OCTOBER 2014

Property Council of Australia

The effect of the Victorian Aged Care Rule on the retirement village sector

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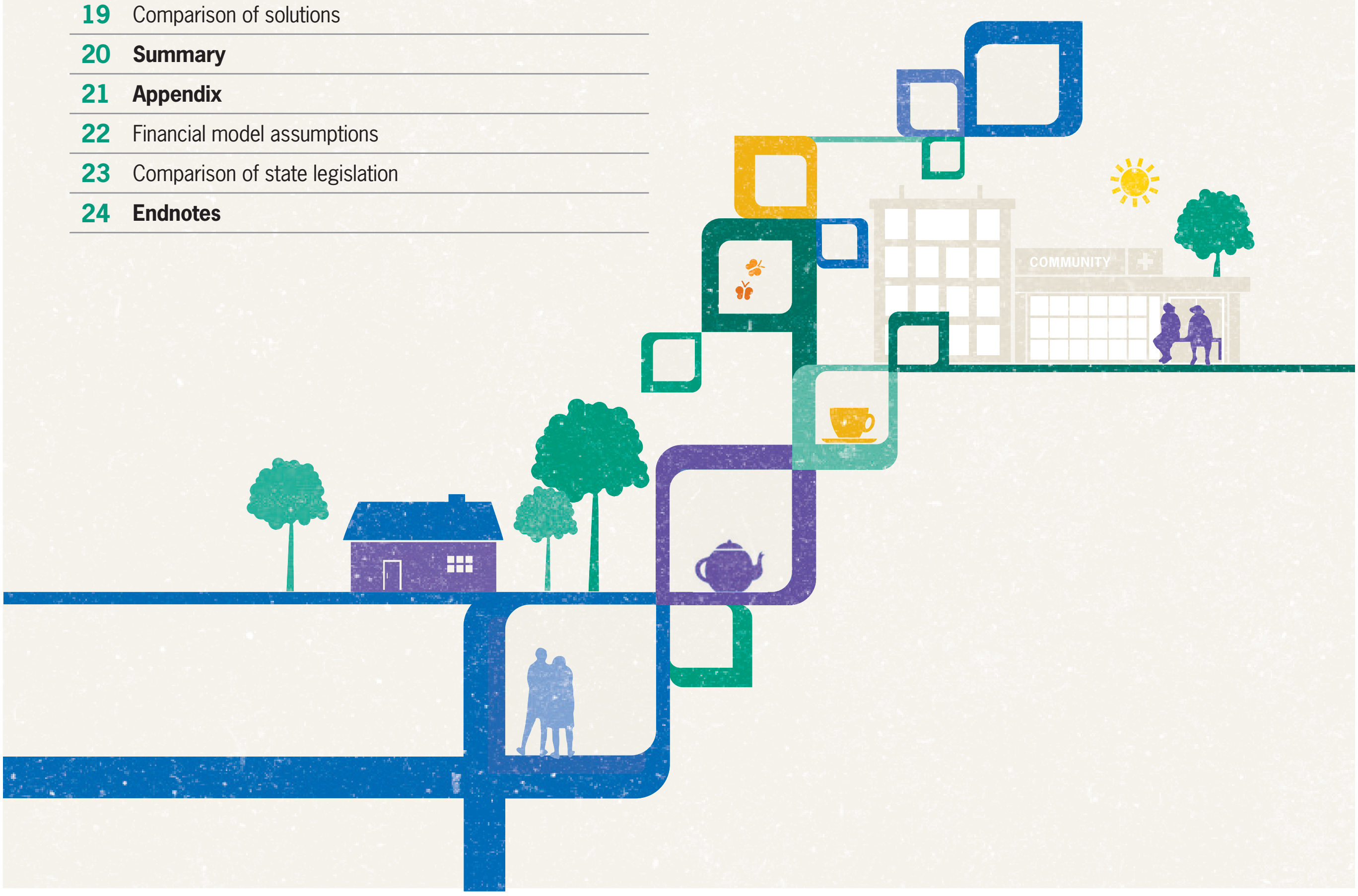

Executive Summary

The dramatic increase in the number of Australians turning 65 over the next 20 years is an established demographic fact. Indeed, the Commonwealth Treasury projects a doubling of the senior's population by 2050, with an economically significant reduction in the ratio of taxpayers to retirees.

Logic suggests that there needs to be a huge corresponding increase in the amount of purpose-built housing so that the 8.1 million Australians who will be over 65 by 2050 continue to have the housing choice, independence and autonomy that they expect and deserve.

Currently, about 184,000 Australians live in retirement villages, or 5.7 per cent of the over 65 population. For this penetration rate to remain stable, and the same proportion of future over 65s to have the same retirement living choices of the current generation, increased private investment will be required.

The Private and Not for Profit sectors can play a much greater role in meeting the needs of senior Victorians at no additional cost to the public purse.

In order to secure this increase, regulations which discourage investment in the supply of housing and services for our seniors will need to be amended.

One of the biggest threats to Victoria's ability to meet future demand is the Aged Care Rule which affects operators of all sizes.

This is why the Property Council of Australia, with advisory firm Grant Thornton, have developed this report to quantify its impact and to come up with a solution which ensures that the sector continues to expand.

The new application of the Aged Care Rule is not what was originally intended; the goal posts have changed.

In the simplest of terms, the Aged Care Rule provides that village residents who move to a residential aged care facility and elect to pay a bond, are entitled to an exit payment from the village owner within six months, even if their dwelling is not sold. In practice, this is causing considerable financial harm to several Victorian retirement villages. The Aged Care Rule has a blanket application and does not differentiate between whether or not an outgoing resident controls key sale conditions (such as the right to appoint an agent and set the price), which carry implications for operators' balance sheets. At the time of the Rule being introduced (2006), it only applied to low care accommodation. Now, with changes to Commonwealth legislation, the Rule applies to both low and high care accommodation.

According to Grant Thornton modelling, in 2014 Victorian retirement villages will need to fund approximately $58 million in Refundable Accommodation Deposit ("RAD") payments. This is forecast to increase to $604 million by 2021. Indeed, once the Aged Care Rule takes full effect (once all residents have signed post 2006 contracts), a typical retirement village of 200 dwellings will need to gain financing of approximately $4-5 million each year to fund the early payment of exit entitlements and potentially more if dwelling sale times increase beyond 18 months. For most retirement village operators, this will be very difficult to achieve, and for smaller businesses, impossible.

In all likelihood, if left unchecked, the Aged Care Rule will see several retirement village operators become insolvent which will in turn have a devastating effect on their residents.

The Property Council and its retirement living members support socially responsible regulation, and recognise the need to ensure that residents wishing to move to aged care facilities can afford to do so. However, as things stand now, the Aged Care Rule is having the opposite effect by jeopardising the housing and services provided to tens of thousands of people.

The Aged Care Rule will see several retirement village operators become insolvent, which will in turn have a devastating effect on their residents.

In order to avoid the situation worsening, the Property Council and Grant Thornton have devised an alternative to the Aged Care Rule. (Full details can be found in this report on page 17). This report has two sections:

- **Section 1** of this report analyses the Aged Care Rule and the impacts it will have on retirement villages and their residents; and
- **Section 2** discusses our proposed solution and the alternate solutions we have considered.

While our optimal result would be to have the Aged Care Rule rescinded, we believe that our proposed solution will ensure a fairer and more sustainable outcome is delivered for all stakeholders. Importantly, it does so by creating a regulatory environment which encourages growth, investment and rising service delivery standards. The retirement village sector is a vital health and housing sector with great potential. We encourage all decision makers overseeing this area to consider these reforms carefully.

Co signed

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Statement of Limitation

In preparing this report, GTAL has relied upon, and presumed accurate, any information (or confirmation of the absence thereof) provided by the Property Council of Australia and the Retirement Living Council and/or from other sources. Except as otherwise stated in the report, GTAL has not attempted to verify the accuracy or completeness of any such information. If the information is subsequently determined to be false, inaccurate or incomplete then it is possible that our observations and conclusions as expressed in this report may change.

