Key considerations for a capital model to support sustainability in the aged care sector

OCTOBER 2023

Foreword

The Minister for Aged Care has taken proactive measures by instituting the Aged Care Taskforce with the primary objectives of reviewing existing funding arrangements in the aged care sector, designing a fair and equitable system for all Australians and incorporating the recommendations of the Royal Commission into Aged Care Quality and Safety.

In its endeavour to evaluate aged care funding mechanisms, the Taskforce's core focus remains on ensuring the sustainability of the system.

This report was prepared for the Taskforce to provide information regarding the capital model of the aged care sector, for their consideration. The views expressed in this report are based on accounting principles.

The aged care sector is undergoing significant changes due to regulatory reform, market shifts and competition for the labour and capital required to sustain it. As an industry segment within the broader health sector, aged care experiences significant tailwinds from an ageing Australia. Whilst demand for aged care services is increasing, the sector is competing against more lucrative industries for labour and capital.

This report seeks to describe the aged care sector in terms of its capital needs and suggests ways to make it an attractive investment sector compared to other industries.

This report was not possible without the insights provided by ANZ, CBA, NAB, Westpac, NextCapital, Mr Mark Brandon and a number of aged care providers. Our thanks are also extended to the Aged Care Taskforce representatives in attendance as observers to the discussion and process, and to the Grant Thornton Partners and staff who participated in the workshop and review processes.

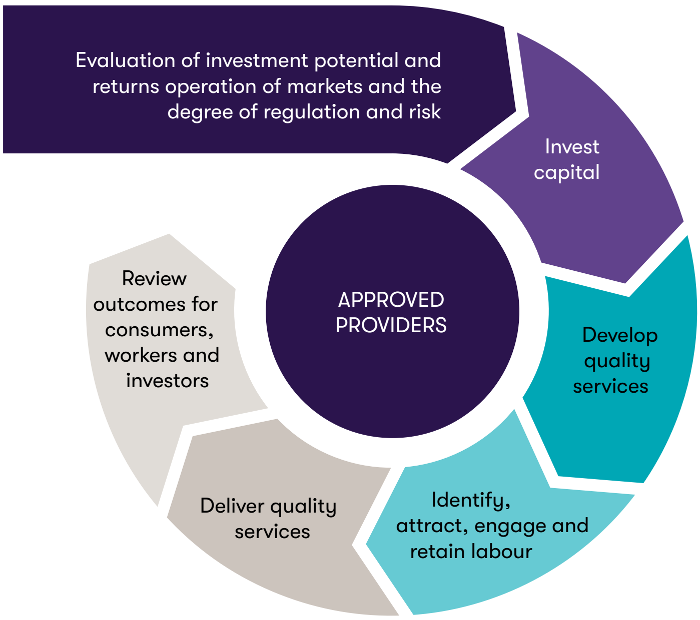
The information is based on publicly available data. It has been noted in this report where further work is required to update and validate the assumptions.

Contents

Models that shape capital investment

The two models described below assist in understanding the capital model of the aged care sector.

The first model describes the role that capital plays in attracting a strong workforce, developing quality goods and services, investing in innovation and refreshing its asset base over time. The second model describes the interaction between consumer, labour and capital markets.



Industries that have a sound capital model that provide returns for investors are both attractive for workers and provide benefits for consumers through improved goods and services.

Amongst other pressures, the uncertainty over the replacement of the Refundable Accommodation Deposits (RAD) capital model is likely stifling investment in facilities, services and innovation.

Labour markets co-exist with capital and consumer markets.

Getting the balance right is critical to the success of industries.

In the aged care sector – where labour is the biggest expense, and is necessary to deliver quality services for consumers – getting the balance right is even more critical.

What's driving the need for capital in the sector?

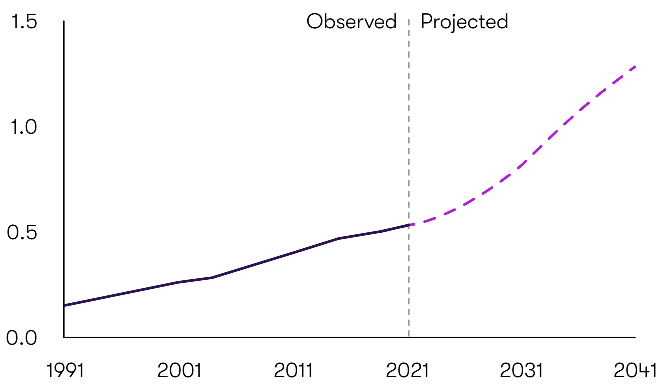
The Royal Commission into Aged Care Quality and Safety commissioned a study into the future demographic demand for services in the aged care sector[1]. The key metrics highlighted in this report acknowledges that:

- the number of older people will increase from 3.9m in 2019 (15.3 per cent of the population) to 8.8m in 2058 (22.3 per cent of the population)
- the number of people aged 85 years and over will increase from 515,700 in 2018–2019 (2.0 per cent of the population) to more than 1.5m by 2058 (3.7 per cent of the population)
- the ageing of the population has implications for the demand for and provision of aged care services
- the number of people receiving aged care services will increase from approximately 1.3m in 2018-2019 to approximately 3.5m by 2058
- the number of residential aged care places will need to increase from about 214,000 in 2018–2019 to about 588,000 by 2058.

The Report considered the demographics of the workforce of the future, stating:

- the aged care workforce is diverse, with workers from various backgrounds, cultures, languages, genders, ages and qualifications. The majority of the workforce is female (87 per cent) and many workers are born overseas (37 per cent) or speak a language other than English at home (23 per cent)
- the number of direct care workers will need to increase from approximately 366,000 in 2019 to approximately 980,000 by 2050, and the number of allied health professionals will need to increase from approximately 28,000 in 2019 to approximately 75,000 by 2050.

Figure 1: Population aged 85+ in Australia, 1991-2041
(millions)



Source of observed data: ABS. Wilson, temp (2022)[2]

1 Royal Commission into Aged Care Quality and Safety Final Report - Care, Dignity and Respect: Volume 1

2 New projections for Australia's ageing population

Comparing the aged care sector to successful industry models

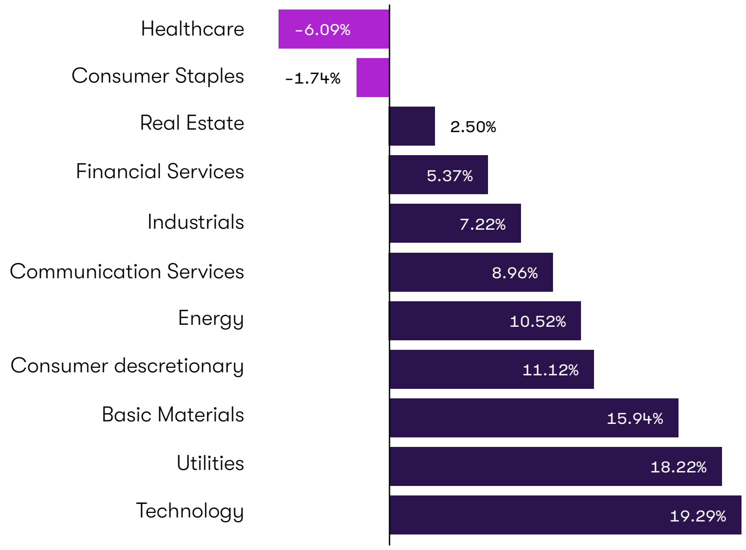
The aged care sector competes against other industries for investment and debt capital. The factors that drive investment and banking confidence in industries vary over time, however, the fundamentals include strong leadership and governance, sound economics, financial stability, regulatory certainty, market liquidity and access to workforce and industry inputs.

Methodology

A workshop was conducted with bankers and investors to consider the key attributes of 'bankable' industries. Using Porter's Five Forces[3] as a framework, the aged care sector was compared to industries that attract and retain capital.

An analysis of ASX Industries shows the relative capital returns of the main listed industry segments. This does not include income from dividends but reflects the capital growth of the segments.

