A PROBLEM OF INAPPROPRIATE COVENANTS

'CARE THOUGHTS' JUNE 2021

1. Introduction

In our last paper we contrasted the cost and availability of debt for Care Home operators with the experience of Housing Associations. We suggested that this arose largely from differences in the regulatory regime – which affected the willingness of investors to provide long term debt directly to Care Home Operators.

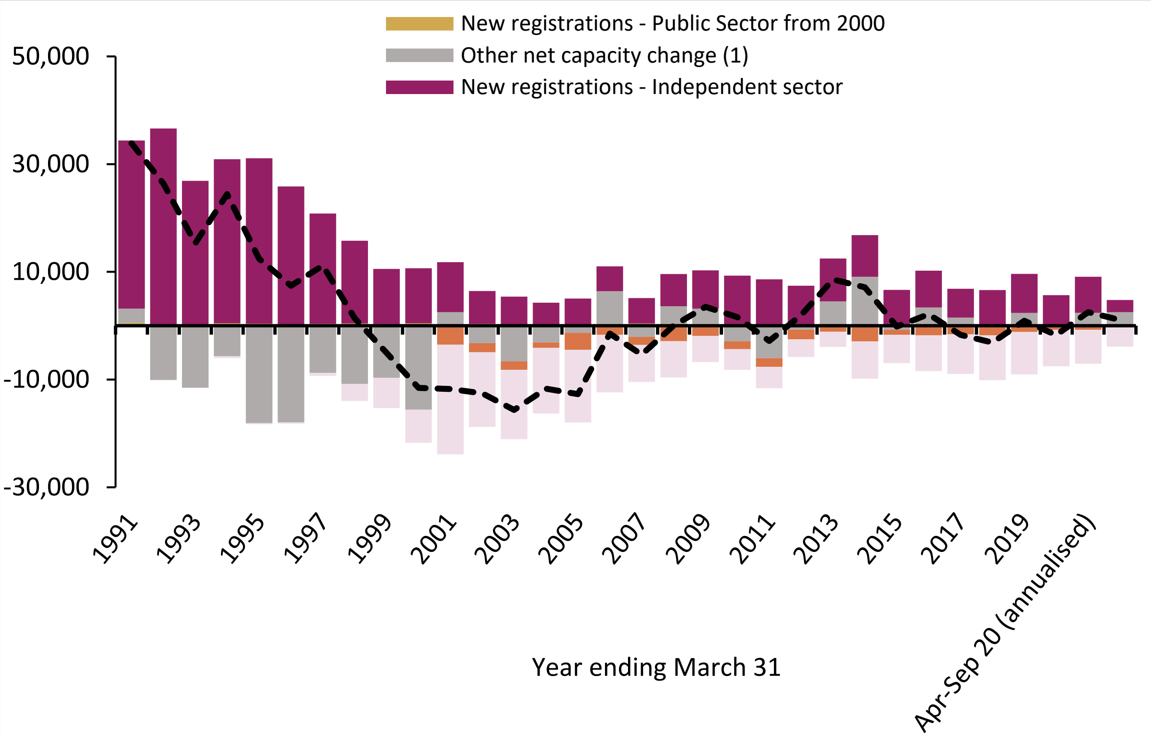
We concluded that without a change in the attitude of lenders the sector will continue to be constrained by a lack of capital while investment will be biased towards “sale and Leaseback” structures which are expensive and inflexible and risk leaving providers with an unacceptable level of operating risk.

In this paper we look at the financial ratios used by existing lenders to the sector. We argue that one of these is inappropriate and reflects a failure to understand the dynamics of value creation in Care Homes. It is also considerably more restrictive in practice than any of the ratios applied to Housing Associations – or providers of Private Rented Accommodation – while imposing a major constraint on both the quality of care and the capacity of good quality operators to expand.

