



Thursday, 7 May 2015

ASX Announcement

NAB 2015 Half Year Results

Executing our strategy, building a stronger bank

Highlights

- Cash earnings² up 5.4% and statutory net profit up 20.4% over the year
- All major businesses contributing
- Interim dividend 99 cents per share fully franked
- UK demerger and IPO intention by 2015 calendar year end
- Life reinsurance agreement capital release
- \$5.5 billion rights issue to boost CET1 ratio

Key points

The March 2015 half year results are compared with March 2014 half year results unless otherwise stated. March 2015 half year financials have been prepared incorporating the requirements of AASB9¹, with transitional adjustments reflected in retained earnings. Prior periods have not been restated.

- On a statutory basis, net profit attributable to owners of the Company was \$3.44 billion, an increase of \$584 million or 20.4%.
- Cash earnings² were \$3.32 billion, an increase of \$170 million or 5.4% with improved performances across all major businesses. Excluding prior period UK conduct related charges, cash earnings rose 0.3%. The main difference between statutory and cash earnings during the period relates to the elimination of treasury shares² coupled with the effects of fair value and hedge ineffectiveness².
- On a cash earnings basis:
 - Revenue increased 3.1%. Excluding gains on the UK Commercial Real Estate (CRE) loan portfolio sale and SGA asset sales, revenue rose 2.2% benefitting from higher lending balances, the impact of changes in foreign exchange rates, stronger Markets and Treasury³ income and increased NAB Wealth net income. Group net interest margin (NIM) declined 2 basis points over the year and 1 basis point when compared to the September 2014 half year.
 - Expenses were broadly flat but excluding a fine paid in relation to UK conduct and prior period UK conduct related charges rose 4.0%. The increase mainly reflects the impact of changes in foreign exchange rates, investment in the Group's priority customer segments and higher technology costs, combined with occupancy and Enterprise Bargaining wage increases.

¹ Note 1 (page 78) to the Group's 2015 Half Year Results Announcement published on 7 May 2015 includes further detail regarding AASB 9.

² Refer to note on cash earnings, treasury shares and fair value and hedge ineffectiveness on page 6 of this document.

³ Markets and Treasury income represents Customer Risk Management and NAB Risk Management income.

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- Improved asset quality resulted in a total charge to provide for bad and doubtful debts (B&DDs) of \$455 million, down 13.8%. This primarily reflects lower charges in UK Banking and NAB UK CRE. Compared to the September 2014 half year, the B&DD charge rose 30.4% due to releases from the Group economic cycle adjustment and NAB UK CRE overlay of \$104 million in the prior period which were not repeated.
 - The Group's Basel III Common Equity Tier 1 (CET1) ratio was 8.87% as at 31 March 2015, an increase of 24 basis points from September 2014. As previously announced, the Group's CET1 target ratio from 1 January 2016 remains between 8.75% – 9.25%, based on current regulatory requirements.
 - The interim dividend is 99 cents per share (cps) fully franked, unchanged from the prior interim dividend.
 - For the March 2015 half year the Group has raised approximately \$17.3 billion of term wholesale funding. The weighted average term to maturity of the funds raised by the Group for the March 2015 half year was approximately 5.0 years.
 - The Group's quarterly average liquidity coverage ratio as at 31 March 2015 was 118%.

Executive Commentary

“Our focus over the March 2015 half year has been on delivering against our strategic priorities outlined in October 2014 – building a stronger Australian and New Zealand franchise and dealing with our low returning and legacy assets. We are encouraged by the progress we have made on both fronts over this period with all major businesses contributing to cash earnings growth,” NAB Group Chief Executive Officer Andrew Thorburn said.

“At the time of our 2014 full year results we made it clear that a customer focused strategy, executed well, is at the heart of our Australia and New Zealand business. We've seen an improvement in our Net Promoter Score (NPS) as a result of a number of changes we've made to simplify the way we do business with customers, but there is more to do.

