Market Commentary

A TALE OF THREE

Aged care financial review

Listed aged care providers half-year financial analysis

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KEY TRENDS

- Margin compression to continue
- RAD/DAP mix appears to have stabilised
- Diversification becoming a strategic imperative

The 1HFY2018 results were a mixed bag and reflective of three different stories at play. The aged care sector has had a lot to deal with in the past 12 to 24 months including, negative changes in ACFI funding, increased operational costs, deregulation of the home care regime, additional Government intervention surrounding the legalities of capital replacement/asset replacement charges as well as certain additional service fees related to care.

All three players are looking to deliver additional scale through greenfield developments and improve portfolio quality through brownfields and potentially acquisitions – albeit only Regis made an acquisition during the half.

Estia bucked the trend of earnings erosion as it seems to have somehow avoided the impact of severe influenza, as well as decline in ACFI funding. Although it should be noted, that in regard to the latter, Estia had room for improvement which appears to have delivered with some additional upside still to be had.

All three players experienced reasonable net RAD inflow driven by both volume and price differentials between historical and new RAD's, with the trend set to continue largely in line with current flows as additional beds are delivered. Interestingly, Japara has now also moved to co-located RV's as part of their operational strategy as they foreshadowed at the AGM together with Regis however, Estia remains silent on diversification play. It should also be noted that whilst both Regis and Japara already play in the RV space, neither provide any level of direct home care and so, whilst villages will be co located, they will not be integrated from a service perspective, immediately at least.

Lastly, the Federal court deemed the Asset Replacement Charge as being inconsistent with the Aged Care Act of 1997 meaning all provisioned income must now be written off. Whilst this announcement doesn't impact earnings for either Regis or Estia, Japara has been taking their arc revenue to account and more importantly it forms part of their FY18 earnings guidance. That said, there are distinct differences in how Japara charges its fee which may mean that it can continue doing so.

Understandably, the market's reaction was innocuous given that both Regis and Japara managed expectations well through market updates on earnings impact, whilst the Estia pleasantly surprised with an underlying increase in earnings, but broadly in line with expectations.

The analysis herein will compare and contrast the salient profit and loss drivers together with an overview of the RAD/DAP regime and key trends, influencing and impacting the operations for next 6 – 12 months.

Methodology

In addition to the reported results, a review of the presentation made by the listed players as well as wider sector data and independent research has been utilised in providing the views outlined herein. Of course, certain assumptions have been made in deriving the granular detail and has been reconciled to the data provided to ensure as accurate a picture as possible.

To minimise the distortionary impact that this approach can have, revenue levers have been broken down on a per-occupied bed day ('POCBD') and expense items on a per operational bed day ('POBD'). The rationale behind the difference is due to the correlation between revenue and occupancy which approaches 1:1, as compared with the cost structure which is far less positively correlated and follows more of a step structure.

Lastly, charts across a number of observational metrics are provided for ease of comparison. It should also be noted, that although the funding and operational frameworks for all three players is identical for all players, there is variability in both composition and allocation of revenue and expense items. As a result, while there may be differences in POCBD of POBD run rates, the total revenue and expense run rates are sufficient to provide an accurate narrative.

The Results

A summary of the listed player 1HY18 results is outlined below and highlights this variability in operations and returns.

	Japara 1HFY17	Japara 1HFY18	Regis 1HFY17	Regis 1HFY18	Estia 1HFY17	Estia 1HFY18
Portfolio Statistics						
Number of Facilities	43	44	54	58	68	68
Operating Bed Days1 (P.O.B.D)	679,924.79	707,501.63	1,061,259.00	1,061,259.00	1,083,920.00	1,083,920.00
Occupied Bed Days1 (P.O.C.B.D)	641,849.00	653,024.00	1,013,259.79	1,045,774.65	1,011,148.00	1,024,957.00
Operating Places (calculated)	1,862.81	1,938.36	2,931.42	3,097.44	2,937.72	3,003.32
Average Occupancy	94.40%	92.30%	94.70%	92.50%	94.30%	93.50%
Concessional Ratio	40.00%	40.00%	41.00%	42.00%	41.00%	44.00%
Summary Profit & Loss ($ millions)						
Total Revenue	178.50	182.51	284.73	297.00	263.10	271.70
Total Depreciation & Amortisation	6.72	7.76	13.20	14.00	8.47	10.70
Total Expenses	149.45	158.24	222.60	235.80	220.18	226.32
Disposal, valuation and acquisition gains	-1.41	-1.91	-5.04	-5.62	-	-0.39
Total EBITDA	27.65	22.35	57.09	55.58	42.93	44.99
Total EBIT	20.93	14.59	43.89	41.58	34.45	34.30
NPAT	14.63	10.28	31.93	30.70	19.72	23.01
EBITDA Margin	15.66%	12.48%	21.82%	20.61%	16.32%	16.70%
EBIT Margin	11.87%	8.19%	17.18%	15.89%	13.10%	12.76%
EBITDA annualised per operational place (post H/O costs)	15,783.42	12,611.88	22,379.25	21,360.24	15,494.89	16,159.32
Summary Balance Sheet						
Total Bond/RAD liability ($m)	440.37	478.46	899.75	953.90	690.39	762.82
Net RAD inflow ($m)	28.96	25.85	46.84	23.21	38.73	33.55
RAD Payers	0.58	0.57	0.47	0.55	0.61	0.60
DAP Payers	0.24	0.26	0.06	0.08	0.23	0.22
Combination Payers	0.18	0.17	0.47	0.37	0.16	0.18
Total Assets ($m)	1,130.90	1,177.27	1,429.69	1,686.90	1,782.41	1,803.35
Shareholders Equity ($m)	518.70	522.72	272.24	272.80	735.27	801.83

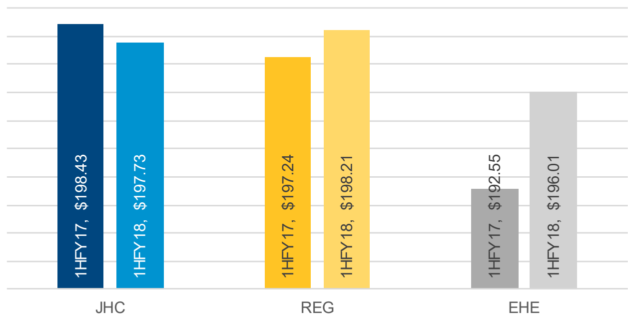
1. Operational and occupied place days have been calculated taking into account total operational places, adjusted for places being bought on line progressively where possible, with the resulting total occupancy adjusted.

