A MORE SUSTAINABLE INVESTMENT STRATEGY?

Why active investment strategies are crucial to sustainable aged care

Perpetual

Executive summary

"When the facts change, I change my mind.
What do you do...?"
John Maynard Keynes, economist

Faced with rising costs and falling occupancy rates, many aged care providers need to put their facilities on a stronger financial footing. In this White Paper we ask if a change to investment strategies can help underpin a more sustainable aged care sector.

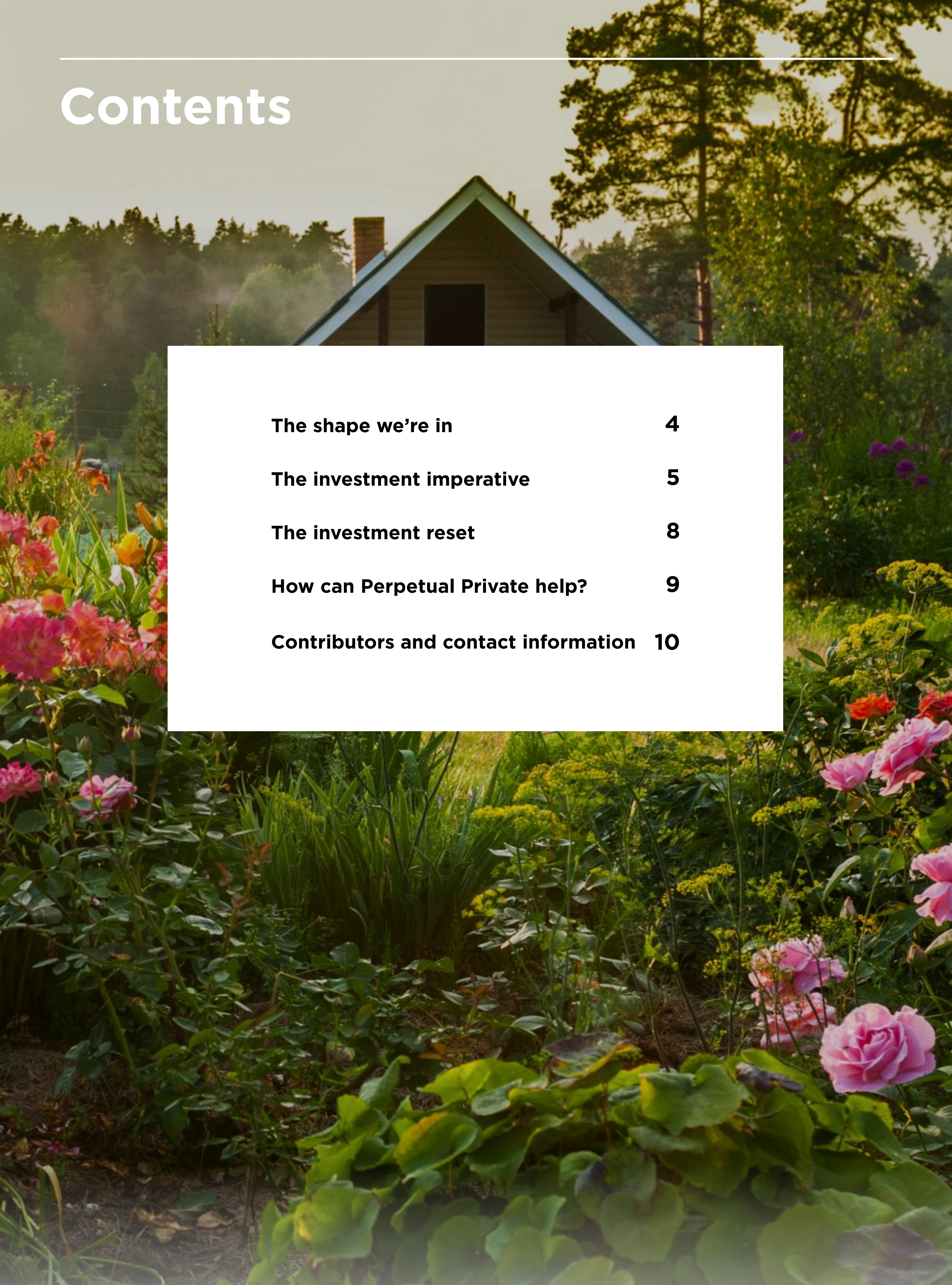
Aged care providers are dealing with significant cost pressure arising from sliding occupancy, COVID-19 effects and major cost increases likely to be imposed onto the sector in the aftermath of the Royal Commission into Aged Care Quality and Safety. This threatens the long-term sustainability of some providers.

