NDIA SDA Pricing Review 2022-23

Technical Report – Capital Asset Pricing Model Report

Reliance Restricted

04 April 2023 | Final Report

Notice

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Ernst & Young ("EY") was engaged on the instructions of National Disability Insurance Agency ("NDIA") to assist in undertaking technical research and analysis to support the Specialist Disability Accommodation ("SDA") Pricing Review ("Project"), in accordance with the contract dated 26 September 2022.

The results of Ernst & Young's work, including the assumptions and qualifications made in preparing the report, are set out in Ernst & Young's report dated 4 April 2023 ("Report"). The Report should be read in its entirety including this notice, the applicable scope of the work and any limitations. A reference to the Report includes any part of the Report. No further work has been undertaken by Ernst & Young since the date of the Report to update it.

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We highlight that our analysis and Report do not constitute investment advice or a recommendation to you on a future course of action. We provide no assurance that the scenarios we have modelled will be accepted by any relevant authority or third party.

Our conclusions are based, in part, on the assumptions stated and on information from both publicly available information and other sources used during the course of the engagement. The modelled outcomes are contingent on the collection of assumptions as agreed with NDIA and no consideration of other market events, announcements or other changing circumstances are reflected in this Report. Neither Ernst & Young nor any member or employee thereof undertakes responsibility in any way whatsoever to any person in respect of errors in this Report arising from incorrect information provided by the NDIA or other information sources used.

The analysis and Report do not constitute a recommendation on a future course of action.

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1 Executive Summary

Purpose and Findings

Purpose

Ernst & Young ("EY") has been engaged by the National Disability Insurance Agency ("NDIA") to assist in undertaking technical research and analysis to support the Specialist Disability Accommodation ("SDA") Pricing Review. This report will examine Capital Asset Pricing Model ("CAPM") parameters as a key input to assist the NDIA in developing new SDA benchmark prices. Further information on the SDA Pricing Review can be found on the NDIS website (NDIS website).

Equity Beta

- Market research of comparable industries/sectors and feedback from market participants indicated an Equity Beta range between **0.8 to 1.2.** The historic equity beta assumption of 0.9 used by the NDIA is consistent with asset classes that operate in established markets. While the SDA market can expect to achieve maturity in the future, the historic assumption used by NDIA does not appropriately reflect the risks of SDA investment at this early stage of market development. On this basis we consider an appropriate Equity Beta for SDA should sit at the mid-point of the research range.

Gearing Ratio

- The SDA debt market is predominately characterised by three tiers including institutional, mid-tier and private (mum and dad) investment/debt. The SDA Pricing Model has been formulated on the basis of institutional investment to deliver scale within the market. Therefore, the gearing assumption within the model is predicated on institutional debt.
- Market research suggests a debt-to-value ratio of 50% / 50% (debt /equity) is reasonable for institutional investment into SDA, this is supported by various bank lending policies lend against going concern values.
- The historic SDA Pricing Model assumption used by NDIA is a gearing ratio of 60% / 40% (debt /equity) – on a debt to total development cost basis. This differs to the market, which is prepared to lend against Market Value (security value) of the completed SDA property, for most "at scale" or institutional investors.
- The difference between the two ("debt to total development cost" and "debt to Market Value") is considered to be the development margin (or Market Value uplift) that a commercial investor would require in order to take on the original development risk.
- The historic model assumption (based on **60% / 40%** debt to total development cost) remains reasonable on the basis this gearing is explicit of any Market Value uplift attributed to the completed SDA property.
- Development margins for SDA vary throughout the market based on project and organisational objectives; however, the majority target a minimum return of between 5% to 20%, on costs to be viable.

Imputation Credits

- Based on research of common investment structures adopted by investors into SDA, the imputation credit assumption should remain unchanged assuming no franking credits within investors taxed at marginal rates.

Gross Rental Yield

- The historic assumptions regarding the gross rental yield inputs within the SDA Pricing Model used by NDIA are considered reasonable and supported by market research.

Risk-free Rate and Market Risk Premium

- Based on the market research the nominal risk-free rate should reflect the 90 day average of the 10 year Australian Government bond rate as at the date the new pricing is set by the NDIA.
- The historic market risk premium assumption of 6.00% used by the NDIA sits within a reasonable range of 6.00% to 6.90% in line with market research.

General Comments

- The SDA Pricing Model used by NDIA adopts a Weighted Average Cost of Capital (“WACC”) hurdle to reflect the cost of financing an SDA investment, including the cost of debt and a return over a 20 year investment term.
- This performance metric and investment term is rarely used by the market to inform real estate investment decisions. The market generally adopts an Internal Rate of Return (“IRR”) metric to analyse investment viability and compare returns on a like-for-like basis with other real estate asset classes, generally on a 10 year or shorter investment maturity.

Table 1: SDA Pricing Model Assumptions

CAPM Input	Historical Assumption	Market Research Range
Equity Beta	0.90	0.80 – 1.20
Gearing Ratio	Debt based on total development cost 60%	Debt to Market Value 50%
Imputation Credits	Zero	Zero
Risk-free Rate	2.70% (10 year Australian Government bond rate - 90 day average)	10 year Australian Government bond rate (90 day average)
Market Risk Premium	6.00%	6.00% to 6.90%
Gross Rental Yield Input		
Houses	5.5%	4.5% to 6.5%
Apartment	6.5%	5.5% to 7.5%

Source: Historic SDA Model 2016**/** EY Research/Analysis

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Introduction

Background and Scope

Background

EY has been engaged by the NDIA to assist in undertaking technical research and analysis to support the SDA Pricing Review. This report will examine CAPM parameters as a key input to assist the NDIA in developing new SDA benchmark prices.

The CAPM forms a key assumption within the SDA Pricing Model used by the NDIA with the Weighted Average Cost of Capital ("WACC") incorporated as a measure of reflecting the cost of financing an SDA investment, including the cost of debt and a reasonable return on equity (commensurate with non-diversifiable risk).

Scope

This report presents the findings from research and analysis on estimated national benchmark construction costs for SDA in response to the below report scope provided by the NDIA.

1. The Equity Beta for SDA investments;
2. The efficient Gearing Ratio for SDA investments; and
3. The extent to which the typical equity investor in SDA can use the franking credits attached to its dividends because of the payment of company tax.

Further to the abovementioned research regarding the CAPM, this Report has also considered the following scope with regard to gross rental yield research:

- Estimated the typical gross rental yields that can be expected from SDA type properties in the Australian economy in 2023-24, including the extent to which gross rental yields significantly vary by Design Category, Building Type and Size, and Region.