Financial Analysis

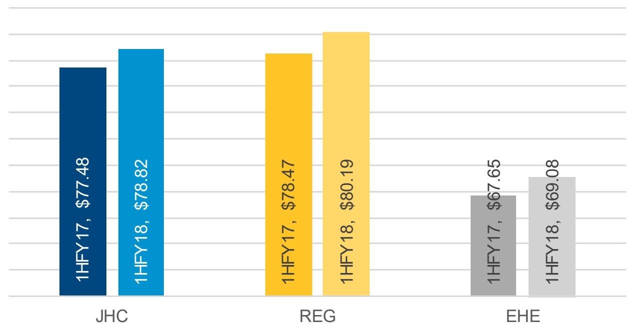
KEY ISSUES

- Potential changes to ACFI still to come
- Balancing operational cost with margin requirement
- Generating adequate return on capital deployed

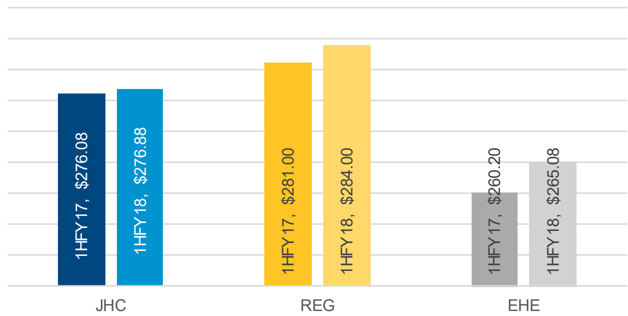
GOVERNMENT REVENUE (POCBD)



RESIDENT REVENUE (POCBD)



TOTAL REVENUE (EXCLUDING OTHER NON-RECURRENT INCOME)



Revenue

The market eagerly awaited these first half results for a multitude of reason, not least of which was to determine the actual impact of the ACFI indexation freeze. Surprisingly and pleasingly the impact was not as pronounced as initially feared with only Japara's Government revenue line declining on a POCBD basis albeit flat in comparison to FY17 ($197.53). Both Regis and Estia in fact, increased their Government POCBD in comparison to prior comparable period (PCP), and FY17 positions that indicates an overall increase in resident acuity profile either through active reassessments of existing residents and/or new residents entering with higher levels of acuity as well as the uplift stemming from significant refurbishments programs. In relative terms, Japara was quicker to move on the significant refurbishment program than its' peers and therefore logically the reduction in their Government revenue line makes sense.

Estia's increase of $3.46 POCBD from 1HFY17 to 1HFY18 (and $3.53 since FY17) is especially noteworthy, as it signals the second phase of its repositioning strategy that it flagged at both the FY17 annual results and subsequent AGM – Management refresh is complete, systems are fully integrated and focus now on returns to growing earnings through organic, development and acquisitive means.

	Japara 1HFY17	Japara 1HFY18	Regis 1HFY17	Regis 1HFY18	Estia 1HFY17	Estia 1HFY18
Revenue Stats (POCBD)						
Government Revenue	198.43	197.73	197.24	198.21	192.55	196.01
Resident Revenue (composition below)	77.48	78.82	78.47	80.19	67.65	69.08
Basic daily care fee (FY17 average)	-	48.55	-	48.55	-	48.55
Means tested fee (average rate of $22.7, $29.12 and $14.85 respectively)	-	13.58	-	15.29	-	7.16
DAP based on average incoming FY17 RAD - 50/50 RAD/DAP split for combos	-	11.35	-	11.11	-	10.69
Additional services fee (average of $25, $35 and $13 respectively)	-	1.92	-	2.61	-	0.84
Capital maintenance fee ($10 per day on RAD payers only)	-	1.97	-	-	-	-
Total Revenue (excluding other non-recurrent income)	276.08	276.88	281.00	284.00	260.20	265.08

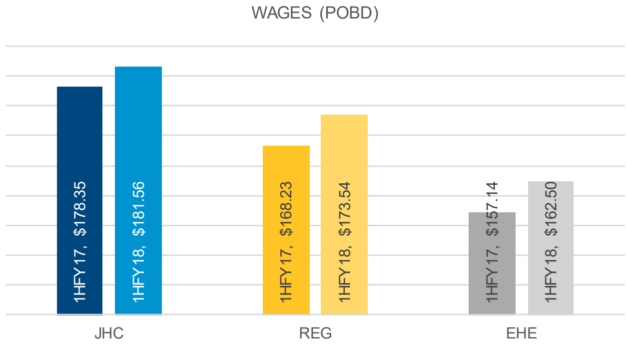
Whilst it is impossible to definitively know the composition of all revenue items, we have calculated approximate run rates (depicted overleaf) in order to provide some level of insight into the push and pull factors of each player. Regis resident revenue continues to be buoyed by their additional services fees as well as means tested fee in line with the affluence of their incoming residents. Worthy of note is that all of Regis income from the asset replacement charge (ARC) will now need to be expensed as the Federal Court has ruled it to be inconsistent with the Aged Care Act of 1997. Lastly, it will be crucially important for Estia to continue on its organic improvement plan in delivering uplift across both the means tested and additional service revenue lines, given its portfolio composition is primarily located in mid to high socio-economic areas.

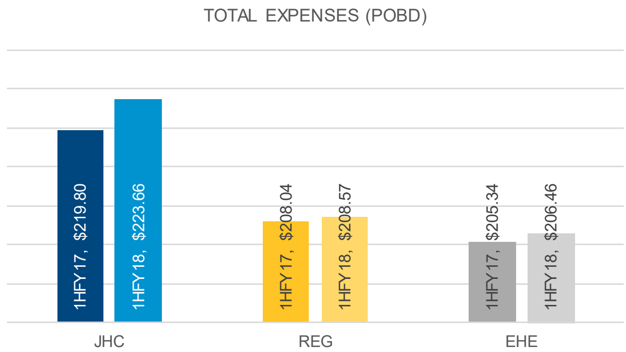
DAP income is a significant driver for all three and on first glance, there is little difference in the POCBD run rates across all three despite large variances in average incoming RAD prices. The main factor driving normalisation of the rates is volume. Both Japara and Estia have significantly higher pure DAP payers which more than curtails the absolute price difference that they have relative to Regis in incoming RAD's. In other words, whilst Regis has the highest incoming RAD's, it's revenue base from DAP's is lower as there are fewer pure DAP payers relative to Japara and Estia. That said, the shortfall is made up by the marked difference in Regis combination payers meaning that on a blended basis, the DAP run rate is broadly similar to its peers. Regis resident payment structures are in part due to the portfolio being positioned at the premium to boutique end of the market and reflecting the relatively higher level of wealth and financial acumen.

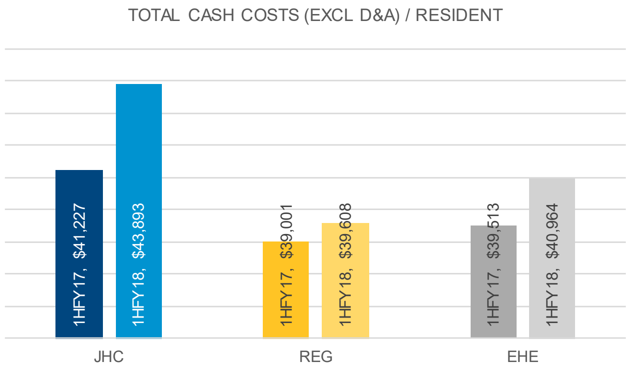
Ultimately, there are limited levers the players can pull to drive revenue growth and with continued pressure on Government funding which represents the majority of total revenue, diversification across the healthcare continuum becomes increasingly important. In this vein, whilst Japara and Regis are both opting for co located retirement villages that will deliver returns over time, provision of home care has not been mentioned. It is fully acknowledged that since the deregulation of the home care space there has been a rapid rise in the number of home care providers and that system is still finding its levelling point between consumer expectations and service capability. Notwithstanding, given these operators are well accustomed with the care aspects of the home care regime, it is a logical step that should be explored especially in the context of their co located retirement villages. After all, the residents will need care and if they don't provide it, the resident will find someone who does.

Costs

Whilst the expense line items are the same across all three groups, each player has different items included resulting in what appears to be vast differences in certain expenses. In assessing run rates on a total expense basis, Japara remains circa $15 POBD above its peers with the majority of the variance stemming from wages. Whilst EBA increases continue to drive the majority of cost increases for all







three players the additional staff costs for Japara are likely to stem from a more people intensive governance structure that goes hand in hand with its' care model.

