challenger

Challenger Limited ACN 106 842 371

# Analyst Pack 1H17

31 December 2016

Challenger Limited – providing our customers with financial security for retirement.

# Table of contents



## Investor Relations contacts


Stuart Kingham
Head of Investor Relations
+61 2 9994 7125
skingham@challenger.com.au

Jana Flanagan
Investor Relations Manager
+61 2 9994 7815
jflanagan@challenger.com.au


**Important Note**

Information presented in the Analyst Pack 1H17 is presented on an operational basis (rather than statutory) to reflect a management view of the business. Challenger Limited (ACN 106 842 371) also provides statutory reporting as prescribed under the Corporations Act 2001. The Challenger Limited Interim Financial Report 2017 is available from Challenger's website at www.challenger.com.au.

The analyst pack is not audited. The statutory net profit after-tax as disclosed in the consolidated profit and loss (page 2) has been prepared in accordance with Australian Accounting Standards and the Corporations Act 2001. Challenger's external auditors, Ernst & Young, have reviewed the statutory net profit after-tax as disclosed in the consolidated profit and loss. Normalised profit after-tax, as disclosed in the consolidated profit and loss (see page 2) has been prepared in accordance with a normalised profit framework. The normalised profit framework has been disclosed in section 2.2 of the Directors' Report in the Challenger Limited Interim Financial Report 2017. The normalised profit after-tax has been subject to a review performed by Ernst & Young.

Any forward looking statements included in this document are by nature subject to significant uncertainties, risks and contingencies, many of which are outside the control of, and are unknown to, Challenger, so that actual results or events may vary from those forward looking statements, and the assumptions on which they are based.

Past performance is not an indicator of future performance. While Challenger has sought to ensure that information is accurate by undertaking a review process, it makes no representation or warranty as to the accuracy or completeness of any information or statement in this document. In particular, information and statements in this document do not constitute investment advice or a recommendation on any matter, and should not be relied upon.

# Key performance indicators

| | 1H17 | 2H16 | 1H16 | 2H15 | 1H15 |
|---|---|---|---|---|---|
| **Earnings** | | | | | |
| Normalised NPAT ($m) | 196.6 | 179.6 | 182.1 | 179.1 | 154.9 |
| Statutory NPAT ($m) | 201.5 | 93.4 | 234.3 | 168.9 | 130.1 |
| Normalised EBIT ($m) | 256.4 | 232.8 | 238.7 | 232.0 | 206.4 |
| Underlying operating cash flow ($m) | 168.5 | 149.7 | 147.4 | 194.3 | 93.6 |
| Normalised cost to income ratio | 32.9% | 35.4% | 33.8% | 33.3% | 34.4% |
| Normalised effective tax rate | 22.6% | 22.3% | 23.0% | 22.1% | 24.3% |
| **Earnings per share (cents)** | | | | | |
| Basic – normalised | 35.0 | 32.0 | 32.6 | 32.4 | 28.8 |
| Basic – statutory | 35.8 | 16.6 | 41.9 | 30.5 | 24.2 |
| Diluted – normalised | 33.3 | 30.3 | 30.5 | 30.0 | 27.0 |
| Diluted – statutory | 34.1 | 16.3 | 39.0 | 28.3 | 22.8 |
| **Return on equity (%)** | | | | | |
| Normalised Return on Equity (ROE) – pre-tax | 18.7% | 17.4% | 18.1% | 18.6% | 17.4% |
| Normalised Return on Equity (ROE) – post-tax | 14.5% | 13.6% | 14.0% | 14.5% | 13.2% |
| Statutory Return on Equity (ROE) – post-tax | 14.8% | 7.1% | 18.0% | 13.7% | 11.1% |
| **Capital management** | | | | | |
| Net assets – average[1] ($m) | 2,694 | 2,664 | 2,592 | 2,494 | 2,331 |
| Net assets – closing ($m) | 2,781 | 2,681 | 2,696 | 2,543 | 2,443 |
| Net assets per basic share ($) | 4.95 | 4.80 | 4.80 | 4.60 | 4.42 |
| Net tangible assets ($m) | 2,192 | 2,097 | 2,111 | 1,994 | 1,896 |
| Net tangible assets per basic share ($) | 3.90 | 3.75 | 3.75 | 3.60 | 3.43 |
| Dividend (cps) | 17.0 | 16.5 | 16.0 | 15.5 | 14.5 |
| Dividend franking (%) | 100.0 | 100.0 | 100.0 | 100.0 | 70.0 |
| Normalised dividend payout ratio | 48.6% | 51.6% | 49.1% | 47.8% | 50.4% |
| **Sales, net flows and assets under management** | | | | | |
| Life annuity sales ($m) | 2,196.1 | 1,710.1 | 1,641.1 | 1,178.3 | 1,574.8 |
| Other Life sales ($m) | 562.3 | 588.8 | 409.7 | 395.1 | 548.9 |
| Total Life sales ($m) | 2,758.4 | 2,298.9 | 2,050.8 | 1,573.4 | 2,123.7 |
| Life annuity net flows ($m) | 448.9 | 469.9 | 270.5 | 177.4 | 560.8 |
| Life annuity book ($m) | 9,784.9 | 9,558.5 | 8,868.4 | 8,692.6 | 8,573.1 |
| Life annuity net book growth | 4.7% | 5.4% | 3.1% | 2.2% | 7.2% |
| Total Life net flows ($m) | 843.4 | 721.2 | 347.1 | 212.5 | 438.4 |
| Total Life book[2] ($m) | 11,418.1 | 10,874.0 | 9,903.5 | 9,637.7 | 9,527.9 |
| Total Life net book growth | 7.8% | 7.5% | 3.6% | 2.4% | 4.9% |
| Funds Management – net flows[3] ($m) | 3,217.1 | 1,839.2 | (4,356.4) | 972.7 | 6,766.2 |
| Total Group assets under management | 64,705 | 60,051 | 57,617 | 59,789 | 57,169 |
| **Other** | | | | | |
| Headcount – closing FTEs | 632 | 635 | 618 | 560 | 563 |
| Weighted average number of basic shares on issue (m) | 562.3 | 561.2 | 559.1 | 553.2 | 538.2 |
| Number of basic shares on issue (m) | 562.3 | 558.8 | 562.2 | 553.4 | 552.9 |
| Share price closing ($) | 11.24 | 8.63 | 8.72 | 6.72 | 6.53 |

1. Net assets – average calculated on a monthly basis.
2. Total Life book includes Life annuity book, Guaranteed Index Return and Challenger Index Plus liabilities.
3. Funds Management 1H16 net flows include $5.4bn derecognition of Kapstream following the sale in July 2015. Fidante Partners will no longer receive distribution fees on Kapstream institutional FUM ($5.4bn) and as a result has derecognised this FUM in 1H16.

# Consolidated profit and loss

| $m | 1H17 | 2H16 | 1H16 | 2H15 | 1H15 |
|---|---|---|---|---|---|
| Cash earnings | 265.3 | 247.4 | 244.5 | 240.1 | 223.3 |
| Normalised capital growth | 51.1 | 52.1 | 48.4 | 45.9 | 34.5 |
| **Normalised Cash Operating Earnings (COE)** | **316.4** | **299.5** | **292.9** | **286.0** | **257.8** |
| Net fee income | 65.3 | 60.6 | 67.1 | 61.4 | 56.1 |
| Other income | 0.4 | 0.4 | 0.6 | 0.6 | 0.7 |
| **Total net income** | **382.1** | **360.5** | **360.6** | **348.0** | **314.6** |
| Personnel expenses | (87.9) | (89.0) | (83.8) | (78.3) | (76.5) |
| Other expenses | (37.8) | (38.7) | (38.1) | (37.7) | (31.7) |
| **Total expenses** | **(125.7)** | **(127.7)** | **(121.9)** | **(116.0)** | **(108.2)** |
| **Normalised EBIT** | **256.4** | **232.8** | **238.7** | **232.0** | **206.4** |
| Interest and borrowing costs | (2.3) | (1.8) | (2.3) | (2.1) | (1.7) |
| **Normalised profit before tax** | **254.1** | **231.0** | **236.4** | **229.9** | **204.7** |
| Normalised tax | (57.5) | (51.4) | (54.3) | (50.8) | (49.8) |
| **Normalised profit after tax** | **196.6** | **179.6** | **182.1** | **179.1** | **154.9** |
| Investment experience after-tax | 4.9 | (86.2) | 30.1 | (10.2) | (24.8) |
| Significant items after-tax[1] | - | - | 22.1 | - | - |
| **Statutory net profit after-tax** | **201.5** | **93.4** | **234.3** | **168.9** | **130.1** |
| **Performance analysis** | | | | | |
| Normalised earnings per share – basic (cents) | 35.0 | 32.0 | 32.6 | 32.4 | 28.8 |
| Shares for basic EPS calculation | 562.3 | 561.2 | 559.1 | 553.2 | 538.2 |
| Normalised cost to income ratio | 32.9% | 35.4% | 33.8% | 33.3% | 34.4% |
| Normalised effective tax rate | 22.6% | 22.3% | 23.0% | 22.1% | 24.3% |
| **Total net income analysis** | | | | | |
| Cash earnings (Life) | 69.4% | 68.6% | 67.8% | 69.0% | 71.0% |
| Normalised capital growth (Life) | 13.4% | 14.5% | 13.4% | 13.2% | 11.0% |
| Net fee income (Funds Management) | 17.1% | 16.8% | 18.6% | 17.6% | 17.8% |
| Other income (Corporate) | 0.1% | 0.1% | 0.2% | 0.2% | 0.2% |
| **Normalised EBIT by division** | | | | | |
| Life | 267.0 | 250.9 | 248.9 | 240.9 | 215.8 |
| Funds Management | 20.7 | 15.8 | 21.6 | 23.3 | 20.8 |
| Corporate | (31.3) | (33.9) | (31.8) | (32.2) | (30.2) |
| **Normalised EBIT** | **256.4** | **232.8** | **238.7** | **232.0** | **206.4** |

1. 1H16 significant items after tax primarily represents the gain on sale of Challenger's equity investment in Kapstream, offset by boutique impairments and office relocation costs.

## Normalised profit after-tax

1H17 normalised profit after-tax was $197m, up $15m (8%) from $182m in 1H16. The increase in normalised profit after-tax includes an $18m (7%) increase in EBIT, partially offset by a $3m increase in normalised tax.

EBIT increased as a result of a 12% increase in total assets under management (AUM), increasing total net income by $22m (6%), partially offset by a $4m (3%) increase in expenses.

## Normalised earnings per share (EPS)

Normalised EPS increased by 7% from 32.6 cps in 1H16 to 35.0 cps in 1H17. The increase in normalised EPS reflects higher normalised profit after-tax.

The weighted average number of shares on issue in 1H17 was 1% higher than in 1H16 (refer to page 7 for more detail), with the increase reflecting the release of treasury shares to meet Challenger Performance Plan requirements.

## Total net income

Total net income increased by $21m (6%) in 1H17 due to:

- $23m increase (up 8%) in Life Cash Operating Earnings (COE) from higher Life average AUM (up 10%), partially offset by a lower COE margin due to a lower return on shareholder capital (refer to page 12 for more detail); and
- $2m decrease (down 3%) in Funds Management net fee income. Funds Management net income benefited from an increase in average FUM, and a rebound in UK revenue following the Brexit vote, however was offset by lower performance fees.

## Expenses

1H17 total expenses were $126m, up $4m (3%) on 1H16. The increase in expenses relates to higher personnel costs, increasing $4m (5%) due to higher employee numbers and general salary increases.

Challenger's full time equivalent employees at 31 December 2016 was 632, up 2% from 31 December 2015.

In 1H17, the cost to income ratio decreased by 90 bps to a new low of 32.9%, and is toward the lower end of Challenger's targeted normalised cost to income ratio guidance range of between 32% and 36%.

Challenger remains one of Australia's most efficient financial services companies with a cost to income ratio 17 percentage points lower than the average ratio across ASX100 banks and diversified financial companies.

## Normalised EBIT

1H17 normalised EBIT was $256m, and increased by $18m (7%) from $239m in 1H16. EBIT increased by $18m (7%) in Life, decreased by $1m (4%) in Funds Management, and Corporate EBIT (loss of $31m) improved by $1m.

The increase in Life normalised EBIT reflects a 10% increase in average AUM, partially offset by an 8 bps reduction in Life's COE margin (refer to page 12 for more detail on Life's COE margin).

The decrease in Funds Management EBIT reflects lower Fidante Partners' and Challenger Investment Partners' net income. The benefit of higher average FUM in both businesses was offset by lower performance fees.

## Normalised Return on Equity (ROE)

1H17 normalised ROE was 18.7% (pre-tax) and increased by 60 bps from 1H16. The increase reflects higher normalised net profit before tax (up 7%) partially offset by higher average net assets (up 4%).

Challenger targets a long term pre-tax normalised ROE of 18% and achieved this target in 1H17.

## Normalised tax

Normalised tax was $58m in 1H17, with an effective tax rate of 23%.

The effective tax rate of 23% is unchanged from 1H16 and within Challenger's medium term expected normalised effective tax rate range of between 23% and 25%, with this range based on current business mix.

## Investment experience after-tax

Challenger Life is required by Australian accounting standards to value investment assets and liabilities supporting the Life business at fair value. This gives rise to fluctuating valuation movements on investment assets and liabilities being recognised in the profit and loss. Challenger is generally a long term holder of assets, due to them being held to match the term of life contract liabilities. As a result, Challenger takes a long term view of the expected capital growth of the portfolio rather than focusing on short term movements.

Investment experience relates to the Life business and pre-tax investment experience is disclosed as part of Life's financial results.

1H17 investment experience was a pre-tax gain of $8m (refer to page 13 for more detail), or $5m post-tax.

### Significant one-off items

Significant one-off items represent non-recurring and abnormal income and expense items. There were no significant one-off items in 1H17.

1H16 significant one-off items ($22m after-tax) predominately related to a gain on the sale of Kapstream, a Funds Management boutique manager sold in July 2015.

### Statutory net profit after-tax

Statutory net profit includes after-tax investment experience and significant one-off items.

Statutory net profit after-tax in 1H17 was $202m, down $33m (14%) from $234m in 1H16. The decrease in statutory net profit after-tax reflects higher normalised profit after-tax (up $15m), no significant one-off items in 1H17 (down $22m), and lower after-tax investment experience (down $25m).

## Dividends

### Interim dividend

The 1H17 dividend was 17.0 cents per share, up 6% on the 1H16 dividend.

The normalised dividend payout ratio for the 1H17 dividend was 49%, and within Challenger's dividend payout ratio guidance of between 45% and 50% of normalised profit after-tax.

Challenger's franking account balance at 31 December 2016 was $40m.

1H17 dividend dates are as follows:

- Ex-date: 28 February 2017;
- Record date: 1 March 2017;
- Final DRP election date: 2 March 2017; and
- Dividend payment date: 28 March 2017.

### Dividend Reinvestment Plan

The Challenger Limited Board established a Dividend Reinvestment Plan (DRP) in September 2015. The DRP provides an effective way for shareholders to reinvest their dividends and increase their shareholding without incurring transaction costs.

The DRP participation rate for the final FY16 dividend (paid in September 2016) was 4% of issued capital, with 0.5m new Challenger shares issued. Under the terms of the DRP, new Challenger shares were issued based on a ten day Challenger share VWAP, with no share price discount applied.

The DRP had the effect of reducing the effective cash dividend payout ratio for the final FY16 dividend from 52% to 50%.

For the 1H17 interim dividend, new Challenger shares will be issued in order to fulfil DRP requirements, and will continue to be issued based on a ten day Challenger share VWAP, with no discount applied.

## Credit ratings

In November 2016, Standard & Poor's (S&P) affirmed both Challenger Life Company (CLC) and Challenger Limited's credit ratings. The S&P ratings reflect the financial strength of Challenger Limited and CLC, with ratings reconfirmed as:

- CLC: 'A' with a stable outlook; and
- Challenger Limited: 'BBB+' with a stable outlook.

## FY17 guidance

### Life COE

Life FY17 COE guidance is a range of $620m to $640m (FY16 actual $592m). 1H17 Life COE was $316m.

In maintaining FY17 COE guidance, Challenger expects the 2H17 COE margin to be stable on 1H17 (excluding the one-off Life Risk fee of ~$10m received in 1H17). FY17 COE guidance also includes the impact of lower interest rates on shareholder capital, with shareholder capital not hedged for movements in interest rates.

### Dividend policy

Challenger targets a dividend payout ratio in the range of 45% to 50% of normalised profit after-tax and aims to frank dividends to the maximum extent possible. Based on current expectations, the Board expects future dividends to be fully franked. However, the actual dividend payout ratio and franking levels will depend on prevailing market conditions and capital allocation priorities.

### Cost to income ratio

Challenger's business remains one of Australia's most efficient financial services companies and is highly scalable. Challenger targets a normalised cost to income ratio in the range of 32% to 36% and is currently (1H17 32.9%) toward the bottom end of the guidance range.

