Children's Social Care: supplementary submission to the CMA (updated)

Balanced Economy Project, August 2021

These supplementary notes replaces and builds on the Balanced Economy Project's original published submission to the Competition and Markets Authority (CMA) on children's social care.

*These notes were prepared by **Michelle Meagher** and **Nicholas Shaxson** of the Balanced Economy Project, in partnership with **Vivek Kotecha**. This updated version was submitted in August 2021.*

Note: this update corrects a meaningful error of characterisation in our original published submission, and replaces and expands upon it. In earlier versions, we treated shareholder loans principally as debt, with some characteristics of equity. This updated submission treats shareholder loans more like equity, but with some characteristics of debt. It also modifies a section on the potential tax benefits of shareholder loans.

1. Introduction and Summary

This submission focuses on a business model pioneered by private equity, elements of which have spread widely beyond private equity firms themselves.

Our central contention is that the private equity (PE) model allows principals to separate risk from reward – enjoying rewards while shifting the related risks to others – thus undermining a central bargain at the heart of capitalism and creating incentives for recklessness and encouraging rent-seeking. Risk-shifting of this kind is a standard feature of limited liability, but the PE model super-charges it, principally by extensive use of debt, corporate complexity, and a relative lack of regulation or transparency. The model generates market distortions and in the process harms economic resilience and long term viability.

We described the key contours of private equity:

- Private equity companies buy up businesses (whether in children's social care, pizza restaurants, or others) and re-engineer them for profit.

- The owners and controllers of PE firms put in very little of their own money, instead taking funds from external investors (such as pension funds) then deploying them to purchase active businesses. Those outside investors take a share of the economic profits generated, but a large slice flows via fees and other instruments to the PE owners, who bear little risk themselves.

- Private equity firms' core technique for increasing returns to their funds, and to themselves, is to use debt[1]. They force the companies that they buy to borrow externally (e.g. from banks) and internally (e.g. from the PE owners):

    - The cash proceeds of external borrowing is often paid partly or even fully to the

[1] Sections 2.1-2.4 below show evidence of higher debt and risk in children's social care.

investors and owners, rather than invested in the underlying business[2]. If enough debt is raised and paid this way, investors may be able to use the cash proceeds essentially to acquire the company "for free" with little risk, since the obligation to repay the external debt and interest will be shouldered by the underlying portfolio business (the children's care company, in this case), rather than by the private equity owners or investors. **Annex 3** below outlines the "Dividend recapitalisation" (or "special dividend") technique in more detail. Reward is thus further separated from risk.

- ♦ Internally, PE owners or other "related parties" inside the corporate structure may lend money to the underlying businesses. The interest rates on these "shareholder loans" we found in Children's Social Care (CSC) range from 7-14%. Interest payments are typically added to the principal rather than paid in cash, so that debts (to shareholders) can build up rapidly without raising alarm bells because cashflows are not immediately affected. The owners are repaid when they "exit" in a sale to another investor[3]. These loans magnify managers' incentives to maximise financial returns (Section 2.2 below) and can confer tax gains (though that is now significantly restricted, Section 2.5 below.) These loans can mask true economic profitability for the owners.

- ♦ Private equity (PE) firms' core expertise is typically less in the operations of the businesses they buy than in knowing **debt** markets, and knowing how to organise corporate structures and operations to maximise borrowing.

- ♦ The financial pressures that result from excessive external borrowing force the underlying companies to adopt a **range of other strategies** to boost internal profitability, such as:

  - Restructuring, often involving tax havens, to cut the tax bill e.g. setting high interest costs of shareholder loans (*Section 2.5* below);
  - Cutting staff costs, pay, benefits, staffing levels and so on;
  - Cutting capital investment, upkeep of buildings, etc;
  - Using market power obtained through acquisitions to raise prices and fees charged to local authorities, to suppliers, and to others, including co-investors.

  All these may reduce the quality of service provided, and may reduce supply.

- ♦ Private equity owners and investors normally aim to realise their main profit on '**exit**' - when they sell the company to the next investor(s), hopefully for high returns.[4] This

[2] A standard technique is the "dividend recapitalisation" which involves a PE firm borrowing to give itself and/or its investors a quick cash payout. See, for instance, PE firms keep deploying dividend recaps despite the risks, Adam Lewis, Pitchbook, Aug 15, 2019.

[3] PE firms are less concerned about making annual net profits so long as EBITDA (Section 2.7 below) is high enough to cover debt costs. The majority of their expected return comes upon sale where a rising EBITDA, expansion and a good growth narrative can justify a higher valuation.

[4] For instance, as described in Harvard Business Review: "*the fundamental reason for private equity's success is the strategy of buying to sell—one rarely employed by public companies, which, in pursuit of synergies, usually buy to keep.*" In independent foster care, for instance, an investigation by the Department of Health published in 2018 found that the rate of return was "2-3 times the original investment amount". (That is a standard PE baseline rate; for a five-year investment that is 15-25% a year, a high bar.) See *'Alarm bells' over private equity foster care firms, councils warn*, Sanchia Berg, BBC Radio 4 Today programme, Aug 27, 2019

"buy to sell with high returns" strategy should raise warning flags because:

- Social care, unlike (for example) high technology, has fairly limited potential for rapid underlying economic growth, economies or scale or synergies (Section 1.2 below).[5] Extra value must therefore be "extracted" from the underlying business[6].

- On "exit", debts that built up may be passed like a hot potato from one investor to the next. (The next investor is likely also a firm using PE models, also with little financial downside for principals.) Ultimately, however, debts become due.

♦ Overall, the combination of PE owners deploying "Other People's Money" from outside co-investors, along with their ability to *receive* the proceeds of external borrowing while *making other people* (in this case, the underlying CSC companies) responsible for paying back the debt, generates perverse incentives.

  o If the owners can create profitable upsides for themselves, while all but eliminating their downsides – like **flipping a coin** where you win big on heads, but lose little or nothing on tails – this creates moral hazard that leads to **recklessness** and **heightened acquisitiveness**. The incentive is to flip as many coins as possible – or here, to buy as many CSC businesses as possible.

  o These rent-seeking activities mean the PE firms can pay higher multiples (of earnings) than more traditional businesses to acquire CSC companies, partly because their debt-enhanced ability *and* incentive to extract higher financial returns from the underlying businesses makes them more valuable to the PE firm than to a traditional firm not using such techniques. **PE can thus out-compete more traditional businesses** in this market, increasing market share on factors that are both market-distorting and also socially harmful (to children especially).

♦ A related problem is harmful "**competitive contagion**" where non-PE companies competing against PE firms (for example, in the market for acquisitions) feel they need to adopt similar extractive strategies if they want to be able to match PE bids and stay in the race for acquisitions.)

While all firms providing CSC provide useful services - not least, providing care for vulnerable children, and productive investment therein – these are services that can be provided by other business models. We argue that the features that distinguish the private equity business model from more traditional business models, outlined above, are problematic in any economic sector, and especially problematic where vulnerable children are concerned. Any efficiencies that may be created are, because of the debt-fueled financial incentives, more likely to flow to financial returns than to children's care.

We provide new evidence to support these ideas, below.

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[5] For instance, Langbuisson states "There are limited economies of scale which could underpin the value proposition for care home brands." See Care Homes for Older People, Langbuisson, July 24, 2018.

[6] PE companies often hold very diverse portfolios (e.g. see Annex 2 below) so potential for synergies is often marginal or non-existent.

2. Our findings, with new data

We examine the corporate structures of the 13 largest CSC providers, of which eight are Private Equity owned.[7]

Table A, below, is new. It updates Table 1 in our original submission with new data, as we have changed our characterisation of shareholder loans, from debt to equity.[8]

Table A: Sustainability metrics for 13 of the largest children's social care providers

Company name	**Brand**	**PE ?**	**Net Assets £m**	**Net tangible assets £m**	**Interest cover**	**Gearing %**	**Years to repay debt**	**Years to repay external debt**
CareTech Holdings Plc	Caretech	No	353	186	5.2	145	5.1	5
Keys Group Limited	Keys	Yes	23	-47	1.0	303	20	11.6
SSCP Spring Topco Limited	The Outcomes First Group / NFA	Yes	90	-272	1.5	546	14	9.4
Priory Group UK 1 Ltd	Priory	Yes	-32	-163	1.2	Negative	8.5	0
Horizon Care and Education Group Ltd	Horizon	Yes	6.0	5.5	n/a	102	1.7	0
HCS Group Limited	Hexagon Care Services	No	6.5	5.8	16	98	1.4	0.7
SC Topco Lmited	Sandcastle Care	Yes	17	1.2	0.5	116	45	45.5
Picnic Topco Limited	Esland Group Holdings Ltd	Yes	14	-6.8	0.9	188	22	12.9
Homes 2 Inspire Limited	Homes 2 Inspire	No	-1.8	-3.7	-0.9	Negative	n/a	0
Nutrius Uk Topco Limited	FCA / Core Assets	Yes	49	-120	2.8	298	4.6	4.6
Advent Topco Limited	Compass	Yes	20	-38	2.7	254	7.5	5
Alderbury Holdings Ltd	BSN Social Care	No	11	5.4	29	45	0.7	0.7
Capstone Foster Care Limited	Capstone	No	9.5	-8.4	18	89	1.9	1.9
Non-Private Equity average (5 companies)			75.8	37.0	13.4	94	2.3	1.7
Private Equity average (8 companies)			23.2	-80.0	1.5	258	15.4	11.1

Source: latest accounts available (at time of original submission) from Companies House.

