

Ageing Australia Remains a Positive Tailwind for Aveo

Strategy of incorporating ancillary health and aged-care services in villages is a differentiator and could deliver long-term value.

Morningstar Equity Research

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Executive Summary

Aveo is substantially ramping up the number of retirement living units it develops annually, but we don't think investors fully appreciate the upside potential from the firm's pivot towards caring for the elderly. We see Aveo undergoing a renaissance of sorts, where the incorporation of healthcare services into a retirement living environment is likely to boost the selling price for each unit. The pivot towards aged care means Aveo will be targeting an older demographic, which supports higher average occupancy and increases the frequency with which Aveo charges deferred management fees. We anticipate that, in outer years, this means the firm will be less reliant on more volatile development earnings.

Key Takeaways

- ▶ The retirement living sector is supported by very positive growth fundamentals, as the number of Australians turning 75 (the average entry age to a retirement village) is set to increase from 142,000 in 2015 to 195,000 in 2020 and 241,000 in 2022, reflecting CAGRs of 6.4% and 7.8%, respectively. With a development pipeline of over 5,000 units, Aveo is well positioned to benefit from this strong organic growth.
- ▶ Retirement unit prices are expected to grow solidly over the next five years, as the sector is already undersupplied and we think the build rate of new units will fall below organic demand. As retirees typically sell their home to purchase a retirement unit, strong recent house price appreciation means residents are well placed to absorb industrywide price increases. Aveo stands to benefit from higher selling prices on the units it already owns and from higher margins on units it develops in coming years.

Aveo is attractively priced, with the current AUD 3.15 price representing a 10% discount to our AUD 3.50 fair value estimate. We see two catalysts that could drive a rerating. The first is the February 2016 acquisition of Freedom Aged Care, which provided the firm with a differentiated proposition in retirement living. Second, the buyout of Retirement Villages Group in August 2016 gives the firm control over an ageing portfolio with significant development upside from upgrading the portfolio to contemporary standards.

Companies Mentioned

Name/Ticker	Economic Moat	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Morningstar Recommendation	Market Cap(Bil)
Aveo AOG	None	AUD	3.50	3.15	Medium	Hold	1.8
Ryman Healthcare RYM	Narrow	NZD	9.10	8.70	Medium	Hold	4.3
Stockland SGP	Narrow	AUD	4.50	4.70	Medium	Hold	11.3

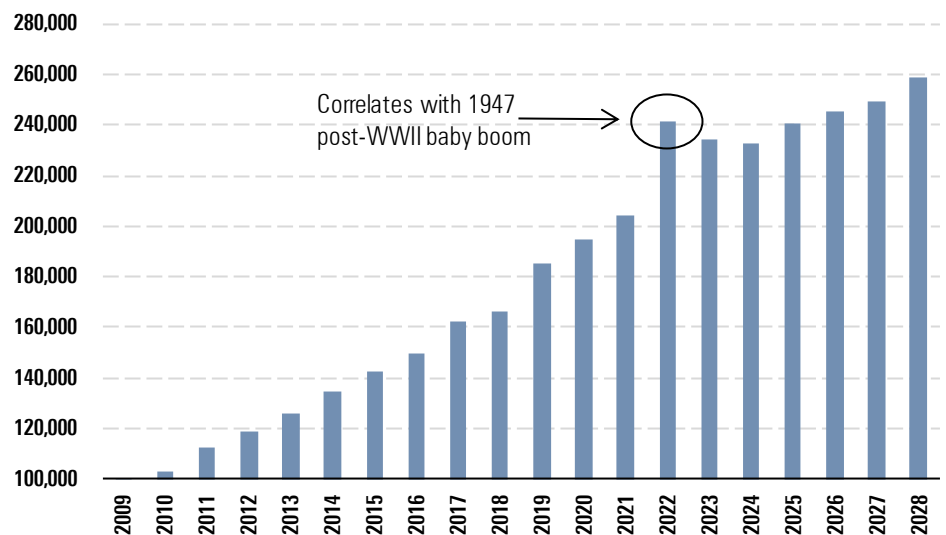
Demographics Underpin Robust Demand Outlook

The Australian population is ageing, pointing to strengthened demand over the next decade for places in Aveo's retirement and aged-care villages. This is a positive catalyst for earnings, as villages should be close to fully occupied and downtime for resident turnover will be short. An ageing demographic will also put upward pressure on prices of independent living units, or ILUs, and serviced apartments, or SAs, as demand for places looks set to significantly exceed supply.

