PROVIDING CARE IN THE UK

Struggling with a broken funding structure

'CARE THOUGHTS' APRIL 2021

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1. Introduction

Investment in the assets required for the provision of care and supported living has many aspects in common with Social Housing.

Both address a strong social need where demand far outstrips supply. Both have a heavy dependence on government funding – generally delivered in the case of care through Local Authorities or the NHS – while both benefit from high levels of regulatory oversight.

Yet this is where the similarities end.

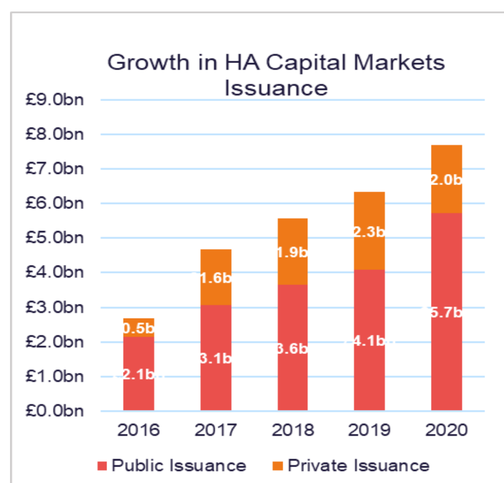
In the case of Social Housing, funding has grown steadily over the last 10 years as institutional investors have come to recognize the attractions of the asset class – particularly for pension funds:

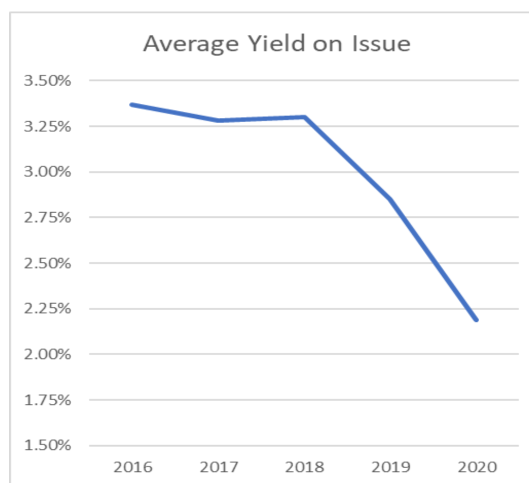
- High quality, long dated, low risk cash flows
- Strong Social and, increasingly, Sustainable Impact

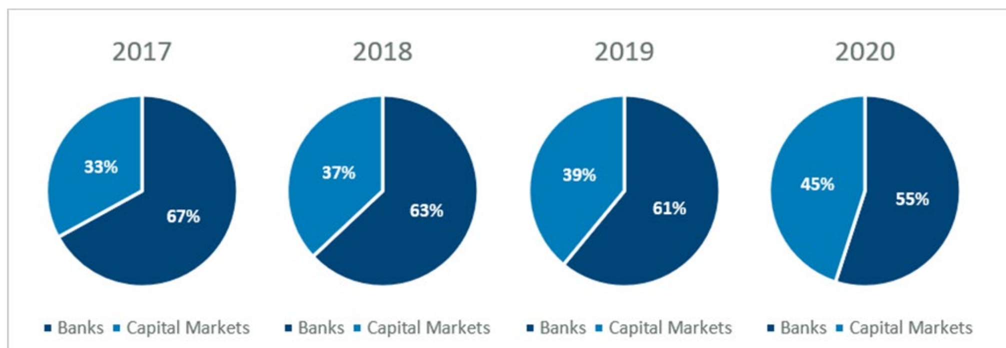
As a consequence, the appetite for Housing Association debt has increased steadily to a point where it constitutes an established asset class in the Sterling bond market with its own performance index; while pension funds have started to move from debt into the direct ownership of general needs and shared ownership housing.

In the process, the cost of capital for Housing Associations and other Social Housing providers has fallen steadily – from 5-6% real (i.e. inflation adjusted) in 2010 to 2 – 3% today. As the cost of capital accounts for approximately 30% of the cost of providing social housing, the impact has been to expand provision and make it substantially more affordable

Growth of HA debt 2010 – 2021:







The contrast with the provision of Care could not be more stark.

Care also depends on investment in high quality assets to meet a steady growth in demand. Yet, if anything, the supply of long-term capital has become more constrained over the last 10 years while the cost of capital has actually moved in the wrong direction – rising steadily to a point where it stands at at least 5 – 6% today.