One lever that aged care leadership can pull to offset these cost pressures is improved investment performance. With over A$25 billion in investable funds in the Refundable Accommodation Deposit (RAD) pool, aged care providers have scope to generate more income – if they make a strategic shift in their investment philosophy.

RADs must be promptly repaid when due and aged care providers' boards are naturally cautious about investing in volatile markets. However, a strategy that better balances risk and return has the potential to relieve some of the pressure on aged care sector balance sheets.

Over the past five years (including COVID-19 impacts) a conservative diversified portfolio would have provided significantly higher returns than a traditional portfolio based around Term Deposits.

In making this strategic shift aged care providers need to carefully calibrate their new investment strategy to suit their specific needs.



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The shape we're in

To be truly sustainable, any industry and any organisation within it must have a grasp of the issues influencing future success as well as current performance. So, what are the short and long-term factors affecting the Australian aged care sector today? What levers can leaders within the sector pull to enhance their short-term position and long-term sustainability?

Pressures

COVID-19

The pandemic has put intense pressure on staff, leadership, resources and, most importantly, clients within the aged care sector. Ongoing efforts to mitigate the threat that COVID-19 poses to aging Australians will continue to add complexity, costs and risk to aged care operations across the country.

Occupancy rates

In recent years, occupancy rates in aged care have slid as government policy – in particular, a focus on better resourcing and funding for Home Care - has reduced the flow of potential clients. COVID-19 has further exacerbated this pressure with concerns about safety in an aged care setting discouraging potential clients from making the aged care choice. According to a recent report from aged care technology organisation, Mirus Australia, occupancy rates are now at 10-year lows.[1] The rate of occupancy in 2019 was 89.4%, continuing a steady decline.[2]

Royal Commission

The effects of the Royal Commission will be rolling out for years to come and its recommendations will intersect with many changes required by the sector's response to the pandemic. Increased levels of reporting and accountability are a given and this has implications for costs and management focus. Even more importantly, additional staffing and higher wage costs are almost certain if the Royal Commission's expected reform package is implemented. It suggests, for example, an extra 80,000 staff and significantly higher training and wage levels will need to be in place by the end of the decade.[3]

Strengths

Underlying demand

Despite the increased focus on Home Care services and the short-term impact of COVID-19, demographics still favour growth in the aged care sector. According to a recent Royal Commission paper, the number of Australians aged 85 and over will double by 2050.[4]

Resilient property markets

Over the past decade operators have been warned repeatedly to factor house price falls and their effect on RADs into their thinking. However, these fears have largely been unrealised. In the aftermath of the GFC, the pre-election slump of late 2018 and the early impact of the COVID-19 crisis, house prices in Australia have been resilient. Seven out of eight state capitals saw house prices rise in October 2020.[5]

[1] https://hellocaremail.com.au/covid-19-drives-aged-care-occupancy-rate-10-year-low/
[2] Aged Care Financing Authority, Eighth Report on the Funding and Financing of the Aged Care Industry – July 2020 https://www.health.gov.au/resources/publications/eighth-report-on-the-funding-and-financing-of-the-aged-care-industry-july-2020
[3] https://agedcare.royalcommission.gov.au/news-and-media/high-quality-aged-care-affordable-and-achievable-7-september-2020
[4] Aged Care Reform: Projecting Future Impacts, September 2020 (Research Paper 11, Royal Commission into Aged Care Quality and Safety).
[5] https://www.afr.com/wealth/personal-finance/house-prices-rise-for-first-time-in-october-20201022-p567qz

The investment imperative

What does this very brief review tell us? Whilst the aged care sector is supported by resilient property markets and strong underlying demographics, pressures arising from the Royal Commission, COVID-19 and Government policy are pushing up costs and challenging the viability of the sector. Indeed, in a recent BDO report for the Aged Care Royal Commission, the accounting firm suggested some 10% of Residential Aged Providers were 'not viable' while a further 39% "may be viable."[6]

In this situation aged care leaders need to use all the levers they can pull to improve financial performance. One of those levers is investment performance. In the balance of this paper we look at the issue of investment portfolio performance, why it matters, how it can be improved and the potential benefits for the aged care sector.

