REVIEW FROM DEON VILJOEN

Discovery Financial Director

The 2017 financial year showed a robust performance by the Group. We believe our unique Vitality Shared-Value Insurance model, together with a well-diversified business, by industry and geography, and a strong focus on innovative product design will enable us to continue to perform well relative to the wider industry.

Discovery

The 2017 financial year showed a robust performance by the Group, despite it being a year characterised by global sociopolitical and economic uncertainty. We believe our unique Vitality Shared-Value Insurance model together with a well-diversified business, by industry and geography, and strong focus on innovative product design will enable us to continue to perform well relative to the wider industry.

CORE NEW BUSINESS ANNUALISED PREMIUM INCOME INCREASED 16% TO R16 993 MILLION AND **NORMALISED PROFIT** FROM OPERATIONS INCREASED TO R7 048 MILLION (+10%).

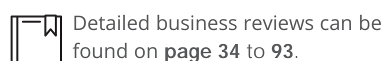
Core new business annualised premium income (excluding the volatility caused by on-boarding of new closed schemes and gross revenues from the Vitality Group) increased 16% to R16 993 million and normalised profit from operations increased to R7 048 million (+10%). These results were negatively impacted by the strengthening of the rand against sterling and in constant currency terms, core new business annualised premium income grew by 22% to R17 871 million and normalised profit from operations grew by 12% to R7 190 million. This demonstrates an acceleration in new business growth with strong operating profit gains, notwithstanding our continuing spend on new strategic initiatives. Normalised headline earnings increased to R4 656 million (+8%). In order to facilitate analysis of the results, the Group traditionally provides "Normalised" results which adjust for once-off, non-trading items or accounting adjustments to better reflect the economic substance of transactions.

The below table shows the reconciliation of profit from operations according to the Income Statement to normalised profit from operations.

R million	Group 2017	Group 2016	% change
Profit from operations	**6 245**	5 803	8%
Investment income earned on shareholder investments	**(150)**	(265)	
Net realised gains on available-for-sale (AFS) financial assets	**(8)**	(5)	
Rebranding and business acquisition expenses	**99**	365	
Amortisation of intangibles from business combinations	**171**	275	
Share of net profits/(losses) from equity-accounted investments	**26**	(66)	
Additional 54.99% share of Discovery Card after tax profit		86	
IFRS reporting adjustments			
– UK Life[1]	**103**	214	
– Deferred tax asset (Discovery Life)[2]	**562**		
Normalised profit from operations	**7 048**	6 407	10%

1 *The VitalityLife results, for business written on the PAC license, are reclassified to account for the contractual arrangement as a reinsurance contract under IFRS 4.*

2 *The accounting impact on operating profit in respect of the recognition of a deferred tax asset arising from the Discovery Life Individual Policyholder Fund (IPF) has been excluded from normalised profit from operations for segmental purposes (See the financial highlights section for more detail on this item).*



Detailed business reviews can be found on **page 34** to **93**.

The table below shows the reconciliation between earnings, headline earnings and normalised headline earnings:

R million	Group 2017	Group 2016	% change
NET PROFIT ATTRIBUTABLE TO ORDINARY SHAREHOLDERS	4 411	3 655	21%
Gains from business combinations		(8)	
Gains on disposal of property & equipment	(1)	(2)	
Realised gains on AFS financial assets net of CGT	(6)	(4)	
HEADLINE EARNINGS AS REPORTED	4 404	3 641	21%
Accrual of dividends payable to preference shareholders	(1)	(4)	
Additional 54.99% share of Discovery Card profits		86	
Amortisation of intangibles from business combinations net of deferred tax	154	224	
Rebranding and business acquisition expenses	99	365	
NORMALISED HEADLINE EARNINGS	4 656	4 312	8%

Embedded value grew to R57 294 million (+8%) from R53 080 million in the prior year despite the negative translation impact from the appreciation of the rand and investment in new and developing businesses. Return on embedded value increased to 10.2% pa, a considerable increase over the prior year's return of 2.6% pa (prior year supressed by increase in the beta assumption). Experience variances were marginally positive, driven by strong positive experience variances in Health and Vitality in South Africa, offset against negative variances in Life and Invest. Almost half of the negative variances in Life and Invest are attributable to economic variances (volatile with deviations expected to average out over time) and management is in the process of implementing specific action to mitigate the balance of variances observed.

Financial highlights 2017

PROGRESS AGAINST DISCOVERY'S ORGANIC GROWTH METHODOLOGY

- In terms of financial impact, the nature of the Vitality Shared-Value Insurance model means that businesses are grown largely organically, guided by an earnings growth methodology that targets operating profit growth of CPI +10% with a substantive investment in new initiatives (set at approximately 10% of earnings). The emerging businesses that evolve from these new initiatives have a targeted profit growth of CPI +30%, and ultimately develop into established businesses, which are set a targeted profit growth of CPI +5% overall. In terms of our earnings growth target of CPI +10%, earnings grew by 12% in constant currency terms during the period. The established businesses marginally exceeded the target of CPI +5% in constant currency terms, while the emerging businesses tracked above target showing a decrease in operating losses of 61%, although not yet significantly contributing to earnings. Further, 8% of earnings was invested in new initiatives, which include Discovery's intent to enter banking, the planned UK investment business, a commercial offering in Discovery Insure, and Discovery Invest's Umbrella Fund offering.

