Return on Equity: Private Health Insurance's Grand Canyon

Private health insurance funds are forced to have the same business model by regulation. Those same regulations even force them to take on roughly the same underwriting risks. Accordingly, you'd expect there to be broad consistency of profit levels measure by return on capital invested, right?

Wrong.

The opposite is true.

At the top end there are scintillating returns by some of the leaders: Medibank, nib and Australian Unity each recorded ROEs of 28% or better in 2016. For context, that is up there with ROE targets of some venture capital funds. Or another context, about double the ROE of the most profitable banks (CBA & NAB with 16% and 14% respectively).

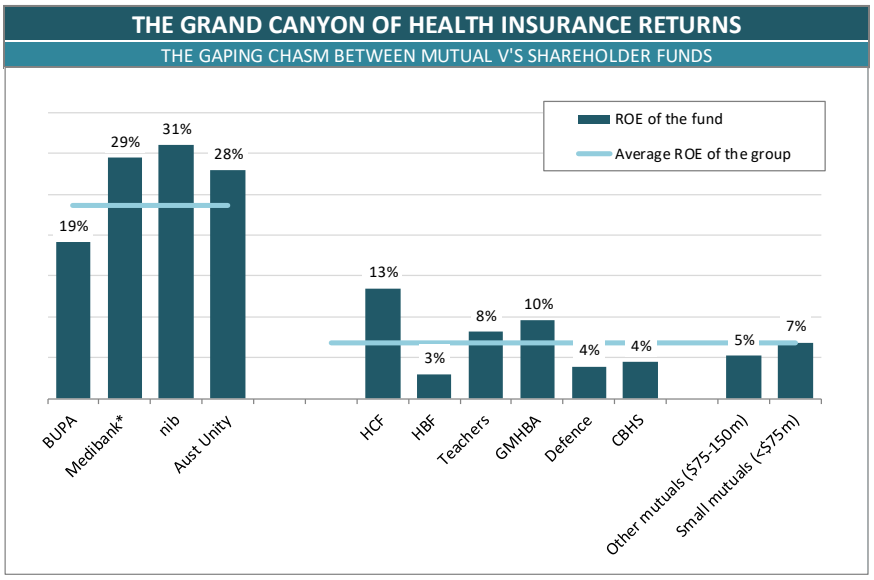
But it's not as if the whole sector is enjoying this level of profitability: ROEs for twenty-one of the 32 registered funds was less than 10% and was less than 5% for 13 of the 32 funds.

This in spite of there being high business models consistency: Each fund provides the same core functions of (i) receiving premiums; (ii) contracting providers; (iii) paying claims; (iv) addressing member enquiries; and (v) investing into liquid asset markets.

Each fund has the same imperative to win and retain policyholders. Each fund (must) offer fundamentally the same product of Hospital and Extras Cover (albeit there are differences at the margins care of co-pays; excesses & restrictions).

Each fund has a similar risks profile care of the Regulatory Principle of 'Community Rating'.

Finally, each fund has the same Commonwealth Government approving its premium rates every year at the same time every year.

