Appendix 1

Method and technical descriptions

1. Local authority spending data (section 251 return based) was accessed to describe the level of spending on foster care and residential children's services as reported to the Department for Education by local authorities in England. In addition, spending on Independent non-maintained schools for SEND and specialist needs was accessed as many of the providers in the sample are mixed groups where this income stream is indistinguishable from the social care-based streams. This information is used for benchmarking of the aggregated reported income of the largest providers in those sectors. This gives an indication of what proportion of all spending is made with the sample of providers being reported in this study.

2. The largest provider organisations were identified through approaches to Ofsted, to trade associations (ICHA and NAFP), and through access to previous Revolution Consulting projects and databases involving these sectors. We are grateful to all of those organisations for volunteering or reviewing lists of providers. LGA also reviewed the final list of selected providers to confirm that the expected organisations were present in the sample.

3. The latest available public accounts of the identified providers were downloaded from Companies House for the sample of providers in November 2019. One parent company organisation is USA based and the group accounts were accessed from NASDAQ disclosures for Acadia Healthcare Company Inc. The most recent Caretech figures are from the preliminary results declared to the London Stock Exchange in December 2019. Due to very recent acquisition activity it was necessary to include in the sample the accounts of predecessor companies for pre-acquisition periods. In total 29 legal entities were included in the sample and 92 sets of annual statements analysed. The primary and overwhelming majority of information used in this study was therefore independently audited financial statements of provider organisations.

4. Key information and indicators from the downloaded financial statements were extracted covering up to a five-year period from 2015-2019. This was necessary due to the variable accounting reference dates of providers (some report to end March each year, others report to August, September or to December) in order to cover three full accounting periods.

The information extracted included turnover, operating profits, financing costs, data required to calculate EBITDA, external funding levels and terms, solvency indicators and data to calculate the same. Technical descriptions of data and calculations follow in this Appendix below.

5. Sources were screened for those providers where a substantial part of their income derives from providing fostering and/or children's homes services.

Some large providers were excluded from analysis on the basis that their results included a large majority of non-fostering, non-children's homes activity. Exclusion from the sample and the further analysis was on the basis of the results of a provider being significantly contaminated by other trades (e.g. Adult social care, Supported Living income or other services). Also excluded were groups where the schools revenue was likely to be dominant on their disclosed results. Excluded companies on these bases:

- Antin/Kisimul/Hesley schools
- Action for Children
- Barnardos
- Charme/Witherslack

6. Results were screened to identify providers where the separation of results of fostering vs children's homes vs other services can be achieved. The availability of such analysis was severely limited to voluntary analysis by Caretech, and to organisations that appear to operate in just one sub-segment and so, by default, give a view of just that segment. Results presented in this report are therefore predominantly a mixed or blended aggregate of a provider's children's services combined.

Profitability – what to measure?

There are several different measures of profitability, each with its own purpose. Audited financial statements include several measures of profit in the published Profit and Loss Account statement (one of the key sources of information in any set of accounts).

The different profit measures used are essentially different from one another based on what they include and exclude from the calculations.

Some of the key differentiators are related to the inclusion or exclusion of:

- Corporate Taxes where these are payable (primarily in the private sector).

- Interest receivable and interest payable (this relates to the financing structure of the business).

These are not the only differentiators.

If the purpose of examining profitability is to obtain an understanding and insight to the profitability of the underlying trading or operations of an organisation then there are additional profit measures that can be derived from the information disclosed in accounts. Some larger providers sometimes disclose this calculation in their own accounts. This report seeks to examine that underlying trading picture as a key objective.

The financial accounts of a provider include all or most of the costs of providing the service in addition to the income levels. It is therefore possible to gain some indication of what level of profit is earned from the fees received using the accounts information.

The measure used in this study seeks to remove the “noise” of non-trading items from the profit measure it uses.

The measure is:

EBITDA = Earnings before Interest, Tax, Depreciation and Amortisation

The elimination of depreciation and amortisation removes accounting complexities related to what are essentially capital transactions. Whilst not unimportant, they are often removed when just the underlying trading position is being examined.

This measure is also widely used in financial analysis and is used extensively by the investment industry. Where a provider self-calculates and discloses EBITDA the provider’s own measure is used in this study. The majority of providers do not self-disclose the calculation, so it was derived and calculated from figures extracted from the accounts of those providers using the formula above.

Some financial analyses go further in also looking to eliminate rental costs of property but for consistency this study has not taken that further step. It remains a possibility to extend this type of study in this way.

Solvency and sustainability – what to measure?

Solvency of a business is essentially related to an organisation’s ability to generate cash and thereby to be able to pay its bills as they become due.

Without that ability an organisation’s survival becomes increasingly dependent on the willingness of those who are owed money to support the organisation while it goes about raising enough money to settle its liabilities.

If those parties owned monies lose confidence in the ability of the business to repay the sums due then it can lead to sale, liquidation and cessation of the business altogether.

Some PSOs are heavily dependent upon the continued support of the owners and funders of the business to remain sustainable in the short and medium term.

