

Submission to the Royal Commission into Aged Care Quality and Safety

September 2019



CONFIDENCE LEADS TO SUCCESS

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IMPACT STATEMENT

Viability and sustainability of providers are key drivers of quality and safety for residents in residential aged care.

This submission highlights the current negative impact of a number of policy/regulatory settings on provider viability and sector sustainability and makes suggestions as to changes in these settings that could positively impact the viability of providers and sustainability of the sector.

While the impact on Govt. funding of implementing some of these suggestions requires further analysis there are a number of options available that will improve viability and sustainability that have no or limited impact on Govt. outlays and are consistent with increased consumer choice.

The matters considered in this submission have the potential to increase provider viability and sector sustainability as follows:

Initiative	Impact
Set the accommodation supplement relative to the average capital cost of a residential place.	Boost investment in new accommodation for supported residents by increasing the return on investment derived from the accommodation supplement.
Remove the subsidy reduction where supported ratio is less than the arbitrary 40% supported ratio and apply the reduction where the supported ratio falls below the local supported ratio.	Allows providers to derive higher accommodation charges and additional services revenue from greater portion of residents.
	Saving on Govt. outlays from a reduced number of supported residents offset by a higher supplement on those currently achieving local ratios that are less than 40%
	Matches places for supported residents to local need.
Set the policy to actively facilitate and encourage the greater adoption of Additional Services.	Based on work done by Pride Living with our clients the potential to increase EBITDA and NPBT per bed ranges from \$1,200 - \$2,000 per bed per annum.
Allow providers to offer RAD or DAP as the means of residents paying their accommodation in lieu of the current system where this is a resident decision.	Reduction in the excess Lump Sum Accommodation bond pool and exposure of Govt. against default of between \$4.9Bn - \$7.6Bn
	Potential to increase average EBITDA/NPBT per bed per annum of providers from greater uptake of daily accommodation payments (DAP) – Impact - \$888 (11.6%) - \$1,385 (18%) with no cost to Govt.
	Increase Return on Equity by allowing providers to manage the level of RAD they take in as accommodation payments – Impact between 42% - 65%

Increasing provider viability allows providers to invest in the systems, processes, training and staff to enhance the safety and quality of care provided to consumers. Increasing the adoption of additional services compliments the Consumer Directed Care model.

EXECUTIVE SUMMARY

In 2015 the Aged Care Financing Authority published a study on the “Factors influencing the financial performance of residential aged care providers [ACFA Report](#). This report drew on research undertaken by RSM Australia and PWC [RSM Report](#). Stewart Brown publishes the Aged Care Sector Financial Performance Survey on a quarterly basis [SB Survey](#).

The above reports consistently present a picture of an industry where financial performance is highly variable, and a significant percentage of the sector is at risk of financial failure. Across both the in-home and residential sectors there is undeniable pressure on margins and profitability which threatens both the short- and long-term survival of many service providers. These pressures translate into a higher incidence of failure to meet quality and safety standards.

The Australian experience is not unique, in May 2019 it was reported that the large UK operator Four Seasons had gone into administration [Four Seasons](#).

The provision of residential services to older Australians is generally articulated in the following terms:

1. Accommodation;
2. Lifestyle/hotel services; and
3. Care supports.

Where the service recipient is living in their historical accommodation setting the services are focussed on care supports provided through home care packages.

For some service recipients, the appropriate setting is a residential aged care facility, in this setting the services can be described as holistic; encompassing accommodation, lifestyle/hotel services and care support. Persons receiving services in this setting are generally seen as more vulnerable.

With over 50 years of involvement in advising participants (providers) in the aged care sector the consultants at Pride Living have an intimate understanding of the dynamics impacting the aged care sector and an appreciation of the macro policy implications of changes to these settings. Our consultants have worked with Government¹, providers and care recipients across the spectrum of size, ownership and geography.

This submission focusses on key elements impacting financial performance as they relate to the following terms of reference of the Royal Commission:

- a. ***the future challenges and opportunities for delivering accessible, affordable and high-quality aged care services*** in Australia, including:
 - i. in the context of changing demographics and preferences, in particular people's desire to remain living at home as they age; and
 - ii. in remote, rural and regional Australia;
- b. what the Australian Government, aged care industry, Australian families and the wider community can do to strengthen the system of aged care services to ***ensure that the services provided are of high quality and safe;***
- c. how to ensure that aged care services are person-centred, including through ***allowing people to exercise greater choice, control*** and independence in relation to their care, and improving engagement with families and carers on care-related matters;
- d. ***how best to deliver aged care services in a sustainable way***, including through innovative models of care, increased use of technology, and investment in the aged care workforce and capital infrastructure.

Irrespective of the ownership structure of providers achieving the outcomes articulated in the terms of reference require that service providers are both viable² and that the industry provides a sustainable³ operating model that attracts new and continued investment to meet the growing cohort of older Australians.

¹ Managing Director Bruce Bailey was the lead partner on the RSM research conducted for ACFA

² Short term capacity to generate positive cash flow

³ Long term capacity to attract and retain investment required to meet demand

This submission addresses three key aspects of regulation that directly impact (negatively) equity of access, provider viability and sustainability:

1. Consumer choice;
2. Accommodation funding; and
3. Lifestyle services.

Based on our research and experience we make the following submissions:

1. The 40% supported ratio is an arbitrary and inappropriate formula for funding accommodation of supported residents.
2. The accommodation supplement does not provide an appropriate return on investment to encourage providers to invest in services for supported residents.
3. The current regulatory framework for accommodation charges is not supportive of industry sustainability.
4. The model whereby consumers choose how to pay accommodation charges has resulted in excess liquidity in the sector at the cost of EBITDA of providers and is negatively impacting provider viability, Govt. exposure under the bond guarantee scheme and preventing the development of alternative models of facility ownership, most notably the participation of REITS⁴ in the sector.

This submission considers the impact on providers of four key policy change.

	Recommendation	Operator impact	Policy impact
1.	That the accommodation supplement be set based on regionally supported resident ratios rather than the arbitrary level of 40%.	Removes arbitrary penalty to providers and aligns access/funding to local need.	Maintains appropriate equity of access. Marginal cost to Govt. with possible offsets, net cost to be determined.
2.	The accommodation supplement be set and maintained at a level that provides an appropriate return on investment on the cost of appropriate accommodation.	Removes bias towards self-funded care recipients and improves viability and sustainability.	Enhances equity of access. Marginal cost to Govt. to be determined.
3.	The regulations surrounding specified care and services and additional services be drafted in a way that encourages the differentiation and provision of additional services.	Removes risk and encourages providers to be more consumer-centric.	Embeds consumer-directed care and consumer choice. Shifts Govt funding from default funder to safety net funding. No financial impact to Govt.
4.	The regulation for accommodation payment options allows providers rather than service recipients to set the payment preference.	Enhances viability and sustainability by allowing providers to manage their balance sheets to achieve an appropriate risk-weighted return on capital employed. Supports a model that attracts investment capital to provide infrastructure and separate asset ownership from service provision.	Reduces exposure under the prudential guarantee scheme. No financial impact to Govt.

