RESIDENTIAL CARE HOME FINANCES

2014 – 2016

REPORT BY:

OPUS RESTRUCTURING LLP

AND

COMPANY WATCH

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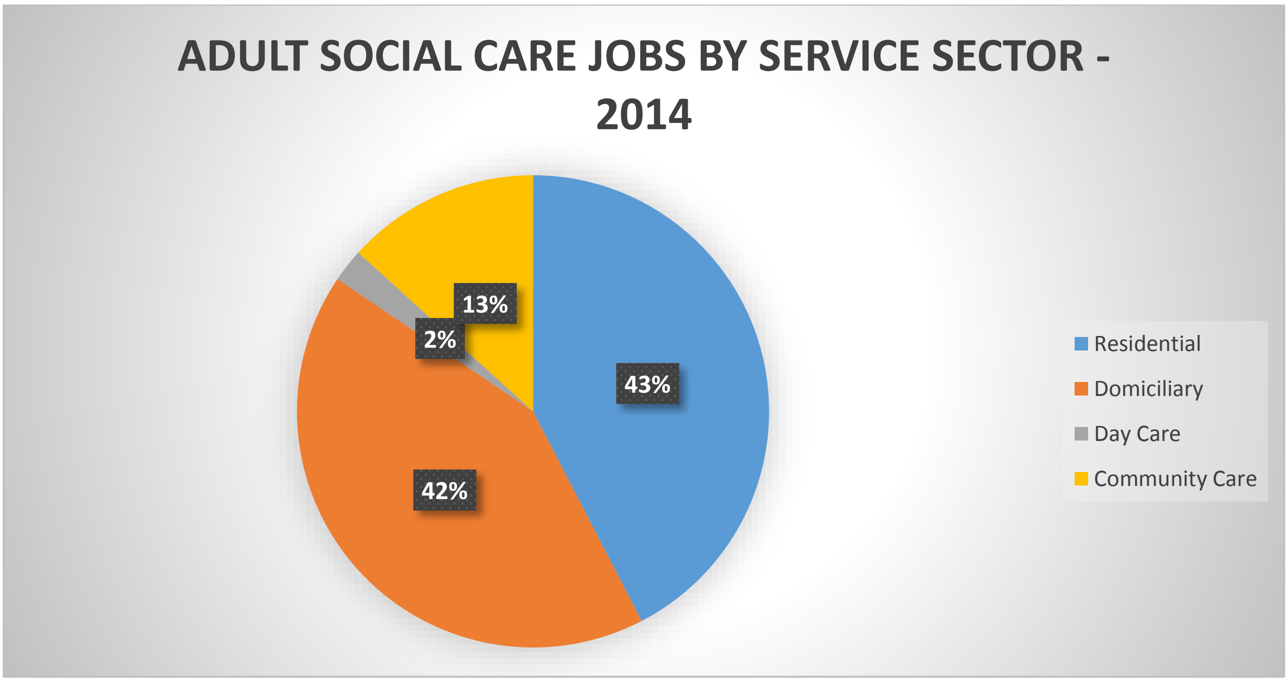
INTRODUCTION

The financial state of the UK's residential care homes has been the subject of increasing debate and public concern since government austerity measures began to bite into local authority budgets and as the largest cost component for most homes, staff costs have risen inexorably to increasingly unsustainable levels. Company Watch and Opus Restructuring have now been publishing research data on the financial health of the sector since 2013, seeking to raise awareness of this escalating crisis.

RESIDENTIAL CARE WITHIN THE UK ADULT CARE INDUSTRY

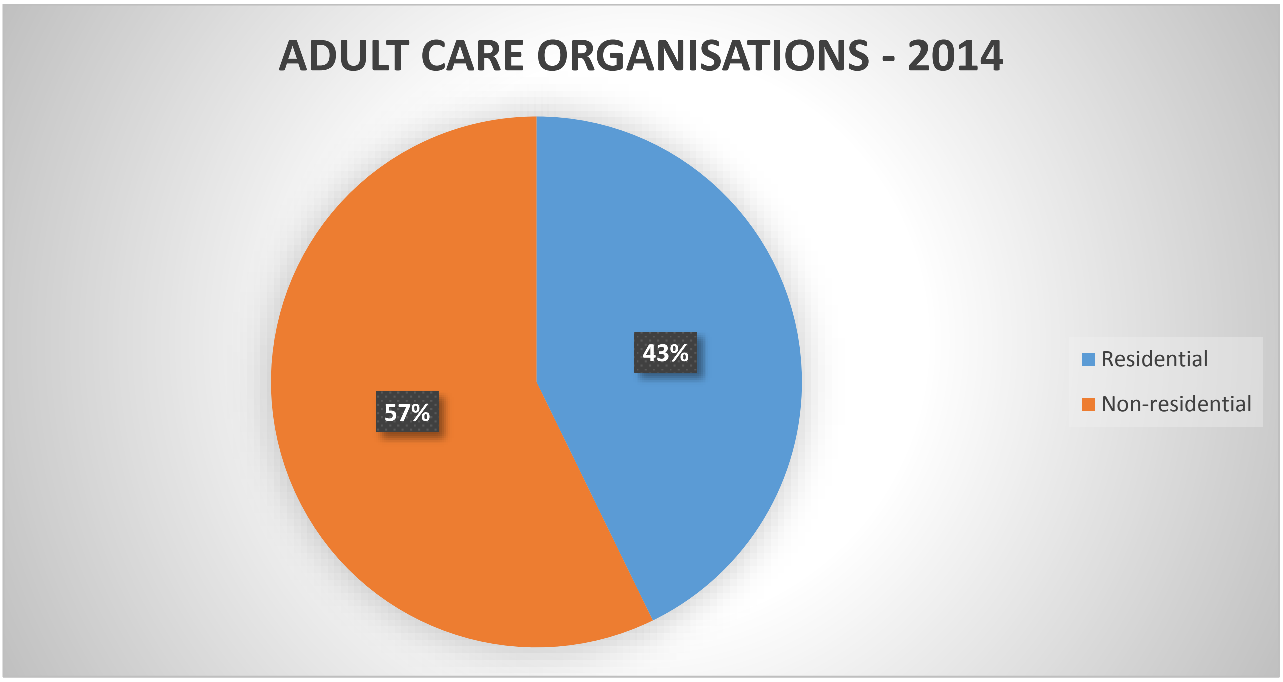
Residential care is only part of a complex, inter-related ecosystem, which seeks to meet the increasing demands of the UK's ageing population. Stresses in any one part of this ecosystem tend to migrate to others, as illustrated by the present 'bed blocking' issue in the NHS, which is caused by a lack of domiciliary and residential care capacity. Equally, a lack of domiciliary resource will tend to push those needing care towards the residential sector as well as vice versa, although to a lesser extent. In terms of 'users' of adult care services, those receiving domiciliary care are estimated to be approximately 900,000 compared to some 300,000 residents in care homes.