Figure 2: ASX Sector Growth – 12 Months to September 2023[4]



Reality check

Investors seeking profits gravitate towards industries where there is a greater degree of certainty for investment returns and valuations remain stable or grow.

Healthcare's performance -6.09%, which includes listed aged care providers (now only Estia and Regis) is underperforming against all other sectors.

As capital is generally drawn to high-growth sectors away from low or negative growth sectors, the Healthcare sector may struggle to attract investors.

3 The Five Competitive Forces That Shape Strategy, Harvard Business Review

4 www.marketindex.com.au

What are the characteristics of an attractive industry for investment?

Leadership and governance

Industries that thrive are represented by good governance practices and strong management capability with clear planned strategies and aspirations.

Good leadership instils confidence and trust in markets and investors while poor leadership can destroy both. Consistent, quality leadership across an industry ensures it remains stable and predictable over time, attracting investment.

Economic factors

The economic environment is critical to all industries. However, some benefit from factors that others are impacted by. The key economic variables include interest rates, exchange rates, tax rates, inflation, labour supply and demand, wages, laws and policies, government activities and recessions.

Debt backed industries suffer from increasing interest rates, reducing returns. The feasibility of planned investments reduces, and less capital is invested. The capital models of 'attractive industries' are structured to withstand shifts in these economic factors and adverse circumstances such as recessions. Investors consider industry resilience when comparing investments across sectors competing for capital. Capital investments are made when expected returns are commensurate with sector risk and similar to other sectors.

Financial considerations

Industries that have strong, stable and predictable earnings and cash flows are favoured by investors. Stability reduces the capital risk of investments failing and ensures desired returns are achievable. Financial returns must correspond to the risk of the investment.

Asset-backed industries provide more certainty with less volatility in values, particularly where the quality of assets is understood. Financial margins need to be predicable and sustainable over the life of asset investments.

Businesses operating within the industry must be able to demonstrate sustainable profitability after meeting all of their taxation obligations and preserving profits for future investments.

Markets

Attractive industries have strong markets with growth outlooks. The needs of customers are clearly defined, and demand is clearly understood. In consumer markets, the demographics and customer behaviour are evident.

When competition and competitive rivalry are high, earnings tend to stabilise across an industry. This increases predictability of earnings and is desirable from an investment and banking perspective. Competition forms natural control over pricing and allows participants to choose their price points relative to quality.

Reasonable barriers to entry are the economic hurdles new entrants face while entering the market. Higher barriers to entry limit the financial impacts on existing businesses by new participants. At the same time, barriers can stifle innovation and allow existing businesses to maintain market share and power. The types of barriers to entry are capital costs, competition, legal barriers, marketing barriers, limited market, predatory pricing, finding suppliers, technology, learning curve and economies of scale.

In considering consolidation strategies, private equity firms assess the degree of fragmentation in given markets. Higher fragmentation creates greater opportunity to achieve economy of scale benefits from aggregated investments.

Regulation

Regulation is a necessary part of attractive industries. It provides ground rules for how business is conducted and what markets can expect from active and responsible players. Investors in attractive industries favour the stability and predictability of the regulatory environment and regulatory certainty over time. Where investments are long term, this certainty ensures that returns are maintained over their life.

Regulation will influence the behaviour of players, the capital and revenue models that lead to successful participants.

Professor Gary Banks AO was Chairman of the Productivity Commission from its inception in 1998 until 2013. Prof. Banks noted that good regulation is regulation which, in achieving its goal, brings the greatest net benefit to the community. But the word 'net' is important. It signifies that regulation must be judged not only by its beneficial effects but also by the costs that arise in achieving them.

For this overall net benefit requirement to be satisfied, regulation needs to meet three other tests:

- regulation must be the most effective way of addressing an identified problem;
- it must impose the minimum burden on those regulated; and
- cause the minimum amount of collateral damage to others. [5]

In essence, too much and too little are equally bad. Attractive industries generally get the balance right.

Investors and bankers look at the regulatory framework and assess its effectiveness and volatility in determining their support for participants.

Labour markets

All industries rely on skilled and capable workers to deliver services and create goods for their markets. Workers must have access to appropriate training and career development as incentives to commit to their chosen industry. Wages must be commensurate with the same skilled and experienced workers in other sectors. Other than industrial regulation, the operating environment must protect workers and ensure they remain safe.

Industrial supplies and services

Industries must have ready and timely access to the suppliers and services required to sustain them over time. These include the systems, process, goods and services required for an industry to manufacture its goods, and/or deliver its services.

How does the aged care sector compare?

The aged care sector is a complex sector delivering services to older Australians in need of support and care as they age. It currently provides services in three main categories: residential care, home care and home supports. Each of these categories has different characteristics, including the skill and experience of labour, supplies and services, and markets.

Leadership and governance

The not-for-profit sector dominates the aged care sector, with approximately 57 per cent of providers charitable and for purpose. There is an argument that aged care services, being social services, should be in the hands of social enterprise. However, the aged care sector is consistent with most sectors of the Australian healthcare market, which is delivered by a combination of private and not-for-profit providers. The leadership of not-for-profit businesses are driven by purpose and may have a different focus than purely commercial enterprises, however, the largest not-for-profit providers are typically seeking returns from their aged care operations to reinvest. In many cases not-for-profit entities are regulated by different legislation creating challenges for the raising of debt and capital. The governance and leadership across both business models is relatively consistent, although it has been reported that aged care has been challenged to attract and retain high calibre management due to adverse publicity and a high level of change.

Economic factors

With significant capital invested in aged care assets, the capital efficiency of both residential and home care services is important. There is a considerable debt in the sector, through resident loans (refundable accommodation deposits) and borrowings.

The use of interest-free resident debt enables aged care providers to operate with lower levels of equity than participants in other industries. This has been a significant factor in attracting capital to the industry but is currently challenged by the very low returns on the equity invested, which make it unattractive for investors. The results of this have been an exit of private capital in recent years.

5 Challenges for Australia in Regulatory Reform. Gary Banks, Chairman, Productivity Commission. July 2001.

Financial considerations

The aged care sector has had a history of variable earnings and cash flows.

The Living Longer Living Better reforms injected much-needed revenue and capital. However, it was short lived, with changes to revenue indexation and other measures stripping revenue from residential care providers. The resulting downturn in revenues led to reduced profitability and lower investments.

Very few residential care facilities are now being built at a time when demand is increasing. This impacts on future consumers choices, as the result of this underinvestment will be exacerbated by the time taken for planning, development approval and financing of assets – which is typically five years.

Overall, periodic changes in regulations have had a negative impact on financial returns and are making the sector unattractive to investors.

In FY20, the residential care sector made a negative net profit of 1.9 per cent, after adjusting for COVID-19 costs. Anecdotally, financial performance of providers has improved with the introduction of the Australian National Aged Care Classification (AN-ACC) funding model. However, a full year's impact will not be seen until FY24, and this has been ahead of the requirements for mandated care minutes. Stewart Brown's[6] benchmarking analysis and reporting supports this position.

Home care is experiencing declining profitability as increasing regulation erodes margins. Grant Thornton analysis of ACFA data reported that between 2016/17 and 2019/20 the overall values of home care businesses have declined in line with falling profitability. In 2021, 275,000 home care packages were available. Using EBITDA per client per annum ($1.369 in 2020) and a valuation multiplier of between 3 and 5, the segment was valued at between $1.13b and $1.88b. By 2040, 425,000 home care packages will be available packages, at a valuation of between $1.75b and $2.91b using the same methodology. Interestingly, the policy changes in 2016/2017 resulted in a loss of value between $1.20b and $2.00b in value from the home care subsector.

This has reduced confidence and trust in market conditions for investors and lenders.

Consumer markets

The aged care market is sustained by demographic tailwinds with demand increasing in the foreseeable future.

