Group Finance Director's report

Group results

Financial year 2018 was a tumultuous year on many fronts. The South African economy continues to struggle despite the global economy providing a favourable backdrop. In addition, the market rally and business confidence benefit from political changes in December 2017 were short-lived compared to initial expectations.

Within MMI we also experienced significant changes with the most externally visible being that the CEO, Deputy CEO, and FD are now all different to that of a year ago. There was also significant turnover in other key positions in the group, plus the new management team implemented changes to operational and tactical plans upon appointment. All of these developments caused some degree of short-term uncertainty. The new leadership team has agreed upon a roadmap that, if delivered on, is expected to result in normalised headline earnings of R3.6bn – R4.0bn by F2021, three years from now. This earnings range is the target that we will measure ourselves to over the next three years.

Group results – earnings

Core headline earnings declined by 12% to R2 809m during F2018. Operating profit before the increased share of losses in our new initiatives were down 5% year-on-year.

Rm	F2018	F2017	Year-on-year (%)
Momentum Retail	955	1 281	(25)
Metropolitan Retail	582	660	(12)
Momentum Corporate	903	835	8
International	227	19	> 100
Operating profit	**2 667**	**2 795**	**(5)**
New Initiatives	(322)	(195)	(65)
Shareholder Capital	464	608	(24)
Diluted core headline earnings	**2 809**	**3 208**	**(12)**

Momentum Retail, which focuses mainly on middle to affluent consumers, is our largest segment and its earnings declined by 25% to end at R955m for the year. The segment's result was affected by a few unusual items including a reinsurance corrections balance (R181m) and by increased spending on technology aimed at improving intermediary and client experiences (R70m). We also took the decision to treat a negative spread earned on a particular block of guaranteed endowments as part of core earnings whereas previously the negative impact was considered as an investment variance (R106m impact on core earnings).

Our retail insurance business targeting lower income consumers, **Metropolitan Retail**, had a disappointing year with earnings declining by 12% to R582m. The weakness in the real economy is particularly visible in Metropolitan Retail's premium collection rates, which have deteriorated meaningfully over the past two years. We are taking a number of steps to improve the quality of our policy book, including improvements to the professionalism of the agency force interacting with consumers in this market segment.

Momentum Corporate, who provide insurance, asset management, general insurance, and administration services to employers, had a strong year with earnings growing 8% to R903m. Momentum Corporate is the

Risto Ketola

Group Finance Director

leading provider of temporary and permanent disability products in the South African market and has thus been significantly affected by the soft underwriting cycle in that market segment over the past three years. The business was successful in taking corrective action during F2018 on these product lines and this had a major impact on the improvement in profitability. Guardrisk, our specialist insurance business, also showed strong profit growth.

Profits from our **International** operations increased substantially with the decision to exit certain frontier markets having a positive impact on the bottom line. The operations in Southern Africa remain highly profitable despite some weakness in persistency in Namibia. Our business in Ghana is worthy of a particular mention with earnings well up on the prior year.

Investment in **New Initiatives** increased substantially with India being the largest expense in the year (R217m vs R148m in the previous year). Operationally the India business (a joint venture with Aditya Birla Capital) continues to deliver against business plans. Other initiatives that we have classified into this category include aYo (a joint venture with MTN providing mobile insurance in rest of Africa), and MMI Lending (a joint venture with African Bank).

The **Shareholder** segment represents the investment income earned on our shareholder funds less the head office costs not charged out to segments. Investment income declined on the back of reduction in investable assets (due to capital invested in new ventures) and a lower yield earned on the investments. Furthermore, finance cost increased due to additional subordinated debt issued in the year. Head office costs were up substantially year-on-year due to costs related to various changes in senior leadership positions, and due to high consulting fees incurred during the year.

