Tuesday 4 June 2024

focus

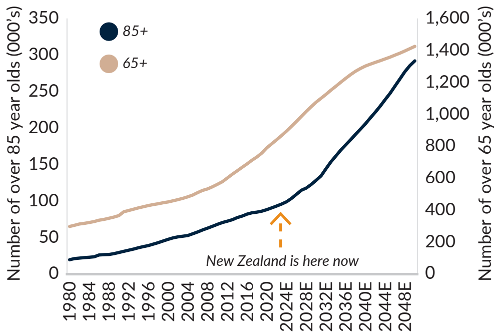
Aged care: Demographics is Destiny

If Demographics is Destiny, the outlook for New Zealand aged care companies is promising. Over the next 15 years, the number of 85+ year-olds in New Zealand will double and more than one in four of these people will need aged residential care. The uncertainty around these estimates is very low; the future 85+ year-olds are 70+ years-old today.

FORSYTH BARR

> **...Providing care for elderly is a core part of a welfare society. It is also big business...**

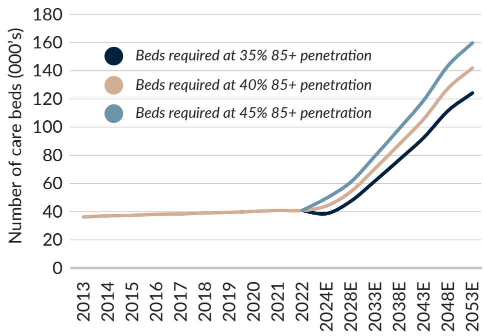
THE GROWING ELDERLY POPULATION IS VERY PREDICTABLE



Source: Statistics NZ

15 years may seem like a long time. But with twice as many 85+ year-olds, even allowing for some beneficial health trends and more home care, New Zealand will need at least 30,000 net new care beds, about 2,000 added per year. That compares to the last decade when New Zealand added around 500 beds per year.

AGED CARE BEDS NEEDED TO SERVICE THE GROWING ELDERLY POPULATION



Source: Statistics NZ, Aged Care Association, Forsyth Barr analysis

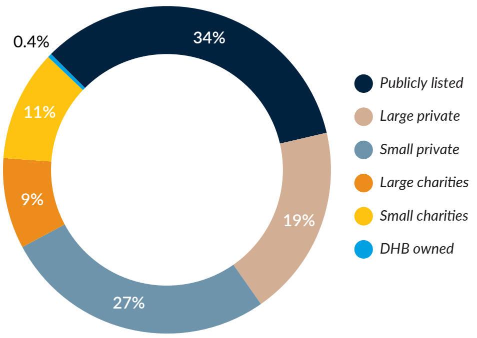
Providing care for elderly is a core part of a welfare society. It is also big business, with billions in revenues shared amongst a diverse group of large NZX-listed companies, cooperatives, religious organisations, as well as mum and dad providers.

Lately the business of providing care has come under immense pressure as revenues have not kept pace with soaring costs. Profits amongst the listed companies have all but evaporated and over 1,000 beds have closed down. Is the model broken? We think not. We believe New Zealand has an unusually well-structured and efficient aged care sector, but one that finds itself at an important juncture.

The New Zealand aged care industry: a hybrid funding model

New Zealand has a public-private hybrid model for paying for aged residential care, however, the actual services are almost exclusively provided by private operators. These private operators can loosely be split into three groups. Large commercial operators (including the listed operators) which make up half of the market. Then small private companies and not-for-profit organisations each make up about one quarter each.

BED OWNERSHIP BREAKDOWN



Source: Aged Care Association

While the care beds are privately owned, the funding comes from a combination of private and government. For aged care residents below a certain income and wealth threshold, the state pays for their care. But at relatively modest levels of wealth (total assets of $240,000) the residents have to pay for their own. Similarly, residents with enough income (including superannuation) have to pay for all or a proportion of their care.

A mix of offerings as the industry has responded to changing preferences

Government funding for a standard care bed ranges from around $175 to $300 a day depending on level of care. This compares to a hospital bed which costs $1,700 a day according to the Aged Care Association. To avoid the risk of a race to the bottom and to protect a vulnerable cohort, strict criteria are set for the minimum service that needs to be provided. This applies to everything from room size, staffing, and access to amenities.

