12 November 2021

# Children's social care market study
# Compass Community Limited's response to CMA's interim report

## Opening remarks

As a national provider of care, education and therapy, Compass Community Limited ("**Compass**") welcomes the opportunity to respond to the CMA's interim report dated 22 October 2021 (the "**Report**").[1]

As the Report has acknowledged, children's social care in the UK currently faces many challenges. As the Report recognises, the sector has been hit particularly hard by broader issues that are being felt across the economy, including in relation to labour supply and availability of housing and local authority funding. Covid-19 has compounded these issues, affecting the sector in innumerable different ways: from a slowdown in new Ofsted registrations; to increased difficulties in recruiting staff and foster carers; to difficulties in making social worker visits to struggling families. Against this backdrop, the CMA has expressed concerns that there are insufficient placements of the right type and in the right places. And yet, from a private provider's perspective, too often the spare capacity that does exist in the system is not properly utilised, with fostering services running pockets of high levels of vacancies and some residential placements proving slow to fill.

As such, we welcome the many positive conclusions in the Report in relation to the private sector's contribution to tackling these challenges. As the Report recognises, the private sector provides an additional source of supply of children's homes which, based on Ofsted ratings (which are of critical importance to private providers' business), is of comparable quality to local authority provision.[2] It does so at prices which are typically not higher than the cost of providing placements in-house by local authorities ("**LAs**"). These findings on quality and price also do not take into account differences in the average age and level of needs of children (which, as the Report acknowledges, are usually higher for independent homes[3]), nor the differences in how the Ofsted inspection regime applies to the public and private sectors (with local authority fostering services assessed at local authority level, not, more rigorously at service level, which is the case for private provision).

As the Report recognises, the private sector is able to achieve this in part due to significantly lower operating costs and better overall efficiency than local authorities. The Report acknowledges that these conclusions apply equally to PE-owned private providers, who have also proved themselves to be operationally resilient in the face of Covid-19 and the other economy-wide challenges referenced above and who, as the CMA has acknowledged, have continued to invest.[4] These efficiencies have allowed the private sector to maintain profit margins, but these margins are entirely reasonable in light of the risks identified above and the need to invest in further capacity. Importantly, the CMA has not found any evidence of increasing profit margins – to the extent prices have risen, these rises have been driven by rising costs.[5]

Likewise, for fostering, while the Report has concluded that the average price per child that local authorities pay for independent provision from the largest providers is higher than the cost of their in-house provision, we recognise the CMA's acknowledgement that the level of needs of children in the independent sector are also generally higher. As explained further below, we would also reiterate that, in the fostering sector, local authorities also benefit from private firms' investments in recruiting and training foster carers, allowing them to operate at lower costs.

As such, we agree with the Report's conclusion that a full market investigation would be inappropriate. We also welcome the Report's conclusion that direct controls on the prices and profits of independent providers would not address the core issues faced by the sector (and indeed would, in our view, be counterproductive). As stressed in our response to the CMA's Invitation to Comment, while there appears to be, in some quarters, an ideological resistance to private sector involvement in children's social care in the UK, the simple reality is that children's needs are too diverse for either the state or the private sector to tackle on its own – as the Report acknowledges, these sectors currently can play

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[1] See here. For Appendices, see here.
[2] As the Report acknowledges at paragraph 3.55, it is simply not possible to compare Ofsted ratings in this way for fostering.
[3] e.g. see paragraph 29 of the Summary.
[4] See para 3.69.
[5] See para 3.28.

very different roles, and should be working together more collaboratively.[6] The proper solution to the current challenges identified in the sector is surely to incentivise more investment in high-quality, high-complexity provision of care, not less. We agree that at the heart of this is better procurement by local authorities, but this is not simply a question of aggregation of scale, but rather better planning and crucially, better rolling collaboration between local authorities and the full range of providers to ensure that the process of matching services to needs works well.