# Group balance sheet[1]

| $m | 1H17 | FY16 | 1H16 | FY15 | 1H15 |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| **Life investment assets** | | | | | |
| Fixed income and cash (net) | 9,520.9 | 9,315.5 | 8,487.6 | 8,513.7 | 8,541.1 |
| Property (net) | 3,328.3 | 3,150.0 | 3,063.2 | 2,883.7 | 2,716.4 |
| Equity and other investments | 1,231.6 | 1,079.0 | 1,060.0 | 882.8 | 632.4 |
| Infrastructure (net) | 526.4 | 567.2 | 536.4 | 514.4 | 503.0 |
| **Life investment assets** | **14,607.2** | **14,111.7** | **13,147.2** | **12,794.6** | **12,392.9** |
| Cash and cash equivalents (Group cash) | 80.7 | 84.2 | 89.3 | 98.6 | 126.0 |
| Receivables | 121.0 | 120.2 | 148.5 | 175.7 | 217.4 |
| Derivative assets | 226.0 | 354.2 | 292.6 | 255.0 | 356.6 |
| Investment in associates | 49.1 | 51.5 | 30.2 | 43.4 | 39.4 |
| Other assets | 48.2 | 48.0 | 50.7 | 27.3 | 42.6 |
| Fixed assets | 32.9 | 34.9 | 34.3 | 8.4 | 10.9 |
| Goodwill and intangibles | 588.4 | 583.9 | 585.5 | 549.4 | 547.2 |
| Less Group/Life eliminations[2] | (93.2) | (105.3) | (123.0) | (136.5) | (154.9) |
| **Total assets** | **15,660.3** | **15,283.3** | **14,255.3** | **13,815.9** | **13,578.1** |
| **Liabilities** | | | | | |
| Payables | 219.8 | 228.6 | 184.9 | 181.5 | 195.0 |
| Tax liabilities | 177.7 | 162.6 | 182.4 | 155.3 | 150.4 |
| Derivative liabilities | 322.7 | 409.5 | 352.8 | 370.6 | 344.5 |
| Subordinated debt | 384.8 | 576.7 | 576.5 | 567.0 | 560.7 |
| Challenger Capital Notes | 339.3 | 338.5 | 337.7 | 336.8 | 336.2 |
| Provisions | 17.4 | 12.5 | 21.3 | 23.8 | 20.5 |
| Life annuity book | 9,784.9 | 9,558.5 | 8,868.4 | 8,693.0 | 8,573.1 |
| Guaranteed Index Return (GIR) and Challenger Index Plus liabilities | 1,633.2 | 1,315.5 | 1,035.1 | 944.7 | 954.8 |
| **Total liabilities** | **12,879.8** | **12,602.4** | **11,559.1** | **11,272.7** | **11,135.2** |
| **Group net assets** | **2,780.5** | **2,680.9** | **2,696.2** | **2,543.2** | **2,442.9** |
| **Equity** | | | | | |
| Contributed equity | 1,560.1 | 1,546.7 | 1,576.8 | 1,527.2 | 1,524.3 |
| Reserves | (29.9) | (7.9) | (19.7) | 23.7 | 13.8 |
| Retained earnings | 1,250.3 | 1,142.1 | 1,139.1 | 992.3 | 904.8 |
| **Total equity** | **2,780.5** | **2,680.9** | **2,696.2** | **2,543.2** | **2,442.9** |

# Change in Group net assets

| $m | 1H17 | 2H16 | 1H16 | 2H15 | 1H15 |
|---|---|---|---|---|---|
| **Opening net assets** | **2,680.9** | **2,696.2** | **2,543.2** | **2,442.9** | **2,153.3** |
| Statutory net profit after tax | 201.5 | 93.4 | 234.3 | 168.9 | 130.1 |
| Dividends paid | (93.3) | (90.4) | (87.5) | (81.4) | (71.3) |
| New share issue | 4.1 | 4.9 | 6.3 | - | 287.2 |
| Reserve movements | (22.0) | 11.8 | (43.4) | 9.9 | (56.0) |
| CPP Trust movements | 9.3 | (35.0) | 43.3 | 2.9 | (0.4) |
| **Closing net assets** | **2,780.5** | **2,680.9** | **2,696.2** | **2,543.2** | **2,442.9** |

1. Excludes consolidation of Special Purpose Vehicles (SPV's) and non-controlling interests.
2. Group/Life eliminations represent the fair value of the SPV residual income notes (i.e. NIM) held by Challenger Life Company Ltd.

# Issued share capital

| Number of shares (m) | 1H17 | 2H16 | 1H16 | 2H15 | 1H15 |
|---|---|---|---|---|---|
| Basic share count | 562.3 | 558.8 | 562.2 | 553.4 | 552.9 |
| CPP 'treasury' shares | 9.4 | 12.4 | 8.4 | 16.3 | 16.8 |
| **Total issued shares** | **571.7** | **571.2** | **570.6** | **569.7** | **569.7** |
| **Movement in basic share count** | | | | | |
| Opening | 558.8 | 562.2 | 553.4 | 552.9 | 510.6 |
| CPP deferred share purchase | (2.0) | (4.0) | - | - | (4.6) |
| Net treasury shares (acquired)/released | 5.0 | - | 7.9 | 0.5 | 8.1 |
| New share issues | 0.5 | 0.6 | 0.9 | - | 38.8 |
| Closing | 562.3 | 558.8 | 562.2 | 553.4 | 552.9 |
| **Movement in CPP 'treasury' shares** | | | | | |
| Opening | 12.4 | 8.4 | 16.3 | 16.8 | 20.3 |
| Shares vested to participants | (6.0) | (0.5) | (9.0) | (0.5) | (13.6) |
| CPP deferred share purchase | 2.0 | 4.0 | - | - | 4.6 |
| Shares bought into CPP Trust | 1.0 | 0.5 | 1.1 | - | 5.5 |
| Closing | 9.4 | 12.4 | 8.4 | 16.3 | 16.8 |

| Weighted average number of shares (m) | 1H17 | 2H16 | 1H16 | 2H15 | 1H15 |
|---|---|---|---|---|---|
| **Basic EPS shares** | | | | | |
| Total issued shares | 571.4 | 570.9 | 570.1 | 569.7 | 556.0 |
| Less CPP 'treasury' shares | (9.1) | (9.7) | (11.0) | (16.5) | (17.8) |
| Shares for basic EPS calculation | 562.3 | 561.2 | 559.1 | 553.2 | 538.2 |
| **Diluted EPS shares** | | | | | |
| Shares for basic EPS calculation | 562.3 | 561.2 | 559.1 | 553.2 | 538.2 |
| Add dilutive impact of equity awards schemes | 14.7 | 15.7 | 17.7 | 18.6 | 23.0 |
| Add dilutive impact of capital notes | 31.8 | 39.1 | 41.6 | 51.2 | 25.4 |
| Shares for dilutive EPS calculation | 608.8 | 616.0 | 618.4 | 623.0 | 586.6 |

| Summary of Share Rights (m) | 1H17 | 2H16 | 1H16 | 2H15 | 1H15 |
|---|---|---|---|---|---|
| **Hurdled Performance Share Rights** | | | | | |
| Opening | 12.5 | 13.0 | 17.3 | 17.6 | 26.6 |
| New grants | 2.5 | - | 3.4 | 0.2 | 2.4 |
| Vesting/forfeiture | (4.6) | (0.5) | (7.7) | (0.5) | (11.4) |
| Closing | 10.4 | 12.5 | 13.0 | 17.3 | 17.6 |
| **Deferred Performance Share Rights** | | | | | |
| Opening | 3.8 | 3.8 | 3.5 | 3.6 | 3.8 |
| New grants | 1.6 | - | 2.3 | - | 2.3 |
| Vesting/forfeiture | (1.7) | - | (2.0) | (0.1) | (2.5) |
| Closing | 3.7 | 3.8 | 3.8 | 3.5 | 3.6 |

# Issued share capital

## Issued share capital and diluted share count

The number of Challenger Limited shares listed on the Australian Securities Exchange (ASX) at 31 December 2016 was 572m shares, and increased 0.5m in 1H17 for new shares issued as result of the September 2016 Dividend Reinvestment Plan (DRP).

The basic share count used to determine Challenger's normalised and statutory EPS is based on requirements set out in Australian Accounting Standards. Under Australian Accounting Standards:

- the basic share count is reduced for treasury shares;
- the dilutive share count includes unvested equity awards made to employees under the Challenger Performance Plan; and
- the dilutive share count considers convertible instruments (e.g. Challenger Capital Notes) with inclusion in the dilutive share count determined by a probability of vesting test.

In 1H17 the basic share count increased by 3.5m shares following the net release of treasury shares in order to meet Challenger Performance Plan requirements, and 0.5m new shares issued as part of Challenger's DRP.

## Treasury shares

The Challenger Performance Plan (CPP) Trust was established to purchase shares to satisfy Challenger's employee equity obligations arising from hurdled and non-hurdled equity awards issued under employee remuneration structures.

Shares are acquired by the CPP Trust to mitigate shareholder dilution and provide a mechanism to hedge the cash cost of acquiring shares in the future to satisfy vested equity awards.

The CPP Trust typically acquires physical shares on market or via forward share purchase agreements. The use of forward share purchase agreements was implemented to increase capital efficiency. Shares held by the CPP Trust are classified as treasury shares.

It is expected that should equity awards vest in the future, the CPP Trust will satisfy equity requirements via a combination of treasury shares and settlement of forward purchase agreements. As such, it is not anticipated that new Challenger shares will be issued to meet future vesting obligations of equity awards.

# Unvested equity awards

## Hurdled Performance Share Rights (HPSRs)

Challenger's approach to executive remuneration includes providing Long Term Incentive (LTI) awards to ensure alignment between key employees and shareholders.

LTI awards are delivered as HPSRs, which vest over a period of up to five years and subject to meeting total shareholder return performance hurdles and continued employment before vesting.

## Deferred Performance Share Rights (DPSRs)

A portion of Short Term Incentive (STI) awards are deferred and vest over a period of up to three years. The deferred STI is delivered as DPSRs with vesting subject to continued employment.

# Challenger Capital Notes

In October 2014, Challenger issued Challenger Capital Notes to the value of $345m, which are subordinated, unsecured convertible notes issued by Challenger Limited.

Under Australian Accounting Standards convertible debt is considered dilutive whenever the interest per ordinary share obtainable on conversion is less than the basic earnings per share. As such, for Challenger Capital Notes a test is required to be undertaken each reporting period to determine if they are included in the dilutive share count.

Under Australian Accounting Standards, Challenger Capital Notes have been considered to be dilutive at 31 December 2016 and are included in Challenger's 1H17 dilutive share count.

Challenger Capital Notes are convertible to ordinary shares at any time before May 2022 on the occurrence of certain events, and mandatorily convertible to ordinary shares thereafter, in both cases subject to meeting certain conditions.

However, Challenger retains the option to redeem or resell Challenger Capital Notes and has an outright option to redeem or resell on 25 May 2020 (both subject to certain conditions being met). If Challenger exercises its option to redeem or resell, there will be no conversion of Challenger Capital Notes to Challenger ordinary shares and no subsequent dilution.

# Consolidated operating cash flow

| $m | 1H17 | 2H16 | 1H16 | 2H15 | 1H15 |
|---|---|---|---|---|---|
| Receipts from customers | 339.0 | 317.2 | 281.2 | 288.8 | 254.2 |
| Dividends received | 36.0 | 24.2 | 32.2 | 43.1 | 34.0 |
| Interest received | 326.5 | 294.3 | 344.8 | 316.3 | 269.6 |
| Interest paid | (233.5) | (221.0) | (223.8) | (225.3) | (213.4) |
| Payments to suppliers and employees | (261.5) | (231.6) | (256.5) | (206.6) | (207.1) |
| Income tax paid | (38.0) | (33.4) | (30.5) | (22.0) | (43.7) |
| **Underlying operating cash flow** | **168.5** | **149.7** | **147.4** | **194.3** | **93.6** |
| Adjust for: | | | | | |
| Net annuity policy capital receipts | 448.9 | 469.9 | 270.5 | 177.4 | 560.8 |
| Net other Life capital receipts/(payments) | 345.0 | 230.1 | 78.9 | (16.7) | (170.0) |
| Other[1] | (22.5) | (34.9) | (29.2) | (7.7) | (15.8) |
| **Operating cash flow per financial report** | **939.9** | **814.8** | **467.6** | **347.3** | **468.6** |

Underlying operating cash flow excludes cash flows that are capital in nature such as annuity sales and annuity capital payments.

1H17 underlying operating cash flow was $169m, up $21m (14%) from 1H16.

1H17 underlying operating cash flow varies from 1H17 normalised net profit after-tax ($197m) mainly due to non-cash normalised capital growth ($51m), timing of dividends from Fidante Partners boutiques, and income tax paid.

## Net annuity policy capital receipts

1H17 net annuity policy capital receipts were $449m and comprise:

- Annuity sales of $2,196m; less
- Annuity capital payments of $1,747m.

Annuity capital payments are returns of capital to annuitants and exclude interest payments.

1H17 annuity net book growth was 4.7% (1H16 3.1%) and can be calculated as annuity net flows ($449m) divided by opening period Life annuity book ($9,558m – refer to page 10).

## Net other Life capital receipts

1H17 net other Life capital receipts in 1H17 were $345m and comprise:

- Other Life sales of $562m; less
- Other Life capital payments of $217m.

Other Life sales includes a new ~$200m Guaranteed Index Return (GIR) mandate from an existing client, a ~$200m re-investment, and ~$150m mandate for the new Challenger Index Plus product. Challenger Index Plus is a pooled version of GIR, and was launched in the second quarter of FY17.

1H17 total Life book growth was 7.8% (1H16 3.6%) and can be calculated as total net flows ($843m) divided by the sum of the opening period annuity liability and GIR liabilities ($10,874m – refer to page 10).

1. Other includes net SPV operating cash flow and adjustments for classification differences between statutory operating cash flow and normalised cash operating earnings.

# Life financial results

| $m | 1H17 | 2H16 | 1H16 | 2H15 | 1H15 |
|---|---|---|---|---|---|
| Investment yield – policyholders' funds | 405.0 | 385.1 | 382.4 | 390.2 | 375.6 |
| Interest expense | (210.3) | (203.5) | (206.9) | (209.1) | (204.7) |
| Distribution expense | (16.5) | (14.3) | (10.2) | (11.5) | (14.0) |
| Other income[1] | 24.5 | 12.8 | 11.6 | 10.8 | 9.0 |
| **Product cash margin** | **202.7** | **180.1** | **176.9** | **180.4** | **165.9** |
| Investment yield – shareholders' funds | 62.6 | 67.3 | 67.6 | 59.7 | 57.4 |
| **Cash earnings** | **265.3** | **247.4** | **244.5** | **240.1** | **223.3** |
| Normalised capital growth | 51.1 | 52.1 | 48.4 | 45.9 | 34.5 |
| **Normalised Cash Operating Earnings (COE)** | **316.4** | **299.5** | **292.9** | **286.0** | **257.8** |
| Personnel expenses | (30.1) | (29.8) | (26.9) | (25.6) | (25.4) |
| Other expenses | (19.3) | (18.8) | (17.1) | (19.5) | (16.6) |
| **Total expenses** | **(49.4)** | **(48.6)** | **(44.0)** | **(45.1)** | **(42.0)** |
| **Normalised EBIT** | **267.0** | **250.9** | **248.9** | **240.9** | **215.8** |
| Investment experience | 8.5 | (111.4) | 43.0 | (14.6) | (35.4) |
| **Net profit after investment experience before tax** | **275.5** | **139.5** | **291.9** | **226.3** | **180.4** |
| **Reconciliation of investment experience to capital growth** | | | | | |
| Investment experience | 8.5 | (111.4) | 43.0 | (14.6) | (35.4) |
| Normalised capital growth | 51.1 | 52.1 | 48.4 | 45.9 | 34.5 |
| **Capital growth** | **59.6** | **(59.3)** | **91.4** | **31.3** | **(0.9)** |
| **Performance analysis** | | | | | |
| Cost to income ratio[2] | 15.6% | 16.2% | 15.0% | 15.8% | 16.3% |
| Net assets – average[3] | 2,468 | 2,487 | 2,441 | 2,383 | 2,318 |
| Normalised ROE (pre-tax) | 21.5% | 20.3% | 20.3% | 20.4% | 18.5% |

1. Other income includes Accurium revenue and Life Risk revenue (premiums net of claims).
2. Cost to income ratio calculated as total expenses divided by Normalised Cash Operating Earnings.
3. Net assets – average calculated on a monthly basis. Prior comparative periods have been restated to reflect monthly average calculations.

# Life financial results

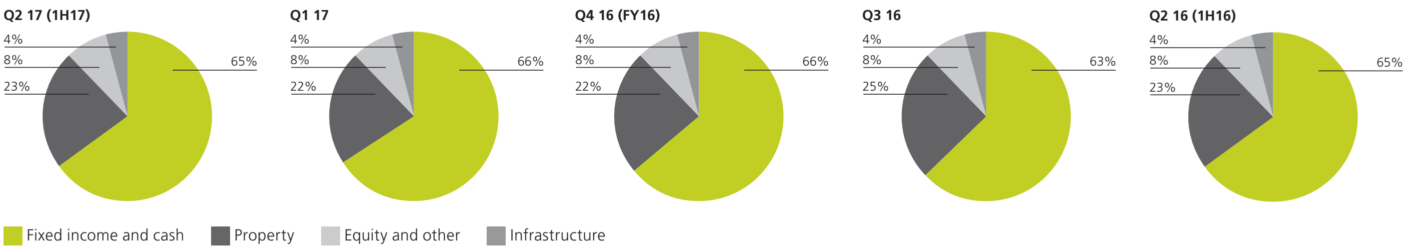
| $m | 1H17 | 2H16 | 1H16 | 2H15 | 1H15 |
|---|---|---|---|---|---|
| **Sales** | | | | | |
| Fixed Term sales | 1,641.9 | 1,357.4 | 1,412.4 | 1,017.6 | 1,255.6 |
| Lifetime sales | 554.2 | 352.7 | 228.7 | 160.7 | 319.2 |
| **Life annuity sales** | **2,196.1** | **1,710.1** | **1,641.1** | **1,178.3** | **1,574.8** |
| Maturities and repayments | (1,747.2) | (1,240.2) | (1,370.6) | (1,000.9) | (1,014.0) |
| **Life annuity net flows** | **448.9** | **469.9** | **270.5** | **177.4** | **560.8** |
| Life annuity book | 9,784.9 | 9,558.5 | 8,868.4 | 8,692.6 | 8,573.1 |
| **Annuity net book growth** | **4.7%** | **5.4%** | **3.1%** | **2.2%** | **7.2%** |
| | | | | | |
| Other Life sales | 562.3 | 588.8 | 409.7 | 395.1 | 548.9 |
| Other maturities and repayments | (167.8) | (337.5) | (333.1) | (360.0) | (671.3) |
| **Other Life net flows** | **394.5** | **251.3** | **76.6** | **35.1** | **(122.4)** |
| Guaranteed Index Return (GIR) and Challenger Index Plus liabilities | 1,633.2 | 1,315.5 | 1,035.1 | 944.7 | 954.8 |
| **Other Life net book growth** | **30.0%** | **26.6%** | **8.1%** | **3.2%** | **(11.4%)** |
| Total Life net flows | 843.4 | 721.2 | 347.1 | 212.5 | 438.4 |
| Life annuity book, GIR and Challenger Index Plus liabilities | 11,418.1 | 10,874.0 | 9,903.5 | 9,637.3 | 9,527.9 |
| **Total Life net book growth[1]** | **7.8%** | **7.5%** | **3.6%** | **2.4%** | **4.9%** |
| | | | | | |
| **Assets** | | | | | |
| **Closing investment assets** | **14,607** | **14,112** | **13,147** | **12,795** | **12,393** |
| Fixed income and cash[2] | 9,434 | 8,537 | 8,409 | 8,575 | 8,234 |
| Property | 3,205 | 3,220 | 3,120 | 2,906 | 2,385 |
| Equity and other investments | 1,110 | 1,059 | 928 | 742 | 511 |
| Infrastructure | 538 | 553 | 545 | 518 | 512 |
| **Average investment assets[3]** | **14,287** | **13,369** | **13,002** | **12,741** | **11,642** |
| | | | | | |
| **Liabilities** | | | | | |
| **Closing liabilities – annuities, GIR, capital notes and sub debt** | **12,148** | **11,796** | **10,825** | **10,550** | **10,436** |
| Average liabilities – annuities and GIR | 11,133 | 10,166 | 9,786 | 9,706 | 9,107 |
| Average liabilities – capital notes | 345 | 345 | 345 | 345 | 148 |
| Average liabilities – sub debt | 556 | 574 | 584 | 582 | 543 |
| **Average liabilities[3]** | **12,034** | **11,085** | **10,715** | **10,633** | **9,798** |
| | | | | | |
| **Margins[4]** | | | | | |
| Investment yield – policyholders' funds | 5.62% | 5.80% | 5.84% | 6.18% | 6.40% |
| Interest expense | (2.92%) | (3.06%) | (3.16%) | (3.31%) | (3.49%) |
| Distribution expense | (0.23%) | (0.22%) | (0.16%) | (0.18%) | (0.24%) |
| Other income | 0.34% | 0.19% | 0.18% | 0.17% | 0.15% |
| **Product cash margin** | **2.81%** | **2.71%** | **2.70%** | **2.86%** | **2.82%** |
| Investment yield – shareholders' funds | 0.87% | 1.01% | 1.03% | 0.94% | 0.98% |
| **Cash earnings** | **3.68%** | **3.72%** | **3.73%** | **3.80%** | **3.80%** |
| Normalised capital growth | 0.71% | 0.79% | 0.74% | 0.73% | 0.59% |
| **Normalised Cash Operating Earnings (COE)** | **4.39%** | **4.51%** | **4.47%** | **4.53%** | **4.39%** |

1. Total life net book growth represents Life annuity net flows and other Life net flows over the period divided by the opening Life annuity book and Guaranteed Index Return and Challenger Index Plus liabilities.
2. Includes NIM (1H17: $98m, 1H16: $123m, 1H15: $168m).
3. Average investment assets and average liabilities are calculated on a monthly basis.
4. Ratio of Normalised Cash Operating Earnings components divided by average investment assets.

