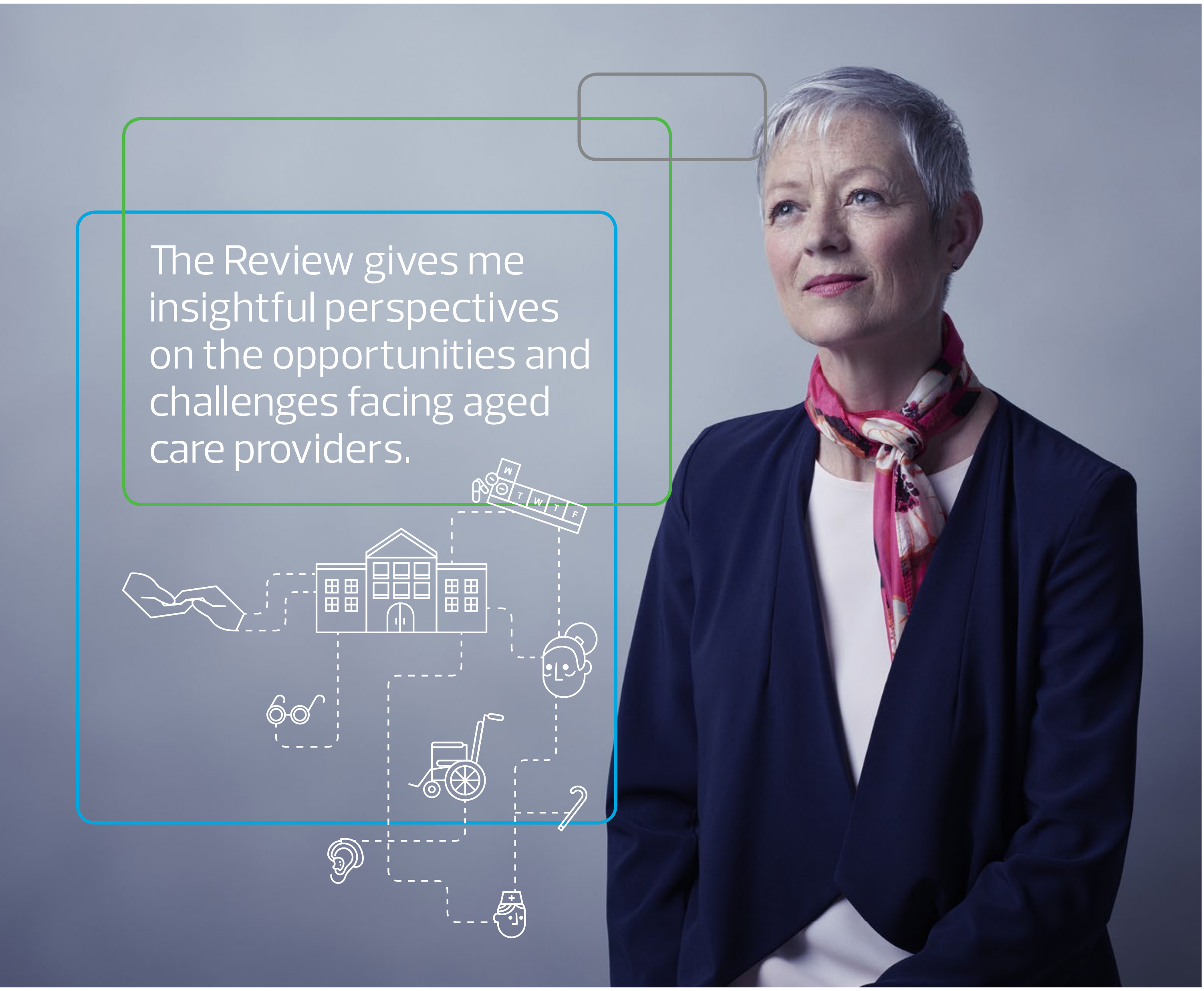

RSM AGED CARE SUSTAINABILITY REVIEW 2016

Insights into market dynamics, financial dynamics and other factors at play in aged care.

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CONTENTS

OVERVIEW

RSM is pleased to bring you the first Residential Aged Care Sustainability Review (Review). The provision of aged care services is undergoing fundamental change arising from:

- The increasing population of older Australians
- Changing family dynamics
- Increased life expectancy and
- Government policy

Successful navigation through this change depends on the capacity of market participants to understand these drivers and the consequences of the changes. There are a number of reports and datasets covering various issues relevant to the Residential Aged Care Sector. These include:

- Aged Care Financing Authority surveys and reports
- Annual stocktake of places
- ACAR round outcomes
- Productivity Commission Reports
- Bureau of statistics population data
- Operational Benchmarking services

In addition to the above there are a number of research papers and commentaries published in any year. Some of these publications are annual reports while others are periodic or discrete in nature.

Despite the existence of multiple data sets there isn't an integrated analysis of the trends in the key drivers of sustainability. The **Review** provides a level of insight that can inform market participants (providers, policy makers and service providers) of the longitudinal trends emerging in the provision of residential aged care and the impact of the regulatory reforms.

The **Review** analyses data from a number of sources and presents; insights into short and medium term trends emerging in the residential aged care sector. We provide analysis and opinion of emerging issues facing the sector utilising skills and knowledge developed from our involvement in the industry over more than 15 year. As appropriate we draw on information from our recent research into the qualitative and quantitative factors impacting the performance of residential aged care providers (link) undertaken by RSM for the Aged Care Financing Authority.

This inaugural edition of the review focuses on the following issues:

Market dynamics

- **Demographics** – is there a consensus forecast of the aging population
- **Supply and demand** – what are the supply and demand dynamics related to the demographics.
- **Investment in new stock and refurbishment** – what insights can be gained from the supply and demand dynamics and recent investment trends

Financial dynamics

- **Operational performance (operating results)** – what trends are there in operational performance over time and how does this inform ongoing financial viability and attractiveness of the sector
- **Financial performance (funding and returns)** – What are the trends in investment performance of the industry
- **Funding expansion** – what are the implications on return and financing flowing from lump sum accommodation payments as the sector continues to transition to a user pays environment

Other factors at play

- **Stay, Grow or Go** – some insights on these three business strategies
- **Downside risks** – we provide our insights and conclusions on the above as they relate to strategy
- **The shift to user pays** – a review of relative contribution to aged care costs
- **Business Model considerations** – some high level thoughts for executives and boards to consider at this time.

The **Review** seeks to provide participants in the sector a holistic view of the changes in the primary drivers of sustainability of residential aged care. It provides executives, boards and other market participants with critical analysis and insight into the impact and implications of the changes occurring within the sector. In subsequent years we intend to build on the first report by enlisting providers in a survey of qualitative and quantitative data to provide a richer analysis of trends and intentions.

We anticipate the **Review** will become a valuable industry resource. We trust you find this first edition of the **Review** informative and interesting.

We wish to acknowledge the support of Macquarie Telecom and St.George bank, our partners who have made this publication possible.

Macquarie Telecom is Australia's number one B2B telecommunications company. With business-grade Voice, Data and Mobile services, we offer a truly integrated end-to-end telecommunications solution. However, Macquarie Telecom is not 'just another Telco'. With a net promoter score of +56 we have some of the happiest customers in the Industry. In working with aged care providers for over 15 years now, we understand the challenges they face and how to tailor the right solutions to meet their needs.

Dedicated to Seniors Living Banking for more than 20 years, St.George recognises that the sustainability of the aged care sector is critical in shaping a positive outcome for Australia's social landscape. We are proud to be partnering with RSM to bring you the inaugural Residential Sustainability Review.

