Profit making and Risk in Independent Children’s Social Care Placement Providers.

Final Report: January 2020

Andrew Rome
January 2020
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**Introduction**

This study examines the evidence that is available in relation to the financial performance of the largest independent sector children’s social care provider organisations operating in England. In this report reference to the independent sector includes both private companies and voluntary sector bodies.

The report was commissioned by the Local Government Association (LGA) in November 2019. The particular focus is to identify for the LGA the amount of profit being made by the largest independent fostering and children’s residential care providers in England, and to identify indicators of risk in those organisations. The work did not look specifically at independent special schools, providers of support services or other organisations supporting children and young people, except to the extent that such services are part of larger groups where fostering and children’s homes are a substantial part. The method statement in Appendix 1 describes the selection criteria more fully.

Revolution Consulting Limited has researched the financial performance of provider sectors since 2003-2004, and has previously reported on extracts and analysis derived from the data collected for, amongst others, the Department for Education (e.g. Children’s Homes Data Pack and Commissioning Support Programme), for Sir Martin Narey and Mark Owers (Fostering Stocktake), and annually for the National Children’s Commissioning and Training Conference.

The predominant source of information for the study is Companies House where, subject to Companies Act 2006 requirements, the majority of the provider organisations file financial statements for historical periods.

Those statements are prepared to UK accounting standards and are independently audited.

Lead researcher Andrew Rome is a Fellow of the Institute of Chartered Accountants in England and Wales. Whilst it is clear that there are technical accountancy issues that need to be understood in order to perform the analysis, wherever possible this report is written assuming the reader is not a qualified accountant or finance professional. Some technical terms are unavoidable, but explanations of such terms used are provided, and interpretation of the results seeks to use non-technical language.

A preliminary report of interim findings was provided in December 2019. Around 40% of the organisations studied during November 2019 filed updated accounts by the end of December 2019. This final report and analysis are therefore a more up to date and representative picture of reported performance.
Copyright statement

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Disclaimer: Though every care has been taken to ensure accuracy of the material contained in this report, no liability can be accepted for errors or omissions. If the reader identifies any potential mistakes in this report, or would like to offer observations on it, please contact Andrew Rome at Revolution Consulting via www.revolution-consulting.org and we will endeavour to explain or rectify any incorrect details and take other observations into account in future studies.
Summary of results

Local Authorities in England spend £1.7-1.8 billion a year buying fostering and children’s homes services from private and voluntary sector organisations, and a further £0.9 billion on independent special school services, some of which are provided by the same organisations.

The largest sixteen provider organisations studied in this project have income in excess of £1.37 billion, and although some of this derives from outside of England and from additional services, they are now a more dominant factor in these sectors than ever before.

There is evidence of increasingly rapid and recent consolidation of the sector, especially amongst the very largest providers. The Competition and Markets Authority have investigated transactions in the sector on more than one occasion, but as yet have not prevented an acquisition from completing.

As the income of providers has grown in recent years, so too have profits. Measured using the popular EBITDA method (see Appendix 1 for definition) providers in this study achieved a weighted average rate of 17.4% of income.

This profit level equates to over £239 million per annum for the sample group.

Profit levels are not uniform. Larger providers generally achieve the higher levels of profitability, and the higher levels of growth.

Linked to profit levels achieved in these sectors, there is also evidence of above-average returns on investment made by some investors, several of which are from the Private Equity industry. There are currently also two stock market quoted providers in this study, one in London, one in the USA.

Professional investors and markets have brought financial engineering techniques to the children’s services sector, and these include significantly increasing debt levels and their associated risk.

For commissioners and policy makers these sectors now present additional challenges due to the way that the supply side is developing. Commissioning faces the challenge of how to partner with providers operating on a national scale while also stewarding service sectors that include in-house, smaller, and voluntary sector providers to meet growing levels and growing complexity of needs. That partnering also brings a responsibility to manage increasingly sophisticated financial risks in the sectors.

Accessing information about provider performance is a complex task and the rapid consolidation in the sector means the evolving picture is not yet fully apparent. There are indictors and methods outlined in this report that begin to address the monitoring and risk management task, and a discussion of related issues.
PART A

Scope

Children’s social care in England is experiencing a combination of financial pressures linked to the combined effects of increased demand for social care services allied to competing demands on funding sources that have not increased at the same rate.