“Our strategy involves focusing on the things we are good at, which is why we've added 150 new business banker positions in the March 2015 half year and intend to add a further 70 over the remainder of the year. While competition remains intense in business lending, we are encouraged by more favourable market share trends in priority customer areas of Micro and Small to Medium business. In Australian home lending, we have seen continued momentum with volume growth over the six months to March 2015, benefitting from investment in our home loans origination capability. We remain confident about the quality of our housing lending book and are taking steps to slow growth in investor mortgage lending to meet APRA's 10% year-on-year threshold.

“Pleasingly, measures taken to improve performance in NAB Wealth have seen cash earnings continue to strengthen with an increase of 28%. In October 2014 we highlighted that while we remain committed to distributing wealth products, recent regulatory changes had prompted us to evaluate options to improve overall returns from our Wealth business. We have announced today a reinsurance agreement which is an important step towards achieving these goals, releasing \$500 million of capital.

“At the full year 2014 result we stated our intention to exit a number of legacy assets and we have made good progress over the first half of 2015. We announced a secondary public offering of Great Western Bank (GWB) common shares in the US, following the 2014 IPO of a 31.8% stake,

which sees our ownership fall to 28.5%. We have further reduced our UK CRE portfolio selling £1.2 billion of higher risk loans in December 2014, reducing the portfolio size to £0.6 billion compared with the original balance of £5.6 billion in October 2012. The remaining UK CRE portfolio largely comprises performing loans, effectively bringing closure to one of our legacy positions. Additionally, the run-down of the SGA portfolio has continued, with risk weighted assets reducing from \$4.1 billion to \$2.1 billion largely due to asset sales over the period. Management of the remaining SGA exposures has now been absorbed into our Australian Banking operations.

“In relation to exiting our UK Banking business, we have been examining a broad range of options including those provided by public markets. It is a priority to exit this business, and we are today announcing our intention to pursue a demerger and IPO of the UK Banking business.

“A strong balance sheet has always been a priority at NAB which is why we are today announcing that we will be raising \$5.5 billion of capital through a rights issue, as described below. The capital raising facilitates our proposed exit from the UK Banking business and positions us ahead of anticipated regulatory changes.

“While there is still much more to be done, we are clear about our priorities and are focused on what needs to be achieved. We are determined to deliver better outcomes for our shareholders, customers and employees,” Mr Thorburn said.

UK Banking exit update

The Group's intention to exit the UK Banking business was signalled in October 2014 as a result of the strategy to focus on the Australian and New Zealand franchise. Significant work has since been undertaken on various exit options, in particular public market options which offer increased certainty on the ability to transact and timing. While remaining open to a trade sale, we intend to pursue a public market option of a demerger of approximately 70-80% of Clydesdale Bank's holding company National Australia Group Europe Ltd and its subsidiaries (Listco) to NAB shareholders and a sale of the balance by way of IPO (approximately 20-30%) to institutional investors. A demerger accelerates the full exit of the UK business, as opposed to a prolonged multi-staged public market sell-down, and allows an exit to be targeted by the end of this calendar year, subject to market conditions.

Following a period of successful restructuring, the UK Banking business is now in a position to be demerged to shareholders and listed as a standalone retail and business bank with a strong franchise across its core regional UK markets, a strong balance sheet and capital position, a robust business plan and an experienced management team. Under the proposed transaction, Listco will have a primary listing on the London Stock Exchange (LSE) and a CHESS Depository Interest (CDI) listing on the Australian Securities Exchange (ASX). Shareholders will have the option to receive shares or CDIs.

