

REVIEW FROM ADRIAN GORE

Discovery Chief Executive

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Continued replication and advancement of Discovery's unique business model

When Discovery started almost 25 years ago, the complexity of the South African healthcare environment at the time provided a powerful and relevant incubator for innovation. South Africa's high disease burden, the undersupply of doctors and Discovery's desire to build an inclusive, community-rated health insurance system necessitated a new paradigm for addressing healthcare challenges. This was in the form of wellness and prevention, typically under-consumed because benefits are hidden while the cost and effort required are immediate, as opposed to healthcare, typically overconsumed as benefits are immediate while price is hidden.

Societal need – rather than being an external force and source of opportunism – has always been fundamental

to our business strategy and culture. As outlined in this year's integrated annual report, Discovery's business model reflects this. It incentivises members to improve their health, provides access to a broad range of wellness and prevention pathways for them to do so, measures engagement clinically and actuarially, and uses the actuarial surplus generated from improved health to fund further incentives.

Discovery has succeeded in triggering a positive systemic change that rewards lower-risk behaviour and enables the dynamic pricing of mortality, morbidity, and health risk. This shared-value insurance model encourages members to become healthier, and rewards them for doing so, with their premiums increasing or decreasing based on their engagement. As a result, we experience lower claims rates, with a higher retention rate for healthier lives. Through our health-promotion programme, Vitality, we deliver health and value for our clients, our partner insurers, and society at large. Refer to page 22.

As outlined on page 22, it is evident that the societal needs Discovery identified and responded to, have only become more acute. Risk is now predominantly driven by four lifestyle behaviours – poor diet, physical inactivity, excessive alcohol intake and tobacco use – which drive four chronic diseases (cardiovascular disease, diabetes, chronic lung disease, and various cancers). However, most life underwriting in the industry remains static and fails to account for the health improvements people make during their lifetime.

Technology is also playing a bigger role, with health promotion becoming more personalised, due to wearable devices. This has profound implications, given that insurers, alongside governments, are the only stakeholders with the capacity to monetise the positive effects of health behaviour change.

Our business model is even more relevant than before, as we have the ability to offer health, protection and savings products that create and share value and are dynamic, and allow people to manage their evolving health and wellness needs throughout their lives and be rewarded for improvements. This paves the way for growth in existing sectors and territories, expansion into new territories in existing sectors, and expansion into adjacent sectors and new business and product lines. These aspects are outlined in this integrated annual report on pages 36 and 37.

The financial and societal success of shared-value insurance has resulted in it becoming a compelling proposition to other insurers. Discovery has continued to enhance the sophistication of its business model to export it to leading insurers around the world. It has done so through the establishment of the Global Vitality Network.

The Global Vitality Network consists of partner insurers that employ the Vitality Shared-Value Insurance model and participate in collective network assets, such as opportunities for growth through the strength of the partner insurers themselves, global reward partnerships, technology collaborations, and academic and media partnerships.

This is a system of partner insurers that employ the Vitality Shared-Value Insurance model and participate in collective network assets. These include opportunities for growth through the strength of the partner insurers themselves, global reward partnerships, technology collaborations, and academic and media partnerships. Over the past five years, Discovery has entered into partnerships with AIA in Asia and Australia, Generali in Europe, John Hancock in the US, John Hancock's parent company Manulife in Canada, and Ping An in China. Recently, Discovery announced a partnership with leading Japanese insurer Sumitomo. All these organisations now act as ambassadors and proponents of shared-value insurance.

Discovery has continued to expand into adjacent industries, by extending shared-value insurance from our original product offering of health insurance and protection. In the past five years, the Group has developed a highly successful short-term insurance offering that employs the Vitality philosophy to encourage safer driving. Research shows that people are as irrational about their driving as they are about

their health. Using the latest telematics technology, driving behaviour is tracked and measured, and drivers are incentivised to reduce their driving risk. Emerging evidence validates that driving behaviour improves as a result, with benefits for the driver (fewer accidents and cash back on fuel spend), ourselves as the insurer through fewer claims, and society at large in the form of safer roads for other drivers and pedestrians. Refer to pages 75 to 77.

Given the irrationality at play in savings behaviour, there is an opportunity for the shared-value insurance model to disrupt traditional banking business – Discovery's next targeted adjacency. During the year under review, important progress was made in achieving the Group's strategy of entering into banking in South Africa.

The expansion of Discovery's model through a new insurance category – Vitality Shared-Value Insurance

One area that has received significant focus over the past few years is the execution required to export the Group's shared-value insurance model to new markets. To achieve this, Discovery has reorganised the management of global partnerships, giving rise to a division called Discovery Partner Markets. This division oversees the international roll-out of the model, providing systems, consulting support and governance to its partners, while partners act as franchisees, acquiring licences to use the Vitality Shared-Value Insurance model and related assets, in exchange for a "franchise fee" and a share of premiums.