Councils have highlighted to the LGA that prices for placements with independent fostering agencies (IFAs) and independent children’s homes (ICHs) have been rising in recent times, and that there are capacity and supply shortages.

The LGA has requested detail on the facts related to profit levels of IFAs and ICHs, at how the owners of those organisations extract value from those organisations, and at risks associated to the financial structures employed that could impact on sufficiency and quality of supply. Alongside those topics the LGA would like to identify indicators that would enable a degree of oversight of the sector.

It is intended that these facts can then accurately inform sector-wide discussions to develop a market that effectively meets children’s needs.

Spending Levels

The primary foci of this study are the fostering and children’s homes sectors, where children’s social care budgets have reported the highest levels of overspending in the last 2-3 years. Figure 1 below illustrates that spending on IFA and ICH services by councils in England was £778 million and £1,021 million respectively in 2018-19 with ICH spend growing most rapidly.¹

As this research progressed it was clear that many of the provider organisations studied were also providing education and residential special school services alongside fostering and children’s homes. Hence, much of the provider-level information extracted for this study is based on blended results generated from activity in all three sectors.

For context Figure 1 therefore also shows that councils spent £881 million on SEN/Special schools in the non-maintained and independent sectors in 2018-19, a 4% reduction year on year.²

² ibid
Sample

The criteria for selection of provider organisations to be studied is set out in the detail of the method statement (Appendix 1). The sample selected are generally regarded by Ofsted, trade associations and other independent sources as the largest providers operating as IFAs and/or ICHs in England and where information is accessible in relation to their financial performance.

Figure 2 below shows both the list of the legal entity names that are included in the sample, and an indication of the main provider trading name or brand. The larger providers often operate a number of different brands within the overall umbrella organisation (See Appendix 3).

Each blue block in figure 2 represents a set of statutory financial information retrieved from Companies House for this study. The Companies Act 2006 generally requires companies and groups to submit independently audited accounts on an annual basis, and to do so within 9 months of the end of the year the accounts relate to (public limited companies (PLC) such as those listed on the London Stock Exchange (LSE) have only 6 months to do so). Companies can select any start and end date; hence companies report to a variety of different schedules. As can be seen in figure 2 this means that to gain the most recently available three-year view it is necessary to go back as far as 2015.

The red dotted blocks represent the expected next set of accounts for each provider at the time of this report.
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Figure 2 is organised vertically to group those legal entities that have most recently merged or come together through acquisition. It is notable that 2018-2019 has seen the consolidation of providers that were already amongst the largest providers operating in these sectors. This scale of acquisition is relatively unprecedented in the sector.

Some 29 different legal entities were studied during this research, and by the end of the period examined they are already consolidated into just 16 different groups.

The systems and timetables of reporting mean that it can take some time for statutory reporting to begin to show the full consolidated impact of the acquisition activity. Hence at the time of this study we are awaiting the first insights into some of the effects of the combination of the very largest consolidated providers, for example:

- The impact of Outcomes First being acquired by NFA/Acorn (subject to Competition and Markets Authority investigation) will not be seen until SSCP Spring Topco reports for the year to 31 August 2019.³
- The first combined annual results of Caretech and Cambian were

³ Accounts should be filed by 31 May 2020 unless the group opts to extend the financial period.
reported to the LSE as a preliminary report on 12th December 2019. Full accounts are not yet filed at Companies House.

- Capvest acquired FCA/Core Assets and then Partnerships in Children’s Services and Orange Grove from Sovereign Capital in quick succession in October 2018 and January 2019 respectively. The results of Core Assets have been impacted by reorganisation of the group structure prior to sale to Capvest, and by accounting reference period changes and not all of the business being sold to Capvest. A new ultimate parent organisation named Nutrius is not due to report the new combined group results until mid 2020.

Until such time as the fully consolidated accounts of these groups are reported the approach taken in this research gathers together (where possible) the reported results of predecessor organisations to produce indications of the relative size of the newly formed groupings. Particular care is needed however, in that the debt structures of the new combined groups is only visible once the new group produces and makes available its statutory accounts.
PART B

Income

To gain an indication of the relative scale of each of the sampled providers, and to calculate the aggregate income from the children’s services part of each provider’s operations we can look to the reported fee income from the accounts of the providers. There is almost no private funding for the services covered by this research so the reported turnover, or income of providers is almost exclusively derived from fees invoiced to councils for placements.

