MONEY TIP$

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Purpose: This modelling is intended to give a basic overview of industry charges using averages, information in annual reports and data which can be used as a proxy to give a picture of the current risk/return structuring.
Model Inputs: page 13.

1. Revenue earned by operators: Big-6 type contract

Interest-free loan received:	**Unit Price**	**Unit Price**	**Unit Price**
Capital outlay paid by resident: • Occupational Rights Agreement • Recorded in annual accounts as interest free loan to operator	$500,000	$750,000	$1,000,000
Average tenure for independent living: • Generally due to lifespan of resident • Average tenure from Summerset accounts	7 years	7 years	7 years
Operator Revenue: Big-6 model 100% capital gains/losses kept by operator 25% DMF	**$**	**$**	**$**
1. Development margin for operator* • 25% • Summerset average used as proxy 2015-22	**$125,000** One-off	**$187,500** One-off	**$250,000** One-off
2. Weekly fee paid to operator: • Fixed or CPI adjusted. $150 proxy • Covers costs for maintenance, gardens, council and water rates, buildings insurance, staff costs, window cleaning, security bell	**$54,600** ($7,800p.a.)	**$54,600** ($7,800p.a.)	**$54,600** ($7,800p.a.)
3. Operator Deferred Management Fee • Exit fee on death or leaving village, pays for use of village facilities on a delayed basis. • 25% of purchase price of Occupational Rights Agreement (average of top 20 operators) • Full amount payable after 4 years (Ryman proxy), but spread over tenure of 7 years	**$125,000** ($31,250p.a.) Years 1-4	**$187,500** ($46,875p.a.) Years 1-4	**$250,000** ($62,500p.a.) Years 1-4
4. Benefit of operator's interest-free loan • Business loan base rate, average rate for 2017-2022 = 4.24% • Source RBNZ • No risk margin added • Compounded for 7-year tenure (x 33.73%)	**$168,668** ($24,095p.a.)	**$253,002** ($36,143p.a.)	**£337,336** ($48,190p.a.)
5. Capital gains to operator • 71% increase in house prices 2017-22 (7.97% annualised) • Jan 2016 median house price $445,000 • Jan 2023 median house price $762,500 • Source: REINZ/interest.co.nz	**71%** **$355,000** ($50,714p.a.)	**71%** **$532,000** ($76,000p.a.)	**71%** **$710,000** ($101,428p.a.)
Operator earnings after 7 years (1+2+3+4+5) • Per resident / unit	**$828,268**	**$1,214,602**	**$1,601,936**
Operator's annual earnings over 7 years • Per resident / unit	**$118,324**	**$173,514**	**$228,848**
Operator's weekly earnings over 7 years • Per resident / unit	**$2,275**	**$3,336**	**$4,400**

*Development margin is earned on the first cycle, but not the next 7-year cycle.

2. Revenue earned by operators – Vivid and Karaka Pines

Operator Revenue: Vivid Gains shared 50/50, no losses. DMF 15% of purchase price	**$500,000**	**$750,000**	**$1,000,000**
1. Development margin for operator* • 25% (assumed for consistency)	**$125,000** One-off	**$187,500** One-off	**$250,000** One-off
2. Weekly fee paid to operator: • Fixed or CPI adjusted. $150 proxy	**$54,600**	**$54,600**	**$54,600**
3. Operator Deferred Management Fee • 15%	**$75,000**	**$112,500**	**$150,000**
4. Benefit of operator's interest-free loan • Compounded for 7-year tenure (x 33.73%) • On 50% of the purchase price	**$84,334**	**$126,501**	**£168,668**
5. Capital gains to operator • 71% increase in house prices 2017-22 • 50% of the gains kept	**$177,500**	**$266,000**	**$355,000**
Operator earnings after 7 years (1+2+3+4+5) • Per resident / unit	**$516,434**	**$747,101**	**$978,268**

Operator Revenue: Karaka Pines Capital gains/loss kept by resident. DMF 12.5% of sale price	**$**	**$**	**$**
1. **Development margin for operator*** • 25% (assumed for consistency)	**$125,000** One-off	**$187,500** One-off	**$250,000** One-off
2. **Weekly fee paid to operator**: • Fixed or CPI adjusted. $150 proxy	**$54,600**	**$54,600**	**$54,600**
3. **Operator Deferred Management Fee** • 12.5% of sale price • $500,000 x 71% = $855,000 • $750,000 x 71% = $1,282,500 • $1,000,000 x 71% = $1,710,000	**$106,875**	**$160,312**	**$213,750**
Operator earnings after 7 years (1+2+3) • Per resident / unit	**$286,475**	**$402,412**	**$518,350**

3. Revenue earned by operators in a 7-year cycle – compared

Unit price	**$500,000**	**$750,000**	**$1,000,000**
Big-6 type contract • Per resident / unit	$828,268	$1,214,602	$1,601,936
Vivid • Per resident / unit	$516,434	$747,101	$978,268
Karaka Pines • Per resident / unit	$286,475	$402,412	$518,350

$1.2 million in earnings and benefits - unit price of $750,000 over 7 years

These tables show all inputs in the product structure, with the output being the right to occupy and no exposure to capital loss. When a resident pays $750,000 for a unit, an operator will increase their earnings by over $1.2 million in the form of capital gains, free-funding benefits and the Deferred Management Fee. On top of $1.2 million, they have access to $750,000 in capital for the 7-year tenure and this is replaced and maintained on the next sale.

