URB INVESTMENTS LIMITED

ABN: 89 615 320 262

QUARTERLY REPORT

HEALTHCARE – BENEFITING FROM URBAN RENEWAL

This Quarterly Report focuses on the opportunities that exist within the healthcare industry. These opportunities are the result of favourable macroeconomic factors including Australia's population growth and rapidly aging population.

JUNE 2018

URB is managed by Contact Asset Management
AFSL 494045

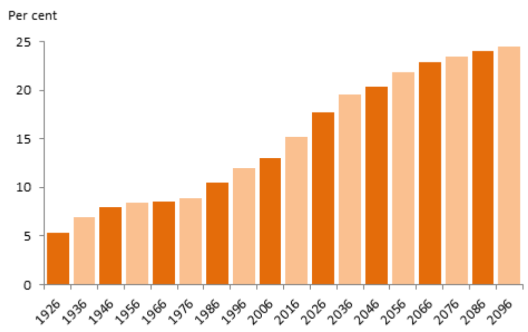
Welcome to the fourth issue of the URB Investments Limited (URB) Quarterly Report, prepared by Contact Asset Management. These reports provide us with an opportunity to communicate with URB shareholders on high-level topics of interest. The reports are available on the website at www.urbinvest.com.au. We also encourage you to subscribe to the URB mailing list.

In this edition, we focus on the changing dynamics within the healthcare and aged care industries. We will also consider how firms within these industries stand to benefit from key macroeconomic trends over the next several years. The health and aged care industries are particularly important over the near term with Australia's population experiencing a net population increase of 1.6% in the year to June 2017. This has outpaced the rest of the developed world with US at 0.7%, Canada at 0.9% and the global average being 1.1%[1].

THE BACKGROUND

To accommodate Australia's growing population, cities are being forced to expand and require healthcare services to expand with it. Additionally, Australia has a considerable aging population with 15% of the population aged over 65 in 2016, and by 2026 this number will be closer to 20%, equating to approximately five million people[2].

Figure 1: Australian population aged 65 and over, at 30 June,



Sources: ABS [1, 2].

This segment of the population will require considerable investment to be made either by the participants within the industries or by State and Federal Governments as healthcare and aged care services will increasingly be in high demand.

In this report, we cover two key trends and consider the impact on three segments of the health and aged care industry in which URB has made investments. The key trends are:

- the expansion of Australia's capital cities due to population growth; and
- the high level of Federal and State Government spending on infrastructure projects.

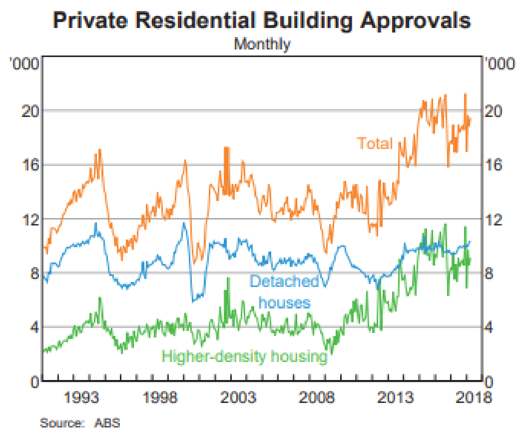
The three sections of the industry which will be covered are aged care providers, retirement living providers and hospitals.

MY ISLAND HOME – MIGRATION DRIVES POPULATION GROWTH

The scale of change which is currently occurring within Australia's capital cities is staggering, particularly in terms of population growth, with the capital cities all growing at double digit rates between 2006 and 2016[3]. According to ABS data, Greater Capital Cities grew at 21.7% while the rest of Australia grew at 12.2% during the 10 year period[3]. According to the latest minutes from the RBA this is being "*driven in large part by net overseas migration of younger people*"[4].

In Victoria, areas like Bacchus Marsh and Wallan, both over 50 kilometres way from Melbourne's CBD, have population growth of over 5.0%pa. Areas nearer to the CBD like Brunswick and Essendon only have population growth between 1.0%pa and 2.0%pa[3]. This population expansion is in conjunction with the growing residential approvals and commencements, which have been at record highs for some time. According to the RBA Board, *"The amount of building work in the pipeline remained high; the pipeline of work was expected to support a high level of dwelling investment for some time"*[4].

The below graphs highlight how the approvals in residential buildings have increased considerably.