The UK Prudential Regulation Authority (PRA) has advised that in order to demerge Listco, NAB will be required to provide capital support for Listco against potential losses related to legacy conduct costs. These are centred on payment protection insurance, interest rate hedging products and fixed rate tailored business loan conduct issues not covered by existing provisions, to a total cap of £1.7 billion, provided that the demerger occurs within the intended timeframe. The cap amount is expected to be deducted from NAB's CET1 ratio upon completion of the demerger. While this figure is substantially in excess of NAB's own stress test scenario, we believe that the

disadvantage of the expected capital deduction is outweighed by the benefits of separating the business. To the extent actual losses are ultimately lower than the £1.7 billion, this is expected to result in a commensurate CET1 benefit for NAB. However, the form of support, duration and final regulatory capital treatment of the £1.7 billion remains subject to on-going regulatory discussion.

While significant progress has been made, including engagement with key stakeholders such as regulators, there is no certainty a transaction will occur. The proposed demerger and IPO remains subject to a range of matters, including shareholder approval and approvals from regulatory authorities in the UK and Australia, UK and Australian listing authorities and the boards of NAB and Listco. Additionally, the demerger and IPO will be a substantial and complex undertaking subject to a range of risks and issues.

Capital raising and financial implications

NAB will be undertaking a 2 for 25 fully underwritten pro rata accelerated renounceable rights issue with retail rights trading (the Entitlement Offer) at an offer price of \$28.50, to raise approximately \$5.5 billion. Approximately 194 million new NAB ordinary shares are to be issued (approximately 8.0% of issued capital). New shares issued under the Entitlement Offer will rank equally with existing shares from the date of allotment. New shares will not however be entitled to the interim dividend for the half year ended 31 March 2015 of 99 cps because they will not be issued before the dividend record date.

While completion of the UK demerger and IPO could have been achieved with a more limited capital raising by way of a partial dividend underwrite, this would likely have resulted in a CET1 ratio near the lower end of our 8.75 – 9.25% target range.

The pro forma CET1 ratio as at 31 March 2015 is approximately 10%, reflecting the impact of the rights issue and the UK separation and a range of announced and intended capital initiatives. This provides a pro forma CET1 ratio buffer of 100 basis points above the midpoint of the Group's target range to absorb potential regulatory changes.

Following the capital raising, NAB's pro forma cash earnings per share (EPS) diluted for the March 2015 half year is expected to be approximately 4.5% lower and pro forma cash earnings return on equity for the same period is expected to be 1.4% lower. Subject to finalisation and independent audit of the Group's September 2015 full year results, it is NAB's intention to maintain a fully franked dividend of 99 cps in the September 2015 half year.

NAB announces life reinsurance agreement

NAB Wealth today announced it has received APRA approval for its life insurance arm to enter into a reinsurance arrangement with a major global reinsurer for approximately 21% of its in-force retail advised insurance book.

The transaction is expected to release approximately \$500 million of CET1 capital (13 basis points) to the NAB Group, and represents approximately 15% of NAB Wealth's life insurance embedded value⁴. This is expected to result in a reduction in NAB Wealth cash earnings of approximately \$25 million per annum.

⁴ Based on internal estimates and calculations of MLC and insurance activities embedded value as at 30 September 2014.

The reinsurance arrangement reduces the Group's exposure to retail life insurance while maintaining distribution of life insurance products and services to the Group's customers.

The transaction is scheduled to take effect in the fourth quarter of financial year 2015. The final capital release is subject to APRA approval.

Business Unit Commentary

Australian Banking cash earnings were \$2,574 million, an increase of 4.0%, with revenue the key driver. Revenue rose 3.9% reflecting a stronger trading performance, combined with higher volumes of housing and business lending, partly offset by weaker margins. NIM declined 3 basis points to 1.60% as a result of asset competition and lending mix impacts. Expenses rose 3.8% driven by additional service roles and front line business bankers, combined with Enterprise Bargaining wage increases and higher technology costs. Asset quality metrics continued to improve and B&DD charges of \$366 million fell 2.4%, benefitting from lower business impairment activity partly offset by higher collective provision charges including a \$49 million overlay for agriculture and resource sectors.

