Key issues facing the UK residential care home sector

An age old problem?

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Historical backdrop

The collapse of over 750 care homes operated by the Southern Cross group in 2011 following rapid expansion financed by the sale of leases of its homes exposed the financial risks inherent in the residential care home sector. Reports by industry specialists have, in the six years since, repeatedly highlighted the parlous state of the UK's care homes' finances, strained as they are by rising operating costs and cuts to funding by local authorities.

Despite attempts by the Government to address the problem, including through the introduction of the Better Care Fund (the legislative framework for which is set out in the Care Act 2014) and the Council tax adult social care precept (announced in the Government's 2015 Autumn Statement and modified in December 2016), the sector's finances have continued to descend into disarray as care homes across the country struggle with the introduction of the National Living Wage (NLW); auto-enrolment and the workplace pension scheme; a nursing shortage; and the financial uncertainty that Brexit brings.

The sector is reaching crisis point. A recent report by accountancy and advisory firm, Moore Stephens, stated that 12% of care homes are at risk of becoming insolvent in the next three years.

In this article, we look in more depth at some of the key issues facing the residential care home sector. We also examine some of the unique restructuring challenges faced by stakeholders and professional advisors within the UK as well as potential solutions to distressed situations.

Key factors leading to a sector in crisis

A number of factors, both long-standing issues (including rising operating costs and cuts to local authority funding) and more recent developments (the introduction of both the NLW and the workplace pension, the nursing shortage and Brexit), contribute to the precarious financial status in which the healthcare sector finds itself.

Local authority funding pressures

Whilst spending reviews have highlighted the need for additional funding, the National Health Service (NHS) and local authorities are, in the aftermath of the global financial crisis, continually under pressure from the Government to slash budgets, which has knock-on consequences for private funding.
Withdrawal of local authority funding

It has been reported that over the past five years, local authority funding has fallen by £4.6 billion, representing a 31% reduction in real terms, which is significant in light of the fact that around 60% of residential care homes are local authority funded. A withdrawal of funding from local authorities has led providers to look to a greater extent to private funding, predominantly by increasing the proportion of privately funded residents which they accommodate in their care homes and/or by seeking "top up" payments from residents or their family to subsidise local authority funding.

In the UK, a resident of a care home will have their fees met (in full or in part) by the state unless they own capital (including real estate) with a value in excess of (for example, in England) £23,250, in which case they are expected to fund the fees privately. As austerity measures continue to be implemented, pressure will continue to be levied on local authorities to reduce spending, and care home operators and their residents will bear the brunt of the continued cuts. There is already concern over the quality of care provided in care homes and reductions in social care funding will compromise service levels further.

Social care council tax precept

The Government's social care council tax precept allows councils to increase council tax in their areas by 2% per annum to fund social care. In the face of the current sector funding crisis, the Government recently (December 2016) proposed that councils will now be permitted to raise council tax by 3% in the next two years. It is hoped that around £208 million extra will be raised by increasing the social care precept from 2% to 3% in 2017-18 and £444 million in 2018-19. However, it has been made clear that the net increase of the social care precept will need to remain at 6% over the next three financial years, meaning that if councils choose to levy 3% in both 2017-18 and in 2018-19, they would not be able to raise a precept in 2019-20.

Whilst the precept is a welcome source of funds, industry analysis (in particular research published by the Association of Directors of Adult Social Services (ADASS) in July last year following a survey of 151 adult social services directors) indicates that the extra money raised is failing to cover the cost of the new NLW, let alone address the huge shortfall in funding in the sector in light of increasing demand. ADASS estimates that the total cost of the NLW (including compliance with the existing National Minimum Wage), is calculated to total over £600 million; the precept raises less than two thirds of this at around £380 million, which leaves directors of adult social services this year having to find around £941 million to keep services operating. In addition, the financial impact of the precept differs according to region, with those areas in greatest need seeing smaller amounts being raised through the precept.

Cap on private contributions

In addition to this, but whilst currently on hold until 2020, the CA introduces a cap on an individual's contribution to the cost of their care which will place further pressure on local authorities to cover the shortfall.

Employment issues

As a sector that employs a large number of low-wage staff, the introduction of the NLW and requirement of auto enrolment in a workplace pension scheme has had damaging financial consequences for care home operators. This is compounded by a shortage of skilled care, qualified nurses and experienced care home managers, which has led to a significant stretch on existing resources and the need to rely on the use of more expensive agency staff, further eroding already tight operating margins.

