Perpetual Private

THE ACHES AND PAINS OF AGED CARE

LOW RATES AND HIGH PRESSURE

September 2019

Perpetual

EXECUTIVE SUMMARY

Low-interest rates are here to stay, it seems. For aged care providers that follow traditional, conservative investment strategies, this may have a significant negative impact on their finances.

The time has come for change, and for aged care executives to rethink their investment strategies. To move away from old-school thinking and embrace alternative investment strategies that are aimed at increasing returns, while staying well within the acceptable risk.

This white paper examines:

- Disruption in the aged care sector
- The key areas of change
- An in-depth look at interest rates
- The impact of scale
- Investment management decisions for boards

This white paper aims to provide greater insight into the disruption facing Australia's aged care sector and some ideas for how boards and executive teams of aged care providers can approach their investment strategies to address the challenging economic environment.

DISRUPTION IN THE AGED CARE SECTOR

We have all, by now, become used to disruption – in technology, financial markets, and politics. We have come to expect the unexpected.

Should we be expecting the same disruption in something as critical to our social fabric as aged care and retirement living? In a word: yes.

In its 2019 annual report, the Aged Care Financing Authority (ACFA) said:

"The overriding challenge facing the Government is maintaining confidence and trust in the quality of aged care services and the funding and financing arrangements for the industry" (ACFA, 2019 Annual Report on the Funding and Financing of the Aged Care Industry (section 9.2)).

As well as the increasing prospect of closer government oversight, we are also facing a powerful demographic shift. Our ageing, but longer-living population underpins a greater need for a cohesive and comprehensive future framework for individuals and operators. From the industry operators' perspective, the overriding challenge is to maintain efficacy and efficiency in operations against this uncertain backdrop. With uncertain revenue patterns, rising compliance and operating costs and an increasingly sensitised consumer base, this isn't easy.

The pressures on senior living have never been so intense. In these times, it is critical that boards and executives focus on each and every element of operational efficiency and financing to find those things that might make a difference.

AGED CARE OPERATION PRESSURE POINTS

REVENUE

- Home care
- Changing age of entry
- Occupancy rates
- Comsumer choice
- Aged Care Funding Instrument pressures

COST

- Compliance
- Regulations
- Staffing
- Commission-related costs
- Higher acuity care costs
- Capex/upgrading

ENVIRONMENTAL

- Royal Commission
- Housing prices
- Interest rates
- Refundable Accommodation Deposit changes
- Daily Accommodation Payment changes

KEY AREAS OF CHANGE

The signs of disruption are already here. Softening occupancy rates, at a time when the number of potential residents is rising. Pressure on the profitability of operators across the sector because of changing usage patterns. Rapid and substantial regulatory change. The recent change to home care regulation, strongly influencing age profiles and costs. The appointment and extension of a Royal Commission into Aged Care Quality and Safety - which has parallels with the Financial Services Royal Commission.

At the same time, broader economic trends have recently emerged that are intensifying pressure on the sector.

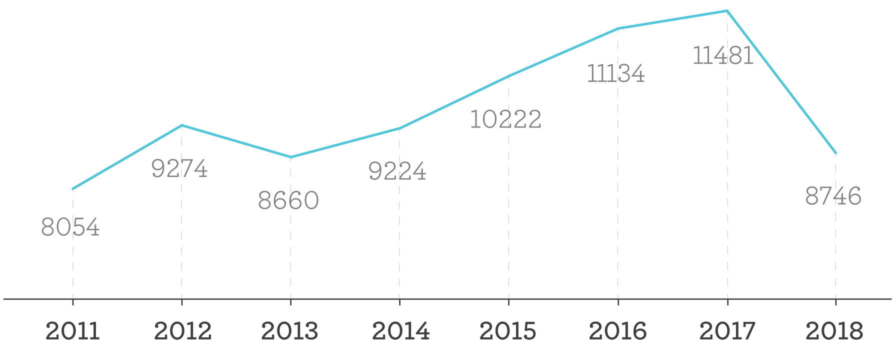
- Volatility in residential home prices, which has an impact on the capacity (and perhaps willingness) of consumers to fund Redeemable Accommodation Deposits (RADs) through residential housing sales
- A continuing reduction in interest rates, in response to a slowing local and international economy, which may result in lower returns from traditionally conservative investment strategies

By way of comparison, the Royal Commission into Financial Services has had a significant impact on the financial services sector:

- Realigning operating models;
- Substantially raising provisioning for costs of compliance; and
- Permanently changing oversight of the sector.

