ELECTUS
FUND MANAGERS

Neil Brown & Richard Hasson
Co-Heads

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THE SOUTH AFRICAN PRIVATE SECTOR HOSPITAL INDUSTRY AND ITS LISTED COMPANIES – WILL THEY RECOVER OR IS IT TERMINAL?

by Neil Brown

Background:

I first became a designated research analyst on the South African (SA) Healthcare industry and its related companies in the mid-1990's. Over the past 20 years, there have been a few times that I have been the designated research analyst for the SA Healthcare sector, while I have always been an SA fund manager, able to invest across the SA Healthcare sector. The SA Healthcare sector incorporates both listed private sector hospital companies (Mediclinic, Netcare and Life Healthcare) as well as listed Pharmaceutical companies (Aspen and Adcock).

The latter half of the 1990's was when the SA private hospital industry consolidated and when the hugely successful Pharmaceutical company, Aspen, became listed and investable with the acquisition of the much larger company, SA Druggists. Essentially, for investors on SA's JSE, the SA Healthcare sector "came of age" in the latter half of the 1990's.

The purpose of this Strategy Note is to focus on the SA private hospital industry within the SA Healthcare sector and the SA listed companies, Mediclinic, Netcare and Life Healthcare. To best understand the SA private hospital industry and Mediclinic, Netcare and Life Healthcare, we thought it is best to analyse the past 20 years. The pharmaceutical industry has little in common with the hospital industry, with its very different business drivers and models, so in this Strategy Note we do not cover the pharmaceutical industry in any detail.

History of the SA Private Sector Hospital Environment:

In the mid-1990's Mediclinic was well established and, as it is today, a listed subsidiary of Remgro. Life Healthcare was also well established and listed in the form of Afrox Healthcare, a subsidiary of Afrox. In 2005 Afrox Healthcare was sold to private equity firms and delisted, changing its name to Life Healthcare. In 2010, Life Healthcare was once again listed on SA's JSE. Netcare was founded in 1994 and listed on the JSE in 1996. Importantly, in the mid-1990's, the SA hospital environment was extremely fragmented, with several hospital owners.

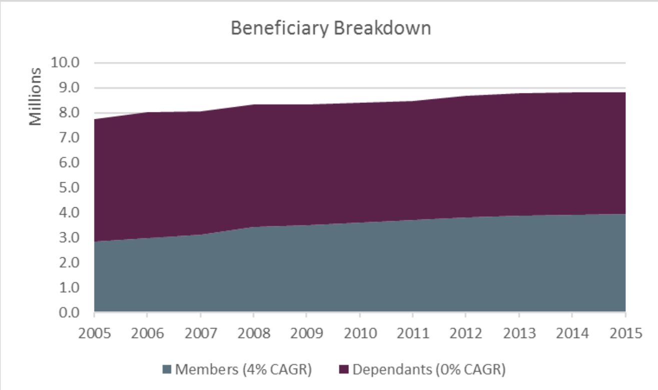
In the latter half of the 1990's the SA hospital environment changed dramatically, with the three listed hospital companies becoming very acquisitive and consolidating the SA hospital market. During 1995-2000 Mediclinic, Netcare and Life Healthcare together acquired just over 100 hospitals across SA and a strong private sector "Big 3 Oligopoly" was formed. These three listed hospital groups are now of similar size in SA, managing ±160 SA hospitals in aggregate in 2017 and account for ±80% of the private hospital beds in SA, while individually, they are easily larger than any other private sector competitor.

With the newly consolidated SA hospital environment and a restriction on the issuing of new hospital licences in SA, the relaxation of SA's Exchange Controls enabled the three SA listed hospital companies to look offshore for further investments. Since 2005 the three SA listed hospital companies, with their very strong SA businesses, have all made offshore acquisitions, with varying degrees of success. These offshore investments are important in determining the quality of Mediclinic's, Netcare's and Life Healthcare's businesses, which we discuss later in this Strategy Note.

SA Private Sector Hospital Dynamics:

The key drivers for hospital companies are volume and pricing. In SA, the volume is based on the number of people who have private medical aid cover. In SA, there are ±9m beneficiaries with private medical aid cover, being ±17% of SA's total population, consisting of ±4m primary members and ±5m dependents (See Chart 1).