The national living wage

The NLW was introduced on 1 April 2016 for all working people aged 25 and over, and is currently set at £7.20 per hour, with anticipated increases to £9.00 per hour by 2020.

The Care Quality Commission (CQC) (the independent regulator of health and social care in England) has reported that staff costs on average make up around 60% of total costs in care homes and residential homes. It is not uncommon for a significant proportion of a care home's staff (representing it's largest overhead) to be paid on or around the minimum wage.

Workplace pension auto-enrolment

Following legislation introduced in 2012, all employers must, by 2018, offer a workplace pension scheme and
automatically enrol its eligible employees in it, placing additional strain on care home operator finances. At present, a minimum total contribution in the sum of 2% of an employee's earnings is required, with 1% of that amount being contributed by the employer. The minimum total contribution is set to increase to 8% of an employee's earnings, with 3% from the employer by April 2019 onwards.

Whilst the NLW and workplace pension will impact upon the margins of all care operators, those which employ a higher proportion of staff earning minimum wage will likely be worst affected.

Nursing and experienced care home manager shortage

In light of a current nursing shortage, driven by falling UK student nursing places, reduced government spending (nursing bursaries are to be scrapped in favour of loans, placing a financial cap on funding), policies on immigration and regulatory compliance issues (such as, in some instances, a requirement by the CQC to increase the staff-patient ratio or to undertake improvements following a care home inspection), care home operators are forced to supplement their workforces through the use of more expensive agency staff.

In addition, a shortage of experienced care home managers means that many care homes operate without a registered manager for several months or years at a time. Due to this shortage, experienced care home managers often attract increasingly high salaries, which places an additional financial burden on a care home business. Absence of a full time care home manager almost inevitably leads to a drop in standards and the consequent regulatory and reputational issues arising from that.

Analysis has shown that half of all registered managers in the adult social care sector are aged over 50, which could see 10,000 staff retire in the next 15 years. Fewer and fewer young people appear to consider elderly nursing as a viable career option, particularly in light of low wages.

The possible impact of Brexit on staffing should also not be forgotten. In a report prepared by the CQC, it is estimated that non-British EU workers made up 7% of the adult social care workforce in 2015/16 (equating to around 90,000 jobs) and it is uncertain as to the extent to which they will be affected by the vote to leave the European Union.

Whilst the government is considering ways in which it can mitigate the nursing shortage through the reduction of immigration restrictions and flexing skill requirements for nurses (so that fewer qualified nurses are required or the need for specific qualifications is reduced), the attractiveness of agency salaries to workers may prevail and the impact of such governmental measures will be slow to impact on care operator costs.

Any attempt by care home operators to limit the impact of wage costs by the reduction of staff numbers may ultimately compromise the quality of care provided and lead to further regulatory compliance issues for the operator, which bring their own costs issues.

Increased regulation

The care home sector is the focus of increased regulation in light of a number of high profile incidents in relation to care levels and is seen as necessary in order to protect some of the most vulnerable members of society.

The CQC determines the ratings for care homes and if a care home fails to meet the minimum industry standards, the CQC has the power to revoke the care home operator's registration. A reduction in CQC rating will often impact negatively upon the operator's ability to demand top-up fees from their residents or families. In addition, in areas where lack of care home places is not an issue, lower rated care homes may find it more difficult to attract residents.

Increased regulation in the sector will inevitably drive an increase in in-house monitoring costs and may require further investment from the operator in order to remedy any areas of underperformance in service delivery. A well led management team with a focussed strategy is key to avoiding or minimising any costs incurred through increased regulation. Indeed, care homes that are well managed financially, tend also to deliver higher quality care.

A high maintenance sector

A further issue for operators is the property comprising the care home itself. Industry opinion suggests that buildings converted into care homes, rather than purpose built care homes, are often more likely to fail due to the higher long-term maintenance costs required to ensure that the home complies with ever-increasing regulation standards. In addition, converted buildings are unlikely to deliver, to the same extent, the occupancy requirements of present day residents and
may therefore not be as attractive to residents or their families. An operator of a converted building care home will be
required to factor in to their business model the, sometimes significant, building maintenance costs alongside the raft of
additional operating costs which it has to bear.

International investor interest in real estate, not business development

Whilst overseas investors have looked to the UK care home market for investment opportunities, few of them seem
inclined to take responsibility for the running and development of the business itself and simply invest on a sale and
leaseback basis, usually involving premium care homes in wealthy areas. There is little appetite to invest in the smaller
local authority funded care home as the operators of such homes do not often represent a tenant of strong financial
covenant.

