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Fair Trading Retirement Village Model – Distributional Impacts

Research Report to the Property Council of Australia

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1 Key Points

- The Fair Trading Model's adoption of oversimplified, standardised assumptions of operations are of concern. Aside from the accuracy of assumptions, oversimplification into averages neglects the risks of concentrated negative impacts in specific locations and segments of industry.
- The most important requests to make are that the NSW Government demonstrate:
  - the veracity of its own assumptions
  - distributional effects within industry, not just estimated average effects
  - potential interactions with other policies, market conditions and cash flow impacts.
- The key assumptions worthy of particularly close scrutiny are: Property Prices; Time to Sale; Capital Growth Share; Applicable Interest Rate and Fee Inflation.
- Price and duration to sale assumptions are particularly important, with assumptions for these variables are drawn from the online calculator and interstate sources. Limitations in data appears to have led to significant inaccuracies and created heightened risks of unintended policy outcomes.
- Fair Trading's modelling and reform proposals require more investigation and validation of the range of impacts across the retirement industry and the broader community. Key risks are:
  1. focusing only on estimated average effects to the neglect of concentrated impacts on particular regions or operators
  2. no consideration of impacts on remaining retirement village residents, workers serving residents or the broader local communities to which both workers and residents contribute.
- Corview's analysis demonstrates a wide range of outcomes across the industry, with few operators accurately represented by the assumptions. This suggests distributional consequences deserve much closer scrutiny. Case studies of select villages suggest that:
  - operators in a range of metropolitan contexts could see their profitability reduced by anywhere between 6 to 30 per cent
  - profitable small regional operators may become unviable and face closure.
- The proposed policy changes would interact, positively or negatively, with other aspects of government policy and prevailing market conditions. This means:
  1. there are unexplored risks of 'double whammys' for industry
  2. changes to other policies would need to 'lighten the load' of the regulatory imposts.
- The Fair Trading analysis does not account for the potential for adverse impacts on retirement villages to flow through to the broader communities to which they contribute.

2 Assessment of Key Fair Trading Assumptions

The table below summarises Corview's assessment of the key assumptions underpinning the Fair Trading Model.

Assumption	Value	Source	Assessment	Likely Sensitivity to Modelled Results
Median Cost of Retirement Dwelling (Metro, 2018)	$734,500	Analysis of dataset underlying the NSW Fair Trading Retirement Village Calculator, i.e. potential residents input their potential purchase price information into an online calculator.	Requires further validation Close consideration of the distribution is highly important, especially in how it interacts with the duration to sale (see charts below). Reliance on the online calculator is unlikely to be representative (see charts below).	Highly sensitive Relevant to size of exit payment, impost on operators.
Median Cost of Retirement Dwelling (Non-Metro, 2018)	$470,000	Analysis of dataset underlying the NSW Fair Trading Retirement Village Calculator, i.e. potential residents input their potential purchase price information into an online calculator.	Requires further validation Close consideration of the distribution is highly important, especially in how it interacts with the duration to sale (see charts below). Reliance on the online calculator is unlikely to be representative (see charts below).	Highly sensitive Relevant to size of exit payment, impost on operators.
Average Duration between exit and settlement (metro)	202 Days	Based on Victorian data, with metro adjustment	Requires further validation This is perhaps the most important variable in the analysis, yet relies on data sourced from outside NSW.	Highly sensitive This should be modelled as a distribution <u>for each operator</u>, not an average.
Average Duration between exit and settlement (non-metro)	399 Days	Based on Victorian data, with non-metro adjustment	The distribution around the average based on cost and geography has not been referred to, nor modelled. However, it is the distribution for each operator, not the average, that will drive impacts. See charts below on NSW, Metro & non-Metro pricing.	Highly sensitive