Competition for residential accommodation is regulated through the issue of bed licences that restrict when and where providers can develop residential aged care facilities. The use of bed licences to restrict competition will be formally removed on 30 June 2024. The resulting impairment of bed licenses held as assets on provider balance sheets has eroded overall enterprise value of these businesses. Further, price controls in the form of pricing approvals over set limits (currently $550,000) dampen competition and innovation. These and other regulations have the effect of reducing competition and making providers less price efficient. It is anticipated that competition will increase with the removal of bed licences, particularly in attractive metropolitan markets.

Home care and home supports markets are generally competitive in most geographies.

Australia's population is concentrated in the south-east corner of the continent, with many people living in smaller rural and remote towns. Many of these centres are thin markets, where access to skilled labour and services is very limited. Some outer metro services operate in thin markets. These markets are generally uncompetitive.

Residential care requires significant capital investment in the form of accommodation, daily living services and equipment used in delivering care. This capital requirement serves as a barrier to entry restricting investors' ability to establish new businesses. Historically, the main pathway to entry is acquisition of existing assets and services. At times, this has created competition for these assets, and the industry was characterised by a number of consolidations.

The aged care sector remains fragmented with many small providers and may be attractive for a consolidator. Many smaller providers are not-for-profit entities whose purpose is to provide aged care services. Proceeds from the sale of businesses or assets are generally required to be applied to the purpose - aged care. This provides a barrier to acquisitions in many instances. The quality, age, location and availability of potential acquisitions for consolidations remain uncertain.

6 StewartBrown March 2023 Aged Care Financial Performance Survey.

Regulation

The aged care sector began its life as a social service provided by churches and charitable organisations for people who required supports as they aged. Over time the acuity of those who needed support grew, requiring greater inputs from clinical professionals, particularly nurses. As this occurred, and the number and range of providers increased, regulation increased to ensure services delivered quality and safe services.

Subsequent to the Royal Commission into Aged Care Quality and Safety, regulation and oversight has increased significantly, and service providers report increasing administration in reporting of financial, clinical and operational measures. This additional reporting burden requires resourcing. Larger providers have the capacity to automate much of this over time, however smaller providers will struggle to adapt. While funding has increased, it is not uncommon for providers to opine that the additional costs of compliance exceed the additional revenue provided. In these circumstances, economies of scale provide an advantage.

On the surface, aged care regulation continually evolves and does not have a long-term stable foundation for investors to rely on. While the operating principles remain the same, the frequent addition of regulations has adversely impacted the profitability of providers and the sector over time. The current process to introduce a new aged care act is one example of this.

Changing regulation impacting profitability has resulted in the sector becoming less attractive for investors over time.

Labour markets

The aged care sector requires a skilled, experienced and motivated workforce. Traditionally, wages were low and uncompetitive compared to similar sectors such as disability services, primary and tertiary care. The Fair Work Commission recently determined that some aged care workers would increase by 15 per cent. These workers include personal care workers, recreation/lifestyle activities officers, nursing assistants, enrolled nurses, registered nurses, nurse practitioners working in aged care, home care workers working in aged care and some senior food services personal. Many workers were not included. While this has narrowed the gap between aged care and other health and social services, the gap is growing again.

There are significant labour shortages in aged care in Australia, particularly in thin markets. Some providers have closed services as a result and others are considering their options. Unfortunately, the industry pays lower wages in comparison to other sectors, and in many cases, workers are unable to find affordable accommodation close to the services that need them. Several providers report they have established their own accommodation to ensure workers can easily access employment. Providers also report paying above award wages to attract workers, particularly those more skilled and experienced.

With an ageing population, Australia will need to find greater labour efficiencies as the ratio of workers to retirees falls (from 4.5 per cent in 2015 to 2.7 per cent in 2054)[7].

Overall competition for skilled experienced and motivated workers is very high and is likely to increase. This is likely to result in wage inflation as providers pay above award for certain skills required to deliver aged care services.

Industrial supplies and services

Recent inflationary pressures have increased the input costs for aged care providers, particularly those providing residential care. The costs of utilities, insurances, food and medical supplies have increased. Over the 12 months to June 2023, inflation rose 6.0 per cent. Recently, food and non-alcoholic beverages contributed at the rate of 5.6 per cent.[8]

Indexation of revenues needs to keep pace with inflationary pressures in order to maintain sustainable aged care services.

7 Australia, number of workers for each retiree

8 ABS price indexes and inflation

Key takeaway

In summary, the aged care sector is far less attractive than other industries from an investment perspective. Low returns, high and variable regulation, regulated revenues and access to workforce are significant contributors to this view.

What makes an approved provider attractive to investors and lenders?

The following characteristics are different between the provider and what makes a good sector, however, there is a cross-over.

Investors and lenders consider their support of aged care providers on their merits. Some of the key factors taken into consideration relate to the strength of the sector, financial performance, market performance, the quality of assets, labour market and quality of leadership and governance. Banks and investors use similar key measures with some exceptions relative to their specific requirements.

Story

The fundamental purpose of enterprises is a key feature of the support provided by investors and lenders. A clear and unambiguous thematic creates more confidence and certainty that leaders know what they are doing. In aged care, the community benefit of services being delivered are often in line with the values and 'social purpose' of banks and investors.

People

The overall governance of the organisations includes skills, experience and quality of leaders and management. Leaders need to be able to demonstrate a clear understanding of the business drivers in aged care and capacity to adapt to the complexity of delivering human services in a highly regulated environment.

This needs to be supported by a strong labour market that encourages investment in training and skills development, career pathways, including access to, attraction, and retention of workforce.

Property

Are the facilities new/modern and purpose built? How will they compete in the marketplace versus a new residential aged care facility? Can the impact of older style facilities be disbursed across a large portfolio of assets?

Consumers and markets

Investors and lenders assess market opportunities as well as the geography of services and facilities. With many aged care facilities in thin markets, the value of assets can be uncertain, making both serviceability of lending and recovery of debt or investment risky.

Competition will be assessed, and the provider will be considered in line with its assets and ability to compete in its given market.

Financial performance

The long-term financial performance of providers is critical in evaluating debt and investment. Stability of earnings and cashflows over time underpin support. Strong prudential policies on cash requirements, Refundable Accommodation Deposits (RAD) management, administration and overhead costs, asset management, occupancy and profitability support residential services.

Efficient and effective utilisation of labour ensures success in home care businesses.

Banks will assess their ability to be repaid debt advanced to providers, considering overall gearing ratios, leverage and serviceability.

Investors will consider earnings, profitability and potential for capital growth in assets.

Invariably, the question will be asked regarding the most effective use of the capital being sought: what are the alternate uses and returns?

Overall, acquisition or investment prices will be compared to bank or investor valuations to ensure gearing or equity contributions are appropriate.

Clinical management and compliance

Effective clinical management and appropriate compliance are key success factors in aged care businesses. Care quality will be assessed by reviewing compliance reports by the Department of Health and Aged Care and the Aged Care Quality and Safety Commission (ACQSC), considering the history of sanctions, unmet requirements, and checking star ratings. As banks are not clinicians, these independent metrics are an important indicator of management effectiveness in dealing with clinical and compliance regulations. From a banking perspective, banks use this as an indicator for discussions and assessment with management in the lending process.

What metrics are used in evaluating investments and lending support?

The key financial and operational measures applied to evaluate debt and investments will be compared to other sectors to ensure capital is used effectively. This list is not comprehensive but provides insights into the key measures used by lenders and investors in evaluating their support.

