



SOCIETY OF ACTUARIES

Article from:

International News

January 2012 – Issue No.55



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Brazilian Private Health Care Market—Ready for Liftoff

By Ronald Poon Affat

INTRODUCTION

The Brazilian private health care market ended 2010 with US \$48 billion worth of premium. This already makes it Latin America's largest health care market and sixth in the world ranking. Even though less than a quarter of the population have a private plan, consumer surveys consistently say that after home ownership, private health care is now the second most desired product for the growing and socially mobile middle class. Brazil's leading investment bank, BTG Pactual, is projecting a remarkable compound annual growth rate (CAGR) of between 9 percent and 12 percent. This translates to premium of between US \$110 billion and US \$150 billion for 2020. This article will discuss the facts and figures behind such an audacious estimate.

QUICK FACTS AND FIGURES (U.S.\$1 = BRAZILIAN REAL R\$1.6)

Brazil's population stands at 200 million. Just 23 percent of the population (46 million people) has private health care insurance. The industry is subject to strict government regulation by the *Agência Nacional de Saúde Suplementar* (ANS). Health care companies include insurance companies (e.g., Bradesco, Sul America, Tempo), HMOs (e.g., Amil, Omint), self-funded plans (e.g., Petrobras, Citibank), cooperatives (e.g., Unimed) and philanthropic entities (e.g., Santa Casa). Table 1 sets out the membership distribution of just over 1,000 providers but one can see that it is very concentrated with 37 companies having a 50 percent market share. Table 2 shows that corporate policies dominate the market with a 75 percent share. The average monthly premium that clients pay for health insurance is US \$88. Last, but not least, Table 3 shows that the health care sector's share valu-

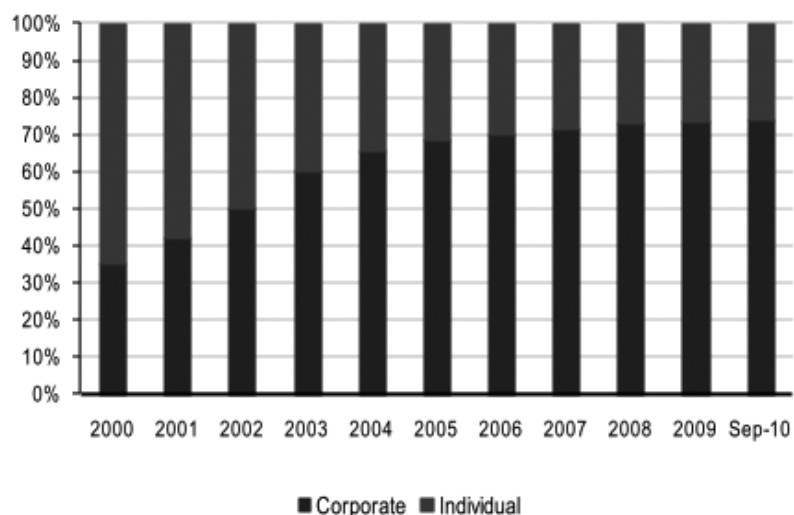
ation rose by 52 percent in 2010, substantially above the local stock market's (Ibovespa) less-than-impressive 1 percent. This is the reason investment bankers are sitting up and taking notice of health care in Brazil.

Table 1. Health Care Market Growing, But Still Concentrated (in 000's).

Health Care		
Total	Number Operators	Number Average Lives
4.490.194	709	6.333
4.477.050	156	28.699
4.489.099	83	54.086
4.447.335	46	96.681
4.297.091	30	143.236
4.543.175	17	267.246
4.469.864	9	496.652
4.074.495	5	814.899
4.851.271	4	1.212.818
4.644.192	2	2.322.096

Source: ANS

Table 2. Corporate Health Care Plans Reached 75% of Total Market in 2009.



Source: ANS, 2010

Just 23 percent of the population has private health care insurance.

Table 3. Health Care Companies and Ibovespa.