GTAL derived the data in this report from information sourced from the Property Council of Australia and the Retirement Living Council (if any) and/or available in the public domain at the time or times outlined in this report. The passage of time, manifestation of latent conditions or impacts of future events may require further examination of the project and subsequent data analysis, and re-evaluation of the data, findings, observations and conclusions expressed in this report. GTAL has prepared this report in accordance with the usual care and thoroughness of the consulting profession, for the sole purpose described above and by reference to applicable standards, guidelines, procedures and practices at the date of issue of this report. For the reasons outlined above, however, no other warranty or guarantee, whether expressed or implied, is made as to the data, observations and findings expressed in this report, to the extent permitted by law.

This report should be read in full and no excerpts are to be taken as representative of the findings. No responsibility is accepted by GTAL for use of any part of this report in any other context. This report has been prepared on behalf of, and for the exclusive use of, the Property Council of Australia and the Retirement Living Council, and is subject to, and issued in accordance with, the provisions of the agreement between GTAL and the Property Council of Australia and the Retirement Living Council. GTAL accepts no liability or responsibility whatsoever for, or in respect of, any use of, or reliance upon, this report by any third party.

Glossary

Aged care	Aged care refers to residential aged care and is an accommodation option for older people who cannot live independently at home and have been assessed by a member of the Aged Care Assessment Service (in Victoria) or Aged Care Assessment Team (other jurisdictions) as needing this care.
Control over sale	A resident has control over the sale of their dwelling if certain prescribed clauses are included in the residence contract which give the resident control over the sale of their dwelling with respect to choosing the selling agent and setting the price.
Daily Accommodation Payment ("DAP")	The DAP is the equivalent daily payment for accommodation costs in an Australian Government-subsidised aged care home. You make this payment on a regular basis, up to a month in advance, similar to paying rent. This payment is non refundable. See also Refundable Accommodation Deposit ("RAD").
Deferred Management Fee ("DMF")	A DMF is the amount a retirement village operator charges a resident when they leave the village. It is agreed at the time of entry and applied on exit. The method of calculating the DMF differs across retirement village operators.
Dwelling	A single unit, apartment or villa in a retirement village.
Exit entitlement	The amount paid to the resident once they vacate their dwelling. This usually consists of the ingoing contribution (see ingoing contribution definition below), plus any capital gains as stipulated in the contract, less the DMF, less the cost of reinstatement/refurbishment as stipulated in the contract.
Freehold	Freehold refers to a form of agreement for accommodation in a retirement village where the resident owns the dwelling. DMF is still normally accrued in this agreement.
Gross Domestic Product ("GDP")	GDP is the value that is contributed to the economy in one year. This is measured in Australian dollars.
Ingoing contribution	The upfront payment made by the resident to enter into a leasehold agreement for a dwelling in a retirement village, by way of a refundable payment.
Leasehold	A form of agreement for accommodation in a retirement village where the resident leases the dwelling from the operator. This is the most common form of agreement for residents in a retirement village.
Net tax	Net tax includes the company tax, GST and payroll tax paid by the retirement village sector.
Non-owner resident	A non-owner resident describes a resident who does not own their dwelling. This usually refers to a resident who holds their dwelling under a leasehold agreement.
Out-going resident	An out-going resident refers to a person vacating a retirement village.
Resident	In this report a resident is a senior living in a retirement village.
Refundable Accommodation Deposit ("RAD")	The RAD is a lump-sum payment for accommodation costs in an Australian Government-subsidised aged care home. This lump sum will be refunded when you leave the aged care facility. Since July 1 2014, a person entering aged care has the choice of paying a RAD or a DAP (see Daily Accommodation Payment).
Retirement village	A facility that contains a number of dwellings that accommodates seniors.
Retirement village operator	A retirement village operator is a legal entity that owns and operates one or more retirement villages.
Senior	A senior for the purposes of this report is a person aged 55 years or more.

Definition of a retirement village

Retirement villages offer their residents independent living in a community environment supported by additional services

What is a retirement village?

A retirement village is a residential, multi-dwelling complex specifically designed for seniors aged 55 years and over. The majority of villages are single-level or low-rise villas occupying landscaped grounds and community spaces.

Retirement villages offer a range of health, leisure and support services. Many include recreational and medical facilities, such as community halls, bowling greens, and rooms for visiting doctors or allied health professionals.[1*]

Retirement villages and aged care facilities differ in the level of personal support and payment structures.

The level of support offered to residents differs:

Retirement village residents;

- Live independently;
- Range from requiring no assistance to low levels of assistance; and
- Access to additional assistance through paid help such as a cleaner or community care packages.

Aged care residents;

- Less independent; and
- More frail, require a high level of care and daily assistance with personal care such as dressing, bathing and cooking.

Payment structures:

Retirement village;

- Commonly leasehold or freehold with a deferred management fee (DMF) paid;
- Ingoing contribution is paid on entry and is repaid, minus the DMF, on exit and sale of the dwelling; and
- A resident may also receive a share of any capital gains.

Aged care;

- A choice between a Refundable Accommodation Deposit (RAD) and Daily Accommodation Payment (DAP), or a combination of both.

* See endnotes on page 26

Overview of retirement villages

While retirement villages vary in size and ownership, they all generate income through the sale of dwellings

The majority of residents have a leasehold agreement.

Three main agreement types exist between the resident and the retirement village operator:

- 81 per cent have a leasehold agreement.[2] A leasehold contract involves the resident paying an ingoing contribution and having it reimbursed once they vacate the dwelling; and
- Other agreements include rental (15 per cent) and freehold (four per cent).[2]

For those with a leasehold agreement, an exit entitlement is generally paid once they leave the village and the dwelling has been sold.

This exit entitlement is calculated differently across the sector but generally includes the following:

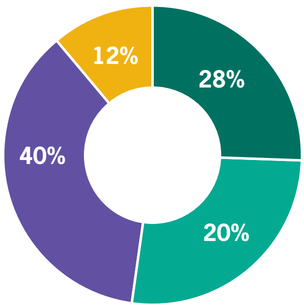
- An amount equal to the ingoing contribution, plus any capital gain they are entitled to, less the DMF, and less any reinstatement/refurbishment costs they must pay; and
- The DMF is often calculated as a percentage of the entry or exit leasehold value and is usually capped (e.g. three per cent per year capped at 30 per cent after ten years).

The main source of income for retirement village operators is the sale and resale of dwellings.

- Operators generally profit from the sale of a dwelling, and this provides their main source of cash flow;
- These ingoing contributions are used as working capital for facility administration and maintenance, as opposed to being held in a bank account awaiting payment to outgoing residents. As a result, liquidity can be an issue for a retirement village, especially smaller operators; and
- Additional resident services are charged at cost and do not generally generate profit for the village operator.

Retirement village operators in Australia operate anywhere from one site to 76. 28 per cent of retirement village operators own under 50 dwellings.[3] These smaller organisations are likely to be family run while the larger multisite businesses are either corporations or mission based Not for Profits.

