Infratil Update

Investing in the Retirement Sector

May 2015

Infratil

Retirement Accommodation and Aged Care

In December 2014 Infratil and its partner, the New Zealand Superannuation Fund, each acquired 50% of RetireAustralia for a sum which valued the Company at approximately A$650 million (debt A$210 million and equity A$440 million).

Infratil now has over $400 million invested in retirement accommodation and aged care in New Zealand and Australia.

Metlifecare (20% owned by Infratil) and RetireAustralia (50% owned) provide homes for almost 11,000 people in approximately 8,000 units, apartments and care facilities.

Housing (not just for the elderly) is a topic drawing attention from academic, regulatory, political and commercial sources. Aspects of the housing market are felt to be inefficient and there are many suggested solutions.

This Update outlines RetireAustralia and Infratil's investment case. It also explains why the investment outlook for retirement accommodation differs from the returns and risks of other segments of the housing market.

Context

Although it's a part of the wider housing market, accommodation for the elderly has its own demographics, special demand characteristics, and a unique model for charging residents.

Metlifecare and RetireAustralia provide a type of accommodation for which there is growing and predictable demand and relatively low risk revenues. This combination is why they have attracted "institutional capital" which is allowing them to increase their provision of accommodation as they invest for growth.

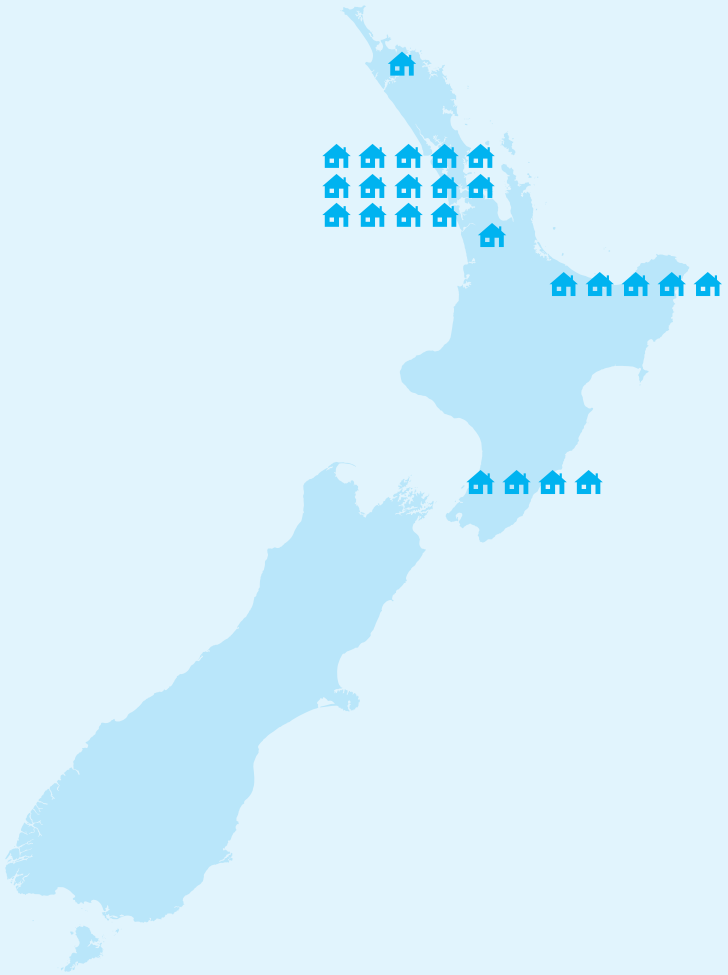
The sector has developed in different ways in New Zealand and Australia, but as operators become more attuned to resident needs the differences are being reduced. Not surprisingly, elderly people on both sides of the Tasman tend to want the same thing, especially if they have higher care needs.

RetireAustralia

Queensland	810 units
New South Wales	1,680 units
South Australia	1,210 units

Metlifecare

Kerikeri	48 units
Auckland	2,353 units
Hamilton	198 units
Bay of Plenty	714 units
Lower North Island	595 units



The Housing Market

Retirement accommodation is a distinct segment of the overall housing market and a brief commentary of that wider market is helpful to set the scene and to illustrate the lack of homogeneity.

