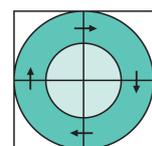


# **Profit making and Risk in Independent Children's Social Care Placement Providers.**

**2<sup>nd</sup> Update Report: May 2021**

Andrew Rome  
May 2021



**Revolution  
Consulting**

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## Introduction

This study completes the second annual collection of 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 first report in this series was published in February 2020 and the original intent was to repeat the study one year on to yield additional information of emerging trends that would add value to the exercise. The study has been updated in two tranches, the first of which was reported in January 2021. One of the reliefs from statutory deadlines granted by Government during the Coronavirus crisis was to give organisations an extra 3 months to report their financial results, so just under half of the sample had not updated their information from the original study by December 2020. This second update therefore includes new financial information for all the studied organisations.

The work is commissioned by the Local Government Association (LGA) and seeks to identify the profitability of the largest independent children's social 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.

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

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

Whilst there are technical accountancy issues that need to be understood 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.

The sample of providers has also been supplemented with new study subjects to expand the sample to twenty organisations/groups in this update.

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## Summary of results

This update completes the second annual study of the largest children's social care providers. All sixteen provider groups from the original February 2020 study have disclosed a further year of financial accounts, and the studied group has been expanded to the largest twenty providers in this 2021 study.

Although most of the updated financial information relates to periods ending before the impact of the first spring lockdown, the impact of the Covid-19 pandemic features in most of the narrative reporting of provider organisations. Providers expressed concerns about the uncertainty of the impact, with varying early experiences of the effect on demand. They also evidenced proactive, risk assessed adjustments to policies and practice in order to keep their essential services operating throughout the year. Failing to provide services for the most vulnerable children in the UK was generally not considered an option.

The largest twenty provider organisations studied in this project have income of **£1.58 billion**, an increasing proportion of the spending by local authorities on fostering, children's homes, and other social care services including residential school places and leaving care.

Aggregate profits measured using the popular EBITDA method (Earnings before Interest, Depreciation and Amortisation) amount to **£278 million** at an EBITDA margin of **17.6%**.

On a like-for-like basis compared to the first study, there is evidence of continued growth of income, profits, and EBITDA margin amongst the largest of provider organisations in aggregate, although growth is not uniform across all providers.

The increased clarity of insight gained into performance from the new information shows that, after the largest acquisitions the sector has ever experienced, the consolidation and integration of the largest groups is a strong factor in this growth. Acquisition activity is continuing despite the impact and concerns related to Covid-19.

Private Equity ownership and the associated funding models stand out amongst the providers studied. Although the impact is to introduce additional risk into the sector, we are not to date experiencing corporate failures as a result of the funding models used. The report investigates this further and illustrates how, despite record high debt levels in the sector, there is also evidence of growth and a continued appetite for investment.

The smaller organisations in both this study and those that disclose their performance via the Independent Children's Homes Association State of the Sector survey report results that are more mixed with lower growth and lower profitability.

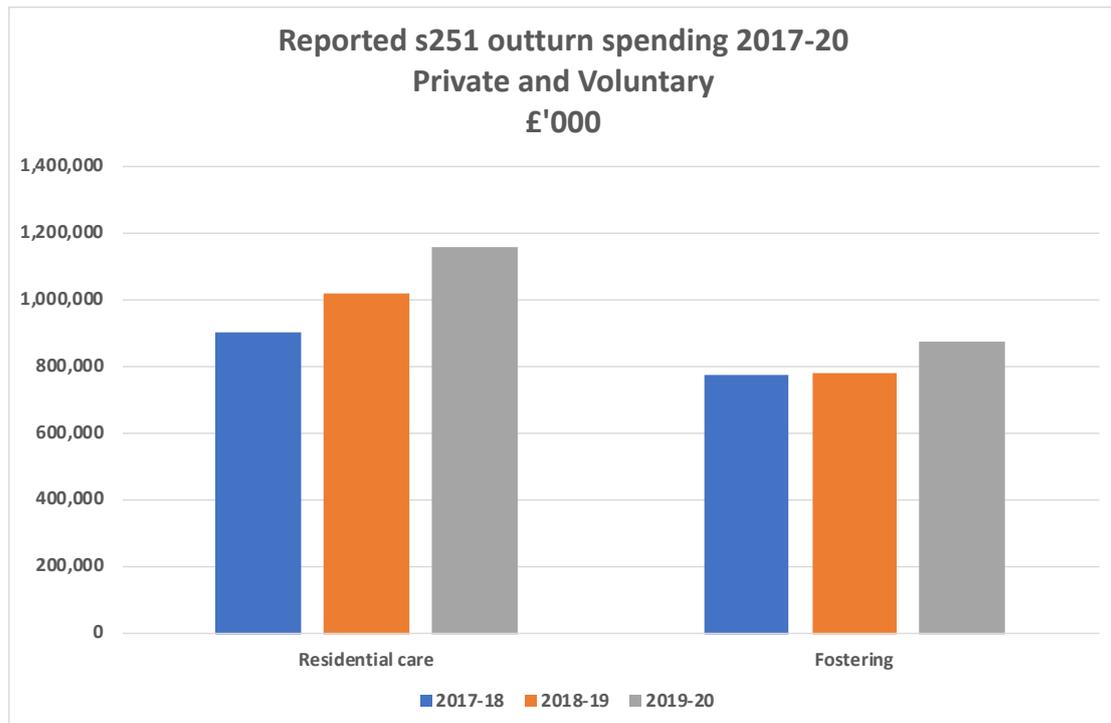
Across the sector there is recognition amongst providers of the fragility of the income from local authorities that report severe budget deficits in children's services and the substantial impact of Covid-19 on council income.

