Friends Provident plc 2007 Interim Results Presentation, 8 August 2007

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Sir Adrian Montague

Slide 4 - Agenda
Good morning everybody. So good morning ladies and gentlemen and welcome to this presentation of Friends Provident's 2007 interim results. Our agenda today has a familiar running order, but we've adjusted the content of each section to recognize that you are as interested in our proposed merger with Resolution as in our half year results.

After this brief introduction I'll hand over to Philip who will remind us of the advances that the Friends Provident Group has made so far this year. They are significant and deserve not to be overshadowed by the excitement surrounding the merger.

Jim will then lead us through our half year trading and financial results in some detail before we hand back to Philip to comment on the outlook for Friends Provident as we stand today; a successful company with excellent prospects for profitable growth. This is a strong and exciting position for the Group to be in and it's right that we spend a few minutes to consider the real standalone position, rather than simply allowing the headlines to dominate our discussion.

Philip will then conclude the formal part of the meeting by coming back to the proposed merger and why we believe that this is the right move to make, the right deal to do. Right for the future of the Group, right for customers of both companies and right for the shareholders.

The merger has attracted a lot of comment, but I'm struck by how the strategic case is taken as read for both companies, each benefiting from the other and in so doing, creating a new and powerful force in the industry.

No doubt you'll have a few questions and we will answer them as fully as we can. To help us do that, we're also going to be joined today by Ben Gunn, Chief Executive of Friends Provident Life & Pensions, and by Alain Grisay, Chief Executive of F&C Asset Management. And of course, we'll take your questions at the end of the formal proceedings.

So now I'll hand over to Philip.

Philip Moore

Slide 6 – Group highlights
Thank you, Adrian and good morning everybody. As you can see, we've had a very active first half, characterized by further growth and diversification. Our underlying profits from an embedded value basis are up 7%. We've had good new business results in Life & Pensions driven by Group pensions in the UK and in International against some pretty tough comparatives. We've gained new licenses in Singapore and the United Arab Emirates. We've made good progress in our activities in Germany for FPI and Switzerland for Lombard. And we are satisfied with F&C's progress on its three year plan.

Investment performance is improving, we continue to strengthen the team and we successfully launched a number of new innovative products. We acquired Sesame and Pantheon Financial giving us further insight into the high net worth and investment segments. We continue to actively manage risk by, for example, the transfer of longevity exposure to Swiss Re. And, of course, we have the exciting prospect of the merger.

Jim?

Jim Smart

Slide 8 – Group financial highlights
Thanks, Philip. Good morning everyone. Looking through the Group financial highlights, Life & Pension' sales were up 13% at GBP3,428 million. Contribution from new business increased 7% with progress in the UK offset by a slight decline in our International business. Life & Pensions underlying profit was up 18%, benefiting from positive experience variances. Asset management profit was down 37% as a result of the investment in the growth plan. In total, therefore, Group underlying profit was up 7% to GBP264 million.

On the IFRS basis, Group underlying profit was down 8% at GBP111 million. An increase in Life & Pensions' profit was offset by a reduction in Asset Management profit. Group profit before tax increased reflecting that in 2006 there was a charge for impairment of intangible assets. This did not recur in 2007. Basic earnings per share were 2.2p and dividend per share was 2.7p, a increase of 2% in line with our standalone dividend policy.

Slide 9 – UK Life & Pensions new business
In the UK sales were up 12%. Protection sales were up 2% maintaining share in a subdued market. Investment sales were down 26% owing to an extremely competitive market. Pensions and annuity sales however showed good growth across the portfolio.

Contribution from new business was GBP62 million, helped by unusually high rebates from the Department of Works & Pensions. Contribution from Protection was down owing to margin being lower than that achieved in the first half of 2006. But at this level, it shows an increase on the margin achieved in half two of 2006. Savings contribution was also down, margins having declined as a result of the competitive market conditions and of more onerous persistency assumptions which reflect recent lapse experience. In total though UK VNB margin increased to 2.7% benefiting from sales growing faster than costs. The internal rate of return in the UK increased to 11.9% and discounted payback improved to 11 years.

