Market release

Challenger Limited

14 August 2018

FULL YEAR RESULT DEMONSTRATES STRONG BUSINESS MOMENTUM

- Group assets under management **$81** billion, up **16%**
- Record normalised net profit before tax[1] **$547** million, up **8%**
- Record normalised net profit after tax **$406** million, up **6%**
- Statutory net profit after tax **$323** million, down **19%**
- Life book growth of **$1.8** billion, up **37%**
- Funds Management net flows of **$5.3** billion
- Normalised cost to income ratio of **32.7%,** improved **70 bps**
- Full year dividend of **35.5** cents

Challenger Limited (ASX:CGF) today announced its results for the 2018 financial year with the company delivering excellent growth in assets under management (AUM) and record normalised net profit after tax.

Managing Director and Chief Executive Officer Brian Benari said: “Challenger has great business momentum and is well positioned for the next phase of growth. We are diversifying our product and distribution reach to capture strong growth opportunities, supported by increasing industry and government focus on the retirement phase of superannuation.

“A key driver of these results is our success in expanding our customer base by broadening our products and distribution activities. Over recent years we have developed a wide range of term and lifetime annuities, including our fastest growing product CarePlus. We have further diversified with new institutional products, such as the Challenger Index Plus Fund, and a successful partnership in Japan, which is delivering in line with expectations. Following continued progress implementing our platform strategy, within weeks we will be present on the platforms used by two-thirds of Australia’s financial advisers.

“In addition, we are one of Australia’s fastest growing active fund managers with our Fidante Partners business establishing new boutique managers during the year and our Challenger Investment Partners business continuing to win third-party property and fixed income mandates.

“Significantly, providing options for Australia’s retirees to convert their superannuation into income that lasts for life has become an increasing focus for industry and government. The Government’s Retirement Income Framework, announced in the May 2018 Federal Budget, is a major step forward in developing the retirement phase of superannuation. This reform will improve living standards for retirees and boost the choices they have at retirement. As a leader in retirement incomes, Challenger is ideally positioned as lifetime products become an increasingly mainstream option in retirement.”

Group financial performance

Challenger's performance in 2018 was underpinned by continued rapid growth in AUM which increased 16% to more than $81 billion. Over the last five years AUM has increased by more than $36 billion reflecting significant growth in Life sales and very strong fund flows in the Funds Management business.

Normalised net profit before tax was up 8% to $547 million. Normalised net profit after tax increased 6% to $406 million, reflecting a 2% higher normalised tax rate. Statutory net profit after tax, which includes investment experience, was down 19% to $323 million.

As forecast, normalised pre-tax return on equity (ROE) was lower at 16.5%, following the $500 million strategic equity placement to MS&AD Insurance Group Holdings, the parent company of Challenger's Japanese annuity partner Mitsui Sumitomo Primary Life Insurance Company (MS Primary).

Challenger achieved a record low cost to income ratio for the year of 32.7%. This has reduced 15% over 10 years, demonstrating the efficiency and scalability of the business.

The full year dividend increased by 3% to 35.5 cents per share, fully franked.

Capital

Challenger Life finished the year strongly capitalised with $1.3 billion of excess regulatory capital. This represents 1.53 times the Prescribed Capital Amount (PCA) set by the Australian Prudential Regulation Authority (APRA), which is at the top end of Challenger's target range of 1.3 to 1.6 times.

During the period, S&P Global Ratings affirmed its A rating for Challenger Life and lifted the outlook from stable to positive.

The deployment of capital from the MS&AD equity placement led to higher capital intensity in the first half and has subsequently reduced as capital was deployed into lower intensity investments and as Life's investment portfolio commenced reweighting from property to fixed income investments.

Challenger Life

Total 2018 Life sales were up 12% to $5.6 billion. This comprised $4.0 billion of annuity sales, unchanged from the previous year, and $1.6 billion of Other Life sales, up 65%. Other Life sales included Guaranteed Index Return client mandates and the Challenger Index Plus Fund.

As expected, the annuity maturity rate benefited from the focus on long-term sales, reducing to 25% and on track to fall further in 2019. Long-term annuities (Lifetime and MS Primary) now represent 43% of the total annuity book, up from 21% five years ago.

With both strong sales and a reduction in the annuity maturity rate, Life's total net book growth increased by 37% to a record $1.8 billion. This represents growth in Life's annuity and other policy liabilities of 15% for the year.

Life's average investment assets increased by 16% and both normalised cash operating earnings (COE) and normalised earnings before interest and tax (EBIT) increased by 6%. The increase in earnings was less than the increase in average investment assets materially due to product diversification changing the mix of products sold. This change in product mix, combined with asset yield compression, led to a COE margin of 3.93%, compared with 4.29% in 2017.

Growth in the Life business has been driven by a strategy of diversifying product offerings and extending distribution reach. In September 2017, Challenger's range of annuity products were launched via AMP's adviser portal, supported by Challenger's tools and calculators and AMP's retirement income model portfolio. Challenger annuities remain on track to launch on the BT Panorama platform in the September 2018 quarter.

Challenger has broadened its range of Liquid Lifetime annuities by adding a Deferred Lifetime Annuity option, with the new means test rules commencing on 1 July 2019.

Reflecting Australia's ageing population, sales of CarePlus grew to over $0.3 billion, an increase of 63% on last year. The number of advisers writing CarePlus has grown by 32% over the year reflecting the key role the product plays in helping meet the needs of the more than 300 people who move into permanent residential and home aged care every day.

