CONAGHAN
HEALTHCARE CORPORATE FINANCE

Retirement Communities and 'Event Fees'

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29 June 2016

What is an 'Event Fee'?

Event Fees – also called Transfer, Exit, Assignment or Deferred Membership Fees – are charged by many retirement community Operators and are payable when the owner of a residential unit leaves that unit. Event fees typically range from 5%-30% of the gross resale value of the unit at the time of exit. The balance of the proceeds of the unit's resale accrues to the resident's estate. Such fees, which provide a valuable annuity stream to Operators, are becoming commonplace in the retirement community sector in the United Kingdom.

- **The Law Commission has today published its interim recommendations on Event Fees in retirement communities; it concludes that 'event fees can benefit consumers but they must be disclosed to prospective buyers early, clearly and prominently'**
- **'Urgent action is needed to ensure that Event Fees are transparent'; the Commission advocates new guidance for sales agents, a new Code of Practice, including penalties for breach, and a statutory trust for certain Event Fees**
- **In this note, we look at the Commission's recommendations and the wider retirement community market, including how Event Fees may be valued by Operators, investors and lenders.**

Law Commission's New Deal for Retirement Living

Background: In October 2015, the Law Commission – an independent body which keeps the law under review and may recommend reform – published a consultation paper on fees payable in connection with residential leases on a transfer of title, change of occupancy and other events; these are known as 'Event Fees'. The Department for Communities and Local Government (DCLG) asked the Commission to look into this matter following a 2013 Office of Fair Trading report which found that lease terms of specialist housing for older people were potentially unfair. The Law Commission has never contemplated legislation against event fees and they have noted that often purchasers who are capital rich but income poor may welcome an opportunity to defer fees. However, they have also said that Event Fees should be much more transparent.

The Law Commission's report, published today, is supportive of the sector and makes four recommendations. First, that estate agents acting for retirement community operators should be given guidance on their obligations to disclose Event Fees to prospective buyers; second, that the industry should work with the Commission to create a single set of 'Code of Practice provisions' relating to Event Fees; third, that where there has been a breach of the code provisions, the Event Fees in question should be 'presumptively unfair and unenforceable'; fourth, that Event Fees which are 'solely for maintenance, repair or improvement' of a retirement community estate (as opposed to generating additional revenue for the operator, which is commonplace) should be subject to a statutory trust.

Taken together, we view the Commission's Recommendations as strong positive for the retirement community sector, not least removing what it calls 'a black cloud over the industry' left by the inconclusive OFT report of 2013. We note that the Commission's fourth and final recommendation – statutory trusts for what are essentially sinking funds created by Event Fees – would require primary legislation and is a more long-term objective. The other recommendations will have more immediate effect and are likely to be implemented within the next year using existing legislation.

Regarding guidance for selling agents to protect and inform prospective purchasers, the Commission says that the Property Ombudsman has agreed 'in principle' to produce such guidance on the sale of retirement property and Event Fees. This will tighten the existing regime of Consumer Protection Regulations ('CPRs') which agents are already subject to. It will also mean that agents must fully understand the retirement community product, which differs significantly from traditional residential product.

The Commission's call for an industry-wide Code of Practice will be welcomed. Notwithstanding ARCO's Consumer Code (see sidebar, below), there is a need for what the Commission calls 'a fuller and more standardised solution'. The new Code will have teeth, according to the Commission, including 'stringent requirements relating to event fees' and, importantly, will require law courts to take its provisions into account in any dispute relating to such fees 'even if neither party is a signatory to the code'.

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'Law reform is needed to restore legal certainty and provide a legal framework that gives vulnerable elderly consumers greater protection while enabling investors to lend, and builders to build, with confidence' – The Law Commission

Among other things, the new Code will likely require that buyers of properties in retirement communities are given 'realistic worked examples' of Event Fees; only a few operators currently do this.

A key element of the Commission's report is that, as it puts it, 'If the rules are broken, the Fee should not be payable'. Its third recommendation is that a breach of Code provisions will make Fees 'presumptively unfair and unenforceable'. One way of ensuring this would be to add an entry to the so-called 'grey list' in Schedule 2 of the Consumer Rights Act 2015. This list is of contractual terms in consumer contracts which may be regarded as unfair. Currently, a consumer does not have this 'grey list' protection vis a vis Event Fees; if such an addition were made, however, the Commission says that in the event that the code of practice can be shown to have been broken, 'a court would be highly likely to find the event fee to be unfair. As a consequence, the fee would not have to be paid'. Developers and operators would also gain clarity about what is deemed fair and unfair under this proposal.

