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JAPARA

Committee Secretary
Senate Finance and Public Administration Committee
Department of the Senate
P.O Box 6100
Parliament House
CANBERRA ACT 2600

26 November 2008

Dear Sir/Madam,

I am writing in respect of the Senate Inquiry into the viability and sustainability of the aged care industry.

By way of introduction, Japara is one of the largest private sector Approved Providers in Australia and we currently have a portfolio of 32 aged care facilities which comprise some 2,615 beds. We are constructing an additional 3 facilities being a 136 bed facility in Launceston (75 high and 61 low care beds due for completion in March 2009) a 120 bed facility in Bundaberg (50 high care and 40 low care beds due for completion in late 2009) and a 60 bed extension in Doncaster (60 low care beds due for completion in late 2009).

We feel there is a great opportunity to see long term sustainable reform in our industry, so providers can continue to provide high quality and flexible services, which meet the community needs and the ever increasing demand from elderly population.

Whilst this reform may take a number of components which I am happy to discuss with you, I am writing specifically to raise the critical issues affecting the provision of high care places. Firstly, new aged care facilities (high care) are not being built because the cost of building new high care facilities far exceeds the end value, based on current government funding arrangements.

Secondly the cost of upgrading older style existing high care facilities to best practice standards and 2008 compliance is significant, however as no additional revenue is obtained to provide a return on this capital expenditure, Approved Providers cannot undertake these essential upgrades.

This is the major issue - It is not financially viable for Approved Providers to either redevelop existing high care facilities or develop new high care facilities in Australia.

This issue needs to be resolved immediately, otherwise the industry will risk failing to provide for the needs of the elderly and frail citizens of Australia.

The population projections by the Australian Bureau of Statistics show that the number of over 65's will rise by from 2.8 million to 6.0 million over the next 25 years, and the number of 85's will increase from 363,000 to 933,000 over the next 25 years. These statistics also indicate that those who do enter residential facilities will increasingly require higher levels of care and therefore the demand for high care facilities over the next 10 years will be significant.

Currently there exists a shortage of new high care facilities in Australia to meet the demand of our elderly, and this will only get worse as our population grows older as the industry cannot afford to build these facilities under current financial arrangements.

The reason for this is that the total cost of developing a new high care residential aged care facility is far greater than its end value. To explain this, I have detailed below a project cost schedule, for developing a new 100 bed high care facility in an outer suburban location of one of our capital cities.

<u>Land</u>

Land Purchase price		
(7,000 sqm @ $500/sqm)	$ 3,500,000	
Stamp Duty	$ 192,500	
Legal fees	$ 2,500	
Land survey	$ 4,000	
		$ 3,699,000

<u>Town Planning</u>

Schematic Design	$ 40,000	
Town Planning Consultant	$ 25,000	
Landscape Report	$ 10,000	
Traffic Expenses Report	$ 10,000	
Planning Application Fee	$ 20,000	
		$ 105,000

<u>Construction Costs</u>

Base Construction Cost	$12,000,000	
Building levy/council charges	$ 55,000	
Electrical substation	$ 30,000	
Furniture and fit out	$ 950,000	
Landscaping	$ 85,000	
		$13,120,000

<u>Professional Fees</u>

Architects	$ 400,000	
Legals	$ 15,000	
Electrical Engineer	$ 145,000	

Building Surveyor	$ 16,000	
Structural and Civil Engineer	$ 200,000	
Landscape Architect	$ 15,000	
Geotechnical Report	$ 15,000	
Fire Engineer	$ 5,000	
Aborist	$ 5,000	
Interior Design	$ 20,000	
Quantity Surveyor	$ 60,000	
Valuation Report	$ 15,000	
		$ 911,000

Finance Cost

30 month development period 16 month construction period Interest on land cost $3,699,000 @ 7.0% p.a. for full development period	$ 647,325	
Interest on Construction costs $13,120,000 @ 8% p.a. for half construction period (S curve)	$ 699,733	
		$ 1,347,058