This reflects a classic case of "group think" amongst institutional investors created by concerns over "reputational risk" arising from the well-publicized failings of individual care homes; exacerbated by the legacy of the failed, over-optimistic, over-leveraged OpCo/PropCo funding structures created for Care Home businesses by private equity in the late 2000's.

It has created a situation where there is an absence of long-term funding for Care Home owners/operators, leading to over-dependence on inflation linked sale and leaseback arrangements. These are both expensive and inflexible – burdening operators with high, long term, fixed overheads that can only ever be cancelled at considerable expense and contributing to a reputation for asset lite operationally overleveraged businesses, vulnerable to any variation in pricing or levels of demand.

In this paper we explore the issues that have led to this – and discuss how they may be addressed.

2. Background to the care market

Over the last 10 years, the economics of care has been subject to three major influences:

1. Supply and demand, with a growing need for facilities as:
    - The population ages
    - There is a move towards homes and care in the community

2. Increasing standards as the CQC raises the bar on the quality of provision:
    - Driving the need for new purpose built homes
    - A significant upgrade in existing homes

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3. Pressure on margins:
    - A reduction in Local Authorities payments
    - Rising costs as a result of increases in the minimum wage

In many respects these developments mirror the influences effecting the Social Housing market:

- A growing shortage of affordable housing
- Increasing regulatory oversight on “decent homes standard” and Zero carbon
- Falling grant levels and four years of 1% rent reductions

But while many of the pressures are similar, the impact on funding has been very different.

To some extent this reflects the impact of failure. Shortfalls in the quality of Social Housing provision have been treated as isolated local incidents or – like Grenfell Tower – part of a wider problem where Housing Associations were the innocent victims of a broader Government failure.

In contrast, Care Home failures have often attracted national publicity and high profile prosecutions which have highlighted a lack of empathy in addressing the needs of the vulnerable.

Yet the bigger issue relates to the impact on the funders. The regulator of Social Housing recognizes the need to protect funders from the outcome of incompetent or inappropriate management.

In this respect, it mirrors the statutory duties of the Utility regulators which, while primarily responsible for protecting the interests of the consumers have to give regard to the interests of the lenders.

In both cases, this is achieved by imposing minimum requirements on capital structures. With Housing Associations, this involves a V1-V4 regulatory system. On Utilities it involves requirements for a minimum rating within the regulated entity.

In both, it is backed up by the ability to seize and reallocate the ownership of the assets, primarily in the interests of the consumer but also with regard to the interests of borrowers.

This all makes perfect sense. They are both asset heavy operations where the cost of capital has a major impact on the cost of the service that is provided. In affording a degree of protection to lenders, regulators encourage the inflow of capital and reduce the cost of debt; thus delivering an improved and more price competitive service for consumers.

Unfortunately, this has not been the experience with Care Homes.

Rating a home as inadequate places considerable pressures on the operator and in the event of failure, runs the risk of involving the lender in needing to help clear up the mess. This imposes severe reputational risk which any funder will wish to avoid.

3. Consequences for the care sector

This has created a situation where long term lenders have decided to either avoid the risk by avoiding the sector or distance themselves from it by lending through third parties.

It has led to a range of publicly listed or privately owned businesses that own the care homes and lease them on to the care operator. As befits organisations that are starved of long term capital, the assets are rented out on long term inflation linked agreements that start on yields of 6% and above and rise steadily thereafter. Cancellation of the leases then attracts severe penalties – which could easily equal to 50% of the notional capital amount.

It creates operations that are asset poor and operationally leveraged, with little flexibility to respond to changes in the market by restructuring the business or reducing leverage through the disposal of assets.

With the sale and leasebacks inflation linked, it also runs the risk that the level of the annual rents moves out of alignment with the market – making the facility uneconomic. While many of the new Sale and leasebacks have caps and collars on inflation of 1 – 5% this may not provide adequate protection as on a 10 year view this could still lead to increases of 62% over the period.

Organisations with historic Sale and Leaseback contracts are now paying levels of “rent” on the premises that are substantially above current market levels without any mechanism for redress.

It has given rise to an increasingly fragile and disorganized market funded by asset owners remote from the delivery of care and managed by operators using a highly leveraged and inflexible business models.

The alternative of relying on bank funding involves dependence on debt with a five year maturity. This leaves the borrower with considerable refinancing risk and the need to renew or refinance the debt every four years.

In either case, the funding structure does not encourage a focus on long term service provision, leaving the sector vulnerable to any short term adverse development – like, for instance COVID-19.

It also constrains consolidation as there is a natural limitation to the level of short dated debt or Sale and leasebacks it would be advisable for any organisation to contract.

