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Nursing care homes back to health

KEY POINTS

- High fixed costs and falling property values have given the care home sector serious problems.
- The reputational issues of managing a care home in financial distress are significant.
- Insolvency Practitioners running a care home have to manage their statutory responsibilities carefully and failure to do so may lead to criminal sanctions.

With record numbers of centenarians announced in the UK last year and life expectancy rates increasing year on year, it seems logical to assume a continuing and increasing need for high quality care provision in the UK. A casual observer could assume that this market is 'recession proof', in that people will continue to require care, whatever the market conditions and that people will always seek the best care they can afford. This simple assertion is not borne out by recent events, which show large numbers of care homes in serious financial distress.

STATE OF THE MARKET

The latest statistics show a marked reduction in the number of adults entering permanent residential care [(Adult Social Care Statistics, published 20 April 2011 by NHS Health and Social Care Information Centre)], which is likely due to the cost-cutting measures implemented by the Comprehensive Spending Review and an increased focus on caring for people in their own homes, again to reduce the overall cost of care.

The care sector is fragmented and chaotic, particularly towards the lower end of the market. Five major operators control approximately 80 per cent of the market, with the remainder held by individual investors and small chains.

There is a clear divide between modern, purpose-built facilities, which provide ample living space and luxurious amenities (so-called 'Super Homes'), and many independent homes, which are dated, dilapidated, suffering badly from a lack of investment and no longer fit for purpose.

While the Super Homes enjoy high occupancy rates and command a premium from occupants, large numbers of the more dated facilities are nearing the end of their useful life and require significant investment to bring their standards in line with more modern competitors.

A number of homes are converted residential or hotel properties. Whilst these may enjoy some architectural charm in comparison with purpose purpose-built homes, the operator will have to 'shoehorn' in the facilities required to operate the premises as a care home and there are numerous conversion difficulties.

Often the homes are operated by inexperienced investors, many of whom regarded the acquisition of a care home as largely a property play, or a retirement nest egg. Some were simply ill-equipped to cope with the financial and management rigours required to successfully operate a care home within a strictly regulated framework.

CHALLENGES FOR OPERATORS

Those running homes face significant fixed costs. Chief among these are:

- Compliance costs: The Care Quality Commission ('CQC') is an independent regulatory body established to monitor and regulate the activities of adult care facilities in the UK. Complying with the requirements of the CQC can be expensive to implement but unavoidable if the home wishes to continue to trade. From April 2010, all health and adult social care providers undertaking 'regulated activities' are required to register with the CQC in order to operate. To do so, they must show that they are meeting a wide range of essential standards of safety and quality, set out under the Health and Social Care Act 2008 (Registration Requirements) Regulations 2009. The CQC are ever more vigilant in carrying out their duties and poorly run homes are at constant risk of being closed, or having a 'block' placed on the number of occupants they may take. In a business where success or failure depends entirely upon achieving a certain minimum level of occupancy (typically around 85 per cent), this sort of intervention can quickly spell the death knell for a marginal business.
- For those operators who do not own the premises from which they trade, there will be a significant rent bill to meet each quarter. Many businesses are structured on an 'op-co/prop-co' basis, with the freehold to the property held in a separate entity, whilst the operating business trades from the premises under a rack-rent lease. One of the key contributing factors to Southern Cross's recent financial woes was the inability to meet the rent bill, which resulted from a previous sale and lease-back restructuring of the business.
- The wage bill: operators are obliged to maintain staffing levels at a certain ratio to the number of patients being cared for and those staff have to be of a certain standard. Consequently, wages are by far the biggest overhead for any operator. Operators either have to pay a premium to acquire and retain suitably qualified staff or invest heavily in their training. In a market where staff are often paid only minimum wage, it is difficult to retain and motivate key employees.
- Crown debt: in common with many other businesses, the reduction in availability of 'time to pay' arrangements with the Crown is placing severe cash flow pressures on underperforming operators.
- Bank borrowing: many operators are over-leveraged, having borrowed heavily in the good times to acquire and refurbish properties. The significant costs incurred in completing a refurbishment take a long time to recoup and servicing the existing debt is placing a serious financial burden on many smaller operators.

CHALLENGES FOR LENDERS

Lenders who have advanced facilities to care home operators are currently facing serious challenges in managing their investments.

