

Care homes market study

Financial analysis working paper

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The Competition and Markets Authority (CMA) has excluded from this published version of the working paper information which the CMA considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure).

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Purpose of the working paper

1. This document presents the interim findings of the financial analysis of care homes industry in the UK that the CMA is undertaking as part of its market study.¹ For the avoidance of doubt:
 - (a) the findings in this working paper should be viewed as preliminary until we publish our Final Report in December 2017; and
 - (b) this working paper is a standalone analysis of the industry. We do not comment on the methodology that may have been used in other analyses and reports.

2. This working paper shares the underlying analysis that informed our view on profitability for the Update Paper² that was published in June 2017, along with some further analysis carried out after that date. Our analysis:
 - (a) examines the historic trends in revenues, costs, and margins for care home providers in the UK. Our analysis has been carried out based on one of the most comprehensive and detailed datasets³ which has been used in the industry, including:
 - (i) an extensive dataset from Companies House covering approximately three quarters of the industry measured by revenue; and
 - (ii) a detailed dataset from 26 large providers covering nearly a third of the industry, measured by revenue. These providers were chosen because they have nationwide operations, thus providing a holistic understanding of the performance, at a UK level, of an important segment of the industry. It should be noted that this dataset includes financial information at a group and individual care home level. It also includes the financial information of providers that are registered offshore, and who do not file group accounts with Companies House.
 - (b) explores variations in operating profit levels between providers by the source of resident funding, type of care, and geography;
 - (c) describes key concepts underpinning the cost of investing in a care home and how a reasonable return for investors in the industry could be identified when assessing the cost of care;

¹ [Care homes market study case page.](#)

² [Care homes market study update paper.](#)

³ See paragraph 9 of the main body.

- (d) assesses the financial risks for the industry arising from factors such as high borrowing levels; and
 - (e) presents our preliminary views on what these findings indicate to us about the short-term viability (ie up to approximately 3 to 5 years) and long-term sustainability (ie greater than approximately 10 years) of the industry.
- 3. A key objective of our analysis has been to understand the scale of the financial challenges that have faced the industry. We have assessed whether the industry has been generating adequate operating profits to allow for short term financial viability. We have also analysed whether margins in the industry have been high enough to encourage investment to meet future capacity. Based on submissions to this study, we have given particular weight to the financial position of the segment serving local authority funded residents.
- 4. In publishing the working paper at this stage of our study, we are inviting views on our financial analysis with regards to:
 - (a) the methodology and evidence of market performance, which should inform the wider debate on the financial sustainability of the industry; and
 - (b) how the findings could inform the design of specific recommendations.
- 5. We welcome any comment and further evidence that stakeholders can provide to enhance and develop our financial analysis. In that context, we have also identified some questions in Appendix A. We will consider these submissions and update our analysis where additional evidence is available for our Final Report.
- 6. Respondents are also invited to comment on the implications of our findings for our market study into the care homes market.
- 7. We welcome written submissions on this working paper, including any supporting documents or analysis, by 5pm on 29 September. To respond, please email or post your submission to:

Email: carehomes@cma.gsi.gov.uk

Post: Care Homes Market Study
Competition and Markets Authority
7th floor
Victoria House
37 Southampton Row
London WC1B 4AD

8. As part of our commitment to transparency and to inform the wider debate, we may reference your submissions in our Final Report. Therefore please:
 - (a) disclose your organisations and/or the interests that you represent; and
 - (b) highlight, where appropriate, whether you are providing any material that you consider to be confidential and why this is the case.

Introduction

1. Care homes⁴ in the UK are mainly⁵ operated by private sector providers.⁶ Most providers serve both self-funded and state-funded⁷ residents, but to varying degrees. Over half of all residents in care homes have some of their costs paid through state funding (local authorities⁸ and the NHS, or Integrated Health Trusts in Northern Ireland), and the care is usually delivered by the private sector. For simplicity, we have referred to local authority and self-funded segments meaning providers, or care homes, primarily serving one or other of these customer groups.
2. The public sector contracts directly with private industry providers for care home places. The price paid by the public sector is based on commercial terms and this interaction between the public and private sectors is an important determinant of the financial performance of the industry.
3. Care home providers, industry analysts and regulators have raised concerns about the current financial performance and future sustainability of the industry, in particular the segment that caters for local authority funded residents. Some providers have told us that local authority fee rates have covered less than the full⁹ cost of providing care, and that this trend has been particularly acute over the last 7 years. Other challenges facing the industry include increasing staff costs and difficulties in the recruitment and retention of carers and nurses.
4. We have been told that reductions in local authority fee rates have had several negative outcomes:
 - (a) Some industry analysts have told us that they have observed investment for new care homes going almost entirely into the self-funded segment,¹⁰ with almost negligible sums having been directed at the local authority

⁴ Providers of residential care for older people aged 65 years or more in residential homes (care homes which only provide accommodation and personal care) and nursing homes (care homes which provide personal care and nursing).

⁵ Some local authorities and the NHS operate their own care homes. However, they comprise an insignificant proportion of the overall market.

⁶ Private industry providers include for profit and not-for-profit providers such as charities. Our analysis is focused on private industry providers.

⁷ Local authorities are the largest single purchasers in their local areas, but the NHS (and HSC Trusts in Northern Ireland) also procure care home services.

⁸ Care of Older People UK Market Report 27th edition, 2016, page 197 by LaingBuisson. The providers' dataset also shows a similar proportion.

⁹ The full costs include the operating costs and the cost of capital.

¹⁰ <https://assets.publishing.service.gov.uk/media/5941057be5274a5e4e00023b/care-homes-market-study-update-paper.pdf>, paragraph 7.12.

segment.¹¹ Some providers have added that they have been building new care homes in locations with higher proportions of self-funded residents and that they have been restricted in building new capacity in certain locations due to the lack of self-funded residents.

- (b) Some providers have told us that they have scaled back their capital expenditures¹² on those care homes, which primarily cater for local authority-funded residents¹³ and that they are spending only limited amounts to undertake basic refurbishments or to meet minimum care standards.
- (c) Some providers have told us that, since 2010,¹⁴ the real fee rates paid by local authorities have reduced on average. This is consistent with the Care Quality Commission's (CQC) analysis, which reported that from 2010/11 to 2013/14 the rate per week paid by local authorities in England for residential and nursing care fell from £673 to £611 (at 2015/16 prices).^{15,16} It noted that local authority focused providers have been exposed to 'severe financial strain'. It found that those with more than half of their turnover funded by local authorities achieved, on average, 10% less fee income per bed and generated almost 28% less profit per bed, compared with other providers.¹⁷
- (d) The CQC has said that the sustainability of the adult social care industry in England was approaching a 'tipping point', which it considered was driven by a challenging financial climate that had resulted in unmet demand for an ageing population, living with long-term conditions.¹⁸ The CQC also observed that it had come across instances where local authority-focused care home providers were exiting the local authority

¹¹ Some local authorities have told us that they have managed to attract some investment by offering financial incentives such as favourable prices on land acquisition and block contracts.

¹² This includes extensions to increase capacity (number of beds).

¹³ This affects care homes with higher proportions of local authority funded residents, and homes with lower proportions of local authority funded residents.

¹⁴ The Comprehensive Spending Review was launched in 2010. The NAO has estimated that central government has reduced its funding to local authorities by 37% in real terms between 2010/11 and 2015/16.

¹⁵ Health Foundation, Representation to the 2015 Comprehensive Spending Review, 2015, reported in CQC The State of Health Care and Adult Social Care in England 2015/16.

¹⁶ The King's Fund reported that 81% of local authorities cut their spending in real terms on social care for older people since 2010. In more than half of local authorities the reduction was at least 10%. However, the picture is not uniform –18% maintained or increased spending (Kings Fund, September 2016).

¹⁷ CQC's *The State of Health Care and Adult Social Care in England 2015/16*, p43.

¹⁸ CQC news, '[Adult social care 'approaching tipping point', warns quality regulator'](#)'.

segment and that some providers had handed back care home contracts to local authorities.¹⁹

(e) One market expert, LaingBuisson, has estimated a 'funding gap'²⁰ of £1.3 billion a year in the care homes industry in England with regards to the local authority funded segment.²¹

5. Some industry analysts have also raised concerns about the high financial gearing levels among some of the large providers, especially those owned by private equity funds. These analysts have also pointed out that several of these highly-g geared providers also have significant exposure to local authority funded residents.

Financial analysis

6. In response to these concerns we have performed our own financial analysis of the industry. Our analysis aims to inform the debate regarding:

(a) the short (ie up to approximately 3 to 5 years) to medium (ie up to approximately 6 to 10 years) term financial viability; and

(b) long term sustainability (ie greater than approximately 10 years) of the industry.

7. For a care home provider to:

(a) operate and be financially secure in the short to medium term, its revenues need at least to cover the operating costs of an efficient operator, while delivering a reasonable quality of care, and that it should not have unsustainable levels of debt; and

(b) be sustainable in the long term, its operating profits should also cover the costs of financing investment in the industry, both in terms of property and in the specialist equipment required to operate a care home. Where revenues, driven by fee rates, are sufficient to cover both operating costs and a return on investment, and this is expected to continue, this should encourage investment in capacity to help meet future demand.

¹⁹ In its state of healthcare and adult social care in England 2015/16 report, the CQC cites data from ADASS that suggests that 32 local authorities had residential or nursing care contracts handed back to them in the six months up to May 2016.

²⁰ An estimate of the average fee per resident actually paid by local authorities less LaingBuisson's estimate of reasonable total costs.

²¹ LaingBuisson news (January 2017), '[Care home funding shortfall leaves self-funders filling £1.3 billion gap](#)'.

8. Therefore, in this section, we summarise the key findings of our financial analysis of the industry. An important objective of this analysis is to understand whether the industry has been generating adequate revenues to cover its operating costs, and crucially to encourage new investment. We have sought to assess the financial performance of the industry overall, and of the local authority funded segment, compared to the self-funded segment. We have also disaggregated the data to understand whether there are different patterns for different types of providers, for example by geography and the type of care provided.
9. We have obtained data from two sources:
 - (a) Companies House. We extracted the audited financial statements for 7,563 companies in the UK including England and the devolved administrations.²² For the profitability analysis, we have used data for 4,232²³ of the 7,563 care homes companies. The primary financial statement used in the analysis has been the profit and loss statement (P&L). The period of analysis is between 2010 and 2015.²⁴ The average annual revenues of this dataset during this period was £10.4 billion, thus comprising just under three quarters²⁵ of the estimated market size of £15.9 billion.²⁶ We subsequently refer to this as the 'Companies House financial dataset'.²⁷ We understand that this is the largest dataset that has recently been used for financial analysis of the industry.
 - (b) Large providers in the UK. We obtained detailed financial information from 2015 to 2017²⁸ from 26 providers. We analysed the financial information of 2,115 care homes operated by these providers. The average annual group revenue during this period for these providers was £4.3 billion, thus comprising nearly a third of the estimated market size measured by

²² We identified these companies by using their SIC codes 871 and 873 on Companies House. Therefore, this dataset only includes companies registered with Companies House in the UK. We also identified additional care homes from a CQC database. <http://www.cqc.org.uk/about-us/transparency/using-cqc-data#directory>

²³ The total number of companies from 2010 to 2015 in the Companies House extract was 7,421. However, 3,189 of these companies had nil values in their P&L and we excluded these companies from the profitability analysis. Hence, as a starting point, we analysed 4,232 companies for the profitability analysis. Where relevant, we have disaggregated or chosen segments of this dataset for our analysis.

²⁴ We will consider extending our dataset to include 2016 numbers, which are currently excluded because most companies had not filed their 2016 returns when we started the analysis.

²⁵ Using the aggregate revenue from this dataset in 2015 of £11.7 billion.

²⁶ Care of Older People UK Market Report 27th edition, 2016 by LaingBuisson estimates that the market size was £15.9 billion in 2014.

²⁷ For the financial risk analysis, we used data for 2,016 of the 7,563 care home companies. We subsequently refer to this as the 'Companies House debt analysis dataset';

²⁸ We have used their actual results for 2015 and 2016, and forecasts for 2017.

revenue. We have used this dataset for the profitability and financial risk analysis and subsequently refer to this as ‘the providers’ dataset’.²⁹

10. We note that the datasets from the two sources complement each other in that some of the large providers, for whom we have obtained financial information, do not file their group consolidated accounts with Companies House.³⁰ However, these group level findings are included in the providers’ dataset.
11. For the avoidance of doubt, our analysis and commentary relates to the industry, and not to individual companies. So, we have presented all our analysis at an aggregate level,³¹ not at the level of any individual provider. However, we note that there are variations among the financial performance of providers and among individual care homes within the same group. Where it varies due to key factors related to the industry, we have disaggregated the analysis (see paragraph 8). However, the findings also vary due to factors specific to individual care homes.
12. The performance of some care homes will be significantly better or worse than the aggregate data presented in this paper. Nevertheless, given the large size of our Companies House financial dataset, we consider that the overall industry analysis and trends identified in our analysis provide a robust indication of trends for the industry as a whole. Where possible, we have also tested this analysis against the providers’ dataset, and against stakeholders’ submissions and statements.
13. The findings of our analysis have been summarised below and the detailed analysis including the methodology and the full presentation of the findings has been laid out in Appendix B.

Profitability

14. Our analysis has sought to measure the profitability of the care homes industry. We have used measures of profitability and financial performance, which we understand are generally used in the industry, as described below.

²⁹ Where relevant, we have disaggregated or chosen segments of this dataset for our analysis.

³⁰ This is because these entities are not registered in the U.K. We understand that several of these entities are registered offshore.