Portfolio size

Thanks to the 'float' provided by RADs, aged care providers effectively have some A$30 billion[7] investable today. Having worked with a wide range of industry operators, Perpetual believes this very significant sum has been invested too conservatively. The industry runs an overly cautious balance sheet at a time when it should be using all the resources at its disposal to manage both short and long-term cost pressures.

Perhaps understandably, many aged care providers have a relatively conservative investment policy, knowing that at any time they may be asked to refund RADs in full. However, industry analysis suggests that payouts are replaced quickly and therefore industry liquidity is high. Aged care providers do have more room to invest in search of higher returns. Let's have a look at the difference that approach could make.

Optimising aged care providers' investment returns

The chart on the following page compares the capital value and income generated by two different investment options over the 5 years to 30 June 2020. It assumes an aged care provider is investing reserves of A$10m in:

Option 1:
A diversified 'Conservative' portfolio. The asset allocation in this fund comprises 70% defensive assets such as cash, credit and fixed income and 30% in growth assets including local and international shares.

OR

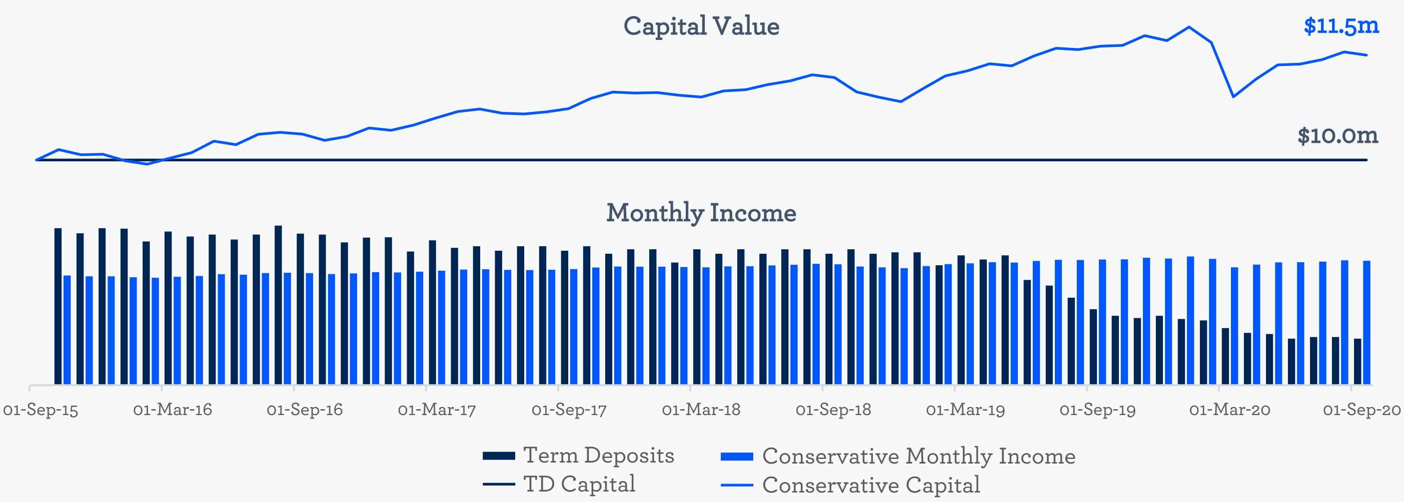
Option 2:
A portfolio where funds are invested purely in Term Deposits.

This is not a model – it's the reality of the past five years and includes the impact of the COVID-19 market falls. Let's pull out the key points.

[6] Report on the profitability and viability of the Australian aged care industry. September 2020 (Research Paper 12, Royal Commission into Aged Care Quality and Safety). https://agedcare.royalcommission.gov.au/publications/research-paper-12-report-profitability-and-viability-australian-aged-care-industry

[7] Aged Care Financing Authority, Eighth Report on the Funding and Financing of the Aged Care Industry – July 2020 https://www.health.gov.au/resources/publications/eighth-report-on-the-funding-and-financing-of-the-aged-care-industry-july-2020

Income and Growth: Conservative portfolio versus Term Deposits, 2015-2020



Source: Perpetual Private

Growth

As you can see, the Conservative portfolio has grown to be worth A$11.5 million, even after income was drawn from the portfolio. The Term Deposit portfolio retains the same capital value (A$10 million).