[7] Of the remaining 5, one is publicly listed, two are private businesses (non private equity), and two are charities/employee owned.

[8] Shareholder loans have aspects of equity and debt, and ratings agencies treat them as both, depending on circumstance. See *Debt and Equity Treatment for hybrid instruments of speculative non-financial companies*, Moody's, July 31, 2013. However, for the purposes of this report, they usually behave more like equity.

Note 1: *Interest charged for shareholder loans and preference shares is excluded from calculations of interest cover in Table A. Outstanding shareholder loans and preference shares have been treated in this table as equity, not debt.* ***Note 2:*** *Shaded rows concern companies where values were recalculated from Table 1 in our first submission, to reflect our updated treatment of shareholder loans, as equity instead of debt.*

These findings are not dissimilar to previous research on the adult care home industry has found that Private Equity-owned homes had borrowed the most (£35,072) per care bed, and their interest costs were over five times as large as other owner types, at £102 per bed per week, amounting to 16% of the weighted average weekly fee for residential care (and a much higher share of non-staff costs).[9]

2.1 Evidence of financial vulnerability due to high debt

Table A does not fundamentally change any of our previous conclusions from Table 1 in our original submission, even if many of the numbers have changed. The conclusions are:

i) PE firms had **strongly negative net tangible assets**, on average, while for non-PE firms they are positive;
ii) **interest cover** is many times higher on average for non-PE firms than for PE;
iii) PE firms had **very high financial leverage/gearing** compared to non-PE firms;
iv) PE firms need **many more years (15.4 versus 2.3) to repay their external debts** than non-PE firms.

All this highlights the heightened financial vulnerability of PE firms in the long term.

However, our recharacterisation of shareholder loans as resembling equity more than debt does give PE firms a potential cushion of equity. For example Priory Group UK 1 Ltd's 2019 accounts (p7) state:

> "*Under the severe but plausible downside scenarios prepared by the Directors, the forecast cash flows indicate that operating cash flows may not be sufficient to meet interest payments as they accrue*".

The accounts add, however, that debt and interest (due to US-based owner Acadia Healthcare) "will not be extracted to the extent that it exceeds forecast free cashflow."

It remains a question, however: why would auditors sign off the accounts on companies with negative net assets, which are also lossmaking in successive years? A key answer is that, in general, PE companies state explicitly that owners are willing to keep providing liquidity (i.e. lending money) to them, so on this basis they are treated as viable 'going concerns.' (Section 4.2 below.). The shareholder loans potentially act as a shock-absorber in this respect, as equity would.

[9] Kotecha (2019). https://chpi.org.uk/wp-content/uploads/2019/11/CHPI-PluggingTheLeaks-Nov19-FINAL.pdf

2.2 Evidence of shareholder loan notes / preference shares

As mentioned, interest payments on the internal debts of a portfolio company (such as a CSC company) to PE owners can be deferred so that the interest is not paid cash but instead is added to the principal, thus eliminating immediate pressure on cashflows. This boosts debt owed to shareholders. Generally, though, these 'shareholder loans' usually behave more like equity than like debt: partly because shareholders are unlikely to take action upon tripping debt covenants on loans owed to themselves, which could throw their companies into turmoil. Shareholders may absorb losses via write-downs on their loans, as they might with an equity cushion. (Shareholder debt is "junior" in the creditor hierarchy: above equity but below debt to external parties like banks.)

Repayment of this debt at 'exit' – whether in a sale to another PE firm, or flotation on a stock market – can be the main way that PE firms realise returns in care and in other sectors[10].

Shareholder loans serve two principal functions for PE firms:

- The high interest payments may be and often are deductible for tax purposes (though this possibility has recently been restricted; Section 2.5 below);
- They supercharge management incentives to boost financial performance[11]. This can create perverse management incentives to "sweat the asset" through extractive techniques, especially in sectors like CSC where there is little prospect of large-scale productivity improvements or economies of scale.

A third outcome is that shareholder loans can mask true economic profitability for owners. On the balance sheet, profits, dividends (and executive payouts) are the most often noticed and remarked upon. Shareholder loans – for PE owners, which may constitute the main payout at the end of the day – tend to be less noticed, and also their value less certain, since they are only realised at some future date if a successful 'exit' can be arranged.)

None of these purposes seems socially beneficial, certainly in the children's social care sector where expected returns are relatively low. What is more, shareholder loans may constitute the lion's share of investor rewards from an investment, and 'loss aversion' among investors may add to the pressure to boost financial performance, to repay those loan pots that have grown large through years of accumulated high interest rates ahead of 'exit'.

We found five companies in the study - four PE and 1 employee-owned – using shareholder loans / notes - loans from related parties to the underlying businesses - and/or preference shares (which operate a little like shareholder loans: they pay a fixed remuneration, and are becoming more common given recent restrictions since 2017 on interest deductibility that impact shareholder loans; Section 2.5 below),[12] at high interest rates.

We found that while *external* borrowing may have been contracted closer to market interest

[10] See, for instance, Revolution Consulting, 2020, p15.

[11] Shareholder loans supercharge management incentives in two main ways. First, managers own shares/equity (called "sweet equity"), which usually only receives a return after (high) interest on shareholder loans is (nominally) paid, thus requiring high financial performance; and ii) the smaller the equity sliver as a share of the company's value, the higher the relative returns on that equity. See, for instance, *Tax issues on private equity transactions*, Brenda Coleman, Andrew Howard, Leo Arnaboldi III, Tax Journal, Nov 7, 2018, Section 9.

[12] For example, see https://www.londonstockexchange.com/personal-investing/what-differences-between-ordinary-and-preference-shares-CISI Also see ibid, Sections 10 and 12.

rates, *internal* borrowing (i.e. the "shareholder loans from related companies inside the corporate structure) is charged at 7-14 percent annually[13]. Table B below provides some examples.

Table B: Borrowing costs for five of the largest children's social care providers

Company name	**PE?**	**Shareholder loan notes (interest rate)**	**Preference shares (interest rate)**	**Bank /external loans (interest rate)**
Advent Topco Limited	Yes	10% cumulative per year	-	LIBOR + 2.75-4.25%
Capstone Foster Care Limited	No	7, 10% per year	-	LIBOR + 2.75%
Keys Group Limited	Yes	N/a	12% per year	LIBOR + 3.25%, 7%
Picnic Topco Limited	Yes	12.5% per year	-	LIBOR + 2.5%, 6.5%
SSCP Spring Topco Limited	Yes	14% per year	-	LIBOR + 6.25%

(A loan with 14% added annually to the principal would, all else being equal, double in under five and a half years.)

Keys Group Limited, for example, says on p1 of its accounts to March 2020 that a £10.7m loss:

> *"is stated after non-cash charges including an interest charge of £5,940,000 on a shareholder debt (2019: £5,332,000) which is not payable until the earlier of a shareholder exit, or 2027."*

It also states that the group's liabilities included £87.5m in secured loans plus £57.2m in preference shares, also payable in 2027 or at exit.

Will they successfully 'exit' to another investor by 2027? If not, who will pay these liabilities? It is technically the responsibility of the underlying company to pay, but given that it has been loss-making for a number of years, it seems unlikely to be able to pay in any reasonable time frame, given limited opportunities for growth. Will loss-aversion among shareholders increase their willingness to 'sweat the asset' ahead of exit, if there is a risk of write-down of their loans?

Also worth considering is that loans from related parties or external funders may (or may not) be **"secured"** putting them higher up the creditor hierarchy to be repaid ahead of other stakeholders (such as staff or pensioners or taxpayers) in the event of bankruptcy.[14] We have not surveyed this but it is an important issue to watch.

2.3 High debt levels lead to a focus on extraction and not investment

Priory Group UK 1 Ltd's 2019 accounts (p7) also provide an example of the extractive nature of private equity firms:

[13] In order to justify the above market financing rates, PE companies invoke higher risks associated with preferred shares, which are subordinated to senior debt provided by external financiers. However, the risks sit largely on the shoulders of the care companies rather than the preferred shareholders.

[14] For an explanation, see, for example, 'We must curb excesses of the buyout barons': Two peers from either side of the House of Lords voice concerns about private equity predators, Lord Sikka and Baroness Altmann, thisismoney.co.uk, May 31, 2021.

"*The Group generates sufficient cash to cover its liabilities and surplus balances are transferred to Acadia Healthcare to reduce the accrued interest and loan capital balances ahead of their scheduled repayment dates*".

The stated focus here is to send surplus cash to the US parent company, rather than investing in care or facilities. Again, we have not surveyed this but it is worth watching.

2.4 Opco / Propco splits

Annex 1 below describes the "Opco-Propco" or "sale and leaseback" techniques to engineer real estate holdings in the corporate structure principally to maximise borrowing.