# Life quarterly sales and investment assets

| $m | Q2 17 | Q1 17 | Q4 16 | Q3 16 | Q2 16 |
|---|---|---|---|---|---|
| **Life sales** | | | | | |
| Fixed Term | 905 | 737 | 912 | 445 | 801 |
| Lifetime (including Care) | 258 | 296 | 223 | 130 | 133 |
| **Total annuity sales** | **1,163** | **1,033** | **1,135** | **575** | **934** |
| Other Life sales | 512 | 50 | 300 | 289 | 233 |
| **Total Life sales** | **1,675** | **1,083** | **1,435** | **864** | **1,167** |
| | | | | | |
| **Life** | | | | | |
| Fixed income and cash[1] | 9,521 | 9,518 | 9,316 | 8,280 | 8,488 |
| Property[1] | 3,328 | 3,183 | 3,150 | 3,243 | 3,063 |
| Equity and other | 1,232 | 1,079 | 1,079 | 1,042 | 1,060 |
| Infrastructure[1] | 526 | 536 | 567 | 537 | 536 |
| **Total Life investment assets** | **14,607** | **14,316** | **14,112** | **13,102** | **13,147** |
| **Average Life investment assets[2]** | **14,354** | **14,227** | **13,535** | **13,134** | **13,047** |

## Life asset allocation




1. Fixed income, property and infrastructure are reported net of debt.
2. Average Life investment assets calculated on a monthly basis.

# Life financial results

Challenger Life Company Ltd (CLC) is Australia's leading provider of annuities and guaranteed retirement income products.

Life's products appeal to investors seeking the security and certainty of guaranteed cash flows with protection against market, inflation and longevity risks.

Products are distributed via financial advisers, both independent and within the major hubs. Being an independent product manufacturer, CLC's products are included on all major hub Approved Product Lists (APLs).

CLC is diversifying its product range and distribution footprint by launching new products and making products more broadly available to financial advisers and their customers through investment and administration platforms.

CLC has also formed an annuity relationship with Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary), a leading provider of Australian dollar denominated annuities in Japan (refer to page 16 for more detail).

CLC has won the Association of Financial Advisers/Plan for Life 'Annuity Provider of the Year' for the past eight years.

The Life business also includes Accurium, Australia's leading provider of Self-Managed Superannuation Fund (SMSF) actuarial certificates (refer to page 17 for more detail).

CLC is diversifying its capital and earnings base by participating in wholesale reinsurance longevity and mortality transactions (Life Risk). Life is experienced in managing, pricing and reinsuring longevity and mortality risk. Refer to page 16 for additional details on Life Risk.

CLC is an APRA regulated entity and its financial strength is rated by Standard & Poor's with an 'A' rating and stable outlook. CLC is strongly capitalised with significant excess capital above APRA's minimum requirements. CLC's regulatory capital base, prescribed capital amount, and excess capital is disclosed on page 30.

## Normalised EBIT and ROE

1H17 Life normalised EBIT was $267m and increased by $18m (7%) on 1H16. The increase in EBIT reflects a $23m increase in Normalised Cash Operating Earnings, partly offset by a $5m increase in expenses.

1H17 Life ROE (pre-tax) was 21.5%, and increased 120 bps from 20.3% in 1H16.

## Normalised Cash Operating Earnings (COE) and COE margin

1H17 normalised COE was $316m and increased by $23m (8%) on 1H16. The increase in normalised COE is a result of higher average AUM (up 10%), partially offset by a 8 bps reduction in Life's COE margin.

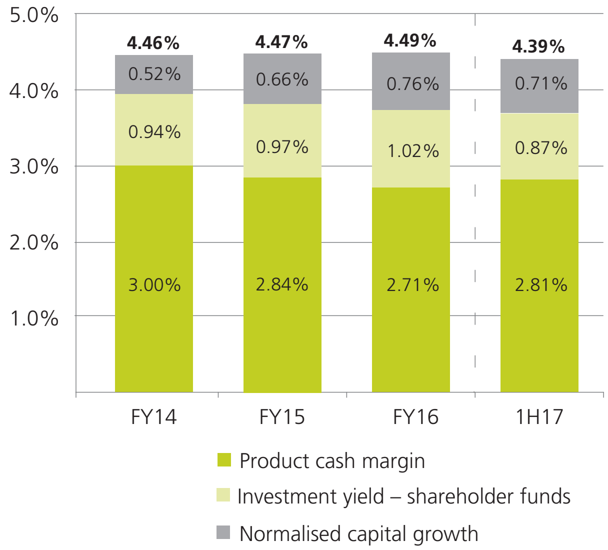
Life's 1H17 COE margin was 4.39%, down 8 bps from 4.47% in 1H16. 1H17 Life COE margin includes the following components:

- Product cash margin of 2.81% – up 11 bps on 1H16 with lower asset returns fully offset by lower annuity funding rates. Within product cash margin, other income increased by 16 bps on 1H16 to 0.34% (refer below for more detail);
- Return on shareholder funds of 0.87% – down 16 bps on 1H16 due to lower interest rates impacting the return on shareholder capital, which is not hedged for movements in interest rates. Return on shareholder funds in 1H17 was 5.59% down from 6.05% in 1H16; and
- Normalised capital growth of 0.71% – down 3 bps on 1H16.

1H17 normalised COE includes other income of $24m (34 bps), and was $13m higher than in 1H16. Other income includes Accurium revenue of $4m (1H16 $5m) and Life Risk revenue of $20m (1H16 $7m).

Life Risk revenue represents premiums net of expected claims on wholesale reinsurance longevity and mortality transactions (refer to page 16 for more detail). The increase in Life Risk revenue (up $13m) includes a one-off fee (~$10m) as a result of the counterparty restructuring a Life Risk transaction.

**Life COE margin composition**



## Expenses

1H17 total expenses were $49m, up $5m (12%) on 1H16 and were relatively unchanged from 2H16. The increase on 1H16 reflects higher personnel costs in 2H16 associated with resources supporting Life's strategy to expand its distribution and product footprint, including annuities on platforms, and entering the new annuity relationship with Mitsui Sumitomo Primary Life Insurance Company Limited (refer to page 16 for more information).

Life's cost to income ratio increased by 60 bps on 1H16 to 15.6% in 1H17, however decreased by 60 bps on 2H16 as a result of higher normalised COE (up 6%) and a 2% increase in expenses.

# Investment experience overview

Challenger Life is required by Australian Accounting Standards to value investment assets and liabilities supporting the Life business at fair value. This gives rise to fluctuating valuation movements on investment assets and liabilities being recognised in the profit and loss. Challenger is generally a long term holder of assets, due to them being held to match the term of life contract liabilities. As a result, Challenger takes a long term view of the expected capital growth of the portfolio rather than focusing on short term movements.

Investment experience represents the difference between actual investment gains/losses (both realised and unrealised) and expected gains/losses based on Challenger's long term expected returns. Refer to page 44 for details on Challenger's assumed long term expected returns by asset class.

Investment experience also includes any impact from changes in economic variables and assumptions, including changes in discount rates used to value Life's liabilities (refer to page 45 for more detail).

1H17 investment experience was an $8m (pre-tax) gain, comprising a $36m gain on Life's investment assets and a $28m loss on Life's annuity liabilities.

| Asset class ($m) | Actual capital growth | Normalised capital growth | Investment experience |
|---|---|---|---|
| Fixed income | 53 | 17 | 70 |
| Property | 48 | (32) | 16 |
| Infrastructure | (30) | (11) | (41) |
| Equity and other | 16 | (25) | (9) |
| **Asset investment experience** | **87** | **(51)** | **36** |
| Annuity liability valuation experience | (28) | - | (28) |
| **Total investment experience** | **59** | **(51)** | **8** |

## Asset investment experience

The gain on Life's investment assets in 1H17 of $36m was primarily due to:

- gains on Life's fixed income portfolio (+$70m) reflecting a ~30 bps contraction in credit spreads on Challenger's fixed income portfolio. As Challenger is generally a hold to maturity investor, any unrealised revaluation of Challenger's fixed income portfolio is expected to reverse over time. The credit default allowance recognised in the profit and loss in 1H17 was +$2m or +2 bps (1H16 -$5m or -6 bps) with a recovery of prior period credit defaults included in 1H17;
- property valuation gains (+$16m), which include unrealised revaluations, realised gains on properties disposed, and unrealised gains on Life's listed REIT portfolio. Direct property valuations increased by 1.1% in 1H17 and the listed REIT portfolio increased by 7%, both increasing by more than Challenger's 2% per annum normalised growth assumption;
- losses on infrastructure (-$41m) as a result of infrastructure underperforming Challenger's normalised growth assumption due to lower interest rates during 1H17. Infrastructure investment experience also includes the revaluation of an asset following the repositioning and establishment of a new long term lease; and
- losses on Life's equity portfolio (-$9m) as a result of equities underperforming Challenger's normalised growth assumption of 4.5% per annum.

## Annuity valuation investment experience

Investment experience includes the impact of changes in macroeconomic variables on the valuation of Challenger Life's policy liabilities. Economic and actuarial assumption changes include changes to bond yields and expected inflation rates, expense assumptions, losses on new business (new business strain) and other factors.

The investment experience on Life's annuity liabilities was a loss of $28m in 1H17, and was primarily due to:

- net new business strain (loss of $35m);
- higher illiquidity premium used to value Life's annuity liabilities (loss of $21m). The illiquidity premium increased as a result of a contraction in fixed income credit spreads; offset by
- other assumption changes (gain of $28m).

## Illiquidity premium

In accordance with Prudential Standards and Australian Accounting Standards, Challenger Life values term annuities at fair value and lifetime annuities using a risk-free discount rate, both of which are based on the Australian Commonwealth Government bond curve plus an illiquidity premium.

Movements in credit spreads impact the fair value of assets as well as the illiquidity premium which forms part of the discount rate used to value policy liabilities.

The illiquidity premium used to value policy liabilities is calculated in accordance with AASB 1038 Life Insurance Contracts and AASB 139 Financial Instruments: Recognition and Measurement.

## New business strain

In accordance with Australian Accounting Standards, Challenger Life values term annuities at fair value and lifetime annuities using a risk-free discount rate, both of which are based on the Australian Commonwealth Government bond curve plus an illiquidity premium.

Life tends to offer annuity rates which are higher than these rates. As a result, on writing new annuity business, a loss is recognised when issuing the annuity contract due to a lower discount rate used to value the liability.

New business strain is a non-cash item and subsequently unwinds over the period of the contract. 1H17 net new business strain included in investment experience was a loss $35m.

# Sales and AUM

## Annuity sales

1H17 Life annuity sales were $2.2bn, and increased by 34% on 1H16. Term annuity sales increased by 16% and lifetime annuity sales more than doubled (up 142%). Annuity sales were strong across both the first and second quarters, with both quarter's sales exceeding $1 billion.

Both term and lifetime annuity sales continue to benefit from favourable demographic trends, including an ageing population and retirees taking a more conservative approach to retirement investing. These favourable demographic trends are being leveraged by Challenger's market leading retirement income brand, highly rated distribution team, thought leadership, research and product capability.

Challenger's annuity sales growth is also benefiting from new distribution relationships, allowing access to Challenger's annuities via investment and administration platforms.

During FY16, Challenger annuities were made available on the Colonial First State platforms, which followed Challenger annuities being integrated with VicSuper account-based pensions to effectively create Australia's first Comprehensive Income Product for Retirement (CIPR) in June 2015.

In 1H17 Challenger annuities were also made available on the ClearView Wealth Solutions platform, to members of three profit-for-member funds (caresuper, legalsuper, Local Government Super) and Suncorp commenced selling Suncorp branded annuities backed by Challenger. These initiatives are expanding Challenger's distribution footprint and making Challenger annuities more easily accessible by financial advisers and their clients.

In October 2016 Challenger announced a new annuity relationship with AMP, who operates Australia's largest retail adviser network. Through this new relationship, commencing in the first quarter of FY18, Challenger's full range of annuity products will be available via AMP's investment and administration platforms.

In February 2017, Challenger announced a new annuity relationship with BT Financial Group, one of Australia's leading wealth management organisations. The new annuity relationship with BT Financial Group will see BT work towards offering Challenger annuities through the innovative BT Panorama platform in the first quarter of FY18.

These new platform and distribution initiatives are significantly broadening access to Challenger annuities. Following the launch of Challenger annuities on the AMP and BT platforms, approximately two thirds of Australian financial advisers will be able to access Challenger annuities via investment and administration platforms.

In October 2016, Challenger announced a new annuity relationship with Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary), a leading provider of Australian dollar annuity and life insurance products in Japan. Annuity sales via the MS Primary annuity relationship commenced on 1 November 2016, with $125m of sales for the first two months (refer to page 16 for more information on the MS Primary annuity relationship).

## Focus on long term annuity sales

Challenger is focused on growing its long term annuity business as it embeds significant value for Challenger shareholders. Approximately 31% of 1H17 sales were either lifetime annuities or via the MS Primary annuities (20 year fixed term).

Long term annuity business is attractive for Challenger as it:

- lengthens the annuity book tenor;
- improves the maturity outlook;
- assists future book growth; and
- enhances overall book quality.

Strong growth in both lifetime annuities and MS Primary annuities provides the opportunity to substitute shorter term business with long term business.

Liquid Lifetime annuity sales are benefiting from new platform distribution initiatives, and lifetime annuities being included in retirement income model portfolios.

Lifetime annuity sales were $554m in 1H17, up 142% on 1H16. 1H17 lifetime sales comprise Liquid Lifetime of $464m (1H16 $215m) and CarePlus of $90m (1H16 $14m).

CarePlus was launched in FY16 and is a product designed specifically for the aged care market. CarePlus sales were $90m in 1H17, representing a 100% increase on 2H16 CarePlus sales.

1H17 lifetime sales represented 25% of 1H17 annuity sales, up from 14% in 1H16.

## New business tenor

As a result of a larger proportion of sales being lifetime annuities and longer dated MS Primary annuity sales, new business tenor increased to 8.7 years in 1H17, up from 5.6 years in 1H16.

New business tenor on domestic annuity business (excluding MS Primary) was 7.7 years in 1H17, up from 5.6 years in 1H16.

## Other Life sales

1H17 other Life sales represent Challenger's Guaranteed Index Return (GIR) and Challenger's Index Plus products, with sales increasing by 37% to $562m in 1H17.

1H17 other Life sales include a new ~$200m mandate from an existing client, ~$200m re-investment and a ~$150m mandate for the new Challenger Index Plus product, which was launched in the second quarter of FY17.

## Net book growth

**Life annuity net book growth**

1H17 Life annuity net flows (i.e. annuity sales less capital repayments) were $449m. Based on the closing FY16 Life annuity book ($9,558m), 1H17 annuity net book growth was 4.7% (1H16 3.1%).

**Other Life net book growth**

1H17 other Life net flows (i.e. sales less capital repayments) were $394m, up from $77m in 1H16.

**Total Life net book growth**

1H17 total Life net flows across both annuities and other products (Guaranteed Index Return and Challenger Index Plus) was $843m, including annuity net flows of $449m and other net flows of $394m.

Based on the closing FY16 annuity liability ($9,558m) and GIR liability ($1,316m), 1H17 total Life net book growth was 7.8%, up from 3.6% in 1H16.

## Average AUM

Life's 1H17 average investment assets were $14.3bn, and increased by 10% ($1.3bn) on 1H16. The increase in average investment assets is due to annuity net flows, growth in other products and Life earnings (net of dividends to Group).

## Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary) annuity relationship

Consistent with Challenger's strategy to diversify its range of products and expand its distribution relationships, in 1H17 Challenger announced a new annuity relationship with Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary).

MS Primary provides annuity and life insurance products for Japanese customers and is part of MS&AD Insurance Group Holdings, Inc, a Nikkei 225 company.

Japan has one of the world's most rapidly ageing populations who are looking for income from longer dated products due to the low Japanese interest rate environment. This has driven a significant increase in demand for foreign currency annuities, including Australian dollar denominated annuities. Challenger estimates sales of Australian dollar annuities in Japan to be ~$30bn per year, which is over seven times the size of Australia's annuities market.

MS Primary is a leading provider of Australian dollar annuity and life insurance products in Japan. MS Primary had ~A$24 billion of Australian dollar annuities and life insurance products in force as at 31 December 2016.

In late August 2016, MS Primary launched a new innovative and differentiated Australian dollar product with a 20 year fixed rate in Japan. The product is being distributed through the Japanese bancassurance channel. Under the terms of the new product, the customer can choose an annuity payment period of 5, 10 or 20 years, with a benefit payable upon death.

In relation to this new product, from 1 November 2016, Challenger commenced issuing Australian dollar fixed rate annuities with a 20 year term in order to support a reinsurance agreement with MS Primary. Challenger provides a guaranteed interest rate and assumes the investment risk, on a portion of each new policy issued by MS Primary.

Challenger's 1H17 fixed term annuity sales include $125m of annuity sales related to MS Primary (for two months since 1 November 2016).

The MS Primary annuity portfolio will be invested in the key asset classes that Challenger currently invests in and accounted for under Australian Generally Accepted Accounting Principles and Challenger's normalised profit framework, consistent with Challenger's Life business.

As the product is an Australian dollar product, Challenger assumes no foreign currency risk and the product is confined to a fixed 20 year period.

