GCR RATINGS

Credit Rating Report | South African Medical Schemes | October 2021

Fedhealth Medical Scheme

Rated Entity / Issue	Rating class	Rating scale	Rating	Outlook/Watch
Fedhealth	Financial strength	National	AA-(ZA)	Stable Outlook

Strengths

- Strong and well managed solvency;
- Sound liquidity supported by sufficient operational cash flow generation

Weaknesses

- Membership loss and moderate membership profile with relatively high beneficiary age

Rating rationale

The rating for Fedhealth reflects the scheme's sound capitalisation and liquidity, supported by healthy earnings. The business profile remained within an intermediate level, despite review year contraction in membership attributable to economic pressures and structural changes in the scheme. Positively, the scheme's membership profile is gradually improving with considerable success in the recruitment of younger members.

The scheme's membership decreased by 3.6% in FY20 as a result of economic strain from the Covid 19 pandemic, as well as terminations from former Topmed members and other members who did not prefer the new product range introduced in 2019. The membership of Fedhealth excluding Topmed members however remained stable in FY20 registering an average growth of 2.1% in FY20. Fedhealth's share of the open industry membership base however remained relatively stable around 3%. The scheme managed to recruit younger members with an average age of 39,3 years compared to the average age of terminating members of 46.2 years. Average age of beneficiaries however remains high though at 41.1 (FY19: 39.9), while the pensioner ratio reduced increased to 19% (FY19: 17%). GCR expects the membership profile to remain at the current levels as the scheme's growth is mainly from products aimed at a younger demographic.

Review year earnings strengthened as a result of low claims experienced due to restrictions on movement in the midst of the Covid-19 pandemic, which notably saw the postponement of elective procedures. In this respect, the claims ratio lowered to 84% in FY20 from 93.3% in FY19. Lower claims supported a surplus of R189.1m despite a decline in investment income of 43% in FY20. The scheme has however experienced higher claims in the first half of the current year compared to the same period in FY20, with the claims ratio forecast to close the year at c. 91%.

Capitalisation strengthened on the back of positive earnings posted in FY20, boosting reserve levels. Resultantly, the scheme's accumulated funds equated to R1.66bn at FY20, representing 13% growth over the previous year balance. As such, reserve accumulation along with contained exposure to aggregate risks saw GCR capital adequacy ratio ("CAR") and statutory solvency for the scheme sustained at a strong 2.1x and 45% at FY20 (FY19: 2.1x and 43%) respectively. The strengthening in capitalisation may support a higher factor assessment, if earnings risk is well managed. While GCR expects capitalisation to remain strong in the next 12 months, with the statutory solvency ratio expected to remain above 40%, the scheme's ability to stabilise capitalisation at improved levels represents a key rating consideration over the medium term.

Liquidity improved as a result of the net surplus, with the value of the investment portfolio increasing by c.15% to R1.9bn at FY20. Consequently, gross cash and stressed financial assets coverage of claims equated to a higher 5.5 months (FY19: 4.7 months), while operational cash coverage registered at 1.0x (FY19: 0.9x). Nevertheless, the likelihood of claims elevation over the medium term may result in liquidity metrics reverting to previous levels, given management's plans to maintain a relatively similar asset allocation post Covid 19. GCR expects the scheme's liquidity to remain strong, with the gross stressed financial assets coverage of claims expected to be above 4.5x at FY21.

Outlook statement

The Stable Outlook reflects expectations that the scheme's membership profile is not likely to improve, while capitalisation and liquidity will be maintained at strong levels over the next 12 months. Accumulated reserves are viewed to be sufficient to tolerate claims pressure, as well as potential earnings strain from Covid-19 pandemic risks, such as reductions in contributions and investment income.

Rating triggers

Upward rating movement is unlikely over the medium term, although material and sustained earnings strength positively impacting on capitalisation, while liquidity is sustained within strong levels could lead to a rating upgrade. On the contrary, downward rating action could follow material deterioration in membership profile and/or sustained reduction in earnings, resulting in solvency and/or liquidity moderation beyond expectations.