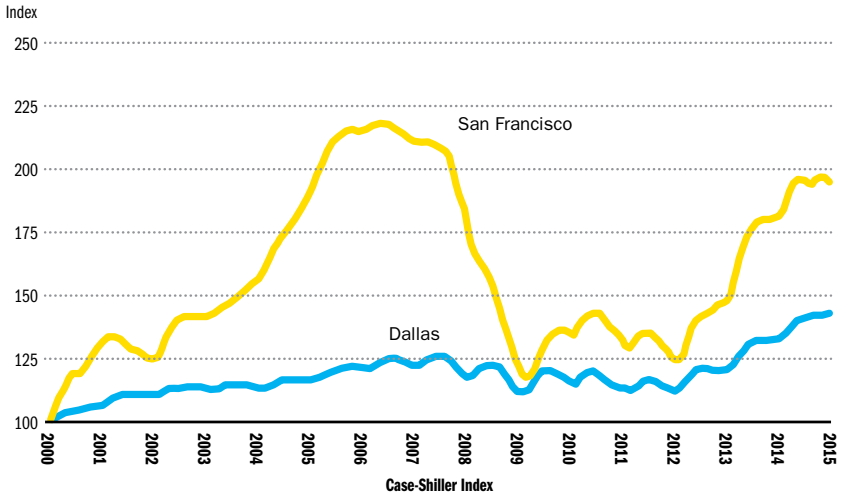
It would be difficult for anyone in New Zealand or Australia to be oblivious to concerns about how house prices in some cities are outstripping logic, but media coverage tends to focus on hot-spots. It is important to appreciate that the "housing market" is in reality a series of individual markets with varying degrees of connection.

House prices rise when supply cannot keep pace with expanding demand and the demand/supply imbalance can be quite local. The US market during its 2002–2006 bubble is a good illustration (because of excellent data). Dallas home prices rose 10% (+US$18,000), San Francisco's 55% (+US$311,000). Dallas has ample land available for development and accommodating planning rules, San Francisco doesn't. Both regional markets comprise over a million homes and both had similar economic and bank-credit backdrops.

What mainly drives sharp upward changes in house prices is restrictions on supply. This matters a great deal more than increases in the number of buyers, whether from population increases, more people who can afford a house because of higher wages or cheaper bank loans, speculation, or some other factor.

House Prices in Different Markets

As the San Francisco price line shows in the graph, even after a housing market collapse so huge it spawned a global financial crisis, house prices bounce back when supply is restricted.



In New Zealand, over the last couple of years, major research reports on housing have been released by the Productivity Commission (343 pages), Motu (68 pages), The NZ Initiative (5 reports amounting to 243 pages), Centre for Housing Research (491 pages), along with a constant stream of information from government ministries, the Reserve Bank, trading banks, REINZ, Massey University and other interested parties. There is even more to read in Australia.