³¹ Aggregation of the financial results of several companies. For example, the EBITDAR margin = (total revenue generated - total operating costs incurred) / the total revenue generated by all the firms in the Companies House dataset. I.e the disclosed margin is not a standard average of all 4,232 companies.

Explanation of operating costs and profits

15. The standard metric to measure accounting profitability of the care home industry is profit margins, which is a return on revenue measure (in percentage terms) equal to relevant margin divided by revenue. We have explained the relevant margins in the table below.

Table 1: Profitability definitions

| Profit margin | Definition | Costs included to calculate the margin |
|----------------------|--|--|
| EBITDARM | Earnings before interest, tax, depreciation, amortisation, rent and management fees. This is used to measure the operating profitability of individual care homes. | Staff costs associated with providing care and services in the care home. For example, payroll costs of carers and nurses. Non-staff operating costs incurred at the care home level to operate the home. For example: food, utilities, maintenance and other overheads |
| EBITDAR | Earnings before interest, tax, depreciation, amortisation, and rent. This is used to measure the operating profitability of providers. It is also used to assess the ability of providers to generate adequate profits (and cash) to meet rental payments. It excludes property related costs such as rent, depreciation and interest costs. | As above and Central (head office) costs such as group finance, legal and management's salary. Fees related to charges levied by shareholders, mostly private equity funds, in relation to management services that they have provided the company. |
| EBITDA | Earnings before interest, tax, depreciation and amortisation. This is used to assess the ability of providers to generate adequate profits (and cash) to meet interest payment obligations. | As above and Rent |
| EBIT | Earnings before interest and tax. | As above and Depreciation and amortisation, which don't have a cash impact |
| PBT | Profit before tax | As above and interest expense |
| PAT | Profit after tax | As above and tax |
| Exceptional items | Non-recurring or one off costs that a provider would not incur in the normal course of operating a care home. Examples include restructuring costs, gains or losses on disposal, and redundancy payments. The analysis of margins pre-exceptional items gives a truer position of the operating profitability. | |

Explanation of the cost of capital and economic profits

16. The cost of capital is the return that investors³² require to invest in a business. When considering any capital investment, investors factor in the opportunity cost of that investment. This is the return that the investor could earn by investing in another business instead with a similar level of risk. This return is required both to cover the cost of providing finance³³ and, more crucially, a margin to reflect the risk taken by investors.³⁴
17. Risk is an unavoidable part of any investment. Part of the risk faced by investors in the industry is the result of the general economic environment, eg the economic cycle and interest rate changes. Risk can also arise from factors that are specific to the care homes industry. Examples include uncertainty over both the levels of future local authority fee rates and the process to set these rates. If investors consider that the risks of investing in the care homes industry are particularly high, they will seek higher returns. Where expected returns to new investment are below the level required to compensate investors for risk, then they may not invest in the care homes industry. We note that the principle that returns to investors need to take account of risk over the life of the investment applies to care home providers of all sizes and complexities in terms of their operations and sources of finance.
18. Therefore, providers need to earn an economic profit (see Table 2), over and above break-even operating profits, to cover the cost of investing in the assets that are required to operate a care home. In our analysis, we have used an indicative range for the return required on these assets of 5-8%, based on comparisons with other industries and trends in market data (see Appendix B, paragraphs to 45 to 56 for further details).

³² The providers of finance can broadly be considered as debt financiers and/or equity shareholders. In practice, providers can use a mix of debt, equity finance, and mezzanine finance, which is a hybrid of debt and equity financing that gives the debt holders the rights to convert to equity under certain circumstances such as, but not limited to a default of debt.

³³ This relates to the time value of money. The essence is that an amount of money (e.g. £100) is worth more to an investor today, than the same amount of money on any given date in the future.

³⁴ We note that even the public sector applies a discount rate of 3.5% with regards to its investment decisions. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220541/green_book_complete.pdf

Table 2: Calculations with regards to the cost of capital

| Measure | Calculation |
|------------------------|-------------------------------------|
| Cost of capital | Capital employed x % rate of return |
| Total cost | Operating costs + cost of capital |
| Economic profit/(loss) | Revenue – total costs |
| Economic profit margin | Economic profit / revenue |

19. The cost of capital is similar to other overhead costs³⁵ within the cost of care, to the extent that it is incurred in order to acquire and invest in the facilities within a care home. The cost of capital is a real cost for the business with a cash flow impact, for example holders of debt finance are paid interest and equity investors are paid dividends. However, the cost of capital is unusual in that it is not directly measurable as per accounting standards, and is not part of the reported operating costs in the profit and loss (P&L) accounts of providers.
20. Providers incur both operating costs and the cost of capital, which together can be termed, ‘total costs’. If revenues from operating a care home are sufficient to cover operating costs, but insufficient to cover the total costs, this would result in an economic loss. This would permit providers to continue to operate in the short term, or until such time that the assets would need replacing, ie the persistence of economic loss in the short term implies that investors would not be expected to invest in building new homes and/or to undertake capital expenditure in existing homes. It may also incentivise some investors in existing care homes to exit the market.³⁶ Therefore, the persistence of economic losses, at least over the medium to long term, would raise concerns about the sustainability of those care homes in the long term.
21. If, however, revenues are sufficient to cover total costs, and are expected to continue in the future, then this should offer sufficient incentives for investors to remain in the industry, and to undertake further capital expenditure, where necessary. This principle applies where the public sector procures care from private providers, and also where investors make commercial investments targeted at the self-funded segment.

³⁵ Examples of overhead costs include utilities and maintenance costs.

³⁶ If returns in the care homes industry are below the cost of capital, then investors can consider investing in other industries. Likewise, investors invest in the care homes industry based on projections of future fee rates and asset values.

Summary of findings

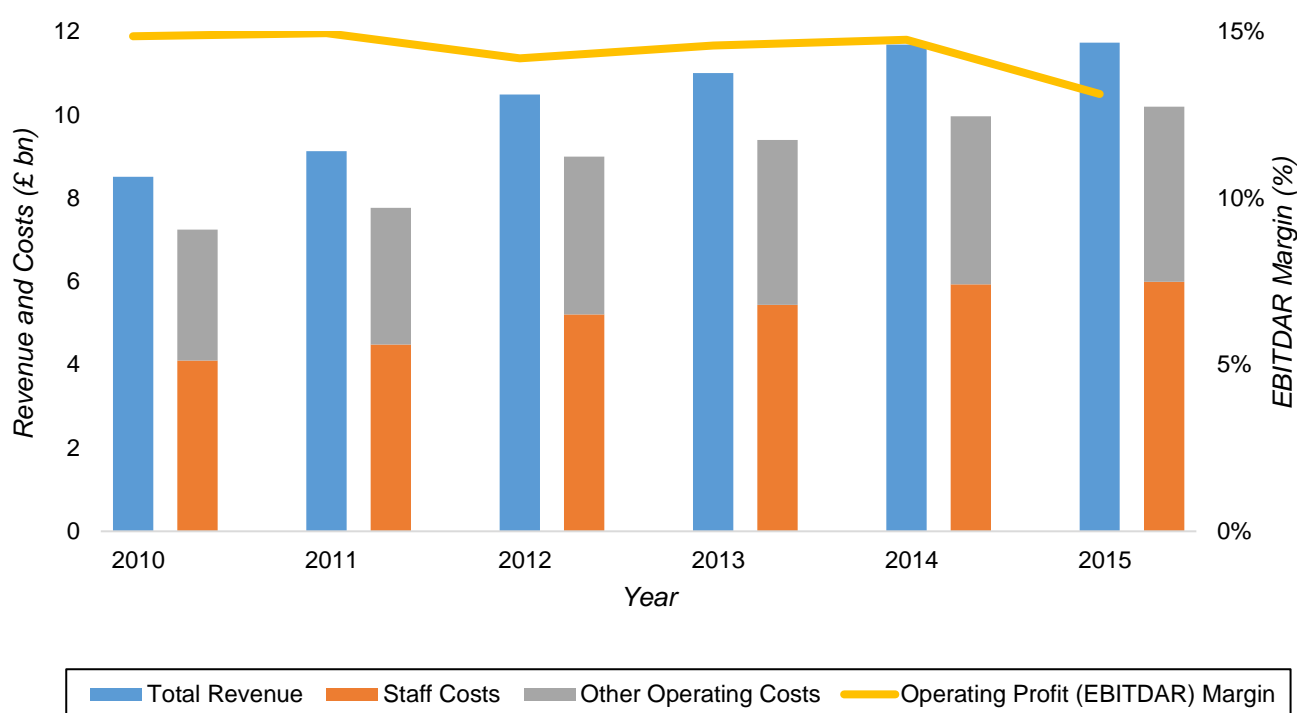
Aggregate

22. In this section, we provide analysis of the financial performance of the industry in aggregate, based on the data and profit measures described above.

- *Operating profitability*

23. We have assessed the trends in revenue, operating costs and operating profit margins, using the Companies House financial dataset.³⁷

Figure 1: Aggregate operating profitability, 2010–2015



Source: CMA analysis of P&L information of Companies House financial dataset.

24. Figure 1 indicates that the industry, in aggregate,³⁸ has generated consistent and positive operating profit margins, measured by the EBITDAR margin. Also, despite a challenging environment for local authority fee levels, industry revenues have increased by more than inflation over the period, and this has broadly offset the effects of operating cost inflation (see also Appendix B,

³⁷ It covers around approximately three quarters of the industry by revenue in 2015.

³⁸ This includes providers focused on local authority funded and self-funded residents.

paragraph 14). In other words, increases in operating costs³⁹ have been matched by increases in revenue.

25. Hence, this margin has not significantly eroded during the period of review, and has averaged at approximately 14%. This is despite the increasing levels of wage rates, driven by increases in the National Minimum Wage over this period.
26. The finding that care home providers have generated positive operating profit margins is supported by analysis from the providers' dataset. This shows that 26 providers generated positive operating profits, measured by pre-exceptional EBITDAR. The average margin in 2015 and 2016 was approximately 20%.⁴⁰ Even though the National Living Wage came into effect on 1 April 2016, we also observe that the 2016 aggregate margin did not significantly decrease from 2015. In addition, aggregated forecasts show that providers expect this margin to increase incrementally in 2017 (see Appendix B, Table 1). This implies fee levels, overall, have been increasing to offset increased costs.
27. Positive aggregate operating profit margins imply that the industry, overall, has been viable in aggregate in the short term, ie it has generated adequate revenues to cover its operating costs, which comprise the largest portion of its cost base and which also has a significant impact on cash flow. Our assessment of the short-term viability is also corroborated by the low levels⁴¹ of insolvencies, at approximately 44 per year, in the industry between 2010 and 2016⁴² (see Appendix B, paragraphs 24 to 27 for further details).
 - *Economic profitability*
28. In addition to measuring operating profitability based on accounting data, we have considered the economic profitability of the industry. In particular, we have looked at whether revenues have covered the total costs including investment costs, ie the cost of capital.
29. The analysis of economic profitability requires a broader set of assumptions, compared to the analysis of operating profitability, which relies on observable

³⁹ Operating costs comprise staff costs and other operating costs.

⁴⁰ We observe a difference in the reported margins between the datasets, as the two measures of profitability are not entirely like-for-like. However, the same pattern that EBITDAR margins have been positive and stable can be observed in both datasets.

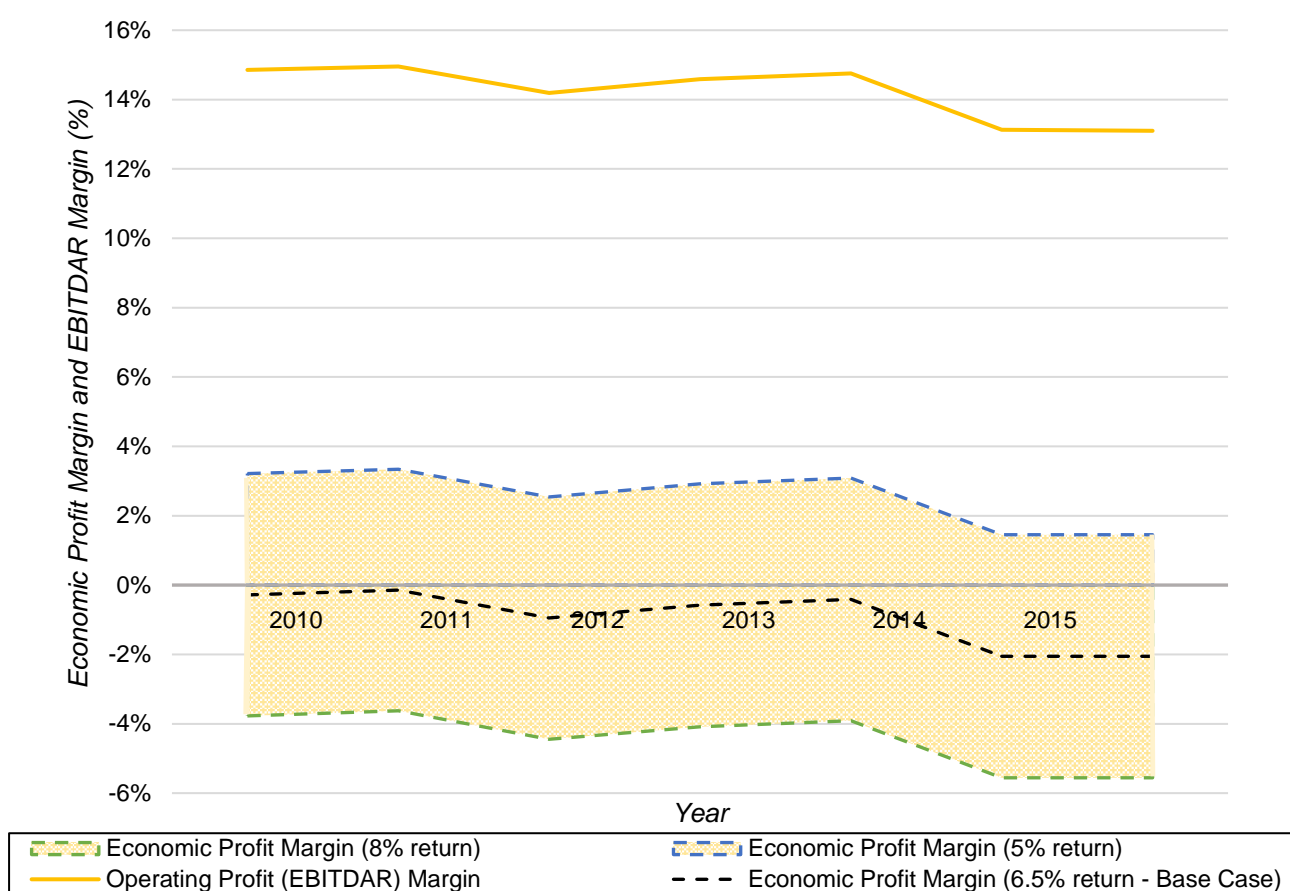
⁴¹ Compared to the overall market size and number of providers, which is estimated as exceeding 15,000.