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Related criteria and research

Criteria for the GCR Ratings Framework, May 2019
Criteria for Rating Insurance Companies, May 2019
GCR Ratings Scales, Symbols & Definitions, May 2019
GCR Country Risk Scores, October 2021
GCR South African Medical Schemes Sector Risk Score, April 2021

Rating history

Fedhealth Medical Scheme

Rating class	Review	Rating scale	Rating	Outlook	Date
Claims paying ability	Initial	National	BB(ZA)	Stable	October 2001
Financial strength	Last	National	AA-(ZA)	Stable	October 2020

Analytical entity: Fedhealth Medical Scheme

Fedhealth was established as an open medical scheme. The scheme is administered by Medscheme. The scheme's products are categorised into three ranges, which include the low cost option , MyFed. The product ranges cater for market segments at different life stages from comprehensive options like Maxifed, for conservative and sicker members to affordable options such as Flexifed, for young and healthy members.

Fedhealth continues to focus on balancing affordability with reserve utilisation, aiming to grow the membership base without adversely impacting the financial sustainability of the scheme. This is accompanied by various claims control measures ncluding tariff negotiation. The scheme aims to continue to enhance its products to attract and retain members, with the growth strategy tilted towards the lower cost options. The scheme has maintained a strong financial profile, characterised by a very strong solvency margin and broadly positive operational cash flow generation.

Operating environment

The South African country and sector risk scores apply as Fedhealth operates exclusively in South Africa.

Country risk

The South African country risk score of '7.0' reflects mounting challenges facing the economy amidst a prolonged pandemic that has continued to blunt recovery prospects. A sharp contraction in GDP growth, lower GDP per capita, worsening fiscal position, rising unemployment and social inequality all contribute to a broadly negative overlay on future prospects. The assessment is somewhat supported by fairly stable institutional scores based on the World Bank Governance Indicators & World Economic Forum Global Competitiveness Index which are in the middle of the range, but better than regional peers. For details regarding South Africa's country risk score please visit: https://gcrratings.com/wp-content/uploads/2021/08/20210805-Country-Risk-publication_FINAL.pdf

Sector risk

The medical scheme sector risk score was kept unchanged as low non-essential benefit utilisation supported a significant net surplus in 2020. This resulted in a material increase in average solvency levels, positioning the industry to absorb potential earnings risk going forward. We think that solvency will reduce over the longer term as claims frequency normalises post-COVID, given expectations of lower contribution increases. Furthermore, we still see risks associated with low economic growth and higher unemployment. For details regarding the South African medical scheme sector risk score please visit: https://gcrratings.com/wp-content/uploads/2019/08/GCR-South-African-Medical-Schemes-Sector-Risk-Score_28-April-2021.pdf

Business profile

Membership profile

Moderate membership profile with relatively high beneficiary age

Table 1: Membership scale and growth

	2018	2019	2020
Principal members	72 808	79 815	74 494
Average principal members (Excluding Topmed members)	72 285	74 615	76 215
Market share (%)	3.1	3.0	3.4
Membership retention (%)	77.8	80.1	88.0
Principal member growth (%)	1.2	9.6	(6.7)
Average principal membership growth(Excluding Topmed members)	0.1	3.2	2.1

The membership for Fedhealth remained stable in FY20 registering an average growth of 2.1% in FY20. However, the membership from Topmed medical scheme after the amalgamation resulted in an overall negative growth of 3.6% in FY20, due to terminations from former Topmed members and other members who did not prefer the new product range introduced in 2019 as well as the economic strain from the Covid 19 pandemic. Fedhealth's share of the open industry membership base however remained relatively stable around 3%. Given the economic environment, membership growth is expected to be flat or slightly negative over the outlook horizon. However, we note initiatives that are underway to attract new members and grow membership.

