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THE THIRD WAVE OF CONSOLIDATION

A NEW INVESTMENT CYCLE BEGINS IN THE AGED CARE SECTOR

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CAM ANSELL

Just 6 years ago, we released our report on the Second Wave of investment in aged care. The industry was booming and capital investment was ramping up as private equity and foreign investors descended on a market full of promise. Within a stagnant economy, the newly listed aged care providers were the ASX darlings.

So much has happened since then – the Federal Budget Cuts of 2016, a Royal Commission, COVID-19 and most recently the Government's "reform" response. All of these are now culminating into the next investment cycle.

Whilst the second wave was driven by investor confidence, this wave will be carried by a will to survive as the Federal Government ramps up its compliance regime and austerity funding arrangements. The combined pressure of COVID-19 and the Royal Commission has seen an exodus of leaders and clinicians, spreading management talent thinly across an expanding sector.

This is a dangerous place for small operators and many large providers are positioning to scale up and bunker down against more stormy weather. As latent demand builds within an ageing population, the mergers and acquisitions market is now moving into full swing.

The Federal Government has cleverly avoided the Royal Commission recommendations for an entitlement based aged care system and it retains tight control over supply and price for now. Consumers and providers will do it tough for a couple of election cycles.

Despite all of these challenges, aged care represents one of the few certain growth markets in a post-COVID-19 world. For those that can get through this next period, a very different consumer market awaits – the Baby Boomers. In an environment of empowered consumers, the government will have little choice but to address the Royal Commission's recommendations in earnest.

And the fourth wave will begin.

Until then, it's time to get big, get tough or get out!

WHAT DOES THE FUTURE LOOK LIKE?

It's the first question our clients are asking us.

After a year of COVID-19, 30 months of a Royal Commission, and finally a lacklustre Federal Government response (Budget 2021), the sector is seriously fatigued.

The impact of COVID-19 was not only devastating for the residents and staff of nursing homes in which almost half of Australia's deaths occurred, it was damaging for a sector still reeling from the austerity measures introduced in the 2016 Federal Budget.

While many hoped for answers in the Royal Commission, the report drew little attention from the media or the public. Although well-meaning, the authors proposed a utopian future for aged care that required a level of public empathy that was far too optimistic. They proposed that their new system would be funded by an Aged Care Levy that could never be supported by either political party and the two Commissioners had inconsistent views on how reforms should be introduced.

It was the perfect scenario for the Morrison Government who was able to bypass the central recommendation for a needs-based system and retain the 24-year-old ration-based system. They also managed to add safeguards that should keep the sector off the public radar for at least two election cycles and removed the Aged Care Financing Authority which publicly tracked the financial impacts of government policy.

During this time, nursing home developments across the country have virtually ground to a halt. The clock is ticking on the massive Baby Boomer consumer cohort and the Federal Government's aged care infrastructure targets now cannot be met in time for them based on current dependence levels.

The Royal Commission did force the Federal Government to move forward with the implementation of case-mix funding and minimum staff levels. These will move the aged care system more in line with the acute hospital sector. Residential aged care will become more focussed on clinically, sub-acute models. The quality regulator will have additional funding and authority to police these changes.

If the Federal Government's investment in home care can be sustained, the demand for substitute services will grow exponentially against an ageing population that is far more demanding than present day consumers.

It's not the change the sector hoped for, but for those that can see beyond the hurdles – there are opportunities for growth. There is also a huge amount of international investor money looking for a home. The certainty of ageing provides some hope in this unsettled COVID-19 era and international investors are looking at Australia's aged care and retirement living sectors very seriously.

We believe that the aged care sector will be shaped by 6 major influences:

1. **Migration of executive and clinical** talent away from the sector after COVID-19 and the Royal Commission;
2. **Mandated staff hours** and minimum clinical inputs (Registered Nurse hours);
3. Increased resourcing of the Government's **quality regulator**;
4. Move to **case-mix funding** - Australian National Aged Care Classification (AN-ACC);
5. Greater availability of **Home Care packages within an ageing population**; and
6. Changing **investment appetites**.