⁴ Real Estate Investment Trusts

VIABILITY AND SUSTAINABILITY

The terms viability and sustainability are regularly associated with the aged care sector. Their meaning can vary depending on the context within which they are used for example:

- a. Is residential aged care a viable option for a particular care recipient?
- b. Is the aged care system sustainable from a Government funding perspective?
- c. Are there sustainable returns to be derived by operators in the sector?

In any discussion about the viability and sustainability of the sector it is first necessary to define what these terms mean and to whom they relate. Referring to the terms of reference the Commission is concerned with matters that go to ensuring, amongst other things:

- a. ***delivering accessible, affordable and high-quality aged care services;***
- b. ***allowing people to exercise greater choice, control;***
- c. ***how best to deliver aged care services in a sustainable way.***

This submission is focussed on the viability and sustainability of approved providers as it is through providers that the above objectives will be realised (or not). Acknowledging the above elements of the terms of reference we use the terms viability and sustainability as follows;

Viability - short term measure of ***a provider's ability*** to generate positive operating cash flow from operations (solvency).

Sustainability - the capacity ***of the sector*** and providers to provide sufficient financial returns to entice providers to enter or expand their operations in the residential aged care sector over the longer term.

While consumer preference and Gov't. policy will influence the demand for, and relative percentage of care services provided to older Australians in a residential setting, the supply of future infrastructure and services will be determined by the view players providing these services take on viability and sustainability.

The ACFA and Stewart Brown reports provide insights into the pressures on viability and to a lesser extent, sustainability, neither of these reports specifically addresses the issues of viability and sustainability and how specific policy/regulatory settings can impact/address these issues. They observe outcomes rather than seek to identify the drivers of these outcomes.

In contrast the RSM report, considering the financial information of all providers in the sector and qualitative measures based on a statistically robust sample made the following findings in relation to drivers of viability:

- a. Non-viable providers are more likely to be Not for Profit based;
- b. Size, the number of facilities operated was not a major predictor of viability;
- c. Providers with higher financial performance generated more revenue per resident;
- d. Operating costs measured on a per resident basis were not significantly different between providers with higher and lower financial performance;
- e. Better business performance was associated with better capital and liquidity management;
- f. Better business performance was associated with a narrower focus on services;
- g. Poor current period performance was not necessarily a predictor of future performance.

Recognising the time that has elapsed since the RSM report we have analysed the policy settings and the actual financial performance as reported in the ACFA annual reports up to the 2019 report.

REVENUE STREAMS IN RESIDENTIAL AGED CARE

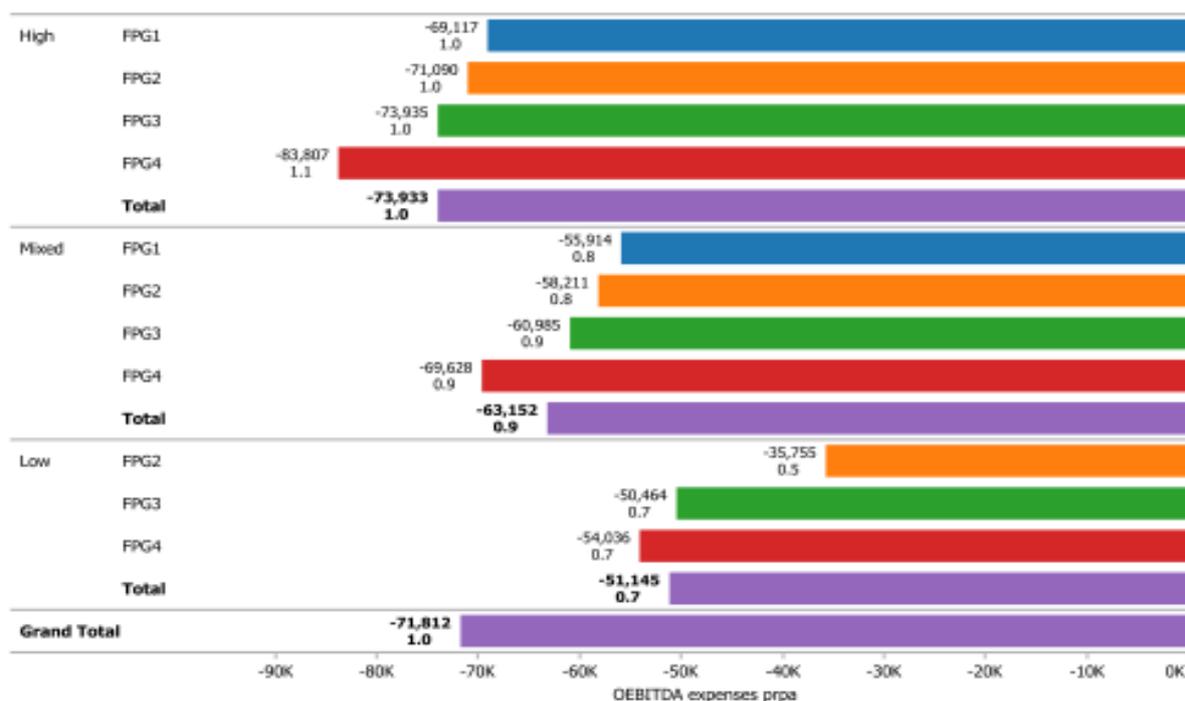
In relation to the three core revenue streams in residential aged care the following table sets out the regulatory framework and our observations on the impediments to viability and sustainability.

Service area	Regulatory framework	Key impediments to viability and sustainability
Hotel Services	Mandated (specified care and services) & variable (additional /extra services)	A single price point for specified services irrespective of quality does not foster innovation or choice. Regulatory constraints on variable revenue from additional services have constrained the adoption.
Care Services	Mandated – ACFI	Funding reflects needs however growth in funding has not matched growth in care costs (wages and related) to meet these needs.
Accommodation	Mandated (supported supplement) & regulated (accommodation pricing)	Supported supplement not linked to asset investment and socio-economic need. Excess RAD liquidity depresses operating performance and increases exposure to default.

The single price point “basic daily fee” and the funding of care ACFI or its replacement are not matters addressed in this report. Similarly, the issue of mandated staff ratios is not considered in this report other than to observe that if ACFI funding reflects the level of care a resident requires then there should be a high correlation between the cost of care and the funding for care. It flows from this that an appropriate measure of the appropriateness of staffing could be viewed through a lens of the relationship between costs and revenue.