Table 2: Option diversification and perfomance(%)

	Member growth (%)		Claims/NPI (%)		Net healthcare result (R'm)	
	FY19	FY20	FY19	FY20	FY19	FY20
Maxima Exec Grid	0.0	51.8	201.2	0.0	0,0	(10.2)
Maxima Exec	3.9	(15.9)	100.7	97.4	(34.7)	(10.8)
Maxima Plus/ Maxima Plus and Ultimax	10.1	(20.0)	110.3	87.2	(0.5)	16.8
FlexiFed 4 Elect/Maxima Standard Elect	(14.2)	(5.0)	91.7	58.8	6.1	7.6
FlexiFed 4 Grid	0.0	17.0	95.4	96.8	0.0	(3.2)
FlexiFed 4/ Maxima Advance and standard	(17.3)	(13.9)	93.5	86.3	(41.5)	52.2
FlexiFed 3 Elect	0.0	63.6	103.2	83.7	0.0	0.4
FlexiFed 3 Grid/ Max Bas Grid and Max Core Grid	81.2	7.5	108.2	95.2	(4.3)	(5.2)
FlexiFed 3/ Maxima Core and Basis	15.6	(11.9)	94.1	85.6	(15.8)	26.8
FlexiFed 2 Elect	0	40.2	89.1	93.8	0.0	(0.5)
FlexiFed 2 Grid/ Maxima Saver Grid	120.3	(5.8)	89.9	84.7	2.2	4.4
FlexiFed 2/ Maxima Saver	1.3	(1.6)	97.6	89.8	(5.4)	(4.1)
FlexiFed 1 Elect	0.0	126.8	69.4	47.5	0.0	15.0
FlexiFed 1/ Max Entry Zone and Saver	17.2	(6.0)	78.6	67.8	18.6	102.3
MyFed/ Blue Door Plus	(5.5)	(5.7)	91.2	0.0	(8.2)	(2.3)
Dynamic Saver and Hospital	0.0	0.0	0.0	0.0	(0.1)	0
Total	**9.6**	**(6.7)**	**93.3**	**83.7**	**(83.5)**	**189.2**

The scheme managed to recruit younger members with an average age of 39,3 years compared to the average age of terminating members of 46.2 years. Average age of beneficiaries however remains high at 41.1 (FY19: 39.9), while the pensioner ratio reduced increased to 19% (FY19: 17%). GCR expects the membership profile to remain at the current levels as the scheme's growth is mainly from products aimed at a younger demographic.

Table 3: Member age profile

	2018	2019	2020
Average age of beneficiaries (years)	39.0	39.9	41.1
Pensioner ratio (%)	15.4	17.0	19.3

Management and governance

GCR considers Fedhealth management and governance to be neutral to the rating.

Financial profile

Earnings

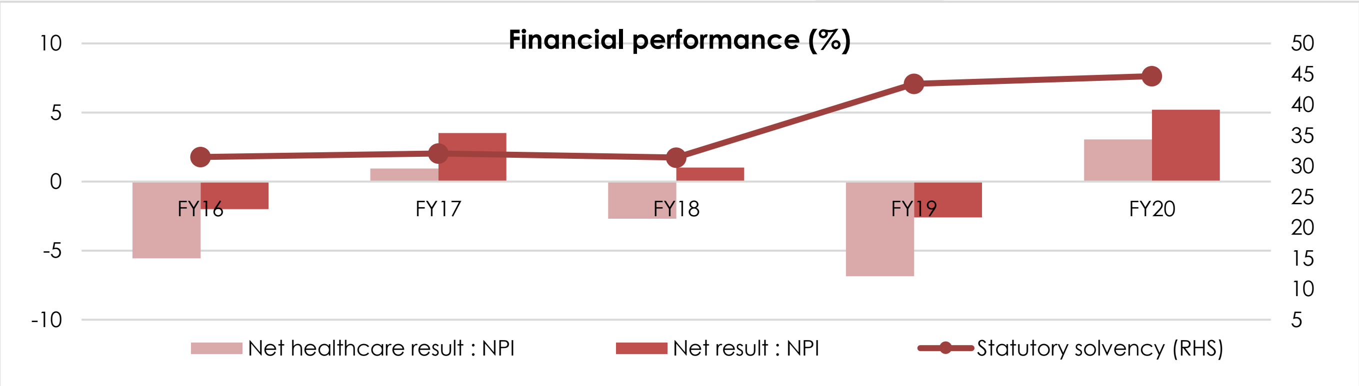
Earnings spiked during COVID-19 but likely to moderate over the next 12 to 18 months as claims frequency picks up.

