CARING FOR OLDER AUSTRALIANS

SUBMISSION IN REPONSE TO DRAFT REPORT OF THE PRODUCTIVITY COMMISSION JANUARY 2011

THE ROLE OF BONDS IN RESIDENTIAL AGED CARE

Insight Understanding Innovation

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The Challenge of Capital Financing in Residential Aged Care

In the community residential housing finance tends to be matched to the period of occupancy of the dwelling irrespective of whether the home is owned (outright or with a mortgage) or rented. This is achieved initially by the use of long term debt (25 – 30 years) and in retirement through equity in the residential accommodation unit.

The current bond system in residential aged care provides an equivalent to this situation. Owners can chose extra service or low can and contribute “quasi” equity though bonds and renters in opting for high care can have some equivalence within residential aged care. Allowing bonds on all residential aged care places would enhance this equivalence

Notwithstanding the acknowledged gap between the cost of providing accommodation and the current regulated accommodation charge resident bonds allow accommodation in residential Aged Care Facilities to be provided cost efficiently to residents.

If residential Aged Care adopts a corporate financing model it cannot achieve the same long term debt finance provided through bonds and this change will cause a dramatic increase in the cost of residential aged care to the resident without changing the financial position of the owners of the facility. Rather than create a win win situation this will create a lose lose outcome.

Providing potential residents of residential aged care facilities with a real choice means ensuring that the overall accommodation charges to the resident as nearly as possible equates to the cost of residing in their own home. Accordingly it is submitted that the question is what mix of capital; equity, debt and resident bonds best achieves this outcome for the resident?

This submission considers the impact on a proposed 120 bed facility[1] of shifting its finance from bonds to debt. This case study clearly shows the importance of retaining resident bonds as a dominant source of capital in residential aged care facilities.

Facility viability is integrally linked to access to resident bonds accordingly the determination of bond levels should be Consumer directed rather than Government regulated

[1] Viability under the existing model has been achieved.

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Summary of Commissions Key Findings

Chapter 6.3 the draft report addresses the issues around the current use of bonds as part of the capital structure of residential aged care facilities and at page 176 the Commission seeks input with respect to the options canvassed as alternatives for the future.

The report makes the following key observations: -

1. Bonds don't reflect costs

This Assessment appears to conflict with the reports own findings specifically that average bonds are $233,000 and estimated construction costs range between $200,000 and $250,000[2]. It is submitted that on balance bonds would appear to reflect the capital cost on a per bed basis.

2. That equity efficiency and sustainability would be enhanced by having common funding options across all categories of residential aged care

The arguments in support of this are undeniable, no one size will fit all potential residents and so any system that has as a foundation restrictions' on flexibility (as is the case by not allowing bonds in high care) can only cause allocative inefficiency and possibly restrict equity and access to those seeking residential aged care places. This is evidenced in the current bias to Extra Service and low care beds.

3. The accommodation charge should reflect the cost (including an appropriate return on capital) of providing RAC places

For there to be sustainability this is clearly the case and we agree with the observations and findings of the Commission that the current accommodation charge is below this level and that urgent change is required. As potential residents (save for the disadvantaged) currently choose how much to pay for their residential accommodation in private dwellings (either through rents or the capital cost of their home) the current system runs contrary to the approach generally supported in the community. Aligning choice through market pricing (of bonds & accommodation charges) in aged care will assist residential aged care in becoming a more integrated option with in the community and will support the consumer directed model espoused by the Commission.

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[2] Page 159

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4. Choice in payment options for accommodation

Residential accommodation in the community at large is either by way of owned housing or rented housing. Residential Aged Care should provide the same options (free of allocative distortions) for residents wishing to move into residential aged care facilities. Accordingly we support the Commissions view that payment options should involve both daily charges and bonds; consistent with the principle of choice we support a system where the quantum and mix is determined between the operator and the resident.

Because of the expected short term occupancy in residential Aged Care (for men 90% will stay less than 5 years and for women 81% will stay less than 5 years) traditional ownership would involve higher capital risks to residents.

Resident bonds provide a surrogate form of ownership without the risks inherent in short term ownership. Similarly a variable market based accommodation charge would provide an alternative to the traditional rental model.