Over time the aged care providers have realised that residents both want and are willing to pay extra for premium offerings. These Premium Accommodation Charges (PACs) can, in theory, apply to anything that is not required by regulation, from a towel rack to a private bathroom or balcony. What the operators charge for these PACs is largely unregulated – a function of supply and demand. Today, over half of care beds have a PAC. For the listed operators, it is the vast majority.

Lately the aged care operators have introduced care suites. These are mini apartments, licensed to deliver care, and often hospital level care. Operators sell care suites under an Occupational Rights Agreement (ORA). The ORA gives the resident most of the rights that come with ownership. When the resident no longer can or needs to use the care suite (or unit), the aged care provider sells it to a new resident and the original resident gets back around 70% of the purchase price (there is a range). The 30% retained by the operator is a Deferred Management Fee and covers its cost of capital, maintenance, amenities etc. A care suite typically costs about $250,000 to $500,000.

Recent challenges faced by aged care companies

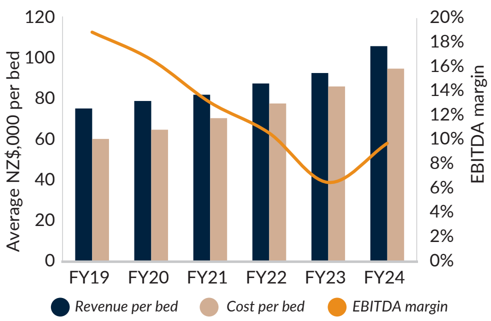
Providing aged care has been a reasonably good business in New Zealand historically. Providers have been compensated for operating expenses with a sufficient margin to eke out a reasonable return on the significant capital investment needed to build care homes. And care homes have become better and better at attracting more customers into the retirement villages. But with only one buyer, the negotiating position of the aged care companies has slowly deteriorated. The temptation for consecutive governments to make short-term gains (the care homes are already built) at the expense of long-term pain (no more are being built) is always there. The care operators are more or less forced to accept

...against the back drop of the number of 85+ year-olds increasing by about 6,000 per year...

what the government offers – and lately that has been woefully inadequate. The triple whammy of COVID with less immigration, absenteeism, and increased demand from higher paying District Health Boards (DHBs) created an extreme shortage of clinical staff. Many smaller operators were not able to hire adequate staff and had to shut down. The only response available to the sector is to stop building new standard care beds, and that is what they have done.

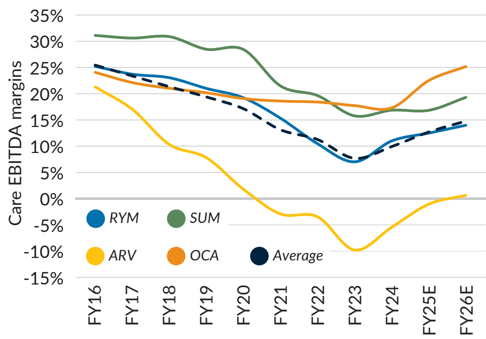
Profitability of the listed sector is through the floor

COSTS PER BED VS REVENUES PER BED



Source: Company reports, Forsyth Barr analysis

EBITDA MARGIN (FORSYTH BARR ESTIMATES)



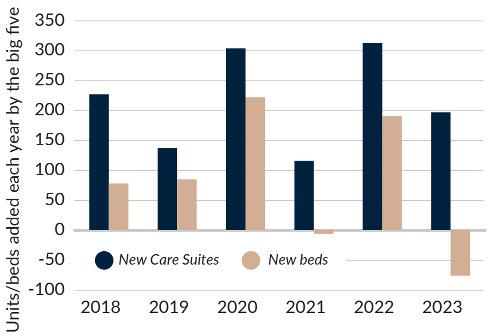
Source: Company reports, Forsyth Barr analysis

The long squeeze

What happens if funding doesn't improve? In the short term, not that much. There isn't anything the aged care operators can do. The facilities are already built, hence, as long as the funding broadly covers cash costs, it pays to keep the facilities open, even if the return on the invested capital is near zero as it is today. Over the long-term however, the situation will become increasingly unsustainable.

...the cost of one hospital bed is around four times that of an aged care bed...