Challenger continues to focus on capturing growth opportunities in Japan. Building on the success of the first product, Challenger and MS Primary have developed a new Australian dollar lifetime annuity for the Japanese market. The partnership is progressing well and contributed 15% of Challenger's annuity sales for the year, in line with expectations. Challenger has opened a Tokyo office to support the strategic relationship with MS&AD, develop new distribution channels and manage real estate for Challenger Life and third-party clients.

Update on retirement income reform

There has been significant focus on policy areas that affect retirees over the last year and Challenger has actively participated in processes to drive reform. Following the introduction of new rules to enable a wider range of retirement income products in 2017, the Government announced new means test rules for these products to support their development and use. These new rules come into effect on 1 July 2019 and provide a strong foundation to further grow the use of lifetime income products.

Building on these reforms, the Government also announced in the May 2018 Federal Budget a new Retirement Income Framework that aims to significantly enhance the retirement phase of superannuation by placing more focus on the role of superannuation funds in providing members with reliable income for life. This will include a requirement for funds to offer members Comprehensive Income Products for Retirement.

These are positive developments that will help ensure lifetime income products are an option for more Australians in retirement.

Funds Management

Funds Management achieved net flows of $5.3 billion for the year, representing an increase of 8% on opening funds under management (FUM). Average FUM rose to $73.4 billion, up 19% on the prior year due to continued strong net flows and positive investment markets.

EBIT was $58 million, an increase of 28% with net income up 13% to $151 million with increased performance fees offset by lower transaction activity in the UK.

Growth in Funds Management is underpinned by strong fund performance with 91% of FUM outperforming benchmark in 2018 and 96% outperforming benchmark over five years.

Funds Management has continued to expand its offering with Fidante Partners introducing two new US-based boutiques and launching six new investment strategies. Fidante Partners has also announced plans to launch a series of Exchange Traded Funds (ETFs) for its boutique fund managers under the Fidante Partners ActiveX brand, starting with an active fixed income ETF expected to launch in the first half of the 2019 financial year. These initiatives will broaden access to Fidante funds for retail investors and help self managed superannuation funds diversify their investments.

Challenger Investment Partners (CIP) continues to attract third party mandates, winning over $1 billion of mandates across real estate and property during the year. This included a $500 million real estate debt mandate in Australia and New Zealand in partnership with the Canada Pension Plan Investment Board, which is in the process of being filled. In October 2017, CIP launched its Challenger Credit Income Fund, which targets a cash plus 3% return and has so far attracted $130 million and is outperforming benchmark.

Outlook

While the low yield environment remains challenging, the outlook is supportive for Challenger. Demand for retirement income solutions is underpinned by accelerating growth in the number of retirees, the higher balances they are retiring with and the increasing length of their retirements.

Industry and government are increasingly focused on creating options for retirees that provide both security and flexibility in retirement. Challenger is ideally placed as the leader in retirement incomes with a highly differentiated model that gives the business considerable competitive advantages.

Underpinning growth, Challenger continues to apply a disciplined asset allocation framework to optimise its asset mix, with a strong focus on risk, optimising return on equity and ensuring the business is well placed to fund future growth.

For FY19 Challenger is targeting normalised net profit before tax growth on FY18 of between 8% and 12%.

The company continues to target an overall normalised pre-tax return on equity of 18%, with FY19 normalised pre-tax return on equity expected to increase from FY18 but not reach the target.

Challenger targets a fully franked dividend payout ratio of 45% to 50% of normalised profit after tax, subject to prevailing market conditions and capital allocation priorities.

Investor presentation webcast

Challenger's 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 14 August 2018. The presentation will be streamed live via webcast which can be accessed at www.challenger.com.au.

Key metrics

	FY18	FY17	Change
Total assets under management ($bn)	81.1	70.0	16%
Life book growth ($bn)	1.8	1.3	37%
Total Life sales ($bn)	5.6	5.0	12%
Annuity sales ($bn)	4.0	4.0	Unchanged
Funds Management net flows ($bn)	5.3	6.2	(15%)
Normalised NPBT ($m)	547	505	8%
Normalised NPAT ($m)	406	385	6%
Statutory NPAT ($m)	323	398	(19%)
Normalised EPS (cps)	68.1	68.5	(1%)
Statutory EPS (cps)	54.0	70.7	(24%)
Normalised ROE pre-tax (%)	16.5	18.3	(180 bps)
Statutory ROE post-tax (%)	9.7	14.4	(470 bps)
Normalised cost to income ratio (%)	32.7	33.4	(70 bps)
Full year dividend (cps)	35.5	34.5	(3%)

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 includes both assets and policy liability experience and net new business strain. Asset and liability experience is calculated as the difference between actual investment gains/losses (both realised and unrealised) and normalised capital growth in relation to assets, plus any economic and actuarial assumption changes in relation to policy liabilities for the period. New business strain results from using the risk-free rate plus an illiquidity premium to value term and lifetime annuities. New business strain is a non-cash item and subsequently reverses over the future period of the contract. The normalised profit also excludes any significant items which represent non-recurring income and expense items for the period. The normalised profit framework and reconciliation to statutory profit have been discussed in Section 8 of the Operating and Financial Review in the 2018 Annual Report. The normalised profit is not audited but is subject to a review performed by Ernst & Young.

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About Challenger

Challenger Limited (Challenger) is an investment management firm managing $81* billion in assets. It is focused on providing 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 largest provider of annuities.

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