Income

More strikingly, total income from the Term Deposit portfolio was A$1,014,559, as compared to A$994,650 in income generated by the Conservative portfolio. Whilst the traditional Term Deposit portfolio generated a slightly higher income return over the period (around A$20,000), most of this was made in the early years, and income has recently declined substantially. More importantly, this was offset multiple times by the additional A$1.5 million in capital growth achieved by the more diversified option, so total investment returns on the Conservative portfolio were notably higher. Crucially, that additional capital increases the ability of the portfolio to generate even higher income returns in the future.

"It's important to note that, with just 30% of the portfolio in risk assets, this Conservative fund option is still a positive approach given the long-term nature of aged care providers' investment strategies," says Scott Hawker, Perpetual Private's National Manager, Not for Profit Endowments.

"Aged care Providers that took a more positive approach – perhaps those who have substantial reserves or highly predictable cashflows - might reap even higher returns and offset more of their increased operational costs."

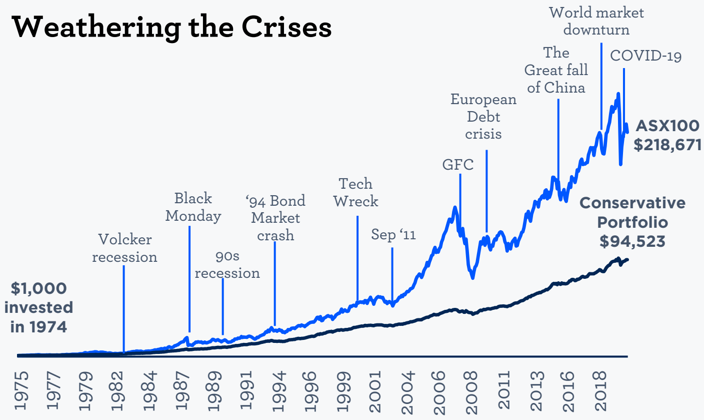
But what about volatility?

Naturally, aged care providers who pursue more diversified investment strategies are 'going up the risk curve' in doing so – exposing their capital to more short-term fluctuations.

But the chart shows, equity market investing rewards a longer-term approach, which gives portfolios more time to recover from the short-term shocks of events like the '87 crash, GFC and COVID-19 crisis. Perhaps more tellingly for aged care providers that may take a relatively conservative view, given current pressures on the sector, it shows how a diversified but conservative investment portfolio has provided long-term growth without the peaks and troughs of an all-equity approach.

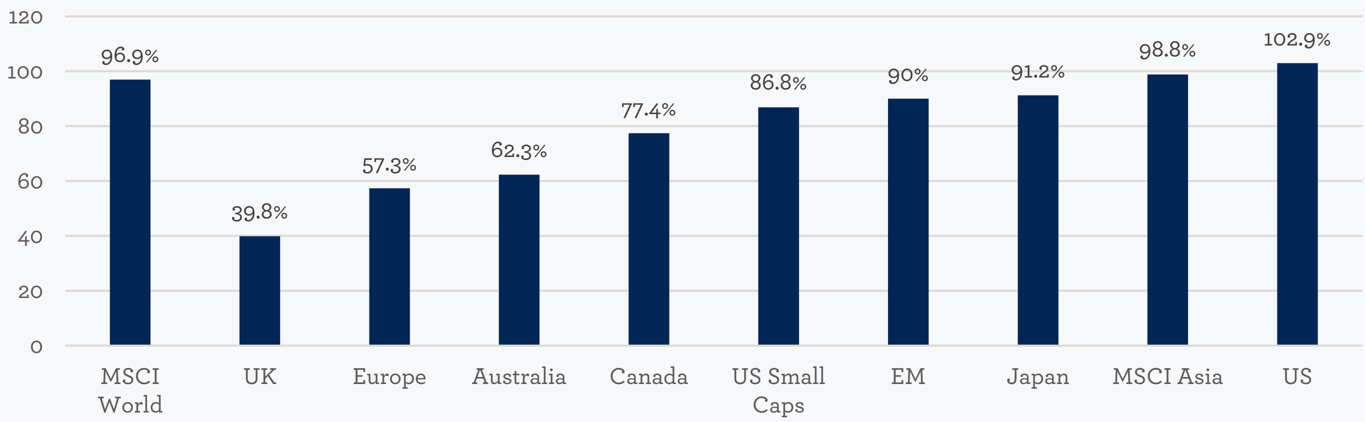
The difference between the two portfolio approaches also underlines the need for a sensible and detailed Investment Management Strategy based on an in-depth discussion with an investment adviser.