Table 4: Financial performance (%)

	2018	2019	2020
Claims ratio	89.4	93.3	84.3
Non h/c expense ratio	11.6	13.2	12.3
Net healthcare margin	(2.7)	(6.9)	3.0
Net margin	1.0	(2.6)	5.2

Earnings strengthened in FY20 as a result of low claims experience due to restrictions on movement in the midst of the Covid-19 pandemic, which notably saw the postponement of elective procedures and low non-essential benefit utilisation causing atypically low claims frequency, in line with industry experience. In this respect, the claims ratio lowered to 84% in FY20 from 93.3% in FY19. Lower claims supported a surplus of R189.1m despite a decline in investment income of 43% in FY20.

Chart 1: Financial performance (%)



The scheme has however experienced higher claims in the first half of the current year compared to the same period in FY20, with the claims ratio forecast to close the year at c. 91%. We nevertheless expect earnings to progressively normalise over the medium term as the claims impact of COVID-19 subsides. Going forward the claims ratio is forecast to increase to c92% at FY21. The net healthcare surplus is forecasted to be cR47m in FY21. In this regard, the normalised net margin is expected to be between 1% and 3%, with potential for small fluctuations within this range, stemming from investment market performance.

Capitalisation

Strong and well managed capitalisation with accumulation of high reserve levels

Table 5: Solvency

	2018	2019	2020

Accumulated funds (R'm)	1,116,8	1,466.6	1,655,7
Statutory solvency margin (%)	31.4	43.3	44.7

Capitalisation strengthened on the back of positive earnings posted in FY20, boosting reserve levels. Resultantly, the scheme's accumulated funds equated to R1.66bn at FY20, representing 13% growth over the previous year balance. As such, reserve accumulation along with contained exposure to aggregate risks saw GCR capital adequacy ratio ("CAR") and statutory solvency for the scheme sustained at a strong 2.1x and 45% at FY20 (FY19: 2.1x and 43%) respectively. The strengthening in capitalisation may support a higher factor assessment if earnings risk is well managed. While GCR expects capitalisation to remain strong in the next 12 months, with the statutory solvency ratio expected to remain above 40%, the scheme's ability to stabilise capitalisation at improved levels represents a key rating consideration over the medium term.

Liquidity

Improved liquidity supported by operational cash generation and investment growth.

Liquidity improved as a result of the net surplus, with the value of the investment portfolio increasing by c.15% to R1.9bn at FY20. Consequently, gross cash and stressed financial assets coverage of claims equated to a higher 5.5 months (FY19: 4.7 months), while operational cash coverage registered at 1.0x (FY19: 0.9x). Nevertheless, the likelihood of claims elevation over the medium term may result in liquidity metrics reverting to previous levels, given management's plans to maintain a relatively similar asset allocation post Covid 19. GCR expects the scheme's liquidity to remain strong, with the gross stressed financial assets coverage of claims expected to be above 4.5x at FY21.

Table 6: Investment composition

	FY19		FY20	
	ZAR'm	%	ZAR'm	%
Cash on-hand	14.1	0.8	24.6	1.3
Short term deposits	85.9	5.2	106.7	5.6
Money market assets	407.0	24.4	406.6	21.3
Cash and equivalents	**507.0**	**30.4**	**537.9**	**28.1**
Interest securities	473.0	28.4	620.4	32.5
Shares-Listed (ordinary)	590.0	35,4.	660.9	34.6
Investment property	96.6	5.8	91.7	4.8
Non-cash investments	**1 159.5**	**69.6**	**1 373.1**	**71.9**
Total investments	**1 666.5**	**100.0**	**1 911.0**	**100.0**

Comparative profile

The comparative profile is a neutral component for the ratings.

