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Restructuring Services Sector Outlook Series

Bringing industry challenges to the surface

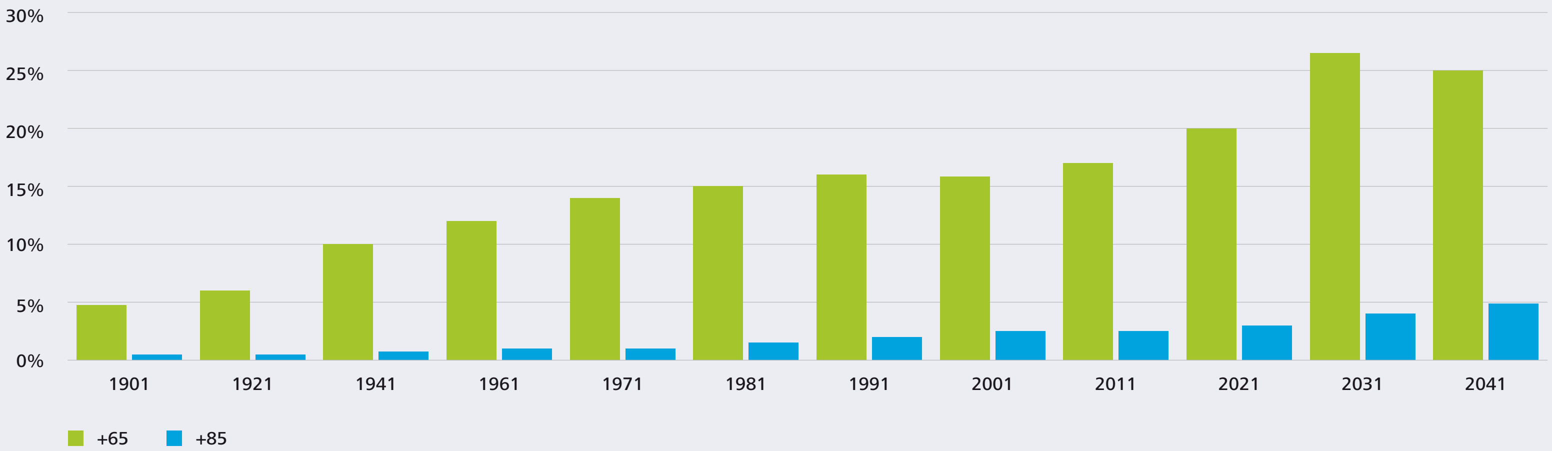
Adult Social Care – In Troubled Water

May 2016

The Adult Social Care sector in the UK is in difficulty. The sector is experiencing the perfect storm of an ageing UK population (Figure 1) which is increasing demand for services at the same time as it tries to respond to five years of real term **funding cuts,** significant **wage inflation** and increasing **regulation.**

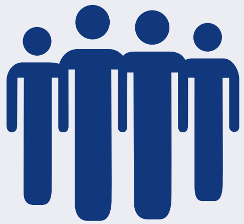
As we look ahead to the rest of 2016 and 2017, the impact of this 'storm' is far reaching and will place pressure on both operators and the Government, due to the legal obligation that Local Authorities (LAs) have to provide care to those who are not in a position to fund it themselves. In addition, responsibility for care, in a scenario where operators fail, falls back on LAs and as such there is significant pressure on the Government alongside other stakeholders to play a role in solving this crisis.

Figure 1. Proportion of Britain's population aged 65 and 85 plus (%), 1901 – 2041



Source: ONS Population Trends & Population Projections

The number of people over 85 in the UK is expected to double between 2016 and 2040 to 3.4m[1]



1 ONS Population Trends & Population Projections

Funding cuts

Over the past five years, LA funding has fallen by **£4.6 billion,** representing a **31% reduction** in real terms.[2] The implications of the funding cuts are significant given that c.60% of residential care homes and c.70% of the home care market[3] are LA funded.

Looking at the movement in average weekly fees (AWF) compared to the movement in staff costs demonstrates the increasing pressure on operators since LA funding cuts began in 2011 (Figure 2).