Biog box

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Much of the business value is tied to the value of the property from which the business operates – like hotels and pubs, it is difficult to divorce the business from the premises. As property prices are depressed, business values also have to be re-set, meaning that sale values for the businesses are equally depressed.

One of the key issues is that the basis of bank lending on the original facilities provided to the operator may not reflect current market conditions. In many scenarios, the valuation of the property (and therefore the basis of the lending) is based on multiples of EBITDA for the business. When the level of multiple applied to EBITDA for the purposes of the Bank's lending criteria may well have changed. As a result, many operators cannot now comply with financial or occupancy covenants and are in default.

In today's market, if the home ceases to trade the lender's only recourse is against the value of the property. That value in the current market will bear little correspondence to the original EBITDA valuation and many lenders will be facing significant shortfalls when comparing loan to value.

Notwithstanding that many operators are in breach of their loan to value covenants and struggling to service their existing debts, lenders are reluctant to take positive steps to drive an exit. A formal insolvency process is not attractive, being perceived as difficult and expensive for the stakeholders and risky for the insolvency practitioners.

On closure, the only real exit options available are the appointment of an LPA Receiver or liquidator, or a consensual sale of the property with management. Administration may be unattractive given the liabilities which an administrator would potentially face as outlined below.

There is only a limited pool of buyers likely to be interested in acquiring a distressed care facility. Any locality will have a finite care requirement, so most likely buyers are either existing operators, seeking to consolidate their offering/increase market share or developers exploring an alternative use for the premises.

Perhaps as important for many stakeholders is the fear of negative publicity from being involved in the closure of a care facility. Being associated with the closure of a home and the eviction of vulnerable residents is highly unattractive, particularly as mortality rates tend to rise amongst residents affected by such a closure, due to the distress caused by the disruption.

CHALLENGES FOR INSOLVENCY PRACTITIONERS

Many challenges facing the lender will also be felt by any insolvency practitioner ('IP') asked to take appointment over a distressed care home. Reputational concerns over negative publicity will weigh equally on the mind of the IP. Of more concern will be the risk of incurring personal liability in respect of any harm coming to any of residents. IPs are not equipped to run a home independently and must rely either upon the existing staff to do their jobs properly or incur the cost of installing interim managing agents, who assume liability for the proper running of the home during any trading period.

While IPs act as agents for the company without personal liability, that agency does not extend to protect them from criminal and statutory responsibilities under (for example) health and safety legislation, corporate manslaughter regulations or requirements of the CQC. For example, if an IP fails to confirm on appointment that all staff working at the home are CRB checked and approved by the Independent Safeguarding Authority, they will have committed a criminal offence.

The IP is obliged to provide the CQC with a 'statement of purpose' as soon as reasonably practicable after taking appointment, setting out certain prescribed information about what regulated activities he will be undertaking and from which locations. Any breach of these notification requirements is punishable by a fine. There are many such traps for the unwary IP.

Any IP asked to accept office will be concerned as to how his costs will be met, where he is asked to run a home that is trading at a loss. Unlike a manufacturing or retail trading administration, there is no accumulated stock or work in progress that can be run down whilst trading, so the risk of suffering net trading losses is increased.

RESTRUCTURING VIA A FORMAL INSOLVENCY PROCESS

Where a formal insolvency process is unavoidable, the reputational, financial and regulatory risks associated with trading a care home all point towards using a properly planned and structured 'pre-pack' solution to achieve a disposal of the business. This has the benefit of minimising the risks to the IP, who avoids the risks associated with a trading period, as well as providing certainty of outcome for the stakeholders. From the buyer's perspective, this can be an attractive way of avoiding acquiring historic business liabilities whilst preserving any residual goodwill.

Sadly, this is not a 'magic bullet' solution and there are still many difficulties attendant upon such a process.

If a disposal as a going concern is proposed, the buyer must be CQC registered to run that facility. Depending on the method of disposal (see below), this could cause a significant time lag between first agreeing the deal and the buyer being approved to run the home (typically, 16 weeks or more). There is no guarantee that the CQC will approve a transaction and careful consideration has to be given at the outset as to whether both the buyer and the deal will be acceptable from the CQC's perspective.

