Can Retirement Village Operators Afford Any Finite Regulated Mandatory Buyback Period?

A recent article by a financial commentator suggested that the cost of a mandatory buyback 28 days after exit or termination of a former resident's Occupation Right Agreement (ORA) is $13,500 and therefore affordable by operators. The commentator also suggests that operators can earn $1,000,000 from a single customer. However, the commentator has overlooked some the costs to operators and benefits to residents in arriving at these conclusions.

When a resident purchases an ORA, they are purchasing a package of services that includes use of the community facilities in addition to the right to occupy their unit for as long as they choose. Residents generally move to a retirement village at a change of life stage such as losing a partner, health issues meaning they may not be able to maintain their own home themselves, or for lifestyle. Many residents are seeking security, companionship, and certainty in addition to the use of the community facilities, that the retirement village lifestyle provides. Certainty includes a set weekly fee that many operators set at a level that affords residents a comfortable lifestyle if their only or main source of income is New Zealand Superannuation which in most cases does not fully cover the operating costs of the village including maintenance of the residents' units, the community facilities and village infrastructure. In consideration of these benefits the residents pay a deferred management fee and, in most cases, forgo capital gains on re-sale of their units. Therefore, it is inconsistent to compare an ORA with other forms of property transactions in financial terms alone.

Not all the capital gain on re-sale accrues as profit or an operating cash surplus to operators. From the gain on re-sale, along with the deferred management fee, operators must firstly cover village operating costs not funded from resident weekly fees, including repairs and maintenance and village re-investment. Retirement villages require a greater level of re-investment than other forms of property to present the villages "as new" and remain attractive to future residents in addition to current residents' enjoyment. As villages age, as many are now, the cost of village reinvestment will be hundreds of millions of dollars across the sector. It is inappropriate to look at revenue alone. The cost of operating the village must also be considered. It is also reasonable that operators earn a return on their investment. Absent a return, operators wouldn't invest meaning a retirement village lifestyle may not be available for those that choose it.

Following a large operator needing to raise further capital, analysts have been critical of the increase in bank debt held by the listed operators, reduced focus on conversion of investment back into cash and arguably needing to borrow to pay dividends to shareholders. There has also been an increase in bank debt held by private operators to fund development of new units to meet forecast demand as the population ages. This disproves the commentator's statement that there is "money sloshing around the financial model." It is also incorrect that "you could build one blind and still do well." There have been failures in the sector while other operators have experienced financial distress. If it were that simple more investors would have entered the sector and banks would have appetite to fund those investors.

However, bank funding appetite is limited as the risks of lending to the retirement village sector are greater than other sectors. Some banks limit funding to the very large and listed operators only, while those banks that do fund private and trusts/not for profit operators will only lend to experienced operators. My opinion is that small, private and not for profit operators would not be able to obtain bank facilities to fund mandatory buybacks. They would need to fund buybacks from equity/cash reserves. The very large and listed operators may be able to obtain some bank support although this is not certain. Before considering the cost of funding buybacks the capacity to fund buybacks needs to be addressed.

For directors and trustees to meet their fiduciary obligations they would need to consider the amount of equity/cash reserves and undrawn bank lines available, if banks agree to provide such lines, to fund buybacks including in a severe market downturn. For simplicity we'll use the numbers in the Ministry of Housing and Urban Development's model and data from JLL's 2022 Retirement Village Database. We also assume that directors and trustees determine that they need the capacity to fund 12 months of buybacks to cover their obligations in a severe market downturn.

The national average village size is 78 units. Assuming 12% churn, that is 9.36 re-sales per annum, at $450,000 per ORA, requiring available equity/cash of $4,212,000 to fund the mandatory buyback obligation.

Re-sales do not occur evenly. For small villages, say less than 50 units, annual average re-sales would be six per year, although over the longer term they may experience some years of no or low re-sales meaning, they firstly need to hold sufficient equity/cash reserves to fund village operating costs not covered by resident weekly fees, including repairs, maintenance and village re-investment in low re-sales years before providing the cash to fund mandatory buybacks. Low re-sales years tend to be followed by higher re-sales years, or at least residents departing the village, meaning that the risk of needing to funding mandatory buybacks in increased. Such operators generally have limited working capital, do not qualify for bank funding and would be unlikely to hold sufficient cash reserves to fund a mandatory buyback obligation - $2,700,000 for a 50-unit village using the stated assumptions.

Trusts do not have access to further capital. Trusts mostly provide affordable and/or faith-based accommodation options and have limited operating cashflows. For a trust with say 150 units, they would need to hold $8,100,000 in available cash to fund a mandatory buy back obligation.

For the very large and listed operators the amount of available cash reserves and bank funding lines would range from $95,000,000 to $403,000,000.

If directors and trustees determined that capacity to fund say six months of buybacks was sufficient, the amount of required cash and bank funding lines, if available, would still exceed the ability and capacity of most private and trust/not for profit operators to provide.

If trusts and private operators exited the sector because only the large operators have the capacity to fund buybacks, intending village residents would be poorer for it. Large operators generally run large villages on higher density sites targeted at the middle market. Intending residents seeking affordable accommodation, premium accommodation, a village offering more space, a boutique village, or a village in a regional location that is unsuited to the large operators' models would be excluded from the retirement village lifestyle.

How much the operators are making as stated by the commentator needs to be reconsidered:

- In my experience the development margin for a village as a whole is considerably less than 20%. A development margin is once only – it can't be added to subsequent re-sales of each unit in the village.
- Deferred management fees are accrued over the expected length of stay of the resident, although are only realised once the units are re-sold.
- Capital gains are not all profit. Capital gains, along with the deferred management fee are applied to fund village operating costs and village re-investment.

- Profit is not a cash surplus. Capital expenditure is capitalised rather than being expensed through the profit and loss account, although is paid in cash while the deferred management fee is not earned until the unit is re-sold. The cash surplus achieved by an operator in any year is different to the reported profit, often materially so and can be negative.

My opinion is that operators do not have the capacity to fund mandatory buybacks for any finite period that could be introduced by legislation and therefore can't afford it. Whether that cost is $13,500 or another number after the unit has been re-sold is academic. When considering if that fair or not, the benefits residents enjoy including non-financial benefits, along with the costs need to be considered. New Zealand has an ageing population with forecast demand for a further ~22,000 units by 2033. If the sector is to meet the needs of current and future potential residents, what is commercially and financially viable also needs to be considered.

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