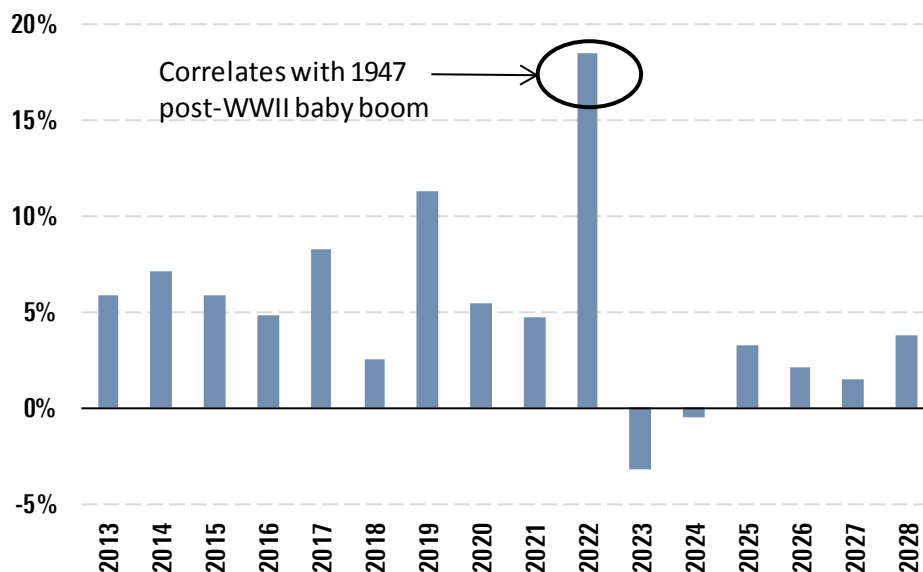
The entry age for retirement villages is highly variable, with residents preferring villages where their age broadly aligns with the average resident age. Aveo's portfolio is consistent with the overall industry, with an average entry age of 75 years and the average age of existing residents at 82 years. In contrast, the average resident age in newly built villages (where the entrance age is usually over 55 or over 65) is significantly lower than that in mature villages.

If we anchor our analysis on Aveo's average entry age of 75 years, Australian Bureau of Statistics demographic data points to exponential growth in its customer base over the coming decade. First, the number of Australians turning 75 was 150,000 in 2016, but will increase to around 240,000 in 2022 (excluding effects of mortality)—see Exhibit 1. Second, while the number of Australians turning 75 will grow at a slower rate from 2022, the natural rotation between age cohorts (that is, the replacement of the small pool of people currently 85 years old with the large pool of those currently 75 years old) will be a further demand catalyst.

Exhibit 1 Australians Turning 75



Source: Australian Bureau of Statistics, Morningstar analysis

Exhibit 2 Annual Change in Australians Turning 75

Source: Australian Bureau of Statistics, Morningstar analysis

Determining the change in demand for ILU/SA accommodation is not an exact science, as the age upon entry is highly variable.

- ▶ Our approach is to estimate the change in the "demand pool" as the difference between the number of Australians turning 75 each year (average entry age) as published by the Australian Bureau of Statistics, with the average resident age (82 years). Notionally, the seven-year difference approximates the average resident stay, being a blend of the typical 10-year stay for ILU residents and four years for SA residents.
- ▶ We estimate that 7% of the population turning 75 will seek to move into a ILU/SA. This figure is above the 5.7% penetration rate (as determined by the Property Council of Australia and Grant Thornton in 2014) for 65-year-olds, as we think the penetration rate will be higher for Australians aged 75. We have also assumed 1.2 people reside in each ILU/SA, based on published metrics of the listed retirement operators.

Combining the above, we deduce an annual requirement for an additional 3,100 new units in 2018, increasing to 5,800 in 2022 (see Exhibit 3).

