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Challenger International Limited (CLI) today released the scheme booklet for its proposed merger with CPH Investment Corp (CPHIC). According to the scheme booklet, the merged entity, "Challenger Financial Services Group," will focus on annuities, traditional funds management, financial planning, margin lending and capital management of the existing assets. Can you outline your intended strategy?

**Acting CEO Chris Cuffe**

I can't comment beyond the content of this morning's explanatory memorandum and scheme documentation because the merger's still in progress. But the immediate strategy will be to continue the review we commenced when my management team and I came aboard in early April. That involves identifying opportunities to improve the performance of Challenger's existing business and fast track its development.

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What are the benefits of the merger?

**Acting CEO Chris Cuffe**

Looking through the eyes of CPHIC, accessing the fast-growing funds management industry is number one. The industry's got the wind in its sails from the compulsory superannuation system, and certainly having exposure to the annuities market, which not all competitors are represented in, is attractive. CPHIC

is also happy to get exposure to the financial planning and margin lending industries, as well as to a very high quality property portfolio.

From Challenger's eyes, the benefit is accessing a capital base that allows it to continue to grow the annuity business. Challenger also benefits from increased management expertise, and improved management information systems will be a by-product of that. At the same time, looking at the business with fresh eyes is helping to identify cost savings that may not have already been identified.

And for both parties, the combined entity is likely to have a higher Australian share market index weighting, and that's important for how investors allocate capital.

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What's the basis for your review of Challenger's structure and operations, and what do you hope to achieve?

**Acting CEO Chris Cuffe**

The basis is to identify inefficiencies and sort out how we can improve the business. The key things are to reset the basic management and functional structures, and look at the products to see how they can be better positioned, where there are any gaps or overlaps, and take action from there.

Really, we're looking at ways to make the whole structure a lot simpler. Challenger has multiple structures and systems in place from past acquisitions, so we're looking at those and once we've got the product strategy in place, a systems strategy will be confirmed. Accommodation is another area we're looking at.

We're also looking closely at using our capital more efficiently, particularly in the annuities business, and making sure we meet the needs of the regulator, APRA. And another important part of the review is to establish how we can improve the transparency of the business and the understanding of life-structure accounting.

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What measurements will you employ when assessing the financial performance of Challenger in the future and how will this differ from the past?

**Acting CEO Chris Cuffe**

First, we intend to split the non-life assets from the life-company assets so it's easier to understand the business's performance. I believe the way we should look at success in the life business is very different from that of the non-life businesses.

The current structure has the life company owning a lot of non-life assets, which then have to use appraisal value accounting, so it's quite difficult to see the performance of one part of the business over another. We want to split the businesses into a pure life company business comprising the two existing life companies, which we hope will be merged into one, and a separate non-life

business, including funds management, financial planning, the Synergy master trust, margin lending etc. Then we can start to look at financial performance.

In the life company, we'll measure performance by looking at the annuity profit margins and the capital of the property portfolio, while in the non-life businesses one of the key ratios I'd be looking at is the cost-to-income ratio. Of course there are other financial measurements we'll use, and obviously looking at how our market shares trend in the various areas is also important.

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In the past, the market hasn't regarded CLI's reported earnings as a reliable valuation benchmark. What will be the profit reporting methodology of the merged company? Do you intend to continue using mark-to-market accounting methodology for Challenger's life business?

**Acting CEO Chris Cuffe**

We're addressing these issues by moving the management and administration businesses out of the life companies and by changing the property evaluation methodology.

We intend to change the methodology so the total value of the income and capital units of the life company won't exceed the see-through value of the underlying assets, which is basically the property less debt. That should help to make the life company's performance more transparent.

And of course, accrual accounting will come naturally for the non-life assets that are taken out of the life company environment. We'll be able to record those assets on an historical cost basis and won't have to deal with concepts of appraisal value.

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CPH Management, the responsible entity for CPHIC, was entitled to management and performance fees relating to CPHIC's assets and investment performance and will remain entitled to these fees in respect of the Challenger investment. Some CLI shareholders see the payment of fees relating to their assets as unfair. Why is the fee structure being maintained?

**Acting CEO Chris Cuffe**

First we have to start with history. CPHIC has been an investment trust to date and its fee structure has been in place for a number of years. It's normal for a trust, particularly an investment trust, to have a responsible entity that earns fees for its services.

The fee structure compensates CPH Management for such things as identifying, evaluating and implementing investments and providing CPHIC the opportunity to participate in investments made available via the CPH group. It also covers the on-going management of CPHIC investments, including those in private companies where there is board representation.

It's important to note that Challenger's independent expert, Grant Samuel, stated that Challenger's business will have greater value as part of the merged entity, more than offsets the capitalised value of the management fees. Market values to date have recognised that.

In any event, a hurdle has been implemented that says the value of the Challenger asset won't attract a management fee until the unit price exceeds 60 cents. So substantial value has to be created before that's reached.