Group results – new business

Our life insurance new business (as measured by the present value of new business premium (PVNBP)) for F2018 was up 1% year-on-year. Best growth was seen in products offering a high level of security (e.g. our guaranteed rate products) which reflects the risk-averse nature of consumers at present.

PVNBP[1], Rm	F2018	F2017	Year-on-year (%)
Momentum Retail	23 531	22 774	3
Metropolitan Retail	5 091	5 164	(1)
Momentum Corporate	11 218	11 121	1
International	2 337	2 536	(8)
Total	**42 177**	**41 595**	**1**

[1] Present value of future premiums in respect of new business net of reinsurance, using the risk discount rate and other valuation assumptions.

Momentum Retail experienced strong sales of its Guaranteed Return Option endowment product with consumers showing strong preference for the fixed return nature of this product. Conversely, sales of market-linked products, such as living annuities, were lower than the previous year. Recurring premium new business also showed quite distinct trends with decent demand for savings products but weaker sales of protection (life and disability) products. This mix change also has a negative impact on new business margins as discussed on the next page.

Metropolitan Retail new business volumes fell marginally year-on-year. The decline was affected by strengthening of the persistency assumptions on funeral cover products. It should be noted that the PVNBP measures the present value of all premiums expected from a contract, and as such, the persistency assumptions have an impact on the measure. The one area that showed pleasing volumes at Metropolitan Retail was single premium investment and retirement products.

Momentum Corporate sales were effectively unchanged year-on-year, but the business remains a very significant player in terms of employee benefits market share. The past year was characterised by ongoing strong demand for our umbrella fund solution (FundsAtWork) whereas we remained quite disciplined, and thus walked away from some deals, in the large schemes risk market. The institutional annuity market showed limited activity in F2018, but we believe that we are well positioned to secure new business when pensioner outsourcing activity picks up again.

International volumes declined by 8%. Sales volumes were significantly lower than in the prior year in both Namibia and in Lesotho. Namibia sales were affected by lower sales of retail risk business whereas Lesotho was not able to repeat the unusually high corporate new business flows in F2018.

Value of new business (VNB) measures the present value of expected profits on contracts issued during the year. VNB declined by 45% relative to the previous year. A common feature in many of the segments was that growth in acquisition expenses was higher than the observed volume growth – this negative operational gearing has put pressure on profit margins. Expected profits on business sold during F2018 was 0.7% of expected premium income, down from 1.3% in the previous year. We would expect new business margins to be in excess of 1.0% in most years and as such F2018 delivered a highly disappointing VNB.

VNB, Rm	F2018	F2017	Year-on-year (%)
Momentum Retail	98	228	(57)
Metropolitan Retail	84	178	(53)
Momentum Corporate	124	68	82
International	(5)	73	< (100)
Total	**301**	**547**	**(45)**
% of PVNBP	0.7	1.3	

New business margin declined from 1.0% to 0.4% for **Momentum Retail**. One of the major reasons for the decline in new business margin was the new (reduced) pricing on our Wealth platform. The new guaranteed rate solution, which is selling well since its introduction, also has lower margins than the product it has replaced. Finally, the increase in renewal and initial expenses also impacted VNB negatively.

The weak early duration persistency recently experienced on funeral plans is the main contributor to the lower VNB at **Metropolitan Retail**. The weak persistency experience is particularly evident on business where premiums are collected via bank debit order rather than via employer payroll deductions. The new actuarial basis now allows for this recent experience and thus ascribes lower VNB to funeral plan sales. The current 1.6% margin for Metropolitan Retail is significantly lower than what we believe to be a sustainable long-term margin for this segment.

Momentum Corporate was the only area where margins improved year-on-year (from 0.6% to 1.1% of premiums). This improvement was driven by increased pricing discipline on risk business written during the year, ongoing demand for our umbrella fund offering (FundsAtWork), and the knock-on benefit on expected expenses from tight expense management achieved by Momentum Corporate during F2018.

