Medibank Well Positioned for Long-Term Growth

Investors should pre-register for the Medibank IPO.

Morningstar Equity Research
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Executive Summary

Currently owned by the Australian government, Medibank Private Limited, or Medibank, is the largest provider of health insurance in Australia. The government plans to sell the business via an initial public offer, or IPO, with the prospectus expected in late October 2014. IPO pricing is yet to be determined, but the offer is likely to be attractive given the government's eagerness to sell the asset and maximise retail ownership. Narrow moat-rated Medibank is expected to list on the Australian Securities Exchange, or ASX, in December and, assuming a realistic issue price and no negative surprises in the prospectus, demand for the stock should be healthy. A solid share market, successful recent floats, limited availability for institutional investors and a dearth of attractively priced, high-quality defensive businesses should ensure robust pricing once listed.

Key Takeaways

- We recommend investors pre-register for a Medibank Share Offer prospectus. Pre-registration is expected to open late September and carries no obligation to proceed. Based on our assessment, of Medibank's latest published accounts, our research on listed competitor NIB Holdings (ASX: NHF), and publicly available industry information, we are positive on the long-term outlook for the private health insurance industry.
- A comprehensive analysis of the Medibank IPO, including Morningstar's valuation and investment recommendation, will be published in our pre-IPO report following the release of the prospectus.
- Government-regulated pricing and risk sharing across the industry limit earnings upside, but also create a floor for minimum profitability. The Medibank investment proposition is built around a profitable, large-scale, easy-to-understand private health insurer operating in a heavily regulated industry. Strong leverage to a growing industry with regulatory and demographic tailwinds should appeal to investors seeking solid long-term defensive earnings growth.
- Medibank is Australia's largest private health insurer with 29.5% market share. The industry is highly concentrated, with the five largest funds holding 83% market share. Further industry consolidation may be restricted by competition concerns, the regulated industry, the pricing structure and regulated risk sharing. While the industry is dominated by the majors, there are also many small funds — 24 of the 34 registered health funds hold less than 1% market share each, and could be acquisition targets.
- The ability to deliver consistent underwriting profits as the largest player in Australia's health insurance oligopoly supports our view that Medibank has sustainable competitive advantages, warranting a narrow Morningstar Economic Moat Rating.

Rationale for Our Positive View on Medibank

The Medibank investment proposition is built around a sound, relatively well managed, large-scale, easy-to-understand private health insurer operating in a government-regulated industry with inbuilt minimum profit levels. We expect the insurer will have a strong balance sheet on listing – debt-free with surplus capital and strong solvency ratios. Robust organic capital growth supports future growth opportunities, and, in the absence of any strategic initiatives, surplus capital could be returned to shareholders. Australia's private health insurance sector benefits from high entry barriers as a result of heavy regulatory requirements, a unique industry structure, the high cost of replicating infrastructure, high customer switching costs and strong brands. Health insurers earn stable underwriting profits because of government-controlled "carrots and sticks" and the lack of significant volatility in claims costs.

Exhibit 1. Health Insurance Industry Summary

30-June-2013	Premium Revenue (AUD billion)	Management Expense Ratio	Net Margin	Market Share	For Profit/ Not For Profit
Medibank Private*	5.2	9.2%	3.6%	29%	For Profit
BUPA Australia	4.9	8.5%	6.6%	27%	For Profit
HCF	2.1	7.1%	1.3%	11%	Not For Profit
NIB	1.2	8.2%	5.0%	8%	For Profit
HBF	1.2	9.9%	6.3%	8%	Not For Profit
Others	3.4	9.3%	2.8%	17%	7 for Profit/22 Not For Profit
Industry	18.0	8.8%	4.3%	100%	34

*Medibank Private includes ahm
Source: Morningstar, Company Accounts, Private Health Insurance Administration Council

Health insurers are low-risk and tend to operate more like profitable consumer businesses, rather than higher-risk and more volatile general insurance companies. Health insurers typically receive regulatory approval each year to increase premiums in line with increasing claims costs, limiting the risk of margin erosion. Medibank is focused on customer service, product innovation, brand awareness, customer loyalty, marketing, niche product targeting and leveraging technology. Most health insurers have the underwriting acumen to properly price policies and the proper incentives for underwriters to avoid poorly priced polices.

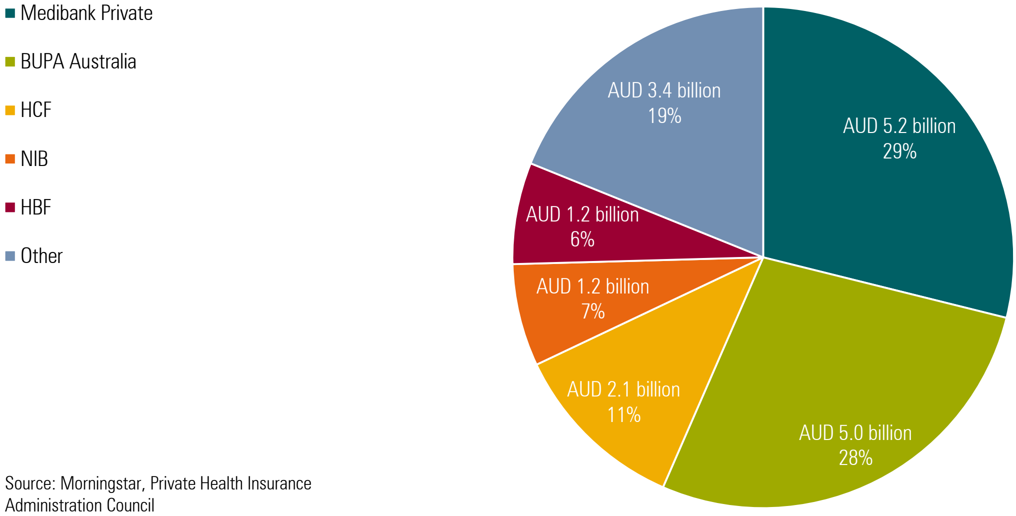
Exhibit 2. Industry Premium Revenue Growth

	Jun-09	Jun-10	Jun-11	Jun-12	Jun-13	CAGR
Medibank Private*	6.3%	7.8%	7.6%	7.0%	5.6%	6.9%
BUPA Australia/MBF	7.0%	7.1%	7.6%	6.7%	6.9%	7.1%
HCF	10.1%	9.2%	11.9%	28.2%	10.1%	13.7%
NIB	9.4%	8.7%	10.0%	10.5%	8.4%	9.4%
HBF	7.7%	9.3%	8.0%	8.7%	7.4%	8.2%
Industry	7.3%	8.4%	8.8%	8.4%	7.5%	8.1%

*Medibank Private includes ahm
Source: Morningstar, Private Health Insurance Administration Council

Currently owned by the Australian government, Medibank is the largest provider of health insurance in Australia. Medibank's 29.5% market share eclipses BUPA at 26.8%, and other major competitors such as HCF at 10.8%, NIB Holdings at 7.7% and HBF at 7.5%. Medibank's two brands, Medibank Private and ahm Health Insurance, provide private health insurance to more than 3.8 million people with significant membership in every state and territory. The insurer reported revenue of AUD 5.9 billion in fiscal 2013 and will join Australia's fourth-largest health fund, NIB Holdings, as the only health insurers listed on the ASX. In addition to private health insurance, the firm provides a range of specialty insurance including life, pet, travel insurance, as well as health insurance for overseas students and temporary overseas workers in Australia. Medibank Health Solutions (9% of group revenue in fiscal 2013) provides a wide range of related health-care services to businesses, governments and communities across Australia and New Zealand.