MS Primary is responsible for marketing and distributing the product in Japan, including making payments to policyholders. Challenger guarantees a rate to MS Primary, which effectively includes Challenger's contribution toward marketing, distributing and adminstration costs in Japan. As such, for this product, Challenger will incur limited distribution and administration costs as part of its direct expense base.

The guaranteed interest rate on new business can be revised for changes in both interest rates and margin, and the reinsurance agreement has mechanisms to regulate volumes between MS Primary and Challenger. There are also the usual termination rights for both parties, including material breach, failure to make payments and events that may be triggered by changes in MS Primary's regulatory environment.

## Life Risk

Undertaking wholesale longevity and mortality transactions is a natural business extension for the Life business. Life is participating in established markets, has specialised expertise and is taking a disciplined approach to the wholesale Life Risk opportunity.

1H17 Life COE includes $20m of income as a result of Life Risk transactions, up from $7m in 1H16. Life Risk income represents premiums net of expected claims.

The increase in Life Risk (up $13m) in 1H17 includes a one-off fee (~$10m) as a result of the counterparty restructuring a Life Risk transaction.

The present value of future profits arising from the Life Risk portfolio was $273m at 31 December 2016, up from $243m at 30 June 2016. The Life Risk portfolio has an average duration of 14 years.

## Accurium

Accurium is Australia's leading provider of Self-Managed Superannuation Fund (SMSF) actuarial certificates. An actuarial certificate is required by a SMSF when one (or more) members are in the retirement phase of superannuation and one (or more) are in the savings (accumulation) phase of superannuation.

Accurium's 1H17 revenue was $4m (1H16 $5m) and is disclosed as part of other income within Life's normalised profit framework.

Accurium's vision is to become Australia's SMSF retirement specialist and leverage existing relationships with SMSF practitioners to increase the level of engagement and education for SMSF retirement solutions.

Accurium has launched a SMSF Retirement Healthcheck in order to help build an understanding of the sustainability of retirement spending and retirement issues.

# Life balance sheet

| $m | 1H17 | FY16 | 1H16 | FY15 | 1H15 |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| **Life investment assets** | | | | | |
| Cash and equivalents | 1,172.7 | 1,990.6 | 1,631.9 | 728.4 | 1,307.3 |
| Asset backed securities | 4,362.8 | 4,138.1 | 4,044.5 | 4,340.6 | 4,209.5 |
| Corporate credit | 3,985.4 | 3,186.8 | 2,811.2 | 3,444.7 | 3,024.3 |
| **Fixed income and cash (net)** | **9,520.9** | **9,315.5** | **8,487.6** | **8,513.7** | **8,541.1** |
| Australian – Office | 1,563.1 | 1,498.4 | 1,385.2 | 1,359.0 | 1,138.2 |
| Australian – Retail | 921.3 | 962.0 | 986.1 | 818.0 | 721.6 |
| Australian – Industrial | 195.6 | 188.3 | 98.6 | 96.7 | 162.8 |
| Japanese – Retail | 226.9 | 242.4 | 203.6 | 225.1 | 204.3 |
| REITs and other | 421.4 | 258.9 | 389.7 | 384.9 | 489.5 |
| **Property (net)** | **3,328.3** | **3,150.0** | **3,063.2** | **2,883.7** | **2,716.4** |
| Equity and other investments | 1,231.6 | 1,079.0 | 1,060.0 | 882.8 | 632.4 |
| Infrastructure (net) | 526.4 | 567.2 | 536.4 | 514.4 | 503.0 |
| **Life investment assets** | **14,607.2** | **14,111.7** | **13,147.2** | **12,794.6** | **12,392.9** |
| Other assets (including intangibles) | 389.4 | 516.0 | 460.1 | 456.4 | 601.4 |
| **Total assets** | **14,996.6** | **14,627.7** | **13,607.3** | **13,251.0** | **12,994.3** |
| **Liabilities** | | | | | |
| Life annuity book | 9,784.9 | 9,558.5 | 8,868.4 | 8,693.0 | 8,573.1 |
| Guaranteed Index Return (GIR) and Challenger Index Plus liabilities | 1,633.2 | 1,315.5 | 1,035.1 | 944.7 | 954.8 |
| Subordinated debt | 384.8 | 576.7 | 576.5 | 567.0 | 560.7 |
| Challenger Capital Notes | 345.0 | 345.0 | 345.0 | 345.0 | 345.0 |
| Other liabilities | 295.3 | 342.6 | 215.2 | 292.3 | 199.8 |
| **Total liabilities** | **12,443.2** | **12,138.3** | **11,040.2** | **10,842.0** | **10,633.4** |
| **Net assets** | **2,553.4** | **2,489.4** | **2,567.1** | **2,409.0** | **2,360.9** |

# Life balance sheet

Life maintains a high quality investment portfolio in order to generate cash flows to meet future annuity obligations.

## Life investment portfolio overview

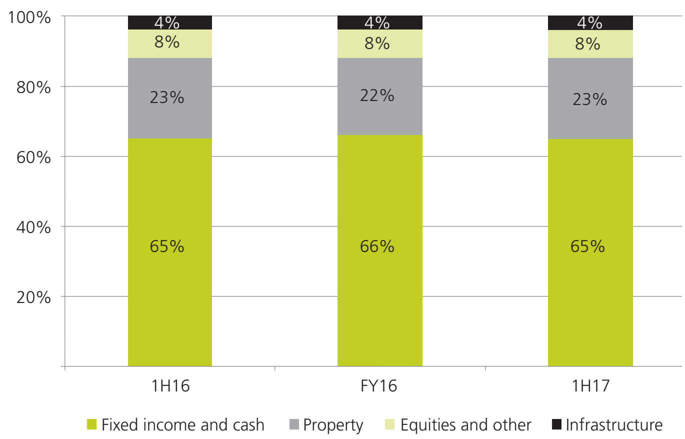
Life reviews its investment asset allocation based on the relative value of different asset classes, expected return on equity, and the tenor of annuity sales as Life maintains a cash flow matched portfolio. Accordingly, Life's investment asset allocation may vary from time to time.

Life's investment assets at 31 December 2016 comprised:

- Fixed income and cash 65%;
- Property 23%;
- Equities and other investments 8%; and
- Infrastructure 4%.

Detailed information on Life's investment assets is included on pages 20 to 28.

## Life investment portfolio overview chart




## Fixed income portfolio overview

Life's fixed income and cash portfolio was $9.5bn (net of debt) at 31 December 2016 up from $9.3bn at 30 June 2016. Fixed income and cash represented 65% of Life's 31 December 2016 total investment assets, down 1% for the half year.

Challenger manages credit risk by maintaining a high quality investment portfolio and applying a rigorous investment process. The fixed income portfolio is diversified across different industries, rating bands, asset classes and geographies.

Life's liabilities and cash flows are long term in nature and contracted, providing the opportunity to invest in long-dated and illiquid fixed income investments, allowing Life to earn an illiquidity premium on fixed income. The average fixed income illiquidity premium generated over the last five years is between 1% and 2%.

The fixed income portfolio comprises over 1,000 different securities with 79% of the fixed income portfolio investment grade (i.e. BBB or higher), down from 81% at 30 June 2016 and is unchanged from 31 December 2015.

A total of 76% of the fixed income portfolio is externally rated (Standard & Poor's, Fitch or Moody's) and 24% based on internal ratings calibrated to Standard & Poor's or Moody's ratings framework.

The fixed income and cash portfolio is predominately Australian focused, with approximately 70% of the fixed income portfolio invested in Australian based securities.

Approximately 25% of Life's fixed income portfolio represents fixed income investments originated by Challenger. Direct fixed income origination includes senior secured loans, asset backed securities and commercial real estate lending. Life's direct origination capability has been in place for over ten years and provides opportunities to capture relative value including illiquidity premiums.

Detailed disclosure of Life's fixed income portfolio is included on pages 20 to 23. The fixed income disclosures include the following tables.

1. Table 1 – fixed income portfolio overview;
2. Table 2 – fixed income portfolio by credit rating;
3. Table 3 – fixed income portfolio by rating type;
4. Table 4 – fixed income portfolio by industry sector; and
5. Table 5 – fixed income portfolio by geography and credit rating.

# Table 1: Fixed income portfolio overview

| 31 December 2016 | | $m | % portfolio | |
|---|---|---|---|---|
| **Liquids** | | 1,173 | 12% | Includes cash and equivalents and Government Bonds (net of repurchase agreements). |
| **Asset Backed Securities (ABS)** | RMBS | 1,936 | 20% | Residential mortgage backed securities (RMBS). RMBS expertise developed when Challenger was Australia's largest non-bank securitiser of RMBS (via Mortgage Management business sold in 2009). Also includes NIM notes. |
| | Other ABS | 997 | 10% | Financing secured against underlying assets. Asset security includes motor vehicle, equipment and consumer finance. |
| | Senior Secured Bank Loans | 793 | 8% | Senior debt secured by collateral and typically originated by Challenger. |
| | Aviation Finance | 272 | 3% | Secured commercial aircraft financing. |
| | CMBS | 365 | 5% | Commercial Mortgage Backed Securities (CMBS). |
| **Corporate Credit** | Banks & Financials | 996 | 10% | Corporate loans to banks, insurance companies and fund managers. |
| | Infrastructure | 977 | 10% | Long dated inflation linked bonds issued by Public Private Partnership projects and loans to infrastructure companies. |
| | Non-Financial Corporates | 1,026 | 11% | Traded commercial loans to industrials and retailers. |
| | Commercial Real Estate | 986 | 11% | Loans secured against commercial real estate assets and typically originated by Challenger. |
| **Total** | | **9,521** | **100%** | |

# Table 2: Fixed income portfolio by credit rating

| 31 December 2016 ($m) | Investment grade | | | | | | Non-investment grade | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| | Liquids | AAA | AA | A | BBB | Total | BB | B or lower | Total | $m |
| **Liquids** | | | | | | | | | | |
| Government Bonds | 611 | - | - | - | - | **611** | - | - | **-** | **611** |
| Cash & equivalents | 562 | - | - | - | - | **562** | - | - | **-** | **562** |
| **Asset Backed Securities (ABS)** | | | | | | | | | | |
| RMBS | - | 658 | 325 | 471 | 300 | **1,754** | 89 | 93 | **182** | **1,936** |
| Other ABS | - | 144 | 102 | 182 | 172 | **600** | 292 | 105 | **397** | **997** |
| Senior Secured Loans | - | 241 | 23 | 113 | 292 | **669** | 104 | 20 | **124** | **793** |
| Aviation Finance | - | - | - | 78 | 97 | **175** | 35 | 62 | **97** | **272** |
| CMBS | - | 36 | 11 | 39 | 90 | **176** | 147 | 42 | **189** | **365** |
| **Corporate credit** | | | | | | | | | | |
| Banks & Financials | - | - | 32 | 485 | 412 | **929** | 51 | 16 | **67** | **996** |
| Infrastructure | - | 7 | 125 | 155 | 525 | **812** | 97 | 68 | **165** | **977** |
| Non-Financial Corporates | - | 2 | 13 | 123 | 306 | **444** | 422 | 160 | **582** | **1,026** |
| Commercial Real Estate | - | 26 | 28 | 198 | 559 | **811** | 175 | - | **175** | **986** |
| **Total** | **1,173** | **1,114** | **659** | **1,844** | **2,753** | **7,543** | **1,412** | **566** | **1,978** | **9,521** |
| Fixed income portfolio % | 12% | 12% | 7% | 19% | 29% | **79%** | 15% | 6% | **21%** | **100%** |
| Average duration (years) | 0.0 | 1.8 | 3.9 | 2.6 | 3.5 | **3.0** | 3.5 | 3.3 | **3.4** | **3.1** |

| 31 December 2016 (%) | Investment grade | | | | | | Non-investment grade | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| | Liquids | AAA | AA | A | BBB | Total | BB | B or lower | Total | % |
| **Liquids** | | | | | | | | | | |
| Government Bonds | 100% | - | - | - | - | **100%** | - | - | - | **100%** |
| Cash & equivalents | 100% | - | - | - | - | **100%** | - | - | - | **100%** |
| **Asset Backed Securities (ABS)** | | | | | | | | | | |
| RMBS | - | 34% | 17% | 24% | 16% | **91%** | 5% | 4% | **9%** | **100%** |
| Other ABS | - | 14% | 10% | 18% | 18% | **60%** | 29% | 11% | **40%** | **100%** |
| Senior Secured Loans | - | 30% | 3% | 14% | 37% | **84%** | 13% | 3% | **16%** | **100%** |
| Aviation Finance | - | - | - | 29% | 35% | **64%** | 13% | 23% | **36%** | **100%** |
| CMBS | - | 10% | 3% | 11% | 24% | **48%** | 40% | 12% | **52%** | **100%** |
| **Corporate credit** | | | | | | | | | | |
| Banks & Financials | - | - | 3% | 49% | 41% | **93%** | 5% | 2% | **7%** | **100%** |
| Infrastructure | - | 1% | 13% | 16% | 53% | **83%** | 10% | 7% | **17%** | **100%** |
| Non-Financial Corporates | - | - | 1% | 12% | 30% | **43%** | 41% | 16% | **57%** | **100%** |
| Commercial Real Estate | - | 3% | 3% | 20% | 56% | **82%** | 18% | - | **18%** | **100%** |
| **Total** | **12%** | **12%** | **7%** | **19%** | **29%** | **79%** | **15%** | **6%** | **21%** | **100%** |

# Table 3: Fixed income portfolio by rating type

| | Investment grade | | | | | | Non-investment grade | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| **31 December 2016 ($m)** | **Liquids** | **AAA** | **AA** | **A** | **BBB** | **Total** | **BB** | **B or lower** | **Total** | **$m** |
| **Liquids** | | | | | | | | | | |
| Externally rated | 1,173 | - | - | - | - | **1,173** | - | - | - | **1,173** |
| Internally rated | - | - | - | - | - | - | - | - | - | - |
| **Asset Backed Securities (ABS)** | | | | | | | | | | |
| Externally rated | - | 1,035 | 457 | 649 | 533 | **2,674** | 178 | 96 | **274** | **2,948** |
| Internally rated | - | 44 | 4 | 235 | 417 | **700** | 488 | 227 | **715** | **1,415** |
| **Corporate credit** | | | | | | | | | | |
| Externally rated | - | 35 | 198 | 922 | 1,504 | **2,659** | 301 | 159 | **460** | **3,119** |
| Internally rated | - | - | - | 38 | 299 | **337** | 445 | 84 | **529** | **866** |
| **Total** | **1,173** | **1,114** | **659** | **1,844** | **2,753** | **7,543** | **1,412** | **566** | **1,978** | **9,521** |
| Externally rated | 100% | 96% | 99% | 85% | 74% | **86%** | 34% | 45% | **37%** | **76%** |
| Internally rated | - | 4% | 1% | 15% | 26% | **14%** | 66% | 55% | **63%** | **24%** |

| | Investment grade | | | | | | Non-investment grade | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| **31 December 2016 (%)** | **Liquids** | **AAA** | **AA** | **A** | **BBB** | **Total** | **BB** | **B or lower** | **Total** | **%** |
| **Liquids** | | | | | | | | | | |
| Externally rated | 100% | - | - | - | - | **100%** | - | - | - | **100%** |
| Internally rated | - | - | - | - | - | - | - | - | - | - |
| **Asset Backed Securities (ABS)** | | | | | | | | | | |
| Externally rated | - | 35% | 16% | 22% | 18% | **91%** | 6% | 3% | **9%** | **100%** |
| Internally rated | - | 3% | - | 17% | 29% | **49%** | 34% | 17% | **51%** | **100%** |
| **Corporate credit** | | | | | | | | | | |
| Externally rated | - | 1% | 6% | 30% | 48% | **85%** | 10% | 5% | **15%** | **100%** |
| Internally rated | - | - | - | 4% | 35% | **39%** | 51% | 10% | **61%** | **100%** |

# Table 4: Fixed income portfolio by industry sector

| | Investment grade | | | | | | Non-investment grade | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| **31 December 2016 ($m)** | **Liquids** | **AAA** | **AA** | **A** | **BBB** | **Total** | **BB** | **B or lower** | **Total** | **$m** |
| Industrials and Consumers | - | 316 | 154 | 370 | 816 | **1,656** | 786 | 347 | **1,133** | **2,789** |
| Residential Property | - | 686 | 315 | 518 | 299 | **1,818** | 89 | 94 | **183** | **2,001** |
| Banks, Financials & Insurance | 562 | 4 | 38 | 585 | 419 | **1,608** | 87 | 16 | **103** | **1,711** |
| Government | 611 | - | - | - | - | **611** | - | - | **-** | **611** |
| Commercial Property | - | 34 | 27 | 170 | 632 | **863** | 323 | 41 | **364** | **1,227** |
| Infrastructure & Utilities | - | 7 | 125 | 155 | 530 | **817** | 100 | 68 | **168** | **985** |
| Other | - | 67 | - | 46 | 57 | **170** | 27 | - | **27** | **197** |
| **Total** | **1,173** | **1,114** | **659** | **1,844** | **2,753** | **7,543** | **1,412** | **566** | **1,978** | **9,521** |

| | Investment grade | | | | | | Non-investment grade | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| **31 December 2016 (%)** | **Liquids** | **AAA** | **AA** | **A** | **BBB** | **Total** | **BB** | **B or lower** | **Total** | **%** |
| Industrials and Consumers | - | 11% | 6% | 13% | 29% | **59%** | 28% | 13% | **41%** | **100%** |
| Residential Property | - | 34% | 16% | 26% | 15% | **91%** | 4% | 5% | **9%** | **100%** |
| Banks, Financials & Insurance | 33% | - | 2% | 34% | 25% | **94%** | 5% | 1% | **6%** | **100%** |
| Government | 100% | - | - | - | - | **100%** | - | - | **-** | **100%** |
| Commercial Property | - | 3% | 2% | 14% | 51% | **70%** | 26% | 4% | **30%** | **100%** |
| Infrastructure & Utilities | - | 1% | 13% | 16% | 53% | **83%** | 10% | 7% | **17%** | **100%** |
| Other | - | 34% | - | 23% | 29% | **86%** | 14% | - | **14%** | **100%** |
| **Total** | **12%** | **12%** | **7%** | **19%** | **29%** | **79%** | **15%** | **6%** | **21%** | **100%** |

# Table 5: Fixed income portfolio by geography and credit rating

| | Investment grade | | | | | | Non-investment grade | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| **31 December 2016 ($m)** | **Liquids** | **AAA** | **AA** | **A** | **BBB** | **Total** | **BB** | **B or lower** | **Total** | **$m** |
| Australia | 1,088 | 778 | 465 | 1,190 | 1,675 | **5,196** | 977 | 280 | **1,257** | **6,453** |
| United States | 44 | 127 | 54 | 276 | 625 | **1,126** | 211 | 189 | **400** | **1,526** |
| Rest of World | 24 | 173 | 14 | 128 | 121 | **460** | 55 | 54 | **109** | **569** |
| United Kingdom | 9 | 36 | 60 | 116 | 153 | **374** | 51 | 19 | **70** | **444** |
| Europe | 7 | - | 18 | 98 | 139 | **262** | 67 | 3 | **70** | **332** |
| New Zealand | 1 | - | 48 | 36 | 40 | **125** | 51 | 21 | **72** | **197** |
| **Total** | **1,173** | **1,114** | **659** | **1,844** | **2,753** | **7,543** | **1,412** | **566** | **1,978** | **9,521** |

| | Investment grade | | | | | | Non-investment grade | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| **31 December 2016 (%)** | **Liquids** | **AAA** | **AA** | **A** | **BBB** | **Total** | **BB** | **B or lower** | **Total** | **%** |
| Australia | 17% | 12% | 7% | 18% | 27% | **81%** | 15% | 4% | **19%** | **100%** |
| United States | 3% | 8% | 4% | 18% | 41% | **74%** | 14% | 12% | **26%** | **100%** |
| Rest of World | 4% | 30% | 2% | 22% | 23% | **81%** | 10% | 9% | **19%** | **100%** |
| United Kingdom | 2% | 8% | 14% | 26% | 34% | **84%** | 11% | 5% | **16%** | **100%** |
| Europe | 2% | - | 5% | 30% | 42% | **79%** | 20% | 1% | **21%** | **100%** |
| New Zealand | 1% | - | 24% | 18% | 20% | **63%** | 26% | 11% | **37%** | **100%** |
| **Total** | **12%** | **12%** | **7%** | **19%** | **29%** | **79%** | **15%** | **6%** | **21%** | **100%** |

## Property portfolio overview

Life's property portfolio of $3.3bn (net of debt) at 31 December 2016 represented 23% of Life's total investment assets, up from 22% at 30 June 2016.