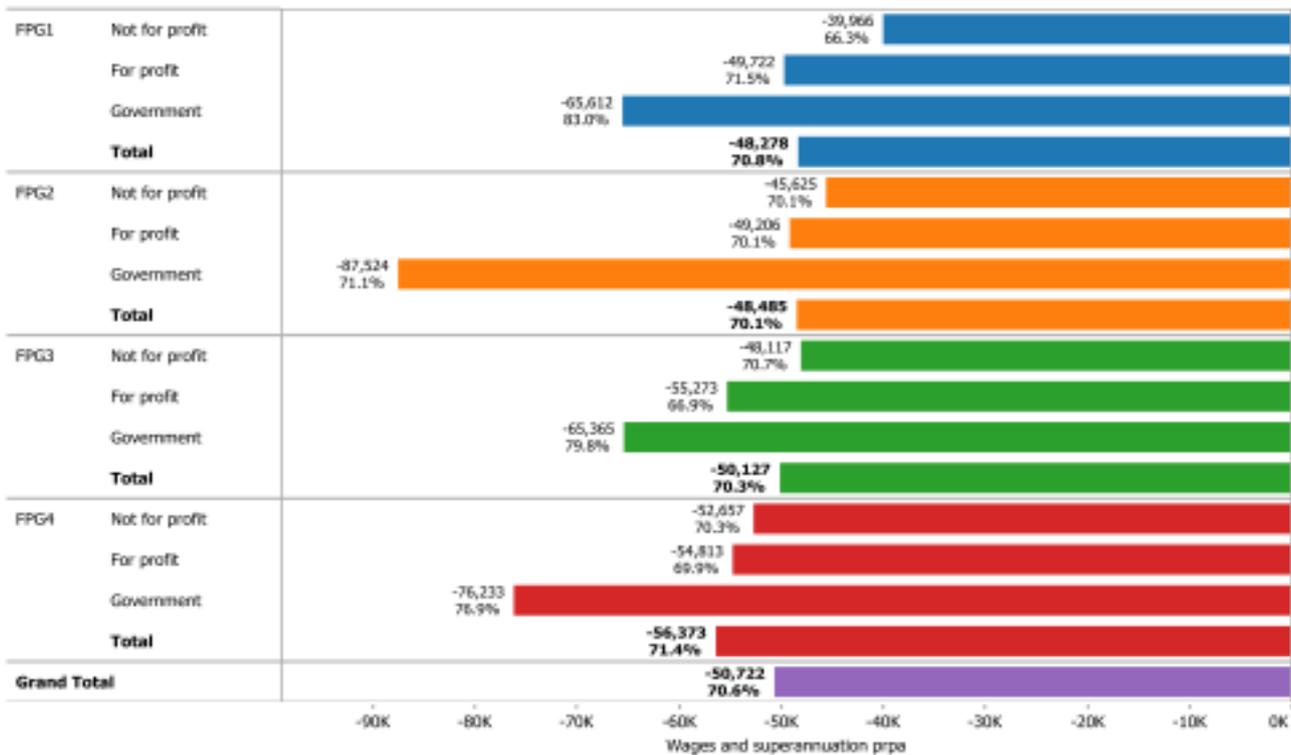
Charts 030 and 031 of the RSM report does this and excluding government providers found the cost of care (measured relative to total costs and care profile of residents) did not vary significantly. It is arguable therefore that under the current funding model staff ratios are not appropriate unless they are based on a de minimus rule.

Chart 030: Operating Expenses prpa by Resident Care Profile and Financial Performance Group (FPG)



Source: RSM_Aged-Care_factors-influencing-fin-performance-of-aged-care-providers-report

Chart 031: Wages and Superannuation prpa by Financial Performance Group (FPG) and Ownership



Source: RSM_Aged-Care_factors-influencing-fin-performance-of-aged-care-providers-report

SUPPORTED RATIO

The ACFA report on access to care for supported residents [SR Report](#) provides an overview of the history and policy objective of the supported ratio and its relationship to the accommodation supplement. Across the aged care planning regions (ACPR) the ratios vary from 16% (1 of) to 40% (5 of). Of the seventy-two ACPR only 7% (5) of the regions have a supported ratio of 40% or greater.

Against this the supplement paid to providers whose resident profile does not include 40% of supported residents is reduced by 25%.

Given that 93% of ACPR have supported ratios of less than 40% it is difficult to reconcile the policy justification that the 25% discount is *"a mechanism used by Government to promote access to care for supported residents"*⁵.

In its report on Access to Care for Supported Residents [ACFA report](#) ACFA recommended that the ratio be maintained, on the ground that;

ACFA is of the view that the 40 per cent rule provides an important incentive to providers to accept supported residents. In light of ACFA's proposal to remove the regional ratio, ACFA considers it essential that the 40 per cent rule remains and considers it is providing an appropriate financial incentive to providers and supporting access to care for supported residents. A 40 per cent target ratio remains appropriate noting that supported residents make up around 47 per cent of all residents nationally

We note that a criterion for the ACFA report was that any proposals were to be "cost neutral" to Govt. It is unsurprising that given the penalty for not achieving the 40% ratio that the industry does achieve this level. It is arguable that achieving a 40% level is not necessary to achieve equity of access based on assessed socio-economic needs as 93% of regions assess this at a lower ratio. Indeed if the ratio of supported residents is higher than the community requirement it is arguable the policy has the following negative impacts:

1. Increases Govt. outlays because of the bias for providers to achieve the 40% ratio;
2. Reduces capacity of providers to derive higher revenue from self-funded residents;
3. The combined effect of the above is to reduce provider viability.

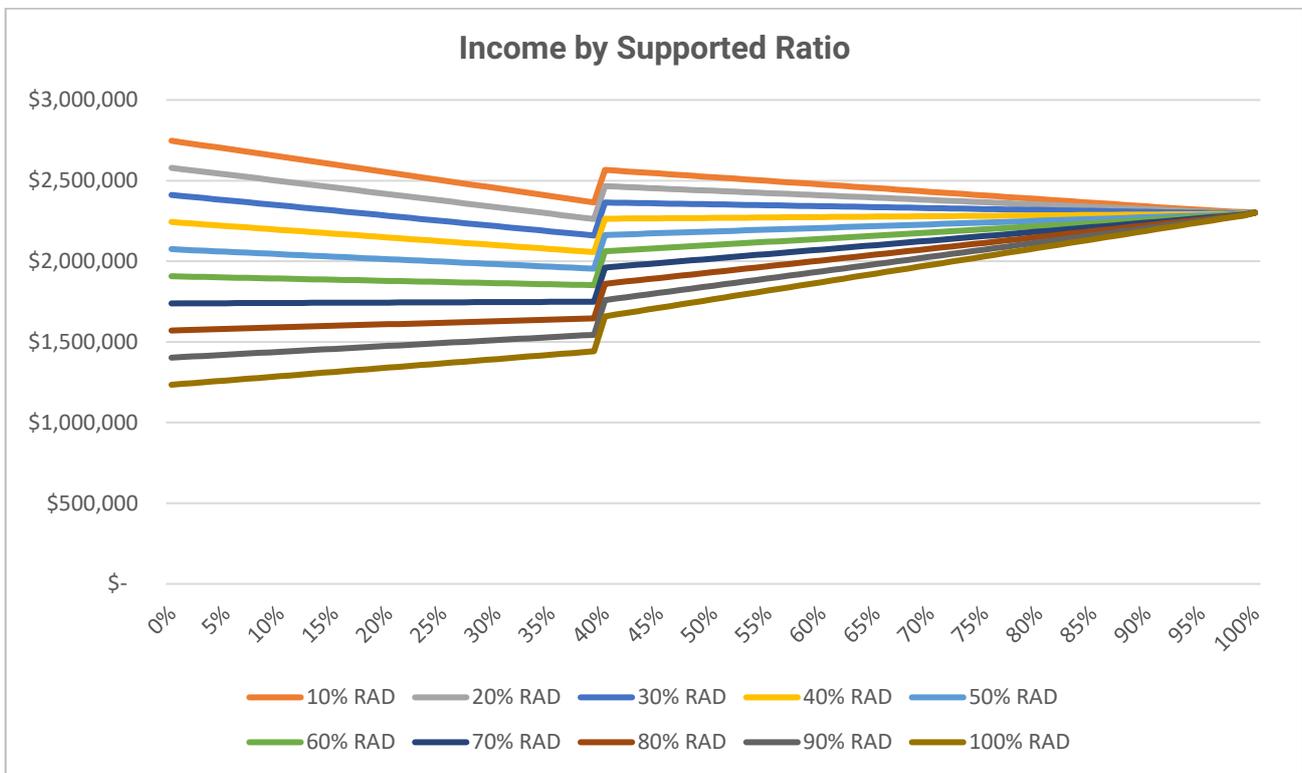
To understand the impact on revenue and therefore the financial outcome of providers targeting ratios less than 40% we modelled the net impact on accommodation revenue under a number of scenarios.