Bed Licences

Assume bed licences are obtained through Aged Care Allocation Round	$ Nil	
		$ 0

Start Up Costs

Operational losses in 6 month period to get to 95% occupancy	$ 750,000	
		$ 750,000

Total Project Costs **$19,932,058**

Based on the new aged care funding instrument (ACFI) that has recently been implemented by the Department of Health and Ageing, 100 bed high care facility will generate earnings before interest, tax, depreciation and amortisation (EBITDA), once fully operational of between $12,000 per bed to $14,000 per bed, depending upon the management capability of the Approved Provider. Very few aged care providers are generating this level of EBITDA, however if best practice is achieved in processes, management and organisation structure, this level of EBITDA can be obtained on a consolidated and corporatised basis.

At an EBITDA of $13,000 per bed average, a total EBITDA of $1,300,000 per annum can be achieved once the facility is fully occupied and operational.

An independent valuer will currently apply a multiplier of approximately 10 times this EBITDA to determine a value of the facility. Therefore such a facility, upon completion, will have a value of between $13,000,000 and $14,000,000 as a going concern, and indeed this is what the facility would sell for in a normal market. This value is supported by comparable sales evidence and independent valuations conducted for us from organisations such as Jones Lang LaSalle, Ernst and Young and Knight Frank.

Therefore, under current arrangements the construction of a 100 bed aged care facility would result in a capital loss of between $6,000,000 and $7,000,000. No organisation will invest $20,000,000 to create an asset that has a value of $14,000,000.

It is for this reason that the construction of high care facilities is abating and there is not enough supply to meet future demand requirements.

The industry is however building new aged care facilities which comprise both low care and high care or high care extra service because, in some instances, these developments are financially viable. This is because low care and extra service beds generate accommodation bonds which can generate interest for the Approved Provider and increases the income earned to a level which provides a marginal but acceptable return on investment.

This however will change with interest rates on the decline, thus making low care/high care developments marginal in a low interest rate environment. Lower interest rates will reduce interest cost is in the development (on land cost and constructional costs) but this is a capital cost. A reduced income stream is a reduction in an annuity, which has a negative impact on value, which is much more significant.

I have detailed below an immediate solution to this issue which is workable.

- Accommodation bonds or a similar financial instrument should be introduced into high care. This will enable Approved Providers to receive the capital required to build new facilities and complete extensive renovations on older style facilities to bring them up to best practice standards. This will also cover the anomalies surrounding the use of accommodation bonds whereby availability of bonds for low care and extra service high care exist but not ordinary high care places. This leads to unwarranted and inequitable cross subsides and inhibits the flows of funds into provision of ordinary high care places where demand is likely to grow most rapidly.
- A restriction to be placed on Approved Providers so that no less than 25% of their high care beds are maintained as concessional places which cannot attract accommodation bonds. This would ensure that adequate high care beds are made available to the elderly and frail residents of Australia that do not have assets to support payment of accommodation bonds.
- The retention amount from accommodation should be set at 5% per annum of the bond paid.
- The period for which retention fees can be deducted from bonds should be extended beyond 5 years.

The above solution is a user pay solution and therefore will not require the Federal Labour Government to increase funding significantly in the high care sector.

The Australian Government Productivity Commission 2008 report titled Trends in Aged Care Services and the Grant Thornton 2008 Aged Care Survey conclude that the aged care industry is unstainable based on current funding arrangements.

The Grant Thornton report states that the average return on investment is approximately 1.1% for modern single bed facilities, which means the aged care industry is non viable on current funding arrangements.

Both identified that increased annuity funding and accommodation bonds on high care are necessary to ensure the long term viability and sustainability of the aged care sector.

The Federal Labour Government have a great opportunity to ensure our elderly and frail population are provided with the very best care and high quality accommodation by implementing bonds on high care and increasing the funding to the industry, something the previous Liberal governments of the past 6 years have failed to do.

I would be happy to provide you with support documentation if you require and look forward to working with the Federal Government in resolving this most critical issue.

Yours faithfully,

Andrew Sudholz
Chief Executive Officer