⁴² Data obtained from the Insolvency Service for insolvencies between 2010 and 2016 for SIC codes 871 Residential nursing care activities and 873 Residential care activities for the elderly and disabled. In addition, operators will have exited voluntarily and some care homes closed, while others are sold to alternative operators.

and audited numbers. Most importantly, we have assumed values of assets used in the industry, these cannot be observed directly from financial statements. Hence, we have used a wide dataset of market based valuations for properties, which we have used to estimate suitable values for the industry.

30. We have also assumed that the real returns required by investors would range between 5-8%, with a base case of 6.5% (see Appendix B, paragraphs 45 to 56). Figure 2 provides our estimate of a range for the aggregate profitability of the industry on this basis.

Figure 2: Aggregate economic profitability for the Companies House financial dataset, 2010–2015



Source for accounting profitability: CMA analysis of P&L information of Companies House financial dataset.
 Source for economic profitability: As above, and asset valuations based submissions from some large providers.

31. The results indicate that the industry has made low or close to break-even levels of economic profits, ie revenues,⁴³ which are driven by fee rates,⁴⁴ are close to total costs; and that economic profits could even be negative.
32. Even though this analysis is dependent on several assumptions, it is reasonable to consider that not all investors in the industry would have been making sufficient returns, ie their revenue would be below total cost. For instance, Figure 2 illustrates that in each of the years that we analysed, the range of returns includes scenarios where the returns were at, or below, benchmark (ie break-even) levels.
33. Figure 2 indicates a range for the economic profit margins in the industry. As noted above (see paragraph 9(a)), the size of the UK care homes industry⁴⁵ measured by revenue is approximately £15.9 billion.⁴⁶ Hence, this economic profit analysis can be used to illustrate, in very general terms, the financial and economic position of the care homes industry across the UK.
34. The key messages from this profitability analysis, overall, are that:
 - (a) in recent years, the operating profit margins have been broadly stable. Also, the industry, overall, appears to have covered its operating costs (see Figure 1). In addition, 2016 aggregated operating profit margins have held up and are expected to increase incrementally in 2017 (see paragraph 26 and Appendix B, Table 1 and Appendix B, paragraph 14);
 - (b) in some areas or for some residents, fees earned by providers are below total cost and/or have reduced in real terms. Nevertheless, the industry, overall, has been able to offset these with higher fee rates to cover total costs; and
 - (c) given the ongoing financial challenges⁴⁷ to the industry, if there continues to be the expectation that financial performance is likely to decline, then there could be a risk that the industry may not be sustainable in the long term.
35. As discussed above, these figures are based on aggregate data. Hence, the profitability of homes varies significantly across providers and according to how residents are funded. We discuss some of this disaggregated analysis further in the next sections.

⁴³ This includes companies and care homes with a mix of self-funded and local authority funded residents.

⁴⁴ We understand that occupancy rates in the industry are generally at levels consistent with KPIs.

⁴⁵ This includes a wide range of providers.

⁴⁶ Care of Older People UK Market Report 27th edition, 2016 by LaingBuisson.

⁴⁷ For example, increasing staff costs coupled with uncertainty over fee setting.

Local authority and self-funded segment

36. Based on submissions by stakeholders that finances are particularly challenging in the local authority funded segment, we have sought to compare the profitability of providers that focus on self-funded residents to those that focus on local authority funded residents.
37. We note that most care homes and providers have both local authority and self-funded residents. This means that there is no direct measure, on a per resident basis, of how each segment contributes to the total costs of the industry, as these homes and providers report their costs on an aggregate basis. Nevertheless, we have been able to use our datasets to estimate the relative contribution of the two segments.
38. For example, we have had to use regions as a proxy for funding source when analysing the Companies House financial dataset (see Appendix B, paragraphs 17 to 19). When analysing the provider dataset, we have used the overall resident mix at a group and individual care home level. We also note that the Companies House financial dataset and providers' dataset may have been reported on a differing basis (also, see footnote to paragraph 26). These differences explain the divergences in observed margins between the local authority funded and other segments such as in paragraphs 39 to 42 and Table 3 below.
- *Operating profit margins*
39. The findings from the Companies House financial and providers' datasets are that providers with greater proportions of local authority funded residents have, in aggregate, earned lower, but positive, operating profit margins.
40. By analysing the providers' dataset (see paragraph 9(b)) for their group level results, the findings are that the 26⁴⁸ providers collectively generated EBITDAR margins of 21% between 2015 and 2017.⁴⁹ However, providers that generated the greatest proportions of revenue from local authority funded residents⁵⁰ earned significantly lower EBITDAR margins at 17%. This compares to providers with relatively lower proportions of revenue generation from local authority funded residents that earned the highest EBITDAR margins of 27%.⁵¹

⁴⁸ This is one less than the 27 submissions that we received. One provider that submitted financial information could not do so for its operating profit margins. Therefore, we used data for 26 providers for this analysis.

⁴⁹ Calculated using actual reported figures for 2015 and 2016 and forecasts for 2017.

⁵⁰ Or had the highest proportions of local authority funded residents.

⁵¹ See Appendix B, Figure 7.

41. Similar findings also emerge when we analyse the providers' dataset for their care home level results between 2015 and 2016 for the 26 providers. Using their actual results for 2015 and 2016, we observe that these care homes collectively generated EBITDARM margins of 27%. However, those with the highest proportions of self-funded residents generated significantly higher EBITDARM profit margins at 37%, compared to those care homes with primarily local authority-funded residents that only generated 22% margins.⁵²
42. The relative profitability of the self-funded segment is also corroborated by analysing data from the Companies House financial dataset for small and medium-sized (SMEs) providers.⁵³ The findings are that all these SMEs collectively generated average EBITDAR margins of 15% between 2010 and 2015. However, regions with relatively higher proportions of local authority-funded residents earned lower EBITDAR margins at 13%. Providers in regions with mixed⁵⁴ proportions of residents, and consequently lower proportions of local authority funded residents, generated the highest EBITDAR margins of 17% (see Appendix B paragraphs 17 to 19).

- *Economic profits*

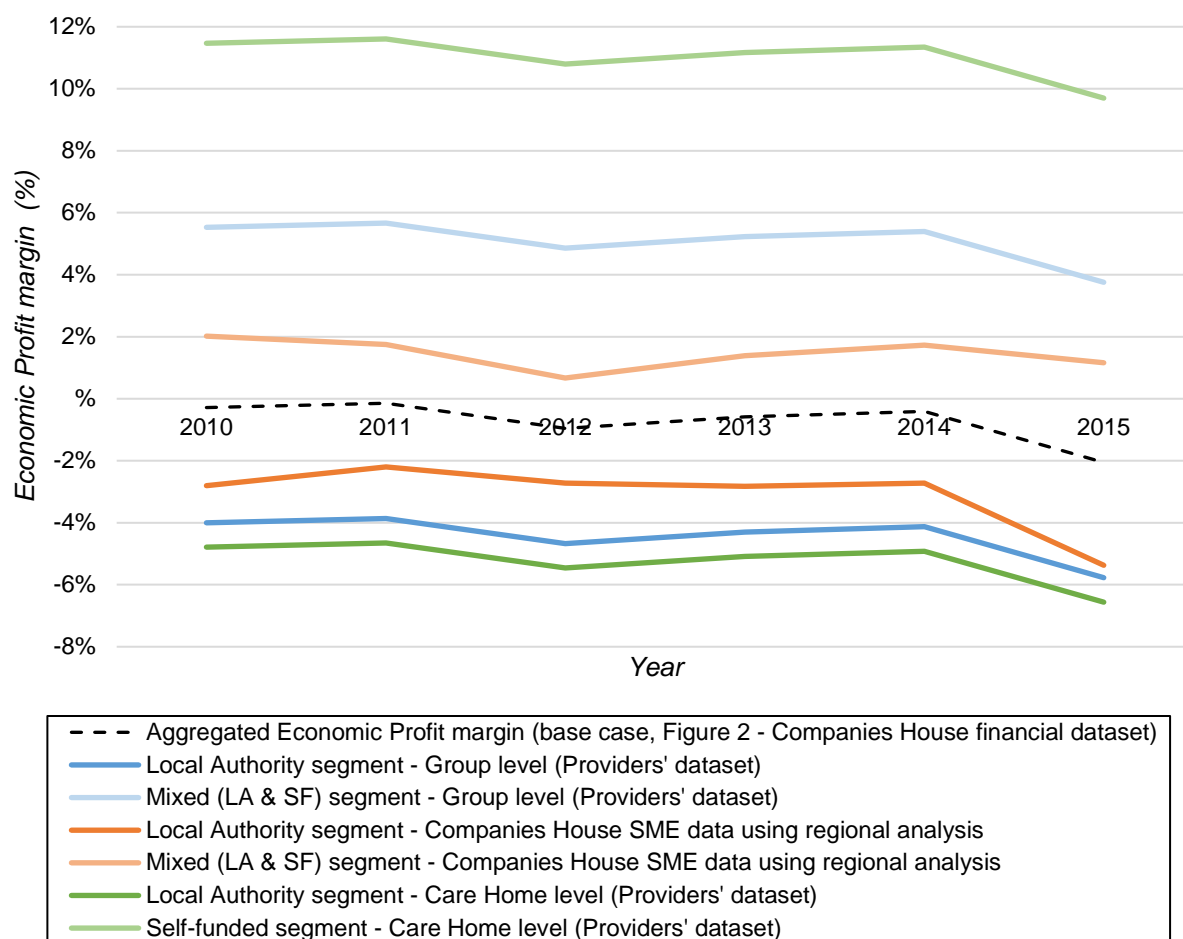
43. The industry, including the local authority and self-funded segments together, has been close to break-even levels of economic profitability between 2010 and 2015 (see Figure 2). We also observe that the local authority segment has generated significantly lower operating profits than the self-funded segment (see paragraph 39). Therefore, it is reasonable to infer that, in aggregate, the local authority segment would have generated economic losses and the self-funded segment would have generated economic profits.
44. We illustrate this in Figure 3 by modelling the effects of the observed differentials in the operating profits between these segments (see paragraphs 39 to 42), on the observed levels of economic profits as shown in Figure 2. For the avoidance of doubt, we have used a constant rate of return of 6.5% in real terms. The methodology is laid out in Appendix B, paragraphs 45 to 56.

⁵² See 7 Figure in Appendix B.

⁵³ These providers overwhelmingly tend to operate in the region in which they are registered with Companies House.

⁵⁴ Mixed regions include both state and self-funded residents.

Figure 3: Modelling of economic profits for the self-funded and local authority funded segments



Source: CMA analysis of P&L information of Companies House financial dataset and P&L and asset valuations based submissions from some large providers.

Note: We have used a 6.5% return for the base case and all modelling of scenarios.

Note: Economic profit = EBITDAR – cost of capital

45. Figure 3 shows that the local authority segment is likely to have made economic losses and the self-funded segment is likely to have made economic profits. In other words, the local authority revenues, overall, have been lower than total costs, at least in the recent years for which we have data. Specifically, Figure 3 illustrates that the average economic profit margin between 2010 and 2015 for the local authority segment could range from -3.1% to -5.25%. Likewise, Figure 3 also illustrates that the average economic profit margin between 2010 and 2015 for the self-funded segment could range from 1.5% to 11%.

46. As with our findings for the overall industry (see paragraphs 31 to 32), our analysis in Figure 3 can be used to provide an illustration of the financial and economic positions of the local authority and self-funded segments in the UK. We understand that the local authority funded segment constitutes approximately 50%, the self-funded segment constitutes approximately 40%,

and the NHS constitutes approximately 10% of the total number of care home beds in the UK.⁵⁵ We observe similar proportions when analysing the providers' dataset (see Appendix B, Figure 8).