Measures used in this study look at both balance sheet measures of solvency and at the relationship of cash generated by the operational trade of the business to the requirement to pay interest and capital amounts back to funders.

Figure 10: Solvency and Sustainability indicators

Balance Sheet Total Net Assets/(Liabilities) – fundamentally, does the business have more assets than liabilities as at the balance sheet date?

Net Tangible Assets/(Liabilities) – More of an acid test that assumes intangible assets such as the goodwill accounted for at acquisition of a business has zero value (e.g. in a winding-up process).

Interest Cover: (EBITDA: Interest Paid ratio) – Asks the question as to how easily the current operations can at least pay interest on borrowings as it becomes due for actual payment.

Years to pay bank debt – How many years would it take for current levels of trading to generate enough cash to pay off money due to third party banks only (typically those with security over the business assets and the right to step in and liquidate if necessary)?

Relating profitability to cash generation

In this study for simplicity we have used EBITDA as a proxy for operational cashflow generated. Generally speaking, for the purposes of these initial simple indicators this is appropriate, but a more sophisticated approach would be advisable for regular monitoring.

Linking Profit, Valuation and Debt

In simple terms the co-existence of profitable growth in the study but also significant debt may appear contradictory.

If a company is profitable and increasingly so, and if that profit turns into surplus cash (as it predominantly does in these PSOs), then it would not be unreasonable to expect the business to be able pay off debts and become debt free, all other things being equal.

So, what is happening to create the picture we see with PSOs, and especially the PE backed PSOs?

The answer lies in the interrelation between profit levels, how businesses are valued when ownership changes, and how the buyer of a business provides the money.

The NFA case study in Appendix 4 of the report provides clear examples of how this works.

The relationships can be stated relatively simply.

- A highly profitable organisation, one showing growth, allows an owner of the business to project a picture of continuing profitable growth into the future.

- This may be attractive to potential investors looking to enter the sector in the belief that it offers stable income and growth for a period that may allow the new investor to add even more value.

- The further into the future that profits are projected, the less certain the outcome. So future projections of expected profits are increasingly discounted the further into the future they project.

- When one owner sells to a new incoming investor both will carry out valuations of the business based on the future expectations and perceptions of certainty of the future. If they can reach an agreed valuation, and if the funds needed to execute the transaction are available then the change of ownership will go ahead at this agreed price.

- One simplified way that the agreed price is sometimes represented is as a multiple of current EBITDA. Essentially this gives an idea of how many years the current profit level is expected to continue into the future.

Value = EBITDA x Profit Multiple

- For example, a valuation using a discount rate of 15% for each future year on existing EBITDA levels would equate to a multiple of 6.7 x profits.

- The incoming new investor effectively takes a risk that they can at least continue to run the business and generate the current level of profits into the foreseeable future.

The outgoing owner has effectively forward-sold profits of years to come.

- In order to pay the outgoing owner for the future years of profit, the new investor needs to raise money to pay the value/price agreed.

- PE investors use a combination of investment funds they have already raised (sources of those funds may be private individuals, other investment and pension funds[9]), and money they borrow from banks.

- Banks will generally be more cautious than the PE investor in the amount they are willing to lend against an expected future profit and cashflow and will generally require security over the business assets and first rights to step in and protect their loans if things do not go to plan. In return the bank receives a relatively lower rate of interest (usually fixed against an underlying bank rate e.g. bank base or LIBOR[10]), but a rate that still reflects the risk they are taking by lending.

- Monies provided by the PE investor may come in the form of debt or equity. In most private equity examples loans (debt) are used. This usually ranks behind any bank debt in terms of rights, and is therefore riskier debt, carrying higher interest rates.

- Hence many PE investments are done with a mix of bank money and PE funds. As the bank's return is capped by its interest and loan capital amount, any excess return above that goes to the PE owner. This is the essence of "leveraged debt". Effectively the PE investor takes the highest risk but therefore takes the upside of any returns made. The NFA case study provides some clear examples of how this works.

- The majority of funds raised as borrowings and loans and equity from banks and from the PE funds are used to buy the business from the previous owner (and to pay transaction and advice fees). These debts are generally placed on the balance sheet of the holding company used by the PE investor to buy the business. It is this holding company, or group level of accounts information that have been accessed by this study in order to view the whole, fully funded picture.

- This study includes clear examples of these mechanisms at work. PSO accounts evidence growth and profits and disclose that PSOs are increasingly being traded in a serial fashion by PE investors. Each time a successful sale occurs, a larger forward profit is projected, and more debt is raised to fund the transaction.

Increased profits = Increased valuation

Increased valuation = Increased debt at next sale

- The mechanism works if confidence in all parties is sustained. The period of study of this core sample of PSOs is an illustration of the

[9] As an example Acorn Care and Education was 100% owned by the Ontario Teachers Pension Fund until August 2016.
[10] London Interbank Offered Rate

mechanisms working for funders and investors.

- The serial acquisitions by owners and funders of several of the core sample PSOs clearly indicate a belief in the continued demand for outsourced children's services and that prices and margins earned historically will continue or grow into the future.

