Home truths

The children's residential care sector is a much overlooked victim of the austerity cuts. **Ploy Radford** investigates further

"This... is... certainly not... a market... in a position to attract a new wave of investors with deep pockets of risk capital, innovative approaches and motivation." These are damning words to describe any industry but as they refer to the children's residential care market in this instance, the sentiment becomes somewhat tragic.

The quote comes from a recently released report by the Institute of Public Care (IPC) into the financial stability of the children's residential care sector and the rest of its conclusions were pretty bleak. One of its most startling findings is that 44% of the 20 largest providers "are reported as having negative tangible net worth and declining performance, including the impact of debt levels". Furthermore, "over half reported weaker balance sheets in the most recent reported period".

The depressing figures go on. Among the next size tier of providers in this space, which is largely made up of charitable organisations, "75% reported weaker profit or surplus performance in the last reported period".

While the IPC acknowledges that there have been no large or wholesale corporate failures as yet, because other providers have taken on failed services, it believes the risk is still high. "...the possibility cannot be ruled out that one or more large providers, or a series of smaller and medium sized businesses may yet fail in the face of further spending pressures on local authorities

and ever tightening budgets," the report warns.

Fears of business failures in the social care market are generally highly publicised. Elderly residential care is one sub-sector pored over by the press after the failure of Southern Cross. Both that sub-sector and the domiciliary care market have also been highly vocal about how austerity cuts have affected them. However, despite the fact that two thirds of the largest 20 providers of children's residential care space are trading below the bottom of the range normally seen in other asset-backed care sub-sectors, its woes have largely flown under the radar.

This is probably in part due to its size and niche nature. Defining children's residential care can be hard, but in brief it refers to non-secure residential units for children. The IPC divides these children into three groups: children with "profound and multiple disabilities"; children with "specific behavioural conditions" and children with "a series of problems stemming from their family and/or environment". In terms of market

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IPC's break down of the largest 20 providers

(They are not named in the report but in the instance of a few, *HealthInvestor* has made an educated guess to the identities)

- One AIM-listed company (CareTech)
- One London Stock Exchange-listed company with a private equity house still involved (Cambian Group)
- Six wholly owned by private equity
- One owned by a bank (Options Group)
- Eight owned by private individuals or families
- Three owned by charities or trusts.

size, as of 31 March 2014, only 7.6% of the 68,840 children looked after by local authorities were in residential care. Three quarters of units in this space are run by the private or voluntary sector and the largest 20 providers own 37% of that. It is possibly unsurprising that private equity have a presence among the bigger platforms (six of the largest 20 are wholly owned by private equity according to the IPC, and Cambian which is among those 20 still has GI Partners invested in it).

Given private equity's presence among the 20 largest providers, it would be easy to question whether it is actually that serious a matter that 44% of them have negative net tangible worth if that 44% is made up of private equity- backed businesses (which is not disclosed by IPC). Not only do private equity traditionally use a lot of debt to buy a business, a lot of the equity they provide is put into the business as loan notes, which looks like debt too. The company is not expected to regularly pay the interest on loan notes, though, private equity get that back when they sell on the business.

Furthermore you could argue that historic performance does not necessarily mean a business will fail if it has the right backing, private equity or otherwise. "We don't really take much credence of the balance sheet – the points to take into account are is it a going concern, cash flow, sustainability of the business model and the preparedness of shareholders to put money in if needed," says Nancy Hollendoner, senior advisor at Smith Square Partners.

However, there is no denying that the children's residential care market is in a bad way and providers of all sizes have taken a large hit to profits. "Between 2010 and 2011 Castlecare had a record level of profit and then the austerity measures really kicked in, I mean we nearly lost 20% of the fee," says Lee Jones, director of operations at Castlecare. "Local authority funding was cut... to make our turnover we had to increase our occupancy which increased our costs, which is why you see the ebitda dropping in 2011 to 2013." Castlecare was not alone in suffering fee cuts; the IPC report relates that some businesses saw their fees dropping by 25% overnight. As things stand, the average weekly fee is £3,289 per week with the range dipping as low as £1,900 per week for some providers (and rising as high as £9,325 per week with others).

Tightened local authority budgets are not the only problem; fostering services have to a certain extent cannibalised the sector, which some would argue is unfair. "Residential care is also in many ways a market of last resort with 30% of children placed in residential care having had six or more previous care placements," reads the IPC report. Commissioners even told the report's authors that there is a clear hierarchy for placing children in need of social services: local authority run fostering first, then foster care provided by the independent sector, then the child could be placed in council-run residential units and only if all that doesn't work will they then be placed in residential units run by independent providers.

Fostering where appropriate is undoubtedly a very valuable service and the best one in a wide range of situations, but for severely troubled children or those with profound disabilities, it isn't always the most appropriate path. These children need the highest levels of supervision, most of which is only available in residential care units. This 'last resort'

mentality is ultimately terrible for the children because the ability of children's residential care units to be beneficial is much diminished at the point when most of these children finally reach them.

Shockingly, providers also reported that a staggering 95% of referrals that are made to them are inappropriate anyway. And, many feel that commissioners are more concerned about getting the lowest price possible rather than the best care for the child – several providers recounted tales of commissioners removing children at very short notice to place them in cheaper facilities.