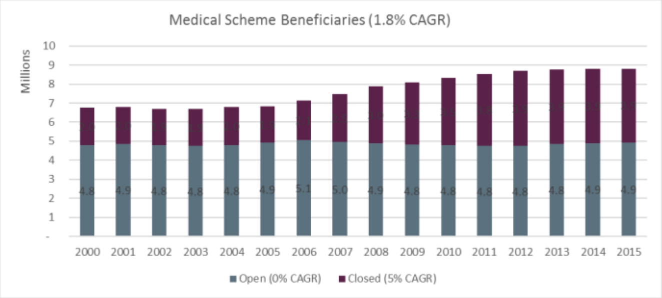
Chart 1: SA Medical Aid Beneficiaries



Source: Council for Medical Schemes

These ±9m beneficiaries consist of ±5m in Open schemes and ±4m in Closed schemes (See Chart 2).

Chart 2: SA Medical Aid Beneficiaries



Source: Council for Medical Schemes

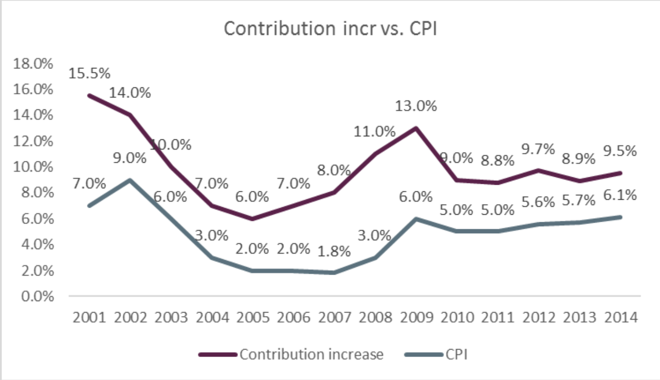
In the above Chart, the only meaningful increase in beneficiaries has been due to the launch in January 2005 of SA's Government Employees Medical Scheme (GEMS), a Closed scheme for Government employees, which now totals almost 2m beneficiaries. With a vast gap between the private sector and public sector hospital experience, private sector medical aid cover is expected by the formally employed. It should be mentioned that the key gatekeeper for the private hospitals are the doctors, who, due to legislation, are not allowed to be employed by the private hospitals.

From the mid-1990's until the mid-2000's, the environment was almost perfect for the SA hospital companies. The "Big 3 Oligopoly" grew stronger, the number of people with private medical aid cover grew gradually and pricing increased well above SA's inflation rate. There was also almost zero negative legislative or regulatory impact by the SA Government and Medical Schemes.

Since the mid-2000's the environment for SA hospital companies and medical aid beneficiaries has become increasingly tough. The key problem is that since 2011 the SA private hospital costs have risen between 10%-11.5% per annum, which is well above general inflation, and is largely due to the high cost of nursing staff training and salary increases, the capitalised cost increases of equipment that is required to attract top surgeons and the ongoing capitalised cost of property management and development.

At the same time, medical aid contribution increases have risen by ±9% per annum, which is also well above general inflation, and is mainly due to the above-mentioned SA private hospital cost inflation, while a portion is probably a result of high medical scheme administration costs (See Chart 3).

Chart 3: SA Medical Aid Contribution Increases



Source: Council for Medical Schemes

Both the above-mentioned private hospital cost and medical aid contribution increases are well above SA's general inflation rate, which since 2011 has been between 5-6%. The high cost inflation for the SA private hospital and other areas of private healthcare, has led to an ever-increasing portion of private sector treatment having to be funded by "out-of-pocket" payments by patients with medical aid.

There have been increasing pressures brought onto the SA hospital companies by tougher legislative and regulatory impact by the SA Government and Medical Schemes, who are attempting to lower the medical inflation rate and align it more closely with SA's general inflation rate. The SA hospital industry is now mature in the private sector, which is part of the reason that the SA hospital companies are growing into aligned segments such as Day Clinics and Mental Health.

Legislative and Regulatory Impact on SA Private Hospital Companies:

The first major legislative change introduced by the SA Government was the Single-Exit drug pricing, which was introduced in 2004. This effectively limited the pricing of drugs charged by hospitals and pharmacies, hurting one of the hospitals' profit streams. A positive impact of this legislation was that, in aggregate, SA hospitals and pharmacies started selling a steadily increasing ratio of cheaper generic drugs relative to patented drugs.

While the SA Government has historically tried to "manage" the pricing charged by private hospitals, this has never been successfully implemented. Currently the private hospitals negotiate annual tariff increases with each Medical Scheme Administrator, which means that the "tug of war" is between the private hospitals and the Medical Scheme Administrators, who have consolidated and grown in strength since the mid-2000's. The three largest Medical Scheme Administrators – Discovery Health, Medscheme and Metropolitan Health – administer ±75% of Medical Scheme members. The Medical Scheme Administrators use this greater strength to try to limit the hospital annual price increases to close to inflation. The private hospital bills to the Medical Schemes consists of "ward, theatre and equipment" charges, while the "pharmacy" charge is billed at the cost price to the hospital.