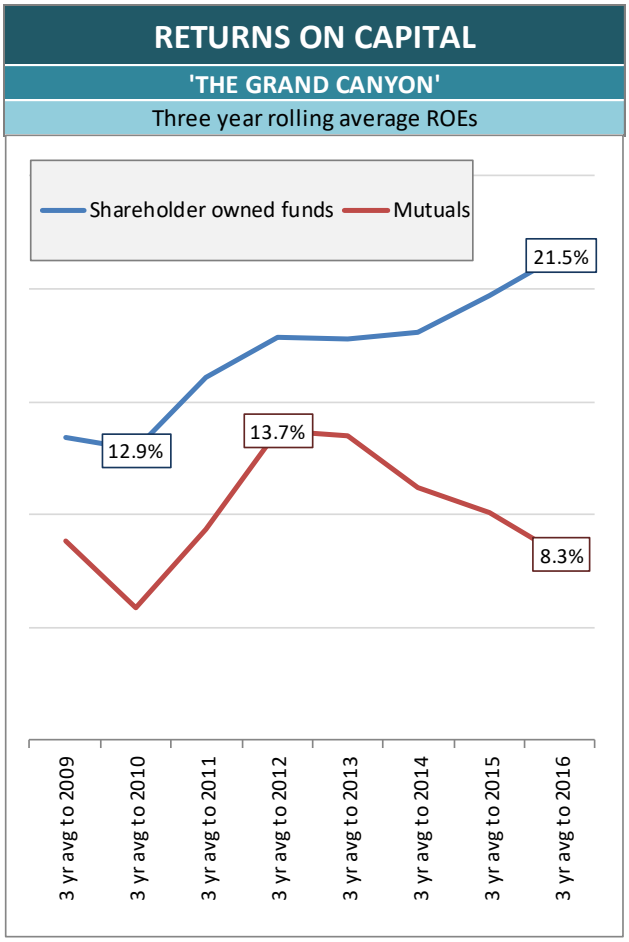


Sources: Hilvert Advisory + APRA reports + PHIAC reports + Company filings
Note 1: BUPA's ROE is lower than APRA reporting suggests because APRA exclude goodwill on acquisitions
Note 2: NIB and Medibank ROEs are slightly different to Group reported ROEs because the group ROEs capture assets and earnings outside of the Fund.

Comparison to banks makes things odder still: Banks, Life Insurers and General Insurers are permitted far more flexibility to price for risk or shun markets that they do not wish to participate in (to segment the market in other words). But ROEs of banks are far more consistent than health insurers. In 2016, all Australian registered banks earned ROEs of between 8% and 16% - nothing like the 'canyon' in health insurance where ROEs ranged from 31% (nib) to negative 7% (one of the smaller mutual funds).

So what's going? The fundamental driver of ROE in health insurance is ownership. Fourteen of the 32 funds are shareholder owned and their average return was 24% in 2016 (or 22% smoothed over three years) whilst the other 18 funds are member owned mutual funds and their ROE was just 7% (or 8% smoothed).

Interestingly, the gap has widened in recent years. Over the past three years, shareholder owned funds have become more profitable whilst mutual funds have become less profitable.



Sources: Hilvert Advisory + APRA reports + PHIAC reports "All Shareholder funds' = BUPA + Medibank + nib + AU Health + six smaller funds. Medibank was Government owned pre 2014 but had 'For-Profit status' since 2010.

'All mutuals' = HCF + HBF + Teachers + GMHBA + Defence + CBHS + 18 others.

Questions this raises

- What's underpinning this chasm?
- Are the mutual fund policyholders better off given their fund makes less ROE?
- Are some of the mutuals about to go broke given some are loss making?
- Or be acquired?
- Are those scintillating returns (of sometimes 25 or 30%) there for the taking? Could other corporates (or Private Equity) charge in and do that well?
- What is the outlook for the 'grand-canyon'? Will ROEs continue to improve for the Shareholder owned funds? And keep getting worse for the mutuals?

Below we explore each of those questions in turn, please join us for the discussion.

What's underpinning the chasm?

Firstly, mutual funds pay-out a higher proportion of policyholder premiums received than do shareholder owned funds. Expressed differently, gross profits are lower on average for mutual funds versus shareholder owned funds.

In 2016, for example, mutual funds had an average gross profit of $378 per policyholder whereas Shareholder owned funds recorded an average profit of $513 per policyholder. This gap of $135 equates to 4% of premiums and it has been surprisingly consistent over the past decade or so. This difference is largely 'by design'; ie., mutual funds target a lower level of gross profit versus shareholder owned funds because

- they are not under pressure from shareholders to make a higher return;
- they already have too much capital so don't know what to do with the surplus; and
- they do not have to pay tax making it easier for them to maintain capital targets whereas shareholder owned funds do have to pay tax and dividends.