Peer analysis

No peer adjustments have been factored into the ratings.

Group support

Group support is not applicable to the rating.

Rating adjustment factors

Structural adjustments

No adjustment factors have been factored into the rating.

Instrument ratings

No adjustments for instrument ratings are applicable.

Risk score summary

Rating components & factors	Risk scores
Operating environment	**14.75**
Country risk score	7.00
Sector risk score	7.75
Business profile	**(1.25)**
Membership profile	(1.75)
Membership Diversification	0.50
Management and governance	0.00
Financial profile	**2.25**
Earnings	0.00
Capitalisation	1.50
Liquidity	0.75
Comparative profile	**0.00**
Peer analysis	0.00
Total score	**15.75**

Fedhealth medical scheme

(ZAR'm in millions except as noted)

Year ended : 31 December	2016	2017	2018	2019	2020
Income Statement					
Gross premium income	3 114,1	3 382,2	3 554,4	3 376,5	3 707,2
Members' savings contributions	(237,9)	(418,3)	(444,8)	(91,0)	(91,9)
Net premium income	**2 876,3**	**2 963,8**	**3 109,6**	**3 285,6**	**3 615,2**
Net claims paid	(2 690,6)	(2 574,9)	(2 779,9)	(3 066,4)	(3 048,3)
Gross underwriting surplus / (deficit)	**185,7**	**388,9**	**329,7**	**219,2**	**566,9**
Administration fees	(213,0)	(225,5)	(242,8)	(270,5)	(280,8)
Acquisition costs	(50,7)	(56,4)	(61,9)	(66,5)	(72,1)
Other operating expenses	(81,8)	(79,0)	(108,4)	(107,6)	(103,8)
Net healthcare result	**(159,8)**	**28,0**	**(83,5)**	**(225,4)**	**110,2**
Investment income	101,4	74,1	83,6	131,7	75,0
Other income / (expenses)	1,3	1,8	31,2	8,7	2,9
Net surplus / (deficit) for the year	**(57,2)**	**103,8**	**31,4**	**(85,1)**	**188,2**
Unrealised investment movements	**(48,4)**	**17,1**	**(20,4)**	**11,4**	**10,7**
Balance Sheet					
Members' surplus	**994,1**	**1 115,0**	**1 126,0**	**1 487,1**	**1 687,0**
Accumulated funds	981,6	1 085,4	1 116,8	1 466,6	1 655,7
Revaluation reserve	12,6	29,6	9,2	20,6	31,3
Members' savings accounts	186,0	216,5	214,2	195,4	163,2
Provision for claims	113,1	144,9	161,2	209,2	245,1
Other liabilities	28,0	34,2	32,8	67,1	109,3
Total Surplus & Liabilities	**1 321,2**	**1 510,7**	**1 534,1**	**1 958,9**	**2 204,6**
Fixed Assets	0,0	0,0	0,0	0,0	0,0
Cash & cash equivalents*	515,2	863,1	499,6	507,0	537,9
Other investments	601,5	591,3	805,9	1 159,5	1 373,1
Debtors & prepayments	204,5	56,2	228,6	292,4	293,6
Total Assets	**1 321,2**	**1 510,7**	**1 534,1**	**1 958,9**	**2 204,6**
Key Ratios					
Solvency and Liquidity					
Accumulated funds : Net premium income	34,1	36,6	35,9	44,6	45,8
Members' surplus : Net premium income	34,6	37,6	36,2	45,3	46,7
Financial base : Net premium income	45,0	49,8	48,3	57,6	58,0
Statutory funding ratio	31,5	32,1	31,4	43,4	44,7
Net cash coverage ratio	1,5	3,0	1,2	1,2	1,5
Gross cash coverage ratio	2,3	3,5	1,9	1,9	2,0
Contribution cash flow : underwriting expenses	0,9	1,1	0,9	0,9	1,0
Membership Statistics					
Principal members at year-end	73 480	71 980	72 808	79 815	74 494
Principal membership growth	3,2	(2,0)	1,2	9,6	(6,7)
Beneficiaries at year-end	146 327	142 726	144 554	156 904	140 303
Underwriting and Efficiency					(9,0)
Claims incurred : Net premium income	93,5	86,9	89,4	93,3	84,3
Administration fees : Gross premium income	6,8	6,7	6,8	8,0	7,6