47. Crucially, the differences in the observed (see Figure 3) economic profit margins between the local authority and self-funded segments can be explained almost entirely by the differences in the average fee rates between these two segments. Therefore, Figure 3 also provides an indication of the scale of the differential in fee rates between the local authority and self-funded segments, for each of the datasets.
48. The results shown in Figure 3 and paragraphs 39 to 42 for the performance between the local authority and self-funded segments is consistent with:
 - (a) information provided to us by large providers on the differences between fee rates between these customer segments; and
 - (b) analysis from the providers' dataset which shows that local authorities have been the largest revenue stream (just under half) for these large providers, and that this segment has earned lower fees per resident than self-funded and NHS funded residents (see Figures 8 and 9, Appendix B).
49. This economic profit analysis relies on several assumptions, and therefore our analysis above of the financial performance of the local authority segment should be used with some caution, compared to the analysis on the relative operating profit margins, which uses actual reported numbers.⁵⁶ Nevertheless, we have tested a range of approaches to measure the relative profitability of the different segments. With regards to the local authority segment, the findings provide a consistent pattern that operating profitability has been lower and economic profitability is likely to be negative (see Appendix B, paragraph 45 to 60 for further details).
 - *Summary of findings*
50. In summary, our aggregated analysis shows that:
 - (a) the overall revenues at an industry level have been close to total costs including the cost of capital (Figure 2);
 - (b) revenues generated by providers that have the greatest proportion of local authority funded residents have, overall, been lower than total costs,

⁵⁵ Care of Older People UK Market Report 27th edition, 2016, page 197 by LaingBuisson

⁵⁶ This analysis of deficits refers to the services which have been procured from care homes. It does not consider whether the quantity and type of care procured is optimal.

including any return on capital, but have been higher than operating costs (Figure 3);

(c) revenues generated by providers that have the lowest proportion of local authority funded residents, and consequently greater proportions of self-funded residents, have, overall, been higher than total costs (Figure 3); and

(d) we can, therefore, infer that providers have generated most of their profits, in aggregate and on a per resident basis, from non-local authority funded residents. In other words, self-funded residents have made a higher contribution towards fixed costs and common costs such as overheads. However, providers have been loss-making in economic terms, ie returns below the cost of capital, on local authority funded residents.

51. Given that the costs to serve residents, irrespective of their funding source, in any care home are generally similar⁵⁷ and that occupancy levels between these sub-groups do not differ significantly,⁵⁸ our analysis indicates that this differential can be attributed to lower fee rates having been paid by local authorities. This is also consistent with data on the fee differential between these two segments that large providers submitted to us. However, this analysis does not take account of any differences in services received by self-funded and state funded residents which do not directly impose costs, which could account for the fee differentials.⁵⁹

Results by nation

52. We have also compared the operating profitability of providers based on the country in which they operate by using the Companies House financial dataset between 2010 and 2015 for small and medium-sized providers. The findings are that the average levels of EBITDAR margin were highest in Wales (22%), followed by England (16%), Scotland (14%) and Northern Ireland (12%). See Appendix B, paragraphs 21 to 22 for further details.

⁵⁷ Almost all providers we asked submitted that the costs to serve local authority and self-funded residents does not significantly differ within a home. That is, it costs a similar amount to serve residents with a similar acuity of needs, irrespective of the source of funding.

⁵⁸ Most care homes have a mixture of local authority and self-funded residents. We also understand that providers set occupancy KPI targets for care homes across their portfolio of homes, which do not differentiate between local authority and self-funded residents.

⁵⁹ In other words, all else being equal, the cost of, for example, the building and servicing a 'room with a better view' would not differ significantly from a 'room with a worse view'.

Nursing vs residential care

53. The findings from our analysis also demonstrate that nursing homes generated higher operating profit margins than residential care homes. Specifically, the findings from the Companies House financial dataset (see paragraph 9(a)) are that the EBITDAR margin for nursing care homes has consistently been higher, on average, at 16% between 2010 and 2015, than that for residential homes at 12%. See Appendix B, paragraph 22 to 23 for further details including on the methodology.

Top-ups

54. We also observe that top-up fees⁶⁰ are not a significant revenue stream for the large providers, and are therefore unlikely to significantly impact their profit margins. When using the providers' data set, and analysing the financial information of:
- (a) 22 providers, we discover that top-up fees accounted for only 1.5% of their total revenue.
 - (b) 16 providers that submitted values for top-ups, we note that top-up fees accounted for 1.9% of their total revenue.

Financial risk

55. Certain stakeholders have raised concerns about the financial risk arising both from the levels of debt on the balance sheets of providers, and off balance sheet risks such as those arising from sale and lease back transactions. Concerns were raised about the financial risks of providers owned by private equity funds, coupled with significant exposure to local authority funded residents. Therefore, we have undertaken some high-level analysis to assess the levels of debt in the industry.
56. A review of 7,563 companies between 2010 and 2015 using the Companies House data indicates that only 2,016 of these companies had debt on their balance sheets. The average annual level of aggregate debt during this period was £8.7 billion, compared to revenues that these companies generated of £10.4 billion. Crucially, we observe that:

⁶⁰ Top-up fees arise when the prospective resident's preferred care home costs more than the amount specified in the residents' budget set by the local authority. Top-ups payments, must be distinguished from charges made by the home for extra items not covered by the home's core residential fees, such as hairdressing, which the care home can charge to the resident.

- (a) the level of debt has been declining since 2010, despite increasing revenue; and
 - (b) debt has been more heavily concentrated in large companies, compared to small and medium sized companies⁶¹ (see Appendix B, paragraphs 67 to 69).
57. We also analysed the providers' dataset of between 2015 and 2017.⁶² Of the 26 providers in the dataset, 22 carried debt on their balance sheets. These 22 providers generated £4.0 billion of annual average revenue during this period and carried debt on their balance sheets of £3.3 billion.
58. Crucially, we observe that the debt is not concentrated in private equity owned providers, any more than it is in non-private equity owned providers. For example, of the 22 providers, those owned by private equity funds carried approximately 40% of the total debt, and these same providers also contributed a similar proportion towards the total revenue for these companies.
59. Most large providers told us that they did not have any off-balance sheet liabilities, as of their most recent financial year ends. Of the few that did report off balance sheet liabilities, we observe that some of these values were significant when compared to their reported net assets.

Conclusion

60. The care home industry is one that has significant asset investments, both in property and in assets within the homes. We are, therefore, not surprised to observe that there is some debt associated with these companies in order to finance these assets. However, the levels of debt, in aggregate, do not look unusually high.
61. Whilst some large providers have significantly more debt than small to medium providers, the findings suggest that these debt levels have not been increasing in aggregate. Whilst this does not imply that debt levels within all these highly-g geared providers are sustainable, it is not indicative of any immediate concerns about financial viability across the industry as a whole.

⁶¹ We segmented the companies, that generated revenues between 2010 and 2015, into quartiles based on 2015 revenues. The top quartile has been classed as large companies, the second and third as medium sized companies and the bottom quartile as small companies.

⁶² FY 2015 and 2016 numbers are actuals, and FY 2017 numbers are forecasts.

Appendix A: Questions for stakeholders

1. In this working paper, we have presented our financial analysis, which should be considered alongside our Update Paper that was published in June 2016.⁶³
2. We will present our findings in the Final Report by drawing on aspects of this analysis in developing our recommendations. We welcome comments from all stakeholders on each of:
 - (a) the approach we have taken to analysis of the industry;
 - (b) the findings from our analysis and our interpretation of those findings; and
 - (c) the impact of this analysis for suitable recommendations to address any issues identified.
3. We have set out some questions that would help us to prepare the final version of this analysis in our Final Report. We are particularly interested in views both on the interaction between our analysis and suitable recommendations, and where stakeholders have evidence as to the accuracy of the conclusions that we have drawn from our analysis.

Approach

- i. Please comment on our approach to analysing the financial performance and position of the industry including the assumptions that we have made.
- ii. Our analysis of the relative profitability of the self-funded to local authority funded segments is primarily based on the analysis of 26 large providers. Would you expect the findings in the industry overall to be different? If so, please provide evidence.⁶⁴

Cost of capital

- iii. We welcome views of local authorities, investors and operators of a suitable approach which could be used by stakeholders in estimating the cost of capital:

⁶³ <https://assets.publishing.service.gov.uk/media/5941057be5274a5e4e00023b/care-homes-market-study-update-paper.pdf>

⁶⁴ Note that we disaggregated the Companies House financial dataset using regions as a proxy for funding source.

- (a) Are our estimates a reasonable starting point for estimating benchmark returns?
 - (b) is there any sector-specific market data that could be used to identify a benchmark return for the industry (see appendix B, paragraphs 61 to 64)
- iv. If you have information on 'required rates of return' or 'cost of capital' for recent investment projects, please submit details including the methodology used to determine rates of return.
- v. Are there reasons why providers might be prepared to accept lower rates of return when investing in capacity for local authority funded residents?

Key findings and interpretation

- vi. Please comment on our key findings in Figures 1, 2 and 3 of the main body.
- vii. What could explain the divergence in the operating margins among the 4 nations (see paragraph 52 of the main body)?
- viii. What could explain the divergence in the operating margins between nursing and residential care homes (see paragraph 53 of the main body)?
- ix. Do you agree with our findings in respect of top-ups being a low share of total revenue?
- x. Do you agree with our findings in respect of the levels of debt and financial viability of the industry?

Recommendations

- xi. What are your views as to how the cost of care might be calculated in the future?
 - (a) What information would help local authorities and providers in negotiating a price which takes account of the total cost of care, including a reasonable profit?

Appendix B: Financial analysis

1. The appendix lays out the methodology, and some additional findings from our financial analysis. As noted in paragraph 9 of the main body, we have sourced our data from Companies House and large providers.

Companies House financial dataset

2. We have analysed the financial performance of approximately 4,232 care home companies⁶⁵ in the UK between 2010 to 2015⁶⁶ using their statutory accounts⁶⁷ from Companies House. We identified these companies by their SIC codes,⁶⁸ and, where applicable, the Care Quality Commission registrations.⁶⁹
3. The combined total revenue in 2015 of these 4,232 companies was £11.7 billion. When compared to the estimated market size of £15.9 billion,⁷⁰ the dataset represents nearly three quarters of the market, measured by revenue. It is also spread over a six-year period and includes companies in all phases of their business life cycle including growth, maturity and decline. As far as we are aware, this is the most extensive dataset on which any financial analysis of UK care homes has been based in recent years.
4. We note that this dataset includes many new company registrations and companies that have also ceased trading during the same period. We consider that such companies are likely to be at an early phase of their growth or the later phase of decline, and thus sometimes tend to report financial results that are significantly different from companies that have been operating for several years. We have taken this into account when we have assessed the medium- to long-term profitability of companies in the industry.
5. We have also disaggregated the dataset to assess the profitability of care homes in different regions, between nursing and residential care homes and

⁶⁵This includes group accounts filed with Companies House, and subsidiary accounts when no group accounts have been filed with Companies House.

⁶⁶ To account for differences in the financial year ends across the 4,232 companies, we have allocated data to financial years based on the year in which most of the reported results fall. For example, if a company's year-end is June (ie the financial year falls evenly across two calendar years), its accounts are assigned to the later of the two years.

⁶⁷ This includes group accounts filed with Companies House, and subsidiary accounts when no group accounts have been filed with Companies House.

⁶⁸ SIC codes 871 and 873

⁶⁹ Nursing homes providing care to the elderly <http://www.cqc.org.uk/content/how-get-and-re-use-cqc-information-and-data#directory>

⁷⁰ Care of Older People UK Market Report 27th edition, 2016

the impact when care homes have differing proportions of local authority funded residents.

6. We have used the EBITDAR margin⁷¹ to assess the operating profitability of providers. This includes all costs of operating a care home and any central charges for shared services such as finance, legal and management fees. This measure excludes property related costs such as rent, lease, depreciation and interest. For example, the relevant property related charges in the P&L would differ depending on whether a property is:
 - (a) bought outright with equity shareholder's cash, with no property related charge in the P&L;
 - (b) rented, in which case the entire rental payment would be included as 'rent', with no depreciation charge in the P&L;
 - (c) leased and classified as a finance lease⁷² for accounting purposes, the financing cost would be included under 'interest', with a depreciation charge in the P&L; or
 - (d) mortgaged, the financing cost (only the interest element) would be included under 'interest', with a depreciation charge in the P&L.
7. Therefore, providers can choose different ways to finance their portfolio of care homes, which affects the P&L differently. By excluding property related costs, the EBITDAR margin provides a comparable benchmark to assess the operating profitability of care homes.
8. In our analysis, we have used the pre-exceptional⁷³ EBITDAR margins as the operating profit margin metric to ensure consistency and comparability of reported results.
9. EBITDAR is also an indication of the ability of providers to generate adequate cash inflows before the requirements to make other cash outflows such as those related to property (see Appendix B, paragraph 6), which can be significant at approximately 13% of revenue (see Appendix B, Table 1); corporation tax, which is not payable by loss making companies; and capital expenditure and dividends, which have the potential to be deferred for a period.

⁷¹ 'EBITDAR' is a profit measure equal to earnings before interest, tax, depreciation, amortisation and rent.

'EBITDAR Margin' is a return on sales measure (in percentage terms) equal to EBITDAR divided by revenue.

⁷² The risks and rewards associated with owning the asset are with the lessee.