Assumption	Value	Source	Assessment	Likely Sensitivity to Modelled Results
Benchmark interest Rate	5.65 per cent	RBS Small business lending rates	Requires further validation A blunt assumption of a single prevailing rate across the industry is inappropriate. Less secure / profitable entities will initially face higher rates, with lenders likely to charge higher risk premiums as a result of the proposed policy changes. For example, working capital requirements are likely to increase significantly for some entities.	Highly sensitive The distribution matters, as does the impact of the policy on rates for the most vulnerable owners.
Capital Gain Shares	50:50	Assumption	Requires further validation Rapid review of online agreements suggests that capital growth shares are widely dispersed and potentially related to location/cost of dwelling.	Highly sensitive Relevant to size of exit payment, impost on operators.

2.1 Further Assessment of Exit Entitlement Assumptions

2.1.1 Property Prices

Summary Assessment: Validation of the average and review of the distributional effects is required.

The Fair Trading Model's adopted assumptions for property prices are:

- Metro -- $734,500
- Non-metro -- $470,000

The data source is website inputs on the Fair Trading Retirement Village calculator. There are many issues with this approach:

- website users themselves would rely on other assumptions. For example, if a user was currently living in a 3 bedroom apartment that could sell for $750,000, they might use the calculator based on a $750,000 entry fee.

- Higher wealth individuals might not use the calculator proportionately if they are more likely to rely on financial advisors. This would bias the results downward.
- Lower wealth individuals might not use the calculator proportionately if they are less likely to be aware of the calculator. This would bias the results upward.

The Property Council/PWC (2018) Retirement Census suggests the average price of a retirement village unit was around 44 per cent of the median property price in the Sydney Metro area. This suggests the average unit price may be significantly overstated by the Fair Trading Model assumption.

Aside from the assumption itself, the approach to the analysis overlooks the fact that the distribution around the average, rather than the average itself, matters most in understanding the implications of the policy.

Put another way, whether the average values are correct or not, there are likely to be considerable differences in the impact of this policy between across village structures. Take for example:

- Case A - a 200 unit village complex with an average unit price of $350,000
- Case B - a 20 unit village with an average unit price of $1,200,000.

In Case A, there is more exposure due to more units, and a significant financial burden for operators if they need to pay out unit holders within six months, but a larger pool of demand to tap into.

In Case B, demand may be thinner, with less liquidity potentially creating concentrated impacts, especially noting financial carrying costs can be spread across fewer unit holders.

2.1.2 Time to Sale

Summary Assessment: Validation of the average and review of the distributional effects is required.

The Fair Trading Model's adopted assumptions are:

- Metro — 202 Days
- Non-Metro – 399 Days.

The assumptions are drawn from Victorian data, with adjustments made for the Metro and Non-Metro areas to reflect the longer duration of sales in Non-Metro areas.

Aside from reliance on out-of-State data, the problems of relying on averages to undertake analysis can be seen though considering:

- the incredible diversity across the Sydney Metro area, including both:
  - high demand areas with long waiting lists, short sales windows and easy turnover
  - lower demand locations that behave more like a non-metro area
- NSW non-metro includes some towns that are retirement hot-spots, and many that are not
- Confounding regions that run against general trends (such as Port Macquarie compared to Non-Metro)
- Many specific features of villages, their facilities, price, the demographic profiles of their feeder suburbs will impact on demand
- Demand may be "lumpy," or subject to changes or cycles over time.

In particular, where a Metro village has sales characteristics generally more representative of Non-Metro areas, the declines in profitability for a village may be disproportionate. This could be the case for operators in pockets of western Sydney.

This is likely to be exacerbated if a village is already under a significant burden and faces higher capital costs.

2.1.3 Capital Growth Share

Summary Assessment: Validation of the assumption against actual data and review of the distributional effects is required.

The Fair Trading Model's adopted assumption is a capital growth share of 50/50. The Fair Trading analysis does not cite a source for this, noting that this is based on an assumption only.