[1] *Australia's Population Growth Outpaces World as Migrants Rush in*, Reuters, December 2017

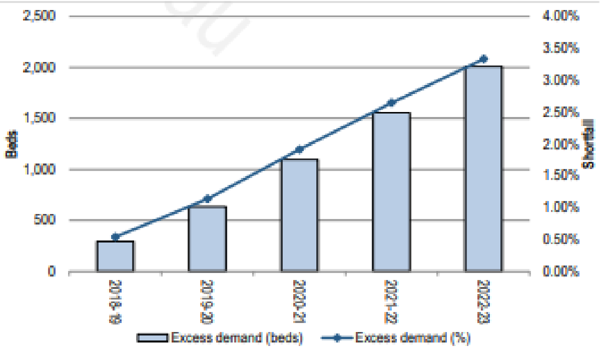
[2] *Older Australia at a Glance*, Australian Institute of Health and Welfare, April 2017

[3] *ABS 2017 Census of Population and Housing*, 2016, Australian Bureau of Statistics

[4] Minutes of the Monetary Policy Meeting of the Reserve Bank Board, June 5 2018

PRIVATE HOSPITALS TO THE RESCUE – ALLEVIATING THE SHORTAGE OF HOSPITAL BEDS

The industry tailwinds present an opportunity for the healthcare and retirement living industries, and the more capable management teams are putting in place measures to best take advantage of them. The expansion in population is placing an increasing strain on the number of available beds within both public and private hospitals. The shortages in availability of public hospital beds is expected to reach at least 3000 beds[5] by 2023.



Source: APRA, AIHW, Credit Suisse estimates

This is causing Governments to adopt policy measures to encourage more of the population to take up private health insurance. This includes a tax levy for high-income earners who do not have private health insurance, a rebate to make private insurance more affordable and a financial incentive to take out insurance before age 30.

However, one challenge is that there are still approximately 800,000 patients per year who have private health insurance but are being treated in public hospitals.

At a recent private healthcare presentation that we attended, Mr. Michael Roff (CEO of Australian Private Hospitals Association) noted that between 2007 and 2016 there was an estimated growth in the number of *private* patients in the *public* system of up to 700%. This costs private hospitals, health funds and the taxpayer millions of dollars each year.

While Private Hospital operators continue to lobby for change, they are also undertaking self-help initiatives by redeveloping existing sites to improve the comfort of patients and drive more volume where possible.

This investment will also help to overcome the perception that the amenities and care in public hospitals is equal to that in private hospitals.

PROPERTY PRICES AND THE GROWING POPULATION

The increasing population has been one factor in property price appreciation over the last few years. This has made it increasingly difficult for many Australians to afford to buy a home. It also creates an affordability challenge for those in retirement phase who do not have a steady income stream. This has led to many retirees looking to outer-metro and regional areas. Companies such as Stockland and Lendlease have targeted this segment through the development of large communities specifically for retirement aged Australians.

Stockland has 65 senior living communities[6] around Australia and Lendlease has 71[7], many of which are branded as "affordable housing".

Stockland Retirement Communities[6]

LendLease Retirement Communities[7]

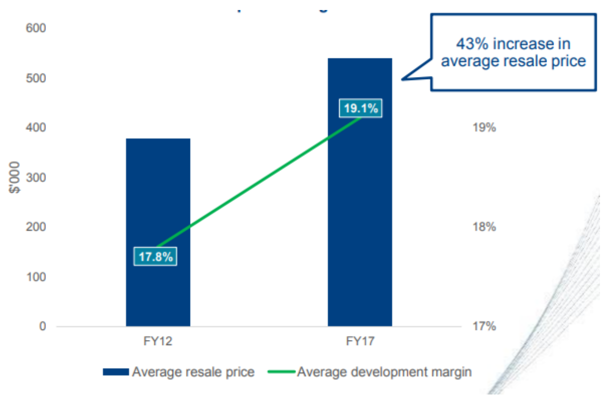
While the definition of "affordable housing" may be a stretch Stockland's Elara community has average

[5] *Australian Private Hospitals*, APRA, AIHW and Credit Suisse estimates, 2018

[6] https://www.stockland.com.au/retirement-living/find-your-village, June 2018

[7] https://www.lendlease.com/au/living/retirement-living/, June 2018

prices for two bedroom homes at over $700k it is a sign that these companies are trying to tap into this market. This is crucial for the retirement living industry as new developments are often further away from the centre of cities and must therefore be affordable to attract customers. Additionally they are constructing several of these Retirement Communities in the same development site as their traditional homes, which is beneficial from a scale perspective but also allows loved ones to live nearby.