Life's property portfolio increased by $0.2bn (net of debt) in 1H17 due to property acquisitions and an increase in listed REIT investments, partially offset by the disposal of two properties.

Challenger Life has a policy that all properties are independently valued each year with approximately 50% valued in June and 50% valued in December. Internal valuations are also undertaken for properties not independently valued each June and December. An independent valuation is subsequently undertaken if the internal valuation shows a significant variance to the most recent independent valuation. Independent valuations were undertaken for 51% of Life's properties in 1H17.

Compared to Life's normalised growth assumption of 2.0% per annum, direct properties increased by ~1.1% in 1H17 and listed REITs by 7%.

Property acquisitions incur stamp duty and acquisition costs. Under Australian Accounting Standards, property acquisition and transaction costs are required to initially be capitalised. When the property is subsequently revalued, there is generally no value ascribed to the acquisition costs which may result in a reduction in the property valuation and corresponding negative investment experience. During 1H17, all properties acquired in 2H16 were subject to either an independent valuation or directors' valuation, with $4m of transaction costs (including stamp duty) offset against property valuation gains.

In 1H17, there were no property acquisition costs, and as a result there will be no impact to property revaluations in 2H17.

Life's property portfolio principally comprises directly held properties and is diversified across office, retail, and industrial properties.

Property includes a net $227m exposure to Japanese property (7% of the property portfolio), consisting of suburban shopping centres that are focused on non-discretionary retailing.

Property also includes a $163m investment in listed REITs. Challenger has traditionally invested in listed REITs. Following the ~20% sell off in the Australian REIT sector during 1H17, Challenger acquired a portfolio of REIT investments in late 1H17.

Rental income is diversified across sectors and tenants, with 51% (by 1H17 gross rental income) of tenants classified investment grade (i.e. rated BBB or higher).

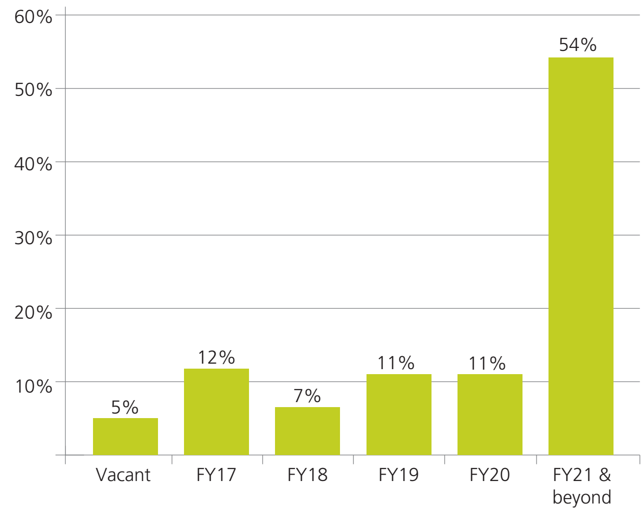
The Australian Government is a major tenant, leasing a range of commercial office buildings and accounted for approximately 32% of 1H17 gross rental income[1].

Full details of Life's property portfolio are listed on pages 26 and 27.

## Property portfolio summary

| % of total portfolio | 1H17 | FY16 |
|---|---|---|
| Australian office | 47% | 48% |
| Australian retail | 28% | 30% |
| Australian industrial | 6% | 6% |
| Australian listed REITs | 5% | – |
| Australian unlisted REITs | 3% | 4% |
| **Australian total** | **89%** | **88%** |
| Japanese retail | 7% | 8% |
| Other (including offshore) | 4% | 4% |
| **Total** | **100%** | **100%** |

## Portfolio lease expiry overview[2]




The property portfolio generates long term cash flows in order to match long term liabilities. Approximately 54% of contracted leases expire in FY21 and beyond, demonstrating the long term nature of property cash flows.

1. Represents total gross passing income attributable to the direct property portfolio.
2. Direct property portfolio and jointly held assets only and excludes Australian REITs and development assets.

# Direct property portfolio overview[1]

| 31 December 2016 | | Office | Retail | Industrial | Total |
|---|---|---|---|---|---|
| Total rent (%)[2] | | 53% | 38% | 9% | 100% |
| WALE | | 3.6 | 5.5 | 4.7 | 4.5 |
| | | | | | |
| Tenant credit ratings | | | | | |
| | AAA | 24% | - | - | 24% |
| | AA | 8% | 1% | - | 9% |
| | A | - | 2% | 1% | 3% |
| | BBB | 3% | 9% | 3% | 15% |
| | BB | 12% | 19% | 1% | 32% |
| | B or below | 1% | 1% | 1% | 3% |
| | Not rated | 2% | 5% | 2% | 9% |
| | Vacant | 3% | 1% | 1% | 5% |
| | **Total** | **53%** | **38%** | **9%** | **100%** |
| % of total gross rent | Investment grade | 35% | 12% | 4% | 51% |
| | Non-investment grade | 15% | 25% | 4% | 44% |
| | Vacant | 3% | 1% | 1% | 5% |

1. Direct property portfolio and jointly held assets only and excludes Australian REITs and development assets.
2. Includes vacant floors/suites available for lease.

# Direct property investments

| 31 December 2016 | | | Acquisition date[1] | Total cost $m[2] | Carrying value $m | Cap rate 1H17 %[3] | Last external valuation date |
|---|---|---|---|---|---|---|---|
| **Australia** | | | | | | | |
| | Office | | | | | | |
| | | 31 Queen Street, VIC | 31-Mar-11 | 96.6 | 131.0 | 6.00 | 31-Dec-16 |
| | | 35 Clarence Street, NSW | 15-Jan-15 | 145.0 | 172.5 | 6.00 | 31-Dec-16 |
| | | 53 Albert Street, QLD | 12-Dec-14 | 222.6 | 220.2 | 6.50 | 30-Jun-16 |
| | | 565 Bourke Street, VIC | 28-Jan-15 | 86.5 | 87.7 | 6.25 | 31-Dec-16 |
| | | ABS Building, ACT | 01-Jan-00 | 120.5 | 121.4 | 7.20 | 30-Jun-16 |
| | | 215 Adelaide Street, QLD | 31-Jul-15 | 238.7 | 229.3 | 6.75 | 30-Jun-16 |
| | | County Court, VIC | 30-Jun-00 | 213.6 | 300.0 | 6.25 | 31-Dec-16 |
| | | DIBP (formerly DIAC) Building, ACT | 01-Dec-01 | 103.3 | 119.0 | 7.50 | 30-Jun-16 |
| | | Discovery House, ACT | 28-Apr-98 | 87.4 | 104.0 | 7.50 | 31-Dec-16 |
| | | Elder House, SA | 21-Jun-02 | 48.2 | 24.9 | 8.75 | 30-Jun-16 |
| | | Executive Building, TAS | 30-Mar-01 | 32.5 | 39.6 | 7.75 | 31-Dec-16 |
| | | Makerston House, QLD | 14-Dec-00 | 67.2 | 68.0 | 8.00 | 31-Dec-16 |
| | Retail | | | | | | |
| | | Bunbury Forum, WA | 03-Oct-13 | 152.3 | 149.2 | 6.25 | 30-Jun-16 |
| | | Century City Walk, VIC | 16-Oct-06 | 30.2 | 41.3 | 7.25 | 30-Jun-16 |
| | | Channel Court, TAS | 21-Aug-15 | 80.3 | 80.0 | 7.50 | 30-Jun-16 |
| | | Golden Grove, SA | 31-Jul-14 | 139.9 | 142.8 | 6.50 | 30-Jun-16 |
| | | Karratha, WA | 28-Jun-13 | 53.9 | 60.6 | 7.00 | 30-Jun-16 |
| | | Kings Langley, NSW | 29-Jul-01 | 15.9 | 21.5 | 6.50 | 30-Jun-16 |
| | | Lennox, NSW | 27-Jul-13 | 27.9 | 34.7 | 6.25 | 30-Jun-16 |
| | | Next Hotel, QLD | 25-Mar-15 | 142.0 | 130.0 | 6.76 | 31-Dec-16 |
| | | North Rocks, NSW | 18-Sep-15 | 135.9 | 127.7 | 6.75 | 30-Jun-16 |
| | Industrial | | | | | | |
| | | 12-30 Toll Drive, Altona North, VIC | 31-Dec-08 | 13.9 | 13.8 | 7.50 | 30-Jun-16 |
| | | 2-10 Toll Drive, Altona North, VIC | 31-Dec-08 | 6.3 | 6.8 | 7.00 | 31-Dec-16 |
| | | Spotlight, Laverton North, VIC | 31-Dec-08 | 16.3 | 20.7 | 7.00 | 31-Dec-16 |
| | | Cosgrave Industrial Park, Enfield, NSW | 31-Dec-08 | 92.4 | 105.1 | 6.46 | 31-Dec-16 |
| | | 21 O'Sullivan Circuit, NT | 27-Jan-16 | 47.6 | 43.0 | 7.75 | 31-Dec-16 |
| | | 31 O'Sullivan Circuit, NT | 27-Jan-16 | 28.6 | 27.5 | 8.00 | 31-Dec-16 |
| | Mixed use | | | | | | |
| | | The Barracks, QLD | 31-Oct-14 | 153.3 | 145.8 | 7.50 | 30-Jun-16 |
| **Total Australia** | | | | **2,598.8** | **2,768.1** | | |

1. Acquisition date represents the date of CLC's initial acquisition or consolidation of the investment vehicle holding the asset.
2. Total cost represents the original acquisition cost plus capex.
3. The capitalisation rate is derived by dividing property net income over carrying value of an investment property.

# Direct property investments

| 31 December 2016 | | | Acquisition date[1] | Total cost $m[2] | Carrying value $m | Cap rate 1H17 %[3] | Last external valuation date |
|---|---|---|---|---|---|---|---|
| **Japan** | | | | | | | |
| | Retail | | | | | | |
| | | Aeon Kushiro | 31-Jan-10 | 30.5 | 32.3 | 5.50 | 30-Jun-16 |
| | | Carino Chitosedai | 31-Jan-10 | 118.3 | 120.6 | 4.70 | 31-Dec-16 |
| | | Carino Tokiwadai | 31-Jan-10 | 77.0 | 76.2 | 4.80 | 30-Jun-16 |
| | | DeoDeo Kure | 31-Jan-10 | 31.4 | 28.9 | 5.70 | 30-Jun-16 |
| | | Fitta Natalie Hatsukaichi | 28-Aug-15 | 11.4 | 13.3 | 5.90 | 31-Dec-16 |
| | | Izumiya Hakubaicho | 31-Jan-10 | 68.8 | 68.3 | 5.00 | 31-Dec-16 |
| | | Kansai Super Saigo | 31-Jan-10 | 13.1 | 12.8 | 5.50 | 30-Jun-16 |
| | | Kojima Nishiarai | 31-Jan-10 | 12.2 | 13.4 | 4.80 | 30-Jun-16 |
| | | Life Asakusa | 31-Jan-10 | 27.8 | 31.5 | 4.70 | 30-Jun-16 |
| | | Life Higashinakano | 31-Jan-10 | 32.9 | 34.3 | 4.70 | 31-Dec-16 |
| | | Life Nagata | 31-Jan-10 | 25.2 | 25.8 | 5.00 | 30-Jun-16 |
| | | MaxValu Tarumi | 28-Aug-15 | 16.9 | 18.4 | 5.70 | 31-Dec-16 |
| | | Seiyu Miyagino | 31-Jan-10 | 9.7 | 9.8 | 5.70 | 30-Jun-16 |
| | | Valor Takinomizu | 31-Jan-10 | 26.8 | 23.8 | 5.70 | 31-Dec-16 |
| | | Valor Toda | 31-Jan-10 | 42.5 | 40.7 | 5.70 | 30-Jun-16 |
| | | Yaoko Sakato Chiyoda | 31-Jan-10 | 18.8 | 17.4 | 5.00 | 31-Dec-16 |
| **Total Japan** | | | | **563.3** | **567.5** | | |
| **Europe** | | | | | | | |
| | Industrial | | | | | | |
| | | 105 Route d'Orleans, Sully sur Loire | 31-Dec-08 | 27.1 | 7.3 | 10.00 | 31-Dec-16 |
| | | Gennevilliers,140 Rue Marcel Paul | 31-Dec-08 | 14.1 | 9.9 | 9.75 | 31-Dec-16 |
| | | Parcay-Meslay, ZAC Papillon | 31-Dec-08 | 10.1 | 7.0 | 9.25 | 31-Dec-16 |
| | | Villeneuve les Beziers, Rue Charles Nicolle | 31-Dec-08 | 18.3 | 12.4 | 8.75 | 31-Dec-16 |
| | | Rozalia Park | 12-Apr-07 | 81.1 | 20.0 | 9.25 | 31-Dec-16 |
| | Retail | | | | | | |
| | | Aulnay sous Bois, Avenue de Savigny | 31-Dec-08 | 20.3 | 14.9 | 6.50 | 31-Dec-16 |
| **Total Europe** | | | | **171.0** | **71.5** | | |
| **Total Overseas** | | | | **734.3** | **639.0** | | |
| **Development** | | | | | | | |
| | | 839 Collins Street, VIC | 22-Dec-16 | 14.2 | 14.2 | - | - |
| | | Gateway – Stage 1 | 01-Jul-15 | 75.0 | 75.5 | - | - |
| | | Maitland | 06-Dec-06 | 54.5 | 37.1 | - | - |
| | | TRE Data Centre site | 14-Apr-10 | 12.9 | 12.9 | - | - |
| **Total development** | | | | **156.6** | **139.7** | | |
| **Total direct portfolio investments** | | | | **3,489.7** | **3,546.8** | | |

1. Acquisition date represents the date of CLC's initial acquisition or consolidation of the investment vehicle holding the asset.
2. Total cost represents the original acquisition cost plus capex.
3. The capitalisation rate is derived by dividing property income over carrying value of an investment property.

## Equity and other portfolio overview

Life's equity and other portfolio ($1.2bn) represented 8% of Life's total investment assets at 31 December 2016, and increased by ~$150m in 1H17. Life's equity and other portfolio consists of beta, alternatives and other investments.

Listed beta equity investments ($407m) represents investments in long only equities, including ETFs. Unlisted beta equity investments ($279m) represent investments managed by a range of third party investment managers. Beta investment returns are expected to be correlated to listed equity market returns.

Alternatives and other equity investments ($546m) represent a range of investments including absolute return funds and unlisted investments. Returns are considered to generally be uncorrelated to listed equity market returns.

## Equity and other portfolio

| 31 December 2016 ($m) | Domestic | Offshore | Total |
|---|---|---|---|
| Listed beta | 93.8 | 313.4 | 407.2 |
| Unlisted beta | 71.0 | 207.6 | 278.6 |
| Alternatives and other | 152.0 | 393.8 | 545.8 |
| **Total** | 316.8 | 914.8 | 1,231.6 |

## Infrastructure portfolio overview

Life's infrastructure portfolio of $0.5bn (net of debt) represented 4% of Life's investment assets at 31 December 2016, unchanged in 1H17.

Challenger Life seeks infrastructure assets that generate reliable and consistent cash flows, which are preferably inflation linked, giving rise to sustainable income growth over time. Infrastructure investments comprise directly held infrastructure assets and indirectly held listed and unlisted investments.

Approximately 70% of the infrastructure portfolio is unlisted.

The infrastructure portfolio is diversified across a number of geographic regions and sectors.

## Infrastructure portfolio by sector

| 31 December 2016 | $m | % |
|---|---|---|
| Logistics | 68 | 13% |
| Utilities | 59 | 11% |
| Patronage | 85 | 16% |
| Airport | 18 | 3% |
| Power Generation | 30 | 6% |
| Renewable | 105 | 20% |
| Core infrastructure | 161 | 31% |
| **Total** | **526** | **100** |

## Infrastructure portfolio by geography

| 31 December 2016 | $m | % |
|---|---|---|
| Australia | 264 | 50% |
| United Kingdom | 155 | 29% |
| Europe | 20 | 4% |
| North America | 53 | 10% |
| South America | 29 | 6% |
| Asia | 5 | 1% |
| **Total** | **526** | 100% |

# Challenger Life Company (CLC) debt facilities

| $m | 1H17 | FY16 | 1H16 | FY15 | 1H15 |
|---|---|---|---|---|---|
| Controlled property debt | 535.8 | 572.9 | 652.9 | 566.1 | 679.2 |
| Subordinated debt | 384.8 | 576.7 | 576.5 | 567.0 | 560.7 |
| Repurchase agreements | 3,482.9 | 2,454.2 | 1,875.1 | 1,267.3 | 1,163.3 |
| Infrastructure debt | 202.9 | 204.3 | 206.0 | 206.0 | 205.0 |
| Other finance | 17.8 | 18.8 | 19.5 | 1.4 | 3.3 |
| **Total CLC debt facilities** | **4,624.2** | **3,826.9** | **3,330.0** | **2,607.8** | **2,611.5** |

## CLC debt facilities

CLC debt facilities includes debt which is non-recourse to the Challenger Group and secured against assets held in investment vehicles by CLC, including direct properties and infrastructure investments. CLC debt facilities increased by $0.8bn during 1H17, as a result of an increase in repurchase agreements used to hedge for interest rate movements.