- The mechanisms have driven increasing values and debt levels in exactly the way set out above (see NFA example in Appendix 4).

Appendix 2

Limitations of data and areas for potential further study

The limitations of the information available from Companies House is variously described at different points in the main report body. Each area of limitation has a corresponding potential for further study.

Limitation	Further study
There is a perception of a lack of clarity as to responsibility for monitoring of provider solvency and performance.	Ofsted has limited scope in regulation. LAs have only rights granted by contracts, and limited visibility from statute only. There is no equivalent to the CQC monitoring function in adult services. This would be worth investigation.
Information at Companies House is historical.	Consider extra-statutory reporting of management information and forecasts by providers.
Information at Companies House is limited for small and medium sized providers.	Consider additional disclosure requirements for all providers of children's social care services through statute or via a sector-led transparency code.
Information is usually for the whole company or group and not reported segmentally.	Consider development of a sector-led transparency code.
Profitability of some provider organisations is not completely visible due to transactions with other related parties	Carry out EBITDAR analysis and interview providers. Consider development of a sector-led transparency code.
Use of offshore ownership has the potential to further reduce visibility	Consider development of a sector-led transparency code.
Monitoring of returns made by private equity ownership is not a statutory requirement and sometimes not possible through reconstruction	Consider development of a sector-led transparency code or increased disclosure regulation.

Appendix 3

Owners and brands

Although this research looked at 29 different legal entities to obtain a comprehensive historical view over three years, by December 2019 those entities had consolidated down to just 16 groups.

Six of the groups were private equity owned, 6 still in private hands, two are stock market quoted companies (one the London stock exchange, one on the US NASDAQ exchange), and two are voluntary sector charities.

The earliest private equity involvement in the sector can be traced back almost 20 years, and although marked financial success can be seen (for example as set out in Appendix 4), there has also been some less successful involvement, predominantly in the children's homes sub-segment.

Figure 10 lists the groups covered by this study and includes their ownership at December 2019 and a non-exhaustive list of brands that they have accumulated.

Figure 10

Group	Owner	Brands
NFA	Stirling Square Capital Partners	NFA, Acorn, Outcomes First, Options, Hillcrest, Children First Fostering, Alliance, Alpha Plus, Jay Fostering, CAMS, Archway, IFCS, Belmont School, Bramfield House, Crookhey Hall, Focus, Fostering Solutions, Heath Farm, Hopscotch, Kestrel House, Knossington Grange, Longdon Hall, Meadowcroft, Pathway Care, Threemilestone, Underley Schools, Waterloo Lodge, CC Bureau, Brighter Futures
Caretech Cambian	London Stock Exchange	Caretech, Branas Isaf, FSG, Park, Rosedale, ROC North West, Greenfields, Cambian Schools, Care Aspirations, Advanced Childcare, Continuum, Clifford House, SACCS, Herts Care, By the Bridge, Signpost, Elite, Farrow House, Green Corns
Core Assets FCA	Capvest Equity Partners	FCA, Core Assets, Fostering People, Leaving Care Solutions, Outcomes for Children, PICS, Fosterplus, ISP, Clifford House fostering, Orange Grove
Priory	Acadia Healthcare Company Inc.	Priory Education and Care, Craegmoor, Partnerships in care, Quantum, Progress

Group	Owner	Brands
Keys	G Square Healthcare	Keys, Stepping Stones, Active8, Broadwood, New Horizons, Little Islands, The Leaving Care Company, Quality, Prospects, rowan Tree, Promoting Positive Lives
Compass	Graphite Capital Partners	Compass, Freshstart, Oasis, Fostering Together, Applegreen, Link, Fostering Outcomes, Children's Services Bureau
Five Rivers	Midhurst PJ McConnell	Five Rivers
The Together Trust	Charity	The Together Trust
BSN Social Care	Alderbury Holdings Private	Blue Sky, Nexus, Parts of Pathway and Fostering Solutions (following CMA intervention on NFA/Acorn merger)
Capstone	Private	Capstone, Welcome foster care, Classic, Fostering Yorkshire, Fostercare UK, Excel fostering
TACT	Charity	The Adolescent and Children's Trust
SWIIS	Private G S Dadral K Dadral	SWIIS
Horizon	NBGI Private Equity (National Bank of Greece)	Horizon, Educare, Key 2 Futures, Aurora
Hexagon	Private M Bell	Hexagon, HCS
Esland	August Equity	Esland
Bryn Melyn	Private B McNutt	Bryn Melyn

Appendix 4

NFA: Case Study

As one of the largest PSOs in the UK, NFA offers unique insight as a case study. It's history prior to the acquisition of Acorn was as an IFA.

