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UNDER THE KNIFE

From a high-level perspective, it's easy to appreciate the investment appeal of the private healthcare industry as the sector benefits from a range of favourable longer term dynamics. In emerging markets, rising living standards and a higher disease burden underpin demand. In developed markets, these trends are coupled with ageing demographics, and overburdened state health systems. Combining these positive demand factors with strong financial cash flows makes the private healthcare industry an attractive destination for capital in a world bereft of growth. However, with our three SA-listed hospital groups all operating in different countries, and facing varying regulatory pressures and funding dynamics, putting these three investment cases "under the knife" is no simple matter.

PRIVATE HEALTHCARE IN SOUTH AFRICA

The South African private healthcare market can be described as an oligopoly, with the three listed players, the "Big Three" (Mediclinic International, Life Healthcare and Netcare) commanding 80% of the total market[1]. There's plenty to like about the South African healthcare market. The tailwinds that have supported higher healthcare demand, notably an ageing core insured population and rising burdens of disease, are likely to remain in place for the foreseeable future. A weak public healthcare system provides little competition, and anyone that can afford treatment in the private sector generally chooses this option.

The South African healthcare industry reflects the severe levels of income inequality that exist in the country. For the 16% that can afford it through medical scheme insurance, a high-quality private healthcare system exists. The remaining population, who cannot afford private healthcare, are forced to use sub-standard public healthcare facilities and resources. Surprisingly, the number of public beds has declined to about 90 000, from 120 000 four decades ago. This compares with the 3 listed groups, who now have a total of 26,741 beds.

The South African private healthcare industry is facing its own set of potential regulatory headwinds. The Competition Commission is currently reviewing what it deems to be excessive fees charged by the private sector for healthcare services. Whilst this inquiry is still ongoing, the listed hospital groups are strongly of the opinion that the basis for the inquiry is flawed, arguing that the levels of profit they are yielding is not excessive, given the pricing pressures faced by them, a shortage of doctors and nurses, as well as a cost base rising at a rate faster than CPI. A draft report of the inquiry is expected by the end of 2016, but it is believed that any concrete action from this inquiry (if at all) is still many years away. We view the government's proposed introduction of a National Health Insurance (NHI) system in South Africa as highly unfeasible in its suggested form and believe it could take up to a generation before such a system could realistically be put in place.

An interesting dynamic in the South African hospital space is that the private hospitals are not allowed to employ doctors. As such, the hospitals themselves cannot dictate the days and hours that a doctor should work. Most of the treatments that patients receive at hospitals are charged to their outside doctors, who function as health practitioners at the hospital in their personal capacities. One possible positive outcome out of the healthcare inquiry is that this law may be abolished. This would be positive for the private healthcare groups as it would give them better control over their cost base, allow them to plan patient procedures and utilize hospital capacity more efficiently and in this way improve margins earned.

LIFE HEALTHCARE

Life Healthcare's management is arguably best in class in terms of driving operating efficiencies amongst the Big Three. Not only have they successfully positioned their business to cater for 'complementary' medical disciplines such as mental healthcare and renal dialysis (at higher margins than surgical cases), they have also proven adept at managing a "Diagnostic Related Grouping" (DRG) payment system.

Typically, hospitals are remunerated on a "fee for service" system, whereby they bill for every service, treatment and consumable used to treat the patient. Under a DRG system, the hospital receives a standardized, fixed fee related to the diagnosis of each patient, regardless of the actual services and consumables utilized during that patient's admission. In this way, the risk of individual patients being "over-serviced" by the hospital team passes from the medical funder back to the hospital case manager. Life Healthcare's management have invested in the appropriate systems and instilled a strong ethos of cost control in order to manage such a system, with plenty of margin benefits being realized.

All of this efficiency has contributed towards Life Healthcare's SA business delivering an EBITDA margin superior to that of its local peers. However, the sentiment is that margins may have peaked in their SA business, as patient mix, higher US$ capex costs, and increased competition begin to erode this very strong position.

With big market shares, regulatory pressure, and a tough economy keeping a lid on long-term South African growth, global expansion has become a key focus for each of the three locally listed hospital groups. Life Healthcare has to date invested in two emerging market regions - Poland (via Scanmed), and India via an associate stake in Max Healthcare, the 2nd largest private healthcare group in the region. The Max hospitals operate at high levels of occupancy due to high demand, but inefficiencies in Max Healthcare's cost base have resulted in the business delivering low margins. Even though one of Life Healthcare's key strengths is cost management, the fact that they don't have a controlling stake in the business leaves them unable to control the Board and thereby make the decisions that would drive the kind of margin enhancing changes to the business that they excel at. It appears highly unlikely that this control structure will change in the foreseeable future.