The underlying strength of the Discovery Partner Markets proposition is being supported through the expansion of the Vitality Shared-Value Insurance model and the Global Vitality Network. The Vitality Shared-Value Insurance model has now been adopted by six partner companies in 14 markets around the world with Vitality impacting close to four million lives globally (including South Africa). In Europe, Generali launched in two markets over the past six months. In the more established partner markets, Discovery is seeing evidence of the efficacy of the Vitality Shared-Value Insurance model in the Group's results.

Supporting Discovery's ambition to develop international partnerships, considerable work was done with Apple to develop a global wellness infrastructure, namely Vitality Active Rewards with Apple Watch. This enables the real-time measurement and incentivising of wellness behaviour, as well as creating personalised goals for members. The success of Vitality Active Rewards with Apple Watch in changing wellness behaviour and segmenting insurance risk in South Africa and the United States has advanced the science underpinning the Vitality Shared-Value Insurance model.

Results during the first six months of the benefit being available to clients, showed dramatic and sustained behaviour change, with a 20% increase in physical activity for those who engaged in the benefit, and 81% for those clients with the Apple Watch. This is the most successful benefit of Vitality to date, as measured by take-up and engagement, with engaged members expected to demonstrate lower morbidity and mortality experience than other Vitality members over the long term. The benefit was also recently launched in China through Ping An Life. It will be attached to Ping An Life's flagship life insurance product, available through its one million strong agency force. This presents a meaningful opportunity to elevate the Vitality brand in China. Vitality Active Rewards will be rolled out globally over the next 12 months.

Going forward, the Group's focus will be on refining the way in which shared value is measured. Discovery's participation in major national and international initiatives exploring the concept and measurement of shared value will enable the Group to maintain thought leadership in this area, and contribute to its further development.

The year under review

The year under review was notable for three reasons. First, for a solid performance in our established businesses and a stronger performance in the second half of the year; a sustained investment in growth, including a continuing roll-out of Vitality Shared-Value Insurance to new markets; adjacent expansion in Discovery's Primary Markets with the intention to enter banking in South Africa; and refinements in the science underpinning the business model through the Vitality Active Rewards methodology. Secondly, it was marked by challenging market conditions, which showed the resilience of our business model in Discovery's primary markets of South Africa and the United Kingdom.

Discovery made a total investment of R823 million in new initiatives over the course of the year, funded by both debt and a rights issue. This marks a 73% increase over the previous year, equal to 13% of earnings, and double the long-term average investment between 2011 and 2015. Although this had a dampening effect on short-term profits, this investment is expected to be profit-enhancing in the long term.

In Discovery's primary market of South Africa, progress was made with respect to Discovery's intention to enter banking. The licensing and regulatory processes commenced and while the licence application is pending regulatory approval, key engagements are underway with the South African Reserve Bank and other regulatory bodies. Discovery has attracted a combination of senior seasoned bankers. With Discovery executives, they will lead the execution and delivery of the banking business. It is in the process of finalising operating processes, including system selection. Insights are being developed that will be utilised in the design of our final product offering.

Businesses in South Africa and the United Kingdom continued to gain market share and demonstrated robustness in new business and financial performance. This validates the relevance of the Vitality Shared-Value Insurance model in a complex operating and macro-environment.

Discovery Health and Discovery Life delivered strong performances overall, with normalised operating profit increasing by 12% and 18% respectively for the second half of 2016 compared with the second half of 2015.

Discovery Health's performance exceeded expectations in a period characterised by high healthcare inflation driven by higher hospital use. Discovery Health continued its significant investment in digital healthcare assets, with further expansion in the functionality and coverage of HealthID, the country's leading electronic health record system. This is now in regular use by over one million members and almost 50% of doctors treating members of Discovery Health's client medical schemes. The fully digital healthcare plan – the Discovery Health Medical Scheme Smart Plan – has also continued to prove successful in attracting a younger demographic. Discovery Life showed accelerated growth and performance while increasingly recognising and rewarding better health and longevity, and sharing gains from health improvements through paybacks from actuarial surplus – highlighting the value derived by healthy clients.

Vitality UK, Discovery's second primary market, delivered a strong performance, and demonstrated its resilience in an uncertain political and economic environment. Both VitalityHealth and VitalityLife continued to realise the benefits of Vitality. VitalityHealth experienced strong new business growth over the period, with particularly strong growth in the profitable individual market – up by 44% – and direct-to-market channels, which now comprise almost 40% of new business. VitalityLife produced a strong performance in the face of complex changes and achieved success in positioning its new-generation risk offering in the market. This was evident in the strong continued adoption of the Vitality-integrated model over the period, with the Vitality Optimiser product comprising over 60% of all new business sales. The performance of all Discovery businesses is discussed in detail in the business reviews.

The Discovery Foundation, now in its tenth year, has been instrumental in retaining doctors in public health, advancing research in crucial areas of medicine and supporting improved health outcomes in rural areas. In the past **10 years, over R160 million in grants has been awarded**, supporting the education and training requirements of some 300 healthcare specialists and institutions.