So, what is to be done?

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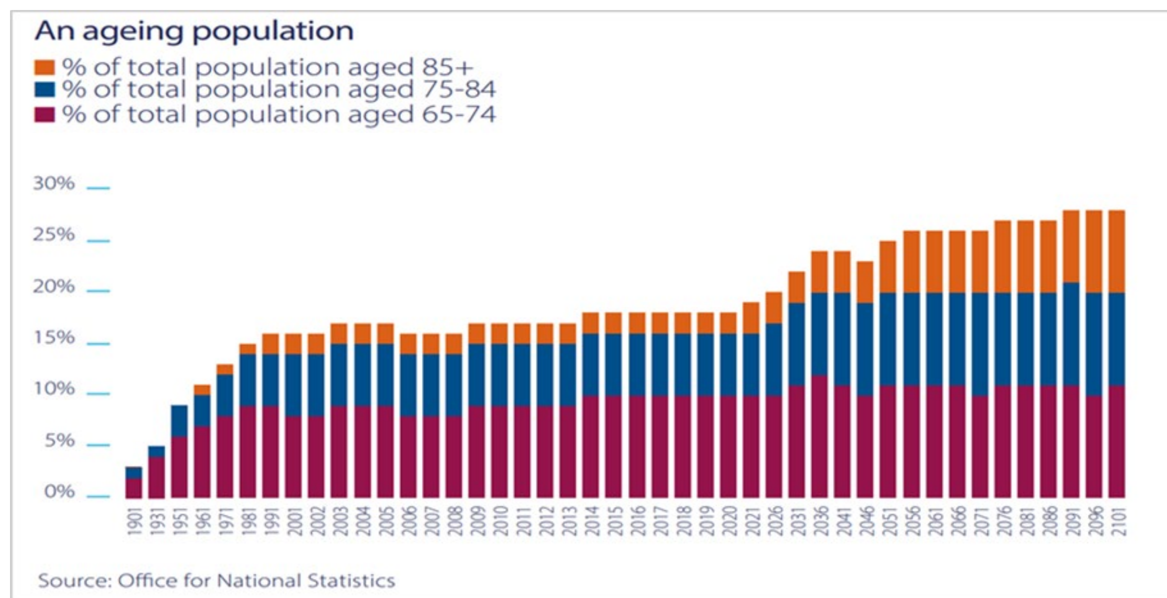
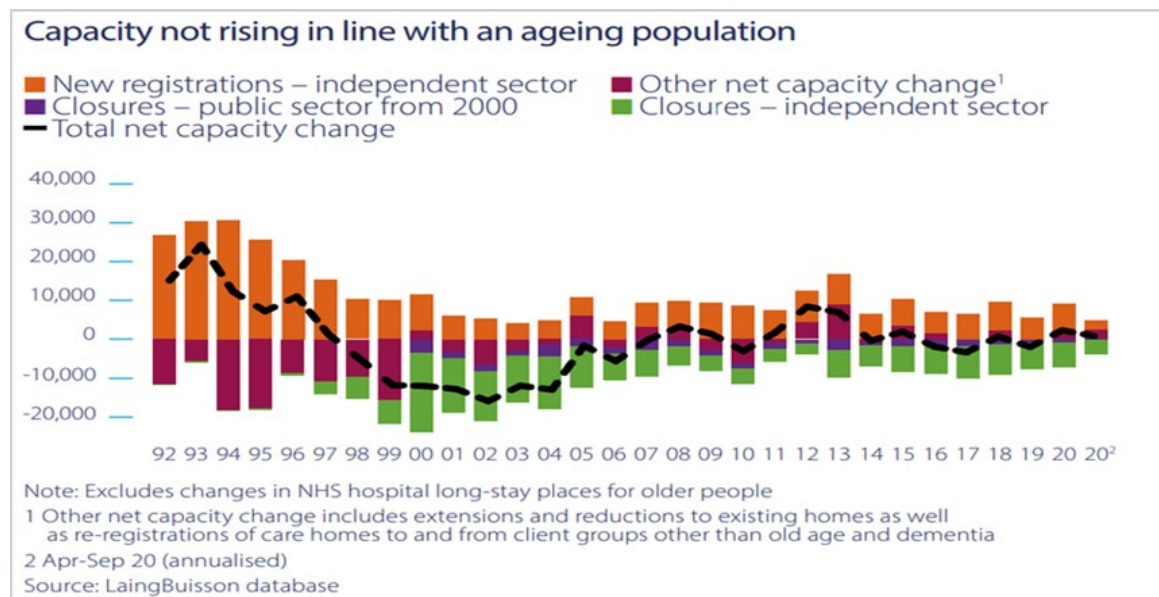
4. Promoting the Care Home Sector

Operating Care Homes generate high social impact.

