The Constant Investor

David Duffy, CEO CYBG, took part in an Australian podcast interview on 'The Constant Investor' with host, Alan Kohler on 1st August. This was uploaded to their website at 7.30am on 6th August and the full transcript of the interview is below. The podcast can be heard at the following link: *https://omny.fm/shows/the-constant-investor/david-duffy-cybg*

Alan Kohler here with today's CEO and today it's David Duffy, the CEO of a business called CYBG PLC, which is an English company, but most of its shareholders are Australian. The reason for that is because it used to be Clydesdale and Yorkshire Bank, which was a part of National Australia Bank until it was hived off in 2016. The NAB shareholders ended up with shares in this thing called CYBG, wondering what on earth they'd got and there you are. All the NAB shareholders there ended up as investors in this English company as well and it's gone quite well. Ever since hiving it off, the setting up of the business, the shares are up 50% and NAB itself is only up 5.8% over that time.

As I pointed out to David Duffy, the two tracked quite closely together up until October/November last year at which point they diverged and NAB went down and CYBG kept going up. Part of the reason for that is because they paid their first dividend, CYBG, but it was only a tiny one. The yield is 0.3%. So you're not buying CYBG right now as a yield stock but its potential for growth because it's in the process of taking over Virgin Money, which is the Richard Branson bank in the UK, which has a very strong credit card business and a mortgage business and it looks like, from what David Duffy says in the interview, they're going to use Virgin as their key retail brand and digital brand.

I think this is a very interesting proposition and should be seen as a possible growth stock, as opposed to simply another retail bank and income stock. Here is David Duffy, the CEO of CYBG PLC. David, it's interesting looking at the charts of the NAB share price and the CYBG share price since CYBG was created back in 2016. The two tracked along quite closely together, apart from a couple of blips here and there, until October/November last year and then they diverged and NAB went down and CYBG went up. Which raises obviously the question, why did that happen, do you think? I know you don't want to comment directly on share prices, but what do you reckon happened at that point?

Well, I think it's really a lot to do with the starting point and I think in my experience with NAB there's been a strong process of investing in core parts of the business and running a business very remotely is difficult. But they had also been looking to sell it for a period of time and when you do that you create an environment of a little bit of inertia, a little bit of uncertainty. At the start we were a little bit unsure what the direction is. That starting point was probably our deflated starting point for the franchise. Then what happened was we hired a very strong team and we launched an IPO in what would have been one of the worst markets in 10 years in the UK, and so again the starting point might have been a little bit deflated in terms of the share price.

But really what we were talking about was taking this business and investing very strongly in the customer side of it and then building out a strategy on digital on top of that, which hadn't really been prevalent in the franchise at that stage when we built B as a third brand which has now got 190,000 customers and £1.8 billion of deposits. So you took an existing franchise, you built out a digital piece to it, then you also took the SME franchise which had been quite limited in its growth whilst they were unsure what strategy they would pursue, and we've really rebuilt that and created a very powerful core franchise in the UK. That is an area that's very underserved by other competitors, so people really like what we're doing in that. Then of course I think you've got a market that is very open in terms of – you've got things like open banking, you've got competitive agendas with the regulators, you've got a lot of encouragements for competition to happen and we had, thanks to our investors, sufficient capital to invest very much in that growth. So you had a nascent SME business you built, you had a strong retail franchise, you had a big build out of a digital capability, you had the capital for that and you had a receptive environment for competition. That's really, I think, how we created momentum.

Then there are different initiatives like the Williams & Glyn piece we can talk about, but that's really getting an option to fast-track the growth of your SME business with some taxpayer funded investment and that's a key part of this and obviously then is the acquisition. A lot of things really dramatically changed from the starting point and I think that's probably why you've seen some of the divergence.

To what extent do you think a part of the success is due to your knowledge of the scene there? Obviously, your background in Ireland, running the Allied Irish Bank, Standard Bank – although that was more international than around the British Isles. You were much more attuned to the scene in Northern England than perhaps the NAB management were in Australia.