Departure of Leadership and Clinical Talent

In October 2019, the Royal Commission released a damning interim report, entitled “Neglect” which was highly critical of those working within the aged care industry. The report came as a shock to many industry leaders as well as the nurses and carers on the front line. The Royal Commission research later determined that the cause of the “neglect” was under-resourcing, but much of the damage had been done. Providers across the country have found it increasingly challenging to recruit clinical and executive talent within a system marred by the Royal Commission’s publications and a frenzy of negative media.

The impact from COVID-19 has dramatically worsened this position and there are an unprecedented number of homes across the country unable to secure qualified staff to meet client need. While all States and Territories have been impacted, Victoria has been hardest hit. Over the 2020 Christmas period, after the peak infection, some of our larger Victorian clients lost up to a third of their facility managers.

This paradigm is particularly challenging for small providers, most of which can offer only limited career opportunities. A loss of key executives and clinical staff, or sustained loss of care staff, will place at risk the entire operation. This becomes more acute under a heavier compliance regime (refer below) and mandated minimum staffing levels. For small operators, these issues cannot be addressed through the sharing of resources between sites.

Increased resourcing of the government’s quality regulator

In May 2021, the Federal Government committed $263 million to strengthen the powers of the Quality regulator and significantly increase the number of audits. Providers are already facing workforce challenges and they will now be competing with the Aged Care Quality & Safety Commission as they expand their assessor teams.

The proactive management of clinical leaders is the key to survival in this new reality. This means rethinking the way providers structure their organisations, communicate within their teams and reward those that embody our vision of service quality and clinical compliance.

Investment in systems, people and monitoring requires considerable resources and the future compliance environment is more conducive to larger organisations. Non-compliance determinations within smaller organisations is already causing the divestment and closure of nursing homes across the country.

Casemix Funding

The Government committed to the introduction of Casemix funding in 2018 and the current funding instrument is scheduled for replacement next year. Casemix funding is normally used in hospitals and the Federal Government has had no practical experience implementing it in residential aged care. Early site trials have revealed significant inconsistencies between resident acuity levels assessed under AN-ACC.

Given the extremely tight financial margins in aged care, the introduction of an untested funding model may place this vulnerable sector in a precarious position. Resident subsidies will be drawn essentially from the same funding pool, but the re-allocation of funds through a new instrument is likely to produce winners and losers, as the Government tries to correlate funding with consumer need.

For larger providers, there may a balancing of fortunes within a scale portfolio – underfunding in one home could be offset by over-funding in another. Unfortunately, 54% of residential aged care providers are small and most of these are already losing money from their current allocation of the funding pool.

Mandated Staffing Hours

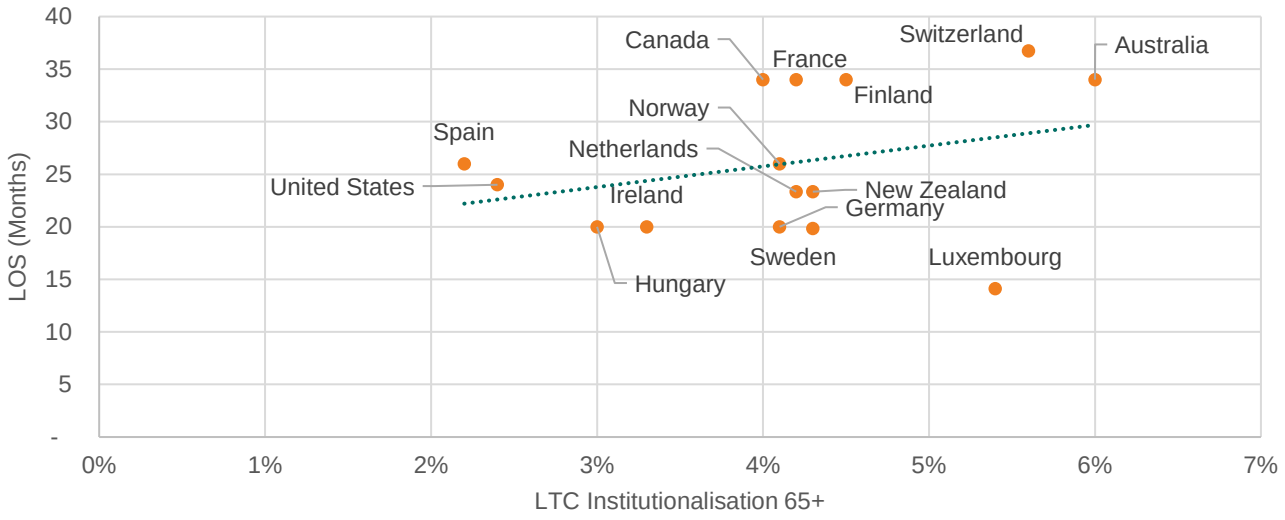
The 2021 Federal Budget allocated additional funding to maintain a minimum mandatory staff allocation of 200 minutes per resident per day by 2023. Included in the mandated time is 40 minutes of Registered Nurse contact.

