Challenger Limited

13 August 2019

CHALLENGER ANNOUNCES FY19 RESULTS

- Group assets under management $81.8 billion, up 1%
- Normalised net profit before tax $548 million, up $1 million
- Normalised net profit after tax $396 million, down $10 million
- Statutory net profit after tax $308 million, down $15 million
- Strong capital position with $1.5 billion of excess regulatory capital and Group cash
- Full year dividend 35.5 cents per share

Challenger Limited (ASX:CGF) today announced its results for the 2019 financial year, with steady normalised earnings highlighting the resilience of the business in a challenging operating environment.

Managing Director and Chief Executive Officer, Richard Howes said: "While significant disruption has clearly impacted our results in 2019, our outcomes demonstrate the strength of the franchise we've built. Our market leading brand, diverse distribution channels and compelling product offering underpin our performance.

"Challenger has continued to attract solid retail inflows in both Funds Management and Life, despite retail flows across the sector hitting record lows last year. In our Life business, domestic sales were marginally down, with lower sales from major hubs offset by stronger sales by independent financial advisers.

"In Funds Management, when removing the impact of performance fees, we saw solid growth in underlying earnings before interest and tax of 23%.

"Our capital position remains strong, with our PCA ratio towards the top end of our target range. These results demonstrate the resilience of our business in the face of the challenges in our operating environment this year caused by the significant disruption in the advice industry."

Looking ahead, Mr Howes said Challenger is well placed to capture opportunities for growth in both its Life and Funds Management businesses, with superannuation industry assets expected to double over the next 10 years.

"We're responding to the current environment with a range of initiatives to address the adviser disruption we face, and we continue to implement our strategy for long-term growth.

"In 2020, our investment of up to $15 million in new distribution, product and marketing initiatives builds on the strong foundations of our business to drive the next phase of growth. These initiatives support our goal to make annuities a mainstream option in retirement by promoting bottom-up customer demand for our products, and better supporting advisers to write annuities."

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Group financial performance

Group performance was impacted by the challenging operating environment driven by the disruption in the financial advice industry, with key metrics below expectations set at the beginning of the financial year.

Normalised net profit before tax (NPBT) was up $1 million to $548 million. This was in line with the revised guidance provided in January 2019. Normalised net profit after tax (NPAT) was down $10 million to $396 million.

Group assets under management (AUM) were up slightly on FY18 finishing the year at $82 billion. The growth was lower than expected due to industry disruption and redemptions by a major superannuation fund predominantly driven by internalisation of their investment management.

Statutory profit after tax was down $15 million to $308 million. This includes $88 million of negative investment experience, which represents fair value movements on Challenger Life's assets and liabilities.

Normalised pre-tax return on equity (ROE) was lower at 15.8%, reflecting higher capital levels and below target earnings.

Challenger again achieved a record low cost to income ratio of 32.6% with expenses down $1 million to $267 million. This result demonstrates the efficiency of the business.

Reflecting the resilience in the business and strong capital position, the full-year dividend was stable on FY18 at 35.5 cents per share, fully franked. The payout ratio of 54.2% is above the target range reflecting the Board's confidence that Challenger is well positioned to return to growth as conditions improve. The final dividend of 18 cents per share will be paid on 25 September 2019.

Capital

Challenger has maintained a strong capital position, with $1.5 billion of excess regulatory capital and Group cash. This is an increase of $0.1 billion due to higher retained earnings and lower capital intensity. The Prescribed Capital Amount (PCA) ratio of 1.53 times is towards the top end of the target range of 1.3 to 1.6 times the minimum amount set by the Australian Prudential Regulation Authority (APRA). This strong capital position supports future growth in Challenger's annuity book and ensures the business is positioned well to manage through this period.

In December 2018, Standard & Poor's (S&P) reaffirmed the credit rating and outlook for Challenger Life Company Limited as 'A' with a positive outlook; and Challenger Limited as 'BBB+', also with a positive outlook.

Challenger Life

Challenger Life earnings remained steady for the year with book growth offset by a lower margin.

Normalised earnings before interest and tax (EBIT) was up $1 million to $564 million, reflecting stable normalised cash operating earnings (COE) of $670 million and stable expenses. Higher average investment assets were offset by a lower margin.

Life's ROE was 17.8%, down by 70 basis points, as a result of higher capital levels.

Total Life sales were $4.6 billion, down 18% on FY18. This included lower annuity sales, down $0.5 billion to $3.5 billion, and lower Other Life sales, also down $0.5 billion to $1.0 billion.

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The biggest driver of the decline in annuity sales was MS Primary sales in Japan, which were down 54% due to the higher US interest rates relative to Australia. The contribution from MS Primary is expected to increase significantly in FY20 following an agreement with Challenger to reinsure US dollar annuities in Japan, which commenced on 1 July 2019. Minimum FY20 volumes will be approximately $660 million, and this agreement will continue for a minimum of five years[1].