The graph below shows the impact on accommodation revenue as the supported ratio moves from zero to 100% across a series of different percentages of non supported residents who chose to pay their accommodation via a refundable accommodation deposit.

The graph shows the following characteristics:

- a. Unsurprisingly where the rate of residents paying a RAD and the supported ratio is low accommodation income is highest (orange line);
- b. In this scenario only where less than 40% of residents chose to pay their accommodation by RAD can the provider replace the revenue lost from falling below the 40% supported ratio (orange, grey, blue and yellow lines);
- c. For all providers, once the 40% ratio is breached on the downside, there is an immediate and significant loss of accommodation revenue.

⁵ Consultation Paper: seeking comments on possible options for changes to the supported resident ratio rules in residential aged care.



Given that the Govt. assessment of the ratio by regions found that the ratio was below 40% in 93% of cases and the disincentive for providers to fall below the 40% ratio it is arguable that policy or cost to Govt. rather than demand by supported residents is driving provider behaviour.

As Govt. is currently paying those providers who have supported ratios greater than 40% the higher supplement to the extent that these providers reduce their supported ratio and take in more self-funded residents there would be a marginal saving to Govt.(less overall supported residents). Against this, there would be a marginal cost to Govt. for providers who are currently achieving the regional supported ratio but not the 40% level. Finally, there would be no cost to Govt. for providers who do not achieve the regional ratio. Subject to further modelling it may be possible to adjust the subsidy level (reduce) to make this change cost neutral to Govt.

From the providers perspective, a shift in resident profile towards more self-funded residents would allow providers to receive higher accommodation charges with the further potential to generate more revenue through additional services. In this way setting the accommodation supplement based on regional ratios would boost viability and sustainability.

Based on Govt. data the policy of reducing accommodation supplement by 25% where the supported resident ratio within a facility falls below 40% bears no relationship to the need for access by supported residents. The negative consequence on operating revenue of providers of breaching the 40% supported ratio on the downside appears to be negatively influencing providers ability to manage this aspect of their revenue. As supported residents have a reduced capacity to pay higher accommodation and other charges, this would negatively impact both viability and sustainability of affected providers.

ACCOMMODATION SUPPLEMENT

In addition to the impact on the viability of a provider of not meeting the supported ratio, there is also an impact on the sustainability of providers flowing from the level of the accommodation supplement.

As at July 2019, the supported supplement is \$57.14⁶ this translates to \$20,856 (\$19,604 at 94% occupancy) per resident per annum. Using the formula to determine the RAD equivalent of a daily payment the RAD equivalent of this daily supplement is \$376,464⁷.

While the per place cost of developing an aged care facility varies⁸, in our experience, the normal range is between \$350,000 and \$450,000 per place. Based on the current supplement a provider who is considering developing a new aged care facility can anticipate the following return on investment from the accommodation revenue from a supported resident.

Accommodation Supplement @ 40% supported ratio	\$350,000 build cost	\$450,000 build cost
100% occupancy \$20,856	6%	5%
94% occupancy \$19,604	5.6%	4.4%
Accommodation Supplement @ < 40% supported ratio	\$350,000 build cost	\$450,000 build cost
100% occupancy \$15,642	4.5%	3.5%
94% occupancy \$14,703	4%	3%

As vacancy is a factor the 94% occupancy rate of return is more relevant. Based on the current accommodation supplement an investor who builds a new facility can anticipate a gross return on investment from the accommodation supplement of between 4.4% and 5.6% from a supported resident. Where the supported ratio is below the 40% this anticipated return declines to between 3% - 4% Aged care accommodation is specialised, and it is questionable as to whether these rates of return are sufficient to attract new investment to the sector, this goes directly to sustainability.

Where a provider wanted to separate asset ownership from the operations it would be difficult to find an investor who would accept an ungeared return at these levels. In this way, the supplement is an impediment to attracting capital to the sector to “own” the physical assets (REIT).

As the provider cannot receive a market-based RAD or DAP from supported residents, and there is limited opportunity to charge these residents for additional services there is limited capacity for a provider to compensate for this low yield other than through higher RAD/DAP charges to non-supported residents. This is an inappropriate cross-subsidy. Furthermore, where the provider increases RAD on self-funded residents this increases Govt. exposure under the bond guarantee scheme.

We have analysed the pattern of capital investment in the sector over the period 2009 – 2018 and as the following charts shows;

