Market release

2018 first half results

Challenger Limited
13 February 2018

RECORD AUM AND NORMALISED PROFIT DELIVERING ON STRATEGY FOR GROWTH

- Group assets under management **$76.5** billion, up **18%**
- Record normalised net profit before tax[1] **$275** million, up **8%**
- Normalised net profit after tax[1] **$208** million, up **6%**
- Statutory net profit after tax **$195** million, down **3%**
- Challenger Life book growth of **$948** million, up **12%**
- Life sales of **$3.3** billion, up **21%**
- Funds Management net flows of **$3.9** billion, up **22%**
- Record low normalised cost to income ratio of **32.1%,** improved **80 bps**
- Interim dividend **17.5** cents per share, up **3%**

Challenger Limited (ASX:CGF) delivered continued growth in the first half of the 2018 financial year supported by excellent growth in assets under management, up 18%.

Challenger Chief Executive Officer Brian Benari said: “In these results we are seeing the benefits from diversifying our distribution channels and product offering, which is driving increased sales. At the same time, we are reweighting to longer term business, which is reducing the proportion of annuities reaching maturity and maximising our return to shareholders. This is underpinning our future growth.

“There has been particularly strong demand for products such as our new Challenger Guaranteed Index Plus Fund, which is targeted at Australian super funds, and our CarePlus aged care annuity. Meanwhile, sales in Japan through our relationship with Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary) contributed 17% of Challenger Life’s annuity sales in the half.

"In our Funds Management business, superior long-term performance and a focus on active investment management continues to attract funds faster than most of the industry, contributing to a 20% increase in average funds under management (FUM).

"We are one of the most efficient companies in financial services with a cost to income ratio of 32.1%, a full 17 percentage points below the sector average[2]. We have achieved this while increasing investment in the first half to capture new distribution opportunities.

"The strength of our business is supported by prudent capital management and during the half we placed $500 million of equity to be used for growth."

Group financial performance

Growth in assets under management was strong, finishing the half 18% up on the first half of 2017.

Normalised net profit before tax was up 8% to $275 million. Normalised net profit after tax (NPAT) was up 6% to $208 million. Statutory net profit after tax was down 3% to $195 million, reflecting negative investment experience of $13 million.

Normalised pre-tax return on equity (ROE) was 16.8%, due to the temporary impact of new capital following the $500 million placement to MS&AD Insurance Group Holdings Inc. (MS&AD) on 23 August 2017. Normalised pre-tax ROE is expected to increase as the benefits from the new capital are generated.

The equity placement to MS&AD, the parent company of MS Primary, forms part of a broader strategic relationship, which enhances Challenger's access to the Japanese market.

Normalised earnings per share was 35.2 cents per share, compared with 35.0 cents in 1H17 and reflects the 6% increase in normalised net profit after tax, partially offset by a 5% increase in the weighted average number of shares on issue. The interim dividend increased 3% to 17.5 cents per share, fully franked.

Challenger Life performance

Total 1H18 Life sales were $3.3 billion, up 21%. Life's total net book grew by $0.9 billion, which was up 12% on 1H17 and represents book growth of 7.9% for the half year.

Annuity sales grew to $2.3 billion, up 4% compared with 1H17, a period when sales were elevated ahead of changes to the Age Pension taper rate that commenced 1 January 2017.

Annuity book growth was strong at $0.8 billion for the half, up 69% on 1H17. It was driven by robust sales and a significantly reduced level of maturing annuities. The value of annuities reaching maturity fell by $0.2 billion, compared with 1H17. In 1H18 approximately 15% of the annuity book matured. This is expected to step down to approximately 10% in 2H18 due to the continued focus on long-term sales.

Long-term sales, which include Australian lifetime annuities and 20-year maturity MS Primary Japanese business, accounted for 36% of 1H18 sales, up from 31% in 1H17. The continued reweighting to longer term annuity business meant that the average tenor of new business sales[3] lifted to 9.3 years, up from 8.7 years in 1H17 and 5.6 years in 1H16.

Sales of other Life products grew strongly, driven by Guaranteed Index Return (GIR) institutional client mandates and reinvestments of $800 million, and $200 million in sales to superannuation funds of the new Challenger Guaranteed Index Plus Fund.

Life normalised cash operating earnings (COE) was up 6% to $336 million. Life earnings before interest and tax (EBIT) was up 6% to $283 million.

The COE margin was 4.05%, down from 4.19% in 2H17. As previously indicated, the margin was impacted by a change in product mix with a higher proportion of institutional GIR and Japanese annuity business at lower margins. This is reflected in lower asset yields, partly offset by lower interest and distribution expenses. All product categories target Challenger's 18% normalised ROE.

Capital

Challenger Life remains strongly capitalised with $1.3 billion of excess regulatory capital. This is 1.49 times the Prescribed Capital Amount (PCA) ratio set by the Australian Prudential Regulation Authority (APRA) and is above the mid-point of Challenger's target range of 1.3 times to 1.6 times.

Challenger is deploying this capital to acquire investment assets and support its annuity book growth. Challenger is in a strong capital position to fund future growth through expanded domestic distribution relationships, development of new products and opportunities in Japan.

Funds Management performance

Funds Management achieved strong growth in FUM across Fidante Partners and Challenger Investment Partners. Net flows continued to exceed industry averages at $3.9 billion for the half year, representing 6% growth on opening FUM. Average FUM increased to $71 billion, up 20% on 1H17, due to a positive contribution from both Fidante Partners, increasing by 21%, and Challenger

Investment Partners which increased 18%. Both businesses experienced strong net flows and positive investment performance.