Limitations

Limitations

Based on the scope of work and the information available to us we have performed a like-for-like comparison. To enable this, certain assumptions have also been made. This Report is limited in time and scope, other more detailed reviews or investigations may identify additional issues or considerations than this Report has noted. The results of this work are limited by the availability and quality of data. The results of this work and procedures performed do not constitute an audit, a review or other form of assurance in accordance with any generally accepted auditing, review or other assurance standards, and accordingly EY does not express any form of assurance.

Our findings are based, in part, on the assumptions stated and on information from both publicly available information and other sources used during the course of the engagement. The modelled outcomes (where appliable) are contingent on the assumptions as agreed with the NDIA and no consideration of other market events, announcements or other changing circumstances are reflected in this Report. Neither Ernst & Young nor any member or employee thereof undertakes responsibility in any way whatsoever to any person in respect of errors in this Report arising from incorrect information provided by the NDIA and other information sources used.

Methodology

The approach in undertaking the CAPM research methodology is detailed below.

1. Historic Assumptions

- ► Identified the methodology and historic assumptions adopted by NDIA within the SDA Pricing Model.

2. Collect and Process Data

- ► Researched S&P Capital IQ to identify comparable industry/sector equity beta datasets.
- ► Researched gearing ratios provided by lenders with established lending policies for SDA in addition to the wider social and healthcare sectors.

3. Analyse Data and Outline Key Findings

- ► Provided an overview of the historic methodology and the application of the assumptions within the existing SDA Pricing Model used by NDIA.
- ► Assessed the investment framework for SDA including benchmarking returns and parameters across Design Category, Building Type and Region. Evaluate factors impacting SDA returns and how the market would respond to these factors.
- ► Analysed and benchmarked equity beta datasets based off comparable industries/sectors such as health care facilities and assisted living facilities & services.
- ► Benchmarked industry gearing ratios for SDA investments (where available) and related social and healthcare sectors. Outlined differences between asset categories and regions.
- ► Assessed tax implication considerations for key investor cohorts in relation to tax structures and dividends.

4 Historic Methodology and Assumptions

Historic CAPM Methodology

The CAPM forms a key assumption within the SDA Pricing Model used by the NDIA ("the Model") with the Weighted Average Cost of Capital ("WACC") incorporated as a measure of reflecting the cost of financing an SDA investment, including the cost of debt and a reasonable return on equity (commensurate with non-diversifiable risk).

The WACC has been informed with consideration to the following inputs:

- Risk free rate
- Market risk premium
- Equity beta
- Assumed level of equity/debt
- Effective tax rate
- Value of imputation credits
- Inflation
- Debt margin

Of specific focus to this Report, the following key parameters of the WACC have been investigated:

A. the Equity Beta for SDA investments;

B. the efficient Gearing Ratio for SDA investments; and

C. the extent to which the typical equity investor in SDA can use the franking credits attached to its dividends because of the payment of company tax.

The CAPM used by NDIA adopts the historic assumptions provided in Table 2.

Table 2: Historic CAPM Assumptions

Input	Assumption
Equity Beta	0.90
Gearing Ratio	Equity - 40% / Debt - 60%
Imputation Credits	Zero
Risk Free Rate	2.70%
Market Risk Premium	6.00%

Source: Historic SDA Model 2016

Equity Beta

The equity beta measures the operational risk associated with a business/sector relative to the market as a whole for a given financial risk based on a gearing level. The SDA Pricing Model used by NDIA assumes an equity beta of **0.90** for SDA informed based on the health care sector generally reflecting less than 1.00.

Gearing Ratio

The gearing ratio applied within the Model used by NDIA reflects an assumed level of equity/debt of **40% / 60%** respectively based on the typical benchmark level applied by lenders for assets within more regulated industries.

Tax/Imputation Credit Assumptions

The Model used by NDIA assumes an effective tax rate of 30% in line with the Australian corporate tax rate. Furthermore, imputation credits on tax paid by a company is currently assumed to be **zero (0)** on the basis of no available evidence and therefore a conservative assumption was applied by the NDIA.

Risk-free Rate and Market Risk Premium

A nominal risk-free rate of return of 2.70% based on the 90 day average of the 10 year Australian Government bond rate as at 31 March 2016 was adopted by NDIA. Furthermore, a market risk premium of 6.00% was adopted by NDIA reflecting the difference between the expected holdings from a market portfolio and the risk-free rate.

5 Analysis - Equity Beta

Equity Beta Research

- Equity Beta represents a key metric of systemic risk associated with investment in the SDA sector in comparison to the overall market. It is commonly used by lenders and investors as an indicator of investment volatility. The equity beta within the Model used by NDIA forms a key input in calculating the WACC (reflecting the cost of financing an SDA investment, including the cost of debt and a reasonable return on equity).
- There is a lack of listed companies with material exposure to SDA to enable comparative analysis of equity betas for SDA specifically. Therefore, we have analysed 26 companies of similar and established industries and localities (see Appendices E). These companies being Global Health Care Facilities, Global Health Care REITs, Health Care Facilities & REITs located in Australia, Health Care Facilities & REITs located in New Zealand.

Table 3 reflects our research of equity beta's of companies in comparative industries. We have utilised a tax rate of 30% in line with the Australian corporate tax rate and a range of gearing ratios in calculating the equity beta, expressed as:

- Low – 60% debt and 40% equity.
- Mid – 55% debt and 45% equity.
- High – 50% debt and 50% equity.

Table 3: Equity Beta Research Ranges

	Health Care Facilities			Health Care REITs			Australian Health Care Facilities & REITs			New Zealand Health Care Facilities & REITs			Companies Included in Market Consultation Feedback		
Gearing Ratio	**Low**	**Mid**	**High**	**Low**	**Mid**	**High**	**Low**	**Mid**	**High**	**Low**	**Mid**	**High**	**Low**	**Mid**	**High**
Equity Beta	**1.01**	**0.98**	**0.96**	**0.71**	**0.69**	**0.67**	**0.84**	**0.82**	**0.80**	**1.10**	**1.07**	**1.05**	**1.17**	**1.14**	**1.11**
Equity / V	66.7%	64.5%	62.5%	66.7%	64.5%	62.5%	66.7%	64.5%	62.5%	66.7%	64.5%	62.5%	66.7%	64.5%	62.5%
Debt / V	33.3%	35.5%	37.5%	33.3%	35.5%	37.5%	33.3%	35.5%	37.5%	33.3%	35.5%	37.5%	33.3%	35.5%	37.5%

Source: Capital IQ & EY Research

Equity Beta Market Consultation Findings

SDA Pricing Model Assumption Analysis

- The historic Model's Equity Beta assumption by NDIA of 0.9 is consistent with asset classes that operate in a regulated environment and are mature and established. While the SDA market can expect to achieve maturity in the future, the sector is largely viewed as a nascent market and does not reflect the risk of SDA investment at this early stage of market development.

