



Key Credit Strengths		Key Risk Factors
<p>Analyst Chris Cudsi (03) 8080 6684 chris.cudsi@australiaratings.com</p> <p>Credit Rating</p> <ul style="list-style-type: none"> 'BBB+' an Intermediate degree of creditworthiness <p>Product Complexity Indicator</p> <ul style="list-style-type: none"> Green <p>ASX Code</p> <ul style="list-style-type: none"> AYUHA 	<ul style="list-style-type: none"> Robust and competitive health insurance arm that generates 62% of adjusted EBITDA¹ Prudent and moderately conservative risk appetite with regard to gearing levels and maintenance of buffers above regulatory capital requirements Increasing diversification benefits of continued expansion into Retirement Living and Financial Services businesses 	<ul style="list-style-type: none"> All three of the Australian Unity Group's major businesses (Healthcare, Financial Services and Retirement Living) operate in areas subject to significant regulatory scrutiny and/or political pressure to minimise price increases Increasing exposure to project and construction risks inherent in property development Restricted financial flexibility, given Australian Unity Limited's mutual status precludes future equity raising

Credit Rating

The 'BBB+' rating assigned to the Australian Unity Notes (AUNs; ASX code: AYUHA) primarily reflects the assessed credit quality of both their issuer, Australian Unity Limited (AUL) and the wider Australian Unity Group (AU), a diversified mutual specialising in the provision of healthcare (largely comprising health insurance), financial services and retirement living.

Australia Ratings considers the 'BBB+' rating on the AUNs to be stable, meaning the rating is unlikely to change in the next one to two years.

The rating on the AUNs is very unlikely to be raised in the next one to two years given the potentially significant increases in non-recourse **debt likely to accompany AU's** sizeable proposed capital expenditure on retirement living projects.

The rating on the AUNs may be lowered if there arises a **material risk to the cashflows of AU's health insurance** business, within Australian Unity Healthcare (AUH), for example if there were very adverse changes in the regulatory (especially, price-setting) framework; or if

construction of AU's retirement living projects led to material unbudgeted increases in execution costs and delays.

Product Description

The AUNs:

- Are unsecured obligations of AUL, the holding company of AU.
- Have a maturity of 5 years.
- Rank behind secured creditors and rank equally amongst themselves and rank at least equally with all other unsecured obligations of AUL (other than those obligations mandatorily preferred by law).

The purpose of the A\$120 million AUN issue is to raise funds as part of the Australian Unity Group's **capital** management programme. The amount raised by the AUN issue will be used partly to repay debt and for general working capital and business purposes.

Product Complexity Indicator

The AUNs have been assigned a Green Product Complexity Indicator. The AUNs rank below secured debt **in AUL's capital structure but above equity.**

¹ Adjusted EBITDA equals earnings before interest, tax, depreciation, amortisation, investment income and other non-recurring expenditure

A Green designation indicates the terms and conditions of the notes are simple and straightforward with a very low level of **complexity on Australia Ratings' five point Complexity Indicator scale**.

This designation denotes that the AUNs do not contain complex terms and conditions that can alter the timing, form and amount of return an investor may receive. While there are a range of different circumstances under which the AUNs may be redeemed, the circumstances are considered exceptional and explained in a straightforward manner in the prospectus.

Business Profile

AUL (a public, unlisted company) is the ultimate holding company of AU. AUL controls a number of subsidiaries that carry out the major operational business activities of AU. AUL is a mutual company comprising some 285,000 members.

The Australian Unity Group

The Australian Unity Group (AU) is a diversified organisation specialising in provision of healthcare, financial services and retirement living.

AU generates around 62% of adjusted EBITDA¹ from its health insurance business (operating within Australian Unity Healthcare (AUH)) and another 19% from its Retirement Living business (AURL), with the remainder of earnings driven by its Financial Services business (AUFS).

The AU Group is based in Victoria, but is also expanding into Queensland, New South Wales, South Australia (through its 2009 merger with Lifeplan Australia Friendly Society) and Western Australia.