Expect the same in Aged Care.

AVERAGE EBITDA* PER RESIDENT



*Earnings before interest, taxes, depreciation and amortization.
Source: AFCA, 2019 Annual Report, Section 6.3.3

For all these reasons — mounting pressures, increasing scrutiny and reputational risk — executive teams and boards should be pro-active, taking action now before things become more critical.

Leadership teams will need to work all levers to respond to these changes in underlying dynamics, as well as the potential ructions of the Royal Commission interim report later this year. They will need to protect and preserve operating margins in the face of financial pressure from both sides — changes in revenue growth and volatility, balanced against rising cost pressures.

In these financially challenging times, trying to increase the amount of revenue generated by an organisation's investments seems an obvious move. However, due to the low-interest rate environment, increasing the rate of return substantially without moving outside an organisation's risk appetite requires more skill in investing than many aged care organisations may be able to muster.

Adding an extra layer of difficulty for boards and executive teams is the fact that RADs (which often make up the majority of investable assets) are considered critical by other stakeholders – families in particular, who often make financial sacrifices to help house their relatives. This builds trust and security, which are crucial elements of the investment management process. As a consequence, directors frequently take the view that extra caution and conservatism are required. It is therefore critical that boards emphasise the quality of investment manager to ensure that all stakeholders can have confidence in the process.

NEGATIVE INTEREST RATES
CONSIDERATIONS FOR BOARDS

All of this disruption comes at a time when interest rates in major economies are falling to all-time lows, and look likely to remain there for some time.

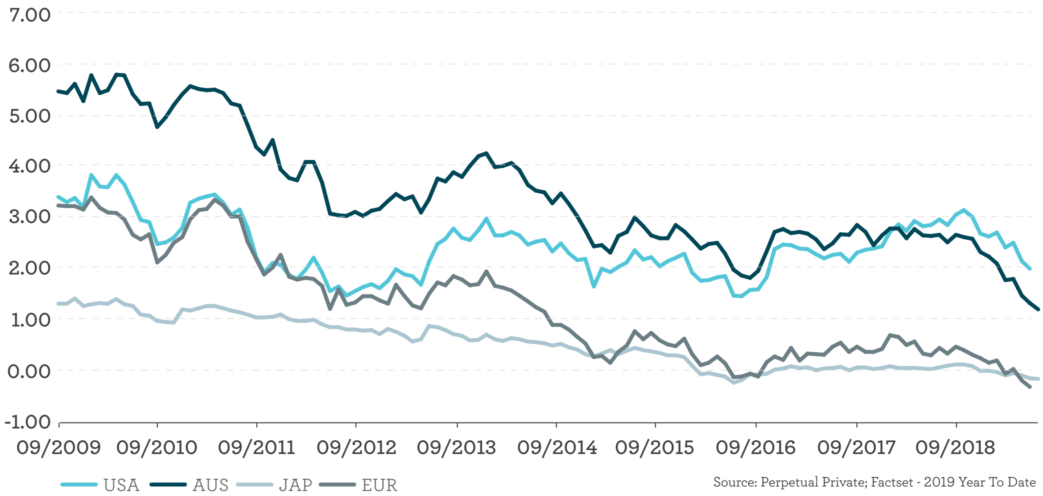
Around the world, more than US$16 trillion of interest-bearing bonds are currently trading at a negative yield – that means, in simple terms, that if I lend you 100 today, I am happy to get back 95 on repayment day. Why? Because it's probably better than the alternative, which might be taking on substantially more risk to generate additional returns. The key market participants to make money out of these negative yields are arbitrageurs and traders, leaving the rest of us to seek alternative avenues for income.

The principal reason for the low yield environment is the floods of cash that are washing around the world because of deliberate policies of central banks to keep global economies afloat. This reflects ongoing central bank strategies since 2008, and the continuing downward pressure on global inflation that has arisen from changes in technology, production capacity, growth in China, and so on.