Because of the above "tug of war" on pricing between private hospitals and other areas of private healthcare and the Medical Scheme Administrators, there has been a gradually increasing percentage of the hospital bills that are not covered by the Medical Scheme and this must be borne by the patient. As mentioned above, this is referred to as the "out-of-pocket" payment and its growth is likely to put increasing pressure on patients, who must make financial sacrifices elsewhere.

Since the mid-2000's the SA Government has been keen to introduce a policy of National Health Insurance (NHI). The policy has been put forward by the Department of Health and National Treasury, but due to its complexity and cost, has not progressed much beyond Primary Healthcare services. Ideally the Government would like the NHI to be financed by all SA residents, who will then be able to utilise the health services provided by both public and private hospitals and doctors. The plan would be that all residents can access these healthcare services without further payment, but patients would have to start any treatments at primary healthcare facilities. For the NHI to be successful, a first step would require much improved services from the public hospitals. In its current form, NHI is unaffordable and we do not forecast it to be introduced.

In January 2014, the SA Competition Commission started an inquiry into the SA private healthcare industry. This market inquiry is general in nature because the SA Competition Commission "*has reason to believe that there are features of the sector that prevent, distort or restrict competition*". The SA Competition Commission "*further believes that conducting this inquiry will assist in understanding how it may promote competition in the healthcare sector*". While this broad inquiry began exactly three years ago, there has been no final inquiry report, and a final inquiry report and possible recommendations have now been further delayed until December 2017. While we only have a basic idea what this inquiry into the SA private healthcare industry will state or recommend, it is unlikely that it will be positive for the SA private hospitals. In the meantime, the uncertainty is not good for the SA private hospital industry.

Offshore Private Hospital Dynamics:

As mentioned above, with the consolidated nature of the SA private hospital environment, a restriction on the issuing of new hospital licences in SA, and the relaxation of SA's Exchange Controls, since 2005, Mediclinic, Netcare and Life Healthcare have all made offshore acquisitions. These acquisitions have had varying levels of success and they are very important in understanding the underlying quality and valuations of the three listed companies in SA. As the offshore dynamics of private hospitals are varied, it is best to analyse them by country.

UK:

The UK has a healthcare system dominated by the National Health Service (NHS), the publicly funded healthcare system, which is funded via the general tax system. There are separate NHS systems for England, Scotland, Wales and Northern Ireland, providing free healthcare to residents. Unlike in SA where most formally employed people utilise the private hospitals and the poorer people utilise the public services, in the UK the vast majority of the population utilise the NHS.

Due to a severe underfunding and lack of facilities, partly because of an increasingly aging population that requires increased medical treatments, the NHS has been partnering with the private hospitals in order to manage the workload of NHS patients. The private hospitals are increasingly seeing patients that are paid for by the NHS. Whilst this improves the occupancies of the private hospitals they get paid less by the NHS than they would receive for non-NHS patients.

The UK is an important country for all three of the SA listed companies, with the NHS being the key client. Netcare entered the UK private hospital market through the acquisition of GHG in 2006, while Mediclinic bought 30% of the listed private hospital company, Spire, in 2015 and Life Healthcare made the acquisition of Alliance Medical, a diagnostic imaging business in late 2016.

Switzerland:

Switzerland has a very strong publicly funded healthcare system with quality public hospitals. While Switzerland is a wealthy country it also suffers from an increasingly aging population that requires increased medical treatments. Personal health insurance is compulsory in Switzerland and covers the cost of medical treatment and hospitalisation of the insured, but often requires a co-payment by the patient. Private hospitals can be used by the population, but while the personal health insurance covers costs up to the official tariff level, patients are required to pay for any costs that are above the official tariff level. Switzerland is very important for Mediclinic, who entered the Swiss market by buying the private hospital group, Hirslanden, in 2007.

The healthcare system tries to remain competitive across cantonal lines, but there is currently some legislative and regulatory debate in the canton of Zurich relating to a proposed tax for private hospitals based on the proportion of private patients they treat. This may lead to a referendum in 2017 and to possible increased costs for the private hospitals in the Zurich canton, where Mediclinic's hospital is easily the largest.

Dubai and Abu Dhabi:

While Dubai and Abu Dhabi are separate countries, they are operated as one unit by Mediclinic, which is the only SA hospital company operating in the Middle East.

