal with other structural constraints that are keeping the economy from delivering its full potential.

These include plans to deal with the dire financial positions and inefficient service delivery at several SOEs that I mentioned earlier, plans to implement measures that can improve the quality of education in the country and plans to eradicate the ambiguities surrounding other policy initiatives. This includes the uncertainty around the implementation and impact of the National Health

Insurance scheme on the delivery of quality health care in South Africa. Especially if one weighs the ambitions of such a scheme against the country's current skills and financial constraints.

FIRSTRAND DEMONSTRATES AGAIN THAT THE BUSINESS IS EFFECTIVELY NAVIGATING DIFFICULT CONDITIONS

Now turning back to the group's performance, despite this mixed economic and political backdrop, FirstRand's portfolio of businesses once again produced quality results for the year to June 2018. Normalised earnings increased 8% with a normalised ROE of 23.0%. The numbers are unpacked in detail in the CFO's report on pages 26 to 44 and, in his CEO's report, Alan Pullinger shares his vision for an integrated financial services model which will ensure that the group fully capitalises on its portfolio of leading businesses to deliver long-term sustainable returns for our shareholders.

It is a very compelling strategy which accommodates a broad set of growth opportunities across the financial services universe from a product, market, segment and geographic perspective.

There has been a prevailing view for some time that businesses with large and profitable domestic franchises would be unable to deliver growth because of the poor macroeconomic environment, and that the broader African continent represented more fertile ground for growth. FirstRand's earnings remain very tilted towards South Africa, yet the business continues to outperform. This demonstrates that the group's excellent leadership, sound strategic thinking, focused execution and unique culture remain the cornerstones of its track record of delivering superior returns for shareholders.

The group finalised a meaningful acquisition during the year, acquiring the UK challenger bank Aldermore Group plc, and the strategic rationale for this transaction is unpacked in detail in the CEO's report. Importantly, post this transaction, FirstRand still operates well above its stated capital targets. Its ongoing strong capital generation and high return profile means that the board

remains comfortable with a dividend cover of 1.7x, which continues to track below its stated long-term cover range of 1.8x to 2.2x. As previously communicated, however, should capital demand increase to support sustainable balance sheet growth, the board will revisit whether it should migrate back into the stated long-term cover range.

GOOD CORPORATE GOVERNANCE REQUIRES THE RIGHT BLEND OF SKILLS, DIVERSITY AND EXPERIENCE

FirstRand prides itself on its approach to governance and one of the topics that I take a particular interest in is the composition of the FirstRand board and how we achieve the right balance from a skills, race, gender and tenure perspective.

There is excellent value in appointing independent directors to the board as these directors play a crucial role through the provision of independent perspectives. They also act as custodians of the rights of shareholders (including minority shareholders) and stakeholders. I believe that between King IV and the Banks Act there are appropriate measures in place to deal with issues of independence.

However, we need to balance independence with experience. Worryingly, international best practice is moving towards the practice of tenure as a mechanistic criterion to determine independence. This will not be a good outcome for the financial services sector which is extremely complex and, as the custodians of the nation's savings, banks are systemically important institutions.

In an effort to reconcile these two conflicting requirements of independence and tenure, the group undertook a King IV independence assessment on directors with tenure of more than nine years. The details of this assessment are outlined on page 81 of the governance section. The board is satisfied that the independent non-executive directors who have served continuously for nine years or more are able to act independently and in the best interests of the group.

Over the course of the year we have seen some significant changes at a board level. Laurie Dippenaar, Paul Harris, Pat Goss, Hennie van Greuning and Ben van der Ross have all retired. On behalf of the board, I want to thank them for their outstanding contributions over many years. On a personal note, I would like to thank my predecessor, Laurie Dippenaar, for his stewardship as chairman of FirstRand over a period of ten years and his great interest and assistance in my transition to the role of chairman. Johan Burger resigned from his position as CEO at the end of March and joined the board as a non-executive director with effect from 1 September. The board appreciates Johan's deep influence and impact on the group having served FirstRand in various capacities over 32 years and wishes to express its profound gratitude to him for his role in building the company. We are delighted that he will remain on the board as a non-executive director. I also want to welcome to the board Tom Winterboer as a new independent non-executive and Mary Vilakazi, our new group chief operating officer.

I feel that the board represents a good balance of skills and diversity, with 54% independent non-executives, 31% women and 56% black. The board regularly reviews its composition with a view to strengthening its skills and demographic mix over time.

I would also like to welcome to the group, Phillip Monks, the CEO of Aldermore and all of our new colleagues at Aldermore.

LOOKING FORWARD WE REMAIN CAUTIOUSLY OPTIMISTIC

Many of the risks I described at the beginning of my statement will be around for quite some time, and it is easy to be pessimistic about the future. We should, however, not forget how despondent we were this time last year and that 2018 started in a much more positive place following the change in leadership of the governing party, the appointment of President Ramaphosa as head of the government and a relatively investor-friendly cabinet reshuffle in February. The country avoided further downgrades. All of this we should celebrate.

Looking forward, I remain hopeful that the government will partner with business and labour and successfully implement the measures included in the stimulus package. These reforms are not expected to lift economic activity meaningfully over the near term, however, together with other structural reform initiatives – such as addressing SOE finances and removing other policy uncertainties – they could start to bear fruit towards the end of next year and into 2020.

Failure to implement these initiatives will, unfortunately, keep South Africa's growth prospects weak and unemployment high. A low growth environment will raise concerns around government debt sustainability and pose serious socio-economic and business challenges for all stakeholders in the South African economy.

FirstRand has proved time and again it can weather difficult operating conditions. The operations are in great shape, the new growth strategies that Alan outlines in his CEO report are gaining traction and we consider ourselves strategically well positioned to benefit from renewed system growth.

In closing I would like to send a heartfelt thank you to all of the employees of the group, it is your commitment and hard work that drives continued outperformance.



ROGER JARDINE

Chairman: FirstRand Limited