Sainsbury's Bank

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Debt Investor Call Transcript

Kevin O'Byrne
Group Chief Financial Officer
Good afternoon everyone. My name is Kevin O'Byrne, I am the Chief Financial Officer for Sainsbury's plc. You are very welcome on the call today. I am joined on the call today by Peter Griffiths, CEO of Sainsbury's Bank who will lead the call, David Samper, Interim CFO of Sainsbury's Bank and Richard Harding, Group Treasurer for Sainsbury's.

The website, the Presentation and slides we will use today are on the website and on the webcast but I will use the slide numbers just if you are not on the webcast so you can follow it on the website.

The purpose of today's call is to update investors on the Bank performance for 2017/18 and the strategic progress that we are making. If I just move you onto slide 3, Sainsbury's Group laid out a clear strategy in 2014 which identified the Bank as one of our four key priorities for the coming years. And on slide 4, you can see the benefits we see as having the Bank as part of the Group. In a challenging and dynamic retail environment the Bank helps us attract and retain loyal Sainsbury's and Argos shoppers to the Group. It provides products to help our customers live well for less, and the Bank generates sales and profits for the Group also.

Before handing over to Peter to talk in more detail about the Bank, I thought I would just say a few words on slide 5 about the performance of the Group in the 12 months to March and you will see here the heading says, unaudited results for the year 2017/18. As you will probably be aware, we issued unaudited results on Monday as we pulled forward the announcement about the potential Asda combination. These numbers were actually issued again this morning as audited just for practical reasons because we had to pull forward the announcement due to a leak. We didn't have the audit process finished. But they were finished and issued as planned this morning.

In the year, underlying profit before tax was £589 million, a return to growth and that was ahead of market expectations which was, the consensus was £572 million. And we were particularly pleased in the second half, we saw strong growth of 11 per cent with improved food margin trends. We delivered our cost savings and Argos acquisition synergies ahead of plan. Sainsbury's Bank, as Peter will come on and talk about delivered profits up 11 per cent year on year and there was strong cash generation across the business with free cash flow of £432 million, up 35 per cent to £113 million year on year. That allowed us to reduce our lease adjusted net debt, and our lease adjusted net debt to EBITDAR ratio went down from 3.7 to 3.2. And we also confirmed at our announcement on Monday that we were comfortable with the full year 2018 consensus for underlying profit before tax of £629 million. So a good year results from a profit point of view, ahead of expectations and from a cash point of view, ahead of expectations with net debt reducing where the market had expected net debt to remain flat.

So I would not like to hand you over to Peter, thank you.

Peter Griffiths
Bank Chief Executive Officer
Hi, afternoon all. Just at the headline level we will turn some of the pages. I think the key point for me is the strategy that we talked about on the road remains unchanged. We will continue very much with the plans to change the shape of the asset portfolio through the growth of our mortgage business which has started quite well and we will touch upon that later. Continue to drive commission lines and also an efficiency programme to change the cost profile whilst looking to maximise the potential of the Argos financial services business which we have been investing quite heavily in. And also touching upon how we might play the potential advantages we see following the recent acquisition of the Nectar business which adds another significant piece to the Bank and the Group jigsaw.

So I think at the headline level, I think it is decent progress over the last 12 months and pretty much delivered everything to plan. The new Bank programme which we will touch upon on the cards delivery and migration later this year is broadly on track. David will give a forward view but fair to say, at the outset we expect profits to decline in the near term as we take on the capital and IFRS 9 costs and start to amortise the new Banking platform cognisant of the fact that having made the investment, the Bank remains subscale. But in the medium term I think we have still got significant confidence in our ability to generate growth and healthy returns for the Bank and the Group and define the customer proposition for the Sainsbury's shopper which is always been our underlying strategy.

So if we turn you to page 7, I think this is pretty consistent with everything we have talked about before. If we look at fee income, we do have a very strong mix of capital light commission income streams, we have had a very strong performance particularly from our travel money business this year. Our insurance businesses which we put onto our new broker model has shown a much significant uptick, albeit slightly later than we'd expected because the project took a little bit longer to implement but all in all we are now looking at retention coming through some of those initial deals and the numbers this year are looking relatively strong which is good.

In terms of efficiency, we now have a very modern core banking platform and we will be looking at how we use that platform to build scale and improve operational efficiency. We have guided previously to bringing the cost to income ratio down somewhere towards near 50/55 over time subject to credit conditions on the portfolio that we seek to build. And at the same time we are now looking at how we accelerate the next part of our technology journey which is through data, which is through digital and which is through payment. And we are doing that, taking a Group lens on some of those as well as a Bank lens.

Customer numbers, quite a good successful year in terms of growth of some of our businesses which David will touch upon later. As I said earlier we still haven't really started to drive the potential out of the Argos Financial Services business while we build the capability, reshape the systems and get a lot of backend operational improvements before we believe the customer proposition is one we want to push too hard, but clearly significant upside and the higher Argos Financial Services penetration is there to support sales of Argos product as we have previously talked about.