Structural Factors Affecting Risk in SDA

- As the NDIA are the sole source of participant funding, revenue is entirely reliant on the NDIA's selection criteria and approval process. This results in additional inherent risk associated with investment in the sector when compared to Aged Care and Retirement Village income models which are partially and sometimes wholly funded by participants.
- Consultation feedback has noted SDA is in the early stages of development, both in terms of supply and implementation. Long lead-times are required for tenant approval, protracted response to tenant eligibility appeals and delays in receipt of payments for existing tenants has had severe adverse economic impacts on early development. Investors participating in these early stages of the SDA sector have been exposed to elevated risk and require higher returns in order to accept the risk.
- A large portion of underlying potential tenants in the SDA market do not yet have their SDA or support funding, placing a limit to the effective size of the market. This increases the risk for SDA at this stage of its development relative to comparable sectors, which have long-standing, readily forecastable demand for their product.

Comparable Market Risk Assessment

- Consultation participants have analysed the equity beta's of companies within the Aged Care and Retirement Village sectors. Table 4 highlights a mean equity beta of ~**1.27** among these companies.
- Government subsidies for Aged Care are more established, well-understood and have a track record of efficient administration, with less bottlenecks, constraints, and room for uncertainty, particularly around eligibility and approvals. Furthermore, Aged Care Assessment Team ("ACAT") approvals are processed significantly faster in Aged Care compared to the NDIS approval model.
- SDA is a thinner market than comparable sectors, with larger point risk at the location and investment level. By way of example, at 30 June 2021 there were 16,033 people with SDA in their plan (the vast majority of which retained the SDA assessment they held at the time of scheme transition) as compared to 191,000 in residential Aged Care dwellings.

Table 4: Equity Betas in Sectors Similar to SDA

	Gearing[1]	Average Equity Beta[2]	Predominant Sector
Estia Health Ltd	0.17	1.08	Aged Care
Regis Healthcare Ltd	0.63	1.25	Aged Care
Arvida Group Ltd	0.25	1.09	Aged Care and Retirement Village
Ryman Healthcare Ltd	0.39	1.49	Retirement Village
Summerset Group Holdings Ltd	0.33	1.43	Retirement Village
Mean	**0.35**	**1.27**	
Median	**0.33**	**1.25**	

Source: Summer Foundation SDA Price Review Submission 2022
[1] Bloomberg 5-year average debt to (debt plus net assets) as at 30 September 2022.
[2] Average of 2, 5 & 10 Year Weekly Equity Beta's sourced from Bloomberg, FactSet & Axiom, 2022.

6 Analysis - Gearing Ratio

Gearing Ratio

The gearing assumption within the SDA Pricing Model used by NDIA forms a key input in calculating the WACC (reflecting the cost of financing an SDA investment, including the cost of debt and a reasonable return on equity).

The gearing input assumes the level of debt applicable to an investor when purchasing a SDA property. The existing assumption within the Model used by NDIA reflects a debt to total development cost ratio of 60% / 40%, indicating an investor would borrow debt of up to 60% of the total development cost (land plus building cost) of the property from a lender and would be required to put down the remaining 40% in equity.

Notably, this differs to the market, which is prepared to lend against Market Value (security value) of the completed SDA property, for most ‘at scale’ or institutional investors.

The difference between the two (“debt to total development cost” and “debt to market value”) is considered to be the development margin (or market value uplift) that a commercial investor would require in order to take on the original development risk.

The historic assumption (based on **60% / 40%** debt to total development cost) remains reasonable on the basis this gearing is explicit of any market value uplift attributed to the completed SDA property.

Development margins for SDA vary throughout the market based on project and organisational objectives; however, the majority target a minimum return of between 5% to 20%, on costs to be viable.

The SDA debt market is predominately characterised by three tiers including institutional, mid-tier and private (mum and dad) investment/debt. The SDA Pricing Model has been formulated on the basis of institutional investment to deliver scale within the market. Therefore, the gearing assumption within the model is predicated on institutional debt.

Lending Policies

Across the real estate sector, banks and financiers adopt lending policies for various asset classes outlining the extent of debt they are willing to lend against various asset classes known as loan-to-value ratio's ("LVR"). Simply, the LVR reflects the amount of a loan (debt) as a percentage of the market value of the property.

Gearing Ratio's (LVR's) for Commercial Real Estate

As outlined within Table 5, LVR's for commercial real estate asset classes typically range up to a maximum of 50% to 65%. Furthermore, lenders will additionally consider the interest coverage ratio ("ICR") associated with an asset based on its ability to cover the interest expenses on debt from rental revenue (net passing).

Table 5: LVR's and ICR's by Real Estate Sector

Real Estate Sector	LVR Range	ICR Range
Office	50% - 60%	1.8 – 2.5
Industrial	50% - 65%	1.8 – 2.5
Retail	55% - 65%	1.8 – 2.5
Healthcare	50% - 65%	1.8 – 2.5
Other commercial[1]	50% - 55%	1.8 – 2.5

Source: EY Research based on discussions with lenders

Notes:
1. Other commercial includes services stations, childcare centres, transport and special purpose assets

Institutional Gearing Ratio's

Research of a sample of Australian Real Estate Investment Trusts ("AREIT's") operating across various commercial real estate sectors indicate gearing ratio's between **20.0% to 33.2%.** According to BDO's *A-REIT Survey 2022: Navigating Choppy Waters*, A-REITS indicated an average gearing level of 27.9% in FY22.