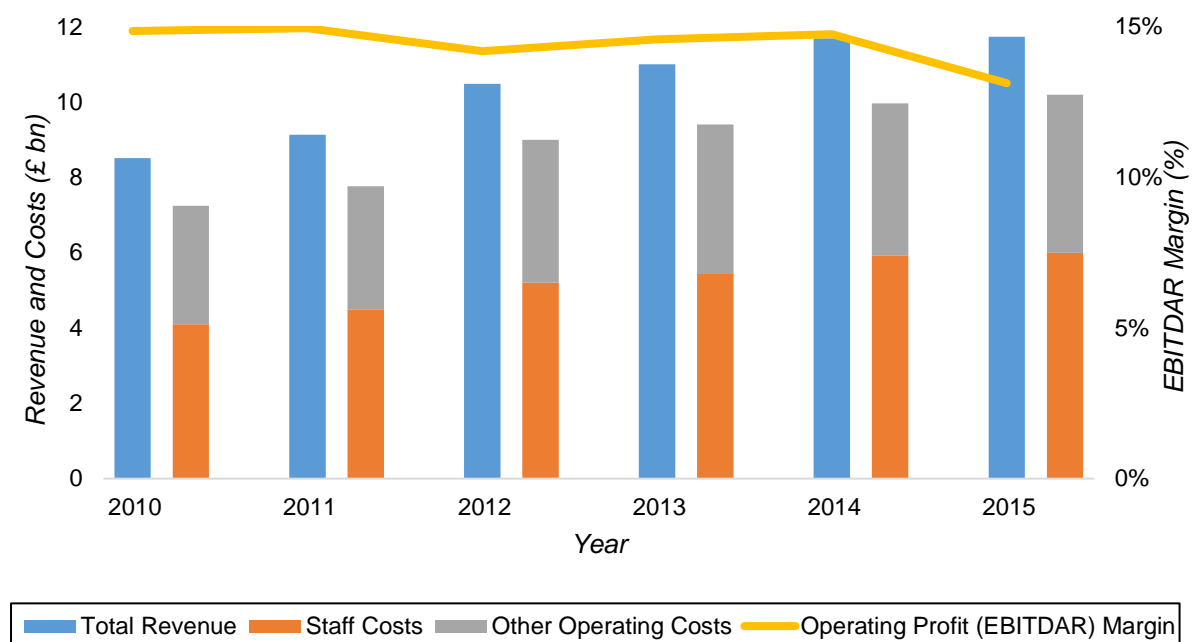
⁷³ These include one off gains or losses that are not part of the normal operating cycle. Examples include restructuring costs, gains or losses on disposals or assets and penalty payments.

Findings

Aggregate

10. As a starting point, we aggregated each of the line items in the P&L⁷⁴ for each year from 2010 to 2015 for the 4,232⁷⁵ companies in the dataset.⁷⁶

Figure 1: Aggregate operating profitability, 2010–2015



Source: CMA analysis of P&L information of the Companies House financial dataset.

11. The fully aggregated findings as per Figure 1 above (Figure 1 in the main body) indicate that the EBITDAR margin remained relatively stable between 2010 and 2014 at approximately 15%. However, the margin declined by approximately 2% in 2015, which can mostly be attributed to the rate of revenue growth slowing down and being flat between 2014 and 2015, whilst costs increased slightly.
12. Overall, we observe that that the levels of EBITDAR margin erosion between 2010 and 2015 are not significant, and that the average EBITDAR margin over the period was approximately 14%. This suggests that the companies, in aggregate, have generated adequate revenues to cover their operating costs

⁷⁴ For example, EBITDARM margin = the sum of EBITDARM for the 4,232 care home companies/the sum of revenues for the 4,232 care home companies.

⁷⁵ The total number of companies from 2010 to 2015 in the Companies House extract was 7,421. However, 3,189 of these companies had nil values in their P&L and we excluded these companies from the profitability analysis. Hence, as a starting point, we analysed 4,232 companies for the profitability analysis.

⁷⁶ This includes group accounts filed with Companies House, and subsidiary accounts when no group accounts have been filed with Companies House.

for each of the years from 2010 to 2015. Also, the relatively flat, albeit slight downward sloping, EBITDAR margin can be explained by increases in revenue largely keeping pace with the increases in operating costs (for example staff costs).⁷⁷ In other words, average operating costs as a percentage of revenue remained flat at approximately 85-86% over this period.

13. For those companies that have consistently reported⁷⁸ staff costs, we can observe a clear trend of aggregated staff costs increasing over time. However, between 2010 and 2015 staff costs as a percentage of revenue accounted for, on average, approximately 50% of aggregated revenue, which suggests that the industry has managed their increases in staff costs by increasing revenue.
14. The introduction of the National Living Wage in April 2016, has not been captured in the financial data assessed for the years 2010 to 2015. The preliminary data for 2016 that we have obtained contains a fraction of the companies, compared to 2015, that have filed returns with Companies House. Nevertheless, the preliminary findings for 2016 show that EBITDAR margins have not significantly declined in aggregate for those companies and that revenues have increased to match increasing staff costs.

Sub-section of aggregate – analysis of trading companies

15. Using the Companies House financial dataset,⁷⁹ we have only selected companies that had traded⁸⁰ for each of the years between 2010 and 2015. We found that there were 919 such companies⁸¹ (see Appendix B, paragraph 4 for the underlying reasons for doing so). These 919 companies generated £8.5 billion of revenue in 2015 and thus this sub-set comprises approximately 72%⁸² of aggregated revenue (Appendix B, paragraph 3).

⁷⁷The average annual rate of revenue and operating cost growth over the period were 6.7% and 7.2% respectively. Staff costs are the single largest cost item, comprising half of aggregated revenue. Thus, small increases in staff costs such as pay rates can have an important bearing on operating profits.

⁷⁸ In Figure 1 and subsequent disclosures using Companies House financial data, we recognise that the staff costs line item may be under-reported, ie staff costs could instead be included within other operating costs and not disclosed as a separate line item under staff costs. This simply relates to account classifications between staff costs and non-staff operating costs. It does not change the reported EBITDAR margins.

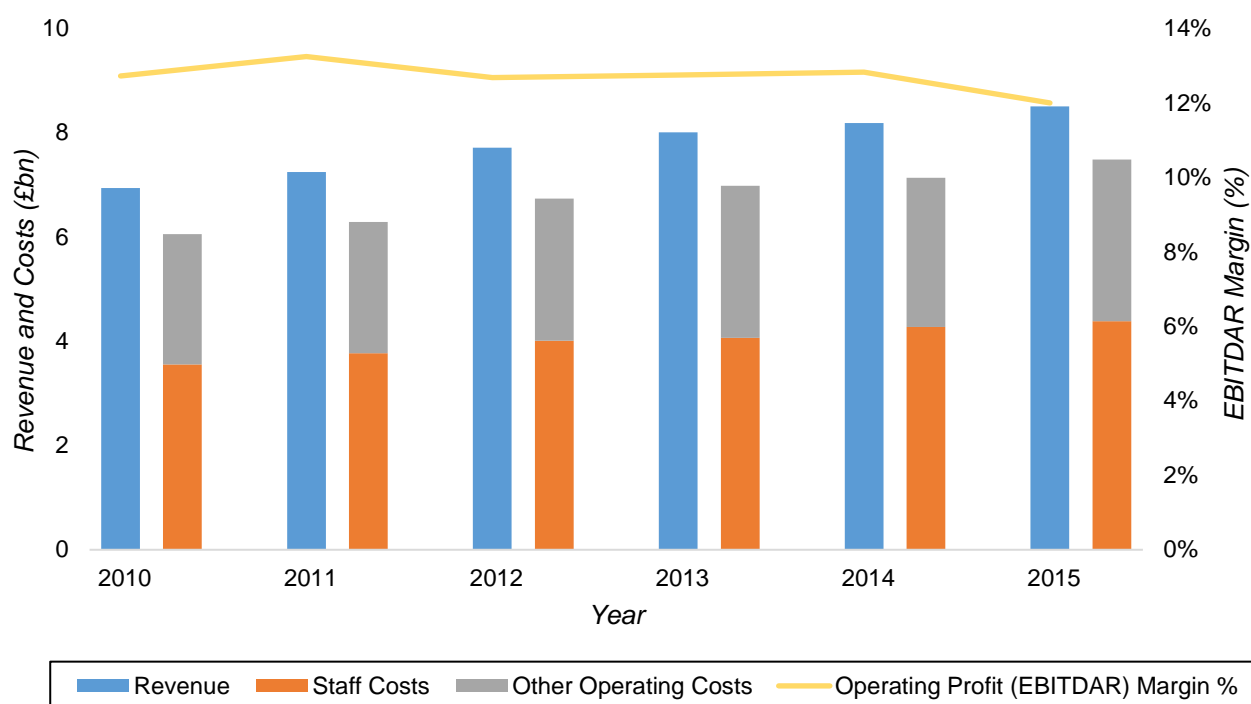
⁷⁹ See paragraph 9(a) of the main body and Appendix B, paragraph 10.

⁸⁰ Companies that had P&L data between 2010 and 2015. Hence, we excluded from the dataset any companies that had not generated revenue between 2010 and 2015.

⁸¹ The number of companies for which we could obtain P&L financial data for each year from 2010 to 2015.

⁸² £8.5 billion revenue out of a total £11.7 billion revenue in 2015 for the entire dataset.

Figure 2: Aggregate operating profitability for trading companies, 2010–2015



Source: CMA analysis of P&L information of the Companies House financial dataset.

16. Figure 2 shows that by using this sub-set of trading companies, the findings are broadly consistent with those for the Companies House financial dataset (see Appendix B, paragraphs 11 to 14).

Local authority and self-funded segments

17. We have sought to understand whether, and the extent to which, the local authority segment has been less profitable than the self-funded segment. However, the Companies House financial dataset does not disclose the customer mix⁸³ of companies. Therefore, we have used regions as a proxy to understand the effect of local authority funded residents on profitability.
18. We identified regions with higher and lower proportions of local authority funded residents.⁸⁴ Then, using the Companies House financial dataset, we selected small and medium sized (SMEs) companies to use in this analysis.⁸⁵

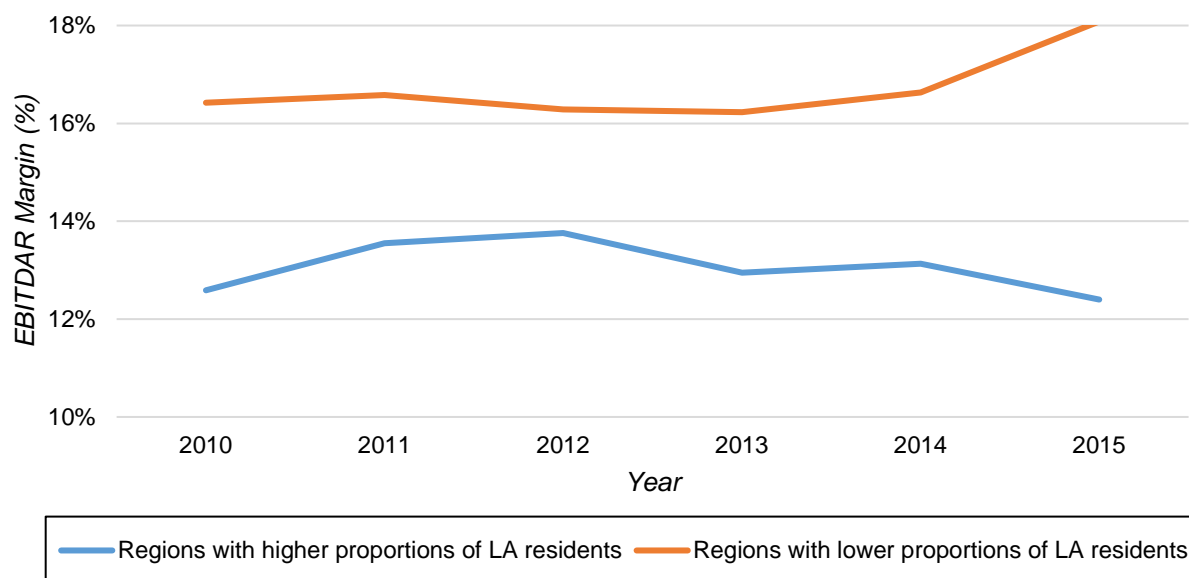
⁸³ The proportions and/or numbers of local authority and self-funded residents within a care home company.

⁸⁴ We obtained the proportions of local authority funded residents in each region, from data sourced from LaingBuisson (September 2014): Care of Older People UK Market Report 27th edition. We also sense checked this to data from NHS digital, which identifies regions based on proportions of care home places purchased by the local authority.

⁸⁵ A SME, by and large, tends to operate in the region in which it has registered with Companies House ie a company's registered address with Companies House. This contrasts to large providers, whom we have excluded, who have significant operations in regions outside their registered address with Companies House.

As a third step, we grouped these SMEs by region and by whether they appeared to serve predominantly local authority funded residents.⁸⁶

Figure 3: EBITDAR margin for regions with higher and lower proportions of local authority funded residents, 2010–2015



Source: CMA analysis of P&L information of the Companies House financial dataset.

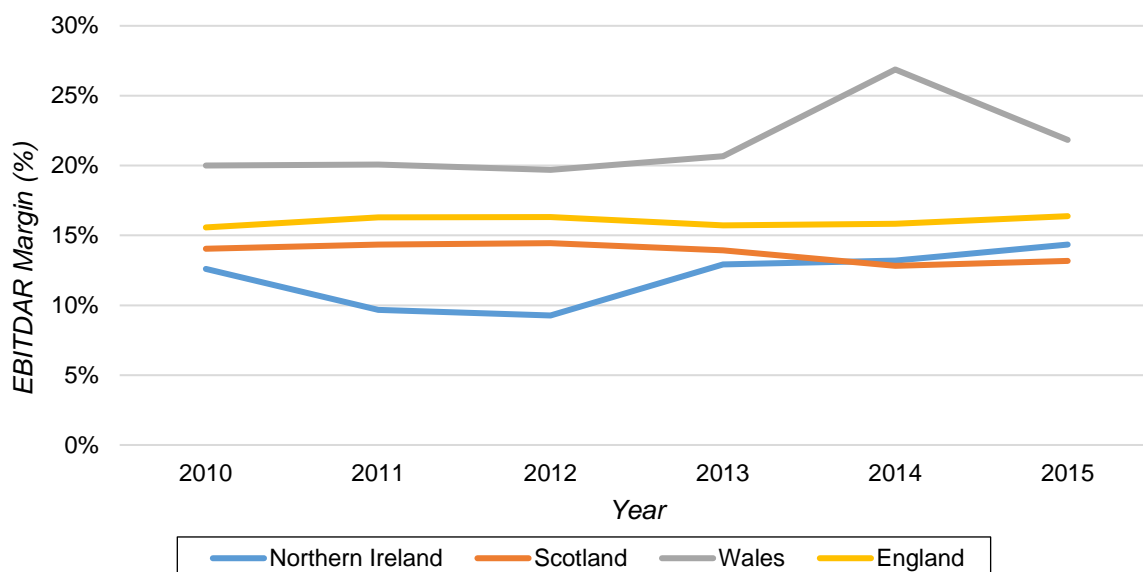
19. The findings indicate that the EBITDAR margins between 2010 and 2015 have consistently been lower at, an average of 13%, for providers in regions with higher proportions of local authority funded residents. This compares to an average of 17% for providers in regions with lower proportions of local authority funded residents. We also observe that the gap in the margins has widened since 2013.