We wish to take this opportunity to comment on some of the CMA's proposed recommendations, as well as the analysis which underpins them, with a view to ensuring that any future changes in this sector properly target the changes needed to secure better outcomes for looked-after children.

**Profitability analysis**

As explained above, we welcome the Report's findings that private sector services are, on average, comparable in price and quality to public sector services. This is in the context of the disproportionate number of placements of children with complex needs allocated to independent providers which in turn – as acknowledged in the Report – are likely to result in higher costs.[7] This would imply (on an adjusted basis) that the private sector is in fact delivering better quality/value for money than LAs.

Profit is important to drive further investment in capacity, as evidenced by Compass' highly ambitious programme for opening new homes. It also reflects the risks which need to be borne by independent providers - most recently illustrated by the wide-ranging impacts of Covid-19 (which are still being felt and have lasted longer than expected), but also including the reputational risks of receiving low Ofsted ratings (which, as the Report acknowledges, can greatly impact on a private providers' business). However, the Report has found no evidence that providers are currently earning excessive levels of profits, nor that profits are persistent and rising. Indeed, according to the CMA’s own analysis, profit margins have remained stable over a number of years.

The Report does not appear to identify any harm to users in relation to prices, quality or profit levels in this market that are associated with high profits of private providers. Independent providers who price services at no more than the costs of public provision should not be penalised for being more efficient. Independent providers have driven innovation and increased capacity in the sector – something that the Report acknowledges and indeed suggests might be a source of best practice for the public sector.

Rather, the CMA has identified aspects of poor market functioning – especially regarding commissioning of services – leading to weakened incentives for effective private sector investment. On this basis, therefore, we would suggest that focusing on understanding and improving market functioning so that providers can more effectively meet the needs of LAs should be the CMA’s principal focus going forward. Investing more time and effort in refining its calculations of profitability are, in our view, unlikely to shed further light on the key issues at hand.

However, we note that, at Question 8 of the Report, the CMA specifically requests comments on the approach it has taken to its financial analysis. Therefore, notwithstanding our overall position above, we have made some comments on the CMA's profitability analysis in the Annex. In short, we consider that the CMA’s analysis to date does not indicate excessive profits on the part of private providers, therefore we see no case for progressing the analysis further. Notwithstanding this, we suggest some areas where the analysis could be refined to provide for a more robust estimate of profitability of the sector.

**Pricing/costs analysis**

Similarly, we consider that detailed comments in relation to the CMA's analysis of pricing and costs are unnecessary as, overall, the Report does not identify any pricing harms.

Nevertheless, because the CMA specifically requests comments on the approach it has taken to its financial analysis, we would like to make the following observations:

[6] See para 3.52.
[7] CMA (2021), Children’s social care market study, Interim report, para 3.60(a)

- The comparison of private provider prices and LA costs set out by the CMA in Appendix A does not capture differences in the services provided. If anything, the gap in apparent efficiency whereby independent providers' costs are around 26% lower than those of LAs in residential homes could be even wider when differences in provision are taken into account. Most notably, differences in the complexity or acuity of services and support required by the children have a significant impact on the costs of provision (for example due to the facilities and/or staff required to provide support). This means that the portfolio or composition of services provided has a material impact on provider costs and prices, such that aggregated analysis does not allow meaningful consideration of differences. We note that the CMA recognises this challenge and is planning to take it into account in further analysis.[8] We would expect any such further analysis to take account of both demand and supply-side factors which might affect prices, such as types of services provided, scale of services and cost factors (including building and staff costs).

- In our view, the Report's conclusion that the average price per child that LAs pay for independent fostering provision is higher than the cost of their in-house provision[9] is unlikely to properly take account of LA's overheads. It also does not take into account the fact that children placed with private foster carers typically have more complex needs. In any event, this comparison of pricing overlooks the fundamental issue that private providers spend significant amounts in recruiting and training carers which LAs also benefit from if these carers move to a different employer in the sector. This also goes some way to explaining the Report's conclusion at paragraph 3.33 that average profit margins are high for a business with relatively few capital assets – as mentioned in our ITC response, each successful applicant requires a significant upfront non-capex cost to be incurred before any revenue is generated and no guarantee of placements.