NZ Banking local currency cash earnings rose 4.5% to NZ\$418 million with higher revenue given steady growth in lending volumes and improved margins reflecting lower funding costs and benefits from both higher capital levels and higher earnings on capital. Costs rose 1.8% due mainly to increased personnel expenses, but were broadly flat compared to the September 2014 half year. B&DD charges were higher over the period with lower collective provision write-backs, but were flat over the six months to 31 March 2015 given the continued benign credit environment.

NAB Wealth cash earnings increased 28.2% to \$223 million reflecting improved results from both the investments and insurance businesses, and lower operating expenses. Net income rose 8.0% due to improved insurance claims performance, stable lapses and growth in funds under management (FUM) as a result of strong investment markets, partly offset by lower investment margins related to a change in business mix. There was no repeat of the insurance reserve increases seen in prior periods.

UK Banking local currency cash earnings grew 35.6% to £99 million driven by a further material reduction in B&DD charges as the business benefitted from improved economic conditions and loan portfolio shifts. Revenue was slightly weaker despite good growth in home lending volumes with competitive pressures resulting in NIM decline. Costs fell 1.2% with increased restructuring and marketing spend more than offset by a one-off pension scheme gain in the March 2015 half year and conduct related charges⁵ that were incurred only in the March 2014 half year.

Group Asset Quality

Group asset quality metrics continued to improve over the period. The ratio of Group 90+ days past due and gross impaired assets to gross loans and acceptances of 0.85% at 31 March 2015 was 34 basis points lower compared to 30 September 2014 and 67 basis points lower compared to 31 March 2014.

⁵ Charges relating to the UK fine during the March 2015 half year and conduct charges relating to payment protection insurance and interest rate hedging products incurred in prior periods have been included within Corporate Functions and Other division results.

The ratio of collective provision to credit risk weighted assets was 1.01% at 31 March 2015 compared to 0.83% at 30 September 2014 with the increase over the period reflecting transition to AASB 9. The ratio of specific provisions to impaired assets was 35.5% at 31 March 2015, which compares to 35.3% at 30 September 2014 and 34.8% at 31 March 2014.

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The pro forma financial information included in this announcement does not purport to be in compliance with Article 11 of Regulation S-X under the Securities Act, and was not prepared with a view towards compliance with either the U.S. Securities and Exchange Commission's or the American Institute of Certified Public Accountants' published guidelines for the preparation and presentation of pro forma financial information.

Note on Cash Earnings

Full detail on how cash earnings is defined, a discussion of non-cash earnings items and a full reconciliation of statutory net profit attributable to owners for the half year ended 31 March 2015 is set out on pages 2 to 7 of the 2015 Half Year Results Announcement under the heading "Profit Reconciliation".

The Group's results and Review of Divisional Operations and Results are presented on a cash earnings basis, unless otherwise stated. Cash earnings is a key financial performance measure used by NAB, the investment community and NAB's Australian peers with a similar business portfolio. NAB also uses cash earnings for its internal management reporting, as it better reflects what NAB considers to be the underlying performance of the Group. It is not a statutory financial measure and is not presented in accordance with Australian Accounting Standards nor audited or reviewed in accordance with Australian Auditing Standards. "Cash earnings" is calculated by excluding some items which are included within the statutory net profit attributable to owners of the Company. The Group's financial statements, prepared in accordance with the *Corporations Act 2001* (Cth) and Australian Accounting Standards, and reviewed by the auditors in accordance with Australian Auditing Standards, are included in Section 5 of the 2015 Half Year Results Announcement.

Treasury shares are shares in the NAB held by the Group's life insurance business and in trust by a controlled entity of the Group to meet the requirements of employee incentive schemes. The unrealised mark-to-market movements arising from changes in the share price, dividend income and realised profit and losses arising from the sale of shares held by the Group's life insurance business are eliminated for statutory reporting purposes.

Fair value and hedge ineffectiveness represents volatility attributable to the Group's application of the fair value option, ineffectiveness from designated accounting and economic hedge relationships and economic hedges of significant approved funding activities where hedge accounting has not been applied.