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Medibank Private (MPL)

Sustainable Earnings Upgrades

Recommendation
Buy (Hold)
Price
$2.50
Target (12 months)
$2.97 (previously $2.63)

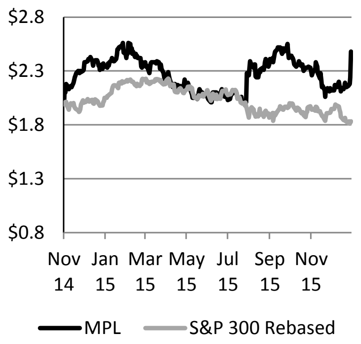
Expected Return	
Capital growth	**18.8%**
Dividend yield	**4.2%**
Total expected return	**23.0%**
Company Data & Ratios	
Enterprise value	**$6,885.0m**
Market cap	**$6,885.0m**
Issued capital	**2,754m**
Free float	**100%**
Avg. daily val. (52wk)	**$35m**
12 month price range	**$1.99 - $2.71**
GICS sector	**Diversified Financials**

Disclosure: Bell Potter Securities acted as Lead manager in the company's 2014 IPO and received fees for that service.

Price Performance

	(1m)	(3m)	(12m)
Price (A$)	2.11	2.52	2.36
Absolute (%)	17.54	-1.59	5.08
Rel market (%)	21.60	5.30	12.54

Absolute Price



SOURCE: IRESS

Key Messages From Earnings Upgrade Statement

Medibank delivered its first earnings upgrade as a listed entity today. The Health Insurance Business (HIB) operating profit for FY16 is now expected to be above $470m compared to previous guidance of above $370m. This represents a 27% upgrade to operating profit.

The only negative aspect of the announcement was the softer than expected revenue growth. MPL achieved 1H16 revenue growth of ~4.6% and has guided to full year revenue growth between 4.5% and 5%. The original guidance for FY16 was above 5.5%.

The key driver of the upgrade has been claims management. Since listing MPL has described its significant investment in systems replacement. Project DelPHI now provides the company with previously unparalleled ability to analyse and monitor claims. This analysis combined with its right to conduct regular claims audits under new hospital contracts has yielded significant benefits in claims control. MPL has been able to enforce its right to not pay for hospital acquired complications, hospital upgrades and spurious claims.

The net result of the adjusted guidance implies a revised gross underwriting profit margin in FY16 of ~16% relative to the 14.3% achieved in FY15. More importantly, the claims analysis and audit process remain in their infancy with a little more than one third of operators subject to the new contract arrangements. For this reason, in our view the gross profit margin should remain higher.

As a result of the better than expected financial performance, MPL has resubmitted its request for premium price rises due from 1 April 2016. It intends to pass on at least some of the claims savings to policy holders in the form of lower premiums.

Target price raised, upgrade to Buy

Following significant upgrades to EPS in FY16 and FY17 target price is revised from $2.63 to $2.97 and we upgrade our recommendation from Hold to Buy.

Earnings Forecast

Year End June	FY15	FY16e	FY17e	FY18e
Revenues	6,576.0	6,845.1	7,155.9	7,482.3
Operating profit	320.0	462.4	479.3	502.8
Investment income	93.8	84.1	88.4	113.8
NPAT (underlying) $m	291.8	381.7	396.7	431.4
NPAT Reported	285.3	381.7	396.7	431.4
EPS underlying (cps)	10.6	13.9	14.4	15.7
EPS growth %	13%	31%	4%	9%
PER (x)	23.6	18.0	17.4	16.0
FCF yield (%)	6.0%	4.2%	6.2%	5.3%
Dividend (cps)	5.3	10.5	11.5	11.7
Yield	2.1%	4.2%	4.6%	4.7%
Franking	100.0%	100.0%	100.0%	100.0%
ROE %	19.8%	24.8%	23.9%	24.4%

SOURCE: BELL POTTER SECURITIES ESTIMATES

Key changes to earnings model following guidance upgrade:

Revenues

- Growth in policy holder numbers changed from +0.5% to -0.5%; and
- FY16 premium increase lowered from 6.0% to 5.5%.

As a result these changes, the net premium revenue increase in the health insurance business is reduced to 4.8% (from 5.8%) which is in line with revised company guidance for premium revenue growth of between 4.5% and 5.0%.

Claims

- As a result of numerous drivers, claims expenses are lower than anticipated. To reflect this change, we have increased the gross underwriting profit from 14.3% to 16% in FY16.
- There are no changes to the absolute value of management expenses at $523m.

The net impact of these changes at the HIB operating profit line is an increase in the FY16e from $375m to $472m. Guidance is for the FY16 result to be above $470m.