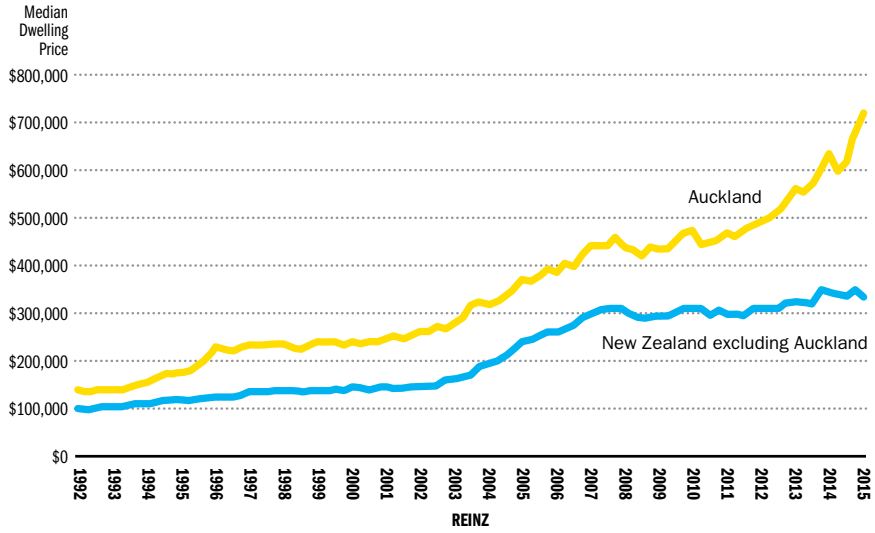
Most of this research points to supply restrictions as the key problem, but there are plenty of red herrings (banks being too loose with their lending, high building costs, tax incentives, Chinese speculators and increasing house size; to name a few). Notwithstanding the alternative theories, today someone buying a residential "investment property" in Auckland (or Sydney) is mainly betting that restrictions on land availability and construction will continue for some time yet.

While that's been a winning proposition for the last decade, institutional investors have not chased it mainly because such investors tend to be unwilling to bet on continuing bad regulation and market inefficiency. Logic dictates that politicians and regulators will "sort it out", eventually.

In the meantime retirement accommodation is investable because its risk characteristics are different to those of other forms of housing.

The degree of divergence between local, but still nearby, markets is remarkable. Over the last ten years the average house price in Auckland has doubled, which when adjusted for rising consumer prices or household earning is an increase of 40% to 50%. On the same basis house prices in the rest of New Zealand are, on average, almost the same today as they were a decade ago.

A comparable level of distinctiveness exists between the wider housing market and that for retirement accommodation.



Dwelling Prices in Auckland and New Zealand excluding Auckland 1992–2015

The "housing market" is not a single market. It is a series of local markets. This is reflected in the different price performance between the average Auckland house and the average house elsewhere in New Zealand.

Location, location, location

As outlined in this Update, and as can be inferred from the sharemarket performance of sector participants, it is profitable to invest in the provision of retirement accommodation. Well managed companies can produce returns above the cost of capital for a sustained period.

Yet a tenet of markets is that good returns attract capital, which results in competition and a whittling down of returns. What appears to have allowed, at least some, retirement village operators to earn more than would occur in a perfectly competitive market are barriers to entry.

Elderly people prefer to enter a village near where they or their immediate family live. However, in such locations (which are often in established suburbs) it can be difficult to buy land and build new villages. As with all residential accommodation, factors other than price are the key determinants of demand and demand is not the key driver of supply.

Retirement Accommodation

Pricing and Value

Many aspects of retirement accommodation make it a unique segment of the wider market; the numbers of potential residents, their earnings prospects and wealth, their facility and location requirements.

One which especially matters for investors is the way in which accommodation in a retirement village is usually purchased. It does not entail buying a freehold interest or renting.

A village resident usually makes an upfront payment to an operator and has a fee deducted when they leave their unit. The initial payment helps fund the village operator, but the actual cost of accommodation is the fee which is deducted at the end of occupancy.

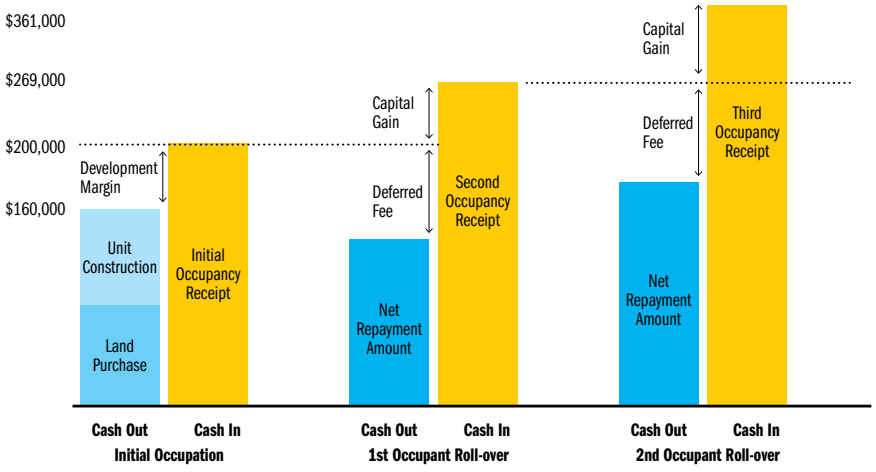
This charging structure involving a "deferred management fee" creates a unique cash flow and profitability profile for an operator and is quite different to what occurs with other forms of property investment.