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EXECUTIVE SUMMARY

The inaugural edition of the RSM Aged Care Sustainability Review has highlighted a number of issues and trends that directly relate to the viability and sustainability of the residential aged care sector. Key findings from our research include:

1. Forecasts as to the population who may access residential aged care services in the future vary considerably.
2. Official estimates of demand are more likely to be understated than over stated. If the current utilisation rates are maintained then the base rate of demand may be up to 13% (35,000 places) above official forecasts.
3. Recent domestic trends and overseas experience suggest that the basis on which future demand has been forecast may need to be revised.
4. We see little evidence that sufficient supply can be created to meet the most optimistic forecasts of demand during the next decade
5. The available statistics suggest that even if supply could be created to meet demand that there is insufficient appetite for this within the sector.
6. There is an emerging trend towards shorter stays (1–3 mths) and this may be contributing to higher vacancy factors
7. Increased interest in applying for new places is yet to translate into more operational places
8. Despite improvement in operating performance in 2014 the industry is no more profitable than it was in 2012.
9. The profitability of the industry is declining
10. Return on assets and equity continue to decline
11. Indications are that the industry will become increasing reliant on short term finance in the form of resident loans which increases the risk profile of the industry
12. Recent interest in the industry is more focused on investment returns than creating additional capacity

MARKET DYNAMICS

DEMAND

The Productivity Commission Inquiry into Caring for Older Australians[1] (LLLB) considered the future demand for residential aged care as Australia's population increases and ages. The Inquiry found that demand for residential aged care services is projected to increase by almost 68% in the next 40 years.[2] Since the release of LLLB there have been 2 intergenerational reports and in 2015 the Productivity Commission report[3] which contained updated population forecasts.

There is no disputing that the Australian population is growing and aging to a degree that will significantly impact the demand for residential aged care services in the future.

In this chapter we analyse the various population forecasts and consider the impact this has on the forecast demand for residential aged care places.

To understand the future demand it is necessary to consider:

1. The future population projections of those who potentially use aged care services
2. The rate at which various age cohorts' access residential aged care and
3. The duration of their stay in care.

Population projections of potential users

Figure 1 shows the projected population (65+) under the main available forecasts.[4]

> In the short term (2020) there is a 43% variance in the forecast population .

This variance reduces to 37% in 2050. This severely impacts the degree of precision that can be applied to assessing the future demand for residential aged care services and as we will show has significant implications in an environment where the government manages supply.

The number of people over 65 years old is projected to more than double by 2055 compared to 2015.

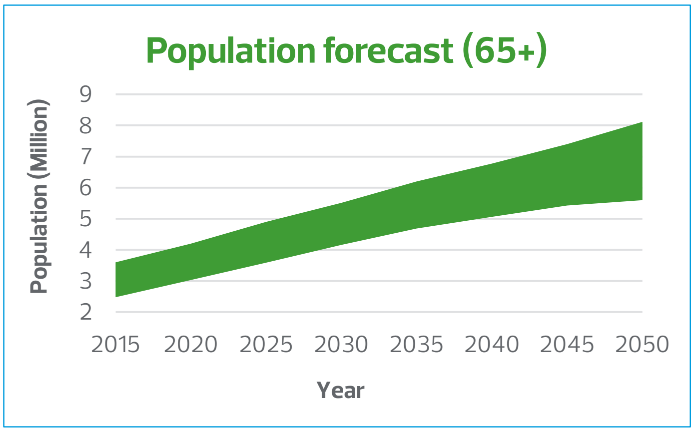


Figure 1 — Proportion of population aged 65+ [4]

Forecast population to access residential aged care

The Aged Care Division of the Department of Health, develops and manages the supply of residential aged care places using a ratio of the population over 70 it anticipates will require residential aged care. Reflecting the recent aged care reforms, the department has set the target to 80 places per 1000 persons over the age of 70. The ratio was previously 83 places per 1000 in 2014.[5] This suggests that the Department is projecting 8% of people over 70 will access residential aged care during their lifetime.

Figure 2[6] shows the actual utilisation of residential aged care by various aged subgroups. This utilisation data allows for a more nuanced forecast of future demand than the 8% base.

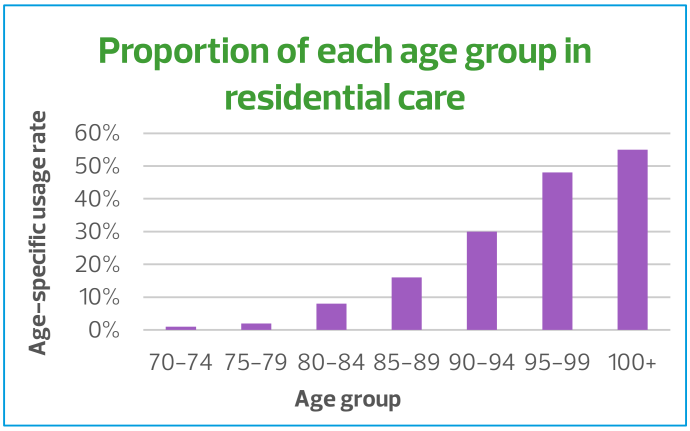


Figure 2 — Proportion of each age group in residential care, 30 June 2014 [7]

Using the high and low range population forecasts we compared the forecast demand based on the 8% ratio and that derived using the utilisation experience data. Figure 3 shows the degree of variation between both data sets.

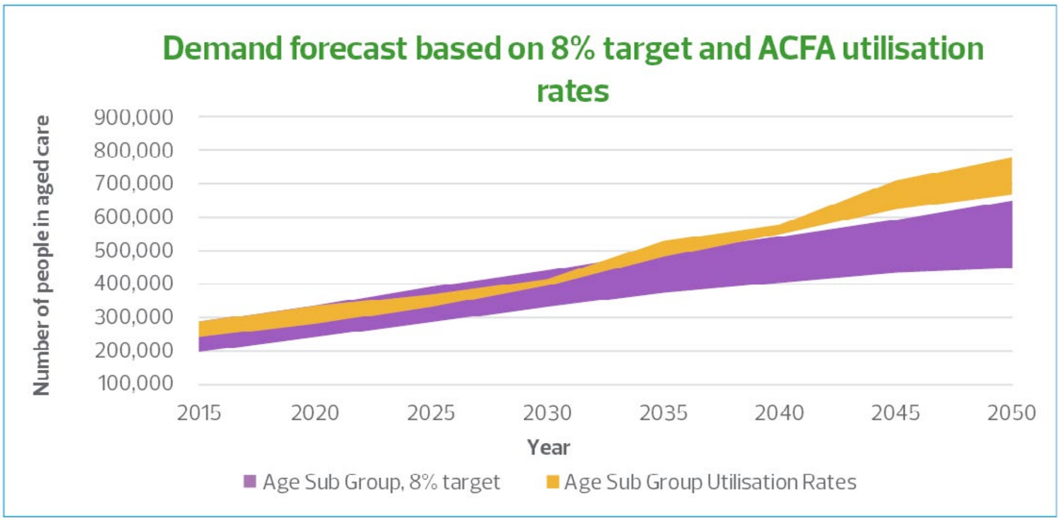


Figure 3 – Demand forecast based on 8% ratio and ACFA rates (2020– 2055) [8] [9] [10]

> While the forecast demand for residential places overlaps under both scenarios, the use experience forecast is consistently higher than the 8% forecast.

Table 1 shows the divergence in the forecast demand between these two methods of forecasting.

