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Taking stock of the year ahead

FIRST Interview with CEO Nick Kirk

Topics of discussion

- *Sale of Hunter Hall's 10% shareholding and Cyclone Ita*
- *The outlook for FY14 – some additional detail on Calliden's profit guidance*
- *A recap on Calliden's FY13 result – questions arising from recent investor meetings*
- Strategic and operating environment in 2014 – market trends, managing business risk and starting new ventures.

Sale of Hunter Hall holding, Cyclone Ita and more detail on FY14 Guidance

FIRST Interview

Long standing shareholder, Hunter Hall, exited the register last week (10 April) by selling its remaining 10% interest in the company. Under the Continuity of Ownership Test (COT) certain changes to the register can affect Calliden's ability to access its tax losses. *How has Hunter Hall's exit impacted Calliden and can you explain what this might mean for the future?*

CEO Nick Kirk

Two of our existing shareholders, Adam Smith Asset Management and First Samuel, have acquired the majority of Hunter Hall's interest. Both shareholders have lodged substantial shareholder notices indicating that they have lifted their interest in Calliden to 6.17% and 8.17% respectively which, by our calculation, leaves us with a 20% continuity of ownership test "buffer". In the June 2013 First Interview and in various presentations we have stressed that the best way of preserving the tax losses for shareholders' benefit is to ensure that shareholders with less than 10% of the stock, or new investors, do not increase their shareholding to 10% or more. This is the effective outcome of the latest sale by Hunter Hall, the best result we could have hoped for and clearly to the benefit of all shareholders in terms of preserving the tax losses.

With Australian Unity now the only shareholder with a greater than 10% holding, I think we are probably now in a stronger position to retain the tax losses than we were before Hunter Hall's sale.

FIRST Interview

Cyclone Ita hit far north Queensland over the weekend (12-13 April). *What impact will this have on Calliden?*

CEO Nick Kirk

So far we have not received any claim notifications from the cyclone and, compared with other parts of the country, our exposure in the area is relatively light. Given the nature of the event and potential for consequent flooding though it is likely that any claims will come in over the next few days and weeks. While at this stage it looks unlikely, if the claims develop for Calliden we will update shareholders at that time.

FIRST Interview

Calliden has provided guidance for FY14 of \$7.5-9.5m net profit after tax which implies growth of up to 53% in its first full year of operation under the new business model. *How will that play out in terms of the first half/second half split and the relative contribution made by the Insurer vs Agency businesses?*

CEO Nick Kirk

The result will be much less skewed to the second half in 2014 being 40-45% first half and 60-55% second half. The agency business will generate 60 – 70% of the target profit.

FIRST Interview

Calliden's NTA has increased from 17.5cps in 2011 to 22.5cps largely due to a reduction in intangible assets arising from the amortization of systems development costs. First, where do you see NTA increasing to as a result of this ongoing reduction in intangibles and second, what does this say about Calliden's ongoing expenditure on technology and systems?

CEO Nick Kirk

NTA at the end of 2014 will be determined not just by our final profit figure and technology investments but also by the amount of any 2014 interim dividend, which will in turn be affected by the half year profit figure. Rather than trying to factor in all of these variables to give an estimated year-end NTA position I think it is probably easier to just say that we plan to invest around \$2m in technology and systems this year while our amortization will be in excess of \$4m. That amortization amount starts to fall significantly in 2016 when the bulk of customer lists and a proportion of the IT integration costs from the Australian Unity General Insurance purchase have run off.

We believe that while still continuing to invest in technology, our steady state capital expenditure cost will be around \$2m from then on. This includes the investment we are making to connect to insurance broker systems starting with the Steadfast Virtual Underwriter platform later this year.

FIRST Interview

The recent sale of Calliden's interest in the Arena joint venture realized a small profit of \$0.5m. Will this be included as part of reported profit and if so has this already been factored into your guidance for FY14? Is the other joint venture also for sale?