I think any business – and I've run global businesses as well and when you're running businesses from a distance it's quite a challenge, especially as large a distance as the Australia to the UK. What we were able to do is take a team of people who all have very, very good track records in turnarounds, in change management, in customer service from all parts of the world. Then put those people on the ground and there's nothing works quite as well as when you're on the ground, you're in your customer's office, their phone, their location and you're going to see them repeatedly.

I think having the critical mass of senior people and expertise on location in all of the jurisdictions in the north was really quite a powerful shift for us. I think the interesting thing is when you're a CEO of a business and you go up north and you're talking to customers, they're used to seeing a more junior director from one of the big banks because they're all based in London or have overseas franchises, so seeing the CEO and the full senior team of the bank repeatedly in your market and in your business is quite a difference.

I think that ability to put a really capable resource on the ground, in front of the customer repeatedly, and the most important thing of all – demonstrate that you will deliver what you promised, going back repeatedly and saying, 'I said I'd do this, we've done it.' I think that made a huge difference.

Another thing that seems to have made a difference, stands out in fact from your financial performance, is the reduction in the cost to income ratio which has come down quite a long way. I don't think it's actually quite as low as some of the Australian banks. At 67% it seems to be still fairly high, but how important has that been in reducing that and to what extent is that due in part to you being on the ground there?

I think it's a few things, to be honest, Alan. I think one is absolutely being on the ground, you get your hands around the issues, you can execute in a much more disciplined and rigorous way. But I also think we were investing significantly in the streamlining of the customer journey. In other words, you are serving a customer, serve them in a much simpler, better, more sophisticated way with better technology. Ask them what they want and deliver that. When you're doing that, you're able to take a lot of cost out of that process. Then lastly, shifting your franchise into a much more digitally serviced model means that clearly your cost to serve your customers through a digital model is less, so I think it's a combination of those factors. But I'm also very much of the view that the journey is only on its way, we're not at a final point or a final destination. I think the cost to income ratio, the improvement has been really, really strong and I think comparator today would not suggest we've arrived at a final point competitively and so we will continue to focus very much on the cost to income ratio. It's two parts, obviously it's income as well as cost and we will look to continually grow the income. The core team has a very strong focus on this cost and I think it's going to digital and the advancing model of how digital works is going to make a big impact on that cost ratio over time.

Yeah, well it seems to me that there's some operating leverage still available to you in that.

Well I think we've talked to all of our investors and said we will continually focus on this, this conferment with the income. I'm not in a position to give new guidance but we have said to investors that we expect to continue on the journey of improving that cost to income ratio over time.

One of the presentations I've read has you saying that we're reaching an inflexion point in the banking industry where the winners lead on technology. It was actually the presentation to do with the Virgin Money acquisition which we'll talk about in a moment, but can you explain to us what you mean by inflexion point? What exactly is it?

I think what we mean by that is that there is a turning point or an inflexion point in how customers see their lives and use services in general and it applies to many industries. What we see is an individual who's your consumer is starting to access a lot of their digital capabilities in single places and they want to do it in a way that is very immediate, there's very little cost, it's very convenient and the ability to batch those surfaces together and provide them in that manner to a customer is the starting point.

But what creates an inflexion point is you have two major influences. You have open banking, which basically the simple principle is, imagine that banks have had a proprietary and protective ownership of the customer data and under open banking it's akin to if the customer or the consumer says, 'I want you to give my data to somebody else.' They could almost walk into your bank, go to the filling cabinet and take their file out, so just think of it as that intrusive element of the customer absolutely owning their own data and being able to direct who accesses it.

That's a very, very significant shift in the relationship between traditional bank models and the customer and that introduces a whole wide broad perspective of potential new entrants into the relationship with your customer. That's the first thing I would say and then the second point…

Before you move onto point two, in your experience over the last couple of years of running this bank has that led to gains or losses for CYBG? Have you used open banking to pick up customers or have you lost them?

