ATTACHMENT:DISCOVERY

Singing in the rain

Rob Rose & Stephen Cranston: Financial Mail, 12 September 2019

IT HAS been one of the more challenging weeks for SA's quintessential corporate optimist, Adrian Gore, to keep the legendary pep in his step. Gore, who built Discovery into SA's largest medical aid administrator in just 27 years, has long been the antidote to the waves of negativity that seem to assail SA every few months. At a conference last November, he spoke of how "in SA we are particularly gloomy, but we are incredibly inaccurate about our gloominess. We are confidently wrong; we are stubbornly stupid". But with SA on the brink of a rating downgrade, unemployment having deepened to 29 percent, a wave of xenophobic-based looting and an inexplicably brutal spate of violence against women, has Gore changed his tune? He says he hasn't shifted an inch. "On the contrary, I'm sticking to the view that statistically, while we always move from problem to problem, someone with a declinist mindset always believes the current problem is evidence of the inevitable demise." Of course, there are intractable problems, he adds - it's just that if you have the right mindset, these problems can be solved. And President Cyril Ramaphosa has actually done a lot more things than people give him credit for. The Zondo Commission on State Capture is just one example, as are changes at the SA Revenue Service and the National Prosecuting Authority. Gore says: "You've just got to be a little patient. We're in a tough world - look at Brexit." Only, it's not just Discovery's home country that is stuttering, thanks partly to Ramaphosa's leaden feet.

Unprecedented siege

Gore's own business, including SA's largest medical aid administrator, Discovery Health, is under unprecedented siege too. For a start, the new National Health Insurance (NHI) bill proposes creating a new universal healthcare system, at a cost of R450-billion, which will all but wipe out private medical aids. And perhaps more trenchantly, accusations are piling up that years of "aggressive accounting" by Discovery has conspired to understate risk in the business. In February, SBG Securities published a report titled "Looking past the narrative" which recommends that investors sell out, based on "findings that the business has an aggressive operating strategy and accounting policy". It adds: "Discovery's strategy and growth narrative is highly compelling and is marketed very well to investors … [but] many investors do not understand the nuances of the accounts, similar to the lack of product understanding by consumers." Other analysts have also questioned Gore's shtick. Certainly, as the face of SA's most innovative company, Gore is nothing if not a consummate salesman: believable, and able to stir the hearts of even the most apathetic and cynical. As the pioneer of "shared value" through its Vitality programme, which is built on the principles of behavioural economics, Gore is lionised as a visionary in a sector renowned for dour actuaries. Vitality uses "rewards", including flight discounts and gym membership, to encourage customers to be healthier, which in turn drives down health costs. But it's clear the "Discovery story" is now under its most intense scrutiny yet. And the picture isn't pretty. Founded by Gore in 1992 with R10-million seed capital from RMB CEO Laurie Dippenaar, Discovery has had its worst stock performance since listing on the JSE in 1999. Over 12 months, the stock has fallen 32 percent to R118. It's not exactly the trajectory Gore would want, having launched a new bank - billed as "the world's first behavioural bank" - in the past few months. The share price fall is due to a toxic mix of concerns about the NHI, weaker financial results and "overwhelmingly negative sentiment in SA", says Bryan Lloyd, portfolio manager at one of Discovery's overseas shareholders, Harding Loevner. He said a lot of these issues aren't really new. The healthcare bill is something they've been talking about for a little over a decade, so it's always been something that's been hanging out there. The fact that it came to light in this way, what felt like virtually overnight, did surprise the market. It all coalesced in uninspiring financial results for the year to June, released last week. Overall, Discovery's operating profit fell 9 percent to R7.5-billion (its own calculation of "normalised earnings" showed a 3 percent fall). But there was a R1.4-billion decrease in cash, as it invested in new operations such as its bank. At its largest arm, Discovery Health, which makes about a third of the group's profit, earnings rose 10 percent; at Discovery Life, profit fell 9 percent. There were bright spots (its 25 percent share of its Chinese venture Ping An saw new business soar 76 percent) but overall, the financials didn't exactly punch out the lights. Analysts said the results did little to change their view on Discovery's opaque disclosure, aggressive accounting, high financial leverage, and weak cash generation. The criticism clearly worries Gore.