It is essential to note that children’s services income derived this way is not completely comparable to the spending reported by local authorities (see Figure 1 above) as it may also include:

- Income from provision of services outside of England, typically Scotland and Wales for example.
- Income from related services such as supported accommodation, leaving care, assessment, other community services.
- Some of the voluntary organisations in the study receive amounts of charitable income or donations, and one also received DfE grants during the period of study.
- It is also possible that some of the income reported may relate to services for young adults that may be funded other than via children’s services budgets.

Despite these areas of potential mismatch, it is clear from figure 3 below that the sample selected for this work represents a substantial share of the target sectors, and therefore of the spending by LAs in England.

The aggregated children’s services (mainly fostering, children’s homes, residential special schools, education and leaving care services) income of the providers in this study is £1,373 million.

It is notable that the largest three providers (NFA, Caretech, Core Assets) substantially outweigh the rest of the sample, with 59.3% of the income of the whole sample, and the top 6 (also including Priory, Keys and Compass) accounts for 80% of the whole sample measured by income. The recent consolidation activity clearly contributes to this significant reshaping of the sector.
Most of the providers mainly or exclusively operate in children’s services, with notable exceptions being Caretech, Priory and SWIIS. For these three organisations the income from children’s services alone was derived either from a subsidiary company or grouping below the parent undertaking accounts, or from the voluntary disclosure of the information by the provider through segmental reporting within the accounts.

Related to acquisition activities some newly formed groups use provisions of the Companies Act to adjust the reporting period for the legal entities involved. This can result in lengthened or shortened periods of accounting. The income represented in figure 3 is an annualised equivalent of any period not originally reported as a year.
When it comes to detailed accounting disclosures, segmental disclosure is, to a large degree, defined by the directors of the company and the basis on which they manage and oversee the business. In particular, they may decide that children's services as a descriptor is a sufficiently detailed segmentation in its own right and therefore the accounts of those organisations do not provide a further detailed breakdown at the fostering or children's homes level. It can be seen in figure 3 that such further detail is rarely available via voluntary disclosure. Much of the analysis in this research is therefore restricted to the total children's services level.

**Income growth**

The aggregated income shown in Figure 3 is the latest annualised income.

This research has also looked across a period back to 2015 to gain a three-year trend-based view.

Between 31 March 2015 and 31 March 2019, the number of Looked After Children in England grew by 12.5%.

Across the same period the average income growth of the sampled providers was 20%. That growth was however driven significantly by acquisition activity in addition to organic growth.

Figure 4 shows the different growth trajectories of the top 6 providers (who represent 80% of the income of all providers in the sample):

---

4 Children Looked After in England 2019 National Tables. www.gov.uk
Almost all of the largest providers reported growth across the period.

The combination of Caretech and Cambian in 2018/2019 is most notable, although when measured by children’s services income NFA/SSCP remain the largest group.

The continued growth of NFA/SSCP following the incorporation of the Acorn results into the results from 2016 is seen in figure 4. The Competition and Markets Authority approved the merging of Outcomes First into SSCP in December 2019 so a further step change will be seen when the combined group accounts are made public later in 2020.

The main anomaly was FCA/Core Assets where reorganisation of the group prior to sale and the treatment of business not included in the sale has complicated the picture. Once the PICS and Orange Grove acquisitions begin to be reported as part of the new Nutrius/Core Assets consolidated group in 2020 then it is likely to show growth also.

Figure 5 also shows growth trends for the rest of the sample.
Most of this tier show continuous income growth patterns.

The anomalies are TACT and SWIIS.

TACT’s growth pattern is heavily impacted by the outsourcing of Peterborough City Council services to TACT (supported by Government/DfE innovation fund grants). Latest accounts disclose that this relationship has however been terminated.

SWIIS also reported lower revenues.

Viewed from a potential investor perspective, the overall picture is of a sector showing strong income growth trends for providers and this has helped to fuel further investment intent.
Part C

Profitability

Income and income growth are important indicators for independent businesses. The ability of the operations of a business to deliver their services in an effective and efficient manner and then to yield a profit or surplus out of the income is of even greater fundamental importance to the sustainability of the business, to its future growth and to the value of the business.

The method statement in Appendix 1 sets out the rationale for the use of EBITDA (Earnings before interest, tax, depreciation and amortisation) as the profit measure for this study.