Over and above the features of its individual businesses (described below), the AU **Group's business profile is supported by the following key strengths:**

- A prudent and conservative approach to corporate management and strategy, supported by comprehensive, regular reporting;
- Benefit of increasing diversification away from reliance on AUH;
- Status as a mutual that would be expected to translate into higher customer loyalty; and

¹ Adjusted EBITDA equals earnings before interest, tax, depreciation, amortisation, investment income and other non-recurring expenditure

- Increasing integration across the group that should translate into increased cross-selling of products **across the group's diverse customer base.**

Australian Unity Healthcare (AUH)

Australian Unity Healthcare comprises a portfolio of businesses, namely Health Insurance and Allied Health. The Health Insurance business comprises a retail health insurance business and a corporate health insurance business. **AU's creditworthiness is underpinned by its retail health insurance business.** AUH contributes around 62% of adjusted EBITDA¹ As at 31 December 2010, the retail health insurance business is **Australia's 6th largest health insurer**, with almost a 3.0% market share nationwide and enjoys a particularly competitive position in its home market of Victoria, with a 9% market share, and is also expanding into Queensland, New South Wales and Western Australia.

The retail health insurance business has maintained an efficient operating performance, with a net underwriting margin consistently higher than its peers – in 2010, the retail health insurance business recorded a net margin of 8.1%, against an industry average of 4.5%. This has been achieved partly by the retail health insurance business reducing its combined ratio below the industry average in recent years - in 2010, the retail health insurance business recorded a combined ratio of 91.9%, compared with an industry average of 95.5%. In 2010, the retail health insurance business also maintained its management expense ratio (MER) at 9.9%, compared with a lower industry average of 9.2%.

Constraining the business profile of health insurers generally is the requirement for health insurers to obtain regulatory approval for premium increases from the Minister of Health and Ageing.

Risks to the retail health insurance business profile may arise from:

- Ongoing pressure on margins driven by political pressure to minimise health insurance costs, coupled with ongoing increases in the cost of health care provision.
- Regulatory restrictions on selecting and pricing risks, partly mitigated by the Commonwealth **Government's risk equalisation pooling arrangements.**

There are some levers available to AUH that would enable it to mitigate these risks. These include the ability to make changes to the benefits mix of its health

insurance products (with 90 day leadtime) and going out of contract with hospitals. Neither of these has been used by AUH, but they could be utilised in the event of financial stress, caused by a materially adverse regulatory outcome.

Australian Unity Retirement Living (AURL)

AU's business profile is bolstered by its Retirement Living business (AURL) that contributes around 19% of group adjusted EBITDA¹, through the building and operating of retirement villages and provision of aged care.

The average occupancy rates at AURL's retirement village and aged care sites consistently meet or surpass industry averages, while cash flows from aged care accommodation bonds are also stronger than the industry average.

AURL is currently working on a significant A\$400 million worth of development projects spanning a ten year timeframe, with potential peak debt not exceeding A\$79m across the portfolio of projects. The largest of these is **AU's A\$180 million** planned Wellbeing Precinct in the inner-Melbourne suburb of Carlton, in co-operation with the Victorian Government.

Certain features of AURL's operating model mitigate a significant portion of the execution and cost risks inherent in property development. Some of these mitigating features include:

- Securing certain levels of pre-commitment, typically around 40%;
- Phasing of projects; and
- Receipt of 50% of any capital gains achieved by village residents upon resale of units.

Australian Unity Financial Services (AUFS)

AU's business mix is further strengthened by its Financial Services business (AUFS) which comprises Investments (AUI) and Personal Financial Services (AUPFS) contributing 25% and minus 6% of group adjusted EBITDA¹ respectively. **AUI's contribution is through earning returns on AU's own funds of A\$4.0billion and management fees on another A\$8.4billion of investor funds.**

AU has built up extensive in-house property and mortgage fund manager expertise and has expanded its offerings to investors through the formation of joint ventures and strategic alliances with other organisations that have specialist proficiencies in other asset classes (including equities and fixed interest). These include:

Acorn Capital, Vianova Asset Management, Platypus Asset Management, Wingate Asset Management and Seres Asset Management.

Constraints to AUI's business are posed by:

- Potential regulatory changes aimed at reducing costs to consumers of managed funds, though this is **largely mitigated by AUI's low cost base; and**
- Current cyclical investor risk aversion to the activist type of managed funds that AUI has as joint venture partners; this risk aversion is expected to recede in line with anticipated recovery from the recent financial crisis.

Lifeplan Friendly Society Limited

In August 2009, Lifeplan Australia Friendly Society Limited, a leading provider of investment, funeral and education savings bonds, formally merged with AUL.

Lifeplan Australia Friendly Society Limited, together with the smaller AUL bonds business, now form a combined A\$2 billion bonds business within the AUI business.