The Occupational Rights Agreement (ORA) keeps ownership rights of each unit with the operator as well as capital gains/losses. The resident is not paid interest on their capital lump-sum payment. This generates free funding (recognised as an interest-free loan in the financial accounts) and allows the operator to use its residents as a source of free capital to build more retirement villages for the benefit of shareholders.

- This rearrangement of cashflows is in contradiction of economic-norms which would prevail if there was an equal balance of power in a contract.

- Earnings made and benefits received by the operator, are without capital outlay, as the resident has paid for the value of the unit as a license fee.

- The Deferred Management Fee reflects the delayed payment for the enjoyment of village facilities which the resident hasn't paid for in the price of the unit.

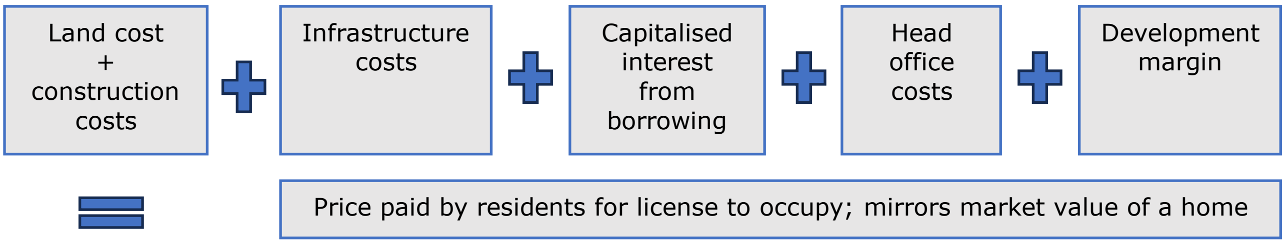
- This model includes an interest payment in the costs to give a full picture of economic flows that are being extracted by operators. In any analysis of a financial product, all flows need to be included in order to get an accurate overview of the costs and benefits to each party.

Adjusting out development margin - $1 million in earnings and benefits

We could remove the development margin in the construction of the unit, as this represents a normal part of a property transaction to achieve a market value. It is however a cashflow in the full model shown above. It can be argued that this margin is intrinsic in all property transactions and residents will pay this on any new home, or it will be absorbed into past pricing of older homes.

- **License fee is a mirror of house prices**: The inclusion of development margin in a unit price shows up in operators annual accounts and proves that residents are paying a market price for a unit. The legal wrapper of an ORA is simply a mirror image of home ownership.

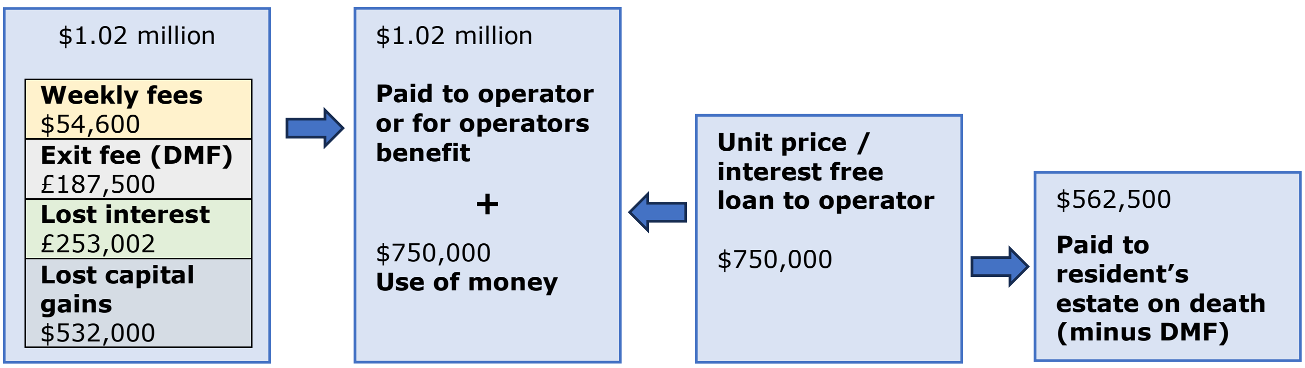
- **Development margin is realised in the first sale**: The price includes construction costs, land costs, infrastructure, capitalised interest on borrowing, head-office costs and a development margin as per any normal property development. Evidence Summerset Accounts (see model inputs page 13).



- **The ORA doesn't restructure** the timing of payment for the full market value of the unit, as the licence fee doesn't discount the price of the unit or defer it.

- **The ORA does restructure** the timing of the payment for village facilities. Residents pay for these on a deferred basis on death or exit, via the Deferred Management Fee plus the giving up of capital gains.

- **Weekly fee is evidence the ORA replicates home ownership:** residents pay a weekly fee (in the model $150 a week/ $7,800 per year). This covers gardening, window cleaning, maintenance, staff costs, alarm bell, rates and buildings insurance). Villages differ, but the concept holds.



4. Costs to Residents of living in a retirement village

Over the last twenty years, New Zealand has experienced substantial house price inflation and retirement village profits have soared in response to this. It will not always be the case, but an aging population and migration indicate a long-term trend, despite current property price falls. Unit prices have defied this and risen in value. This shows a rigidity in retirement village pricing that has not been tested or observable before.

In assessing fairness of how a contract is priced, we need to look at the two components to the transaction from a resident's perspective:

1. The cost paid for the right to live in a unit

2. The cost paid to enjoy the assets and services provided by operators in the village hub

1. Costs residents pay to occupy the unit	**$**	**$**	**$**
Purchase price of license for the unit • Recorded as interest free loan to operator • Pays for the right to live in the unit	$500,000	$750,000	$1,000,000
Weekly fee $150 paid to operator: • Costs over 7 years, maintenance etc.	$54,600	$54,600	$54,600

- It is clear the upfront capital payment made under an 'Occupational Rights Agreement' (ORA) and the weekly fee payment are part of a legal structure which economically mirrors home ownership. There may be some situations where operators under-estimate the weekly fee, but given the back-up of the Deferred Management Fee, there is room for this risk to be covered.