The design mix for the end state portfolio over time will be broadly 60 per cent secured lending. We need to move that up from our recent foray into the markets, so very much a low single digit right now. And then clearly as we again talked about on the road last time is to make sure that we manage earnings volatility through the cycle. So you will see that we have started to re-risk the balance sheet as we now have the potential to offer secured and a wider range of unsecured product.

If I just move you onto page 8 in terms of where we are in terms of investing and delivering on our infrastructure. We committed to delivering the new cards platform in the summer of 2018 that is very much on track and on time. It is a pretty complex programme, but I will remind everybody that we have already delivered savings platforms, savings migration, online capability, ATM capability and migration and our new loans platform and all of those are working and working well. So what we have seen over time is that the investment in the systems has been a bit more complex and expensive than anticipated, but those systems have landed well and very much performing according to plan and giving the scale of all platforms that we need to build the future out on.

So if I take you onto page 9, as I touched upon, mortgages which are a key part of our strategy going forward. We have launched, we have broadly about £300 million now as we speak. We have taken a fairly steady path in terms of how we have turned that proposition on. It is a broker led proposition, intermediary led. Average loan size of £230,000 is slightly higher than we had anticipated. Average LTV at 55 per cent is slightly better than we had anticipated, but we started the proposition in the South-East so by definition as we turn on more brokers we will see the numbers coming probably more in line with what our original business plan anticipated. So plenty of opportunity to build that and we would probably look to put about a billion pound plus of volume on in the next 12 months.

Savings account in terms of our ability to fund the balance sheet since we returned our new FIS savings platform on, that has allowed us to change the shape of the product mix. So taking very much what on large part we talked about before, we have a lot of notice accounts, but if you look at stickability of those and you look at the FSCS compensation scheme, we found that those balances are very resilient and act more like term deposits albeit they are in effect notice accounts. But now we have a much wider savings portfolio which is what we always sought to do. And that has gone very, very well and so we are very comfortable with our ability to fund.

Our unsecured lending, we continue to drive a very high price point on our loans business and that is because it is self select in terms of quality. So we are 11 per cent growth in new accounts in a very competitive market and we have seen margin compression which David will talk about. But ultimately we are prepared to trade margin compression for high quality portfolio and that is what we are seeing. As I said the new loans platform has successfully launched and we have seen the Argos storecard credit attachment move up, that is the number of people that take a facility for their purchases to broadly settling that down now to about 20 per cent where originally when we took that business on it was just over 16 per cent. But with significant upside to change the shape of that should we choose to do so.

And then as we touched upon, travel money continues to go from strength to strength, transactions up 26 per cent. Our APM estate group by over 5 per cent. I think there is going to be some downward pressure on ATM income as the decline of cash may start to accelerate. And against that we have tried to build a hedge by reshaping our insurance portfolio and we have seen good successes as indicated up 42 per cent and 39 per cent following the move to a panel provider. So we know that we have got quite a significant opportunity to drive commission income particularly using Nectar data.

So if I take you to slide 10, why is the Nectar opportunity important for the Bank? It is important at many levels. So we have acquired all of the Nectar businesses within the Group. And now we have a full independent operation of the loyalty programme. Our whole model is built on a Sainsbury's Bank for a Sainsbury's shopper and Group benefits as well as Bank benefits and supports our strategy of knowing our customers better than anybody else. The key points we have learnt from Nectar over the years is that we do believe it is 30 per cent cheaper to acquire new bank customers. 75 per cent of bank customers have a Nectar relationship and 80 per cent of our insurance customers are linked to a Nectar card.

And what we know from a credit quality perspective is that if you are a Nectar card holder you are significantly more, or less likely to default. So we believe as we built out our understanding with Nectar now that Nectar is within our ownership that that gives us a very sound footing to build a broader customer proposition.

Moving onto page 11, in terms of Argos Financial Services. I think I have said before, we had quite a level of investment to make in what we felt was an underinvested business. We have been doing that very aggressively over the course of the last 6 to 9 months. We know that we can drive higher ticket sales through the provision of credit products to Argos shoppers so we do this very much as a Group opportunity rather than a Bank Argos Financial Services opportunity. We know that we have a very stable base of loyal customers there and we know that we can re-shape the product portfolio and the customer proposition once we have completed our investment in the totality of the infrastructure, and again that has been quite a complex programme of work as we build the capabilities to allow us to have the footing on which to build the business. So I am comfortable with the numbers displayed in terms of the 2017/18 performance, but I think it tends to only scratch the surface of what we could achieve here and I like the iPhones sales, that one in three sold within Argos was bought on an Argos card. So what we are seeing I think as we build our Argos strategy out is the relationship between technology and credit so people procuring finance through mobile as an example as well as through face to face in the stores.

So those are the broad headlines from me. I will pass over to David to take you through from slide 13 on.

David Samper
Bank Interim CFO
Thank you Peter, I will take you through some of the highlights for the financials for the year to February 2018. In terms of key metrics these have improved year on year with income up 30 per cent to £451 million, underlying profit up 11 per cent to £69 million. Both metrics reflect full year inclusion including Argos Financial Services (AFS). As we push on with our successful product strategies, we continue to grow our customer base with Bank up 8 per cent and Argos Financial Services up 6 per cent. Our net interest margin excluding AFS we are slightly down in part due to the Bank of England Term Funding Scheme (TFS) which has sharpened headline pricing in this competitive market.