Exhibit 3 Australian Population Pyramid and Implications for Incremental ILUs and SAs

Year of birth	Turn 75 in Year	Age at June 2015	Number of Australians	Difference to 7 Years Prior	Incremental ILUs/SAs required
1953	2028	62	258,809	54,767	3,195
1952	2027	63	249,457	54,543	3,182
1951	2026	64	245,669	60,771	3,545
1950	2025	65	240,467	74,346	4,337
1949	2024	66	232,902	70,835	4,132
1948	2023	67	234,058	84,380	4,922
1947	2022	68	241,789	99,036	5,777
1946	2021	69	204,042	69,224	4,038
1945	2020	70	194,914	69,019	4,026
1944	2019	71	184,898	65,945	3,847
1943	2018	72	166,121	54,193	3,161
1942	2017	73	162,067	59,344	3,462
1941	2016	74	149,678	54,373	3,172
1940	2015	75	142,753	52,894	3,085
1939	2014	76	134,818	50,875	2,968
1938	2013	77	125,895	44,543	2,598
1937	2012	78	118,953	43,752	2,552
1936	2011	79	111,928	44,628	2,603

Source: Australian Bureau of Statistics, Morningstar analysis

Industry Supply Is Falling Short of Demand Growth

We see the looming supply shortage as a medium-term positive for Aveo, as we anticipate it will put upwards pressure on prices for newly developed units, and as the industry is also experiencing strong price growth when existing units are resold.

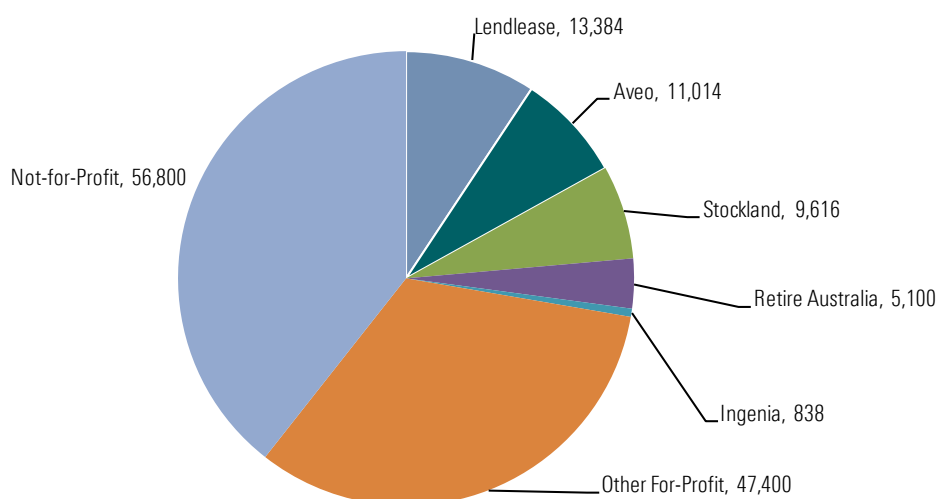
It is difficult to determine exactly the number of retirement units being added each year, given that much of the new supply comes from existing operators densifying villages. This generally occurs when operators demolish ageing townhouses and replace with midrise apartments of three to four stories. Obtaining accurate figures on new supply is also complicated by a blurring of the lines between retirement living, assisted living, and aged care. Further, there is also an emerging trend for operators (for example, Stockland and Lendlease) to build aged-care facilities (low-care and high-care) on underutilised land, with third parties managing the aged-care facilities. The addition of aged care to a site is generally a win-win for the residents and the operator. Resident amenity increases when the health of residents deteriorates and residents can relocate to an adjacent aged-care facility. In addition, operators benefit from higher earnings, given that rental yields on aged-care facilities of around 8% substantially exceed current funding costs.

Private-sector operators represent approximately 60% of the current Australian retirement market and are steadily increasing the build rate for new retirement units. But we think the planned delivery rate for private-sector operators still materially trails organic demand growth. The not-for-profit sector is also building new units, but the volume is very low in comparison, as all but a few lack the balance sheet capacity to fund large developments. The not-for-profit sector's capacity to expand is also hampered by the fact that most have very limited access to new capital. We estimate

the overall market build rate for both the for-profit and the not-for-profit operators is materially below organic demand growth.

