

## Medibank Private Share Offer - Discussion Paper

As a service to Banksia Partners clients and other interested parties, Banksia Partners has prepared a discussion paper to help potential investors assess the merits or otherwise of an investment in the Medibank Private Share Offer.

### Background to Medibank Private Share Offer

The healthcare industry in Australia accounts for just under 10 per cent of Australia's GDP with spending of about \$145 billion last year, total revenue of the private health insurance industry represents just under \$20 Billion of that amount. Private health insurance is integral to the sustainability of our 'universal' health coverage system because without it the private hospital system could not function – currently more surgical procedures occur in private hospitals each year than occur in public hospitals!

From a 'growth' perspective, private health insurer's revenues have grown at an average 8.4% over the last 10 years while spending has increased at 7.9% over the same period. Moreover, with a growing population and an aging 'baby boomer' generation, that rate of spending is likely to continue increasing.

Medibank Private is the largest of the health insurers in the market with a 29.1% market share and over 1.9 million policy holders. The federal government – which heavily regulates private health insurance – sees no value in owning a business which operates in a highly contested market place along with 35 other private health insurance providers.

### Terms of the Offer

Some 2.754 Billion Medibank Private shares will be sold to the public and various local and overseas financial institutions and superannuation funds by the Federal government.

The 'price' at which the shares will be sold will be determined by an institutional 'book build' scheduled to occur between 18<sup>th</sup> and 20<sup>th</sup> of November 2014 - the estimated indicative range is between \$1.55 per share and \$2.00 per share – although the book build may result in a 'final price' higher than \$2 per share. ***Importantly, the price that retail investors (i.e. you) will pay will be capped at \$2 per share.***

As a worst case scenario, assuming the maximum retail price of \$2 per share, Medibank Private is being 'sold' on a prospective 'Price to Earnings' ratio of about 22 times earnings (expensive) with an indicative fully franked dividend yield estimated at 3.5% for the 2015 financial year (FY).

Unlike previous Federal government privatisations (CBA, Telstra, Qantas), the difference here is that prospective retail shareholders will not know the price they will ultimately pay for their shares until **after** they have applied for shares and until **after** the institutional book build is completed.

### Benefits of investing in the Medibank Private Share Offer

We have summarised the various benefits of investing in Medibank Private for the long term (in no particular order) as:

- A large business with predicable cash flows in a growth industry;
- Once listed on the ASX the company will be capitalised between the top 40 and top 70 companies on the exchange;

- Medibank Private's net insurance margin is currently lower than many of its competitors so there is scope through better management of expenses to improve this margin & therefore profitability;
- Earnings volatility is lower for private health insurers compared with general insurers because general insurers are exposed to large claims events (weather, bushfires, etc.) and economic cycles while private health insurers are not;
- While the industry's ability to increase income (premiums) is limited by government regulated pricing, risk sharing across the industry means a minimum 'profitability floor' is created;
- Non-renewal of the 'immigration contract' will see an immediate improvement in Medibank Private's underlying insurance margin;
- Will pay an attractive fully franked dividend – with a payout ratio of between 70% & 75% of future earnings after tax;
- The company has no debt & meets the minimum capital requirements of the regulator (APRA);
- Opportunities for industry rationalisation which could benefit the major industry participants (Medibank Private & BUPA).

### Potential Risks & Exposures of investing in the Medibank Private Share Offer

We have summarised the various 'key risks' of investing in Medibank Private (in no particular order) as:

- While heavily regulated by government, this can be both a negative as well as a positive. Changes to tax policy could remove present incentives to own private health insurance;
- With rising premiums, affordability could be impacted leading to lower participation rates (currently 55% of the population);
- Investment income on investments may fall, impacting revenue;
- Medibank Private may lose market share or suffer brand and reputational damage as a result of miss-pricing, incorrect product design, poor execution or claims handling, systems & IT failure, failure to reach satisfactory agreements with healthcare providers, etc. etc.

### Conclusion

On balance, and subject to our disclaimer below, Banksia Partners considers the Medicare Private Share Offer represents an opportunity to buy into a stable business with ongoing growth prospects and an attractive underlying yield. An investment in Medibank Private will be particularly attractive to investors such as Self-Managed Superannuation Funds or other self-funded retirees seeking a growing, fully franked dividend where the tax credits can be reclaimed or offset against other tax liabilities.

While we considered it 'expensive' at the capped retail price of \$2 per share - Morningstar Equity research consider the businesses 'fair value estimate' as \$2.10 per share – any discount below \$2 in the 'Final' price will represent an even better outcome for retail investors. You should further consult your Banksia Partners adviser concerning your personal and particular requirements.

**This discussion paper should be considered as 'general' advice only and not 'personal' advice. Investors should give careful consideration to all of their financial circumstances, needs, and financial objectives when considering an investment in the Medibank Private Share Offer. Banksia Partners warrants that neither it nor its authorised representatives have a commercial interest in the promotion, sale, or successful completion of the Medibank Private Share Offer.**