Retirement Accommodation Cash Flow Example

Assume the following. In a new village a unit is built for $160,000. An incoming resident purchases a right to occupy the unit for $200,000 and thereafter makes a small fixed weekly payment to cover village costs. A decade later the resident moves out and receives back their initial payment less a 30% fee of $60,000.

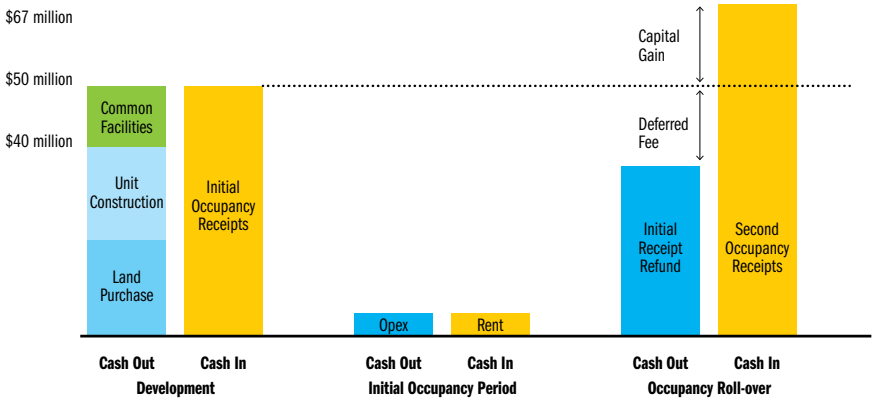
A second resident occupies the unit having made a $269,000 occupancy payment (that is 3% per annum higher than the initial amount), and so on for future residents. For an operator the cash flows associated with the individual unit are as depicted in the diagram.

Individual Unit Cash Flow



Now assume that the above transactions are replicated throughout a 250 unit retirement village. The village costs $50 million to build, comprising $10 million on common-use facilities and $40 million on land and units. This gives the depicted cash flow profile for the first 10 years. In this example the operator's cost of building the village is the same as the initial lease receipts and therefore the first net cash receipts take ten years to arrive.

Retirement Village Cash Flow



As will be apparent from the diagrams on the previous page, the operator generates positive cash flows as villages "mature", which takes a long time, and the exact scale and timing of those cash flows will largely depend on:

1. The resident's length of occupancy.
2. The up-front payment amount and the terms of the deferred management fee.
3. The value subsequent residents are willing to pay to occupy the unit, which will often reflect nearby house values at that time.

The value and risks associated with these factors are explained further below.

Retirement Village Value

Using the above example, what is the village worth? What someone would pay today to receive the cash which it is assumed will be generated as units are re-contracted in the future.

The following table shows the future cash flows to the village owner if a unit changes hands every 10 years (with 3% per annum unit-value inflation and 30% fee deduction). The first cash receipt shown in the table occurs in ten years' time when the first resident gets back $140,000 of their original $200,000 payment and the incoming resident deposits $269,000.

Unit Cashflow	In 10 years	In 20 years	In 30 years	In 40 years	>50 years
Incoming Resident	$269,000	$361,000	$486,000	$652,000	Too far out to matter
Outgoing Resident	($140,000)	($188,000)	($253,000)	($340,000)	
Net Cash	**$129,000**	**$173,000**	**$233,000**	**$312,000**	

If this income stream is discounted at 15% per annum its present value is $47,000. i.e. someone who invests $47,000 today in exchange for the Net Cash amounts shown in the table will earn 15% per annum. Over 250 units that adds up to $11,750,000 were someone to buy the whole village.