Source: Bloomberg and BTG

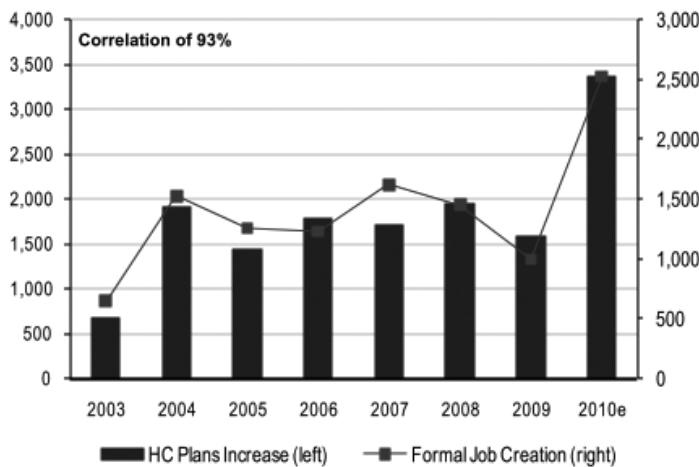
FACTS AND FIGURES BEHIND PROJECTED GROWTH

Table 4 shows that there is a 93 percent correlation between formal job creation and health care plan membership. Table 5 tracks the growth of middle-class consumers (households whose monthly income is between US \$625 and US \$3,100) from 63 million in 2005 to 93 million in 2010. If current employment and real wage trends continue, the middle class will grow 10 percent per year over the next four years. This will directly translate to a boost in health care plan penetration.

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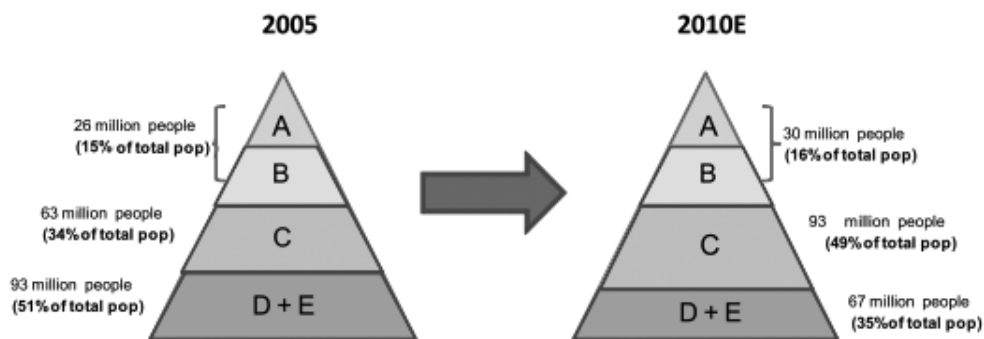
Table 4. Formal Jobs: A Key Factor to Growth in HC Plan Members.



Source: Caged and BTG Pactual

Brazil currently has a young population. The median age is 29.3 years (males 28.5 and females 30.1). The decrease in birth rate will contribute to a gradual aging of the population. The over-60s represent 10 percent of the population, but this group is projected to rise to 14 percent by 2020. This will also be a driver for expanded health care per capita consumption. The average life expectancy stands at 73 years, and this is estimated to steadily increase to 81 by 2050. The combined demographic impact of population growth and aging (shown graphically in Tables 6 and 7) is estimated to contribute an additional 2 percent CAGR in health care premiums in real terms.

Table 5. Emerging Middle Class Consumers.

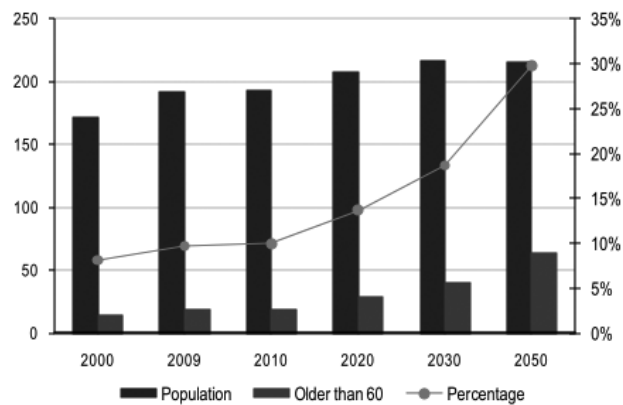


Source: Raymond James

There is a very low penetration of health care plans. As we said before, only 23 percent of the Brazilian population has private health care coverage, compared with 77 percent in the United States and 60 percent in Mexico. Brazil's health care as a percentage of GNP is 5.2 percent compared with 16 percent in the United States. The dominant source of growth in health care penetration is expected to come from lower income groups.