Overall, Life Healthcare trades on a forward PE multiple of 17.6x and offers the purest "emerging market" exposure of the three listed hospitals. Valuing Max Healthcare at R4.80 per share, and the Polish business at R1 a share, implies that the SA business is trading at a forward PE multiple of 16x. While not excessively high for a quality business, we struggle to see much upside potential. Life Healthcare have also noted that they are targeting to spend up to USD1bn on an acquisition in a developed European country, raising the possibility of an equity raise in the future.

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[1] Based on number of private beds in South Africa as of September 2015

Chart 1: JSE Listed Hospitals
(Earnings split by Geography)

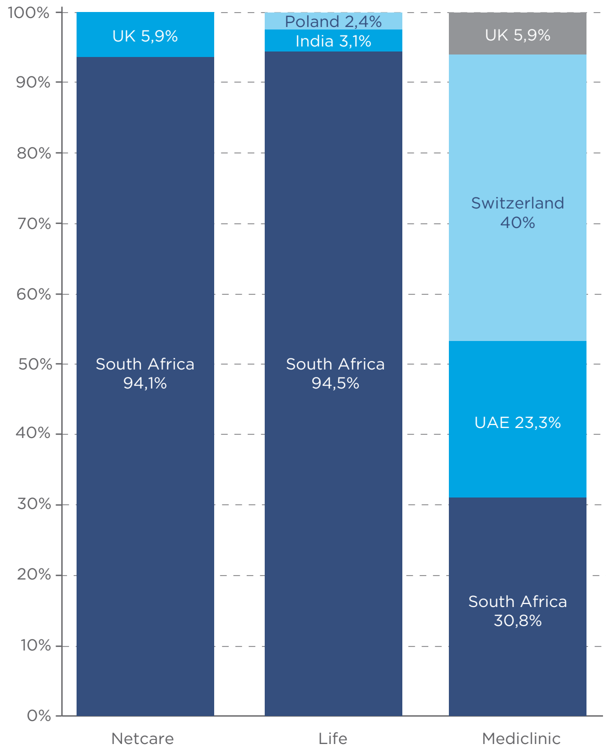
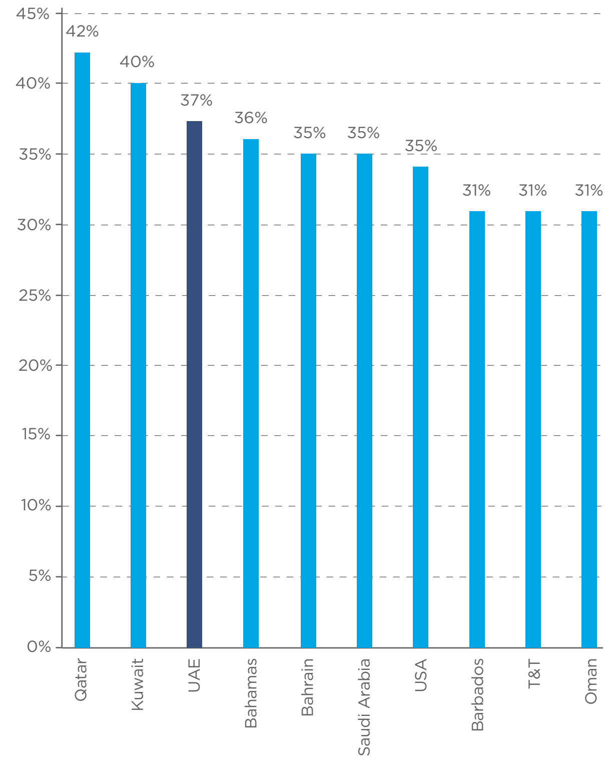


Chart 2: Global Top 10
(Obesity among the population 2013)



Source: Deutsche Bank

MEDICLINIC INTERNATIONAL

Mediclinic's unique appeal is its high quality hospital network in high-end, defensive markets with strong diversification and hard currency earnings. With significant operations in SA, Switzerland, Dubai, Abu Dhabi and the UK (via Spire), their international strategy has culminated in a primary listing on the LSE, inclusion in the FTSE100 index, and in becoming the third largest multi-country hospital group outside of the US.

After their acquisition of the Al Noor Hospital Group (with hospitals primarily in Abu Dhabi), Mediclinic is the largest player in the UAE. Structurally, the UAE is seen as an attractive growth market, with high levels of demand for healthcare, strong fundamental growth, a rising incidence of lifestyle diseases, and best of all, no corporate tax. Despite the poor health statistics in the region (low across the broader Middle East region, refer to table alongside), healthcare spending remains relatively low. UAE, Saudi Arabia, Kuwait, Oman and Qatar all spend less than 3.5% of GDP on healthcare, compared with a global average of 8.7%. Recent headwinds in the UAE have come in the form of a government-imposed 20% co-payment requirement from patients, and the potential introduction of a DRG payment system. In addition, Mediclinic recently flagged that their UAE business lost a number of doctors in their Abu Dhabi hospitals, which will ultimately affect revenue and margins. These factors prompted a sell-off in the stock.