Metric	Key questions	Selective Comments
Financial metrics		
Return on capital	What returns are being made on capital invested by owners?	
Profitability	What is the after-tax profit of the enterprise?	
EBITDA / EBIT	How much cash is generated by the business?	
Liquidity	Is there sufficient working capital to meet known commitments?	
Equity	How much have owners invested relative to other sources of capital?	
Stability of earnings	Are forecasts predictable and/or sustainable over time?	
Quality of stock	Are assets contemporary and/or being maintained in good condition to support future business?	
Industry metrics		
Industry growth opportunity	What opportunities for growth will the industry enjoy?	
Consumer demand	Are there headwinds or tailwinds in demand impacting future business?	
Borrowing metrics		
Repayment capability and capacity	Will the debt be repaid?	In the case of development debt, can sufficient RADs be raised to extinguish the development debt?
Interest cover ratio	Is there sufficient profit to meet the costs of debt over time?	Generally, EBIT should be at least twice the interest cost, however in more volatile riskier industries this would be higher.
Debt services coverage ratio	Can the business services its borrowings?	Generally, net operating income should be 1.25 times enterprise debt. At less than 1, the business is not earning enough to repay its debt.
Loan to value ratio	How much are assets geared?	A loan to valuation of 70 per cent - 75 per cent is considered normal. However, for higher risk industries and businesses the Loan to Value Ratio (LVR) will be lower than that.
Security	What will secure the debt if borrowings cannot be serviced?	What is the quality of assets supporting borrowings?
Investor metrics		
Greenfield and brownfield opportunities	What opportunities are available for growth and what is the likely capital commitment required to realise the benefits?	Private equity firms will look at where they can commit capital to take advantage of growth opportunities,
Consolidation opportunities	How many participants are ready and willing to exit through a divestment?	This will depend on vendor price expectations, related to overall asset and industry performance.
Other metrics		
History of compliance	What regulatory risks are associated with the conduct of the business?	A key measure and 'gate-opener' for banks to consider a transaction.
Quality of governance and management	Who is leading the business and how much skill, experience and knowledge do they have?	Very important for banks.
Regulatory standing, e.g., the cost of sanctions	How much has any historical regulatory event cost the providers and what impact did it have on the business?	The cost of sanctions can be a factor in the viability of smaller providers, adversely impacting banking covenants.

The evaluation of providers, financial, operational, compliance and leadership factors are key to the decision to lend or invest money. It is critical that enterprises can optimise profits to successfully meet borrowing obligations and return funds to investors.

Quantifying the aged care capital model

The Aged Care Financing Authority (ACFA) published an annual report until 2020/21, analysing the aggregated assets, and funding sources of providers. The following analysis is based on the information contained in those reports.

What are the sources of capital?

Aged care accesses capital from investors, borrowings, provisions, trade and other liabilities. The residential aged care sector accesses interest-free loans known as RADs.

The aged care sector is a fragmented industry with many smaller providers, although large providers (20+ facilities) hold 36 per cent of approved places.[9] Further, the not-for-profit sector is highly represented. Smaller providers have access to less bank debt than larger players. Not-for-profit players do not have access to capital markets and investor equity[10]. Larger not-for-profits have access to debt in some circumstances.

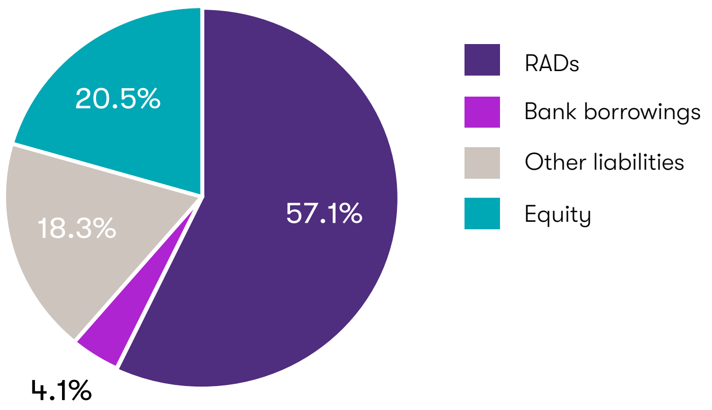
Several providers have used Operating Company (OPCO) / Property Company Deal (PROPCO) structures to access capital where an investor owns the residential care facility, and the approved provider operates it on a lease basis. There are examples of where this works well and several examples of where it has failed.

Home care and home support businesses tend to be funded organically from owner equity, although there have been examples of private equity investments in these services.

Current capital

Figure 3: Grant Thornton analysis of data contained in ACFA's 9th Annual Report

Residential care funding as a percentage of the total assets

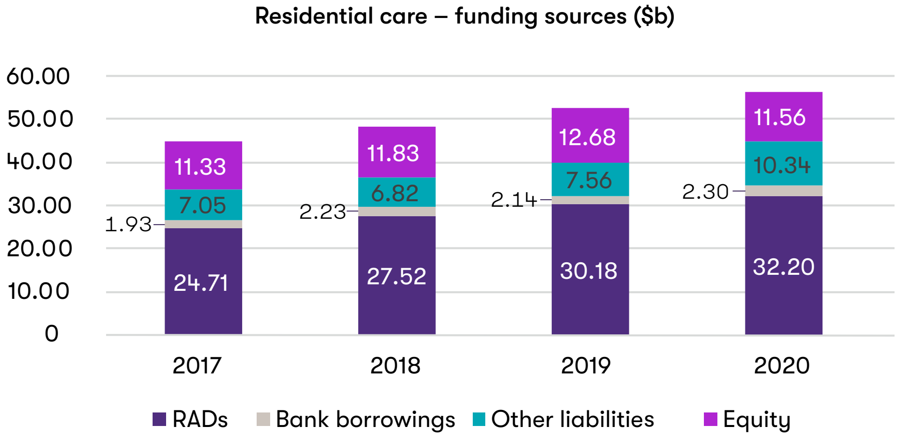


> **Reality check**
>
> In discussions with the major banks, it was revealed that their assessment of bank lending to the sector is more likely to be circa $8b. This would increase the proportion of bank lending to approximately 14 per cent. Some of this gap may be undrawn funds against facility limits. Explained in more detail below.

9 See comments on industry structure below

10 See comments on industry structure below

Figure 4: Residential Care – Funding Sources [11]



The availability and use of RADs allows the sector to have lower equity as a source of funding than other sectors. It is a critical component of the current capital structure of the industry.

Figure 5: Residential Care – Funding Sources 2017 to 2020[12]

Overall, total assets grew at a rate of 6.3 per cent from 2017 to 2020, while total liabilities grew at 8.3 per cent. Net assets (equity) grew at 0.5 per cent. At the same time, the ASX All Ordinaries Index grew at an annual rate of 3.25 per cent.

	2017 ($b)	2018 ($b)	2019 ($b)	2020 ($b)	% of total assets
Residential care					
Cash and receivables	6.39	6.71	7.00	7.26	12.9%
Current assets	6.75	7.39	7.37	6.89	12.2%
Non current assets	31.88	34.30	38.20	42.25	74.9%
Total assets	**45.02**	**48.40**	**52.57**	**56.40**	**100.0%**
	2017	**2018**	**2019**	**2020**	
2021 funding					
RADs	24.17	27.52	30.18	32.20	57.1%
Bank borrowings	1.93	2.23	2.14	2.30	4.1%
Other liabilities	7.05	6.82	7.56	10.34	18.3%
Total liabilities	**33.69**	**36.57**	**39.89**	**44.84**	**79.5%**
Equity	**11.33**	**11.83**	**12.68**	**11.56**	**20.5%**

RADS continue to be a favourable source of funds for the majority of approved providers.

Reality check

While ACFA reported $2.3b in bank borrowings, the banks report they believe that the total value of their support is closer to $8b (undrawn liquidity allowing cash to be reinvested). This could include debt support through finance leases and other financial products included in 'other liabilities'.

The adjacent table refers to drawn borrowings, a part of the gap between the $8b and the $2.3b is likely what is drawn debt versus approved facility limits.

11 Grant Thornton Analysis of the 6th to 9th Annual ACFA Reports.

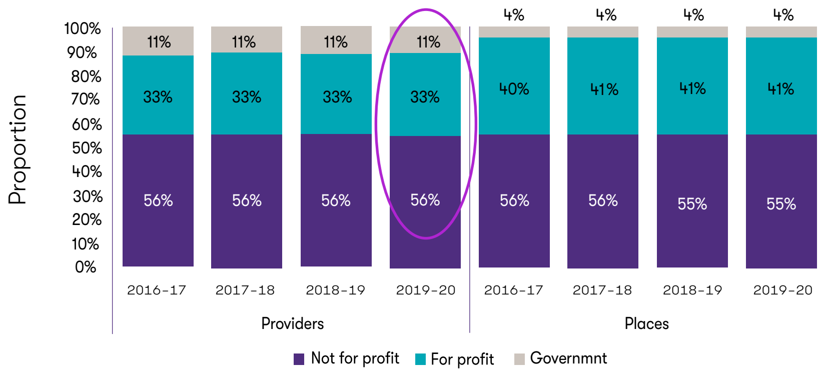
12 Grant Thornton Analysis of the 6th to 9th Annual ACFA Reports

Who can access capital?