Exhibit 3. Market Share of Private Health Insurance Industry Premium Revenues (estimated size AUD 18 billion at June 2013)

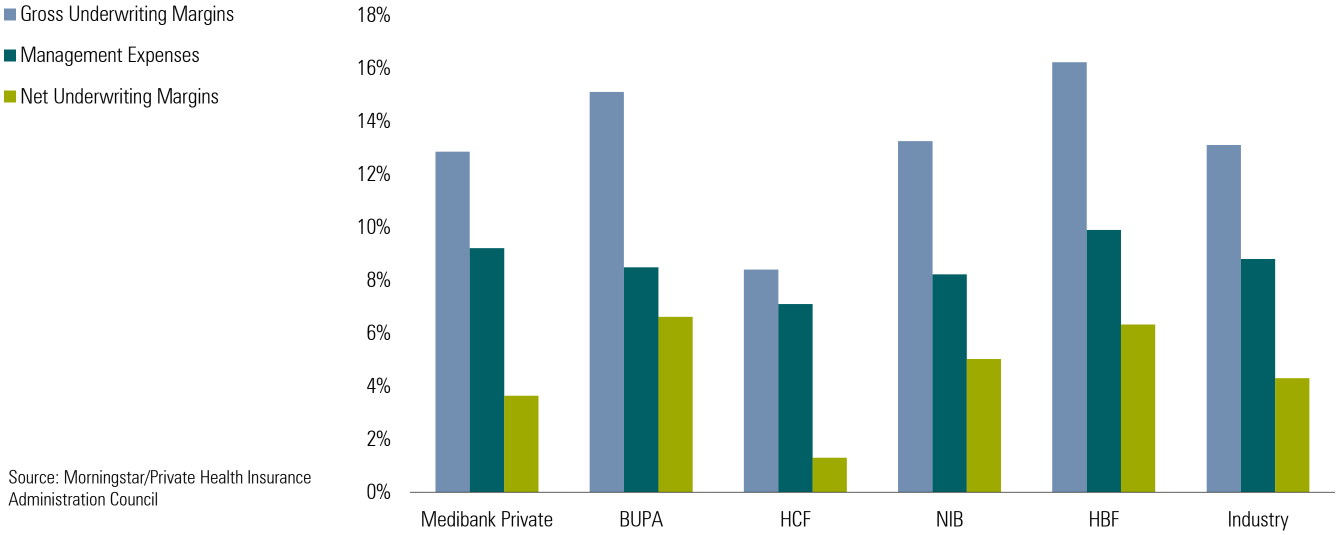


Source: Morningstar, Private Health Insurance Administration Council

Privatisation enables Medibank to optimise its corporate and capital structures, with improved access to capital markets ensuring the business is well placed to take advantage of future growth opportunities. Potential capital and operating efficiencies as a listed company support our positive long-term view. Medibank is well placed to take advantage of industry consolidation, but the industry structure creates no real incentive for the smaller players to participate in mergers. Mergers between the five major insurers would likely be complicated by competition issues. Mergers with smaller participants would likely be immaterial because of the tiny size of the smaller insurers.

Tight regulation is both positive and negative, as changes to government policy could impact Medibank's private health insurance franchise. Government changes to the risk equalisation system, the Medicare levy, the Medicare levy surcharge and the private health insurance rebate are examples of potential policy changes. Other risks include increasing policyholder lapse rates caused by weaker economic conditions, higher-than-expected claims costs, pricing risks, greater utilisation of hospital and ancillary services and lower investment returns. The threat of increased competition from existing participants and potential new entrants is an increasing risk, particularly as rapid advancements in technology lower setup costs and expand customer reach.

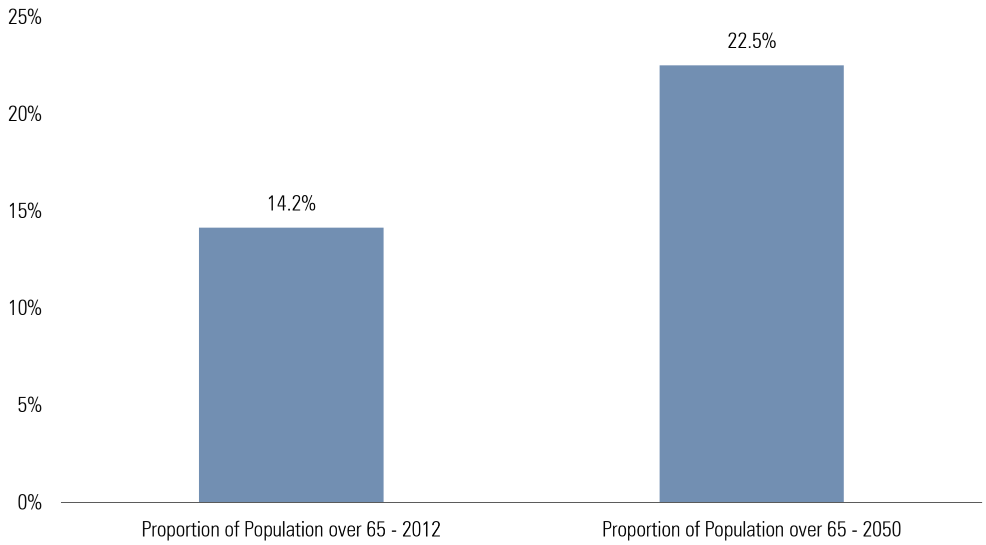
Exhibit 4. Profitability of the Five Major Health Funds as at June 2013



Source: Morningstar/Private Health Insurance Administration Council

Medibank is strongly positioned thanks to its long history, large scale and trusted brand. Medibank's pristine balance sheet could change in the future if management follows a growth-by-acquisition strategy. Medibank and BUPA dominate the private health insurance market. Strong leverage to a growing industry with regulatory and demographic tailwinds should appeal to investors seeking solid long-term defensive earnings growth. National spending on health care is growing at a rate of 7%, or approximately AUD 10 billion, per year and accounts for almost 10% of GDP. Demand for health-care services will likely increase exponentially as the population ages, with the number people of aged 65 years or more estimated to increase from 14% of the population to 23% by 2050. Medibank operates nationally and, with a solid track record of growth based on customer acquisition and retention, the insurer boasts coverage of approximately 1.8 million policyholders and 3.8 million individuals. Growth is underpinned by product innovation, competitive pricing, modern distribution capability and strong branding.

Exhibit 5. Forecast Proportion of Australia's Population Aged More than 65 Years

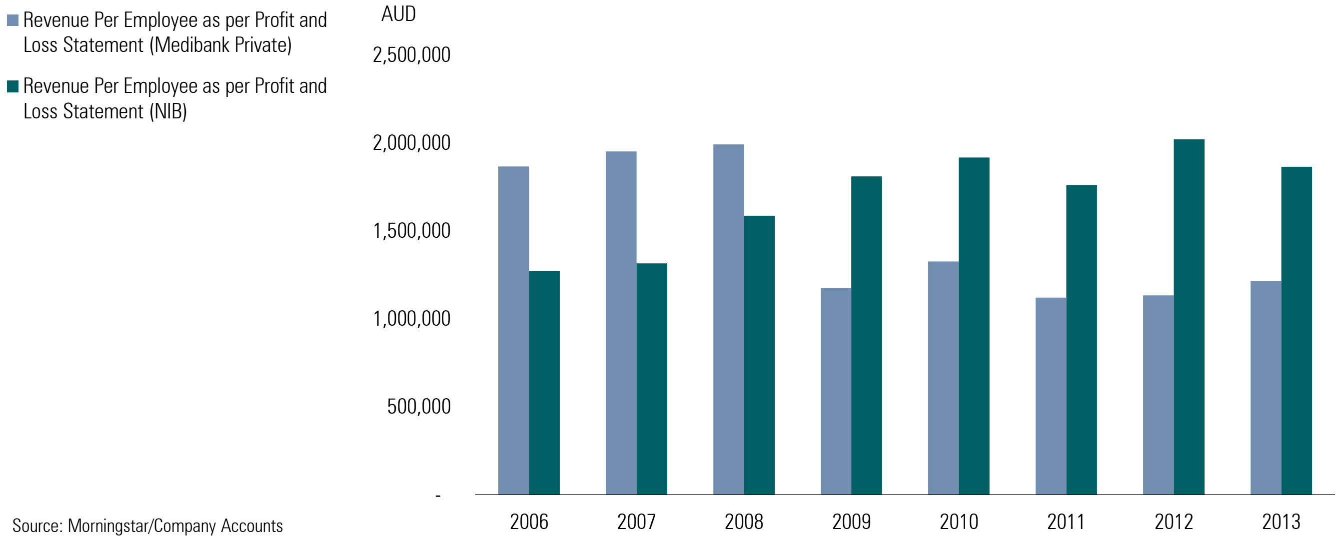


Source: Morningstar, Australian Bureau of Statistics

We expect early gains in profitability to come from productivity improvements as the previously government-run business becomes more shareholder focused. Increased focus on improving legacy process, procedures, contracts and pricing is expected as management will become incentivised to grow the business, improve productivity, lower the cost base, drive up profits and boost returns on equity, or ROE. Over time, ROEs should move from the current mid-teens closer to 20%, delivering potential uplift in shareholder returns. We anticipate improved financial performance during the next three to five years. With respect to potential efficiency gains, group staff numbers have steadily increased from 1,577 in 2007 to 4,819 in 2014 reflecting organic growth and the merger of ahm and Health Services Australia in 2009. It is possible the government sale agreement may prohibit staff redundancies for a number of years. However, growth in revenue with little increase in headcount should generate initial productivity gains and, over time, operating margins should increase.