* *CPI of 4.8% (weighted average of CPI at 30 June 2017 in South Africa, United Kingdom, United States of America and China, weighted by the proportion of group earnings from those regions).*

Investment income reduced from R265 million in FY 2016 to R150 million in FY 2017. This is a result of proceeds from the rights offer in April 2015 only being fully deployed towards the end of H1 2016.

Borrowings were increased in H2 2016, which, together with additional borrowings raised in the current financial year in line with funding plans, contribute to the year-on-year increase in finance charges to R478 million (2016: R293 million).

Read more about borrowings on **page 14**.

Recent tax amendments for South African Life companies introduced a fifth fund known as the "Risk Policy Fund" for all new risk business written effective 1 July 2016. In terms of the legislation, Discovery Life has elected to move existing risk business to this fund. As a result, a portion of the assessed loss of R16.5 billion in the Individual Policyholder Fund is now expected to be utilised over time. No deferred tax asset was previously recognised in respect of this assessed loss. A value of R562 million, implicit in the valuation of insurance contract liabilities has therefore been reclassified and recognised as an explicit deferred tax asset in terms of IAS 12: Income Taxes. The impact of this recognition on the Statement of financial position is an increase in the "Deferred tax asset" of R562 million and a corresponding increase in "Liabilities arising from insurance contracts". The impact on the Income statement is an increase in "Transfer from liabilities under insurance contracts" of R562 million and a corresponding decrease in "Income tax expense". Although this impacts the Group's operating profit and tax expense, there is no impact on profit after tax.

CHALLENGES EXPERIENCED IN 2017

The economic uncertainty surrounding the UK's decision to leave the European Union has had a number of implications for VitalityLife. The most significant being low and volatile long-term interest rates, which have negatively impacted profitability (prior period second tier margin releases led to a reduction of approximately 25% in the current period earnings). Management responded with a drive towards more capital efficient products and a focus on business mix resulting in an improvement in Value of New Business (VNB) margin to 36% for the financial year. The new structure is robust in the current environment with potential upside should interest rates increase, which is the expectation considering the current negative real yield environment.

CAPITAL, CASH MANAGEMENT AND THE USE OF FINANCIAL REINSURANCE

Our capital management philosophy served us well during the year with the cash buffer increasing to R1.6 billion and our Financial Leverage Ratio well within the 28% risk appetite at 26.7% as at 30 June 2017.

Discovery's capital management framework comprises three components:

1 **Statutory/required capital:** Regulated entities are capitalised in line with regulatory solvency requirements at a 1-in-200-year level, but with an additional buffer to ensure that after a 1-in-25-year event we remain compliant with the regulatory 1-in-200 level.

2 **Allocated capital:** Based on robust, prudent 5-year business plans, this is the amount of liquid and tangible assets across the Group (in excess of what is required to meet the entities' statutory/capital requirements) that can be made available to the Group to meet funding requirements for all known strategic initiatives (including funding for new business strain) with explicit buffers for prudence and a general margin for uncertainty. These assets are sourced both internally from retained earnings and externally from FinRe and debt (subject to the 28% FLR constraint).

3 **Buffer:** Discovery aims for an additional general buffer on a Group-wide basis of R1 billion to R2 billion at all times.

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.

In capital allocation decisions, reference is made to the Group's required hurdle rate of risk-free +10%.

The Group's Return on Capital for the year ended 30 June 2017 was 14.4% (2016:13%), still reflecting the dilution caused by the R5 billion rights issue in April 2015, given that some of the proceeds were deployed in new initiatives which will only become profitable over time.

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	2017	2016
Discovery Life	South Africa	1 x Statutory Capital Adequacy Requirement (CAR)	**388%**	356%
Discovery Insure	South Africa	1 x Statutory Capital Adequacy Requirement (CAR)	**221%**	265%
VitalityHealth Limited	United Kingdom	1 x Solvency Capital Requirement under Solvency II	**145%**	140%
VitalityLife Limited	United Kingdom	1 x Solvency Capital Requirement under Solvency II	**215%**	295%

The Solvency Assessment and Management regulatory regime, expected to be effective in South Africa for FY 2019, will also introduce a Group statutory capital requirement. Discovery has been monitoring and reporting its Group 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 when 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 Financial Leverage Ratio broadly in-line with industry norm. Per Discovery's Group Risk Appetite statement, an FLR not exceeding 28% should ideally be maintained. The table below summarises the Financial Leverage Ratio at 30 June:

R million	2017	2016
– Borrowings at amortised cost	**8 524**	5 400
– Amount owed to previous joint-venture party[3]	**3 080**	4 248
– Guarantees issued for reinsurance contracts	**171**	1 322
Total debt and guarantees	**11 775**	10 970
Total equity	**32 290**	30 607
Financial Leverage Ratio (%)	**26.7%**	26.4%

3 The amount owing to Prudential Assurance Company Limited ("PAC") is in respect of life business in the United Kingdom originally written on PAC's statement of financial position.