This means that when a unit holder sells their unit, capital growth (or losses) are shared equally between the village and the unit holder.

For example, if a unit holder buys in at $700,000, and sells at $800,000, the unit holder would be eligible for an exit pay out of $750,000. Exit fees would bring this payment down. If the unit holder had been in the village for 10 years or more, an exit fee of $210,000 could be payable, so under this arrangement the exit entitlement would be $540,000.

Where a unit holder is guaranteed an exit entitlement (as in the 100/0 sharing arrangement) within a certain timeframe (under the proposed changes to regulation), villages in declining markets are likely to suffer significant financial hardship, and may need to sell units quickly under conditions of distress to sustain cash flow, rather than maximising sale proceeds.

2.1.4 Interest Rate

Summary Assessment: Validation of the average and review of the distributional effects is required, preferably by reference to liaison with financial market entities.

The Fair Trading Model's adopted assumption is a cost of capital for villages of 5.65 per cent. This is based on the Reserve Bank of Australia's small business lending rate.

The small business lending rate is appropriate as an initial pass at an average, but overlooks the likely variety in rates within the industry. Liaison either with financial market entities would be valuable in this respect.

In particular, operators in areas with limited demand or that have existing cashflow issues could be expected to face higher risk premiums because of the changes, and so disproportionate impacts could result for these villages.

2.1.5 Other Assumptions of Lower Significance

DMF Charge: When a unit holder leaves a village, the village keeps a proportion of their incoming contribution. In this case, it is assumed that this fee is 5 per cent per annum, capped at 30 per cent.

> This is not likely to be significantly impacted by the policy.

Retirement Village Penetration: The rate of 65 and over persons occupying retirement villages is assumed to be 7.1 per cent until 2021, rising to 7.5 per cent in 2025.

> This could be most relevant in considering potential impacts between grandfathered versus retroactive policy approaches.

Distribution of tenure length: The model has a detailed tenure length analysis based on AIHW data.

> This could be most relevant in considering potential impacts between grandfathered versus retroactive policy approaches.

2.2 Further Assessment of Recurrent Charges Assumptions

2.2.1 Time to Sale

Summary Assessment: Validation of the average and review of the distributional effects is required.

In addition to exit entitlements, time to sale impacts on operating costs.

For example, any costs that cannot be recouped from exiting unit holders will either be absorbed by villages or borne by the remaining or new villagers.

Even if accurate, the blunt averages adopted neglect the likelihood of significant differences between villages in terms of their number of unit holders and their operating cost structure.

2.2.2 Capital Growth (Fee Share)

Summary Assessment: Validation of the assumption against actual data and review of the distributional effects is required.

In addition to exit entitlements, capital growth shares bear some connection impact on operating costs and capacity to recover lifecycle costs through fee mechanisms post-exit. This warrants closer consideration than afforded in the discussion paper.

2.2.3 Fee Inflation

Summary Assessment: Validation of the assumption against actual data and review of the distributional effects is required.

The Fair Trading Model's adopted assumption is fee inflation of 3 per cent per annum. While this appears a reasonable assumption, it should be validated, noting Consumer Price Index measures only address the Sydney Metro area.

It should be noted proposed changes would not be implemented in a vacuum. Necessarily, they would interact with other policies and prevailing market conditions.

2.3 Review of Alternative Data Points and Assumptions

Corview's analysis of industry data on behalf of the Property Council suggests there is likely to be a wide range of distributional impacts across the industry.

The most adversely affected villages are likely to bear a number of traits potentially including:

- a high dwelling price
- long holding periods to sale to sale, noting the different thresholds for exit fee payments across regional and metro NSW
- high vacancies
- risk profiles favouring the resident.

The most significant interactions between these traits relate to higher dwelling prices and long periods to sale. Higher prices imply a higher financing burden for operators if the duration to sale exceeds the thresholds suggested by the policy proposals.

