REVIEW FROM RICHARD FARBER

Discovery Chief Financial Officer

Discovery is a well-diversified business, by industry and geography. This, together with unique and valuable benefit and service differentiators, will enable us to continue to perform well.

The full-year period ending 30 June 2016 showed a robust performance by the Group. **Normalised profit from operations increased to R6.4 billion (+11%) and new business increased to R16.2 billion (+22%)** (excluding R4.2 billion in respect of the Bankmed Medical Scheme administration and managed care services contract taken on in the prior year).

This full-year performance was robust and driven by an acceleration in the latter half of the year with operating profit increasing 14% versus 7% in the first half. Normalised headline earnings increased to R4.3 billion (+7%). The reduction in headline earnings to R3 641 million from R5 285 million was due to the accounting treatment from the acquisition of Prudential's remaining stake in the UK joint venture in November 2014. The excess between the consideration paid and the carrying amount of the puttable non-controlling interest's financial liability was included as a profit in headline earnings in the prior year. This is reversed out when calculating normalised headline earnings. Embedded value grew to R53 billion (+2%), with the muted growth driven by an increase in the risk discount rate used to value the business, due to observed market economic factors.

Financial highlights for 2016

1. VitalityLife commenced writing new business on its own licence with effect from 1 January 2016. In terms of the funding for statutory capital requirements, part of the proceeds of the rights issue concluded in April 2015 was allocated to VitalityLife and is expected to be sufficient for its statutory capital requirements for a number of years to come. New business strain (commission and acquisition costs) will be funded by a combination of full risk transfer financial reinsurance and debt. This replaces the negative reserve funding previously provided by Prudential Assurance Company Limited (Prudential).

2. Costs related to the rebranding of PruHealth and PruProtect to VitalityHealth and VitalityLife totalling R365 million in the year ended 30 June 2016, have been excluded from normalised headline earnings.

3. At the end of June 2016, Discovery finalised the syndicated refinancing of our R3 billion bridging loan (replacing all of our South African borrowings). We now have the following long-term facilities:

   - A fixed-rate term loan facility of R1.6 billion was entered into with Rand Merchant Bank, a division of FirstRand Bank Limited.

   The facility has the following profile:

   - R500 million at a fixed interest rate of 10.79% per annum, payable quarterly in arrears, with capital repayable on 10 June 2021.
   - R1.1 billion at a fixed interest rate of 10.44% per annum, payable quarterly in arrears, with an amortising capital profile, having the first repayment on 10 June 2019 and final settlement on 10 June 2021.

   A subsidiary of the Discovery Group issued 1 400 A preference shares at an issue price of R1 million each (a total of R1.4 billion), by way of a private placement to Investec Bank Limited. The preference shares were issued at a fixed coupon rate of 8.015% per annum, paid bi-annually. The shares are cumulative, non-participating, non-convertible preference shares and redeemable on 29 June 2021.

4. In December 2015, Discovery paid R1.4 billion to FirstRand Bank Limited (FRB) to increase its economic interest in the Discovery branded FNB credit card (Discovery Card) from 20% to 74.99%. The increase in economic interest was realised through Discovery's subscription for redeemable preference shares in the share capital of FRB.

   In terms of IAS 38: Intangible Assets, the preference shares have been disclosed as an intangible asset in the Statement of Financial Position as the substance of the arrangement is a right to receive an additional 54.99% of the profits generated by Discovery Card. This will be amortised through profit or loss, as profits are expected to emerge and added back into the calculation of normalised headline earnings.

   R121 million is receivable in respect of the 54.99% profits generated by Discovery Card from 1 July 2015 to 30 June 2016. As the contractual rights under the preference shares were only finalised in April 2016, any profits earned prior to that, being R86 million, represent an adjustment to the purchase price of the intangible asset rather than income received. This therefore reduced the value of the intangible asset recognised and was added to normalised headline earnings.

Read our capital discussion on page 14 of this report.

Challenges experienced in 2016

1. In our primary market of South Africa, the current economic climate poses challenges for our industry and our business. With an expectation of rising inflation and interest rates, low GDP growth and a weak currency, our members, clients and policyholders will face challenging economic times over the next 12 to 24 months. This raises the risk of lower new business volumes, increased lapses and the buying down of cover. However, Discovery is a well-diversified business, by industry and geography, which together with unique and valuable benefit and service differentiators will enable us to perform well relative to the wider industry.

2. We closely monitor metrics that reflect the impact of these economic conditions on Discovery. We continue to experience low lapse rates in Discovery Health and Discovery Life, low missed debit orders across our businesses and our credit card book continues to perform extremely well relative to the market. In Discovery Health, we have seen a slowdown in the growth of new members joining existing employers in Discovery Health Medical Scheme – a reflection of a slower-growing economy. This resulted in lives administered by Discovery Health Medical Scheme increasing by 1.5% for the financial year.

3. As outlined in our annual financial results presentation, in our international business of VitalityHealth we experienced challenges moving to our own system infrastructure following the migration from the Transitional Services Agreement with Standard Life Healthcare. This resulted in significant claims adjustments and increased operating expenses totalling £5 million in the first six months of the financial year.