Slide 10 – The economics of group pensions in the UK
Now there's been some interest in the economics of our Group pensions product, so I thought it may be helpful to explain why we believe it is right to compete in this market. We now have 618,000 scheme members on our platform. As we get more scheme members onto the platform, and as our efficiency improves as a result, we now have GBP28 million of assets under management for each of our customer service employees. We now have in total GBP6.7 billion under management, which is an increase of 56% in the year.

But at this stage of the development of the business, the income generated from these assets does not yet cover new business cost and the net cash outflow for this business in the first half was GBP40 million. The internal rate of return earned on the new business was 9.4% and this IRR excludes the benefit of future annuity business, or the profit made by F&C on the funds under management.

Our calculation is that, in the medium to long term, there are very substantial assets to be managed by insurers and that our efficient systems and expertise mean that we should be ideally placed to gain a major and profitable market position.

We also believe that the economics of the business will continue to improve. New business strain should ease over time as the proportion of incremental business and the proportion of nil commission new business rise. At the same time, the number of scheme members will continue to grow and as schemes mature and as investment returns are earned, the average amount of savings per member will increase. In this way, income from the portfolio will grow rapidly. Our best estimate is that the business will be cash neutral by around 2011 and cash positive beyond that. At the same time, we believe that the IRR and payback will continue to improve.

Slide 11 – International Life & Pensions new business
Turning now to our International business. Sales here were up 16%. The mix of products and of territories in which sales were made, reduced margin. As we indicated at the time of our preliminary results, we expect Lombard to have a quieter year after the 21% growth in contribution seen in 2006. The International businesses though continue to be very profitable with internal rate of return at 23.1% and discounted payback of four years.

Slide 12 – Asset Management
In asset management net revenues fell reflecting loss of funds from balanced mandates. Revenue margin however increased owing to the success in attracting retail funds. Operating expenses increased to GBP84 million to fund the people and infrastructure which are required to set up the multi-boutique model and to launch the associated products. Underlying profit fell to GBP32 million and underlying EPS fell to 4.2p. In the first half funds under management fell to GBP101 billion, but within that fund losses were in line with the anticipated balanced mandate losses which we indicated at the time of the preliminary results.

Slide 13 – EEV result
Turning to the embedded value result. Profit before tax is GBP363 million, up from GBP60 million in 2006. Contribution from new business was up 7% to GBP95 million. Contribution from in-force business was higher, owing to GBP20 million of positive experience variances. GBP12 million of this results from the reinsurance of GBP1.7 billion worth of annuity liabilities. The remainder largely results from improved modeling of risks in the with profit book.

In total, the embedded value profit has been charged with GBP7 million for persistency experience. This results largely from legacy products, particularly with profit bonds and old style Group pension schemes. We are however seeing increased lapses in our investment portfolio bond product as customers withdraw savings or are advised to move to new products. This is an emerging trend and it's not yet possible to be precise about the size of the operating assumption change which we may have to make at year end. However as an indication of scale, if experience remains at current levels we would anticipate taking a total charge of around GBP70 million, which is in line with that recognized last year.

The main driver of growth in profit before tax are investment return variances and economic basis changes which reflect movements in interest rates and in equity markets. Other non-underlying charges are lower this year. 2006 included a charge for impairment of intangible assets; this has not been repeated in 2007.

Slide 14 – IFRS result
On an IFRS basis, profit before tax is up 125% to GBP102 million. New business strain was lower than in 2006 owing to product mix and to the impact of reserving basis changes made in the second half of last year. In-force surplus was reduced by the reserving basis changes and also benefited by GBP11 million from the reinsurance of annuity liabilities. The other lines in the IFRS income statement are affected by the same factors as affected their equivalent in the EEV income statement.

Slide 15 – Dividend and balance sheet
Turning to dividend and balance sheet. Underlying earnings per share were up 21% at 4.6p implying a dividend cover of 1.1 times. Pro forma EEV increased 4% to GBP3,808 million. We will implement the change to UK tax rates in the second half, but we estimate this will increase the EEV by around GBP34 million. The balance sheet remains strong with gearing at 29.4% and maintaining our A minus credit rating.

The Group's capital position also remains strong. Excess capital resources are GBP1 billion on a regulatory basis. Longevity risk has been managed down by reinsuring a proportion of the portfolio.