5. Competition should place downward pressure on bonds

If bonds currently reflect (on average) the cost of facilities, as is suggested by the data in the draft report[3] then this may not be the case. It is submitted that in a consumer driven model bond levels will, like house prices be determined by the market. We see this as appropriate.

Our modelling and current market experience shows that average bonds equate to the average cost of facilities (on a per bed basis). This suggests that residents are comfortable with the current bond levels.

6. Capped bonds

The Commission is not attracted to this option and for the reasons stated above we agree with the Commission in this. The restrictive pricing practices of the current system have created the current problems with sustainability and placing restrictions on bonds will likely lead to similar outcomes over time. The draft report suggests that capping is motivated from other policy reasons (Social Security). However it is submitted that if on average bonds represent facility cost then the impact on government costs may not be as significant as thought.

The consumer is best placed to set a cap on bonds through the mechanism of supply and demand.

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7. Removing distortions between payment methods

There appears to be an assumption that choice of payment method is both desirable (bond or accommodation charge) and an economically rational decision. Such an assumption would be dangerous and deny that potential residents act more emotionally than rationally in relation to such choices (as they do with traditional home ownership). It is important that there is choice for consumers. While from an economically rational perspective there may appear to be financial distortions in the system any such distortions merely reflect the different value placed on the alternatives by residents.

8. Accommodation bond equivalent to accommodation charge

In our view it is neither possible nor desirable to strive for an equivalent alternative pricing between bonds and accommodation charges. There are two key reasons for this: -

a. There isn't one market nor do all residents equate equivalence in the same terms.
b. We see bonds as a capital contribution where as accommodation charges are designed to meet the ongoing cost of service provision (including capital return). The existence of bonds actively reduces the required capital return.

Our modelling clearly demonstrates that where average bonds equate to the cost of facilities the system can provide a real choice for the resident. The Commissions findings that average bonds equate to average cost support the notion that the market (for bonds) has already reached an equilibrium point.

The role of bonds is not to replace the accommodation charge (which represents the ongoing cost of service provision) rather it is to provide capital to finance the cost of residential accommodation units.

It is appropriate for residents to contribute both to the capital and the ongoing costs of residential aged care facilities

9. Supported residents

We agree with the Commission that supported residents should be subject to a safety net provision as is the case in housing in the community.

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The Impact of Reducing Bonds in Residential Aged Care

We have modelled the impact of substituting debt for bonds in the funding of a 120 bed aged care facility. As we are comparing a current proposal, based on the existing use of bonds we have been able to compare the impact of reducing bonds (and increasing the use of debt) on both the facility and the resident.

Our modelling shows that from the provider's perspective: -

- Assuming a constant level of equity then to be cash flow neutral (and worse off then under the current system) the daily charge needs to increase as the level of gearing increases. At 44% initial gearing the charge needs to increase by $30.53 per day or more than 100% and at 34% gearing ration the charge needs to increase by $24.21 per day.

- In the For Profit Sector charges need to continue to increase over time due to the effect of taxation on the cost of debt repayment.

- Any policy setting that causes a downward shift in the use of bonds will directly increase the cost of accommodation to the community (including the cost to government of providing subsidies for supported residents)

From the residents perspective

- If debt replaces bonds then on average net accommodation costs will increase by between 13% and 29%[4].

- Taking into account the alternative investment of the capital that would have been allocated to the bond the resident is worse off.

If funding of residential aged care shifts from bonds to debt then all other factors remaining constant overall cost to residents will rise and operators will be no better off.

[4] Depending on marginal tax rate of individual on assumed interest earned on retained bond

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Why Residents Are Not Well Served By Not Paying Bonds

Subject to increasing vacancy factors bonds provide an ongoing source of capital to facility operators. By comparison debt involves an additional cost (interest) and is temporary; with lenders requiring amortisation of the debt facility. In addition to this lenders impose covenants on borrowers that may themselves force higher accommodation charges to meet profit hurdles. The most common of these covenants is an interest cover.

Where a facility funds its operations through debt it must simultaneously achieve four outcomes if it is to be sustainable these are: -

1. It must meet any interest cover covenant imposed by its lenders.

2. It must generate sufficient profit to pay a dividend to motivate an investor to provide equity to the venture.

3. It must generate sufficient after tax cash flow to meet its requirements for debt repayment and interest payments.

4. Capital reinvestment in order to maintain the infrastructure of the facility at a level that meets community expectations.

