

Current Issues in the Analysis and Valuation of Established Retirement Villages

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The retirement village industry in Australia has achieved significant growth over the last 20 to 30 years and is now entering a more mature phase where greater focus on medium to long-term issues is anticipated. The entry of the larger institutional investor into the sector in the early part of this decade resulted in a higher proportion of these assets being held to greater reporting requirements and accountability. Furthermore there are now villages which have operated successfully for over 30 years displaying an established track record enabling analysis as to the veracity of assumptions within the Discounted Cash Flow (DCF) method of analysis and valuation.

The early 2000's was distinguished by a boom in asset prices, from which retirement villages were not immune. The Global Financial Crisis (GFC) which commenced (internationally) in 2007 resulted in a significant decline in asset prices across the board. The extent of this decline on retirement village assets is yet to be fully determined in the transaction market.

Retirement Village values in Australia are primarily determined by the Deferred Management Fee (DMF) business model; an owners' interest in the village incorporates the value of the DMF business, any unsold units plus developable land, where applicable. Standard industry practice is to use a method of value appropriate to each of these components: DCF analysis determines the value of the owners' interest; direct comparison and/or incorporation into the DCF determines the value of any unsold units and the value of the units "in one line"; and direct comparison and/or hypothetical development determines the value of the developable land.

Whereas the existing residents' profile and incoming prices of the units are known; the analysis of an established retirement village incorporates assumptions on the part of a valuer/analyst:

- The Discount Rate of the DMF business;
- The growth rate of prices of the physical units;
- Take-up rates, turnover periods of residents and rates of sale of used units;
- Refurbishment of units;
- The term of the DCF;
- Estimates of the village life cycle including redevelopment opportunities; and
- Operational factors.

These factors are all interrelated, in that changing one assumption will have a bearing on other assumptions. While much of the focus has been on discount rates and their movements, the other components can have an equally significant influence on values and returns.

Discount Rates

In the late 1990s the main owners/operators of retirement villages constituted the not-for-profit (including religious groups and charities) sector and private operators. In the years 2004 to 2007 significant sales activity occurred in the retirement living sector. Institutions sought to gain a position in this prospective sector and to diversify their existing investment portfolio offerings; furthermore established operators sought to increase market share.

The ready availability and relatively lower cost of debt and equity finance coupled with the bullishness of investor sentiment resulted in tightening of discount rates, and in one case were

reported as below 10% for a portfolio sale. Following the GFC, the reduced availability and higher cost of equity and debt finance resulted in discount rates trending upwards in line with other types of investment property.

While the not-for-profit sector still constitutes a significant owner the seniors' living sector has now been incorporated into the investment property universe and as a consequence its performance can be anticipated to be coupled with institutional investment property.

A retirement village incorporates both an operating business and an interest in the real property which is different from most conventional forms of real property investment. An investor is exposed to this additional business risk, and following traditional portfolio theory would require an additional risk-adjusted return.

There has been limited evidence of "clean" transactions of established villages taking place since mid-2008; hence the new market level of discount rates has yet to be established.

Growth Rates

The "value" and growth rate of retirement village units is primarily impacted by the main catchment area residential market. The majority of residents in any retirement village need to sell their existing home to finance the move.

In Australia in 2007 -- 2008 the residential property market experienced a notable correction with declining sale prices and increased marketing periods. Correspondingly village operators have experienced an increase in vacancy levels, a slowing of the rate at which residents enter the village and greater price sensitivity. This situation cannot be expected to last forever and any DCF analysis in excess of 10 years can be anticipated to have residential market cycles of this nature (although not necessarily of the magnitude recently experienced in some markets).

Longer term average rates of growth do not necessarily incorporate volatility in the DCF, particularly when zero or negative rates of growth can be anticipated in the initial years. These lower initial rates can result in a significantly lower value when compared to applying an average rate of growth across the entire term of the DCF.

Term of the DCF

The returns from an established retirement village are realised when a resident departs and a new one enters the village, "a turnover". At this point the owner receives the DMF plus any share of capital gain in accordance with the resident's contract. The time between individual turnovers and the number per year in a village can fluctuate markedly, therefore for a DCF to represent a stabilised return a cash flow of between at least 25 and 40 years is required.

For traditional property investment, DCF techniques generally focus on a 10 year term, with a terminal value based on capitalisation analysis at the end of the cash flow. With a DCF term of between 25 and 40 years the importance of this terminal value varies.

A longer term DCF changes the emphasis of differing components. The longer the DCF the lesser importance the terminal value comprises, however the capital expenditure, particularly in the earlier years, to maintain that value assumes greater importance.

The term of the DCF has particular implications with the ageing of retirement village stock; studio and single bedroom units are proving harder (in some cases impossible) to sell to new residents and the situation is anticipated to be exacerbated in the future. Any strategy of remodelling existing units or constructing new units plus paying out departing residents needs to be incorporated into any DCF analysis.