Revenue per employee for Medibank has averaged AUD 1.2 million during the past five years to June 2013, while listed peer, NIB Holdings, has generated average revenue per employee 50% higher at AUD 1.8 million per year for the same period.

Exhibit 6. Revenue per Employee



Source: Morningstar/Company Accounts

Medibank qualifies for a narrow Morningstar Economic Moat Rating. The heavily regulated health insurance industry and competitive advantages protect existing participants from new competition, and surplus financial returns are unlikely to be eroded any time soon. We prefer companies with protective moats because they tend to produce returns in excess of their cost of capital for extended periods as they are better placed to withstand outside forces.

Australia's Private Health Insurance Industry

Funded by the federal and state governments, Australia's public health system provides heavily subsidised health care to Australian residents. Helping fund public health expenditure is a taxpayer levy of 2.0% on each individual's taxable income, and an additional tax levy for higher income earners without hospital insurance cover. The aim at the national level is to achieve an appropriate mix of publicly and privately funded health services. Despite the heavily government-subsidised public system, 47% of Australia's population of 23.6 million is covered for private hospital treatment, driven by a combination of taxation benefits and penalties, shorter wait times, and a choice of specialist doctor and/or hospital. About 55% of the population, or 12.6 million individuals, hold "general" cover which includes private hospital treatment, dental care, optical, and other ancillary services. Private health insurance costs approximately AUD 4,000 to AUD 6,000 per year for high income earners seeking a "top extras" family policy covering hospital costs and limited ancillary benefits. Private health insurance does not cover out-of-hospital GP and specialist costs.

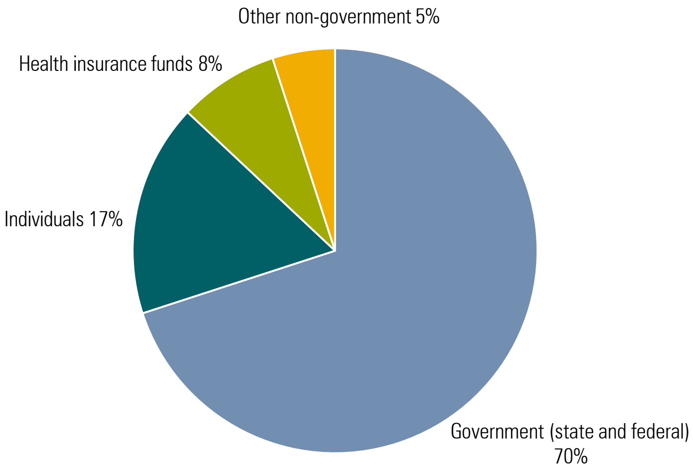
Exhibit 7. Industry Claims Growth

	Jun-09	Jun-10	Jun-11	Jun-12	Jun-13
Medibank Private*	9.9%	6.8%	6.0%	8.6%	6.9%
BUPA Australia/MBF	8.5%	5.6%	6.5%	6.3%	9.0%
HCF	9.4%	11.5%	12.0%	27.2%	11.2%
NIB	9.4%	8.5%	9.5%	11.3%	10.1%
HBF	14.3%	8.8%	7.5%	7.2%	4.4%
Industry	9.3%	7.7%	7.6%	8.9%	9.0%

*Medibank Private includes ahm
Source: Morningstar, Private Health Insurance Administration Council

Medibank and BUPA hold dominant market positions in the highly concentrated and heavily regulated market. There are 34 registered health insurers in Australia, with the top five accounting for 83% of the market. The private health insurance market is efficiently serviced by existing players focused on maintaining high returns on capital, but low relative margins. The private health insurance regulator reported average returns on capital of approximately 33% across the various "for-profit" insurers for the 2011-12 financial year, which we consider attractive. Medibank reported group ROE of 15.4% in fiscal 2013, including the non-health insurance businesses. Despite strong returns, there have been minimal new entrants, supporting our view the industry benefits from effective entry barriers.

Exhibit 8. Australia's Health Expenditure as at June 2012 Estimated to Be AUD 140 billion



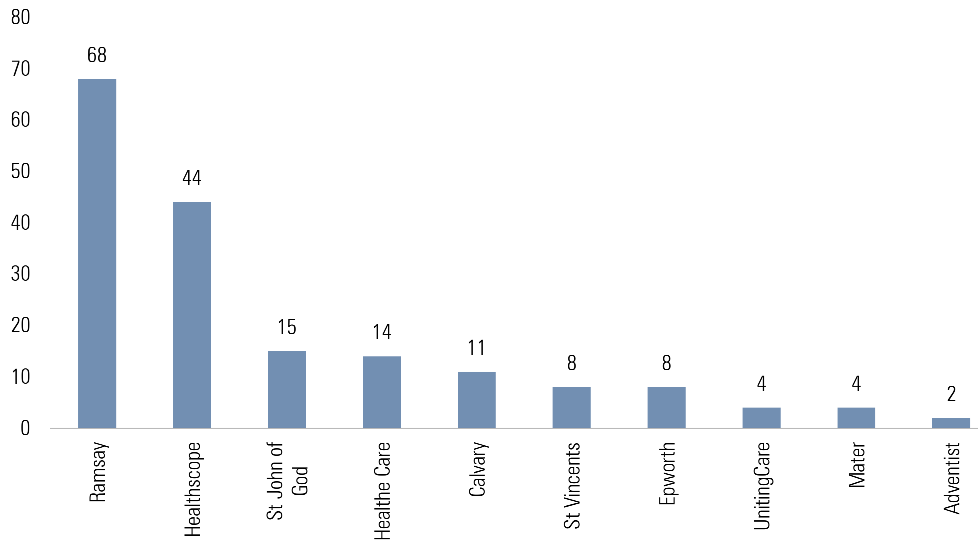
Source: Morningstar, Australian Institute of Health and Welfare

Almost every part of the business of a private health insurer is regulated. Government policy settings are in place to promote the take-up and retention of private health insurance products. Insurance providers still benefit from large numbers of consumers preferring to stay with existing providers despite cost differentials. This is strengthened by the large number of product alternatives and difficulty in product and price comparisons.

Medibank provides health insurance through the Medibank Private and ahm brands, as well as a wide range of related health services. We estimate Medibank's average policyholder age is about 41 years, well above our estimate of NIB Holdings' average policyholder age of 35 years. The five largest funds control over 80% of the industry, with further industry consolidation possible. There are two types of funds: "for-profit"; and "not-for-profit", typically mutual entities. The 24 not-for-profit funds account for 31% of the market while the 10 for-profit funds control 69% of the market. The three largest for-profit funds control 64% of the market with Medibank (29.5%), BUPA (26.8%) and NIB Holdings (7.7%). Not all health funds are open to the public, with 22 open and 12 restricted. Restricted health funds are typically specific industry funds, not-for-profit and open to employees of individual organisations, union members or industry associations. Restricted funds typically cover school teachers, police, railway employees and defence staff.

The industry structure in Australia supports the profitability of all participants despite pricing power on cost inputs being shared between the insurers and the private hospital operators. The insurers have a symbiotic relationship with the private hospital operators, but this relationship is vital to the insurers' profitability as significant amounts of insurers' expenditure is directed to private hospitals. Private health insurers paid out AUD 11.2 billion in recurrent health expenditure in 2011-12, with 49.1% paid to private hospitals. Other major recipients included dental services (11.3%), medical services (10.7%) and public hospitals (7.2%). Concentration is relatively even at present: the five major private health insurers control 83% of the market, which compares to our estimate of 85% control for the five largest private hospital operators. Private hospitals are not regulated as firmly as private health funds.