In a system based on resident bonds outcomes 1 and 3 are zero and so the facility only needs to generate sufficient profit to pay a dividend to the owners and provide for capital reinvestment.

The use of debt increase the cash flow needs of the facility which must be met from increased profits.

How Much Debt to Use

As accommodation in a residential aged care facility replaces accommodation in the traditional home we have calculated the borrowing capacity of a facility (using generally acceptable commercial repayment terms) that will result in the same periodic repayment as a notional housing loan ($100,000, 30 years 7.25%).

Under these scenarios the following equivalent gearing is possible: -

	Housing	Residential Aged Care Facility		
Periodic Payment	$682	$682	$682	$682
Interest Rate	7.25%	8.75%	8.75%	8.75%
Term	30 years	15 Years	10 years	7 Years
Gearing ratio	80%	55%	44%	34%

While we cannot predict what term banks will be prepared to lend to facility operators based on current commercial practice the terms are unlikely to exceed 10 years terms and 7 years would not be an unexpected outcome. We have modelled the effect on daily accommodation charges on both these debt repayment periods.

How Much Equity to Use

Equity contributions vary between operators however as we are comparing the impact of the proposed changes on an existing proposal we have maintained the same level of equity i.e. $6,700,000 which equates to 24.25% of total capital required.

How Much Bonds to Use

Based on the assumed gearing ratios and equity contribution bonds are a balancing factor and represent $8,832,000 or 32% of total funding, at a gearing level of 44% and $11,592,000 or 42% at a gearing level of 34%

The current market for bonds in our case study has been externally assessed as $250,000. This approximates the cost per room of $230,000.

Assuming the average bond is maintained this represents 22 bonded places or 18% of beds at 44% gearing or 33 bonded places or 27.5% of beds at 34% gearing.

Both levels of bonded places meet the Commissions goal of providing real (rather than Hobson's) choice for consumers and accommodate the current concessional percentages.

How Changing the Use of Bonds Impacts the Required Outcomes

When this mix of capital is modelled against the above criteria the following outcomes are seen: -

	44% Gearing	34% Gearing	Current Proposal
Minimum EBITDA to meet interest covenant	$2,010,000	$1,642,000	$1,500,000
EBITDA per Bed	$16,750	$13,685	$12,500
Emerging cash flow after debt, dividend and capital replacement	$(432,000)	$(789,000)	
Dividend @5% yield	$331,200	$331,200	$331,200
EBITDA to create neutral cash flow	$3,888,000	$3,625,000	Not applicable
EBITDA per Bed	$23,100	$20,900	Not applicable
Estimated increase in daily accommodation charge	$30.53	$24.21	Not Applicable

Our analysis shows that at gearing levels above 34% the actual profit required to create a balanced cash flow is greater than the minimum needed to meet interest rate covenants and represents an increase of 242% on the profit compared to the existing bonded model.

The EBITDA at the neutral cash flow position is $1,100,000 less than the for current forecast cash flow for this facility.

As debt is paid down the minimum EBITDA to generate a neutral cash flow increases. This is reflects the after tax nature of debt repayments.

Put simply to achieve a neutral cash flow, which from the operators perspective is significantly (>$1,000,000) worse than the current cash flow accommodation charges need to increase between $24.21 and $30.53 per day!

Changing Risk Profile Impacts Profit Expectations

The impact on the balance sheet of operators of substituting debt for bonds is as follows: –

	44% Gearing	34% Gearing	Current Proposal
Capital cost of facility	$27,600,000	$27,600,000	$27,600,000
Bonds	$8,832,000	$11,592,000	22,500,000
Debt	$12,068,000	$9,308,000	$(1,600,000)
Equity	$6,700,000	$6,700,000	$6,700,000

In our modelling we have assumed that the only change in profit is to meet cash flow requirements this ignores the changing risk profile of operators.

As debt increases so does risk and accordingly it is to be anticipated that operators will require even higher profit margins to compensate for this increased risk.

Taxation Effect on Debt Repayment

In the For Profit Sector the impact of taxation on the use of debt is significant. Debt repayments are made out of after tax income. For every $1,000,000 of debt repaid the facility must earn $1,408,450. This cost of debt repayment will be included in the accommodation charge

The tax payable on debt repayments effectively becomes a tax on residents in Residential Aged Care Facilities.