- At paragraph 3.25(a), the Report suggests that average weekly prices have steadily increased for children's homes from £2,977 in 2016 to £3,830 in 2020. However, these figures cannot be compared like-for-like as there are more children receiving additional therapy in 2020 than in 2016.

- At paragraph 3.54, the Report acknowledges that LAs attempt to fill their in-house provision first, using independent providers only where no suitable in-house place is available. Of course, this has an impact on independent providers' prices insofar as it increases volatility in the market and reduces supply. A more holistic approach by LAs would therefore be more productive.

**Financial leverage and resilience**

In our view, remedies designed to reduce the risk of an unexpected disorderly exit and mitigate its effects are unnecessary and would impose a disproportionate regulatory burden (and therefore further costs) on the sector.

The operational resilience of PE-owned independent providers of children's homes and foster care is self-evident. Despite the many challenges facing the industry (as referenced above), PE-owned firms have been able to offer services at lower cost and comparable prices and quality to non-PE-owned private firms and the public sector.

In terms of financial resilience, we note that the CMA has performed an initial assessment of total debt compared to fixed assets (alongside other key debt coverage ratios) and concluded that large providers are carrying more debt than can be secured by the underlying assets. As noted in the Annex, we would question whether this finding is indicative of asset values being under-estimated rather than debt levels being too high.

It is not clear whether the CMA's analysis of key debt coverage ratios is based on existing covenants for providers or market norms/benchmarks, from the CMA's own analysis. In order to establish what the 'sustainable' level of debt might be, the CMA could attempt to benchmark key metrics such as EBITDA/debt ratios against typical ratios for other relevant industries. Again, factors such as profit volatility will need to be taken into account, but at a high level this will give an indication of whether this

[8] See paragraph 83(c) of Appendix A.
[9] e.g. at paragraph 30 of the Summary.

industry is an outlier from that point of view. Analysis provided by Compass in its response to the CMA's first RFI, showing analysis of EBITDA/debt ratios conducted by S&P, indicates that a debt multiple of approximately 4-5 x EBITDA is in line with market norms.

Evidently, it is not in our interest to breach or be close to breaching covenants and ultimately becoming insolvent. We consider this commercial incentive sufficient to manage the risk of firms exiting – which we note has not been seen in the children's social care market.

In any event, in the hypothetical event of a PE-owned provider becoming insolvent, we believe the damage would be limited. The Report has already recognised that, in relation to foster care, foster carers can transfer to another agency relatively easily. In relation to children's homes, because these homes rarely make an operating loss, it is likely that they would remain an attractive proposition for another buyer in the event of collapse. Those which would be less attractive are generally underutilised anyway and, as such, the loss of capacity from these homes would be relatively small.

Artificial controls on financial leverage would merely deter investment in the sector, which as the CMA recognises is much needed – as capacity has to adapt and increase to meet rising demand.

If the CMA does intend to pursue potential recommendations on financial leverage and resilience further, we would request an opportunity to engage with the CMA on this to ensure any added regulatory burden is proportionate to the risk.

**Commissioning**

Overall, we are supportive of the CMA's proposed recommendations to revisit the way that commissioning works. As already explained in our response to the CMA's Invitation to Comment, we believe longer-term strategic commissioning should be encouraged, aligning incentives for LAs and providers to share relevant information. This would help independent providers to adjust and meet evolving local need as required. Commissioning should be collaborative, and should always be needs-led, rather than price-led, focused on ensuring the best outcomes for children by identifying and meeting their needs as soon as possible before further neurological harm can occur. This ultimately reduces total costs as earlier intervention avoids the more complex and costly interventions required with older children.