Positively, APRA provides regulatory oversight of Lifeplan Australia Friendly Society Limited, thereby **providing some assurance that Lifeplan's operations are undertaken in adherence to independently-established, consistent standards.**

Financial Profile

AU's intermediate business profile is matched by an intermediate financial profile.

AU reported a full year net profit after tax (NPAT) of A\$17.1 million in 2010, returning towards levels of profitability prior to the 2008-2009 global financial crisis (GFC). Positively, AU's **profitability** appears quite resilient, given only a minor pre-tax loss of A\$2.9 million was recorded in 2009, during the GFC. This resilience is also supported by sensitivity analysis undertaken by Australia Ratings in relation to various scenarios.

Balance sheet gearing (including benefit funds) increased moderately, with gearing increasing to 37.6% in 2010 (from 34.0% in 2009).

AU's liquidity is prudent, supported by a significant buffer in excess of regulatory requirements as at 30 June 2010. AU benefits from a group approach to capital management, such that capital can be easily reallocated and deployed between its different businesses as the need arises.

Significant forecast capital expenditure on retirement villages, particularly the Carlton Project will likely involve

significant increases in debt which could place financial pressure on AU. While the vast bulk of any such anticipated, additional debt will be non-recourse to the wider Australian Unity Group, Australia Ratings expects such future borrowings to be prudently managed so that AUL and its subsidiaries honour their respective debt obligations.

AU maintains a fairly well-staggered debt maturity profile, which will be improved markedly by the paydown of A\$50 million in maturities (Westpac Cash Advance Facility) using proceeds of the AUN issue.

AU's mutual status and lack of access to additional equity (except as generated through retained earnings and mergers) limits its financial flexibility and capacity to pursue growth initiatives. However, while in the next one-two years there may be increased capital expenditure associated with the Retirement Living business and associated increases in debt levels, the absence of distribution payments to members is **expected to lead to continued growth in members' funds** which could be reinvested into growth opportunities or used to reduce debt levels. Nonetheless, on balance, given the significant forecast increase in debt levels in the next one-two years, the lack of access to further equity raising is expected to outweigh the absence of pressure to pay distributions during this period.

Key Terms and Conditions of the AUNs

There are a number of terms and conditions of the AUNs that are important from a creditworthiness perspective.

Undertakings

AUL has made some undertakings that provide a significant level of comfort to AUN holders.

In particular, AU will undertake:

- **To limit the debt of AUL to a prescribed level of gearing of 45%** – specifically, that the aggregate (without double counting) of Consolidated Interest Bearing Liabilities and AUL Guarantees (minus Lifeplan Australia Building Society Liabilities and Lifeplan Australia Building Society Guarantees) divided by the aggregate of Consolidated Interest Bearing Liabilities and AUL Guarantees (minus Lifeplan Australia Building Society Liabilities and Lifeplan Australia Building Society Guarantees) plus Total Equity (minus the equity of Lifeplan Australia Building Society) is less than 45% .
- **To provide a negative pledge to AUN holders** - that is, that no member of the AU Group may grant

security for any financial indebtedness (other than certain specified exceptions, discussed below in the **section 'AUNs Ranking vis-a-vis Senior Debt'**) without also providing the same or equal ranking security to AUN holders; and

- **That AUN holders are not structurally subordinated to other financial creditors of AUL** (other than certain specified exceptions, discussed **below in the section 'AUNs Ranking vis-a-vis Senior Debt'**).

Payment of Interest

Interest payments on AUNs are compulsory and not deferrable by AUL.

The calculation of interest payments is explained in the **section below titled 'Interest Payments'**.

AUNs Ranking vis-a-vis Other AU Debt

The AUNs are unsecured obligations of AUL, the holding company of AU.

Therefore, they rank behind secured creditors and rank equally amongst themselves and rank at least equally with all other unsecured obligations of AUL (other than those obligations mandatorily preferred by law).

Security

AUNs do not benefit from any security against any assets of AUL or AU.