Corview's analysis of the data suggests a number of villages in the South West and Central Coast, classified as metro villages, face market profiles more representative of the non-metro market.

The data made available to Corview does not represent the characteristics of the industry as a whole. In particular, only a relatively small number of smaller operators are included in the sample, and the available data does not distinguish between registered and non—registered interest holders. These limitations should be considered by the NSW Government in addressing the limitations of the Fair Trading Model analysis.

In considering these effects further, it is important that the NSW Government address that it is the distribution for each operator, not their average or the industry average, that will drive the extent of regulatory impost they face, as reflected in diminished profitability.

In turn, reduced profitability from regulatory imposts can lead to other potential knock-on effects for operators, including:

- increases in working capital requirements
- higher risk premiums and interest rates demanded by lenders.

Profitability impacts and each of these knock-on effects is explored in further detail in the next section of this report.

3 Financial Impacts

This section provides highly indicative assessments of the profitability impacts on the changes in exit fees and the changes in management fees on a range of village types. These are only indicative, as the Fair Trading Model itself is not publicly available for review.

The approach, following Fair Trading assumptions as much as possible, was to:

> Use average prices of dwellings, number of sales, management fees and number of owners to get revenues in the base case

> Use the profit rate of 7 per cent of revenue to determine profits in the base case

> Assess the impacts on profit of the interventions.

– For the exit fee, this was based on the number of days over the pay out period (6 months metro, 12 months non-metro) that villages would face a financing cost (at the small business rate of 4.95 per cent)

– For the management fee, this was days above 42 at the shared rate of management fee.

Case study				
Indicator	Central Coast (vulnerable)	Wollondilly area (vulnerable)	Inner city high cost, low turnover	Niche rural
Annual profit before reform (thous)	$70	$30	$283	$11
Impact of exit fee reform (thous)	-$20	-$4	-$70	-$17
Impact of management fee reform (thous)	-$1	>-$1	-$4	-$1
New profit (Worst case scenario) (thous)	$49	$26	$209	-$-18
Decline in profit	-30%	-13%	-26%	-154%

Source: Fair Trading assumptions; PCA data; Corview analysis

The table above shows the impacts on four different classes of vulnerable villages. The reasons for the relatively high impacts on these types of villages are:

- Central Coast (Vulnerable): This village has a relatively high time to sale, like many villages in the Central Coast, but would be treated as a metro village under this policy. The village also has a relatively high vacancy rate. The impacts are softened on this village, relative to others in the sample due to the large number of units, and the relatively low cost per unit
- Wollondilly Area (Vulnerable): This village has a relatively high time to sale, like many villages in the far outer suburbs, but would be treated as a metro village under this policy. The impacts are softened on this village, relative to others in the sample due to the large number of units, low vacancy rate, and the relatively low cost per unit

- Inner City (high cost, low turnover): Profitability is reduced by 26% in this village, which significant. The main reason for this is that this village has a small number of high value units, and a higher sales time, which means that any early payout means a high carrying cost
- Niche Rural: This is a small well serviced village, in a niche area. Village accommodation is expensive for this community and on average it takes around 2 years to sell a dwelling. Given the low number of units to spread this additional cost around, this village would suffer significantly from a policy of this type.

3.1 Potential financing implications and flow on outcomes

The immediate impact of reduced profitability is reduced cash flow and diminished working capital. This places pressure on village operators to continue to meet current payment obligations, and potentially calls into question whether an operator will continue to generate enough short-term assets to meet its short-term liabilities.

In the extreme case, a village could go into administration, or even be wound-up, if diminished profitability and cash flow led to a conclusion an otherwise profitable company was now insolvent, and unable to meet its obligations as they arise.

One of the potential mitigations to the impacts of reduced profitability on working capital is to seek greater financial accommodations through an expanded loan facility. However, this will incur additional charges payable to the banks and other financial institutions providing the loan facility.