In 1H16 the HIB is expected to achieve operating profit of $270m inclusive of a $21m provision release. This implies $200m of operating profit for the second half. The lower earnings in second half are consistent with normal industry seasonality that is driven by higher claims in the January to June period and higher marketing expense.

Commentary

The most recent industry statistics indicate Private Health Insurance (PHI) coverage levels are stable at 47% of the population. Despite this, the listed insurance providers have reported increasing churn rates and in the case of MPL, its share of market declined modestly in FY15.

MPL stated 1H16 revenue growth was ~4.6%. We now expect the modest loss of market share has continued in FY16. MPL has now advised that it expects net premium revenue growth of between 4.5% and 5% for FY16 (previously 5.5%).

Contributing to the lower than expected revenue growth were tight market conditions and the fact that the AHM brand was off the iSelect panel for most of the first half.

The more interesting aspect of the earnings upgrade was in relation to the claims experience during 1H16. MPL has experienced what it described as a light claims period. While the company could not quantify this statement, industry statistics for the September 2015 quarter indicate benefits paid increased by 4.7% vs pcp, hence in our opinion, MPL's experience would appear to be relatively consistent with the industry. We estimate the long term industry growth rate for claims inflation at between 6% and 7%.

Secondly, the company pointed towards earlier than expected gains from its compliance monitoring program. The new hospital contracts enable MPL to audit claims on a regular basis. This process has allowed Medibank to weed out numerous non complying claims including those related to hospital acquired complications, upgrades and spurious claims.

The benefits from the light claims and claims savings for the surveillance program are well beyond our expectation. The FY16 guidance for operating profit now implies a gross profit margin of 16% for the year (FY15: 14.2%) versus our expectation of ~14.5%. 1H16 guidance implies a gross underwriting profit of closer to 17% (inclusive of the $21m provision release) and approximately 15.4% for the second half.

Looking forward the company also commented that 2H16 is likely to be a more relevant benchmark for future years.

MPL was also quick to point out that it had not cut reimbursement rates on any policies and had paid 100% of valid claims.

In our opinion this outcome on claims management is entirely consistent with the aims of project DelPHI, albeit the quantum of the savings is larger and developed more quickly than we had thought.

FY16 PREMIUM INCREASE RE-SUBMITTED

The implied net operating margin from the operating profit guidance is 7.6% in FY16 (FY15 5.5%). We estimate this may increase to 8% in FY17. These margins are potentially beyond what is required in order to maintain solvency and deliver a reasonable return on capital.

Consequently, MPL intends to deliver at least some of the benefit to policy holders in the form of lower premium increases. Each year in approximately November, health insurance funds make submission to the regulator for premium increase to apply from 1 April the following year. Due to the stronger than expected results in 1H16, MPL has voluntarily re-submitted its premium increase request for premium price changes coming into effect from 1 April 2016.

MPL premiums increased by 6.2% on average from 1 April 2015. We expect this year's increase will be below 6% contributing to an overall 5% increase in premium revenues in FY17.

EARNINGS SUSTAINABILITY

Two key issues for earnings sustainability:

In our view the period of light claims is most likely a timing issue. We expect the claims inflation rate will return to the normal range in the December 2015 quarter and this normalisation is included in the company guidance.

Secondly, in relation to claims savings from compliance monitoring. This process remains in its infancy. In October 2015, approximately one-third of operators were subject to the new contracts permitting these compliance audits, hence there are reasonable grounds to believe that these savings may accelerate before reaching a plateau.

The next extension of the contracting process not yet widely discussed is the inclusion of bed clauses for certain brownfield expansions. Medibank is using its market power to negotiate bed rates for private hospital expansions in geographic areas that are already over serviced by existing facilities.

Our best estimate is that the full benefits of this program may not be realised for a further two to three years – when all operators will have rolled over to new contracts. For this reason in the forecasts years beyond FY16, we have maintained the gross profit margin at 15.5% and this drives the considerable EPS upgrades over the period of the forecast.

Figure 1 - Summary of earnings changes

		FY16			FY17	
Summary of earnings changes	**Old**	**New**	**% change**	**Old**	**New**	**% change**
Revenues	6,908	6,845	-0.9%	7,269	7,156	-1.6%
Operating profit	366	462	26.3%	408	479	17.5%
Investment earnings	84	84	0.1%	88	88	0.4%
NPAT - ex once off items	313	382	22.0%	346	397	14.7%
EPS	11.4	13.9	21.6%	12.6	14.4	14.3%

SOURCE: BELL POTTER SECURITIES ESTIMATES

Target Price raised by 13% from $2.63 to $2.97. The target price reflects a price earnings multiple of 21.3x and 20.6x EPS in FY15 and FY16 respectively.