That said, EBA increases coupled with access to qualified workforce becoming an increasing issue, it is likely that upward wage pressure will persist going forward. Further, with the deregulation of the home care space putting further demands on qualified people, it is likely that retention of key staff becomes a larger problem as people opt for better pay rates and or more flexible work environments interfacing with less acute residents.

Notably, Estia is maintaining a lower total expense run rate relative to its peers driven by its hub and spoke facility structure (as distinct from their previous network structure) as well as electronic systems. There is also an element of timing difference in EBA

	Japara 1HFY17	Japara 1HFY18	Regis 1HFY17	Regis 1HFY18	Estia 1HFY17	Estia 1HFY18
Expense stats						
Wages (POBD)	178.35	181.56	168.23	173.54	157.14	162.50
Resident (POBD)	20.69	21.38	19.63	15.13	25.96	22.81
Administration (POBD)	8.41	6.94	12.71	12.12	8.44	7.88
Occupancy (POBD)	12.35	13.79	7.48	7.78	13.79	13.27
Total expenses (POBD)	219.80	223.66	208.04	208.57	205.34	206.46
Total Cash Costs (excl D&A) / Resident	41,226.94	43,892.53	39,000.84	39,608.28	39,513.21	40,964.07
Total labour Bill as a % of Revenue (per Resident)	67.93%	70.38%	63.22%	66.06%	64.04%	65.56%

increases, which over the remaining six months should see Estia rates approximate Regis.

Ultimately, operational costs are increasing at a faster rate than revenue and therefore, reducing margins unless one is playing in the purely boutique and premium end of the market where the residents are both willing to and have the ability to pay for higher levels of service and accommodation.

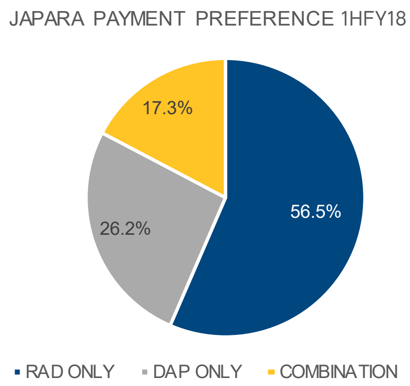
Capital

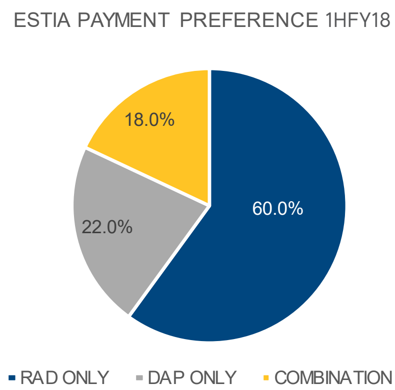
A natural way to offset margin pressure is to increase scale and provide incremental earnings, in order to maintain/ grow earnings. Since deregulation of the licence regime occurred, and the initial inflow from previously non-RAD beds now normalises, growth via development needs to be looked at closely.

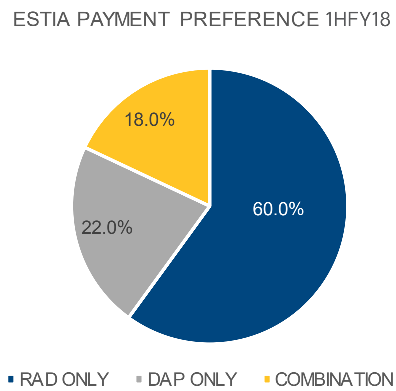
Prima facie it appears that the payment mix across the listed players has stabilised at roughly 60%/40% RAD, DAP mix although anecdotally, we are seeing a greater skew towards DAP's and combination payments whereby the final mix approximates a 50/50 DAP RAD mix. In part, we think that this preference is driven by the relatively low interest rate (5.72%) on which the DAP is calculated and also average lengths of stay decreasing across the broader landscape.

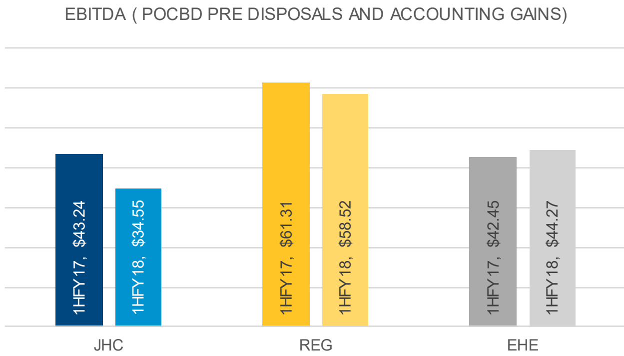
It is likely there is additional correction to come in this space as residents consider more closely their financial structures and seek professional advice on how to minimise their direct costs. Whilst it might be tempting to think that the sector may then be capital starved, there are significant amounts of the capital available from the private and open markets that will readily step in - but for a price.

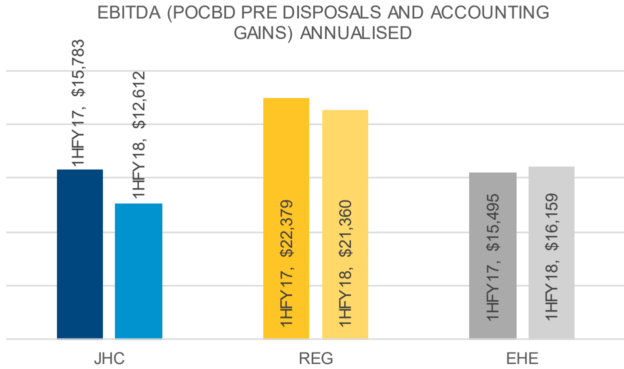
From a capital management perspective, the impact of shortening length of stay is likely to present itself in the form of committed but not collected RAD's and or collected RAD's for a very short of time. Either way, operators generally need to think about how to manage capital adequacy going forward.