AUNs Relative Ranking

As at 31 December 2010, AU had A\$229.1 million of other financial debt that ranks ahead of the AUNs. This senior debt is marked in green in the table below, while equity (junior to the AUNs) is marked in blue:

	<u>Drawn Financial Indebtedness and Equity</u>	<u>Amount Drawn A\$</u>
Senior Financial Indebtedness or Financial Indebtedness in respect of which the person to whom the Financial Indebtedness is owed only has claims against certain Subsidiaries or certain assets of the AUL Group	– Westpac Cash Advance Facility	\$50.0m
	– Health Insurance subordinated capital notes	\$25.0m
	– Limited recourse debt	\$3.6m
	– Preferential units in Australian Unity Aged Care Trusts #1, #2 and #3	\$10.0m
	– Retirement Village Investment Notes	\$61.8m
	– Lifeplan Australia Building Society deposits	\$78.7m
Subordinated	– Equity	\$373.8m

Additional Debt

AUL has the right to issue additional notes or other securities that have the same or different terms and conditions to the AUNs and which may rank ahead, equally with or behind the AUNs and whether or not secured, without the approval of AUN holders (subject to compliance with the negative pledge and the gearing ratio, **both covered in the section above titled ‘Key Terms and Conditions of the AUNs’**).

In addition to its existing secured debt, AUL may, within limits, incur additional secured debt or give security over existing debt. If this was to occur, AUNs would also rank behind such new or additional secured debt. However, in addition to the constraints imposed by the negative pledge and gearing ratio, there are the following additional restrictions around the issuance of such new or additional secured debt:

AU will undertake that:

- No member of AU will grant security for any debt (other than certain specified exceptions set out in the AUN terms) without also providing the same or equal ranking security to AUN holders; and
- No subsidiary of AUL will incur new debt (other than certain specified exceptions set out in the AUN terms) unless that subsidiary has provided a guarantee and indemnity in favour of the Trustee for all moneys owing in respect of the AUNs. This undertaking is intended to limit the extent to which AUN holders are structurally subordinated to other financial creditors of AU.
- Security cannot be granted to existing new or additional debt without equivalent security also being granted to AUN holders, except for the following permitted security interests:
 - liens, and other charges arising in the ordinary course of business;
 - any security interest over any asset that is currently security for the Westpac Cash Advance Facility;
 - any security interest provided in relation to the development finance for the proposed Wellbeing Precinct in Carlton, Victoria;
 - certain existing security interests over the assets of subsidiaries that may be acquired by AU in future;
 - any security interest granted for the Retirement Village Investment Notes issued by Australian Unity Finance Limited;
 - any security interest for limited recourse debt, including **AU’s retirement living** projects; and
 - any other security interest provided the aggregate value of assets subject to such security interests is not more than 10 percent of total equity.

Term

The AUNs have a maturity of 5 years, unless they are redeemed early.

Early redemption may occur in a number of ways, as outlined below.

Early Redemption by AUL

AUL may redeem all (but not some) of the AUNs prior to maturity. If AUL exercises this right, or if AUL implements or carries out a demutualisation (in which case redemption is mandatory), AUL must pay AUN holders the face value of \$100 per AUN, plus any outstanding Interest due and payable, plus an Early Redemption Payment of:

- \$5 if redemption occurs within 1 year of issue;
- \$4 if redemption occurs between 1 and 2 years after issue; and
- \$2 if redemption occurs more than 2 years after issue.

In addition, AUL may redeem the AUNs prior to maturity if:

- The face value of the outstanding AUNs is less than 10 percent of the AUNs originally issued;
- An event of default occurs; or
- Other specified taxation or regulatory events occurs;

If AUNs are redeemed prior to maturity in these circumstances, AUN holders will receive the aggregate principal amount outstanding plus any outstanding interest due and payable

Early Redemption by AUN Holders

AUN holders may sell their AUNs on the ASX at any time.

In addition, AUN holders may redeem the AUNs in the following circumstances:

- AUNs cease to be quoted on the ASX or trading of the AUNs on the ASX is suspended for more than 15 consecutive business days; or
- if there is an event of default, the Trustee may require AUL to redeem the AUNs.

If AUNs are redeemed by holders prior to maturity, AUN holders will receive the aggregate principal amount outstanding plus any outstanding Interest due and payable.

Interest

The interest rate payable for each interest period will be the sum of the three-month BBSW, as determined on the first business day of the relevant interest period, and the Margin.

Interest Rate = three-month BBSW + Margin

The Margin has been set at 3.55% and is fixed for the term of the Australian Unity Notes.

The amount of interest scheduled to be paid on each AUN in respect of each interest period will be calculated using the following formula:

$$\text{Interest payable} = \frac{\text{Interest Rate} \times \$100 \times N}{365}$$

where:

- N means the number of days in the Interest Period

For example, if the interest rate was 9% per annum and the interest period was 90 days in length, the interest payable for each AUN for the relevant interest period would be calculated as follows:

$$\frac{9\% \times \$100 \times 90}{365} = \$2.22 \text{ per AUN}$$

Market Risk

As AUNs will be an ASX listed security (ASX code: AYUHA), if an investor wishes to redeem the investment, the security can be sold through the ASX with the investor receiving the price quoted as a buy price on the exchange.