Based on discussions with the major for-profit operators and assessment of developments being presold by other operators, we estimate the current rate of supply falls well short of organic demand growth. Accordingly, we think the current undersupply will become more acute. Based on Aveo's development pipeline of 231 new units in fiscal 2017 and a further 501 units in fiscal 2018, the firm is the most aggressive of the operators in adding new retirement accommodation stock. The other listed players operating in Australia (Lendlease, Stockland, Ryman Healthcare) are all planning to increase the number of accommodation units, but have not yet released annual targets, indicating they are not as advanced as Aveo with respect to permitting and planning.

Exhibit 4 Retirement Units of Major Participants in Australian Retirement Living Industry



Source: National Overview of Retirement Living Sector, Retirement Living Council, Grant Thornton 2014, company data

Exhibit 5 Aveo's ILU, SA Portfolio Plus Aged-Care Beds as at December 2016

	Villages	ILU	SA Total ILU/SA	Aged Care	
AOG 100% owned	40	4,242	801	5,043	184
RVG Portfolio	29	2,837	601	3,438	0
Aveo and RVG	69	7,079	1,402	8,481	184
Freedom	15	0	1,069	1,069	0
Portfolio (100% owned)	84	7,079	2,471	9,550	184
Aveo Healthcare (86% owned)	5	1,217	247	1,464	0
Total Portfolio (reconstructed)	89	8,296	2,718	11,014	184

Source: Company announcements, Morningstar analysis

We Foresee Robust Price Growth, and Hence Margins, Over the Next One to Five Years

We expect Aveo and the broader retirement living sector to benefit from further appreciation in the value of retirement units over the medium term, as we think demand is relatively inelastic and the members of the target demographic are quite wealthy. We view demand for retirement village accommodation as quite inelastic because it is largely needs-based, rather than aspirational (a major reason why members of the general population move house). Our discussions with retirement village landlords reveal most residents choose retirement villages because they cannot continue living in their current dwelling due to deterioration in their health and wellbeing. Secondary reasons for choosing a retirement village include security, peace of mind, and companionship. The death of a partner is a common catalyst for residents leaving the family home and buying an ILU. We don't see any of the underlying reasons for choosing an ILU changing in the future, and on this basis, demand should steadily increase as the population ages.

Second, the strong appreciation in Australian house prices means most elderly Australians have experienced very large capital gains on their primary dwelling. This means prospective residents have much larger pools of funds to buy a retirement unit, which in an undersupplied market is leading to price growth. However, should dwelling prices fall in Australia, we'd anticipate retirement unit price growth to slow or potentially decline.

Demand and Supply Fundamentals Positive for Incumbent Operators

With respect to the expected ILU/SA supply shortfall, we think incumbent operators have a slight competitive advantage over new entrants.

- ▶ First, existing operators' sites already have regulatory and planning approvals, which means any further densification of the sites — by replacing townhouses with multilevel apartments — can generally be done quite easily.
- ▶ Second, retirement village development is capital-intensive, and we think established operators have a slight advantage over new entrants, as these operators have better access to capital and most likely lower funding costs, given their ability to use existing villages as security for new village development loans. Aspiring entrants will find it difficult to obtain development finance in the near term, as new villages typically take three years to become cash flow positive from the time of acquiring the site.
- ▶ Third, the highly capital-intensive nature of retirement village development favours the private sector over the not-for-profit sector, with the latter having limited access to capital.

Much of the retirement living stock in Australia is ageing, with far lower amenity found in contemporary housing. Market sources indicate dwellings operated by the not-for-profit sector are some of the oldest. We think this is an opportunity for the private sector, particularly as incoming residents are prepared to pay significantly more for ILUs/SAs that have been refurbished. Our discussions with operators have revealed that it is quite common for the operator to spend AUD 40,000 on an individual unit refurbishment, thereby boosting the resale price by AUD 100,000-AUD 200,000.