Table 6: AREIT – Company Breakdown

AREIT	Real Estate Sector	Gearing Ratio Range
Scentre Group	Retail	27.5%
Dexus	Office, industrial, retail & healthcare	26.9%
Mirvac	Residential, Office, Industrial, Retail and Build to Rent	20% to 30%
GPT	Retail, Office and Logistics	27.3%
Vicinity Centres	Retail	25.1%
Charter Hall	Office, Industrial, Logistics, Retail, Social Infrastructure and Development Projects.	25.8% to 30.5%
Centuria	Office, Healthcare, Agriculture and Infrastructure	33.2%
RAM	Healthcare, Retail, Fitness and Non Essential	29.9%

Source: Annual reports for relevant groups across 2021/22

Gearing Ratio Consultation Feedback

SDA Pricing Model Assumption Analysis

- Consultations noted the Model used by NDIA assumes a gearing ratio of 60% with the gearing ratio defined as the ratio of debt to total development cost (land and building cost), rather than debt to value.
- One feedback participant noted that the gearing ratio does not consider debt or interest servicing covenants that would limit an investor's ability to achieve a higher loan to value ratio (i.e. up to 60%), particularly where vacancy is greater than the NDIA's assumptions.
- One feedback participant recommends that the SDA Price Review undertaken by NDIA considers gearing in relation to the cashflow/yields generated by Design Categories such as Fully Accessible and Robust, where debt capacity is already considered constrained due to the lower SDA payment level.

Interest Cover Ratio Restrictions

- One lender noted that an Interest Cover Ratio (ICR) of 2.0 – 2.5 times would apply for scale portfolios or investors (first tested after an agreed trade-up period and once stabilised performance is achieved). Applying an ICR of 2.0 to the NDIA's worked example, at the assumed occupancy rate, would result in a breach.
- Given actual occupancy is well below the historic Model's rate used by NDIA and, in practice, is subject to some volatility, consultation feedback has suggested a 50% LTV would be more appropriate.

7 Analysis - Risk Free Rate & Market Risk Premium

Risk Free Rate

The risk-free rate reflects the return that is available to investors on an investment that is completely free of risk. The historic SDA Pricing Model used by NDIA adopted a nominal risk-free rate of return of 2.70% based on the 90 day average of the 10 year Australian Government bond rate as at 31 March 2016.

Based on the market research the nominal risk-free rate should reflect the 90 day average of the 10 year Australian Government bond rate as at the date the new pricing is set.

Market Risk Premium

The Market Risk Premium ("MRP") reflects the premium over and above the nominal return on a risk free asset that investors would require for investing in the asset assumed by NDIA to be 6.0% within the historic SDA Pricing Model.

The 2022 CA ANZ Valuation Practice Survey coordinated by Chartered Accountants Australia and New Zealand provided insights into key metrics adopted by CA Business Valuation Specialists including adopted MRP's.

The survey outlined the majority of respondents (59%) adopted a MRP of 6.0% to 6.9%. Approximately 7% of respondents adopted a MRP above 7.0% and approximately 25% adopted an MRP below 5.9%.

The majority of respondents (41%) primarily derived the MRP through in house analysis within 29% calculating the MRP from equity returns.

Based on the current market research outlined, the historic assumption of 6.0% used by NDIA sits within the research range of 6.0% to 6.9% and can remain as is.

Table 7: Risk Free Rate and Market Risk Premium

Input	Historic Assumption	Research Range
Risk-free Rate	2.7%	90 day average of the 10 year Australian Government bond rate as at the date the SDA pricing is set.
Market Risk Premium	6.0%	6.0% to 6.9%

Source: SDA Pricing Model / EY Research

Figure 1: 10-year Australian Government Bond Yield

Source: RBA, Yieldbroker, 2022

8 Analysis - Tax Considerations

Tax/Imputation Credit Assumptions

The Model used by NDIA assumes an effective tax rate of **30%** in line with the Australian corporate tax rate. Furthermore, imputation credits on tax paid by a company is currently assumed to be **zero (0)** on the basis of no available evidence and therefore a conservative assumption was applied. Based on the research as further discussed within this section, the historic assumption regarding imputation credits should remain unchanged assuming no franking credits (with investors taxed at marginal rates).

Franking Credits

Franking credits arise for shareholders when certain Australian resident companies pay income tax on their taxable income and distribute their after-tax profits by way of franked dividends. The franking credits represent an offset available to the shareholder to use against their income tax as the distribution they received was already taxed at the corporate level.

However, the benchmarking rule provides a limit on the number of franking credits which can be applied to distributions. Broadly, the benchmarking rule requires frankable distributions within a similar time period to be franked to the same or similar extent. Once a corporate tax entity has franked a distribution to a certain extent, other frankable distributions made in the same 6-month period will generally have to be franked to the same extent.

Potential Holding Structures

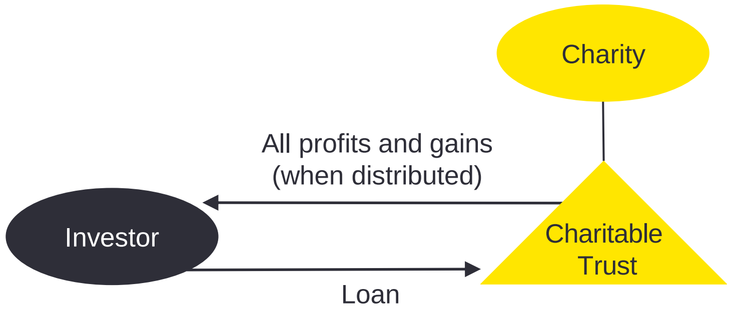
The impact of franking credits on the Model used by NDIA should depend on the ultimate investment structure adopted by an equity investor in investing in Specialist Disability Accommodation.

In our experience, such investments are ordinarily held under one of three holding structures:

- *Charitable trust*: SDA is held by a charitable trust, with institutional investors providing a loan to the trust;
- *SPV trust*: SDA is held by a special purpose vehicle ("SPV") established as an Australian resident unit trust; and
- *SPV company*: SDA is held by an SPV incorporated as an Australian resident company ("SPV Co").

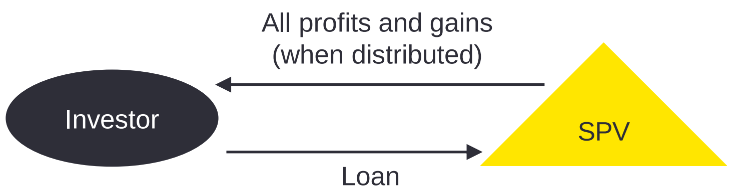
We note that the third investment structure is rarely adopted in the context of Specialist Disability Accommodation. However, the impact of franking credits on the Model used by NDIA under each of these investment structures are discussed in the following pages of this Report.