- This upfront part of the model reflects the economic-norm where the license payment is used to buy the right to live in the unit. While the legal wrapper of an ORA doesn't convey ownership rights, the set-up still mimics ownership. The operator gets free use of the resident's capital and no interest is paid. It is inconceivable that any further payments would be required to pay for the right to live in the unit.

- It should be noted that operators marketing material across the industry, contains an unexplained financial error. It is claimed the Deferred Management Fee gives ***"the right to occupy your unit and enjoy village amenities"*** (source Ryman). Economically, this cannot be true as the right to occupy has been paid for via the lump-sum capital payment which includes all construction, land, infrastructure and funding costs plus a development margin. There is a weekly fee for maintenance and no interest on the resident's license payment.

- The upfront payment of a license fee, fairly reflects the value of an arms-length transaction, with development margins. For the purposes of this analysis, we need to assume the marketing material is an error, given it doesn't stand up to scrutiny.

2. Costs residents pay for village facilities	Unit Price **$500,000**	Unit Price **$750,000**	Unit Price **$1,000,000**
Deferred Management Fee • **25%** of purchase price, paid on death/exit • Pays for the use of village facilities for 7-year average tenure. • Accrued in full after 4-years	$125,000	$187,500	$250,000
Lost access to capital gains /losses • 7 years (proxy: median house price 2016-23) • 71% gain	$355,000	$532,000	$710,000
Price paid for the enjoyment and maintenance of village facilities over 7 years	**$480,000**	**$719,500**	**$960,000**
Annualised	$68,571	$102,785	$137,142

From a resident's perspective any further costs or giving up of economic rights, must be assumed to pay for the enjoyment of village services and assets (village hub; cinema, café, pool etc).

The alternative legal wrapper of an Occupational Rights Agreement (ORA) substitutes a lease or unit title and appears to be a practical solution, given residents are only paying for the unit itself and will delay the payment for their share and use of village facilities until death or exit. The legal wrapper allows for the two parts of the transaction. This choice of wrapper doesn't prevent capital gains being shared or paid in full to residents. The Summerset ORA allows for all gains to go to a resident in the case of natural disaster, where the unit isn't rebuilt.

It is in the second part of the transaction (the delayed payment of village facilities) that the legal structure becomes confusing and deviates from economic norms.

At a basic financial level, the ORA is clear and lawyers can explain to clients the quantum of the Deferred Management Fee and the loss of capital gains. What lawyers and residents can't do, is get any perspective on whether these terms are fair or reflect the concept of value for money in a property transaction which includes an element of lifestyle (a village hub).

Lawyers acting on behalf of consumers have been hamstrung by a one-model market, giving no competition and clients with limited time. Associating legal advice with some sort of test of consumer protection is not intellectually honest in this industry.

The legal obligation appears to be that residents only need to understand the quantum of charges (25% Deferred Management Fee) and the direction of economic cash flows i.e., that both capital gains are lost and there is no interest paid on their capital lumpsum. Further analysis probably exceeds the financial knowledge of most family lawyers and is difficult to assess given three factors:

1. That the Deferred Management Fee is charged as a percentage of the license fee

2. That capital gains are lost, but these are difficult to quantify and predict in advance.

3. That the entire model is one of cross subsidisation

Confusion 1: Deferred Management Fee is charged as a percentage of the license fee

Residents pay for village facilities on a deferred basis and operators also claim the fee covers refurbishment costs when the resident dies/exits. This doesn't stand up to financial scrutiny given a refurbishment will increase the value of the unit, but the operator takes the capital gains. Legal advice will find this difficult to explain in terms of fairness, but the existence of the anomaly can be conveyed in a factual sense.

The maths around a percentage charge, means the legal adviser would need to make it clear that enjoyment to village services is not paid for on the basis of each individual paying the same amount. Unlike a membership to a gym or sports centre or cinema complex, a village hub is paid for on the basis of wealth. Those with higher value homes pay more.

The difference between a $500,000 unit and $750,000, adds over $60,000 to the deferred fee, for no more enjoyment or additional services.

In addition, the Deferred Management Fee accrues to operators over 4 years (Ryman used as the proxy). This means a resident who doesn't survive the average length of time of 7 years, may have clocked up the full fee regardless. Speed of accrual works in the operator's favour.

It is not clear how well legal advice discloses this or how well residents understand this in relation to what they feel would be fair. Given there are few alternatives to this model, it becomes one of acceptance, because analysing it doesn't reveal any other choice. Residents social, security and wellbeing, have to rank more highly than the cost. Both lawyers and residents are trapped.

The structure of the fee as a percentage of purchase price, financially encourages operators to build higher value units and increase their deferred fees. This is a structural fact with this model.

Value returned to resident on death/exit
- Purchase price $500,000 less Deferred Management Fee (25%) **$125,000** = $375,000
- Purchase price $750,000 less Deferred Management Fee (25%) **$187,500** = $562,500
- Purchase price $1,000,000 less Deferred Management Fee (25%) **$250,000** = $750,000

Confusion 2: Capital gains are lost

Capital gains / losses are retained by operators and can only be assumed to pay for the cost of village facilities in the model (given the right to occupy the unit has proven to be a fairly priced transaction).