Discovery as a force for social good

Discovery is active in supporting healthier and more prosperous communities (see Discovery's Sustainable Development Report pages 38 to 39 for additional detail). Initiatives such as the Discovery Foundation, now in its tenth year, has been instrumental in retaining doctors in public health, advancing research in crucial areas of medicine and supporting improved health outcomes in rural areas. In the past 10 years, over R160 million in grants has been awarded, supporting the education and training requirements of some 300 healthcare specialists and institutions.

One of Discovery's core values is intellectual leadership. A pioneering approach to the development of shared-value products and services in the insurance sector has created financial capital for the Discovery business, shareholders and members, and other significant benefits, as described throughout our integrated annual report.

Discovery's intellectual capital is an asset for the Group, underpinning the expansion of the Vitality Shared-Value Insurance model to international markets. We therefore invest continually in training and development initiatives for employees (see our online Sustainable Development Report).

Discovery is also proud to be a catalyst in creating opportunities for employment and economic development. Given existing pressures on government and businesses, the most sustainable way to create jobs at the required rate is to stimulate the development of and to support different stages of small and medium enterprises (SMEs). Discovery is privileged to be part of an initiative under guidance of the South African Minister of Finance, Pravin Gordhan, to develop a solution in response to the varied challenges small and medium businesses face. Following consultation with experts across the private, public and non-profit sectors, the SA SME Fund was announced in September 2016. This Fund, seeded with capital from the private sector, will be additive to the ecosystem of existing SME support. Its aim will be to give high-potential entrepreneurs and SMEs the opportunity to create jobs, access to accredited funders, professional services and mentors.

Discovery's other partnerships, which include active participation in international bodies such as the United Nations Global Compact, business partnerships through initiatives such as Britain's Healthiest Company, and social partnerships such as with the City of Johannesburg, enrich our intellectual capital by improving an understanding of the context in which Discovery operates and enabling the Group to shape our environment for greater social benefit. Through a leadership role, Discovery with pharmaceutical company Novo Nordisk, in a recently-announced United Nations Global Compact initiative, aims to improve understanding of the role of health in sustainable development and to develop metrics against which businesses can report their health and wellness impacts. Refer to Discovery's Sustainable Development Report pages 50 to 51.

People as one of Discovery's most important assets

Employees play a critical role in enabling the Group to achieve its business objectives. In South Africa in particular, there is a clear imperative to achieve an inclusive and transformed workforce that equitably represents all sectors of society. Recruiting and retaining black South Africans in senior positions remain a key priority. Discovery competes with other businesses in South Africa for a limited pool of talent and the Group has therefore set a target of 25% representation by employment equity candidates in each of the business unit executive committees. We have met this target in all but two business units.

Some of the many initiatives undertaken to support transformation in Discovery's workforce include:

- Sourcing black talent through the Discovery network of employees
- Developing talented black employees
- Encouraging equity employees to develop skills classified as scarce and critical
- Providing new bursaries for the children and families of long-serving equity employees, who wish to acquire scarce and critical skills

Globally, Discovery invests significantly in employee health and wellness awareness, as there is recognition for the strong link between employee health, wellness and productivity. Discovery therefore provides detailed reporting on the health of our employees. See pages 26 to 35 of Discovery's Sustainable Development Report.

Looking forward

Discovery set an ambitious 2018 vision in 2014 to be the best insurer in the world and a powerful force for social good. The Group continues to make progress towards achieving these goals. In the longer term, Discovery will continue to leverage the shared-value insurance philosophy that underpins all businesses and initiatives in our markets and adjacencies, and we will continue to invest in new initiatives that are profit and society-enhancing. Over time, Discovery is building businesses that will become additions to the Group's portfolio and which will track well above economic growth. Discovery is well capitalised to fund further growth initiatives and has buffers in place to withstand adverse economic circumstances, while safeguarding future earnings and maintaining acceptable levels of debt.

Discovery's strategy will continue to be one of strong organic growth and building the Vitality Shared-Value Insurance model globally.



Conclusion

The year under review has been one of robust performance in spite of a volatile economic environment, an acceleration of the Group's performance and a substantial investment in new initiatives, most notably, the evolution of the Vitality Shared-Value Insurance model and Global Vitality Network. The success during the past year has been made possible by the vision, entrepreneurial spirit and commitment of our people, who I believe is one of Discovery's biggest assets. A special mention must be made commending Richard Farber, Discovery's Chief Financial Officer over the past 13 years, who will be relocating at the end of 2016. We thank him for his significant contribution to the Group's success. Richard will remain a Director of Discovery. On behalf of the Discovery Board of Directors, we would like to wish Richard and his family well in his future endeavours.

We remain excited by the potential of the unique business we have built over the past 25 years, and look forward to moving closer to our ambition of being the best insurance organisation in the world.