iSelect's private drama

Over the years we have observed many opaque business arrangements between public and private companies. Below is an examination into another arrangement, which actually ended with a failure of a private company.

We have been following the story of iSelect (ISU) for a while, and we think that neither the market nor the management (in its communication with the market) seem to pay enough attention to the impact of the drama that has unfolded between the company and one of its key customers.

We tried approaching management with our enquiry, but we were unsuccessful getting exact details. Hence, we are posing the question more widely and presenting our reasoning on why we think this is a worthwhile exercise.

For those who don't know, iSelect is an online comparison business where consumers compare offerings and purchase a range of products such as insurance. One of its core business segments is private health insurance, which has an enviable share of the Australian market.

One issue that has dogged the company since listing in 2013 has been a chronic lack of positive free cash flow. Accounting profits were healthy, but free cash did not correlate with reported earnings. This inspired further investigation.

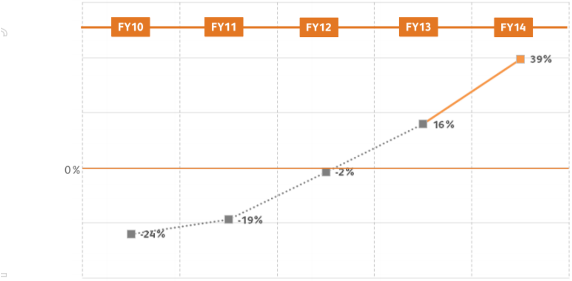
On close inspection, ISU had an unusual relationship with one of its health insurance customers – NIA Health Pty Ltd (owner of health insurer health.com.au). It turned out that NIA Health Pty Ltd (NIA) had a loan agreement with ISU, which resulted in a very interesting cash flow treatment in the ISU's accounts. The summary is that ISU sold NIA's insurance policies in exchange for a fee. However, NIA did not have the cash to pay these fees, so it used ISU's own cash to do that. (Confused? Stay with us) The funny bit was that instead of just keeping a non-cash record of ISU's revenue and NIA's liability, the companies had actually been exchanging cash with each other (as management put it: for GST reasons). As we understand it, ISU would first send the cash to NIA as a loan, which NIA returned back to ISU on that very same day as a fee for services (+a GST amount). This resulted in the following cash flow statement reported by ISU:

	Note	Consolidated 30 June 2014 $'000	Consolidated 30 June 2013 $'000
Cash Flows from Operating Activities			
Receipts from customers		131,080	109,276
Payments to suppliers and employees		(119,546)	(105,067)
Income taxes paid		–	–
Net cash provided by/(used in) operating activities	6	**11,534**	**4,209**
Cash Flows from Investing Activities			
Payments for property, plant and equipment and intangible assets		(4,844)	(4,401)
Interest received		4,049	1,154
Increase in NIA facility		(17,388)	(15,378)
Net cash used in investing activities		**(18,183)**	**(18,625)**

Source: iSelect Annual report 2014

The operating cash flow line above appears quite healthy (and this is what many investors tend to look at). The management referred to this line in their presentations to highlight "acceleration in operating cash conversion".

Continued acceleration in operating cash conversion¹



	FY10	FY11	FY12	FY13	FY14
Operating cashflow	-$2.2m	-$3.3m	-$0.4m	$4.2m	$11.5m
Normalised EBITDA	$9.3m	$17.4m	$24.1m	$26.5m(2)	$29.2m(2)

Operating cashflow & cash conversion have improved significantly
Net cashflow reflective of facility with NIA

Cashflow Statement $m, YE 30 June	FY13	FY14	Change
Operating cashflow	**4.2**	**11.5**	**174%**
Capital expenditure	-4.4	-4.8	10%
Interest income	1.2	4.0	251%
NIA facility advances	-15.4	-17.4	13%
Investing cashflow	**-18.6**	**-18.2**	**-2%**
Finance costs	-4.5	-0.7	-84%
Proceeds from share issues	129.9	1.6	-99%
IPO cost payments	-10.6	-3.6	-66%
Proceeds from borrowings	50.0	0.0	-
Repayment of borrowings	-85.0	0.0	-
Financing cashflow	**79.7**	**-2.8**	**-103%**
Net movement in cash	**65.3**	**-9.4**	**-114%**

Key observations

- Strong growth in operating cashflow due to:
  - faster growth in 'upfront' health policies
  - increased trail commission receipts
  - contribution of newer business units
- Investing cashflow composition:
  - ongoing IT related capex
  - interest received on NIA loan
  - NIA advances in line with earned commissions

Source: iSelect FY14 Annual Results Presentation

Look a bit further down, though, and you will see a massive cash outflow reported in the investing cash flows section called "increase in NIA facility". These outflows represented the cash that ISU lent to NIA, which was then immediately wired back to ISU and recorded as "receipts from customers". In other words, starting from FY2013, ISU's reported net cash flow from operating activities included quite a lot of what effectively was its own cash, which had been recycled through the hands of NIA. So, had it not been for that cash exchange between ISU and NIA, ISU's net cash flow from operating activities would have been reported as negative -$7.6m[1] and -$12.7m for FY14 and FY13 respectively.