If interest was paid on the resident's lumpsum, this could be seen as a restructuring of risks and returns. Lower risk taken for a lower return (via an interest rate) by the resident. And a higher risk for higher potential return (via capital gains) taken by the operator.

When capital gains/losses are given up *and* no interest paid, the economic norms fall apart. What was the consideration paid, for their forfeiture? It's zero. It cannot be argued that this part of the equation is mathematically worth zero. There is no academic theory which supports protecting residents from losses by taking all their gains. The mathematical probability of this isn't a 1:1 payoff. If modelled correctly, the payoff would show only a small proportion of gains should be forfeited in exchange for not suffering any capital losses.

For the operator to remove both of these flows from the product, is highly irregular and can only occur if the balance of economic power has failed.

Legal advice can explain the facts; that capital gains accrue to the operator and they will take capital losses. But it is not clear if this is explained to residents in terms of these two flows having a positive value, not a zero-sum. Add in interest-free loans from residents and most consumers will feel this is double-dipping. It is a winner takes all model. An interest-free unconditional payment is a normal trade off for the right to occupy and mirrors home ownership. But that cannot exist in conjunction with the removal of gains/losses.

Either an exposure to gains/losses must exist, or an offsetting positive payment such as an interest rate, for economic norms to prevail.

Again, because there is no choice, other human needs are going to force price-taker acceptance.

Lost access to capital gains/losses

- Purchase price $500,000 + 71% gain **$355,000** = $855,000 Sale price to next resident
- Purchase price $750,000 + 71% gain **$532,000** = $1,282,000 Sale price to next resident
- Purchase price $1,000,000 + 71% gain **$710,000** = $1,710,000 Sale price to next resident
- REINZ median house price 2016-2023 ($445,000 to $762,000 = 71% increase)

Confusion 3: Cross subsidisation

The Deferred Management Fee accrues fully after 4 years. A resident who dies/exits at year four pays the same charge for village services as one who dies after 10 or 20 years.

The average tenure of a resident living independently is 7 years, but death prior to this date has a completely different mathematical cost than those who live beyond the average.

Advice on whether this arrangement is suitable for an individual will depend on the age they enter the village and their health conditions. Residents entering in their 80's clearly have statistical disadvantages to those entering in their 70's, but are forced into cross subsidisation despite a very high likelihood of it having a bad financial outcome. It is a difficult conversation to explain the average tenure is only 7 years in an independent living unit, down to 2 years in a care suite. It's not in the marketing material. Residents won't be weighing up this stat against the embedded costs.

The model is not one of clean cross subsidisation. The fee would accrue up to the seven-year average life span if so. It is heavily skewed in the operators favour at the four-year point.

It needs to be debated if operators should be allowed to run models like this which clearly disadvantage many families. This is not an insurance product where society has agreed to spread risk. In any liberal democracy, housing is priced on a user pays model. There should be a clear relationship between the length of time spent in the unit and the costs involved.

Even if lawyers are giving advice on the fairness and suitability of the product to their older or health-impaired clients, human priorities force price acceptance.

5. New Business Models

There are some signs of change in the retirement village business model, but these are too limited and too slow to be acceptable in terms of competition realigning the market and creating financial fairness.

The Fletchers model (Vivid Living): gives 50% share of capital gains (the resident is not exposed to any losses) and a 15% exit fee. This demonstrates a risk/return model that makes academic sense. Gains and losses are not shared on a 1:1 basis because they don't have the same probability over the long term. To get half of the gains, it is mathematically fairer if the operator takes all the losses. The probability if modelled correctly will be even more strongly in a resident's favour than this 50% upside/0% downside, Vivid Living have agreed to.

Karaka Pines Villages: residents keep all the capital gains. The Deferred Management Fee is 12.5% of the sale price. Effectively the operator is participating in capital gains via the exit-fee being linked to the sale price, not the purchase price as is currently the case with the big-6. This is a good example of a risk/return model which reflects fairness to the consumer and academic structuring of risk/return.

Comparison with new generation models:

Fletchers/Vivid: 50% gains shared, 15% DMF	**Unit Cost**	**Unit Cost**	**Unit Cost**
Capital outlay paid by resident:	$500,000	$750,000	$1,000,000
1. Deferred Management Fee (DMF) 15% of purchase price	$75,000	$112,500	$150,000
2. 50% capital gains paid to operator (half of 71%) Based on gains from 2016 to 2023	35.5% $177,500	35.5% $266,000	35.5% $355,000
Cost to resident after 7 years (1+2 above)	**$252,500**	**$378,500**	**$505,000**
Annual cost to resident	$36,071	$54,071	$72,142
Weekly cost to resident	$693	$1,039	$1,387

Karaka Pines Villages: Resident keeps gains, 12.5 DMF paid on sale price	**Unit Cost**	**Unit Cost**	**Unit Cost**
Capital outlay paid by resident:	$500,000	$750,000	$1,000,000
1. Deferred Management Fee (DMF) 12.5% of sale price (capital gain modelled at 71%)	$106,875	$160,312	$213,750
Cost to resident after 7 years (1. above)	**$106,875**	**$160,312**	**$213,750**
Annual cost to resident	$15,267	$22,901	$30,535
Weekly cost to resident	$293	$440	$587