Unhelpful perceptions

He said the NHI's impact on SA's private healthcare system worries international investors, but "we don't believe that these risks are likely to manifest and have worked hard to try to correct the perception". It turns out this is just one of many incorrect and unhelpful perceptions - like the view within government circles that SA's private healthcare market is awash in cash and is particularly wasteful. Gore said there is this view that people on medical aids have endless money. It's not true. We know how hard it is for people to afford medical scheme coverage, we see it in the choices they make. If there's one other stereotype that gets to Gore it's the frequent sniping about Discovery's swish new headquarters, which cost R3-billionn to build. It's impressive: made from recycled steel, with a running track on the roof, 90 indigenous trees, and a gym. One reader of the Financial Mail dubbed it a "message to medical aid members and policyholders as to how their inflated and hard-earned contributions are utilised". But this is just one example of the skewed perceptions of the money washing around the SA healthcare sector - the view that it's a bottomless well which the government can easily tap through the NHI, to cover up its inability to fix public health. In a nutshell, the NHI bill envisages a scenario where every South African will pay, through their taxes, into a government-run fund that would finance all medical care in SA. Ratings agency Fitch say it will cost R450-billion by 2028, two years after the scheme is meant to be up and running. The NHI is an attempt to address a skewed situation where R160-billion is spent by the 10.6-million wealthiest South Africans on private healthcare, while the government spends just R183-billion on the other 46-million South Africans. Walk into most state hospitals, and you'll see decrepit facilities, manned by vanishingly few doctors and nurses, many of whom are exhausted and work virtually unsupervised with scant access to the right equipment. But Fitch warned that the NHI faces "significant hurdles" such as the widely held view that it would open the door for "mass corruption and slow delivery of care". A worry for Discovery is that the way the bill is drafted means private medical aids won't be allowed to offer services covered by the NHI but only "complementary services", whatever that means. It is an assault on the private medical sector, which, Citi analysts showed last month, is actually remarkably efficient. Private healthcare costs, on average, R16 000 a person a year in SA, against the equivalent of R60 000 for the UK's National Health Service or R150 000 in the US.

Skills shortage exacerbated

The analysts said they do not believe SA taxpayers can currently afford to contribute much more to healthcare, adding that if private healthcare choices are restricted or costs increase, the severe medical and other skills shortage in SA could be exacerbated. The government should instead focus on improving public health facilities and make it more attractive for doctors and nurses to operate in that sector. SBG Securities also singles out the NHI as “a material risk” to the medical aid industry. For Discovery Health, which built its brand on the medical aid it administers, it may even be an existential threat. Though the medical aid (called the Discovery Health Medical Scheme) is supposed to be a non-profit independent entity run for the benefit of its members, it has for its entire existence paid Discovery for “administration” and “managed care” services every year. Discovery Health now administers more than 56 percent of the open medical scheme market. But if people are forced to divert their medical aid spending into a government-run fund, many at the bottom of the income pyramid will have to forgo private medical aid. And the business model would fall apart. Gore doesn’t think this will happen. He said if the NHI could replicate what people are getting now, they’d drop out and use the NHI. But it seems highly unlikely that will happen. But, he said, what does seem inevitable is that people will be paying more for healthcare: they will pay something for the NHI, and they will pay something towards the private system.

So, what is likely to happen?

At this point it seems the NHI will emerge in some form, much diluted from the current nuclear option and much later than the 2026 deadline. The best case for Discovery, it would seem, is that there would still be a large “complementary” role for private medical aids under the NHI. But if the NHI is implemented badly it would be a disaster for everyone. As Gore puts it, SA’s debt would spiral out of control, income tax rates would rocket to pay for the R450-billion the NHI will cost, doctors and specialists would flee, and wealthier citizens would become disenchanted. Gore said the sentiment is overdone but this is what worries him far more than the reality. He said it is going to be a long process and he does not believe we’ll end up with an extreme. Or rather, fingers crossed that we don’t end up there. There is no escaping the fact that Discovery’s healthcare arm is still a fantastically strong franchise. As much as the government is attacking this through the NHI, it’s unlikely to disappear any time soon. As Gore puts it: “Healthcare is the biggest industry in the world, and you can’t contain the costs. No matter what the issue is, healthcare costs will grow because demand is always there. So, in every growing economy with a growing middle-class, you’ll see healthcare costs rising.” Which should be good for Discovery, unless the government does something silly. In which case, it won’t be the only corporate casualty.

• This is an edited version of today’s Financial Mail cover story