	2020	2025
Indicative demand based on 8% ratio		
Low population forecast[8]	235,000	278,000
High population forecast[9]	336,000	392,000
Indicative demand based on age utilisation[7]		
Low population forecast[8]	266,000	314,000
High population forecast[9]	334,000	368,000

Table 1 – Demand forecast based on 8% ratio and ACFA rates (2020 & 2025)

Official estimates suggest an increase of 82,000 residential places is required by 2025 to meet forecast demand.[10] According to the stocktake of operational places there were 196,000 operational places in 2015. Therefore the forecast total demand by 2025 is 278,000. This is in line with the low population forecast in Table 1.

As the sub group utilisation is based on actual experience whereas the 8% is a supply target future demand may well be higher than the supply targets being used by government predict.

> If the current utilisation rates are maintained then the base rate of demand will be 314,000 places which is 13% (35,000 places) above the official estimate.

If the use experience is a more accurate prediction of future demand this has significant implications for supply management under the current arrangements.

Impact of changes in usage patterns

As noted above the target percentage utilisation has been reduced as a result of recent policy changes, most notably the shift in focus to in home care. To date the reforms have not had time to reflect in any further downward shift in demand. It is reported that in the United States of America there has been a long term decline in the percentage of residents within the over 75 age cohort who access residential aged care (see figure 4).

Percentage of Americans aged 75+ in residential aged care

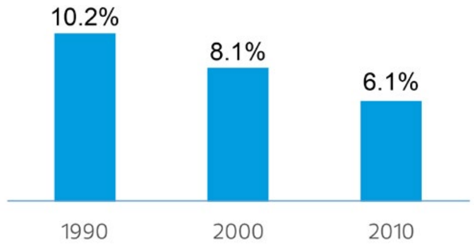


Figure 4 — Aged care ratio in America [11]

It is possible that the recent changes, which shift the onus of cost to the consumer combined with the increased focus on home based care, may result in demand in Australia following the American trend.

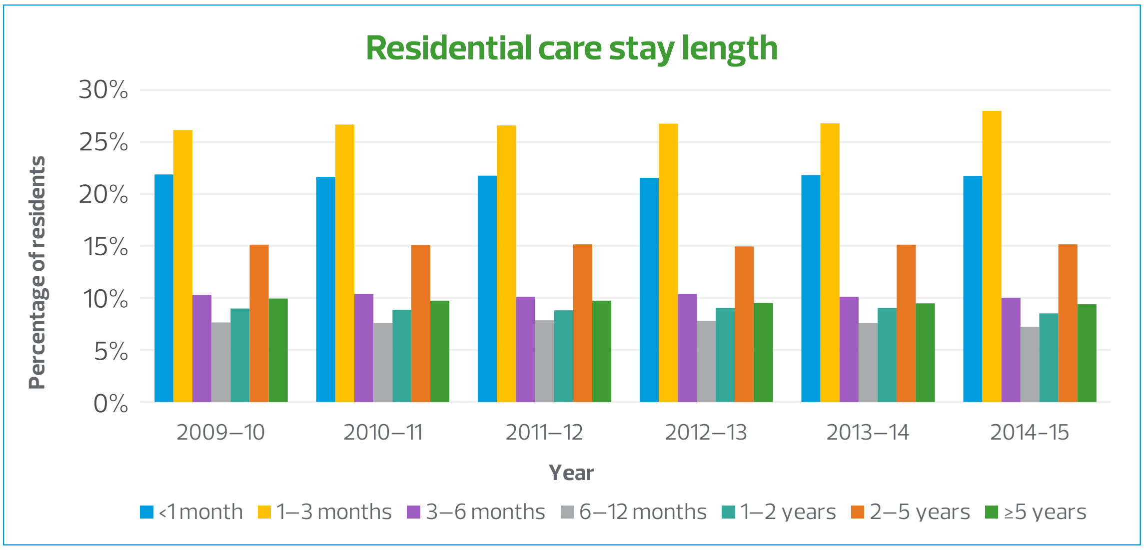
If, as many commentators suggest, the sector will benefit significantly from innovation in the future then it is not unreasonable to expect that the underlying demand for residential places may follow the trend in USA. If this occurs it will reduce aggregate demand for places.

Current planning ratios reflect the recent demand and the current view of future demand expectations. The degree to which they anticipate changes in demand as a result of policy changes is unable to be quantified. However the available data suggests there is significant uncertainty in forecasting future demand for residential aged care places at a macro level.

Duration of stay

Changing trends in accessing residential care impact the length of stay. This in turn impacts the number of places required to meet the aggregate demand and vacancy rates. For example if the average stay was to decline from 1 year to 6 months, this would in effect double the number of notional places available. This is analogous to the situation with a restaurant where the number of tables needed is determined by the number of times in an evening that a table can be used. Understanding the trend in the length of stay in residential age care is therefore important to understanding the future supply / demand balance of places.

Figure 5 shows the trend in length of stay from 2010 - 2015. The series includes data one year after the implementation of the latest reforms and this affords us an opportunity to see whether the changes impact this key driver. It is clear that for the 5 years to 2014 the trend in length of stay has remained very stable.



In 2015 there is a change in length of stay in the period 0-3mths.

Figure 5 — Residential care stay length 2009-2015 [12] [13]

The data in table 2 shows an increase of 1.2% in the time group 1-3mths which is a significant increase relative to the past trend.

	<1 mth	1–3 mths	3–6 mths	6–12 mths	1–2 years	2–5 years	≥5 years
Difference between 2013-14 & 2014-15	-0.1%	1.2%	-0.1%	-0.4%	-0.5%	0.0%	-0.1%

Table 2 — Changes in length of stay in residential care between 2013-14 & 2014-15

The increase in this short stay period is compensated by a decline in the 6 –24mth periods. As we interact with the industry we see considerable anecdotal evidence that the length of stay is declining which is borne out in these statistics. If this trend is maintained it will bring the managed creation of supply into closer alignment with forecast demand over the next decade.

Where demand is heading

> When the three principal drivers of demand (Forecast Population, Utilisation by population subgroup and the time in care) are considered perhaps the best conclusion that can be drawn is that while demand is increasing the shift to user pays and increased focus on in home care may result in relative level of demand declining over the medium to long term.

As a decision to build or acquire a residential aged care asset is a long term investment players, considering expanding their involvement in the sector would be well advised to go beyond simply relying on the target ratio the government uses when allocating places in the Aged Care Approvals Round ACAR when making decisions as to location.

SUPPLY

If the market for aged care places were to be deregulated there would be an expectation that supply would find a level appropriate to demand. However the supply of places is tightly regulated. Using available data we have analysed the likely rate at which places come on line and other factors impacting supply to gain a better understanding of opportunities for players in the industry and to understand how policy initiatives have been received by industry players.

Allocation of places

The principal constraints to supply are the allocation of places and the time it takes for allocated places to become operational.

Table 3 shows the pattern of ACAR allocations from 2009 to and including the 2015 round.

	2009 (Dec 08)	2010 (Dec)	2011 (June)	2013 (Dec 12)	2014 (June)	2015 (Sept)
ACAR places offered / allocated	5,748	5,643	7,933	7,775	11,196	10,940
ACAR places sought			12,295	10,975	19,169	38,859
Places sought relative to places offered			1.6*	1.4*	1.7*	3.6

Table 3 — Aged Care Approvals Round results 2009–2015 [14]

The Department has responded to the forecast increase in demand by lifting the number of places allocated in both 2014 and 2015.