During this lengthy period of uncertainty, the stakeholders will expect the proposed IP to take control of running the business, although the IP will have no statutory powers to do so until they are in office. All parties are reliant on the continued co-operation of the owner/operator during this period. From the lender's perspective, they will need to continue to fund trading during this time and may have to pay to stave off aggressive creditors, in circumstances where there is nothing to bind the proposed buyer into completing the deal. The lender runs a real risk of incurring significant professional fees and increasing its exposure, with no comfort that the anticipated realisation will be achieved.

Most IPs are likely to engage managing agents to act as responsible persons in the care home, both prior to taking appointment and (on a trading appointment) to trade the home following appointment. Clearly, such managing agents come at a cost and the underlying business will need be able to sustain that cost, or it will otherwise have to be underwritten.

SHARE SALE VS ASSET SALE

A major consideration for a buyer will be the method of acquisition, whether it should be by share purchase of the existing trading entity

Sector Focus

Biog box
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(assuming corporate ownership), or an asset purchase. There are pros and cons to both, see Table A.

RESTRUCTURING THROUGH CONTINUED TRADING

The challenges involved in restructuring an ailing care home via an insolvency process will often lead lenders to conclude that the better option is informal restructuring on a 'solvent' basis, allowing the existing business to continue under the control of the existing management, or a voluntary disposal avoiding the need for any formal appointment.

Lenders and investors need to be inventive in the way that the business's finances are restructured. Options include debt for equity swaps, a sale and leaseback of premises, property overage agreements in return for further funding or disposal of underperforming parts of the business – this list is not exhaustive and all parties must be open to novel solutions.

Assuming the home can continue to trade outside of a formal appointment scenario, the key issue is lender support (or a continued line of funding) whilst a sale of business, refinance or another restructure is achieved. Although providing additional funding is unpalatable, it is often justified if the end result is a successful restructuring.

From the operator's perspective, they need to consider carefully whether it is appropriate to continue to trade, in circumstances where it is clear that the business is facing insolvency and sustaining additional losses it cannot hope to meet. Where valuations are heavily dependent on continued trading, it is arguable that management have a duty to continue to trade, in order to preserve value for creditors. They would need to take advice on their potential liabilities for wrongful trading, although these might be mitigated by the potential benefit to creditors through continuing to trade.

This is a crucial time for management to liaise closely with the CQC and ensure that it keeps a mindful eye on its compliance even whilst other stresses come to the fore. For this reason, many lenders to operators insist on interim directors or managing agents becoming involved in the restructuring process, in order to preserve value in their investment.

CONCLUSION

Care home operators are facing a rapidly changing landscape: increased regulation, a reduction in funding, the fluctuating property market and a shift towards providing care at home are putting severe financial pressure on those operators.

These pressures can result in corners being cut or management losing control of cash. As a result, lenders must closely monitor performance, constantly looking out for key warning signs such as breach of borrowing covenants, drops in occupancy levels, failure to meet essential fixed costs on time or (more dramatically) intervention by the CQC.

Advisers have a key role to play in nursing failing care homes back to financial health: they should be involved in the business as soon as early warning signs are spotted, with a view to achieving a solvent restructuring or consensual exit. The key role of advisers is to guide stakeholders on the level of funding required in order to achieve a successful restructure or exit while keeping in mind the potential costs of an alternative recovery process, given that the balance between options is such a fine one. ■

TABLE A

ISSUE	SHARE SALE	ASSET SALE
Liability	Assumption of all pre-existing liabilities, requirement for extensive due diligence to identify same. Not attractive if Company has significant trading liabilities/Crown debt	Pre-existing liabilities left in old company – 'fresh start' means less due diligence necessary
Stamp Duty payable	Share acquisition at 0.5 per cent – significant tax saving compared to property purchase	Property acquisition – 4 per cent if price over £500K
CQC Registration	No change in the registered person – existing registration continues, notification requirements less onerous	Need for buyer to register new entity – can cause significant delay (approx 16 weeks) in completing transaction
Landlord consent for assignment of operating lease	Not required	Required – possible further delay
TUPE issues	Employment contracts continue	Staff transfer, although some limited scope to reduce staff on transfer
Supplier contracts	Continue unaffected	Need for novation/assignment
Data protection issues	Data remains with existing entity	Transfer of sensitive personal data (eg medical records) creates Data Protection Act compliance requirements
Capital depreciation on assets acquired	Not available	Available – amortisation of acquired assets may have tax benefits
Preservation of trading losses for group relief	Available	Not available