20th May 2011

Mr Mike Woods
Deputy Chairman
Productivity Commission
GPO Box 1428
Canberra City ACT 2601

Email: mwoods@pc.gov.au

Dear Mike,

Re: Follow up letter to Productivity Commission Hearing on behalf of Regis Group, Bupa Aged Care Services, Japara Holdings Pty Ltd, Domain Principal Group and Lend Lease Primelife Aged Care

This document is designed to bring the Productivity Commission's attention to what we believe are serious issues that will flow from proposed changes to the accommodation bonds in the draft report dated January 2011

In particular we bring to your attention the following impacts:

- Either change outlined herein will see reduced cash flow to providers. The impact should funding not be increased to compensate will range from small cash flow deficits to potential forced closure for providers with older bonded facilities.
- Removal of a provider's flexibility to charge bonds according to a resident's financial means will reduce access for residents with less financial means. At present, this flexibility works for both residents and providers.
- Our examples looked at various ages of facilities, we believe the most material impacts will be on providers with smaller facilities over fifteen years old. This is the rump of the stock in the industry today.
- Additionally we believe strongly that any changes to accommodation bond legislation should only be introduced after funding has been increased to compensate allowing providers enough time (2-5 years, dependant on changes) to adjust their balance sheets.
- We believe any proposed changes should only be undertaken with the full support of the principal lenders in the industry. In that context we these groups are ANZ, NAB, St George and CBA.
- Currently, a substantial amount of the equity in the industry is derived from debt funding, accommodation bond cash flows directly support this. Any material unfavourable changes to this relationship will see reduced access to capital for provides.

We have constructed worked examples for your information which focuses on the impacts (profit, debt and equity) of the amendments to bonds outlined in your initial report.

Given the outline was unclear in your draft report, we have provided worked examples based on two scenarios;

Scenario One

Periodic payment / bond values based on replacement costs for a new single room ensuited building.

Scenario Two

Likely bond values and current valuations based on a "bank valuation" (going concern valuation used for procuring debt).

The purpose of these examples is to highlight to the Productivity Commission the potential significant impacts flowing from them.

In any scenario, we draw the Productivity Commission's attention to the following:

1. Adequate alternative sources of funding

    - Future alternative sources of funding will need to be adequate to encourage sufficient investment in this essential infrastructure to meet current and future demands

2. Appropriate transition period

    - Existing approved providers in the market will require adequate time to adjust their existing accommodation bond pools on their balance sheets to reflect any changes to the capital funding mechanism.

To assist in the understanding of our position, we have elaborated further on these two points and provide two worked examples with additional commentary.

Adequate alternative sources of funding

As you are aware, most approved providers utilise accommodation bond cash flows to acquire facilities, construct new facilities and/or retire debt related to these. The accommodation bond concept allows non interest bearing debt to replace interest bearing debt. This is important because:

- Existing capital funding of a recurrent nature (i.e. accommodation charge, retentions etc) is inadequate to support the funding costs associated with development activity if the capital outlays are not considerably offset by accommodation bonds

- The capital structure (level and mix of debt and equity) required to fund future development would be negatively impacted thereby placing a further constraint on future development.

The implementation of an effective cap on individual accommodation bonds in isolation would inevitably have a negative impact on development funding and therefore society's ability to cope with future demand. To meet future demand, the impact of such a policy change would need to be more than offset by the benefits of some other source of funding.

It is important to note that while there are situations where approved providers do charge individual accommodation bonds that are greater than the unit cost of the associated room, an accommodation bond cannot be charged to all residents (unless a 100% Extra Service facility). Using Regis as an example, it only charges an accommodation bond to approximately 40% of all its residents. The other 60% of Regis residents contribute nothing to the cost of capital development or only pay the accommodation charge which is a grossly inadequate amount to justify development and an adequate return on investment.

Regis has been one of the few aged care developers of any scale in recent years. Future development plans have slowed as it is highly constrained in terms of geographic location and the risk relating to prospective accommodation bond pools has increased.

Alternative sources of funding could be obtained by a broadening of the accommodation bond paying resident base from current levels and / or an increase in recurrent capital charges.

It is a fact that in recent years there has been very limited development of high care beds, which is where the demand exists. It is also a fact that greenfield development timeframes are 5-7 years given the ACAR process and planning consents required. To meet future demand for residential high care the benefits of alternative funding sources will need to significantly exceed the negative impact of a policy that caps individual accommodation bonds.

Appropriate transition period

The cash outflow from any isolated policy capping accommodation bonds runs the risk of placing significant financial stress on all providers holding accommodation bonds. This will be the case particularly for the smaller, less diversified approved providers that have a higher percentage of bonded residents or higher average bond levels. Debt financing arrangements rarely exceed four years and existing financing arrangements are, naturally, based on the current funding model. While prudent liquidity management strategies should be in place for all approved providers the stress testing would need to be re-evaluated for an isolated policy change capping accommodation bonds.

Given the increasing acuity of residents, the cash outflows over the short term may be significantly higher than previously expected. Approved providers that are financially less sophisticated may underestimate the impact of these changes if they are not carefully modelled and implemented.

Without an offsetting capital funding policy change, we estimate that in 18-24 months valuations would move materially downward causing many approved providers extreme duress in finding this additional cash flow to maintain their balance sheets and source appropriate future debt and equity funding

Given the "Prudential Compliance" legislation regarding the use of accommodation bond cash flows is about to be released mid year any change would have to be implemented to allow approved providers time to achieve the obligations outlined therein.

Worked examples and additional commentary

In relation to alternative funding sources should accommodation bonds be capped, we provide the following worked examples to assist the commission in their considerations. We have outlined in our submission the level of return required to achieve this in order to build and or acquire new facilities which are generally debt funded due to the cash flow support required.