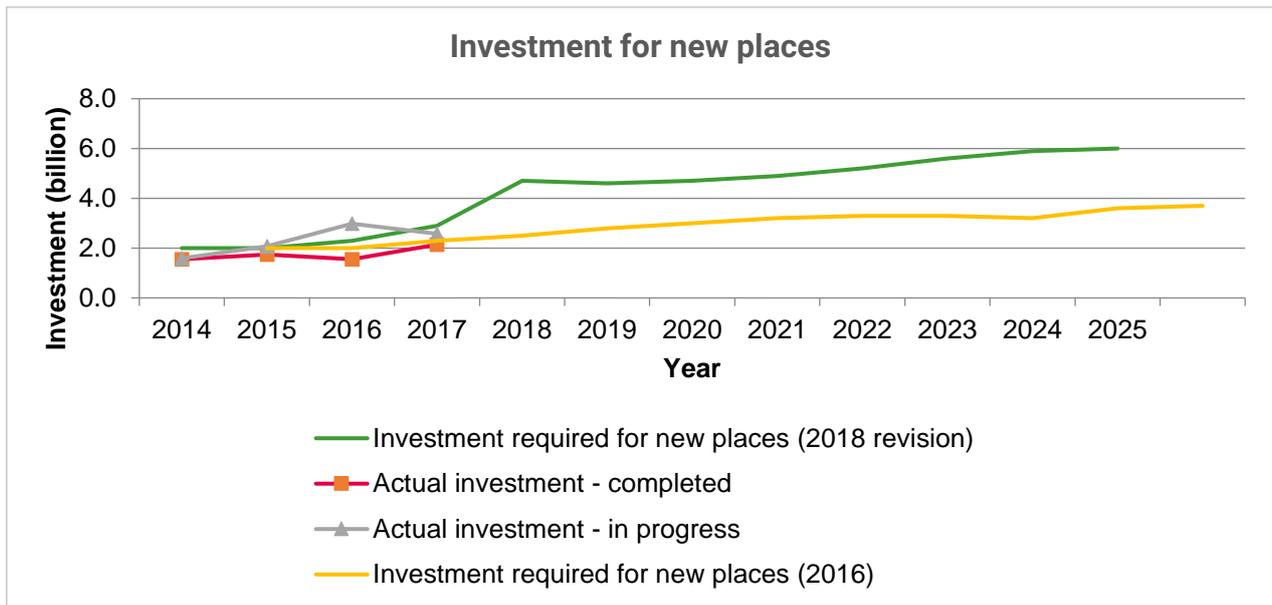
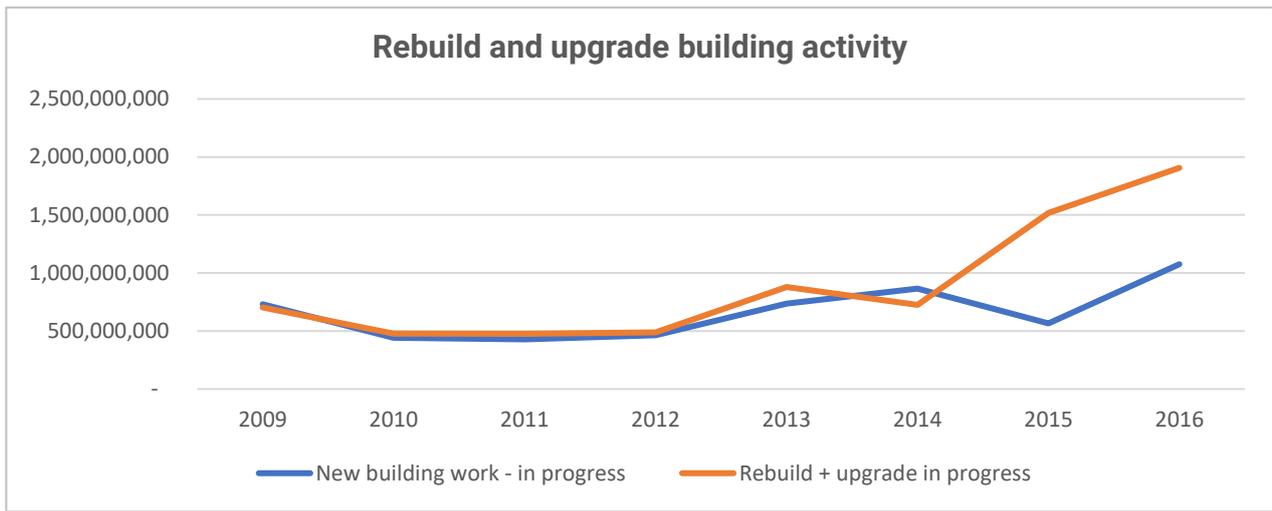
- Total investment continually falls short of ACFA forecast investment needed to meet its estimate of demand; and
- There is a significant bias towards rebuild and upgrade investment as against new building work.

This data is consistent with a hypothesis that the yields from property assets in the aged care sector are unattractive.

⁶https://agedcare.health.gov.au/sites/default/files/documents/06_2019/schedule_of_fees_and_charges_for_residential_and_home_care_from_1_july_2019.pdf

⁷ MPIR 5.54%

⁸ This could be determined from data in ACAR applications



While there are many factors contributing to the lack of capital investment in the sector return on investment/return on equity would be a contributing factor and the current level of accommodation supplement directly impacts this in relation to supported residents.

The accommodation supplement is set at a level that appears to be unsupportive of continued new investment in the sector. This goes directly to the sustainability of the sector.

ACCOMMODATION CHARGES NON-SUPPORTED RESIDENTS

At their option non-supported residents pay for their accommodation either via a refundable lump sum (RAD) or a daily fee (equivalent to rent) (DAP). The relativity between these two forms of payment is controlled under the Aged Care Act and the Fees and Payments Principles. As the choice of payment is with the resident this means that providers have limited capacity to manage their balance sheets and their preference for EBITDA over debt. As noted earlier, the RSM research found that providers with higher financial performance were better managers of equity and liquidity. The evidence is compelling that this disempowerment is negatively impacting ROE, EBITDA, exposure under the Bond Guarantee Scheme and thereby sustainability.

How lump sums are used by providers

To understand the macro impact of lump sums on sustainability we analysed the movement in key asset and liability categories of the sector balance sheet for the period 2014 – 2019. This provides insight into the degree to which lump sums held by providers are used to fund the increased stock of places and the change in liquidity that has occurred with the increased use of lump sums as a means of meeting accommodation payments. Table 2 provides a summary of this information.

Table 2

Balance Sheet	2014	2015	2016	2017	2018
Assets					
Cash	3558	5170	5611	8199	9047
Fixed assets	10238	10674	11455	22963	24061
Other assets	19866	20742	23629	13855	15292
Total assets	33662	36586	40695	45017	48400
Liabilities					
RAD	15611	18213	21872	24710	27540
Other liabilities	6883	7472	7878	8981	9050
Total liabilities	22494	25685	29750	33691	36590
Equity	11168	10901	10945	11326	11810
Ratios					
Cash/RAD	23%	28%	26%	33%	33%
EBITDA margin	11%	11%	9%	12%	9%
RAD /Total liabilities	69%	71%	74%	73%	75%
Equity/ Assets	33%	30%	27%	25%	24%
Percentage of increased RAD represented by increased cash liquidity		62%	12%	91%	30%

Table 2 shows the following:

- Liquidity of RAD in the system, measured as cash to RAD liability has increased steadily from 23% in 2014 to 33% in 2018;
- RAD as a source of finance has increased from 69% to 75% of funding;
- With the increase in cash and RAD the relative use of equity has declined steadily from 33% to 25%;
- During this period EBITDA margin has remained relatively constant;
- Over a period of five years, RAD has increased by \$11.9Bn while cash reserves have increased by \$5.5Bn;
- **Less than 50% of new RAD is being deployed into new or improved stock.**

As the system was in balance prior to 2014, it is unsurprising that there would be an initial increase in liquidity as providers were confronted with an inflow of lump sums over which they had no control.

⁹ Latest data available from ACFA

That this initial growth in liquidity continued rather than reversed suggests that the inflow of RAD since 2014 has been greater than the capacity or willingness of the industry to deploy that RAD to permitted uses associated with the provision of residential care – construction of new stock.

It follows that as system liquidity has increased since 2014, there is less liquidity risk in the system in 2018 than there was in 2014. This finding is consistent with the data on the frequency and value of triggers of the bond guarantee scheme.