Adult care employed 1.55m people in 2014, split between sectors as follows:



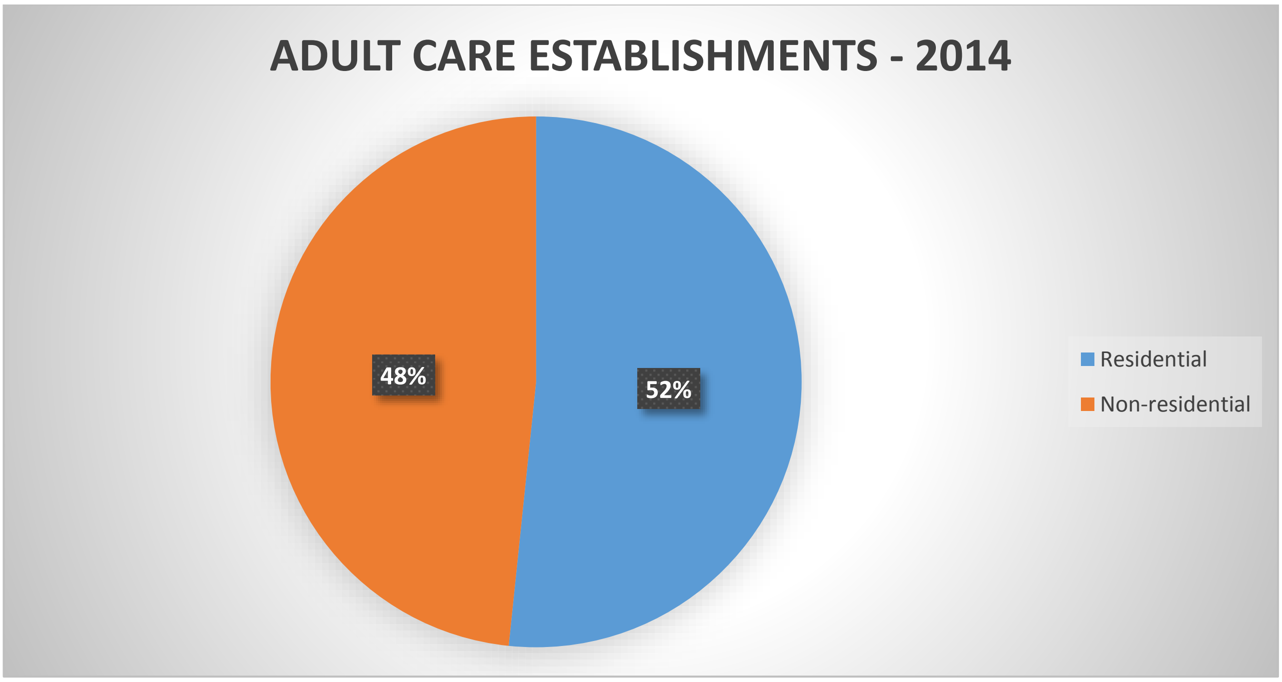
Source: Skills for Care – The Size & Structure of the Adult Social Care Sector & Workforce in England, 2015

In 2014, the adult care industry is comprised of some 18,000 organisations, split as follows:



Source: Skills for Care – The Size & Structure of the Adult Social Care Sector & Workforce in England, 2015

These organisations operated from 39,500 establishments, split as follows:



Source: Skills for Care – The Size & Structure of the Adult Social Care Sector & Workforce in England, 2015

SCOPE

This report is based on a detailed financial analysis of all of the companies in the UK, which use one of the Standard Industrial Classification ("SIC") codes on their file at Company House indicating that they operate residential care homes of one type or another. Our research covers a sample of 6,158 care home operators.

In addition, we have included in our sample the data for one of the UK's largest residential care home operators, Care UK which does not use any of the appropriate SIC codes. We have also included the information for the most appropriate subsidiary of the BUPA group, another major player in this sector.

Our analysis does not include data for another three of the five largest UK operators (Four Seasons, HC-One and Barchester Healthcare) because their parent companies are registered offshore, preventing access to sufficiently comprehensive financial data. On the basis of the limited financial data available for these major care home chains, we believe that if they were included in our research, the overall financial health of the sector would be shown to be materially worse than revealed by this report.

Our sample covers all but the estimated 750 homes run by Four Seasons, HC-One & Barchester, leaving some 20,250 (96.4%) out of the estimated total of 21,000 homes within our research.

Our analysis has been carried using the Company Watch methodology, which allocates a financial health score (H-Score®) out of a maximum of 100. This is derived from a company's published financial results and quantifies how closely the accounts resemble those of companies which subsequently failed. Companies with an H-Score of 25 or less are placed in what is known as the Warning Area. Not all companies in the Warning Area will fail; however, of the companies that do fail, the vast majority were in the Company Watch Warning Area prior to their collapse.

Because of the delay in filing accounts at Companies House, our research is based on a range of accounting dates, mainly ending in 2015. This means that our research does not yet reflect the impact on care home operators of the introduction of the National Living Wage in April 2016, which has caused a major increase in labour costs for the sector. We discuss the potential effect of this later in this report.

It should be noted that it is estimated that there are some 21,000 care homes in the UK, which indicates that even allowing for the number of homes run by three major operators which are not covered by this research, the average number of homes run by each operator is a little over three.

In order to measure the change in the financial profile of the sector in recent years, this report includes comparatives taken from research carried out by Opus Restructuring and Company Watch in January 2016 and March 2014, using the same methodology as this current analysis.

EXECUTIVE SUMMARY

- 1,718 (28%) care home operators fall within the Company Watch Warning Area.

- 2,807 (46%) care home operators have H-Scores of 50% or below, indicating a below par financial position.

- Only 15% of care home operators borrow any significant amount. 2% borrow less than £10,000 and 83% have no borrowings at all.

- Despite this, the overall gearing level for our sample is 80%, well above accepted financial norms. But for the 15% with significant borrowings, the average level of gearing is 121%. Total borrowings are £4.5bn.

- 745 (12%) care home operators are 'zombie' companies, with liabilities greater than their assets.

- These zombie operators have a combined 'negative net equity' of £671m.

- The average annual pre-tax profit of a care home operator is only £34,000, equivalent to just over £10,000 per care home.