The Commission's fourth recommendation deals with the issue of Event Fees which are used solely for maintenance capex or improvement of the estate of a retirement community. It notes that there is currently a 'legal anomaly' where money from contingency fees is not protected by a statutory trust. The recommendation is 'not intended to change the way that event fees are spent', the Commission says in its report. 'It would only apply where the money is already required to be used exclusively for the benefit of the property.' It points out that such an instrument would protect these contingency funds in the event of a landlord's insolvency. Where such funds are held on trust, the Commission believes they should be exempt from the proposed 'grey list' addition.

Taking a step back from the detail of the Commission's report, we note that it addresses the 'theory' that developers of retirement communities may be able to borrow against future income streams from Event Fees to finance new projects. Removing legal uncertainty will, in our view, accelerate this potential, although as we say elsewhere in this note it will also depend on lenders seeing such communities reach maturity or 'steady state' and delivering reliable Event Fee cash flows.

What of existing residents of retirement communities, a small number of whom are aggrieved about clauses in their leases? The Commission is candid that its proposed reforms are 'prospective only', although it notes 'the genuine sense of grievance on the part of many leaseholders, many of whom have suffered from poor practices and lack of transparency in the past when they bought their properties'. The Commission states that it is considering 'avenues of redress' for such cases, including an option to bring claims in the First-tier Tribunal rather than in the County Court.

The Commission has laid out its next steps. It aims to have guidance for estate agents, a new industry-wide code of practice and 'grey list' addition in place by April 2017. In the longer term, the Commission will make more detailed recommendations to bring in a statutory trust and amend unfair terms. It concludes that if such recommendations are accepted by DCLG and if the legislative timetable allows it, a Bill would be drafted 'sometime during the 2017-2018 financial year'. It is likely the Commission has its eye on already enacted legislation in mature markets, such as New Zealand's Retirement Villages Act 2003 (see Page 7, below).

In conclusion, today's recommendations are a clear positive for the retirement community sector and are likely to spur further investment in new sites, particularly those aimed at the mid-market. They will also mitigate the negative media coverage which has constrained some operators. The Commission places the need to be fair to prospective purchasers of retirement properties with Event Fees squarely on operators. But its proposals will also be a fillip to the market, given the Commission's acknowledgement of the importance and current undersupply of this type of housing stock, particularly for an ageing population. Those elderly people considering downsizing both need and deserve reassurance that retirement communities are an appropriate purchase option. The reforms this important report advocates will, in the Commission's own words, 'give vulnerable elderly consumers greater protection while enabling investors to lend, and builders to build, with confidence'.

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The ARCO Consumer Code

The Associated Retirement Community Operators (ARCO) is the body which represents the housing-with-care sector for older people in the UK. In 2015, ARCO launched its own Consumer Code for the industry to set standards and improve transparency on initial sales and on Event Fees and service charges levied by Operators. The Code also ensures core levels of service in retirement communities and that a 'fair and consultative relationship' is maintained between residents and Operators.

Regarding Event Fees, the Code includes provisions to 'provide customers with information on any deferred fees that may be payable when they sell or sublet the property'. This should be at the earliest opportunity: 'We will provide this when customers view the site or any property, or otherwise before any deposit is paid to reserve the property'. It also asks its members to 'provide realistic worked examples of their financial impact, clearly stating the assumptions behind the examples'.

ARCO, whose 23 members include leading players in the retirement community sector such as Anchor, Audley, the ExtraCare Charitable Trust and LifeCare Residences, has worked closely with the Law Commission on the latter's Consultation on Event Fees.

www.arcouk.org

Retirement Communities in the UK

Extracare – broadly speaking, housing-with-care – is seeing strong growth in the UK, as existing operators bring retirement community developments on stream and new entrants arrive. The market is still nascent, with an estimated 15,000-20,000 units currently built out, but we expect this number to at least double over the next five years.

