It pays to care – if you get the details right

Investment Simon Rutman explains why, despite a recent high-profile failure, care homes still attract private equity investors

Despite the collapse of Southern Cross in 2011, the care homes sector continues to attract investment. Why does this sector appeal to private equity investors and what are the challenges that they face on the purchase or development of a care home?

Financial state of the sector

The care homes sector overall experienced four years of declining profits from 2007 to 2011, but profits have since started to rise. This overview obscures a more complex reality — certain categories of home have seen good profits throughout the recession. The successful homes share the following characteristics:

● **A high proportion of self-funded residents.** According to Laing & Buisson's *The Role of Private Equity in UK Health and Care Services* (July 2012), 41% of residents are "pure" private payers in the sense that they receive no public sector support, and a further 14% top up local authority fees in order to increase their choice. The most profitable homes target privately funded residents, whereas those homes that care for mainly publicly funded residents face an uncertain future.

● **Affluent locations.** In London, the South East and the East, as well as the M4 corridor and parts of the South West, land prices and staff wages are higher than elsewhere, but these costs are balanced by a higher proportion of privately funded residents and a higher occupancy rate, which both support higher fees.

● **Optimal size.** According to Knight Frank's *Care Homes Trading Performance 2012* the optimum is 60 to 79 residents. At this level, staff costs and property costs are lower than in the smaller homes, and occupancy rates are still high enough to maintain a good profit margin.

● **Good buildings.** The homes at the bottom end of the market are typically older properties that have often been poorly converted from residential or hotel buildings and are now dilapidated and outdated. By contrast, the more successful homes tend to be modern, purpose-built and spacious.

● **Professional operator.** Around 80% of homes are run by five major operators, and the rest by individuals or small groups. The larger groups can reduce expenditure on consumables and there are economies of scale in management and office costs.

Why invest?

The financial picture outlined above does not show a glowing picture but, as evidenced by Terra Firma's purchase of Four Seasons Healthcare earlier this year, there is a healthy appetite for private equity investment in this sector. Currently, private equity providers account for around 8% of the total market size (depending on the definition of "private equity") and this proportion looks set to increase. One reason for this is that analysts are predicting:

● an increase in local authority funding levels (1.6% increase for the financial year 2012/13 according to Laing & Buisson);

● that the anticipated closure of some failing homes will increase occupancy rates in the more successful homes; and

● demographics mean that the number of elderly needing care will continue to increase.

A second reason is that current restraints on bank lending mean that private equity will continue to play an important role in providing funds for additional capacity and for the upgrading of existing facilities, and also in unlocking bank debt funding, because of their involvement in development projects.