The valuation is sensitive to many variables. As time passes the valuation will rise (because the future income gets closer), conversely if a higher return were required the value would fall.

Village Value	Today Value	In 5 years' time Value
15% per annum required yield	$11,750,000	$23,680,000
20% per annum required yield	$6,630,000	$16,490,000

Changing any of the variables to alter the timing and scale of the future income stream impacts the village's present value, but the key variable is the period units are occupied.

In the base case where residents change every decade the village is initially worth $11,750,000. Were residents expected to change every five years the value would rise to $24,140,000.

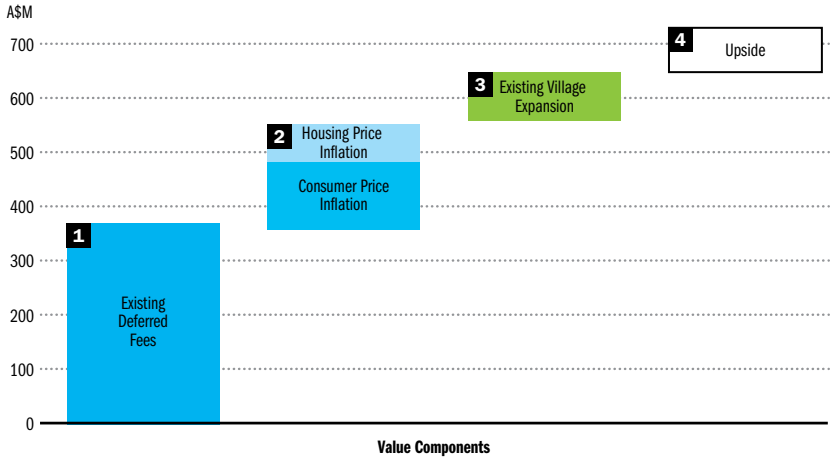
RetireAustralia

Infratil's Valuation

Infratil's acquisition price for 50% of RetireAustralia valued the whole company at about A$650 million. This valuation was a great deal more complex than the simple case study provided on the previous pages and it took a large number of Infratil's management several months to fully investigate the business prospects and risks and to arrive at a value and agreed transaction terms.

The breakdown of the A$650 million valuation is set out in the diagram and explained below.

RetireAustralia Acquisition Value



1 About half of the total value reflects the present value of the fees to be deducted from residents when they vacate the existing units (more precisely, the net cash difference between what will be paid to departing residents and received from incoming residents) were the new residents to make the same occupancy payment as previously made by the departing resident, i.e. if the value of the units remains unchanged over time.

- The key to this forecast is the length of time residents occupy their units. Although few people know when they are likely to move homes, averages can be forecast based on historic patterns of how long people tend to stay put and their age.
- The second variable is the amount of fee each resident will have deducted when they leave their unit. This is defined by each resident's occupancy contract.
- The other key determinant of the present value is the discount rate used to value the future income stream.

2 If future residents pay more to occupy a unit than what the previous resident did, RetireAustralia will benefit from the value rise. This forecast increase made up about a third of the value.

- "A rising tide lifts all boats." Rising house prices tend to be reflected in the value people can, and will, pay for units in a retirement village.
- The expected rise in value can be broken down into CPI and the amount by which house prices rise above the CPI. Over the last two decades Australian consumer prices have risen by 2.6% per annum and house prices by about 6.1% per annum (in New Zealand the respective rates were 2.1% per annum and 6.1% per annum). Recognising that the 6.1% per annum rate of Australia's house price inflation is a national average and there have been large regional variations.
- Infratil's valuation forecasts that Australian consumer prices rise over the next decade at about 2% per annum and average house prices increase at a 0.5% to 1% per annum faster rate.

3 Within RetireAustralia's existing villages there is the capacity to build approximately 500 further units. Because the land and common use facilities are already owned by RetireAustralia, this form of incremental development is profitable and relatively low risk.