The four nations

20. Using the Companies House financial dataset for SMEs, we compared the operating profitability of providers in the four nations.

⁸⁶ We have used a cut off threshold of 60%, ie if a region had 60% or more of its residents funded by the local authority, then we have grouped this as a 'region with higher proportions of local authority funded residents'. We have applied the same principle and cut off point of 60% for 'regions with lower proportions of local authority funded residents' (See Figure 3).

Figure 4: Aggregate EBITDAR margin for England, Northern Ireland, Scotland and Wales 2010–2015



Source: CMA analysis of P&L information of the Companies House financial dataset

- Figure 4 shows that providers in Scotland and Northern Ireland have been less profitable than providers in England, and providers in Wales have been the most profitable.

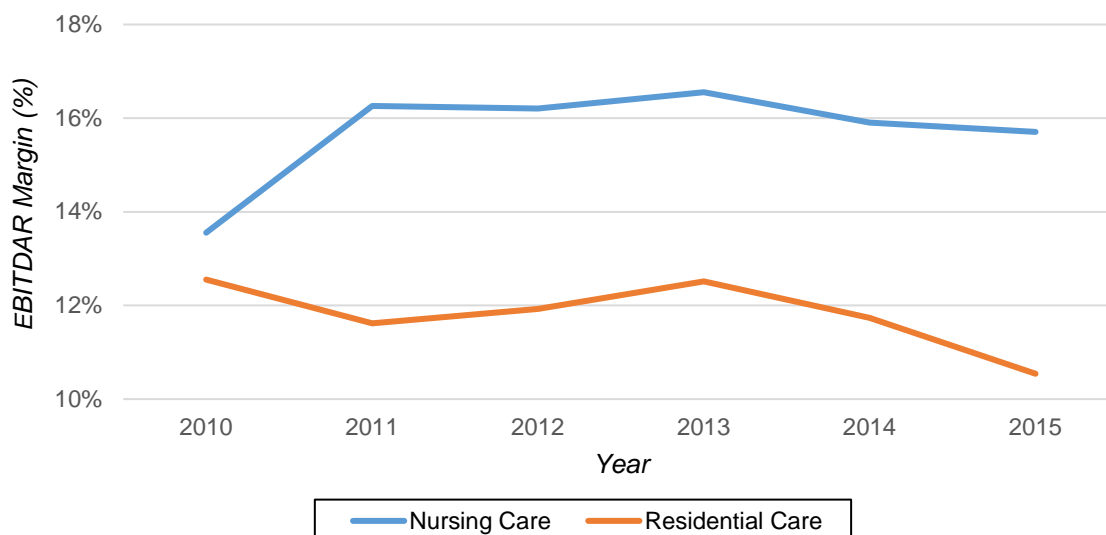
Nursing and residential care

- Using the Companies House financial dataset for trading companies,⁸⁷ we have assessed the financial performance of nursing and residential care homes.⁸⁸

⁸⁷ See Appendix B, paragraph 15.

⁸⁸ We identified whether a company was a nursing or residential care home by its SIC registration with Companies House. Specifically, we grouped those companies with a SIC codes 871 as nursing homes; and those companies with a SIC code 873 as residential care homes.

Figure 5: Aggregate EBITDAR margin for nursing and residential care homes, 2010–2015



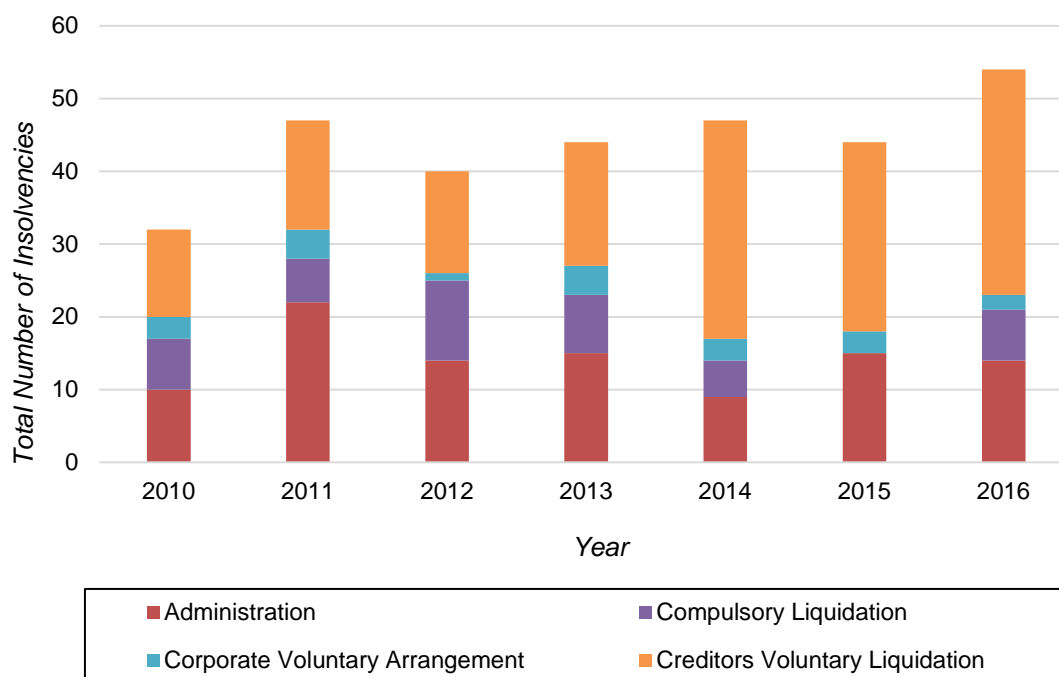
Source: CMA analysis of P&L information of Companies House financial dataset.

23. Figure 5 shows that between 2010 and 2015, the EBITDAR margin for nursing care homes has consistently been higher at an average of 16%, compared to an average of 12% for residential homes. The divergence in the margin has been increasing since 2013, driven by the relative deterioration in financial performance of residential homes.

Insolvency data from the Insolvency Service

24. We obtained a list from the Insolvency Service of all insolvencies in the UK between 1 January 2010 and 31 December 2016 for companies registered under the SIC codes 871 and 873. These codes relate to care and nursing homes for the elderly.

Figure 6: Number of Insolvencies by type, 2010–2016



Source: Insolvency Service.

25. Figure 6 shows that the level of insolvencies in the UK since 2010 has been very low, relative to the overall number of providers, at approximately 44 companies a year. There has been no significant increase in this level, relative to the number of providers in the industry, since 2010.⁸⁹ We also observe an increase in the numbers of voluntary insolvency arrangements, where a company’s directors voluntarily enter an insolvency. This contrasts to the declining trends in administrations or compulsory liquidations, where the insolvency procedures are led by the creditors.
26. Separately, we also observe that no large UK-wide provider has entered any formal insolvency procedure, since Southern Cross Healthcare Group plc went into administration in 2011.
27. Regulators and lenders have told us that as far as the care homes industry is concerned, creditors tend to resort to insolvency as a last measure, thus preferring to work out going concern solutions. Even when a care home enters an insolvency procedure, stakeholders make all reasonable attempts to run the care home while attempting to sell it as an operating business.

⁸⁹ We note that the insolvency data excludes care home providers that exited the industry without having filed for an insolvency. Such exits could either be the result of market conditions culminating in a deterioration of financial performance or planned exits where, for example, the owners of smaller care homes choose to retire. The impact on overall capacity in either case would depend on whether the new owner of the care home continued to operate it.

Profitability data from providers

28. We have analysed a dataset of 26 providers across the UK between 2015 and 2017. The average annual revenue during this period for these providers was £4.3 billion. The dataset also contains analysis of 2,032 individual care homes at a care home level. We refer to this as the providers' dataset (see paragraph 9(b) of the main body).

Group level findings

Aggregated

29. Using the providers' dataset, we have constructed an aggregated P&L for 26 providers (see Table 1 below).

Table 1: Aggregated P&L for 26 large providers, 2010–2017 (2017 forecast)

| Aggregated income statement for 26 large providers | | | | | Year on year (YOY) Growth | |
|--|------------------|------------------|--------------------|------------------------------|---------------------------|---------------|
| £'million | 2015 (Actual) | 2016 (Actual) | 2017 (Forecast) | Average (2015 to 2017) | 2015- 2016 | 2016- 2017 |
| Revenue | 4,144 | 4,314 | 4,453 | 4,304 | 4.1% | 3.2% |
| Staff costs | 2,447 | 2,518 | 2,548 | 2,505 | 2.9% | 1.2% |
| Non-staff operating costs | 634 | 710 | 720 | 688 | 12.1% | 1.4% |
| EBITDARM | 1,063 | 1,086 | 1,184 | 1,111 | 2.1% | 9.0% |
| EBITDARM % | 25.7% | 25.2% | 26.6% | 25.8% | (1.9%) | 5.7% |
| Management fee | 203 | 221 | 234 | 219 | 9.0% | 5.7% |
| EBITDAR | 860 | 865 | 950 | 892 | 0.5% | 9.9% |
| EBITDAR % | 20.8% | 20.0% | 21.3% | 20.7% | (3.5%) | 6.5% |
| Rent | 406 | 373 | 403 | 394 | (8.2%) | 8.0% |
| EBITDA (pre-exceptional) | 454 | 492 | 548 | 498 | 8.3% | 11.3% |
| EBITDA (pre-exceptional) % | 11.0% | 11.4% | 12.3% | 11.5% | 4.0% | 7.9% |
| Exceptional items (costs) | 341 | 13 | 56 | 137 | (96.1%) | 318.8% |
| EBITDA post-exceptional | 113 | 478 | 491 | 361 | 324.9% | 2.7% |
| EBITDA post-exceptional % | 2.7% | 11.1% | 11.0% | 8.3% | 308.2% | (0.5%) |

| | | | | | | |
|--|---------------|-------------|-----------------|----------------|-----------------|----------------|
| Depreciation and amortisation | 243 | 222 | 237 | 234 | (8.7%) | 6.9% |
| EBIT | (131) | 256 | 254 | 126 | (296.0%) | (0.9%) |
| <i>EBIT %</i> | <i>(3.2%)</i> | <i>5.9%</i> | <i>5.7%</i> | <i>2.8%</i> | <i>(288.3%)</i> | <i>(4.0%)</i> |
| Interest expense | 164 | 176 | 189 | 177 | 6.8% | 7.8% |
| Profit before tax | (295) | 81 | 64 | (50) | (127.3%) | (19.9%) |
| <i>Profit before tax %</i> | <i>(7.1%)</i> | <i>1.9%</i> | <i>1.4%</i> | <i>(1.3%)</i> | <i>(126.2%)</i> | <i>(22.4%)</i> |
| Additional profitability measures | | | | | | |
| EBIT (pre-exceptional) | 211 | 270 | 310 | 264 | 28.0% | 15.0% |
| <i>EBIT (pre-exceptional) %</i> | <i>5.1%</i> | <i>6.2%</i> | <i>7.0%</i> | <i>6.1%</i> | | |
| Profit before tax (pre-exceptional) | 46 | 94 | 121 | 87 | 103.2% | 28.6% |
| <i>Profit before tax (pre-exceptional) %</i> | <i>1.1%</i> | <i>2.2%</i> | <i>2.7%</i> | <i>2.0%</i> | | |
| EBTDA (pre-exceptional) | 289 | 316 | 358 | 321 | 9.2% | 13.3% |
| <i>EBTDA (pre-exceptional) %</i> | <i>7.0%</i> | <i>7.3%</i> | <i>8.0%</i> | <i>7.5%</i> | | |
| Costs as a % of revenue | 2015 | 2016 | Forecast | Average | | |
| Staff costs | 59.1% | 58.4% | 57.2% | 58.2% | | |
| Non-staff operating costs | 15.3% | 16.5% | 16.2% | 16.0% | | |
| Management fee | 4.9% | 5.1% | 5.3% | 5.1% | | |
| Rent | 9.8% | 8.6% | 9.0% | 9.2% | | |
| Exceptional items | 8.2% | 0.3% | 1.3% | 3.2% | | |
| Depreciation and amortisation | 5.9% | 5.1% | 5.3% | 5.4% | | |
| Interest expense | 4.0% | 4.1% | 4.3% | 4.1% | | |
| <u>Property related expenses</u> | | | | | | |
| Rent and interest | 13.8% | 12.7% | 13.3% | 13.3% | | |
| Rent, interest and depreciation | 19.6% | 17.9% | 18.6% | 18.7% | | |

Source: CMA analysis of P&L information submitted by 26 large providers (the providers' dataset)