Dubai has been a stable country for Mediclinic since it entered the region through acquisition in 2006. With Mediclinic's recent acquisition of Al Noor and reverse listing onto the UK stock market, Abu Dhabi has now become an important country for Mediclinic. As per the SA and Swiss governments, the Abu Dhabi government is becoming tougher on private hospitals and is now demanding a 20% co-payment by Abu Dhabi nationals who wish to use private hospitals.

India:

While India has a population of >1billion people it has an underdeveloped private hospital sector. Life Healthcare bought into the private hospital company, Max Healthcare, in 2011. While India has huge potential in the long-term, with a lack of medical insurance and only ±4% of the population being covered, a shortage of medical professionals and very expensive cost of building of new private hospitals, it is unlikely that India will make a material contribution to Life Healthcare in the foreseeable future.

Poland:

While Poland is small in the global hospital industry, it is relevant as Life Healthcare bought into Poland in 2014. As per the SA, Swiss and Abu Dhabi governments, the Polish government has recently become much tougher on their private healthcare industry, through reduced tariffs, meaning that Poland will probably remain insignificant in Life Healthcare's overall business.

Analysis of Business Models:

When we analyse the SA private hospital industry as well as the key offshore countries mentioned above, the following are the key drivers and aspects of relevance for Mediclinic, Netcare and Life Healthcare:

Good:

- Demand by patients for private hospitals in SA will remain solid, supported by an aging population, which in turn will ensure that occupancies remain high.
- Demand for private hospitals in SA is inelastic for the formally employed, as public hospitals are not a realistic option.
- There is an "oligopoly" in SA, with almost no new licences being granted, which means that there are extremely high barriers to entry in the SA private hospital industry.
- SA private hospital companies are not making excessive profit or Return on Equity (ROE) for new "greenfield" hospitals. This should mean that the SA Government and Competition Commission is unlikely to "punish" the private hospitals too severely.

Bad:

- As SA and global Governments are under increasing fiscal pressure there is likely to be increasingly onerous Government and industry legislation and regulation across the healthcare sectors.
- While the SA private hospitals are not making excessive profit or ROE's on new "greenfield" hospitals, the above point is likely to mean that Mediclinic, Netcare and Life Healthcare are likely to have some small margin pressure in future.
- Medical Scheme Administrators, led by Discovery Health, will ensure that pricing discussions will remain very tough and price increases will be close to inflation, while nursing staff wage and training costs will probably rise faster than inflation.
- While Mediclinic, Netcare and Life Healthcare have diversified the SA specific risk since 2005, none of their offshore acquisitions, except possibly for Mediclinic's acquisitions in Dubai and Hirslanden in Switzerland, have proved to be value enhancing deals.

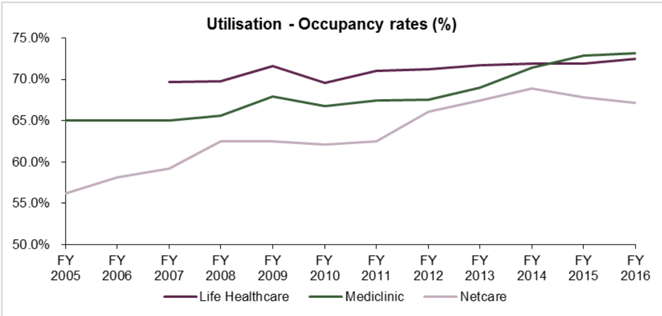
In aggregate the above factors will result in Mediclinic, Netcare and Life Healthcare being classified as "defensive" shares. The final, but critical, role of a Healthcare sector analyst is to decide on the valuations of these three companies.

Summary and Valuation of SA Private Hospital Companies:

Once the above has been adequately analysed and understood, all our work is related to determining the valuation of Mediclinic, Netcare and Life Healthcare. Based on the above it is clear to us that Mediclinic, Netcare and Life Healthcare are stable and defensive businesses. Their SA private hospital businesses are therefore predictable and relatively easy to value since assumptions around cash flows, growth, and risk are reasonably stable.