Notwithstanding the reduced liquidity risk there is an increased risk of failure as the earnings from RAD is materially less than the alternative DAP. This means excess RAD is directly reducing profits and viability of providers. The risk of failure is ultimately borne by Govt., or prudent and successful providers under the Bond Guarantee Scheme.

The excess liquidity has caused the sector balance sheet to expand and resulted in a reduced level of equity being used to fund the assets on the balance sheet. It is arguable that to manage this excess liquidity the only option providers have is to increase dividend payout ratio. It is noted that at least one listed provider had a dividend payout ratio of 100% of EBITDA in 2019.

More broadly as equity in dollar terms has remained constant at a macro level the apparent reduction in the use of equity is a direct result of the excess RAD in the system.

Should the system suffer a financial shock, or the viability decline then this shock will increasingly be borne by the providers of RAD or the guarantor (Govt. and sustainable providers). Thus, punishing the responsible operators for the actions of less capable providers.

As increases in equity are primarily sourced from retained profits the lack of growth in equity (in dollar terms) is a reflection of the depressed net operating margin (NPAT), as opposed to the EBITDA, and or providers experiencing excess liquidity paying dividends/distributions to shareholders.

In separate research undertaken by Pride Living our modelling shows that the sector is not deficient of the capital to construct the forecast required additional stock. This is confirmed by the major lenders who admit that they are essentially providing construction finance to the sector which is in turn repaid from the inflow of lump sums. We submit that the lack of investment is a reflection of policy uncertainty the difficulty in obtaining places and the poor investment returns from the sector.

The sector balance sheet is bloated and inefficient with much of the additional RAD received since 2013 being held in cash. There appears to be a capital strike within the sector.

CHANGE IN PROVIDER VIABILITY AND SUSTAINABILITY 2014 - 2018

Stuart Brown benchmark data shows declining EBITDA (measured on a per bed basis) in the sector over the period 2014 -2018.

This decline in EBITDA directly impacts the viability of the sector and adds to the longer-term risk of provider failure. This failure can arise from three factors;

1. Reduced viability can and is causing providers to operate with negative EBITDA;
2. Reduced profitability increases the risk of quality failures which in turn impose a catastrophic cost on providers which can result in failure;
3. Reduced profitability impacts providers ability to secure traditional finance to repay RAD.

Return on equity

Having defined sustainability as the capacity of the sector to provide sufficient financial returns to entice providers to enter or expand their operations in the residential aged care sector over the longer term we analysed the return on equity over the period 2013 -2018 and compared this to that reported by ACFA. Table 3 summarises the investment returns derived by the sector in the period 2014 to 2018.

Table 3

	2014	2015	2016	2017	2018
ROE (ACFA) - calculated using EBITDA	14.2%	16.3%	17.7%	18.3%	13.5%
ROE (calculated) - using NPBT	6.38%	8.32%	5.27%	8.88%	3.70%

Notwithstanding a 27% reduction in the proportion of equity (33% to 24% of assets) used to fund providers activity, return on equity, as measured by both EBITDA and NPBT has declined by 42% in the period under review.

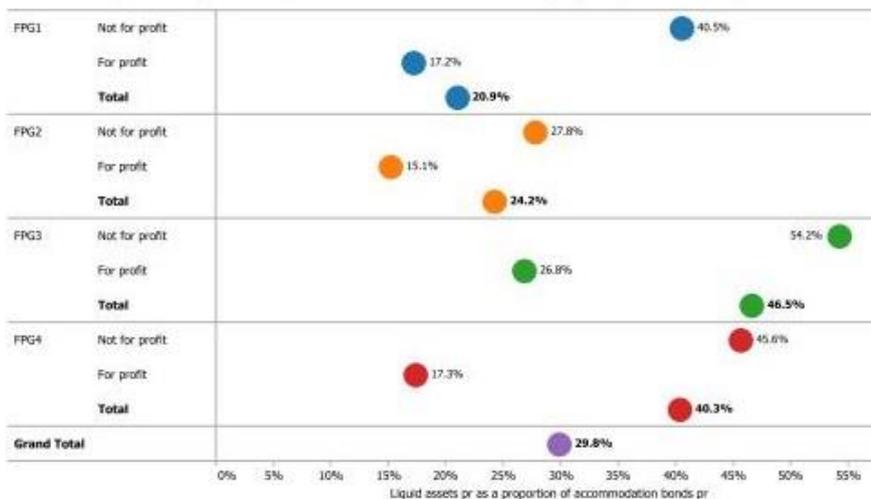
ACFA reports industry Return on Equity using EBITDA; we do not accept this as an appropriate measure when considering sustainability. The RSM research found that providers with superior financial performance operated on facility lifecycles of 9.5 years. Depreciation recognises the wasting nature of the physical assets. Measuring performance against NPBT acknowledges the life cycle of assets and places FP and NFP providers on a common footing. The other reason we do not accept EBITDA as an appropriate measure of ROE is that Equity is reduced by the charge to profit for depreciation thereby reducing equity without a corresponding reduction in return.

The data shows that on both measures, ROE increased in the early years, this would reflect the reducing use of equity, and has declined significantly following changes to funding in 2017 and 2018 reflecting the narrowing operating margins being derived by operators.

THE IMPACT OF LIQUIDITY ON INVESTMENT RETURN AND VIABILITY

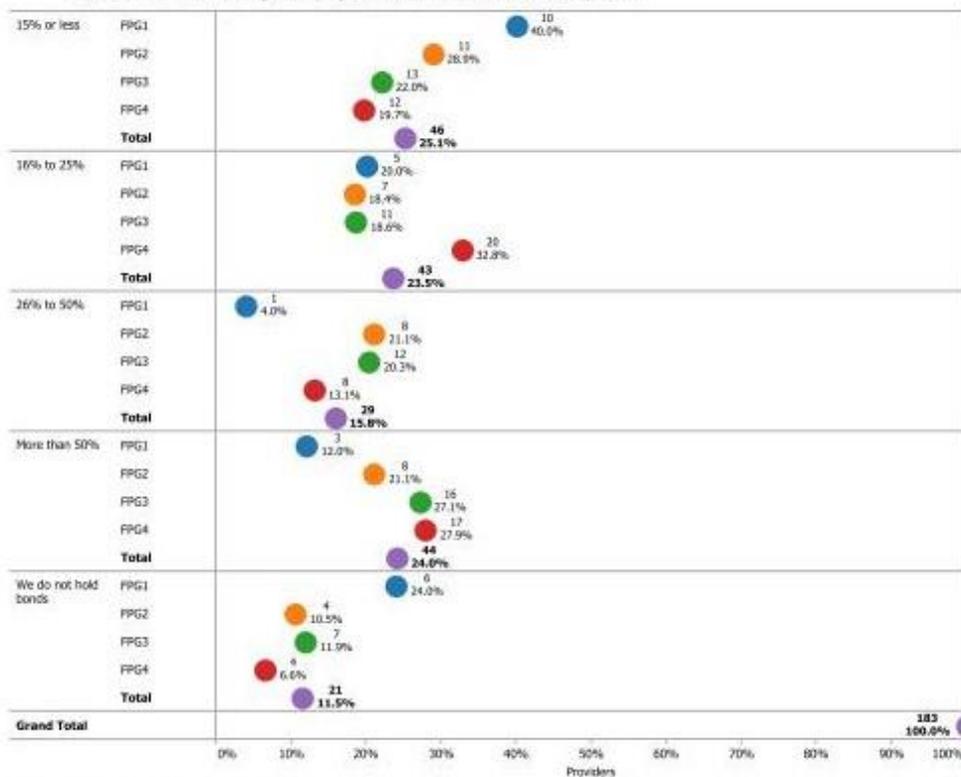
The RSM study found that higher performance was associated with better liquidity management. Charts 037 and 038 confirm that these providers operate with liquidity levels tending towards 15%¹⁰ or less. This compares to apparent industry liquidity of 34%.