Forecast FY16 dividend is increased by 1.9cps to 10.5 cents, fully franked maintaining the payout ratio at 75%.

About Medibank Private

Medibank Private is Australia's largest private health insurer with approximately 29% market share and revenues exceeding $6.8bn. The company provides private health insurance to more than 3.6m Australian's and is an iconic brand name across the country. It is the number one or two provider in each market in which it operates.

The private health insurance industry performs a vital role in funding the healthcare needs of Australia with more than 60% of all hospital separations across the country from the private system. As healthcare expenditure continues to grow Medibank Private represents a relatively low risk avenue to invest in this trend.

The industry is supported by highly accommodative government incentives for members of the public to take out and maintain private health insurance. Many of these features are unique in Australia.

The company is led by George Saviddes, an industry veteran. He is supported by a highly experienced Board and management team. Most of the senior management team have come from outside of the industry in recent years and will play an important role in transforming the business from government ownership to private ownership.

The price target is derived from a capitalised earnings model which is most sensitive to the valuation applied to the health insurance underwriting business to which we apply a multiple of 18x forecast FY16 underwriting profit. The target price is not impacted by volatility in investment earnings.

The key risk items are:

Regulatory risk – the Federal government's long standing legislative measures to compel all Australians into private health insurance are crucial for the long term success of the company. Any measure to unwind or lessen these incentives is likely to result in lower rates of membership for private health insurance.

Product mispricing – health insurers are only permitted to change pricing annually. Products that are mispriced relative to the benefits offered are likely to attract value seeking policy holders and this may result in significant losses. Annual premium increases continue to be subject to the approval of the Minister for Health who may not approve increases where it is deemed contrary to public interest. Product pricing relies heavily on numerous actuarial assumptions and estimates which may be materially incorrect.

Risk equalisation – the net Risk Equalisation Trust Fund (RETF) receipt or payment is critical to determining the overall profitability of the company. Increasing the policy holder base of younger members may (ironically) decrease the profitability of the fund. The company has indicated its intention to grow the value centred ahm brand. Average premiums in this brand are lower compared to the Medibank brand, however, the increase in policy holder numbers will increase the gross deficit or contribution to the RETF.

Failure to reach agreement with healthcare providers – Medibank must continue to have profitable service provider agreements with all the major private hospital operators. It is in neither party's interest to go out of contract as policyholders/patients may be required to pay increased out of pocket costs. As the largest health insurer, Medibank is well positioned for future negotiations.

Investment earnings - are subject to volatility and losses and this may impact EPS growth estimates.

Loss of the Australian Defence Force contract in 2016 – should the Complementary Services business fail to renew the Defence force contract, material impairment charges and losses are likely.

Medibank Private
as at 22 January 2016

Recommendation	Buy
Price	$2.50
Target (12 months)	$2.97

Table 1 - Financial summary

PROFIT AND LOSS	2014	2015	2016e	2017e	2018e
Year end June $m					
Gross written premium (GWP)	6,367	6,576	6,845	7,156	7,482
Net claims incurred	-5,418	-5,603	-5,731	-6,025	-6,301
Gross profit	949	974	1,114	1,131	1,182
Gross profit margin	14.9%	14.8%	16.3%	15.8%	15.8%
Underwriting expense	-669	-630	-627	-626	-652
Underwriting result	**280**	**344**	**487**	**505**	**530**
Corporate expenses	-25	-24	-25	-26	-27
Operating profit	**255**	**320**	**462**	**479**	**503**
Margin	4.0%	4.9%	6.8%	6.7%	6.7%
Net investment income	114	94	84	88	114
Other	-8	-8	-9	-9	-9
Profit before tax	**361**	**406**	**538**	**559**	**608**
Income tax expense	-103	-114	-156	-162	-176
Reported profit after tax	**258**	**292**	**382**	**397**	**431**
Once off items	128	-7	0	0	0
Statutory NPAT	131	285	382	397	431

CASHFLOW	2014	2015	2016e	2017e	2018e
Operating profit	255	306	462	479	503
Change in working capital	85	85	-61	86	2
Depreciation and amtz	47	41	56	56	56
Customer acquisition costs	-21	-29	0	0	0
Changes in other assets and liabilities	28	72	-81	-93	-98
Income tax payable	-64	-97	-156	-162	-176
Cash flow from operations	329	377	221	366	287
Capital expenditure	-112	-53	-35	-65	-65
Proceeds from asset sales	5	4	0	0	0
Net cash used in investing activities	-107	-49	-35	-65	-65
Investment income	49	41	75	79	105
Other items	0	-430	-13	1	1
Dividends paid		-239	-284	-277	-320
		-628	-222	-196	-214
Change in cash held		-300	-36	105	8
Cash at the beginning of the period		708	409	374	478
Cash at end of period		409	373	479	486