Further, if the bank or financial institution perceives that the regulatory changes have fundamentally changed the risk profile of the retirement village sector, or particular villages within it, this would translate into a higher risk premium and increased financing costs for the sector or operator.

Those villages most adversely affected by the changes would be most exposed to increases in financing costs and most likely to face difficulties in financing their operations on an ongoing basis. This is because increases in cost impacts and risks will likely be proportionate to the increase in the risk premium required by banks and other financial institutions:

Two other potential mitigations to the impacts of reduced profitability on working capital are to:

- increase recurrent fees to remaining residents[1]
- cut costs by reducing employment or other purchases.

Both of these potential mitigations can help reduce pressure on village operators and increase working capital. However, both mitigations lead to adverse community impacts, explored in the next section.

[1] It should be noted that legislation does not allow an operator to make a profit off resident recurrent fee revenues / annual budget.

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4 Flow-on Impacts for Local Communities

The Discussion Paper implicitly assumes all impacts will be contained within the retirement sector through reduced profitability. This assumption may be true for some parts of the sector, but in other cases, it would probably result in:

> costs and risks being passed through to new and existing residents through other mechanisms

> consequent reductions in investment, service levels and staffing to control costs.

On the latter point, higher costs borne by villages could be expected to reduce employment. This may have a pronounced affect in regional areas where job markets tend to offer less diversity and fewer opportunities. In some areas, the proposals could amount to a “job tax” on one of the few “engines of growth” available to a regional economy.

In turn, fewer jobs or hours worked will reduce incomes for workers in the sector. If workers have lower incomes, they will also tend to spend less within their communities, harming profits and wages in other “population-serving” sectors like retail and hospitality.

In these respects, the proposed reforms create the risk of significant flow-on economic impacts for communities. Retirement villages are significant employers, particularly for regional locations with relatively few alternative sources of employment.

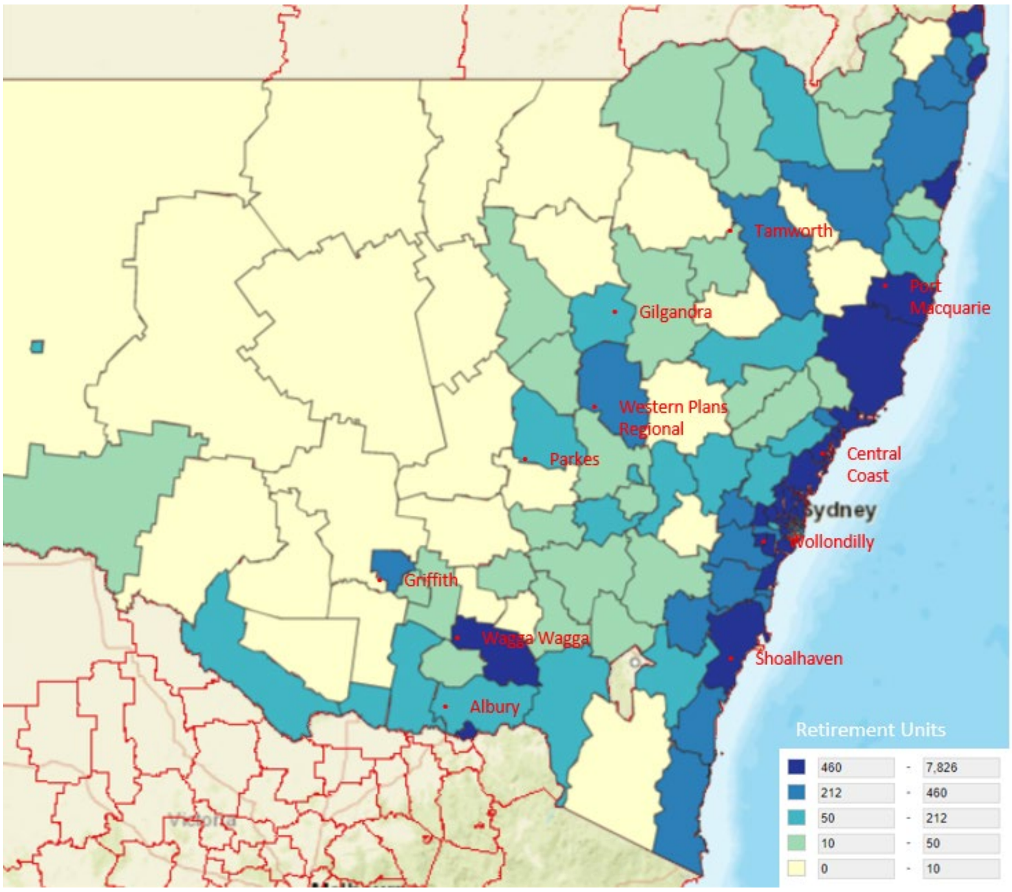
This section of the report highlights the potential impact the reform changes will have on some specific communities that are not considered ‘average’. Communities for consideration include the Central Coast, Wollondilly and the Southern Highlands and the Eastern Suburbs.