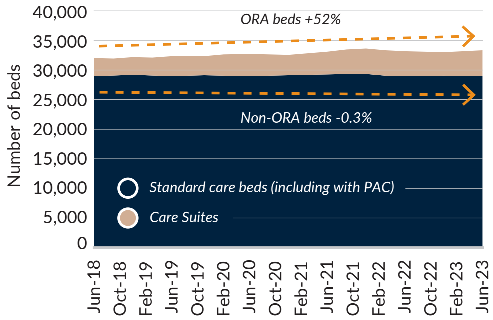
NUMBER OF PAY AS YOU GO (I.E. NON CARE SUITES) BUILT BY THE BIG FIVE (RYMAN, SUMMERSET, METLIFE, OCEANIA AND ARVIDA) VS CARE SUITES OVER LAST FIVE YEARS



Source: Company reports, Forsyth Barr analysis

On a net basis, the aged care sector overall has essentially stopped building care beds as an equal amount of beds are being shut down as are being built. Exacerbating the issue is that the vast majority of beds being built are premium care suites. The number of standard beds, even including those that carry a Premium Accommodation Charge is declining in New Zealand. This is happening against the back drop of the number of 85+ year-olds increasing by about 6,000 per year.

STANDARD AGED CARE BEDS HAVE FALLEN OVER THE PAST FIVE YEARS

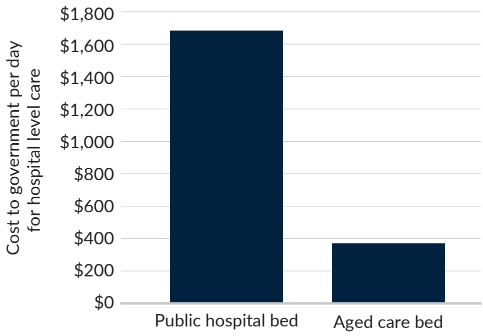


Source: Aged Care Association

What happens if funding doesn't improve?

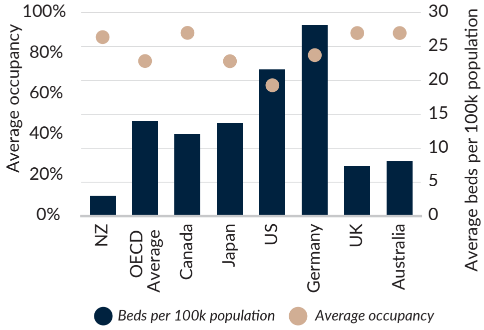
We don't know for sure what will happen next, but we do know that fewer 85+ year-olds and less care needs is an extremely unlikely scenario. As utilisation of standard care beds approaches 100%, elderly in need of care will either end up in hospital or having to stay at home longer than they should. Neither scenario is positive. Apart from the fact that New Zealand's hospitals are already amongst the busiest in the OECD with very few empty beds, the cost of one hospital bed is around four times that of an aged care bed, even one delivering hospital level care. We estimate that New Zealand has about 1,000 empty hospital beds on average; enough to cater for less than one year of increased demand.

COST OF HOSPITAL LEVEL CARE IN A HOSPITAL VERSUS AGED CARE FACILITY



Source: Aged Care Association

HOSPITAL UTILISATION AND BEDS VS OECD PEERS



Source: OECD, Forsyth Barr analysis

Light at the end of the tunnel

Is it all doom and gloom? We think not. Certainly not for the aged care operators. We have had four unusual years, to put it mildly, where the government's focus has been squarely on the short-term economic and health impacts from COVID. As things are starting to return to normal, it appears as if the government has finally realised that something has to be done. The latest funding round, completed in July 2023, implies a funding increase of about 10% per bed per annum. While it's not enough to restore any reasonable degree of profitability, it is enough to stop a further deterioration. Changes in migration settings have also eased the previously acute labour shortages. Separately, as discussed above, the aged care companies themselves are taking action and are committing no new capital to standard beds and very little to premium beds. Instead they are building care suites. The build out of the care suite product provides diversification for the aged care operators. Should funding improve enough (we estimate by around 30%) to entice new-builds of traditional care beds, it would vastly improve the profitability of care overall. If funding doesn't improve, care will become increasingly scarce. In such a scenario, the demand for care suites and other premium private solutions will likely increase dramatically.

The aged care sector has been through a turbulent period in recent years, but the attractive long-term fundamentals remain intact. A wave of elderly is coming towards us over the next decade, which will boost the demand for aged care services. The listed New Zealand aged care operators are well positioned to benefit from this megatrend in the years ahead.

If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

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