> The increase in provider interest in 2014 reversed the decline in interest in 2013, while 2015 confirms strong investor interest in the sector.

The unsatisfied demand for places in the 2015 ACAR was 28,000 places. While many applications relate to the same area the record level of interest suggests even higher interest in 2016. The results in 2015 and 16 combined with our supply/demand analysis lead us to conclude there is an opportunity for the number of places allocated to be increased in 2016.

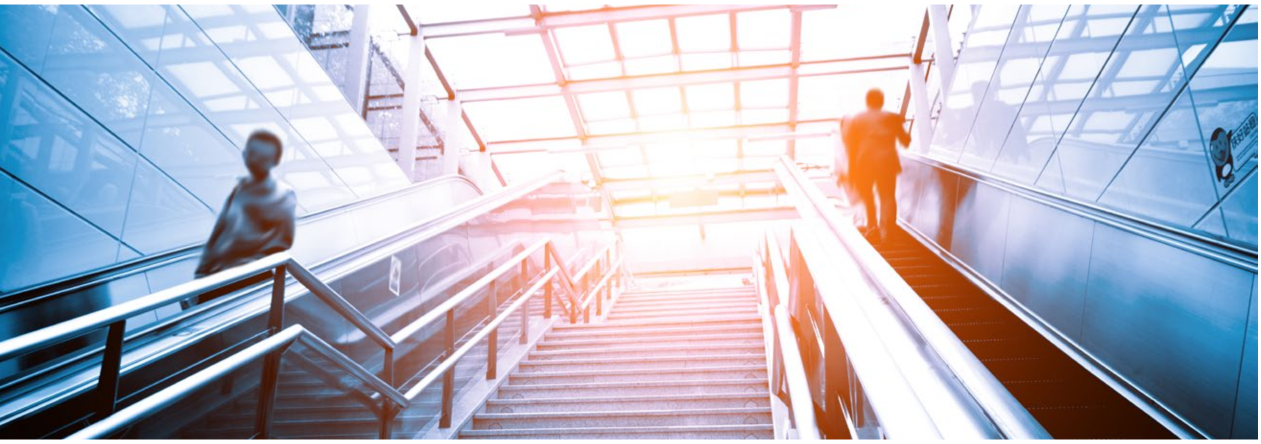
The provisional allocation of places is only the first step in a process that takes many years to see an allocated place become active. The median time for an allocated place to become active is 4 years.[15]

Operational places

The most significant factor impacting the supply of places is the rate at which places become active. The Dept. undertakes an annual stocktake of places and from this data we have calculated the ratio between allocated places and operational places. Changes in this ratio are indicative of the rate at which providers are constructing new facilities. Table 4 shows the history of this relationship since 2011.

	2011	2012	2013	2014	2015
Stocktake Operational places	185,559	187,941	189,761	192,834	195,953
Stocktake Allocated places	207,279	214,059	220,030	220,585	231,615
Operational percentage	90%	88%	86%	87%	85%

Table 4 — Stocktake of operational vs. active places [16]



While the interest in the 2014 and 15 ACAR rounds suggest that the decline in the percentage of operational places that occurred between 2011 and 2015 should reverse based on the percentage of allocated places that are operational it is too early to have confidence in this at this time.

Continuing erosion of the income base of the sector as has been seen in the last 18 months and as recently as the Dec15 announcement could undermine the rate at which places become active preventing a turnaround in the operational percentage, or worse: see a continuation of a decline in the percentage of operational places.

Forecast places

To understand the likely supply of places over the next decade we used the historical pattern in the allocation of places and the rate at which places are brought on line to forecast and the future supply of operational places.

Table 5 contains our forecast of operational places to 2024.

	2014–15	2015–16	2016–17	2017–18	2018–19	2019–20	2020–21	2021–22	2022–23	2023–24
Forecast active places	193,000	198,000	203,000	209,000	216,000	224,000	233,000	242,000	252,000	262,000

Table 5 — RSM forecast active places

BALANCING SUPPLY AND DEMAND

Ideally government and industry would like a situation where the system is as near balanced as possible. This would see high occupancy rates for providers, easy access for consumers and a high level of sustainability for the sector.

Figure 6 compares our projection of operational places against the various demand forecasts to show the relative balance in the system.

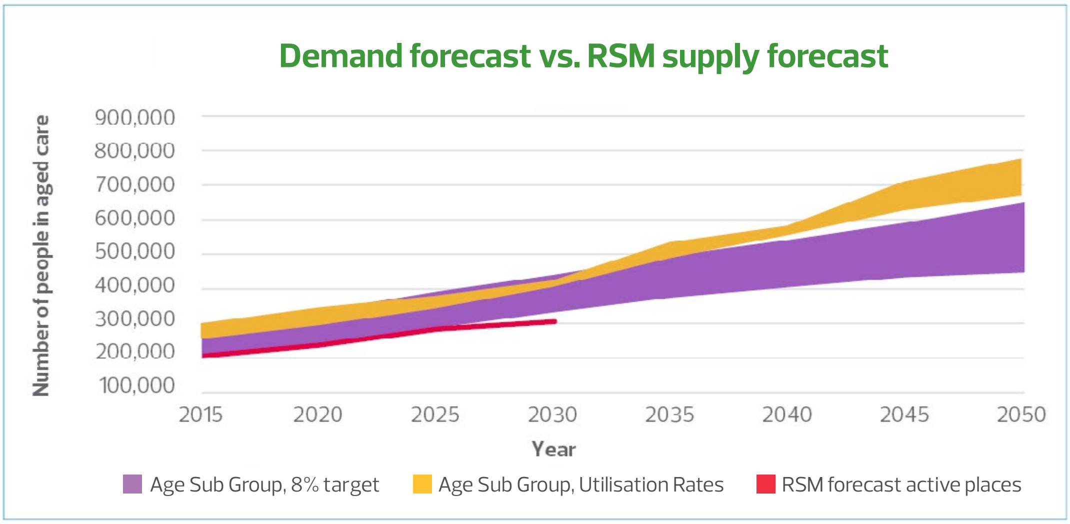
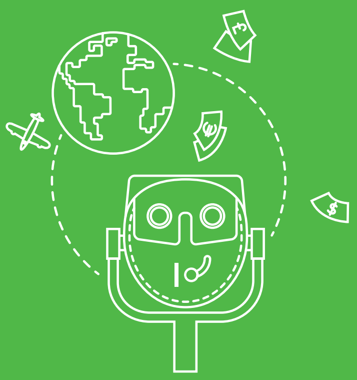


Figure 6 — Demand vs. supply forecast [17 18 19]



Continuing erosion of the income base of the sector could undermine the rate at which places become active.

Based on this analysis the rate at which new supply is made operational will see aggregate demand continue to outstrip supply over the next 15 years. The apparent excess in demand will reduce if there is a shift in aggregate demand in line with the experience in USA or the trend in the reduction in the length of stay continues.

> As the government forecast of 8% is based on the lower of the available population predictions, it is probable that demand will outstrip the rate at which active places are being created over the next decade.

Based on currently available data we do not see a situation where supply will exceed demand in the near term. This is positive news at the investment level.

OCCUPANCY

Occupancy rates provide a reality check on supply – demand analysis. Figure 7 shows the historical occupancy levels at an industry level.