It also constitutes an "essential service" where the demand for high quality facilities significantly outstrips supply – particularly when it comes to care for older people.





Yet by comparison with Social Housing or Utilities, the sector suffers from a remarkable lack of recognition, particularly amongst funders. This needs to change. Expanding the provision of care places contributes just as much to resolving the housing crisis as building a new housing unit.

<u>Lobbying the long-term lenders</u>

It suggests that the first thing the Care Sector needs to do is embark on a lobbying campaign designed to raise its profile with funders – particularly amongst institutional investors.

This needs to focus their attention on:

- the supply/demand characteristics of the sector
- the active secondary market for modern purpose built homes
- the predictable high quality revenues available from Local Authorities and the NHS
- the strong performance of efficient Care Home operators
- The potential for investment grade credit ratings

Housing Associations with large Care Home businesses like Sanctuary or Anchor Hanover benefit from strong investment grade ratings for their operations. With sensible gearing, established occupancy levels and respectable CQC ratings there is no reason why Care Home operators will not benefit from the same Investment grade ratings.

Yet this is not how they are currently seen by institutional investors.

Building a strong profile on Social impact

After a slow start, ESG has become a major influence on funding decisions. The Social Housing Sector has embraced this, signing up to:

- The Good Economy Sustainable Reporting Standard
- Alignment to the globally recognized International Capital Markets Association and the London Market Association's ESG principals for their bond issues and loans.

This in turn allows lenders to meet their own publicly stated commitments to making ESG loans – which impacts their ability to attract funding or assets under management. As a result, the level of funding or investment in Social Housing has become a major target for banks like Lloyds and Nat West, while the Chief Executive of L&G, one of the largest institutional investors in the UK, has made it a key deliverable.

Moreover, lenders are providing discounts on the cost of debt for strong ESG performance and accelerated impact.

Yet if sustainability is hard coded into Housing Association operations delivering strong social impact is hard coded into the operations of any good care operator.

It is only by delivering a good product strong long term relationships can be built with local authority funders or a steady and predictable, flow of self-funded clients attracted to their homes.

From the work we have done with major care operators, it is clear they adopt a wide range of measures designed to produce strong social impact. These include:

- Training
- Staff management, pay and retention
- Close monitoring of customer satisfaction levels
- Detailed analysis of occupancy levels

- CQC scores

It would be relatively easy for the sector to engage on this issue with organisations like the Impact Investing Institute, an organisation which grew out of the Government's taskforce on Growing a culture of Social Impact Investing in the UK.

It has already launched major initiatives designed to encourage institutional support for placed based impact investing and sustainability reporting by Housing Associations.

Focusing on support for investment into the development of Care Homes and supported Housing would be a natural extension of its areas of interest. With Local Authority Pension Funds now accounting for a major proportion of all active Defined Benefit Pension Funds, encouraging a culture of investment into the development of appropriate care facilities would be logical, delivering benefit for society and their own rate payers.

In the current climate favouring ESG, promoting itself as a natural generator of Social Impact turns the tables on investors – so that the question ceases to be will you" support us?", but "why are you not supporting us when we delivering such strong social impact".

Lobbying for a shift in the responsibilities/actions of the CQC

A more supportive approach on funding from the CQC would help to open up the market for low cost capital to the benefit of all operators.

It may prove controversial for many as it would involve either an extension of, or a more transparent regulatory oversight. Yet we believe the benefits are likely to substantially outstrip the costs.

Creating a situation where the CQC monitors and reports on financial risk is likely to help provide a framework for sound balance sheet and operational gearing. It may also contribute to concepts governing the appropriate level of returns from investment into care homes.

However, the real benefit arises if in return, the CQC assumes some responsibility for resolving failure. In an area of great social impact, this is the issue which worries lenders the most. No lender wishes to close an underperforming home or put residents onto the street.

The utility regulator has succeeded in maintaining stability in the sector by protecting the interests of senior lenders while making it clear that equity is at risk. This encourages limits to be put on leverage and an operational approach that will protect all stakeholders. Similarly, in the housing association sector, to date no senior lender has lost money.

So, assuming a more active role in resolving the problems of underperformance would ensure the CQC becomes a more supportive force for lenders in the sector.

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