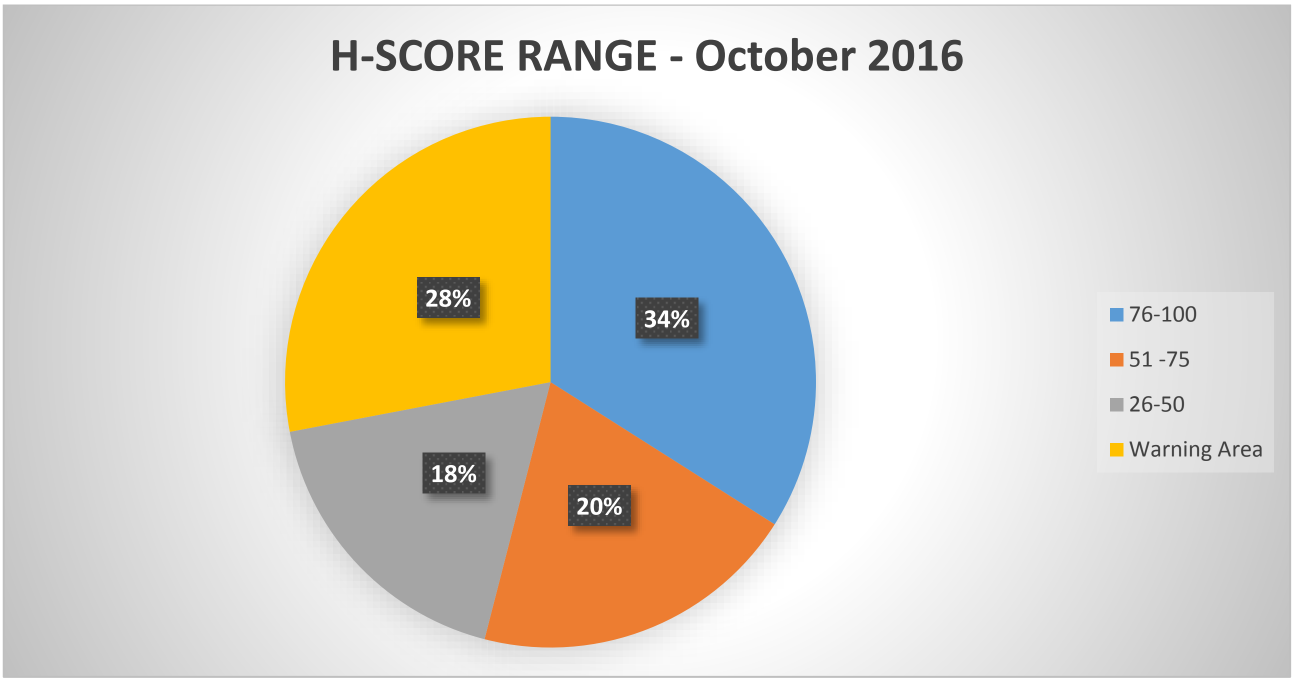
- The total annual pre-tax profits of the sector are £209m, compared to total gross assets of £15.2bn and total net worth of £6.3bn. This represents a return on capital employed of just 3.3%.

- The potential increase in annual costs from the introduction of the National Living Wage in April 2016 is £414m, almost twice the total profits of the sector.

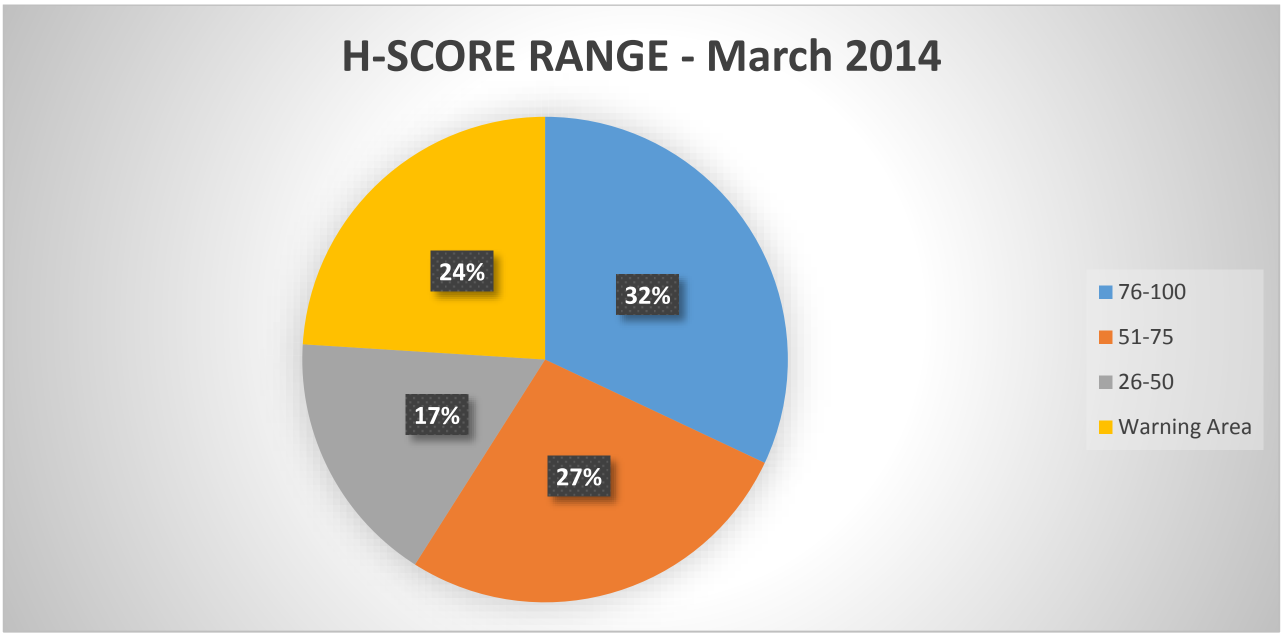
- There are significant regional variations:
    - Scotland has the best financial health ratings.
    - The South East has the most profitable operators, the North West has the least profitable.
    - Wales has the highest gearing levels, London has the lowest.

FINANCIAL HEALTH ANALYSIS

The latest spectrum of H-Scores for care home operators is as follows:



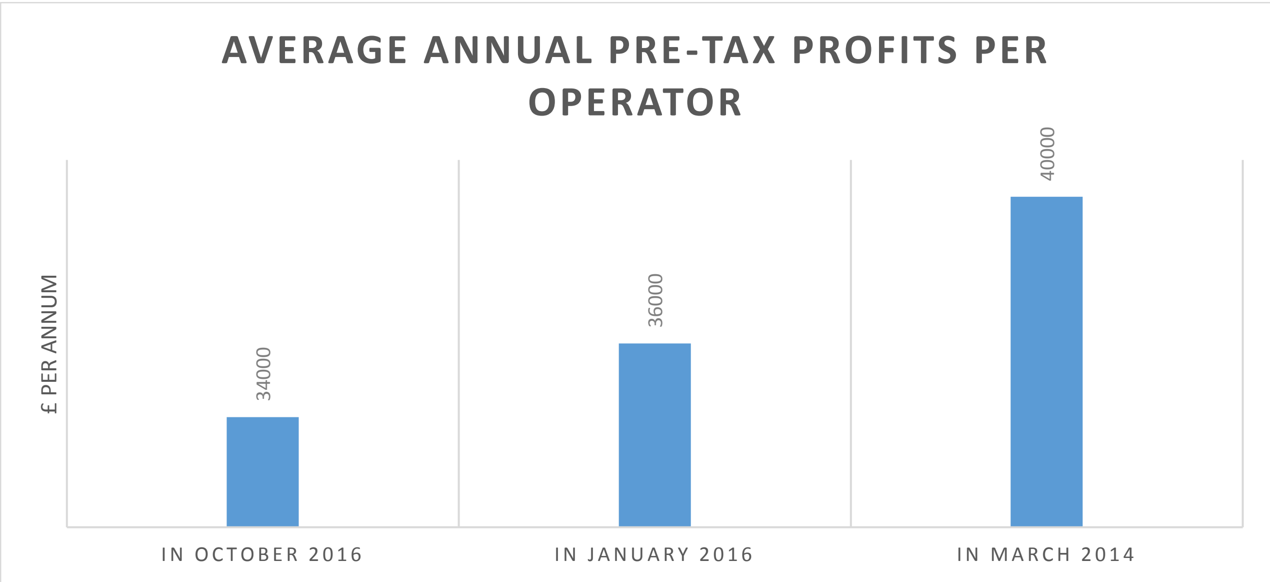
The equivalent profile in March 2014 was:



