nabhealth

more than money

INSIGHTS AGED CARE

Navigating a changing investment landscape

October 2016

INTRODUCTION

Australia's aging population is our fastest growing demographic trend. Meeting the aged care services this growth demands is an exciting opportunity for providers that will require a shift in thinking for many. This insights paper has been prepared by NAB Corporate Health and JBWere to address the current challenges facing providers and to examine some of the successful strategies being adopted.

Sticking with the status quo isn't an option anymore

Australia currently has around 200,000 residential aged care places with another 76,000[1] needed over the next decade. For many providers, that means finding a lot of money to invest in new stock and to upgrade existing facilities. The Health Department calculates the cost to meet growing demand is around $33 billion before 2026[1].

John McCarthy, Head of NAB Corporate Health, says the huge investment needed is leading to a lot of rationalisation in the aged care sector. "Funding growth is the biggest challenge facing all providers at the moment. Marginal players are struggling the most. They have to make a strategic choice about whether to remain in the sector or sell to a larger entity. And if they stay, how they can grow sufficiently to survive and prosper."

McCarthy explains that in the past many players, especially in the dominant not-for-profit sector, have sat on their large balance sheets. We are now seeing a more sophisticated approach to board governments and this is driving a much sharper strategic and operational focus. This is resulting in many well run organisations generating attractive returns and surplus for reinvestment. "Operators need to think very differently now, especially some of the not-for-profit and smaller family operators that have to raise capital to draw on. They've still got to meet their social mission and growing demand," he comments.

> Funding the growth aged care operators need to stay competitive and meet increasing demand will require a shift in strategy for many. It can be uncomfortable moving on from the status quo, but once their new financial strategy is in place and allowing them to achieve their mission goals, clients often wonder why they didn't do it earlier."
>
> **John McCarthy, Head of NAB Corporate Health**

[1] *Source: Aged Care Financing Authority's 2016 Report on Funding and Financing of the Aged Care Industry. Department of Health, means the government body that administers the sector.*

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> The separation between the real estate owner and the aged care operator is clear in the US and UK, and our market is moving in that direction."

Hun Aung, NAB Director of Client Solutions & Advisory

While banks and other institutions are still providing debt facilities, alternative funding sources will be needed to pay for future capital investment in the sector. "Historically, the aged care market has been highly fragmented, with a lot of not-for-profit operators," says Hun Aung, NAB Director of Client Solutions & Advisory. "What we're seeing is increasing consolidation with more for-profit entities coming into the sector, and more sale and leaseback transactions. If we look at the US market in particular, we see quite a distinction between the real estate owner and the aged care operator. This split frees up capital for operators to invest in their facilities, and market commentary suggests Australia is heading in the same direction."

Capital investment [2]

Financial year 2015

Completed

$1.7 BILLION

across 20% of all homes

Work in progress

$2.1 BILLION

estimated across 17% of all homes

Financial year 2017

$2.5 BILLION

estimated requirement

Financial year 2026

$4.0 BILLION

estimated requirement

[2] *Source: Aged Care Financing Authority's 2016 Report on Funding and Financing of the Aged Care Industry. Department of Health, means the government body that administers the sector.*

Sale & leaseback transactions 2015-2016[3]

Seller/ Tenant	Buyer/ Landlord	Facilities/ beds	Price ($m)	Yield	Lease	Other features
Hall & Prior	Vital Healthcare Property Trust (NZX listed REIT)	4/275	41.0	8.0%	20 years	• Reaffirms capital relationship between partners, which will generate a pipeline of brownfield development and follow-on acquisition opportunities. • Hall & Prior sees the partnership as critical to supporting its growth initiatives, which may include consolidation of small players supplemented with new builds.
Infinite Care	Heathley Asset management (unlisted)	5/386 beds (doubles/ singles)	50.8	8.2%	20 years	• This forms the seed property of the Heathley Aged Care Property Fund No1; an unlisted closed-end fund with an 8-year term. • Infinite will pay all costs except for CAPEX, which the fund will rentalise at 8.2% (max $20m). • Infinite has a buy-back option.
RSL Care	Generation healthcare (ASX listed REIT)	3/311 single ensuited)	45.8	7.65%	20 years + 2 x 10yr options	• Properties are co-located with RSL retirement villages. • Generation Healthcare (GHC) has also entered into a collaboration with RSL Care to acquire further properties as part of RSL Care's growth strategy. • RSL Care sees GHC partnership as enabling them to grow in their provision over the next 5 years.

[3] *Source: Vital Healthcare Property Trust Market release 2 March 2016; Heathley Aged Care Property Fund No, 1 Fund Summary 2016; Generation Healthcare ASX Announcement 28 April 2015.*

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Partnering to finance your core business growth

John McCarthy's Corporate Health team is helping operators create strategic financial plans that include funding growth. They start by encouraging operators to look closely at the growth they need to achieve, their business model, the management team and board, and their vision.

"Most aged care businesses want to remain focused on the operating side; how they can improve services, provide what users want and meet the new Aging in Place model demands," notes McCarthy. "Often that means acknowledging they don't have the funds to acquire property as well as invest in their core business facilities. And that leads to investigating whether property sale and leaseback is right for them."