4. On 24 June 2016, the announcement of Brexit sent shockwaves through the global economy. United Kingdom (UK) GDP growth expectations were revised downwards and the Bank of England reduced interest rates. The decline in UK bond yields resulted in increased life-product capital requirements, release of margins and a reduced ability to absorb future adverse outcomes.

Discovery's objective regarding capital management is capital optimisation and value creation for the Group while keeping within the Group's stated risk appetite, meeting regulatory requirements, and allowing for the Group's investment strategy.

Capital, capital management and the use of financial reinsurance

A key focus area for the business during the year under review was capital and capital management. Capital refers to:

- **Required capital:** This is the amount of capital needed to act as a shock absorber to protect against losses arising from adverse events and to maintain regulatory and economic solvency. This includes both the minimum capital requirements as per the relevant regulatory regime and any additional buffer required by the Group's risk appetite.
- **Funding available:** This is the amount of liquid and tangible assets across the Group (in excess of what is required to meet the entities' statutory or required capital requirement), which can be made available to the Group to meet funding requirements (for example to fund growth, new strategic initiatives and Group dividend payments). This would include funding for new business strain.

Discovery's objective regarding capital management is capital optimisation and value creation for the Group while keeping within the Group's stated risk appetite, meeting regulatory requirements, and allowing for the Group's investment strategy.

The objective of capital optimisation and value creation will be realised by:

- Optimising the risk-adjusted return on capital
- Reducing the cost of capital
- Maximising expected earnings
- Ensuring the most efficient deployment of capital to entities within the Group.

In capital allocation decisions, forecast return is expected to be at least equal to the Group's required hurdle rate of risk-free +10%.

The table below summarises the minimum statutory capital across material Group subsidiaries and the actual solvency capital held as a percentage of this requirement, for each of them at 30 June:

			Actual solvency	
Insurance operations	Jurisdiction	Statutory solvency requirement	2016	2015
Discovery Life	South Africa	1 x Statutory Capital Adequacy Requirement (CAR)	**356%**	386%
Discovery Life Investment Services	South Africa	13/52 x annualised operational expenses	**281%**	201%
Discovery Life Collective Investments (DLCI)	South Africa	13/52 x annualised fixed operational expenses plus a portion of risk capital on investments held by DLCI	**218%**	308%
Discovery Insure	South Africa	1 x Statutory Capital Adequacy Requirement (CAR)	**265%**	266%
VitalityHealth Limited	United Kingdom	Highest capital requirement determined under the Solvency II Directive	**140%**	–
VitalityHealth Insurance Limited	United Kingdom	Highest capital requirement determined under the Solvency II Directive	**481%**	–
VitalityLife Limited	United Kingdom	1 x Solvency Capital Requirement under Solvency II	**295%**	n/a

The Solvency Assessment and Management regulatory regime, expected to be effective in South Africa in 2017, will implement a Group statutory capital requirement. Discovery has been monitoring and reporting the Group's statutory capital position to the Financial Services Board as part of the industry-wide parallel-run exercise. The implications of the new regime have been considered in formulating the capital management strategy going forward.

Financial Leverage Ratio

As part of the capital management process, the Group monitors its capital structure utilising the Financial Leverage Ratio (FLR). This ratio is calculated as total debt divided by total debt plus total equity. The Group's strategy is to maintain a prudent FLR broadly in line with industry norms. In line with the Group's risk appetite statement, an FLR of less than 28% needs to be maintained.

The table below summarises the Financial Leverage Ratio at 30 June:

R million	2016	2015
– Negative reserve funding	4 248	5 437
– Borrowings at amortised cost	5 400	954
– Guarantees issued for reinsurance contracts	1 322	1 274
Total debt and guarantees	10 970	7 665
Total equity	30 607	27 356
Financial Leverage Ratio (%)	26.4%	21.9%

Borrowings at amortised cost

An analysis of borrowings at amortised cost from 2015 to 2016 is provided below

	2016 Rm	2015 Rm	Change Rm
SA borrowings	3.014	402	2.612
UK borrowings	2.226	506	1.720
Other	160	46	114
Total	5.400	954	4.446

South African borrowings

The increase in South African borrowings is largely attributable to a timing difference as part of the proceeds from the rights issue in April 2015 which was earmarked for VitalityLife statutory capital, and used to repay the R1.5 billion bridging loan incurred in the acquisition of Prudential's remaining stake in the UK joint venture (November 2014). This was to minimise interest costs until the statutory capital was required to be paid across to VitalityLife. This took place in December 2015 ahead of the granting of our life insurance licence in the UK and required the raising of a "replacement" bridge loan of R1.5 billion. In addition, funding was required for other parts of the Discovery Group.