We have recommended a 14% WACC[1] be adopted to offset the reduction in bond cash flows, this would have to be applied to a "valuation of a facility" in order for it not to unfairly prejudice approved providers with more invested in better quality facilities. This provides for a 45% debt funded and 55% equity funded model.

We have attached worked examples of two scenarios for your information (see Attachments 1 and 2).

Additionally, this change would be viewed by lenders as a material denigration of current cash flows for approved providers in the industry. Similarly, we believe there would be a significant impact on valuations from this change in funding as we have outlined above. Reduction in bond cash flows are assessed as a $1 for $1 reduction in the value of a facility by valuers. We firmly believe that bond cash flows are a surrogate for debt in terms of an approved providers cash flows and therefore are quite an effective tool for residents, government and approved providers.

Debt is in order of 8% p.a. whilst a reasonable return on weighted average capital deployed is in the order of 14% p.a. by any measure this is an efficient system. The lack of current stock coming to market we believe is a function of the uncertainty around availability of licenses and extra service places not a sign that the current system is not working efficiently.

Similarly the escalation that is applied to this formula should be in line with movements in the median house price, currently accommodation bonds track this metric across the industry. Any metrics lower than these will constrain lending to the sector and will again in a few short years amount to a form of price control, we are not sure how this sits with a competitive market environment as outlined repeatedly throughout the commissions report.

If bond escalation were to be capped at CPI, this would be the only form of residential accommodation artificially capped in this way and disparity would soon occur with the residential market. Land and built form prices fluctuate principally through supply and demand metrics, not CPI. With Australia's supply side constraints on land, new development in aged care will very quickly become uneconomic through land price escalation over and above CPI.

Additionally residential aged care facilities require constant capital to achieve the level of presentation and compliance necessary to compete in the market. Any movement away from the median house price metric would have to see the base used for establishing the return adjusted up to accommodate this capital expenditure.

[1] Weighted Average Cost of Capital

An average facility we would expect would undergo the following in its life cycle.

- minor renovation every five years; 5% of capital cost
- major renovation every ten years; 25% of capital cost

Yours Sincerely,

Encl. Worked Examples – Attachment 1
– Attachment 2

Attachment 1 - Worked example based on replacement value

1.1. New Single Bed Ensuited Room (assumes no accommodation bonds)

Cost to develop[2]	$302,400.00
Return PA @ 14% (WACC)	$42,336.00
Funding per day	$115.99
Current accommodation charge for non supported resident	$30.55
Increase in capital funding required	**$85.44 per day**

1.2. New Single Bed Ensuited Room (assumes accommodation bonds exist)

Facility Age	Going Concern Value	Value per bed	Average Individual Bond Value[3]	Equity/debt required to replace single bond loss	Additional Equity/debt required to replace total bond loss based on fully occupied facility[4]
New	N/A	$302,400	$302,400	$302,400	$24,192,000

Assumptions:

- 100 bed facility
- 80% bonded (generally new developments are not considered unless this level can be achieved)
- individual bonds at "cost to develop"

[2] Assumes no cost associated with licences as they have been allocated via Aged Care Approvals Round

[3] Actual bond values vary depending upon resident assets. Charging some residents a larger bond where this suits their situation allows a provider to accept residents paying a bond lower than the cost to build (or no bond at all) and still maintain necessary level of capital contribution.

[4] Additional equity / debt requirement, not total equity / debt requirement. Original construction would have required equity and debt contributions and some of the original debt would still be outstanding based on this scenario

If accommodation bonds are maintained but 'capped' in some fashion then some part of the existing bond balances will need to be replaced by other forms of capital financing. This financing will:

1. Come at an additional cost (compared to the existing non interest bearing accommodation bonds)

2. Need to come from equity and debt capital markets which are already constrained in terms of their sector allocations to aged care as an asset class

Attachment 2 - Worked example based on going concern valuation

1. Single Bed Ensuited Room, various ages per table

Facility Age	Capital Value (WDV of replacement cost used as a proxy))	Cap Rate (assumed)	Implied Net Value per Bed	Net Facility Value	Total Bonds Held (potential additional equity / debt required)	Gross Value	Funding Deficit at Current Replacement Costs[5]
New	302,400	13%	107,692	6,461,538	10,886,400	17,347,938	796,062
5 years	264,600	13%	107,692	6,461,538	9,525,600	15,987,138	2,156,862
10 years	226,800	14%	100,000	6,000,000	8,164,800	14,164,800	3,979,200
15 years	189,000	15%	93,333	5,600,000	6,804,000	12,404,000	5,740,000
20 years	151,200	16%	87,500	5,250,000	5,443,200	10,693,200	7,450,800
30 years	75,600	20%	70,000	4,200,000	2,721,600	6,921,600	11,222,400

- Assumptions
  - 60 bed facility (closer reflection of broader industry than a new development)
  - 60% bonded (closer reflection of broader industry than a new development)
  - Calculation based on "bank" valuation
    - To ensure sensible outcomes aligned with recent transaction evidence of single facilities, $14,000 EBITDA has been assumed[6]
  - Average existing individual bonds assumed to equate to WDV of room capex across the facility

While some broad assumptions have been made in the above table, it demonstrates what is already well understood, that accommodation bonds have been an important and significant component of funding for aged care. This holds true for all facilities, old and new, not just new developments. Relative bond pools tend to reflect the age of the building which are a reasonable proxy for what consumers want in terms of amenity and property offering. While lower in relative terms, even older style aged care facilities can have considerable bond pools.

[5] Gross Value – (# beds * per room replacement cost). i.e. $17,347,938 – (60 * $302,400)

[6] Stewart Brown survey 6 months ended 31 December 2010 showed average EBITDA per annum of only $7,336 for all survey participants.