Exhibit 9. Number of Private Overnight Hospitals Owned or Operated by Key Market Participants



Source: Morningstar, Healthscope

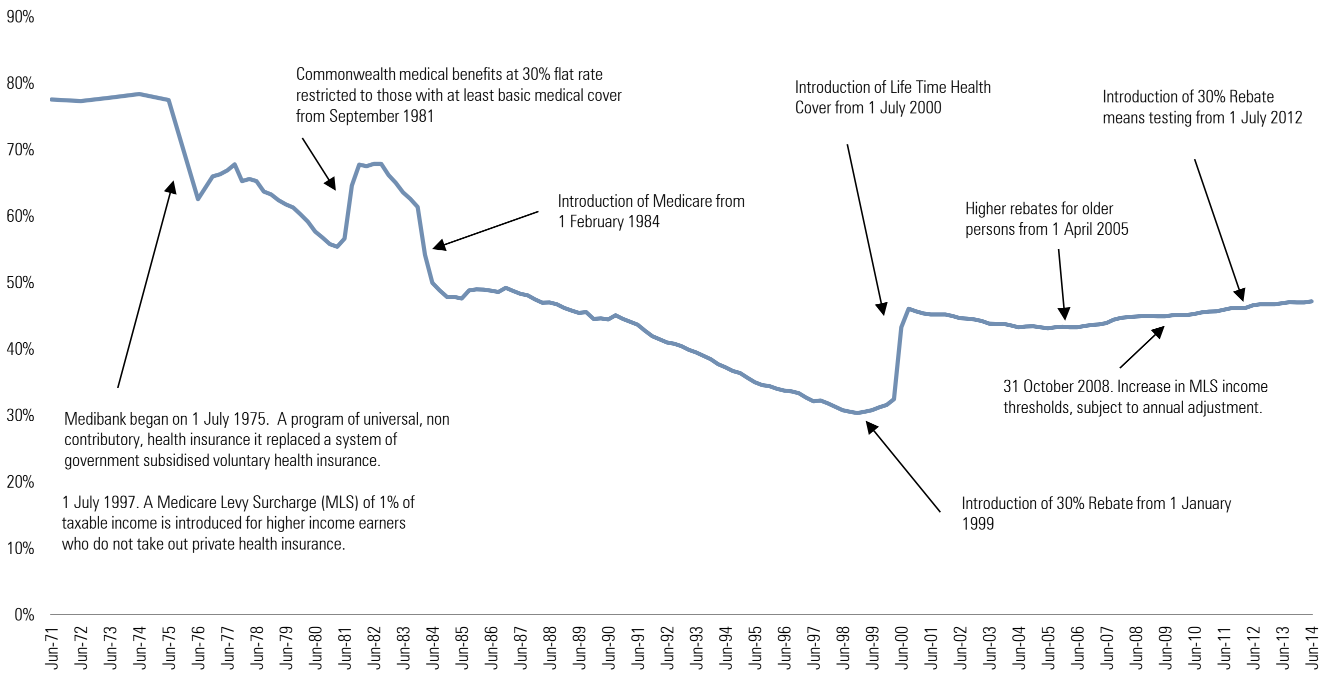
Despite the high cost of insurance and the availability of heavily subsidised health care, private health insurance penetration has increased because of taxation benefits and penalties, shorter wait times, a choice of doctor and hospital, and cover of ancillary health services. Importantly, the private health industry in Australia continues to garner government support. Policies, such as the Medicare Levy Surcharge introduced in 1997 and the private health insurance rebate in 1999, have proven effective, with a dramatic rise in private hospital cover penetration rates, from 30% in 1998 to 47% in 2014. With some assistance from population growth, the number of individuals with private hospital cover has almost doubled, from 5.6 million to 11.0 million during the same period.

Medicare levy surcharge: Individuals who earn more than AUD 88,000 per annum and families earning above AUD 176,000 per annum, and without private hospital cover, are liable for a Medicare levy surcharge, which is charged in addition to the 2% Medicare levy. Depending on an individual's taxable income, the surcharge ranges between 1% and 1.5%.

Private health insurance rebate: The federal government helps cover the cost of private health insurance by providing policyholders an income-tested rebate. The rebate for under-65 year olds ranges from 0% to 29%, and is as high as 39% for those more than 70 years old.

Lifetime health cover: Encourages people to get cover as early in life as possible, with individuals who do not have private health insurance cover before the 1st of July following their 31st birthday and subsequently seeking private health insurance cover, paying a 2% loading above their premium for every year over the age of 30 that they did not have private health insurance. The maximum loading is 70% and is removed if paid for 10 consecutive years.

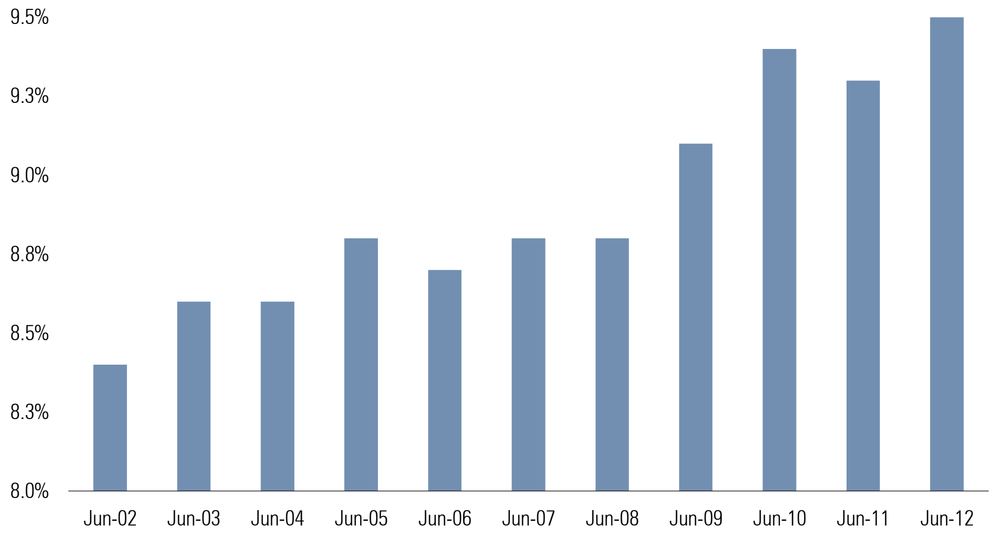
Exhibit 10. Percentage of Australian Population with Private Hospital Insurance Cover



Source: Morningstar/Private Health Insurance Administration Council

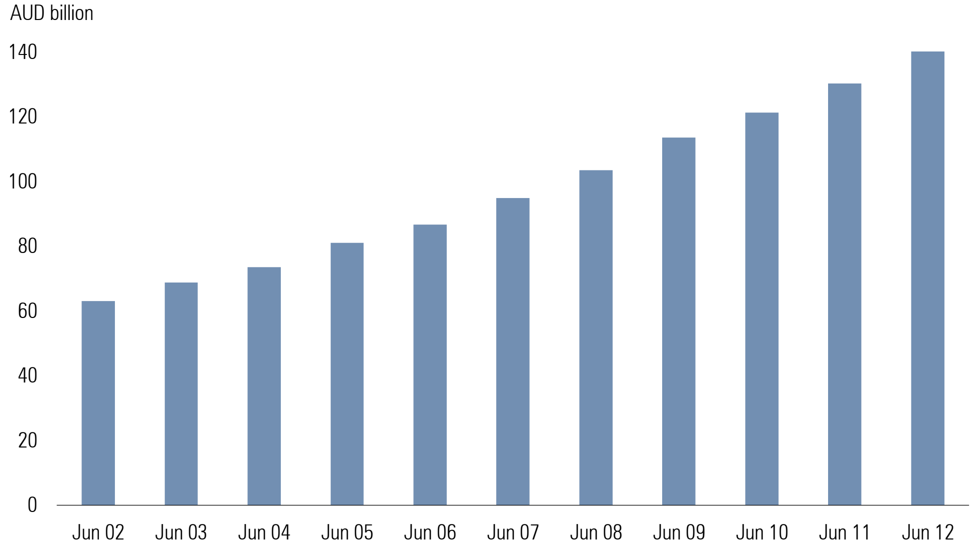
Rising health-care spend in Australia, with the federal and state governments currently contributing 70% of the bill, provides confidence the government will continue implementing incentives and penalties to encourage use of private health insurance, underpinning industry-wide long-term growth. During the past 10 years, total health-care expenditure in Australia has increased at a compound annual growth rate of 7.5%, now in excess of AUD 140 billion. Population growth, an ageing population, increased life expectancy, health awareness, and technological advancements in surgical techniques, devices and pharmaceuticals are expected to continue to drive industry costs higher. The cost to the government is forecast to rise from 4% of gross domestic product to 7% by 2050. Over time, individuals will likely be required to take more financial responsibility for spiralling health-care costs and the government is looking to the private sector to play a greater role in sharing the burden.

Exhibit 11. Australia's Health Expenditure as a Percentage of Gross Domestic Product



Source: Morningstar/Australian Institute of Health and Welfare

Exhibit 12. Health Expenditure in Current Terms



Source: Morningstar/Australian Institute of Health and Welfare

Regulated under legislation, health funds apply to the federal health minister on an annual basis for approval to raise premiums, with the onus on the funds to demonstrate the price increase is necessary to cover the cost of paying out benefits to members. Premium increases apply from 1 April each year for all registered private health funds. The Private Health Insurance Administration Council, or PHIAC, reviews the proposal, and, while not entirely transparent, we believe it takes into consideration a fund's net margin (generally in the order of 3% to 6%), management expense ratio (about 9%), and projected claims costs.