Chart 1: Number of dwellings by organisation

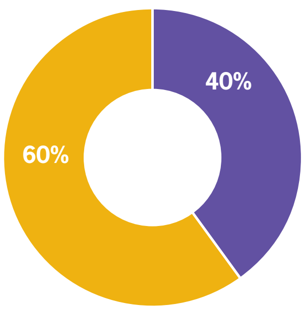


28 per cent of organisations own less than 50 dwellings. These are likely to be family owned and run.[3]

Number of dwellings across the organisation

- 0 - 50
- 51 - 100
- 101 - 500
- > 500

Chart 2: Percentage of Profit and Not for Profit



40 per cent of retirement village sites are Not for Profit.[3]

- Not for Profit
- For Profit

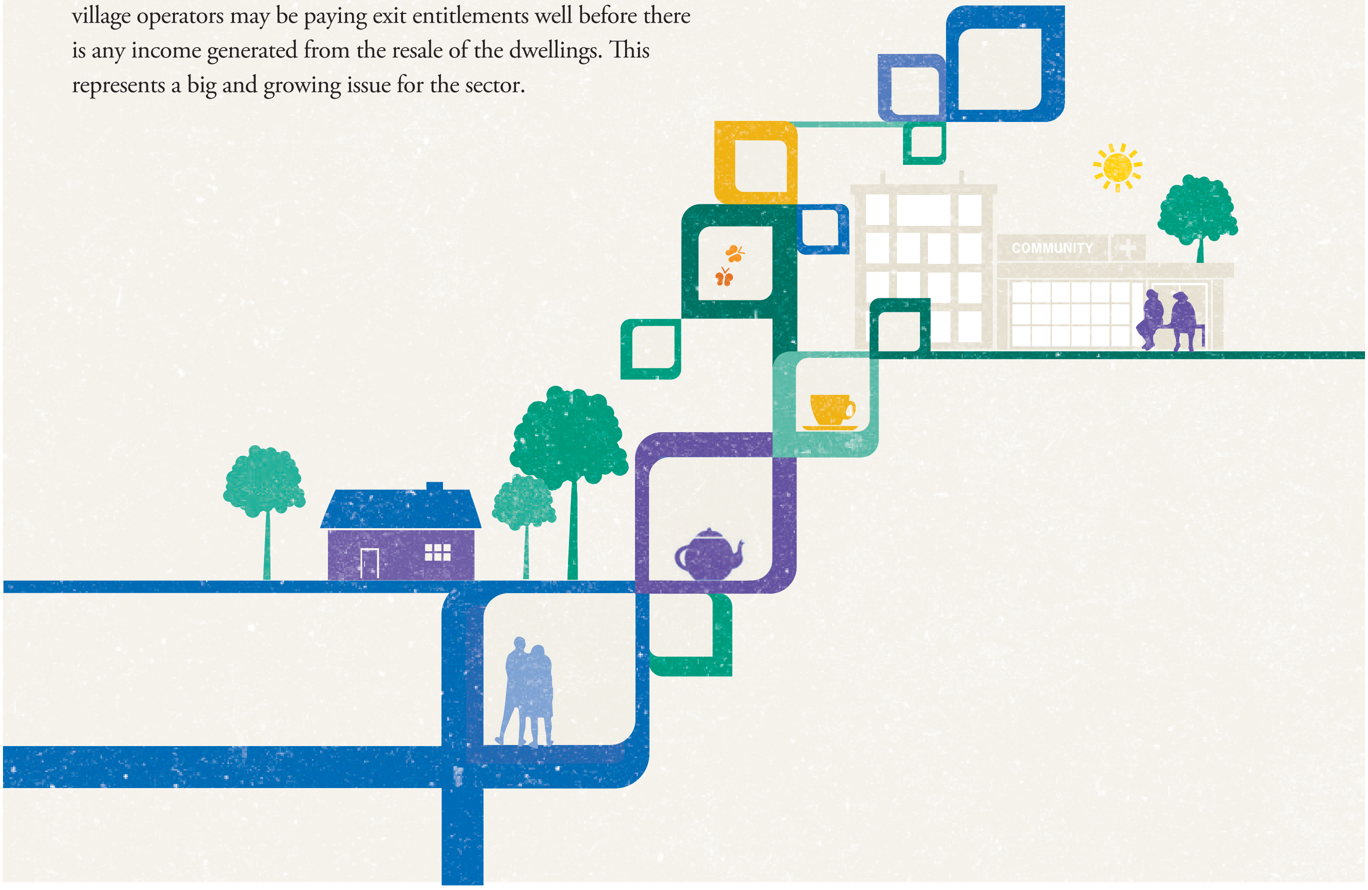
Section 1: Impacts of the Aged Care Rule

01. Impact of the Victorian Aged Care Rule

02. Proposed Solutions

In Victoria in 2006, two rules were introduced that resulted in the early payment of exit entitlements: the Aged Care Rule and the Six Month Rule.

Introduction of the Aged Care Rule has meant that retirement village operators may be paying exit entitlements well before there is any income generated from the resale of the dwellings. This represents a big and growing issue for the sector.



Explanation of the Aged Care Rule

In Victoria during 2006, two rules were introduced that impacted exit entitlement payments

Aged Care Rule

Regulation 6 of the *Retirement Villages (Contractual Arrangements) Regulation 2006* (Vic) provides that where a non-owner resident moves from a retirement village into a residential aged care facility and agrees to pay a bond (now referred to as a RAD), then the resident is entitled to at least part of their exit entitlements,[4] and potentially all of their entitlement. Whether the resident receives all or part of their exit entitlement will depend on the price of their outgoing unit and the price of the RAD, which are outside the control of the village operator.

Six Month Rule

Section 26 (2) of the *Retirement Villages Act 1986* (Vic) and regulation 5 of the *Retirement Villages (Contractual Arrangements) Regulations 2006* (Vic) states that if certain prescribed clauses are not included in the residence contract (which give the resident control over the sale of their dwelling with respect to choosing the selling agent and setting the price), then the non-owner resident has access to their exit entitlement within six months of vacant possession regardless of whether their dwelling has been sold.[4]

At the time these two rules were introduced two factors resulted in their limited application:

1. To manage the impact of the Six Month Rule, retirement village operators gave non-owner residents control over the sale of their dwelling. This removed the requirement upon the retirement village operator to pay the resident's exit entitlements before the dwelling had been sold; and
2. The Aged Care Rule only triggered exit entitlements for residents moving to the low level of aged care, as this was the only level of care where a bond (RAD) was required. As the Rule only applies to post 2006 contracts, many of the residents that have moved to aged care to date have not fallen under these provisions. This is now changing as more exiting residents have post 2006 contracts.

When the Commonwealth *Living Longer, Living Better* aged care reforms took effect on 1 July 2014, the distinction between low care and high care facilities was removed, with a person now being able to elect to pay a bond (RAD) for all aged care accommodation. As a result:

- Residents who have entered a retirement village on a post 2006 contract and are now moving to aged care, typically have control over the sale and yet receive early payment of their exit entitlements regardless of whether they have sold their dwelling;
- Furthermore, this situation gives rise to the residents having little incentive to sell their dwelling if they have already received all of their exit entitlement; and
- This has resulted in the unintended consequence of an early payout to every resident moving to aged care that chooses to pay a RAD. The number of retirement village residents moving to aged care has grown over recent years to now comprise approximately 60 per cent of residents that leave a retirement village.[5 and 6]

Originally designed to give leasehold residents equivalent rights to freehold, the Aged Care Rule has actually given leasehold residents substantially more rights and protections. Owner residents do not have the benefit of the Aged Care Rule. Owner residents also continue to pay the recurrent service fees for their dwelling until settlement of the sale of their dwelling occurs. Non-owner residents have the benefit of the Aged Care Rule and are not required to pay the recurrent service fee at the expiration of six months of vacating the dwelling. This means that there is significantly less incentive for the non-owner resident to set a realistic sale price as, due to the Aged Care Rule, they can rely on retirement villages paying their RAD.

This situation has the potential to cause a major cash flow shortfall that many operators will not be able to fund (refer to pages 13 and 14 for more information). It also has negative consequences for both the operator and the remaining residents.