Macro demographic trends and the build-up of very substantial housing equity combine to make a large target audience for operators offering housing-with-care to elderly people. Typically, purchasers are seeking secure environments which offer companionship, leisure facilities and care. Initially, they may require low-level domiciliary care, but over time are likely to seek closer care, palliative and end-of-life care. Many operators cater for this with assisted living units and on-site nursing facilities alongside residential units.

Units in retirement communities, which are typically, one and two-bedroom apartments and townhouses, are normally sold on long leaseholds and priced with a premium over comparable local residential property or, where the retirement community operator charges a large Event Fee on exit, with no premium. Besides the upfront purchase price of a unit, most retirement community residents will pay a monthly service charge (in some cases, fixed and capped for the duration of their occupancy, but more usually rising annually with RPI), as well as a ground rent and fees for care, either on an *a la carte* basis or in longer-term planned care packages.

While Event Fees are now becoming commonplace, they are still a new concept in the UK and have attracted the attention of both the Office of Fair Trading and, more recently, the Law Commission. Such fees vary considerably from operator to operator, typically in a range of between 5% and 30%. For the purchaser, they may mitigate higher upfront costs and service charges; for the operators, they offset lower efficiency ratios (Net Sellable Area to Gross Internal Area) as a result of larger amenity and communal areas compared to a normal residential development. But they are also a valuable part of the business model. Maturing villages, such as those operated by Richmond Villages, Retirement Villages UK and LifeCare Residences are beginning to provide proof of the accretive value of deferred fee models which create long-term annuity streams for operators. As the market matures, such annuity streams are likely to be recognised by lenders and, in time, by pension fund investors. (Note that not all operators charge Event Fees and some of those who do make a case for such fees as a contribution to maintenance capex.)

Looking at the extracare market as a whole, it can be segmented by age group, location and fees model. Invariably, the starting point on age restriction is 55, but many operators insist on a minimum entry age of 60 or 65. Some actively market to 'second retirees' – people in their seventies and eighties who are likely to be making their final property purchase and who will have more acute care needs; in time, retirement communities tend to become self-selecting, as people of similar age groups coalesce. Age of entry of residents will drive the average length of stay in the property; the lower the average length of stay, the higher the revenue from Event Fees.

In terms of location, the traditional retirement areas such as the Home Counties, Kent, the South Coast and the West Country are popular with developers and operators targeting exit sales prices of GBP 400–600 per sq ft. In the South East, a further concentration is developing around the M25, led by Audley, PegasusLife (which does not charge Event Fees) and Elysian Residences. In London, where exit sales prices start at around GBP 850 per sq ft (in Zone 3, for example) and rise steeply, at least a half dozen retirement communities are now in planning and construction. One of the first central London communities, LifeCare Residences' 108-unit Battersea Place development, had Practical Completion in the Spring and reported strong pre-sales of the majority of its units, which are priced between GBP 650,000 and GBP 3.0m.

Extracare developers typically require C2 ('residential accommodation and care') consent from planning authorities. Such consent typically comes without any requirement for affordable housing provision, meaning developers are able to pay premium prices for land. Local authorities often look favourably on extracare schemes because they increase the in-borough provision of housing and specialist care for the elderly, and because they bring significant local employment: a 100-unit development with care on-site can mean 60-70 new jobs for RGNs, care workers and ancillary staff.

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Care Quality Commission (CQC) registration of retirement community operators creates both continuing obligations and a barrier to entry. However, we are seeing an increasing number of partnerships between non-registered developers partnering with CQC-registered care providers. Indeed, the softening of the premium residential market in London and elsewhere has prompted several large housebuilders to begin developing strategies to participate in the extracare sector.

Retirement Community Operators / Event Fees

Operator / Parent	Brand	Villages	Units	Event Fee (Max.)
The ExtraCare Charitable Trust	The ExtraCare Charitable Trust	16	3,701	10.0%
Retirement Villages UK	Retirement Villages	16	1,354	12.5%
Audley	Audley	14	1,298	15.0%
	Mayfield	10*	2,500	*nd*
MHA	MHA	4	724	2.3%
BUPA	Richmond Villages	7	659	10.0%
Helical Bar	Renaissance Villages	4	633	10.0%
Anchor Trust	Anchor	3	615	4.5%
Rangeford Holdings / Octopus Invts	Rangeford	3	554	10.0%
LifeCare Residences	LifeCare Residences	3	292	30.0%
Berkeley Healthcare	Berkeley Healthcare	2	172	*nd*
Oak Retirement	Oak Retirement	2	141	4.5%
Elysian	Elysian Residences	1	110	*nd*
Red & Yellow	Red & Yellow	1	102	20.0%
Chantry Court	Chantry Court	1	68	10.0%
		87	**12,923**	