2. The background to the market.

There is a growing shortage of high quality Care Home accommodation with an aging population increasing pressure on places and the development of new homes/upgrading of existing homes to modern standards barely keeping pace with the retirement of legacy care homes

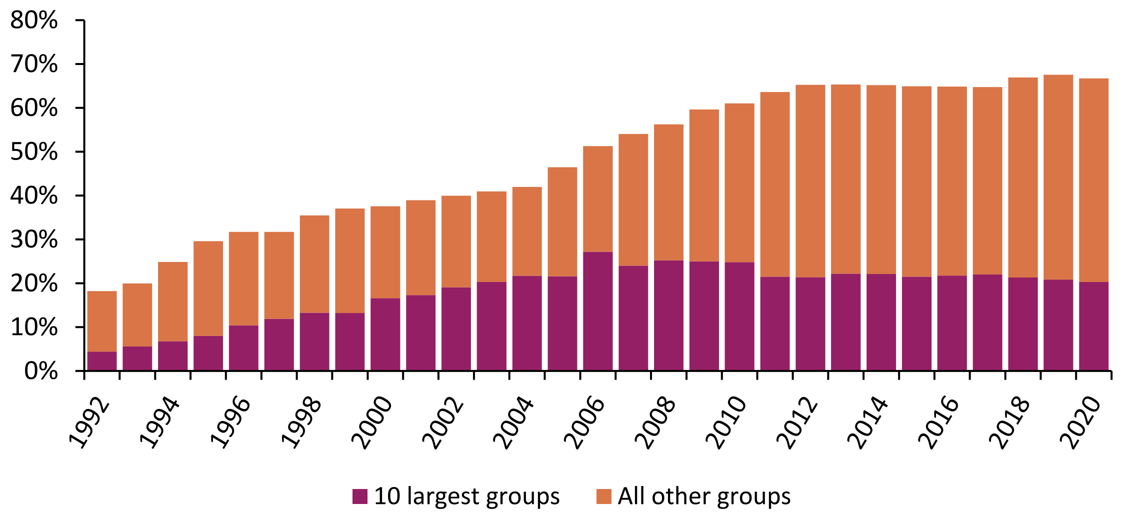
Figure 1 Bed capacity gains and losses from new registrations, closures and other net changes including extensions and reductions in registered beds in existing homes – all independent and public sector care homes* for older people and dementia (65+), UK, 1990-2020



Source LaingBuisson

In these circumstances, a curious paradox has emerged on funding – completed modern care homes are generally worth more than their construction costs – while their enterprise value is higher still once fully occupied. Development finance while expensive is freely available on relatively high loan to Gross Development Cost (LDC) yet there is a reluctance amongst most medium size operators (the dominant force in the market) to energetically expand.

Figure 2 Share of bed capacity owned or leased by a) the ten largest independent sector care home groups and b) all groups (1) with 3 or more homes - care homes for older people and dementia (65+), UK, 1992-2020 (2).



Source LaingBuisson

This is the result of the constraints created by the funding market where there is a shortage of longer term credit. So there is over dependence on short term lending from banks as the principal source of debt which leaves Care Home operators subject to major refinancing risk.

Financial covenants on this bank debt then act as a major constraint on the development of new homes by the organisations best equipped to run them successfully – the experienced and established operators.

3. The standard financial metrics used by the market.

Most bank lenders to the Care Home sector use four key metrics on their loans:

- Interest cover – which fluctuates between 1.25 – 2.0x
- Loan to Value (LTV) – at cost or valuation, which is generally capped at 65 -70%
- CQC scores with good or excellent ratings required for security on individual homes, and
- Debt to EBITDA – which varies between 5.5 and 7x

In addition, for bank loans there is generally a requirement for an element of amortization over the life of the loan even though the loans only have a 3 or 5 year maturity. This imposes a major pressure on cash flow (amortization generally starts in year 1 and involves repayments capable of liquidating the loan over 15 -25 years) and further reduces the average life of the debt.

The first three ratios do not appear inappropriate nor create any real problems for successful operators. The interest cover ratio is entirely reasonable while the LTV ratio reflects standard practice in the property market.

The LTV ratio is lower than the LDC ratio offered on development finance but this probably reflects the fact that:

- completed homes are generally worth more than the build cost, while
- established homes have a still higher value once they operate at capacity.

It also contrasts with the 100% available on Sale and Leaseback contracts but these clearly come without the option to take advantage of any rise in property values, a key ingredient in the build-up of value in most successful Care Home operations.