CEO Nick Kirk

The profit from the sale of Arena will be included in our reported result and given it is a relatively modest amount it is one of the pluses and minuses factored into our guidance range.

In our year end presentation we flagged that we are keen to re activate our successful joint venture strategy. We plan to launch a niche personal lines agency in the second half of this year and this is progressing well. I did get a couple of questions as to whether the sale of Arena was contrary to that strategy, so this is a good opportunity to clarify that. Our interest in joint ventures has always been driven by the attractive annual returns that can be achieved by agency businesses as well as the high valuations they can command once they are established.

Values of agency businesses are quite high at present and the fact that we effectively pay tax on their annual profits but not on the proceeds of a sale made this a transaction which we felt was in shareholders' best interests. This will remain very much a part of our thinking on ventures now and in the future.

A recap on the FY13 Profit Result**FIRST Interview**

Calliden reported a profit of \$6.2m, comfortably within the updated guidance range provided to the market in November 2013. As expected the second half was much stronger than the first half and represents the first full six month period of Calliden trading, post transition to the new structure. *From this point on, is there any reason why the market would not model incremental growth in profit, period on period (aside from specific underwriting events) and is this how you have arrived at the updated forecast for FY14?*

CEO Nick Kirk

While the transition process was all but completed in 2013, during the year there was still a fair bit of movement which makes the half on half comparison problematic for 2014. It is probably simpler to think about our forecast profit for 2014 which is between \$7.5m and \$9.5m. We have based that forecast on the 2013 actual reported profit and added the effect of a full year's fees and the reserve increases in 2013 and

deducted an amount for the better than average catastrophe experience, increased commission expense on a larger portfolio and assumed a lower investment return. In 2015 I think that half on half comparisons will, as you suggest, be much more straight forward.

FIRST Interview

Calliden seemed to be travelling well in 2013 up until it encountered problems with its Builders Warranty portfolio, a development which seemed to come out of the blue. *Would you have achieved your original target of \$10m NPAT for 2013 without that and, aside from weather related events, how confident are you that there aren't any other Builders Warranty type issues that could surface?*

CEO Nick Kirk

Without the Builders Warranty deterioration we would have delivered the \$10m target profit for 2013 that we had set for ourselves back in early 2012. While we have done a lot to reduce risk in the insurance portfolio in the last two years we still have an insurance company as part of our group. Insurance companies write risk and as such will be subject to uncertainties, principally from claims experience and reserve movements. The insurer is a valuable part of our overall group, writing niche commercial business through some longer term agency partners and supporting our own agency business, Calliden Agency Services, for home and motor.

We get an actuarial valuation of our claims reserves twice a year. The results of our latest valuation were included in our full year 2013 results that we released at the end of February. That process valued our Builders Warranty reserves pretty much in the middle of the range we had estimated internally, based on the first three quarters of our 2013 claims experience. We believe that process is the right one and have no plans to change it.

FIRST Interview

One feature of the past year, for all insurers not just Calliden, has been the benefit to the bottom line arising from the fall in both the cost of reinsurance and level of cover compared to 2012. *Can you explain what the reduction in quota share means in relation to the risk profile of Calliden Insurance and do you think there is some mixed messaging associated with its strategy of de-risking the business by moving to an MGA model on the one hand and the reduction in Calliden's reinsurance cover on the other?*

CEO Nick Kirk

I recognize that reinsurance is a relatively complex area which can be confusing to understand. Quota share or proportional reinsurance is where the reinsurer receives a proportion of the premium and pays the same proportion of our claims. In 2011 before we started the transition to our new model we had a 40% quota share reinsurance treaty whereas in 2013 we reduced that to 25% and this will reduce further in 2014 to 20%.