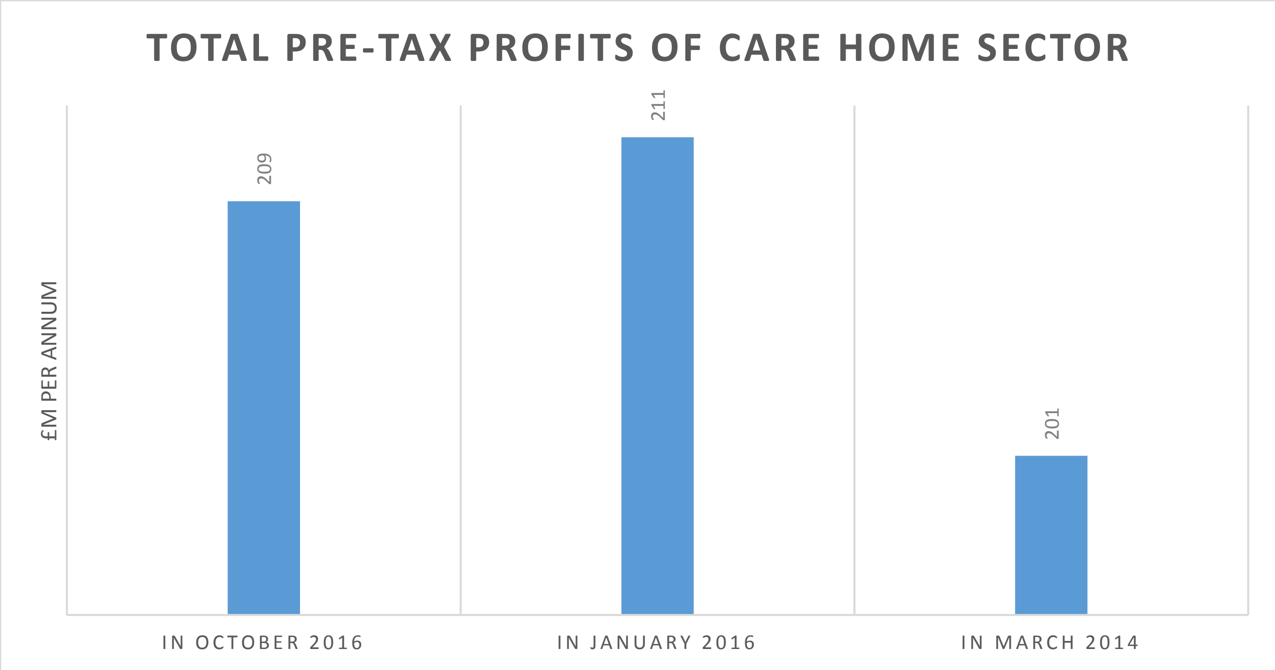
The key point is that the percentage of care home operators in the strongest H-Score range (76-100) has fallen from 34% to 32%, while the percentage in the Warning Area and therefore vulnerable to failure has risen sharply from 24% to 28%.

PROFITABILITY

The average care home operator in our sample earns an annual pre-tax profit of £34,000. This is on a consistent downward trend, comparing with £36,000 in January 2016 and £40,000 in March 2014. As noted earlier in this report, this means that the average pre-tax profit per home, rather than per operator is a little over £11,000.



The latest total annual pre-tax profits for the sector are £209m, compared to £211m in January 2016 and £201m in March 2014. These figures do not yet reflect the effect of the National Living Wage, which we believe will be greater than the current profits, threatening to make the sector loss making as a whole. We discuss this issue later in this report.



THE NATIONAL LIVING WAGE (NLW)

The NLW came into force in April 2016. Those workers aged 25 or over must be paid a minimum of £7.20 per hour, which is 7.5% higher than the previous equivalent National Minimum Wage (NMW) rate of £6.70 per hour. For those workers under the age of 25, the relevant current NMW rate still applies.

The first comprehensive study of the impact on the care sector of this change in pay rates was carried out by the Resolution Foundation and published in late August 2016. Based on the pay data for 80,000 employees of more than 2,000 care providers, it found that the overall pay bill had risen by more than twice that needed to meet the new minimum alone.

The study suggests that 57% of frontline workers (54% of all) have benefited directly from the £7.20 minimum with an average pay rise of 9.2%. This includes 83% of those aged under 25 who are now receiving £7.20 or more, even though it is not required by law. The overall pay bill for those employees surveyed had risen by 6.9%.

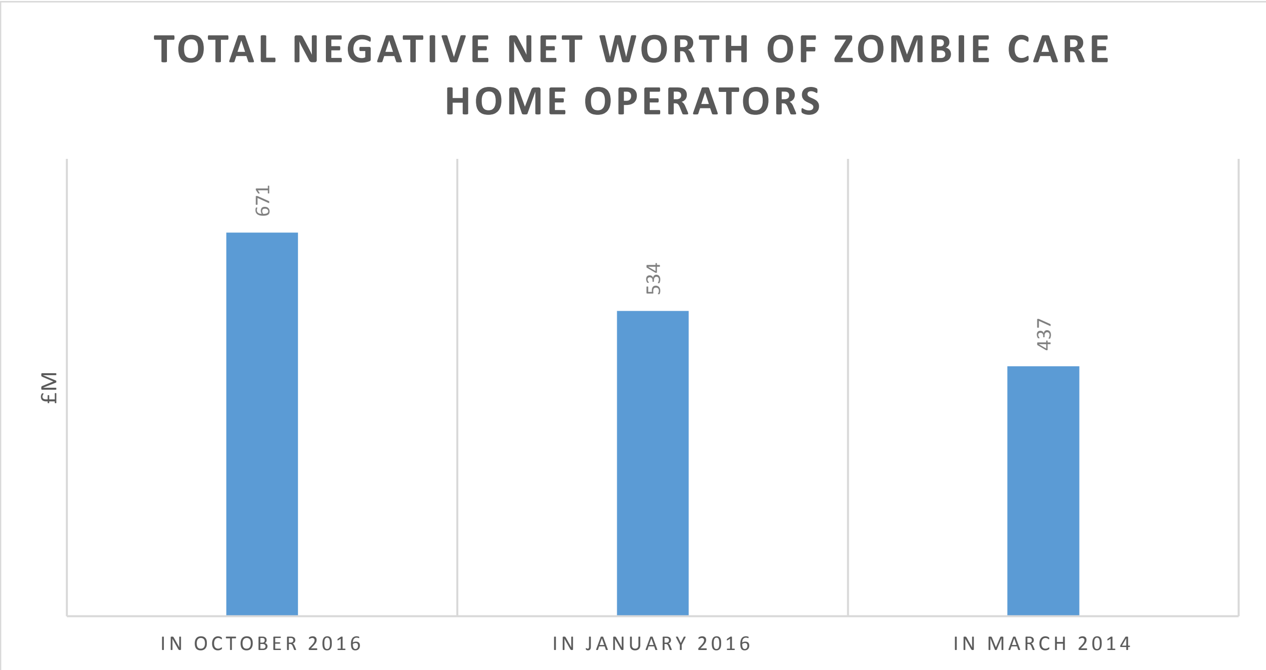
There is no comprehensive data for the overall labour costs for the residential care sector, but Care England have calculated that they represent 60% of total operating costs. Based on a broad estimate of approximately 300,000 residents across the sector and an estimated labour cost per resident of £20,000 (extrapolated from a study carried out by Knight Frank in 2013, which found that the average labour cost per resident in 2012 was £18,489), it seems likely that the total labour cost for the sector is approximately £6bn per annum.