Protect and Grow
Weathering the Crises



Source: FactSet

Regional Sharemarket Recovery Rates from March trough (%)



Source: Bloomberg as at 9th October 2020

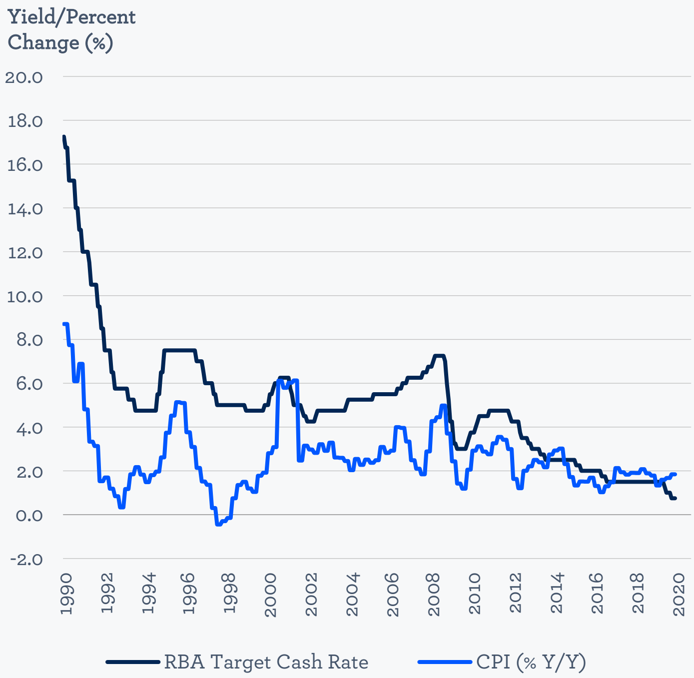
It is also important to note the performance of global equity markets since the nadir of the COVID-19 crisis has been relatively strong (see chart below). The likelihood of further Government and Central Bank support may continue to underpin equity markets over the next few years - especially if a vaccine or some level of community immunity begins to weaken the economic impact of the virus.

The problem with cash

As prefigured above, there's another reason aged care providers should consider a move to a more diversified investment portfolio – the likelihood that income returns from cash-heavy portfolios will continue to fall in the foreseeable future. Currently, the RBA cash rate is below inflation (see chart below), so any interest income being generated on cash/term deposits is being eroded by inflation, delivering aged care providers a negative real return on their cash reserves.

Given the efforts that Central Banks around the world are putting into restarting the global economy, it is unlikely interest rates in Australia will rise significantly in the next five years. That spells a further significant cashflow shortfall if aged care providers do not reassess their current investment strategy.

Cash versus inflation: 1990-2020



Source: FactSet, 2020

The investment reset

So how can aged care providers unlock some extra return to deploy against rising costs and so make their operations more sustainable? Obviously, it is not something that can be done without careful planning and a strategic approach. Some of the issues that need to be considered are:

Cashflows

Predictable RAD cashflows can give providers more confidence in the long-term picture and support a move to a slightly more aggressive portfolio strategy. Strong underpinning cashflows mean less likelihood of any liquidity issues and therefore more scope to invest in higher-returning, long-term assets.

Reserves

Aged care providers with significant reserves may also be able to move to a total return investment strategy. Their larger reserve pool gives them the ability to quarantine funds for liquidity purposes whilst investing for higher returns. In short, critical mass is critical.

Experience and culture

Whilst financial factors are important, the move to a more sophisticated investment strategy embracing higher-returning assets is also a cultural and management issue. Organisations need to ensure that all key stakeholders – leadership, staff and partner organisations - can understand and contribute to this strategic shift.

Time

As discussed above, many aged care providers need to get ahead of coming cost pressures and improve the sustainability of their organisation. However, a strategic investment shift takes time – time for the careful analysis of cashflows, liquidity, operational needs, future expenses and much more. Time invested in this analysis means the 'new' investment strategy can be better tailored to the provider's specific needs.

How can Perpetual Private help?

"Investment strategy changes are a significant but powerful step", says Anthony Hamawi, Aged Care specialist in Perpetual Private. "The key to making them work is to get the leaders of the organisation to work through the organisation's financials, strategy, operational imperatives and goals in a structured way."

Perpetual runs Investment Management Strategy workshops for aged care providers across Australia. They help providers understand the risks, costs and benefits of any strategic investment change and often involve the completion of a liquidity management assessment to ensure the investment shift is aligned to the cashflows and obligations of the organisation.