For-profit providers (33 per cent[13]) have access to traditional sources of capital from investors and capital markets, whereas not-for-profit providers (56 per cent) do not. It is unlikely there will be significant investments by government providers (11 per cent) in this period.

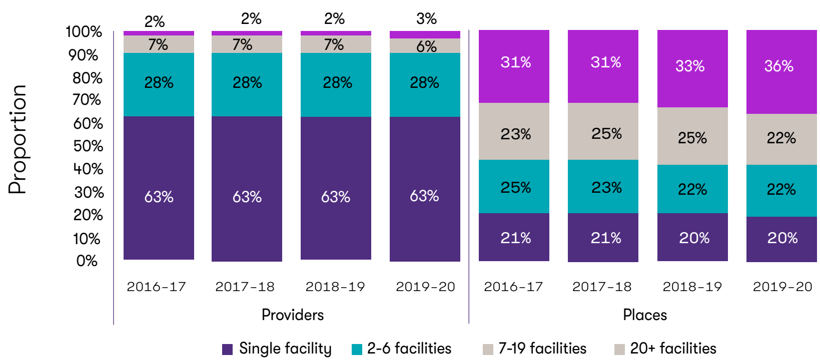
In order to fund the estimated $72b of investment required over the next seven years, capital will primarily have to found by the for-profit sector.

Figure 6: Residential care provider and operational places by ownership type[14]



At the same time, there is a considerable number of aged care providers that operate only a single or small number of facilities. These providers are less attractive to bankers, however, may be the target of consolidators if industry attractiveness improves.

Figure 7: Residential care provider and operational by provider scale[15]



13 This data is prior to Japara being taken off market by Calvary Health and subsequent transactions.
14 9th ACFA Report. Chart 6.3: Residential care provider and operational places by ownership type, 2016-17 to 2019-20
15 9th ACFA Report. Chart 6.4: Residential care provider and operational places by provider scale, 2016-17 to 2019-20

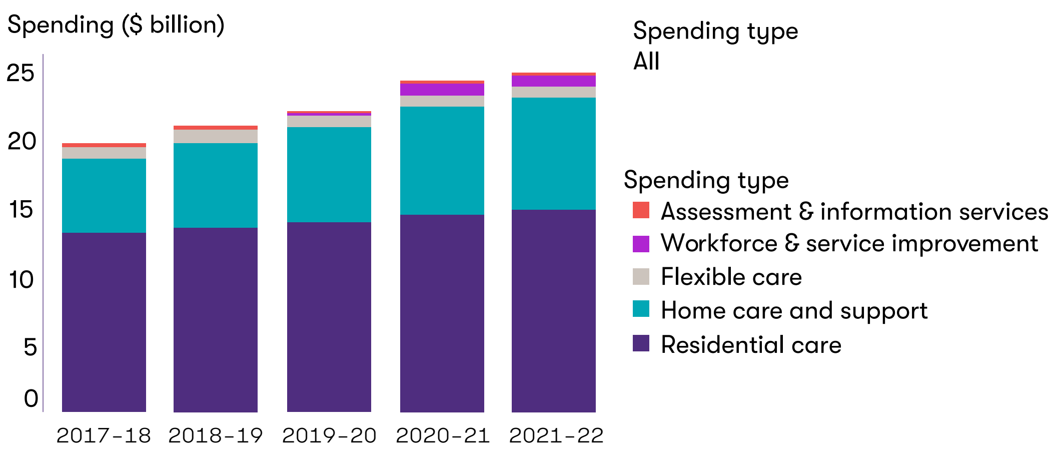
Government funding as a source of revenue for providers

The Federal Government provides funding for the aged care sector by paying approved providers a range of subsidies to support those in need of residential care, as well as funding consumers to acquire services from home care and home support providers.

In addition to this, consumers are assessed to determine whether they have the means to pay for accommodation services themselves. For those who do not have the means, the government funds accommodation through a supplement to the provider. Those that can pay can elect to pay either RAD or daily accommodation payment (DAP).

With an ageing demographic requiring services, the impacts on the Federal Budget will be significant.

Figure 8: Government spending on aged care 2017-18 to 2021-22[16]



*Workforce and Quality, and Aging and Service improvement
Source: Report on Government Service 2023 Part F, Section 14, Aged Care Services report
Note: Time series financial data are adjusted to 2021-22 dollars using the General Government Final Consumption Expenditure (GCFCE) chain defiator
Gen-agedcaredata.com.au

In 2022–23 $28.7b was provided in the Federal Budget, and $32.7b in the 2023–24 Federal Budget.[17]

16 GEN Aged Care Data - Spending on Aged Care.

17 2023 Federal Budget - Aged Care

The current financial performance of the sector[18]

Residential Care

The following chart describes the aggregated operating performance of residential care providers across the sector. It demonstrates declining industry performance over time until there was a negative result of -1.9 per cent in 2019/2020. After adding back COVID-19 costs, the sector still fell short with a net loss (after COVID-19 costs) of 0.9 per cent.

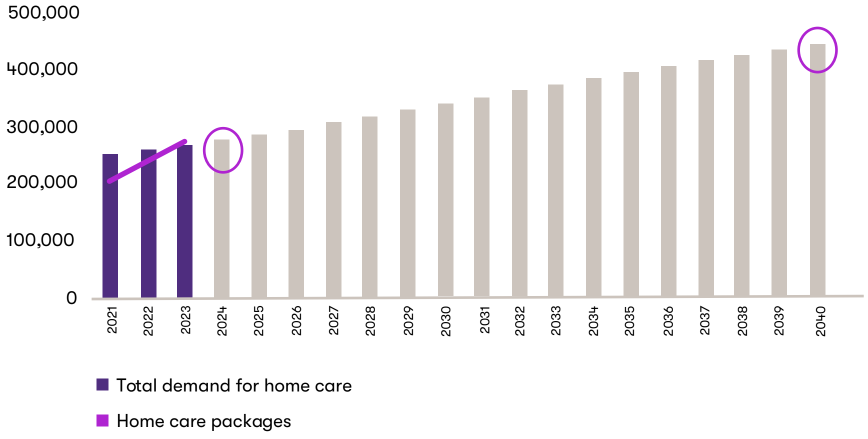
	2018 ($b)	2019 ($b)	2020 ($b)	% of revenue
Care revenue	$11.80	$12.44	$12.93	63.0%
Daily living	$3.47	$3.67	$3.86	18.8%
Accommodation	$1.85	$2.06	$2.21	10.7%
Other	$0.96	$1.14	$1.54	7.5%
	$18.07	**$19.30**	**$20.54**	**100%**
Employee	$12.43	$12.99	$13.97	68.0%
COVID			$0.21	1.0%
Other	$4.05	$4.77	$5.16	25.1%
EBITDA	$1.59	$1.54	$1.21	5.9%
Depreciation	$0.97	$1.07	$1.27	6.2%
Interest	$0.19	$0.21	$0.32	1.6%
Net Profit	$0.43	$0.26	$0.38	-1.9%
	2.4%	1.4%	-1.9%	
Excluding COVID	$0.43	$0.26	-$0.18	-0.9%
	2.4%	1.4%	-0.9%	

Home care

The amount of capital deployed in the home care sector is difficult to calculate from available data. To determine the amount of capital utilised on the home care sector, a simple valuation methodology has been applied. The valuation of the home care sector has been assessed by using EBITDA performance and a valuation multiplier.