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Funding Debt Repayment

Banks require amortisation of loans. The term of the loan determines the rate of repayment. As business loans are unlikely to match the term of residential mortgages this increases the annual capital repayment. As this repayment comes from after tax income this reduced repayment period must be met through increased profits which therefore means an increase in accommodation charges.

In appendix B we have shown the impact this increased cash flow requirement places on the profit (per bed) required by the facility. Currently this facility can operate at $12,500 EBITDA per bed. To meet the cash flow requirements of interest and debt repayment this needs to increase to $23,000 per bed.

In the Not For Profit Sector there is no tax consequence in the repayment of debt. This creates a competitive advantage to this sector.

As most residents are retirees they would normally have paid off the mortgage on their home so any debt repayment introduces a new cash requirement on them relative to the use of bonds.

The Impact of Interest

Interest costs are tax deductible accordingly the effective interest rate paid by For Profit Operators is reduced by the tax benefit. In our modelling the gross interest rate was 8.75% accordingly the after tax cost is 6.20%. For Not for Profit (For Service) operator's interest is not deductible and so this adds an additional cost to them which counter balances the advantage they achieve in relation to debt repayment.

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Understanding the Increase in Accommodation Charges

To leave the operator no worse off, and recognising the stress that operators currently operate on this must be a minimum requirement, using a reasonable level of debt to replace bonds impacts daily charges as follows: -

	44% Gearing	34% Gearing
Daily charge to fund interest	20.43	17.73
Charge to cover debt repayment	19.74	22.55
Charge to cover tax on debt repayment	8.06	9.21
Estimated increase in daily accommodation charge	$48.23	$49.49

Against this increased charge a resident will gain the after tax benefit from interest on the bond not paid of $26.78 resulting in a net cost increase to the resident of between $22.71 and $21.45

Any action that distorts the market in resident bonds will increase both the absolute cost of residential aged care and the cost relative to accommodation in the community. Such increases will result in reduced effective real choice.

Conclusion

Residential Aged Care should be a real choice for those consumers who require it. For this to occur in a consumer directed model the cost of accommodation must be relatively similar to that of community based residential accommodation.

From an operators perspective cost is determined by the cost of capital (debt and equity) and the cash flow to meet debt obligations. As residential Aged Care is an alternative to community accommodation the use of resident bonds is the most equivalent form of capital to ensure price equivalence.

Shifting the funding base to debt or equity will only increase the cost of accommodation to residents in absolute terms and relative to the cost of community residential accommodation.

Based on the findings in the draft report placing artificial caps on bond levels appears unnecessary and likely to increase costs without providing any greater access to residents.

Because of the tax impact on capital repayment the use of debt effectively imposes a new tax on residents.

Bruce Bailey BFA; FCA; M Tax
Managing Director &
Head of Aged Care Advisory Division

Guild Accountants Pty Limited

Sydney
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Appendix A

Data & Inputs	Scenario 1	Scenario 2	Scenario 3
Development cost per bed (incl land)	$230,000	$230,000	$230,000
Building component	50%	50%	50%
Borrowing Percentage	***44%***	***34%***	***0%***
Resident Bonds Percentage	***32%***	***42%***	***80%***
Term (years)	10	10	10
Interest	8.75%	8.75%	9.00%
Beds	120	120	120
Equity	24%	24%	0%
Interest cover	2	2	2
Tax rate	29%	29%	29%
Capital replacement allowance	2.5%	2.5%	2.5%
Minimum dividend yield	5.0%	5.0%	5.0%
Building useful life years	30.00	30.00	30.00
Plant & equipment depreciation	12.5%	12.5%	12.5%
P & E percentage of Build	22.0%	22.0%	22.0%
Current EBITDA	$12,500	$12,500	$12,500
Occupancy rate	95.0%	95.0%	95.0%
Capital cost	$27,600,000	$27,600,000	$27,600,000
Current accommodation charge	$28.72		
Effective average bond	$230,000	$230,000	$230,000
Debt	$12,144,000	$9,384,000	$ -
Resident Bonds	$8,832,000	$11,592,000	$22,080,000
Equity	$6,624,000	$6,624,000	$5,520,000