We found seven companies in our study with Opco-Propco splits, of which 4 were PE-owned companies.[15] We did no underlying analysis of the arrangements.

However, we offer anecdotal evidence of an additional risk generated by the Opco-Propco model: actions by independent landlords that may affect the supply or quality of care.

For example, Four Seasons healthcare was criticised in 2018 for closing its Ross Wyld care home in Walthamstow, owned externally under an Opco-Propco arrangement, after the home could not agree a lease renewal with the freeholder. Four Seasons said it had not been involved in negotiating the lease, which was presumably a result of the opco-propco split. The owner appears to have wanted to demolish the building and convert it into apartments.[16]

The local authority only discovered the closure after it had been announced, and it appeared that there had even been difficulty in contacting the owner.

2.5 Tax avoidance

PE owners and investors can escape tax in several ways. For example:

a) the use of high interest payments, notably for "shareholder loans/notes" (see above) to use as costs to set against the tax bill.). Changes to tax legislation in 2017 have strongly restricted these possibilities, however.[17]

b) profitable "exit" via sale, which, if it is structured correctly, can be realised offshore with minimal tax due, or accrue as capital gains which are at taxed at lower rates than dividends.

We found evidence that companies were mostly not paying (taxable) dividends. Of the 13 companies, only three announced dividends in their accounts (1 listed, 2 private non-PE).

[15] The companies in groups where this was evident were: CareTech Holdings Plc, Keys Group Limited, Priory Group UK 1 Ltd, HCS Group Limited, SC Topco Limited, Nutrius Uk Topco Limited, Alderbury Holdings Ltd.
[16] See GMB call on Four Seasons Health Care to explain care home closure decision, GMB London, April 18, 2018; Four Seasons to Close Waltham Forest Home, Care Home Professional, April 18, 2018; and p163 of the relevant planning document.
[17] See, for instance, *UK restriction on corporate interest tax relief*, Eloise Walker, Pinsent Masons, Jul 25, 2017.

2.6 Evidence of opportunistic transactions

PE owners may charge their portfolio companies high 'service fees' e.g. for monitoring or management[18] - and these fees may be paid to the PE owners not the wider investor group.

We found that 11 of the 13 companies recorded at least some form of opportunistic transaction. The two most common examples were: renting/selling properties to directors/related companies and monitoring fees charged by PE companies. On monitoring fees, for example, we found:

Table C: Monitoring fees charged for four of the largest children's social care providers

Company name	Monitoring Fees size
Advent Topco Limited	£151,000
Nutrius Uk Topco Limited	£299,000
Picnic Topco Limited	£120,000
SSCP Spring Topco Limited	£400,000

Source: Companies House, latest accounts (at time of original submission).

These are significant charges, especially if the companies are loss-making.

2.7 Evidence of profitability

A Key Performance Indicator (KPI) for private equity is a common measure of profitability called EBIDTA (earnings before interest, taxes, depreciation, and amortisation.) This is a measure of the essentials of operating profitability and cashflow before various deductions are made, which enables better comparisons of core earnings across different kinds of company (stripping out elements that may vary widely such as high debt levels / high interest deductions, levels of depreciation, tax avoidance, etc[19]).

Our data shows that nearly all of the private sector companies are highly profitable on the EBITDA basis, as this table shows. This is consistent with a statement by Josh MacAlister, the head of the government's independent review of CSC, who was quoted in June 2021 as saying that private companies in the sector were making "indefensible" profits - over £250 million per year from the top 20 providers.

In Table D, below, we found total EBIDTA of £340 million for the top 13 providers, using latest annual accounts.

[18] One analysis finds such fees add up to seven percent annually. See, for instance, *The exorbitant privilege enjoyed by private equity firms*, Jonathan Ford, Financial Times, Sept 8, 2019.

[19] Private equity firms also like EBITDAR - the 'R' stands for Rent, which is significant for Opco-Propco Structures as mentioned in the original submission (Annex 3.)

Table D: EBIDTA for 13 of the largest children's social care providers

Company name	Brand	EBITDA £m	EBITDA%
CareTech Holdings Plc	Caretech	80.6	18.7
Keys Group Limited	Keys	6.1	7.6
SSCP Spring Topco Limited	The Outcomes First Group / NFA	52.1	19.6
Priory Group UK 1 Ltd	Priory	137.5	16
Horizon Care and Education Group Ltd	Horizon	3.6	13.2
HCS Group Limited	Hexagon Care Services	4.6	16.7
SC Topco Lmited	Sandcastle Care	399	4.6
Picnic Topco Limited	Esland Group Holdings Ltd	2	11.8
Homes 2 Inspire Limited	Homes 2 Inspire	-360	Negative
Nutrius Uk Topco Limited	FCA / Core Assets	32.2	16.5
Advent Topco Limited	Compass	9.9	14.1
Alderbury Holdings Ltd	BSN Social Care	7.4	18.1
Capstone Foster Care Ltd	Capstone	4.4	13
		Total	**Average**
		340.3	14.2

Source: latest accounts available (at time of original submission) from Companies House.

Note: The EBITDA% column refers to EBITDA margin, or EBIDTA as a percentage of sales. The higher this number, the lower its operating expenses are in relation to total revenue - i.e. less is being spent on the actual costs of providing care. So an average EBITDA margin of over 14 percent suggests that £14 of every £100 (nearly all received from councils) is turned into profit, which is very high for a labour-intensive industry where staff costs make up more than half of total costs. (The aforementioned study by Revolution Consulting of 20 companies in 2020 found an average margin of 17.2% and 17.4% in the previous year.) These very high numbers are another indicator that the market is distorted.

PE-owned firms are generally happy to have overall loss-making companies so long as EBITDA is high enough to cover their debts. As an example of this, see the 2019 accounts (p16) of PE-owned Keys Group Limited:

"*The cash outflows associated with the Group's debt in this period are limited to only to bank interest payments, limiting the size of required cash outflows on the Group's financing*".

2.8 Heightened acquisitiveness, including for market power

Private equity firms sometimes describe the 'build by acquisition' approach as doing "roll-ups." The objectives, beyond the coin-flip incentive (Section 1 above) include:

- Acquire market power, including monopsony power over suppliers and employees, and over local councils.[20] Indeed, an expert in private equity, who asked not to be identified, stated to us in August:

[20] For example, a 2016 *Financial Times* article on a CMA investigation into the private healthcare industry reported that five large firms were "accused of carving up the country into local monopolies and of striking cosy relationships with doctors and insurance companies that pushed up prices." (This goes far beyond price, of course.) This 2019 analysis of roll-ups (in US dental care) highlights the several objectives, including "reducing competition" and "pricing power;" and "more negotiating position over suppliers." Langbuisson, 2018, p215, listed a source of economies of scale as "greater purchasing power for consumables such as utilities and food, which absorb about 10% of care home revenue."

"Anyone following the activity of PE firms can see that they are always keen to use their so-called 'roll-up' approach in sectors that offer oligopolistic or quasi-monopoly characteristics'".

The expert added that due to a general lack of transparency in the sector, it was hard either for the public or for regulators to see clearly or quickly enough what was going on, such as a "startling" roll-ups ongoing in veterinary services.[21]

- Increase "multiples." Larger firms can typically be sold for higher multiples of earnings than smaller firms can, partly because they have greater access to capital (and this is a feature of markets generally, far beyond PE.)[22]

We have seen preliminary indicators of this here and in related sectors.

- A Department of Education study found that large independent fostering agencies, led by private equity firms, grew at 7.7% annually from 2013-18 (thus a 45% total growth rate) while the total number of children in care rose at just 1% annually.[23]
- A *Times* investigation quoted a local director of children's services as saying that smaller providers were increasingly being "swallowed up by larger conglomerates" leading to a 'gradual diminution of standards."[24]
- More broadly, there is extensive evidence of above-market growth rates of private equity in social care (and many other) sectors.

Analysts report now that multiples and earnings are high in the health & care sectors at the moment[25], and especially high in the children's care sector,[26] which suggest high acquisition prices and therefore a harder route to profitable 'exit,' increasing the chances of a disruptive 'credit event' at debt maturity.

We believe that the CSC sector is likely in an earlier stage of "market maturity" than the adult social care sector, where PE business models have already triggered severe crises. For instance, the collapse of Southern Cross (Annex 1, below) and, more recently, the troubles of Four Seasons healthcare, in the UK, involved private equity firms 'flipping' the underlying company more than once, injecting more debt at each stage, until eventually nobody wanted

[21] The expert added, via e-mail: "The immunity from public scrutiny that regulators confer on [PE] may make it a particular risk, relative to (say) quoted companies: (a) PE is nimbler and more opportunistic than some other business models, so can move faster . . . (b) it may be less easy to see what PE firms are up to in a given sector (though the CMA might dispute this); (c) being out of the public eye may make PE firms worry less about any public opprobrium that does arise."