Figure 6 shows the absolute amount of the latest annualised EBITDA for each provider in the sample, and also what proportion of the income that EBITDA represents (EBITDA % = EBITDA as a percentage of the total income level).

Figure 6

<table>
<thead>
<tr>
<th>£</th>
<th>Children's services income</th>
<th>Fostering</th>
<th>Children's Homes</th>
<th>Year End</th>
<th>Children's services income</th>
<th>Fostering</th>
<th>Children's Homes</th>
<th>Children's services income</th>
<th>Fostering</th>
<th>Children's Homes</th>
</tr>
</thead>
<tbody>
<tr>
<td>NFA</td>
<td>241,209,000</td>
<td>Aug-18</td>
<td>50,699,000</td>
<td>21.0%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outcomes First</td>
<td>83,025,015</td>
<td>Dec-18</td>
<td>14,814,246</td>
<td>17.8%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NFA subtotal</td>
<td>324,234,015</td>
<td></td>
<td>65,513,246</td>
<td>20.2%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Caretech/Cambian subtotal</td>
<td>271,359,000</td>
<td>40,784,000</td>
<td>Sep-19</td>
<td>63,183,000</td>
<td>7,551,000</td>
<td>23.3%</td>
<td>18.5%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FCA/Core Assets</td>
<td>162,798,711</td>
<td>Dec-18</td>
<td>22,195,310</td>
<td>13.6%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PICS</td>
<td>46,292,327</td>
<td>Mar-18</td>
<td>7,077,376</td>
<td>17.6%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Orange Grove</td>
<td>15,042,593</td>
<td>Mar-18</td>
<td>1,394,900</td>
<td>9.3%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Caretech/Cambian subtotal</td>
<td>218,133,631</td>
<td></td>
<td>30,667,586</td>
<td>14.1%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Priory</td>
<td>143,926,000</td>
<td>Dec-18</td>
<td>38,495,000</td>
<td>26.7%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Keys</td>
<td>79,396,000</td>
<td>Mar-19</td>
<td>7,408,000</td>
<td>9.3%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compass</td>
<td>61,114,248</td>
<td>Mar-19</td>
<td>9,705,222</td>
<td>15.9%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BSN Social Care</td>
<td>41,126,519</td>
<td>Mar-19</td>
<td>7,448,011</td>
<td>18.1%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TACT</td>
<td>36,786,000</td>
<td>Mar-19</td>
<td>-861,000</td>
<td>-2.3%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capstone</td>
<td>34,027,533</td>
<td>34,027,533</td>
<td>Mar-19</td>
<td>4,703,262</td>
<td>4,703,262</td>
<td>13.8%</td>
<td>13.8%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Five Rivers</td>
<td>33,144,549</td>
<td>Sep-18</td>
<td>824,487</td>
<td>2.5%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Horizon/Educare</td>
<td>30,086,425</td>
<td>Aug-18</td>
<td>2,718,675</td>
<td>9.0%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Together Trust</td>
<td>28,755,000</td>
<td>Mar-19</td>
<td>2,553,000</td>
<td>8.9%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hexagon</td>
<td>23,742,479</td>
<td>Mar-19</td>
<td>2,996,313</td>
<td>12.6%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SWIS</td>
<td>17,094,726</td>
<td>17,094,726</td>
<td>Sep-18</td>
<td>78,150</td>
<td>78,150</td>
<td>0.5%</td>
<td>0.5%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Esland</td>
<td>15,770,849</td>
<td>15,770,849</td>
<td>Nov-18</td>
<td>3,179,346</td>
<td>3,179,346</td>
<td>20.2%</td>
<td>20.2%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bryn Melyn</td>
<td>14,196,147</td>
<td>Mar-19</td>
<td>587,170</td>
<td>4.1%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td>1,372,893,121</td>
<td></td>
<td>239,200,158</td>
<td>17.4%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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In total some £239 million of EBITDA is generated from the £1,373 million of income at an average rate of 17.4%.

The top 6 providers (who account for 80% of the income of all providers in this study) account for an even higher proportion of the EBITDA (£215 million or 90%). This would be consistent with economies of scale from buy-and-build strategies and more efficient business models.

The only loss-making provider in the sample is TACT. The outsourcing from Peterborough Council (PCC), alongside other investments made by TACT and some property revaluation impact, appears to have significantly disturbed the ability of TACT to make a surplus in the last two reported years. The PCC contract is reported as having been terminated.