Chart 037: Liquid Assets pr as a Proportion of Accommodation Bonds pr by Group and Ownership



Source: RSM_Aged-Care_factors-influencing-fin-performance-of-aged-care-providers-report

Chart 038: Bond Management by Financial Performance Group (FPG)



*Null and "Unknown" responses are excluded.

Source: RSM_Aged-Care_factors-influencing-fin-performance-of-aged-care-providers-report

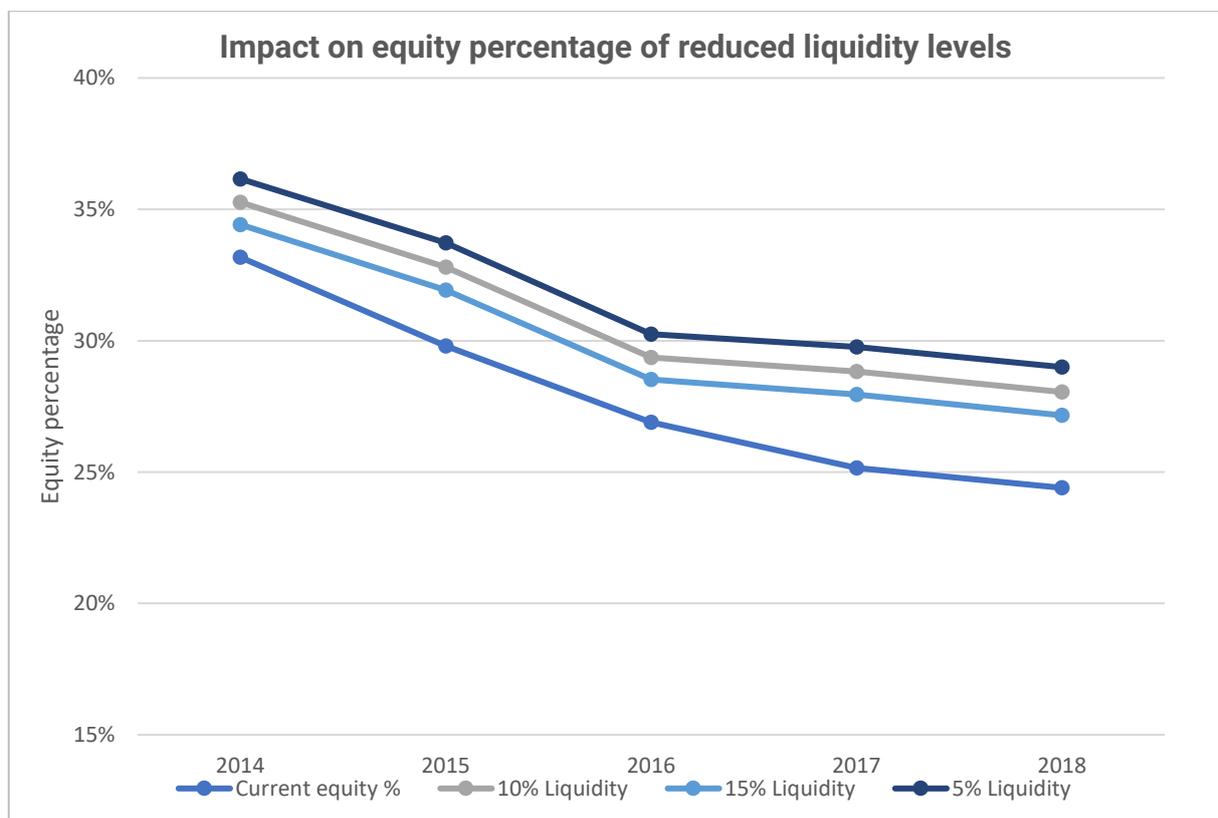
¹⁰ Recent advice on reforms to the prudential regulation of lump sums has suggest liquidity levels of 10% many be appropriate

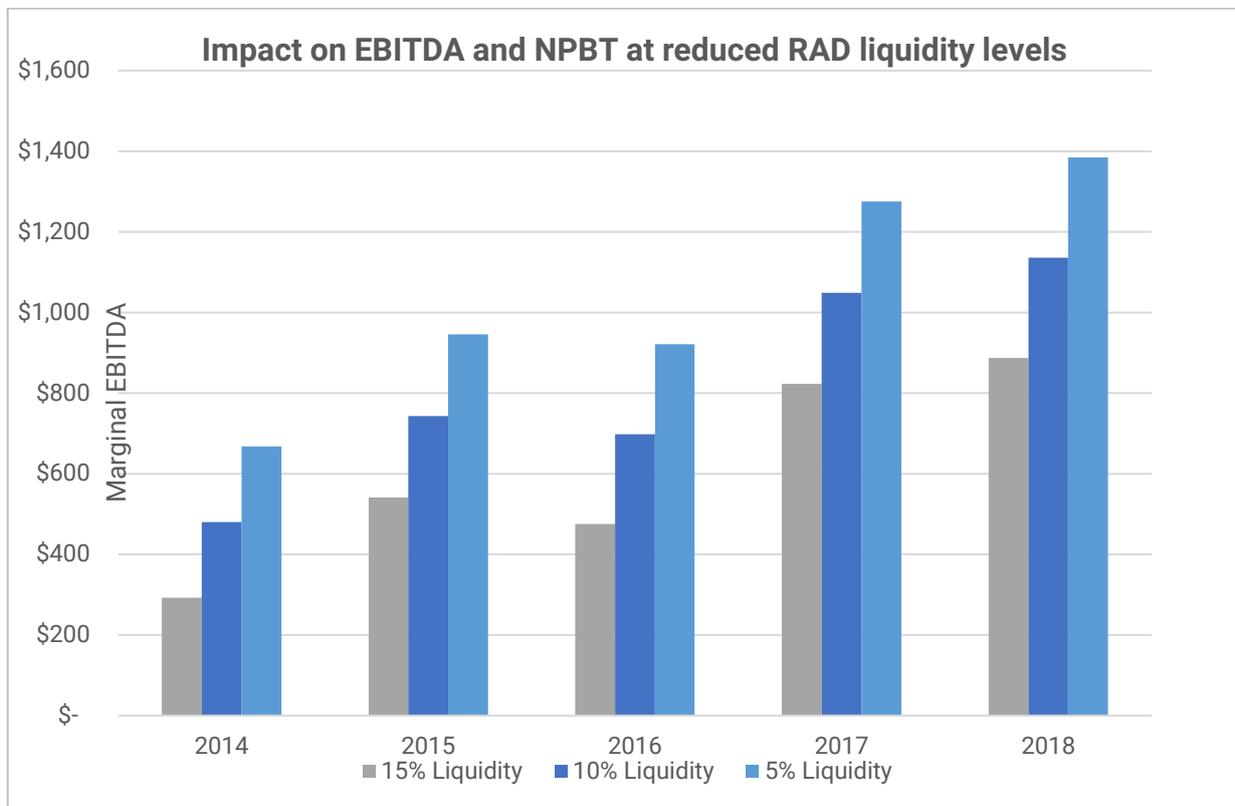
Noting that in aggregate provider liquidity has increased significantly we used ACFA data to model the impact on EBITDA, NPBT and ROE of reducing the liquidity levels across the sector from their actual levels (24% to 33%) between 2014 and 2018 to 5%, 10% and 15% respectively. Based on this modelling we estimate that reducing the current excess liquidity in the aged care sector would increase EBITDA and NPBT by between \$888 and \$1,385 per bed per annum.