[22] Economies of scale are often cited as justifications, but this is hard in sectors such as CSC where staff hours are the main source of value. Diversification is also a factor why larger companies often enjoy greater multiples. Langbuisson (2018) added that the other economy of scale (beyond greater purchasing power) was "access to capital at lower cost." As a 2021 analysis described it more broadly: "Doing a roll-up is designed to take advantage of how capital markets value bigger companies versus small ones, or what is called multiple expansion. Buying a small family owned business for three to four times its cash flow . . . [then] putting it into a conglomerate that financiers then call a 'platform' or 'market leader', means you can often sell the much bigger company for eight to ten times that cash flow later on." On large firms having greater access to capital, see LangBuisson 2018, p215.

[23] Narey-Owers review, Dept. of Education, Feb 2018, p63.

[24] *Children in care: private equity swoops to exploit 'broken market'*, Billy Kenber, The Times, Jun 17, 2021

[25] See for instance UK mid-market PE Review, KPMG, Feb 2021, p4

[26] See *Children's care triggers bumper returns for private equity owners*, Gill Plimmer, Financial Times, June 17, 2021, which states: "Children's' care providers are far more profitable than other care sectors. The top 26 adult residential care providers had a combined 7.4 per cent margin according to Nick Hood, analyst at Opus Restructuring" [compared to 17.4 percent for children's social care.]

to take on the 'hot potato' of debt, and collapse ensued[27].

2.9 "Exit" and profit on sale of the companies

As discussed previously, PE makes most of its profits at "exit" when it sells the company on, typically, 3-7years after acquisition[28]. PE-owned Keys Group Limited's 2019 accounts (p32) gives an idea of the expected sale price after 5 years of ownership: a multiple of **10 times earnings**.

PE firms like to claim that these multiple increases – "multiple arbitrage" are a result of skill, or sharp injections of expertise. This can happen but is much harder in care sectors. The multiple expansions generally result from factors that are either true for public non-PE firms too, or are extractive: i) economies of scale (less so in care sectors with high staff costs, see Section 3.3 below); ii) diversification which reduces risks from single-ownership; iii) falling interest rates and generally rising markets; iv) extractive techniques as outlined above, such as building market power.

The buyer is often another PE firm. They will typically finance a higher sale price with additional debt loaded onto the underlying care business. They may in turn try to 'flip' it again after increasing multiples further, often through further acquisitions.[29]

The new owners will then have to find a way to pay off this higher debt and generate a return. This game of 'load the donkey' can only feasibly continue in a growing market with cheap debt and even falling interest rates, regular payments, and the presence of willing buyers. Any change in these conditions – and interest rates may now plausibly be set to rise now -- could lead to a breakdown in the business model, and precipitate a collapse or necessitate a bailout, as the case of Southern Cross and Four Seasons in Section 1.2 above illustrate.

2.10 Acquisitions, and "competitive contagion"

The market for children's social care is consolidating.[30] As asserted in our Introduction above firms using the private equity model have both the means and the incentive to expand and potentially crowd out other players less willing or able to use these techniques.

Evidence of acquisitiveness was provided by Revolution Consulting in December 2020 (our emphasis added):

> *"The **largest twenty** provider organisations studied in this project have income of £1.54 billion, **an increasing proportion** of the spending by local authorities on fostering,*

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[27] See, for instance, Four Seasons woes expose private care home risks, Sarah Neville, Gill Plimmer and Javier Espinoza, Financial Times, May 6 2019.

[28] See, for instance, Private Equity Strategies for Exiting a Leveraged Buyout by Rashida K. La Lande, Gibson, Dunn & Crutcher LLP, with Practical Law Corporate and M&A, Thomson Reuters Practical Law, July 2016.

[29] If the claim is that better financial performance is from a sharp injection of expertise, that claim is harder to sustain on a secondary buyout, where the injection of expertise presumably happened the first time around.

[30] As Caretech stated in its annual report for 2020 (p31): "The market has been steadily consolidating and a small number of large 'corporate' providers have emerged."

children's homes, and other social care services including residential school places and leaving care.

. . .

On a like-for-like basis compared to the first study, there is evidence of continued growth of income, profits and EBITDA margin amongst the largest of provider organisations.

. . .

After ***the largest acquisitions the sector has ever experienced, the consolidation and integration of the largest groups is a strong factor in this growth.*** *Acquisition activity is continuing despite the impact and concerns related to Covid-19.* ***Private Equity ownership and funding models*** *stand out amongst the providers studied."*

For example. Keys Group Limited stated in its accounts to March 2020 that it had acquired the businesses Build-A-Future; Artemis Young Person's Care and Education Services Limited; and South West Childcare Services Limited, and that its turnover had increased to £93.4 million from £79.4 million in the previous year.

Also anecdotally, a BBC Wales investigation quoted Kristy Edwards, a whistleblower at a Cardiff children's home run by Orbis Education & Care Ltd. said:

"It's made very clear to you in your training that Orbis are going to be the biggest health and social care provider in Wales, in the UK."

Of the 16 companies in the Revolution study for which comparable prior-year data was available, 14 had income equal to or greater than in the previous year, while two had lower income, with an average 7.3% rise year-on-year, faster than the growth in children numbers.

In terms of 'contagion' where non-PE firms felt pressured to adopt PE techniques to 'stay in the race' for acquisitions, we found less evidence, the most notable indicator being that three of the seven firms that had separated their property companies from their operating companies – Caretech, HCS and Alderbury – were not private equity firms. (We did not analyse these aspects further.)

We have seen examples of this in other care sectors[31], and although non-PE firms in this sector tend to be less aggressive than PE firms, this could change as the market becomes more mature.

2.11 Price and quality metrics

Price or quality are not necessarily the most useful metrics in assessing private equity in CSC. The key reason is that their superior access to finance plus heightened incentives to borrow enables them to ensure price and quality (the most visible aspect of their services) are within reasonable bounds and do not attract unwanted attention, while rent-seeking activity happens elsewhere.

[31] For example, a report by the Centre for International Corporate Tax Accountability and Research (CICTAR) of adult social care in Australia found several PE-like techniques and concluded that "The largest non-profit residential aged care operators, like their for-profit counterparts, suffer from a lack of accountability and appear to prioritise investment and growth over care" and "a pattern of extracting revenue from government subsidised residential aged care to fund property investments." See *Caring for Growth: Australia's largest non-profit aged care operators,* CICTAR, July 2020.

We did not survey the CSC market more widely to assess whether price or quality are worse overall under PE. Even so, some external evidence of this exists in the care sectors.[32]

For example, a report at the U.S. National Bureau of Economic Research (NBER)[33] studied the impact of private equity in US adult care and concluded that PE ownership increased the short-term mortality of Medicare patients by 10 percent, alongside other declines in well-being – while staffing was lower, compliance with standards was lower, and there was "a systematic shift in operating costs post-acquisition toward non-patient care items such as monitoring fees, interest, and lease payments."

In the UK, anecdotal horror stories exist of firms using PE techniques in adult social care. For example, in the case of Winterbourne View care home, undercover BBC filming uncovered staff behaviour that an expert described as "torture". A Department of Health review subsequently concluded that:

> *"Opportunities to pick up poor quality of care were repeatedly missed by multiple agencies." (para 2.12)*

A BBC Wales investigation found a number of shortcomings from PE ownership: high costs; children being cared for further away from home; cheap food and products; lack of cleaning products or PPE; a failure to replace broken items, and allegations that "money is the priority and that caused harm to the children" and that "Children have [said] that they feel like they're being bought and sold on a market."

Separately, a Times newspaper investigation of CSC in 2021 reported that:

> *"Private providers have been criticised for playing local authorities off against one another and setting excessively high fees in a market with a chronic shortage of placements.[34]"*

If the CMA finds evidence that certain PE providers of CSC do offer lower prices or higher quality, we would urge scrutiny of the source of those cost savings.

3. Discussion

Many people see the private equity sector as a *source* of (often foreign) investment capital. This report tells a different story: these apparent investment inflows may be better understood simply as pump-priming down payments on significantly larger future *outflows* of capital, both from the CSC sector, and from the UK.[35] Essentially, because of its rent-

[32] For instance, see "*The quasi-market for adult residential care in the UK: Do for-profit, not-for-profit or public sector residential care and nursing homes provide better quality care*?" David N. Barron, Elizabeth West, Social Science & Medicine 179 (2017). They state "care homes and nursing homes that are operated by non-profit organizations and those that are run by local authorities are, on average, of higher quality than those operated by for-profit providers." See also *Quality of care in for-profit and not-for-profit nursing homes: systematic review and meta-analysis*, British Medical Journal, 2009; or *What Happens to a Nursing Home Chain When Private Equity Takes Over? A Longitudinal Case Study,* Aline Bos, Charlene Harrington, Journal of Health Care Organization, Provision and Financing, Nov 22, 2017.

[33] See *Does Private Equity Investment in Healthcare Benefit Patients? Evidence from Nursing Homes* Atul Gupta, Sabrina T. Howell, Constantine Yannelis & Abhinav Gupta, Working Paper 28474, Feb 2021.

[34] *Children in care: private equity swoops to exploit 'broken market'*, Billy Kenber, The Times, Jun 17, 2021.

[35] For a good general discussion of this "negative investment" problem, beyond private equity, see *"We're Just Speculating*

seeking nature, the private equity model is in our view often a source of long-term net *dis*investment, or 'negative investment.'