WHEN WILL THIS LOW INTEREST, LOW YIELD ENVIRONMENT END?

There's a strong likelihood that these conditions will persist for some time, and the impact this long-term trend will have is significant. In the past, investment managers have been able to use the screen of "a return to normality". They have measured investment returns over periods up to 25 years to support their value case. Now, however, the anaemic growth and low inflation or "Japanification" of major markets, particularly around cash and near-cash investments, is becoming more widespread, and low investment returns at the low-risk end of the spectrum might be expected to continue for some time.

LONG TERM INTEREST RATES
DECLINING 10-YEAR BOND YIELDS



Source: Perpetual Private; Factset - 2019 Year To Date

For aged care operators, the impact of low cash returns is likely to be two-fold.

1. Low rates tend to underpin housing prices, which at first blush, is positive. Steady or firmer housing prices translate into an increased capacity for ageing families to sell their homes and to finance RADs in particular. As we now know, however, it's not just interest rates, but also the appetite of banks to lend, and the influence of the banking regulators, that dictates funding, demand and therefore residential pricing.
2. For conservative investors, low rates make it much more challenging to deliver an investment return which is above inflation and so able to contribute to earnings. With term deposits under 2% for 3-6 month money, Australian investors should be clamouring for additional returns from other investments.

WITH LOW-INTEREST RATES LIKELY TO CONTINUE, WHAT IS THE OPPORTUNITY COST OF KEEPING A CONSERVATIVE INVESTMENT POLICY?

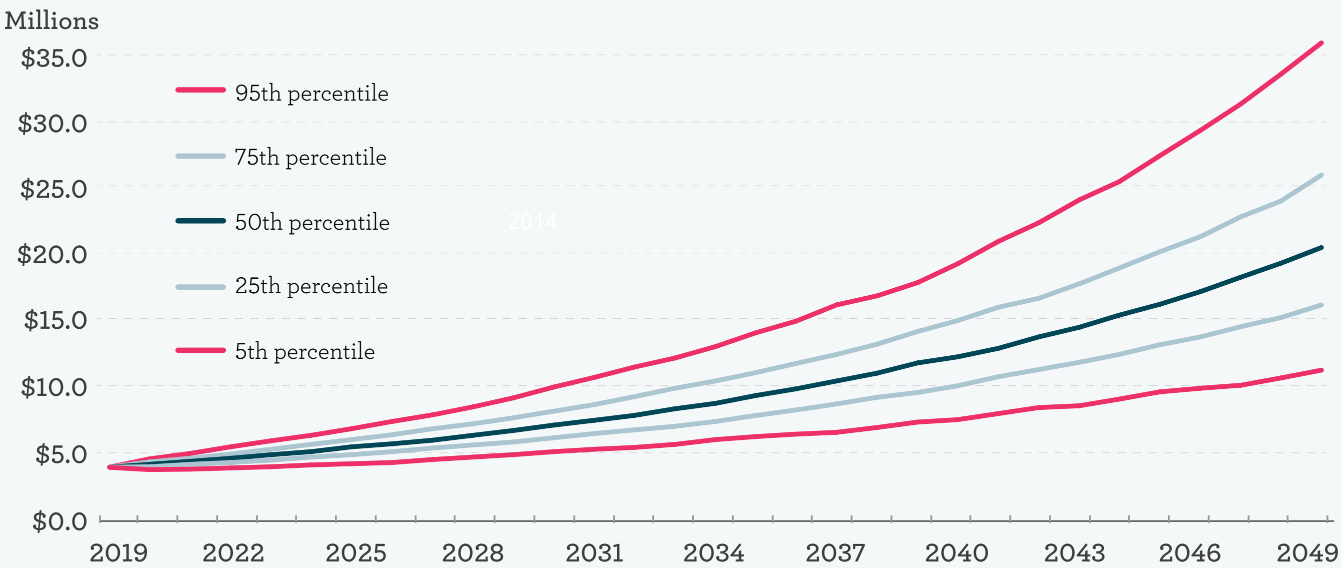
A "Monte Carlo simulation" is one way of looking at the opportunity cost of underutilising a portion of the balance sheet.

