Absa Group pre-close call transcript

13 December 2023

Arrie Rautenbach

Morning everybody. I think we can start this call. Let me start by thanking everybody for joining us as we cover our 2023 trading update. I'm joined by Chris Snyman, who stepped in as the Interim FD. Chris has been with the organization for 15 years, and then we've also got Alan on Teams.

I'm going to start by just reflecting on the macro environment, the operating environment and I think it's safe to say, that it remains a very tough, very challenging macro environment.

If I focus on South Africa in particular, which is our biggest market, we have to say that the macros have stayed very tough, specifically also into the second half of this year, particularly as a consequence of the rapidly rising interest rates and the fact that it stayed high, which continuously impacts our SA consumer franchise amidst continued low confidence as well as low growth. And we've seen a particularly disappointing 3Q GDP print.

It’s safe to say that we continue to see better growth potential in ARO, but our sovereign risk in key markets stays a key focus for us. I have to call out at this point Ghana that is dealing with very high inflation.

If I just for a second reflect internally where we are as a group, I have to start off by just saying that every division is very focused on the execution of their strategies and continue to show good momentum against that execution. At a group level, we've got key specific focus areas and in particular, key organisational health metrics that we are tracking.

I'm very happy to say that if we look at our organisation, our colleague engagement scores and participation with the recent survey that we've done, we're seeing the highest engagement scores across the organisation in recent history and in particular, very strong engagement across our most senior colleagues, higher than the average across the full organisation.

Secondly, we've had a strong emphasis on our customer experience and we're seeing very good

customer experience outcomes across all the segments. And lastly, we measure active customer numbers in SA and ARO and we are seeing very good growth on customer active customer numbers going into the second half as well. This gives us particular confidence as we look at our performance expectations, in our medium-term plan.

In SA, what is very clear is that our consumers remain under pressure, as significantly higher interest rates have increased credit impairments while we've also seen a slowdown in customer activity.

A big focus area for us has been on managing credit risk in two very specific areas. Firstly, as we look at our collection strategies and our focus here is very much working with our customers to help them through this rapidly increasing interest rate cycle.

And secondly as we think about acquisition, with our maintained focus on growth in specific segments within the risk appetite adjustments that we've made. We have seen early delinquencies improve during the second half, although the flow through into late arrears and NPLs caused our impairments to be more sticky than our expectations.

Particularly pleasing is to see the benefit of diversification with strong revenue and earnings growth from both ARO as well as CIB.

Before I just reflect on our key focus areas going forward, we have to say that we have strong performance momentum across the medium-term and as we look at 2024 and beyond, a couple of key focus areas that I want to highlight before I hand over to Chris to go into some more detail on the trading update.

Firstly, we maintain a very strong focus on growth, particularly outside SA, but still with a very keen focus on key segments in SA. Secondly, it’s very important to say that all the pricing actions that we've taken in retail SA is now behind us, and is in the base, and this should assist our non-interest revenue momentum as we go into 2024.

Strong focus on risk quality and continued improvement in delinquencies as we go into 2024, aided by a stable or lower rate outlook. Very strong focus on our organisational efficiencies and productivity and

lastly continued momentum in our organisational health metrics, some of the areas that I've highlighted before, which gives us confidence in our medium-term plan that we took to our board recently.

At this point, I'm going to ask Chris to go into a bit more detail and then we'll open up for questions at the end of these comments.

Chris, over to you.

Chris Snyman
Thanks Arrie and good morning everyone.

Firstly, I want to talk about our full year guidance. There are mainly two drivers behind the slightly softer guidance that we provided and I will unpack both. The first being the SA consumer pressure that Arrie spoke about and secondly the impact of applying hyperinflationary accounting in Ghana.

So firstly, if I talk about the SA consumer position, the pressure is evident in a slightly weaker revenue position and we're seeing that on net interest income from slower loan origination and from lower transactional volumes, as well as on credit impairments.

On our credit impairments, it's only our SA secured portfolios that are worse than we expected with the other books broadly in line, including unsecured retail in South Africa. Consumer delinquencies started increasing in the third quarter of 2022 and rose as rates increased rapidly over the period. We expected delinquencies to improve in the second half of 2023. What we've seen is that early delinquencies have improved, although migration of the 2022 and first half of 2023 delinquencies into higher coverage buckets was a bit worse than expected.