We support the CMA's prioritisation of this sector and of the needs of vulnerable consumers. If in other sectors the impact of private equity may be neutral or mildly harmful in many cases, in children's social care the tolerance level for risk is justifiably far lower as the end consumers in question are among the most vulnerable in society. Moreover, unlike in many other sectors (such as capital-intensive high technology companies) where private equity is also active, the primary value added in children's social care is provided by staff and especially frontline carers, rather than from management or technological expertise or economies of scale, so any potential risks to carers' wellbeing from these debt-focused strategies (and others) will disproportionately impact performance, dynamism and value-added compared to in those other sectors.

3.1 Cash-rich, debt-heavy

Firms using the private equity model, despite their often loss-making (on profits before tax) operations, also tend to have access to significant cash, principally because of their superior ability to borrow, from capital markets and from related parties.

This financial flexibility allows firms using the private equity model to mask the immediate impact of potential long-term problems (such as low interest cover, high gearing, or negative net tangible assets) since they are able to cover interest payments.

3.2 Price, quality or even profit are not the best metric

This flexibility also means that price or quality are unlikely to be the most relevant indicators for studying private equity: if they plan wisely, they will be able to marshal the resources to ensure they are not outliers in terms of quality of service, or price, in order not to attract the attention of the CQC or anyone else who may take an interest.

Section 3.1 above also shows that that *profit*, as shown in the profit and loss account, is not necessary a good metric for assessing their performance either. Access to borrowing enables this number, and various others, to be manipulated.

The main trouble from the private equity model is likely to show up in other factors, especially a **loss of long-term resilience** (principally, due to high external debt), that may require careful investigation to discover, or which may materialise catastrophically in firm failure later on. Low prices and acceptable quality today will not compensate for future disruption to care and possible state bailouts later[36].

Here… The Rise of Wall Street and the Fall of American Investment," Oren Cass, American Compass, March 25, 2021.

[36] For instance, the collapse of ABC Learning, a nursery provider working in Australia, the UK and elsewhere, led to major bailouts. ABC Learning had used many private equity techniques including extensive use of debt and was also highly acquisitive.

The (di)stress point may come when PE owners cannot find buyers and achieve 'exit,' as with Southern Cross and Four Seasons healthcare as described above. While this would be distressing for investors, which may not be the CMA's primary concern here, it would also likely involve disruption likely to harm outcomes for vulnerable children.

What is more, when the distress point comes, it may be after a long period (lengthened by good access to debt markets) in which acquisitions have built the company into a large or major player. Distress and/or bankruptcy will likely then have larger, more systemic effects.

3.3 Storing up trouble

Higher levels of debt (leverage) and heightened acquisitiveness (scaling up) lead PE portfolio companies to focus on a 'growth' story to justify a higher 'exit' price.

However, growth in this sector is hard to achieve through operational improvements and economies of scale: the cost model of social care varies little between businesses since a large proportion of costs are staffing, property, and consumables/supplies, which cannot be lowered greatly without affecting quality, while a large majority of revenues are from state payors, whose rates fluctuate little.

A rapid-growth mindset, plus leverage and interest costs, will exert downward pressure on costs (to increase profits and cashflow available for debt service).

Below the surface, high and mounting debts are storing up trouble for the future, both for CSC and for the wider economy. While we have not yet seen overt signs of wide financial distress in the CSC market, we have seen it in related markets such as adult social care.

Research in the US has found that being acquired by a private equity company makes a firm *ten times* more likely to go bankrupt,[37] and we certainly do find several worrying financial indicators in UK CSC, as indicated above.

It seems that the "exit" market – where other firms, usually PE firms, buy out existing owners, may still be functioning in CSC, unlike in other seemingly more mature markets where firms have sometimes struggled to find a secondary buyout partner to 'exit' to. However, it should be noted that the short-term outlook of an ownership cycle typically between 3-5 years, would be problematic for business investment, and discourage for example the construction of new buildings to contribute to supply. (We did not survey supply issues).

Dangers from high debt levels may include:

[37] Alicia McElhaney, "LBOs Make (More) Companies Go Bankrupt, Research Shows," Institutional Investor, July 26, 2019, and *Leveraged Buyouts and Financial Distress*, Brian Ayash, Mahdi Rastad, July 2019. A UK-related example would be Greybull Capital, which has profited from a string of business bankruptcies: British Steel, Comet, Rileys, Monarch Airlines, M Local Convenience Stores. Greybull typically bought (or helped buy) struggling businesses then used secured loans to extract maximum value at bankruptcy.

- higher risks to the stability of the care homes. In the worst case scenario, the company is at risk of bankruptcy and closure, as has happened elsewhere in the UK care sectors, as outlined below. This poses dangers to the security of supply, and for a large company may pose wider financial stability risks too.
- Reduced benefits and conditions for staff, thus potentially harming the quality of care, and reducing the supply of available good staff.
- Worse outcomes for cared-for children, the ultimate consumers.
- Pressure to increase prices paid by local authorities.
- A disconnect between a) prices paid by public authorities for children's social care, and b) supply of care, as increased prices may feed into higher borrowing (made possible by higher projected future revenues due to higher prices paid) and consequently higher debt service payments, rather than feeding into frontline services. This would disrupt competitive price signals and tend to reduce supply.

The key overall risk from the private equity model is that it is likely to reduce supply, and sap long term economic resilience with possible system-wide economic effects.

3.4. Distorting the markets for social care companies

There are several market distortions identified.

1. Private equity's superior ability and eagerness to access and use debt, plus its use of tax minimisation and other techniques to extract outsized profits for shareholders, leads to a situation where PE can generally pay higher multiples of earnings for care companies than traditional investors can, often because of factors (higher debt, and other extractive techniques) that are socially harmful in the long run. (This market distortion in favour of PE is an economy-wide phenomenon, and the distortion has been widened by quantitative easing and rising liquidity in markets.[38]) In addition, the separation of risk-taking from reward, the "OPM" principle outlined above, encourages extreme acquisitiveness, as per the "coin flip" mentality outlined in the Introduction. So PE has a financially-enhanced *incentive* to buy up companies in the sector, plus a financially-enhanced *competitive advantage* in the acquisition market. This suggests a likely spread of PE in this sector, unless unchecked.

- In this situation, other non-PE players would have the incentive to adopt PE techniques to compete with PE over acquisition targets. This 'competitive contagion' has seen widespread adoption of PE techniques (such as borrowing to pay dividends) in other markets. Our original submission suggests that these techniques are mostly found in the PE sector in CSC, though the past may not be a good guide to the future.

- There is a major balance of power asymmetry between private equity owners (the "General Partners" or GPs) and their co-investors (the "Limited Partners" or LPs) who

[38] See, for instance, *Private equity and the raid on corporate Britain*, Kaye Wiggins, Harriet Agnew and Daniel Thomas, *Financial Times,* Jul 12, 2021, focusing on PE's "rampant" acquisitions of listed companies. It notes: "Sir John Kay, one of the UK's leading economists, says "market distortions set up by quantitative easing" have contributed to a long-term shift from public equity to private equity."

provide most of the capital. The best indicator of this balance of power is the fees that private equity owners extract from these structures at the expense of co-investors. A number of studies have found that returns to LPs have not outperformed stock markets for at least 15 years, and that fees typically amount to a staggering seven percent of money invested, annually, amid "multiple layers of agency conflict in the asset management industry."[39]

3.5 Tax

Whether or not the CMA considers tax in its purview, it merits discussion because it impacts competitive dynamics[40]. This is part of a broader discussion because tax creates many harmful market distortions.

Private equity firms focus heavily on tax 'optimisation.' One could argue that this is not an issue because a) tax saved by the care company could be transferred to social care instead, with no net loss; and b) tax is an issue for HMRC, not the CMA.

We would push back on both arguments, because a) the low interest cover and other indicators of financial soundness suggest that additional cashflows obtained from tax optimisation and other strategies outlined above are typically being swallowed up by debt repayments, rather than invested for growth; and b) as mentioned, tax optimisation is a contributor to the distortion in the market for CSC companies, which we argue could and should be a matter for the CMA.

3.6. Regional issues and government policy

These financial techniques described so far tend to have asymmetric geographical effects. Flows of wealth obtained through such techniques will tend to accrue to GPs and shareholders in and around wealthier parts of the country, especially in and around London, or overseas and offshore. By contrast, any losses due to ‘extraction’ that are ultimately borne by carers and cared-for children (and other stakeholders), by contrast, will tend to be distributed more broadly across the UK. (Some of these potential losses may not have crystallised yet, and are instead stored up for the future if debt becomes unsupportable.)

The net result will be a) the transfer of wealth from poorer to richer areas, posing a problem of upwards geographical redistribution within the UK, from poorer to richer areas, thus threatening the government's "Leveling up" agenda; and b) an outwards transfer of wealth outside the UK to non-resident owners/investors, posing a potential leakage of national income.