Source: Stockland HY18 Financial Information

AGED CARE IS ALSO ANOTHER AREA OF OPPORTUNITY

The providers of Aged Care facilities such as Regis Healthcare, Estia and Japara are also beneficiaries of the growing population, with the number of Australians aged over 65 growing at seven percent between 1996 and 2016[8]. This has allowed these businesses to open up new sites and redevelop existing sites in order to increase the number of beds they own. Over the next 10 years, it is estimated that approximately 83,500 new places will be required, which represents an investment by the industry of almost $35 billion[9].

"By 2042, there will only be 2.5 people of working age supporting each person aged over 65. Compared to 5 people of working age in 2002"

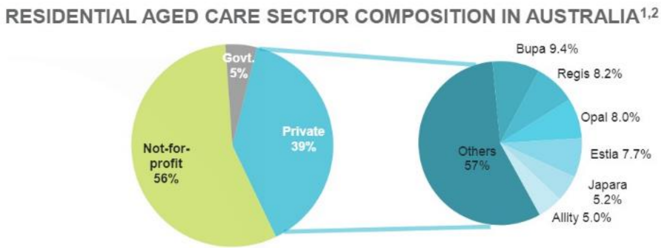
- Treasury Department paper on Population Demographics

This is a staggering amount particularly when considering that in the previous 10 years only 33,367 new places became available[9].

This investment will largely be made by the major industry players such as Regis, Estia and Japara as the Federal Government has announced cuts to its current funding for the aged care industry and more stringent measures around the how funding is determined.

With Government funding accounting for approximately 80% of industry revenue, the new policy will be a blow to the industry particularly to the 30% of providers who are operating at a loss[9]. Again, this provides a significant opportunity for the major operators in the industry as the fragmented industry will begin to rationalise as many of the smaller players will not be able to continue to operate with Government funding declining.

Source: ACFA, 2015.



GOVERNMENT INFRASTRUCTURE SPENDING

The spending by Federal and State Governments on transport infrastructure across Australia has opened up previously under-developed areas around capital cities.

In URB's previous quarterly report, my colleague, Jovana Gagic, mentioned that Western Sydney alone will have nearly $20 billion worth of infrastructure investment over the next decade. The Western Sydney Airport is a key part of this $20 billion investment, representing a $5 billion investment. This in turn is leading to new communities being established in this part of Sydney[10].

NEW COMMUNITIES – FROM WIDE OPEN PLAINS TO EXTRA WIDE PLANES

One key example of this is a 344-hectare site being developed near the new Western Sydney Airport. This new site will have a university, a Westfield and most importantly a mixed use residential and retail offering[11]. This new community will also require healthcare facilities to support the area's population growth, such as hospitals, medical centres, retirement and aged care facilities.

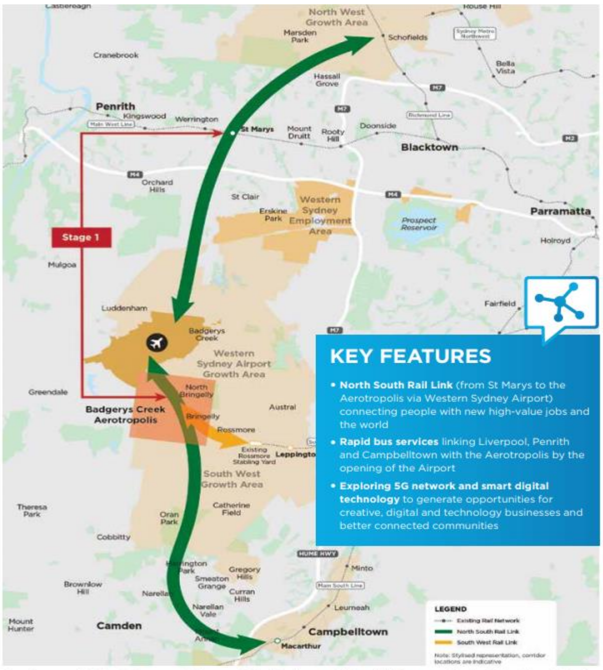
[8] *Older Australia at a Glance*, Australian Institute of Health and Welfare, April 2017

[9] *2017 Report on the Funding and Financing of the Aged Care Industry*, Department of Health, October 2017

[10] *Western Sydney City Deal*, March 2018

[11] *New 344-Hectare Badgerys Creek Masterplan Announced*, Australian Financial Review, 28 May 2018

Western Sydney Airport, the 'Aerotropolis' highlighted in red is the new 344 hectare site.