Importantly though, all the consumer books improved noticeably from the elevated first half charge, and our group credit loss ratio is noticeably better than the elevated first half charge.

Moving on to the second aspect, on hyperinflationary accounting, it's now an industry-wide requirement to apply hyperinflationary accounting to entities in Ghana. This was only confirmed in October of this year.

The impact is material to our second half 2023 headline earnings position, given that Ghana is one of our largest subsidiaries outside of South Africa. We expect this impact to be a roughly 2% drag on our group headline earnings.

A couple of other key elements that I wanted to highlight.

Firstly, we flagged that our second half revenue growth would slow when we provided our outlook in March, with base effects a key driver including from the disposal of our asset management business, which is in revenue and pre-provision profit but a non-headline item. We also had a litigation recovery and an insurance payout from SASRIA due to the 2021 KwaZulu Natal unrest. Excluding these base effects, momentum was better, although it's still slightly lower than our first half growth.

We guided that our NII growth will be a lot stronger than our NIR growth in 2023 partly reflected by those base effects that mainly impacts on our NIR.

Moving on to cost growth, is broadly in line with our previous guidance and reflects Investments that we made in key areas which includes frontline staff, marketing and technology. We are looking strategically at our cost base opportunities as we move forward and, as we've discussed with you in the past, we see opportunities in our retail network, as well as in our corporate real estate.

Moving on to RoE, our RoE for the full year is somewhat below last year's 16.4%, but above our internal group cost of equity of 14.5%. Within that, the second half returns are lower and it's impacted by hyperinflationary accounting.

We've also had further debt restructures in Ghana during the period and as we flagged, our BEE deal is in from September of this year and is approximately a 1% drag on our 2023 earnings.

Also remember that our second half cost-to-income ratio is usually higher than our first half ratio, which means that our return on equity in the second half is typically worse than our first half.

We will provide 2024 guidance with our results when we publish the 2023 results on 11 March

next year, but maybe just in closing, I want to highlight that we remain committed to delivering an RoE which is sustainably above 17% and a cost-to-income ratio which is sustainably in the low 50s over the medium-term.

Improving our credit loss ratio is a key driver of improving our RoE in the near-term and the sensitivity there is that every 15 basis point reduction in our credit loss ratio equates to about a 1% RoE uplift.

With that, I'll hand back to Arrie.

Arrie Rautenbach
Chris thanks for taking us through that detail. I think those are our comments on our trading update. I'm very comfortable for us to spend some time just answering some questions. So if you just raise your hand if you have a question and I will cover that. I'll take a couple of questions at a time and then we will respond.

Q&A
Harry Botha – I'd just like to get a sense of some of the challenges you're facing in the secured lending markets, if you could possibly highlight where you've been growing ahead of peers, or where you faced collection challenges and the headwinds you've had in those products in South Africa. And then, if you could maybe speak to the likelihood of returning capital to shareholders via share buybacks, particularly with a share price below 1x price to book at the moment.

Charles Russell – Can you comment on the second half performance in rest of Africa, excluding the Ghana hyperinflation, which you've separated out? And then, also if you could just unpack your internal CoE calculation resulting in a CoE of 14.5%?

Ross Krige – For me, within non-interest revenue in the retail bank in SA, it sounds like that was a key driver of the lower-than-expected revenue growth. You've given us some indication on the weak consumer, but please unpack it more relative to peers. It was an area that wasn't necessarily called out, so it sounds like it's gotten worse over a three month period. So any more detail you can give there. And just to clarify, it sounds like you are expecting an improving run rate into 1H24? So if you can just correct me or confirm that.

Chris Snyman – Harry, on the secured portfolio, this is a portfolio we have grown steadily over the past couple of years. In Home Loans, we have seen a broadly stable market share over the medium-term. And we have seen that in VAF we have increased slightly. It's certainly a business we have tried to grow in order to build scale. As you look at the performance from a credit perspective, very much what we highlighted earlier. When rates increased in 2022, we saw early delinquencies come through strongly. The expectation was that as we moved into the second half of this year that the delinquencies would stabilise, and certainly on early delinquencies, we've seen that. But it's the flow into later buckets that has had an adverse impact on the charge. We are working with our customers here and we've got a couple of interventions that we've rolled out in order to help them through the period of stress. You'll know that with slightly longer duration assets, the impact on the repayment profile is higher than for shorter dated products. That is why we are seeing the pressure slightly more elevated.