[39] See for instance, *Private equity fees have become a rentier’s bonanza*, Jonathan Ford, Financial Times, Aug 30, 2020; or *An Inconvenient Fact: Private Equity Returns & The Billionaire Factory,* Ludovic Phalippou, University of Oxford, Said Business School, June 2020, p25; or Value for money? Private equity in the UK restaurant industry, 2006-14, Peter Morris, SSRN, July 2016.

[40] For example, see *Small Businesses versus the Platforms*, The Counterbalance, March 29, 2021.

4. FAQ and common questions

In response to our original submission, we received questions from different parties, who asked to remain anonymous. This next section responds to some of the main queries.

4.1 Why do bankers lend to these risky companies?

It might seem odd that banks lend cash to portfolio companies, only to have the private equity owners take the proceeds of that cash for themselves, rather than investing for productivity and a sustainable future, leaving highly indebted companies prone to bankruptcy and a possible need to write down loans. Yet private equity firms seem to be able to find a steady stream of lenders, for several reasons:

First, The world is awash in 'liquidity' or put crudely a global 'wall of money' looking for investment opportunities. Amid a long decline in interest rates, private equity-generated debt typically pays relatively high returns, so there has been even a rising appetite to lend. For example, a *Financial Times* analysis in 2020 quoted a private equity official as describing how far the balance of power had tipped in the relationship between PE and lenders:

> *"There used to be a sense that private equity firms needed to take care of the lenders that funded their LBOs," . . . "Now, they don't seem to care at all and they have no qualms about burning their lenders really badly."*[41]

In another *Financial Times* article entitled *Desperate hunt for yield forces investors to take 'extreme risk',* a banker was quoted as saying that "yield-chasing behaviour has become much more pronounced . . . you are forced to go down in quality and take extreme risk."

Second, private equity firms tend to be experts in tailoring their corporate structures to provide a range of lending 'niches' to maximise the profitable opportunities for lenders, and thus maximise lending. Thus a complex corporate structures may for instance offer lending opportunities at the level of the whole firm; at the level of a particular geographical segment; or at the level of a particular holding company, each with its own mix of risk and reward.

Third, private equity loans are often fed into securitisation processes, reflecting fundamental historical changes to banking that preceded and contributed greatly to the global financial crisis.

Under a traditional banking model, a bank makes a loan, and carries the risk of default on its balance sheet. With securitisation, by contrast, a bank makes a loan (e.g. to a PE-owned portfolio company) then parcels that loan up with many others into new packages such as

[41] *Neiman Marcus: how a creditor's crusade against private equity power went wrong,* Sujeet Indap and Mark Vandevelde, Financial Times, Oct 4, 2020. See also Desperate hunt for yield forces investors to take 'extreme risk,' ft.com, Colby Smith, July 27, 2020, which cites a top Citigroup official saying (amid the pandemic) that "Yield-chasing behaviour has become much more pronounced" and "you are forced to go down in quality and take extreme risk."

Collateralised Loan Obligations (CLOs,[42]) and the risk is sold to other investors, for a profit. This process shifts the loan risk off the bank's balance sheet onto other investors. Once the risk leaves the bank's balance sheet, then it can lend again, extracting further fees, theoretically continuing indefinitely. The incentive, then, is to maximise the 'flow' of such deals to maximise fees, which helps explain the pressure to lend.

Ahead of the financial crisis, the driving narrative of securitisation was that it was a beneficial process shifting risk onto the shoulders of those best able to bear it; reality revealed that securitisation shifted risks to those least able to understand it. Although CLOs that fund many PE deals are not the free-for-all of the kinds of Collateralised Debt Obligations (CDOs) that became famous in the crisis, the most essential problem with them - that they let banks shift risk off their balance sheet and thus gives them an incentive to maximise lending despite risks - remains intact.

Fourth, individuals bankers face these same incentives to lend, while they face little personal risk from failure. These factors are further examples of the OPM principle outlined in the Introduction above.

Overall, lending is not unlimited: the effective limit tends to be set by external financiers in the covenants of the financing contracts.

4.2 Why do PE's indebted, loss-making firms not go bankrupt?

We have provided evidence (Table A, above) that private equity firms in the sector on average have large negative net tangible assets (in contrast to non-PE firms, which are strongly positive on average), and PE firms also tend to be lossmaking after interest costs, depreciation and so on are accounted for. Frequently, auditors would raise red flags in such situations that a highly indebted and loss-making company may not be considered a "going concern" (i.e. that it is effectively insolvent.) Yet we have not seen waves of bankruptcies in PE-owned CSC companies. The key reason for this is that 'related parties' extend explicit guarantees to the companies to lend as necessary to cover costs. This guarantee allows them to continue as a "Going Concern."

Box: Priory Group as a "Going Concern"

For example, the latest accounts for Priory Group UK 1 Ltd. state, under the headline "Going Concern", (p7) that it made a £66m loss in 2019 "and is forecast to make a further loss," while adding that the group had £1.16bn in debt to Acadia Healthcare , and under "severe but plausible downside scenarios" cash flows may be insufficient to meet interest payments. However, it is able to continue as a going concern because:

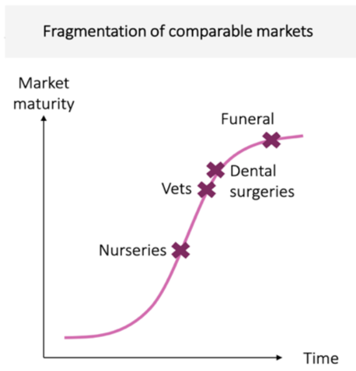
> *The Group has received confirmation that Acadia Healthcare will provide financial support to the extent that monies are not otherwise available to meet liabilities."*

Another reason why the lack of CSC industry bankruptcies is no grounds for complacency is because it seems likely that the market for CSC is simply less saturated by

[42] See, for instance, *Hail the new private debt machine: private equity,leveraged loans, and collateralised loan obligations*, Vincenzo Bavoso, Law and Financial Markets Review, 2020, Vol. 14 No. 3.

private equity techniques than is the adult social care market, which has seen several major bankruptcies and disruptions. The past is certainly not a reliable guide to the future in this market: as the CSC market matures and becomes more saturated and concentrated, bankruptcies - and big bankruptcies - seem more likely over time.

This image, from a [2020 report on the UK childcare market by Cairneagle/LaingBuisson](), shows that such sectors can get more concentrated over time, with (in this case) nurseries still a relatively fragmented market while funeral parlours are more heavily concentrated. (We have not researched this particular aspect o f the children's social care market: the terms of this inquiry say that several mergers of larger firms have happened in recent years, but the "basic industry structure has remained.")



4.3 Does it matter if lenders lose their shirts?

If lenders lend to risky firms, which subsequently go bankrupt, that may be viewed as normal 'creative destruction' with bankers simply needing to exercise more prudence. Yet we argue it would be a mistake to ignore these issues, for a couple of reasons.

First, private equity is increasingly becoming a systemic actor across the entire economy, and through market distortions explained above will become steadily more dominant if unchecked. The PE model generates moral hazard, where the prospect of taxpayers stepping in to pick up the pieces in the event of bankruptcy enourages recklessness and risk-taking, as happened ahead of the global financial crisis of 2008. Bailouts could be imagined of both children's home companies, and also of banks if wider systemic issues should emerge.

Second, collapses and bankruptcies can be rapid and disruptive, with overseers such as the Care Quality Commission possibly far behind the curve, and unable or unwilling to step in until it is far too late. Children, carers and local authorities are likely to experience major disruption. In addition, if a company looks like it is headed towards a collapse, owners are likely to seek to extract maximum value from a company ahead of bankruptcy, which may be felt as pressures on the care system, for some time ahead of collapse.

4.4 Won't robust intervention curb investment and competitiveness?

This report makes a clear case that investment in the sector via a PE model often ends up, when the long view is taken, as 'negative investment,' since the model is extractive. For example, a £10 million shareholder loan to a portfolio company at 15% annually, with all the proceeds channelled to owners, would mean that after five years the underlying company owes some £20 million, which if realised on 'exit' is likely to have been mostly obtained through 'sweating the asset' or market power rather than genuine operational improvements, for reasons given above. This implies that the £10 million is not an inward investment, but more like a tool to extract larger sums over time, or 'negative investment.'.

Robust intervention to curb the PE model, therefore, will not only secure a healthier children's social care sector, but will also *increase* long-term net investment levels, by eliminating the costly 'negative investment'. However one defines 'national competitiveness,' this would be a benefit.[43]

5. Recommendations

In this section we do not presume to understand the limits of the CMA's remit in terms of addressing the issues. For example, the tax issues that we've identified clearly distort markets, and may warrant action by the CMA – but the CMA may take the view that this is HMRC's area. We will make the recommendations in any case.

We also take no view on the relative merits of state provision versus private provision. This report instead focuses on private equity, a subset of private provision, and concludes that the private equity model is incompatible with a healthy system of children's social care.

Overall, a crude but powerful option for addressing issues identified in these reports would be an immediate and outright ban on private equity firms buying any more children's social care companies. We would support this option, which would eliminate a lot of the trouble at a stroke. This should be complemented by other, stronger options, including full or partial divestment by PE firms in this sector.