Source: Company reports; C&Co.
**Planned villages, announced April 2016*

Growth in the extracare market is constrained partly by the time it takes to acquire sites, gain planning, construct and deliver schemes. In London and within the M25, land prices will dictate that villages are likely to remain at the premium end of the market; elsewhere, a mid-market is rapidly emerging. These developments will be larger in size and priced to reflect equity release levels in local housing stock. Mayfield, Audley's new mid-market brand, for example, will deliver two new villages per year for the next five years, a total of 2,500 homes. Some new mid-market stock will be delivered by construction companies such as Castleoak, which has built 'turnkey' villages for Richmond (BUPA), Retirement Villages UK and the Joseph Rowntree Housing Trust, among others. LNT, a well-established developer of turnkey elderly residential care homes, is also seeking to enter this market. Separately, we note the emergence of the rental-only retirement community model; Avery Healthcare Group, which currently has four such communities branded as The Hawthorns, is growing this sub-sector successfully.

Notwithstanding caution in the lending market following the EU Referendum result, we see sustained appetite for the financing of retirement community developments. Typically, senior lending comes from the clearing banks, which are increasingly using both their healthcare and corporate real estate teams to assess transactions in this nascent asset class. We note the recent funding by Bank Leumi for Audley Retirement's 126-unit Redwood scheme near Bristol, which has a GDV of GBP 70m. (Bank Leumi previously provided financing for Audley's Chalfont Dene village). We see 60% Loan-to-Cost as the standard ratio for senior lending. Mezzanine finance typically comes from specialist lenders and large real estate debt funds, some of whom prefer to underwrite 'whole loans' (i.e. senior plus mezzanine) for developments. Where mezzanine is deployed, total Loan-to-Cost is normally no higher than 75%. Invariably, these senior and mezzanine loans are for construction on land with planning permission and are repaid by the proceeds of the sale of units at Practical Completion. In all cases, Loan-to-GDV is often the key ratio for lenders (50% for senior debt; 60% for mezzanine). Care homes which sit alongside retirement living units can be financed independently and are much more familiar to lenders; they are clearly valuable assets in their own right, with mature, purpose-built homes attracting valuations of 10x-12x EBITDA. Finally, as the market develops, we expect to see lending against Event Fee cashflows, but lenders will need to see evidence of individual retirement communities reaching 'steady state' in terms of resales.

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Event Fees – Key Points

- Event Fees vary between Operators and often depend on the number of years a resident has owned his or her property; the full fee may not be charged if there is an exit in the first one or two years
- Once a retirement community has opened, an Operator has to wait several years before the units begin to generate Event Fee revenue
- The average length of stay of residents drives the number of apartments resold every year
- At steady state, the number of resold apartments generates a stable and recurring income stream for the Operator.

Valuing Event Fees

The Event Fee example below is based on the acquisition of long lease on a retirement village property for GBP 550,000. It assumes that the value of the property would appreciate by 4.0% per annum and that resident leaves the property after six years. In this example, the Event Fee charged by the Operator is 20.0% of the property's value at resale, with the residue paid to the resident's estate.

Assumptions

Unit Acquisition Price	550
Inflation per annum	4.0%
Event Fee rate	20.0%

GBPk	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Acquisition price	550						
Underlying property value		572	595	619	643	669	696
Event Fee to Operator							(139)
Return to Resident's estate							557

Many operators will not charge the full Event Fee if a resident leaves in Year 1 or Year 2. Some operators apply an accruing annual rate per year of occupation: for example, Audley, a leading player in the premium market, applies a deferred management charge of 1.0% per year of occupation, up to a maximum of 15.0%.

Income Stream and Accruals

Depending on the average age of the residents in a newly opened retirement village, it will take some years for the first resident exits and subsequent resales. But once a retirement village is 'mature' and has reached steady state the number of apartments resold every year becomes stable and generates a steady income stream for the Operator.