Arrie Rautenbach – Chris, let me just jump in there on secured. Thanks for those comments. I met with both those business again yesterday. Importantly, the one business has grown slightly faster than the market, is the VAF business. That is off a very specific strategy that we put in place a number of years ago, which is the bank of dealer strategy. And as I said earlier in my opening comments, the effort is on collections strategies and making sure that we continue to optimise those collections strategies. The last rate hike in May only came through in the third quarter, as we saw the delinquencies flow through as a consequence of that last hike. But, we have seen since then the situation stabilizing very nicely for us, with a particularly strong performance as we closed out November, so it's very clear for us that those strategies are beginning to give us the benefit that we are looking for. And again, as you said earlier, as we go into the first half of next year, with a rate environment staying stable, we expect that momentum to continue. And, I think that's why we specifically lifted that out. Chris, happy for you to continue on the other ones.

Chris Snyman – Thanks Arrie. On buybacks, as Arrie has flagged, we remain very focused on growth and we certainly see capital being a strategic asset that will support that strategy. With capital above the top end of our board target range, we believe we have adequate capital to support our growth ambition. If we see that our growth opportunity does not materialise in the medium-term, for whatever reason, that will cause us to reflect on our distributions to shareholders, whether as higher dividends, special dividends or buybacks. We will continue to evaluate that position. But, you would have seen in our guidance that we spoke about a dividend payout of 52% for the full year.

Arrie Rautenbach – Chris, just some comments on ARO. Charles, the momentum on Absa Regional Operations is still very encouraging. I think you've asked us ex-Ghana, again we've seen very strong customer franchise expansion in that space. Every market is very focused on their key opportunities. We aren't seeing that momentum slow down as we close this year. In fact, we continue to flag that as the key area that will grow faster than SA. And you've obviously seen our announcement on the acquisition of part of HSBC in Mauritius, which gives you an indication on our focus outside of SA, although that's only a segment of next year's implementation outcome but you can get a sense of where we expect the growth to come from as we continue to flag.

Chris Snyman – On our CoE, we use a standard CAPM model to build our internal CoE. We use a 3-year average long bond as the risk-free rate to build that up. There's certainly an expectation with the long bond moving as it has recently that as we move forward, the CoE will increase. But due to the decisions – typically medium-term – we make on the back of the CoE, it's important that we use something more stable than you would use for valuation purposes. Certainly, the approach we use is similar to what the other banks in SA use. When we conclude on our CoE, we certainly look at it relative to other banks and we critically challenge it through our Treasury Committee to ensure it is balanced.

Arrie Rautenbach – Let me touch on retail consumers, it's very important that as we saw a slowdown in activity. If I think of the recent Black Friday outcome, that activity was flat on last year, rather than up on last year, which is again just an indication of where the SA consumer finds themselves. The important thing here, is the last of the pricing decisions that we took as we came into 2023, which is both in terms of making Rewards free, which is an important part of our consumer value proposition and some pricing adjustments for entry-level banking propositions to make sure those are aligned with the market. Again, those choices and those decisions are all behind us as we go into next year, and as a consequence of that we expect our NIR growth to show strong momentum as we go into next year. Plus, as I flagged earlier, we see very good customer acquisitions in SA retail base as well as ARO. That should give you a sense of our momentum expectations as we go into next year. So we certainly expect that to move in the right direction. And I think, strong confidence about that outcome.

Chris Snyman – And I think Ross had a question about improving run rates into the second half. I just want to clarify that question. Was that run rates into second half of 2023 or run rates into 2024?

Ross Krige – Thanks Chris, Arrie's already answered that. I was just trying to understand NIR within retail banking.

Keamogetse Konopi – Two questions from my side. So, on the credit loss ratio, which product segments came in line with the through-the-cycle range in 2H and which were above this range? And secondly, on costs, can you expand on Chris' comments for opportunities for better costs on retail network and corporate?