BALANCE SHEET	2014	2015	2016e	2017e	2018e
Cash	708	409	374	478	486
Receivables	339	301	386	403	421
Financial assets at fair value	1,491	1,972	2,052	2,146	2,244
Other assets	47	91	91	91	91
Property, Plant and Equipment	138	106	91	106	121
Deferred tax	8	-	-	-	-
Intangible assets - Goodwill	243	262	256	250	244
Total Assets	**2,974**	**3,141**	**3,250**	**3,474**	**3,608**
Payables	347	420	409	430	394
Outstanding claims	407	411	427	472	493
Unearned premium	665	727	743	781	817
Income tax provision	27	27	16	16	18
Other	135	115	115	115	115
Total Liabilities	**1,580**	**1,699**	**1,711**	**1,815**	**1,837**
Net Assets	**1,394**	**1,442**	**1,539**	**1,659**	**1,771**
Ordinary share capital	85	85	85	85	85
Reserves	21	21	21	21	21
Retained earnings	1,288	1,336	1,433	1,553	1,665
Total Shareholders equity	**1,394**	**1,442**	**1,539**	**1,659**	**1,771**

VALUATION DATA	2014	2015	2016e	2017e	2018e
Year end June $m					
NPAT (cash basis)	131	285	382	397	431
EPS (statutory basis) (cps)	4.7	10.4	13.9	14.4	15.7
EPS (ex once off items)	9.4	10.6	13.9	14.4	15.7
EPS growth (ex once off items)	na	13%	31%	4%	9%
P / E ratio (times)	26.6	23.6	18.0	17.4	16.0
P / Book ratio (times)	4.9	4.8	4.5	4.1	3.9
P / NTA ratio (times)	6.0	5.8	5.4	4.9	4.5
Net DPS (cps)	-	5.3	10.5	11.5	11.7
Yield	na	2.1%	4.2%	4.6%	4.7%
Franking	na	100.0%	100%	100%	100%
Payout (target 70% - 80%)	na	75%	76%	80%	75%

PROFITABILITY	2014	2015	2016e	2017e	2018e
Return on assets	0.04	9.1%	11.7%	11.4%	12.0%
Return on equity	0.09	19.8%	24.8%	23.9%	24.4%
Growth in net earned premium	0.09	3.3%	4.1%	4.5%	4.6%

DIVISIONAL	2014	2015	2016e	2017e	2018e
Health Insurance					
Premium income	5,649	5,935	6,217	6,528	6,854
Growth	*5.7%*	*5.1%*	*4.8%*	*5.0%*	*5.0%*
Gross underwriting profit	764	842	995	1,012	1,062
Gross profit margin	**13.5%**	**14.2%**	**16.0%**	**15.5%**	**15.5%**
Underwriting expenses	-518	-513	-523	-522	-548
HIB operating result	246	329	472	490	514
MER	9.2%	8.6%	8.4%	8.0%	8.0%
Net margin	**4.4%**	**5.5%**	**7.6%**	**7.5%**	**7.5%**
Complementary Services					
Premium income	718	641	628	628	628
Growth	41.5%	-10.7%	-2.1%	0.0%	0.0%
Gross underwriting profit	185	132	119	119	119
Gross profit margin	**25.7%**	**20.5%**	**19.0%**	**19.0%**	**19.0%**
Underwriting expenses	-151	-117	-104	-104	-104
CS operating profit	34	14	16	16	16
Net margin	4.7%	2.2%	2.5%	2.5%	2.5%
Net underwriting profit (ex intergroup profit)	280	344	487	505	530
Combined margin (before corp. expenses)	4.4%	5.2%	7.1%	7.1%	7.1%

INTERIM PROFIT AND LOSS	1H15	2H15	1H16	2H16
Y/e June 30 ($m)				
Premium revenue (NEP)	3,270	3,306	3,423	3,422
Net claims incurred	(2,799)	(2,804)	(2,847)	(2,884)
Underwriting expense	-296	-335	-297	-330
Operating profit result - group	176	168	279	209
Margin	5.4%	5.1%	8.1%	6.1%
Profit before tax	208	198	300	238
Income tax expense	-61	-53	-87	-69
Reported profit after tax	146	146	213	169

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

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