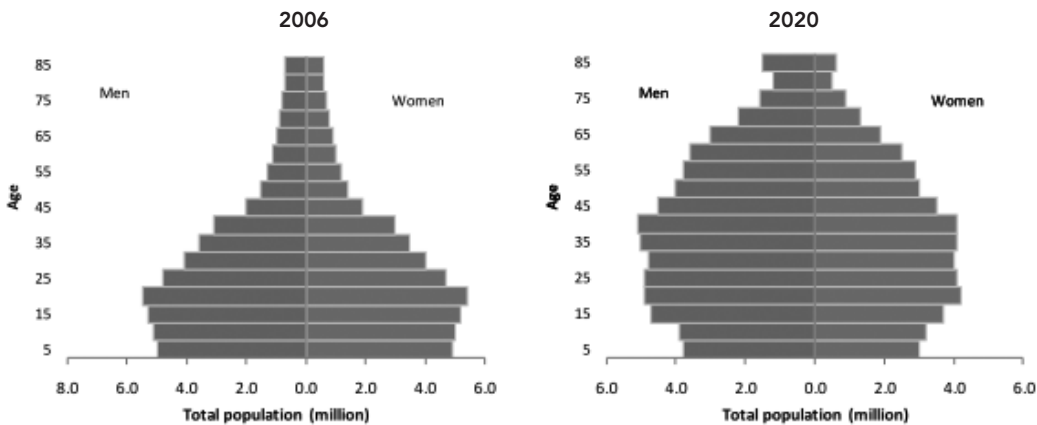
Private health care in Brazil has a limited geographic footprint. A Brazilian historian once referred to colonial life in Brazil as a "civilization of crabs," with most of the population clinging to the shoreline—and few were willing to make inroads into the terrifying interior. Today the same could be said for private health care. Geographically the main players are still fixated on large metropolitan areas focused on high-income regions. There is still plenty of growth potential in the interior. Table 8 confirms the distribution of plan membership.

Table 6. Increasing Share of Elderly People in Total Population.



Source: IBGE

Table 7. Brazilian Population Growth Expectation.

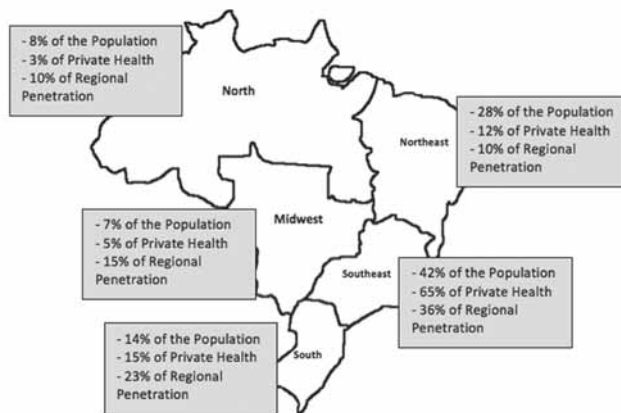


Source: Raymond James

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Table 8. Distribution per Brazilian Region.



Source: ANS, 2010

Sales channels are also quite limited. As mentioned before, the majority of current plans are sponsored by large companies via the traditional corporate brokers; this market is already considered to be a highly penetrated market. The next growth phase will be centered on small and medium enterprises (SMEs) and in the retail market. Even though there are 131 registered banks with 125 million clients, just one bank (Bradesco with 24 million banking clients) has its own health care insurance company. But the present landscape is about to suffer a seismic event. The largest state-owned bank in Latin America, Caixa Economica Federal (with more than 51 million clients), is about to launch its own health care company this year, 2011.

Beyond the health care specifics, global investors are attracted to Brazil for the potential to earn high rates of investment return. Short-term

annual risk-free rates are 12 percent (JP Morgan projects an increase of rates to 12.5 percent by December 2011) with inflation projected to be 6.5 percent this year. Investors recognize that Brazil is the BRIC (Brazil, Russia, India and China) country that holds the best record for free and fair democratic elections, exhibits economic stability and has a government that is respectful of company law/shareholder rights and human rights.

THE CHALLENGES?

While global multinationals are well-positioned in the life, pensions, property and casualty (P&C) and reinsurance markets, the only multinationals that dare to venture into the health care insurance market are Allianz, ING (via a minority investment) and MetLife (but only in dental). So why is that? Regulation.