Smaller, less financially stable operators may not be in a position to capitalise on any international investment
opportunities and need to be wary of onerous sale and leaseback agreements which in the short-term offer an injection of
funds, but in the medium to long-term may prove unsustainable.

Issues on insolvency

Future outlook

Whilst the care home sector is plagued with uncertainty, one thing is clear; the immediate to short-term future brings a
challenging trading environment for many care home operators.

The CQC has reported that profitability of adult social care provision is falling and data analysed by the regulator suggests
that the most vulnerable operators will, unsurprisingly, be those that are funded in whole or in large part by local
authorities.

Care home operators with more than half of their turnover funded by local authorities achieve, on average, 10% less fee
income per bed and generate almost 28% less profit per bed, compared with all operators.

The CQC reports that some operators, particularly in domiciliary care, have withdrawn from local authority contracts
where they felt there was too little funding to enable them to be responsive to people’s needs, with smaller operators
being particularly susceptible to closures. The CQC reports on data from ADASS which suggests that 32 councils had
residential or nursing care contracts handed back to them in the six months up to May 2016. Operators are finding
themselves unable to provide fundamental standards of care whilst maintaining profitability.

Data provided by the CQC shows that for the period October 2010 to December 2015, there were 2,444 residential care
home closures, with 59% of those being small care homes. Operators of a single care home, as opposed to a portfolio of
care homes, will likely be impacted to a greater extent by the issues discussed in the article thus far, given that they are
less able to take advantage of the economies of scale and diversification across a group of homes; they will also likely
have more limited options available to them in a distressed situation from a funding perspective. However, operators of
larger groups of homes are not without their issues and will need to ensure that they have strong management teams in
place to operate profitably and manage any financial risks.

Whilst the outlook for 2017 does not appear bright for many, our experience is that outright failures of care homes are
relatively rare because of the practical difficulties of a formal insolvency and the reputational risks to which the key
stakeholders (funders, insolvency practitioners and the local authority) can be exposed given the sensitive nature of the
sector.

Focused and viable business plan and early action

It goes without saying that an engaged, well-led and advised management team, alive and responsive to the issues the
care home faces will be key to avoiding and minimising any financial instability to the business. Any care home operator
needs to devise a focussed and viable business plan at an early stage, prior to any suggestion of financial distress,
looking at any opportunities on which the business could capitalise, such as third party investment or an increased
demand resulting from the UK’s ageing demographic.

Business models for care homes are often dependent on achieving occupancy levels of 85% or higher. Anything below
this can turn a profitable business into a significant loss-making operator (Southern Cross, for example, had occupancy
levels of 84% prior to its collapse; down from 92%.

The CQC has reported that since 2001, the number of people in England and Wales aged 65 and over has increased consistently; with a total rise up to 2014 of 22%. From 2001 to 2014, the number of people aged 85 and over rose by 33%. The CQC states that future projections show that these trends are set to continue in the coming decades and that it has been estimated that there will be a 49% increase in demand for publicly-funded care home places for older people between 2015 and 2035.

However, despite this increased demand for places and even for care homes operating in a desirable area with a good catchment of potential residents, non-occupation time lags must be built into any business model. Skilful management of cash flow in such situations becomes vitally important, especially for single care home operators.

The management team will also need to carefully consider the business' various overheads, the most significant of which, as we have seen, are staff costs (which will be impacted by the NLW), as these will squeeze already tight EBIT levels.

If the business does experience any financial distress, it is important that the management team recognises the issues and seeks professional advice at an early stage; engaging with the CQC if considered necessary.

**Options in a distressed situation**

The options available to any financially distressed operator will be dependent upon the severity of its predicament, and the corporate and debt structures in place for the operator and/or its group. There will often be a number of external factors to take into consideration too, such as: any possible adverse publicity to the lender and other key stakeholders (such as the local authority or any insolvency practitioner appointed); and political pressure from local members of parliament to keep the care home open and act in the best interests of the vulnerable residents.

**Trading in insolvency**

Trading whilst in insolvency is often not a particularly attractive or viable option for a distressed care home.

In a sector already plagued with financial difficulty, absent ongoing lender support, there will likely be insufficient funding available to allow an insolvency practitioner to trade the business. There is also the prevailing interest of the wellbeing of the vulnerable residents to consider, and the reputational damage for the key stakeholders if the trading insolvency were to put those interests at risk.