Source: Commonwealth of Australia, Department of Infrastructure, Regional Development and Cities, and NSW Department of Premier & Cabinet, Western Sydney City Deal

Hospital providers such as Ramsay Healthcare have an opportunity to set up not only a hospital but pharmacies and smaller healthcare/wellness rooms in the area as well. The major infrastructure projects across the country such as the Outer Sydney orbital road (to be called the M9) present similar possibilities for the industry, as this will lead to more development in this corridor to house the estimate one million extra people in Western Sydney by 2031 and 378,000 new jobs[12]. The key to these opportunities is that they are present now while the significant infrastructure investment is in full swing.

FUNDING CUTS TO AGED CARE – HEADWINDS DISSIPATING

The second order effects of Government infrastructure spending for the aged care industry are very similar to the impact on the retirement living industry. That is, new roads and rail networks increase the value of their land and allow them to open new facilities in locations that were previously more isolated from the metropolitan centres.

Over the last three years, aged care funding has been negatively impacted by a Government looking to reduce its budget deficit. Aged Care has historically been heavily reliant on subsidies, with nearly 80% of industry revenue from Government funding. The good news is that the high level of regulatory change in the industry now seems to be settling.

Nevertheless, there are two new initiatives that will have an impact on the industry:

- the new Aged Care Funding Instrument (ACFI)
- the 'significant refurbishment' subsidies.

The ACFI is a set of criteria against which each patient is measured by the Australian Aged Care and Quality Agency (AACQA) and funding is then determined based on this score. These payments can then be increased by a maximum of $52.49[13] per patient if the facility qualifies as being "significantly refurbished".

In order to qualify, the facility must meet a range of criteria, but importantly the refurbishment must have occurred post April 2012 and have increased the number of rooms in the facility by 25%[14]. It is not easy to qualify for this due to the considerable expenditure that is required to achieve the standard. This is an advantage for the larger aged care providers as they will be more willing and able to make this investment. Regis Healthcare for example has 60%[14] of its facilities being approved as significantly refurbished.

HOW WILL URB TAKE ADVANTAGE OF THESE TRENDS?

RAMSAY HEALTHCARE

Ramsay Healthcare ("RHC") has been under pressure recently with the stock falling almost 25% this calendar year to date. An earnings downgrade has hurt, although we believe the share price reaction has overshot given the earnings downgrades were minimal. The previous guidance provided by management was for EPS growth of 8.0% to 10.0% but this was revised to 7.0% growth.

Ramsay's share price over the past year

Source: Bloomberg

---

12 *Infrastructure Australia*, 2018, infrastructureaustralia.gov.au/projects/map

13 Accessing a higher level of Accommodation Supplement. Guidelines for newly built and significantly refurbished residential aged care services, Department of Social Services, December 2014.

14 Regis HY18 Financial Results

We see the weakness in RHC as an opportunity. We continue to believe that the long-term trends are solid – both domestically and abroad. Firstly as discussed above there are several macroeconomic tailwinds which will assist RHC for years to come. The Company continues to make progress (albeit at a slower rate than originally hoped) in their overseas expansion with 46%[15] of revenue now coming from France and the UK combined.

Finally, we believe they have a very sensible and experienced management team. This has allowed RHC to deliver continually increasing dividends and sustainable earnings growth.

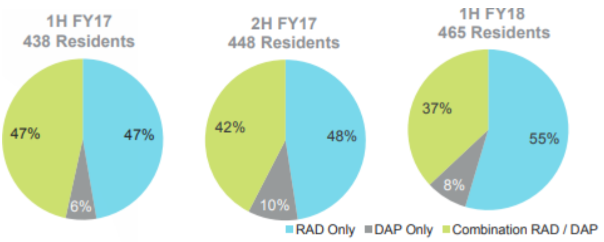
REGIS HEALTHCARE

Regis Healthcare ("REG") is another Company we like as it has a solid history of investment with a number of developments and initiatives underway to renovate and refurbish their various sites.

Source: Regis HY18 Financial Information

This pipeline will help REG grow despite the fall in government funding, and attract higher income residents to whom they can charge a higher rent.

