Tesco Personal Finance Plc (Tesco Bank)

Overview

Tesco Personal Finance Plc, trading under the name of Tesco Bank, is a wholly owned subsidiary of Tesco Group. The bank was originally established in 1997 as a joint venture with RBS (Natwest), with Tesco acquiring the other 50% stake that it didn't own from RBS in 2008 for a cash consideration of £950m. The bank has now grown to service approximately 6.5m customer accounts across a range of financial products and services in the UK and Ireland, including various types of insurance products, such Motor, Home, Pet, Travel, and Life insurance. The majority of its Home and Motor Insurance business is now underwritten by Tesco Underwriting following the successful migration of these insurance customers from RBS Insurance platforms during the year.

Other services provided by the bank includes credit cards, with the number of customers growing over the year to 2.3m (2011: 2.1m), on which total spend on cards now regularly exceeds £1.0bn a month. They also offer unsecured lending and a variety of savings products, with fixed rate deposits growing to £1.5bn since they were launched in October 2010. In addition the bank also operates over 3,000 ATM machines across the UK, with transactions handled growing by 9.4% over the past year to 372m.

As part of its strategy to become a full service retail bank, they are currently in the process of increasing their product range further to include a current account offering and mortgages, with the latter expected to be launched (subject to regulatory approval) during 2012.

Operating Performance

Last year the bank generated total income of £702.3m, up 19.3% from £588.4m in 2011/10. The increase was primarily the result of a change in the insurance operating model whereby gross commissions received are booked to non-interest income, rather than the net amount as previously reported, with the change also contributing to the increase in operating expenses, up 29.9% to £423.5m. Improving credit performance saw the impairment charge taken for the year decline by 5.2% to £124.5m, with the bad debt to asset ratio also falling to 2.4%, from 2.7% in 2010/11.

Following issues arising from the migration to new systems during the first half, the bank took a more conservative approach to new business during second half, with total loans and advances to customers falling 5.5% on the year to £4,423.6m, and from £4,585.7m at the half year. The reduced lending balance, combined with growth in deposits of 6.2% had a drag on the net interest margin, which was down 5.1% on the year to £259m. Overall despite the lower net interest margin and provisions related to potential Payment Protection Insurance claims, reported profit before tax increased 28.3% on the year to £159.6m, while excluding the impact of exceptional items, underlying profit before tax grew 30.7% to £226.95m.

£m	2012/11	2011/10	% Change
Total Income	702.3	588.4	19.3%
Operating Expenses	(423.5)	(325.9)	29.9%
Impairments	(124.5)	(131.4)	5.2%
Profit Before Tax	159.6	124.3	28.3%
Customers: Loans	4,423.6	4,679.2	(5.5%)
Customers: Deposits	5,389.8	5,077.5	6.2%
Total Assets	7,605.1	6,991.6	8.8%
Net Stable Funding Ratio*	120.7%	112.3%	
Core Tier 1 Ratio	15.3%	15.9%	

Source: Company reports
*Ratio calculated by dividing long term funding (over one year maturity) by loans and advances to customers and other liquid assets

Funding

The bank's liquidity position strengthened during the year with the net stable funding ratio rising to 120.7%, from 112.3% in 2011/10, as lending balances contracted and the bank experienced strong deposit growth, with the total deposit balance standing at £5,389.8m at year end, from £5,077.5m last year. In addition the bank followed on from last year's 2018 fixed rate issue with another retail targeted bond issued in December (£60m inflation linked issue due 2019). For the avoidance of doubt, it should be noted that these bonds (table below) are issued directly out of the Tesco Personal Finance / Tesco Bank operating entity, rather than at group level, so any subsequent claim on the assets of the business would need to be made in respect of the operating subsidiary.

The bank also received a £251.5m capital injection from the group in 2011/12, through a subordinated bond (£140m) and the issue of ordinary shares (£111.5m). The core tier 1 ratio did decline during the year but still remains at a relatively healthy 15.3% (2010/11: 15.9%), while the risk asset ratio improved to 16.0%, from 13.6%.

Issuer	Coupon	Maturity	Ask Price	Ask Yield	Nominal Amount Outstanding
Tesco Personal Finance	5.20%	24/08/2018			£125,000,000
Tesco Personal Finance	1.00% (RPI)	16/12/2019			£60,000,000

Source: Investec Bank, Bloomberg

Group Strategy

Much attention recently has focused on the underperformance of Tesco's UK division relative to the industry, which Moody's cited as a key factor for their recent downgrade to Baa1 (rated A- outlook stable with S&P and Fitch). It's worth remembering however that despite this "underperformance", sales in the division still grew 6.2% to £47.4bn turning a trading profit of £2.5bn, while group sales increased 7.4% to £72.0bn.

In addition to turning around performance in their UK division, continued growth of retail services remains a key strategic objective, of which Tesco Bank is a cornerstone, as they seek diversify their revenue streams further and leverage off the existing customer base and brand.

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Source of company information and data: [www.tescoplc.com]

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