Figure 2: Structure 1 - Charitable Trust

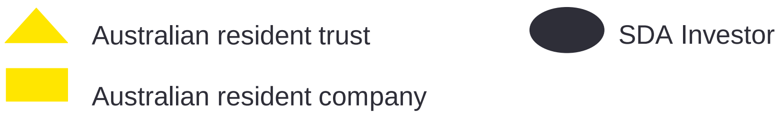


Source: EY Analysis

Figure 3: Structure 2 - SPV Trust



Key



Source: EY Analysis

Structure 1

Income Tax

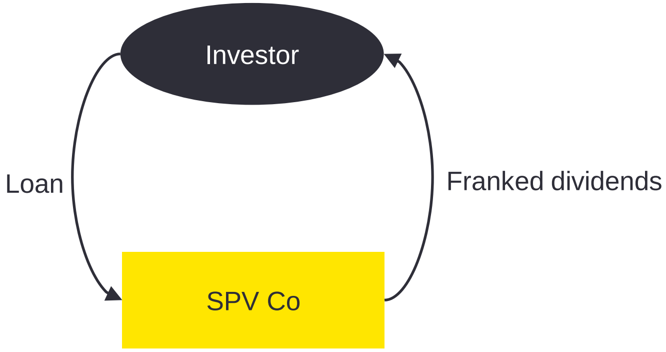
- A “charitable” entity is exempt from income tax under Division 50 of the ITAA97, provided that the activities of the entity are and continue to be carried on for a charitable purpose.
- Tax-exempt entities are not required to pay Australian income tax. Therefore, it is unlikely that, should an exempt entity participate in the SDA investment, any franking credits should arise. Institutional investors will generally lend into these structures and pay tax at their own marginal rate on income received. .

Structure 2

Income Tax Effects

- An SPV established as a trust will be subject to “flow-through” taxation, meaning that there will be no tax payable by the SPV provided that all the income received is distributed to the private investors, who will then pay tax on this income.
- As there is no tax payable by the SPV, no franking credits should arise under this structure. Institutional investors will generally pay tax at their own marginal rate on income received.

Figure 4: Structure 3 - SPV company



Key

Australian resident trust

Australian resident company

SDA Investor

Source: EY Analysis

Structure 3

Income Tax

SPV Co

- SPV Co should be taxed at the ordinary corporate tax rate of 30% (unless SPV Co is a base rate entity).

Investor

- Where shareholders in SPV Co are paid dividends that are fully franked, those shareholders will be required to include the amount of the dividend and the franking credit in their assessable income, but will be entitled to a tax offset equal to the amount of the franking credit.

Corporate investor

- The tax offset to which a corporate investor is entitled to should not be refundable.
- The corporate investor should be entitled to a credit in its own franking account to the extent of the franking credit on the distribution received, and excess franking credits may be converted into a tax loss.

Superfund investor

- Australian superannuation funds are subject to income tax at a concessional rate of 15%. Upon receipt of a fully franked distribution, resident funds are entitled to a tax refund equal to 15% of the franked dividend amount.
- In our experience with the market, superannuation funds place an ~80% value on franking credits.

Foreign resident investor

- Non-residents are not entitled to the benefits of Australia's dividend tax imputation system.
- However, dividends paid to a non-resident investor should not be subject to Australian dividend withholding tax to the extent that the dividends have been franked.
- To the extent that a dividend is unfranked Australian dividend withholding tax will be required to be withheld on behalf of the non-resident investor at a maximum rate of 30%. However, this rate may be reduced under an applicable tax treaty.

Tax Considerations - Market Consultation Feedback

- Stakeholders in the consultations noted that under the Goods and Services Tax (GST) Act, residential investment properties are generally considered input tax supply, implying that investors and landlords cannot claim or charge GST. Amendments to the GST Act were made to ensure various supplies to a participant of NDIS is GST free. However, to take advantage of the amendments, the business must operate under certain business models. In cases where such structures are not practical, GST continues to apply. For many SDA providers, GST is an important issue that forms a barrier to entry and is not recognised in current SDA prices.
- Furthermore, while not-for-profit organisations are not required to charge GST, under current laws GST that had been claimed by a developer can be charged on the value of the final sale price. These and other anomalies require careful management which often results in additional administration costs and risk. To date, the Australian Tax Office has been reluctant to address and rectify these issues.
- Non-GST registered entities are typically used in the acquisition of properties for brownfield development, thus priced at GST inclusive levels with no option to claim GST refunds. This is in line with the GST free supply that is applicable to the SDA asset class. Land developers carry approximately a 10% fluctuation to greenfield acquisitions.

9 Analysis - Gross Rental Yield

Historic Gross Yield Assumptions

For Existing Stock, the SDA Dwelling Price calculation within the SDA Pricing Model used by NDIA is based on the total land and building cost multiplied by the assumed gross rental yield for the broader housing market, differentiating between houses and apartments as outlined within Table 8.

Table 8: Historic Gross Yield Assumptions

Building Type	Gross Yield Model Assumption	Existing Stock Building Types	Comments
Houses	5.5%	The gross rental yield assumption for Houses is applied to the following building types: Villa, Duplex/Townhouses, Houses and Group Accommodation.	The gross yield assumption is applied across the various building types categorised into "Houses" and "Apartments". The historic assumption does not differentiate between design categories, size or region.
Apartments	6.5%	The gross rental yield assumption for Apartments is applied to the following building types: Apartment 1-3 bedrooms.	

Source: SDA Benchmark Pricing Model, 2016

Historic Gross Yield Methodology

- The gross yield assumption was informed from Reserve Bank of Australia[1] ("RBA") indicating an average rental yield of 4.2% across the national housing market and comprised of the following:
  - Real interest rate (ten-year average expectations) – 3.3%
  - Running costs – 1.5%
  - Annual average transaction costs – 0.7%
  - Depreciation – 1.1%

Less

- Expected appreciation – 2.4%

Total

- 4.2%

- The RBA average rental yield of 4.2% was increased to 5.5% by NDIA for Houses to reflect higher maintenance costs and other outgoings associated with SDA assets.
- For Apartment stock, a 1.0% premium was applied by NDIA to the gross rental yield for Houses reflecting a gross yield of 6.5% due to the lower capital growth for Apartment stock.

Gross Yield Range based on Asset Class

Market research has been undertaken into gross rental yields analysed within various asset classes including residential (house and unit), Build to Rent, Specialist Disability Accommodation (new build) and Purpose Built Student Accommodation.

