

Focusing on our customer-centric mission



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I am pleased to report another strong set of results in a highly competitive market driven by the Group's resilient and customer-centric business model. We continued to make significant operational progress in 2018 and we head into a pivotal year of delivery in 2019, with the aim of delivering a springboard from which to grow the contribution from current-year profitability. We maintained good cost discipline in 2018 and are determined to leverage our investment in the business to step change our efficiency. The new technology and greater efficiency are, in turn, designed to support our ambition to innovate more rapidly and find new ways to serve our customers as their demands evolve. Financially, we continued to see the benefits of improving the efficiency of our balance sheet, which has contributed to another attractive dividend, while continuing to invest in the business and maintaining a prudent solvency margin.

Trusted brands and direct growth

Once again, the growth we achieved across Direct Line, Direct Line for Business and Green Flag demonstrated that by giving customers a reason to come to us direct, they will. Since 2014, our own brand in-force policies have grown by over one million, to over seven million policies.

In Direct Line we launched another two new unique propositions – in Home and Motor. Our new Motor proposition removed one of our customers' greatest frustrations and protected their no claim discount on no-fault claims. We now offer a combination of nine Direct Line propositions that our customers cannot get anywhere else in the market.

Direct Line for Business achieved its 11th consecutive year of premium growth. This time last year, we launched a more personalised approach for our business customers, from start-ups to growing businesses. Starting with Hair and Beauty and followed by Bed & Breakfast in 2017, this year we ramped up our delivery by releasing cover for over 500 new trades, taking us to 75% of our target trades on the new platform. A national marketing campaign was launched in the year and the early campaign metrics have been positive. This has driven higher volumes to the website and there has been a 100% increase in brand searches. Work is underway to re-launch two of our biggest products on our new system, Van and Tradesman in 2019. This continues to demonstrate our increased ability to work in an agile way and to launch new, innovative products quickly to meet the ever-changing needs of our customers.

And finally Green Flag, our challenger brand in the Rescue market, continued to display great growth potential and demonstrated this again by achieving another period of double digit percentage growth in policy count and premiums. Our Rescue network dealt with over 640,000 breakdowns in 2018, which is one every 49 seconds. There has been great progress in Rescue in 2018, launching a five-year transformational plan and the team have relocated to a Centre of Excellence, bringing together multi-skilled teams to recognise efficiencies and offer greater flexibility. The Rescue Me app, which is rated 4.8 in the Apple App store, was rebuilt using in-house digital capabilities and was used in over 35,000 claims.

Moving towards best in class in the price comparison website market

We see a real opportunity in strengthening our capabilities on price comparison websites. We increased our focus in 2018 and created a new trading hub in Motor and Home to support this. We made some tactical pricing changes driven by improved anti-fraud capabilities and this helped increase Churchill and Privilege Motor new business volumes by 18%. We believe there is an opportunity to strengthen margins in this channel.

Investing in technology

Whilst we have already made significant progress in delivering our Direct Line for Business systems, most of our transformational work has been going on behind the scenes on our core personal lines technology, as we continued our ambitious programme to build our latest generation IT capabilities.

These systems, which started to go into testing at the end of 2018, are designed to make insurance much easier for our customers by introducing more self-service and customer focused innovations. In addition they are designed also to enable a step change in our ability to use internal and external data more effectively to improve our pricing accuracy and improve our competitiveness. Our new pricing engine is designed to make it much easier and quicker to develop, test and deploy new models. This is intended to allow us to tailor our models better to the price comparison website channel and improve our speed to market. We are also in the process of testing our new digital Travel platform. 2019 is an important year in starting to deliver these systems which we see as a key enabler in transforming our business.

We continue to make good progress on our alternative pricing project which we expect to give us new capability by applying new data science methods and machine learning. We believe this approach will enable us to deepen our competitive footprint with more granular and flexible pricing capabilities. Testing is progressing well and we are aiming to launch in Q2 2019 under a new brand.

Improving our efficiency

In order to be able to give our customers the best value for money, we recognise it is imperative to operate efficiently. Over the past five years, we've made significant strides in reducing our costs, such as through improved marketing efficiency, where we reduced marketing spend by over 30% whilst returning our direct own brands to growth, and reducing our number of sites by nearly a half and annual rental costs by around 40%.

Over the past two years we have been expanding our robotic process automation capability and are now managing concurrently 28 processes and approximately 500,000 automated transactions each quarter. But we don't intend to stop there and have already identified a strong pipeline of processes to add to our existing portfolio and which has the potential to increase our transaction volume capability by a further 500,000 in 2019.

The actions we've taken supported the reduction in the operating expense ratio and we aim to continue to transform our business and improve our efficiency and long-term competitiveness.

Leveraging our scale via partnerships

In Home, we leveraged our capabilities in digital and data to streamline the customer experience. Our improved capabilities in digital are helping us have conversations with potential new partners.