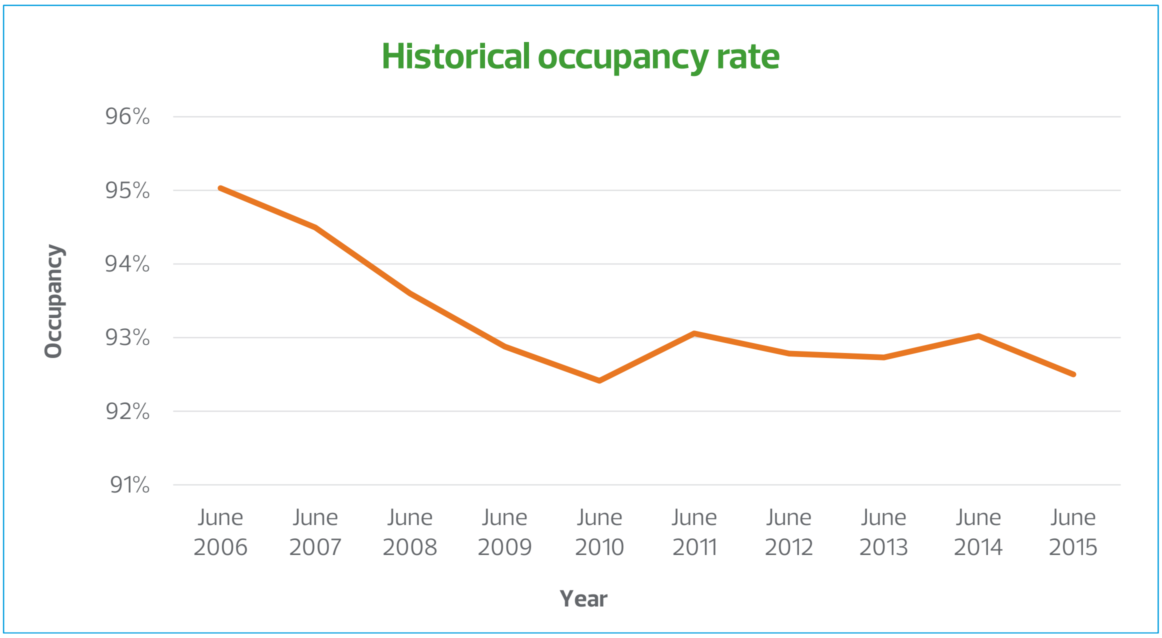
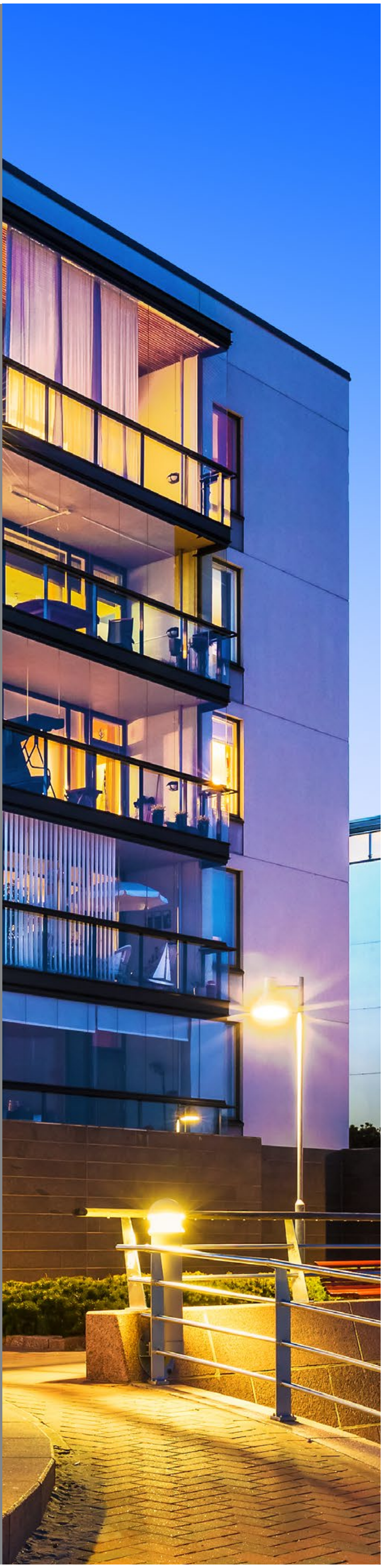


Figure 7 — Historical occupancy rates [20]

Whilst occupancy does relate to the supply – demand balance, readers will be aware that full employment is achieved when the unemployment rate is less than 5.0%.

> In a similar way, full occupancy in residential aged care is achieved at a rate less than 100%.

Occupancy is a measure of the occupied bed days relative to the available bed days (measured as operational places). There are four drivers that impact occupancy of operational places these are:



1. **Resident turnover**
   People enter and leave facilities on a regular basis. If on average it takes 1 – 3 day to fill a vacancy this equates to a vacancy factor of 0.3 – 1%. Taking into account the average length of stay of 1049[21] days and assuming a 3 day turnaround resident turnover could contribute approximately 0.4% to vacancy. Declining length of resident stay will cause this factor to increase. The 2015 trend in occupancy is consistent with this

2. **Trade up of new facilities**
   There are no reliable figures available on the time it takes to fill a new facility. Industry commentators talk in terms of 18 months to 3 years. Based on our forecast rate at which places come on line we estimate that the supply of operational places will continue to expand by approximately 4% per annum (historically 2 –3%). The impact of trading up these new places adds another level of vacancy to the system This could impact occupancy rates by 2 –4%.

3. **Refurbishment of operational places**
   There were 300 homes (10.3% of existing services) that undertook significant refurbishment during 2014–15, which is estimated to be equivalent to 3,043 places, costing $1.26 billion. There were also 120 homes that applied for pre-approval for future refurbishments in this period.[22]

   Given the incentives to providers to undertake significant refurbishments and that to qualify projects must benefit 40% of residents, we anticipate the impact on occupancy from this activity will be both significant and ongoing in the near term. If this is the case then apparent occupancy rates may fall in the near term. The 2015 occupancy statistics are consistent with this.

   The calculation of operational places does not allow for places that are temporarily off line due to refurbishment. As this is an ongoing activity it will also impact reported occupancy rates.

4. **Population shifts**
   The fixed nature of residential aged care places combined with the time it takes to plan and construct a facility mean that supply in regions of declining demand cannot readily be relocated to regions of under supply. This also contributes to overall vacancy factors.

Occupancy expectations

> When the impact of the above drivers of vacancy are considered together it appears that practical full occupancy is likely to be achieved somewhere between 93 & 95%.

While there will be variations in this at a micro level the recent trend in reported occupancy is consistent with this.

In previous research undertaken by RSM we found an association between occupancy and operational performance. Clearly financial returns are maximised when asset utilisation (occupancy) is high. To date there is no clear indication as to when the system achieves effective full occupancy relative to operational places.

INVESTMENT IN NEW AND EXISTING STOCK

As forecast previously, there will be a significant increase in the demand for aged care places in the next decade. In order to fund the building of these new places, capital investment into the sector is required. It has been forecast that a total of $32.9 billion of investment in capital stock is required over the next decade, to meet demand.[22] Table 6 shows the forecast annual investment in new stock required to meet forecast demand over the next decade (these figures do not include the cost of refurbishing existing stock)[23] .

Year	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Investment required (billion)	$2.0	$2.3	$2.6	$2.9	$3.3	$3.6	$3.7	$3.7	$3.6	$3.6	$3.6

Table 6 — Investment required for new places 2015–2024 [22]

Table 7 shows the reported recent investment in new facilities. The 2014 investment reverses a downward trend since 2010.