The ANS provides micromanaging oversight that defines minimum coverage, plan rules, general policies, transfer of plan members' rights between health care plans, monitoring of financial strength and even the annual rate increase for individual plans. When it comes to coverage, the plans are basically the same, with the main differentiator being the quality of the health care network or reimbursement level provided. Regulation prohibits lifetime annual aggregate limits, no limits may be applied to benefits during a single year, and annual deductibles cannot be incorporated within the plan design. Also individual policyholders and senior citizens' rights are well-protected, leading to the acceptance of only corporate plans by many carriers, which are less rigorously regulated. Keeping this in mind, it can be argued that Brazil provides the world's most generous form of private health care benefits.

Whenever due diligence is undertaken by an overseas investor, the following points are invariably cited:

- The HMO's technical reserves are not robust compared with international standards, so any acquisition would require capital injection to strengthen reserves. In addition to which, there have been several recent "high profile" bankruptcies in the sector that have left clients without coverage.
- The technical pricing models are simplistic, and underwriting standards are often either undocumented or not adhered to.
- The large players benefit from lower per policy expenses and are able to negotiate preferential discounts with hospitals, clinics and other health care providers. These pricing advantages drive down the smaller players' margins when they try to compete on price and try to grow "at any cost."
- For health care plan operators who attempt to "vertically integrate" their medical administrative procedures, invariably the lack of maintenance investment and professional management lead to loss-making and inefficient operations in both medical facilities and health plan operations.
- The definition of minimum health care coverages by the ANS stifles creativity in product development and limits cost reduction.
- The international reinsurance market is not prepared to follow the local market's pricing margins. Hence not a single reinsurance treaty has been executed with any-

one. However, to be fair, the reinsurance law does not really give 'fair and direct' access to international reinsurers.

- Last, but not least, the cost of doing business in Brazil is expensive. Office rentals in the cities of São Paulo and Rio de Janeiro are amongst the world's top-10 most expensive. And São Paulo salaries for the "best and brightest" (usually attracted to the financial sector) are, on average, higher than in either New York or London.

CONCLUSION

So what is the best sector to invest in? There are many different answers to this question, depending on whom you speak with. Over the last 24 months, there has been a flurry of mergers and acquisitions (M&A) in all areas of the value chain, namely:

- Health care providers: health Insurance companies, HMOs and specialized dental companies.

Key requirements include: having local underwriting expertise, the ability to operate with low expenses, being a tough negotiator with hospitals/clinics, allocating a large investment to raise brand awareness and establishing broker relationships. This sector is heavily regulated by the government and characterized by mega players who seek to protect their market share at any cost.
- Distribution channels: retailers that specialize in health care products.

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Lower risk. There are not many specialized health care brokers compared with other insurance lines. There exists the opportunity to expand client base on a national basis with only marginal costs. But very high initial administrative costs are associated with acquiring new business.

- Service providers: hospitals, clinics, etc.

One needs to have proven expertise in managing these services and M&A should be considered to reduce unit costs. There's fierce competition with low-margin mega players. Existing facilities are likely to be very costly to modernize, and it is difficult to find qualified and experienced professionals. Also the current legislation forbids foreign ownership of hospitals.

- Pharmaceuticals: The pharmaceutical industry in Brazil is the 10th largest market in the world, the second largest in Latin America, and accounts for a 3.5 percent share of the world market.

Brazil's pharmaceutical market is one of the fastest growing markets in Latin America and has enjoyed steady growth since 2004. The government has moved to align the drug regulatory environment with international standards. Also, in 2007, Brazil launched a major 10-year biotechnology initiative that provides incentives for private-sector research and development (R&D) and production (source: Business Monitor International).

All in all, the opportunities greatly outweigh the challenges, and BTG Pactual's projections appear to be both reasonable and attainable. In order to maximize one's investment, potential investors need to bring to the table specialized

skills (e.g., underwriting, financial management, hospital management) or have a proven track record of consolidation and integration. Health care is one of the few products that's actively sought out by consumers, and this sector will most certainly be an integral part of the projected growth in the Brazilian economy.

I would like to thank Joao Carlos Santos of BTG Pactual for his help in providing supporting financial data. joaocarlos.santos@btgpactual.com.

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