Furthermore we can see from the above chart that the source of income for REG is shifting more towards RADs and away from DAPs. RADs or Refundable Accommodation Deposits are a lump sum payment made to the aged care centre within 6 months of a resident arriving. This lump sum is effectively an interest free loan and can be used by the facility to refurbish and upgrade their facilities. This deposit (less any agreed upon fees) is then refunded to the resident or their estate when they leave the aged care facility. DAPs or Daily Accommodation Payments are a pro rata amount of the RAD paid more regularly.



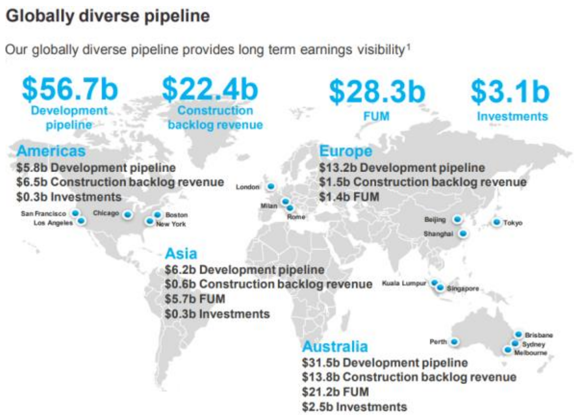
Source: Regis HY18 Financial Information

The DAPs cannot be used by the aged care facility to refurbish or renovate. This is why we believe RADs to be more favourable for aged care providers and the fact that REG has most of its funding coming from RADs is a positive. Due to their strong RAD balance REG is less reliant on government funding and will be able to fund their growth without taking on excessive debt.

REG has a Management team and Board that are aligned with shareholders – the founders still own 27.25% of the Company each[16]. We believe that the significant investment into its facilities in recent years will help underpin earnings growth for some time. We are also attracted to REG dividend yield which is 6.6% on a grossed-up basis[16]

LENDLEASE

Lendlease ("LLC") is a standout in the urban renewal space given its global strategy across Gateway cities. LLC has been a fruitful investment for URB since inception and we continue to see a long runway of growth for the business. The Directors of Contact recently toured the Riverline Project in Chicago and were impressed by the scale, expertise and quality of the development.



Source: LendLease HY Financial Results

The above chart shows the major international pipeline and the scope of LLC operations. One key initiative of the management team is to move away from pure construction into the development area, which allows them to be involved in each step of a project or to bid directly for projects.

We also feel that the growth potential in their other business areas, such as retirement living, are not fully appreciated by the market.

[15] Ramsay HY18 Financial Results

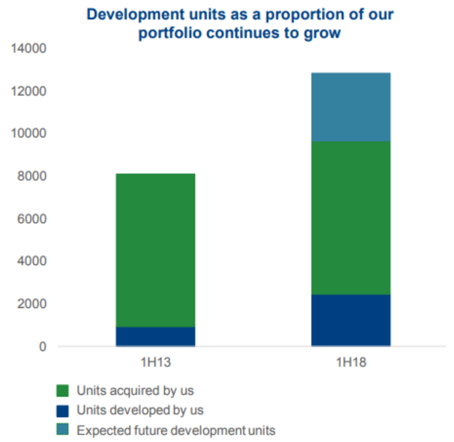
[16] Bloomberg Consensus Data

STOCKLAND

We see some similarities between Stockland ("SGP") and Lendlease, although on a more domestic scale.

SGP sees the importance of the retirement living space and they have recently created an entire division for this area and appointed a CEO of the new division. We recently toured a number of SGP facilities in Sydney and were impressed to find that their key developments are almost all located near important growth corridors.

The Wetherill Park Shopping Centre is a great example of this as it will benefit greatly from the Western Sydney Airport with 11,000 jobs expected to be created in the area, according to Stockland Group Executive John Schroder.



SGP has a very strong pipeline of future developments as the above chart shows and their occupancy rates are also very strong.

The stock is currently trading on Price/Earnings multiple of 13.9 times, which is a discount to peers and the dividend yield is 5.5%. We also believe that SGP boasts a quality management team.

Rahul Tamilarasan
Contact Asset Management

Investments Limited
Level 2, 160 Pitt Street Mall
Sydney NSW 2000
T (02) 9210 7000
F (02) 9210 7099
W: www.urbinvest.com.au