Potentially Accretive Transactions

There were two acquisitions in 2016 that are pivotal to reshaping Aveo's growth prospects. In the first acquisition, through a series of purchases, Aveo acquired the 58% balance of Retirement Villages Group. Prices paid varied, but implied a value for RVG between AUD 326 million and AUD 360 million, with the higher number in line with Aveo's most recent carrying value using the equity accounting method.

Prior to taking full control of RVG, the entity operated under a complicated governance structure, which constrained the amount of ongoing investment in the portfolio. As such, the RVG portfolio, comprising 2837 ILUs and 601 SAs at the time of acquisition, had undergone a prolonged period of underinvestment. Having full management control of RVG will enable Aveo to capture the upside from redeveloping older units to contemporary standards. But, due to uncertainty around timing and the number of units that can be redeveloped, we have not yet factored this upside into our AUD 3.50 per security fair value estimate.

We estimate the embedded upside could be worth around AUD 95 million, equivalent to AUD 0.16 per security, or 4.7% of our fair value estimate. We have derived the AUD 95 million figure by assuming 20% of the RVG ILUs and 50% of RVG's SAs are refurbished to modern standards, at an average cost of AUD 40,000 per unit, with the resale price increasing by an average of AUD 150,000.

The second acquisition was the February 2016 purchase of Freedom Aged Care, or Freedom, with a portfolio at the time comprising 15 villages and 1,004 units. An ancillary motivation for the purchase was that it gave Aveo access to Freedom's innovative healthcare funding model for retirement: the Freedom Care Program. Aveo management believes rolling out the FCP to existing villages will boost the price incoming residents pay for units and will also result in slightly higher average occupancy.

The FCP is a key differentiator, but due to the high uncertainty around timing and benefits, as well as the actual value incoming residents will be prepared to pay for the FCP service, we have not yet factored in any earnings or valuation upside from Aveo's plans to roll out the FCP into as many of its existing 75 villages as possible.

Outline of the Freedom Care Program, or FCP:

- ▶ Incoming residents are given the option to pay a weekly fee covering many (but not all) of their future healthcare requirements.
- ▶ The fee is fixed for the duration of their stay, but residents can only take up the offer at the time of entry.
- ▶ If they elect not to take up the freedom health package, they have the option to pay for their future healthcare services on a "user pays" basis.
- ▶ The FCP fee is based on the annual costs of providing the care for the previous year (less home-care funding), divided by the number of participants.
- ▶ Residents accessing the FCP are obliged to access any sources of government funding to which they are entitled, with these funds remitted to the FCP to keep fees as low as possible.

- The FCP operates as a not-for-profit co-operative for the sole benefit of residents.

Nonetheless, the following illustrates the potential valuation upside. We estimate the value of each unit (SA and ILU) increases by AUD 20,000 under Scenario 1 (conservative) and by AUD 40,000 under Scenario 2 (aggressive). The logistical requirements of the FCP program make it unlikely to be extended to all legacy Aveo villages; as such, we estimate the FCP could be extended to 75% of SAs and 75% of ILUs. Under Scenario 1 (conservative) we calculate a maximum valuation upside of AUD 0.10 per security (2.8%), with upside of AUD 0.19 (5.6%) per security under Scenario 2 (aggressive).

Exhibit 6 Potential Upside From Implementing Freedom Care Program to Legacy SAs and ILUs

Potential Upside From Implementing FCP to Legacy Serviced Apartments

	SA's	AUD	Conversion %	AUD (m)	AUD /share	% of FVE
Scenario 1 (conservative)	1,402	20,000	75%	21.0	0.04	1.0%
Scenario 2 (aggressive)	1402	40,000	75%	42.1	0.07	2.1%

Potential Upside From Implementing FCP to Legacy Independent Living Units

	ILU's	AUD	Conversion %	AUD (m)	AUD/share	% of FVE
Scenario 1 (conservative)	7,079	20,000	25%	35.4	0.06	1.7%
Scenario 2 (aggressive)	7079	40,000	25%	70.8	0.12	3.5%

Potential Upside From Implementing FCP to Legacy SAs and ILUs

	SA's + ILU's	AUD	Conversion %	AUD (m)	AUD/share	% of FVE
Scenario 1 (conservative)	8481	20,000	33%	56	0.10	2.8%
Scenario 2 (aggressive)	8481	40,000	33%	113	0.19	5.6%

Source: Morningstar analysis

Valuation and Risks

Our fair value estimate for Aveo is AUD 3.50 per security, which is derived using a discounted cash flow model with an 8.4% weighted average cost of capital.