18 Data was extracted from the sixth, seventh, eighth and ninth ACFA reports, consolidated analysed and reported.

Figure 9: Projected demand for and supply of home care packages 2020 to 2040 [19]



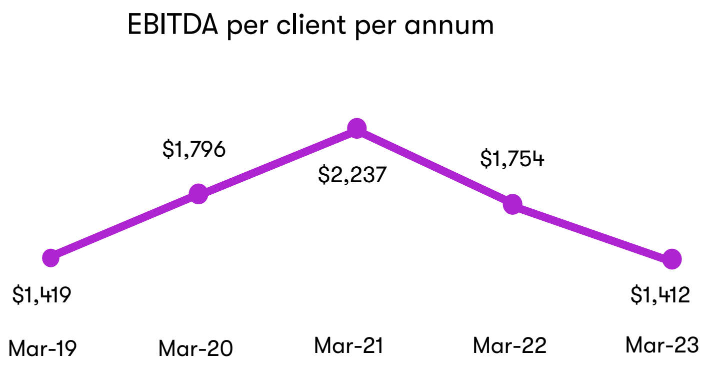
The estimated valuation (in real terms) of the home care sector on multiples of EBITDA based on ACFA Data.

2021 275,000 packages, by $1,369 EBITDA at a multiplier of between 3 and 5 results in a valuation of between $1.13b and $1.88b.

2040 425,000 packages, by $1,369 EBITDA at a multiplier of between 3 and 5 results in a valuation of between $1.75b and $2.91b in real dollars.

Current EBITDA performance per client per annum has not significantly improved. Financial performance and valuations remain soft.

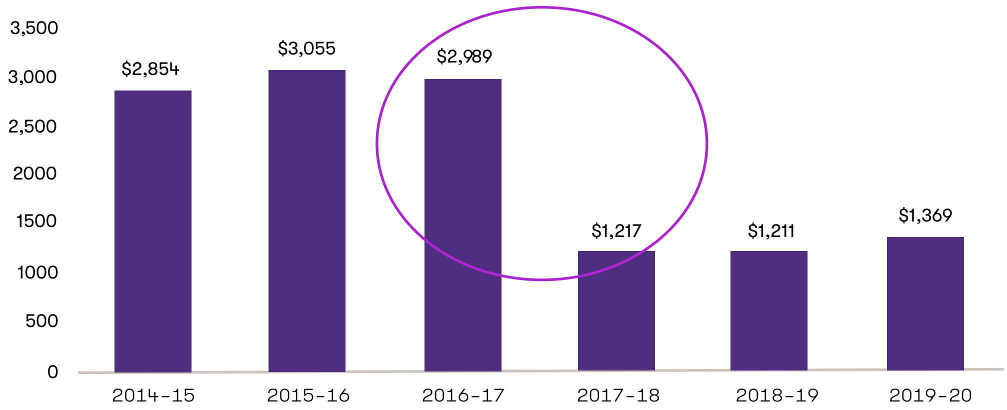
Figure 10: Stewart Brown Aged Care Financial Performance Survey Report, March 2023[20]



19 9th Annual ACPA Report. Chart 8.7: Projected demand for and supply of home care packages, 2020 to 2040

20 Stewart Brown Aged Care Financial Performance Survey Report. For the nine months ended March 2023

Figure 11: Home care providers average EBITDA per consumer per year 2014-15 to 2019-20[21]



2016-2017 to 2017-2018

Based on this methodology, the policy changes in 2016/17 resulted in a write down in overall value of between $1.20b and $2.00b in the home care subsector. For home care to grow at the rate required to meet demand, further capital will be required.

Home supports

The value of the home support sub-sector is uncertain. Many services are provided by dedicated businesses in this sector and others are provided by enterprises that service the general public. Lawn mowing is one example.

On this basis, no attempt has been made to assess the capital required to support this sector. This would be subject to a separate dedicated piece of work.

21 9th Annual ACPA Report Chart 5.3: Home care providers average EBITDA per consumer per year, 2014-15 to 2019 20

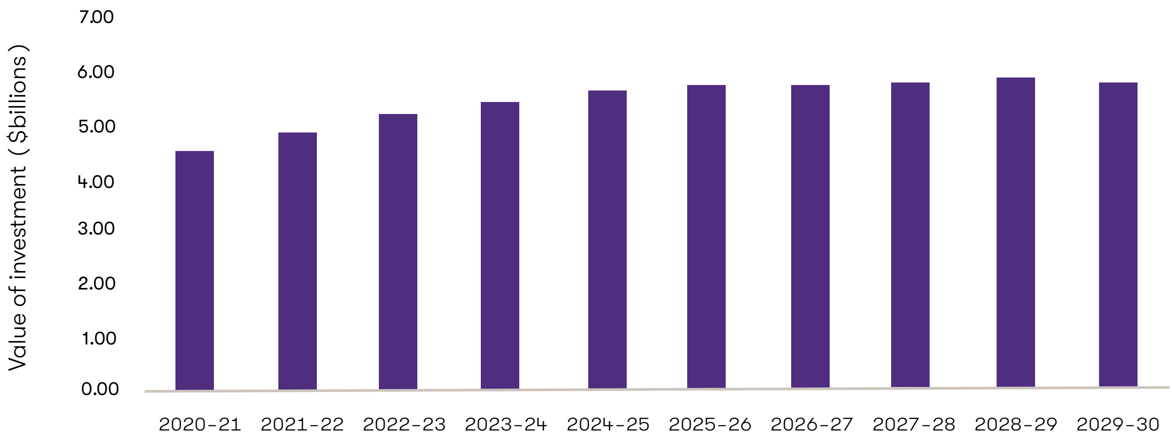
Estimated future annual investment requirements – ACFA

The ACFA reported in their ninth annual report that approximately $5.75b per annum of capital investment will be required from 2022-23 through to 2029-30. Investment in the years preceding this period have not been made, creating a back log.

It should be noted that these estimates by ACFA were unlikely to factor in slightly declining occupancies of residential care facilities (notwithstanding COVID-19) and may be slightly inflated.

In any event, this analysis shows that the level of investment required is substantial and beyond the current means of the sector to finance it. Events since the modelling was done will change the forecasts.

Figure 12: Estimated future capital investment requirements (at 2021 construction values)[22]



The model used to determine the investment requirements was developed for ACFA in 2018 by Deloitte Access Economics. The assumptions behind the analysis are:

- Total place requirements (i.e. the total of all new and rebuilt stock) that is estimated to be operational at each point in the future is based on ACFA's projections, which take into account the current stock of provisionally allocated places; the historical rate of building; and the expected number of flexible residential care places that also contribute to the overall residential care target.
- The share of places that are rebuilt each year is estimated using a flat rate assumption of 2.5 per cent of the stock in that year, i.e., a 40-year average building lifetime.
- The cost of construction differs by region. The base construction costs in 2019-20 (from the Survey of Aged Care Homes) of $288,000 per new place, $213,000 per rebuild, and $24,000 per upgrade have been adjusted by using indices that scale up costs in regional areas relative to the nearest capital city.
- The cost of construction is indexed over time using a 10-year average of Rawlinson's Building Cost Index for each state's metropolitan and regional areas (averaging out at 2.4 per cent per annum nationally).
- The cost of land is sourced from ABS land price data for each state's metropolitan areas and again adjusted using the relevant regional index for that state.
- The cost of land is indexed over time using a flat rate of 4.4 per cent per annum for all areas based on ABS residential property price data.

22 Annual ACFA Report. Chart 8.10: Future annual investment requirement, 2020-21 to 2029-30. July 2021

The value of the investment required

The value of investment required in 2021 dollars is estimated to be $40.25b from FY2024 to FY2030. A construction cost report published in May 2023[23] indicated that construction costs had surged by 30 per cent since 2021. This will increase the required investment to $52.32b, based on a forecast average build cost of $450,000 per bed in 2023. This required investment represents 115,000 additional beds.

This does not include the $15.0b of investment ACFA expected to be made in 2020–21 through to 2022–23.

A significant portion of the residential care stock is nearing or past useful life. On the Grant Thornton assumption, based on provider discussions, that 20 per cent of the current stock of aged care beds (219,965 in 2022) are required to be replaced now[24], an additional 44,000 beds will need to be replaced at a cost of $20.1b in that time.