The construction and sale of units in existing villages will give rise to both immediate cash receipts (from selling occupancy rights to residents) and future cash receipts from deferred fees and re-sales.

4 While the above three sources of cash earnings and value uplift justified Infratil's acquisition price, several other sources of potential added value were also identified.

- Infratil forecasts that RetireAustralia has the capability to build new villages. Such "greenfield" growth will not be as profitable as building units in existing villages (because for a new village land has to be acquired and common use facilities built) but would still increase the value of the Company.
- Additional goods and services may also be sold to residents; ranging from broadband, to food, to health care.

RetireAustralia Return Sensitivities

Infratil's acquisition-case forecasts that returns on the sum invested will be in the mid teens (which would provide a slightly higher return to Infratil shareholders after taking into account the use of debt). However the forecast reflects a number of assumptions and risks.

There are the low probability but high impact risks such as people ceasing to be attracted to this form of accommodation or significant changes to regulation.

There are also the raft of smaller risks which are more interesting because they are more likely and have the potential to incrementally change the rate of return on capital invested, positively and negatively. Some of these are noted on the following page.

Risk Description	Potential Return Impact
Resident tenure. At present the average time a unit is occupied is 10-11 years with a great deal of difference from village to village and between different types of units. This average occupation period could rise or fall if people entering a village are older or younger, or if their needs change faster or slower during their time of residency.	**A one year change to the average occupation period makes +/- 1.5% per annum impact on projected returns.**
The "base case" forecast anticipates about 500 units are built over the next 6-7 years. The rate could turn out to be faster or slower. The construction of new villages could also add to the build rate.	**A change in the build rate by 50 units a year would raise or depress returns by about 1.0% per annum.**
RetireAustralia's average fee deduction is about 35% of a resident's original deposit plus a share of unit value appreciation. Fees vary in respect of the fee percentage, the period over which it accrues and the arrangement for sharing unit value changes. It is anticipated that contract terms will continue to evolve.	**A 5% change to the 35% fee deduction would raise or reduce returns by +/- 0.3% per annum.**
House price and hence unit value inflation is forecast to average about 3% per annum (0.5% to 1% per annum higher than the rise in consumer prices). But many different patterns of unit price change are possible.	**If the average change in unit value was 0.5% per annum higher or lower than the base case, the return impact is +/- 0.7% per annum.**
If residents can be sold additional services, such as internet, food and care, this should increase returns.	**Up to a further 1.0% per annum return could be generated.**

Swings in house price inflation, especially a large and sustained drop, are not within RetireAustralia's control, although it has some protection against adverse local changes through ownership of villages in three states and by offering accommodation which ranges from high-end luxury townhouses to modest apartments.

The other factors noted above are largely within the Company's control and it is expected that having Infratil and the New Zealand Superannuation Fund as supportive shareholders will enable RetireAustralia's management to progress a number of value adding initiatives.

Retirement Accommodation: Who's Who

Company	Units	Market Value (Debt + Equity) Per Unit *	
Lend Lease	12,700	Retirement is a small part of a big company	Diversified ASX listed property developer
Stockland	7,500	Retirement is a small part of a big company	Diversified ASX listed property developer
Aveo	5,100	$300,000	Diversified ASX listed property developer
Ryman	4,500	$800,000	Retirement accommodation and care
Metlifecare	3,900	$270,000	Primarily retirement accommodation
RetireAustralia	3,700	$175,000	Exclusively retirement accommodation
Summerset	2,150	$400,000	Retirement accommodation and care

* For RetireAustralia the per-unit value is simply the value of the company's equity and its debt (total capitalisation) divided by the number of units. For the other companies it means allocating a part of the capitalisation against other assets (care operations or property holdings) to estimate the market's "per unit" valuation. The resulting "per unit" value discrepancies between the companies largely reflect the market's value of each company's growth prospects.

The Reporting Challenge

To give non-accountants a chance to better understanding the value created over the year, providers of retirement accommodation tend to report "normalised" as well as standard results. A typical example is set out below.