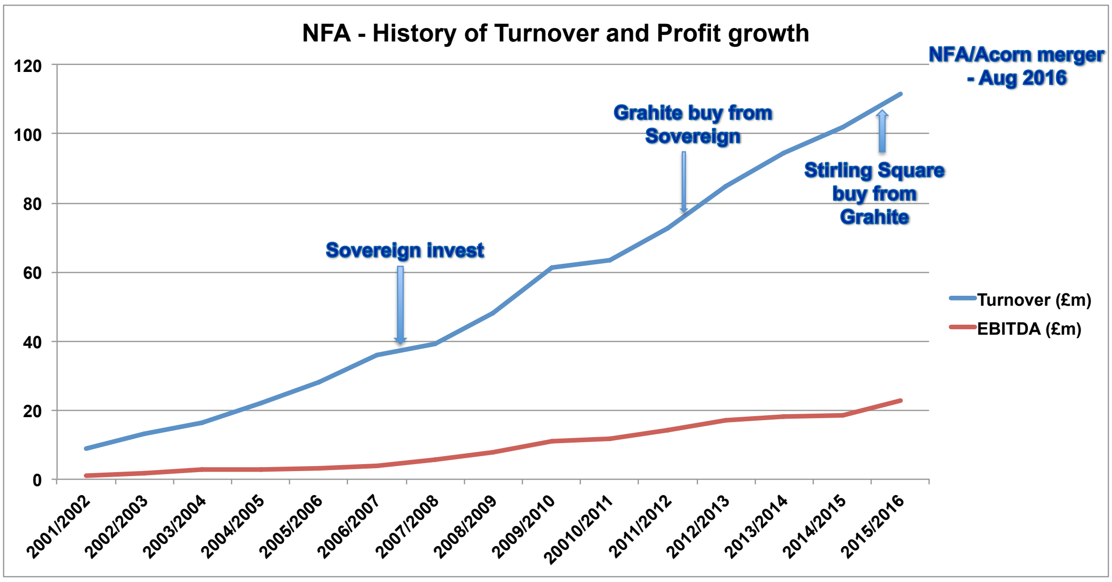
The financial history of NFA provides clear illustration of the mechanics of debt-leveraged financial engineering of PE.

The history of NFA started with two individuals with backgrounds in LA social care forming the London Fostering Agency based in Uxbridge in the second half of the 1990s. Twenty years later, now renamed NFA it had grown to become part of a £400m merger with Acorn in 2016 (Acorn was effectively purchased by NFA for £241.5 million in August 2016).

Growth and profitability

As well as adopting the new NFA name as the agency expanded beyond London, ownership of NFA has seen several changes. The first of these was in 2006, and by that time the organisation was already large enough for company accounts to have disclosed the growth pattern emerging in the years before that first sale. The growth carried on in a fairly unrelenting fashion throughout the years that have followed:

Figure 11



The external drivers during this period were clearly the growth in looked after children numbers and the increased use of fostering as a placement option as evidenced by national statistics. The same period saw attempts, supported by central government programmes[11] to use commissioning at the LA (and regional) levels to manage the development of markets.

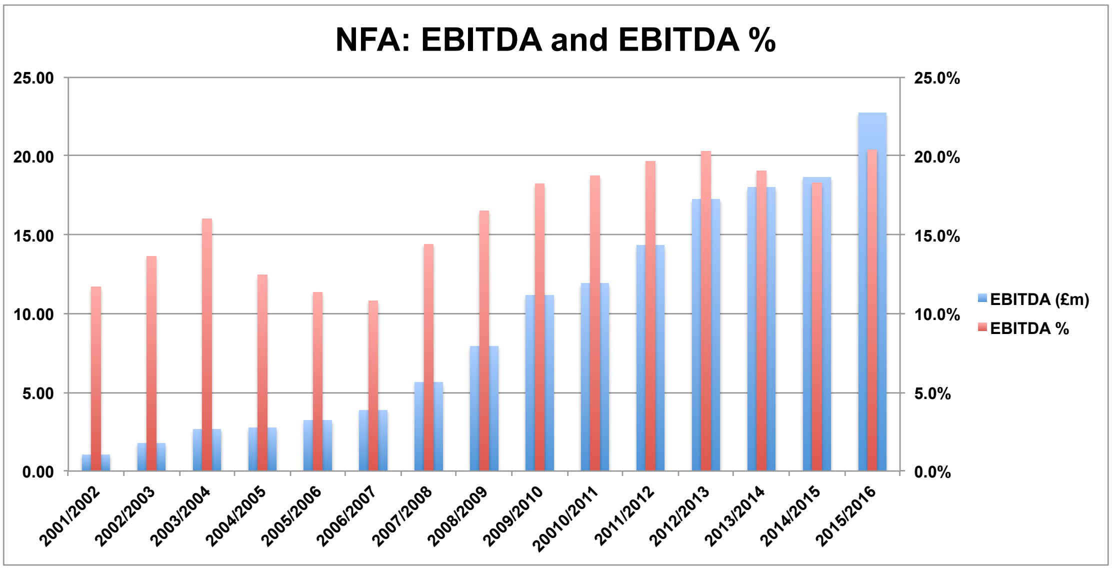
Internal drivers of NFA growth were twofold:

- Organic growth, i.e. successful recruitment and retention of, and placement with, foster carers. Organic growth is evident throughout the period but was the sole driver prior to the first investment by Sovereign in 2006.