The analysed market research undertaken in 2022 has indicated a market research range of 4.5% to 6.5% for houses and 5.5% to 7.5% for apartments as outlined within the Table 9.

Table 9: Gross Yield Range

Building Type	Market Research Range [Low]	Market Research Range [High]	Recommended Gross Yield Input [Mid-point]
Houses	4.5%	6.5%	5.5%
Apartments	5.5%	7.5%	6.5%

Source: EY analysis

Market Research Summary

- In line with the historic methodology into standard residential gross rental yields, research of national residential rates have been analysed for houses and units in 2022. Gross rental yields for houses reflected a range of 2.96% to 5.70% with units reflecting 4.18% to 7.07%.
- Analysis has been undertaken of a sample of valuations of new build SDA assets situated across the country. The analysed sample of valuations undertaken in 2022 reflected gross rental yield assumptions of 7.29% to 9.59%. These assets are considered to reflect higher yields in comparison to existing stock given the higher “new build” SDA funding.
- Purpose Built Student Accommodation and Build-to-Rent asset classes are broadly comparable to Apartment style stock ranging between one-to-three-bedrooms. The analysed sample of valuations undertaken in 2022 indicated gross rental yield assumptions ranging between 4.20% to 6.80% for BtR assets and 6.17% to 10.47% for PBSA assets.

Table 10 outlines the summary of gross rental yield research. Additional detail is provided within the annexures of this Report.

Table 10: Yield Summary Based on Asset Class

Gross Yield Range	
Residential - House (National)	2.96% to 5.70%
Residential - Unit (National)	4.18% to 7.07%
SDA (New Build)	7.29% to 9.59%
BtR	4.20% to 6.80%
PBSA	6.17% to 10.47%

Source: EY analysis

10

Analysis - Market Return Hurdles for SDA

Market Return Hurdles

As previously highlighted within this Report, the SDA Pricing Model used by NDIA utilises a WACC assumption to reflect the cost of financing an SDA investment, including the cost of debt and a reasonable return on equity.

Weighted Average Cost of Capital (WACC)

The WACC is typically utilised as a measure of reflecting the average after-tax cost of a company's capital sources and a measure of the interest return a company pays out for its financing.

Generally, companies use the WACC as a minimum rate for consideration when analysing projects as the minimum threshold required by the firm.

Company investment analysts use the WACC for discounting future cash flows to arrive at a net present value ("NPV") when calculating the value of a company or investment decision, however this metric is rarely used to inform real estate investment decisions.

Internal Rate of Return (IRR)

The IRR can be expressed in a variety of financial and investment scenarios. In practice, the IRR is a key valuation metric used to assess real estate value over an investment horizon or to understand the expected return from a new development project.

The IRR is used by most property companies (i.e. institutional investors) to analyse and inform capital and investment decisions. Investment committees are able to compare returns on a like-for-like basis with other property investment asset classes/opportunities in the market.

IRR for Real Estate Investment

Market evidence and benchmarks for IRR's can be obtained by analysing market transactions, investment mandates and observed pricing across SDA and other comparable property asset classes and are considered on a pre-tax, debt, depreciation and amortisation basis.

SDA investors are therefore likely to consider the IRR as a better indication of the level of investor return required to inform the pricing model and maintain investor interest within SDA as an asset class.

Generally the IRR benchmarks and yield evidence has been based on stabilised assets. It therefore excludes any risk premium to reflect development risk, and potentially operating risk, which can be priced separately.

The market has been able to separate out the specific risks associated with SDA investing by contracting out (notionally or actually) the key services; Development and SDA Management (operations) from property ownership. It is possible to analyse existing market benchmarks/evidence for these to separately price risk for development and operation phases.

The following table provides estimate benchmark ranges for yields and IRR's for SDA asset in comparison to alternative real estate investment assets.

Table 11: Valuation Estimate Benchmark Ranges

Valuation Benchmark (Stabilised)	Income underpinned by Gov Funding	Income model	Capitalisation Rate/Yield	Discount Rate/IRR	Average Capital Investment Size ($m)
SDA (Going Concern)	Yes	Operating Risk	6.75% to 7.50%	7.00% to 9.00%	4 to 8
SDA (Headlease only) [excl. operating margin]	Indirect	Lease	5.00% to 6.00% (20 yrs YP[1]) / 8.00% to 8.75% Perpetuity	6.25% to 7.00%	4 to 8
Aged Care (Property lease – excl. operating margin)	Yes	Lease	6.50% to 7.50%	8.00% to 10.00%	10 to 40
Aged Care (Going concern - EBITDAR)	Yes	Operating Risk	12.00% to 15.00%	-	15 to 50
Retirement Village (going concern - established)	No	Operating Risk	N.A.	12.00% to 16.00%	5 to 30
Private Hospital (Property lease)	Indirect	Lease	4.75% to 5.50%	6.50% to 8.00%	10 to 80
Private Hospital (Going Concern - EBITDAR)	Indirect	Operating Risk	10.00% to 15.00%	-	20 to 150
Medical Centre/Suites (property lease)	Indirect	Lease	5.00% to 6.00%	6.50% to 7.50%	5 to 20
Purpose Built Student Accommodation (going concern)	No	Operating Risk	4.50% to 5.00%	6.00% to 7.00%	40 to 80
Build to Rent (BtR) (going concern)	No	Operating Risk	4.00% to 5.00%	6.00% to 7.00%	50 to 150
Social Housing – (build & operate)	Yes	Operating Risk	N.A.	6.50% to 8.00%	50 to 300

Source: Indicative ranges based on EY Research December 2022

[1] Years purchased (YP)

SDA Operating Models

Two distinct types of SDA operating models have emerged in the market being:

- Direct Operation (Going Concern) - Under this model the SDA owner retains all vacancy risk and either appoints a specialist Property/Tenancy Manager (typically a registered SDA operator) to source tenants and manage; or act as the Property/Tenancy Manager themselves. Typical yields within the market range between 6.75% to 7.50% with IRR's ranging between 7.00% to 9.00%.
- Headlease – Under this model a registered SDA provider or entity take an overriding lease (typically for ten years) over the registered SDA dwelling and pays the owner a fixed rental for the duration of the lease. The Tenant (Head Lessee) typically assumes all operating cost and vacancy risk enabling the SDA owner to be a passive investor. Typical yields within the market range between 5.00% to 6.00% (over 20 years and equivalent to ~8.00% to ~8.75% in perpetuity) with IRR's ranging between 6.25% to 7.00%.