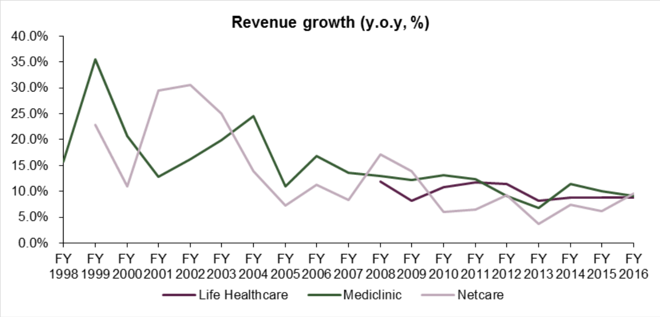
In the 2000's, after the above-mentioned SA private hospital consolidation had already happened, the three listed companies improved all of their operating and financial metrics. This was an excellent time to buy into Mediclinic, Netcare and Life Healthcare as the businesses improved their Occupancy rates and their key financial metrics, such as their Revenue growth, their EBITDA margins, their profits, their Return on Assets (ROA) and Return on Equity (ROE) (See Chart 4, Chart 5, Chart 6, Chart 7, and Chart 8).

Chart 4: Occupancy for SA Hospital Divisions Only



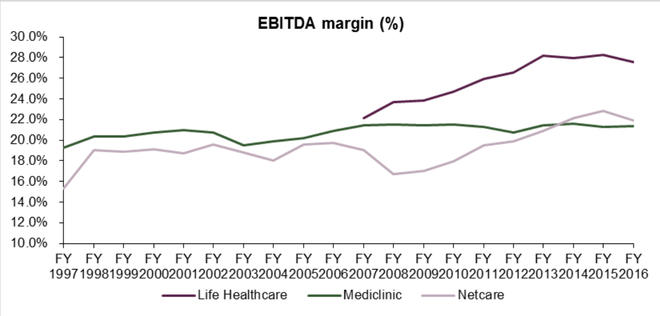
Source: Macquarie

Chart 5: Revenue for SA Hospital Divisions Only



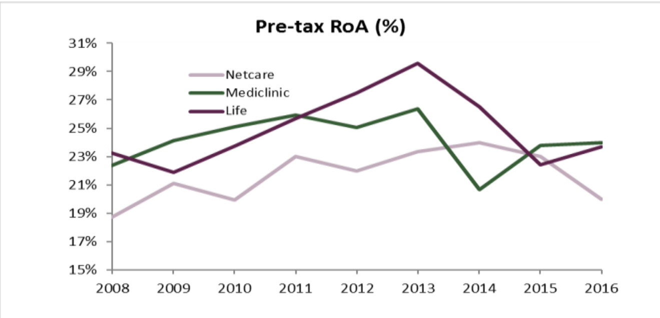
Source: Macquarie

Chart 6: EBITDA Margin for SA Hospital Divisions Only



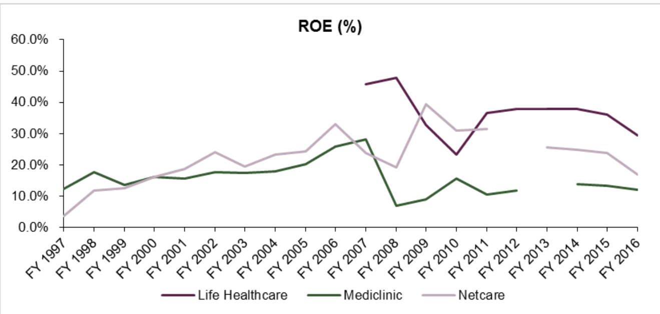
Source: Macquarie

Chart 7: Return on Assets for Listed Company



Source: JP Morgan

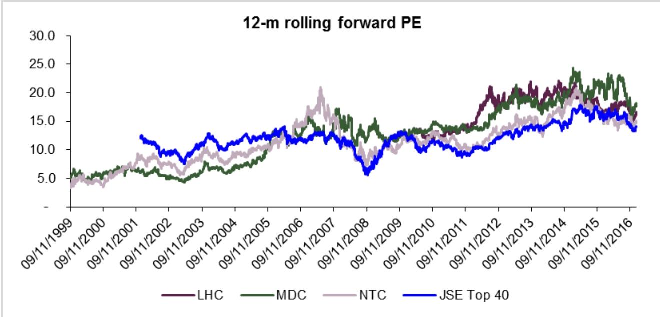
Chart 8: Return on Equity for Listed Company



Source: Macquarie

Importantly, in the 2000's, the above SA hospital sector improved performances led to rising price/earnings (P/E) multiples for Mediclinic, Netcare and Life Healthcare and the three companies moved from trading at meaningful P/E relative discounts to the SA equity market to trading at meaningful premiums to the SA equity market. The improved financial performance, together with the SA hospital sector P/E multiple re-rating meant that during the 2000's our Electus Clients were very well rewarded, mainly through their exposure to Netcare, while the re-listed Life Healthcare exposure added value for Clients during 2010-2013. In the past couple of years, it has become a tougher environment for Mediclinic, Netcare and Life Healthcare as the Government and industry regulatory environments became tougher on a global basis, the Medical Schemes became more powerful in SA and the offshore acquisitive expansions have mostly been poor. This has led to the P/E multiples of the three hospital companies declining and trading at small premiums to the SA equity market. (Chart 9).