Based on average sector EBITDA in 2018 of \$7,681 per bed per annum, reducing sector liquidity to between 5% and 15% would boost EBITDA by between 11.7% and 18.0%.

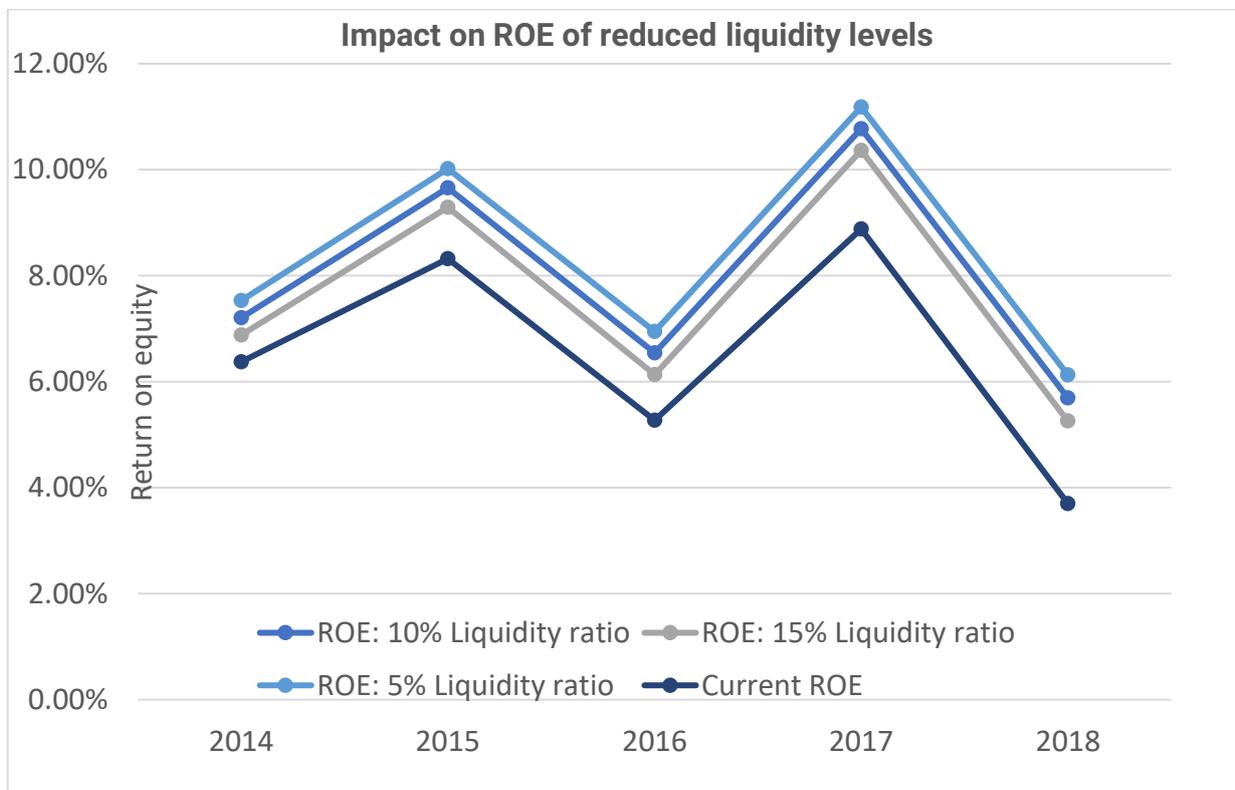
If liquidity levels were to be reduced this would reduce the aggregate size of the sector balance sheet and cause an increase in the relative use of equity, and a reduction in the exposure under the Bond Guarantee Scheme. We modelled the impact on the equity percentage of reducing liquidity as noted above.

	2018 Actual	5% liquidity	10% liquidity	15% liquidity
Reduction in the aggregate balance sheet		\$7.6Bn	\$6.2Bn	\$4.9Bn
Revised ROE percentage	3.7%	6.1%	5.7%	5.3%
Change in ROE		65%	54%	42%
Revised equity percentage	24%	29%	28%	27%





The marginal impact on EBITDA and NPBT and ROE through stronger liquidity management can have a significant positive impact on viability and sustainability of the sector.



Why the current accommodation pricing model is inappropriate

Providers operate in different markets; this results in providers having different opportunities to grow. Where a provider's business model is growth-oriented they can use RAD to assist in the funding of that growth. Conversely, where a provider's profile is oriented towards stability they have limited use for RAD and a bias to DAP. However, the current regulations pertaining to accommodation payments mean that providers cannot match the form of accommodation charge to their needs. This is demonstrated in the rise in aggregate industry liquidity. As demonstrated in this submission, excess liquidity has a number of negative impacts, including reducing viability and sustainability.

If providers rather than residents were able to determine how residents paid their accommodation, then providers could match their accommodation charges to their individual need for capital or earnings.

Where there are alternative providers, residents would be able to choose between providers based on their preference in payment terms. In this way, consumer choice is retained.

Allowing providers to manage their capital including the source and quantum of debt is fundamental to them managing return on investment which drives investment decisions.

REGULATORY OPTIONS FOR ACCOMMODATION PRICING

In light of the above analysis, we provide the following options for consideration as part of the review of accommodation pricing in residential aged care.

Proposal	Rationale
Providers and not residents are given the option as to how they charge accommodation payments.	This will reduce excess liquidity and enhance viability and sustainability as providers will balance the need for debt against the need for EBITDA.
The current nexus between the daily accommodation payment and its lump sum equivalent be modified such that the daily fee cannot be an amount greater than the amount calculated under the current MPIR formula.	This would allow a provider to reduce the daily fee to attract more daily fees where they have excess lump sums. Provides an effective arbitrage between the investment rate on excess lump sum liquidity and a lower daily fee.

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