There are likely to be difficulties for the insolvency practitioner with the management of the business from a legal and regulatory perspective and many hoops to jump through to ensure compliance with the myriad of rules and regulations imposed on such businesses. The insolvency practitioner does have the option of engaging the services of a specialist third party to assist with the running of the business but this may be difficult to come by, is likely to prove costly and will require careful control of the third party by the insolvency practitioner from his or her own risk perspective.

In selling the business there may be considerable delays between the appointment of the insolvency practitioner and the sale of the business due to, for example, purchaser registration requirements (to allow the purchaser lawfully to operate the care home(s)), which is an unavoidable administrative process.

**Pre-pack administration sale**

Pre-pack administrations are used on a regular basis in order to achieve the sale of a distressed business for the benefit of the creditors of the insolvent entity whilst maintaining continuity of service delivery and business value. Whilst a pre-pack administration is not out of the question in the context of a care home there are a number of issues which may make such a process impractical.

Any purchaser will likely wish to exclude from the sale any underperforming parts of the business. In the context of an underperforming care home in the portfolio, the closure of a home is not straightforward and at least 28 days' notice is required to be given to the local authority to enable it to find alternative accommodation for the residents. Any insolvency practitioner will be keen to avoid being left with an underperforming care home which is costly and difficult to deal with, particularly where he/she will owe a duty of care to its residents and be at risk of reputational damage if any issues arise which are not dealt with appropriately.

As noted above, there may be bars to progressing the sale quickly due to the need for the purchaser to be CQC
registered, which may make a pre-pack unworkable. It may be possible to expedite the process if the purchaser is already registered with the CQC as they can make an ‘add-on’ application to an existing registration. However, even registrations such as this can take up to four months to complete. Any delay in completion of the sale where the administrator has not put in place an effective trading plan is likely to cause damage to the business, worsening the home's financial position and putting the care of the residents at risk.

Alternative options

Whilst trading insolvencies and pre-pack administrations may be less favourable options for care home operators in financial distress, there are alternatives to consider, including:

- Negotiating some form of debt forgiveness with key lenders and creditors, and/or entering into a company voluntary arrangement (CVA) involving the restructuring of the unsecured debts of the operator
- Solvent restructuring of the business, for example via:
  - an operator-led restructuring where the operator's management team (perhaps in conjunction with specialist advisers) works with the operator's lender to negotiate a structured financial and trading plan so as to attempt to trade the business back into profit. This could be completed in conjunction with a CVA
  - a third party refinance, possibly involving the sale of the incumbent lender's debt to the incoming third party
  - a lender-led restructuring in circumstances where the lender holds security over the shares of the operator (or has the consent of the operator) and can enforce its rights under its security to alter the board of the operator. The lender could replace existing management with a team of healthcare specialists to execute a turnaround plan
- Investment sought from a third party or overseas investor, perhaps by way of a sale and leaseback in respect of the operator's premises

Conclusion

For years, the care home sector has borne the brunt of funding cuts and the resulting financial uncertainty has prevailed for some time now. The sector is in jeopardy and the risk to vulnerable members of society is growing ever greater.

The financial position of numerous care homes across the country is critical as operators struggle with the introduction of the NLW; auto-enrolment and the workplace pension scheme; a nursing shortage; and the uncertainty of Brexit. It remains to be seen whether or not the Government will be able to deliver an effective solution or, at the very least, a viable plan to mitigate the number of care home insolvencies or closures which appear likely in the short to medium term.

The increase in demand for care home spaces, resulting from an ageing demographic, will come as welcome news to operators but this alone is unlikely to resolve the raft of issues which the sector faces.

Whilst operators may look to increase fees in order to mitigate the impact of an increasing costs-base, attracting privately-funded residents or residents who are prepared to pay "top-ups" is proving difficult in light of the fact that more people of retirement age are choosing, or are forced (due to a lack of local authority funding), to live in their own homes longer, seeking residential care home places only when they develop more complex health conditions, by which point they may be less likely to fund their own care privately.

Key to avoiding and minimising any financial instability to the business will be an engaged and well-led and advised management team, who are live and responsive to the issues the care home faces and who are able to capitalise on profit-making opportunities.

Formal insolvency processes can be fraught with risk and may be difficult, costly and time consuming to implement. Operators need to be monitored on a regular basis and stakeholders need to be mindful of the early warning signs of financial distress so as to be able to consider available options and mitigate any damage to the business and its residents. Engaging with professional advisors, the CQC, local authority and Clinical Commissioning Group at an early stage of any process will be essential to ensure a favourable restructuring of any distressed scenario.

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