The failure to incorporate all cash flows, particularly negative cash flows borne by the operator, can result in inaccurate results.

Village Life Cycle -- Refurbishment and Remodelling

Retirement villages are similar to other property assets, in that obsolescence and other age-related factors become more important the older the village. Analysis on the age of retirement village stock across Australia has shown that pre-1980 stock can be anything between at least 10% and 30% of total retirement village stock in that state.

As a generalisation the age of a retirement village is correlated with the size of individual ILUs, where the older the village the higher the proportion of studio and single bedroom units compared to two bedroom plus study, three bedroom and larger units found in many new villages.

Assuming a village is to be retained, accommodating this ageing product within the cash flow requires further strategies to be analysed, namely

- Retain the units and convert to DMF based serviced apartment accommodation, residential aged care or rental accommodation.
- Demolish or reconfigure older units resulting in newer larger accommodation.

Not only are the majority of the expenses related to these strategies paid by the operator, there is the additional cost of paying out departing or relocating residents all of which is balanced by future contributions from incoming residents or rental income. Furthermore the community facilities, including the dining and kitchen facilities, may need to be upgraded and this cost incorporated into the analysis.

This activity requires capital which may be met by the sinking fund, however where this is inadequate the operator would need to source new funds. Such capital requirements would also need to be incorporated into the DCF analysis.

Village Life Cycle -- Decommissioning

A further issue with regard to smaller and older villagers is their long-term viability. Many of these lack the community facilities now “mandatory” in newer villages and comprise smaller (studio/one-bedroom) units. Their ability into the future to continue to attract incoming residents at prices that will maintain the financial viability of the village becomes questionable.

The decommissioning of a village requires paying out the existing residents when they depart (also dealing with the social considerations of increasingly isolated remaining residents), the clearing/cleaning of the site and addressing potential rezoning issues, and the final sale of the land. In areas where the alternate use may be considerably greater value than the existing village this may result in a positive value. However in instances where the village represents the highest and best use

or an alternate use may not be achievable under existing zoning determining any residual value may be difficult.

Repairs and Maintenance

Repairs and maintenance are paid out of the ongoing retirement village budget, which is met by the weekly/monthly charges (recurrent charges) levied to residents and are essentially run on a breakeven basis as the various retirement village acts dictate whether villages may or may not operate at a profit.

In older villages and those which have extensive community facilities these repairs and maintenance expenses can result in significant service levies.

Retirees generally have fixed incomes and are very sensitive to ongoing charges particularly whether they are perceived as "value for money "(in their timeframe). Villages with high levies relative to other competing villages may find it difficult to continue attracting residents. This would impact upon vacancy levels and the time between turnovers in a DCF analysis.

Refurbishment

The refurbishment of vacated units becomes a greater issue as a village ages and incorporates carpeting, painting, remodelling of the kitchen and bathroom. This is undertaken at the time of a turnover when the unit is vacant. The residency agreement, contracted when that vacating resident entered the village, dictates the apportionment between the operator and the resident.

Older units require more work of this nature resulting in an increasing real cost in the DCF analysis. Therefore the older the village, the greater the requirement for refurbishment of individual units in order to keep attracting new residents. Inadequate levels of refurbishment would then impact upon incoming prices of units, time taken to attract new residents and capital growth assumptions.

Capital Maintenance and Replacement

Various State Retirement Village Acts (and whether the village is strata titled) treat the costing and apportionment of these two components differently. Capital maintenance includes items such as repainting of community facilities, overhauling lifts, hot water services and resurfacing driveways. Capital replacement includes roofing, major plumbing, replacement of lift engines and electrical works.

The degree to which the cost of these items are met by the village sinking fund and the village operator and the ability of either to meet this financial requirement has the potential to become a significant issue as villages age.

Recent trends in the development of retirement villages can only exacerbate this. Traditionally many villages were single level semi-detached across a large site, however the trend towards higher density retirement living results in a village having a larger number of capital works issues including underground communal car parking, lifts and plant and equipment.

Accounting for capital replacement within the DCF requires an estimate of these future items which may only be identifiable and achievable following inspection by an appropriately qualified building engineer and any due diligence on a village requires obtaining appropriate survey reports.

Sinking Fund

The village sinking fund can be used to meet various capital items and State Retirement Village Acts address the management and level of contributions differently. Older villages have greater requirements for capital expenses and the ability of a village sinking fund to meet these needs to be ascertained and incorporated into the analysis. Conversely younger villages have a greater period in which to accumulate a sinking fund.

Conclusion

Predicting future events can be problematical, therefore where longer term averages (growth rates, down time between turnovers, vacancy levels, etc) are adopted these need to incorporate the significant variation which can occur in these factors. The nature of the DCF is to incorporate volatile cash flows rather than rely on long term averages.