Big-6 Largest Operators	**Unit Cost**	**Unit Cost**	**Unit Cost**
Capital outlay paid by resident:	$500,000	$750,000	$1,000,000
1. Deferred Management Fee (DMF) 25% of purchase price	$125,000	$187,500	$250,000
2. 100% capital gains paid to operator (all of 71%). Based on gains from 2016 to 2023	$355,000	$532,000	$710,000
Cost to resident after 7 years (1+2 above)	**$480,000**	**$719,500**	**$960,000**
Annual cost to resident	$68,571	$102,785	$137,142
Weekly cost to resident	$1,318	$1,976	2,637

Comparison of return of capital paid on death/exit (assuming the average 7-year tenure)

Business Model	Big-6	Fletchers/Vivid	Karaka Pines
Purchase price	$750,000	$750,000	$750,000
Sale price (+71%)	$1,282,500	$1,282,500	$1,282,500
Deferred Management Fee	25% of purchase price $187,500	15% of purchase price $112,000	12.5% of sale price $160,312
Purchase price less DMF	$563,000	$638,000	$589,688
Capital gains	$0	$266,000 (50%)	$532,000 (100%)
Total capital returned	**$563,000**	**$904,000**	**$1,121,688**

- Residents with Fletchers/Vivid receive back **60%** more capital on death/exit than those with the big-6 operators.
- Residents with Karaka Pines receive back **99%** more capital on death/exit than those with the big-6 operators.

Comparison of costs paid for village services on death/exit

- Assuming the average 7-year tenure
- Village services are paid for via the Deferred Management Fee and loss of capital gains

Unit Price	Big-6	Fletchers/Vivid	Karaka Pines
$500,000	$480,000	$252,500	$106,875
$750,000	$719,500	$378,500	$160,312
$1,000,000	$960,000	$505,000	$213,750

- Residents with the big-6 operators pay **90%** more over 7 years than those with Fletchers/Vivid
- Residents with the big-6 operators pay **350%** more than those with Karaka Pines.

6. Sensitivity analysis

There are endless variations of sensitivity analysis which can be undertaken.

Just because we are entering a period of low capital gains, it doesn't justify downplaying this as a feature of the past. Regulation needs to concentrate on fairness and value for money, not the quantum or likelihood of the gain. Housing cycles still have long term tail winds from an aging population, supply constraints and migration. Operators will struggle to claim they need to increase DMF levels if gains are removed, because the current economic cycle may have exposed them to this regardless. It is highly unlikely these gains were ever relied on to make normal levels of margin. Their existence over the last 20 years has simply accelerated village construction due to the 'make hay' theory.

Many operators (11 out of the top 20) have an exit fee of 30% so the model understates DMF levels for over half. Others will have made greater capital gains than the proxy of median house prices. No risk margin has been added to the business base rate and it's an average of the last 7 years recorded by the Reserve Bank. No modelling of care-ORAs has been included where residents pay for a suite plus a Deferred Management Fee, but have an average tenure of only 2 years due to life expectancy (the DMF fully accrues in 2 years e.g., Summerset Care ORA). On balance the values shown would be conservative when looking at the significant profit levels made. The model does not attempt to depict any individual operator.

7. Fair exchange of economic power

In a fair and efficient market, both parties would demonstrate an element of power. Even if this wasn't equal, competition, regulation, fair trading laws and basic concepts of value for money tend to prevail. The retirement village market, due to the nature and way it developed demonstrates clear signs of departure from basic economic concepts of fairness.

It is this imbalance and lack of fairness which has created a boom in retirement village building, beyond that seen in culturally similar markets such as the UK, where the model is admired, but difficult to replicate due to regulators.

With any financial product where cash flows are restructured, pricing comes down to common aspects:

1. Economic norms
2. Time value of money
3. Risk
4. Probability of outcomes
5. Margin

This is a simplified explanation of structuring and the mathematics behind this has some complexity.

In the case of the retirement village concept there are two economic norms that form the foundation of a fair exchange of economic power; home ownership and renting.

When structuring a retirement village product, with additional village services, there will be cash-flow rearrangement and margins earned, but the basic economic norms can't be ignored, even when the legal framework for delivery has altered (the ORA). This is only a wrapper, not method of altering fairness or value for money principals i.e., substance over form must prevail.

The retirement village product appears to be very poor value for money and requires urgent regulation for consumers.

This model has been referred to by analysts as *"the beautiful model"*. Why? Commercially, it is difficult to think of another investment for shareholders which provides such a huge transfer of wealth and an imbalance of power preventing any change to this.

The model has developed in a way which defies financial gravity, is mis-priced and makes no sense in terms of economic risk/return analysis. To financial eyes and that of a structurer, the only explanation left is a full transfer of power between a price maker and a price taker.

Shareholders and fund managers have had years of enjoying the super-profit model without thinking too deeply about fairness issues. The retirement village industry has a consumer base who are price-takers making end-of-life housing decisions (even if they are well and active, they are mindful of what lies ahead). Over time it has been particularly easy to mould the contract into one where elderly residents have funded a business expansion for shareholders at the expense of wealth transfer between family members.

Residents go into these contracts with knowledge, but their priorities become tested. They have the need for social interaction, security and maintenance. With a lack of time and mindful of sliding health, they are faced with little choice, but to accept the model. It's not the position future generations should be faced with.

The Retirement Village Residents Association has only been in operation for a few years in its current form. It has $200,000 a year in funding to represent the interests of 50,000 residents and pay a single staff member. The model was fully entrenched before residents gained this limited representation. They have no budget for expert representation.

Operators have become entrenched in the model being a 'life style' for these consumers rather than keeping in mind any responsibility for fair financial outcomes or value for money.