Domestic annuity sales were down marginally at 4%, or $140 million to $3.3 billion, despite significant disruption to the major advice hubs. This resilience was particularly evident in sales by independent financial advisers (IFAs) which were up 26% while major hub sales were down 16%.

The mix of the Life book continued to shift towards long-term annuities, with the proportion increasing by 4% in FY19. The proportion of long-term annuities has doubled over the last four years and now represents approximately half the total annuity book.

Increasing the availability of Challenger annuities via superannuation and investment platforms has supported the shift towards a more diverse and dispersed adviser market. During the year, Challenger launched its annuity products on three leading platforms serving the independent advice market, including BT Panorama, HUB24 and Netwealth.

Challenger has also increased its focus on engaging more directly with customers with the aim of building bottom-up customer demand. This year, Challenger launched a new brand campaign and website aimed at building awareness about Challenger and the benefits of annuities. These initiatives have been informed by customer and adviser research and leverage the expertise and tools Challenger has built, with more content and tools scheduled for release in FY20.

Funds Management

In our Funds Management business, strong underlying earnings were offset by lower performance fees, which were down $16 million to $3 million. This resulted in net income for the year down $1 million to $150 million, but up $14 million excluding performance fees. EBIT was down $7 million (12%) to $51 million.

Average FUM was up 6% to $77.5 billion, including Fidante Partners FUM up 5% to $58.6 billion and Challenger Investment Partners (CIP) up 8% to $18.9 billion.

Fidante Partners FY19 net outflows of $3.6 billion were impacted by a significant redemption by a profit-for-member fund client ($3.9 billion), predominantly driven by internalisation of their investment management capability.

CIP net flows were $1.2 billion as fixed income inflows were partially offset by property outflows as a result of Challenger Life's reallocation from property.

This year Fidante has been focused on expanding products and adding new boutiques. In December, Fidante launched ActiveX, a series of active ETFs to cater to the growing demand from retail investors for different types of investment strategies accessible via the ASX. The series launched an actively managed fixed income ETF from Ardea and we expect to launch new ETFs in

[1] MS Primary will provide Challenger an annual amount of reinsurance, across both Australian and US dollar annuities, of at least ¥50 billion (~A$660 million based on exchange rate at 30 June 2019) per year for a minimum of five years. This is subject to review in the event of a material adverse change for either MS Primary or Challenger Life.

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FY20. In April, Fidante welcomed a new Australian small companies boutique, Eiger Capital to its stable.

Outlook

While FY19 performance has been impacted by disruption across the Australian wealth industry, the business is in good shape to navigate the current operating environment and well positioned to capture opportunities as they emerge. Investment in a range of new distribution, product and marketing growth initiatives in FY20 will support deeper integration with the advice process and build bottom up customer demand for Challenger annuities.

In FY20 challenging operating conditions are expected to persist for domestic sales and is targeting normalised net profit before tax between $500 million and $550 million. This reflects $23 million in earnings impact due to a lower equities normalised growth assumption and investment in a range of initiatives of up to $15 million to drive future growth.

As announced at Challenger's Investor Day in June, the through the cycle normalised return on equity (ROE) target has been revised to the RBA cash rate plus a margin of 14%. This change removes the variable impact of interest rates and continues to represent a strong relative return.

Challenger's dividend is expected to be maintained at 35.5 cents per share in FY20, subject to market conditions and capital allocation priorities.

Investor presentation webcast

Challenger's Managing Director and Chief Executive Officer, Richard Howes, and Chief Financial Officer, Andrew Tobin, will give an investor presentation on the results at 10:30am (Sydney time) on 13 August 2019. The presentation will be streamed live via webcast which can be accessed at www.challenger.com.au.

Key metrics

	FY19	FY18	Change
Total assets under management ($bn)	81.8	81.1	1%
CLC excess regulatory capital and Group cash ($bn)	1.5	1.4	3%
Life net book growth ($bn)	0.5	1.8	-74%
Total Life sales ($bn)	4.6	5.6	-18%
Annuity sales ($bn)	3.5	4.0	-11%
Funds Management net flows ($bn)	-2.4	5.3	Large
Normalised NPBT[1] ($m)	548	547	-
Normalised NPAT[1] ($m)	396	406	-2%
Statutory NPAT ($m)	308	323	-5%
Normalised EPS (cps)	65.5	68.1	-4%
Statutory EPS (cps)	50.9	54.0	-6%
Normalised ROE pre-tax (%)	15.8	16.5	-70 bps
Normalised ROE post-tax (%)	11.4	12.2	-80 bps
Statutory ROE post-tax (%)	8.9	9.7	-80 bps
Normalised cost to income ratio (%)	32.6	32.7	-10 bps
Full year dividend (cps)	35.5	35.5	-

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 2019 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 focusing 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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