A needs-led approach would include reform to the LAs' current preference to place children in-house before looking to the private sector. As explained above, this approach ultimately leads to higher price volatility for private providers, but also does not put the needs of the child first. Instead, LAs should consider offering block contracts with volume and inflation protection in order to give private providers (who have a lower cost base than public sector provision) the certainty needed to properly price their services, predict future demand and formulate a care package which best suits the evolving needs of children. A needs-led approach might also mean certain children being placed outside of their home LA, such as to receive certain specialist services, requiring collaboration between different LAs.

We consider that a national framework for commissioning which assisted local/regional commissioning activity could help improve collaboration between providers and LAs, improve strategic planning and impose greater accountability on LAs. Such a framework should include:

- Independent oversight outside of local government to ensure that a needs-led approach to commissioning is followed at all times (as opposed to decisions taken in favour of in-house provision on ideological grounds).

- A systematic approach to benchmarking children's outcomes taking into account all of their needs over time.

- The use of technology to better track children's plans, measure outcomes and assess need on an individual child and LA basis.

- A means of dialogue between the referring teams and the provider to ensure that the child's voice is better heard during the process of finding placements.

- A unified inspection regime which applies equally to public and private settings, rather than the current status quo where different expectations apply to each.

- A social work training programme that ensures the workforce is fit for purpose.

We consider that any national framework would need to be implemented and managed locally, rather than nationally, as child social care services are fundamentally local in nature.

More generally, independent providers would also welcome any increase in transparency of LA commissioning. Further visibility on LAs' future demand would help private providers make more accurate pricing decisions and plan capacity growth.

However, we also consider that the unpredictability of demand, and the constantly changing balance of needs, means that an improved approach to commissioning will not be a panacea. For example, we have noticed a recent rise in demand for single placements due to the highly complex needs of individual children. Catering such placements is necessarily very expensive and inefficient as it requires a very high level of staffing for a low number of children. If this trend continues, the market could respond by increasing supply of very small homes – but this process would take time. Ultimately, creating the environment for effective and continual dialogue between providers and LAs to manage complex cases is key.

**Proposals to review existing regulations that apply in sector**

We welcome the CMA's potential recommendations to review existing regulations that apply to providers of social care placements. In particular, the challenges we face under existing regulations are:

- As summarised at para 4.64 – 4.70 of the Report, various aspects of the regulatory regime which disincentivise providers from taking on high complexity placements, especially in relation to Ofsted inspection ratings which do not adequately factor into consideration the challenge some children present.

- Slow change of use planning processes, which acts as a significant barrier to increasing capacity to meet demand.

- Rigid regulatory requirements which must be met by Registered Managers, which make recruitment for these roles challenging.

- Uncertainty over the timing of Ofsted approvals of new homes, which again can make it challenging to plan programmes of investment in further homes.

**Conclusion**

We understand that, in the coming weeks and months, the CMA will hold a series of workshops with stakeholders to test its emerging thinking and explore possible options. We welcome this approach, and request to be invited to participate.

## ANNEX
## Observations on the CMA's profitability analysis

The CMA has produced an initial estimate of the level of profitability in the sector based on a number of simplifications and assumptions. The estimate is based on a sample of 15 large providers (covering around a fifth of placements in children's homes and slightly over half of fostering placements) which may not be representative of the market as a whole.

The key assumptions are as follows[10]:

**Valuation of capital employed**

- The CMA has sought to estimate a current property value based on a sample of recently revalued properties in the sector. On this basis, it has applied a typical current asset value to revenue ratio of 1.92 (ie a revenue to asset ratio of 0.52). We agree with the CMA that it is the current replacement value of property that is relevant as this reflects the capital employed by providers operating in the sector at any given point. Providers need to earn a reasonable return on this capital in order to be incentivised to stay in the market.