The example below is based on a retirement village of 110 units with an average price of GBP 550,000 per unit and a total Gross Development Value of GBP 60.5m at Practical Completion. The table shows how the number of resold apartments increases during the first years of operation to reach a steady state at maturity. It assumes that the average length of stay of residents is six years; at steady state circa 16.7% of the 110 units of the village would be resold per annum. Net cash flow in Year 6, therefore, would be GBP 2.1m.

GBPm	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8
GDV inflated	62.9	65.4	68.1	70.8	73.6	76.6	79.6	82.8
Unit resales	-	-	5.0%	9.5%	13.5%	16.7%	16.7%	16.7%
							Steady state	
Event Fee Income	-	-	0.7	1.3	2.0	2.6	2.7	2.8
Tax	-	-	(0.1)	(0.2)	(0.3)	(0.4)	(0.5)	(0.5)
Net Cash Flow	-	-	0.6	1.1	1.6	2.1	2.2	2.3

Note that the table does not show maintenance capex or annual depreciation associated to a sinking fund. Net cash flow received from the Event Fees could therefore be reduced by the costs associated with maintaining and refurbishing the properties (this is a key difference between retirement village developers and traditional residential developers – the former have an ongoing vested interest in the fabric of the building so that units can be resold successfully).

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Valuation Considerations

- Valuation of the Event Fees income stream is based on Discounted Cash Flow analysis, rather than cap rate or yield
- This methodology values the asset at steady state, when cashflows are stable and predictable
- Age of entry of residents will drive the average length of stay in the property; the lower the average length of stay, the higher the revenue from Event Fees
- House price inflation rate plays an important part, because Event Fees are calculated on resale price of the property
- Weighted Average Cost of Capital used (WACC) equals Cost of Equity, between 10% and 12%
- When the market matures to a point when there is lending against Event Fee cashflows, the OpCo values will increase, because of the implied lower cost of capital.

Valuation Methodology

In our view, the most appropriate methodology to value income arising from Event Fees is through Discounted Cash Flows rather than cap rate or yield. Cap rates are appropriate to value cashflows such as rents, which would be constant or vary only with RPI (for example, PropCo / REIT owning care homes with defined rent are usually valued based on Net Initial Yield, between 5.5% and 7.5%). Cash flow arising from Event Fees vary with house price inflation and average length of stay of residents. Conceivably, cash flows from Event Fees could support a Ground Rent in which case a cap rate/yield methodology would be appropriate.

Note that we only value the asset at steady state, as Event Fees during the first years of operation are difficult to predict. Valuing the asset at steady state is then equivalent to calculating a Terminal Value based on the following formula:

$$\text{Terminal Value} = \frac{\text{FCF at Steady State} \times (1 + g)}{(\text{WACC} - g)}$$

where g = Long Term Growth Rate = 3%

and WACC = Cost of Equity = 10%

See detailed calculation in Appendix.

Valuation and Sensitivities

In the example of a 110-unit retirement community, net cash flow is GBP 2.1m in Year 6, when the scheme has reached steady state. This net cash flow figure will, of course, vary from one year to another following the housing market. Looking at historical house price inflation rates (see table), we note that inflation has been 5%-9% on average. Although the outcome of this WACC calculation methodology gives a 10% discount rate, we acknowledge this may seem aggressive given the asset class. Therefore, we run sensitivities with WACC varying between 10% to 12%:

	GBPm	Long Term Growth Rate (house price inflation) 2%	3%	4%
WACC	10%	27.0	31.2	36.7
	11%	24.0	27.3	31.5
	12%	21.6	24.2	27.5

In the example of a mature retirement community which generates GBP 2.1m of net cash flow at steady state, DCF methodology would value the business around GBP 27.3m. This valuation is sensitive to assumptions about the long term growth rate in the residential housing market. For comparison, this valuation is equivalent to 10.7x EBITDA at maturity (based on GBP 2.6m EBITDA in Year 6) and a 9.4% yield which is conservative compared to other sectors.