30. The key finding from Table 1 is that the average pre-exceptional EBITDAR margin between 2015 to 2017 is 21% and that this margin has been relatively stable in 2015 and 2016, and is forecast to increase incrementally in 2017. Increases in revenue have been matched by increases in staff and non-staff operating costs. In other words, staff costs, non-staff costs and the management fee as a percentage of revenue has been relatively stable at

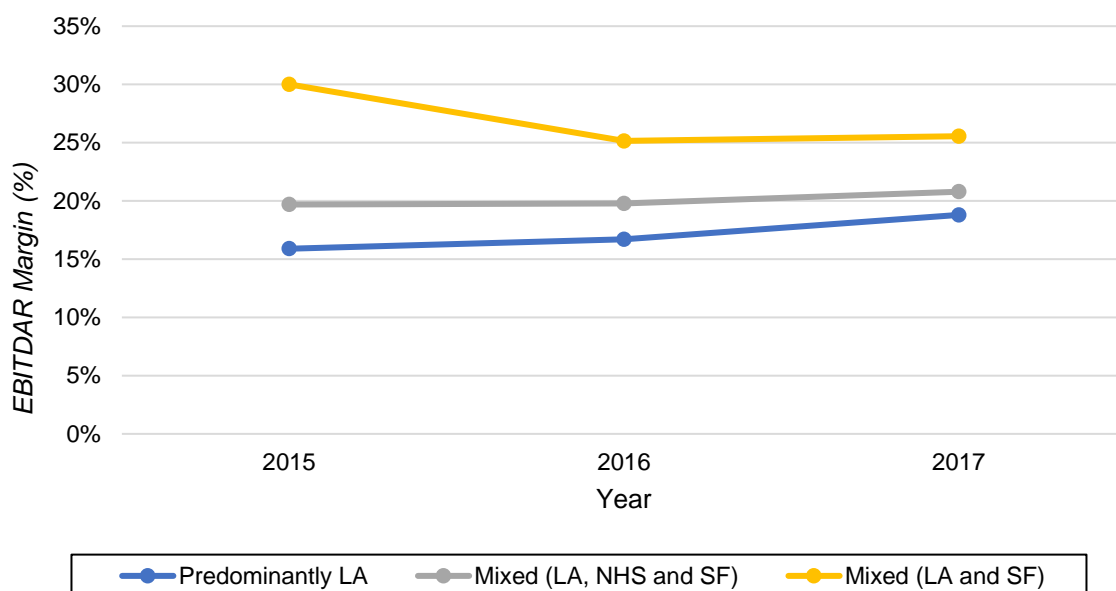
80%. Crucially, staff costs as a proportion of revenue shows a downward trend during this period.

31. Another important finding is that property related costs, such as rent, depreciation and interest expense, are significant at 19% of revenue. These costs have also been relatively stable, when measured as a proportion of revenue. Of this percentage, property related costs that have a cash flow impact, such as rent, and interest (including for leases), accounted for approximately 13% of revenue in 2015 and 2016.
32. A further important finding is that the management fee and central costs line item is significant at 5% of revenue, averaged over this period. Central costs relate to head office costs and management fees relate to charges levied by shareholders, mostly private equity funds, in relation to management services. We consider that central costs are not a significant for most large providers, and therefore, a significant proportion of this cost is likely to relate to management fees.

Providers with predominantly local authority funded residents.

33. We have also grouped these 26 providers in the providers' dataset based on the proportion of their revenues that they generated from local authority funded residents.

Figure 7: Average EBITDAR margin of companies based on proportion of their revenues by source of resident funding, 2010–2017 (forecast)



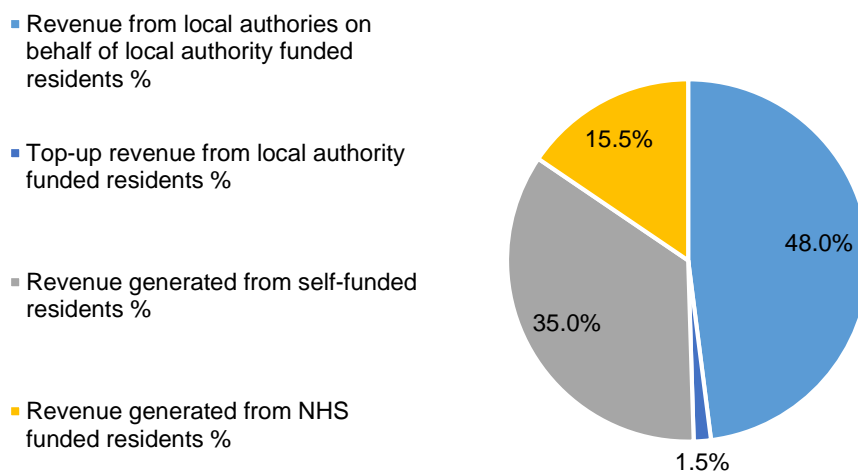
Source: CMA analysis of P&L information submitted by 26 large providers (the providers' dataset)

34. Figure 7 shows that those providers that have greater proportions of local authority funded residents generated lower EBITDAR margins compared providers with lesser proportions of local authority funded residents.

Analysis of revenue streams

35. We have assessed the resident funding mix and its effect on average fees for 22 of the 26 providers in the provider dataset for 2015 and 2016.

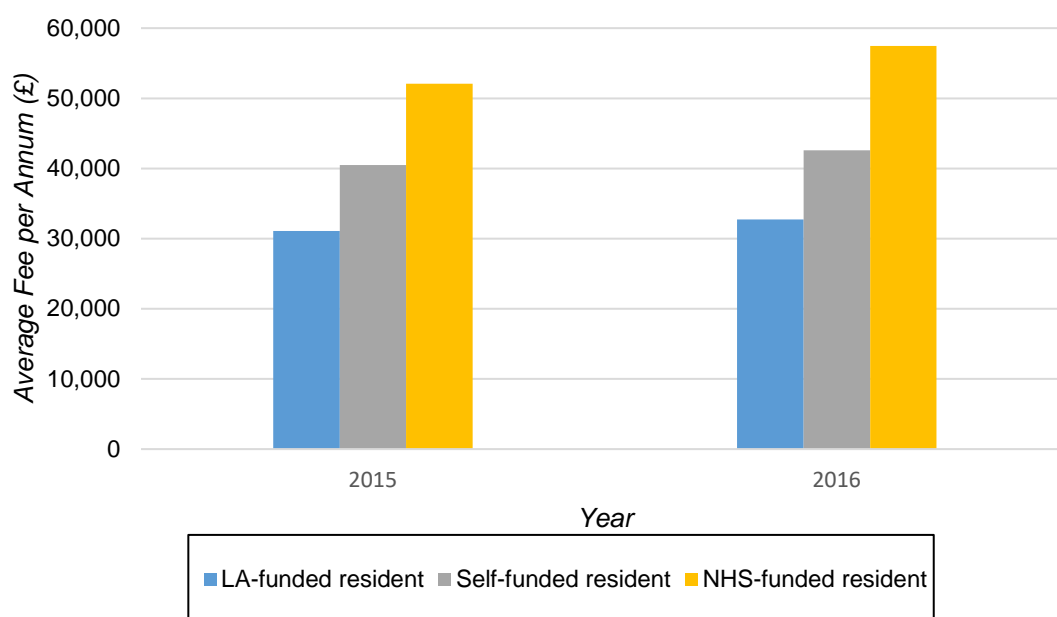
Figure 8: Total provider revenue by source of resident funding, 2015–2016



Source: CMA analysis of P&L information submitted by 22 large providers (the providers' dataset)

36. Figure 8 shows that local authorities accounted for nearly half of the revenue stream for these providers. Revenue from self-funded residents accounted for over a third of total revenue. This shows the relative importance of local authority funded residents via its impact on profitability for these providers in aggregate.
37. We have also compared the average fee per resident generated by these 22 providers based on their source of funding of residents.

Figure 9: Average annual fee per resident by source of resident funding, 2015–2016



Source: CMA analysis of P&L information submitted by 22 large providers (the providers' dataset)

38. Figure 9 shows that providers, on average, generated less revenue per local authority funded resident than per self-funded resident. Also, we can infer from Figures 8 and 9 that local authority funded residents would constitute just over half of all residents for these providers in aggregate.

Care home level findings

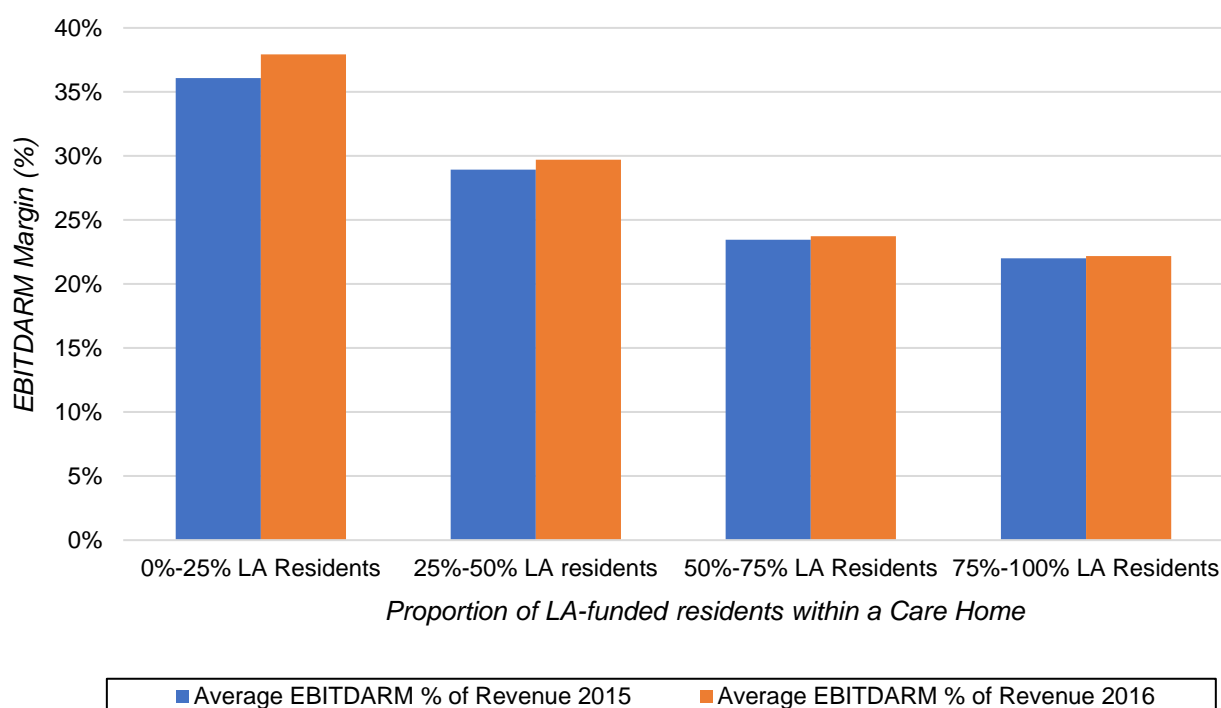
Aggregated

39. As part of the providers' dataset, we used detailed care home level data for 2015 and 2016 from 26 providers for their 2,032 care homes. The total revenues generating by these care homes amounted to an average of approximately £3.5 billion during this period.
40. We found that the average EBITDARM margin over this period was 27%. We also observe a slight increase in margin between 2015 and 2016, despite the introduction of the National Living Wage on 1 April 2016.

Local authority vs self-funded

41. We have also assessed the impact on operating profitability of local authority funded residents for these 2,032 homes.

Figure 10: Average care home EBITDARM margin % by proportion of LA-funded residents, 2015–2016



Source: CMA analysis of Provider supplied care home level data for 2,032 care homes (the providers' dataset)

42. Figure 10 indicates that care homes with higher proportions of local authority funded residents generated lower EBITDARM margins.

Cost of capital

43. In this section, we describe our approach to estimating the cost of capital. We have also discussed how this might be done by local authorities of care home places and providers, when they seek to assess the total costs of providing care.
44. The findings from our analysis indicate that the current market returns (ie economic profit margins) are broadly in line with the estimate of the cost of capital. We have performed this analysis using data from providers, along with further assumptions that we describe below.

How to measure the cost of capital

45. The cost of capital (economic costs) is calculated as the product of:
- (a) The value of the assets invested in the business (capital employed); and
 - (b) The required return on capital.

Asset valuation

46. The asset valuation used in the cost of capital calculation should, in principle, be the market value of those assets. This is because the market value reflects what those assets could be sold for, as an alternative to using the assets for their current purpose, ie the opportunity cost. In relation to:
- (a) assets with an alternative use, such as land and buildings, we consider that the valuation methodology should be similar to the normal practice used in the real estate industry. For example, valuations conducted by chartered surveyors. We see no reason why this methodology would significantly differ for land and buildings in the care home sector; and
 - (b) other assets, such as beds and other facilities (equipment) required to operate a care home, a more usual way to value assets should be based on the actual investment cost, which should be depreciated to reflect the age of the assets.
47. In the case of our economic profit analysis, we have been unable to obtain up to date asset valuations for all companies in the Companies House financial dataset. However, we have used market data on asset valuations provided by several care home providers. This has allowed us to estimate the benchmark levels for the asset values of the care homes under analysis.
48. We have taken the following steps to estimate the asset values:
- (a) we have assumed that an investor in a new care home would have to purchase property (land and building) and equipment, and contribute towards the funding of the operations with working capital and cash. The investor would require a return on those assets. Therefore, we have included these assets in the capital employed, and then applied a return on those assets to estimate the economic costs. Ie the cost of capital.
 - (i) For property, we have estimated asset values by using a ratio of annual revenue⁹⁰ to market values⁹¹ of those homes for which we have market data. We then applied this market based average ratio to the aggregate revenues in the Companies House and providers' financial datasets⁹² to estimate the property market values.