As to the fee structure being maintained, that will be a matter for the board of the merged entity.

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There's a perception in the market that CLI's risk exposure has been unacceptably high given the core life business backs its long-term annuities liabilities with earnings streams from property investments and is dependent on rising property prices. You've stated your intention of maintaining the property-backed annuities model. In your view, what's the risk-reward equation of this model?

**Acting CEO Chris Cuffe**

Possibly the Challenger business has been difficult to understand because of the issues around transparency in accounting that we talked about earlier. But the key thing is that the business model is not dependent on rising property prices. What it is dependent on is the security of the rental streams, because the rental streams satisfy payments to the annuitants.

The reward from the model remains being able to come into the ownership of the properties after the annuitant liabilities have been extinguished. That's not going to change, and the risk-reward equation seems favourable when you look at that.

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On completion of the merger, \$235 million of CPHIC's funds will be transferred into the statutory funds of the life company. To what extent is this transfer necessary for the life company to meet its capital adequacy requirements?

**Acting CEO Chris Cuffe**

Challenger currently meets its capital adequacy requirements. But writing down the value of the capital and income units to the look-through value of the property less the debt requires more capital to be tipped in. The injection enables the life company to meet its capital requirements and allows it to comfortably continue writing annuities.

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Challenger's annuity sales have grown rapidly, increasing to about \$600 million in the year ended June 2002 from virtually nothing five years earlier. What scope is

there for continuing this growth trajectory? Will further injections of capital be required?

**Acting CEO Chris Cuffe**

It's important to understand that growth in sales is a function of a whole lot of factors, including the health of the overall annuities market and our ability to source good quality investments to back the annuity liabilities. While we have no intention of pursuing growth for growth's sake, if those factors are in our favour, there's plenty of scope to increase the business.

The capital position of the merged entity will be very comfortable. The life company part of the merged entity may require additional capital from time to time, depending on the amount of new business. But we've got a number of potential sources. Only part of the capital CPHIC brings to the merged entity is going into the life company statutory fund. Also, capital will be released from the current annuity business as the existing annuities are paid off. And a growing part of the Challenger business will be the non-life side – funds management, financial planning, margin lending and the like – which will also create capital for the business.

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In the scheme booklet, you've indicated you may seek to securitise the non-recourse debt relating to the life company's property portfolio. What impact would this have on your longer-term cash flows and ability to match existing annuity liabilities?

**Acting CEO Chris Cuffe**

If completed, the securitisation exercise will lock in the debt funding for the whole period over which the annuitant payments are made. It should therefore result in an improvement in the quality of cash flow available to meet the annuity payments.

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Challenger's funds management business was built up via a series of acquisitions over the past five years. What do you see as its strengths and weaknesses?

**Acting CEO Chris Cuffe**

Challenger has a good foundation in the non-life area and some excellent products. One in particular, the Howard Mortgage Trust, has a high market share and it's a product that's difficult to replicate. Challenger also has some very good performance numbers in its equity products, its small-cap funds and its mainstream funds.

As an observation, I'd say the easier side of funds management is to create growth products; whereas Challenger has a lot of income-type products, which are more difficult to develop but appeal to people with a lower appetite for risk. Certain cycles of the market are more conducive to these products, and we're perhaps in

one now. So we're well positioned there and the basis exists for building growth products.

Our challenge is to fast track the growth of these products.

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Challenger's major competitors in funds management and retirement products are the big four Australian banks, which have huge distribution networks of their own. Do you believe Challenger can survive as a manufacturer of financial products reliant on independent distributors?

**Acting CEO Chris Cuffe**

I do entirely. The Australian financial services industry has strong demand support through compulsory superannuation, inter-generational wealth transfer and a complex taxation system, particularly in the retirement area. So there's plenty of room for competition.

The thing that's important is that distribution alone is not what sells product. What increasingly sells product in an age of consumer choice and tougher regulation, is good product structures that deliver on their promises at a reasonable price. At the same time, you've got a growing group of investors who value independent advice and distribution. On the investment side too, there's a view that smaller fund managers can do well against their larger competitors. So to me, we have multiple advantages.

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You've indicated you'll make a series of accounting adjustments relating to the merger. Can you detail any write-offs that will be required?

**Acting CEO Chris Cuffe**

The biggest reflects the change in valuation of the income and capital units I mentioned earlier. The net impact of that is \$330 million. The other write-downs aren't significant.

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According to the scheme booklet, the merger will be effective July 1, 2003. What's the likely format of the financial reports of both CLI and CPHIC for the year ending June 2003?

**Acting CEO Chris Cuffe**

We expect the balance sheet of Challenger to be consolidated into the CPHIC financial statements at June 30, and that will include the capital and income unit write-down. Challenger won't be required to produce a separate set of accounts. And for practical purposes, there'll be no P& L impact from Challenger on the underlying CPHIC accounts given the merger takes effect so close to the balance date.

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Thank you Chris.

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