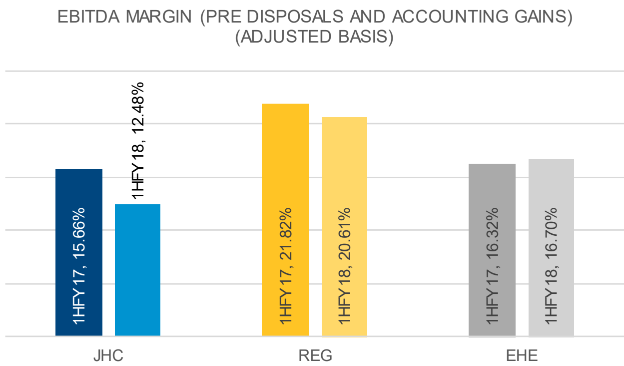


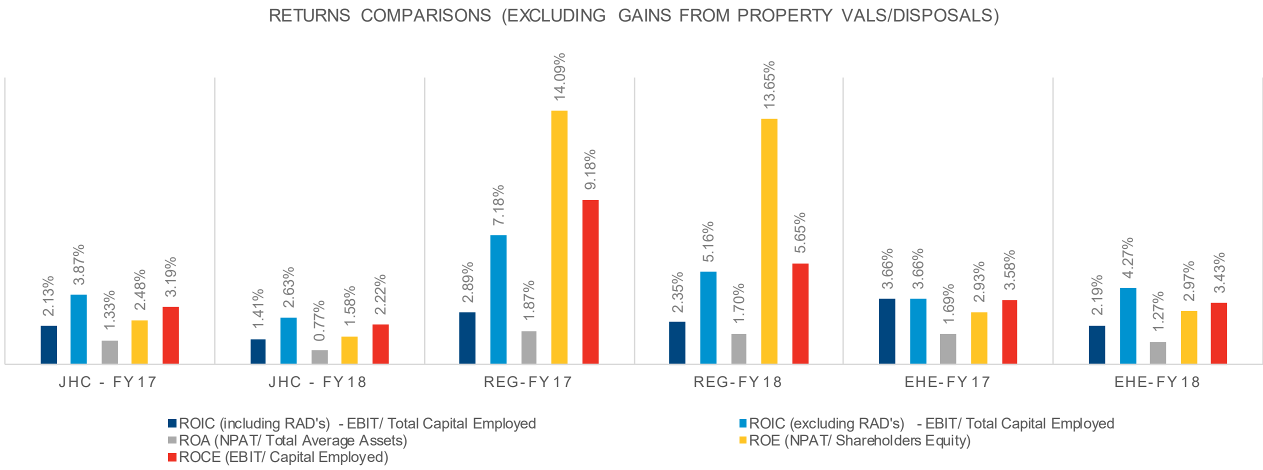
Returns

As yield and return compression occurs across a number of other asset classes, Healthcare in the sense of an umbrella category is increasingly becoming a popular 'alternate investment asset'. In that context, the returns for the half across a number of different metrics are outlined below in order to provide relativities for comparison.

What is immediately clear is dilutionary impact of RAD's in the context of return generation. For a source of capital that is coupon free, incremental earnings are not translating into EBIT efficiently and therefore, the real advantage of RAD capital is eroded quickly.

From the perspective of investment markets, the sector has to find ways of lifting net returns in order to remain relevant for investors on a risk adjusted basis. That said, the sector does offer some unique advantages to other asset classes in that it is counter cyclical to economic downturns, delivers long term cashflow and is underpinned by a demand demographic that is growing at least through to 2050.





Note: Returns outlined are not annualised, nor is shareholders equity adjusted for pre/post listing event. Hence ROE for Regis is particularly pronounced.

Outlook

WHAT TO EXPECT

- More financially aware and astute consumer
- Increase and change in market competition
- Which operating model? Integrated, specialised, general?

The next six months for the operators will be challenging as the full impact of ACFI indexation freezes takes hold and the retirement living and home care sectors continue to innovate and change their operating models, covering more ground than what was traditionally the space of residential aged care providers.

The deregulation of home care has seen an increased rate of the aged population opting to receive their care for longer in their own homes or retirement villages. Albeit, there is still a long way to go before consumer expectations are fully paired with accommodation other than residential care, which by nexus is impacting occupancy rates and lengths of stay across the sector. That said, occupancy will recover more rapidly than last time home care induced a shift in resident care population - when the system was first introduced many years ago and low care effectively disappeared from the residential aged care environment, the impeding volume of RAC users remains high.

The Government is likely to continue to tinker with the funding model as it seeks to manage its outlays not only in residential aged care but across the healthcare spectrum. Whilst a wholesale change to the ACFI framework has been mooted, incremental changes such as adjustments to point scoring or even the set base rates for each domain are far more likely. One also must consider impact of cause and effect – the industry wants deregulation to be able to charge what it likes to consumers, but in that environment, there is little impetus for the Government to fund and therefore, downward adjustments that in order of magnitude at least mirror the uplift are likely to occur. The difference is, deregulation and free markets impact those who can pay, changes to ACFI impacts everyone. A case in point is the decision on the court case arguing the legality of operators being able to charge consumers an ARC (akin to a sinking fund) linked to the physical accommodation. Now that the courts have deemed this to be illegal, revenue pressure has been heightened leading further to a higher volume, lower margin environment.

Those that survive will look to manage costs and charge additional fees where possible, whilst simultaneously managing to minimum levels of maintenance or improvement CAPEX.

Those that thrive will be looking to reposition their business (service and accommodation models) in line with their target consumer base - either diversifying across the continuum of care via integrated retirement villages and allied health as a minimum with either direct home care or via a third party; or becoming smaller in scale, highly specialised with regards to care and moving to a pure fee for service concept.

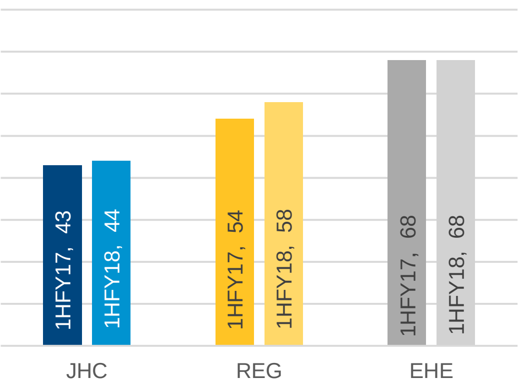
Glossary

Term	Definition
Accommodation supplement	The accommodation supplement is payable on behalf of residents receiving permanent residential aged care who do not have the capacity to contribute to all or part of the cost of their accommodation.
Aged Care Act 1997 (the Act)	The primary legislation governing the provision of aged care services.
Aged Care Funding Instrument (ACFI)	The classification instrument used to pay subsidies to residential aged care services.
Approved provider	An approved provider of aged care is an organisation that has been approved by the Secretary of the Department of Health to provide residential care, home care or flexible care under the Aged Care Act 1997.
Daily Accommodation Payment (DAP)	A rental-type payment which applies to people who entered care after 1 July 2014 and who are asked to contribute towards their accommodation costs.
Earnings Before Interest, Taxes, Depreciation and Amortisation (EBITDA)	Net profit after tax with interest, taxes, depreciation, and amortisation added back to it, and can be used to analyse and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.
EBITDA margin	EBITDA margin shows the average net profit after tax (with interested, taxes, depreciation and amortisation added back into it) generated for each $1 of revenue earned. It's calculated as EBITDA/total revenue.
Facility	A residential aged care facility, approved under the Aged Care Act 1997 to provide government subsidised accommodation and care.
Home and Community Care (HACC)	A program that provides basic support and maintenance to people living at home to help avoid premature or inappropriate admission to long-term residential care (Victoria and WA only). Note: the former Commonwealth HACC program was consolidated into the new CHSP from 1 July 2015.
Home care	Home based care provided through a home care package to help older Australians to remain in their own homes. Home care is provided through the Home Care Packages Programme.
Home care package	A package of services tailored to meet the care needs of a person living at home. The package is coordinated by an approved home care provider, with funding provided by the Australian Government (with some contributions from the consumer). Home care packages range from level 1 to 4 depending on the care needs of the consumer. This program commenced on 1 August 2013 and replaced the Community Aged Care Programme.
Home Care Packages Programme	An Australian Government funded programme which has as its objectives to assist people to remain living at home and enable consumers to have choice and flexibility in the way that care and support is provided at home. The Home Care Packages Programme commenced on 1 August 2013.
Maximum Permissible Interest Rate (MPIR)	The MPIR is the rate used to calculate the equivalent daily payment of a refundable deposit. The refundable deposit is multiplied by the MPIR and divided by 365 days. The MPIR is determined in accordance with Section 6 of the Fees and Payments Principles 2014 (No. 2). The MPIR is available on the Department of Health website and is updated every three months.
Net Profit Before Tax (NPBT)	The NPBT is determined by revenue minus expenses except for taxes.
Net Profit (Before Tax) Margin	Shows the average profitability generated on each $1 of total revenue. It is calculated as Net Profit Before Tax / total revenue.
Operational places/ packages	Operational place refers to a place that was allocated and has since become available for a person to receive care.
Per resident per annum (prpa)	A measure relating to residential aged care residents that converts service financial data to daily amount per resident.
Refundable Accommodation Deposit (RAD)	A lump sum payment applicable to people who entered care after 1 July 2014 and who are asked to contribute towards their accommodation costs.
Residential aged care	A programme that provides a range of care options and accommodation for older people who are unable to continue living independently in their own homes.
Retained earnings	Refers to the percentage of net earnings not paid out as dividends, but retained by the company to be reinvested in its core business, or to pay debt. This is recorded under shareholders' equity on the balance sheet.
Weighted Average Cost of Capital (WACC)	The average cost of financing the assets of the entity weighted by the use of its debt and equity.
Working Capital	Defined as current assets less current liabilities.