> Mediclinic is the third largest multi-country hospital group outside of the US.

However, we share Mediclinic's view that this setback is temporary and fixable. We also still view the UAE market as an attractive one with very strong structural growth dynamics in which Mediclinic is best positioned to capitalize, becoming a medium term consolidator within the fragmented broader Middle East region. The company guided for substantial synergy benefits of AED75m to be realized over the short to medium term through the Al Noor deal – a figure much higher than initially anticipated.

Mediclinic's facilities in Switzerland are world class with many of their private clinics in the region more closely resembling a 4-star hotel! In 2012, the Swiss government introduced healthcare reform whereby basic-insured patients were granted access to the private hospitals, under a DRG system of reimbursement. This led to a sharp decrease in margins earned in Mediclinic's Swiss business. This regulatory change however, has largely played out with the mix between public (low margin) and private (high margin) patients appearing to settle. Management have improved efficiencies and stabilized margins, with further promising efficiency projects already bearing fruit.

We appreciate the diversity of Mediclinic's hard currency earnings stream and their solid management team who have a reputation for "getting the job done". Their SA business is very stable. Switzerland has normalized, showing further positive signs, and there is an expectation of further corporate action in the attractive UK market. At a 20.5x forward PE multiple however, Mediclinic is not cheap, and we would look to add to the counter only on weakness.

NETCARE

Netcare is the biggest hospital group in South Africa, with close to 10,000 private hospital beds. While not known for the same level of operational discipline as Life Healthcare, Netcare have made positive strides in improving their operating margin over the years. This has been achieved largely through enhanced staff productivity and various efficiency projects. Netcare, however still have some way to go before reaching the occupancy levels enjoyed by Life Healthcare and Mediclinic in SA; we view this as an upside opportunity. Netcare have taken positive steps in this regard by increasing their bed exposure in locations with above average job growth (and by implication, higher than average private medical insurance membership growth) in the past year. Their new flagship Christiaan Barnard Memorial Hospital in Cape Town is also expected to contribute to regaining market share from peers.

In 2006, Netcare entered the UK private healthcare market through acquiring a 53% stake in GHG Holdings, which operates as the BMI Hospital Group. The UK private healthcare market is characterized by a stagnant pool of private medically insured (PMI) patients, as well as an overburdened National Health Service (NHS). The UK's NHS system has come under immense pressure from a funding perspective, with an estimated funding gap of GBP30bn expected to be reached by 2020. Waiting times for patients are beginning to breach the maximum limit of 18 weeks due to severe capacity constraints. As a result of these pressures, the government is outsourcing more and more NHS patients to the private sector, and this plays right into the hands of BMI's strategy, with low levels of capacity utilisation in their hospitals (only just above 50% currently).

Netcare have appointed Jill Watts to run their BMI hospitals; she comes with a solid pedigree in running a highly efficient private hospital group in the UK, which was largely geared towards serving NHS patients. Her positive influence on BMI is already being felt and we believe there is still a substantial runway of margin benefits to be realized, as she capitalizes on the significant operating leverage inherent in a business of this nature.

Due to the ill-advised financing structure of Netcare's initial UK acquisition, BMI is left paying rent to their landlords at a rate well above the market rate. BMI has the option to have this inflated rental payment reduced substantially in exchange for a capital investment, with management indicating that they are currently in the process of exercising this option. This deal would prove to be earnings accretive for Netcare (even if it was fully debt funded) and would realize immediate value for shareholders.

In May 2016, Netcare reported a disappointing set of interim results, which put the share price under considerable pressure. A key reason for this underperformance was a sharp drop in the average occupancy level in the SA business, which lead to margin pressure and therefore affected overall earnings. While obviously a concern, the reasons for this drop-off in occupancy levels seem temporary (Netcare cited the impact of Easter falling in this reporting half, as well as two brand new hospitals built towards the end of 2015, which naturally operate at a lower level of occupancy until they eventually reach maturity).

At current valuation levels, we believe that the market is being overly pessimistic regarding Netcare's outlook. We see solid upside potential in the UK business and value NTC's stake in BMI between R4-R5 per share. Looking at this another way, stripping out our valuation of BMI leaves the SA business trading on a forward PE multiple of approximately 13.6x – a fairly low PE for a private hospital with what we regard as clear opportunities. While it could be argued that Netcare should trade at a discount relative to its peers for qualitative reasons, we deem this discount to be excessive. We see clear opportunity for management to unlock value in both the SA business (through increasing occupancy levels and enhancing efficiency) and the UK business (by filling capacity with NHS work and reducing the rental paid). For these reasons, Netcare remains our preferred stock pick in the sector and is held across all of the Tantalum equity portfolios.

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