The market price of AUNs may fluctuate due to various factors that affect financial market conditions or factors relating to AUL. There may be volatility in the market price of AUNs and this may result in a market price below their issue price of \$100. If you sell your AUNs, you may not be able to do so at an acceptable price, or at all, if insufficient liquidity exists in the market for AUNs.

Key Financial Metrics

A\$ m	For the	For the Year Ending June 30			
	half-year ended	2010*	2009*	2008*	2007*
	31-Dec-10				
Revenue from continuing operations	508	934	617	609	603
Segment revenue	356	652	596	578	567
Revenue attributable to members of Australian Unity Limited	360	666	592	582	553
Revenue from Benefit Funds	148	268	25	27	50
Operating earnings	11.9	23.7	9.9	19.4	21.2
Net Profit Before Tax	12.9	18.5	-2.9	39.1	42.3
Net Profit After Tax	11.1	17.1	1.1	32.3	32.1
Equity	373.8	364.7	302.6	301.7	269.6
Assets	2,995.8	2,959.1	1,375.5	1,367.6	1,422.6
Liabilities	2,621.9	2,594.4	1,072.9	1,065.9	1,153.0
Total assets attributable to members of Australian Unity Limited	1,139.5	1,090.9	920.8	880.3	910.1
Total liabilities attributable to members of Australian Unity Limited	765.6	726.2	618.2	578.6	640.5
Total assets attributable to Benefit Fund policyholders	1,856.3	1,868.2	454.7	487.3	512.5
Total liabilities attributable to Benefit Fund policyholders	1,856.3	1,868.2	454.7	487.3	512.5
Debt	229.2	220.1	155.6	152.2	102.2
Equity / Assets (%)	12.5%	12.3%	22.0%	22.1%	19.0%
Equity / Liabilities (%)	14.3%	14.1%	28.2%	28.3%	23.4%
Return On Assets attributable to members of Australian Unity Limited (%)	1.9%#	1.6%	0.1%	3.7%	3.5%
Return On Assets (%)	0.7%#	0.6%	0.1%	2.4%	2.3%
Return On Equity (%)	5.9%#	4.7%	0.4%	10.7%	11.9%
Debt/(Debt+Equity) (%)	38.0%	37.6%	34.0%	33.5%	27.5%
Gearing per Australian Unity Notes Terms (%)	29.2%	28.5%	34.2%	33.8%	27.8%

Notes to the Key Financial Metrics: Profits before tax and operating earnings exclude the impact of the Benefit Funds which are required to be included in the financial statements but which have a zero impact on profit after tax.

* 2010 includes 10 months of Lifeplan Australia Friendly Society group. 2007 includes results of the general insurance business that was sold in 2008, materially affecting comparative results for the years up to and including 2008.

At an annualised rate

Contact Details

Australia Ratings

Mezzanine 6, 181 William Street
Melbourne Vic. 3000

Telephone: (03) 8080 6684

Email: chris.cudsi@australiaratings.com

Web: www.australiaratings.com

Disclaimer

Australia Ratings has made every effort to ensure the reliability of the views and ratings expressed in this report and those published on its websites. Australia Ratings research is based upon information known to us or which was obtained from sources which we believed to be reliable and accurate at time of publication. However, like the markets, we are not perfect.

This report is prepared for general information only, and as such, the specific needs, investment objectives or financial situation of any particular user have not been taken into consideration. Individuals should therefore discuss, with their financial planner or advisor, the merits of each rating for their own specific circumstances and realise that not all investments will be appropriate for all subscribers.

To the extent permitted by law, Australia Ratings and its employees, agents and authorised representatives exclude all liability for any loss or damage (including indirect, special or consequential loss or damage) arising from the use of, or reliance on, any information within the report whether or not caused by any negligent act or omission. If the law prohibits the exclusion of such liability, Australia Ratings hereby limits its liability, to the extent permitted by law, to the resupply of the said information or the cost of the said resupply.

Financial Services Guide

A copy of Australia Ratings' Financial Services Guide can be obtained at www.australiaratings.com. A copy can also be provided free of charge by calling (03) 8080 6684.