The total investment required will be $72.34b over seven years.

Given that lead times for planning, building approvals and design work are approximately five years, this will present further challenges for a sustainable future in aged care.

Between 2023–24 and 2029–30, the estimated required investment is

$52.32b for **115,000 beds**.

On the assumption that 20 per cent of current beds need to be replaced now, an additional

$20.02b for **60,000 replacement beds** will be required.

The total investment will be

$72.34b over **7 years**.

Reality check

The modelling to develop the ACFA forecasts was prepared in 2018. It therefore did not account for the softening of residential care occupancy, the Royal Commission into Aged Care Quality and Safety recommendations, the response from governments on the recommendations or the impacts of COVID-19. These factors are likely to reduce future demand for residential care facilities, increasing focus on home care as an alternative to residential care, however not by much.

Further work is required to accurately assess the capital required to meet this future demand and assess the investment required to return current assets to a condition expected by the consumers.

$450,000 per bed is the seven year average billed cost as advised by providers.

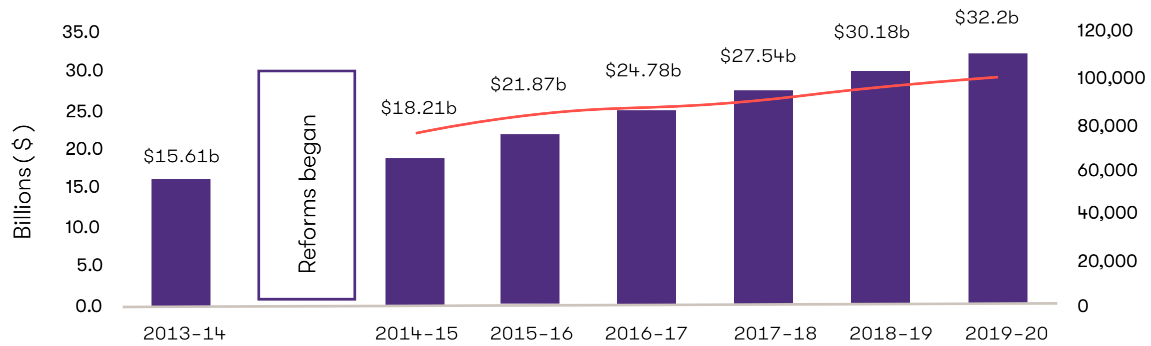
23 KPMG New Builds shelved as construction costs surge. May 2023

24 Grant Thornton assumption based on provider discussions.

Key considerations for the future of Refundable Accommodation Deposits (RADS)

RADs are an essential part of the current capital model for the residential aged care sector, representing 71 per cent of the funding sources in the sector.

Figure 13: Refundable Accommodation Deposits 2014-15 to 2019-20[25]



It is estimated that the aggregated RAD balances have grown to circa $39.1b in 2023.

Providers can use RADs on the following permitted uses[26]:

- capital expenditure as specified by section 62 of the Fees and Payments Principles, or the repayment of debt accrued for the purposes of capital expenditure
- investing in permitted financial products
- making a loan where certain conditions are met
- refunding refundable deposits, or repayment of debt accrued for the purpose of refunding refundable deposits
- repay debt accrued before 1 October 2011 if accrued for the purpose of providing aged care to care recipients
- to meet reasonable business losses that are incurred during the first 12 months that the approved provider receives residential care subsidy.

With a cash holding of approximately $8.2b it is clear that the largest proportion of RADs are invested into property assets. RADs are inextricably tied to the ownership of aged care residential services, and it is difficult to envisage a better model.

25 9th Annual ACFA Report. Chart 7.1: Total value and total number of accommodation deposits held, 2013-14 to 2019-20

26 ACQSC. Permitted use of refundable deposits

Options for funding residential aged care

Given the high reliance on RADs as a source of funding for residential services and the significant value held by providers, a number of alternatives were considered in the process of developing this report. It is noted here that there is a prudential risk to government in the form of a contingent liability that exists through the guarantee[27] provided to consumers in the event that providers fail.

Retain the current RAD arrangements 'as is'

Advantages

RADs are the fundamental source of repayment to aged care development lending. Therefore, any change to RADs would have an impact on bank lending for new aged care developments, the attractiveness of the sector for new equity, as well as the current balance sheets and liquidity of operators.

The current availability of RADs underpins many residential developments. When feasibility studies stack up, banks prefer to fund residential care developments knowing that incoming RADs will reduce development debt and leave a residual commercial debt that is repaid over time. This ensures that the LVR and Debt Service Coverage Ratio (DSCR) are within tolerable risk limits for lending.

Disadvantages

The government has a contingent liability through the RAD Guarantee Scheme. There have been instances whereby the RAD guarantee has been required due to poor liquidity management by providers or uses that contravene the Act. This prudential risk to government has been historically very low.

Price caps limit the price providers can charge to consumers for accommodation, limiting competition, innovation and capital flows, which in turn impairs the functioning of the market and has the potential to restrict new supply.

They are also not well understood by consumers who often don't appreciate the RAD is refundable.

Retain the current RAD arrangements 'as is' and introduce a deferred management fee (DMF) styled payment

Advantages

Consumers could choose to pay a RAD with an effective rental deduction, like a DMF or DAP.

Revenues from the DMF and DAP would improve cashflows and profitability for providers, as well as equalising the relative attractiveness of RADs and DAPs. This will facilitate an increase in the number of people who are able to pay more, to do so, improving cashflow to providers and slightly relieving the burden on government to fund the sector overall. It should be noted that if these are self-funded financial residents and not supported residents, the government doesn't fund the accommodation component now.

Disadvantages

Providers will need to wait until the resident exits before taking the deferred rental or DMF.

The DMF model in retirement living is not well understood by consumers and their families and retentions from accommodation bonds were previously removed in aged care.

Any move to this model will need careful consideration of consumer protections.

27 RCACQS. RAD Guarantee Scheme Explained

Repay current RAD balances with bank debt, converting consumers to DAPs.

Advantages

On the surface it seems to be a simple solution, effectively ensuring providers have enough free cash flow to service and gradually repay development debt over time, rather than repay in the short term with RADs. Consumers will pay 100 per cent DAPs and government payments for accommodation would significantly increase, improving cash flow and profitability for the sector.

Disadvantages

The current support from the banking sector into aged care is reported as being close to $8.0b[28]. To repay the RAD pool, an additional $39b of bank debt will be required, which is beyond the capacity of the senior debt market. With the current financial performance of the sector, it is highly unlikely that this level of borrowing will meet LVR, DSCR, Interest Coverage Ratio (ICR) and securitisation requirements.

Consumers who must pay the DAP may have significant financial assets, such as their home, but very little in the way of cash generating income to meet the DAP cost.

The government will need to secure the additional money to fund a substantial increase in accommodation payments, particularly for fully and partially supported residents.

As a result of RADs providing interest-free capital, the sector experiences a lower level of equity than other sectors. The removal of RADs will put pressure on providers to 'top up' equity to balance out the structural change to their balance sheets. The not-for-profit sector does not have access to capital markets to achieve this.

In receiving RADs, the aged care sector and consumer benefits from the Federal Government's RAD Guarantee Scheme. Therefore, a transition away from RADs (that ultimately removes this Guarantee) will require a source of capital to fund this. This new source of capital will demand a rate of return – given sovereign recourse would not be held – of an adequate level. Internal Rate of Return (IRR) was published in the range of 8 per cent to 10 per cent[29] for the property only and did not take operating margin into account. Anecdotally, it is understood that a 14 per cent to 18 per cent range has been used as a hurdle rate.

The Federal Government's guarantee of RADs in itself represents an industry subsidy – in addition to its direct funding for care – and consequently, any such alternative model should allow for this. The value of the RAD Guarantee should be calculated and reported as a subsidy to consumers whose RADs are unable to be repaid by failing providers.

Repay current RAD balances with other sources of capital, converting consumers to DAPs as a rental

Advantages

Providers would enjoy higher cashflows from the rental payments.