The key drivers of our valuation are: 1) the rate at which residents leave the portfolio; 2) the rate of growth in the deferred management fee and capital gain Aveo achieves for each unit; and 3) the number of new units developed in outer years. Exhibit 7 below outlines our base-case scenario and the sensitivity of our fair value estimate to more conservative and aggressive assumptions. We forecast the number of new units developed to decline over 2020-26, which reflects a moderation in the rate of growth of older Australians, plus a slight loss in Aveo's market share to competitors.

Exhibit 7 Sensitivity of Aveo Valuation to Flex in Major Assumptions

	Bearish	Slightly Bearish	Base Case	Slightly Bullish	Bullish
Portfolio Turnover pa. 2020-26	9.5%	10.0%	10.5%	11.0%	11.5%
Impact on Fair Value Estimate	(0.28)	(0.14)	n.a	0.12	0.27
Annual Growth in DMF/CG 2020-26	1.5%	2.0%	2.5%	3.0%	3.5%
Impact on Fair Value Estimate	(0.17)	(0.09)	n.a	0.09	0.18
Annual Change in New Units Developed 2020-26	-2.0%	-1.50%	-0.9%	0.50%	1.5%
Impact on Fair Value Estimate	(0.08)	(0.04)	n.a	0.10	0.16
Weighted Average Cost of Capital	9.0%	8.7%	8.4%	8.2%	8.0%
Impact on Fair Value Estimate	(0.48)	(0.26)	n.a	0.16	0.34

Source: Morningstar analysis

While we have a positive view of Aveo and the retirement living industry, the sector is not without risks. The key risks we see to our central scenario are falling house prices and a rise in competition. The fact that Australian house prices have been given such a strong boost from record low interest rates presents the risk that dwelling prices could fall when mortgage rates return to more neutral settings. This would hurt Aveo, as incoming residents typically buy an ILU/SA with the proceeds from selling the family home. Thus, a fall in house prices will diminish the pool of funds incoming residents can spend and weigh on the price they are prepared to pay for an ILU/SA. We account for this risk by estimating the deferred management fee and capital gain annual price growth at 2.5%, which takes into account the significantly higher price that Aveo is achieving for newly developed units incorporating higher-quality fit-outs than the legacy portfolio.

The high margins achieved by Aveo and other operators make us think new competitors will enter the sector, most likely those firms that are currently developing residential apartments. We account for this in our forecasts by assuming the annual volume of units Aveo develops and sells will peak in 2022 at around 550 units, then decline 2% annually thereafter, in anticipation of a rise in competition. If we assume peak development volumes in 2020 are 10% lower, at 495 units, this would detract to the tune of AUD 0.12, or 3.4%, from our base-case scenario.

Economic Moat

At their core, retirement living villages are accommodation complexes comprising apartments and/or townhouses; this means that residential apartment developers could enter the sector with reasonable ease. This is reinforced by the fact that the three largest private sectors operators in retirement living (Aveo, Lendlease, and Stockland) currently or formerly operate(d) as residential developers.

We acknowledge the regulatory environment and sales process differs between residential development and retirement living, but overall, we don't view the differences as insurmountable. We have observed several instances where retirement living operators have entered the highly regulated aged-care sector by partnering with existing operators. We think it is only a matter of

time before well-capitalised apartment developers do likewise with retirement operators, particularly the capital-starved not-for-profit sector.

Altogether, we don't think operators in the retirement living sector benefit from sustainable competitive advantages, which underpins our no-moat rating on Aveo. However, we do think incumbent operators have a slight advantage of new entrants, as they have the option to add capacity by converting townhouses to apartments, whereas greenfield developments need to obtain numerous regulatory approvals to build capacity. ■■