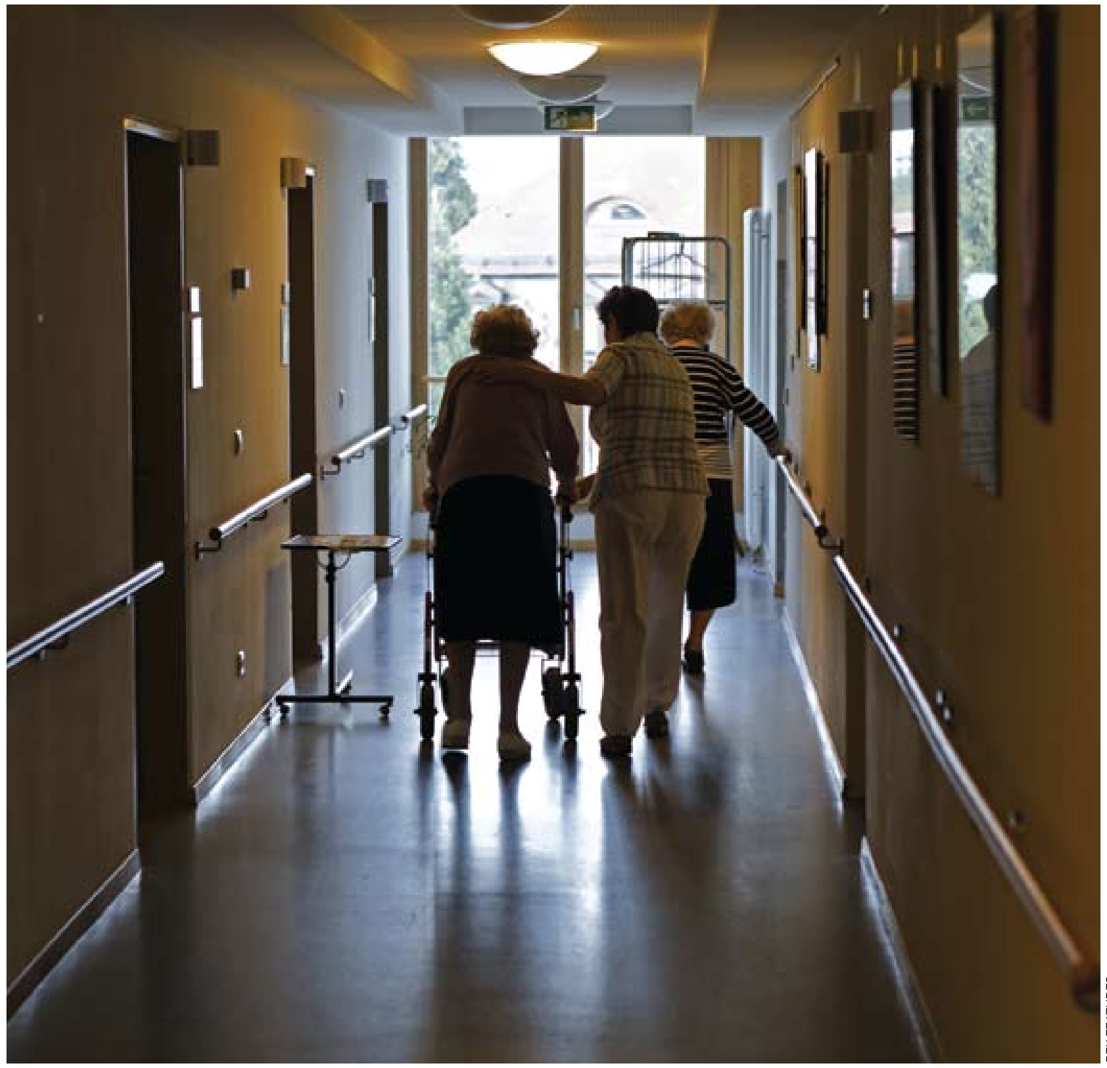
A third factor is that, due to stable land prices in the key areas referenced earlier, care homes offer good underlying security to lenders because of their strong alternative use values.

Planning control

Planning is an interesting element in the development of care homes. The distinction between C2 (residential institutions) and C3 (dwelling houses) use is not always clear in practice and the use or modification of a house as a care home could fall into either category.

Class C2 is defined as use for the provision of residential accommodation and care to people in need of care (other than a use within C3) as well as hospitals, nursing homes, residential schools, colleges or training centres. By contrast, C3 includes use as a dwelling house by a single person or people within a single household, or up to six residents living together as a household, whether or not care is provided. Class C3(b) includes supported housing schemes such as those for learning-disabled adults, where residents live together as a family, rather than a house in which a number of people live independent of each other and for whom care is provided.

Classification as a dwelling house is therefore not based on whether care is given or whether the carer lives on site but on the degree of interdependence (or family-style living) of the residents. Government policy favours the integration of special needs groups within society as far as possible, and in some areas a C3 classification may be more achievable if a developer wishes to use the property as a domestic residence sometime in the future.



REX FEATURES

Regulation

There is an increasing volume of health and safety legislation and care regulation. Most of this is outside the remit of this article except to note firstly, that operators must comply with the same health and safety regulations affecting all landlords and occupiers. Secondly, the Care Quality Commission (CQC) is the body that regulates adult care facilities in the UK, and ensures that they meet the standards of care set out in the Health and Social Care Act 2008. If the operator cannot establish compliance, one of the CQC's sanctions is to restrict the number of residents that they can accept, which can have a real effect on a business, as high occupancy rates are crucial to profitability.