Ross Krige – When one of your peers provided an update a week ago, they commented on renewable energy deals being delayed and the impact there financially, what you seeing there on timing into next year? And then on the loan growth side, you've given us some colour. But again your guidance went from double digit in August to single digit for 2023 guidance now. How do you see 1Q and 2Q24 playing out with what you are seeing on the ground by segment?

Khumbelo Nevhorwa – You provided us limited commentary on CIB business. Ross alluded to the renewable energy deals. Can you tell us how that business is doing on the trading side and on renewables. And can you elaborate on origination into this year and how does 2024 look?

Chris Snyman – Where we stand relative to the through-the-cycle. It's fair to say that outside of SA consumers we are broadly in line with our through-the-cycle expectations. It's the SA consumer books we are still slightly above where we expect to be through-the-cycle, but closer now in the second half on the back of improvements that we've seen there.

The question on cost opportunities, where we see that. Firstly, just to remind you that we ran a big efficiency programme since 2018 and we were very successful in that. But certainly coming out of Covid we are seeing new opportunities emerge on the back of big investments in technology that we have made and changing consumer behaviour. If you look at branches, we've seen rapid declines and cash volumes reducing rapidly, and therefore the type of infrastructure must be revisited. There's also new technologies that are emerging, things like AI, it's certainly a big theme that will drive the productivity agenda as we move this forward. And certainly, the mindset that we taking into the next

cycle rather than being a cost focus, it's a productivity focus. We talk about growth with productivity, not to take away from growth, which is a key focus area.

I wouldn't want to talk too much about growth into 2024 for the moment. The environment is still relatively uncertain. The internal expectation is we still have good opportunity for growth across the segments we operate in, both in SA and ARO. But you see in some consumer segments, as an example, that volumes are down. If you look at home loans, production this year at an industry level is 20-30% lower than last year. It's certainly an opportunity to originate good quality growth at this point in the cycle.

Arrie Rautenbach – The key point to make there Chris is that as I mentioned earlier, I met with those businesses yesterday. Our medium-term posture is to grow revenue slightly stronger than the market. But our big secured portfolios, those markets have slowed down. We have seen the auto market in particular has slowed into the last quarter, but again our risk appetite and value propositions are all in the right place and we are confident that we can at least maintain our market share in those businesses. Unsecured we continue to look for growth, but very sensitive to the quality of the risk.

We made the point that we have invested significantly in our Business Bank and Wealth, a very strong operational performance since we've made those adjustments and key to growing our NIR momentum as we go into next year. CIB is well positioned around renewables and those opportunities in the SA market, but again we have seen very strong CIB performance, CIB momentum coming across our ARO markets. Hopefully the message you're getting is that our businesses are focused on where they are seeing opportunities in their specific areas.

Chris Snyman – On CIB trading, our ARO business still growing well and we continue to see opportunities with them. I flagged that we had some additional restructures in Ghana during the half, particularly on the cocoa bills. There was a position the CIB trading book held that will reflect in results. ARO is still stronger, SA is relatively low, linked to overall confidence in the market. If you think of FX and fixed income trading, that's closely tied to the SA macro story and confidence. Therefore, while we still see growth in that area, it's not nearly as high as what we have seen in ARO business. We have seen good traction in client franchise level, with continued signup of customers, good traction in the corporate business that we see as the centre of the CIB business.

Arrie Rautenbach – Thanks Chris. I think we will flag this when we come back to the market with our results in March, but very strong customer growth, primacy growth specifically in our ARO CIB business, something which we are very positive about.

Alan Hartdegen – I just want to flag some colour on the trading comments. I want to highlight that CIB SA had a weak base in trading in the second half of 2022, so it has grown strongly in the second half this year, they didn't have a great first half. And as Chris said, rest of Africa's trading has slowed off the very high base in the first half. I wanted to mention there are a number of questions on the chat.

Harry Botha – Just on net interest margin, how should we think about the second half given strong momentum in CIB and obviously comments about pressure in stage 3 balances in secured lending. Should we think of a lower NIM in the second half and how that progresses into 2024.

James Starke – To return to asset quality, it feels like Absa is experiencing a bit more pressure than peers, particularly on consumer lending in SA. Perhaps can you give us some colour on that, as everyone should be facing the same macro and rate environment. And is it possibly around how you are approaching restructuring? Is that perhaps impacting your provisioning strategy relative to peers?