Exhibit 13. Average PHIAC-Approved Premium Increases Effective 1 April Each Year

	2010	**2011**	**2012**	**2013**	**2014**
Medibank Private	5.7%	5.4%	4.7%	6.2%	6.5%
BUPA Australia	5.4%	5.1%	4.9%	5.8%	6.4%
HCF	5.9%	6.4%	5.9%	5.7%	6.9%
NIB	6.0%	6.2%	5.5%	6.5%	8.0%
HBF	5.0%	5.9%	5.9%	3.8%	3.7%
Industry Average	5.8%	5.6%	5.1%	5.6%	6.2%
CPI for the June Year End	3.1%	3.6%	1.2%	2.4%	3.0%

*Premium increases are approved by Private Health Insurance Administration Council and the Federal Health Minister. They are effective 1 April each year.

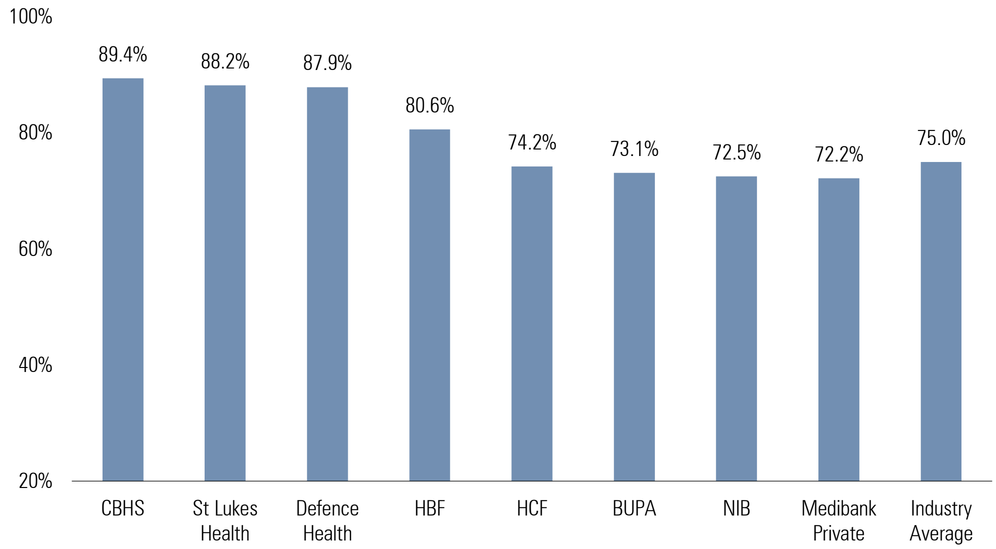
Source: Morningstar, The Department of Health, Australian Bureau of Statistics

Given relatively regulated returns, premium increases are generally similar across the industry, but can vary between periods. For example in fiscal 2002, Medibank passed on an 8.9% price increase compared with the industry at 6.9% and NIB Holdings at 2.8%. In 2004 and 2005, NIB Holdings made up for this mispricing with large 9.1% and 13.9% premium increases, well above the industry. NIB Holdings received PHIAC approval to increase premiums 7.99% effective 1 April 2014 while Medibank's 6.49% increase was closer to the industry average of 6.2%. During the past five years, Medibank's annual premium increases have averaged 5.7%, in line with the industry average, but well below NIB Holdings' 6.4%. Given Medibank is a government-owned entity, it is possible that it has not increased premiums to the full extent it is entitled to, for the benefit of policy holders.

Private Health Insurance Customer Satisfaction

Based on independent analysis by Roy Morgan Research, 75% of private health insurance customers are "very" or "fairly" satisfied with their insurance provider for the 12 months ended 30 June 2014. Not surprisingly, the largest insurers that are also for-profit operators have the lowest customer satisfaction levels. Market leader Medibank (29.5% market share) boasts 72.2% of customers satisfied, with BUPA (26.8% market share) at 73.1%. NIB Holdings, with 7.7% market share, has 72.5% of customers satisfied. The two large not-for-profit insurers HCF (10.8% market share) and HBF (7.5% market share) have customer satisfaction levels of 74.2% and 80.6% respectively. HBF is the only insurer of the big five with a customer satisfaction level above the industry average of 75%. HBF has consistently improved its customer satisfaction the most, moving from 70.7% in 2010 to above 80% in 2014. Medibank Private has done reasonably well, modestly increasing satisfaction from 67.3% in 2010 to more than 72% in 2014.

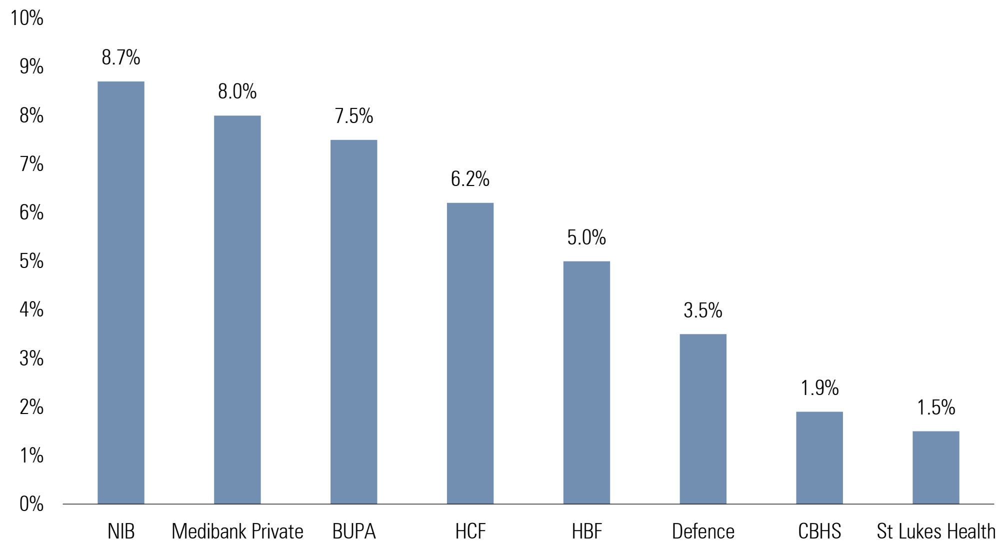
Exhibit 14. Private Health Fund Customer Satisfaction



Source: Morningstar/Roy Morgan Research

The smaller not-for-profit insurers typically have higher customer satisfaction levels, well above the industry average, with CBHS the highest at close to 90%. Market leaders in customer satisfaction, Westfund, CUA Health and St. Lukes Health, have each boosted satisfaction levels in the past five years. Of more concern than the lower customer satisfaction levels for NIB Holdings and Medibank Private, these insurers also rank highly for customer dissatisfaction, with 8.7% of NIB Holdings' customers and 8% of Medibank Private's customers either "very" or "fairly" dissatisfied with their health insurance company.

Exhibit 15. Private Health Fund Customer Dissatisfaction



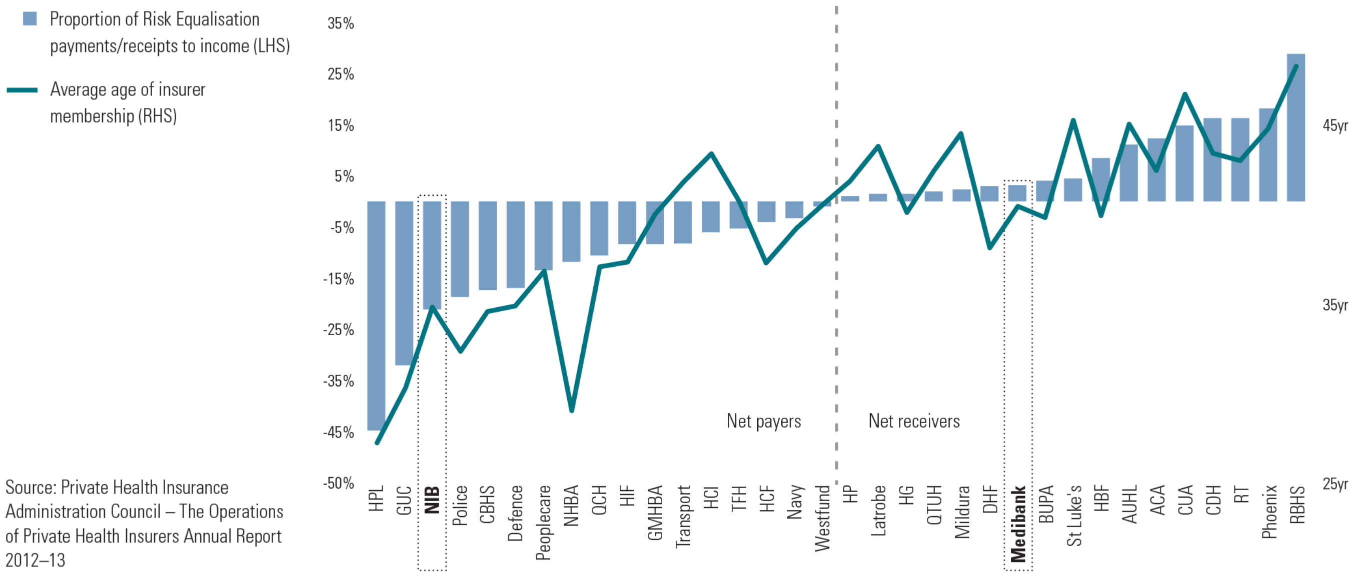
Source: Morningstar/Roy Morgan Research

Risk Sharing Across the Industry

The regulation of domestic health insurance has its own idiosyncrasies, largely based on the concept of community rating. Community rating is a principle that prevents private health insurers from discriminating between policy holders on the basis of health status, age, race, sex, sexuality and prior claims history. Essentially this means consumers have the right to purchase the same product, at the same price, with a guarantee of policy renewal.