- In its current analysis, the CMA has based its estimate on the value of properties with planning permission for use as a children's home. The CMA indicates that this approach may inflate valuations so that they include an element of capitalised excess profits. We disagree with this point for the following reasons: (1) there is no evidence that children's homes are excessively profitable and (2) providers must source properties with appropriate planning permission or apply for planning permission themselves, thus incurring significant time delays and risks. The need to acquire or obtain appropriate planning permission adds real costs on which a return needs to be earned, which a new entrant would need to incur. In our view, the approach that the CMA has adopted is broadly appropriate.

- That said, the CMA valuations are based on a limited set of properties which may or may not be representative of the market as a whole. Property valuations will likely fluctuate widely according to the local area. In view of this, if the CMA is minded to proceed with further profitability analysis, it should consider a range of property valuation metrics before deciding on whether the use of a point estimate is appropriate.

- Similarly, the CMA has included an estimated value of fixtures and fittings in the overall valuation of capital employed on a 'per child' basis at £13k, based on the data provided by the 15 largest providers. Compass' experience is that this number is materially higher.

- The CMA has not factored the value of any intangible assets into its calculation of capital employed. The presence of intangibles may in part explain why the CMA has found debt: tangible asset ratios to be relatively high. As set out in our response to the CMA's initial request for information on 21 April 2021, we consider that providers are likely to have intangible assets in the following forms: i) customer relationships with the LAs, which requires a targeted business development team; ii) a skilled work-force, which requires ongoing investment in quality staff and training; iii) brand value – both in the Compass brand and the home level brand, which requires investment in regulation and compliance, marketing etc.; and iv) within fostering, the asset value of the foster carers, which require material upfront investment and remain with Compass for 5-6 years on average.

- Both these categories of 'internally generated intangibles' represent expenditure that would have been expensed through the P&L but on which a provider would expect to earn future returns (and which a new entrant would need to incur upfront). As such, the asset base including these intangibles might be considerably higher than that estimated by the CMA.

- The presence of such intangibles could also help to explain the apparent contradiction that the CMA has highlighted – namely that despite the apparently high profit margins, new entry and expansion has been limited. One explanation for this could be that the level of investment

[10] Source: CMA (2020), Appendix S: Profitability of funeral directors; Competition Commission, Aggregates, cement & ready-mix concrete final report, Appendix 4.1, Framework for the profitability assessment, para 58.

required – including in property, plant and intangibles, is high in relation to the expected returns.

- As discussed below, the CMA finds that borrowings exceed asset values by some margin. An alternative but plausible conclusion is that the CMA has significantly underestimated asset values.

**EBITDARM**

- The CMA has calculated profitability based on EBITDARM. In our view this is generally appropriate, other than in respect of the omission of the depreciation & amortisation on 'non-property' assets. Depreciation is typically charged on the cost of property, plant and equipment to write the cost off over its useful economic life. Given the CMA has used an estimate of the current value of property assets in its capital employed calculation and property is often assumed not to depreciate, we agree that it is appropriate to strip depreciation expense out of the P&L for property. However, for other asset categories, such as fixtures and fittings, we would expect the depreciation charge to be deducted from the numerator. In other words, EBITDAR is appropriate only where assets don't depreciate. If assets deprecate, EBITR should be used.

**ROCE vs WACC**

- We agree that a ROCE vs WACC approach is an appropriate method through which to evaluate economic profitability. The CMA has seemingly limited this form of analysis to residential homes and has applied margin benchmarking to fostering services. We question whether margins can be reliably benchmarked in this way, using a small sample of firms operating in materially different industries to foster care agencies. For such a comparison to be informative, the cost structure, investment profile, and risk profile would need to be very similar. Unless the comparators are very similar in these respects (which they are not), they may well earn materially different margins. For instance, as far as we are aware, the three companies do not face similar utilisation risks and do not face heavy regulatory burdens which create significant operating risks for the providers of children's social care services.

- For residential services, the CMA has made an initial estimate of ROCE at 11.1% based on a sample of 15 larger providers in the sector. It has not made the analysis underlying this calculation available, and so we are limited in our ability to comment on its accuracy.