Indicators that can be used to monitor sustainability are discussed later in this report. Loss making is however one of the first and simplest indicators that can be used.

**Profit trend.**

As with the analysis of income above, EBITDA has also been tracked over the 2015-2019 period to provide a view of trend.

The average annual profitability growth rate across this period for all providers in the sample is 12.6% which is lower than the income growth rate (20%), suggesting that growing profits is more difficult than growing top line income, even with the potential for economies of scale to have impact.

One reason for this could be that new acquisitions into an existing group can sometimes cause a perturbation in the financial results of the new combined operations while the new business is integrated into the existing. In time the financial benefits and efficiencies of the larger group are seen. Given the high levels of recent acquisition activities in the sector it may take one or two more reporting periods before the full impact of the new groupings is seen.

Figure 7 shows the EBITDA trend for the largest 6 providers.
Figure 7

Profitability growth for the largest 6 providers averages at over 30% per annum due to the acquisition activity impact.

However, the second tier of providers report both lower levels of absolute and percentage profitability, and further report lower growth rates of profitability than the larger providers. In some cases, profits are declining, or losses are reported.

Figure 8 shows the profit trends for the second tier of providers.
Seven of the ten providers in this group saw a reduction in profits in at least one of the years covered by the study. The decline in the TACT result is clearly the most significant and is associated to specific Peterborough contract related issues.

There is further evidence from the children’s homes sector that a third tier of even smaller providers than any of those included in this study are experiencing lower percentage profit levels, and only 30% are reporting any growth in profitability.\(^5\)

The same information about the smaller IFAs is not available and therefore conclusions about profitability and growth of the smaller IFAs cannot be extrapolated from the findings of this study. Clearly this is one area for potential future study.

The evidence that is available suggests that the sector is developing a pattern where the larger and stronger providers are beginning to outperform and outdistance the smaller providers.

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\(^5\) ICHA State of the sector survey February 2019. [www.icha.org.uk](http://www.icha.org.uk). Note – the profit levels in this survey are self-declared and not based on independently researched audited accounts.
Part D

How shareholders extract value

Profits or surpluses created in any accounting period can be used in a wide variety of ways. An operating entity that creates the profits may decide to reinvest the profits back into the business with a view to rewarding employees to increase stability and retention, to enhance quality through training, to improve premises or quality assurance, to increase growth through marketing, or through the development of new capacity or services. The potential list of spending is long and applies to both charities and private sector groups.

There were two voluntary sector providers in this study, Together Trust and TACT, and voluntary sector bodies reinvest their surpluses back into their operations. By contrast, Private sector organisations (PSOs, excluding voluntary organisations) also have the potential to use profits to make payments to the business owners, the shareholders. Although some methods of profit distribution are common to all sizes and types of private sector companies and groups some are more prevalent than others in certain types of PSO. Almost all of the examples given below can be seen somewhere in the accounts included in this study.

Small and medium sized PSOs often have a close relationship with the people who perhaps founded the organisation and who took the risk to start the business. The owner may also be a key director, a full-time employee, and have other relationships with the business such as renting it assets or loaning it capital.

Small business owners therefore might use a variety of methods to extract value from their business, and most tailor their annual extraction in relation to the profit levels being achieved, and to the cash requirements of the business and its future strategic intent.

Hence a business owner might be in receipt of some or all of the following:

- A salary, bonus, pension and other employment benefits as an employee.
- Rental income from assets leased to the business, including property and intellectual property rights.
- Interest and capital repayments on shareholder or director loans made in earlier periods to the business.
- Dividends paid to shareholder(s).
- Other related party transactions including value extracted through family members who may also be employees and/or shareholders and who may have other relationships to the company.
Company accounting disclosure rules offer some insight to these areas, but it is not always possible to quantify all of the benefits in a consistent way across all providers. A case by case study would be required to explore further. Larger PSOs no longer in the ownership of the founder members may face additional calls on the profits of the organisation. As discussed below and later (Part E and Appendix 4), the larger PSOs are more likely to be managing bank loans and overdrafts (referred to as Bank debt or External debt) that the business or owners have raised in relation to their purchase of the business, or to finance acquisitions of other provider organisations for consolidation, or to finance other growth or asset purchases.

Funds raised from third party banks and financial institutions come with strict obligations to pay interest on the debt capital and a schedule of capital repayments. Such calls on the PSO’s resources are likely to have contractual preference before certain other payments to shareholders.