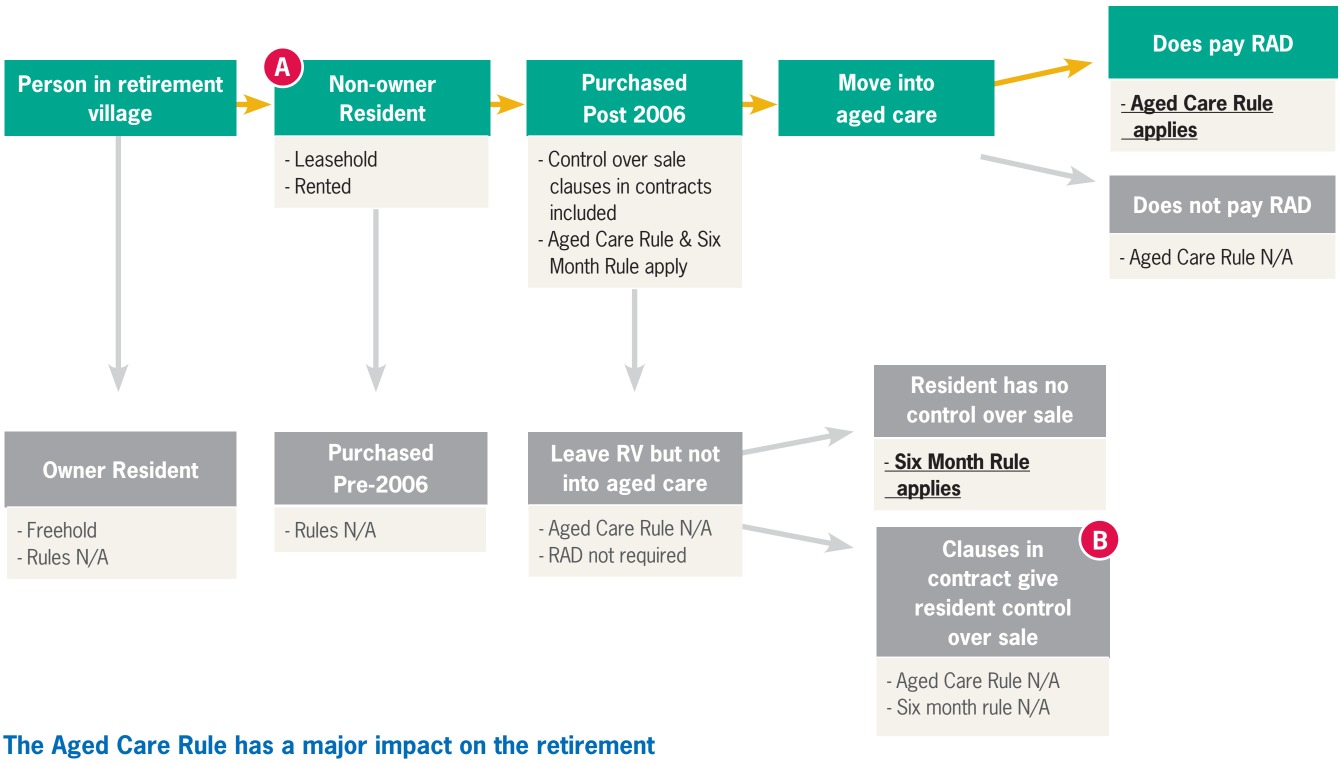
Victoria's regulation is the most prescriptive and inflexible in the country.

While other states have early payout legislation, Victoria's regulation is the most prescriptive and inflexible in the country. For example, in New South Wales if a resident has more than 50 per cent share of capital gains they are not entitled to early payment of exit entitlement. As this is stipulated in the contract, retirement village operators have some control over their exposure to the rule. South Australia and Tasmania have provisions for operators to apply for financial hardship considerations. No such provisions exist in the Victorian legislation. This puts Victorian operators at a disadvantage to their interstate counterparts. For more information refer to the Appendix.

The issues created by the Aged Care Rule

The Aged Care Rule obliges early payments of RADs regardless of whether the retirement village operator has control over the sale

Diagram 1: Applying the Aged Care and Six Month Rules.



The Aged Care Rule has a major impact on the retirement village sector.

- The majority of residents in Victoria are non-owners on leasehold agreements (81 per cent[2]) or renting (15 per cent[2]) **(A)**.
- It became standard industry practice (post 2006) in Victoria to introduce specific clauses into resident contracts providing the non-owner resident with control over the sale of the dwelling. This was a direct response to the Six Month Rule **(B)**.
- However, the right of control now has implications for the Aged Care Rule as the resident is potentially entitled to receive an early payout (prior to sale) while retaining control of the sale.

The Aged Care Rule means that many retirement village owners pay exit entitlements before there is income generated from the resale of the dwelling

Diagram 2: Overview of the Aged Care Rule and the sales cycle.

Depiction of Current State Note 1	**0 months Dwelling vacated, resident moves into aged care**	**Six months RAD payment due**	**12 months** — **Unknown sale time** — **18 months**
Impact of current legislation		Aged Care Rule entitles resident to part or all of their exit entitlement (up to the amount of the RAD) regardless of whether the dwelling has sold. Six Month Rule states resident has access to exit entitlement within six months of vacant possession.	As a means of managing the impact of the Six Month Rule, the resident typically has control over the sale. However the Aged Care Rule requires retirement villages to pay out exit entitlements whether the dwelling has sold or not.
Resident's perspective	Resident moves out of the village into aged care.	Receives RAD proportion of exit entitlements to pay aged care facility.	Upon settlement, resident receives remainder of exit entitlement (if any).
Retirement village's perspective	Exit entitlement calculated	A RAD proportion of exit entitlements paid to resident.	B Remainder of exit entitlement paid, if any.

Period to be funded, creating cash flow strain

- The sales cycle for a retirement village dwelling is quite complex with many stages. Firstly, the retirement village operator has to take vacant possession of the dwelling. They then need to perform a refurbishment and put the dwelling on the market. In addition, if the settlement is dependent on the sale of the incoming resident's previous home, the operator can be waiting an additional 60, 90 or 120 days to receive the incoming contribution. So while a dwelling can sell in nine months, much longer times of 18 or even 24 months are not uncommon. Any deterioration in the property market, as occurred during the GFC, would also further increase sales times.
- The Aged Care Rule has the potential to lengthen the sales cycle. With less incentive (given they have already received early payment of their exit entitlement) and with many having control over the sale, outgoing residents may be tempted to achieve above market rates. This will further lengthen the sales process and increase the operator's financial exposure.
- The period between the retirement village paying the RAD **(A)** and the sale of the dwelling **(B)** can vary. During this time, the retirement village will experience a large outflow of funds placing a strain on operator cash flow. For many operators this will require significant debt financing. Many operators, especially small operators, will find it difficult to secure this financing.

Note 1. Where Aged Care Rule applies for residents with control over sale

Why is this now an issue?

This problem is only going to get bigger, July 2014 was the tipping point

All residents can now pay a lump sum (RAD) for all forms of aged care.

Prior to 1 July 2014, only residents requiring low care support paid bonds (RADs) when they moved to residential aged care.

This limited the number of retirement village residents needing to pay RADs. However, now that moving to any level of aged care can trigger a RAD payment, a substantially larger number of residents will be paying RADs.

The number of residents moving into aged care is increasing due to the ageing population.

As Australia's ageing demographic continues to increase, there will be a greater proportion of residents moving to aged care from retirement villages. The Commonwealth Treasury has projected that the number of people over the age of 65 will grow from 3.2 million currently,[7] to 8.1 million by 2050.[8]

Residents on post 2006 contracts are starting to enter aged care.

Most residents stay in retirement villages for between eight and 15 years.[5 and 6] As eight years has elapsed since the Aged Care Rule came into effect, there is now a steady increase in the number of residents with post 2006 contracts moving to aged care.

Put simply, the sector has now past a critical tipping point. With every day that passes, the financial impact grows. Consequently, now is the time to act.

During 2014, Victorian retirement village operators will face a combined RAD bill of $58 million

Diagram 3: Financial impact of the Aged Care Rule on the Victorian retirement village sector.