Yet even this would not go far enough, as other non-PE firms already use some PE techniques. In general, if firms using PE techniques continue to operate in the sector, most useful approaches would combine i) transparency with ii) appropriate action to re-align risks with rewards; and iii) use international best practice for road-tested solutions.

5.1 Assessment criteria and transparency

- A key performance indicator for private equity should be **long term economic and financial resilience***,* more than price or quality (or even headline rates of profit). Resilience may be harder to measure and more uncertain and subjective than price or quality, but no less important for that. This would monitor and track on a historical and ongoing basis: i) overall debt levels; ii) net assets; iii) net tangible assets; iv) years to repay external debt and all debt; v) interest cover; vi) gearing; vii) EBITDA ratios (Section 2.7), indicating how much is being taken out as profit; viii) levels of capital expenditure over time; ix) changes in depreciation or amortisation over time[44];

[43] For a discussion of the links between 'national competitiveness,' competition policy, and market competition, see the Balanced Economy Project's newsletter on this: *Where tax havens meet monopoly power . . . and why national competitiveness reduces competition,* The Counterbalance, Aug 9, 2021.
[44] Decreasing levels of depreciation (as a proportion of revenues), given a stable or increasing activity, indicates that buildings or machines are being left to age without adequate replacement.

x) possibly other innovative ratios, such as the overall ratio of staff costs to non-staff costs, or the ratio of interest costs to non-staff costs, which might indicate potential for 'leakages.'[45]

- Require information about and examine the **track record** of acquiring companies to check for historical rent-seeking behaviour. Specifically:

    - Provide the five latest audited annual reports at the investment entity level, including the reports before the entry into the capital of the PE firm. It is important to ask for information on all acquisitions, rather than merely a selection, or companies will 'cherry pick' the most flattering ones.

    - Obtain financial information on all acquisitions older than 3-4 years still in the portfolio of the PE firm (because with older firms, they will have had time to put asset-stripping structures in place). Obtain this at the level of the whole PE firm, rather than just the relevant PE fund.

- The acquiring firm should put in place a contingent liquidity facility with a duration that goes beyond the maturity of any shareholder loan arrangement and beyond the maturity of the largest part of the external debt. Escrow accounts should be used routinely to ensure there is sufficient investment in capital expenditure (this tool has been used successfully elsewhere)[46].

- Examine firms' "exit" plans. (For example, in the recent sale of CSC owner Priory Group to the Dutch PE firm, Waterland.) What is their expected investment holding period, and what is their strategy if they cannot find a suitable buyer in time? How sensitive are different companies' liquidity metrics to: i) a rise in interest rates; ii) a freeze on price rises (by purchasers); iii) lower placements (or lower growth rate of placements); iv) a rise in wage rates, for example minimum wage changes.[47]

- PE firms are well-resourced and highly skilled in all aspects of their businesses. Given the steady and recently rapid rise in prominence of PE in the UK economy, especially during the pandemic, the CMA should have and maintain, or build up, the in-house expertise in order to be able to monitor and negotiate with large, complex firms (including any PE firms) in the sector, to track their activities over time, to object robustly to harmful acquisitions or abusive behaviour, and to force appropriate remedies to fix market distortions. Co-ordination with HMRC and others would bring benefits. This expertise would pay dividends across a range of sectors across the

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[45] For an analysis of 'leakages' with reference to staff cost ratios, see "Plugging the Leaks in the UK Care Home Industry," Vivek Kotecha, Centre for Health and the Public Interest, Nov 7, 2019.
[46] For example, in a case involving Tata Steel and ThyssenKrupp, the European Commission text in June 2019 stated: "the Parties committed to an escrow account for the purchaser to drawdown in order to fund capacity expansions, the addition of a R&D facility, and further enhancements to the Packaging Steel Business." (Summary of Commission Decision of 11 June 2019 declaring a concentration incompatible with the internal market and the functioning of the EEA Agreement (Case M.8713 – Tata Steel/ThyssenKrupp/JV,) Official Journal of the European Union, 22 Jan 2021.)
[47] These may be useful to understand the underlying businesses better, but it should also be noted that 'stress-testing' future scenarios can be gamed as financial analysts can prepare rosy scenarios which are not binding.

economy where PE firms are active.

- The CMA should specifically explore and assess the extent to which investors and owners are **shielded from accountability and responsibility** for risk-taking. This necessitates investigations of the corporate structures in which CSC companies are embedded, and investigating issues such as limited liability shields and other mechanisms which allow rewards to flow upwards but accountability and risk-taking to flow downwards, and the extent to which owners genuinely have ‘skin in the game,’ commensurate with rewards or potential rewards. Scepticism of large windfalls for PE owners is justified, as is scepticism of the justifications for those windfalls as being the results of ‘skill’ or superior management. The majority of returns are typically obtained from i) falling interest rates; ii) “multiple arbitrage” due to acquisitions, potentially partly obtained via market power; iii) increased leverage/debt; iv) other extractive techniques, as outlined above. "Skill” can be a factor, but it is not clear why non-PE firms would not also generally deliver it.[48]

- The CMA should conduct regular market-wide investigations of the acquisitions market, and specifically monitor i) heightened acquisitiveness due to skewed incentives; ii) superior access to finance enabling higher bids distorting markets; and ii) ‘competitive contagion’ as other firms feel pressured to match the extractive techniques of PE to “stay in the bidding.”

- The CSC sector is characterised by a large number of small players and a few large ones including those examined in our report. The Care Quality Commission introduced a “Market Oversight” scheme for adult social care in 2015, whereby “difficult-to-replace” providers above a certain size are subject to enhanced monitoring of financial structures. The CMA should consider a similar approach.

- Greater public **transparency** is essential for assessment, with data published openly wherever appropriate or obtained internally by the CMA, as the basis for further investigation. Published UK data is often of reasonably high quality and comprehensiveness as regards the portfolio companies and lower levels of the corporate structures, but often more opaque at the higher levels, especially when owners are located in tax havens like the Cayman Islands with strong secrecy laws. One danger is, as one analyst put it:

  “Because private-equity ventures don’t have to reveal ultimate ownership, potential conflicts of interest can be obscured. For example, two companies in the same sector both owned by private equity could have the same ultimate owner and be quietly colluding without the competition authorities realising.”[49]

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[48] From discussions with private equity experts over several years. As one insider told us: “Gross returns are 1/3 from the stock market, 1/3 from high debt, and 1/3 from all sorts of things, including multiple arbitrage, interest rates going down, running those firms more efficiently – and the largest single factor in that last 1/3 is called luck.”

[49] *Record numbers of UK firms are being swallowed by private equity – should we be worried?* Robert Read, The Conversation, Aug 9, 2021.

In particular, full beneficial ownership information for all firms operating in this sector should be made public.[50] Necessary transparency requirements should not be in the form of guidelines or codes of conduct, but as pre-conditions for continued investment.

5.2 Interventions, curbs, remedies and actions

Transparency and better oversight is only a partial answer. For example, the above-mentioned CQC Market Oversight scheme contains major weaknesses, which are hard to surmount.[51] Interventions beyond transparency are needed to curb elements of the PE model, and might include, for instance:

- Stronger and simpler medicine, which we support, would include a recognition that some firms are 'too complicated to regulate' and in the CSC sector (and possibly others) should not be allowed to grow above a certain size, where their failure could pose critical or even catastrophic social damage.

- Make private equity owners, not the underlying companies, responsible for those companies' debts.

- Ban the use of shareholder loans and high-interest preference shares in this sector, whose core purposes in our view are not socially useful, and insist that owners enter the capital structure only via normal equity.

- Set maximum or minimum levels of interest cover, gearing, and consider innovative other ratios, such as a minimum overall ratio of staff costs to sales.

- Disallow aspects of "secured loans" that place related parties ahead of other creditors (staff, taxpayers, suppliers, HMRC[52] or other stakeholders) in the event of bankruptcy or distress. Raise frontline staff to or near the top of any creditor hierarchy.

- Disallow the deduction of all interest payments for tax purposes in the CSC sector. (This may be applicable in other sectors.)

- Public ownership may of course be a worthy option, where a firm is in distress and there is no suitable buyer (subject to above conditions) willing to acquire it.

If a more comprehensive list of recommendations were required, a useful starting point could

[50] Investigators have discovered that (for example) the Chinese government owns some adult care homes.
[51] In our experience, for example, staff in similar schemes often have a 'tick-box' rather than a true investigative mentality; smart ones are quickly poached by PE firms; in addition regulators avoid flagging risks because they fear this could create a self-fulfilling prophecy, leading to a loss of confidence in an already fragile company, which then collapses with regulators getting blamed.
[52] Under a recently-introduced "Crown Preference", new legislation places HMRC's claims higher up the creditor hierarchy than before. See *Reintroduction of UK Crown Preference from 1 December 2020*, DLA Piper, Nov 24, 2020.

be Elizabeth Warren's "Stop Wall Street Looting Act"[53] in the U.S. which explicitly targets the private equity business model. Many of her US-focused recommendations would be appropriate in a U.K. context.