That covers off on the "R" in ROE but the difference is also explained by the "E".

And it's in this "E" that the grand canyon really opens up. On average, Mutuals have 2.5x as much capital per member versus shareholder owned funds and this gap has been expanding in recent years. On a fund by fund basis the gaps in capitalisation levels can be enormous. At the lean extreme, is nib who hold $592 in capital per policyholder and at the other end of the spectrum there are three smaller mutuals who each hold $5,000 in capital (and a lot more in one case).

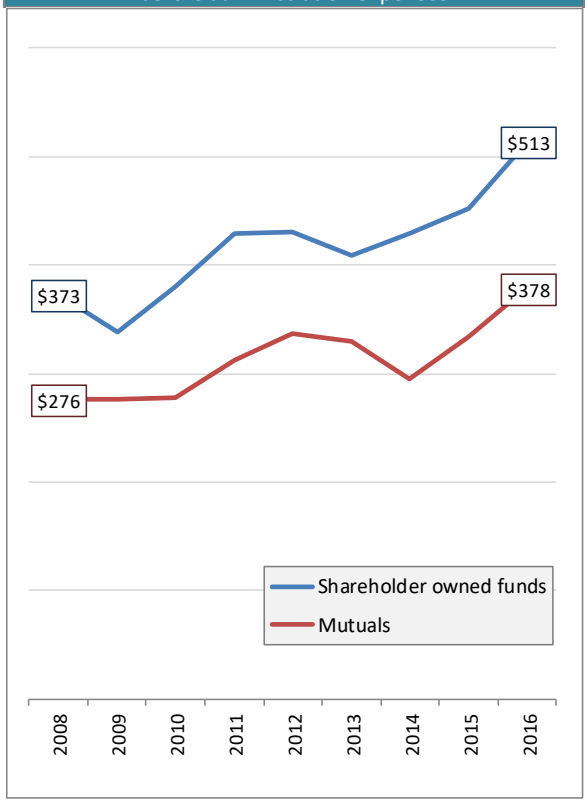
In summary, the grand canyon has been forged by

- sustained differences in claims pay-out ratios; and
- very different attitudes to prudential capitalisation

In case you are wondering, administration expenses do not explain the difference as they are about the same (as a % of premiums).

RELATIVE GROSS PROFIT PER MEMBER

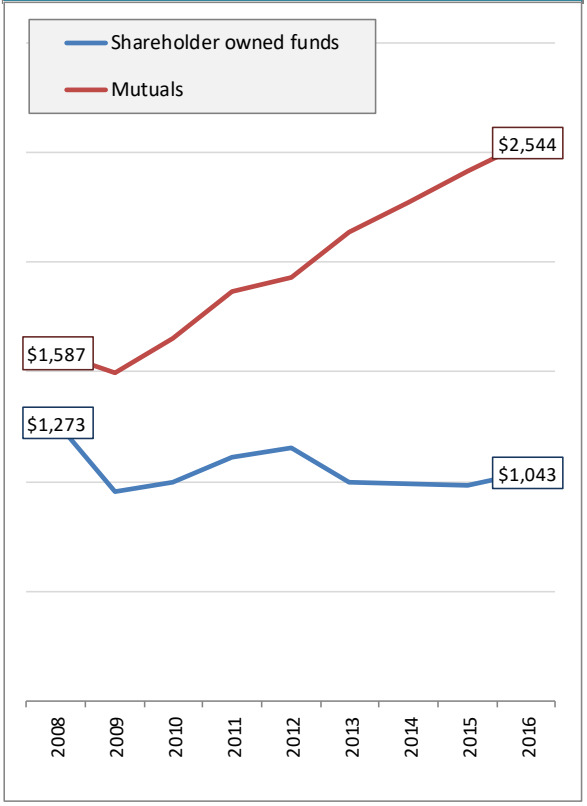
Gross Profit = Profit after claims and risk equalisation but before administration expenses



Sources: Hilvert Advisory + APRA reports + PHIAC reports

RELATIVE CAPITALISATION LEVELS

Capital held per policyholder



Sources: Hilvert Advisory + APRA reports + PHIAC reports

Are the mutual fund policyholders better given their funds makes less ROE?