11 Appendices

Appendices A: Summary of Key Inputs

Table 12 provides a summary of the key inputs within the CAPM comparing the historic assumptions used by NDIA against the market research findings.

Table 12: Historic Assumptions vs Updated Recommended Assumptions

InputMa	Historic Assumption	Updated Recommended Assumption/Comments
Risk-free Rate	2.70%	90 day average of the 10 year Australian Government bond rate as at the date the SDA pricing is set.
Market Risk Premium	6.00%	6.00% to 6.90%
Equity Beta	0.90	0.80 to 1.20
Assumed level of Equity	40.00%	40.00%
Assumed level of Debt	60.00%	60.00%
Effective Tax Rate	30.00%	30.00%
Value of Imputation Credits	0.00	0.00
Expected Inflation	2.50%	To be adopted in line with the expected forecast inflation as at the date the SDA pricing is set.
Debt Margin	2.50%	2.00% to 3.00%

Source: SDA Pricing Model/EY Research

Appendices B: PBSA – Gross Rental Yield Evidence

- Purpose Built Student Accommodation (PBSA) comprises of apartment style accommodation that has been purpose built for tertiary students to live and study in. We have analysed independent valuation reports for PBSA assets undertaken by tier one valuation firms (JLL, CBRE, Knight Frank and Colliers) for premium assets on a national basis. Given the sensitive information contained within the valuation reports we have kept the asset names confidential.
- The selected sample indicates a Gross Market Yield range (based on the core capitalised value) between 6.17% to 10.47% and a Gross Market Yield range between 6.57% to 11.06% (based on the adopted market value after allowances for below the line capital adjustments).
- Furthermore, the sample reflects an adopted capitalisation rate range between 4.50% to 6.50% and an adopted discount rate range between 6.45% to 8.00%.

The PBSA research ranges observed within each peer report are outlined below in Table 13.

Table 13: PBSA Range

Key Metrics	Peer 1	Peer 2	Peer 3	Peer 4	Peer 5	Peer 6	Peer 7	Peer 8	Peer 9	Peer 10	Peer 11	Peer 12	Peer 13
	VIC	VIC	VIC	SA	NSW	QLD	QLD	QLD	NSW	QLD	NSW	VIC	NSW
Gross Market Yield (Based on core capitalised value)	7.10%	8.88%	6.41%	8.97%	6.17%	8.42%	8.42%	9.57%	8.31%	10.47%	8.24%	7.72%	6.83%
Gross Market Yield (Based on adopted market value after capital adjustments)	7.53%	9.56%	6.81%	9.46%	6.57%	8.97%	8.79%	10.41%	8.78%	11.06%	8.55%	8.12%	6.99%
Adopted Discount Rate	7.25%	8.00%	N/A	7.50%	6.75%	8.00%	8.00%	8.00%	6.45%	8.00%	7.00%	7.50%	6.45%
Adopted Capitalisation Rate	5.00%	6.50%	5.25%	5.75%	4.50%	6.00%	6.00%	6.00%	4.65%	5.75%	5.50%	5.25%	4.70%

Source: EY Research 2022

Appendices C: SDA – Gross Rental Yield Evidence

- We have analysed a portfolio of “new build” SDA assets situated within New South Wales, Queensland and the Australian Capital Territory. The portfolio is operated under a head lease agreement and comprises of a range of design types including Group Home, House, Villas and Apartments
- We have analysed independent valuation reports for the portfolio. Given the sensitive information contained within the valuation reports we have kept the asset names confidential.
- The selected sample indicates a Gross Market Yield range (based on the core capitalised value) between 7.29% to 9.59% and a Gross Market Yield range between 6.41% to 7.48% (based on the adopted market value after allowances for below the line capital adjustments).

The SDA research ranges observed within each peer report are outlined below in Table 14.

Table 14: SDA Range

	Peer 1	Peer 2	Peer 3	Peer 4	Peer 5	Peer 6
	NSW	QLD	NSW	QLD	QLD	ACT
Asset Type	Group House (House One 3 x HPS & House Two 1 x HPS) with OOA	House with 4 x HPS and 1 x Study and OOA	6 Villas with OOA (5 x HPS)	Two Villas (Villa 1 has 2 Bed + study) (Villa 2 has 1 Bed + Study) Both include OOA	10 Apartments with OOA (9 x HPS & 1 x FA)	House with OOA and 4 x HPS
Gross Market Yield (Based on core capitalised value)	8.44%	8.25%	9.59%	8.28%	7.61%	7.29%
Gross Market Yield (Based on adopted market value after capital adjustments)	6.52%	6.41%	6.98%	7.48%	7.46%	7.17%

Source: EY Research 2022

Appendices D: BtR – Gross Rental Yield Evidence

- Built to Rent comprises of apartment style residential accommodation. We have analysed independent valuation reports for BtR assets undertaken by tier one valuation firms. Given the sensitive information contained within the valuation reports we have kept the asset names confidential.
- The selected sample indicates a Gross Market Yield range (based on the core capitalised value) between 4.20% to 6.80% and a Gross Market Yield range between 4.16% to 8.36% (based on the adopted market value after allowances for below the line capital adjustments).
- Furthermore, the sample reflects an adopted capitalisation rate range between 3.75% to 6.25% and an adopted discount rate range between 6.00% to 6.75%.

The BtR research ranges observed within each peer report are outlined below in Table 15.

Table 15: BtR Range

	Peer 1	Peer 2	Peer 3	Peer 4	Peer 5	Peer 6
	NSW	QLD	QLD	Vic	WA	WA
Gross Market Yield (Based on core capitalised value)	4.20%	6.25%	6.58%	6.07%	6.80%	6.80%
Gross Market Yield (Based on adopted market value after capital adjustments)	4.23%	6.22%	8.36%	6.97%	4.16%	4.16%
Discount Rate	6.50%	6.50%	6.75%	6.00%	6.75%	6.75%
Capitalisation Rate	3.75%	4.50%	6.25%	6.25%	4.25%	4.25%

Source: EY Research 2022

Appendices E: Residential – Gross Rental Yield Research

- Gross rental research data has been obtained from SQM Research and analysed to identify gross rental yields for houses and units within each state and territory.
- Gross rental yields for houses indicate a range between 2.96% and 5.70%.
- Gross rental yields for units indicate a range between 4.18% and 7.07%.
- On a national basis, there is a 100 basis point differential for gross rental yields between Houses (3.90%) and Units (4.90%).