Bankole Ubogu – following on the asset quality question, you mentioned there's a 15bp to 1% higher RoE. What is your expectation for the continued momentum improvement beyond the 2H23? Are you relying on significantly lower interest rates to see improvement there? And secondly, is there any impact of Ghana on the equity part of your calculation, any restructuring on your equity there? And you mentioned the cocoa bill impairment, is that outside your credit loss ratio comments?

Chris Snyman – Your question around NIM, we have certainly seen a broadly stable NIM into the half. What I would flag is while we have a lower exposure to NIM than some of our peers, we are still positively leveraged to higher rates, particularly in ARO. So our performance in the first half was certainly assisted by the rate upticks in the continent in the prior 18 months. All of those rates are now in the base, so you'd expect it to be stable. So from here, those are linked to the interest rate cycle. Our internal house view is that rates remain higher for longer, so it starts reducing in the second half of 2024. Some think it may be quicker, but that's not how we built our plans into 2024. What I wanted to flag was that while from an unhedged perspective there should be some downward pressure if rates pull

back, our hedge should give us some improvement over time. It's just the dynamics of the hedge. It's a five year instrument. Some of those legacy instruments roll off. That should give us a better margin on that component of our balance sheet, so that should give us some NII resilience going forward.

Arrie Rautenbach – On asset quality, James, I think what's important here is if you look at the shape of our balance sheet, with us having declined with our balance sheet for an extensive period of time, we started coming back into this space in 2018, so you sit with a younger base in your mix, and therefore how they deal with the rapidly rising rates is critical, and therefore we stay very close to those customers. You do know that we have a very conservative posture when it comes to our provisioning methodology, our definition of default, and how we provide for any restructures, which is a key part of our strategy at this point, so hopefully that gives you a sense that it's more in the mix and how we apply our approach to coverage when we restructure.

Chris Snyman – one other point is the composition of our retail portfolio on our overall balance sheet. The composition is slightly higher than some of the peers. You had a question about restructuring, and it's hard to say what our peers are doing, but what we're doing is actively working with customers to work their way through the stress, and that includes short-term and long-term restructures, depending on the quality of the customer. In the short-term, restructures, they stay in the bucket they were in before the restructure.

Arrie Rautenbach – on the chat, there are a couple of questions around Ghana. I'll just read them.

You indicate that Ghana will impact HEPS by c.2%, or c.R400m. Can you indicate where in the P&L this impact will be felt, in impairments or NIR or a combination of the two? Alan, you said there'll be a new line in the P&L.

Chris Snyman – yes, the majority will be in a new line. It's not in pre-provision profit and outside of impairments.

Arrie Rautenbach – There was a question on RoE, Al can you guide us?

Alan Hartdegen – Ja, we can't be that specific. Our guidance is our FY23 RoE will be "somewhat"

below last year's 16.4%, but above our 14.5% internal CoE.

Arrie Rautenbach – there's a question whether excluding the Ghana hyperinflation impact, would operational RoE still have deteriorated in 2H23?

Alan Hartdegen – Yes, it would have.

Chris Snyman – we have given you enough data points that you can triangulate that.

Arrie Rautenbach – Another question: Does the Group expect an improving cost-to-income ratio into next year? What is the likelihood that the improvement in the Retail credit cycle in FY24 is offset by a deterioration in the Corporate and/or Commercial/Business credit cycle, given some of the much-publicised infrastructural difficulties locally, as well as some high-profile distressed credits currently? And what is the extent of the troubled exposure to Ghana cocoa production issue?

Those are the questions in the chat.

Chris Snyman – The question around cost-to-income in 2024, we haven't given our guidance, so I won't be specific. What I would say is some of the drivers, we've made big investments this year. Some of the investments will continue to flow into our P&L next year, some of the hires, the charges associated with some of the tech build. However, costs will be a focus. We will start executing on some of those big opportunities I mentioned. Some of those come with a cost to achieve. We have to take a charge upfront in order to get a medium term payback as we did in the previous cycle. We'll be very specific on the investment case as those come though. We gave the medium-term view that cost-to-income ratio should remain in the low 50s. That should give you an idea of where our headspace is.