Slide 16 – Shareholder cash generation and financing
In the first half of 2007, the Group generated GBP175 million of cash before financing items. New business strain has fallen by GBP49 million largely owing to the reserving bases changes for morbidity and PS06/14 implemented last year.

International and F&C both contributed small cash inflows. And investment returns were more positive than in 2006. In addition, GBP56 million in reserves were released as a result of the annuity reinsurance contract. The cash generated before financing items was deployed GBP110 million to pay the final dividend declared last year, and GBP38 million to repay securitizations. In addition a net GBP48 million was used to purchase our IFA businesses.

Slide 17 – Funding our growth plans
Our funding position has been the subject of some interest, so I thought it might be useful to explain to you how we can fund our organic new business growth plans without recourse to the equity market. As I said, at the time of our preliminary results, the Group's cash position is under strain caused by our new business growth in the UK. You will recall that this caused a GBP62 million outflow in the UK in 2006. I said then that the cash position was under control and could be funded in the short term with one-off reserve releases and by increasing debt, hence gearing up the balance sheet within our current A-minus credit rating.

I also said that in the medium term, it would be necessary to close this gap and to open up a positive gap. Now in the first half of the year, it looks like the cash gap has closed. However, there are a number of factors obscuring the underlying position. In addition, the completion of the PS06/14 reserving basis changes in the second half will deliver around GBP150 million of surplus release but in turn it will reduce both the underlying new business strain and in-force surplus. Therefore, after PS06/14 the 2007 underlying cash flow in the UK for the year is around an GBP80 million outflow.

Going forward, the amount of new business strain depends on market rates of commission and on our growth rates. In the short term we need to invest sufficient to maintain our growth. We will manage this from period-to-period, but our expectation is that this cost will fall in the medium term.

As management charges from funds under management grow, we expect the in-force surplus to increase by GBP20 million to GBP30 million per annum. We thus expect the UK cash gap to close in the next three to four years.

At Group level there is clearly an aggregate cash shortfall until the operating cash flow is sufficient to fund not only the Group's new business growth but also its dividend. We believe that this cash gap is likely to be up to GBP400 million.

As you have seen from our balance sheet, we have adequate surplus capital to fund this, but we want to keep a reasonable buffer for risks and uncertainties, and to have the ability to capture profitable growth opportunities as and when they emerge. Our standalone plan was therefore to raise lower Tier 2 debt of up to GBP500 million. We believe this can be accommodated within the debt capacity consistent with our credit rating. But in light of our proposed merger with Resolution this funding will no longer be required.

Slide 18 - Conclusion
In conclusion, we are making steady progress in Life & Pensions' sales. Returns in the UK business continue to improve, the International businesses which leverage off the UK products, systems and reputation remain very profitable. Asset management has recorded an inflow of GBP3.3 billion in new retail and institutional business and revenue margins have improved as a result.

The Group's capital position remains strong. Longevity risk has been managed down by reinsuring a proportion of the portfolio. The Group's cash position remains under control. We continue to manage it from period-to-period depending on the number and profitability of the opportunities available. There is however adequate debt capacity to fund the cost of our organic growth plans which should deliver profitable market positions both in the UK and internationally.

I will now hand back to Philip.

Philip Moore

Slide 19
Thank you Jim. I intend to cover the outlook in two parts. The first, on a standalone basis and then by adding the additional significant benefits, arising from the merger.

Slide 20 – UK Life & Pensions - Outlook
So let's start by looking at the UK Life & Pensions' outlook. In Protection we have a strong position due to our efficient systems and excellent service, and an 8% market share. But due to the good margins that can be made in Protection, we expect competition to remain intense especially in a flat market. However we do expect to increase our market share in 2007.

Our performance in the investment segment has been poor, due to being behind the market in product development and because of increasing lapses. So we will use the balance of 2007 to completely revamp our investment product range and expect to see progress in 2008.

And we are confident that our relatively low cost Wrap development will allow us to build a strong position in this segment over the medium term.

The Group pension story is unchanged. We expect significant growth in this market because of the move from defined benefit, i.e. final salary schemes into defined contribution, i.e. money purchase schemes and from the move from trust based schemes into contract based schemes. And we are one of the few providers who can efficiently and profitably administer this business. The outlook is indeed bright.