We would absolutely expect to, it's just too early because it's literally in the last couple of months been deployed. It's been talked about but only launched with the major players coming on stream in the last couple of months and we were the first of the non-mandated banks to actually go live with an open API architecture for this. What I see is, it gives us as much of a competitive ability as it would give others but it is probably going to take another 18 months for that to be transparently converting into some sort of assessment of volume or origination. It's early days yet. The customer has to get familiar with it. These are always difficult things when there's a big change. The customer's trying to familiarise themselves with that and we as banks have a responsibility to educate them and for them to see benefits. What is it that this gives you as a customer? Does it make your life cheaper, does it make it more convenient? And absolutely there are individual companies that will try to offer better solutions than banks in various products. I think it's really an emerging ecosystem and that will be very interesting to watch over the next period of time. I think the bigger banks are liable to be the ones that have most difficulty with this because of the smaller offering, companies will have greater agility and newer technology, that sort of thing.

You're number six in the market, do you think that open banking will enable you to climb up to number five, four, three, so on…?

There's a big difference in total asset sizes but I think it does give us the ability to enhance our competitive nature versus those other banks. The agility that we will retain, notwithstanding being number six, we are of a size and the technology that we are going to be very agile versus some of the incumbents. I think there is definitely a competitive advantage that will be given to us through that process. The second point, Alan, just to refer to that, why it's a bit of an inflexion point is, the talk is very often in the market between a big bank group and small neo-banks challenging them through this vehicle.

What I'm much more focused on is the Amazons of the world who are talking to banks and talking to regulators about becoming part of the banking system in some way. They've yet to make that a very specific move, but the dialogue between an Amazon or an equivalent large tech firm is very significant and I think what you're looking at is a big tech entrance to the marketplace over time and that could have dramatic consequences in terms of the infrastructure activity of banks versus the cost to provide the same by those tech firms.

I think what you should be looking at in terms of an inflexion point is the combination of an open banking environment and the threat of large tech companies, disintermediating banking services, either in the payments industry aspect of the banks or in other parts of the service model or in parts of the scaled infrastructure. Those forces coming together over the next five years is where I think you're seeing a fundamental shift in how banking is provided to the customer versus the past.

Which of the big tech companies do you think will go first, Facebook or Google or Amazon?

It's a hard one to predict but I think Amazon seems to be the one that on a behavioural basis is most interested in entering the new spaces and I know that there has been a public reference to dialogue between Amazon and JP Morgan in the US. I think they could be a first mover, but you also look at the world of PayPal. In the US, US lending to SMEs is mostly non-bank, it's 80% private money and there's a lot of point of sale lending done through payments companies. PayPal is very interested in the SME world, it's very active in that, it has a huge global payments architecture, so I would imagine there's a prospect that someone like PayPal or other payments companies could also want to get involved.

I think what you'll see in the next few years is the arrival of a variety of tech firms, each of them with different interest levels whilst they try to tackle higher margin businesses of the banks and disintermediate them in that way. If you combine that with very advanced technologies, very advanced data capabilities and an open banking universe, then I think people have to really think about how they build that relationship with their customer and protect against that or indeed participate in that revolution.

Just onto Virgin Money, obviously there was a time when Virgin Money was a disruptor, a challenger bank, and what surprises me about it is they actually aren't terribly good at digital. They seem to be all about branches. Is that a reasonable observation?

I think it's more of a point of early stage. What they are very good at is scaled mortgage delivery to the customers with very high service ratings. They've also got a very strong credit card business and what they had announced was a material investment strategically in delivering digital capabilities across all of their product capability. For us, we already have built that, so there was a little bit of a timing issue here. We felt that we had invested over the past few years and built a really strong capability, a leading capability of digital in this market place and a lot of innovation in what we were doing. We were first to market, as I said, with open API, first to deal with cheque imaging so you can deposit straight to your account.

They have a very strong growth in the primary asset classes with credit cards and a great service ethic, and we have the technology and we had the SME business and the current account business which they don't have. I think when we looked at both together I think the complementary strengths were there but they were just behind us in the curve. They had the intention but they were behind us in the curve in terms of development of the technology in digital.

And so it sounds like you felt you had to move quickly before they actually started spending too much money on that?

I just felt that we had set out a three-year plan, we had major transformation projects, major investments, we had performance promises we had made and we were delivering on the great majority of those with a lot of those closing in the next 6 months in terms of final delivery. We had a very experienced management team who had done a lot of turnaround. We saw a competitor who was extremely attractive to us in the sense of their compatibility of both institutions.