	Calculation Input	2014	2021
Number of residents moving into aged care	Growing at historical rates, approximately 7,690 retirement village residents nationally will move into aged care in 2014,[9] increasing to 10,090 in 2021.[3]	7,690	10,090
Number of Victorian residents moving into aged care	Approximately 23.4 per cent of retirement village residents nationally are located in Victoria.[3]	1,800	2,360
Number of these residents that are non owner residents	81 per cent of dwellings are leasehold.[2]	1,458	1,911.6
Total number of residents that will receive early payout of their RAD (on post 2006 contracts)	Residents generally stay in the village for between eight and 15 years. This means that residents on post 2006 contracts are starting to enter aged care in 2014.[6] On the assumption that entry into aged care is evenly dispersed over these seven years, the number exiting on post 2006 contracts will increase by approximately 15 per cent each year. Therefore 15 per cent will be on post 2006 contracts in 2014 and 100 per cent in 2021	**218.7**	**1,911.6**
Total cost of RAD to Victorian retirement villages	**Average RAD payment is $265,000[10] in 2014 and estimated at $316,000[3] in 2021.**	**$58.0 million**	**$604.1 million**

The RAD burden on retirement village operators will continue to grow.

We estimate that approximately 218.7[9] RADs will need to be paid in Victoria in 2014. At $265,000[10] per RAD, this will equate to **approximately $58.0 million.**

This figure will grow as:

- The population ages and the number of retirement village residents increase, and
- All new contracts (post 2006) are subject to the Aged Care Rule.

We estimate the number of RADs needing to be paid in 2021 will grow to approximately 1,911.6 costing the sector **$604.1 million annually.**

This will have a profoundly negative impost on the financial and operational health of the sector.

The number of RADs needing to be paid in 2021 will grow to approximately 1,911.6 costing the sector $604.1 million annually.

The Aged Care Rule has the potential to devastate retirement village operators

Cash flow shortage

Retirement villages will face significant strain on their cash flow as they must fund the RAD prior to the sale of the dwelling. The time taken to sell a dwelling can vary anywhere from nine months to several years. Many retirement villages will not be able to fund this impost. For some, this will mean going into liquidation, for others the result will be increased funding costs for residents.

Decreased investment

Investment in village facilities is likely to reduce as funds will be allocated to finance early exit entitlement payouts. This represents the opportunity cost of the early pay out. As a result, operators will be forced to decrease capital expansion projects and refurbishments.

Liquidity challenges

The periods of cash flow shortage may result in the need to obtain external funding. This may create leverage issues for retirement villages as well as breach debt covenants. There may be some cases where additional funding cannot be secured, forcing retirement villages into administration.

Loss of RAD

If a former resident received an early payment of their exit entitlement under the Aged Care Rule and passes away in aged care, their RAD is given to their estate, even if their retirement village dwelling remains unsold. There is no mechanism for the retirement village to recoup their funds until the dwelling is sold.

These consequences are unintended side effects of the legislation. In attempting to protect exiting residents by ensuring a smooth transition into aged care, the remaining residents face uncertainty due to the financial pressure on their village.

Impact on residents

This does not benefit the tens of thousands of residents who remain in villages

In response to the increase in costs associated with the Aged Care Rule, operators will have to increase revenue and reduce costs. The immediate response of operators will be to reduce operating expenses including maintenance and capital improvements. Over time however, increased revenue will likely come from increases in DMF. The changes to DMF have a long lag time before impacting on revenue and cash flow. This is because changes to DMF will only apply to new contracts and will only impact cash flow once those dwellings are resold.

Businesses will face significant liquidity issues. Those operators who do not go out of business are likely to face future challenges as the decrease in village investment spirals into an operational decline. This will detrimentally effect residents.

The extent and severity of the impact will be determined by the characteristics of the retirement village operator.

Decline in investment within the retirement village

Increased pressure on retirement villages as a result of the cash flow strain will be detrimental to their ability to invest in village improvements.

Retirement village facilities become run down and the general quality of the village deteriorates

Without funding available to invest in village improvements, the quality of the facilities offered will deteriorate. The flow on effect of this is a reduced quality of lifestyle for residents and a decline in the environment within the retirement village.

Number of unsold dwellings increases, further decreasing the community ambience

The decline in the quality of facilities will subsequently lead to an increase in the number of unsold dwellings and a decrease in sales price as the village becomes less desirable for prospective buyers. This will further deteriorate the community ambience within the retirement village.

Retirement village is unable to meet debt obligations caused by the Aged Care Rule and becomes insolvent

As cash flow is generated from the sale of dwellings, the decrease in dwelling sales will cause serious cash flow problems for the retirement village and could lead to insolvency. This creates further uncertainty and stress for residents.

Impact on retirement villages

The Aged Care Rule has serious liquidity effects on all operators, especially small villages

Small – Single site

Consolidation/ insolvency

Small operators are a large proportion of the sector. The Aged Care Rule will adversely affect the cash flow position of smaller operators. It will result in large lump sum outflows when the RAD is paid, with extended and unknown periods prior to any inflow of cash.

Where surplus cash is unavailable, villages will need to acquire loans to cover working capital shortages. Lenders have indicated that funding is unlikely to be provided to smaller operators.[8]

While consolidation may be a solution for some small operators, without access to funds to bridge this gap, retirement villages will become insolvent.

Larger - not integrated with aged care

Investment decreases

These types of retirement villages may be able to continue operating, however they may need to re-evaluate their regular expenses to accommodate the large outflows of cash. They will need to create ways of earning the same return, and may resort to cutting operational expenses.

Larger operators may have higher cash balances allowing them to absorb the delay of cash flow. However, the implications of the Aged Care Rule will still result in a decrease in overall margin, leading to a decrease in potential investment.

Integrated with aged care

Absorbs expenses

While the impact is less for integrated organisations (assuming that their residents are exiting to their own aged care facility), there are still cash flow issues to be managed.

The funds needed to support the resident once in aged care remain locked in the retirement village dwelling, and are unavailable to the operator until the dwelling is sold.

While monthly costs during this interim period need to be funded, it does not necessitate an immediate and full financing of the RAD.

These insights are drawn from case studies conducted in Victoria. The financial impact of the Aged Care Rule on a "typical" retirement village is presented on the following page.

Financial modelling of impacts

A detailed analysis of the impact of the Aged Care Rule for a "typical" retirement village is presented below

This scenario is based on a For-Profit village that operates a single site. All residents are non-owner residents on post 2006 contracts. They sell their dwellings for an average of $300,000 with a DMF of five per cent of ingoing contributions per year over six years. Full model assumptions are available in the appendix.

This scenario shows the impacts of increasing the time to sell a dwelling. This may be due to either a deterioration of the market or residents holding off on selling their dwelling to receive a higher price and a larger capital gain, or a combination of the two.

Based on an average sale time of nine months this analysis shows that without an immediate injection of $4.8 million to cover RAD payments, the organisation may become unviable. However, in the event that the average sale time increases to 18 months, the loan required will double to $9.6 million. This retirement village operator will find it difficult to obtain a loan for $4.8 million, not to mention $9.6 million.

This presents a major cash flow issue for the retirement village operator. This impact is exacerbated by the fact that the key criteria for a lender to fund a retirement village is based on operating cash flows.[11] Lenders use the retirement village's Cash Interest Cover Ratio (Cash IRC)[Note 1] to determine the level of risk associated with providing a loan. The difficulty in obtaining a loan is further increased by the fact that once the average sale time increases beyond twelve months, there will be no cash inflows from the resale of dwellings within the financial year. The negative cash flows in the first financial year seen in the 12 and 18 month scenarios will make it more unlikely that the retirement village will be able to access the required loan to keep it from insolvency.

Indeed many smaller operators will find it very difficult to secure any funding at all regardless of their Cash ICR, as their variable cash flows often make securing loans difficult.