Below we address this question in three dimensions:

1. Money returned to members annually: On the crude measure of claims paid back to policyholders as a per-cent of premiums, yes, it is possible to argue that mutual fund policyholders are moderately better off versus policyholders of shareholder owned funds because mutual funds more back to members each year versus shareholder owned funds - the gap was $135 per policy (or 4% of premiums) in 2016. This means that for every dollar of premiums received, mutuals (on average) pay-out 4% more to their members in the form of claims versus shareholder owned fund. And the gap has been broadly consistent over the past decade or see (refer chart).

THE GROSS MARGIN GAP OVER TIME

Shareholder owned funds gross margin minus Mutual funds gross margin (expressed as $ per policy)

But gigantic caveats to this generalisation are:

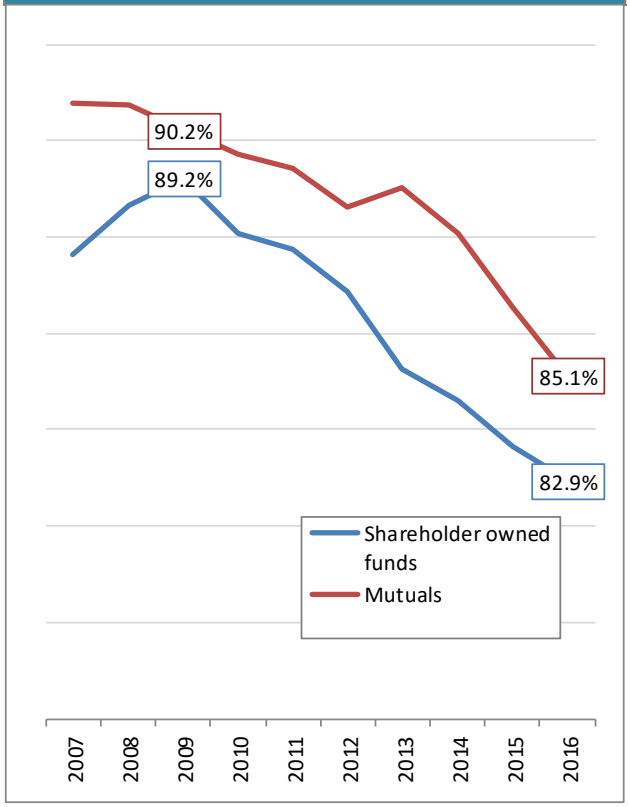
- Individualistic concerns are critical: Proportion of policyholder money paid back to policyholders is a poor measure of value for money on an individualistic basis because most policyholders will not make a hospital claim at all, even over several years. So for the majority of the low claiming policyholders a better measure might be the level of premiums paid. But even comparison of premiums paid is not necessarily a good measure because it does not factor in the unquantifiable value of 'peace-of-mind' which can be higher when a higher level of cover is purchased.
- Averages are not policy comparisons: The 4% gap is an average of the group called 'all shareholder funds' versus 'mutual funds' but there is not a fund called 'all shareholder funds' nor one called 'all mutual funds' that policyholders can take policies with. Moreover, each of the 32 funds has several levels of policy cover and there are vastly different claims pay-out margins in each.
- Risk pooling distorts matters even further: it might be that mutual funds have more 'claimers' versus shareholder funds. If this were the case then the 4% gap cannot be explained by 'value for money' but rather by mutual funds having to pay-out more because their policyholders are more active claimers. If this is the case (and it is not possible to tell one way or the other) then mutual fund policyholders are on average not any better off that than policyholders of shareholder owned funds, even if the 4% gap exists.