Probably the best guide to judging what this means in relation to the exposure or risk of the company is to look at the net earned premium in 2011 vs 2013. In 2011 our net earned premium was \$126m and in 2013 the net premium had fallen to \$58m. While the net premium will increase in 2014 this remains a significant reduction in the risk profile of the current business. At the same time we have created another revenue stream through our agency business which is much less dependent on the claims performance in any one year. So viewed across the business I think it is pretty clear that the risk profile of the business is significantly different to what it was before.

FIRST Interview

To continue the theme of risk, Calliden has been consistent in limiting its investments to the fixed interest market which has resulted in low and decreasing returns over recent years. *Given the significant growth that could have been achieved for this portfolio over the past year by investing in high yield blue chip equities, do you think the investment strategy needs to be reviewed?*

CEO Nick Kirk

We have in fact now reviewed the strategy and will progressively invest \$ 4 -5m in an equity index fund over the balance of this year as a match for our longer term liabilities. This increases our investment risk somewhat but seems a sensible move given our capital position and the reducing yield in term deposits.

FIRST Interview

Following the announcement of the special dividend there has been some speculation that the strength of Calliden's balance sheet is such that the Company's dividend policy may change to incorporate a much higher payout ratio. *Is an increase in payout from the current 60-80% being contemplated or some*

consideration given to other capital management initiatives that could see franking credits distributed to shareholders?

CEO Nick Kirk

We announced our dividend policy in 2013 and we have no plans to change it. The Group has significant tax losses and franking credits which in combination are valuable to shareholders. On the basis of current plans and the dividend policy they would enable us to pay fully franked dividends from pre tax profits for the next five years. The tax losses depend on the continuity of ownership test which we covered in a previous question and should that be failed, the much harsher "same business test". The franking balance is not subject to those tests and would survive even if the tax loss tests were failed.

Strategic and Operating Environment in 2014

FIRST Interview

Now that balance sheet strength is no longer the issue for insurers, major players in the market have moved to identifying opportunities for growth with IAG's offer for Wesfarmers' insurance business seen as the precursor to further industry rationalization. *How do you see industry developments unfolding over the next 12-18 months, and where does Calliden see itself best placed to participate in that?*

CEO Nick Kirk

I think the market environment will get pretty interesting in the coming period. Growth in the overall market was pretty much driven by increasing personal lines pricing which now seems to have stopped. The prospect of a hardening pricing environment in commercial lines also seems to have slipped away as reinsurance cost reductions are being passed on to customers. To fulfil the promises of growth that the bigger guys have been making I think they are almost bound to turn to acquisition. When that happens there is always some business that gets displaced as relationships change and attention turns to integration. That has to be good for us as more business becomes available. Somewhat balancing this of course is the fact that a reduction in price rises does affect both the insurer and our agency business.

On balance though, a period of change and acquisition activity in the market will be good for Calliden. I don't see Calliden as an acquirer at present as the multiples currently being paid for agency businesses are high and would not be accretive for shareholders at our current price. The fact that agencies are commanding high valuations does however validate the change in our strategy and restructure of the business.

FIRST Interview

Calliden's agency business is weighted towards Steadfast and AIMS which together control around 80% of the market between them. *How are you managing the business risk associated with having around half of Calliden's agency revenue delivered by one platform (Steadfast)?*

CEO Nick Kirk

It should be borne in mind that Steadfast and AIMS are major players in the part of the market that we operate in and therefore we are bound to have a large share with them. Both are growing and successful entities and we are really pleased with the relationship and progress we have made with them. It may sound obvious but the best way to manage the risk is to continue to provide them with products and services that they want to buy.

FIRST Interview

You identified in your results presentation that Calliden was intending to refocus on the development of joint ventures and that a new one in Personal lines was planned for launch in the near future. *Is this viewed as a 'third arm' that could in time match the agency and insurance businesses in terms of profit contribution?*

CEO Nick Kirk

If we include the capital value of those ventures then I think it is possible that our ventures could match the agency and insurer business in terms of profit contribution. Our experience from starting ventures has to date been very positive with a return on investment of more than 50%. I see no reason why that cannot continue and build into the future.