	2009	2010	2011	2012	2013	2014
Completed	$968	$1,028	$750	$523	$440	$703
In progress	$731	$441	$428	$464	$735	$865
Total	$1,700	$1,440	$1,050	$896	$920	$1,554

Table 7 — New building work ($million) [24]

In 2013–14, 12% of all facilities completed new building, refurbishment and upgrading work compared to 17% in 2012–13.[22 23] This further suggests that the focus has shifted from refurbishment to new construction.

Critical to bringing new supply on line is the rate at which new building work is undertaken relative to the forecast in table 6. The forecast investment suggests the appropriate level of investment in new stock in 2014 was $2 billion.[24] However actual investment in new stock in 2014 was $703m.

> Given this shortfall in investment in 2014, $3.6billion of investment is required in 2015 to bring the rate of increase in supply in line with the forecast.

As work in progress at 2014 was $865M building capacity at the required rate represents a significant challenge for the industry. Tables 6 & 7 suggest there is a risk that the 2014 shortfall may not be made up in 2015 which will result in future pressure on supply.

OUTLOOK BASED ON DEMAND AND SUPPLY AND INVESTMENT ACTIVITY

As noted earlier there are a number of drivers of both supply and demand for residential aged care places. While there is uncertainty as to the aggregate level of demand going forward our analysis suggests that balance of risk is that supply will not reach the forecast levels.

During the period 2012 — 15 there was an increase in the percentage of allocated places remaining offline. If this reflects the industry's response to policy uncertainty it is possible the recent changes to funding (removal of payroll tax supplement; complex care supplement and changes to ACFI scales) may cause providers to delay investment plans. This will only increase the pressure on the supply of places.

FINANCIAL DYNAMICS

OVERVIEW

Financial sustainability can be linked to both the operating and investment performance of the sector. Notwithstanding positive and improving operating outcomes, this may not provide an attractive return on investment. We analysed both operational and investment performance, at the aggregate and quartile level to gain greater insight into the financial dynamics of the industry. In doing this we have reviewed four primary measures of financial performance.

Operational Performance

1. **Operational profit —** this looks at the absolute return (profit / surplus) on a per bed basis

2. **Operational efficiency —** This looks at the operating result relative to operating revenue

Combined, these measures provide insight into the viability of the industry. That is its ability to generate positive financial outcomes.

Investment performance

3. **Return on assets —** considers the unleveraged return generated from an investment in residential aged care

4. **Investment return —** considers the operating profit relative to the equity invested to derive that profit

Investment return is an indicator of the industry's ability to continue to attract new capital to allow the industry to expand. Given the demand horizon this is a critical measure of the sector at this time.

For our purposes we use the following measures:

- When considering operational performance we look at earnings Before Interest Tax depreciation and Amortisation (EBITDA)
- When considering investment return we look at Net Profit Before Tax (NPBT)

We acknowledge that there are numerous measures and data sets that can be used in this analysis. While there are acknowledged shortcomings in the source data we have used the ACFA annual report data as this contains the complete industry and is based on the audited accounts lodged by Approved Providers. We note that industry performance as represented in other surveys is subject to the limitations of the data sets and consistency of participation over time by respondents.

Some commentators favour EBITDA as the ultimate measure of performance of the sector. We see two inherent shortcomings in this approach;

1. Comparing EBITDA to net assets (equity) is distorted by the impact that deprecation has on net equity (reducing net assets and net equity through annual depreciation and amortisation charges). Over time this has the tendency to show increasing investment performance when this is may not be the case

2. Residential aged care is an asset intensive business and these assets have both a useful life and a requirement to be updated. According to earlier research providers with better financial performance undertake major refurbishments on a cycle between 9.5 and 13.4 years.[25] In this context, depreciation, or the allocation of capital cost over the useful life is a real cost that must be taken into account when assessing overall investment performance.

OPERATING PROFIT

Table 8 shows the key components of our performance measures for the years 2012, 13 and 14 at an industry level. Using these three years immediately prior to the implementation of the recent reforms will enable us to undertake pre and post reform analysis in the coming years.

	2012	2013	2014
NPBT industry (million)	$726	$594	$712
EBITDA industry (million)	$1,544	$1,473	$1,581

Table 8 — Industry Operational performance [26]

Industry EBITDA in 2014 demonstrated an improvement of 7% on the 2013 year.

When compared to the 2012 result the 2014 result shows negligible change.

Provider sustainability

Table 9 shows industry performance on a per place basis.

	2012	2013	2014
NPBT per resident (average)	$4,360	$3,492	$4,150
EBITDA per resident (average)	$9,274	$8,660	$9,224

Table 9 — Operational performance per resident

This analysis takes account of the 5,000 additional operational places in 2014 compared to 2012. While Industry profitability is improving in aggregate terms it is static on a per place basis. The change in profitability of the industry as measured by EBITDA is more to do with the increase in the size of the industry then underlying performance.

Another key component of operating performance is the contribution of other revenue. Table 10 shows the dependency of the industry on other revenue and the shift in its contribution to both EBITDA and NPBT over the three years to 2014.

Other revenue	2012	2013	2014
EBITDA	68%	81%	73%
NPBT	145%	201%	162%

Table 10 — Contribution of Other revenue to EBITDA and NPBT

But for the contribution of other revenue, which includes such components as:

- Capital grants
- Investment income
- Revaluation components
- Donations

The sector would have operated at a loss (NPBT) in each of the last three years and generated aggregate EBITDA of less than 30% of the reported industry EBITDA.

The contribution of the components of other revenue have a significant impact on the reported results of the industry.

Based on the likely impact of recent policy changes as set out in table 11 we anticipate continued challenges in EBITDA and NPBT for providers.

Policy	Impact on EBITDA
Increase in accommodation supplement	Increase in EBITDA
Substitution of lump sums for daily fees	Reduction in EBITDA
Removal of payroll tax supplement	Reduction in EBITDA
Removal of complex care supplement	Reduction in EBITDA
Rescheduling of ACFI	Reduction in EBITDA

Table 11 – Impact of policy changes

While average EBITDA per bed over time provides a high level view of the industry it is unhelpful in understanding the change in sustainability of providers within the industry. Examining quartile performance provides some interesting further insight into the sustainability of providers.

Table 12 contains the quartile EBITDA for providers in each quartile for the 3 years under review and the degree of change in EBITDA by quartiles over the same period. Top quartile performers have increased average EBITDA by only 3.8% while all other quartiles have declined, most significantly the bottom quartile providers' performance has declined by 143%.

	2012	2013	2014	% change (2012–2014)
Top	$21,081	$19,825	$21,889	3.8%
Second	$10,394	$9,884	$10,357	-0.4%
Third	$5,654	$4,468	$5,067	-10.4%
Bottom	-$3,646	-$5,276	-$8,866	-143.2%

Table 12 – EBITDA performance by quartile 2012–2014 [27] [28]

In 2014 the bottom quartile of providers collectively represented a drain of over $400 million[28] or 31% of industry EBITDA

This compares to a drain of 11% in 2012. By any measure this is unsustainable both for these providers and in terms of government outlays.

In previous research undertaken by RSM for ACFA we were able to gain insight into the attributes of providers that are more likely to be in this bottom quartile. Typically bottom quartile providers:

- Have lower revenue and higher costs
- May not have the same focus on achieving financial performance outcomes
- Lower number of beds likely to be linked to lower performance
- Have conservative liquidity management strategies
- Less likely to rely on specialist internal skills to manage revenue
- Derive less EBITDA as care level increase[29]
- Are concentrated in the least financially attractive locations by size and socio economic status

A further measure of sustainability of the industry is to consider the percentage of providers who generated a positive operating result. The data was not published for 2014 however between 2012 and 2013 the percentage declined from 84% to 80%.[31] Given the increase in the drag of the bottom quartile in 2014 we anticipate that the percentage of providers generating a positive EBITDA would have again declined in 2014

Operating efficiency

As the percentage of providers deriving positive EBITDA is in decline this begs the question – what is behind this? When we looked at the EBITDA as a function of operating revenue we observed that over the three years

> EBITDA had declined from 5.6% to 4.8% of revenue.