4.1 Locations with Significant Retirement Village and Jobs

The following map identifies locations in NSW with a large number of independent living units (ILUs). There are a significant number of units across the entire coast of NSW owing to the desirability of retiring close to the ocean.

There are also a significant number of specific inland locations that are overrepresented for retirement dwellings and jobs, including Tamworth, Dubbo, Griffith and Parkes. These jobs include permanent staff, as well as contractors, inclusive of roles in areas like care, management, maintenance, cleaners and cooks.

Figure 1 - NSW LGAs with a large number of retirement specific units (2016)



Source: ABS Census (2016)

Even though care is usually accessed through home care or paid for by the resident, there are cases where the service is provided through the annual budget, e.g. nursing on staff.

Diminished profitability, cost reductions and impacts on investments in new stock would all lead to local economic impacts. In this way, proposed reforms are likely to hurt the economies of NSW's regions, particularly in locations where residential care services represent a large proportion of local jobs.

As examples, residential care services comprise almost 7 per cent of total jobs in the Lockhart LGA (near Wagga Wagga). Care service jobs also account for a high proportion of total jobs at the Mid-Coast LGA (5.4%), Ballina (5.4%), Nambucca (5.3%) and Kempsey (5.2%).

Table 1 - NSW regional LGAs with a high proportion of residential care service jobs

LGA	Residential Care Jobs	Total Employment	% of total employment
Lockhart	60	878	6.8%
Mid-Coast	1,449	26,895	5.4%
Ballina	803	14,912	5.4%
Nambucca	291	5,532	5.3%
Kempsey	481	9,328	5.2%
Eurobodalla	592	11,983	4.9%
Tweed	1,330	28,162	4.7%
Lake Macquarie	2,626	57,758	4.5%
Berrigan	121	2,711	4.5%
Bellingen	161	3,612	4.5%
NSW Average	70,486	3,214,149	2.2%

*residential care includes aged care

Source: ABS Census (2016); Corview analysis

Regions overrepresented for residential care are also often subject to relatively high unemployment rates. For example, 6.8 per cent of jobs in the Mid-Coast Council area are classified as residential care services, and the LGA has a relatively high unemployment rate at 9 per cent.

In these locations, the ability to obtain alternative work may be limited, reflected in the relatively high unemployment rates. Retirement care redundancies may worsen the level of unemployment in certain locations, or drive workers and their families to relocate, reducing expenditure in local economies.

