Healthy pay-off

Roger Montgomery illustrates how an astute investor can identify value

THE GOAL OF VALUE INVESTING IS to buy the proverbial "dollar for 50¢". A value investor seeks to buy stocks for materially less than they are worth. In doing this, a "margin of safety" is created, which acts a bit like an insurance policy: even if the value investor's assessment of value is inadvertently inflated, a high margin of safety will ensure that minimal capital is lost.

Take the initial public offering of Australia's largest private health insurer, Medibank Private. Before listing, the federal government, as the seller, gave retail investors an indicative pricing range of $1.55 to $2 a share. The challenge was to assess whether Medibank was worth materially more than $2 a share, thereby ensuring a safety margin. This task could be boiled down to the following: the investor needed to assess the quality of the business and feed this into an assessment of future earnings potential.

At first glance, the business did not look cheap: at $2, the implied price-earnings ratio was 21.3 for the 2015 financial year. Yet an investor who methodically stepped through the value investing process was rewarded handsomely.

Medibank is the leader in a stable and concentrated private health insurance industry. In general, the more concentrated an industry – from the perspective of the market shares of the players – the less fierce the competition. Being the largest health insurer in Australia gives Medibank an advantage over most of its competitors: it has more bargaining power with healthcare providers, relatively lower marketing expenses and better data analytics – that is, the ability to extract insights from its data to deliver healthcare more efficiently.

This latter point is important as it sheds light on a potential source of profit margin improvement. In the 2015 financial year, Medibank indicated that it would pay out on claims around 86¢ of every dollar of premium earned. This is by far the largest cost – which implies this is also the largest opportunity to boost earnings. To the extent Medibank can reduce the amount it pays on claims each year – for instance, through smarter healthcare delivery or new prevention techniques – then earnings will increase. To the extent earnings will increase in the future, then the price-earnings ratio of 21.3 is effectively overstated and the business appears more expensive than it truly is.

According to Medibank's prospectus: "2.2% of the Medibank-branded policyholders accounted for 35.2% of the Medibank-branded claims expenses relating to hospital and medical claims." In a sense, this is good news because it means that the management knows exactly who to focus on to have the biggest impact on claims expense improvement.

Improving healthcare delivery through technology and smarter processes is a worldwide trend. Private health insurers have a large incentive to improve healthcare value – in the sense of better outcomes at lower costs. For if health insurance becomes too expensive, the healthy drop out, the unhealthy remain and the system becomes unsustainable.

Sensibly quantifying the level of potential improvement is difficult, though examples of localised cost savings of more than 25% have been observed around the world in numerous clinics that are experimenting with new, smarter techniques of delivering healthcare.

If an investor were to believe that, over the next decade, such cost savings could be achieved on the high-cost policyholders, this alone would drive material earnings growth. Combining this with modest organic revenue growth and some additional overhead reduction suggests Medibank's earnings will be materially higher in the future than they are today.

Through this lens, the astute value investor probably identified an opportunity to buy a "dollar" for a lot less than a dollar. While on the surface Medibank hardly looked cheap, upon considering the earnings growth potential it surely was a bargain at $2. For those who took the time to analyse the business quality and value, the rewards have been material. At year's end, just five weeks after listing, Medibank closed at $2.41 a share – a quick 20% profit for retail investors. It would be understandable if an investor locked in such a quick profit. Yet I believe that, should Medibank really start to gain traction in the smarter delivery of healthcare, the rewards will be even higher for a patient investor.

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