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Appendix B

Profit to Meet Bank Interest Cover Requirements

Banks impose an interest rate covenant on borrowers. If debt replaces bonds then this covenant will have implications for minimum profit (EBITDA) levels

	Scenario 1			Scenario 2
	Year 1	**Year 2**	**Year3**	
Minimum EBITDA for bank covenant	$ 2,010,085	$ 1,797,565	$ 1,585,045	$ 1,642,200
Depreciation and capital allowances	1,117,800	1,117,800	1,117,800	1,117,800
Interest	$ 1,005,043	$ 898,783	$ 792,523	$ 821,100
Tax	-			-
Operating Profit after tax	-$ 112,758	-$ 219,018	-$ 325,278	-$ 296,700
EBITDA Per Bed	**$ 16,751**	**$ 14,980**	**$ 13,209**	**$ 13,685**
				$ 3.42
Change in daily accommodation charge	$ 12.26	$ 7.15	$ 2.04	

Cash flow

Operators must generate sustainable cash flows, when debt is used its repayment impact on cash flow must be considered

EBITDA	$ 2,010,085	$ 1,797,565	$ 1,585,045	$ 1,642,200
Tax	-			-
Debt repayment	821,319	927,579	1,033,839	938,400
Interest	$ 1,005,043	$ 898,783	$ 792,523	$ 776,624
Dividend yield	331,200	331,200	331,200	331,200

Capital replacement reserve	345,000	345,000	345,000	345,000	
Cash flow From Operations	**-$ 492,477**	**-$ 704,997**	**-$ 917,517**	**-$ 749,024**	

EBITDA at Neutral Cash flow Outcome

Sustainability requires and EBITDA that will allow all cash flow commitments to be met. Minimum requirement is debt repayment, capital replacement and dividend

Minimum after tax profit before depn to meet cash flow	$ 1,497,519	$ 1,603,779	$ 1,710,039	$ 1,310,856	$ 621,000
Minimum earnings before tax	$ 1,652,616	$ 1,802,278	$ 1,951,940	$ 1,389,709	$ 874,648
Minimum EBIT	$ 2,770,416	$ 2,920,078	$ 3,069,740	$ 2,507,509	$ 1,992,448
EBITDA to meet cash flow	$ 3,888,216	$ 4,037,878	$ 4,187,540	$ 3,625,309	
Minimum EBITDA Per Bed	**$ 23,087**	**$ 24,334**	**$ 25,581**	**$ 20,896**	**$ 16,604**
Increase in daily bed charge	$ 30.53	$ 34.13	$ 37.73	$ 24.21	$ 11.83
Year on year Increase		11.8%	10.5%		

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Appendix C

Residential Aged Care Facility

Pro Forma Statement of Financial Position for Scenario 1

	Year 1	Year 2	Year 3
At Interest Cover EBITDA			
Cash balance	- 492,477	- 1,197,473	- 2,114,990
Capital replacement fund	345,000	690,000	1,035,000
Net cash position	- 147,477	- 507,473	- 1,079,990
Facility Carrying Value			
Cost	27,600,000		
Accumulated depreciation	1,117,800	1,117,800	1,117,800
Written Down Value	26,482,200	25,364,400	24,246,600
	$ 26,334,723	$ 24,856,927	$ 23,166,610
Represented By			
Debt	11,322,681	10,395,102	9,361,262
Bonds	8,832,000	8,832,000	8,832,000
Contributed equity	6,624,000	6,624,000	6,624,000
Accumulated profits / (losses)	- 443,958	- 994,175	- 1,650,653
	$ 26,334,723	$ 24,856,927	$ 23,166,610

	Year 1	Year 2	Year 3
At Cash flow Outcome			
Cash balance	-	-	-
Capital replacement fund	345,000	690,000	1,035,000
Facility Carrying Value			
Cost	27,600,000		
Accumulated depreciation	1,117,800	1,117,800	1,117,800
	26,482,200	25,364,400	24,246,600
	$ 26,827,200	$ 26,054,400	$ 25,281,600
Represented By			
Debt	11,322,681	10,395,102	9,361,262
Bonds	8,832,000	8,832,000	8,832,000
Contributed equity	6,624,000	6,624,000	6,624,000
Accumulated profits / (losses)	48,519	203,298	464,338
	$ 26,827,200	$ 26,054,400	$ 25,281,600