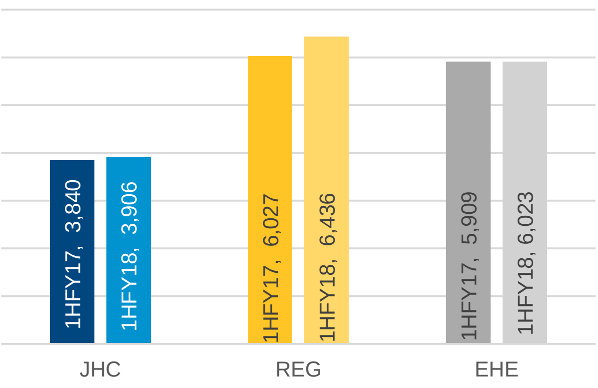
Aged Care Listed Market Analysis 1HFY18

PORTFOLIO STATISTICS

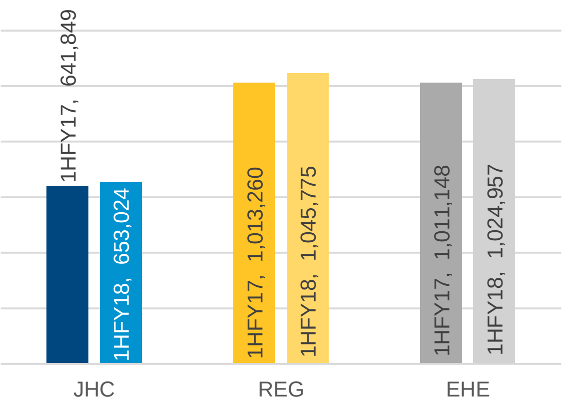
NUMBER OF FACILITIES



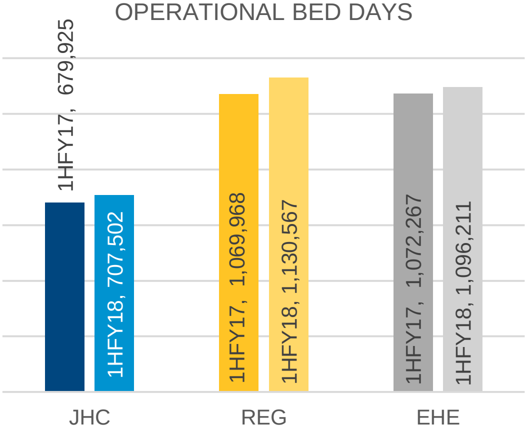
NUMBER OF OPERATIONAL PLACES



OCCUPIED BED DAYS

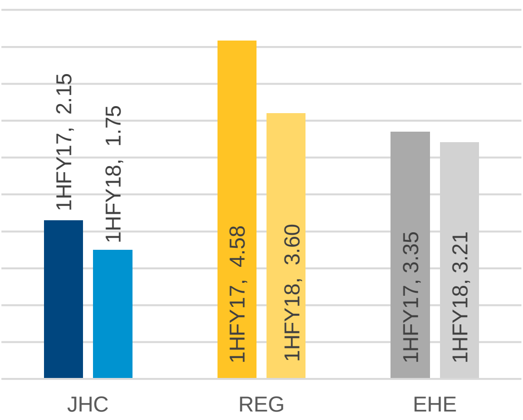


OPERATIONAL BED DAYS

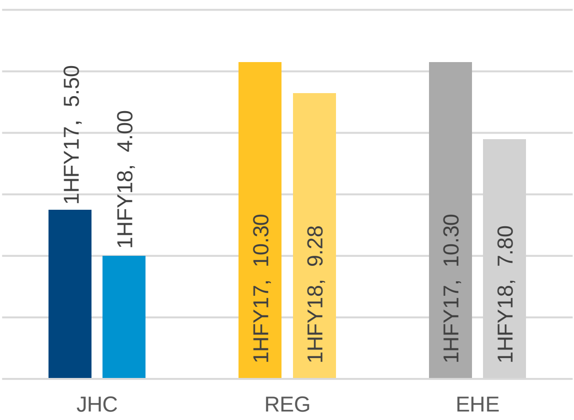


MARKET STATISTICS

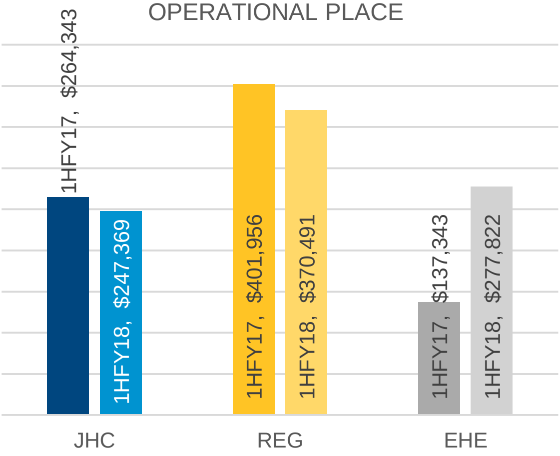
SHARE PRICE



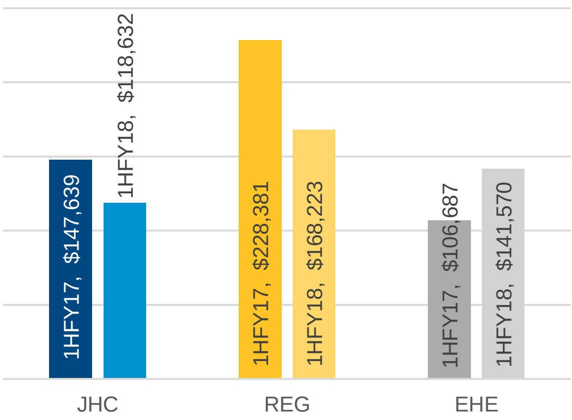
EPS (CENTS PER SHARE)



MARKET ENTERPRISE VALUE PER OPERATIONAL PLACE



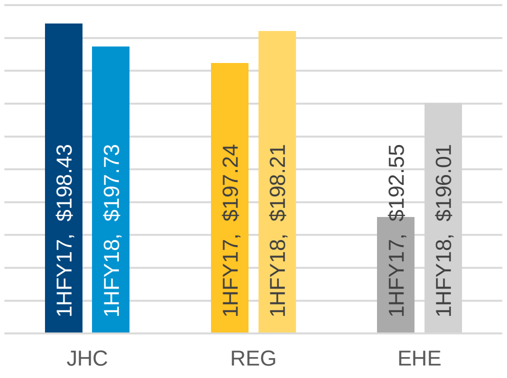
MARKET CAPITALISATION PER OPERATIONAL PLACE