Choosing the separation of service provider and property owner model is happening in Australia. McCarthy says that the feedback has been very positive. "Despite the uncertainty around government funding instruments, operators are backing their beliefs and mission, and looking at debt and capital investment in a new way." He admits that initially, some have found it hard to change their thinking. "But once they've done it, they wonder why they haven't looked at these strategies in the past."

According to Aung, there's such strong demand for Australian healthcare assets that operators can negotiate favourable lease and relationship terms with their property partner. "You can also work strategically with them to pre-agree future funding and pricing arrangements, and importantly to retain some level of influence or control over the property assets. We recently worked with a prominent healthcare operator and sourced a like-minded capital partner for their existing property assets and also for their development pipeline. The operator can focus on their core business and expansion plans now that their funding framework is in place. And while the industry continues to evolve with regulatory change and increasing demand, operators know their interests are aligned with a long-term partner who can work with them to navigate through future change."

Finding the right partner

Aung explains that her team can run a competitive process to find the right investor. They look at it in terms of maximising price and value for the operator and also finding someone who shares the same values and strategic approach. For NAB, the idea is not to do just one transaction. "We would like to find the operator a long-term strategic capital partner so that if they need to free up capital in the future, they can continue with the same investor. There is a lot of interest from offshore investors, as well as local players so the choice is quite wide."

Acting while the window of opportunity is open

Aung says that NAB is happy to talk to healthcare and aged care operators about their strategies and explore whether an alternative funding structure could work for them. "If they come to the conclusion that a property sale and leaseback is not for them, at least they have had the conversation and have made an informed decision," she adds. However, it is important to understand that while there are a lot of investors coming into the market, the window of opportunity isn't infinite. "From the investor's point of view, once they have their partnership and portfolio covered, their appetite diminishes and they become more selective. There's this great opportunity to maximise value and negotiate favourable terms at the moment. But this window will start to close, as all markets do."

> NAB can help you achieve your strategy – not only with loans but also by defining a bigger financing strategy that works in today's constrained and highly competitive environment."
>
> **John McCarthy, Head of NAB Corporate Health**

Expanding into new areas of growth

Growth can also involve expanding into new areas of operation. McCarthy says that home care is an area where many aged care operators are looking to increase their involvement. "People are staying at home for longer, with government encouragement. However, you still need to fund the technology and backend organisation needed to run an efficient operation."

Case study – Prominent health care operator

NAB analysed the key strategic goals of the client to propose and negotiate an innovative solution.

Key goal	Agreed outcome
Pricing for seed properties	• Attractive Pricing achieved for the sale of existing properties, and the leaseback rental yield.
Indication of future pricing for pipeline assets	• Reference rate pre-agreed for future transactions which provides clarity and confidence for ongoing funding.
Financial close	• Ability to meet compressed timeline. • Funding capacity based on existing seed properties and future pipeline.
Development fund process and terms	• Agreed process for fund-through arrangements between parties, including high degree of collaboration and information sharing. • Key criteria were to minimise impacts to the typical development process of the operator and ensure maximum capital is funded by the property owner.
Protection mechanisms	• Key terms were negotiated to ensure ongoing influence over the strategic property assets.

"Healthcare and aged care property assets are highly sought after at the moment, and we encourage operators to take advantage of this window now."

Hun Aung, NAB Director of Client Solutions & Advisory

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Alternative investment strategies for refundable accommodation deposits (RADs)

In the current investment environment, aged care operators with well-structured and documented investment management strategies are investing their refundable accommodation deposits (RADs) in diversified and conservative portfolios. This is generating returns which assist them to improve their services to residents and to better meet their mission statements.

Grant Cashin, Executive Director, JBWere, explains that for most aged care operators, the investment capital and interest earned from their RADs is very important to their operational performance. "When considering their investment options, operators need to assess the minimum level of liquidity they need to repay RADs when residents pass away. However, in such an historically low interest rate cycle, the traditional areas of RAD investment are no longer achieving the returns operators have often budgeted for." Cashin notes that JBWere's expertise in designing and managing investment outcomes for aged care operators involves a genuine and long-term partnership approach.

Steps to creating a tailored investment portfolio

A key part of JBWere's responsibility is to deliver investment advice and recommendations tailored specifically to each aged care operator's unique needs. Constructing and managing an investment portfolio can be broken down into the following four steps:

1. **Gain a thorough understanding of the organisation's investment objectives:** Goals, objectives, risk profile, time horizon, return expectations and liquidity requirements all have a direct bearing on the creation of an investment management strategy.
2. **Asset allocation and risk management:** Undertake an analysis of the most appropriate asset allocation structure within the bounds of the investment management strategy. This will provide a clear roadmap for the investment management process.
3. **Portfolio construction and investment selection:** With an agreed asset allocation strategy in place, extensive internal research is used to select the investments that will populate the portfolio and to ensure the organisation understands their portfolio and the logic for the recommendations made.
4. **Portfolio management:** The ongoing portfolio management is based on an established process and structure for their timely review. The process includes comprehensive investment analysis and portfolio performance reports.

> "We've found that for many operators, the changed investment environment means that adopting an alternate investment strategy to cash and term deposits has become an imperative."
>
> **Grant Cashin, Executive Director, JBWere**

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