This 0.8% decline represents a 17% decline in profitability. Such a decline in profitability arises from a mis-match in the rate of growth in revenue and costs. In aggregate, operating revenues per bed rose by 10% over the three years while costs rose by 14%.[30 31] If the industry is to address the decline in profitability and its impact on sustainability then it will need to address the imbalance in the rate of increase in costs and revenue.

INVESTMENT RETURN

Access to debt in the form of lump sums loaned by residents is a unique feature of the residential aged care sector. Adding to this is the benefit of the government guarantee to repay these loans in the event of default by the provider.[32] The price setting mechanism to determine the alternative lump sum (Refundable Accommodation Deposit) payable by a resident is such that there is an inherent bias towards lump sums. This is supported by the growth in the proportion of residents choosing this form of payment. Over the twelve months to June 2015 the proportion of residents paying accommodation via a lump sum (in whole or in part) grew by 3% from 74% to 77%.[33]

Because of these distorting effects we have analysed investment performance at both the return on equity and return on asset level.

Table 12 and Table 13 show the investment performance of the industry using bother EBITDA and NPBT and expressed as ROA and ROE over the last three years.

EBITDA	2012	2013	2014
ROA	5.5%	4.8%	4.7%
ROE	16.1%	14.5%	14.2%

Table 13 — ROA & ROE calculated as EBITDA 2012-2014 [34 35]

NPBT	2012	2013	2014
ROA	2.6%	1.9%	2.1%
ROE	7.6%	5.8%	6.4%

Table 14 — ROA & ROE calculated as NPBT 2012-2014 [34 35]

Investment returns as measured by ROA and ROE using both EBITDA and NPBT have been declining over recent years; this is primarily driven by stagnant operating performance coupled with increasing assets employed in the industry.

> Given the low rates of return on assets providers may increasingly focus on attracting debt in the form of RAD's to boost equity returns.

In an environment of declining viability this increases the risk profile of the industry. Should this lead to operator failure there may be an impact on the financing arrangements related to RAD's.

ATTRACTING NEW INVESTMENT

Historical investment returns are based on the written down value of assets. In previous research undertaken by RSM we found that the historical value of assets on a per bed basis averaged $114,000. In contrast the return on new investments is based on the current cost of developing facilities and the expected future revenue.

> Estimates as to the cost of new facilities range from $250,000 to $350,000 for general use single ensuite rooms.

The only substantive increase in operating revenue related to this increased investment relates to the increased accommodation supplement for supported residents and higher accommodation charges payable by self-funded residents who do not chose to pay their accommodation via a lump sum.

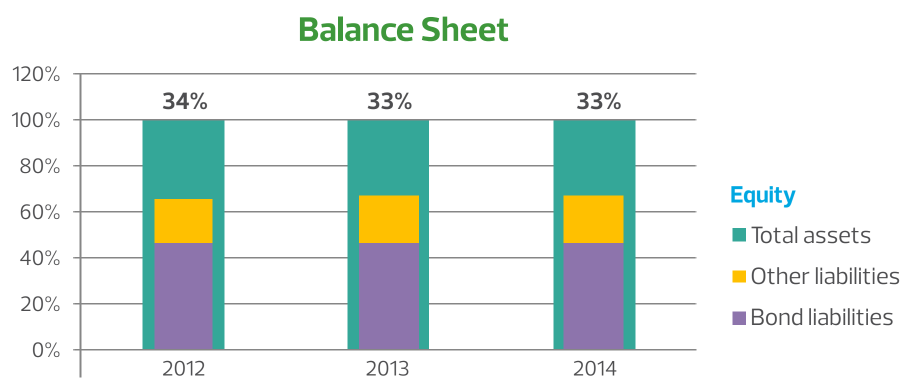
Using the midpoint of this estimate an operator contemplating building a new facility has to invest an additional $184,000 from which they can potentially derive marginal revenue of $10,500. This equates to a return on this marginal investment, as measured by ROA of 6% (before depreciation). This compares favourably to the 4.7% as per table 12. If this place is occupied by a person who provides a RAD this will boost ROE.

As noted previously while there was an increase of new building activity in 2014 this remains well below the level needed to achieve the forecast demand for new places. While there is some basis to expect investment in new places all indications are that insufficient new investment is being attracted to the industry at this time. This may indicate that ROE and ROA are insufficient to attract the level of additional investment required to meet forecast demand.

FUNDING THE EXPANSION OF THE SECTOR

A unique feature of residential aged care is the contribution to funding from residents via lump sum payments (RAD). Using data on the emerging trends in accommodation payments (lump sum vs. daily fee) we modelled the capacity of the system to generate the capital required to bring the forecast 82,000 places on line.

Figure 8 shows that over the period 2012 – 2014 the contribution of lump sums towards the financing of the sector remained constant at 46% of assets.



	2012	2013	2014
Total assets	100%	100%	100%
Other liabilities	20%	21%	20%
Bond liabilities	46%	46%	46%

Figure 8 – Industry Balance Sheet 2012-2014

The forecast growth in investment needed to build the required supply ($34Bn) represents a 100% increase in the assets of the sector.

Estimates suggest the lump sum pool has risen from $16.7Bn to $20bn[36], an increase of 20%. Based on our modelling this suggests that lump sums will equate to between 50 – 55% of assets in the near term.

Using the official estimates of required capital investment the assets of the industry are forecast to grow by $33Bn over the next decade.

The industry will remain dependant on: access to lump sum payments for accommodation; traditional bank finance and new equity to support industry growth.

Our modelling as to the relative contribution of these sources is contained in Table 15.

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	Total
New stock investment	2	2	2.3	2.6	2.9	3.3	3.6	3.7	3.7	3.6	3.55	33
New equity	0.49	0.49	0.56	0.64	0.71	0.81	0.88	0.91	0.91	0.88	0.87	8
New lump sums	1.10	1.10	1.27	1.43	1.60	1.82	1.98	2.04	2.04	1.98	1.95	18
New other liabilities	0.41	0.41	0.47	0.53	0.59	0.67	0.74	0.76	0.76	0.74	0.73	7

Table 15 — Investment required ($ billion) [36]

Much has been made of the growth in listed providers however to date the principal contribution of these players is the acquisition of existing stock. Indeed a prominent investment bank has suggested that an expansion model based on acquisition is more suited to the listed players.

If this bias continues then it will be for the traditional players and other new entrants to provide the equity to fund the expansion of the industry. Our modelling suggests the equity component of the required capital investment lies between $500,000,000 and $900,000,000 per annum. This does not include the investment required to refurbish existing stock.

It is reported that by late 2015 there were approximately 420 applications for the higher accommodation supplement with less than 100 projects completed, 140 in progress and another 180 progressing through the approval stage. For existing providers the greatest marginal impact on viability attaches to the higher accommodation supplement. Given the current take up of the significant refurbishment program and current rates of expansion by existing providers it is possible that much of this new capital will need to come from new entrants to the industry.