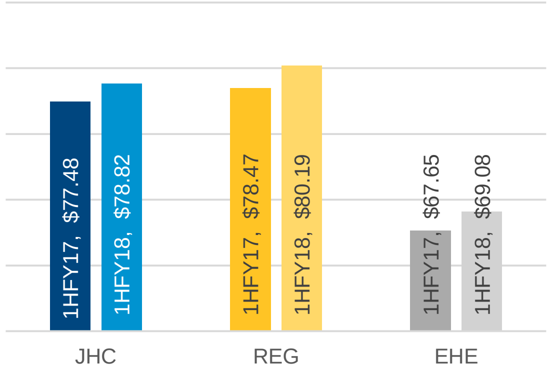
Aged Care Listed Market Analysis 1HFY18

REVENUE STATISTICS

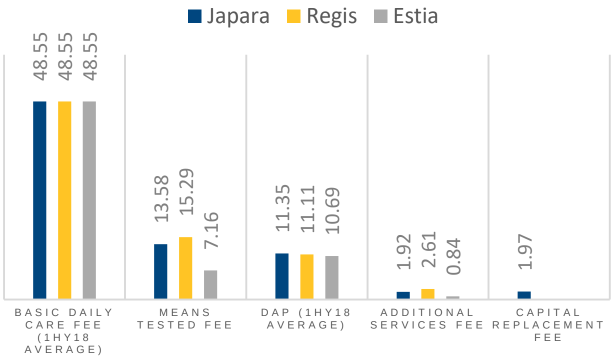
GOVERNMENT REVENUE (POCBD)



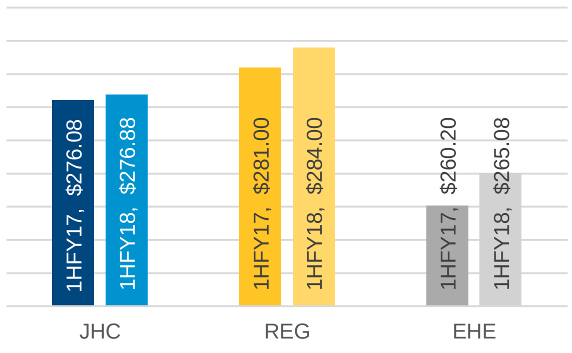
RESIDENT REVENUE (POCBD)



RESIDENT REVENUE COMPOSITION ($ POCBD)

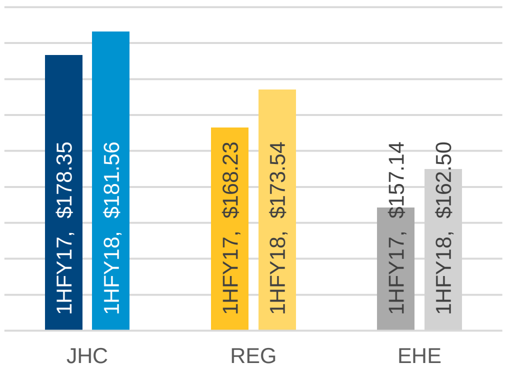


TOTAL REVENUE (EXCLUDING OTHER NON-RECURRENT INCOME)

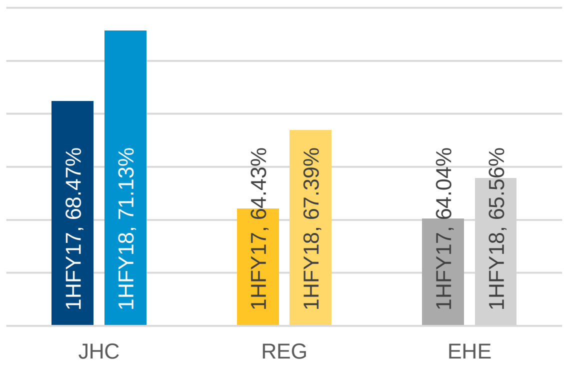


LABOUR COST COMPARISON

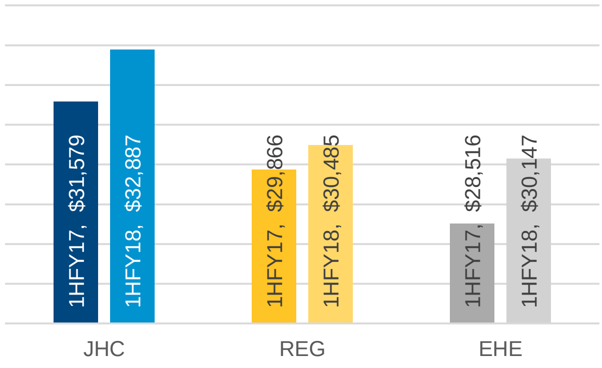
WAGES (POBD)



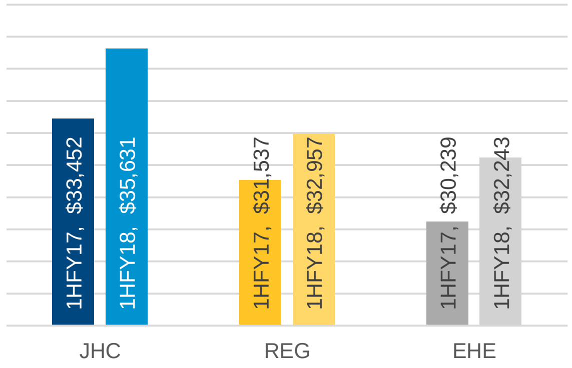
TOTAL STAFF COSTS (WAGES/TOTAL REVENUE)