($000)	P&L
Reported net surplus	**$52**
Back out revaluations	($46)
Add back development margins	$40
Add back resale gains	None
Normalised net surplus	**$46**

The accounting derivation of the $52,000 reported net surplus shown in the above table is explained below and set out in the table at the bottom of the page.

1. Operator builds common use facilities for $40,000 per unit.
2. Operator builds a unit for $160,000 and contracts its initial occupation for $200,000; giving rise to a $40,000 development margin.
3. The deposit is still owned by the resident so is a liability for the operator.
4. In this case the deferred management fee is up to 30% of the deposit amount and is to be deducted over the first five years of occupation ($12,000 a year). However, adding complexity, it is expected that the resident will be an occupant of the unit for 10 years. Therefore the operator's accounts will show a $12,000 fee accrual and a $6,000 provision to reflect the time in the future when the resident is expected to still be an occupant but no longer incurring a fee deduction.
5. Over the year the market value of housing rises 3% and the unit rises in value by $6,000.
6. At the end of the year the operator has a $52,000 reported net surplus. Assets are $258,000 (the unit valued at $206,000, a fee accrual of $12,000 and common use facilities of $40,000) and liabilities are $206,000 (the $200,000 lease deposit and a $6,000 provision against income received in that year that will have to be taken to account in future years).

Accounting Entry ($000)	P&L	Balance Sheet		Cash Flow
Common use facility construction [1]		$40		($40)
Unit construction [2]		$160		($160)
Resident's deposit [2]			($200)[3]	$200
Unit revaluation [2]	$40	$40		
One year's fee accrual [4]	$6	$12	($6)	
Unit market revaluation [5]	$6	$6		
Total [6]	**$52**	**$258**	**($206)**	

RetireAustralia

RetireAustralia owns 28 retirement villages that were mainly acquired in 2006 and 2007 during a period of industry consolidation. However, a downturn in the Australian property market, high levels of debt and the change in credit markets following the Global Financial Crisis saw the Company acquired by funds controlled by two US banks. They, in turn, were the vendors to Infratil and the New Zealand Superannuation Fund.

- RetireAustralia is Australia's fourth largest retirement accommodation provider, by number of units and residents. It has 3,700 units in 28 villages located in New South Wales, Queensland and South Australia.
- The largest village has 440 units and a total market value of A$220 million. The smallest has 13 units and a value of A$8 million.
- The average unit value is A$360,000 with a per-village average value-range of between A$680,000 and A$115,000.
- The average village age is 19 years with a range of 6 years to 30 years. The average age of residents is 82 years with a village average range of 6 years to 30 years.

The priority concerns of the elderly are health, isolation, access to transport, a lack of independence and money. RetireAustralia's villages provide community, purpose built facilities, locations that are proximate to facilities and transport links, independence to residents by offering help if it is required, and a diverse range and value of units.

A brief description of RetireAustralia's largest village, Tarragal Glen, illustrates both the range of facilities offered to residents and its location benefits:

- Tarragal has 440 units and 710 residents.
- Facilities include two community centres with dining facilities, library, park areas, gazebo, bowling green, pool, gymnasium and hair salon.
- The village has a large shopping centre nearby and is convenient to medical facilities, bus and railway connections, parks and sports facilities.
- The average unit has been independently valued at $490,000. Over the last six months 26 were leased at an average price $460,000 (range $300,000 to $665,000).
- The village is located in the Gosford Local Government Area which has 165,000 residents, of whom 32,000 are over 65 years old. The local over 65 age group is forecast to rise by 700 people a year over the next decade. 70% of local housing is owner occupied and in Tarragal's immediate suburban area the average house price was $550,000 in 2014 and over the previous five years the average rate of house price appreciation was 5.2% per annum.
- Most of Gosford is within a 20 minute drive of Tarragal and in the same area there are 10 retirement villages.

Tarragal Glen












Care Versus Accommodation

A differentiating characteristic of the sector between New Zealand and Australia is that in New Zealand, accommodation and care is often integrated and most of the larger operators provide both. In Australia, care and accommodation are typically provided separately.

