Handle with care

Peter Morris *examines the recent troubled history of the UK care home industry, which has seen buyouts, closures and uncertain times for residents*

The general demographics of an ageing population are all too familiar. Here are a few specifics that apply to care homes for the aged. In mid-2016, 1.6m people aged 85 and over were living in the UK, according to the Office for National Statistics (ONS). As of 2018, approximately 410,000 of them live in about 11,300 care homes. A comprehensive recent report by the Competition and Markets Authority (CMA) found that the annual fees these homes receive fall about 6 per cent, or £1bn, short of what the industry needs to be viable in the long term. Meanwhile, the ONS forecasts that by 2041 the over-85 population will have doubled to 3.2m.

Those figures suggest that many vulnerable, elderly people are in danger of losing their homes. Now combine that emotive subject with another one. Private equity firms have been actively trading in and out of the care home sector over the past 20 years. The result has sometimes been explosive.

In 2011, the UK's largest care home provider was Southern Cross Healthcare. A hectic series of deals had seen the private equity group Blackstone create Southern Cross and then float it on the stock market within just two years (2004-06). By 2011, 32,700 elderly residents were living in the 752 homes operated by Southern Cross. Many readers will remember the storm that erupted when Southern Cross went bust in 2011.

Seven years later, Groundhog Day is in the air. Four Seasons Health Care is one of the UK's largest care home chains, operating about 375 homes with 16,500 residents. Like Southern Cross, Four Seasons is a creature of the private equity era. Three buyouts in a row, starting in 1999, put valuations on Four Seasons that ranged from £775m (2004) to £1.4bn (2006) to bankruptcy (2008). The numbers look like they are tracking the mood swings of a manic-depressive. Lenders took control of Four Seasons in September 2008, in the depths of the financial crisis. Who should emerge, blinking, as the involuntary owner of a 38 per cent stake in the care home chain? Take a bow, Royal Bank of Scotland.

But the cavalry was on its way. 2012, the year after the Southern Cross debacle, brought a fourth successive buyout at Four Seasons. Lenders now sold the company for £825m to Guy Hands' private equity group, Terra Firma. A press release at the time said: "With a stable capital structure and clear ownership, Four Seasons will be able to lead the sector in terms of quality of service."

Terra Firma had reckoned without the cuts in council budgets and the increases in the minimum wage and, six years later, Four Seasons has neither a stable capital structure nor clear ownership. Terra Firma has been waging legal trench warfare for months against distressed debt investors over the terms on which those investors will eventually take over the chain of care homes. Not surprisingly, these financial manoeuvrings appear to be affecting quality of service. In a survey based on ratings by the Care Quality Commission, the Consumer Association currently finds that Four Seasons ranks "43rd out of 54 providers overall in England".

Not all private equity care home investments end up like Four Seasons and Southern Cross. The Southern Cross implosion did not result in aged residents becoming homeless, nor is there any suggestion this will happen at Four Seasons. But the resulting levels of uncertainty for residents and their families are clearly undesirable.

> *“ Operations are split from property in order to sell off homes to the highest bidder*

Several factors help to make the care home sector attractive for private equity groups. Contrary to what the bipolar valuations of Four Seasons might suggest, the care home industry generates a stable return on capital. Yes, the sector faces real revenue and cost pressures, but the wild valuation swings come from private equity and its volatile lenders, not from the business itself.

Care homes are also a very fragmented industry. The top 30 providers account for about one-third of capacity; at the other end of the scale, another one-third of capacity belongs to operators of a single home. This invites a standard private equity strategy sometimes called "buy and build" – in more technical terms, consolidating a sector. The way the private equity group Alchemy originally put together Four Seasons between 1999 and 2004 is an example of this.

But another feature – property – is the true fatal attraction. The private equity community often declares that "financial engineering" is a thing of the past. That is like St Augustine's views on chastity: "...not yet".

Care homes might seem to have little in common with consumer sectors such as department stores, fashion chains, gyms, pubs and pizza restaurants but these operations all have one thing in common: the need for premises. That helps to explain why all these sectors have seen waves of private equity investment.

Most of the time, property assets are easy to borrow against. Every homeowner with a mortgage is a financial engineer. They are using a legal performance-enhancing drug called debt. As long as house prices go up, the drug will boost their wealth.

> *Care home operators should be regulated in the same way as water or power companies*

Private equity does this on a larger scale. One financial engineering technique that private equity groups have perfected goes by the unlovely name "opco-propco". This involves splitting operations from property in order to sell off the properties to the highest bidder. Doing this generates a one-time gain up front. Since there is no such thing as a free lunch, though, it comes with a longer-term cost. The company that operates the newly rented facilities – whether shops, gyms or care homes – is now stuck with higher costs, thanks to the rent, that stretch way out into the future.

The CMA's November 2017 report is sanguine about the overall level of financial risk in the care homes sector. It notes that private equity-owned care home chains are not the only ones with high debt. The report also stresses a change that was brought in after the Southern Cross debacle. In 2014, a statutory Market Oversight Scheme was established for care homes. This gives the industry regulator, the Care Quality Commission (CQC), a duty to monitor the financial risk of care home providers that local authorities would find hard to replace. In 2015, the CQC published a 69-page document explaining how this works.

In effect, the CQC now has to act as a specialist care home financial analyst and credit rating agency. Local authorities will also need to know how to respond to any issues the CQC brings to their attention. This is an improvement on the laissez-faire approach that led to the worries after Southern Cross failed, but it falls short of one of the more intriguing suggestions to come from a private equity insider.

Jon Moulton is a private equity veteran whose Alchemy group originally created the Four Seasons chain between 1999 and 2004 (and made a big return). After the Southern Cross debacle in 2011, Moulton told *The Guardian* that care home operators should be regulated in the same way as water or power companies. "I actually think the only thing you can do – and this is against my natural gut reaction – is to make sure this business is sensibly regulated in line with a sort of regulated utility," he said.

For the moment, it seems to be business as usual. In 2014, a group of foreign investors bought the largest group of care homes (HC-One) to emerge from the Southern Cross wreckage. They are following the private equity playbook: high debt, selling and leasing back properties, and consolidating the industry. Most recently, they agreed to buy Bupa's chain of care homes. The UK parent company of what will soon be the country's largest chain of care homes has a name that suggests financial engineering is alive and well in the world of care homes. The company is called FC Skyfall Upper Midco. ■

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