Now, that is not the main point.

It is a lot more interesting to know why ISU extended this loan facility to NIA (it was a $75m loan facility expiring in July 2015). It has not provided that kind of loan facility to other insurers on its panel.

It turned out that NIA's former managing director and CEO was a brother in law of former ISU's CEO and one of ISU's directors was a an investor in Health.com.au (via NIA). ISU's reputation paid a price for that when it faced criticism after not disclosing this in its 2013 Prospectus.

Our initial conclusion was that the purpose of the loan arrangement was to help the start-up insurer health.com.au (NIA) get established. That would have been questionable, but defendable if NIA had been successful. However, the accounts of NIA Limited[2] never appeared to reflect a sustainable business.

---

[1] Assuming NIA topped up the cash received from ISU with 10% GST. That is : 11.5m reported operating cash flow – 17.4m advances to NIA – 1.74m GST = - $7.6m

[2] NIA Limited is the ultimate parent of Health.com.au. Ownership structure is as follows: NIA Limited-> NIA Health Pty Ltd->Health.com.au Pty Ltd. ISelect dealt with NIA Health Pty Ltd.

NIA Limited

Statement of profit or loss and other comprehensive income

For the year ended 30 June 2014

in dollars

		Consolidated	
		Year ended 30 June 2014	**Year ended 30 June 2013**
Premium revenue		59,361,091	25,298,916
Claims expense		(32,711,989)	(12,839,639)
RETF levy		(20,169,279)	(8,388,713)
State levies		(877,883)	(339,554)
Gross profit		**5,601,940**	**3,731,010**
Administrative expenses	*4*	(7,883,796)	(6,953,049)
Customer acquisition costs		(19,000,420)	(13,806,034)
Results from operating activities		**(21,282,276)**	**(17,028,073)**
Finance income		1,019,891	586,970
Finance costs		(1,953,953)	(780,214)
Net finance costs		**(934,062)**	**(193,244)**
Other income		129,121	-
Loss on divestment of subsidiary entity		(267,949)	-
Share of loss of equity accounted investee		(1,542,355)	-
Loss before income tax		**(23,897,521)**	**(17,221,317)**
Tax expense	*6*	-	(1,058)
Loss for the year		**(23,897,521)**	**(17,222,375)**

Source: ASIC, NIA Limited Financial report 2014 (Consolidated)

As can be seen above, the NIA business ran at huge losses in 2013 and 2014, and 2015 was no different with a loss of $22.7m. By far the largest contribution to the losses can be attributed back to the “customer acquisition costs”, most of which was paid to ISU[3] ($14.7m, $19m and $13.8m in FY15, FY14 and FY13 respectively).

During FY2012-FY2013 NIA Limited raised some $33m from a group of private investors and by June 2015 had negative equity of -$36.8m and ended up selling health.com.au to GMHBA for $46m (which was not even enough to pay back ISU in full). We understand NIA investors received about 10c in the dollar, while ISU received $42.2m and wrote off the balance of $9.9m of NIA’s loan.

So the facts suggest to us that NIA was not a viable concern without the lifeline (debt facility) provided by ISU and that despite this lifeline the NIA business model failed anyway. Of course, there may be multiple reasons for this.

In the wash up, NIA shareholders lost about 90% and ISU sold an insurance product for several years, which on a net cash basis it only received GST amounts for during those years. Ultimately ISU received most of what it was owed, but only after NIA was sold to a third party.

That leaves us with the final bit of the puzzle:

What were the benefits for ISU?

[3] We understand that NIA did not pay commissions to any other provider until late FY2015. Note that the revenue recognised by ISU was slightly different from the commission expense recorded by NIA due to differences in recognition standards applied to ISU’s revenue and NIA’s expenses.

One obvious benefit for ISU was having effectively funded a start-up of an additional panellist for its insurance comparison offering, which brought in some $52.2m in revenue over the last 3 years. But importantly, it turns out that ISU has been making pretty sweet margins from that business. Unfortunately, it is not possible to precisely pin down how sweet these margins were, as the company has declined to reveal the exact size of fees NIA paid to ISU per policy.