The principle of community rating is supported by an industry mechanism called risk equalisation. It aims to average out the cost of hospital treatment across the industry, by transferring money from private health insurers with younger healthier members (such as NIB Holdings) which typically have lower average claims, to insurers with an older and less healthy book of policies. Medibank has a higher proportion of members more than 55 years old and therefore its policyholders are more likely to require higher levels of hospital and medical treatment and, as such, it receives risk equalisation payments from the Risk Equalisation Trust Fund.

Exhibit 16. Risk Equalisation Flows Across the Industry



Source: Private Health Insurance Administration Council – The Operations of Private Health Insurers Annual Report 2012–13

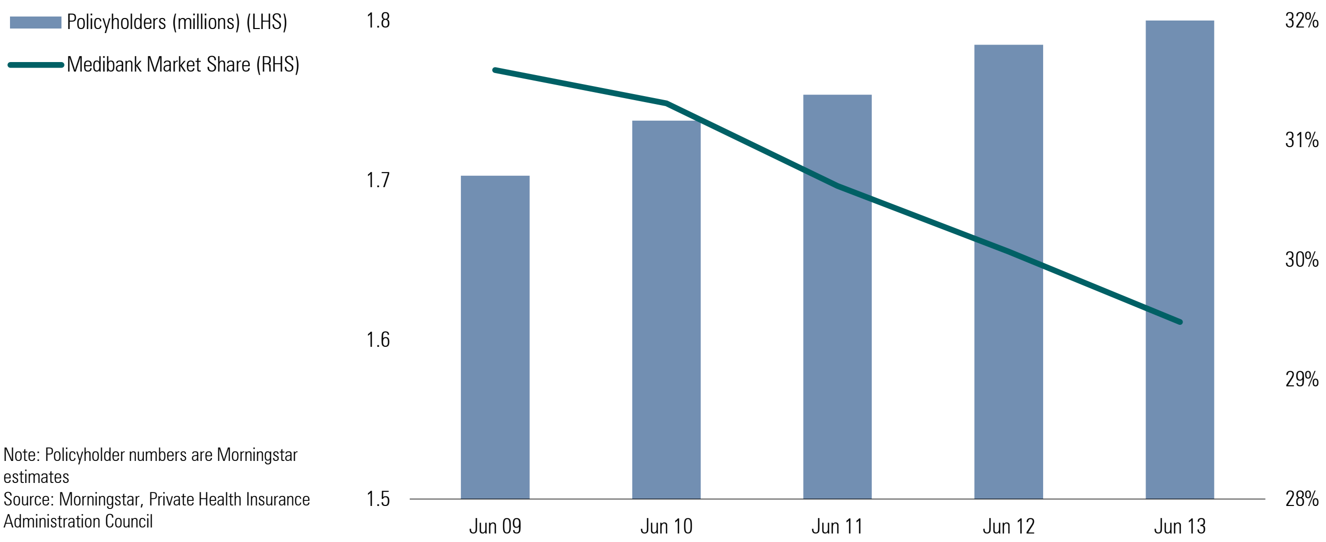
NIB Holdings contributed AUD 191 million into the Risk Equalisation Trust Fund for fiscal 2014 while Medibank received a AUD 98 million risk equalisation payment in fiscal 2013 (Medibank's 2014 figures are not yet available). The AUD 98 million received by Medibank in 2013 represented 1.8% of premium income.

The risk equalisation levy means older and less healthy policyholders remain relatively profitable irrespective of their increased burden on the health system. Older policyholders are generally more loyal. NIB Holdings confirms the lapse rate of policyholders under 40 years of age is materially higher than those more than 40. The twin government policies of risk equalisation and community ratings make the industry less efficient as health funds are not incentivised to attract the lowest-risk customers as higher hospital claims costs are partially subsidised by funds across the industry. The unique industry structure and risk sharing makes consolidation less of a priority, and partly explains why there are so many subscale providers. NIB Holdings has tried to take over smaller funds in Australia but, to date, has not been successful.

Medibank

Medibank has shared in the spoils of a growing market, but not to the extent of some of its more successful peers. During the five years to 30 June 2013, Medibank achieved average annual policyholder growth of 1.8% per annum, below the industry growth rate of 3.2% per annum. We believe Medibank has opportunities to better utilise its scale, shared marketing costs, and purchasing power to reverse this trend. Medibank has a tiered brand strategy, where ahm is used as a no frills low-cost option, though it has been less successful than NIB Holdings in attracting the under-40 age group. NIB Holdings has been taking share, and we believe its brand and product offering tailored to attract the under-40 demographic is benefiting from the government's introduction of lifetime health-care cover which incentivises younger residents to obtain health cover. Winning these younger customers on low-cost "basic-hospital" cover provides upselling and cross-selling opportunities in the long term.

Exhibit 17. Medibank's Market Share and Estimated Policyholder Numbers



Note: Policyholder numbers are Morningstar estimates
Source: Morningstar, Private Health Insurance Administration Council

Medibank's customer-focused strategy aims to drive growth and profitability, reduce the rate of market share loss, and protect its industry leadership position. We believe the core of Medibank's growth strategy is to provide cover which is easy to understand, priced competitively, and tailored to different market segments. Exerting its purchasing power to contain health-care costs should also help limit premium increases and retain satisfied customers. While there are some switching costs in a competitive market where choice is abundant, customer satisfaction is paramount.

Auxiliary initiatives, such as Medicare Health Solutions, bring opportunities to acquire new customers, such as co-ordinating health care for the Australian Defence Force, and Anywhere Healthcare which allows regional and remote Australians to consult with specialists online. Its 24/7 health advice can be used to attract new clients whose particular lifestyle it suits. Medibank has potential to further cross-sell its 1.8 million health insurance policyholders with life, travel, and pet insurance.

Despite being Australia's largest private health insurer, we believe Medibank has failed to fully utilise its scale, and is, in fact, one of the least profitable of the five large players based on net insurance margins. While being a government-owned enterprise does not necessarily mean a bloated cost base or poor underwriting skills, we would expect a cost-out program and a business simplification project following privatisation to boost opportunities for earnings improvement. The prospectus and discussions with management will shed further light on the business and opportunities to improve performance. Apart from HBF, Medibank's management expenses as a percentage of revenue, or MER, is the highest of the large players at 9.2%. This is well above the average of its four key competitors at 8.4%, and only fractionally better than the MER of the small industry players at 9.3%. Costs spread across a larger customer and revenue base help lower the MER. As a result, Medibank's net margin of 3.6% is much stronger than small competitors who, on average, make a modest 2.8%, but it is below the average of its large peers at 4.8%, suggesting potential upside to earnings from more efficient operations is likely.

Exhibit 18. Industry Management Expense Ratio (MER) Summary

	Jun-08	Jun-09	Jun-10	Jun-11	Jun-12	Jun-13
Medibank Private	10.3%	9.7%	8.9%	9.4%	10.3%	9.2%
BUPA Australia/MBF	11.9%	11.2%	9.9%	9.3%	9.5%	8.5%
HCF	7.9%	7.8%	7.3%	6.9%	7.3%	7.1%
NIB	11.7%	9.9%	9.6%	9.1%	8.6%	8.2%
HBF	10.5%	10.0%	9.3%	9.4%	9.0%	9.9%
Industry	10.5%	10.0%	9.2%	9.1%	9.3%	8.8%

Source: Morningstar, Private Health Insurance Administration Council

Medibank passed on the lowest premium rate change of the top six funds in the industry, with an average increase of 4.7% in 2012. This was one of the lowest increases in 10 years, and the fifth consecutive year of below-industry-average premium increases. This increase was insufficient to offset higher costs from its Mi Health support services rollout and higher claims. It is available to Medibank members with hospital cover. In 2012 members claimed AUD 4.3 billion in health benefits, up by AUD 340 million, or 8.6% more than in 2011. By comparison, this was almost double the increase in premiums charged to members. In 2013 and 2014, Medibank's average premium increases of 6.2% and 6.5% marginally exceeded the industry average of 5.6% and 6.2%.