In other words, where there is bank debt then the interest and loan repayments have to be serviced, usually from the cash generated by the profits of the business. That is most likely to be the case where the ownership of a PSO has been purchased by a private equity (PE) owner.

A typical PE approach to buying a business involves borrowing funds from a bank alongside using money from the PE’s own investment funds and combining these amounts to buy out the previous owners. Both the bank debt and the amounts due to the PE house usually appear as liabilities of the group of operating companies acquired.

If the PSO is generating sufficient profit and cashflow to meet its obligations to the third-party banks it may also look to pay interest and capital repayments against the PE debt.

Of the 16 groups that exist at the close of this study period, three of the five largest PSOs have private equity owners (the other two are stock market groups), and three of the second tier are also in PE ownership (see Appendix 3).

In most of the examples studied the PE owners are not extracting payments for capital or from interest payments, even where interest on their loans is charged against profits. The tax deductibility of interest is partly responsible for this approach, but it may also relate to the capacity of the profitability and cashflow to service anything other than the bank debt. This is considered further in Part E below.

It is not unusual for PE owners of a PSO to extract very little from the profit generated by the operations during the period of the PE ownership. PE owners gain value for their investment when they ultimately sell the business.

Indeed, it is the total return on the PE investment that is the key driver of their for-profit funds. The return is predominantly determined by the increase in value in the PSO measured by the price it is sold for, compared to the price
paid for it, often some years earlier.

Although the income streams of the PSOs in this study are predominantly from local authorities, the PE income stream comes from the next investor, be that another PE investor, stock market investors, or other sources such as pension funds.⁶

A case study of how PE owners have made investment returns in the children’s services sector is set out in Appendix 4 and illustrates how two previous PE owners of NFA, Sovereign Capital and Graphite, made their returns between 2006 and 2015.

This offers an insight into the apparent attractiveness of the sector to investors of this type, and into the risks associated with the financial models employed. The subsequent waves of investment in acquisitions and in further consolidation in recent years give clear indication of a continued belief amongst investors that they can make similar returns from the sector in future.

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⁶ Acorn was, until acquisition by NFA, owned by the Ontario Teachers’ Pension Fund.
Part E

Sustainability and Solvency risk indicators

In any form of public sector procurement and purchasing there is a responsibility to consider the viability, sustainability and solvency of the organisations that are being contracted to provide goods or services. The collapse of Carillion has heightened concerns about partners used by the public sector and brings the need for careful stewardship by public sector procurement.

In children’s services that same responsibility applies, and perhaps even more acutely given the need for stability of placement for the vulnerable children and young people at the core of the services. Whilst we have seen the usual forms of credit reference checking in some procurement activity in the sector in recent years, the financial engineering used by PE owners in particular brings a need to consider additional monitoring based on more sophisticated insight and understanding.

For all of the sampled providers we have calculated the outcomes across a range of indicators to gain insight into solvency and the results are included in figure 9.

The indicators used are described more fully in Appendix 1.
As discussed in Part C a pre-cursor indication of potential issues for a provider would come from the analysis of profitability trend. If profits are in decline, or if losses are being incurred these indicators alone provide an initial signal of potential issues.

Losses in particular need to be funded, and otherwise are likely to erode the asset base (especially cash) within a business. If that erosion is substantial it can drive the business into a situation where it runs out of cash, and that is often the crisis moment for the survival of a business.

The balance sheet of the provider also offers many insights into the vulnerability of the organisation. If a balance sheet shows that there are more liabilities than assets then the relative timing of when the liabilities become due compared to when assets can be turned into cash, or more cash generated or input into the business, becomes critical.
The red figures in the first column of figure 9 above indicate that several of the largest providers are reporting net liabilities. This should be taken as a clear indicator that further investigation is worthwhile.

A sterner test based on the balance sheet is to exclude from the assets any intangible items such as goodwill and brands, as these assets may be difficult to convert into cash at short notice. Using a tangible net asset indicator gives us the second column in figure 9 above, and almost half of the providers produce a negative result, which again would be an indicator that further enquiry is necessary.

The level at which these calculations are performed is critical. Where the children’s services trade within a provider group is perhaps only part of a number of services within a group it is important to understand that group structure. It would be very unusual for just the children’s services operations of a group to be separately funded, with its own debt structure. Instead, groups will almost always be funded as a whole, for all operations. This means that cash and profit generative businesses can subsidise loss making or start-up businesses within the group, and that the combined financial position can be used to raise external bank finance. UK and international accounting standards are helpful in that the whole group consolidated picture is usually available at the “ultimate parent” level within the group. The disclosure requirements in some international geographies can limit availability of data, but in this study, this was not found to be the case.