On the cocoa bond exposures, we've restructured what we held previously, similar to the restructures we did in late 2022 on the sovereign bond exposures that we held. The view is that these cocoa instruments are key to the economy, so that gives us a level of comfort. But our focus remains on managing the risk that we see in Ghana.

Arrie Rautenbach – I think we're comfortable with the position we have there now Chris.

Chris Snyman – Bankie had a question about our expectation on the continued improvement of our credit loss ratio into 2024? We are not giving guidance yet. We've seen a better loan loss rate in the second half that we had in the first. Some of that is tied to having a stable rate environment into the second half with rate increases in the base. And we remain exceptionally focused on the levers that will help us to manage that into 2024.

The other question around hyperinflation accounting. As a team we've spent a lot of time on that and bringing it into our internal processes. The dynamic that stands out for me is that the 2% drag on earnings if offset by a 2% increase in our opening equity in retained earnings, so there's a bit of an offset. Broadly the impact of hyperinflationary accounting is NAV neutral. It will have a small impact on RoE because of how those adjustments flow through.

Just on cocoa bonds, you had a question around whether that's in our credit loss ratio guidance we discussed today. The biggest part of that is in non-interest revenue, there's a small amount in credit impairments. The big impact was on non-interest revenue. That is why we flagged that.

Ross Krige – On Ghana, and the impairment side and coco bonds and restructuring and NIR, it seems like the situation is still quite volatile, how comfortable are you, could there be further restructures to other instruments? And then, on hyperinflationary accounting, presumably this 2% relates to adjustment made for full year 2023 and should be in the base, or do we need to think about further impact in FY24?

Chris Snyman – The question on the restructures, whether there are more instruments. Maybe at a country level we have seen recent good news flow on the restructure with the IMF. That process is not fully closed, but seems to be moving in the right direction. There are some instruments that may be subject to conversations with the sovereign, but we certainly expect the impact to be substantially less that what we have experienced to this point. The expectation is that the big instruments where we are likely to suffer a restructure through P&L have been dealt with. But there are some instruments that are subject to further conversations with government.

Then on hyperinflationary accounting, whether that is in the base. Our current expectation is that it will be in effect for two years, given the inflation expectations for the country. There are qualitative and

quantitative factors. The quantitative driver is having cumulative inflation over 100%, the expectation is that 3 year cumulative inflation and into 2024 will still be over 100% so we may end up having to apply hyperinflationary accounting again. It's certainly something that we are having a healthy debate about at an industry level to see how we influence that. It's an annual impact so the adjustment you see for 2023 is likely to be required again in 2024. It's NAV neutral broadly so the adjustment that you see come through on the P&L is broadly matched by an adjustment through the retained earnings line. The closing NAV remains the same, it's the attribution between periods which is impacted by hyperinflation accounting.

Arrie Rautenbach – Just another question on coverage and how we see that going forward?

Chris Snyman – We are having many internal conversations at the moment around where we close the year. Those conversations are almost closed out. As we make those decisions we look at our coverage and the progression through time, and then also our position relative to the peers. All of that comes into play as we finalise our position. Our posture is that we want a strong coverage position.

Arrie Rautenbach – There's a final question on sustainable finance and whether there are any delays. Alan, do you have any comments?

Alan Hartdegen – As you know there have been some delays. We've closed quite a few deals in the second half of this year, and we expect to close some in the first quarter of next year. We did in our UBS presentation in October highlight that currently our pipeline is we have 26 projects totalling about 3.1GW. Also to emphasize, we originate and distribute, so we hold onto only a quarter or a third of what we originate. Our guidance is that as a percent of our total loan book, we expect that to double by 2026 from about 2%. It doesn't have a huge impact on the Group balance sheet but nice to have and you get good trading revenues on the back of that.

Arrie Rautenbach – Ladies and gentlemen, I think we have covered your questions. Again, on behalf of all of us, thank you for joining us for this conversation on our trading update. Al, we will continue to engage if there is a need for any further engagement off the back of this effort Again, just to give you confirmation that management teams are very focused on closing this year in the right position and

making sure we start 2024 in the right place with the right momentum. Thank you for joining us, have a wonderful festive season, we look forward to catching up early in the new year.

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