8. A capital-light, highly profitable model has become entrenched

There are alarmist claims of "catastrophe" if there is regulatory change to the model. There has also been a tendency to suggest a collapse in share prices. Interestingly this has already occurred. It is a function of market concern for a softening housing market as well as rising interest rates (causing the markets to respond to the debt levels of operators). Share prices were frothy and priced in too much future return. Share prices have fallen dramatically without any change to the model and this will continue to be the case in various market cycles as it's a response to debt and the housing cycle.

Operators choose to indebt themselves to expand faster and build more villages to get more of the super-profit model. They have preferred this to organic growth or new equity raising as this dilutes existing shareholders. Debt has been preferred to equity in a low interest rate environment. The cost of interest on this debt gets capitalised into the cost of a unit. Development margins on the first sale still run around 20%.

Operators run particularly capital-light models, borrowing short-term working capital from banks and repaying it as units sell. It's a rinse-and-repeat model, with residents paying for the unit, plus a development margin upfront, but getting no ownership rights. Land banking for future development is funded by longer term bank debt.

Operators borrow from banks as well as borrowing from retail investors in the bond market (issuing bonds at a fixed coupon) and free funding from residents' loans. Interest rates are often managed with interest rate swaps to lock in fixed funding levels. The capital structure of these businesses hasn't stood up well in a rising interest rate environment, but it should be noted this doesn't sway from the underlying model of taking 20-30% Deferred Management Fees and all capital gains, being highly attractive.

More recently, operators have rearranged their capital structures, issuing new shares to the market and repaying debt with the proceeds. This puts risk back with shareholders and relieves them of the burden of rising interest rates and pressure from lenders who may have been nervous in the current climate.

Consumers appear to get confused about debt carried by operators and its relationship to profit. Debt is a function of how an operator chooses to fund expansion, with the alternative option to go to shareholders for new equity or the bond market. Profits are a function of the contractual model of DMF + Gains. While debt drags profit down, it's use is a shareholder risk and choice. The high profits still continue.

Regulation can be positive not catastrophic

Operators claiming that any legislative changes would result in a catastrophe is a red herring. They will not collapse if legislation enforces common economic norms and protects consumers from a very poor value for money product.

If shareholders don't like fair economic principals and more realistic margins, companies can be sold, or debt and equity restructured. They are sitting on big asset bases and a normal profit model would still be very attractive to new shareholders such as pension funds. In order to fix issues for consumers, there will need to be acceptance that some smaller operators will not cope with restructuring and will end up merged into larger businesses. This is already happening. In much the same way as the entire financial industry was regulated to create better value for money and abolish the commission model of income generation, there are always casualties.

Failure to create rentals

The current capital-light model is not conducive to a range of accommodation types within villages; renting, owning, part owning, which we see overseas. Developing a rental market within villages is an important option for the future housing of older New Zealanders. Maintaining the status quo is not only condoning a heavily unfair consumer contract, but it's not conducive to competition.

The big-6 already demonstrate unusual behaviour which they won't explain, regarding competition. One example was the BUPA six-month buy back of a unit, if it hasn't sold. This occurred in 2019, but the Residents Association reports it was deleted 18 months later. They also report seeing this with another large provider. It has to be questioned if the unwillingness to discuss why the feature was withdrawn came from pressure within the industry not to rock the boat and force others to do the same.

9. Occupational Rights Agreement - poor value for money.

Reasons that explain how this unfolded:

- **Life style not ownership**: A sales method which sells a lifestyle not home ownership in order to take capital gains.
- **Risk removal from the 'elderly'**: A sales method which purports to remove risk of capital loss by taking capital gains. These consumers have taken property market risk all their lives and this is part of a long-term exposure, not a new short-term asset class with high volatility. Given the eventual recipient is generally younger family or charities, the risk is not that of the resident. Most New Zealanders are comfortable with property market risk.
- **Mathematically mis-priced risk**: Operators often pose the scenario that if capital gains are shared, residents will become exposed to losses. This is mathematically incorrect when factoring in probability. The correct pricing would be for the operator to take a small percentage of gains, they should underwrite any losses. Operators have successfully fooled residents with this reasoning. Possibly because they didn't have investment bankers and structurers advising them as the model morphed into use, but more likely due to the imbalance of power.
- **Cross subsidisation**: A model which centres around cross subsidisation makes it difficult to see poor value for money on a personal level. Every resident has the same Deferred Management Fee, unless they exit /die very quickly. It is not a user-pays model. Many families are being denied substantial sums of money, in order to fund others. While cross subsidisation is necessary in some financial products (e.g., insurance / EQC levies due to risk levels), housing is not a product which justifies this sort of intervention. The lack of transparency, appears to aid operators in presenting a high-cost model where it is difficult to guess personal outcomes or assess value for money.
- **Accrual speed of DMF**: Given the speed of the accrual of the Deferred Management Fee, it is likely the cross-subsidisation between residents can't be statistically defended. Most accrue in full after 3-4 years occupation. Operators know the average tenure for independent living units is 7-8 years. There's a distinct possibility this gap between accrual and tenure is mainly for the benefit of shareholder profits, with only a small percentage of residents benefiting from cross subsidisation.
- **Family vs elderly**: A sales method that pitches families against elderly in terms of 'greed' and expecting family not to approve of the high costs involved. Retirement villages provide wonderful social and secure environments. These features have to be prioritised over money and family members pointing out bad value for money are in a predicament.
- **A negative view of inheritance and intergenerational wealth transfer**: Operators fail to balance the model against financial fairness and testamentary freedom, where charities can benefit if residents truly believe their family are unsupportive of them.
- **Time-poor**: Even the active-elderly are time poor. They become price-takers.
- **Priorities:** Elderly who are forced to value social and security factors higher than money.
- **Regulations that didn't monitor value for money:** A regulatory system which has made sure costs were clear and legal advice mandatory, but left market forces to sort out pricing. This seems reasonable, but didn't pan out fairly. We now need to address financial fairness and value for money in an uncompetitive market which has developed its own high profit structure without recourse or review.
- **Residents' representation and funding**: Residents have not been represented by a well-funded Residents Association, because retirement housing is a relatively new phenomena and older people want to enjoy these years, not get dragged into administrative groups. The RVRANZ has one full time member of staff and a $200,000 annual budget.
- **The model favours high churn:** Mathematically, the quicker residents turn over, the more profit is made for shareholders. The average age on entry becomes important and results in age restrictions, as young retirees wouldn't be profitable, given this is a cross subsidisation model.
- **Operators insist the model is world leading**: More accurately, our model is world leading for shareholders, not residents. Retirement Village operators have led share market returns for decades and this attracts international attention. Regulation wise, we have an Act of parliament that makes costs clear and legal advice mandatory. This is seen by other countries as providing