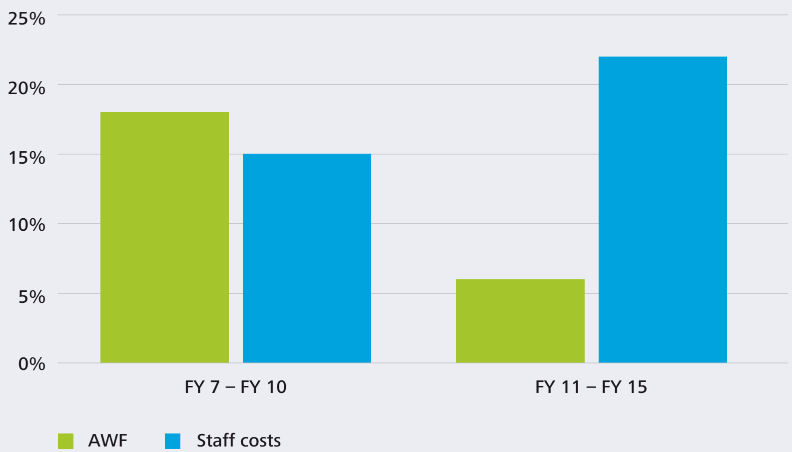
Operators have sought, where possible, to adapt to reduced LA funding through an **increase in private funding.** This is reflected in an increasing focus on private residents and availability of 'top up' options where individuals can choose to supplement LA funding.

Increasing the proportion of privately funded residents to subsidise LA-funded residents has enabled operators to partially offset funding cuts. However the limitations of people's ability to pay for their own care mean that there is a **systemic shortage of funding** which still needs to be resolved.

Additionally, while currently on hold until 2020, The Care Act 2014 will introduce a cap on an individual's contribution to the cost of their care which will further limit private contribution to costs.

LAs have cut their funding in real terms by 31% over the past 5 years

Figure 2. Average weekly fees vs staff costs FY07 – FY15



Source: Knight Frank's 2015 Care Homes Trading Performance Reviews

2 Association of directors of adult social services in England ("ADASS"), Budget Survey 2015

3 Laing and Buisson

Wage costs

Just over 60% of the income received by a care provider is spent on wages (higher for a nursing care home)[4]. Wage costs have risen due primarily to a **shortage of skilled care workers** and nurses which has led to both **higher permanent staff salaries** and increased use of more **expensive agency staff** (on average, agency staff costs double that of permanent staff).

The Government is seeking to mitigate the shortage of nurses by **reducing immigration restrictions** and is also considering **flexing skill requirements** so that fewer qualified nurses are needed or the requirements for qualifications are reduced.

There are currently c.15,000 permanent nurse vacancies in the UK[5]

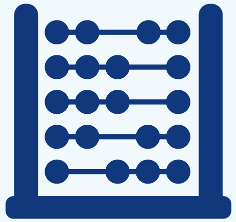
Agency staff costs have increased from 4.8% to 5.8% of total staff costs between 2014 and 2015[4]

This could help stem the rise in wage costs but there is a risk that the attractiveness of agency salaries means that the role of agencies might not easily be diminished. It is also likely to take time to rebalance the workforce which doesn't help address current pressures, including the additional impact that the **National Living Wage** will have on this sector.

As a sector that employs a large number of low wage staff, the introduction of the NLW has had a large impact especially as pay differentials for all grades of staff are likely to be maintained.

While the Chancellor in the Autumn Statement announced that LAs will be able to **increase Council Tax by up to 2%** to fund adult social care, it is yet to be seen how this will translate to a direct uplift in weekly fee agreements between LAs and operators – something which will likely differ by LA. This could raise up to £2bn by 2020. However leading think tanks Care England and Independent Age, believe this **amount is insufficient** to bridge the funding shortfall facing the social care sector which is estimated to be c.£6bn by 2020.

Since FY11, staff costs have increased by 22%[4]



4 Knight Frank's 2015 Care Homes Trading Performance Reviews

5 Nurse and Midwifery Council ("NMC") and Office of National Statistics

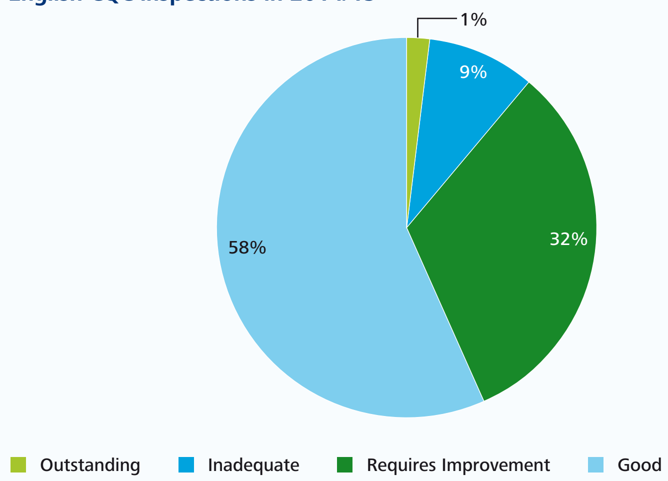
Increased regulation

In addition to the above challenges facing the adult social care sector, there has also been an increase in regulation in order to ensure care homes are stable and operating effectively. This increased regulation brings with it increased costs.