Diagram 4: Impact of the Aged Care Rule on a typical retirement village

Retirement Village Overview	
Size of organisation (dwellings)	200
Residents leaving the village annually 15 per cent	30
Residents moving to aged care annually 60 per cent	18

Impact of the Aged Care Rule ($'000)			
Average Sale Time	**9 months**	**12 months**	**18 months**
Loan needed to fund early payout	$4,800	$4,800	$9,600
Interest on loan	-$96	-$192	-$384
Opportunity cost	-$120	-$240	-$480
Operating cash flow in the first financial year	$1,300	-$5,200	-$5,200
Net operating cash flows over the average sale time	$1,300	$900	$400

Notes for Impact of the Aged Care Rule table:

- The model assumes that all residents leave on the first day of the financial year. Although the timing of the exit becomes less significant as the time to sell increases.
- The loan is taken out after six months of the dwelling being on the market as this is when the RAD payment is due.

Note 1. The Cash Interest Cover Ratio (Cash ICR) is the measurement of an organisation's ability to service their interest payments. It is calculated by dividing the operating cash flows by interest. An interest cover ratio below 2.5[11] for a retirement village operator usually indicates that the organisation presents too much risk for the lender and will not be provided with a loan.

Any worsening of market conditions further accelerates the cash flow consequences resulting from the Aged Care Rule

The seriousness of the financial position of the operator is made obvious by an examination of their cash flow. The base case sees approximately $4.8 million in funding required in the first year of operation.[Note 1]

While the figures in the illustrative example are of concern, there is the potential for greater downside if market conditions worsen, as they did during the Global Financial Crisis. An increase in RAD costs, an increase in sale time or a combination of these further deteriorate the financial position of a retirement village operator.

The effect of dwelling sales times on cash flow

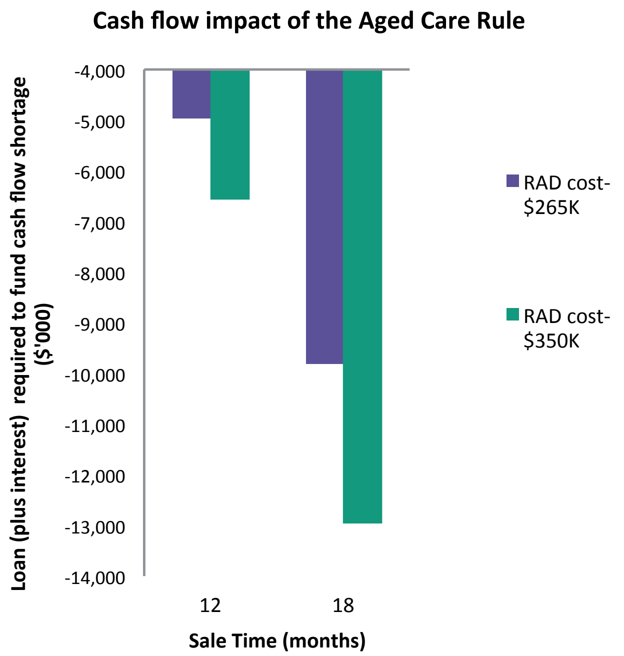
This analysis demonstrates a situation where the sales time of a dwelling has significantly increased. This is likely in the event of a market downturn, such as that which occurred after the Global Financial Crisis. It also shows the situation in which residents choose to hold onto their dwelling to achieve a higher sales price. Even in the current market, sale times of 12 to 18 months or more are extremely common. This time frame includes the exiting resident vacating the dwelling, the operator conducting any required refurbishments, finding a buyer for the dwelling, and then receiving the payment.

The effect of the size of RAD payouts on cash flow

RAD payments have steadily increased. This analysis shows the dramatic effect on cash flow of aged care providers increasing RAD payments from the current average of $265,000.[10] Obviously there are many aged care facilities with RADs much higher than the average. Therefore the cash flow shortfall of $13 million, as depicted in the graph, can easily occur today.

The chart below shows the increase of both sales time and RAD payments on the previous illustrative example.

Chart 3: Sensitivity analysis of required cash flow when sales time and RAD cost increase.



Note 1. Model assumptions are available in the appendix

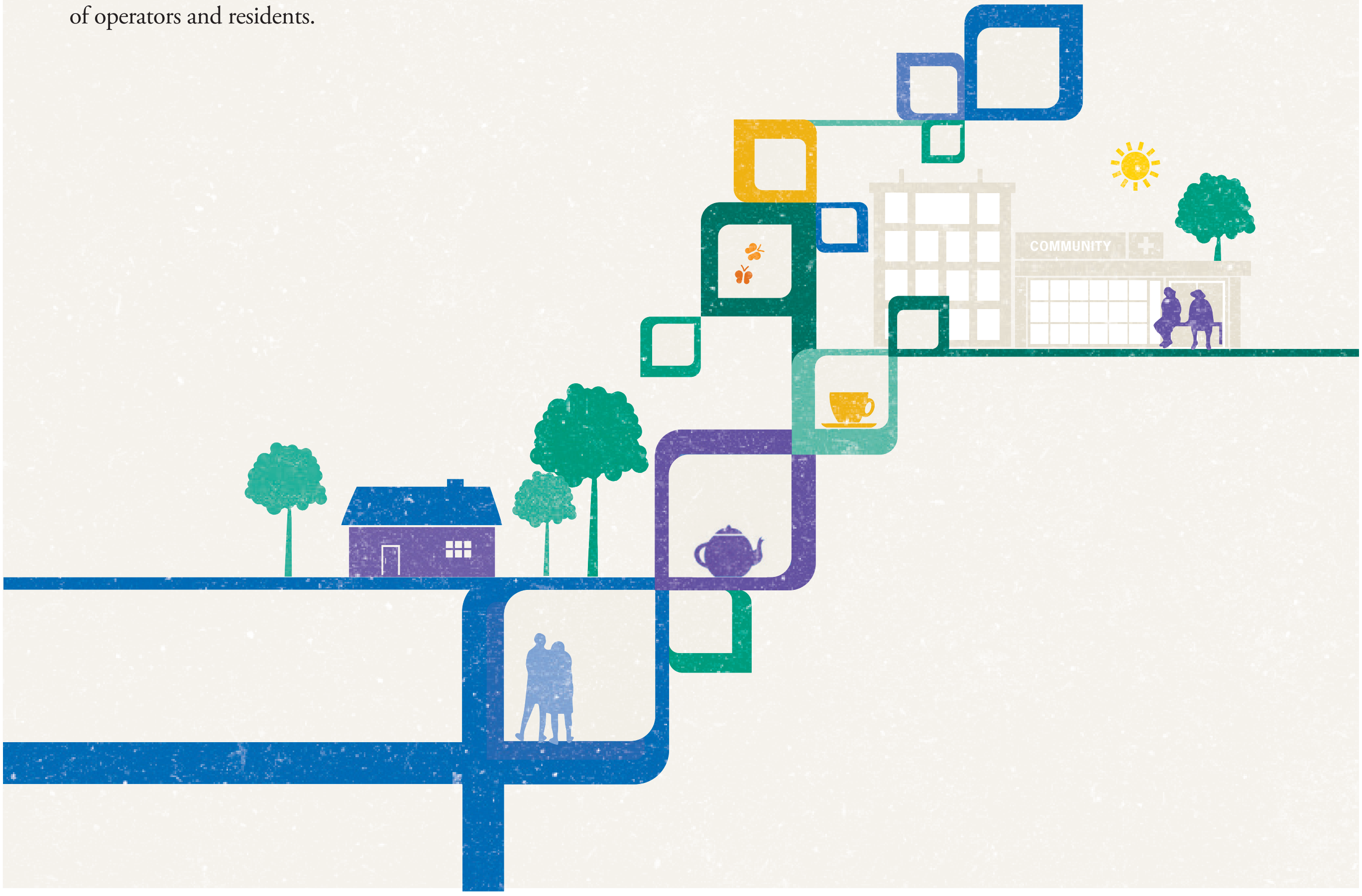
Section 2: Proposed Solutions

01. Impact of the Victorian Aged Care Rule

02. Proposed Solutions

As the critical tipping point has past, now is the opportune time to revisit the public policy rationale for the Aged Care Rule.