good consumer protection. Having an act of parliament is the aspect referred to in most offshore commentary. Unfortunately, what isn't portrayed by operators is these countries will struggle to replicate the financials behind our model due to poor value for money, strong consumer groups, ombudsmen regimes and strong fair-trading laws. Operators will not admit this and prefer to re-quote one-liners from offshore reports.

- **Political conundrum**: with housing supply shortages, the retirement village model free's up the chain of supply. Unfortunately, residents are paying a huge price for this and it's the reason we have operators keen to land-bank and develop as fast as possible. The profits are beyond belief, but it is time to move the market back to fairness and value for money. These companies will not fail. In fact, it may force a restructuring of how they fund themselves and deliver new shareholders from mergers and acquisitions. To have any hope of developing a rental market for retirees within villages we certainly need shareholders with different capital structures. The capital-light model is not conducive to innovating towards rental products.

10. Recommendations:

With a model that is economically unfair to residents due to a pricing power imbalance, future generations need legislation to change the way operators price their contracts.

Important issues which need correcting via legislation are:

1. **Pay capital gains to residents or a market rate of interest**: This returns fair economic norms to the pricing. This will be unattractive to operators, and the purpose would be to put a clear economic value on residents losing gains when a license fee has been paid which reflects the full value of a property. It is unlikely to result in operators choosing to pay interest, but instead acts as a deterrent to taking all the gains.

2. **Clean charging, annual fee model**: Encourage operators towards a clean charging model where costs and profits are extracted via an annual fee with a deferral option.

3. **Allow for shared capital gains via charging the DMF percentage on sale price:** The Deferred Management Fee could be charged on the purchase price or alternatively the sale price of the license to occupy, giving operators a slice of gains.

4. **All capital losses covered by operators:** If the operator benefits from capital gains in any form, they take all capital losses since these do not have a 1:1 probability.

5. **Deferred Management Fees should be quoted annually**: rather than a one-size-fits-all, the DMF should accrue annually for the length of time the resident occupies the unit. Operators should apply either a fixed annual percentage of the purchase price as a fee, or a fixed dollar charge, to make the value of village services financially clear. It is inconceivable that residents living in village, who have paid the price of the unit upfront, should not be fully aware of the annual cost of using village services and be charged for the length of their use. Families who suffer the early death of a resident should not be penalised and funding other residents. Charges should not be opaquely hidden within capital gains, lost interest, a one-size-fits-all DMF, or the fast accrual of the DMF.

6. **Option to pay or defer charges with transparent interest rate:** Currently a one-size-fits-all fee is charged on death. Regulation should require operators to offer the option to pay for village services annually. Some residents will have savings and it's more efficient to pay now, than rollup and pay the time-value-of-money of deferral until death. There should be a transparent rate of interest declared for deferrals (in the same way those using a reverse equity mortgage are told the cost of deferring repayment). Those with less resources who wish to enjoy-now-pay-later can also do so and be fully informed of the cost of doing this. The deferred interest rate should apply on a user pays basis for the tenure of the occupancy.

7. **Buybacks** – allow families to choose a faster buy-back option for the unit with a 5% fee (to cover the operators bridging costs) and unit price based on the average of the last 6–12-month sales of similar sized units.

11. Inputs of the Retirement Village model

- **Ownership of unit**: Operators maintain ownership of property assets (land and buildings). The license to occupy is granted to a resident. Legal structure is an ORA 'Occupational Rights Agreement'.

- **Security:** Operators give a mortgage to a Statutory Supervisor as security for residents' money.

- **Capital payment by residents for an ORA**: The lump-sum paid by a resident is an interest free loan to an operator and recognised in the financial accounts as such. Operators use this to fund the building of new villages for shareholders.

- **Village facilities:** Operators build community hubs that residents do not pay for (community social room, café, cinema and pool possibly). Payment for their enjoyment is deferred until death/exit.

- **First sale price of a unit**: Made up of the construction cost of the unit, proportion of land costs, capitalised interest on lending, infrastructure costs and head office costs. The development margin is the difference between the sales price to residents and these base costs (evidence: Summerset Annual Accounts 2019 page 65).

- **Development margin**: Operators aim to build small units which are roughly 75% of the value of the local house price average, to allow for downsizing. This price is not at a discount. Operators' development margin is 25% on the first sale (shown in annual accounts).