Chart 9: Forward Price/Earnings for Listed Company



Source: Macquarie

Some of the broad assumptions we make for Mediclinic, Netcare and Life Healthcare are as follows:

- SA Medical Scheme beneficiaries will continue its slow growth of 1-2% per annum.
- Due to the slow growth of licensing and new private hospitals, SA hospital occupancies have risen gradually over the recent years and will continue to slowly increase and then remain in the range of 70-76% (See Chart 4).
- SA hospital revenues will grow at 8-9% per annum, being 5-6% inflation and the balance being 2-3% bed/patient growth (See Chart 5).
- SA hospital costs will rise by inflation plus 2-3%, largely due to the above-mentioned issues relating to nursing staff cost increases slightly above inflation, equipment costs and property related costs.
- SA hospital earnings before interest, tax, depreciation and amortisation (EBITDA) margins are normalised, and should be stable around their current levels (See Chart 6).
- Life Healthcare will have a R9bn rights offer in early 2017 to pay for a large portion of the Alliance Medical deal.
- De-gearing will continue post the recent offshore acquisitions and Netcare's likely UK asset restructuring.
- Tax rates will be stable.
- Netcare will restructure its debt in the UK business, while at the same time being able to lower its rental costs and pay more market related rentals.
- While there are likely to be some further offshore acquisitions, we do not specifically forecast future acquisitions in our financial modelling.

From the above the strong, stable and predictable SA bases provide an excellent platform for the sector's offshore expansions. However, the key to successfully investing in Mediclinic, Netcare and Life Healthcare is in analysing and understanding the following:

- Do the offshore acquisitive strategies make sound investment sense?
- Are the management teams able to transfer their SA skills into the global private hospital industry?
- Are we able to forecast and value their offshore businesses with the same certainty as their SA businesses?

Electus Views on Mediclinic, Netcare and Life Healthcare:

Mediclinic:
- Strong SA private hospital business, consistently well managed, but is now mature.
- Solid private hospital company, Hirslanden, in Switzerland, but the regulatory environment has become uncertain in the important Zurich canton.
- Solid private hospital business in Dubai with good growth potential.
- Overpaid for the 2016 acquisition of Al Noor in Abu Dhabi. While it gave Mediclinic a sought-after primary listing in London, there is large regulatory uncertainty in Abu Dhabi.
- While Remgro is a long-standing and supportive owner of ±45% of Mediclinic, now that Mediclinic is listed in London and can access cheap capital, there is no longer an advantage in having Remgro as a shareholder.
- During and after the Al Noor acquisition, the Mediclinic share price was too expensive throughout most of 2016.
- However, following its recent share price collapse, while hard to forecast accurately, for longer-term investors, Mediclinic's share price is now attractively priced relative to our Electus valuation.

Netcare:
- Netcare was very acquisitive of private hospitals in the late 1990's in SA, and with good discipline, has improved its SA hospital management and returns over the past five years.
- Complicated structure of acquisition in 2006 of GHG in the UK. Only started improving the operational performance in the UK in the past couple of years, once again growing its exposure to the lower-margin NHS business.
- Likely to restructure and simplify its GHG business in the UK in 2017, by restructuring its debt, while at the same time being able to lower its rental costs and pay more market-related rentals. This will make the GHG business in the UK easier to analyse and value.
- The Netcare share price is slightly cheap relative to our Electus valuation.

Life Healthcare:
- Performed very strongly after being re-listed on the JSE in 2010, partly due to being a very focused and "lean" business, following its five years in the private equity space.
- Extremely solid and well managed SA private hospital business.
- Poor recent acquisition strategy in India and Poland, lacking scale, integration and management skill relative to their SA hospital management.
- New large acquisition of Alliance Medical, a diagnostic imaging business in the UK. The deal is in process of being concluded, but as it was bought from the private equity firm in an auction-type process, it was probably bought for a full price.
- While the Life Healthcare share price has fallen sharply in the past few months, it is now fairly priced relative to our Electus valuation.
- Life Healthcare will shortly be undertaking a R9bn rights offer to fund the Alliance Medical deal and share prices do not usually perform strongly during large capital raising programs.