Retirement villages cannot afford to fund RAD payments for their outgoing residents. A solution is needed that will address the needs of operators and residents.



Principles and considerations behind possible solutions

Retirement villages cannot afford to fund RAD payments; a solution is needed that addresses the needs of operators and residents

The Aged Care Rule in its current form is unsustainable due to the impact it has on retirement villages and residents.

If the Aged Care Rule is left unchanged:

- Retirement villages will be paying most exit entitlements well before there is any income generated from the resale of the dwellings;
- The problem is only going to get bigger, with 2014 being the tipping point.
- Operators will face damaging financial impacts to their business. The size, financial status and co-location with aged care facilities will determine the degree of the impact; and
- Residents will also be affected as new residents will likely face higher DMF charges while existing residents will see operators reducing capital improvements in an attempt to reduce costs.

Any proposed solution to the Aged Care Rule needs to consider the key problems it causes:

- Disincentive for the resident to sell their dwelling in a timely manner; and
- The disconnect between early payout of exit entitlements at six months (based on the combination of the Aged Care and Six Month Rules) and the average time to sell a dwelling, which is often greater than nine months. [Note 1]

The following principles were applied when developing the proposed solution:

- The solution must not impose unfair financial obligations on retirement village owners;
- The solution must protect;
  - the residents moving into aged care; and
  - the residents who remain in retirement villages.

Note 1. Anonymous retirement village (case study), 2014, interview with Grant Thornton.

The proposed solution

There is a solution that is fairer to everyone

A solution is required that balances the needs of the resident moving to aged care while not jeopardising operator solvency.

The proposed solution is to pay the Daily Accommodation Payment ("DAP") up until the dwelling has been sold.

How the rule will change

Rather than paying the full RAD proportion of a resident's exit entitlement, retirement village operators will pay the DAP to the aged care operator. The payments will be capped to 85 per cent of the value of the resident's exit entitlement in order to account for potential deterioration of the property market. Payments from the retirement village operator will cease when the property is sold and the resident is repaid their exit entitlement.

- If the former village resident does not control terms or conditions of sale of their dwelling, only the DAPs will be deducted from their exit entitlement; and
- If the resident does exercise control over the sale (as is the case for most residents in Victoria), the DAPs plus a token interest rate (i.e. reserve bank rate) will be deducted from the exit entitlement. This interest will assist in paying the funding costs of the retirement village operator who pays the DAP on behalf of the resident.

If the resident and operator cannot agree on a sales price, an independent valuation of the current market value will be sought as is required in Regulation 7 of the *Retirement Villages (Contractual Arrangements) Regulations 2006*. This will require a change in legislation to include a valuation to set the sales price if there is no agreement as this is currently only provided in the regulations to calculate exit entitlements.

This solution ensures that residents can move into aged care facilities without undue financial pressure on retirement village operators and flow on industry effects.

This is a fairer solution that involves minimal legislative change.

Periodic payment of DAPs will reduce the cash strain on individual retirement villages as the upfront payment is reduced from a large lump sum to smaller monthly payments. For example from a $265,000 lump sum to approximately $1,500 per month. This still places a significant financial impost on the retirement village operator but is more manageable than paying the RAD in full.

Leasehold residents are still assured that their entry into aged care will be funded. While the solution still provides leaseholders with more privileges than freehold residents, the gap is lessened.

The incentive to hold on to the dwelling is also reduced as the DAPs are not refundable by the aged care facility, compared to the RAD which is largely refunded.

The range of solutions considered

Solutions considered...

Revoked

The Aged Care Rule is revoked, Six Month Rule applies.

How will the situation change?

Non-owner residents that have control over their sale will receive their exit entitlements on the sale of their dwelling. In other words the Six Month Rule applies whether the resident is leaving to move to aged care or another accommodation setting. [Note 1] Non-owner residents that have control over the sale of their dwelling will be in the same position as most other seniors that need to sell their home before making the transition into an aged care facility.

What issue will this solve?

This eliminates the disconnect caused by the resident controlling the sale and receiving their exit entitlement. It also results in the Six Month Rule being consistently applied to all out going residents.

What issues remain?

Some residents may have difficulty in funding their accommodation in an aged care facility while their dwelling sells. In addition to this, operators still face the prospect of funding RAD payments for residents that do not have control of the sale due to the Six Month Rule.

Payment of DAP

Instead of paying the RAD the operator will pay the DAP to the aged care facility.

How will the situation change?

Rather than one lump sum payment of the RAD at six months, periodic payments of the DAP would be paid each month (up to 85 per cent of the value of the exit entitlement) to the aged care facility until the dwelling is sold, at which point the resident can decide their own future payment method. These DAPs will then be refunded to the retirement village operator, plus a token interest rate if the resident has control over the sale, through a reduction in the exit entitlement.

What issue will this solve?

Payment of DAPs, as opposed to a single RAD payment, will significantly reduce the impact of the cash flow strain on retirement villages, as they will no longer need to fund the full RAD from six months up until the point the dwelling is sold.

What issues remain?

Over time, the DAPs made by the retirement village operator could add up to a substantial cash outflow.

Control over sale

The Aged Care Rule is amended to include a Control Over Sale clause similar to the Six Month Rule.

How will the situation change?

Where a resident has control over the sale, as is the case for most residents in Victoria, they will not be entitled to early payments and will be required to sell the dwelling to receive the funds to cover the RAD.

What issue will this solve?

This option will give the resident an incentive to sell their dwelling at market price as opposed to setting unrealistic prices and prolonging the sale time.

What issues remain?

Operators still face the prospect of funding RAD payments for residents that do not have control of the sale due to the Six Month Rule. From a resident's perspective, some may have difficulty in funding their accommodation in an aged care facility while their dwelling sells.

Longer period

Increase the time to pay the RAD from 6 months to a longer period.

How will the situation change?

This solution will increase the period of time before the RAD is due to be paid.

What issue will this solve?

Through increasing the time required to pay the RAD, the time taken to sell the dwelling will align more closely with that of the RAD's payment, thereby decreasing the period of time where the operator must fund substantial cash deficits.

What issues remain?

The average dwelling sale time in a retirement village varies based on the dwelling and economic conditions making a suitable time variable, as well as delaying revenue to the aged care provider. In addition, the resident may still have an incentive to hold on to the dwelling.

Note 1. For non-owner residents with no control over the sale they will receive their full exit entitlement within 6 months, as stipulated by the Six Month Rule.

Comparison of solutions

Our solution best addresses the needs of all stakeholders

Table 1: Impact of solutions on stakeholders

Solution	Retirement village operator perspective	Existing residents' perspective	Resident moving to aged care perspective	New residents' perspective
Revoked	● • No early payout of RAD.	◕ • Residents not subject to reduced investment in the village or possible displacement due to the village becoming insolvent.	○ • Residents to fund RAD or DAP prior to sale.	◕ • Residents not subject to increased DMF or reduced investment in the village.
DAP payment	◕ • Initial strain on cash flow will be reduced. • DAPs could add up over time to a large cash outflow.	◕ • Retirement village less likely to become insolvent, resulting in a reduced risk of displacement of residents.	◑ • Resident still able to move to an aged care facility when needed.	◕ • Retirement village less likely to increase DMF charges for new residents.
Control over sale	◕ • Cash flow issue reduced as most villages give control over the sale to the resident. This this will reduce the amount of payouts under the Aged Care Rule.	◕ • Residents not subject to reduced investment in the village or possible displacement due to the village becoming insolvent.	◔ • Most residents retain responsibility for sale. Early payment only to those without sales control.	◕ • Residents not subject to increased DMF or reduced investment in the village.
Longer period	◕ • Operators' cash strain will decrease due to greater time to pay and give opportunity to sell dwelling.	◔ • Retirement village less likely to become insolvent, resulting in a reduced risk of displacement of residents. • If the dwelling cannot be sold, a large cash outflow will still be required, which will result in a decrease in investment in the village by the operator.	◔ • Resident needs to pay DAP until their dwelling is sold or the retirement village pays their RAD.	◔ • Retirement village less likely to increase DMF charges. • If the dwelling cannot be sold, a large cash outflow will still be required, which will result in a decrease in investment in the village by the operator.