- **Examples of development margin:** Summerset annual accounts show 2015: 20% / 2016: 22.2% / 2017: 27.3% / 2018: 33.2% / 2019: 27.9% / 2020: 19.6% / 2021: 23.1% / 2022: 29.7%. Arvida half yearly accounts show 2019: 17% / 2020: 19% / 2021: 14% / 2022: 17% / 2023: 20%. Metlifecare targets a development margin between 20% and 30% (when calculated relative to the sale price) with a targeted minimum hurdle range of 15% for new developments.

- **Deferred Management Fees:** Charged on exit/death at 20-30% of purchase price. This is a method of allowing residents to enjoy the village assets and not pay upfront. It also covers refurbishment on death/exit, due to wear and tear, even though the operator benefits from capital gains.

- **Deferred Management Fee examples**: Industry average 25% across 20 providers (11 out of 20 operators charge 30%). Big-6 weighted on market share gives 23.65% (Source: Lyfords and JLL data). Accrues to the operator over 2 to 5 years. Example: Rymans accrue full payment over 4 years.

- **Cross subsidisation of Deferred Management Fee:** All residents pay the same exit fee, regardless of time spent at the village (a cross subsidisation model). The fee accrues in full around 3-4 years after moving in, although the average tenure of a resident living independently is 7 years. Those dying below the average tenure have often clocked up the full fee. The DMF model incentivises the building of high value units given the percentage-basis of charging the fee on the property price, rather than an individual's equal right to use facilities.

- **Average tenure:** Villas 7-8 years, Apartments 5 years, Serviced Apartments 3 years, Memory Care Apartments 3 years and Care Suites 2 years. (Source: Summerset Annual accounts). Health and lifespan decline with the unit-type.

- **Capital gains**: Kept by operators as owners of the asset. These gains are recognised as profit when a license to occupy is terminated and sold to a new resident. Example from Summerset's annual accounts:
    - *"Add realised gain on resales: add the realised gains across all resales of occupation rights during the period. The realised gain for each resale is determined to be the difference between the licence price for the previous occupation right for a retirement unit and the occupation right resold for that same retirement unit during the period. Realised resale gains are a measure of the cash generated from increases in selling prices of occupation rights to incoming residents, less cash amounts repaid to vacated residents for the repayment of the price of their refundable occupation right purchased in an earlier period. Realised resale gains exclude deferred management fees and refurbishment costs."*

- **Business loan base rate**: Source RBNZ**.** Average rate for 2017-2022 = 4.24%.

12. Market Comments

2017 Credit Suisse, Arie Dekker
"A beautiful business model"

"There is no doubt that the business model is very attractive and we highlight the characteristics that make the sector desirable from an investor perspective. We also discuss some of the likely drivers of Ryman's success given what appears to be an increasing convergence in the business models towards the continuum of care model adopted by Ryman successfully over the past 20-plus years."

2019 Richard Hinchliffe
Director Sector Strategies and Sustainable Finance at ANZ Corporate and Business

"So why has New Zealand not embraced a rental option? Two possible reasons spring to mind, the first being the current ORA model (Occupational Rights, Agreement) has worked so well and is well understood by residents, lawyers, bankers, investors etc. The second reason is more complex and reflects how villages fund their businesses. If a village uses the ORA model, it will buy land, commence building stage one and then sell ORAs to repay the development debt associated with stage 1. This is repeated through further stages until the village is compete and often debt is fully repaid. A village using the rental model will not be able to repay debt as it works through each stage. This means villages have to be funded differently and importantly, the funding must be long term. The New Zealand retirement village sector has been developing for over 40 years and its roots are with entrepreneur's who have not typically had access to long term funding (i.e., equity or institutional money). As a result, the ORA model has allowed the sector to grow and for the resident to enjoy some wonderful villages and facilities."

2021 - Is this the best investment on the NZX
Brent Melville, Business Desk

An investment in the listed retirement village stocks 10 years ago would have yielded a return of 25% a year, or a cumulative 839% assuming all dividends were reinvested to date, according to a new property sector report by Urban Economics.

The property industry impact report, commissioned by the Property Council, said retirement villages provided the best returns to NZX investors since 2011, with an average share price yield of 23% and dividend yield of 2%.

Listed real estate investment trust (REIT) companies, over the same period, increased in value by 13% on average, while construction and land development came in at 2% per year, Urban Economics said.

2022 New NZ retirement village follows Australia's lead on capital gains
www.theweeklysource.com.au

A new retirement village in New Zealand is following the lead of Australian villages by giving the residents a share of the capital gains when their units are sold.

Vivid Living at Red Beach, on Auckland's North Shore, is located within owner Fletcher Building's larger Red Beach planned community. The village is charging a 15% Deferred Management Fee – compared to the more typical 20%-30% in NZ, and 30-35% in Australia – and is offering residents a 50% capital gains split.

2023 Forsyth Barr
Radio NZ Report

"In this environment, we believe share price performance will be partly driven by an ability to generate free cash flow and reduce net debt."

In the meantime, it estimated debt servicing would consume about 20 percent of the companies' underlying profits compared with about 10 percent over the 2018 to 2022 financial years, while capitalised interest would eat up about 10 percent of new sales cashflow.

"Outside of company specific details, we expect levels of debt and house prices to dominate the overall performance of the aged care sector over the next 18 months," the report said.

"If interest rates and construction costs remain high, we estimate that the sector has an attractive 'out' by not starting any new build projects.

"This could result in the sector becoming largely debt-free."

Forsyth Barr said the three operators had each indicated they would scale back on development and take a more cautious approach.

"If these operators are able… to pay down debt alongside the development rundown… there would be a sizeable upside to the equity value over the next three to four years," it said.