Continues overleaf ….

2. Policy Retention: A second metric is policy retention or the % of members who chose to retain their policy over each year. Mutual funds perform slightly better than shareholder owned funds on this metric. In 20 16, the two year hospital retention rate was 85.1% for mutual funds versus 82.9% for shareholder owned funds. And in years prior there has been a similar gap.

COMPARATIVE MEMBER RETENTION RATES

Two year hospital retention index (source various PHIO reports & Hilvert calculations)



3. Ownership arrangements: A third consideration is that a member of a mutual has an ownership stake in the fund. This has two benefits for members: (1) that they can participate in fund governance if desired by the member; and (2) if the fund chooses to demutualise and become a shareholder owned fund, then policyholders are paid the proceeds of the sale. The value of this has been as high as $3,828 per member when Doctors' Health Fund demutualised in 2012 (and is now owned by Avant) or as low as $2,298 per member when ahm was demutualised in 2008 (now owned by Medibank). Should other mutuals demutualise, members would collect anywhere between $2,500 and $6,000+ each (on average) depending largely on the level of surplus capital held by each fund (which varies greatly). In any given year, however, it is highly unlikely that a member's fund would demutualise (there haven't been any since 2014) and the member receive the value but over a very long timeframe it is obviously more likely.

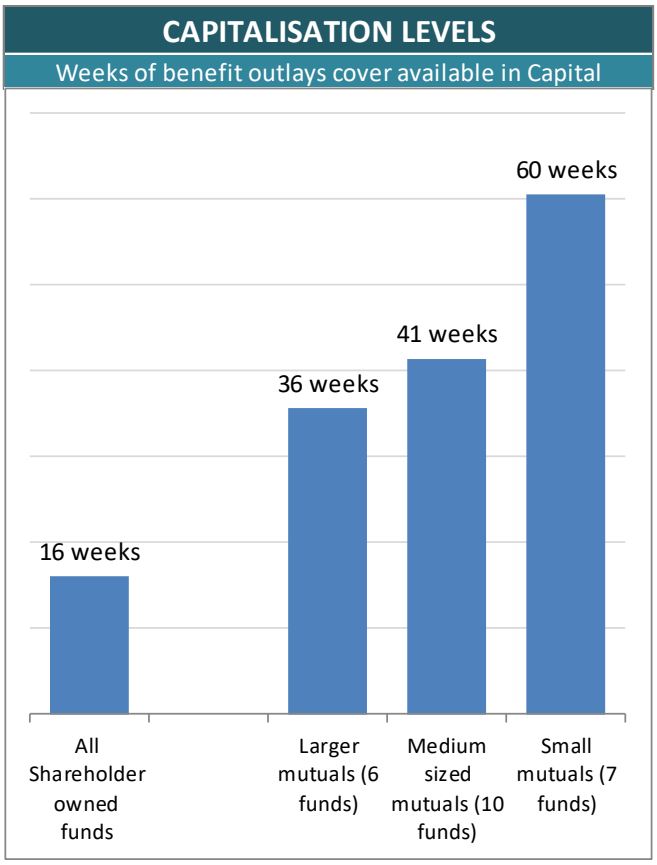
Are some of the mutuals about to go broke given some are loss making?

No. In fact, it's almost inconceivable that this would occur under unless there is an substantial adverse regulatory change. Even the mutual with the deepest loss making position could withstand 14 years at their current rate of losses before they began to have a problem paying claims. In other words, it is not going to happen.

Some mutuals have a year's worth of benefit outlays payments stored in capital. Just think about that for a moment: They are so strongly capitalised that if they did not receive one dollar in premiums they could (theoretically) continue for a whole year before they had a problem paying claims – it's a bit like having a bank that only lends and does not need depositors to back the loans. This obviously has a major impact on ROE and is half of the reason that mutuals earn so little compared to Shareholder Owned funds.