Our House & Unit research ranges observed within each peer report are outlined below in Table 16.

Table 16: House & Unit Research Range

Average State Breakdown (House and Unit) SQM Research									
Dwelling Type	NT	NSW	ACT	QLD	SA	TAS	VIC	WA	National
Gross Rental Yields (Houses)	5.70%	3.52%	3.57%	4.59%	4.38%	3.60%	2.96%	4.98%	3.90%
Gross Rental Yields (Units)	7.07%	4.32%	4.97%	5.38%	6.09%	5.06%	4.18%	6.67%	4.90%

Source: SQM Research, 2022

Appendices F: Equity Beta Analysis

The comparable company analysis research ranges observed within each peer report are outlined below in Table 17.

Table 17: Comparable Company Analysis

Comparable company	Primary Industry	Location	Total Liabilities/ Total Assets %	LT Debt/Capital	Market Cap ($m)	Liquidity	Free float
Regis Healthcare Limited	Health Care Facilities	Australia	95%	52%	602	14%	41%
AlerisLife Inc.	Health Care Facilities	United States	60%	32%	35	63%	57%
Arvida Group Limited	Health Care Facilities	New Zealand	61%	29%	815	15%	91%
National HealthCare Corporation	Health Care Facilities	United States	32%	10%	1,318	57%	81%
Ramsay Health Care Limited	Health Care Facilities	Australia	N/A	N/A	14,945	62%	79%
Ryman Healthcare Limited	Health Care Facilities	New Zealand	70%	46%	2,909	37%	93%
The Ensign Group, Inc.	Health Care Facilities	United States	64%	53%	7,439	104%	96%
The Pennant Group, Inc.	Health Care Facilities	United States	76%	69%	440	124%	95%
Chartwell Retirement Residences	Health Care Facilities	Canada	79%	71%	2,031	48%	100%
Summerset Group Holdings Limited	Health Care Facilities	New Zealand	62%	30%	1,999	21%	100%
Estia Health Limited	Health Care Facilities	Australia	70%	22%	522	26%	84%

Source: Capital IQ & EY Research

Comparable company	Primary Industry	Location	Total Liabilities/ Total Assets %	LT Debt/Capital	Market Cap ($m)	Liquidity	Free float
Omega Healthcare Investors, Inc.	Health Care REITs	United States	59%	58%	10,078	251%	100%
National Health Investors, Inc.	Health Care REITs	United States	47%	46%	3,586	150%	96%
LTC Properties, Inc.	Health Care REITs	United States	50%	49%	2,282	169%	98%
Impact Healthcare REIT PLC	Health Care REITs	United Kingdom	25%	23%	745	46%	97%
Healthpeak Properties, Inc.	Health Care REITs	United States	54%	37%	19,793	185%	100%
Sabra Health Care REIT, Inc.	Health Care REITs	United States	45%	43%	4,229	241%	99%
Aedifica SA	Health Care REITs	Belgium	45%	36%	4,765	37%	100%
CareTrust REIT, Inc.	Health Care REITs	United States	51%	49%	2,779	175%	98%
NorthWest Healthcare Properties Real Estate Investment Trust	Health Care REITs	Canada	55%	24%	2,548	57%	91%
Target Healthcare REIT PLC	Health Care REITs	United Kingdom	27%	25%	883	62%	98%
Vital Healthcare Property Trust	Health Care REITs	New Zealand	N/A	N/A	1,442	20%	72%
Welltower Inc.	Health Care REITs	United States	45%	43%	45,203	135%	100%
HealthCo Healthcare and Wellness REIT	Health Care REITs	Australia	6%	3%	559	33%	76%

Source: Capital IQ & EY Research

Glossary

Term	Meaning
Building Type	The Design Category as per the SDA Framework - Apartment, Duplex/Villa/Townhouse, House or Group Home.
Apartment	Self-contained units that are part of a larger residential building.
Duplex, Villa, Townhouse	Separate but semi-attached properties within a single land title or strata titled area. This also includes stand-alone villas or granny-flats.
House	Detached low-rise buildings with garden or courtyard areas with fewer than 4 bedrooms.
Group Home	Houses that have 4 or 5 bedrooms.
CAPM	Capital Asset Pricing Model
Design Category	The Design Category as per the SDA Framework - Basic, Improved Liveability, Fully Accessible, Robust or High Physical Support.
Basic	Housing without specialised design features but with other important SDA characteristics (e.g. location, privacy, shared supports).
Improved Liveability (IL)	Housing that has been designed to improve “Liveability” by incorporating a reasonable level of physical access and enhanced provision for people with sensory, intellectual or cognitive impairment.
Fully Accessible (FA)	Housing that has been designed to incorporate a high level of physical access provision for people with significant physical impairment.
Robust	Housing that has been designed to incorporate a high level of physical access provision and be very resilient, reducing the likelihood of reactive maintenance and reducing the risk to the participant and the community.
High Physical Support (HPS)	Housing that has been designed to incorporate a high level of physical access provision for people with significant physical impairment and requiring very high levels of support.
Enrolled Dwelling	A dwelling enrolled under section 26 of the *NDIS (Specialist Disability Accommodation) Rules 2020* to provide SDA.
NDIA	National Disability Insurance Agency.
NDIS	National Disability Insurance Scheme.

Term	Meaning
SDA	Specialist Disability Accommodation.
SDA Type	The SDA type under the SDA Framework - Existing, Legacy, New Build or New Build (refurbished).
New Build	An SDA dwelling that was built (has a certificate of occupancy dated) after 1 April 2016 and meets all of the requirements under the SDA Rules and NDIS Price Guide.
Existing	Dwellings built before 1 April 2016 that were used as disability related supported accommodation under a previous State, Territory or Commonwealth scheme. Existing dwellings must substantially comply with the requirements of a new build, and must meet the maximum resident requirement (5 residents or less).
Legacy	Existing dwellings that do not meet the maximum resident requirement of 5 residents or less. Over time, the NDIA will stop making SDA payments towards Legacy dwellings.
New Build (refurbished)	A dwelling that was built before 1 April 2016 but has been significantly refurbished since and now meets all of the requirements for a new build in the SDA Rules and NDIS Price Guide. In order to qualify for as a New Build (refurbished) providers must spend a minimum amount. These minimum amounts are specified per dwelling type in the SDA Price Guide.
Historic Model	2016 SDA Pricing Model developed by NDIA.

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