If successful, Medibank's growth and productivity improvement strategies have meaningful valuation implications, thanks to rising insurance margins and earnings potential. More than 38 years of government control suggests network efficiencies were not a major focus. The challenge is to increase the efficiency in underwriting policies and handling claims. This will result in more revenue and, because of operating leverage, even more profit per unit of capital, and so higher profit and dividends per share.

Exhibit 19. Industry Net Margins

	Jun-08	Jun-09	Jun-10	Jun-11	Jun-12	Jun-13
Medibank Private	5.5%	3.3%	4.9%	5.7%	3.6%	3.6%
BUPA Australia/MBF	3.7%	3.1%	5.7%	7.2%	7.3%	6.6%
HCF	2.1%	2.8%	1.4%	1.7%	2.0%	1.3%
NIB	2.9%	4.8%	5.2%	6.1%	6.0%	5.0%
HBF	6.3%	1.7%	2.8%	3.1%	4.7%	6.3%
Industry	4.3%	3.2%	4.5%	5.6%	4.9%	4.3%

Source: Morningstar/Private Health Insurance Administration Council

Medibank Benefits from a Narrow Economic Moat

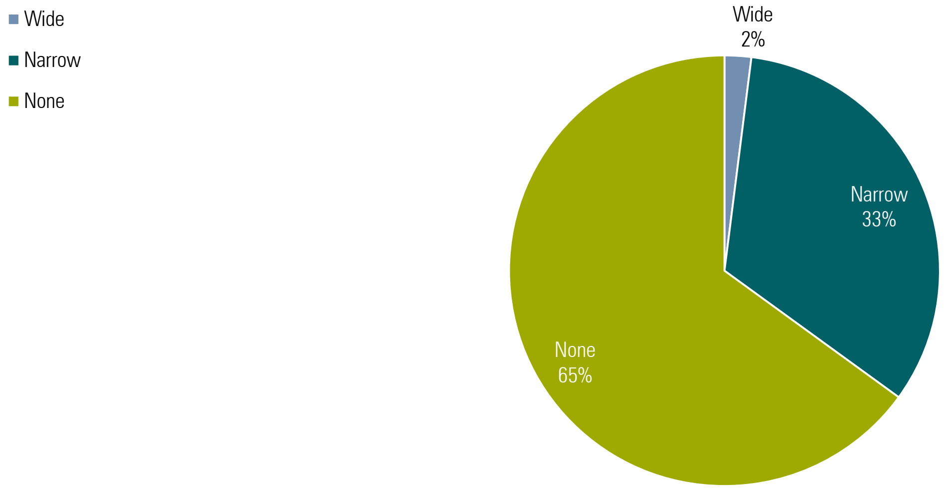
Medibank qualifies for a narrow Morningstar Economic Moat Rating. Medibank's narrow moat stems from its sustainable advantage in being able to consistently underwrite insurance policies that are sufficiently profitable to generate returns well in excess of its cost of capital. The combination of policy pricing expertise, economies of scale, customer switching costs, strong brand, and a heavily regulated oligopoly provide enduring competitive advantages.

The firm's large scale reduces input costs in the underwriting and claims process. Combined with its pricing expertise, this has delivered a long track record of underwriting profitability. Medibank's combined operating ratio averaged 95% during the past 10 years and at no stage has the ratio exceeded 100%. Scale also provides the opportunity for administrative costs to be lower than competitors, but, as a government-run operation, costs are currently higher than peers. Medium-term opportunities exist to improve productivity with a targeted cost-out strategy. Australia's nationally regulated health system and concentrated private hospital system create opportunities for insurers to improve productivity and profitability. Health insurance does not require large numbers of specialised underwriters, and modern technology is shifting large numbers of transactions online, further reducing the demand for human resources. Additionally, bargaining power from Medibank's large scale provides control over some input costs. In some instances, the process of winning and retaining work for private health insurers is intensely contested and very price competitive.

Competitive advantage also stems from the fact that Medibank is a major player in a rational oligopoly operating in a limited market. Potential new entrants are deterred by complex regulation, the need to form direct relationships with hospitals and medical professionals, and high costs of compliance within the health industry. Regulatory hurdles include minimum capital requirements and liquid asset holdings.

Strong brands and high customer loyalty create customer switching costs, but alone are not sufficient to justify a narrow moat. Industry data indicates policyholders are increasingly mobile — switching health insurers and seeking out the best offers in the market. Despite increasing churn and improved access to information online, the majority of policyholders take a "set and forget" approach. This is reinforced by product complexity, which dampens the consumer's capacity to compare and change products. Unlike property and motor vehicle insurers, which sell commoditised products, health insurance products are increasingly tailored and specialised. The wide range of choices in the market discourages consumers from switching because of the time required to compare the different products. Waiting periods before being able to claim for some services can also deter customers from switching.

Exhibit 20. Morningstar Economic Moat Rating Distribution for Insurance Companies Within Morningstar's Global Coverage Universe



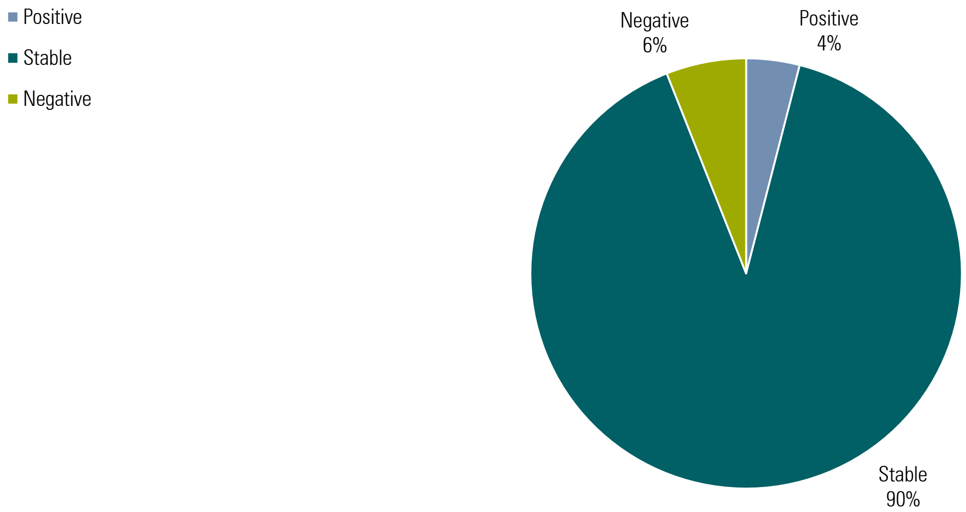
Source: Morningstar

Medibank is precluded from a wide Morningstar Economic Moat Rating because of the concentrated nature of the health services suppliers, the potential for adverse regulatory changes and political risk. Rapid advances in technology could disrupt the bricks-and-mortar retail branch network, enabling low-cost new entrants to move into the industry. We are uncertain excess shareholder returns are more than likely 20 years from now. Customers tend not to pay a meaningful premium for brand and products are easily replicable making cost structure the key differentiator. Morningstar covers 48 insurance companies globally with only Berkshire Hathaway (NYSE:BRK.A) deserving of a wide moat rating. Narrow-moat insurers account for 33% of the total under coverage with two-thirds of global coverage lacking sufficient competitive advantages to justify a moat.

Moat Trend

Medibank's strong competitive position underpins a stable moat trend. Despite strong industry tailwinds, we consider hurdles are high enough to make it difficult for new entrants to establish viable competition and destabilise the rational and profitable oligopoly. Given Australia's ageing and growing population, demand for health-care services will continue to rise, putting additional pressure on Australia's struggling public health-care system and increasing reliance on the private health-care system. The Australian government spent 4% of total GDP on health care, or approximately 16% of the total Australian national budget, during the 2013-14 budget year. Support for private health care is politically agnostic. Various government initiatives designed to shift the cost of health care to the private system are already in place, and we believe this will continue into the future, providing a robust platform for growth for the health insurance industry.