TOTAL LABOUR BILL/ OPERATIONAL PLACE



TOTAL LABOUR BILL/ RESIDENT



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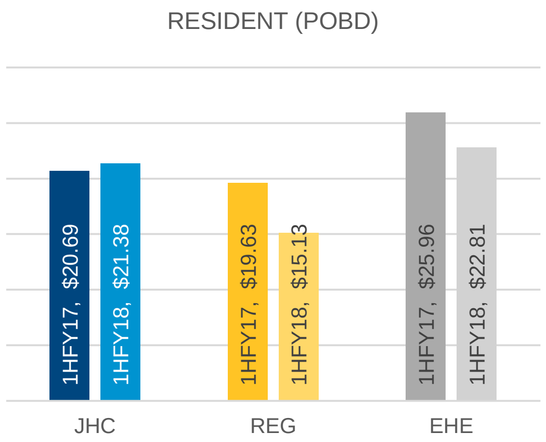
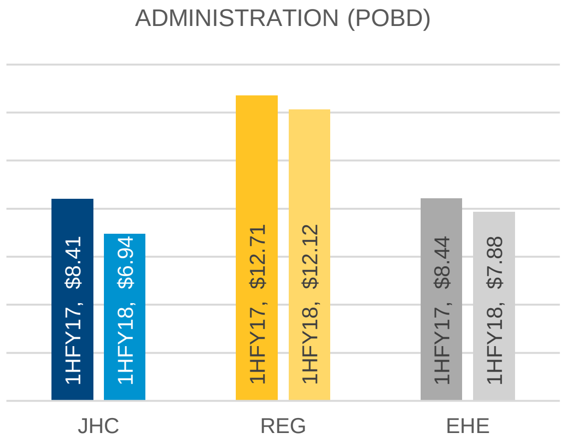
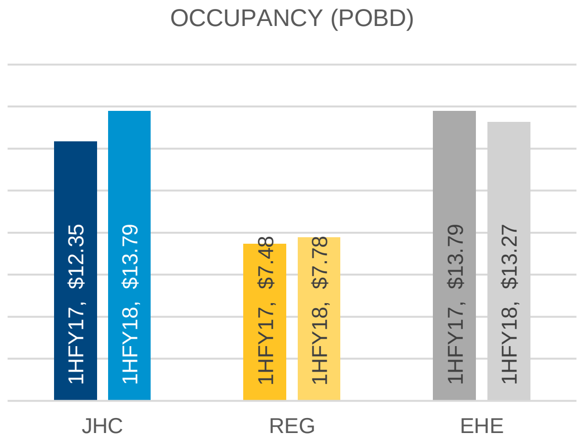
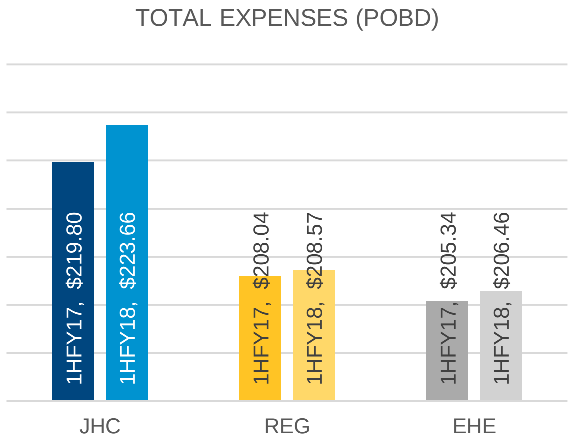
OPERATIONAL COST COMPARISON

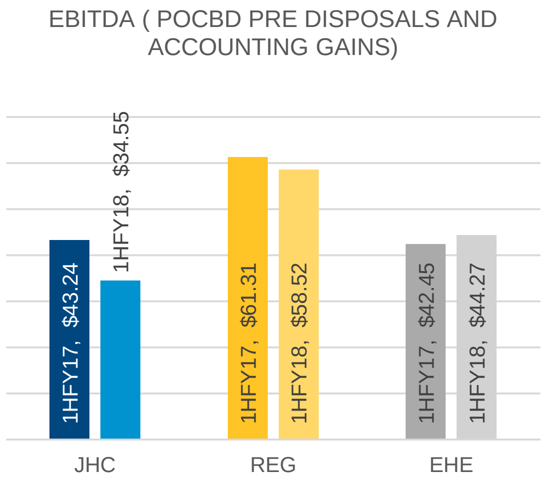


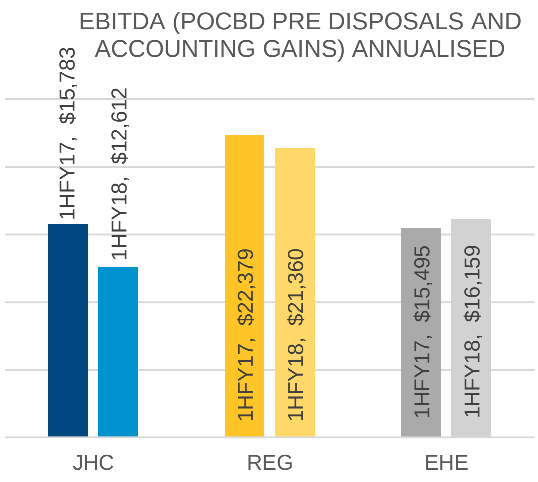


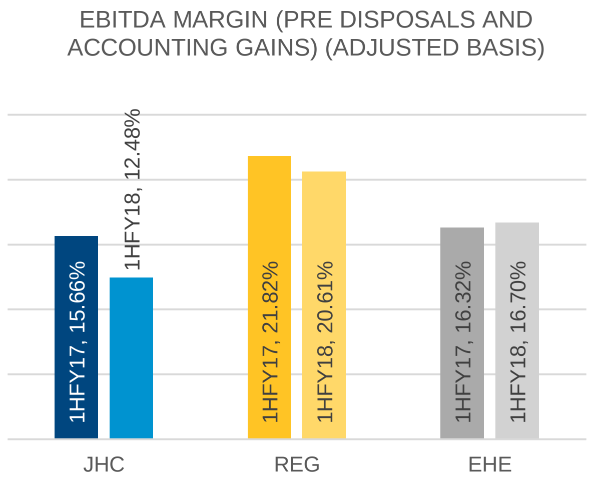


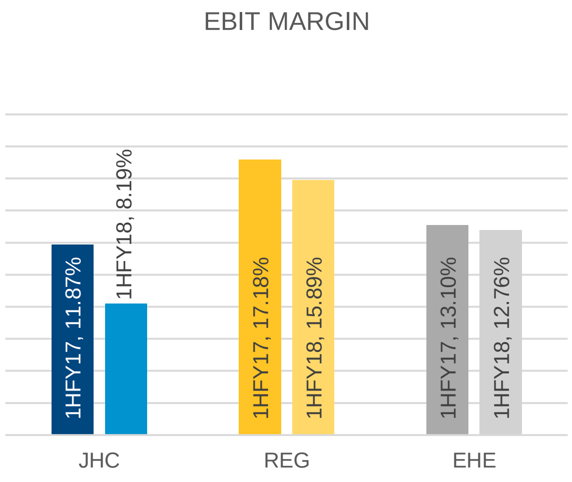


EARNINGS COMPARISON









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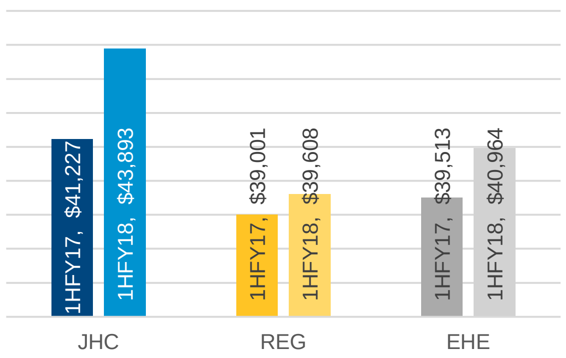
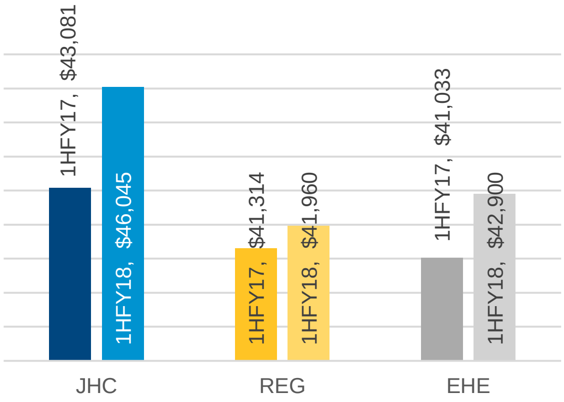
OPERATIONAL COST COMPARISON