House Price Inflation (average per annum)

	1993 to 2015	2010 to 2015
England	+ 7.2%	+ 6.2%
South East	+ 8.9%	+ 5.7%
London	+ 7.3%	+ 9.1%

Source: ONS, House Price Index

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Case Study: New Zealand

New Zealand has led the way both in the development of retirement communities and the financial arrangements between residents and operators. The retirement community concept is now well established and the country represents the world's most mature market, with 5.1% penetration among the 65+ age group and 12.1% among over-75s. New Zealand has a population of 4.5m, of whom 650,000 (14.0%) are over 65 years old. It expects its over 75s population growth to rise from 10,000 per annum to 20,000 per annum by 2031.

The New Zealand retirement community market is diverse, with some 170 different operators owning and managing 376 villages. The six major operators – Ryman, Metlifecare, Summerset, BUPA, Oceania Healthcare and Arvida – have a combined 56% market share; they currently manage a total of 152 villages, with nearly 15,000 existing units and a further 10,000 units in the pipeline.

Parent Companies	Units	Villages	Average size (units)	% Market Share
Ryman	4,792	30	160	18%
Metlifecare	4,033	25	161	15%
Summerset	2,419	21	115	9%
BUPA	1,466	35	42	6%
Oceania	1,163	25	47	4%
Arvida Group	908	16	57	3%
Total	**14,781**	**152**	**97**	**56%**

Companies' websites
JLL, New Zealand Retirement Village Database, November 2015

Ryman (NZE:RYM) is the largest operator with 4,792 units in 30 villages and has spawned a large number of lookalikes seeking to emulate a financial track record which has delivered 14 years of successive double-digit profits growth. The company opened its first village in 1996 and listed on the NZX in 1999. Ryman's business model is one which is being swiftly replicated in the United Kingdom: villages typically comprise Independent Living units (two-bedroom apartments or townhouses), Assisted Living units (one-bedroom apartments with housekeeping and care packages) and a care home or hospital facility with dementia care capability. Ryman targets older residents – IL residents are typically 78-79 years of age on entry, while AL residents are 84+ years of age. The company's business model is driven by an 'Occupancy Advance' from prospective residents which is 'greater than the cost of construction', care fees, the resale of Occupation Rights and Management Fees of up to 20% of the Occupancy Advance. Together, this allows Ryman to '[develop] new villages which are self funding on completion, and which then leave decades of recurring, growing cash flows. In this way, we recycle capital on a village-by-village basis, and extract capital and equity for future developments' *(source: Ryman)*.

From the purchaser's perspective, many NZ operators require them to pay an Event Fee on exit as a matter of course. Typically, a resident's final bill will include a percentage (often 20%-30%) of the purchase price of a unit (rather than the resale price, as in the United Kingdom) and they will also surrender 100% of any capital gain which the property has accrued during their tenure. (For comparison, in our example on Page 5, which showed a retirement community in the UK where a resident's estate would receive GBP 557,000 from a sale at GBP 696,000, in New Zealand the same sale would result in an accrual to that estate of only GBP 440,000).

The New Zealand Retirement Villages Act passed onto the statute book in 2003 and is chiefly concerned with transparency, cost and residual values against the duration of residents' occupancy. Among other things, it requires operators to make a disclosure statement to purchasers of units in retirement communities, detailing all charges, including 'entry costs' and 'transfer costs'. Importantly, the disclosure statement must contain 'the estimated financial return that a resident, former resident, or the estate of a former resident, could expect to receive on the sale or other disposal of a vacant residential unit at intervals of 2 years, 5 years, and 10 years after the resident enters into an occupation right agreement'.

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Appendix 1 – WACC Calculation

There are only a limited number of retirement villages in the United Kingdom which can show historical evidence of income generated by Event Fees. At present, very few banks and lending institutions will lend against this income stream. Therefore, most of retirement villages OpCo's, which are generally the vehicles which collect Event Fees, are unencumbered:

WACC (cost of capital)		= Cost of Equity (Re)	
		= Rf + Beta x (Rm - Rf)	
where	*Rf*	= Risk Free Rate = 1.25% UK 10-year Gilt (average last month)	
	Rm	= Expected market return = 9.48% UK market return	
	Beta	= 1/3 Europe Real Estate (Development)	0.91
		1/3 Europe R.E.I.T.	0.97
		1/3 Europe Healthcare Support Services	1.15
		Average	1.01
therefore	*WACC*	= Cost of Equity = 9.6%	
	WACC (rounded)	= 10%	

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