A 6.9% increase would imply additional labour costs of £414m, which compares to the total profits of the sector of £209m as per our research. The extent to which this extra cost has been funded by increased residents' fees or other cost cuts, whether paid by local authorities or by the residents themselves, will only become clear once later accounts for our sample become available. Never the less, the threat to the financial viability of the sector is obvious.

Looking ahead, the NLW is scheduled to rise to £9 per hour by April 2020, a further increase of 25%. Based on a 6.9% impact of the introduction of the NVL on wage bills, the extra labour costs could be another £1.38bn per annum by 2020.

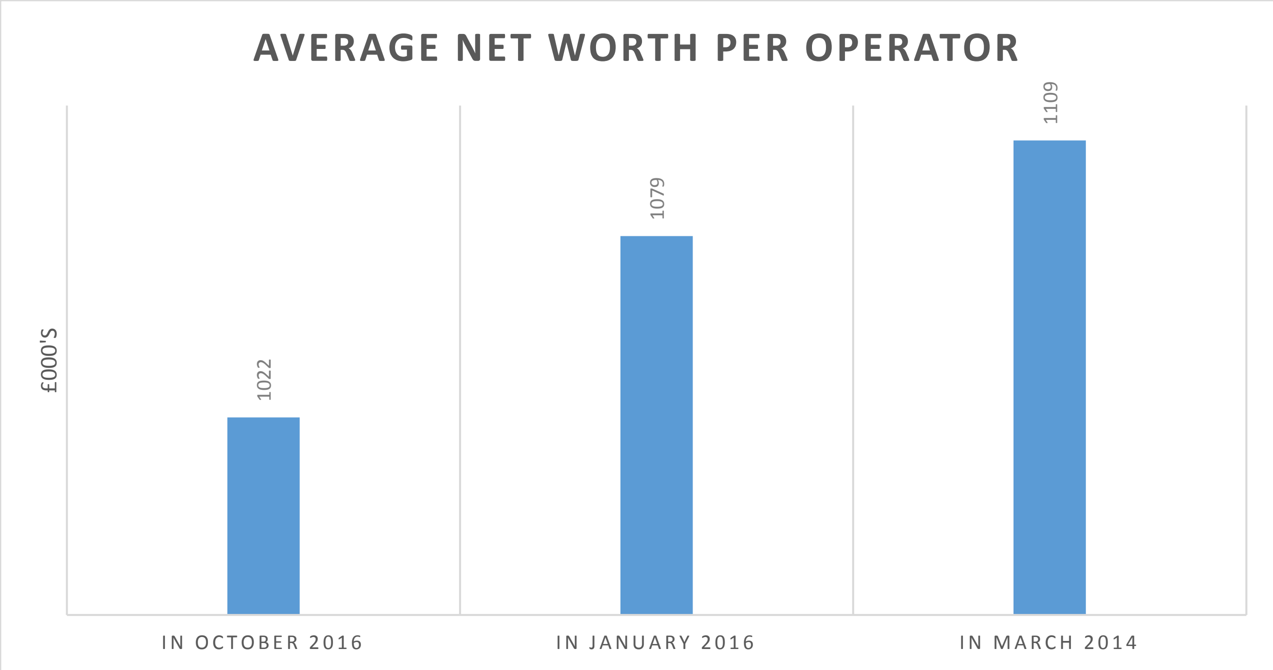
ZOMBIE COMPANIES

We define a zombie company for the purposes of this report as being one where its total liabilities exceed its total assets in its latest published accounts. Although the percentage of operators, which are zombies is falling slightly, our analysis shows a steadily deteriorating and alarming trend in terms of the total 'negative net equity' of these zombies. The total deficit has risen by 53% to £671m since March 2014. This is illustrated below:

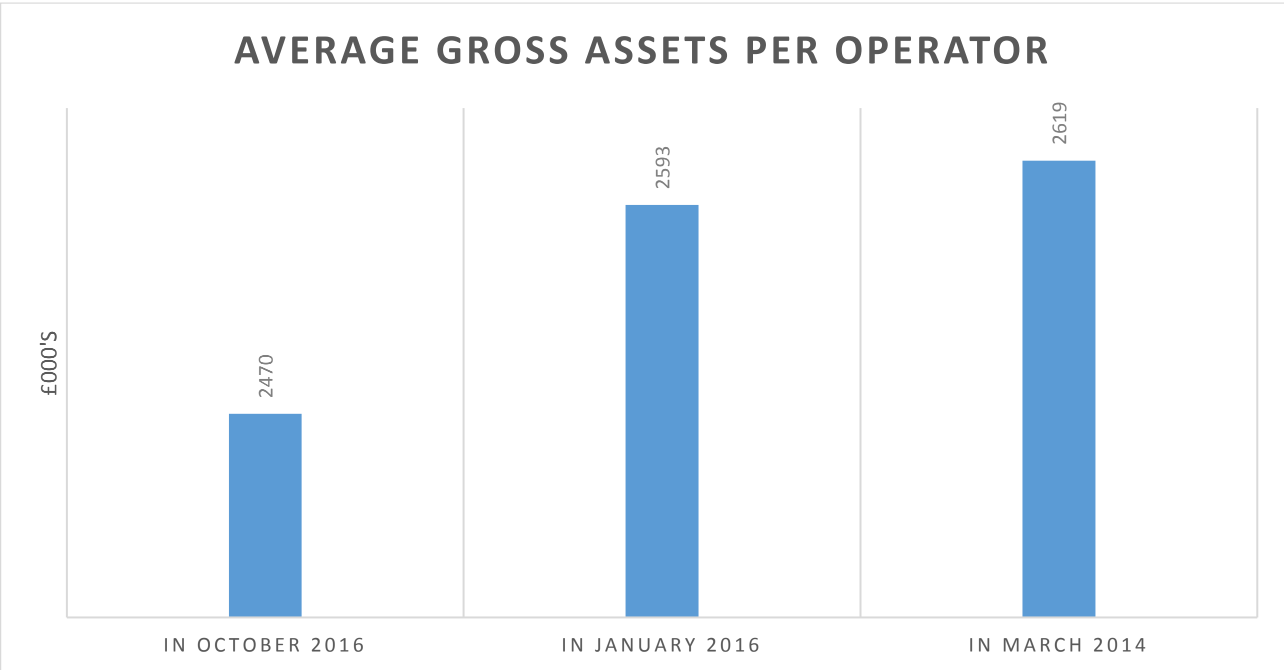


ASSET PROFILES

At the same that the zombie shortfall is rising, the average net worth of operators is falling, indicating a loss of financial substance in the sector. The average operator now has net assets of £1.02m, compared to £1.11m in March 2014, a fall of 8%. The trend can be seen here:



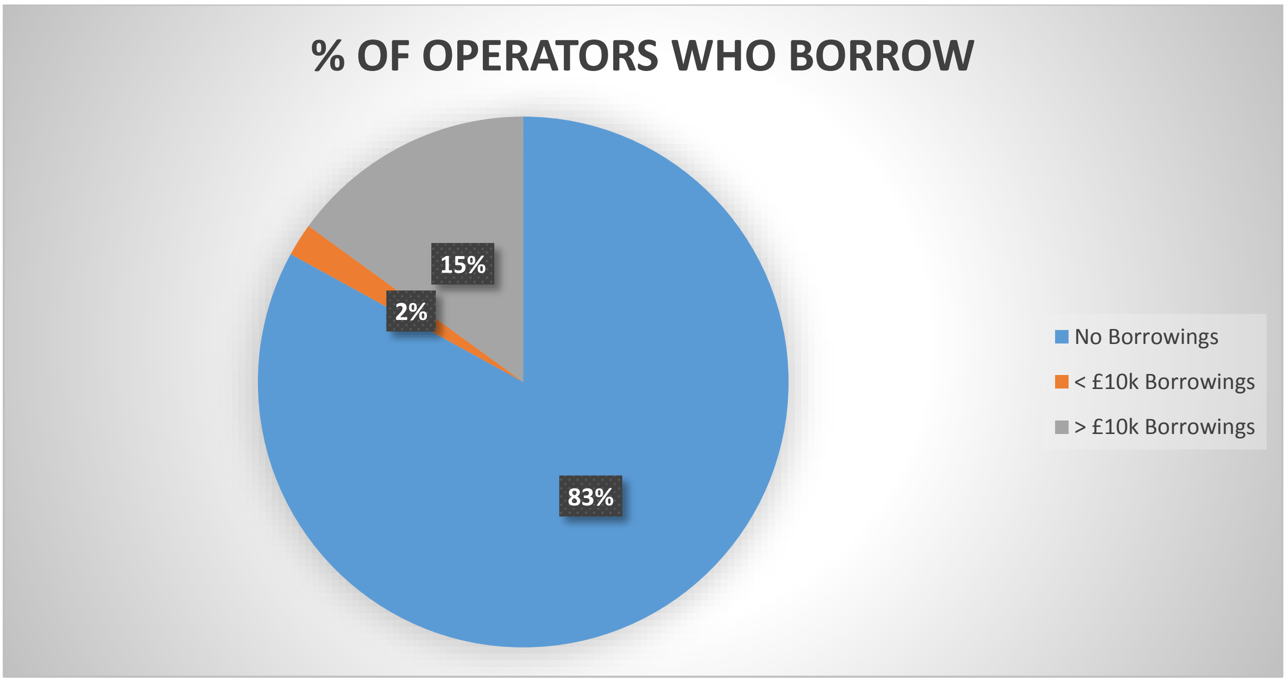
Average gross assets are also reducing, indicating lower investment per operator or falling asset values. The average gross assets per operator is now £2.47m, compared to £2.62m in March 2014, a drop of almost 6%. This is illustrated below:



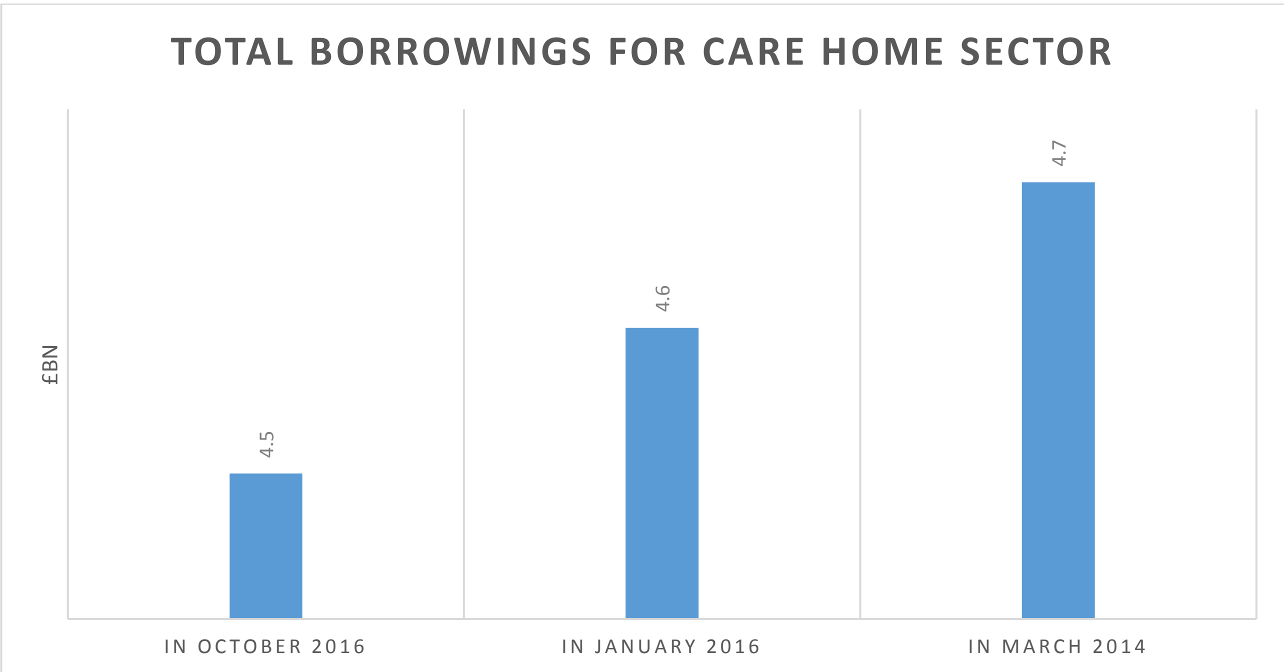
BORROWING & GEARING LEVELS

Despite public perceptions, borrowing is not an endemic part of the UK residential care home operator business model. Out of our sample, only 908 (15%) operators borrow more than £10,000 and 5,101 (83%) have no borrowings at all.

This suggests either that many are operating from rented property (possibly those that were previously local authority homes) or that the freehold of the property and the associated debt are held outside the operating company.