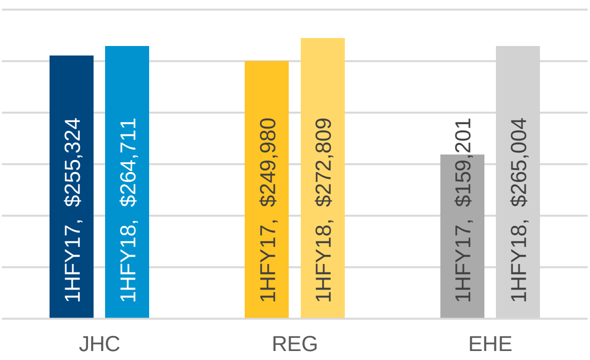
TOTAL CASH COSTS (EXCL D&A) / RESIDENT



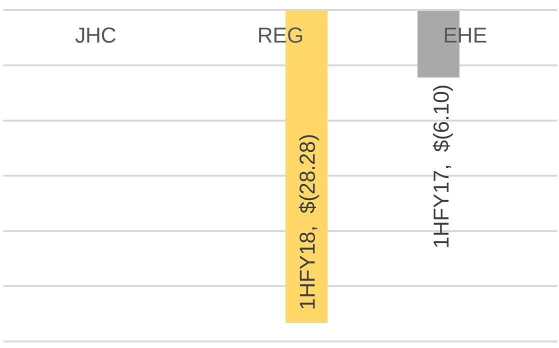
TOTAL CASH COSTS / RESIDENT



CAPITAL DEPLOYED PER BED

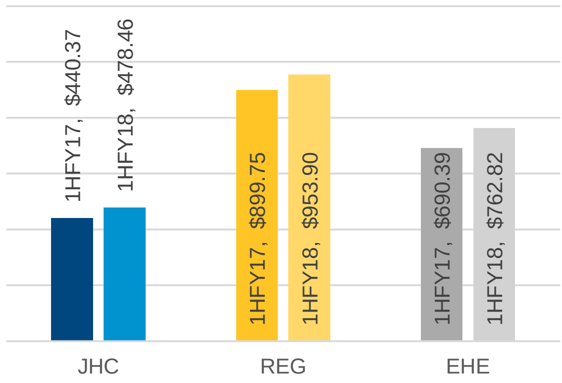


CASH SPENT ON ACQUISITIONS

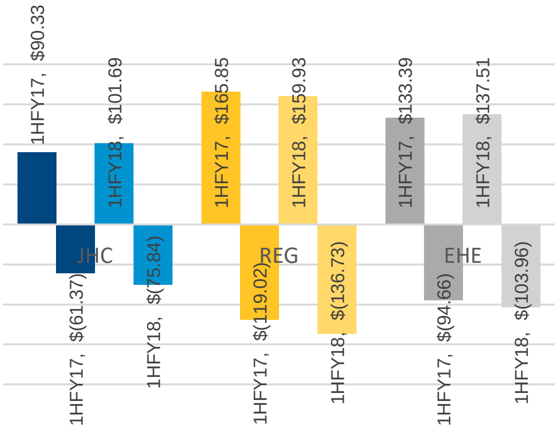


CAPITAL

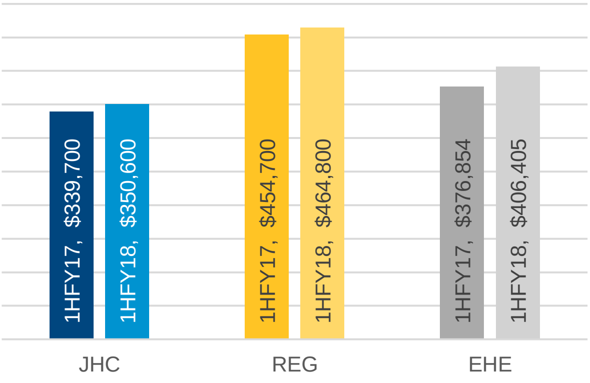
RAD'S/BONDS BALANCE ($M'S)



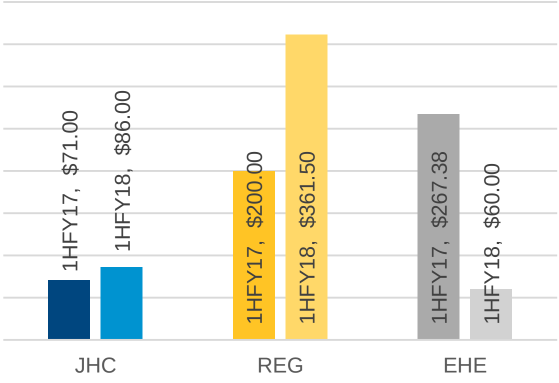
CASH IN/ CASH OUT FROM RAD'S



AVERAGE RAD AMOUNT INCOMING



INTEREST BEARING DEBT $ MILLIONS



Note: All net RAD flows for groups are positive, the smaller numbers depicted above is RAD outflow

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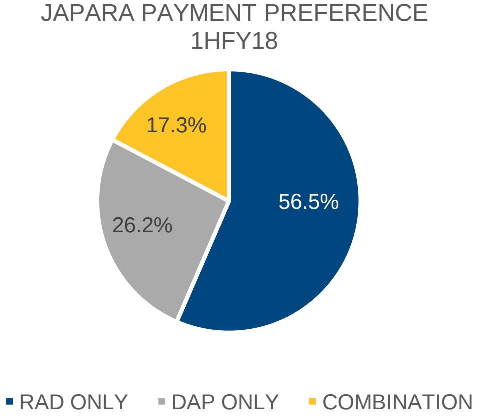
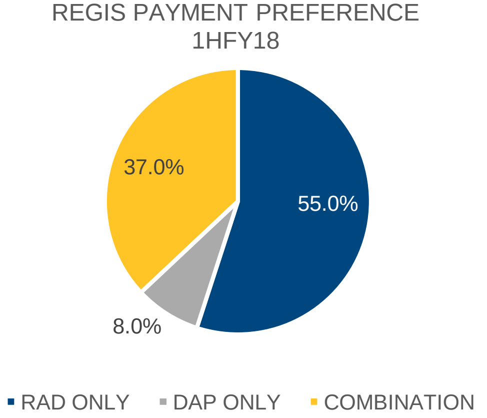
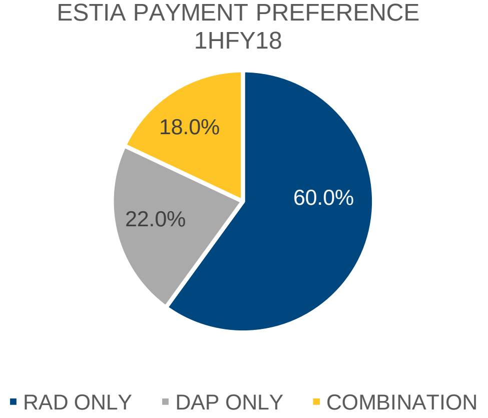
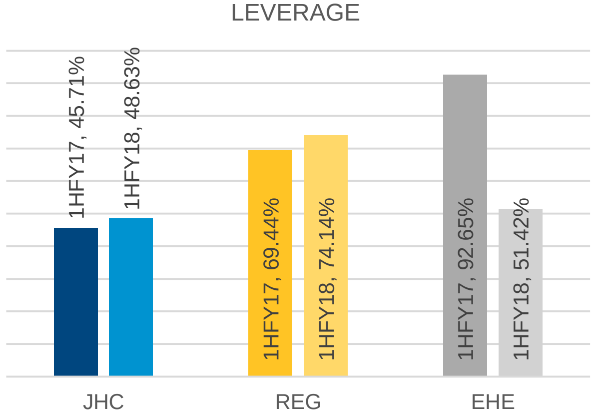
PAYMENT PREFERENCE AND LEVERAGE









RETURNS COMPARISON