"The end result," says Scott Hawker, "is an Investment Management Strategy document that gives the leadership the information it needs to make a decision and, crucially, underpins the long-term approach to investment strategy. We've worked with many organisations who have used these workshops and resulting plans to make important changes to their investment strategy – and so improved the overall sustainability of their organisation."

To review your organisation's investment strategy -and learn how improved investment returns could free up cash for operational investment - contact Perpetual Private's Aged Care specialists on the following pages.

Perpetual Private:

Specialist providers of financial services for the aged care sector

Since 1886 Perpetual has safeguarded investments for Australians from all walks of life. We have deep experience as a trusted fiduciary and investment adviser. We have direct and relevant in-house knowledge of the aged care sector, and we understand the need for reliable support for key stakeholders in the sector.

Whether it is by refining liquidity management for the accommodation deposit portfolio, or developing an investment management statement for longer-term funds, our team of specialists can offer a partnership with tailored advice and a range of services to meet the unique needs of aged care providers.

Investment Policy

Defining how your investment portfolio is to be managed and decisions are to be made, based on your organisation's unique objectives.

Strategic Asset Allocation

Identifying the most suitable mix of assets for your portfolio.

Investment Selection & Implementation

Customising a solution to suit the needs of your organisation.

Governance & Capacity Building

Experience and networking opportunities to support your business

Contributors and contact information

Scott Hawker

National Manager,
Not for Profit Endowments
P: 02 9229 9319
M: 0412 288 418
E: Scott.Hawker@perpetual.com.au

Anthony Hamawi

National Business Development Associate,
Not for Profit Services
P: 03 9611 6665
M: 0402 495 448
E: Anthony.Hamawi@perpetual.com.au

NSW Team

Jamie Cockerill

Partner
P: 02 9229 3476
M: 0431 759 546
E: Jamie.Cockerill@perpetual.com.au

Liz Wheatley

Associate Partner
P: 02 9229 3645
M: 0431 006 670
E: Liz.Wheatley@perpetual.com.au

Greg Kynoch

Senior Financial Adviser
P: 02 9229 3944
M: 0422 411 841
E: Greg.Kynoch@perpetual.com.au

Phillip Bures

Financial Adviser
P: 02 6243 6507
M: 0405 796 992
E: Phillip.Bures@perpetual.com.au

VIC Team

Daniel Tome

Partner
P: 03 8628 0567
M: 0421 286 935
E: Daniel.Tome@perpetual.com.au

Katie Pancari

Senior Financial Adviser
P: 03 9665 0271
M: 0481 907 165
E: Katie.Pancari@perpetual.com.au

Brianna Choi

Financial Adviser
P: 03 8628 0522
E: Brianna.Choi@perpetual.com.au

David Hurley

Adviser
P: 03 8628 0525
M: 0481 902 934
E: David.Hurley@perpetual.com.au

QLD Team

Marisa Senese
Senior Financial Adviser
P: 07 3834 5696
E: Marisa.Senese@perpetual.com.au

Scott Hayward
Financial Adviser
P: 07 3834 5684
E: Scott.Hayward@perpetual.com.au

George Marshall
Associate
P: 07 3834 5602
E: George.Marshall@perpetual.com.au

WA Team

Chris Marshall
Partner
P: 08 9224 4412
M: 0422 236 174
E: Chris.Marshall@perpetual.com.au

Bruce Cooper
Senior Financial Adviser
P: 08 9224 4437
M: 0481 007 844
E: Bruce.Cooper@perpetual.com.au

Daniel Gallacher
Senior Financial Adviser
P: 08 9224 4461
M: 0466 334 280
E: Daniel.Gallacher@perpetual.com.au

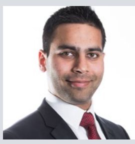
Tyler Hurley
Financial Adviser
P: 08 9224 4403
M: 0402 974 871
E: Tyler.Hurley@perpetual.com.au

Rebecca Galvin
Associate
P: 08 9224 4465
E: Rebecca.Galvin@perpetual.com.au

SA Team

Andrew Parker
Partner
P: 08 8418 5611
M: 0401 544 056
E: Andrew.Parker@perpetual.com.au

Kathy Porter
Senior Financial Adviser
M: 0429 419 874
E: Kathy.Porter@perpetual.com.au



Prabhat Mehla
Financial Adviser
P: 08 8418 5663
M: 0481 006 671
E: Prabhat.Mehla@perpetual.com.au

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This document is dated 30 October 2020. 3107_PPACSI_1020

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