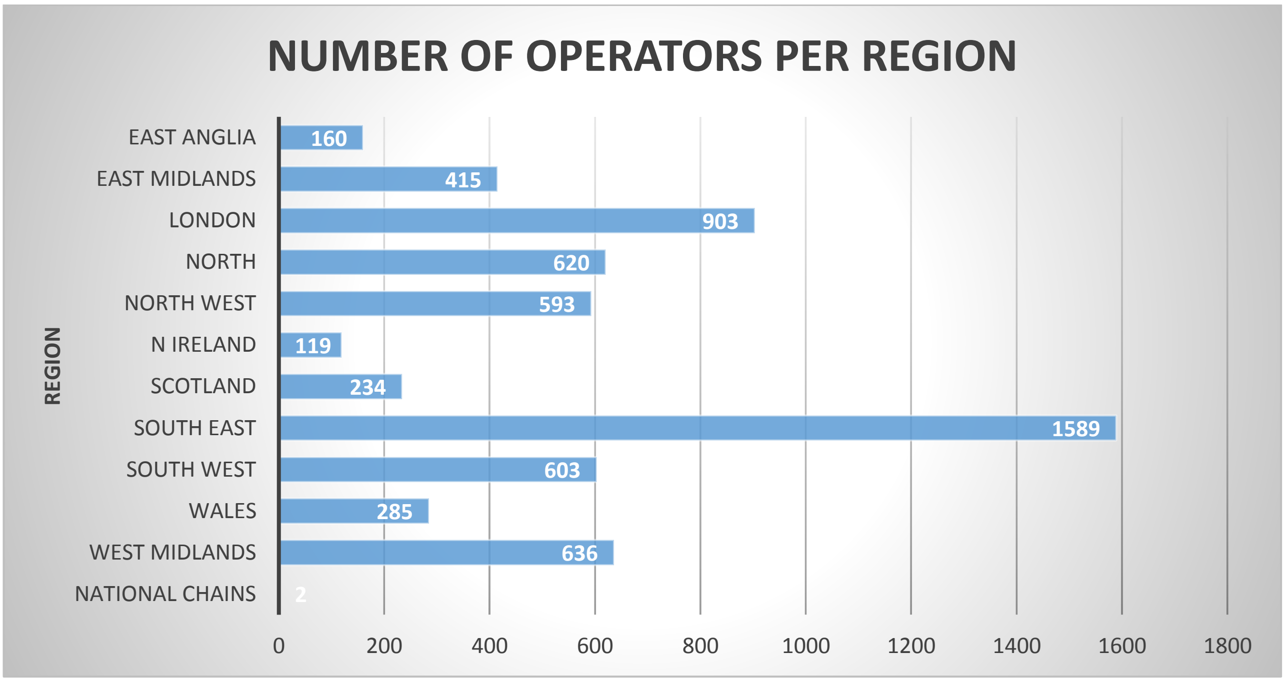
For those who do borrow, the gearing levels are unusually high, beyond normal commercial criteria and reflecting the presence of significant property assets in the borrowers' balance sheets. For the sector as a whole, the average gearing ratio is 80%; excluding those with no borrowings or debts of less than £10,000 this rises to an extraordinary 121%. If the three major operators not included in our sample, notably Four Seasons, were added we have no doubt that this ratio would be even higher. The sector as a whole borrows a little over £4.5bn, which has been declining very slightly but not significantly since March 2014:



REGIONAL VARIATIONS

We have also analysed our data sample by region within the UK. We have allocated operators within regions based on the company's registered office. There will be some instances where an operator may be located in one part of the country but have a registered office with a professional adviser elsewhere and other cases with bigger chains where an operator's homes are based more widely than where their registered office is located. Never the less, we believe this geographical break down to be sufficiently accurate to justify its inclusion.

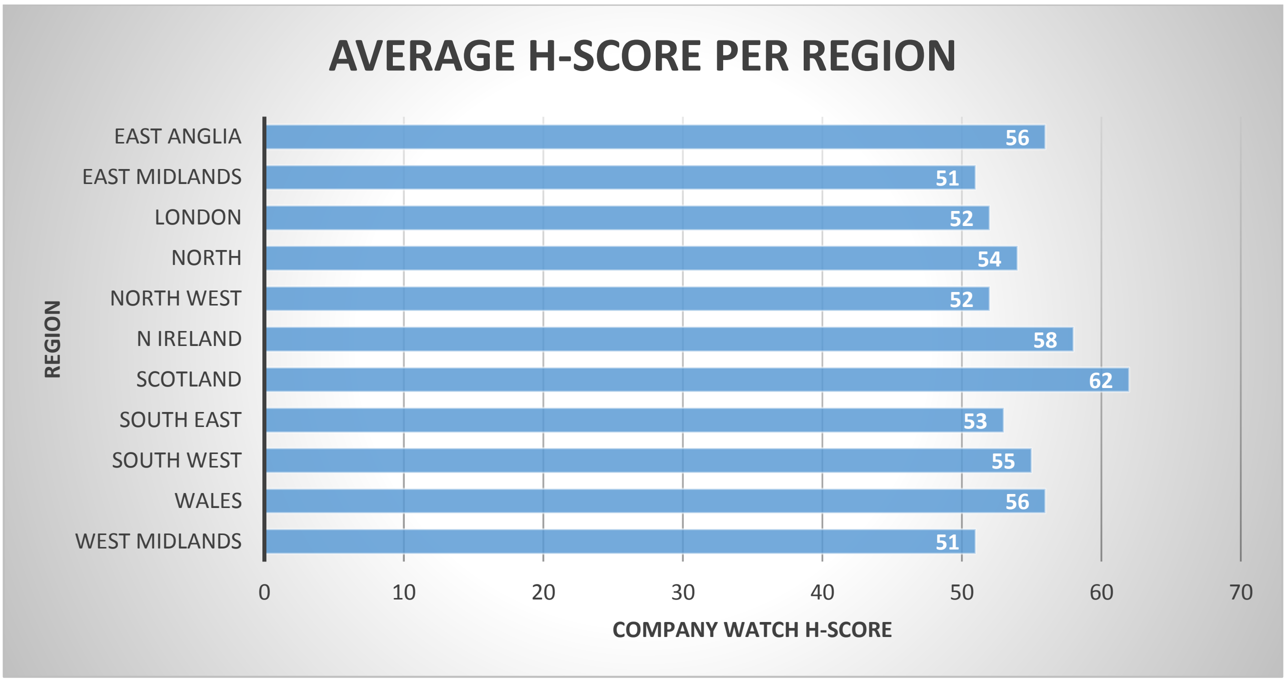
The number of operators per region is as follows:



Note: there are 2 national operator chains in our sample, BUPA with 300+ homes & Care UK with 100+ homes