In determining the appropriate investable portion of a RAD pool, an aged care provider first needs to consider an appropriate liquidity position. Depending on scale, demographics and operator experience, as well as upcoming capex needs, the provider might consider a liquidity range between, say, 5% of RADs at the aggressive end, to perhaps 12% at the more conservative end. On a A$50 million portfolio, this represents an additional 7% that can be invested – A$3.5 million on day one.

Once invested, we can analyse the potential long-term contribution these funds can make over time. The graphic below displays a range of returns from the investment of these additional funds in a balanced portfolio over the long term (30 years), covering the worst 5% of markets to the best 5% (depicted by the 5th and 95th percentiles). Even in weak market conditions, over this lengthy timeframe, putting this 'lazy' cash to work has a meaningful effect on the future state of the balance sheet.

With good market conditions, the difference between term deposits and a professionally managed balanced portfolio can have a significant and long-term positive influence on the financial sustainability of the organisation.

As the graph below shows, the additional A$3.5 million, with average market returns (50th percentile) will generate an additional A$20 million over 30 years.



Source: Perpetual Private

IMPACT OF SCALE

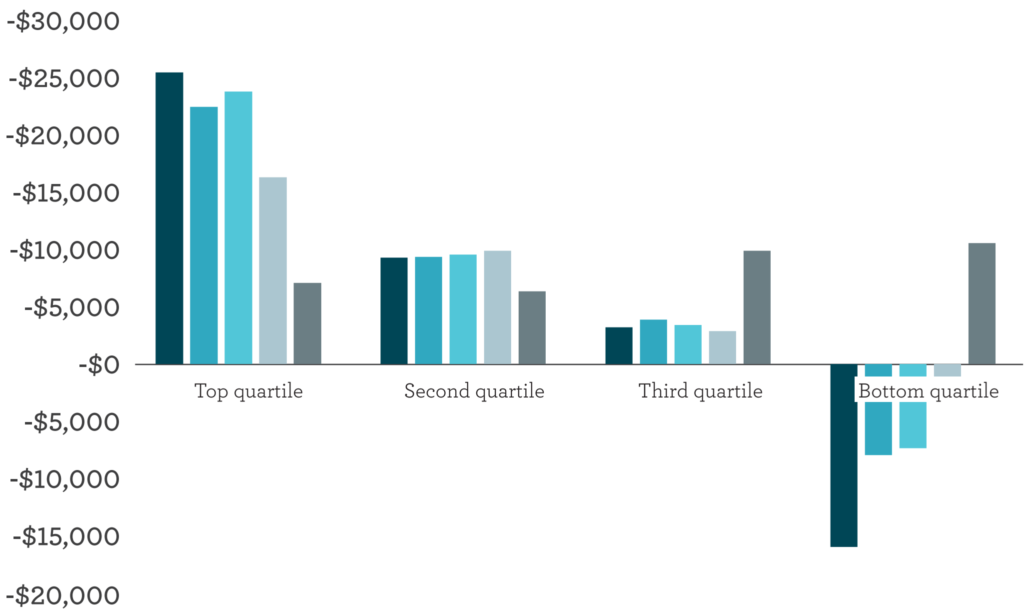
The ACFA Annual Report also highlights a related issue - the impact of scale as an element for boards to consider in assessing risk in their liquidity calculations. ACFA figures (ACFA 2019 Annual Report chart 6.25) show that most operators currently are generally profitable (at the level of EBITDA). However, for small operators, and single facilities in particular, when they come under pressure, the rate of profitability drops quickly.

This is symptomatic of the critical mass issue that is linked to risk in investment markets. All investors need to consider the appropriate risk/return trade-off to achieve their investment goals. However, it's prudent for smaller operators, because of their potential vulnerability to operating pressures, to take a more conservative investment position.

The impact of this is magnified in this environment of low-interest rates. As smaller players tend to have a relatively higher proportion of their investment portfolios in defensive assets, currently low-interest rates amplify the negative impact on overall investment returns.