Legend

● Large positive effect ◕ Positive effect ◑ Neutral effect ◔ Slightly negative effect ○ Negative effect (same as the open market for residents)

Summary

Now is the time to revise the Aged Care Rule

2014 is the opportune time to review this legislation.

From 1 July 2014, residents can elect to pay a lump sum (RAD) for all forms of aged care.

+

An increase in the number of residents moving to aged care due to the ageing population.

+

Residents on post 2006 contracts are starting to enter aged care.

There is a proposed solution that is fairer to everyone and requires minimal change.

The proposed solution is to pay the Daily Accommodation Payment ("DAP") up until the dwelling has been sold.

Rather than one lump sum payment of the RAD at six months, periodic payments of the DAP would be made each month (up to 85 per cent of the value of the exit entitlement). These would be made to the aged care facility until the dwelling is sold, at which point the resident can decide their own future payment method. These DAPs will then be refunded to the retirement village operator, plus a token interest rate if the resident has control over the sale, through a reduction in the exit entitlement.

If the resident and operator can not agree on a sales price, an independent valuation of the current market value will be sought.

This solution involves a relatively minor and simple change to the current legislation.

In order to ensure a sustainable solution for all, there must be consultation with the retirement village sector.

The current situation needs to change to ensure operators remain financially viable. Otherwise operators will face financial pressures leading to an increase in insolvent businesses and an overall decrease in sector investment.

If there is no change residents will face uncertainty and potentially a decrease in the quality of services through operator cost reductions. New residents may also be charged a higher DMF to cover the additional operating costs.

Appendix

Financial Model Assumptions

- 100 per cent of dwellings are leasehold;
- Average tenure in a retirement village is ten years;
- All residents that move to aged care are on post 2006 retirement village contracts;
- Price of an aged care bond is $265,000. Reference: Department of Health and Ageing, 2012;
- All outgoing residents for one financial year leave on 1 July;
- All in going residents enter on the same date;
- Ingoing contribution is $300,000;
- DMF is calculated at five per cent per annum of the ingoing contribution, capped at 30 per cent after six years;
- The amount of the loan is equal to total RADs payable, and does not take into account cash on hand from operating activities. This has been assumed in order to remove unnecessary complication;
- Interest rate is eight per cent per annum;
- Tax rate is 30 per cent and tax becomes payable as DMF is earned;
- Operating expenses and depreciation are calculated as a percentage of DMF. This has been estimated to be 90 per cent;
- Tax payable is paid quarterly;
- Assuming that outgoing residents are delivering up 'vacant possession'. As such outgoing residents are based on dwellings not actual resident numbers. We assume that as resell time increases, total residents in the village also decreases;
- Any services offered in the retirement village are charged on a fee for service agreement and as such, they do not generate a profit;
- An initial asset balancing account has been calculated to balance initial Balance Sheet; and
- The model assumes all outgoing and incoming residents leave/arrive on the same day. This has been assumed in order to remove unnecessary complication.

Additional sensitive analysis assumptions (unless stated otherwise):

1. Nine month sales time;
2. 60 per cent of outgoing residents move to aged care;
3. 15 per cent vacancy rate; and
4. Starting cash balance of $300,000.

Comparison of state legislation

	Payment of exit entitlement before the dwelling is sold?	Are the regulations likely to require the payment of an exit entitlement before the dwelling is sold?	Comments
VIC	Yes	Yes	Aged Care Rule and Six Month Rule.
SA	Yes	*Yes	A resident can apply for early payment of their exit entitlement if they have been approved to move into an aged care facility, are required to pay an accommodation bond, they do not have "ready access to funds" or their personal finances would be "seriously affected by" a requirement to make the payment. The early payment is paid within 60 days of application and is limited to the amount needed to secure entry into the aged care facility. *Note additional requirement that resident must establish no access to funds. In the 2013 Parliamentary Review of the *Retirement Villages Act* 1987, the Select Committee noted comments that the existing law can cause financial hardship to village owners/operators (an "administering authority"). The Committee recommended amending the Act to allow greater flexibility in the way the early payment can be provided.
NSW	Yes	No	A resident who is not a "registered interest holder" is entitled to payment of their exit entitlement six months after providing vacant possession. If the payment would cause the operator undue hardship, they may apply to the NSW Civil & Administrative Tribunal for an order to extend the payment time, or allow the payment to be made by instalments. In making their decision, the Tribunal may consider the hardship this would cause the resident.
QLD	No	No	In August 2014, the Queensland Government released a "Consultation Regulatory Impact Statement", which seeks feedback on the idea of an early payment rule.
TAS	Yes	*Yes	Where the resident enters aged care, the position is similar to that in SA, however the early payment is made within 45 days of application. In other circumstances, the resident is entitled to the exit entitlement within six months of terminating their contract and vacating their dwelling. The Director of Consumer Affairs and Fair Trading may extend the time for payment if the early payment would cause serious financial hardship to the operator.
ACT	Yes	No	A resident who is not a "registered interest holder" is entitled to payment of their exit entitlement six months after providing vacant possession. If the payment would cause the operator undue financial hardship, they may apply to the ACT Civil & Administrative Tribunal for an order to extend the payment time, or allow the payment to be made by instalments. In making their decision, the Tribunal may consider the hardship this would cause the resident.
WA	No	No	
NT	No	No	

*Due to its prescriptive nature, the Aged Care Rule has a significantly more detrimental impact on Victorian retirement village operators compared to those in other states and territories.

Notes:

- The phrase "dwelling is sold" is an umbrella term for the operator having either entered into a sale or tenancy contract with a new resident, received payment for the unit from a new resident, allowed a new resident to take up occupancy, or where the operator has purchased the unit.
- Some legislation prescribes early payment in uncommon circumstances, such as where the residence contract is terminated by a tribunal. These circumstances are not addressed above.
- The residence contract can also prescribe the exit entitlement payment date.
- In ACT, a "registered interest holder" is a resident who: (a) is the registered proprietor of a unit in a units plan or a lot in a community title scheme village; or (b) owns shares in a company title scheme that give rise to a residence right in relation to the unit in the village; or (c) has a residence contract in the form of a registered long-term sublease (registered sub-lease over the title to the land and for a term of at least 50 years or the resident's lifetime that entitles the person to at least 50 per cent of any capital gain).
- In NSW, a "registered interest holder" is a resident who: (a) is the registered proprietor of a lot in a strata scheme or community land scheme village; or (b) owns shares in a company title scheme that give rise to a residence right in relation to the unit in the village; or (c) has a residence contract in the form of a registered long-term lease (registered over the title to the land and for a term of at least 50 years or the resident's lifetime) that entitles the person to at least 50 per cent of any capital gain.

Endnotes

1. Retirement Living Council, Retirement Villages and Residential Aged Care Facilities compared, 2013.
2. Grant Thornton, Retirement Village Association Australia, Retirement Industry – Industry Trends & Prospects, 2011.
3. Grant Thornton, Analysis completed for this report, Melbourne, 2014.
4. Property Council of Australia, Six Month Rule / Aged Care Rule Reform Paper, Melbourne, 2013.
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