## Repurchase agreements

CLC enters into repurchase agreements whereby fixed income securities are sold for cash whilst simultaneously agreeing to repurchase the fixed income security at a fixed price and fixed date in the future. The use of repurchase agreements is part of Challenger's strategy to hedge interest rate movements.

CLC uses Australian Commonwealth Government Bonds (ACGBs) with repurchase agreements, interest rate swaps and bond futures to hedge for movements in interest rates on its asset portfolio, annuity policy liabilities, Guaranteed Index Return mandates, and the Challenger Index Plus Fund.

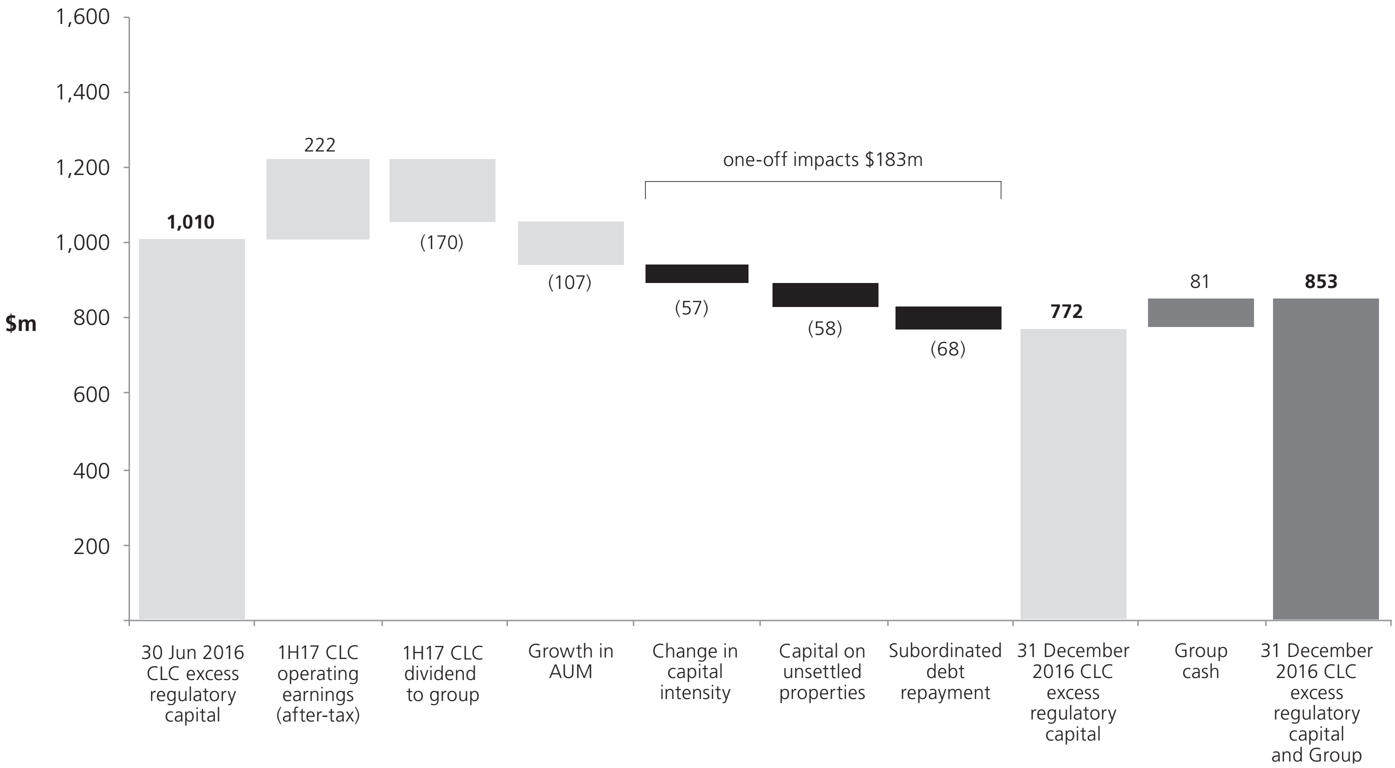
During 1H17, the Commonwealth Government continued to increase supply and extend the duration of the nominal bond curve. Swap spreads, being the difference in yield between interest rate swaps and Commonwealth Government Bonds remained near historical lows in 1H17. As a result, bonds provide a more cost effective hedge than swaps, particularly for longer dated liabilities.

Derivatives such as interest rate swaps and bond futures are self-financing, whereas the use of bonds requires the use of repurchase agreement financing. As a consequence, outstanding repurchase agreements as at 31 December 2016 increased by $1.0bn to $3.5bn.

## Challenger Life Company (CLC) regulatory capital

| $m | | 1H17 | FY16 | 1H16 | FY15 | 1H15 |
|---|---|---|---|---|---|---|
| **CLC's excess capital under LAGIC** | | | | | | |
| Common Equity Tier 1 (CET1) regulatory capital | | 2,046.0 | 2,003.6 | 1,951.8 | 1,907.6 | 1,886.7 |
| Additional Tier 1 | | 345.0 | 345.0 | 345.0 | 345.0 | 345.0 |
| Tier 2 regulatory capital – subordinated debt[1] | | 386.7 | 445.5 | 477.5 | 474.0 | 504.7 |
| **CLC total regulatory capital base** | | **2,777.7** | **2,794.1** | **2,774.3** | **2,726.6** | **2,736.4** |
| **CLC Prescribed Capital Amount (PCA)** | | | | | | |
| Asset risk charge | | 1,933.3 | 1,712.0 | 1,731.3 | 1,773.6 | 1,718.0 |
| Insurance risk charge | | 152.7 | 168.3 | 132.7 | 120.5 | 143.5 |
| Operational risk charge | | 34.9 | 28.7 | 22.7 | 22.6 | 23.9 |
| Aggregation benefit | | (115.5) | (125.3) | (100.4) | (91.9) | (108.5) |
| **CLC prescribed capital amount – excluding transition relief** | | **2,005.4** | **1,783.7** | **1,786.3** | **1,824.8** | **1,776.9** |
| Transition relief | | - | - | (107.6) | (107.6) | (215.2) |
| **CLC prescribed capital amount** | | **2,005.4** | **1,783.7** | **1,678.7** | **1,717.2** | **1,561.7** |
| **CLC excess over prescribed capital amount** | | **772.3** | **1,010.4** | **1,095.6** | **1,009.4** | **1,174.7** |
| PCA ratio (times) | | 1.39 | 1.57 | 1.65 | 1.59 | 1.75 |
| Tier 1 ratio (times) | | 1.19 | 1.32 | 1.37 | 1.31 | 1.43 |
| CET1 ratio (times) | | 1.02 | 1.12 | 1.16 | 1.11 | 1.21 |
| **Tier 2 regulatory capital – subordinated debt[1]** | | | | | | |
| **First call date after 1 Jan 2013** | **Maturity date** | **1H17** | **FY16** | **1H16** | **FY15** | **1H15** |
| 7 Nov 2017 | 7 Nov 2037 | 386.7 | 378.0 | 374.7 | 376.6 | 385.4 |
| 7 Jun 2013 | 7 Dec 2016 | - | 33.4 | 67.6 | 63.5 | 88.3 |
| 7 Dec 2016 | 7 Dec 2026 | - | 34.1 | 35.2 | 33.9 | 31.0 |
| | | **386.7** | **445.5** | **477.5** | **474.0** | **504.7** |

## Change in CLC excess regulatory capital and Group cash graph




1. 1H17 Tier 2 regulatory capital – subordinated debt ($387m) differs to the Group balance sheet ($385m) due to accrued interest and amortised costs ($2m).

# Challenger Life Company Limited (CLC) regulatory capital

## Capital management

CLC holds capital in order to ensure that under a range of adverse scenarios it can continue to meet its regulatory and contractual obligations to customers. CLC is regulated by the Australian Prudential Regulation Authority (APRA) and is required to hold a minimum level of regulatory capital. CLC has an ongoing and open engagement with APRA.

CLC's regulatory capital base and prescribed capital amount have been calculated based on APRA prudential capital standards. APRA issued new capital standards in October 2012 which became effective from 1 January 2013 (the Life and General Insurance Capital Standards or LAGIC).

Following the introduction of LAGIC standards, CLC's regulatory capital requirements increased by $323m, however, APRA provided CLC a three-year transitional period which concluded on 1 January 2016.

## CLC excess regulatory capital

CLC's excess capital above APRA's prescribed capital amount at 31 December 2016 (1H17) was $772m, down $0.2bn during 1H17. The reduction in excess regulatory capital was a result of a $0.2bn increase in CLC's Prescribed Capital Amount (PCA). The PCA increased as a result of growth in Life's annuity and other retirement products, and changes in mix of Life's investment portfolio.

CLC's capital ratios at 31 December 2016 were as follows:

- PCA ratio of 1.39 times;
- Total Tier 1 ratio of 1.19 times; and
- Common Equity Tier 1 (CET1) ratio of 1.02 times.

APRA requires Total Tier 1 capital to be at least 80% of the PCA and CET1 capital to be at least 60% of the PCA. Both Challenger's Total Tier 1 capital ratio (1.19 times) and CET1 capital ratio (1.02 times) are well in excess of APRA's minimum requirements.

CLC maintains a target level of capital representing APRA's prescribed capital amount plus a target surplus. The target surplus is a level of excess capital that CLC seeks to carry over and above APRA's minimum requirement.

CLC's target surplus is set to ensure it provides a buffer so that CLC can continue to meet APRA's minimum requirements following adverse market or insurance risk experience. CLC uses internal capital models to determine its target surplus, which are risk-based and responsive to changes in CLC's asset allocation and market conditions.

While CLC does not target a specific PCA ratio, CLC's internal capital models generate a PCA ratio based upon asset allocation, business mix and economic circumstances. CLC's target PCA range is 1.3 times to 1.6 times.

## Subordinated debt

CLC's total regulatory capital base includes $387m of admissible subordinated debt. Subordinated debt issued prior to 1 January 2013 (implementation date of new LAGIC capital standards) will continue to be fully eligible as Tier 2 regulatory capital under LAGIC until each tranche's first call date after 1 January 2013, and will then amortise over four years.

CLC repaid $190m of subordinated debt in December 2016, with $68m qualifying as regulatory capital.

CLC's remaining $387m of subordinated debt has a call date in November 2017. As such, it will continue to be fully eligible as Tier 2 regulatory capital until its call date in November 2017 and will continue to be partially eligible until November 2021.

## Group cash

In addition to CLC's excess regulatory capital, Challenger maintains cash at a Group level, which can be utilised to meet regulatory requirements. Group cash at 31 December 2016 was $81m, down $3m from 30 June 2016.

Challenger also maintains an undrawn Group banking facility of $400m, which is maintained to provide additional financial flexibility. The banking facility was undrawn at 31 December 2016.

## APRA's Level 3 (conglomerate) capital proposals

APRA has developed a supervisory framework for Level 3 (conglomerate) groups, which was due to be effective from 1 January 2015. Level 3 groups perform material activities across more than one APRA regulated industry.

In March 2016, APRA announced it would defer the Level 3 capital framework until finalisation of other domestic and international capital policy initiatives. Based on draft Level 3 capital standards, Challenger does not expect a material impact on its regulatory capital base should these capital standards be implemented.

## Capital management initiatives

Challenger Life is growing strongly and expects to increase the size of its annuity business in the future. Challenger's market opportunity and growth profile are set out on page 38. In order to support Challenger's growth profile, Challenger intends to launch subordinated, unsecured, convertible notes (Challenger Capital Notes 2) during 3Q17.

The Challenger Capital Notes 2 will be quoted and tradeable on the ASX and pay franked distributions on a quarterly basis. Challenger is targeting to raise $350m via Challenger Capital Notes 2, subject to prevailing market conditions, with the ability to raise more or less.

The proceeds from the Challenger Capital Notes 2 will be injected into CLC as Additional Tier 1 Equity, and will increase CLC's PCA ratio from 1.39 times to 1.52 times on a 31 December 2016 pro forma basis (assuming $350m raised) and invested at the same capital intensity as the 31 December 2016 asset mix.

# Risk Management Framework

Challenger is exposed to a variety of financial risks, including market risk (currency risk, interest rate risk, equity risk), credit default risk and liquidity risk.

The management of these risks is fundamental to Challenger's business and building long term shareholder value.

The Challenger Limited Board is responsible, in conjunction with senior management, for understanding risks associated with the business and implementing structures and policies to adequately monitor and manage these risks.

The Board has established the Group Risk Committee (GRC) and Group Audit Committee (GAC) to assist in discharging certain responsibilities. In particular, these committees assist the Board in setting the risk appetite and ensuring Challenger has an effective Risk Management Framework, incorporating management, operational and financial controls.

The Executive Risk Management Committee (ERMC) is an executive committee, chaired by the Chief Risk Officer (CRO), which assists the GRC, GAC and Board in discharging their risk management obligations by implementing the Board approved Risk Management Framework.

The Group's Risk Management division has day-to-day responsibility for monitoring the implementation of the framework with oversight, analysis, monitoring and reporting of risks. The CRO provides regular reporting to the GRC, and the Board.

## Risk appetite

Challenger's risk appetite requires a range of financial risks, including foreign exchange, interest rate, and inflation risk to be minimised. As a result Challenger takes an active approach to hedging and limiting these financial risks.

Challenger's risk appetite statement provides that, subject to acceptable returns, Challenger can retain exposure to credit risk, property risk, equity and infrastructure risk and Life insurance risk.

| **Accept exposure** (subject to appropriate returns) | **Minimise exposure** |
|---|---|
| ✓ Credit risk | ✗ Foreign exchange risk |
| ✓ Property risk | ✗ Interest rate risk |
| ✓ Equity & infrastructure risk | ✗ Inflation risk |
| ✓ Life insurance risk | ✗ Liquidity risk |
| | ✗ Licence risk |
| | ✗ Operational risk |

## Credit default risk

Credit default risk is the risk of loss in value of an investment due to a counterparty failing to discharge an obligation.

Challenger's approach to credit management utilises a credit risk framework to ensure that the following principles are adhered to:

- credit risk management teams separation from risk originators;
- recognition of the different risks in the various businesses;
- credit exposures being systematically controlled and monitored;
- credit exposures being regularly reviewed in accordance with existing credit procedures; and
- ensuring credit exposures include the impact from derivative transactions.

Challenger makes use of external ratings agencies (Standard & Poor's, Fitch, Moody's) to determine credit ratings.

Where a counterparty or debt obligation is rated by multiple external rating agencies, Challenger will use Standard & Poor's ratings where available.

All credit exposures with an external rating are also reviewed internally and cross-referenced to the external rating, if applicable. Where external credit ratings are not available, internal credit ratings are assigned by appropriately qualified and experienced credit personnel who operate separately from the risk originators.

### Credit spread risk sensitivity

Challenger is exposed to price movements resulting from credit spread fluctuations through its fixed income securities net of subordinated debt. As at 31 December 2016, a 50 basis point increase/decrease in credit spreads results in an unrealised loss/gain of $77m (after-tax).

## Property risk

Property risk is the potential impact of movements in the market value of property investments on Challenger's profit and includes leasing risk which may impact the potential cash flow from these investments.

### Property risk sensitivity

Challenger is exposed to movements in the market value of property investments, both directly held investment properties and property securities.

The direct property sensitivities included on page 36 show the impact of a change in property valuations on balance date and are based on Life's gross direct property investments of $3.8bn (net investments of $3.3bn plus debt of $0.5bn).

## Equity risk

Equity risk is the potential impact of movements in the market value of listed and unlisted equities on Challenger's profit.

Challenger holds equities as part of its investment portfolio in order to provide diversification across the investment portfolio.

**Equity risk sensitivity**

Challenger is exposed to movements in the market value of listed and unlisted equity investments with a 10% move in equity markets at 31 December 2016 resulting in $86m (after-tax) movement in the valuation of equity investments.

## Liquidity risk

Liquidity risk is the risk that Challenger will encounter difficulty in raising funds to meet cash commitments associated with financial instruments and contracted payment obligations to annuitants. This may result from either the inability to sell financial assets at face value, a counterparty failing on repayment of a contractual obligation, or the inability to generate cash inflows as anticipated.

Challenger's liquidity policy aims to ensure that it has sufficient liquidity to meet its obligations on a short, medium and long term basis. In setting the level of sufficient liquidity, Challenger considers new business activities in addition to current contracted obligations. In determining the required levels of liquidity, Challenger considers:

- minimum cash requirements;
- collateral and margin call buffers;
- Australian Financial Services License requirements;
- cash flow forecasts;
- associated reporting requirements;
- other liquidity risks; and
- contingency plans.

Required annuity cash outflows are met from contracted investment cash flows together with assets in Challenger's liquidity pool. As a result, cash flows are well-matched and continue to be rebalanced through time.

## Life insurance risk

Lifetime annuities provide guaranteed payments to customers for life. Through selling lifetime annuities and assuming wholesale reinsurance agreements, CLC is assuming longevity risk, which is the risk annuitant customers live longer, in aggregate, than expected. This is in contrast to mortality risk, which is the risk that people die earlier than expected. CLC is exposed to mortality risk on the wholesale mortality reinsurance business.

CLC is required under APRA Prudential Standards to maintain regulatory capital in relation to the longevity, mortality and morbidity risks it carries.

CLC manages some of its longevity risk exposure by using reinsurance for closed lifetime annuity portfolios as well as regularly reviewing the portfolio for longevity experience to ensure longevity assumptions remain appropriate.

Mortality and morbidity rates are based on industry standards which are adjusted for CLC's own recent experience, and include an allowance for future rates of mortality improvement.

CLC assumes future mortality rates for individual lifetime annuities will improve by between 0% and 2.8% per annum (1H16 0% and 4% per annum) depending on different age cohorts. This has the impact of increasing the life expectancy of a male aged 65 from 22 years (per the base mortality rates) to 24 years.

**Mortality, morbidity and longevity sensitivities**

The mortality sensitivities on page 36 set out the expected impact of an improvement in mortality. This is in addition to the mortality improvements Challenger already assumes.

A 50% increase in mortality improvement rates would increase the life expectancy of a male aged 65 from 24 years to 26 years.

## Foreign exchange risk

It is Challenger's policy to seek to hedge the exposure of all balance sheet items for movements in foreign exchange rates.

Currency exposure arises primarily as a result of Life's investments in Europe (including the United Kingdom), Japan and the United States. As a result, currency risk arises from fluctuations in the value of the Euro, British Pound, Japanese Yen and US Dollar against the Australian Dollar.

In order to protect against foreign currency exchange rate movements, Challenger enters into foreign currency derivatives which limit Challenger's exposure to currency movements.