Why are the capitalisation levels so high for most mutuals ? Two reasons:

- Smaller funds have greater claims volatility so need a larger buffer
- Mutuals (when they make profits) do not pay tax or dividends so it just gets added to their reserves year after year. In other words, there's nothing else they can do with it.



Sources: APRA + Hilvert Advisory

Or be acquired?

From time to time, the Board of a mutual does resolve that it is in members' best interests for the fund to demutualise and have ownership transitioned – historically it has occurred 3-5 times per decade and Hilvert expects that transition to continue at the same rate. The slow pace of change is explained by mutuals not having a compelling reason to demutualise.

- None are distressed (even if they are loss making)
- There is little empirical evidence of a scale curve in the sector (even though there should be) the smaller funds have proven to be extremely lean with their administrative functions and not spent much on marketing versus the larger funds.
- The smaller funds have banded together to share the task of negotiating with the hospital groups (care of a co-operative named the Australian Health Services Alliance);
- The smaller funds also shared claims IT systems and systems costs with each-other and will continue to do so;

- Decent defensive arguments are available to smaller mutuals such as (a) it not being in member interests for claims pay-outs to decline and (b) it not being in member interests for the fund to pay tax.

So for acquisitions to proceed, something quite innovative needs to be offered and it would need to talk very directly to member interests.

Are those scintillating returns (of sometimes 25 or 30%) there for the taking? Could other corporates (or Private Equity) charge in and do that well?

Sorry but no.

No other Corporate or Private Equity Investor could enter the market and reap the higher ROEs unless they are happy to work at it for 10, 20 or 30 years. **The golden goose is 'tenure'.** The high ROEs experienced by Medibank, nib and others is possible only care of their policyholders who have been with their fund for many years and never claimed a hospital event. There are some members in health insurance who have high levels of cover and rarely claim a hospital event (you the reader of this would report are probably one of them). No options exist to win these sorts of top tier members organically in a rapid fashion. These are the available entry pathways and the first two (the rapid ones) offer much, much lower returns on equity.

1. Acquisitive entry pathway: Low returns on offer. The current earnings yield on Medibank and nib is 6% and 4% respectively so acquiring either of them would mean an ROE (excluding synergies) of less than those values based on current share prices. Better ROEs are certainly available on smaller funds (if you can talk them into it) and half decent returns can be achieved with the assistance of synergies but still a far cry from the very high ROEs that a few funds are making.

2. Aggregator entry pathway: Unfortunately many of the members gained through this channel are not financially attractive to the Fund for a variety of reasons such as (a) they intend to claim soon; (b) they are canny purchasers of Extras products; or (c) they will only purchase a cheap Hospital policy which attracts very low gross margin once risk equalisation is calculated. May of those members won't only fail to deliver a high ROE but they will deliver losses for a Fund. Furthermore, the members have higher propensity to churn and they cost of lot money.

Accordingly this channel will most likely deliver single digit ROEs over the long term but often a negative ROE; ie., a loss can and should be expected. That has certainly been the experience of at least half of the funds who have aggressively used aggregators. This sombre view on the disadvantages of using aggregators is supported by the fact that in FY16 there were four loss making funds, three of them used an industry aggregator. This doesn't prove cause / correlation of course but that will be addressed in a subsequent report Hilvert will publish in June or July this year.

3. Organic branded growth pathway: Over a very long time-frame it may be possible to gain the high ROEs using this approach but patience and deep financial pockets are required because the steps involve (1) becoming registered; (2) building a brand and processes infrastructure (which will cost a lot of capital); and (3) and hanging in there with early year losses as the tedious process of building a brand is progressed.

