TACT Fostering & Adoption

TACT Briefing - Profit-making, debt and financial risk among largest independent sector children social care providers

November 2019

The Local Government Association commissioned Revolution Consulting in November 2019 to produce a report on profit-making, debt and financial risk among largest independent sector children social care provider organizations operating in England. The purpose of the report was to find new ways to commission fostering and residential care for children and young people, and to make sure that providers are properly managing their debt risk.

Scope of report

- Identify amount profit being made by largest independent fostering agencies and children's residential care providers
- Identify indicators of risk in those organizations.

The report identifies 16 organizations as the largest providers (sample group).
Subject of study: the largest 16 provider organizations
LGA expenditure in fostering and children's home providers (independent): £1.7-1.8 billion a year.
The largest 16 provider organizations: income in excess of £1.37 billion.
Profits: 17.4% of their income.
Income + profit: @239 million per annum for the sample group
Above-average returns on investment, several from private equity industry. Two stock market quoted providers in study, one in London and one in USA.

Spending levels and income

For the last 2-3 years the children social care budgets have reported highest levels of overspending with spending on IFA and ICH (Independent children's homes) growing rapidly, especially in ICH.

The total income of the providers in this study is £1.37 billion. The largest three providers (NFA, Caretech, Core Assets) substantially outweigh the rest of the sample, with 59.3% of the income of the whole sample, and the top six (also including Priory, Keys and Compass) account for 80% of the whole sample measured by income.

Between 2015 and 2019 the average growth of these providers was 20%, driven significantly by acquisition activity in addition to organic growth. This strong income growth has also helped to fuel further investment intent.

Profitability

In terms of profitability, the top six providers (NFA, Caretech, Core Assets, Priory, Keys and Compass) account for the 90% of the profitability measure of the study (earnings before interest, tax, depreciation and amortization).

The evidence considered in this report suggest that the sector is developing a pattern where the larger and stronger providers are beginning to outperform and outdistance the smaller providers.

The fact that the larger PSOs (Private sector organizations) are no longer in the ownership of the founder members may prompt additional scrutinization of the profits of the organization. The larger

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PSOs are more likely to be managing bank loans and overdrafts (Bank debt
or External debt) that the business or owners have raised in relation to their purchase of the business or to finance acquisitions of other provider organization for consolidation or to finance other growth or assets purchases.

The norm is the typical private equity approach, involving buying a business borrowing funds from a bank alongside using money from the private equity's own investments funds and combining these amounts to buy out the previous owners. Both the bank debt and the amounts due to the private equity house usually appear as liabilities of the group of operating companies acquired.

Of the 16 groups of this study, three of the five largest PSOs have private equity (PE) owners (the other two are stock market groups), and three of the second tier are also in PE ownership.

The sector is attractive to investors of this type but brings the questions of risk associated with the financial models employed. The subsequent waves of investment in acquisition and in further consolidation in recent years give clear indication of a continued belief amongst investors that they can make similar returns from the sector in the future.

Sustainability and solvency risk indicators

The financial engineering used by PE owners brings the need to consider additional monitoring based on more sophisticated insight and understanding.

Debt management has become a serious issue for individual organizations, which has led to a wholesale refinancing of the business. In some cases, shareholders had to commit more funding, in others, the whole business was sold before crisis point, with the financing of the acquisition extinguishing the growing debt.

It is notable but unsurprising that the smaller PSOs more likely to be in private ownership (as opposed to PE ownership) indicate more manageable debt levels. Private owners tend to use debt more selectively for specific purchases than using debt for maximum gearing of their finance structures.

The scale of some providers' organizations, and the level of the debt involved in their financial structures, would appear to merit closer monitoring to assure the commissioner as to the sustainability of these key provider organizations.

Issues

The rate of consolidation in the children's services sector has accelerated and there are now more larger provider organizations which operate across the country, representing a substantial proportion of the total supply.

Priory for example, is part of an international group that has an income from healthcare, which is larger than the entire spend in England by LAs on fostering and children's homes. Other large consolidated providers have income that is many times greater than the entire children's services spend of even the highest spending LAs in England.

Profitability across the sector is not uniform but has been growing the most in the last 2-3 years, especially for the largest providers, as demand has increased. Some investors have made above-average returns on their investments. This is further indication that the traditional methods of commissioning and procurement are struggling to influence the development of the market.

The types of ownership of provider organizations are varied but increasingly involve sophisticated financial investors that bring financing techniques involving increasing amounts of debt and risk. The risk of failure for a provider may result in change or ownership or even outright closure of the service. Each scenario has the potential to disrupt the children in placement and therefore these factors need to be considered by commissioners and policy makers.

The report finishes highlighting two issues closely related:

- Need to find new ways to commission in these sector
- Stewarding the sectors to manage risk.
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Final area for consideration is contingency planning in the event that a large provider was to fail altogether. Children in their care need to be protected as a priority during any transition, so the state may need to take action if an independent sector provider begins to fail financially.

Questions raised by this report:

- Are corporate rules related to administration and liquidation appropriate to the children's service sector organizations?
- Is a different standard needed to protect the children in placement as a greater priority?