International posted a negative VNB for the year. A common feature across many of the countries has been significant increases in acquisition costs. In some of the countries this relates to more accurate attribution of expenses between acquisition expenses and maintenance expenses. Namibia has been particularly affected by the changes to acquisition expenses. Lesotho was the one country where VNB did improve during the year, partially due to a change in business mix towards credit life business.

For our non-covered new business, we consider net client cash flows (NCCF) to be the key volume metric for both the LISP platform (Momentum Wealth) and for the retail unit trust business (Momentum Collective Investments).

NCCF, Rm	F2018	F2017	Year-on-year (%)
Wealth – local platform	(1 943)	(2 091)	7
Wealth – offshore platform	380	510	(25)
Unit Trusts – Momentum	(1 868)	(1 618)	(15)

Assets on our local Wealth management platform grew by 5% during the year from R129bn to R135bn. NCCF on the platform was an outflow of R1.9bn and in line with the experience of the previous year (R2.1bn). The negative flows are a direct result of new business volumes that have been sluggish over the past couple of years as retention rates on the book is in line with expectations and comparable to industry norms. Assets on the Guernsey domiciled Wealth management platform have grown 12% from R26bn to R29bn during the year under review due to positive NCCF of R380m during the year, as well as good investment performance.

Our local collective investment scheme (CIS) range have shown an increase in assets of 12% from R73bn to R82bn. Fee bearing portfolios showed a NCCF of R1.9bn in the year compared to R1.6bn the year before. The composition of the outflow has changed significantly during the year with the majority of net outflows recorded on cash and cash-like mandates while the multi and single asset portfolios outflows improved significantly. A large part of the current year was spent streamlining our CIS offering and positioning our funds in terms of our Outcomes-based Investment philosophy. This included the establishment of new funds, the amalgamation of some, and the discontinuation of others.

Group results – embedded value

The group embedded value ended at R25.43 per share on 30 June 2018. This represents a return on embedded value (ROEV) of -1,1% for the year. This can be attributed to 7% return on the covered operations (i.e. on mature life insurance operations) and -35% on other operations. The weak return on non-covered operations is partially because of a move to a more conservative valuation approach on these operations.

Life insurance ROEV was below normal due to a R975m negative basis adjustment for updated actuarial assumptions. The largest adjustment of the EV basis was in respect of expense assumptions where we have extrapolated the recent high level of expenses into the future. As and when we achieve our planned expense management benefits we will revisit the expense assumptions used in the EV calculation. Termination assumptions were also strengthened. The largest impact was in respect of level premium Myriad contracts where we now assume minimal terminations at older ages which reduces expected profit. The final major assumption change was to asset allocation assumed on reserves held in respect of Myriad policies. We plan to improve the asset-liability matching on Myriad, and the new asset allocation assumption reflects this. The net effect was that we have moved to a lower assumed investment return on the reserve which has a negative impact on EV for the affected contracts.

On non-covered operations we received extensive feedback from shareholders that the previous valuation method (a long-term discounted cash flow (DCF) approach) has resulted in valuations that are inconsistent with current earnings from these businesses. We have thus decided to change the valuation approach to one where near-term earnings have greater impact. We also decided to moderate the assumptions around how quickly loss-making operations can be fixed to a break-even situation. These changes reduced EV by more than R1bn.

Embedded Value, Rm	F2018	F2017
Momentum Retail – covered	15 530	15 716
Metropolitan Retail – covered	6 175	6 007
Momentum Corporate – covered	6 774	6 409
International – covered	3 833	3 913
Shareholders – covered	428	2 020
Total covered EV	**32 740**	**34 065**
Momentum Retail – non-covered	963	2 107
Metropolitan Retail – non-covered	-	(78)
Momentum Corporate – non-covered	5 406	5 747
International – non-covered	750	60
Shareholders – non-covered	(258)	622
TOTAL GROUP EMBEDDED VALUE	**39 601**	**42 523**
Embedded value per share	R25.43	R26.51

Capital management

The capital adequacy ratio (CAR) cover for our primary life insurance business, MMI Group Limited (MMIGL), ended F2018 at 2.7 times the statutory minimum capital level (2.7 times in F2017). The actual required statutory capital was reasonably stable year-on-year. We will start to publish our capital position on the SAM basis from F2019 onwards. Internally we already manage the organisation based on SAM ratios in our capital planning. We are comfortable with our SAM capital position.