Table 2 - NSW regional LGAs with a high proportion of residential care service jobs and high unemployment levels (2016)

LGA	% of total employment	% Unemployment
Lockhart	6.8%	4.2%
Mid-Coast	5.4%	9.0%
Ballina	5.4%	5.8%
Nambucca	5.3%	9.3%
Kempsey	5.2%	8.6%
Eurobodalla	4.9%	7.1%
Tweed	4.7%	7.1%
Lake Macquarie	4.5%	6.9%
Berrigan	4.5%	4.8%
Bellingen	4.5%	7.2%
NSW Average	2.2%	6.2%

Source: ABS Census (2016); Corview analysis *residential care includes aged care

4.2 Potential Flow on Impacts for the Economy and Communities

The potential flow on consequences for workers, incomes, jobs and the broader community are reflected below. This includes what the Corview analysis of profitability impacts would imply for the broader community under certain scenarios.

Wages account for between **60 and 75 per cent** of retirement village operator expenditure – a significant cost. As wage costs are not fixed, operators are likely to recoup some financial losses through reductions in employment

Source: Australian Taxation Office, *Taxation Statistics*; Australian Bureau of Statistics, *National Accounts Input – Output Tables*

$55,000 – the average retirement village wage across NSW.

On average, retirement village workers earn less than the NSW average for all workers at $56,000 meaning these reform changes may be likely to impact those already facing financial stress.

Source: ABS Census (2016)

5,448 retirement village jobs in NSW

$298 million - total residential care wages injected into the NSW economy per year.

Source: ABS Census (2016); Corview analysis

A modest 5% reduction to achieve offsetting savings would be equivalent to a reduction of 272 jobs across NSW.

If reforms led operators to seek a greater saving, leading to a more significant 15% drop, this would be equivalent to 817 people across NSW looking for alternative work – a particularly challenging outcome in areas with insufficient alternative employment opportunities.

4.4 Local Scenario Assessment: Central Coast

314 retirement village jobs in the Central Coast LGA account for 0.3 per cent of total employment

(excludes aged care)

$44,000 – average residential care (retirement) salary across the Central Coast LGA

$43.9 million – LGA retirement wages

Reforms could reduce industry profitability by as much as 30 per cent on the Central Coast

To recoup losses, Central Coast operators will look to cut costs. Labour is the greatest expense, so under a 30 per cent cut scenario labour impacts could amount to:

- **56 total job losses**
- **$2.4 million less in wages paid**

This would have the following flow on impacts to other industries:

↓ $478,000 less spent on housing

↓ $405,000 less spent on food and drink

↓ $354,000 less spent on transport

↓ $295,000 less spent on recreation

↓ $141,000 less spent on medical care

4.5 Local Scenario Assessment: Eastern Suburbs

113 retirement village jobs in the Eastern Suburbs account for 0.1 per cent of total employment

(excludes aged care)

$61,500 – average residential care (retirement) salary across the Eastern Suburbs

$7 million – Eastern Suburbs Wages spent

Reforms could reduce industry profitability by as much as 6 per cent in the Eastern Suburbs

To recoup losses, Eastern Suburbs operators will look to cut costs. Labour is the greatest expense, so under a 6 per cent cut scenario labour impacts could amount to:

- **4 total job losses**
- **$250,000 less in wages paid**

This will have the following flow on impacts to other industries:

- $48,000 less spent on housing
- $41,000 less spent on food and drink
- $36,000 less spent on transport
- $30,000 less spent on recreation
- $14,000 less spent on medical care

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4.6 Local Scenario Assessment: Wollondilly and Southern Highlands

26 residential care jobs (retirement) in the Wollondilly LGA account for 0.1 per cent of total employment

$43,871 – average residential care salary across the LGA

$208 million – LGA residential care wages

Reforms could reduce industry profitability by as much as by 30 per cent in Wollondilly

To recoup losses, operators in the Wollondilly LGA may choose to wholly retrench staff amounting to:

- **2 total job losses**
- **$90,000 less in wages paid per year**

This will have the following flow on impacts to other industries:

- $17,500 less spent on housing
- $15,000 less spent on food and drink
- $13,000 less spent on transport
- $10,800 less spent on recreation
- $5,200 less spent on medical care

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