**Foreign exchange sensitivity**

The impact of movements in foreign currencies on Challenger's profit and loss and balance sheet are set out on page 36. As a result of foreign currency derivatives in place, Challenger's profit and loss is not materially sensitive to movements in foreign currency rates.

## Interest rate risk

Interest rate risk is the risk of fluctuations in Challenger's earnings arising from movements in market interest rates, including changes in the absolute level of interest rates, the shape of the yield curve, the margin between the different yield curves and the volatility of interest rates.

CLC's market risk policy sets out the relevant risk limits for interest rate exposure. It is CLC's policy to minimise the impact of interest rate movements on its projected future cash flows.

**Interest rate sensitivity**

The impact of movements in interest rates on Challenger's profit and loss and balance sheet are set out on page 36.

The sensitivities assume the change in variable occurs on 31 December 2016, and are based on assets and liabilities held at that date. It is Challenger's policy to minimise the impact of movements in interest rates via the use of interest rate swaps, Australian Commonwealth Government bonds and bond futures. As a result the interest rate sensitivities on page 36 show Challenger's profit is not materially sensitive to changes in base interest rates.

## Profit and equity sensitivities

Profit and equity sensitivities set out the expected impact from changes in a range of economic and investment market variables on Challenger's earnings and balance sheet. These sensitivities represent the after-tax impact, assuming a tax rate of 30%.

The sensitivities are not forward looking and make no allowance for events occurring after 31 December 2016.

If using these sensitivities as forward looking, an allowance for changes post 31 December 2016, such as sales and asset growth, should be made.

These sensitivities assess the risk of changes in economic and investment markets on the valuation of assets, which in turn impact earnings. The earnings impact is included in investment experience and does not take into consideration the impact of any under or over performance of normalised growth assumptions for each asset category. Refer to page 44 for normalised growth assumptions.

These sensitivities do not include the indirect impact on fees for the Funds Management business.

Refer to the Risk Management Framework (pages 33 and 34) for additional detail on how to apply the profit and equity sensitivities.

# Profit and equity sensitivities

| $m | Change in variable | Profit/(loss) after-tax 1H17 | Change in equity 1H17 | Profit/(loss) after-tax FY16 | Change in equity FY16 |
|---|---|---|---|---|---|
| **Credit risk** | | | | | |
| Fixed Income assets (change in credit spreads) | +50bps | (76.8) | (76.8) | (71.3) | (71.3) |
| | -50bps | 76.8 | 76.8 | 71.3 | 71.3 |
| **Property risk** | | | | | |
| Direct Property | +1% | 23.8 | 23.8 | 24.1 | 24.1 |
| | -1% | (23.8) | (23.8) | (24.1) | (24.1) |
| Australian listed property securities | +10% | 11.4 | 11.4 | - | - |
| | -10% | (11.4) | (11.4) | - | - |
| Other property securities | +10% | 10.1 | 10.1 | 10.0 | 10.0 |
| | -10% | (10.1) | (10.1) | (10.0) | (10.0) |
| Total | | 45.3 | 45.3 | 34.1 | 34.1 |
| | | (45.3) | (45.3) | (34.1) | (34.1) |
| **Infrastructure and equity risk** | | | | | |
| Infrastructure investments | +10% | 24.7 | 24.7 | 23.8 | 23.8 |
| | -10% | (24.7) | (24.7) | (23.8) | (23.8) |
| Equity investments | +10% | 86.2 | 86.2 | 75.5 | 75.5 |
| | -10% | (86.2) | (86.2) | (75.5) | (75.5) |
| Total | +10% | 110.9 | 110.9 | 99.3 | 99.3 |
| | -10% | (110.9) | (110.9) | (99.3) | (99.3) |
| **Life insurance risk** | | | | | |
| **Mortality, morbidity and longevity**[1] | | | | | |
| Life insurance contract liabilities | +50% | (15.3) | (15.3) | (15.1) | (15.1) |
| | -50% | 15.3 | 15.3 | 15.1 | 15.1 |
| **Interest rate risk** | | | | | |
| Change in interest rates | +100bps | 2.1 | 2.1 | 4.1 | 4.1 |
| | -100bps | (2.1) | (2.1) | (4.1) | (4.1) |
| **Foreign exchange risk** | | | | | |
| British Pound | +10% | (0.1) | (0.1) | 0.7 | 0.7 |
| | -10% | 0.1 | 0.1 | (0.7) | (0.7) |
| US Dollar | +10% | 0.8 | 0.8 | 7.0 | 7.0 |
| | -10% | (0.8) | (0.8) | (7.0) | (7.0) |
| Euro | +10% | (0.2) | (0.2) | (0.3) | (0.3) |
| | -10% | 0.2 | 0.2 | 0.3 | 0.3 |
| Japanese Yen | +10% | - | 0.4 | - | 0.8 |
| | -10% | - | (0.4) | - | (0.8) |
| Other | +10% | 0.2 | 0.2 | 0.4 | 0.4 |
| | -10% | (0.2) | (0.2) | (0.4) | (0.4) |

1. Mortality, morbidity and longevity life insurance contract liabilities sensitivity is net of any reinsurance with third parties.

# Retirement income regulatory reforms update

The Australian Government commissioned the Financial System Inquiry (FSI) to provide a 'blueprint' for Australia's financial system over the next decade. The FSI report (released December 2014) recommended a number of retirement income reforms to enhance the retirement phase of superannuation. These reforms included defining and enshrining the objective of superannuation in legislation; removing the impediments to longevity product development through the Retirement Income Streams Review; and creating a framework for pre-selecting retirement income products at retirement (Comprehensive Income Products for Retirement).

The Government responded to the FSI recommendations in October 2015, supporting all major retirement income recommendations. Over the past eighteen months, the Federal Government has released a series of consultation papers, undertaken a range of industry and key stakeholder engagement, and embarked on a legislative program to implement these reforms.

These reforms are important building blocks in the creation of a world-class retirement income system and will enhance choice for retirees whilst making it easier for superannuation trustees to provide a range of options that deliver lifetime income.

**Objective of superannuation**

The FSI recommended that the objective of superannuation should be to provide income in retirement to substitute or supplement the Age Pension. The Government has adopted this definition and the Superannuation (Objective) Bill 2016 was passed by the House of Representatives in November 2016. The Bill is currently being considered by the Senate.

Making clear the objective of superannuation provides the framework for future Government policy, and also provides guidance to the superannuation industry and retirees.

**New retirement income rules – Retirement Income Streams Review**

As part of the Federal Budget in May 2016, the Government announced a new superannuation framework that will address current longevity product impediments and facilitate a wider range of retirement income products. The new retirement income product rules remove the impediments to longevity products, including deferred lifetime annuities and group self-annuitisation products, and are expected to provide the building blocks for superannuation funds to develop CIPRs.

Deferred Lifetime Annuities (DLAs) are deferred annuity products that provide payments for life once a person reaches a particular age, with the deferral period specified at the time of purchase.

Key enabling legislation for the new category of retirement income products, including DLA's received Royal Assent in November 2016, with the law now providing earnings tax exemptions for these products when in the retirement phase.

Following this the Government has engaged in an industry consultation on the means testing arrangements for retirement income streams. The Government has stated it is mindful of the need for social security means testing arrangments to be complementary to the facilitation of these products.

It is anticipated that the new retirement income rules will be in place by 1 July 2017, enabling new retirement income products to be offered.

**Comprehensive Income Products for Retirement (CIPR)**

The FSI identified the retirement phase of superannuation is underdeveloped and superannuation assets are not being efficiently converted into retirement incomes. The FSI recommended trustees should pre-select for members a Comprehensive Income Product for Retirement (CIPR) to enable seemless transition to retirement and deliver on the superannuation objective to provide retirement income.

In December 2016, the Government released a CIPR discussion paper seeking industry feedback and consultation, with submissions due by the end of April 2017.

The Government discussion paper envisages CIPRs would be a mass-customised, composite retirement income product that would include components to provide a minimum level of income; a broadly constant level of income for life; and a component to provide flexibility.

CIPRs will comprise a combination of products in order to achieve these objectives, and superannuation funds will be able to partner with Life Companies in order to provide pooled longevity products, such as annuities as part of their CIPR offering.

In order to assist with the development of a CIPR framework, the Government is specifically seeking feedback on: the structure and minimum requirements of CIPRs; the framework for regulating CIPRs; and the process for offering a CIPR. As part of its consultation, the Government is proposing to rename CIPRs 'MyRetirement products'.

The CIPR framework is not expected to commence before mid-2018.

## Life outlook

The Australian retirement incomes market is expected to grow strongly over the next 20 years as Australia's Baby Boomers (born 1946 to 1964) move from retirement 'saving' to retirement 'spending'. Over the next 20 years the number of Australians over 65, which is Life's target demographic, is expected to increase by 75%[1].

Challenger Life is well positioned to benefit from changes in retiree risk preferences, including the focus on longevity risk by retirees and their advisers. Annuities address many of the financial concerns retirees face in retirement.

The retirement phase of superannuation is a high growth market driven by ageing demographics and rising superannuation balances from mandatory contributions.

The annual transfer from the accumulation (or savings) phase to the retirement (or spending) phase of superannuation is expected to be $58bn in 2017 and forecast to increase by a compound annual growth rate of ~13%[2] per year for the next 10 years. This will result in the annual transfer to the retirement phase increasing from ~$58bn in 2017 to ~$240bn by 2030.

There is growing recognition that retirees need to take a different approach to investing in retirement and there is a move toward income layering and objectives-based investing. As retirees transition from Government funded aged pensions to private pensions, retirees are demanding safe, secure retirement income products that convert savings to income and provide financial security. Annuities provide safe, secure and reliable retirement income.

Of the total annual transfer from the accumulation to retirement phase each year, currently less than 5% is invested in annuities, which is significantly less than the average for OECD countries. As Australian retirees seek secure retirement income products that convert savings to income, there is a significant opportunity to increase the proportion of retirement savings invested in annuities.

There are a range of retirement income regulatory reforms currently underway (refer page 37 for more detail), which are designed to enhance the retirement phase of superannuation. These reforms provide a significant opportunity to increase the proportion of retirement savings invested in longevity products, including annuities.

Challenger's distribution strategy includes adding its products to the investment and administration platforms of leading superannuation funds.

In the retail superannuation segment, Challenger annuities have been launched on the Colonial First State (CFS) and ClearView Wealth Solutions platforms, and are expected to be launched by both AMP and BT Financial Group in the September 2017 quarter. These retail platform initiatives will result in approximately two thirds of Australian financial advisers being able to access Challenger annuities via an investment administration platform.

In the profit-for-member segment, Challenger backed term and lifetime annuities have been integrated with VicSuper account based pensions to effectively create Australia's first CIPR. Challenger has also formed a partnership with the Link Group, which services the needs of 10 million Australian industry superannuation member accounts. Three of Link Group's clients (caresuper, legalsuper and Local Government Super) have commenced offering their members guaranteed retirement incomes, which are backed by Challenger annuities.

Consistent with Challenger's strategy to diversify its range of products and expand its distribution relationships, in 1H17 Challenger announced a new annuity relationship with Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary). MS Primary is a leading provider of Australian dollar denominated annuity products in Japan (refer to the MS Primary section on page 16).

Japan has one of the world's most rapidly ageing populations who are looking for income from longer dated products due to the low Japanese interest rate environment. This has driven a significant increase in demand for foreign currency annuities, including Australian dollar denominated annuities.

Sales of Australian dollar annuities in Japan are estimated to be ~$30bn per year, which is over seven times the size of Australia's annuities market.

Commencing on 1 November 2016, Challenger issued Australian dollar fixed rate annuities with a 20 year term in order to support a reinsurance agreement with MS Primary. This new relationship has started strongly, with $125m of sales for the first two months.

Australia's retirement income market is a high growth market, driven by Australia's ageing population and mandatory nature of superannuation contributions. As Australia's leading retirement income specialist, Challenger is uniquely positioned to benefit from growth in Australia's retirement income market. Challenger's growth is being amplified through expanding its product and distribution capability, including increasing access to products through administration and investment platforms.

1. Deloitte – Dynamics of the Australian superannuation system: the next 20 years 2015-2035.
2. Rice Warner 2014 Super Projections – forecasted growth over next 10 years based on existing regulatory environment.

# Funds Management financial results

| $m | 1H17 | 2H16 | 1H16 | 2H15 | 1H15 |
|---|---|---|---|---|---|
| **Fidante Partners** | | | | | |
| Fidante Partners income[1] | 39.5 | 33.8 | 37.5 | 25.6 | 27.7 |
| Performance fees | 1.1 | 3.1 | 3.8 | 4.6 | 4.4 |
| **Net income** | **40.6** | **36.9** | **41.3** | **30.2** | **32.1** |
| | | | | | |
| **Challenger Investment Partners (CIP)** | | | | | |
| CIP Income[2] | 24.7 | 23.7 | 25.8 | 23.2 | 24.0 |
| Performance fees | - | - | - | 8.0 | - |
| **Net income** | **24.7** | **23.7** | **25.8** | **31.2** | **24.0** |
| **Total net fee income** | **65.3** | **60.6** | **67.1** | **61.4** | **56.1** |
| | | | | | |
| Personnel expenses | (31.9) | (31.5) | (30.9) | (25.4) | (24.8) |
| Other expenses | (12.7) | (13.3) | (14.6) | (12.7) | (10.5) |
| **Total expenses** | **(44.6)** | **(44.8)** | **(45.5)** | **(38.1)** | **(35.3)** |
| **EBIT** | **20.7** | **15.8** | **21.6** | **23.3** | **20.8** |
| | | | | | |
| **Performance analysis** | | | | | |
| Fidante Partners – income margin (bps)[3] | 18 | 18 | 20 | 14 | 16 |
| Challenger Investment Partners – income margin (bps)[3] | 34 | 36 | 39 | 47 | 39 |
| Cost to income ratio | 68.3% | 73.9% | 67.8% | 62.1% | 62.9% |
| Net assets – average[4] | 176.9 | 165.9 | 151.3 | 121.7 | 127.1 |
| RoE (pre-tax) | 23.2% | 19.2% | 28.4% | 38.6% | 32.5% |
| | | | | | |
| Fidante Partners | 46,958.3 | 43,011.5 | 41,605.1 | 44,667.0 | 42,502.5 |
| Challenger Investment Partners | 15,154.8 | 13,650.2 | 13,092.9 | 13,235.4 | 12,709.4 |
| **Closing FUM – total** | **62,113.1** | **56,661.7** | **54,698.0** | **57,902.4** | **55,211.9** |
| | | | | | |
| Fidante Partners | 44,815.0 | 41,972.9 | 41,710.0 | 44,381.9 | 40,493.9 |
| Challenger Investment Partners | 14,308.0 | 13,346.3 | 13,127.5 | 13,358.2 | 12,066.9 |
| **Average FUM – total[5]** | **59,123.0** | **55,319.2** | **54,837.5** | **57,740.1** | **52,560.8** |
| | | | | | |
| **FUM and net flows analysis** | | | | | |
| Fidante Partners[6] | 1,741.0 | 1,332.1 | (3,941.8) | 678.3 | 5,426.1 |
| Challenger Investment Partners | 1,476.1 | 507.1 | (414.6) | 294.4 | 1,340.1 |
| Net flows | 3,217.1 | 1,839.2 | (4,356.4) | 972.7 | 6,766.2 |
| Distributions | (256.0) | (203.1) | (338.0) | (97.2) | (164.5) |
| Market linked movement | 2,490.3 | 327.6 | 1,490.0 | 1,815.0 | 1,483.7 |
| **Total FUM movement** | **5,451.4** | **1,963.7** | **(3,204.4)** | **2,690.5** | **8,085.4** |

1. Fidante Partners income includes equity accounted profits, distribution fees, administration fees and Fidante Partners Europe transaction fees.
2. CIP income includes asset based management fees and other income. Other income includes leasing fees, asset aquisition and disposal fees, development and placement fees.
3. Income margin represents net income divided by average FUM.
4. Net assets – average calculated on a monthly basis.
5. Average FUM calculated on a monthly basis.
6. Funds Management 1H16 net flows include $5.4bn derecognition of Kapstream following the sale in July 2015. Fidante Partners will no longer receive distribution fees on Kapstream institutional FUM ($5.4bn) and as a result derecognised this FUM in 1H16.

# Assets and Funds Under Management and net flows

| $m | Q2 17 | Q1 17 | Q4 16 | Q3 16 | Q2 16 |
|---|---|---|---|---|---|
| **Funds Management** | | | | | |
| **Fidante Partners** | | | | | |
| Equities | 20,833 | 19,124 | 18,317 | 17,929 | 18,754 |
| Fixed income | 19,726 | 19,065 | 18,364 | 17,707 | 17,305 |
| Alternatives | 6,399 | 6,332 | 6,331 | 5,880 | 5,546 |
| Total Fidante Partners | 46,958 | 44,521 | 43,012 | 41,516 | 41,605 |
| **Challenger Investment Partners** | | | | | |
| Fixed income | 10,357 | 9,703 | 9,059 | 8,425 | 8,541 |
| Property | 4,798 | 4,669 | 4,591 | 4,680 | 4,552 |
| Total Challenger Investment Partners | 15,155 | 14,372 | 13,650 | 13,105 | 13,093 |
| **Total funds under management** | **62,113** | **58,893** | **56,662** | **54,621** | **54,698** |
| | | | | | |
| Average Fidante Partners | 45,516 | 44,041 | 42,539 | 41,292 | 41,071 |
| Average Challenger Investment Partners | 14,632 | 14,000 | 13,506 | 13,126 | 13,029 |
| **Average total funds under management[1]** | **60,148** | **58,041** | **56,045** | **54,418** | **54,100** |
| | | | | | |
| **Analysis of net flows** | | | | | |
| Equities | 936 | (56) | (51) | (182) | 492 |
| Fixed Income | 573 | 369 | 360 | 436 | 199 |
| Alternatives | (50) | (31) | 434 | 336 | (765) |
| **Total Fidante Partners** | **1,459** | **282** | **743** | **590** | **(74)** |
| Challenger Investment Partners | 835 | 641 | 338 | 169 | 131 |
| **Net flows** | **2,294** | **923** | **1,081** | **759** | **57** |

# Reconciliation of Total Group Assets and Funds Under Management

| $m | Q2 17 | Q1 17 | Q4 16 | Q3 16 | Q2 16 |
|---|---|---|---|---|---|
| Funds Management | 62,113 | 58,893 | 56,662 | 54,621 | 54,698 |
| Life investment assets | 14,607 | 14,316 | 14,112 | 13,102 | 13,147 |
| Adjustments to remove double counting of cross holdings | (12,015) | (11,215) | (10,723) | (10,289) | (10,228) |
| **Total Assets and Funds Under Management** | **64,705** | **61,994** | **60,051** | **57,434** | **57,617** |

1. Average total funds under management calculated on a monthly basis.

# Funds Management financial results

Challenger's Funds Management business is Australia's seventh largest investment manager[1] and second largest fixed income manager by FUM[2].