⁹⁰ We used the revenues for FY 2015 and 2016 for care homes from 479 large providers.

⁹¹ We obtained and used recent market values for the same 479 number of care homes, which generated annual revenues of £1 billion. We applied the revenue to asset valuation ratio for these care homes to derive the average ratio.

⁹² With regards to the provider's dataset, we applied this average ratio to the group level revenue.

- (ii) For equipment, we obtained an estimate of the typical capital expenditure spend in a residential and nursing home, on a per resident basis. A large provider told us that equipment, fixtures and fittings for a new home costed in the range of £8,000 - £15,000 per bed. For both datasets, we then multiplied the number of residents by the estimated spend on equipment, by using the mid-point of this range.
- (iii) For working capital, we used the reported working capital between 2010 and 2015 and smoothed the year end reported numbers over the period.
- (iv) For cash, we used the reported numbers.

49. We used the following methods to account for the number of residents:

- (a) for the Companies House financial dataset, we have estimated the number of residents per company by dividing the aggregated companies' annual revenue by the annualised average weekly fee in the UK for residential and nursing homes which is approximately £700.
- (b) for the providers' dataset, we used a combination of their submitted results if available, or an estimate similar to method (a) above, where a few providers did not submit resident numbers.

Our estimate of the cost of capital

50. We have not undertaken new analysis on the cost of capital. However, we consider that it is reasonable to assume that a cost of capital of around 5-8%, measured in real terms, should be sufficient to attract investment (new stock and replenishment of existing stock) into the industry, coupled with a reasonable expectation that fees will be determined in a way that includes such a return on capital consistently over time. We note, for example that:

- (a) our private healthcare investigation found a pre-tax market return on capital of around 9% in nominal terms (ie including inflation).⁹³
 - (i) For that portion of the capital, which is invested in long-lived assets such as land, we consider that a starting assumption would be that prices in the long-run would be more likely to remain constant in real prices than in nominal prices. Therefore, investors would require, an annual return based on a lower real cost of capital in order to obtain a

⁹³ <https://www.gov.uk/cma-cases/private-healthcare-market-investigation>

total nominal return (including inflation) of around 9%. For example, based on the Bank of England's Consumer Prices Index (CPI) inflation target of 2%,⁹⁴ the real rate of return in the long-run would be expected to be equivalent to around 7%.

(ii) Some, stakeholders have commented on the relative stability of the industry in terms of the capacity, and our understanding is that the need for capacity is likely to grow or remain stable over time. Also, our financial analysis indicates that industry revenue and operating profit margins have been relatively stable, without significant volatility.

(iii) Furthermore, the care homes industry is more heavily regulated than private healthcare. It also carries less commercial risk because most revenues are funded by the state, and demand is likely to remain strong due to the demographic circumstances, ie an ageing population. Hence, we would expect the average cost of capital for the care homes industry over the medium to long term, to be lower than that for the private healthcare industry.

(b) At the same time, we consider that the care homes industry faces more risk than that faced by essential services or regulated monopolies, where the returns are determined by economic regulators. Recent regulatory determinations are consistent with a pre-tax cost of capital of 3.5%-4.5% relative to inflation for such companies.⁹⁵

(c) We also note that capital costs, driven largely by interest rates in the OECD,⁹⁶ and including the UK, are currently at historic lows.⁹⁷

51. Therefore, we expect that a full assessment of the average cost of capital for investors in the industry would be of the order of 5-8% in real terms.

52. For our base case in the analysis, we have used 6.5%, in real terms, as the cost of capital. We also used the average revenue to property value ratio based on the submissions of providers and the mid-point on the range for equipment (see Appendix B, see paragraph 48)

53. We have also used a range on 5-8%, in real terms, for the cost of capital in our analysis (see Figure 2 in the main body), which we apply to our benchmark asset value calculation. We note that, in practice, the range of

⁹⁴ [Bank of England: Monetary Policy Framework](#).

⁹⁵ Recent CMA decisions are at: <https://www.gov.uk/topic/competition/regulatory-appeals-references>. We note that there is now a suggestion that the WACC for utilities may be lower than this in forthcoming reviews in the water sector.

⁹⁶ Organisation for Economic Co-operation and Development

⁹⁷ OECD data: [Long-term interest rates](#) and [short-term interest rates](#).

returns could be far wider, as some providers will have asset values that are significantly higher or lower than our average/mid-point benchmark. However, we consider that this range is informative in understanding the likely pattern of returns over the industry.

54. We note that some investors and industry analysts have indicated that the cost of capital may be far higher than that we have used in our analysis, especially in relation to investment in new capacity. We would not be surprised if it were the case that providers of new equity were seeking higher returns.
55. Nevertheless, our analysis provides a benchmark. It will be a commercial decision for any investor and purchaser as to whether a higher return would be necessary and appropriate given the circumstances, including whether other investors can be found which are willing to invest for returns closer to the benchmark level.
56. For the avoidance of doubt, the aim of the cost of capital estimate is to identify an aggregate benchmark level at which we would expect that the industry, as a whole, would be financially sustainable and could meet demand for capacity.

Sensitivities to the cost of capital

Economic profits for the industry

57. Figure 2 of the main body shows the range for economic profits for the industry by using the same asset values for capital employed, but a range for returns on capital employed of between 5-8% on a real basis, as follows:
 - (a) The asset values have been derived by using the average revenue to property valuation ratio and mid-point for equipment (see Appendix B, paragraph 48); and
 - (b) The base case uses a rate of return on a real basis of 6.5%.

Sensitivities for the economic profits for the local authority and self-funded segments

58. Figure 3 of the main body shows the estimated economic profit margins for the self-funded and local authority funded segments. We have used the following steps:

- (a) we calculated the economic profits for the local authority and self-funded (or mixed)⁹⁸ segments, and the average of these two segments, for each of these datasets: Companies House financial and providers' datasets using both their group level, and also their care home level results for the 479 care homes for which we received property market valuations.
 - (b) we calculated the divergences, from the average, of the economic profit margins for the local authority and self-funded (or mixed) segments for each of these datasets.
 - (c) we then used these divergences to model the effect on the base case used in Figure 2, which uses the Companies House financial dataset.
59. We have assumed a constant rate of return of 6.5% in real terms. For property valuations, working capital and cash, we applied the same principle, as that laid out in Appendix B, paragraph 48, separately for the local authority funded and the self-funded segments.
60. However, for the providers' dataset at the care home level, we did not use the average ratio. Instead, we used the actual market valuations for individual care homes submitted by providers for 233⁹⁹ care homes of the 479 care homes.

Calculation of the cost of capital for individual purchasers and providers

61. We note that a practical way for any relevant stakeholders such as commissioners to estimate the cost of capital would be to obtain:
- (a) asset valuations, measured at recent market valuations, of both property (land and building) assets, and the equipment required to operate a care home of a certain number of beds. These estimates can be obtained as follows:
 - (i) local estimates of property costs, based on local market data;
 - (ii) an assessment of typical equipment required and their asset value, based on analysis of industry data;
 - (iii) consider the inclusion of any off-balance sheet assets and liabilities in capital employed;

⁹⁸ Mixed segments had lower proportions of local authority funded residents, and consequently higher proportions of self-funded residents.

⁹⁹ 142 homes consisting of at least 70% local authority funded residents and 91 homes consisting of at least 70% self-funded residents.

- (iv) the application of a benchmark annual return on capital, but which could be reviewed over time;
 - (b) inclusion of other assets such as working capital and cash in the asset base;
 - (c) average annual cost in percentage terms of financing that capital through debt and equity, using market data and judgement, given that it can be difficult to measure.
 - (d) application of the annual cost of finance to the capital base to calculate economic costs
 - (e) The deduction of economic costs from the EBITDAR profit measure, as key costs below the EBITDAR line item such as rent, depreciation, and interest all relate to property.
62. We note that market rents could also be used as a check on or proxy for the returns on property.
63. In applying the cost of capital in practice, one possible approach would be to convert the cost of capital into a benchmark margin. In other words, the approach above could be used to determine benchmark levels for:
- (a) the required return on capital;
 - (b) the comparable benchmark EBITDAR margin; and
 - (c) the comparable benchmark EBITDA margin, for operators that rent or lease their assets.
64. Our understanding is that the portion of the cost of care which relates to a return on capital is less well understood, and that there may be benefit in having external guidance. This could be either as part of the final outcomes of this review, or through a recommendation to government to engage an independent review for this purpose. The objective would be to provide transparency to commissioners and providers as to a suitable level for the cost of capital to use in purchasing decisions.
65. Please see Appendix A for questions on the cost of capital.

Financial risk

Purpose

66. Several stakeholders have raised concerns about the high levels of debt and financial gearing amongst the large providers, particularly those owned by

private equity funds. High levels of debt¹⁰⁰ (gearing) can increase the financial risk profile of a provider because:

- (a) a provider must make regular cash payments to repay¹⁰¹ its debt to avoid default. Hence, it must generate a sufficient level of operating cash flows in each period. However, even relatively minor movements in a provider's cash flows, either arising from changes in revenue or costs, could dramatically affect its ability to do so.
- (b) a provider must also adhere to its debt covenants. These can either be financial (eg gearing ratios) or non-financial such as a negative pledge¹⁰² that might restrict its ability to borrow further. An actual or potential breach of its covenants could trigger a restructuring event that could restrict further funds to the provider from the lender, or at its worst lead to an insolvency.
- (c) providers with long term debt are also likely¹⁰³ to have pledged some or all their assets¹⁰⁴ as security. During normal trading conditions, this restricts the use of these secured assets for other purposes. However, during distressed¹⁰⁵ trading conditions, it gives the creditors the leverage to pursue their interests over those of other stakeholders such as equity investors. As a practical example, the secured creditors could file for an insolvency.

Methodology and findings

Companies House data

67. We have reviewed the audited financial statements of 7,421 companies between 2010 and 2015. Of these, 2,016 companies 27% (of 7,421) carried some debt on their balance sheets in any given year. These 2,016 companies generated an average annual revenue during this period of £10.4 billion and carried £8.7 billion of net annualised debt.¹⁰⁶

¹⁰⁰ Debt is booked as a liability on its balance sheet.

¹⁰¹ The cash repayments relate to interest charges and capital repayments. The frequency and timing of these payments will depend on the type of debt instrument.

¹⁰² An undertaking by the borrower (provider) to a specified lender not to create a class of creditor that ranks above that specified lender, with regards to priority for repayment.

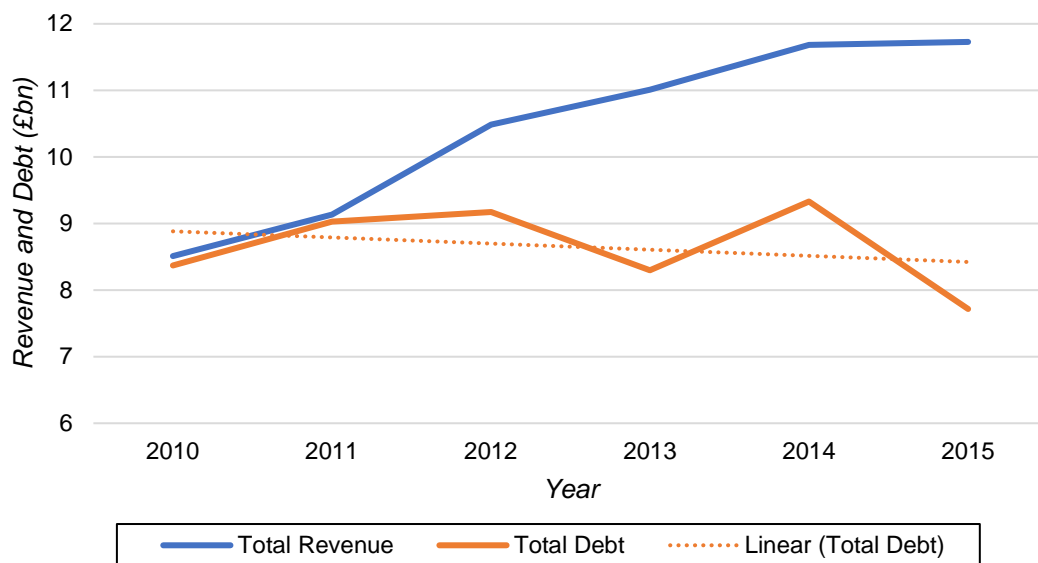
¹⁰³ Secured debt such as term loans are the most common form of debt for companies that do decide to borrow.

¹⁰⁴ In the case of a care home, this is likely to be its land and building.

¹⁰⁵ For example, if a provider is unable to generate adequate cash flows to meet its debt service obligations.

¹⁰⁶ Net debt = Short-term debt + long-term debt + intercompany debt + finance lease liabilities - cash

Figure 11: Total Revenue and Total Debt, 2010–2016



Source: CMA analysis of P&L and Balance Sheet information of the Companies House financial dataset.

68. Figure 11 shows that for these 2,016 companies, net debt declined between 2010 and 2015, despite the revenue growth, suggesting a trend towards deleveraging in the industry. This could be driven by providers unwilling or unable to take on extra debt. The latter could arise due to a tightening of lending and credit to the industry.
69. We also disaggregated these 2,016 companies based on their size in terms of revenue. The top quarter of these companies by average revenue over the period have been classed as large, the second and third quarters have been classed as medium sized and the last quarter has been classed as small. The findings indicate that net debt is most heavily concentrated in large companies (82%), compared to medium sized (16%) and small (2%) companies.