Exhibit 21. Morningstar Economic Moat Trend Rating Distribution for Insurance Companies Within Morningstar's Global Coverage Universe



Source: Morningstar

Private health insurers continue to experience claims inflation. Both the price and volume of claims have been increasing. This is to be expected as the population ages, specialty skills of medical staff increase, medical technology becomes more expensive and advancements in medical procedures and treatments continue. The problem is exacerbated by pronounced skills shortage for nurses, doctors and specialists. However, government immigration policies attempt to address this. While claims inflation is an issue, we see the health system regulator as rational enough to allow premium increases to offset this effect.

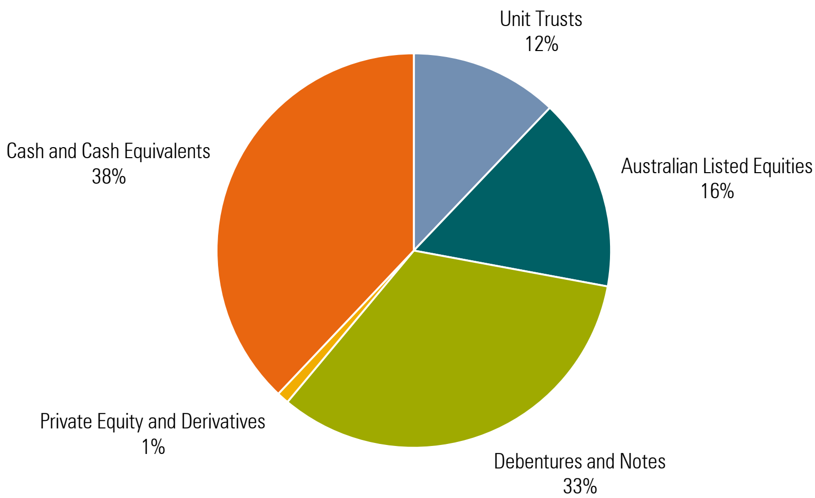
Capital Management

Medibank is a profitable government business enterprise and pays dividends to the Australian government. The payout ratio for ordinary dividends has averaged 55% during the three years to 30 June 2013, representing total dividends of AUD 351 million. In addition to the ordinary dividends, Medibank paid special dividends for fiscal 2011 (AUD 300 million), 2012 (AUD 40 million) and 2013 (AUD 300 million). Following privatisation, we anticipate a dividend payout between 60% and 70%, consistent with listed peer NIB Holdings. Further details on dividend policy, solvency and capital adequacy will be contained in the prospectus.

Investment Portfolio

Medibank reported total cash and investments of AUD 2.3 billion at 30 June 2013. The cash and investment portfolio was split 38% cash, 33% fixed interest, 16% Australian equities, 12% unit trusts and 1% private equity and derivatives. Medibank's investment strategy is higher risk than general insurers Insurance Australia Group, Suncorp Group and QBE Insurance, but not as high as listed health insurer peer NIB Holdings. Growth assets account for 29% of Medibank's investment portfolio compared with NIB Holdings' Australian investment portfolio weighted 39% to growth and 61% defensive assets. Medibank's relatively high proportion of investments allocated to risky assets is reasonable given the low volatility in health insurance claims from year to year.

Exhibit 22. Medibank's Investment Portfolio as at 30 June 2013 (AUD 2.3 billion including cash)



Source: Morningstar/Company Accounts

Risks

The biggest risk is that demand for insurance wanes unexpectedly, but we consider such an outcome highly unlikely for the next decade at least as the Australian government grapples with a rapid increase in health system spending and demand for health services. The Australian Treasury forecasts federal government health-care spending to increase from 4% currently to 7% of GDP by 2050.

Tight regulation is both a positive and negative in that it protects downside and caps upside. Registered health insurers cannot raise premium prices without regulatory approval. This could leave Medibank exposed to political pressures, especially if it is perceived as being "overly" profitable. The national private health insurance regulator approved an average 6% increase in Medibank's premiums effective 1 April 2014. In June 2012, the government enacted changes which precluded high income earners from receiving the 30% private health insurance rebate. Future changes to the rebate system could impact profitability.

Claims inflation is a product of the aging population, skills shortages and the cost of new medical equipment, procedures and treatments, all of which will likely worsen in the medium term. Private hospitals have meaningful bargaining power as the Australian market is dominated by a small number of operators. Medibank could be unable to recover cost increases in a more adverse regulatory environment.

Medibank could be tempted to make expensive acquisitions rather than focus on organic growth. It makes more sense for the insurer to continue to vertically expand into the provision of ancillary medical services such as dental and eye-care clinics. This could potentially give rise to intangibles (brand awareness), provide differentiation to competitors, and be less capital intensive than a life insurance line. It also provides a means for Medibank to gain greater control of claims inflation, especially since it would be in control of the services. Medibank will likely have a strong unleveraged balance sheet following privatisation, giving it the firepower to pursue growth opportunities.

Other risks include increasing lapse rates caused by weaker economic conditions, higher-than-expected claims costs, pricing risks, greater utilisation of hospital and ancillary services and lower investment returns. The threat of increased competition from existing participants and potential new entrants is increasing.

Company Background

Medibank is based in Melbourne and is Australia's largest private health insurer with 1.8 million policyholders covering approximately 3.8 million people under the Medibank and ahm brands. Medibank Private was established in 1976 to bring increased competition to the private health insurance industry. The insurer has evolved into Australia's largest private health insurer and health services business, employing close to 5,000 staff including 1,500 health professionals. Medibank is Australia's most profitable government business enterprise and in fiscal 2013 reported revenue of AUD 5.9 billion and net profit of AUD 233 million.

Medibank holds a 29.5% share of the national private health insurance market. The insurer has a strong capital position and an ungeared balance sheet. The strong focus on customer acquisition and retention, product innovation, competitive pricing, contemporary distribution and brand positioning has established a strong base for future growth in earnings and dividends.

Management and the board appear to be doing a good job as past operating performance has been solid, the growth strategy makes sense and acquisitions appear to have added value. Stakeholder stewardship is good and when assessed under Morningstar methodology, stewardship is ranked "Standard". George Savvides was appointed managing director of Medibank in April 2002. Prior to this, he was on the board of Medibank serving as a non-executive director, and was previously managing director of Smith & Nephew Australasia and Sigma Co.

During the 12 years leading Medibank, Mr Savvides has overseen strong growth, with revenue increasing from AUD 2.0 billion in fiscal 2002 to AUD 5.9 billion in fiscal 2013. He also oversaw the acquisition of ahm (Australian Health Management) and the merger with Health Services Australia in 2009. As a result, the Health Solutions Division of Medibank was established, which offers occupational health services, preventative treatment and health coaching programs. George Savvides has more than 25 years' corporate leadership experience in the health-care industry and is currently vice president of the International Federation of Health Plans. He is a Member of the Business Council of Australia.

Elizabeth Alexander was appointed a director in October 2009 and chairwoman in March 2013. Ms. Alexander is currently chairwoman of Dexus Wholesale Property Limited, a director of Dexus Property Group, and serves on the board of the Australian International Health Institute. She is the Chancellor of the University of Melbourne and chairs its finance committee. In addition to the chairwoman and managing director, Medibank's six non-executive directors are Anna Bligh, Dr. Cherrell Hirst, Peter Hodgett, Linda Bardo, Christine O'Reilly and David Fagan.

Appendix – Medibank Financial Accounts

AUD Million	**Fiscal 2011**	**Fiscal 2012**	**Fiscal 2013**	**2013 v 2012 Change**
Health Insurance Premium Revenue	4,738	5,062	5,344	5.6%
Net Claims Incurred & Levies	(4,014)	(4,394)	(4,696)	6.9%
Net Risk Equalisation Trust Fund	29	83	98	18.1%
Underwriting Expenses	(450)	(539)	(509)	(5.6%)
Underwriting Insurance Result	303	212	237	11.8%
Investment Income	162	43	144	234.9%
Insurance Profit	465	255	381	49.4%
Medibank Health Solutions	258	279	498	78.5%
Operating Expenses	(295)	(337)	(564)	67.4%
Pre-Tax Profit	428	197	315	59.9%
Income Tax	(129)	(71)	(82)	15.5%
Net Profit After Tax (NPAT)	299	126	233	84.9%
Claims Ratio	84.1%	85.2%	86.0%	88 bps
Management Expense Ratio (MER)	9.5%	10.6%	9.5%	-112 bps
Insurance Margin	6.4%	4.2%	4.4%	25 bps
Combined Operating Ratio	93.6%	95.8%	95.6%	-25 bps
Earnings Per Share (cps)	3.53	1.49	2.74	83.9%
Dividend (cps)	1.76	0.90	1.47	63.3%
Special Dividend (cps)	3.53	0.47	3.53	Large
Franking	n/a	n/a	n/a	

Source: Morningstar, Company Accounts