Ownership structures

There is a wide choice of arrangements between landowners and the companies that operate the homes. Sometimes the operator owns the freeholds of its homes, but usually the operator will run its business from a mixture of freehold and leasehold properties.

Where the operator does not own the freehold, a contract will be put in place to deal with the terms under which the operator will occupy the property and the basis on which the rent/profit payments to the freeholder will be calculated. This contract will vary from one similar to a traditional lease at one end of the spectrum (often an FRI lease with annual rent increases linked to RPI with a collar and a cap) to a more complex management agreement (akin to those used in hotels and restaurants) at the other end.

The freeholder might also take a debenture over the tenant operator, which will include the step-in rights usually allowed to a lender, to allow it some control over the running of the home if the operator experiences financial difficulties. However, care must be taken with this mechanism that the landlord only takes the rights that it actually needs and that the terms of the debenture do not restrict the operator's ability to run its business effectively.

Where the operator does not own the freehold, this is sometimes because the group has chosen an "opco/propco" structure where the operating company pays rent to a sister company in which the properties have been vested. Alternatively, the operating company may have been through a sale and leaseback process to raise funding for expansion, where the operator has sold the freehold interests to a third party that becomes its landlord. The way this structure was implemented during the expansion of Southern Cross is thought to have been one of the factors leading to its decline.

VAT

The operation of the VAT system in relation to buildings and construction is notoriously complex, and ridden with anomalies. These anomalies are of magnified importance in the care homes sector, since the underlying business of providing care to residents is exempt from VAT, with the consequence that any VAT incurred by a care homes business can normally be assumed to be irrecoverable. It is therefore critical to navigate a path through the rules on buildings and construction to ensure that either VAT is not charged to the business in the first place or, if it is, that it can be recovered despite the general rule to the contrary.

Where a new home is being built from scratch, the position is relatively straightforward – if the home is to be owner operated, then the builders should be able to zero rate their supplies with the result that the VAT that would normally attach to their costs is eliminated. On the other hand, if an opco/propco structure is to be used, VAT will be charged by builders but the grant of the lease from the propco to the opco once the construction is complete should be treated as zero-rated, with the result that VAT on construction costs can be recovered without the need to charge irrecoverable VAT on opco's rent.

If an existing building is being converted for use as a home, then the opco/propco structure will normally be more attractive since the above treatment will still be available but an owner operator will not be able to secure zero rating of the builders' fees. Similarly, if the purchase of land by the care home operator attracts VAT (because the seller has opted to tax the land), that VAT will only be recoverable if the opco/propco model is adopted.

Care is also needed if a building is not intended for use exclusively as a care home, as this can lead to the complete loss of the favourable VAT treatment (not just the loss of a part of the VAT benefit proportionate to the level of non-care home use). Similarly, the addition of an extension to an existing building is unlikely to qualify for zero rating in either the opco/propco or owner occupied model, meaning it will generally be more attractive to build a separate home next door to the existing one.

Conclusion

Most care home operators have weathered the recession and the sector has yielded higher returns than many other commercial property investments. It is likely that well-run homes in the right locations will continue to attract private equity funding.

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ISSUES FOR INVESTORS

One of the main factors in developing a successful care home is the selection of the right site. The ideal site will be in one of the affluent areas discussed earlier, and will have the following characteristics:

● Good signage – ideally the site will adjoin a busy public highway (for instance, forming part of a larger hospital and care development) but, if not, the developer will want to obtain permission to attach signage to neighbouring land.

● Secure gardens are a key selling point for top-end homes.

● Sufficient car parking for visitors, doctors and ambulances.

● Good transport links for visitors and peripatetic staff.

● Overage is a commonly encountered theme in developing care homes. The developer will need to ensure that the amount payable on development makes financial sense, not just on the first phase of building but also on any subsequent extension or redevelopment.