Intuitively Hilvert suspects it would take 10 years plus of very successful marketing to the right customer groups to get to the point of having sufficient scale and membership quality such that high & maintainable profits can be earned. If your organisation has that sort of long term outlook then, by all means, proceed. But the ROEs still wouldn't be as high as the best in the pack.

What is the outlook for the 'grand-canyon'? Will ROEs continue to improve for the Shareholder owned funds? And keep getting worse for the mutuals?

The trend of ROE divergence will reverse and the two sets of ROEs will get a moderately closer over the next few years.

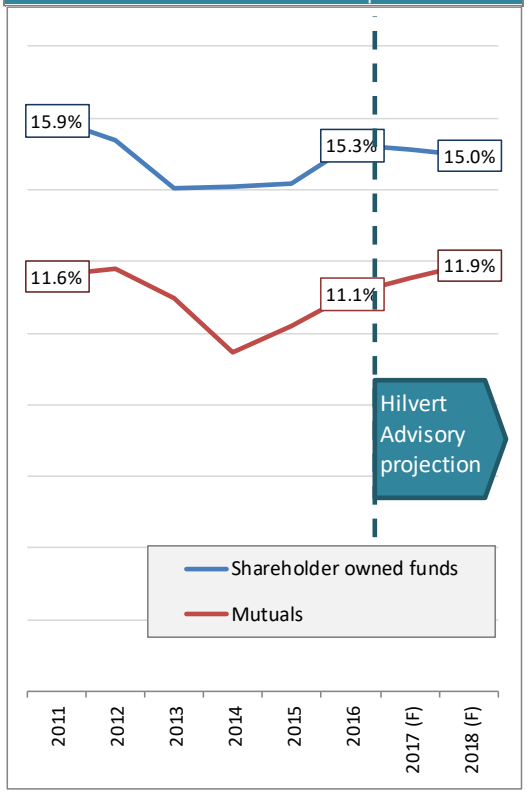
The convergence over the next few years will be driven by:

1. Medibank's gross profit margin declining moderately – it is currently a bit too high so we expect competitive and regulatory forces to nudge it down slightly
2. Some of the mutuals with very low or negative returns will re-price to return to a more sustainable profit footing.

But the grand canyon is here to stay as the forces that underpin it are permanent – albeit, the chasm will be a bit narrower.

GROSS MARGIN PROJECTIONS

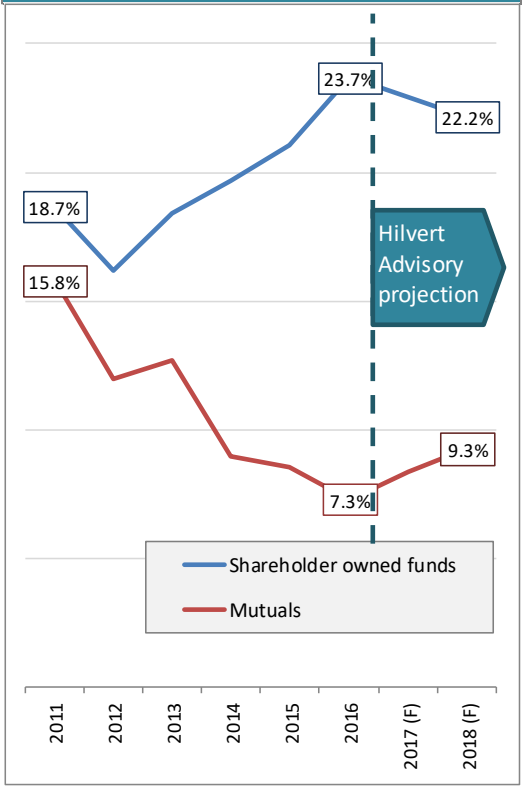
Gross Profit = Profit after claims and risk equalisation but before administration expenses



Sources: Hilvert Advisory + APRA reports

ROE PROJECTIONS

ROE = NPAT / Health Benefits Fund capital. Tax counted only where applicable.



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