The Funds Management business benefits from a clear business strategy focused on investor alignment. Over the last five years FUM has increased by $34bn, increasing by an average of 18% per annum, approximately twice the compound annual growth rate[3] across the Australian funds management market.

Fidante Partners' multi-boutique platform comprises separately branded investment management businesses investing in equities, fixed income, infrastructure and alternatives. The model aligns the interests of investors, boutique investment managers and Fidante Partners. In July 2015, as part of Fidante Partner's international distribution and product expansion strategy, the business was expanded into Europe.

Funds Management also includes Challenger Investment Partners (CIP), comprising fixed income and property investment teams investing on behalf of institutional clients including the Challenger Life Company.

## EBIT and ROE

Funds Management EBIT was $21m and decreased by $1m (4%) on 1H16. The reduction in Funds Management EBIT, was due to a $2m reduction in net income, partially offset by a $1m reduction in expenses.

Funds Management net income reduced as a result of lower performance fees in Fidante Partners and lower other income in Challenger Investment Partners, offset by higher average FUM and a rebound in UK revenue. Excluding the impact of lower Fidante Partners performance fees, EBIT would have increased by 10%.

1H17 Funds Management ROE was 23.2%, down from 28.4% in 1H16 due to lower EBIT, and higher capital invested in the business. 1H17 ROE increased by 400 bps on 2H16.

## Total net fee income

1H17 total net fee income of $65m decreased by $2m (3%), with Fidante Partners net fee income decreasing by $1m (2%), and Challenger Investments Partners net fee income decreasing by $1m (4%).

## Fidante Partners

Fidante Partners' net fee income includes distribution fees, administration fees, transaction fees from Fidante Partners Europe, performance fees and a share in the equity accounted profits of boutique investment managers.

Fidante Partners' net income was $41m in 1H17, down $1m (2%) from 1H16. Fidante Partners' net income reduced from 1H16 as a result of lower performance fees (down $3m) and was partially offset by an increase in Fidante Partners Europe revenue (up $5m). Fidante Partners Europe revenue increased with a rebound in United Kingdom transaction activity following the Brexit vote in June 2016.

Fidante Partners' 1H17 income margin (net income to average FUM) was 18 bps, down 2 bps from 1H16. The decrease in net income margin was due to:

- lower performance fees (-1 bps); and
- lower Fidante Australia net income due to a change in FUM mix, partially offset by an increased contribution from Fidante Partners Europe (-1 bps).

## Expenses

1H17 Funds Management expenses was $45m, and decreased by $1m (down 2%) on 1H16 due to lower Fidante Partners operating expenses.

1H17 cost to income ratio was 68.3%, up from 67.8% in 1H16. The increase in the cost to income ratio reflects lower net income, partially offset by lower expenses.

## Fidante Partners FUM and net flows

Fidante Partners' FUM at 31 December 2016 (1H17) was $47.0bn, increasing by $3.9bn (9%) in 1H17. The increase in Fidante Partners 1H17 FUM was due to:

- $1.7bn of net flows; and
- $2.2bn of positive market movements net of distributions.

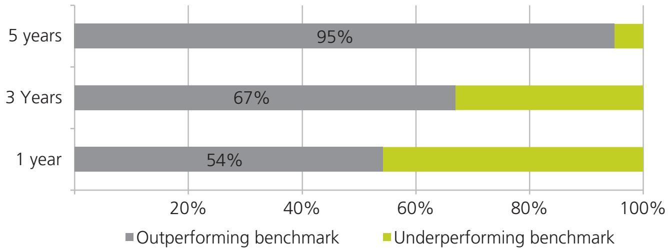
Approximately 44% of Fidante Partners' 1H17 FUM is invested in equities, 42% in fixed income and 14% in alternatives (e.g. infrastructure) products.

1H17 net flows of $1.7bn include $0.9bn of equity product inflows; $0.9bn of fixed income product inflows, and $0.1bn of alternative product outflows.

1. Consolidated FUM for Australian fund managers – Rainmaker Roundup September 2016.
2. Australian fixed income investment managers – Rainmaker Roundup September 2016.
3. Rainmaker Roundup September 2016.

## Fidante Partners' investment performance

Fidante Partners' investment performance represents the percentage of FUM meeting or exceeding performance benchmarks. Total investment performance is weighted by boutique FUM.




Fidante Partners' investment performance has remained strong. Over a five year period, 95% of FUM has exceeded benchmark. Over one year, 54% of FUM has exceeded benchmark.

## Fidante Partners Europe

In July 2015 Fidante Partners acquired 100% of Dexion Capital Holdings Limited (rebranded to Fidante Partners Europe), a European alternative investments group comprising economic interests in three specialist fund managers, as well as a capital raising business serving the needs of listed, closed-end alternative investment companies. The business also boasts a successful distribution team raising capital in listed and private placement format. Fidante Partners Europe employs approximately 30 staff, predominately based in London.

The acquisition also provides Fidante Partners with established distribution to UK and European alternative asset focused investors.

Due to market uncertainty in the UK in the lead up to the Brexit vote (June 2016), UK transaction activity stalled, affecting the raising of capital for close-end listed alternative investment managers. Following the Brexit vote, transaction activity in the United Kingdom has recovered, with Fidante Partners Europe contributing revenue of $12m in 1H17, up from $7m in 1H16.

## Challenger Investment Partners

Challenger Investment Partners' net income was $25m in 1H17, down $1m (4%) on 1H16. Challenger Investment Partners' net income reduced from 1H16 as a result of lower other income (down $3m), partially offset by an increase in average FUM.

Challenger Investment Partners' 1H17 income margin (net income to average FUM) was 34 bps, down 5 bps from 1H16. The decrease in income margin was due to:

- lower non-FUM based income (-5 bps);
- higher proportion of lower margin fixed income FUM (-1 bps); and
- higher property management fees (+1 bps)

## Challenger Investment Partners' (CIP) FUM and net flows

Challenger Investment Partners' FUM at 31 December 2016 was $15.2bn, and increased by $1.5bn (11%) in 1H17.
The increase in Challenger Investment Partners' FUM in 1H17 was due to:

- $1.3bn of Life net flows; and
- $0.2bn of third party client net flows;

Approximately 68% of Challenger Investment Partners' 1H17 FUM is invested in fixed income and approximately 32% is invested in property.

Third party clients account for 24% of Challenger Investment Partners' FUM at 31 December 2016.

## Funds Management outlook

The Australian funds management market remains an attractive market underpinned by mandated superannuation contributions. Contributions are currently 9.5% of gross salaries and are scheduled to increase to 12% by 2025. The mandated nature of Australia's superannuation system is expected to significantly grow the size of Australia's superannuation assets from $2 trillion to $10 trillion over the next 20 years[1].

Funds Management's superior FUM growth over the past five years can be partly attributed to the strength of Challenger's retail and institutional distribution teams, and investor alignment across investors, boutique investment managers and Fidante Partners.

A strategic priority for Funds Management is to expand its product and boutique manager offering both in Australia and offshore. This has included the expansion of the business into Europe and in February 2017 Avenir Capital, a value global equities boutique, was added to the Fidante Partners offering.

The expansion of Fidante Partners into Europe has substantially expanded Fidante Partners' successful multi-boutique model into the European market, whilst opening up global distribution opportunities for existing boutique investment managers.

Challenger Investment Partners continues to build out its client base and product offering. There are opportunities to add new mandates from domestic and international institutions, superannuation funds and sovereign wealth funds. As a result of the low (or negative) interest rate environment across the globe, there is demand from foreign investors seeking higher absolute return Australian assets.

Challenger's Funds Management business is very well positioned to benefit from growth in Australia's superannuation system. The Funds Management platform has multiple brands and strategies with scalable platforms in both Australia and Europe.

Funds Management has approximately $110 billion of available FUM capacity, and when coupled with Challenger's distribution capability, institutional strength administration platform and long term boutique investment manager performance, provides a strong base to continue to grow the business.

1. Deloitte – Dynamics of the Australian superannuation system: the next 20 years 2015-2035.

# Corporate financial results

| $m | 1H17 | 2H16 | 1H16 | 2H15 | 1H15 |
|---|---|---|---|---|---|
| **Other income** | **0.4** | **0.4** | **0.6** | **0.6** | **0.7** |
| Personnel expenses | (17.8) | (19.1) | (18.0) | (18.5) | (18.3) |
| Other expenses | (5.8) | (6.6) | (6.4) | (5.5) | (4.6) |
| **Total expenses (excluding LTI)** | **(23.6)** | **(25.7)** | **(24.4)** | **(24.0)** | **(22.9)** |
| Long term incentives (LTI)[1] | (8.1) | (8.6) | (8.0) | (8.8) | (8.0) |
| **Total expenses** | **(31.7)** | **(34.3)** | **(32.4)** | **(32.8)** | **(30.9)** |
| **Normalised EBIT** | **(31.3)** | **(33.9)** | **(31.8)** | **(32.2)** | **(30.2)** |
| Interest and borrowing costs | (2.3) | (1.8) | (2.3) | (2.1) | (1.7) |
| **Normalised loss before tax** | **(33.6)** | **(35.7)** | **(34.1)** | **(34.3)** | **(31.9)** |

The Corporate division comprises central functions such as group executives, finance, treasury, legal, human resources, risk management and strategy.

Corporate also includes interest received on Group cash balances and any interest and borrowing costs associated with Group debt facilities.

## Normalised EBIT

1H17 Corporate normalised EBIT was a $31m loss, and improved by $1m from 1H16.

## Other income

Other income includes interest received on Group cash balances and was unchanged from 1H16.

## Total expenses

1H17 total expenses were $32m, and consistent with 1H16.

Long term incentive costs relate to the non-cash amortisation of equity grants and were unchanged from 1H16.

## Interest and borrowing costs

1H17 interest and borrowing costs were $2m and were unchanged from 1H16.

The Group maintains a $400m banking facility in order to provide additional financial flexibility.

The Group debt facility was undrawn as at 31 December 2016, with interest and borrowing costs reflecting debt facility fees.

# Normalised profit framework

Life normalised cash operating earnings is Challenger's preferred profitability measure for the Life business, as it aims to reflect the underlying performance trends of the Life business.

The Life normalised cash operating earnings framework was introduced in June 2008 and has been applied consistently since. The framework removes the impact of market and economic variables, which are generally non-cash and a result of external market factors. The normalised profit framework is subject to a review performed by Ernst & Young each half year.

Life normalised cash operating earnings includes cash earnings plus normalised capital growth, but excludes investment experience (refer below).

| | |
|---|---|
| **Cash earnings** | Cash earnings represents investment yield, less interest expenses and distribution expenses.<br><br>**Investment yield**<br>Represents the investment return on assets held to match annuities and the return on shareholder investment assets.<br><br>Investment yield includes net rental income, dividends received, infrastructure distributions, accrued interest on fixed income and cash, and discounts/premiums on fixed income assets amortised on a straight line basis.<br><br>**Interest expense**<br>Represents interest accrued at contracted rates to annuitants and Life subordinated debt holders and other debt holders.<br><br>**Distribution expenses**<br>Represents payments made for the acquisition and management of Life products, including annuities and commissions to third party mortgage brokers on term funded residential mortgage assets (NIM).<br><br>**Other income**<br>Other income includes revenue from Accurium and profits on Life Risk wholesale longevity and mortality transactions (refer to page 16 and 17). |
| **Normalised capital growth** | Normalised capital growth represents the expected capital growth for each asset class through the investment cycle and is based on Challenger's long term expected investment returns for each asset class.<br><br>Normalised capital growth can be determined by multiplying the normalised capital growth assumption (see below) by each asset class average balance for the period (net of debt).<br><br>Normalised capital growth assumptions for 1H17 are as follows:<br><br>• Fixed income and cash – negative 0.35% representing an allowance for credit defaults;<br>• Property – 2.00%;<br>• Infrastructure – 4.00%; and<br>• Equity and alternative asset classes – 4.50%.<br><br>Normalised capital growth assumptions have been set with reference to long term market growth rates and are reviewed regularly to ensure consistency with prevailing medium to long term market returns. |

# Normalised profit framework

| | |
|---|---|
| **Investment experience** | Challenger Life is required by accounting standards and prudential standards to value all assets and liabilities supporting the Life business at fair value. This gives rise to fluctuating valuation movements on assets and liabilities being recognised in the profit and loss, particularly during periods of market volatility. As Challenger is generally a long term holder of assets, due to them being held to match the term of life liabilities, Challenger takes a long term view of the expected capital growth of the portfolio rather than focusing on short term movements.<br><br>Investment experience is a mechanism employed to remove the volatility arising from asset and liability valuation movements from Life business earnings so as to more accurately reflect the underlying performance of the Life business.<br><br>The asset and liability valuation movements are reported as investment experience. These movements are generally non-cash, and by separating them from the Life business result, Life's reported earnings more closely represent the cash earnings of the business.<br><br>**Impact from economic variables**<br>Investment experience also includes the impact of changes in macroeconomic variables on the valuation of Life's assets and liabilities. Economic and actuarial assumption changes include changes to bond yields and inflation factors, expense assumptions, losses on new business and other factors applied in the valuation of life contract liabilities.<br><br>Investment experience is calculated as the difference between actual investment gains/losses (both realised and unrealised) and the normalised capital growth plus any economic and actuarial assumption changes for the period. |

# Glossary of terms

| Terms | Definitions |
|---|---|
| Additional Tier 1 regulatory capital | High quality capital that provides a permanent and unrestricted commitment and is freely available to absorb losses but does not satisfy all the criteria to be included in common equity tier 1 regulatory capital. |
| Cash earnings (Life) | Investment yield and other income less interest and distribution expenses. |
| CET1 ratio | Common Equity Tier 1 regulatory capital divided by prescribed capital amount. |
| CIP income | CIP income includes asset based management fees, and other income such as leasing fees, acquisition and disposal fees, development and placement fees. |
| Common equity tier 1 regulatory capital | The highest quality capital comprising items such as paid-up ordinary shares and retained earnings. Common equity tier 1 capital is subject to certain regulatory adjustments in respect of intangibles and adjusting policy liabilities. |
| Earnings per share | Net profit after-tax divided by weighted average number of shares in the period. |
| Distribution expenses (Life) | Payments made for the acquisition and management of annuities and other Life products. |
| Fidante Partners' income (FM) | Distribution and administration fees; Fidante Partners share of boutique manager profits; and other income from boutique investment managers. |
| Funds under management (FUM) | Total value of listed and unlisted funds/mandates managed by the Funds Management business. |
| Group cash | Cash available to Group excluding cash held by Challenger Life Company Limited. |
| Interest and borrowing costs (Corporate) | Interest and borrowing costs associated with group debt and group debt facilities. |
| Interest expenses (Life) | Interest accrued and paid to annuitants, subordinated debt note holders and other debt providers. |
| Investment experience (Life) | The difference between actual investment gains/losses (both unrealised and realised) and the normalised capital growth assumption plus any economic and actuarial assumption changes for the period. |
| Investment yield (Life) | Net rental income, dividends received and accrued interest and discounts/premiums on fixed income securities amortised on a straight line basis. |
| Investment yield – shareholder funds (Life) | Represents the return on shareholder capital held by the Life business. |
| Life investment assets | Total value of investment assets that are managed by the Life business. |
| Life net annuity policy receipts | Life retail annuity sales less annuity capital payments. |
| Life annuity net book growth | Life net annuity policy capital receipts over the period divided by the opening policy liabilities (Life annuity book). |
| Life total net book growth | Life net annuity and other policy capital receipts over the period divided by the opening policy liabilities (Life annuity book, Guaranteed Index Return liabilities and Challenger Index Plus liabilities). |
| Net assets – average (Group) | Average net assets over the period (excluding non-controlling interests) calculated on a monthly basis. |
| Net fee income (FM) | Fidante Partners' income, performance fees (FM), Challenger Investment Partners' income and performance fees. |
| Net management fees (FM) | Management fees for managing investments. |
| Net tangible assets | Consolidated net assets less goodwill and intangibles. |
| Net Interest Margin (NIM) | Net interest margin on term funded prime mortgages and included as part of Life's investment assets. |

# Glossary of terms

| Terms | Definitions |
|---|---|
| New business tenor | Represents the maximum product maturity of new business sales. These products may amortise over this period. |
| Normalised capital growth | Long term expected capital growth based on long term return assumptions calculated as long term capital growth assumption multiplied by average investment assets. |
| Normalised Cash Operating Earnings (NCOE) (Life) | Cash earnings plus normalised capital growth. |
| Normalised cost to income ratio | Total expenses divided by total net income. |
| Normalised dividend payout ratio | Dividend per share divided by normalised earnings per share (basic). |
| Normalised EBIT (Life) | Normalised cash operating earnings less total Life expenses. |
| Normalised EBIT (FM) | Net income less total FM expenses. |
| Normalised effective tax rate | Normalised tax divided by normalised profit before tax. |
| Normalised Return on Equity (ROE) – pre-tax | Normalised Life EBIT and FM EBIT or Normalised NPBT (Group) divided by average net assets. |
| Normalised Return on Equity (ROE) – post-tax | Group's normalised NPAT divided by average net assets. |
| Other expenses | Non-employee expenses, including external professional services, occupancy costs, marketing and advertising, travel, technology and communications costs. |
| Other income (Corporate) | Includes interest received on Group cash balances. |
| Other income (Life) | Relates to Accurium revenue and Life Risk. Refer to page 16 and 17 for more detail. |
| Performance fees (FM) | Fees earned for outperforming benchmarks. |
| Personnel expenses | Includes fixed and short term variable incentive components of remuneration structures. The amortisation of long term incentive plans is reported separately within the Corporate results. |
| PCA ratio | The ratio of the total CLC tier 1 and tier 2 regulatory capital base divided by the prescribed capital amount. |
| Prescribed capital amount (PCA) | Amount of capital that a life company must hold which is intended to be sufficient to withstand a 1 in 200 year shock and still meet adjusted policy liabilities and other liabilities. For further details refer to APRA's LPS110 Capital Adequacy. |
| Product cash margin (Life) | Represents the return on assets backing annuities and other income, less interest and distribution expenses. |
| Significant items | Non-recurring or abnormal income or expense items. |
| Statutory Return on Equity (ROE) – post-tax | Statutory NPAT divided by average net assets. |
| Tier 1 regulatory capital | Tier 1 regulatory capital comprises common equity tier 1 regulatory capital and additional tier 1 regulatory capital. |
| Tier 2 regulatory capital | Tier 2 capital contributes to the overall strength of a life company and its capacity to absorb losses but does not satisfy all the criteria to be included as Tier 1 regulatory capital. |
| Total expenses | Personnel expenses plus other expenses. |
| Total net income | Normalised Cash Operating Earnings (Life) plus net fee income (FM) plus other income (Corporate). |

challenger

24627/0217