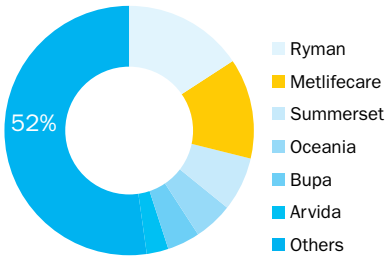
For both residents and operators there are benefits and costs associated with the differences between the “integrated model” and separate provision.

Many fit, healthy elderly people prefer to take up residence in a village which resembles a resort. Others who have greater needs often prefer to know that care options are available and many elderly people do not enjoy moving if they are obliged to relocate to receive greater care.

On balance it seems that a large segment of potential residents do like to know there is care available for either themselves or their partners when they take up residence in a village. RetireAustralia is seeking to lift its provision of care to reflect this demand.

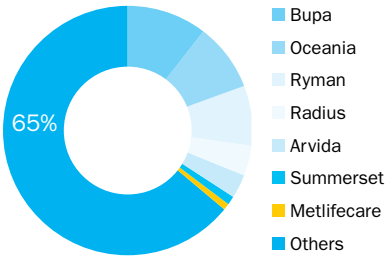
Retirement Villages

New Zealand total 26,000 units

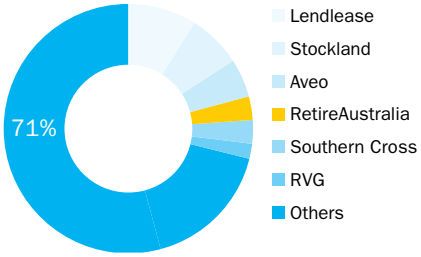


Aged Care

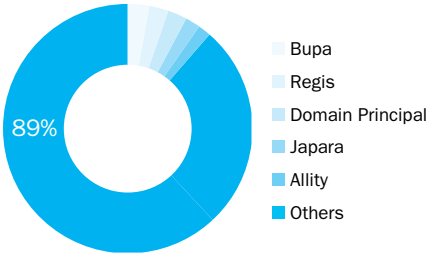
New Zealand total 35,000 beds



Australia total 120,000 units



Australia total 190,000 beds



Infratil's Investment Strategy and its Fit With Retirement Accommodation

Without going through all the criteria which guide Infratil's investment strategy, retirement accommodation has a good fit. This is especially the case with Infratil's objective of owning infrastructure for which there is strong and reliable demand growth.

As the following tables make clear, New Zealand and Australia's population of people over 65 is growing markedly. Using this data it is possible to develop a conservative forecast of the demand for retirement accommodation.

New Zealand	people under 65	65 to 84	Over 85	Implied demand
2015	3,910,000	592,000	78,000	26,000 units
2020	4,020,000	714,000	86,000	32,000 units
2025	4,080,000	838,000	112,000	40,000 units
2030	4,140,000	947,000	143,000	47,000 units
2035	4,180,000	1,027,000	193,000	55,000 units
Growth rate	**7%**	**73%**	**148%**	**112%**

For New Zealand the demand forecast indicates that today a further 1,200 new units are required each year, rising to about 1,600 units a year by the end of the forecast period. This assumes continuation of current rates of occupation.

Australia	people under 65	65 to 84	Over 85	Implied demand
2015	20,400,000	3,100,000	450,000	120,000 units
2025	22,300,000	4,200,000	650,000	175,000 units
2035	24,100,000	5,100,000	1,050,000	210,000 units
Growth rate	**18%**	**65%**	**133%**	**75%**

Australia's projections of its elderly population are similar (although of much bigger scale) than New Zealand's as is the implied demand for retirement accommodation.

From an investor perspective what is especially attractive with these profiles is the certainty of year on year growth. If there is an occasional period of accommodation over-supply, it will be consumed in a year or two.

The substantial increase in the over 85 population cohort also matters with regards to what facilities and services residents will need. It is almost certain that demand for care and other services is going to increase more rapidly than demand for just accommodation.

Infratil