During F2018, Moody's Investor Services confirmed MMIGL's Insurer Financial Strength (IFS) international scale rating of Baa2 (national rating of Aaa.za) and Guardrisk's IFS rating of Baa3- (national scale rating of Aaa.za) with a stable outlook.

On 7 March 2018, MMI announced the Board-approved R2 000 million share buy-back programme as part of its interim results announcement for the 6 months ending 31 December 2017. On the same day, MMI commenced with the programme. Up to 30 June 2018, MMI repurchased 47 million shares at an average share price of R20.66 for a total cumulative consideration of R971 million (excluding trading costs). The repurchase programme has a positive impact on embedded value per share because we are acquiring the shares at below embedded value.

Changes in financial planning and analysis

Significant changes in leadership has a large effect on the way we operate as an organisation. Hillie Meyer's CEO report provides insight into our updated operational priorities, but it is also important for shareholders to know that from a financial decision-making perspective we are now placing greater focus on shorter-term profitability metrics, such as IFRS earnings, to compliment longer-term value metrics, such as EV. Note that we are not ignoring long-term value as measured by EV, but we are arguing that we need to correct the balance between short-term results and longer-term initiatives. The future outcome of this recalibration should be a lower percentage of earnings being invested in new initiatives compared to what is currently the case for the group. We believe that in the longer term the group should not be investing more than 10% of earnings from mature operations into New Initiatives.

In F2019 we will adopt normalised headline earnings as our primary earnings measure. This earnings number will fully account for changes to actuarial reserves, for the impact of investment markets, and will have a significantly more robust policy around treatment of non-recurring items. Importantly, the measure is more comparable to the earnings numbers published by our peers than our current core headline earnings measure.

Internally we have also started a process to report profitability at a more granular level. This enables us to have income statements for all our major product lines and distribution channels. The group balanced scorecard process has also been rolled out to a more granular level than before. Both these changes enable us to monitor and analyse value creation and performance in more detail, and more accurately, than in the past. This in turn has made it possible to roll out our new incentive methodology that differentiates more between business units based on delivery.

As a large organisation we are continuously dealing with capital allocation decisions. We have formalised various processes around capital allocation discipline and we have invited a wider range of senior executives to be involved in those decisions. Differentiated processes that can deal with the distinctions required to fund and monitor start-up ventures versus investments into mature well-established businesses have been designed. Post-investment monitoring to enable us to take corrective action faster has improved.

A decision has been taken to invest time and resources to improve our financial forecasting and modelling capabilities. This enables us to have a clearer understanding of how revenues and earnings should flow from different components of our organisation and helps us with multi-year expense planning and is the starting point towards real-time rolling forecasts to replace the cumbersome annual budgeting process. The improved revenue forecasting is also enabling the group to have more constructive expense efficiency discussions in various segment areas that are operating in low growth market segments.

Outlook

The operating environment in South Africa and in Southern Africa remains challenging. We continue to focus on maintaining tight control on costs and on new investments while ensuring that our clients see continuous improvement in their client experience and that we are delivering benefits as promised at the point of sale. We will emerge as a leaner and more client-orientated business as the economy eventually starts to recover. We have installed an increasing respect for shareholder capital across the group, and we believe that over the next three years, even in a modest economic environment, we can grow normalised headline earnings to at least R3.6bn, but with a more ambitious target of R4.0bn, by F2021.

RISTO KETOLA
Group Finance Director