Electus Fund Positioning in SA Private Hospital Companies:
Our Electus Clients benefitted from owning Netcare shares in 2016 as the share price rose from ±3000cps to ±3500cps, where we sold the shares for our Clients. Our Electus Clients did not own Life Healthcare shares during 2016.

Based on the above work and views, and following the sharp decline in the Mediclinic share price, we have recently bought into Mediclinic for our Electus Clients. While in the shorter-term there are risks due to the regulatory environment in Switzerland and Abu Dhabi, Mediclinic is very well managed, fully integrated on a global basis and its share price is offering good upside potential based on our Electus valuation.

SA EQUITY MARKET OVERVIEW AND ELECTUS FUND MANAGEMENT

by Neil Brown and Richard Hasson

While SA's equity markets were positive in 2016, they were negative over the past six months. Following the rise in the mining related sectors, we believe that most of the key equity market sectors are now "fairly valued". As previously discussed, in 2016 we believe the SA equity market paid greater attention to the "Valuation" (not "value") of companies, and less attention to the Macro or "Momentum" related criteria. A focus on "Valuation" suits how we analyse companies and invest our Client funds and is well aligned with our "bottom-up" methodology of investing. This is also positive for our Client funds as we build focused equity funds holding ±30 shares, but the funds are also very well diversified across key sectors. This focus, with diversification, enables us to target excess returns for Clients from specific share selection and not from sector selection.

As a four person SA equity research team since August 2015, we were initially very focused on building a strong research base for Electus. The research work, which involved undertaking industry, sector and company work, as well as building robust financial models, was completed in January 2016 and pleasingly, the calendar 2016 performance of Client funds was very solid and in the top quartile of relative fund performance. Interestingly, while the strong-performing mining sectors were the key positive drivers of the JSE returns in 2016, in building diversified funds with no extreme sectoral biases, our Client fund weightings across the mining sectors were broadly in line with competitors, ranging between 6-12% throughout 2016. This risk managed approach for Clients is exactly how we have obtained excess returns of >1.5% per annum over the past 15 years' vs our SA Equity peer group and the major JSE indices. Pleasingly, our new SA Long Short Equity Hedge Fund also had a good start since its mid-year launch, with a positive 6-month absolute return, which was ahead of the SA Cash return and well ahead of the JSE SWIX index which returned -3%.

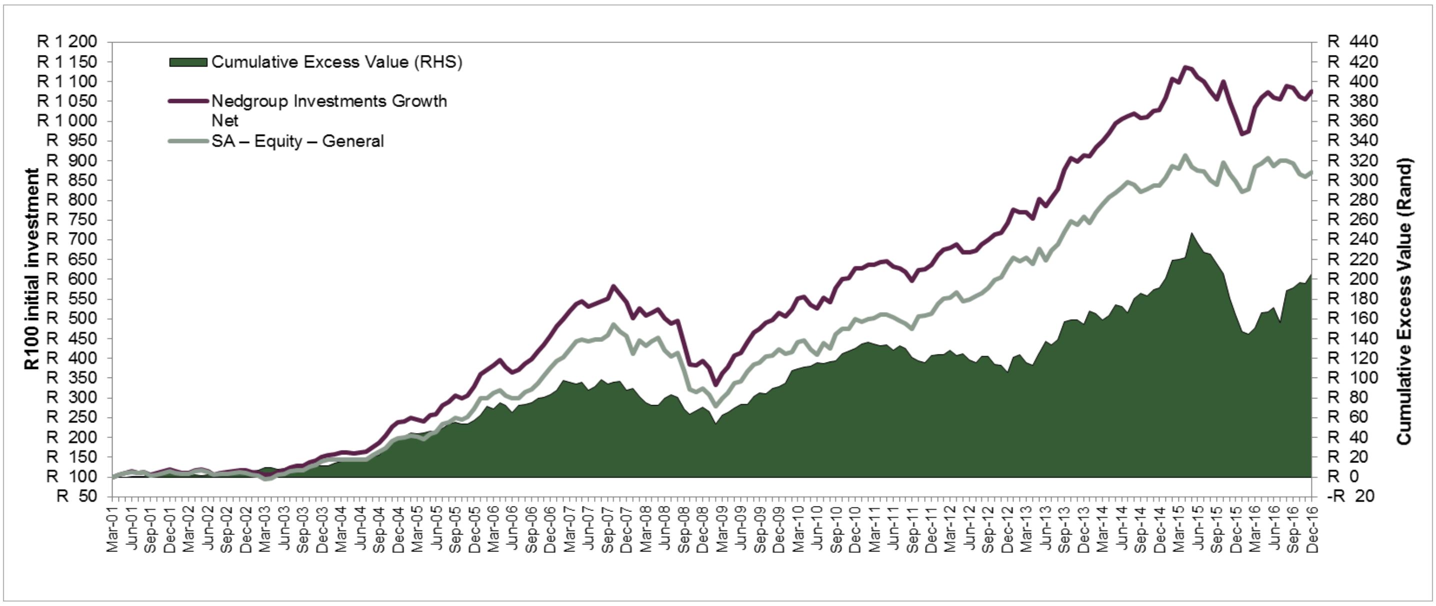
Based on the above, we believe that good share selection will be critical for success in Client funds in 2017 and we therefore remain focused on primarily investing in best-in-class businesses with zero tolerance for poor businesses that have high financial risk. Based on our Electus fundamental valuations, we have been able to identify several mid-sized investment opportunities in the SA equity market, mainly in the Financial and SA Industrial sectors. This means that, in Electus' "bottom-up" aggregation of all shares, while the SA equity market currently has 10% upside, our long only Client funds are extremely undervalued with current upside of 29%. This suggests a well above average expectation of excess returns and we therefore remain confident that the Client funds are well positioned.