- Acquisition growth. Consolidation of the provider side of the sector through a series of purchases of smaller IFAs and absorption into the NFA group became evident. NFA acquired smaller IFAs between 2006 and 2015 at a rate of one per year on average.

There is evidence that this growth and consolidation can bring economies of scale, as evidenced by the growth in EBITDA margin of NFA during the same period:

Figure 12



This track record of profitable growth would have supported the ability of successive owners throughout the period to present the expectation of continued growth each time the business was sold.

The mechanisms of increasing profits driving increased valuations and thus increased debt raised by each incoming new investor described earlier in this report are clearly evidenced in NFA's history.

[11] DCSF Commissioning Support Programme 2008-2010

Increasing Valuation

The valuations placed on NFA at the change of ownership points are disclosed by way of FRS 6 disclosures in the public financial accounts:

Figure 13

	Value (£m)	Multiple of EBITDA
Sovereign invest [12] 7 December 2006	**45.7**	**11.8**
Graphite buy from Sovereign 19 January 2012	**132.7**	**9.3**
Stirling Square buy from Graphite 24 April 2015	**200.2**	**10.7**
NFA and Acorn merger	Merged value of NFA and Acorn rumoured[13] to be £400m	NA

It is also possible to identify from the same public accounts:

- How these changes of ownership brought new levels of debt into NFA,
- How that debt was managed (despite the emergence of the negative tangible net worth indicators as evidenced in Part B of this report), and
- A calculated estimate of the real return on investment for Sovereign and for Graphite from the investment periods they were involved in.

[12] Sovereign acquired 50.3% control and provided less than 25% of the value via loans. This may have helped inflate the multiple.
[13] Healthinvestor UK, May 2017 vol. 4

Sovereign Capital Entry

Investment 7 December 2006 – the first arrival of debt

Sovereign Capital's entry into fostering with the investment into NFA in 2006 was a little unusual for PE that has a preference for 100% ownership.

Sovereign acquired control of the voting share capital but only 50.3% of equity ownership.

Although the transaction valued NFA at £45.7m, Sovereign essentially funded less than 25% of this from their own funds. The balance was provided through loans notes of the founders who remained as significant shareholders, and from a banking and loan facility from Royal Bank of Scotland ("RBS").

Accounts prepared less than 4 months after Sovereign took control (as at 31 March 2007) broadly show how the transaction was financed:

Figure 14: Debt levels at NFA on 31 March 2007

Lender	Facility balance owed at 31 March 2007 (£m)	Interest rate	Facility Terms
RBS Senior Debt A	**16.0**	**LIBOR + 2.25%**	**Capital repayments six monthly from 30 Sept 2007 to 31 March 2012**
RBS Senior Debt B	**8.0**	**LIBOR + 2.75%**	**Capital repayments in two equal instalments 30 Sept 2012 and 31 Mar 2013**
Loan Stock Sovereign	**14.6**	**10%**	**1/3rd of balance at 7 Dec 2011, ½ remainder as at 7 Dec 2012, final balance 7 Dec 2013**
Loan Stock Lovett & Beech	**11.9**	**10%**	**1/3rd of balance at 7 Dec 2011, ½ remainder as at 7 Dec 2012, final balance 7 Dec 2013**
Total facilities	**50.5**		

It is not necessary for the purposes of this study to go into too much further detail about this debt structuring and how it evolved over the following 5 years until Sovereign sold NFA.

However, the purpose of providing the breakdown is to illustrate:

- The valuation of the company directly drives the amount of finance required to fund the deal, and that finance is held on the balance sheet of the group company that owns NFA.

- Bank debt is typically at a lower rate of interest than other loans because of the security and rights that the bank gains via the terms of the facility agreement to step in if various targets ("covenants") are not met.

- Bank debt is overtly linked to LIBOR (London Interbank rate), which itself is closely associated to the official Bank of England base rate.

- When this deal was originally done LIBOR was at a level of over 5%, so the bank loans attracted interest of over 7.25 - 7.75%.

- Following the financial crisis of 2008/9 the Bank of England reduced base rates to 0.5% (and lower to 0.25% in 2016). The cost of the RBS debt therefore reduced substantially two years into Sovereign's ownership.

- Throughout the period since 2008/9 PE has benefited from low interest rates when bringing in third party bank debt. It equally will have had to work hard to secure such facilities as banks became extremely cautious in lending terms at the same time.

- The point for future consideration is that, with an increased number of IFAs carrying debt with terms linked to LIBOR or other variable rate mechanisms, if interest rates are increased by the Bank of England in future, this will feed through into increased pressure on cashflows of the operating IFAs.[14]

- Note how the repayment schedule for the debt is often set out in some detail in the disclosures in the accounts. This allows an analysis to be made about the ability of the business to generate sufficient funds to stay on top of interest and repayment obligations.

[14] It is not unusual to see IFAs with bank debt also investing in interest rate hedge contracts that give them some protection from increases in interest rates, and that therefore delay the impact of interest rate movements.