I will cover bad debts in the next slide, however excluding AFS there is a modest increase which is in line with expectations. On capital side, the Bank continues to be well capitalised with Tier 1 at 14.1 per cent and total capital up to 17.1 per cent.

If you turn over to slide 14, specifically on bad debt. As highlighted previously our lending continues to be concentrated in lower risk and family segments ensuring that our arrears performance is consistently better than industry benchmarks. Again as shared, pre-launches here too, the Bank has consistently managed the lending portfolio where on average the net interest margin above bad debt asset ratio by a multiple of 3-4 times. As you know we are now in the mortgage market and all signs are positive. If this business goes to scale, portfolio losses will continue to be less volatile as the proportion of mortgages increases.

Turning to slide 15. On the balance sheet you can see we remain heavily focused on unsecured lending with approximately one third to two third split on credit cards to loans. Store cards continue to perform well with 10 per cent growth year on year. As mentioned previously mortgages are progressing to plan in excess of £300 million written at February 2018. As lending continues to grow our funding naturally increases and applying liquidity rules we have an excess of £1 billion of cash on balance sheet at February 2018. On retail deposits, we are up by 21 per cent to £5 billion with final equalisation of the term funding scheme increasing the point in time retail wholesale mix. Finally drawings on the TFS were £950 million.

Taking you to slide 16, as Kevin and Peter both highlighted earlier, we remain confident with the Bank's current strategy and as such growth opportunity and healthy returns in the medium term. Looking over a 12 month horizon we expect underlying profits to fall to £30 million, primarily driven by a few items. Covering competitive conditions TFS funding as I touched on earlier impact on margins as well as slightly higher provisions in terms of asset growth. Partly offsetting this, the business is forecasting a strong trading year with mortgages continuing their journey to scale and insurance and travel money commission business going from strength to strength. As Peter previously touched, connecting to the new Bank programme operational costs will grow as we finalise the move to our new banking platforms and as such begin to amortise the previously capitalised costs. With capital commitments of £110 million from the parent in 18/19 and an average £100 million a year thereafter we are continually reviewing will continue we are reviewing our lending mix to ensure the highest medium to long-term overall return on capital.

In 18/19 this results in us stepping back a little on unsecured lending with selective growth and higher quality segments and a natural bias in favour of mortgages as we continue to push the business to optimal scale. As you have seen in the chart at the bottom this takes underlying profit from £69 million to £48 million on a like-for-like view. When we include the known Tier 2 costs and acknowledge the accelerated recognition types here of IFRS 9 compared to IS 39, the asset growth in 18/19 is expected to negatively impact the P&L through IFRS 9 costs. All in this takes profits from £69 to 30 million by February 2019.

With the 12 month profit trajectory as outlined we will build from this space, which Peter I'll hand back to you in terms of covering the final slide.

Peter Griffiths
Bank Chief Executive Officer
Yeah sure, so I am in danger of repeating myself but I will so apologies in advance. I think the strategy is unchanged, the bank is a key pillar of the Group strategy as Kevin articulated, we continue to reduce the balance sheet risk and we will build scale and the mortgage business has kicked off well. We will continue to be very selective in the unsecured to retain a high quality portfolio. We will keep a very strong focus on our commission businesses where we see upside. We see further upside in Argos Financial Services both across the Bank and the Group. And we are very close now to concluding and touching everything that's wooden, the new Bank Programme as we conclude our cards programme later this year and I touched upon that on track. And we are now commencing an efficiency programme to further improve overall financial returns.

So that is the end of the Presentation. So we are now open for questions I believe.

Question and Answer Session

<u>Question 1</u>

David Covey, M&G Investments
Hi thanks guys. I had a question on, you talk about the margins and impairment impact in the 18/19 guidance. Specifically I think TFS is wrapped in there as well as what you call slightly higher provisions. Can you give me a bit more information as to what the relevant impact of each of those are?

Answer: David Samper
So not in absolute terms, but the TFS is as I said, is changing the margins and in the market we are seeing increased competition which maintains the pricing at an exceptionally low rate. And on the margins the question in terms of the up-tick in the margins there is a 10-15 basis point move on the margin in terms of the unsecured going through.

Further question
And provisions, is that something you can share? What do you mean by slightly higher provisions?

Answer: David Samper
Slightly higher provisions in terms of impairment to the P&L rather than provisions on balance sheet.

Further question
Yeah the quantitatively though, like slightly higher than 10 basis points or 50 basis points?

Answer: David Samper
I am not able to disclose that at this time.

David Covey
Okay, had to ask!

Closing Remarks
Kevin O'Byrne
It doesn't look like we have got any more questions so I was going to suggest we wrap up there. Thank you very much for taking the time to join Peter, David, Richard and I on the call today. If you have any other questions, feel free to contact us directly following the call and we would be very happy to help with any questions you have.

Thank you very much and good afternoon.

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