UK borrowings

The growth in UK borrowings (HSBC) of R1,720 million (£87 million), needs to be viewed in the context of the reduction in Negative Reserve Funding of £68 million (R1,189 million). Prior to April 2015, the new business costs of the VitalityLife business (Negative Reserves) were funded by Prudential. This was replaced by drawing down on facilities provided by HSBC to fund the acquisition of new business.

Financial reinsurance

- **Cash financial reinsurance with recourse**
  VitalityHealth and Discovery Insure have made use of financial reinsurance as a financing tool for acquisition costs. Discovery Insure's use of financial reinsurance was discontinued from 1 July 2015. As these short-term businesses are unable to defer acquisition costs or create negative reserves, the receipt from the reinsurer is recognised in income upfront in the year received. Thereafter, the repayment to the reinsurer and the cost of funding are expensed to the income statement. As guarantees have been provided for the repayment of balances owing to the reinsurers, these outstanding balances are included as debt in our calculation of the FLR.
- **Cash financial reinsurance without recourse**
  With effect from 1 January 2016, VitalityLife used cash financial reinsurance as a means of funding. The impact on earnings over the duration of the contract is limited to the cost of funding. Discovery Life's and VitalityLife's cash financing reinsurance is full risk transfer reinsurance so the reinsurer accepts full risk (and some upside) on their reinsured block of business. As there are no guarantees or recourse if the experience is worse than expected (for example, higher lapses or higher claims), the outstanding balances are not considered as borrowings and are excluded from our calculation of the FLR.
- **Cashless financial reinsurance**
  Discovery Life utilises cashless financial reinsurance achieved by combining the sale of guaranteed endowments with a reinsurance structure which, together with the negative reserve, allows cash generated by guaranteed endowments to be freed up as capital. In other words, cash is received from the policyholders and the reinsurer protects against the lapse risk (the reinsurance piece is cashless). As no cash is received from the reinsurer, there is no liability to the reinsurer and no impact on the FLR.

Translation impact of the rand exchange on income from operations outside South Africa

The Group's net income from operations outside South Africa is translated into rand at average exchange rates for consolidation purposes. A weaker average exchange rate during 2016 resulted in an increase in the rand equivalent of foreign profits (mostly GBP denominated) and an increase in the rand equivalent of foreign losses (mostly USD and Chinese RMB denominated).

Average exchange rate	2016	2015	% change
Rand/GBP	21.44	18.04	19%
Rand/USD	14.6	11.49	27%
Rand/RMB	2.25	1.85	22%

Q & A with Richard Farber

Some common questions and concerns raised during our engagement with investors and analysts throughout the financial year, are answered below.

Q *Is your accounting policy for long-term insurance contracts appropriate?*

The current accounting standard for insurance contracts, IFRS 4, does not prescribe any measurement rules for insurance contracts but requires that an insurer's policy to recognise profit on insurance contracts, be applied consistently. Discovery has consistently adopted the policy of setting up a negative reserve approximately equal to the acquisition costs incurred in writing that policy. These acquisition costs are then amortised over the life of the policy and the profit inherent in the policy recognised by Discovery as the risk is borne. This approach is largely consistent with the current thinking in the development of a new accounting standard for Insurance Contracts (IFRS 4 phase 2).

Q *Are you concerned by Discovery Life's cash flows?*

No, there are significant acquisition costs incurred in writing long-term insurance contracts which are recovered over the life of the policy. With a fast-growing business such as Discovery Life, significant investment is required to fund new business acquisition costs. The key issue is that this investment must generate acceptable returns in the long term. We are comfortable that the new policies we are writing meet or exceed our hurdle rate of risk-free +10%. Despite the upfront cash requirement, Discovery Life generated R2 262 million in cash over the period before financial reinsurance and new business strain.

Q *Is your 2018 ambition still achievable?*

Our 2018 ambition is a stretch target aimed at motivating our employees to deliver on our short to medium-term business objectives. We continue to work towards the deliverables that we have set for ourselves as part of that ambition. We recognise that our ambition demands urgency per market and business, despite the strong performance across the Group. We appreciate that some elements (such as our profit target) of our articulated ambition will be harder to achieve than others, but the organisation is still driven to achieve our ambition.

Q *How does Discovery manage the risk of increased global competition in the wellness space?*

The topic of wellness has been growing in prominence over a decade and the rise in consumer awareness around health issues, coupled with new technologies such as wearable devices, all point to increased competition. We are mindful of this issue and invest heavily but purposefully in research and development, data analytics and global expertise in clinical skills and behavioural economics to be at the forefront of product innovation. To stay a leader Discovery has adopted the following approach:

- Stay true to the science of wellness and continue to invest in our extensive knowledge of this
- Use our scale to form unique and innovative partnerships – where possible on a global level. Our recent partnership with Apple Watch is a prime example of this
- Access and leverage the appropriate technologies to ensure we have the best capabilities
- Generate and analyse significant volumes of data linking lifestyle behaviours to mortality and morbidity risks
- Form and be at the centre of a network of insurers using a shared-value approach to insurance, creating a global scale that is difficult to replicate.

Watch the interview with Richard Farber at www.discovery.co.za/info/CFOReport