AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive

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Going Private

Two weeks ago Australia's largest private health insurer ***Medibank Private*** (MPL) provided a surprise upgrade, boosting its operating profit guidance for the 2016 financial year from "*above $370 million*" to "*Operating profit of above $470 million*". This caused a spike in MPL's share price, making it one of the top performing stocks in the miserable equity markets of 2016, returning +13% vs. the ASX200 fall of -9.3%. This upgrade on the back of improved margins was treated as a shock by the majority of the sell side analysts who then scrambled to upgrade their financial models of the company.

In this week's piece we are going to look at privatisations and the reasons why they tend to perform better under private ownership than under government hands.

Background

MPL was floated in late 2014, making it the largest Federal Government privatisation since the T3 ***Telstra*** share float in 2006. Medibank was also the largest government enterprise to be taken private since the $4.6 billion sale of Queensland rail freight company QR National (now ***Aurizon***) in 2010 by the Queensland state government. MPL is Australia's largest private health insurer with 3.8 million members or 29% market share of the PHI market. MPL was founded in 1976 as a Whitlam-era initiative to provide state-sponsored competition in the private health insurance market. Despite being the market leader, under government ownership historically MPL generated margins closer to the sub-scale non-profit insurers.

Passing to into Private Hands

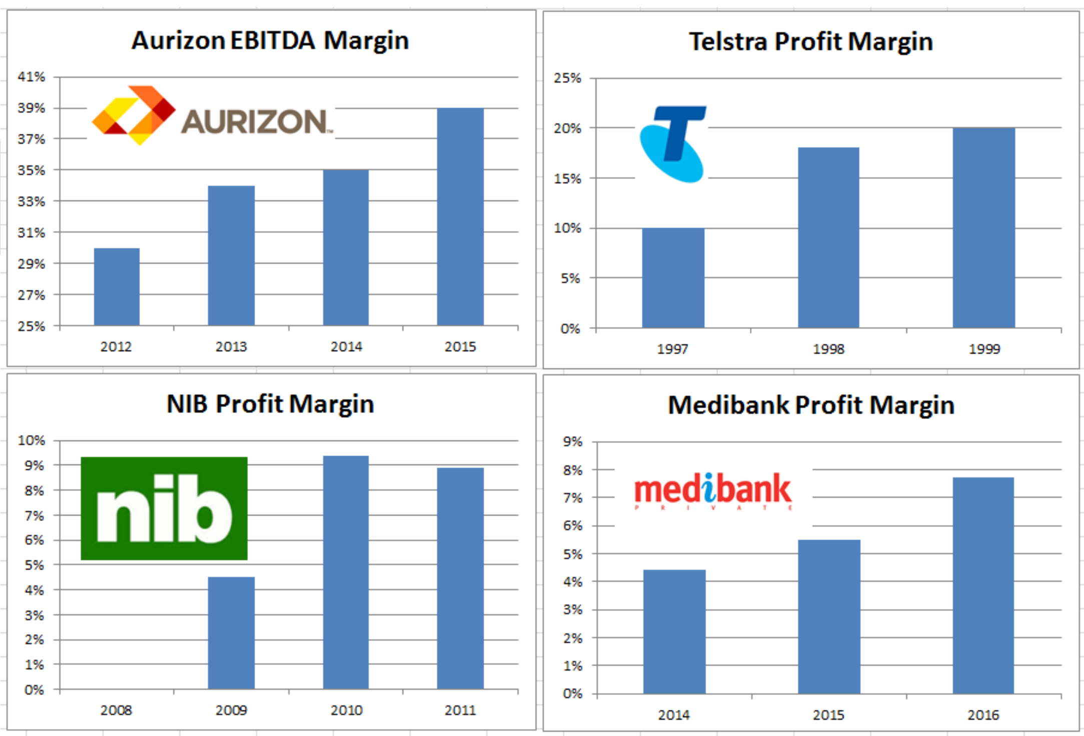
Privatisation refers to the ownership transition of a publicly owned asset or corporation into private hands either via a trade sale (such as the Tatts purchase of NSW Lotteries) or an initial public offering (IPO) to investors such as Telstra in 1997 and ***Qantas*** in 1995. Demutualisation is a similar process in that it converts a member-owned organisation with no underlying profit motive into a company listed on the ASX by issuing shares to its existing members. Examples of this process include ***AMP*** and ***NIB*** which were demutalised in 1997 and 2007 respectively.

In many cases the newly privatised company has been able to increase margins and profits in the years after listing though improving the efficiency of the business. Essentially these efficiency gains come from changes to management incentives. Private ownership increases the emphasis on profits and cost-minimisation, whereas government or mutual ownership creates incentives for management to avoid risk and follow established policies. Managers will tend to make politically sound or career protecting, but not profit maximising decisions.

Prior to privatisation QR National management would have had few incentives to reduce headcount and indeed may have received political pressure from the Queensland Labor governments not to cut well-paid union jobs. Similarly, the management culture at a mutual is generally based on providing a service to members at a cheap cost and boosting member satisfaction, rather than maximising profits for owners.

Management Incentives

Government owned corporations and mutuals frequently have higher levels of staff than comparable private sector companies and management have few incentives to “rock the boat” and eliminate inefficient practices. Post the MPL float in late 2014, senior management were given a range of financial incentives to drive efficiencies. These included the potential to double their remuneration based on targets linked to operating profit, profitable growth in policyholder numbers and an improvement in Medibank’s cost-to-income ratio as well as long term incentives based on earnings per share and dividend growth. Formerly, management received fixed remuneration and essentially worked in a government department. Indeed MPL’s CEO saw his total remuneration increase by $600,000 to over $2 million in 2015 as a result of improved operational performance.



Past Experience

The above table below looks at the operational improvements of some recent IPOs floated out of government hands (QR Rail, Telstra and Medibank) as well as the demutualised health insurer NIB. All were able to lift their margins over the two years following their IPO and beat prospectus forecasts. Looking at NIB, in the years following demutualisation in 2007, management was able to boost profit margins through reducing operating costs in the areas of claims processing and management expenses. More recently Aurizon (née QR Rail) reduced their headcount by 2,401 or 25%, after the IPO from the Queensland government. This allowed the company to increase margins in the face of a tough coal market.

Our Take

Investing in newly privatised companies has tended to be profitable for investors as management have greater incentives to improve operational efficiencies and cut out extra layers of costs that get taken on by owners that are not greatly concerned with profits. This allows the company to increase profitability without relying on positive market conditions. As this is generally a multi-year process, we would expect further margin improvement from MPL. It would however be a mistake to say that all privatisations enrich investors. Those that bought into the second Telstra float (T2) in 1999 just before the dotcom bubble burst in the US in early 2000, may still have to wait a while before Telstra's share price rises above the $7.40 paid. Similarly AMP finished its first day of trading at $18.50 in 1998 and currently trades 70% below that heady peak.

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