Managing Debt levels

During Sovereign's 5-year ownership of NFA seven further acquisitions of smaller IFAs were made and financed.

Throughout this period therefore additional funds were raised, primarily as further loans. At the same time the ever-increasing scale of operations remained profitable and generated cash funds with which to pay the interest and capital repayments on the loans.

It is not necessary to include the full details of the changes to debt levels throughout the period of Sovereign's ownership here, however the road was not one without the occasional bump to navigate.

A snapshot of the position is detailed at each year-end from 2007 onwards in the accounts of NFA.

Standard accounting disclosure rules require accounts to show when debt becomes payable, and, separately, how much operational cash is being generated by the business. Bringing these together allows further debt-management analysis.

As an illustration, the bump in the road was encountered by NFA in 2010.

By March 2010 the NFA group originally purchased with the £50.5m of debt shown in Table 13 above (three years earlier) was showing the following picture:

Analysis of debt

	2010 £000	2009 £000
Debt can be analysed as falling due		
In one year or less, or on demand	**19,150**	3,300
Between one and two years	**-**	3,700
Between two and five years	**27,889**	41,844
In five years or more	**-**	-
	47,039	48,844
Less issue costs	**(820)**	(1,047)
Net debt	**46,219**	47,797

Operational cashflow generated by the fostering business was reported in the same accounts as being £9,747,000 in the year to 31 March 2010 (£6,828,000 in the previous year).

So, contrast the two year ends:

- The £6.8m of cash generated in 2009 would have given some comfort that the £3.3m of debt due in under one year and the £3.7m due in year two were manageable so long as at least that same level of cash could be generated again.

- A year later something has gone awry despite the generation of even more cash. Now the £9.7 generated does not even cover £19.1m of debt due within 12 months.

A further note in the accounts explains that NFA had to renegotiate terms with the bank owed the near term debt:

> In accordance with FRS 25, the bank loans have been classified as falling due within one year as there were minor unresolved technical covenant breaches outstanding at the balance sheet date The lender has at no point requested early repayment of the outstanding balance and the breaches have been resolved to the satisfaction of the lender between the balance sheet date and the date of approval of these financial statements Further details of the bank loans are disclosed in note 14 below

Debt of this scale, and the terms of the facility agreements require close monitoring and management. The situation was clearly resolved by NFA, Sovereign and the bank but this example is an illustration that it may only take a moderate deviation in results from the plan (upon which the debt was structured) before the financial tensions can rise.

Sovereign Capital Exit

Sale 19 January 2012 and return on investment

During the period of Sovereign's control of NFA a second, parallel investment vehicle was used to make the regular acquisitions. It had a different ownership structure, with Sovereign holding higher levels of equity.

Across the combined operations of both parts of the NFA group Sovereign experienced a combination of cashflows to and from NFA:

- Several additional loans made to NFA mainly in relation to the acquiring of other IFAs into the NFA group
- Interest payments to Sovereign from NFA on the various loans
- Fees charged by Sovereign to NFA for investment services and for advisory services
- Capital repayments of loans to Sovereign from NFA when funds were available

The largest incoming cashflow for Sovereign arrived on the sale of NFA to Graphite Capital early in 2012.

At that point all outstanding loans and accrued interest due to Sovereign was repaid.

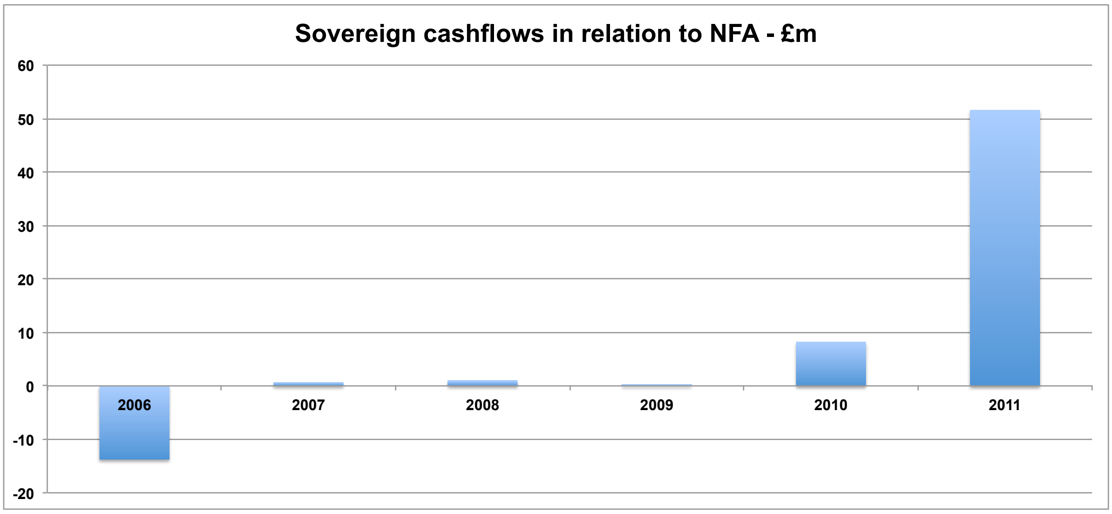
The agreed sale price was £132.7m

After all bank and other loans were repaid £70.7m of the consideration was paid to the equity holders. At that time Sovereign held almost 49% of the originally acquired part of NFA, and 72.5% of the acquired companies.