New entrants face many challenges when considering investment in the sector including the uncertainty surrounding allocation of places. There was a decline of 33 (3%) in Approved Providers between 2013 and 2014.

Implications

The sustainability of the industry is fundamentally linked to its capacity to attract capital to fund the development of the places needed over the coming decade.

The trend in investment over the period 2012 – 2014 combined with the historic and projected investment returns suggests there are headwinds with respect to sustainability of supply. When you consider that the book value of existing assets is much lower than the replacement cost of those assets this creates further uncertainty as to whether the required supply of places will be achieved under the current policy settings.

The current supply management arrangements increase the risk to new entrants. Consistent with the budgetary priorities of government there have been a number of measures that tighten the funding of the sector. In addition to this, the outcome of the impending 2017 review of the impact of the regulatory changes is unknown.

The perception of policy uncertainty particularly as it relates to lump sums and government subsidies, supplements and grants will be an important determinant of the rate at which the required equity is deployed to fund the forecast required growth.

OTHER FACTORS AT PLAY

Stay Grow or Go

On any forecast the industry is expected to expand by approximately 40% over the next decade. In previous research undertaken by RSM a survey of providers indicated the following business models being employed by providers:

Stay	66.0% (130)
Grow	31.0% (61)
Go	3.0% (6)

Of those seeking to grow the strategies included:

Acquire	14.6% (31)
Expand existing	82.6% (176)
Greenfield	21.6% (46)[37]

Irrespective of which strategy and business model is adopted providers can anticipate an increase in lump sums held. This increased pool of lump sums will impact providers differently according to their business models:

For those wishing to expand through acquisition this pool provides ready capital in the short term, recent consolidation activity supports this hypothesis

For those wishing to undertake greenfield developments the statistics on consumer preference provide valuable insight as to how much funding can be accessed from residents, the level of traditional debt and the level of additional capital required to undertake these projects.

Those who are inclined to remain at their existing size face a different challenge; they are likely to see a substitution of lump sums for daily fees for accommodation payments and because of the Permitted Use Rules[38] these funds are likely to remain in low yielding investments. We anticipate that these providers will see a decline in EBITDA, NPBT and ROE. When this is combined with constrained revenue growth from government these providers are likely to face declining profitability. Whether this will lead to those who have indicated a desire to stay as they are ultimately going from the industry time will tell.

Risks

Government has indicated on several occasions that it has a spending problem and not an income problem and aged care is a large area of spending. Since 2014 there have been a number of cost saving changes made so it is instructive to consider what additional measures may be taken. We see two areas that represent further risks to the industry:

1. **Shutting off the higher accommodation supplement.** Given that a significant portion of the sector has questionable long term viability the government might move to shut off access to the significant refurbishment increased accommodation supplement. This could be justified on the basis that it has been available for sufficient period of time for those who are long term contributors to the industry to have taken advantage of it. If this was to occur it is likely to accelerate consolidation particularly of the lower performing operators which in turn is likely to have a positive impact on sustainability.
2. **Charging for the Government guarantee on lump sums.** Our modelling suggests exposure to lump sums will exceed $36Bn by 2025. In an industry where more than 20% of providers are not generating positive EBITDA the risk of failure and a subsequent payment under the bond guarantee scheme increases.

The history of payments under this scheme is contained in Table 15.

	2006–09	2009–11	2012–3	2013–14
Times scheme triggered	3	2	0	3
Amount in payout	$19	$5.5	$ –	$9.6
% of bond liabilities	N/A	N/A	– Nil%	0.06 %

Table 15 — Accommodation Bond Guarantee Scheme payout since activation (million) [39] [40] [41]

While defaults are historically low the expansion of the use of lump sums and challenges to operational performance pose an increased risk of future payouts. The Productivity Commission Inquiry recommended the Government charge residential providers a fee to reflect the costs of providing the Government guarantee on accommodation bonds. While this was not included in the first round of changes it remains a policy option when the 2017 review of the impact of reforms is undertaken. If providers were to incur a cost in relation to the guarantee this would further erode the profitability of providers.

The shift to user pays

We are interested to see how the transition of aged care to a more market based system is reflected in the relative contribution to the revenue of providers. The substitution of revenue based accommodation payments for lump sum based loans (RAD) will distort any direct comparison between the periods before and after 2014. We have included the below comparison to demonstrate the historical position and will build on this analysis in future reports.

	2013	% of Total	2014	% of Total
Government	$9,384	67%	$9,976	67%
Resident	$3,386	24%	$3,694	25%
Other	$1,191	9%	$1,156	8%
Total	$13,961	100%	$14,826	100%

Table 16 – Government vs. Resident contribution to revenue 2013–2014 [42]

Business models

Based on the research and analysis we have undertaken we see the following trends continuing in the near term:

- Government will continue to seek to manage the cost of aged care to the budget
- Demand will grow
- The outlook for operating profitability of providers is at best mixed
- Providers who are unprofitable or only marginally profitable who continue to rely on the old responses are at the greatest risk of becoming non-viable.

Through our involvement in the industry our consultants are exposed to many different business models. When we overlay this experience with the insights gained from this review and our previous research we encourage providers to consider the following elements when reviewing business models and developing strategic plans:

1. To stay the same size you need to grow by 40% over the next decade
2. Maximising occupancy is a precursor to maximising operating outcome which raises issues of: demography; brand and minimising the time between residents occupying a room
3. To succeed in a revenue constrained environment a culture of: innovation; efficiency and progressive development, rather than maintaining the status quo, is essential
4. While lump sums are an attractive source of debt undue reliance on this to fund expansion exposes operators to other potential risks
5. As the system moves to user pay basing a business model on the historical revenue streams limits future opportunity
6. Research has shown that the greatest threats to sustainability are: location; individual facility size; a failure to reinvest: and insufficient focus on revenue maximisation

> Like all commercial activities the sustainability of aged care is reliant on the quality of management, a sound business model and execution of strategy.

Consumer directed care

An emerging trend that has been identified, is the shift in focus to home care with the introduction of Consumer Directed Care (CDC) in July 2015. St.George shares the following observations on the impact that CDC brings to home care providers. These observations could also prove relevant to residential Aged Care operators with the inevitable introduction of consumer lead services in residential aged care.

1. **Meeting the future needs of the consumer.**
   In order to meet the future needs of the consumer, we see the industry's focus directed to infrastructure, information technology (IT) solutions, staff training and service delivery networks. In the same way the banking industry is benchmarked by customer satisfaction surveys – the introduction of the CDC framework (and the impending removal of ACAR rounds), suggests that businesses focused on delivering superior service, stand to benefit.

In the home care market, we see providers with critical mass having potential opportunity to grow. This will specifically be driven by their ability to gain efficiencies from their IT, workforce and infrastructure. For example, providers with IT solutions that incorporate service delivery registers, invoicing and timetabling are likely to be more adaptable than less established providers. We also see the emergence of innovative models, such as franchise frameworks to support smaller operators, providing IT services to manage their reporting requirements under CDC.

2. **Upskilled workforce better positioned to gain a competitive advantage.**
   Moving forward, staff training will become paramount – those with the ability to understand the underlying needs of clients hold the key to success. Initially, some care recipients will be more willing than others to engage in planning their own care. Operators that engage with both the recipient and their families through quality conversations and service delivery will have the ability to cement customer relationships and therefore ongoing cash flows.

FUTURE REVIEWS

Near term viability is a precursor to long term sustainability. In this our first edition we have sought to balance our focus on both the near and longer term. We intend to build on the data series we have established in future reviews. We also intend to include analysis on trends in new construction and provider sentiment.

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