The Federal Government will need to refine its funding arrangements to accommodate this change, but the ability to recruit and retain sufficient staff is the greater challenge. The delivery of these staff resources and monitoring of allocations will require new investment and additional recurrent administration.

In combination with Casemix funding, the focus will need to be on resource efficiency as is inherent in the hospital sector. This will tend to shift the pendulum of residential aged care toward clinical models and sub-acute service delivery.

Compounded by the growth in home care options (see below), we are likely to see an increase in acuity levels among the resident population and a decline in lengths of stay. This would bring us more in line with averages experienced in the rest of the developed world.

Graph 1: Select Countries, LOS and LTC Institutionalisation Rates, Population Aged 65+



These changes will drive consolidation as experienced in the hospital sector where a relatively small number of providers manage the majority of beds.

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Service Design – the Home Care Influence

Like the acute sector, the management of more homogenous, clinically based service models is likely to favour larger providers. As was experienced in the US, it is reasonable to expect that the design of residential aged care homes would follow suit and we expect that there will be a growth in the number of more efficiently designed, larger homes, particularly in middle and lower income markets.

This presents an opportunity for smaller groups willing to diversify and innovate in the areas of residential aged care substitute services. Assisted living options have become common in countries where the focus of residential aged care is designed to address people with the highest levels of functional dependence.

If the Commonwealth honours its commitment to invest more funding long-term in home care services, the combination of government funded and user pay options in assisted living should increase. As residential aged care becomes more focussed on highly complex, end of life care, there becomes greater potential for the development of seniors' accommodation with care services. This is likely to include both services collocated with residential aged care and standalone developments. A number of our clients are already developing this model.

Changing Investment Appetites

For years, the sector has held its breath while the Royal Commission process unfolded. The 2021 Federal Budget response has brought an end to speculation on change. Our team is now busy with acquisition and divestment projects at a level we have not seen since 2014.

A more sophisticated breed of corporate investors is entering the field and buyer expectation and focus is changing. As expected, Real Estate Investment Trusts (REITS) are gearing up for growth in anticipation of market change and expansion. We are also fielding a large amount of enquiries from foreign investment groups interested in what they see as a growth industry.

We are currently seeing residential aged care growth strategies among larger and mid-sized groups wishing to gain scale. However, we are also seeing renewed interest in residential aged care service substitution models, underpinned by in-home support.

When the Casemix and staff structure changes are embedded within the sector, future financial returns are likely to become more predictable. As the funding and resourcing components of aged care become more predictable and homogenous, the attraction of sophisticated investors will increase. If the Commonwealth is forced to move to an entitlement model as recommended by the Royal Commission, that growth will be exponential and the greatest wave of investment in Australia's history will begin.

It is in troubled times that fortunes are made and innovation emerges. Consolidation is inevitable, but there will be scope for diversified service models within this changing environment. Regardless of your scale, now is the time to revisit your mission, evaluate its relevance in this emerging market and get big, get tough or get out!

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