In the analysis of cashflows of Sovereign shown in figure 15 below, some assumptions and estimations are made where the full detail was not available in the accounts of the NFA companies, however we believe the picture is materially correct.

Figure 15 and the summary below show the financial reasons why investments such as that made in NFA are potentially attractive in terms of their payback to investors.

Figure 15 – Sovereign cashflow across the holding of NFA



Sovereign investment success
Cash received from the total investment was over 3.1 x cash invested over a 5 year period
Effective rate of return[15] = 38% per year

Sovereign Capital is a serial investor in fostering (e.g. note that after selling NFA they have since replicated the approach with PiC). Sovereign has also invested in other children's services including residential care and education.

[15] This is the annual rate of return made by an investor. It takes all sources of income and capital gain made by the investor, and those returns are expressed as a percentage of the original investment value.

Graphite Capital

Ownership 19 January 2012 to 24 April 2015

Graphite bought all parts of NFA in January 2012 for £132.7m from Sovereign.

The previous sections of this report detail what that meant for the return on investment for Sovereign, but essentially the cycle of PE ownership starts again with each transaction.

Graphite funded the deal again through a combination of new external bank funding (this time a consortium of banks was used to share the risk) and from Graphite's own investment funds. However, this time around the total price paid for NFA could not be funded from those two sources alone. A third type of finance was required to make up the shortfall. This source sits between the secured bank debt and the more equity styled PE fund debt and adopts the title Mezzanine finance as a result.

Once again, a published balance sheet of the newly acquired NFA, albeit 14 months after the sale to Graphite, gives a representation of the debt raised and applied to NFA:

Figure 16: Debt levels at NFA on 31 March 2013

Lender	Facility balance owed at 31 March 2013 (£m)	Interest rate	Facility Terms
Bank consortium GE Corp Fin Bank SAS Lloyds TSB NatWest	24.5	LIBOR +4.5%	Capital repayments six monthly from 30 Sept 2012 to 31 March 2017
Bank consortium GE Corp Fin Bank SAS Lloyds TSB NatWest	27.5	LIBOR +5.0%	Entire balance due 19 Jan 2019
Mezzanine Loan Beechbrook Mezzanine 2012 Sarl Larojo Sarl	10.0	6m LIBOR +12.5%	1/3rd of balance at 7 Dec 2011, ½ remainder as at 7 Dec 2012, final balance 7 Dec 2013

Loan Notes Graphite Capital	**64.2**	**9.12%**	**Interest capitalized and added to loan balance**
Loan Notes Management	**3.1**	**10.0%**	**Repayable 19 Jan 2020**
Total facilities	**129.3**		

It is again not necessary to dive too much deeper into an analysis of debt levels and terms except to note that:

- The total amount of debt reflects the higher valuation and price paid for NFA by Graphite than when Sovereign had bought NFA five years earlier. The higher valuation would have been primarily driven by the increasing growth, profits and cash generation as illustrated in figure 11 above.

- Note the increased margins above LIBOR compared to those in the Sovereign debt structuring. This may partly reflect the post-2008 funding market but also perhaps reflects some of the risk in the increased scale of borrowing.

- Note also the wider spread of funding providers. This spreads the risk across a number of banks and institutions.

- Some of the funders were non-UK sources. Interest on those sources potentially takes profits away from UK corporate tax jurisdiction.

- Unlike the debt during Sovereign's ownership, there is no fixed repayment date target disclosed in relation to some of the debt categories. This may reflect the expectation that the debt will be renegotiated and rescheduled if and when necessary. It could also signify that the debt will never reach maturity; the expectation was that NFA would be sold again before sufficient cash could be generated to begin to repay those levels of debts.

It is again possible to track in the accounts of NFA the progress of debt repayments during the three years and three months of Graphite's ownership of NFA. To do so again illustrates how the debt is structured to allow operating cashflow to fund the upcoming interest and capital repayments.

In addition, NFA continued with the acquisition strategy, with two more acquisitions of small IFAs during Graphite's ownership period. The impact of these, added to underlying organic growth and increasing margins was that NFA was generating over £22m of profits and cash per annum by 2015/16.

At that level of cash generation the continuing debt burden of over £130m was becoming more easily manageable, allowing NFA to be able to refinance in 2014. This restructuring of debt brought in Santander to the panel of bank lenders and increased the proportion of bank debt, allowing a repayment of loan capital to Graphite.