Sovereign Capital partner Dominic Dalli highlights another issue – the trend in the years following the Winterbourne View scandal for smaller, more personal facilities for users. "Very few businesses in childrens' services, or management teams, are able to manage the tension between commissioners wanting smaller homes and investors wanting larger homes," says Dalli. For investors, bigger units mean less risk of falling occupancy levels and thus profit taking a dip – one less resident in a four bed unit has a much bigger impact than one less in a bigger facility. Dalli warns: "Couple that with the overriding need to prioritise managing risk for this vulnerable client group, and you have no more than a handful of businesses which are economically viable in this sector."

What this all points to is a fractured relationship between providers and commissioners; "lacking in depth" is one of the telling quotes in the IPC report. No wonder then that on a scale of one to five of how worried they are about the state of the market, 55% of providers picked 4 or 5.

The picture all of this paints is not positive. The willingness of investors to back children's residential care will surely fade if the obviously tough trading conditions continue; investors want returns and have to pay back debts – they aren't going to keep throwing good money after bad. This could prove disastrous for businesses.

History has several examples of investments gone sour in this space. "A lot of private equity money came into this without a clear strategy and without understanding the risks in the market; no one particularly anticipated austerity," says Jones. "People lost interest to a certain extent and wanted rid of the services that weren't being profitable."

ECI Partners were the first example of private equity investment to enter this space with the acquisition of The Sedgemoor Group in 2000; in 2007 the company went into receivership. Meanwhile, 3i bought four businesses to create the Continuum Care brand; it reportedly wrote £20 milllion off its original investments before selling it to Advanced Childcare in 2012.

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But it is not all doom and gloom though and there are interesting business models out there for investors. "There are elements of the children's residential market that are attractive to operators, particularly children's homes where you are providing for longer stay children who have profound mental or physical disabilities," says Phil Hall, healthcare director at JLL. With the former there is much more parental involvement. The IPC report found that because of this "placements tend to last longer and attract

Private equity deals in the sector

ECI Partners – bought The Sedgemoor Group in 2000. The company went into receivership in 2007 and Keys Group and others picked up the assets
Equistone Private Equity (formerly known as Barclays Private Equity) – acquired CareTech Community Services in 2002 and exited to the management team following a float on the AIM market
Baird Capital - acquired Castlecare in 2004 and sold it to Priory Group in 2014
Bowmark Capital – Invested in Advanced Childcare in 2004 and sold it to GI Partners in 2011
3i – from 2004 it acquired Green Corns, Farrow House, Herts Care and Cambrian Care and merged them under the Continuum Care banner. It wrote off £20 million of its original investment, allegedly, before selling the business to Advanced Childcare in 2012
Sovereign Capital – acquired Herts Group in 2004 and sold it to 3i. Re-entered the market in 2013 with the acquisition of Hillcrest Group now part of its Outcomes First Group
Advent International-backed Priory Group – entered the sector with the acquisition of Solutions in 2004. It added to this portfolio with the acquisition of Castlecare from Baird Capital in 2014
Phoenix Equity Partners – bought Acorn Care & Education in 2005
Teacher Private Capital – the private equity arm of Ontario Teachers' Pension Plan is believed to have paid around £150 million to Phoenix for Acorn Care & Education in 2010
Livingbridge – bought Witherslack in 2011
NBGI Private Equity – snapped up both Horizon and Educare in 2012.

a higher level of resourcing".

The IPC report also points out that companies that have diversified their offering for example have done much better – the report found that where commissioners paid higher prices there is likely to be the inclusion of education and/or therapeutic input in the price. It is indicative of the success of the diversification strategy that of the 20 largest providers, only 35% solely concentrate their activities on children's homes. Jones believes the fact that Castlecare sits within Priory's portfolio of children's services, which includes fostering, education and CAMHS services means Priory and Castlecare are more likely to get business from commissioners. "When commissioners come to us they want the complete solution," he says. "We've got a care pathway that means the child can stay within Priory from entry point to exit point and into adulthood."

Meanwhile for those bigger businesses that focus more on the emotional and behavioural difficulties end of the market, investor support will be a slow time leaving. As Hollendoner points out, there is a reputational risk for private equity firms that pull out without making a proper go of things. "If you look at somebody like Acorn, that is owned by Teacher Private Capital, Teacher's is a long-term investor. They're not going to let that go, it would destroy its reputation overnight."

Of course, for those smaller family owned businesses, the future can be a bit more uncertain and it is perhaps inevitable that some will fall by the wayside in current trading conditions. One operator's loss is another's gain, though, so this could drive consolidation in the marketplace. "I think it will be the larger players that stay in this market and make the difference," believes Jones. "This is a space for somebody who wants to invest, lead and innovate and has the resources to do so."

Certainly there have been deals in the sector in recent months. Options Group is believed to be in the latter stages of a deal process. Priory bought Castlecare at the end of 2014 and Sovereign Capital re-entered the market with the acquisition of Hillcrest Care in 2013.

Given what is at stake, let us hope that there are investors and trade buyers willing to put their faith and money in children's residential care. ■