- In particular, as mentioned above, a key assumption in the calculation rests on the current value of assets. There is inherent uncertainty in this value, partly due to the lack of comprehensive data on current property values, but also due to the omission of intangible assets. As such, were the CMA to progress its investigation of profitability, we think it should estimate a range of asset valuations and ROCE estimates rather than use point estimates.

- However, assuming the calculation is appropriate, we disagree that the initial estimate of 11.1% can be said to indicate 'excessive profits' for a number of reasons:

- The CMA's conclusion that it is likely that large providers are earning 'substantial economic profits' on the basis of comparing an 11.1% ROCE with a series of WACC benchmarks is flawed.

    - Firstly, the inclusion of regulated utilities appears to be an inappropriate benchmark given the inherent differences between the two industries – in particular private providers of children's services face significant volume/asset utilisation risk which would be expected to materially raise the cost of capital in comparison to a regulated utility.

    - In relation to the other industries chosen (Care Homes and Private Healthcare) the CMA has estimated the WACC range to be 6.5% to 10.5%.

        - The midpoint WACC for Care Homes is cited at 6.5% real. We believe the real WACC is an inappropriate benchmark for nominal returns. We note that the CMA's usual practice is to benchmark outturn profits with a nominal estimate of the WACC.[11] The CMA's own analysis suggests an equivalent range for the nominal WACC of 6.5% to 9.5%.

- The WACC for Private Healthcare is stated as 9% nominal pre-tax, with a range of 7.6% to 10.5%.

- We note the CMA's recent funerals market investigation in which the WACC is estimated at 6.0% to 9.4%.

- Given it is not clear that these industries face equivalent risks to children's care providers, we believe that it is appropriate to choose a point towards the upper end of the range as a point of comparison with which to estimate the WACC for this market. In a well-functioning market, e.g. where planning and commissioning were such that demand was capable of being forecast more effectively, the appropriate WACC benchmark might well be lower. However, In the current market design for children's care, the cost of capital is likely to be significantly higher because of (i) the inherent revenue risk that providers face due to the uncertainty of demand from LAs (ii) considerable political and regulatory risk. For instance, the CMA has acknowledged both LAs and independent providers highlight that the regulatory rating system does not account for the degree of challenge some children present, and at times, adverse outcomes in the short-term are unavoidable – however, independent providers typically care for children with more complex needs and face greater consequences from adverse ratings relative to LA providers.

- Even if the right benchmark was around 9-10% as the CMA benchmarks may suggest, we disagree that a margin of 1-2 ppt could be characterised as 'excessive'. The cost of capital is the minimum rate of return required to keep the factors of production engaged in a given activity. Even if providers were earning slightly more than the absolute minimum required, this would not be an indication that profits are 'excessive'. Moreover, given the inherent uncertainty in estimating WACC, this further indicates that it is unlikely that profitability is excessive, as some of the difference between WACC and ROCE could well be due to estimation error.

- A much more significant margin between out-turn profits and the cost of capital would be required before any suggestion of excessive pricing could arise. Indeed, in the recent funerals market investigation which identified high profitability of providers, the difference between ROCE and WACC was around 20pp,[12] or nearly ten times the margin identified for children's care. In previous market investigations the CMA has typically looked for a relatively large gap between returns and the cost of capital in order to conclude that profits have been excessive.

In summary, we believe that the CMA should amend its calculations to:

- consider a more reasonable range of asset valuations, including the value of relevant intangible assets;

- deduct management fees; and

- estimate a more appropriate WACC such as a business with considerable revenue risk would face.

[11] Competition Commission, Aggregates, cement & ready-mix concrete final report, Appendix 4.1, Framework for the profitability assessment, para 58

[12] Specifically, the CMA found a WACC of 6.0 – 9.4% with a point estimate of 8% and a simple average ROCE of 27%. CMA (2020), Appendix S: Profitability of funeral directors.