The problem really arises with the Debt to EBITDA ratio. This is tight. It contrasts with ratios of between 10 and 20x for high investment grade Housing Associations and generally limits the debt to a level that is significantly below either the interest cover or LTV ratios.

Housing Association	Rating	Debt / EBITDA-MRI
Aster Group Ltd.	A+	13.2
Platform Housing Group	A+	10
Richmond Housing Partnership	A+	10.1
Sanctuary Housing Assn.	A+	17.4
Sovereign Housing Association Ltd.	A+	10.6
Wheatley Housing Group Ltd.	A+	16.4
Karbon Homes Limited	A	10.3
Peabody Trust	A	12.4
Clarion	A-	17.5

While one would expect a differential between the sectors given the operating risk in Care Homes operations, this is a very substantial differential.

It is worth noting that:

- In the place of this ratio, the Regulator of Social Housing monitors Debt to Turnover which is currently 4.0x. By comparison the ratio for most care home operators fluctuates between 0.75x – 1.5x and
- Neither ratio is used in the financial covenants on debt for lending to Housing associations.

The use of the Debt to EBITDA ratio has a number of major drawbacks:

- It is a very volatile ratio where relatively small short-term changes in earnings will have a significant impact on outcomes. It is also particularly invidious as there is little an operator can do to address the problem immediately if earnings come under short term pressure.
- It aligns debt to future earnings. These are inevitably subject to some speculation and a degree of short-term volatility. It therefore forces prudent owners to operate further within the ratio to avoid the risk of breach than is likely to be the case on either interest cover or LTV covenants.
- It penalizes operators of new care homes – as these take time to build up to capacity. It therefore imposes a cap on the speed at which even successful care home operators can expand.

- It has an even less attractive impact on the renovation and upgrading of the estate as this will generally involve some short-term interruption in earnings, and
- More generally, it encourages unfortunate behaviour as it incentivises operators to run their business to maximise short term gain even at the expense of creating long term value or maximizing CQC scores.

This all works as a barrier to building a growing business and means that operators are forced to either limit their capital investment or move towards the sale and leaseback model which has led to so many difficulties in the sector.

If it is meant to measure cash flow generation or debt repayment capacity, it is set far too tight for assets with a minimum operating life of 20 – 25 years.

4. Creating value or generating Cash flow

We believe that Debt to EBITDA is an inappropriate ratio for a business which involves owning long term capital assets. This is because it prioritises generating short term cash flow when creating long term capital value is rather more important.

Care Homes are not a homogeneous product. Each Care Home operates within a local market and provides a service crafted to the needs of the area. Its value depends on the nature and quality of service that it offers.

This allows the home to generate high levels of occupancy, achieve good CQC scores and charge fees towards the upper end of its local market. While this has beneficial implications for cash flow over the medium term it can probably only be bought at a short term cost; focused management resources, better staffing levels, higher remuneration, investment in additional facilities to improve the well-being and quality of life of residents. All outcomes sought by the CQC.

The investment however translates into a significant increase in capital value. Good Care Homes with satisfied residents, high and predictable levels of occupancy and strong CQC scores enjoy a 30 – 50% premium over mediocre or weak ones.

Building an expanding group of high-quality homes involves a cycle of investment in facilities which sacrifices short term EBITDA for the creation of long-term value.

It is also a process of creating maximum social impact – where ESG has become one of the dominant trends in today's funding market.

So how did we arrive with a ratio that was so unhelpful to the sector?

5. Creating competition on the provision of debt.

We believe one reason is the lack of competition between different types of debt. Funders operate within their own regulatory environment while staff move from one institution to a similar one – bank to bank or institutional investor to institutional investor. As a result, a consensus arises over the type of deal or the appropriate ratios to use in a particular sector.

Alternative providers of debt provide a challenge to this view and provide a steady impetus for change. This is largely missing from the care homes sector where banks and quasi banks dominate the environment.

It takes us to the need for funders that provide long term debt and therefore are more heavily focused on the creation of long-term value.

We will explore how this may be done in more detail in another paper.

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