

EQUITY INSIGHTS

Discovery Holdings: NHI Bill Perceived Implications

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RELEASE OF THE BILL AND STOCK REACTION

On 08th August 2019, the Department of Health published its revised National Health Insurance (NHI) Bill which promises universal health coverage in South Africa. An NHI Fund will be established to serve as the single purchaser and payer of health care services. The fund will be a centrally-controlled and administered state-owned entity. A multistage approach aims for full implementation by 2026.

Discovery's stock price has been heavily impacted by the release of this bill, and is down 20% over the last week. Discovery's impacted segment, Health and Vitality SA, contributes an estimated 31% to the group value.

DISCOVERY'S HEALTH AND VITALITY SA BUSINESS

With a dominant 56% market share and strong cost management ability, Discovery Health and Vitality SA has a scale advantage in health insurance. Through leveraging its bargaining power over suppliers, Discovery members pay premiums estimated at 16% below the market. The shared value vitality model unlocks further value for clients and the business through selection of healthier clientele, reducing mortality, claims costs and lapse rates. Market share gains and industry consolidation are likely to endure for at least the next 7 years until the proposed implementation date in 2026. Given the huge obstacles the NHI Fund is expected to face, we think a worst case scenario in 2026 is in no way a foregone conclusion.

THE NHI BILL

The Bill lacks clarity and detail regarding the implications for private health insurance and indeed the wider healthcare industry. A key clarification sought by Discovery is whether private medical schemes could provide cover for services funded by the NHI should citizens not follow the prescribed NHI referral pathways. The Bill does not specify what medical services will be covered, but does state that all users will 'receive necessary quality health care services'.

The previously estimated R256 billion annual cost of the NHI is widely considered to be an underestimate. A 3.5% real GDP growth rate has been used to estimate shortfalls. Lower economic growth may lead to higher funding shortfalls and sustainability challenges. Funding for the NHI will be collected "in accordance with social solidarity" through payroll taxes, a surcharge on personal income tax, the reallocation of medical scheme tax credits and general taxes. Affordability is a key inhibitor, and affordability reduces as taxes increase.

The results of a R4 billion NHI pilot project in 11 health districts between 2012 and 2017 have recently been released, highlighting wide-ranging challenges relating to infrastructure, connectivity, funding, staff shortages and high costs. This provides foresight into the significant implementation obstacles the NHI Fund would likely face. Discovery has built exceptionally rich data on the healthcare ecosystem, something the state lacks and a further obstacle to implementation.

If passed into law, there is likely to be a large difference between what is promised and what is actually implemented, with the NHI expected to lack the capacity to offer a comprehensive list of benefits within the timeline stipulated. Despite overwhelming criticism and caution levied by health sector participants and civil society, the Bill has been tabled and will now be processed by both Houses of Parliament. The Bill and possible future Act, is likely to face formidable and lengthy legal challenges from a broad spectrum of organisations.

CONCLUSION – CONTINUE TO HOLD DISCOVERY FOR THE LONG TERM

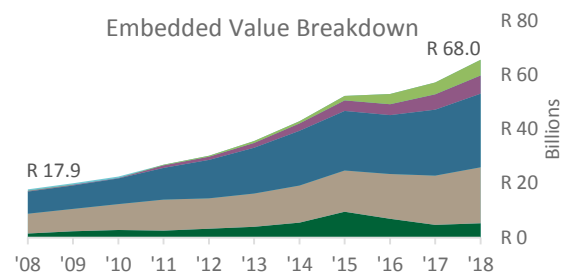
We have and will continue to incorporate the progression of this legislation into our quality, risk and valuation assessment of Discovery. We expect continued growth in embedded value over time to create value for shareholders. As such, we continue to hold Discovery for the long term. The current valuation appears attractive after factoring in the progression of the Bill.

	Discovery Limited
Market Cap	R 66bn
Current Share Price	R 100.44
Price to Embedded Value	0.97x
Forward PE	10.6x
Financial Year End	30 June 2019

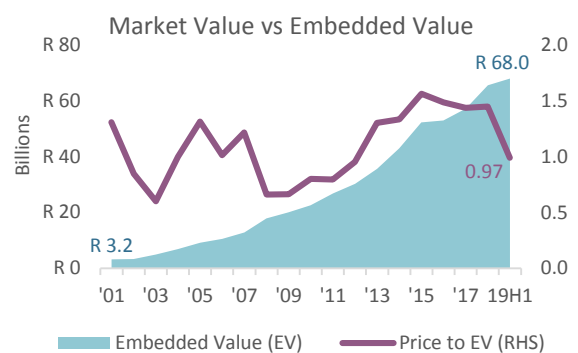
Sources: FactSet, August 2019



Sources: Company Filings, June 2018



Sources: Company Filings, June 2018



Sources: FactSet & Company Filings, August 2019

Embedded Value (EV): The majority of EV consists of the present value of expected future shareholder cash flows from in-force business. This excludes growth in value from new policies or the value inherent in the growing success of Vitality Global Partners and Discovery Insure (vehicles), and the early stage Discovery Bank.

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