Inspection and regulation is necessary to **protect some of the most vulnerable members of society.** As there is an increasing focus on the standard of care homes, it is likely that inspection criteria will drive **higher in-house monitoring costs** and potentially highlight the need for investment to address any areas of underperformance. The scale of this investment is material – 41% of the Care Quality Commission (CQC) inspections carried out during FY15 were either rated as “requires improvement” or “inadequate” (Figure 3).[6]

Inspection and regulation is necessary to protect some of the most vulnerable members of society.

English CQC inspections in 2014/15



6 http://www.cqc.org.uk/content/care-homes

Key considerations for stakeholders

The adult social care sector faces a number of challenges. As options to address these are limited we believe there will likely be considerable restructuring activity in the coming years.

While there is increasing pressure on the Government to make more funding available, no one is sure when this will happen, where the funding will come from and what will trigger action i.e. will it take another failure of a large care home operator as we saw with Southern Cross?

In the absence of additional government or equity funding, operators will have to focus on self-help and look to improve operational efficiency however they can. Given the level of operational gearing across the care home sector, there are limited cost savings that a care home can safely implement while remaining compliant with standards. As such, operators will have to think about other means by which they can manage costs and cash, including collaboration with other providers and their key stakeholders.

CARE HOME OPERATORS

- **Engagement with stakeholders** before performance trends downward.
- Demonstrate to the LA and CQC a **full commitment** to the standards of care.
- Consider size and shape of the portfolio and whether **restructuring/selling assets** could generate needed value.
- Focus on **'top-up' markets** where individuals are able to contribute to their own cost of care.
- **Limit increases in cost base** by negotiating 'pass through' provisions (e.g. for wage increases) where possible.
- Develop a collaborative approach with LAs/commissioning groups with the aim of **reducing hospital admissions** in exchange for higher AWFs and occupancy.

LANDLORDS

- Monitor **standard of properties** – reduced capex will likely impact fabric of the property.
- Obtain **key financial metrics** and monitor non-financial KPIs in order to identify any potential operating issues as early as possible.
- Ensure control can be taken to **protect asset value** during a restructuring. Landlords should consider taking security over the operator if possible and include 'ownership clauses' in operational leases.
- Create a fully worked out **contingency plan** to cater for a scenario where if an operator fails, the landlord is 'handed back' their care home.

INVESTORS

- Assess opportunity for new/existing entrants to develop a **buy & build strategy** in this sector as more care home operators face financial difficulty.
- Investigate ways to attract a higher proportion of **private pay residents** or offer specialist services which fall outside of LA's strict pricing structures for residential and nursing care.
- Carry out **stakeholder analysis** to establish relevant controls and leverage of various groups and engage early.
- Drive **operational improvements** by replacing underperforming home managers or setting up local 'clusters' of homes which provide differing levels of care.

LENDERS (OPCO/PROPCO)

- Monitor **care related KPIs** (e.g. number of safeguarding incidents, pressure sores, skin tears, etc.) as they provide **early warning signs** for operational and liquidity problems.
- Review **security position** – ensure you have security over properties and operating assets, together with control over key operating functions to enable **continuity of care** to be maintained in the event of insolvency.
- **Engage with the CQC** and other stakeholders early if there are signs of difficulty as they can generate goodwill and provide support throughout the restructuring process.

"Whilst there are clearly a number of negative headwinds facing the adult social care sector, there are still investors active in this market as they recognise the longer term opportunity and believe that a government led funding solution is inevitable, although the timing and structure of this solution is far from certain."

David Jones, Healthcare and Life Sciences Lead, Financial Advisory

Adult Social Care credentials

Project George	Executive Care	Project Twilight
Forecast Review Options Analysis Contingency Planning £200m debt	Crisis Management Financial Restructuring Disposal £85m debt	IBR Options Analysis £500m debt

Southern Cross Health Group	Project Bold	Lifestyle Care
IBR Lender Advisory Support	IBR Refinancing	Joint Administrators £200m debt

“The social care sector is already on its knees and the implementation of the National Living Wage has placed further strain on operators.

Some commentators have compared this crisis as being similar to the current steel crisis, however, social care has one major differentiating characteristic, namely the legal obligation of Local Authorities to provide care to those who are not in a position to fund it.

We anticipate a number of restructurings, and potentially failures, of operators until a solution is arrived at. As we saw with the Southern Cross restructuring, given the nature of the underlying businesses, PR and continuity of care will be key considerations for all stakeholders as opposed to a pure focus on maximising financial returns.”

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