In annuities we have maintained our pricing approach to reflect the risk inherent in this type of business and we continue to achieve a good margin. And we expect continued moderate growth as maturities from our in-force pensions book, that then has to tip into an annuity, increase.

In conclusion, we see lots of opportunity in the UK Life & Pensions' market. Although the effect of a competitive protection market and our performance in the investment segment will lengthen the time taken to reach our ambitious 2008 value of new business target.

Slide 21 – International Life & Pensions - Outlook
Our strategy for International remains unchanged and the outlook is good. FPI continues to widen its distribution reach and we are hopeful for the prospects emanating from the new licenses in Singapore and the United Arab Emirates. And we are excited by the potential in Germany during the traditional quarter four pensions bulge. In contrast, Lombard is deepening its relationships with existing distribution partners and developing its Swiss branch, where the potential for Lombard's skills and capabilities remains huge.

As we have said before, we expect our International businesses to enjoy double-digit value of new business growth over the medium term but as we noted, in 2007 we expect it below that trend line as 2006 was above it.

Slide 22 – Asset Management - Outlook
F&C has made satisfactory progress in its three year growth plan. It remains focused on investment performance building on the sharp improvements announced in March. And the recruitment and product launch you've seen in the first half will continue into the second. But in addition the focus will move to distribution as fund inflows have clearly started to accelerate. The target of increasing the underlying earnings per share in 2009 to 50% above the earnings per share in 2007, remains.

Slide 23 – Summary – A strong forward-looking standalone business
In summary, we have three great businesses all at different stages of their development but all with strong prospects and a determination to build on success. And we see good opportunities for all three. Since last year, we're a larger group, with more operations in more territories. Next year, even without the merger, we'll be larger still and will have advanced further afield.

So Friends Provident is a strong and progressive standalone business, differentiated by service and its technology. But the merger will enhance those prospects significantly.

Slide 24
Why do I say that? The merger takes the Friends Provident growth engine and adds to it. It adds some significantly underserved distribution channels and customer bases in Resolution. It adds another powerful protection brand in Scottish Provident. It adds an asset manager with over GBP60 billion of assets and it adds substantial cash flows, which will produce a combined business expected to have ongoing operating cash surpluses after funding additional growth. And for Friends Provident shareholders an enhanced dividend. In short, it is a value creating merger bringing together the combination of growth and cash.

Slide 25 – How the value builds
So how might you look at that value enhancement? How does it build? Well the base line remains the significant embedded value of the combined businesses. These produce strong cash flows which will allow both the dividend uplift I talked about and the potential for future buybacks.

Slide 26
Add to this the potential for additional new business coming from 700 Abbey Bank branches which have considerably lower branch productivity than leading bancassurers. And by adding a tripling of the amount of vesting pensions that can be converted into annuities and the cost selling potential of GBP7 million largely unintermediated customers.

Slide 27
Then add the value of the approximately GBP100 million per annum expected cost and financial synergies.

Slide 28
Plus the enhancement to F&C's strategy coming from additional scale and some more boutiques coming from Resolution asset management. And a business that in 2006 had about GBP1 billion of gross retail inflows and made GBP32 million of pretax profit.

Slide 29
And finally, you might then add the optionality value of, first our ability to pursue other growth opportunities in Life & Pensions and in asset management. Second, from applying Friends Provident's well-known risk and capital management skills to the Resolution funds. And thirdly, by producing a player that is powerful enough to play in the next phase of the consolidation of the UK Life & Pensions' market, be it from acquisition or disposal of books.

All of which gives you, in our view, significant value enhancement for Resolution and Friends Provident shareholders.

Slide 30
So to conclude, Friends Financial has all of Friends Provident's strengths and access to 700 seriously underserved Abbey Bank branches, a big increase in the flow of vesting pensions, a further 7 million customers to serve, the Scottish Provident brand, a source of cash enabling us to fund further growth that meets our financial disciplines. An extensive back book to benefit from Friends Provident's capital and risk management expertise, more than GBP60 billion of funds under management and finally, an increased progressive dividend and the potential for buybacks.

In short, the merger delivers significant financial and operational muscle to enhance our growth prospects.

Thank you very much and we're very happy to take your questions.