However, the company acknowledged that the NIA business (before the sale to GMHBA) used to be priced at the higher end of ISU's pricing range for the private health insurance business.

The company also stated that private health providers on their panel normally paid $700-$800 per policy (average RPS in Health and Car Insurance segment was $679 in FY15). Historical data on NIA policyholder numbers and ISU's cash flows from NIA business are also available in the public domain.

So the only two pieces of relevant information that are missing are the attrition rates in NIA policyholder numbers and the number of policyholders NIA obtained through channels other than ISU. Knowing these two bits of information would allow us to back out the implied price that ISU charged per policy. We would not pretend to know these parameters, but for the sake of highlighting how material the NIA relationship could have potentially been to ISU's profitability we will make our unsophisticated guess (note that we are not experts in this).

Using ISU's own commentary, the average expected life of a private health policy relationship currently stands at about 9-10 years (down from 15 years in 2000). This equates to an average attrition rate of 10.5% p.a. To reflect NIA's start-up status, we will use attrition rate of 15% p.a.

We do not have data to estimate the number of policies NIA sold outside of the ISU arrangement. Nevertheless, we know that NIA sold at least *some* policies directly to customers and later in FY2015 also via other distribution channels. To save us the trouble, let's assume zero sales from all non-ISU channels (this will result in understating the resulting implied price per policy).

You can see the results in the table below.

Table. Estimated price per policy charged by ISU from NIA vs. implied price per NIA policy from the GMHBA transaction

		2012	2013	2014	1H2015	2015
	Reported NIA facility ($000s)	0	15,378	32,766	45,900	52,200
	Approximate NIA Policyholder number[4]	3,456	15,863	31,657	41,657	~41000
a	Change in total NIA policyholder number		12,407	15,794	10,000	
b	Estimated attrition in policyholder number (at 15% p.a)		518	2,379	2,374	
c	Estimated non-iSelect policy sales		?	?	?	?
(a+b-c)	Estimated policies sold via iSelect		12,925	18,173	12,374	
d	Change in NIA facility ($000s)		15,378	17,388	13,134	6,300
d/(a+b-c)	**Average price per policy charged by iSelect ($, ex-GST)**		**1,190**	**957**	**1,061**	
	Total price paid by GMHBA for Health.com.au ($000s)					46,000
	Minus FY15 book value of Health.com.au ($000s)					-14,736
	Implied price paid for NIA policyholders ($000s)					31,264
	Estimated price per policyholder ($)					**763**

Based on the assumptions presented in the table, ISU received at least a 40% premium[5] (from NIA) on average over the "normal" price ($750) paid by other insurers, while also receiving a healthy interest rate on the face value of the loan facility. Based on that understanding, over the last 3 years

[4] Source: FY2012-14: PHIO, State of the health funds reports; 1H2015: ISU's Feb 2015 presentation; FY2015: ISU's commentary

[5] Average of $1190, $957 and $1061 weighted by the respective $ facility amounts and divided by $750

ISU has enjoyed nearly $15m in additional revenue (i.e. $52.2m revenue* (1-1/1.40)) plus collected $5-6m in cash interest from NIA. This $15m is a meaningful number and represents more than 30% of total EBIT (before NIA impairment) that ISU reported since listing.

It is not possible to know how much of that extra revenue fell directly into ISU's bottom line. It could have been close to 100%, but that is not clear. Similarly, it is interesting to know how much ISU would have earned, if NIA business had never existed in the first place.

We don't know what the original plan for NIA was, but the way things turned out, most of the $33m investment by NIA investors ended up funding what looks like a substantial portion of ISU's earnings over the last three years.

Given how material the impact on earnings appears (based on our imperfect information), we think that the management of ISU ought to **provide the public with some means to correctly assess the impact that the failed business model of NIA has had on profitability of the company in the past.**

The company recently released underlying EBIT guidance of $26-28m for FY2016 and flagged industry headwinds in the private health insurance vertical. If our analysis about the NIA fee premium being ~40% is correct, then FY2015 EBIT could have benefitted from some $5-6m of extra earnings from NIA (or 22% of FY15 underlying EBIT). This earnings gap (+ any further softness in the health vertical) will need to be replaced by something else in FY2016. **Hence, it becomes important to know if the company has lost any meaningful earnings power as a result of NIA being sold to a new owner.**

Good investing,

Max Shramchenko

Analyst