In Travel, we are building a new system that is designed to enable customers to self-serve and interact with us day or night, offering greater support and helping us renew our partnerships with RBS Group and Nationwide.

In Motor, our new partnership with Volkswagen Insurance Service (Great Britain) Limited is going well. We provide both annual insurance cover and complimentary '5 day driveaway' cover for customers buying new and used cars from Volkswagen, Volkswagen Commercial Vehicles, SEAT, Audi and ŠKODA dealers.

Investing in our talented people

The success of the business is due to the commitment and dedication of our people who use their expertise to serve our customers. We rightly celebrate our diversity and are united in our customer focus. This focus is reflected in our unique propositions and the fact that on average we manage one claim every single minute of every single hour, every day of the year. The freezing weather earlier in the year hit many drivers, households and businesses hard, and the way our people helped our customers get their lives back on track during this difficult period demonstrated the value of our insurance cover and gives customers a reason to keep coming back to us. Nearly 10,000 of our people now own shares in our company which gives them a real sense of ownership and investment in our future success. Our engagement scores

increased again in 2018 and I'm proud that this year we came third in the Sunday Times list of the 25 Best Big Companies to Work For in 2019¹. This is a huge achievement and is testament to the value we place in our people.

Business performance

We ended 2018 having delivered a sixth successive year of strong financial performance and a return on tangible equity of 21.5% (2017: 23.0%), well ahead of our target of at least a 15% return on tangible equity.

Our direct own brands gross written premium increased by 1.8% whereas total gross written premium was lower as expected due to the exits from Nationwide and Sainsbury's Home partnerships. We achieved an operating profit of £601.7 million (2017: £642.8 million). The reduction in operating profit was primarily due to lower prior-year reserve releases and investment return. Both years benefited from reserve releases relating to the Ogden discount rate. In respect of 2018, we have now assumed a higher Ogden discount rate of 0%, following Royal Assent of the Civil Liability Act 2018 which contributed £55 million to operating profit (2017: £49 million) of which £51 million related to the prior years.

Weather returned to normal levels in 2018 after a benign 2017 and this offset the non-repeat in 2018 of the £57 million non-cash impairment charge incurred in 2017 in relation to IT projects. Normalised for weather and adjusted for the assumed Ogden discount rate change, the combined operating ratio was approximately 93.5%, towards the lower end of our medium-term target range of 93% to 95%.

Overall, our current-year combined operating ratio was stable, demonstrating the value in the Group's diversified product base and channel portfolio, as well as lower operating expenses.

Regulation

The Group has continued to operate within a highly dynamic and evolving regulatory landscape, where there are a number of reviews and initiatives, including those that have been announced by the UK Government, the FCA and the PRA.

In 2018 both the FCA and PRA have been focused on Brexit preparations and the implementation of the Senior Managers and Certification Regime. The PRA's focus continues to be on the pillars of its financial risk framework, namely reserving, pricing, reinsurance and investments. The FCA has also been focused on pricing practices including the launch of its market study. The Group is supportive of the FCA's market study. At this early stage however, the outcomes are not yet known.

The insurance market is very competitive with high levels of switching and lots of introductory discounts which leads to most people shopping around for the best deal. For those customers who don't shop around it is crucial that insurers have active pricing processes for all their long-term customers. We have had these measures in place for several years and increasing numbers of long-standing customers have seen their renewal premium either frozen or reduced as a result. We worked closely with the Association of British Insurers on their pricing principles and actions on premiums which we hope will embed best practice across the whole industry.

Outlook

The Group targets a combined operating ratio of 93% to 95% for 2019 and over the medium term, normalised for weather. Over time, the Group expects to increase the contribution from current-year underwriting as the contribution from prior-year reserve releases reduces. The latter is predominantly as a result of increasing the level of reinsurance purchased by the Group in recent years which has reduced the risk profile of the Group.

The targeted improvement in current-year underwriting profitability is supported by the significant investment the Group is making in building future capability. This aims to improve the current-year loss ratio by delivering additional pricing sophistication and supporting multiple initiatives to combat fraud. In addition, the Group is targeting to improve efficiency through self-service and digitalisation. These improvements are targeted to emerge over a number of years. In 2019, the Group expects to make further progress in reducing operating costs and is targeting operating expenses below £700 million. We reiterate our ongoing target of achieving at least a 15% return on tangible equity.

As I prepare to hand over the reins to Penny not only do I look back over the last ten years with great pride, I also look to the future with great excitement for our customers, people and shareholders. Over the next 12 months, as we begin the roll-out of our new core personal lines IT applications, we plan to increase our flexibility to deal with changing business requirements, offer more self-service and deliver more straight-through processing. This combined with our leading brands and great people will help Direct Line Group with its mission to make insurance much easier and better value for its customers.



PAUL GEDDES
CHIEF EXECUTIVE OFFICER

1. www.b.co.uk/the-lists/big-companies/