In the main, the whole group picture was readily accessible for most providers in this study. For three organisations the turnover and profitability information about their children’s services business was obtained from subsidiary companies or groups but the overall financing and debt structure was obtained from the ultimate parent group.7

Visibility of the whole financing structure behind a group may be limited when, for example, assets such as properties or intellectual property are leased or rented to the operating companies by the company owners. If rentals are not at market levels then this approach can mean that further analysis of profitability may be needed, and that debt may have been raised in relation to those properties outside of the operating group. Further investigation of the overall picture in these circumstances would require non-statutory disclosures by the business and the owners.

The third and fourth columns of figure 9 show bank debt and total debt as at the latest available balance sheet date. The latter includes both the bank debt and the debt due to the shareholder/owners. This may take the form of loan notes, or preference shares for example and these are likely to carry a high notional interest rate, but both rank behind the bank debt in terms of rights to payments (as previously discussed in Part D).

7 Caretech includes adult and children’s services, but the group is financed as one. Priory is ultimately owned by Acadia Healthcare, a NASDAQ group in the USA. SWIIS is ultimately part of SWIIS International Limited, a UK group.
As stand-alone figures the amounts of debt are of limited value as they need to be related to the ability of the underlying business to pay off the interest and principal amounts of the loans.

The final two columns of figure 9 offer two straightforward indicators to begin to test the manageability of debt. This type of analysis is sometimes not performed by standard credit rating tests but is worthwhile in this study.

The two indicators are defined in Appendix 1. In essence they take a straightforward view and ask if the operating profits of the business or group are sufficient to at least pay the interest that is coming due on the bank debt alone (interest cover) and, secondly, how many years of EBITDA would be needed to pay off the underlying bank loans. As a rule of thumb, interest cover calculated this way would need to be above 1.0, and ideally be comfortably so. The number of years to repay debt gives an initial insight into how indebted the group is. A high figure suggests a high debt level and potentially a struggle to pay off that debt.

Some comments on the specific findings in figure 9:

- TACT’s loss made in the most recent reported year has the calculation effect of producing negative indicators related to debt. Essentially this says that a loss making organisation may struggle to manage debt. However, the net tangible asset position of TACT indicates some reserves (although much reduced in the last two years) are present, and bank debt levels are low.

- The two highest levels of absolute debt at this preliminary stage are in Acadia, Priory’s ownership group in the US, and in the SSCP/NFA group. In both cases the indicators are that annual external bank interest is covered, and that total bank debt is at 5-6 years’ level. It would be worthwhile to further investigate the repayment schedule of the bank debt in these cases.

- Where groups are only recently formed through acquisitions the amount of debt raised may not be fully apparent until the next full set of financial statements (although stock market groups have more frequent disclosure requirements). Cambian/Caretech’s December 2019 reporting shows the step change in debt to over £320million brought by the merger. Indications are that this is manageable, but further research of the debt structure and scheduling of repayments would be recommended.

- There are other cases where a further analysis of the timing of debt should be analysed further, including Keys, Compass, Horizon (all PE owned).

- Other examples where the balance sheet shows a deficit in net tangible assets are Capstone and Horizon. The interest cover and years to
repay indicators are significantly different for both however and further analysis of the Horizon debt would be worthwhile.

- It is notable, but unsurprising, that the smaller PSOs, more likely to be in private ownership (as opposed to PE ownership) produce indicators of more manageable debt levels. Private owners tend to use debt more selectively for specific purchases than using debt for maximum gearing of their finance structures.

- The Together Trust stands out as having a £23m asset base and reserves, with seemingly comfortable debt levels.

It can be seen from even this simple analysis of a limited number of solvency indicators that the financing and debt structures of provider groups can vary widely, and often need further detailed individual investigation and analysis.

Looking back across the period of this study there are examples where debt management has become a serious issue for individual organisations. The NFA case study in Appendix 4 includes one such example, but there are others. In all examples the situation has either led to a wholesale refinancing of the business, perhaps with shareholders having to commit more funds, or the whole business was sold to an acquirer before the crisis point was reached, with the financing of the acquisition extinguishing the growing debt issue.