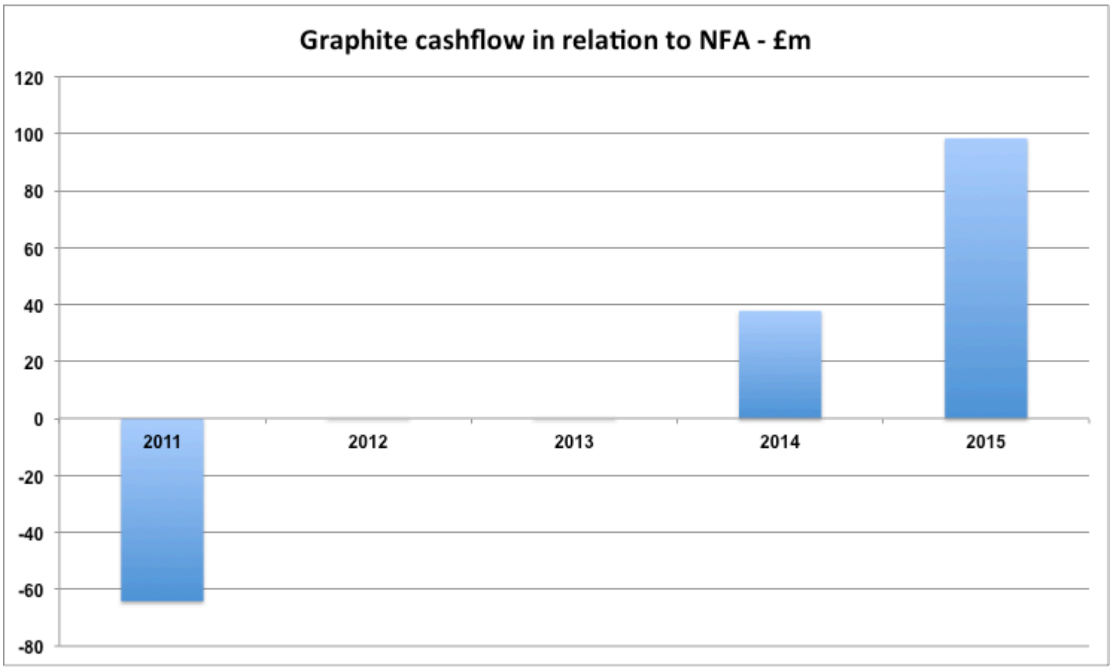
Apart from the loan repayment in 2014 (including accrued interest) there is no disclosure of other payments to Graphite.

The final and most substantial payment to Graphite that substantially determines the return made on their period of investment was on the sale of NFA on 24 April 2015 to Stirling Square for £200.2million.

At that time Graphite owned 75% of NFA.

Figure 17 represents the cashflows involved in Graphite's ownership of NFA:

Figure 17: Graphite cashflow across the holding of NFA



Graphite investment success
Cash received from the total investment was over 2.1 x cash invested over a 3.25 year period
Effective rate of return = 23% per year

NFA story continued

Private Equity has continued to outperform public stock markets in the last decade; the average returns to investors have been 11% (vs. the all share index at 5.6%).[16]

Within any portfolio of investments held by PE there could be a wide range of returns that average to the typical 11%. Clearly however, against this benchmark, both Sovereign's and Graphite's return on investment in NFA is above average.

The NFA story does not stop with the sale to Stirling Square.

In August 2016 it was announced that NFA was acquiring Acorn Care and Education from the Ontario Teacher's Pension Scheme.

In addition to a large fostering business Acorn also includes a large special schools business. Analysis shows this group also generating over £20m of EBITDA per annum before the merger, hence a total value of NFA/Acorn combined of over £400m has been quoted.

Stirling Square remained in ownership, but the new merged entity effectively re-set the debt clock. Other small acquisitions have followed, but another substantial transaction was announced in August 2019 with Sterling Square/NFA buying Outcomes First from Sovereign Capital.

NFA Case study reflections.

This NFA case study offers clear insight into how PE can utilise the strong and growing operational profits and cashflows of a business to attract investment.

However, even the relatively consistent development of NFA across the study period highlighted how a deviation from projected growth (such as the 2010 "bump in the road") can trigger potential issues with debt arrangements. Those issues can include the risk of banks or other funders requesting early repayment of debt, the need for re-negotiation of debt, the stress on the organisation while that occurs, and worst-case the potential failure of the business.

The model can repeat so long as the business continues to grow and there are reasonable prospects of further organic and/or acquisitive growth and future potential buyers for the group when the existing owners decide to sell.

The beginning of diversification of NFA on merging with Acorn and now Outcomes First into non-fostering residential care and education sectors is perhaps not surprising given that the competition authorities have started to

[16] British Venture Capital Association: Performance Management survey 2016

identify that consolidation in fostering has the potential to lead to dominance by one provider in some areas.

That diversification will reduce the visibility of a dedicated fostering business like NFA. There are already the other large multi-sector groups such as Priory and Caretech in operation. This is a clear signal from the provider sector that the supply side already treats children's services sectors as linked and combined.

The marked success of NFA as a financial model is clearly evidenced here. It is more difficult to evidence what would be needed to answer the questions as to whether the quality of the NFA offering and the outcomes achieved for the children and young placed with NFA during this time match the financial success but this would clearly be an area of worthwhile further study.