This may be better for smaller providers with low debt and low growth ambitions.

Disadvantages

As a result of RADs providing no interest capital, the sector experiences a lower level of equity than other sectors. The removal of RADs will put pressure on providers to 'top up' equity to balance out the structural change to their balance sheets. The not-for-profit sector does not have access to capital markets to achieve this.

This model is not adequate for larger providers who require capital to fund their significant growth ambitions.

Consumers who have to pay the DAP may have significant financial assets, such as their home, but very little in the way of cash generating income to meet the DAP cost.

It also reduces consumers ability to pay co-contributions.

The government will need to secure the additional money to fund a substantial increase in DAPs, particularly for fully and partially supported residents.

Lenders see this model as riskier that the current RAD model.

It remains uncertain whether this model produces successful feasibilities or meets the banks debt servicing requirements.

It might be easier introducing this into a new aged care facility. However, with the current lack of investment, it would take a significant time for this model to be well established.

28 ACFA reported "bank borrowings" as $2.30b in 2020.

29 NDIA SDA Pricing Review 2022-23: Technical Research Report -CAPM

OPCO / PROPCO models of external investment

There are many examples of the use of OPCO / PROPCO models in the aged care sector. This model creates an arrangement between landlord and tenant where the PROPCO charges rent to the OPCO. The rent is funded from EBITDA. The PROPCO requires a commercial yield on its investment and to some degree carries the risk of the tenant failing as the service provider.

This model can work at higher levels of financial performance of the operator and there are many examples of this, such as the Bolton Clarke and Generation (now Vital) REIT arrangements. However, there are also examples where it has failed, such as in the Prescare and Catalyst REIT scenario.

The RAD model makes the OPCO / PROPCO model more challenging as it can separate the liability from the asset.

The OPCO / PROPCO model could work more effectively where residents do not pay a RAD, and the operator receives DAPs. Feasibility modelling is required to ensure the arrangement works for both parties, and the consumer who currently has a choice to pay either a RAD or DAP.

Advantages

An external source of capital, which may be sufficient to replace RADs in the medium term.

The introduction of a 'regulated' return for PROPCO investors may reduce the hesitancy to invest at scale, which the sector has lacked to date.

Transparent relationship between the property owner and the tenant operator.

Disadvantages

With increased building costs, the yield required for the PROPCO likely only works at very high-end financial performance by operators.

There is little margin for error for operational shocks, such as temporary reductions in occupancy, such as during COVID. Aged care has high levels of operational leverage which can place the OPCO in a stressed position very quickly.

Consumers' choice to pay either a RAD or a DAP, means RADs can be 'trapped' in the operator who has limited investment opportunities for the capital.

Successful arrangements are complex and require detailed knowledge of the commercial arrangement required to make it work, supported by robust feasibility studies.

Other considerations for the current RAD arrangements

Given the important role they play in financing development in the sector, a viable option is to remain as is with adjustments to restrictions, such as RAD caps (the $550k), which hasn't changed since 2014.

DAPs are currently linked to RADs through the Maximum Permissible Interest Rate (MPIR); however, they don't necessarily need to be. DAPs and RADs could be separately priced to allow providers to offer different pricing incentives for consumers.

Other financial considerations for the viability of aged care providers

When sanctions are applied, providers are unable to accept new residents and, by default, new RADs. Anecdotally, a sanction is estimated to cost approximately $1.5m to $2.5m in lost revenues and additional rectification costs. This places a significant financial burden on providers, particularly smaller providers.

It is worth considering if there is an intermediary step that could be developed and implemented in order to significantly reduce this cost in the first instance and allow operators to continue business as usual operations with oversight and supports. The sector needs a regulator that is the 'iron fist in the velvet glove', the current regime seems onerous.

Policy domains impacting the aged care sector

The aged care sector operates with a policy portfolio overseen by the Federal Government. A number of policy settings in other sectors impact the aged care sector.

Labour market and industrial relations

There is significant competition between health, disability and aged care sectors for a limited labour pool, especially skilled labour. This has traditionally been exacerbated by wage disparities between these sectors with aged care being lowest.

Recent wages gains introduced by the Fair Work Commission in May 2023 are already being eroded by the wage movements in the public health sector, with the gap that was closing, now widening again.

The current uncertainty resulting from planned changes to the industrial relations process has resulted in slowdown in planning. Concerns that wages will increase without sufficient increase in revenue has added a contingency to feasibility studies to cover the risk.

Home care vs residential care

The focus on home care as an alternative to residential care will lead to inefficiencies in delivering services, particularly at the higher end of acuity. The acute care costs of home care recipients is higher than for residential consumers. This is mainly due to logistics factors such as travel and labour utilisation. Home care labour utilisation is less efficient than residential labour for the same or similar services. The costs of 24 hour home care are prohibitive.

Additionally, keeping people in their homes longer means that housing stock is locked up and reduces supply, impacting housing affordability.

Housing

The National Housing Accord[30] will see State and Federal Governments commit to investing in affordable housing to meet the emerging demands of Australia. The Federal Government is establishing the $10b Housing Australia Future Fund to provide a sustainable funding source to increase housing supply and improve service delivery. Investments from the fund will seek to draw in new investment from state and territory governments and private capital providers to deliver new social housing projects.

The fund will provide 20,000 new social housing dwellings, 4,000 of which will be allocated to women and children impacted by family and domestic violence and older women at risk of homelessness. It will also provide 10,000 new affordable housing dwellings, including for frontline workers.

These investments are being made at a time when aged care accommodation will also be a priority and will commit the construction industry to focus on this area. The competition for developers, builders and construction workers will be significant. Recent collapses of development and building companies is adding to this pressure. This could further delay investment in residential aged care accommodation. These forces combining will likely place further impacts on construction costs.

At the same time, the aged care sector is relying on immigration for some workers, and they are unable to find housing close to their workplaces. Providers are building accommodation for them, and also converting existing accommodation for use by workers. The rental crisis and lack of access to affordable properties for first homeowners further inhibit workers. Rising construction costs continue to impact the ability of first home owners to build their first home.

30 Housing Accord

Immigration[31]

The Federal Government is accelerating immigration numbers to assist in meeting the demand for labour. Net Overseas Migration (NOM) is forecast to be 400,000 in 2022–23 and 315,000 in 2023–24. This increase over previous years reflects a one-off catch up from the pandemic as temporary migrants return to Australia. The government expects the increase in migration and population growth to be temporary, with NOM forecast to largely return to normal patterns from 2024–25.

The 2023–24 permanent Migration Program has been set at the pre-COVID planning level of 190,000. This is a slight reduction of 5,000 places compared with the 2022–23 permanent Migration Program planning level of 195,000 places. Immigration is most effective when new arrivals are matched to skills needed and shortages in the labour market.

Immigration at these levels will have further impacts on social services required to support new immigrants and housing to accommodate them. Compounding the issues noted above, the impacts in aged care are to further delay investments due to shortages of construction workers, rising construction costs and financial viability of construction companies[32] .

31 Home Affairs. Migration program planning levels.

32 RBA Financial stress and contagion risks in the residential construction industry

Conclusion

The Minister for Aged Care has taken proactive measures by instituting the Aged Care Taskforce with the primary objectives of reviewing existing funding arrangements in the aged care sector, designing a fair and equitable system for all Australians, and incorporating the recommendations of the Royal Commission into Aged Care Quality and Safety.

In its endeavour to evaluate aged care funding mechanisms, the Taskforce's core focus remains on ensuring the sustainability of the system.

Constant regulatory, policy, and legislative reform, and underfunding of the capital model create ongoing uncertainty for investors and lenders, and therefore consumers.

This report was prepared for the Taskforce to provide information regarding the capital model of the aged care sector, for their consideration. The views expressed in this report are based on accounting principles.

The information is based on publicly available data. It has been noted in this report where further work is required to update and validate the assumptions.

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Partners Nationally

$7.2b
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People Nationally

6
Offices Nationwide

68,000+
People Globally

750+
Offices Globally

145+
Markets

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