Medibank Private: banking on medical

by Roger Montgomery

Medibank Private (MPL) is not a company whose activities need to be described here. Most readers are privately insured and the largest provider is MPL, so you know who the company is and what it does.

The investment thesis that saw Montgomery purchase shares in the float, and its investors subsequently profit from, was relatively simple (although the analysis and valuation work was not).

Medibank had a vast and long-term opportunity to bring down its claims expense and with just 2.2% of policyholders responsible for fully a third of the claims expense, technology and operating leverage could be combined to have a material impact on the margins and profitability of the firm.

At the time of the float, we noted that in FY15, Medibank guided that it will pay around 86 cents of every dollar of premium earned on claims. This is by far the largest bucket of cost – which implies this is also the largest opportunity to boost earnings.

We also observed that to the extent Medibank can reduce the amount it pays on claims each year – for instance, through smarter healthcare delivery or the employment of new prevention techniques to its customers – then earnings will increase. To the extent earnings will increase in the future, then the price-to-earnings ratio of 21.3x is effectively overstated and the business appears more expensive than it truly is.

While it is true that health care remains a political football and at risk of policy revision and while premium increases are regulated, it is also true that a profitable and sustainable private health insurance sector is necessary to avoid government adoption of epochal healthcare expenses.

Since the float, revenues and profits have grown, as have profit margins. The company has also paid IPO investors a 5.3 cent dividend or a 4% yield.

On January 22 (of this year) Medibank announced a profit upgrade for the first half of the 2016 financial year as a result of a combination of reduced claims expense (thanks in part to a decline in improper claims), improved hospital contracting and a reduction in hospital utilisation growth.

While the company lowered its revenue guidance from ‘above 5.5%’ to between 4.5% and 5% (our revenue growth forecasts were below management’s guidance due to continued slow net policy additions of 0.5%), and increased its management expense ratio, thanks to higher marketing expenses, FY16 operating profit is expected to be above $470m, up from previous guidance of “above $370 million” and much higher than the $329 million reported in 2015.

This highlights the scale of the opportunity for efficiency gains in the business, which underpinned our original investment case and these gains are being realised more quickly than expected.

Importantly, it is useful to remember that new policyholders are less profitable than incumbent policyholders. As such, the reduction in management’s revenue growth forecast – being due to slower than expected new policy additions rather than any acceleration in the lapse rate – is a positive influence on margins.

Following MPL’s guidance upgrade, we updated our investment case, valuation range and forecasts.

While over half of the increase in FY16 operating profit guidance can be considered one off, the upgrade also included an approximate 8% increase in sustainable operating profit for the health insurance business.

Given this improvement, it is not unreasonable to expect some ministers to reignite the debate about premium increases and it can be argued that to appease those that might be displaced, MPL will resubmit to the Federal Government a lower price increase proposal for 2016.

The decision to revise down its proposed price increase for 2016 is, however, also in line with our expectations, as we had assumed MPL would need to share some of the efficiency gains with customers. Our forecasts assume 5% price rises between 2016 and 2019.

The result of the update means our valuation now rises but so does the risk of a political backlash and the possibility of further ‘leaks’ about policy changes, if only to test the response of the constituency.

Medibank (MPL)

Source: Yahoo!7 Finance, 29 February 2016

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