5.3 International best practice

It is known that in some countries, such as Germany, some private equity techniques outlined here are not possible because of laws and rules in place. This is beyond the scope of this report, but some intelligence-gathering of this could be fairly straightforward, and would pay dividends.

ANNEXES

Annex 1: Opco-Propco structures

In an Opco-Propco structure, a PE firms typically buys a company rich in real estate, separates it into an operating company (OpCo) and a Property company (PropCo,) then ensures that OpCo signs a lease with Propco. This is a way to unlock additional borrowing, which may be deployed as with the 'special dividend' described above. A hypothetical example illustrates the principle.

1. A private equity firm buys a care home company, then splits it into two parts: an operating company (OpCo) that runs the main business, employs staff etc.; and a property company (PropCo) that owns the real estate.

2. In essence, OpCo sells the real estate to Propco for cash, whether internally (ie as a sale to a related party inside the same overall corporate structure) or externally (where PropCo is sold off to an external investor.)

3. OpCo and PropCo signed agreements where OpCo must now pay rent to PropCo for the lease of the real estate: that rental income will either give lenders confidence that PropCo can service its borrowing, or it will give an external buyer confidence in a high valuation for PropCo. The rental agreement may be made more favourable to PropCo, inflated artificially above market rates, with rents also rising above the rate of inflation. PropCo may therefore be able to borrow more, on the basis of the (inflated) future expected rental income (or it will receive a higher cash value at an external sale). Private equity firms specialise in dressing up PropCo for maximum attractiveness in debt markets.

4. The proceeds of the borrowing (or the cash from the external sale) can be used to pay a special dividend (see above) to the PE fund and thus to the GPs, or to invest productively in the business. The former is the more problematic scenario: often it is a mix of both.

5. The GPs will, as before, use the corporate structure to ensure that they are not personally on the

[53] For an explainer of the Bill and its reasoning, see *End Wall Street's Stranglehold On Our Economy,* Elizabeth Warren, Jul 18, 2019. See the Bill itself here

hook either for PropCo's debts, or for the (potentially) inflated rental payments that OpCo must make: if OpCo goes bankrupt under the weight of rental payments then its stakeholders, not the GPs, will bear the brunt.

In both the examples so far, the rewards to the GPs have been asymmetrical: if their investment turns out badly, then even if they make little money they will not lose money, but other counterparties might. If the investment turns out well, they can make very large returns on their investment.

Again, this should concern the CMA. In the Invitation to Comment it is stated (p13) the prices are high in children's homes, but less so: it might be worth investigating further the children's home sector – which contains significant real estate assets – to judge the extent of use of Opco-Propco structures.

Example: The case of Southern Cross

Although Southern Cross was not providing children's social care, it was a major care home operator, creating important parallels, which illustrate some of the techniques described above. Set up in 1996 by John Moreton, a North Sea gas entrepreneur, the company made numerous and rapid acquisitions, and by 2002 it owned 140 care homes. It was then sold for £80 million to venture capital fund WestLB, acquired more properties and was sold again in 2004 to private equity firm Blackstone, which pledged to turn it into "the leading company in the elderly care market". After multiple further acquisitions funded by heavy borrowing, it was floated on the stock market in 2006, promising in its IPO documents a "sale and leaseback" strategy (the Opco-Propco model.)

When the global financial crisis hit, Southern Cross' strategy put it in a poor position to weather the storm of ensuing austerity and declining revenues, as its Opco-Propco strategy meant it was locked into 30-year leases with rent rising at a fixed 2.5 per cent each year at a time when councils were freezing or reducing their fees, and as cutbacks in quality investments led to falling occupancy rates. Southern Cross collapsed in 2011.[54]

According to media reports, Blackstone had quadrupled its investment in just three years. However, the outcome was clearly undesirable for elderly patients. Our forensic analysis below suggests there may be grounds for concern about similar possibilities in the market for children's social care.

Annex 2: G Square and Graphite Capital Partners, to illustrate wide portfolio focus

This inquiry lists Keys Group as the second largest provider of independent children's homes in the UK, with 118 sites, owned by the private equity firm G Square. The firm's website contains several things of note. First, although G Square which sets overall strategy could claim to be sector-specific, since it focuses on the health sector, its portfolio companies in fact have a wide scope, including telemedicine in Israel, pharmacies and nursing homes in France, surgical equipment, orthodontics, dentistry in the Netherlands, healthcare and care services in Norway and Finland, homecare services in Spain, and an eye clinic in Germany.

It is not clear, beyond financial and 'portfolio' techniques, how great the overlap in competencies

[54] This corporate collapse has been widely reported. See, for instance, *Southern Cross run on failed business model*, Sarah O'Connor, Financial Times, May 30, 2011, or The rise and fall of Southern Cross, Graeme Wearden, The Guardian, Jun 1, 2011.

or economies of scale would be between these and Keys Group, providing care services for children in the UK.

Furthermore, its website outlines a heavily financial strategy: *"G Square invests in mid-market entrepreneurial healthcare companies seeking funds to boost their development through organic growth, international expansion, or the acquisition of products or other companies. . . G Square works on the principle of buy-and-build medical investment strategies . . . helping companies to secure and negotiate proper financing from debt providers. . . G Square can also underwrite and syndicate larger transactions by inviting its limited partners to co-invest.*[1]

The language alone is suggestive of the financial focus. Furthermore, "Buy and Build" has been described by a practitioner as:

"where a PE house invests in a well-positioned platform company and looks to add value to that company through carefully executed additional acquisitions, such that the final value is greater than that of the individual parts."[1]

Buy and build can be a consolidation play, with the potential for building up market power. This in itself should concern the CMA (as noted below, the CMA would need to adopt a robust approach to merger control and in other areas to tackle these risks and others noted below.)

Another company this inquiry mentions is **Graphite Capital Partners,** which owns Horizon Care & Education. The Graphite website shows a far more diverse range of sectors that range far beyond health & care, including recruitment, communications, heating systems, restaurants, diving gases & cylinders, electronic games, cleaning services, footwear, and more. Our aim here is merely to illustrate a tendency among PE firms to have a wide portfolio focus, and a strongly financial focus, nothing more.

Annex 3: Special Dividend or "Dividend Recapitalisation"

A dividend recapitalisation happens when the private equity GPs buy a company, force that company to borrow money, pay themselves a "special dividend" out of that borrowed money, but ensure that the underlying company is on the hook for paying back the debt with interest. Dividend recaps are fairly common in the private equity sector[55].

A hypothetical, somewhat extreme and simplified example illustrates how this technique works.

A private equity firm deploys $10 million of fund capital (mostly provided by the LPs) to buy (for example) a sportswear company, SportsCo. Next, they tell SportsCo to borrow $10 million, then pay the full proceeds to the GPs' fund, in a "dividend recapitalisation" or "special dividend." In effect, the fund has spent $10 million to buy SportsCo but received $10 million straight back from the borrowings, so they effectively acquired SportsCo "for free".[56] Any further profits are 'free icing on

[55] For example, the well known private equity official Steve Schwarzman said in 2015 that this "dividend recap" trick was an alternative to selling a company for a profit. He said: "You just sell them if the sale market is good, and if not, you recap them and you make money that way. . . . we just sort of go with the flow.'' See *Private Equity Wins Even When It Loses, Thanks to Debt Markets*, Nabila Ahmed, Sridhar Natarajan, Bloomberg, March 20, 2017. This article contains several examples of dividend recaps.

[56] Full and immediate 100%+ dividend recapitalisations (where the full amount borrowed is paid immediately back to the GPs/the fund) are rare. However, it is common for dividends to GPs over time to far exceed the profits generated from genuine and socially useful productivity improvements.

the free cake'.

Crucially, however, the corporate structure containing SportsCo effectively uses the shield of limited liability (and carefully tailored creditor hierarchies) to ensure that the GPs / the fund are not liable to pay back that $10 million debt plus interest: it is SportsCo and its stakeholders who are now on the hook.

If, in a **first scenario,** SportsCo can repay the loan through generating a large surge in underlying profits through genuine productive economic efficiencies, a successful brand advertising campaign, or beneficial changes in market trends, that may be a relatively benign scenario (though even here, SportsCo would have been a more dynamic company without the dividend recapitalisation).

However, in a **second scenario,** SportsCo cannot generate such a surge in efficiency, so it may have to reduce investment or squeeze its several stakeholders to find the money to service the debt. Those stakeholders may include some or all of:

- Staff and facilities
- Suppliers
- Consumers
- Tax authorities
- The debt providers (e.g. if SportsCo goes bankrupt.)
- Unemployment benefits, state care for former staff (e.g. if staff are laid off or SportsCo goes bankrupt.)

This latter scenario, where a surge of productivity cannot be attained, would be highly problematic for all concerned. However, now imagine that the underlying portfolio company is not selling sports apparel but instead provides children's social care: this is clearly far more problematic. It is also more likely to conform to this second (problematic) scenario, because revenue streams in this sector tend to be fairly stable and predictable, and because the main value-added is provided by caring staff (rather than, say, through brand advertising) -- so a company providing children's social care will find it harder to deliver the sudden surge in genuine underlying productivity to yield larger revenue streams to pay off the enlarged debt and interest obligations.