They had a very powerful brand which is a sort of ubiquitous recognition in the country and we thought, rather than wait until they got halfway through a process which they might look to be reimbursed for in some capacity, this might be an opportune moment to proceed so that the maximum value of the compatibility, the maximum value of the synergies could all be obtained at this point a lot easier than perhaps in the future. It was really just a strategic approach to what's the best time which gives the best value to the shareholders at the end of the day.

Any thought of using Virgin as your digital brand rather than B?

I think what we have decided in the approach is that the digital brand of the bank going forward in retail will most likely be Virgin and Virgin Money UK, not to be confused with Australia of course, but Virgin Money UK because we think that that national recognition – whilst B has started very well, it will take a very significant investment to get it to the same level of recognition of the brand that Virgin has. We think that the retail side of our business will be very heavily geared towards that Virgin brand and I think the SME piece, they don't have as a business, they haven't proved that yet, so we're looking at detailed research on that to validate whether or not the same would be true for SME. But I think the Virgin brand will be a front and centre in that growth.

Yeah, that would have seemed to me to be quite logical. Clydesdale and Yorkshire obviously are focused on the north of England and Scotland and I presume what B and Virgin give you is more exposure to the south.

Yes, well I think one of the things that we've talked about constantly is how do you create an incredibly efficient strategy on the national basis, how do you drive that? Typically speaking, you have to move to a single brand to achieve that. If you have a digital technology then multiple messages are hard to manage and costly to manage. We would think that if you take a national view we would want to have a national brand and retail really much more geared towards Virgin and then we will make a final decision on SME as we progress there.

Perhaps the main reason that people buy bank shares in Australia historically has been for the dividend, fully franked and all that stuff. CYBG pays a bit of a dividend but would it be fair to say that investors should not see your bank as an income stock?

I think when we talked about this dividend issue in the past, we were talking about building our profitability back, investing in the business and starting out on a dividend journey. What we see here is that the bringing together of the scale of this franchise, the greater profitability, the 6 million customers, all of that and the synergies that you get. I think we will have the ability to accelerate the growth of our dividend. We communicated to our investors as we were touring Australia that that acceleration of profitability and scale will give you the opportunity to accelerate the level of your dividend payout. We haven't given any specific guidance on it but certainly directionally that's absolutely what we would see.

What sort of payout ratio – I mean, perhaps you can't tell me – but what sort of pay out ratio do you think is sustainable for you in running the bank?

I think we can't really give the guidance on that because we haven't talked to the public markets about that. But I think a growing dividend based on this accelerated profile is the commentary we make today and we'll get more specific – probably next year we'll sit on the capital markets day and give better guidance on these types of things.

I suppose it depends to some extent on what your free cash flow is likely to end up being. Do you have plans to do much more investing in future? I know that the Virgin deal is all scrip, so it's not so much…

I think the only reason you'll detect the hesitancy in my voice, Alan, is that until the deal closes and until we've had the opportunity to get inside it in real detail and do some planning, it's hard to determine our performance in absolute terms and therefore, the dividend profile. We're just a little bit early in the process of committing to exactly what that would look like.

It might even result in less need for investment because you won't have to invest so much in your digital brand building B because you've got Virgin which is already quite strong.

Well I think the only way I would probably characterise that, Alan, is if you look at the level of investment of £350m over the last couple of years that we've been doing in our business, we're still able to move to a first dividend being declared within that investment environment. Although you may continue to invest and probably will continue to invest, I still think our view that we'll be able to accelerate the growth of our dividend through this acquisition would stand absolutely.

I'll leave it there, thank you very much, David, it's been great talking to you.

Yeah, likewise. Always a pleasure and I hope that all our retail and other investors will find the opportunity to vote because that's the next thing that happens on the transaction, they all have to vote and they've got vote intention forms, which they will receive by email, by post, and I think it's very important that every single investor gets to vote on this.

All of the information will be there, but I just hope that they can be encouraged to do so.

We'll certainly do our bit to encourage that, thanks.

Fantastic, thank you very much, Alan.

That was David Duffy, the CEO of CYBG PLC, the dual-listed UK bank.

<u>END OF TRANSCRIPT</u>