Funds Management is capturing the benefits of its increased scale and EBIT was $27.1 million, up 31% on 1H17. Net income growth substantially outpaced expense growth. Net income was up 10% to $72 million, benefitting from higher FUM-based fees and performance fees, while expenses were up 1%.

In Australia, Challenger Investment Partners attracted third-party FUM through a new Credit Income Fund while Fidante Partners launched four new investment strategies for its existing stable of boutique fund managers. Fidante Partners Europe formed a new boutique partnership with Garelick Capital Partners, a specialist equity manager based in the United States.

Expanding distribution and product offering

Challenger continues to focus on expanding its distribution footprint. In September 2017, Challenger's range of annuity products was launched via AMP's adviser portal to their retail and corporate superannuation clients. These are supported by Challenger tools and calculators and AMP's retirement income model portfolio. There has been a positive start to the AMP annuity relationship with a focus on long duration annuity sales.

The launch of Challenger annuities on the BT Panorama platform is targeted for the June 2018 quarter. Access to annuities on platforms make it easier and more efficient for financial advisers to recommend the use of annuities to their clients and is a key driver of sales.

Challenger continues to broaden its customer reach through expanding its range of products and product features. In September 2017, following regulatory reform, Challenger launched Australia's first deferred lifetime annuity and is awaiting finalisation of social security means testing treatment for this product. Deferred lifetime annuities are an option within Challenger's Liquid Lifetime range and are also available via AMP and Colonial First State platforms.

Challenger continues to focus on capturing growth opportunities in Japan, with a new Australian dollar lifetime annuity product currently being jointly developed with MS Primary.

Update on retirement income reform

Over the past 18 months the Government has undertaken consultation with industry around provision of income streams in the retirement phase of superannuation and during 1H18 it received industry submissions to Treasury's MyRetirement reform proposals.

In support of the reform agenda, the Department of Social Services (DSS) has released proposed means testing rules for the treatment of lifetime retirement income streams, including lifetime annuities. The discussion paper highlights the importance of achieving a means testing approach that supports the MyRetirement reforms. The DSS is seeking feedback on these proposals.

Outlook

Challenger is well positioned to deliver on its growth strategy, with new product offerings, expanded distribution networks and highly efficient operations.

For FY18 Challenger is on track to achieve its normalised net profit before tax guidance of between $545 million and $565 million, representing growth of 8% to 12% on FY17.

Challenger continues to target an overall normalised pre-tax ROE of 18% over the medium term. FY18 ROE will be affected by higher levels of capital from the MS&AD equity placement. ROE is expected to increase from current levels as the benefits from the new capital are generated.

An interim dividend of 17.5 cents per share has been declared. This represents a payout ratio of 49.7% of normalised NPAT. Challenger expects to maintain a fully franked dividend payout ratio of 45% to 50% of normalised NPAT, subject to prevailing market conditions and capital allocation priorities.

Investor presentation webcast

Challenger Managing Director and Chief Executive Officer, Brian Benari, and Chief Financial Officer, Andrew Tobin, will give an investor presentation on the results at 10:30am (Sydney time) on 13 February 2018. The presentation will be streamed live via webcast which can be accessed at www.challenger.com.au

1. The normalised profit figures are non-statutory amounts and in Challenger's view better reflect the underlying operating performance of the business. The normalised profit figures exclude investment experience and significant items. Investment experience is the difference between actual investment gains and losses (both realised and unrealised) and the normalised gains and losses (being based on Challenger's long term assumed returns), as well as any impact of changes in economic variables and assumptions used to value liabilities. The normalised profit also excludes any significant items which represent one-off or abnormal gains or losses for the period. The normalised profit framework and reconciliation to statutory profit is disclosed in the 2018 Interim Financial Report - Operating and Financial Review section. The normalised profit is not audited but is subject to a review performed by Ernst & Young.
2. The sector average includes Australian and New Zealand Banking Corporation, AMP, Bank of Queensland, Bendigo and Adelaide Bank, BT Investment Management, Commonwealth Bank of Australia, Macquarie Bank, Magellan Financial Group, National Australia Bank, Perpetual and Westpac Banking Corporation.
3. New business tenor represents the average maximum product maturity of new business sales. These products may amortise over the period.

Key metrics

	1H18	1H17	Change
Total assets under management ($bn)	76.5	64.7	18%
Life book growth ($bn)	0.9	0.8	12%
Total Life sales ($bn)	3.3	2.8	21%
Annuity sales ($bn)	2.3	2.2	4%
Funds Management net flows ($bn)	3.9	3.2	22%
Normalised NPBT ($m)	275	254	8%
Normalised NPAT ($m)	208	197	6%
Statutory NPAT ($m)	195	202	(3%)
Normalised EPS (cps)	35.2	35.0	1%
Statutory EPS (cps)	33.1	35.8	(8%)
Normalised ROE pre-tax (%)	16.8	18.7	(190 bps)
Statutory ROE post-tax (%)	11.9	14.8	(290 bps)
Normalised cost to income ratio (%)	32.1	32.9	(80 bps)
Interim dividend (cps)	17.5	17.0	3%

About Challenger

Challenger Limited (Challenger) is an investment management firm with $77 billion* in assets under management. Its vision is to provide customers with financial security for retirement.

Challenger operates two core investment businesses, a fiduciary Funds Management division and an APRA-regulated Life division. Challenger Life Company Limited (Challenger Life) is Australia's leading provider of annuities.

*31 December 2017.

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