Throughout the study it was notable that loan notes and other forms of lending by the business owners over and above the external bank funding, was often not subject to any form of cash repayment, or indeed to actual interest payments. It is not unusual for PE style owners to charge notional interest against profits during the period of their ownership but not to actually withdraw the payment for that interest (a process sometimes referred to as “rolling up” interest). Hence the amount due to the investor is often seen to accumulate through compounding of interest. The investors may only receive repayment of the capital amount of the loan and interest on the onward sale or refinancing of the business (see earlier discussion about rates of return for investors).

The scale of some provider organisations and the scale of the debt involved in their financial structures would appear to merit closer monitoring to assure commissioners as to the sustainability of these key provider organisations.
Part F

Discussion of Issues

The rate of consolidation in the children’s services sector has accelerated and there are now large provider organisations with operations across the country that represent a substantial proportion of all supply.

One of the providers, Priory, is part of an international group that, measured by its income from healthcare, is larger than the entire spend in England by LAs on fostering and children’s homes. Other large consolidated providers have income that is many times greater than the entire children’s services spend of even the highest spending LAs in England.

This mismatch provides a challenge to existing commissioning structures and processes that have historically tried to influence the supply sector from a single LA or regional perspective.

Profitability across the sector is not uniform but has been growing in the most recent 2-3 years, especially for the largest providers, as demand has increased. There is evidence that some investors have made above-average returns on their investments. This is further indication, added to that in several other studies and enquiries, that traditional methods of commissioning and procurement are struggling to influence the development of the market.

The types of ownership of provider organisations are varied but increasingly involve sophisticated financial investors that bring financing techniques involving increasing amounts of debt and risk. The risk of failure of a provider organisation may bring a change of ownership, partial or full sale of assets such as properties, or even outright closure of the service, each scenario having the potential to disrupt children in placement. These factors therefore need to be considered by commissioners and policy makers.

For LAs and/or Government to monitor such issues and be aware of the risks will involve new areas of interaction with the PSOs. For example, reliance on historical statutory accounts is insufficient and more timely information would be required. Disclosure of details not currently subject to statutory or accounting standards-based approaches may also be needed (see Appendix 2).

There is currently no direct equivalent in children’s services to the monitoring role that the Care Quality Commission (CQC) performs in the adult care sector. Learning from the CQC role and processes may also be valuable.

Some insight can be gained from the fact that the external bank funders of PSOs often take an active role in monitoring organisations to whom they have loaned significant sums of money. Set out in the loan contract between the

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8 E.g. Narey/Owers Fostering Stocktake, National Audit Office “Pressures on Children’s Social Care”, HCLG committee enquiry into LA funding.
bank and PSO is a periodic monitoring requirement whereby the PSO is contractually bound to provide additional calculations and information to the bank in relation to bank covenants (a form of solvency indicator set). This might include both current management accounts information and forward forecasts of cashflow used to assess the likelihood of the PSO being able to make the required repayments. There is potential to develop this type of monitoring in a parallel way to monitor PSOs on behalf of the public sector funders of the operations.

Policy makers will undoubtedly need to also consider what could be done as a result of the monitoring activity and its findings. Again, there are perhaps some indicators to give direction from the existing market. The Together Trust (a voluntary sector body) stands out in the solvency data studied as, although it has borrowed money, there are strong reserves and debt appears comfortably contained and manageable compared to many of the PSOs studied.

There may therefore be potential to consider minimum solvency ratio requirements for all provider organisations for example to include minimum reserves levels, or, as an alternative, owner guarantees could be explored where groups are thinly capitalised.

The two issues - needing to find new ways to commission in these sectors, while at the same time stewarding the sectors to manage risk are closely related. Actions taken by LAs to shift the focus of their activities in commissioning (e.g. to shift back to greater investment in in-house provision) will have an indirect impact on the external PSO and voluntary sectors. Monitoring those sectors in deeper and more intelligent ways will be an essential task for the stewards of the sector.

A final area for consideration is contingency planning in the event that a large provider was to fail altogether. Whilst investors may face financial write offs, the children in their services need to be protected as a priority during any transition. Consideration must also be given to what actions the state may need to take if an independent sector provider begins to fail financially. Are the corporate rules related to administration and liquidation appropriate to the children’s services sector organisations? Is a different standard needed to protect the children in placement as a greater priority?