Regional Financial Health

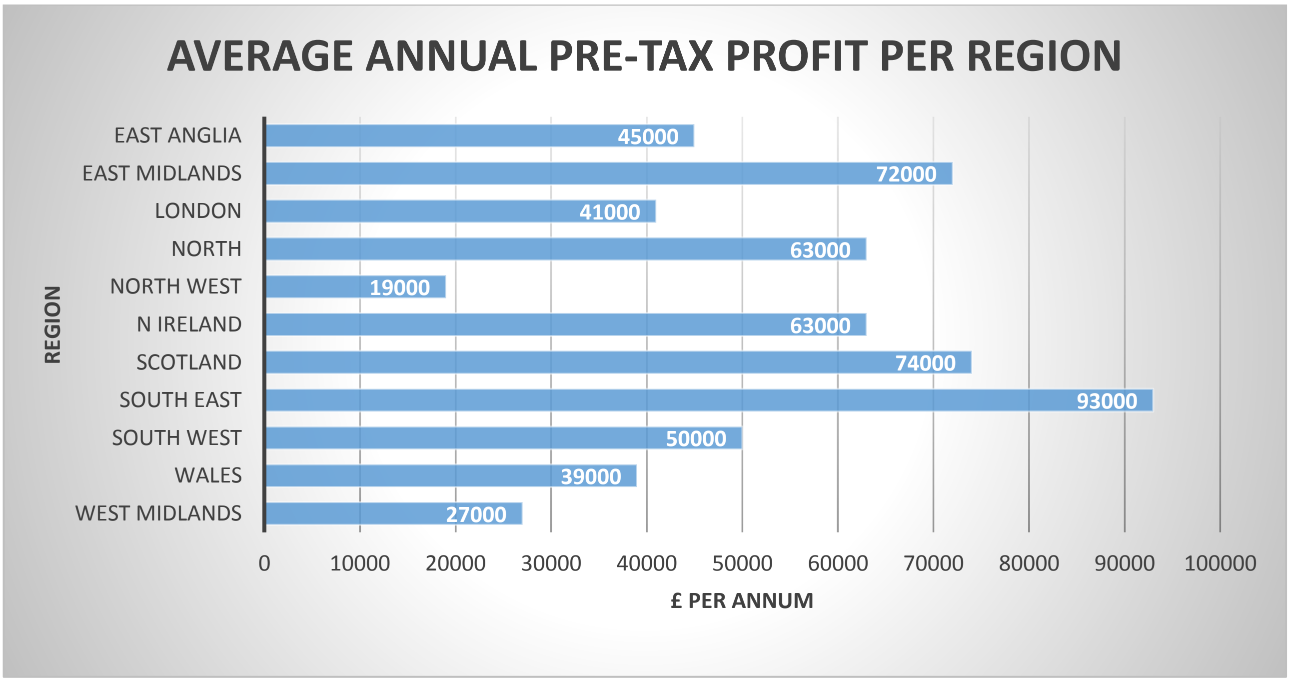
There are wide variations between regions when overall financial health is compared. Scotland has the most financially secure operators with an average H-Score of 62, while the East and West Midlands have the equal lowest average H-Score of 51. The comparative average Company Watch H-Score per region is as follows:



The national chains included in this research have H-Scores of 45 (BUPA) and 3 (Care UK).

Regional Profitability

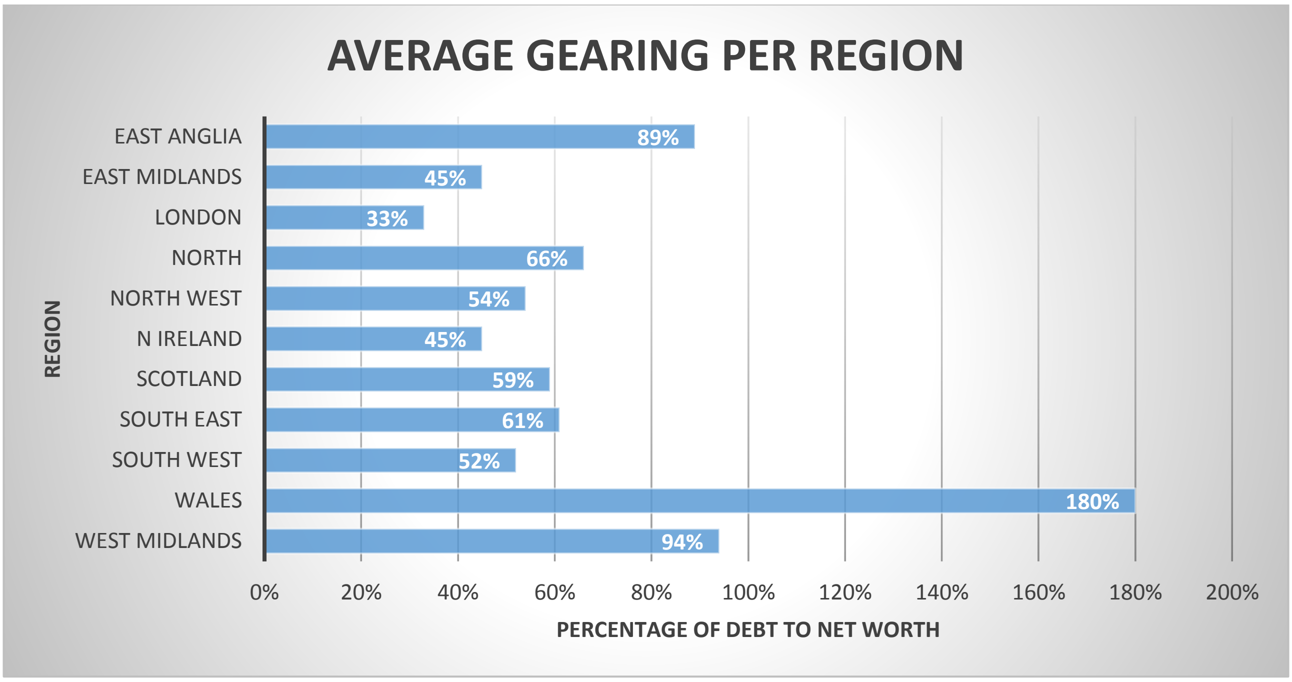
Profitability also varies widely between the regions. Leaving out the national chains, one of which (Care UK) reports losses of over £150m per annum, the most profitable region is the South East where on average operators make an annual pre-tax profit of £93,000. The next most profitable region is Scotland (£74,000 per annum) and the worst is the North West (£19,000). The full analysis is here:



Regional Gearing

The levels of debt in terms of gearing show equally sharp variations, with the lowest gearing ratio being seen in London where operators on average borrow just 33% of their net worth, followed by both the East Midlands and Northern Ireland (45%). The stand out figure is for Wales, where gearing averages 180% caused mainly by a small number of operators, who carry exceptionally high debt levels. We have excluded the national chains from our regional comparisons because of the impact of the figures for Care UK, which borrows £517m against a negative net worth of £478m.

The regional comparisons are:



CONCLUSIONS & REFLECTIONS

The overall picture of the UK's residential care sector is one of low profitability, too many operators in a vulnerable financial position, a worrying number of 'zombie' operators and for the small percentage who borrow, excessively high gearing. Some regional variations are a matter of deep concern.

There is much evidence, outside the scope of this report, of a two tier system emerging, with privately-funded residents paying a heavy price to subsidise the loss-making fees being offered by local authorities for the residents that they finance. Rumours abound of private operators refusing to accept any more public-funded residents. The major question is if and when privately-funded residents and their relatives start refusing to pay the subsidy premium.

As the pressure mounts to increase capacity to deal with the predicted rise in the number of people needing residential care, unless more public funding is made available, the risk is that more and more residential care home operators will leave the market altogether because the returns available do not justify the risk, compounding what is already sustained pressure on social care. Equally, the present crisis in domiciliary care and the NHS can only have the effect of increasing the demand for residential options for those needing care.