BORROWINGS AT AMORTISED COST

An analysis of borrowings at amortised cost is provided below:

R million	2017	2016	Change
SA borrowings	**5 999**	3 015	2 984
UK borrowings	**2 175**	2 224	(49)
Other borrowings	**350**	161	189
Total	**8 524**	5 400	3 124

SA BORROWINGS

The increase in SA borrowings is largely attributable to Discovery utilising the remaining R2 billion of its R5 billion bank-syndicated loan programme entered into in June 2016. A 10-year loan-facility agreement of R650 million was concluded by a subsidiary, of which R495 million was utilised in the current financial year. On 30 June 2017, Discovery Limited issued 5-year Investment Notes totalling R500 million with a floating interest rate linked to a 3-month JIBAR. The main uses of the borrowings related to funding new business strain in the UK and investment in new and developing businesses.

Discovery

UK BORROWINGS

The growth in UK borrowings of £15 million from £113 million to £128 million needs to be viewed in the context of the reduction in Negative Reserve Funding. Prior to April 2015, the new business costs of the VitalityLife business (Negative Reserves) were funded by Prudential Assurance Company Limited (PAC). The Negative Reserve Funding liability has reduced as a result of repayments to PAC as well as the set off of a security deposit of £147 million held by PAC.

Post April 2015, acquisition of new business was funded by drawing down on bank facilities (Cash FinRe is also used by VitalityLife to fund new business strain – see note on FinRe below).

FINANCIAL REINSURANCE (FINRE)

Cash FinRe with recourse

The use of Cash FinRe by VitalityHealth and Discovery Insure necessitated the provision of guarantees for the repayment of balances owing to the reinsurers. Discovery Insure's use of FinRe was discontinued 1 July 2015. These outstanding guarantees are deemed to be debt in our calculation of the FLR and have reduced significantly from R1 322 million at 30 June 2016 to R171 million at 30 June 2017 as a result of the recapture of Cash FinRe by VitalityHealth (refer Cashless FinRe note below).

Cash FinRe without recourse

In Discovery Life (on an ad hoc basis) and VitalityLife (with effect from 1 January 2016), cash financial reinsurance is also used as a means of funding. The upfront cash is received from the reinsurer which generates a liability equal to the expected repayment. The impact on earnings over the duration of the contract is limited to the cost of funding. Discovery Life and VitalityLife's cash financing reinsurance is risk transfer reinsurance, which means that the reinsurer accepts risk (and some upside) on their reinsured block of business. As there are no financial guarantees or recourse, if the experience is worse than expected (eg higher lapses or higher claims), the outstanding balances are not considered as borrowings and are excluded from our calculation of the FLR.

Cashless FinRe

Discovery Life utilises cashless FinRe 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 liquidity funding. In other words, cash is received from the policyholders and the reinsurer protects against the lapse risk (the reinsurance piece is cashless). As no upfront cash is received from the reinsurer, there is no liability to the reinsurer and no impact on the FLR.

VitalityHealth makes use of FinRe in order to offset high acquisition costs that create an upfront cashflow strain upon the sale of a new policy. This enables VitalityHealth to better match these costs with the emergence of acquisition cost loadings, priced into the VitalityHealth product. Previously, VitalityHealth utilised Cash FinRe where the reinsurer made a financing deposit at the outset of the contract. This upfront financing was recognised as income. Thereafter, the repayment to the reinsurer and the cost of funding was expensed to the income statement. Under Solvency II, this funded FinRe was no longer permitted to contribute to solvency levels, enabling VitalityHealth to switch to a more cost effective solution, namely Cashless FinRe. This was done by recapturing GBP 49.6 million of reinsurance obligations under existing cash FinRe treaties (expense of R858 million in the "Recapture of reinsurance" line in the income statement) and replacing this with new cashless FinRe recognised in the "Recovery of expenses from reinsurers" line. The structure of Cashless FinRe is simply an unfunded version of Cash FinRe. Rather than financing being paid upfront by the reinsurer, a debtor is recognised by VitalityHealth for that financing. The debtor is amortised as premiums and claims are ceded to the reinsurer over a period of 7 years.

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 stronger average rand exchange rate during 2017 resulted in a decrease in the rand equivalent of foreign profits (mostly GBP denominated) and a decrease in the rand equivalent of foreign losses (mostly USD denominated).

Average exchange rate	2017	2016	% change
Rand/GBP	**17.29**	21.44	(19%)
Rand/USD	**13.61**	14.6	(7%)
Rand/RMB	**2.00**	2.25	(11%)