These mounting pressures will likely see an increased pace of merger and acquisition activity and consolidation in the sector, as small operators seek to protect themselves from cost and revenue pressures, just as seems to be happening in the listed sector.

RESIDENTIAL CARE PROVIDERS AVERAGE EBITDA/RESIDENT BY SCALE



*This chart contains selected information from the ACFA data – Chart 6.25 in the AFCA annual report also contains average EBITDA/resident. Source: AFCA 2019 Annual Report, Section 6.25

BOARD DECISIONS INVESTMENT MANAGEMENT PROCESSES

With cost and revenue pressures so critical in the current environment, it is incumbent on boards to take an active role in the investment management of their RAD pools. Operators should seek to enhance investment returns on RAD pools with a minimal level of additional risk exposure.

At Perpetual, we manage this by working with boards and investment committees to discuss and discover risk appetite and then designing investment portfolios that match that risk profile.

We consider all the operating risk factors such as **scale, liquidity management** (which is sensitive to demographics and revenue) and **capital expenditure**. We anticipate that capital expenditure will rise meaningfully in the medium term as operators improve facilities in response to issues that may arise from the Commission's findings.

Our investment management policy process generates a clearly articulated document that describes the process that the board has gone through to reach its investment management objectives. It articulates risk appetite and governance for the RAD pool and sets out a Strategic Asset Allocation that is intended to meet the goals of the organisation. It also describes how investment management should be implemented and monitored, as well as describing specifically what investments are appropriate for the organisation based on its circumstances.

CONCLUSION

The aged care and retirement living sector is in the early stages of a period of unprecedented change. Much of it is out of the hands of aged care operators: rising complexity; increased scrutiny and oversight; demographic shifts and evolving consumer trends. Those that fail to adapt will either merge or struggle.

In this environment, it's critical for aged care boards and executives to optimise the factors which are in their control.

Among these is the RAD pool: an often underperforming asset which there is now an imperative to maximise. Boards and finance teams should examine the impact that low interest rates are having on their investment performance and ensure they are optimising returns to help offset pressure on operating margins. For operators without the necessary in-house expertise, it's crucial they engage trusted advisers to assist with balancing the level of risk and return.

MORE INFORMATION

To find out more about how Perpetual manages investments for aged care providers, contact Scott Hawker on 02 9229 9319 or scott.hawker@perpetual.com.au

PERPETUAL PRIVATE
SPECIALIST PROVIDERS OF FINANCIAL SERVICES FOR THE AGED CARE SECTOR

Since 1886 Perpetual has safeguarded investments for Australians from all walks of life. We have deep experience as a trusted fiduciary and investment adviser. We have direct and relevant in-house knowledge of the aged care sector, and we understand the need for reliable support for key stakeholders in the sector.

Whether it is by refining liquidity management for the accommodation deposit portfolio, or developing an investment management statement for longer-term funds, our team of specialists can offer a partnership with tailored advice and a range of services to meet the unique needs of aged care providers.

HOW WE WORK WITH AGED CARE PROVIDERS

INVESTMENT POLICY
Defining how your investment portfolio is to be managed and decisions are to be made, based on your organisation's unique objectives.

STRATEGIC ASSET ALLOCATION
Identifying the most suitable mix of asseys for your portfolio.

INVESTMENT SELECTION & IMPLEMENTATION
Customising a solution to suit the needs of your organisation.

GOVERNANCE & CAPACITY BUILDING
Experience and networking opportunities to support your business.

ABOUT THE AUTHOR

SCOTT HAWKER

National Manager, Not-For-Profit Endowments, Perpetual

Scott's specific focus is working with not-for-profit entities and endowments to define investment policy and strategy, to manage and protect their investment assets.

Scott joined Perpetual after a 30-year career in global financial institutions, having worked for a number of blue-chip investment and institutional banks in Australia and abroad.

He has a Masters in Applied Finance, a Bachelor of Commerce and a Diploma in Financial Planning and is a Graduate of the Australian Institute of Company Directors, as well as a Trustee Fellow of the Association of Superannuation Funds of Australia.

He is a former board member of the Nature Conservation Trust of NSW and a former non-executive director of the Cemeteries and Crematoria Agency of NSW.

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