Chart 10:

Long-Term Performance History

Nedgroup Investments Growth Unit Trust to 31.12.16

Excess Return pa vs General Equity Peer Group Unit Trust of 1.7% (Net vs Net)



Source: Morningstar and Electus

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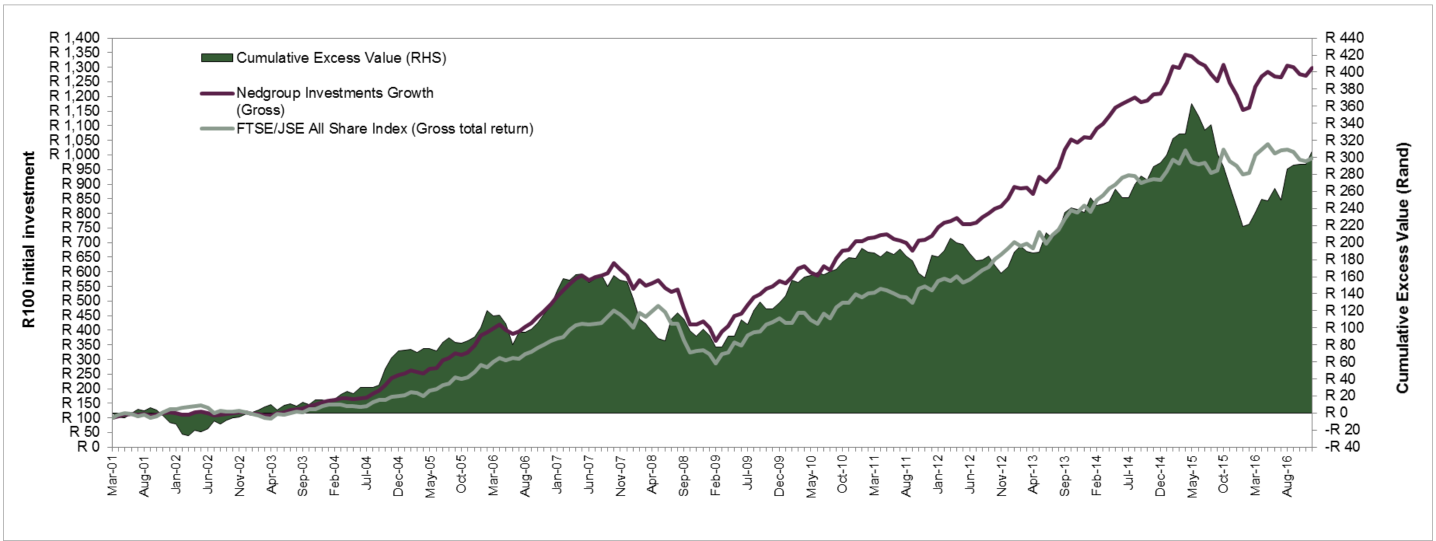
Chart 11:

Long-Term Performance History

Nedgroup Investments Growth Unit Trust to 31.12.16

Excess Return pa vs FTSE/JSE All Share Index (ALSI) of 2.0% (Gross vs Gross)



Source: Morningstar and Electus

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CONTACT DETAILS:
GREAT WESTERFORD BUILDING, 240 MAIN ROAD, NEWLANDS, CAPE TOWN 7700
TELEPHONE NUMBER: +27 21 680 7500

WEBSITE ADDRESS
www.electus.co.za

ELECTUS FUND MANAGERS