Acquisition costs : Gross premium income	1,6	1,7	1,7	2,0	1,9
Operating costs : Gross premium income	2,6	2,3	3,1	3,2	2,8
Non h/c expenses : Gross premium income	11,1	10,7	11,6	13,2	12,3
Net healthcare result : Net premium income	(5,6)	0,9	(2,7)	(6,9)	3,0
Net result: NPI	(2,0)	3,5	1,0	(2,6)	5,2
Gross avg investment yield (excl. unrealised movements)	9,8	6,9	6,5	9,3	4,5
Net avg investment yield (excl. unrealised movements)**	10,3	6,8	7,2	10,3	4,7

Glossary

Assets	A resource with economic value that a company owns or controls with the expectation that it will provide future benefit.
Beneficiary	Nominated person or institution in the policy document that is entitled to receive the proceeds stated in the policy.
Budget	Financial plan that serves as an estimate of future cost, revenues or both.
Capacity	The largest amount of insurance available from a company. In a broader sense, it can refer to the largest amount of insurance available in the marketplace.
Cash	Funds that can be readily spent or used to meet current obligations.
Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
Claim	A request for payment of a loss, which may come under the terms of an insurance contract.
Credit Rating	An opinion regarding the creditworthiness of an entity, a security or financial instrument, or an issuer of securities or financial instruments, using an established and defined ranking system of rating categories.
Liquidity	The speed at which assets can be converted to cash. The ability of an insurer to convert its assets into cash to pay claims if necessary. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Rating Horizon	The rating outlook period
Rating Outlook	A rating outlook indicates the potential direction of a rated entity's rating over the medium term, typically one to two years. An outlook may be defined as: 'Stable' (nothing to suggest that the rating will change), 'Positive' (the rating symbol may be raised), 'Negative' (the rating symbol may be lowered) or 'Evolving' (the rating symbol may be raised or lowered).
Reserve	An amount representing actual or potential liabilities kept by an insurer to cover debts to policyholders.
Solvency	With regard to insurers, having sufficient assets (capital, surplus, reserves) and being able to satisfy financial requirements (investments, annual reports, examinations) to be eligible to transact insurance business and meet liabilities.
Statutory Solvency Margin	Gives an indication as to whether the minimum regulatory solvency margin is being met, based on the net statutory assets to statutory net premiums ratio.

SALIENT POINTS OF ACCORDED RATING

GCR affirms that a.) no part of the rating process was influenced by any other business activities of the credit rating agency; b.) the rating is based solely on the merits of the rated entity, security or financial instrument being rated; and c.) such rating is an independent evaluation of the risks and merits of the rated entity, security or financial instrument.

The credit rating has been disclosed to the rated entity. The rating was solicited by, or on behalf of, the rated entity, and therefore, GCR has been compensated for the provision of the rating. The rated entity participated in the rating process via virtual management meetings, and other written correspondence. Furthermore, the quality of information received was considered adequate and has been independently verified where possible.

The information received from the entity and other reliable third parties to accord the credit rating included:

- Audited financial statements to 31 December 2020;
- Four years of comparative audited financial statements to 31 December;
- Full year budgeted financial statements to 31 December 2021;
- Unaudited management accounts to 31 May 2021;
- Other relevant documents

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