This renewed understanding of financial dynamics arms policy makers, commissioners, the Independent Review of Children's Social Care and the associated market study by the Competition and Markets Authority, with further information to inform their strategies and recommendations.

## Representativeness of the sample

This study is particularly concerned with the services that local authorities purchase from social care budgets. The fostering and children's homes sectors are therefore the primary target areas. These are also the sectors where children's social care budgets have reported the highest levels of overspending in the last 2-3 years.

Reported spending by local authorities on these elements of children's services and where there is significant outsourcing to the independent sector is illustrated below.



Total reported spending on residential care and fostering with the independent sector across the period of this study has grown to £2,035 million (an increase of 21% between 2017/18 and 2019/20), led by residential care spending growth of 29% and lower fostering growth of 13%. In addition, councils spend around a further £900 million on placements in SEN/Special schools in the non-maintained and independent sectors.

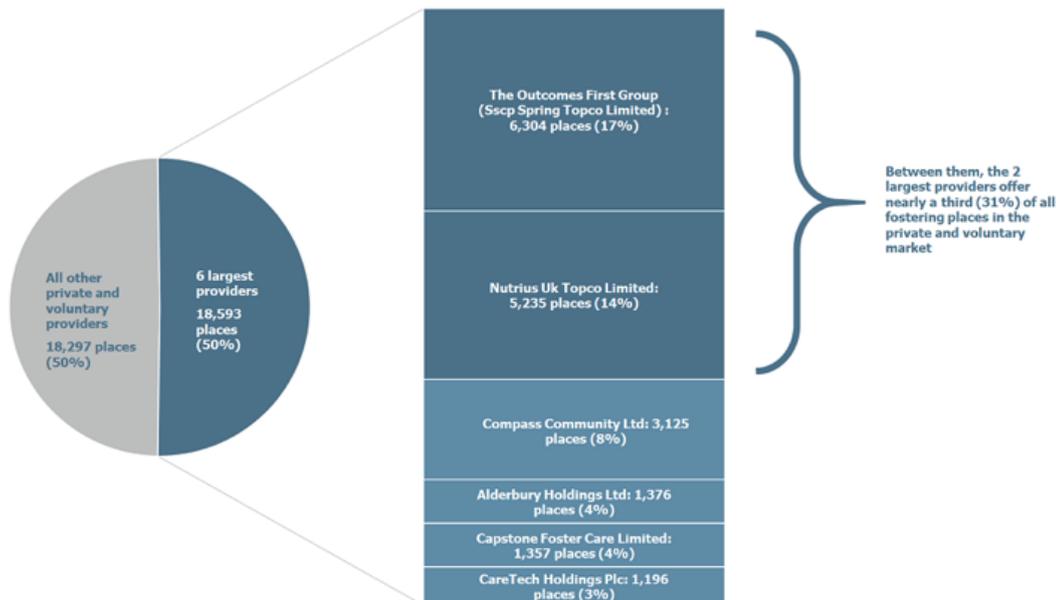
The total annual fee income for children's services of all types for the twenty groups included in this update study is £1,579 million (£1,373 million for the smaller sample in the first report). This aggregate income includes income for special schools' services that may be funded from non-social care budgets, also for leaving care services and services provided to local authorities outside of England. Hence the aggregate income of the sampled providers is not directly comparable to England-only spending reported by councils (represented in the chart above) but provides an indicator of relative scale.

Since the first report Ofsted have also published data on the makeup of the provider sector using data in relation to registered children's homes' and independent fostering agencies' capacity and ownership:

**Figure 1: Proportion of all private and voluntary children’s homes owned by the 10 largest providers.**



**Figure 4: Proportion of all fostering places provided by the 6 largest providers.**



It can be seen from these charts that the larger providers of services represent a higher proportion of the fostering sector (6 providers make up 50% of places) than

the children's homes sector (10 providers make up 30%).

Two provider groups, Outcomes First and Caretech (including Cambian) are present amongst these largest providers in both types of service.

All the provider groups identified in the above Ofsted reporting are included in this update study except one.

The Partnership of Care Today, as its name suggests, is a partnership organisational structure and as such it is not constituted as a company, and therefore accounts are not available in the public domain at Companies House. It is not therefore possible to include it in this study.

This update report has studied a wider sample of organisations than the original study (including seven additional large providers). The method statement in Appendix 1 explains the selection criteria for these organisations. Their reporting dates, and the periods of financial accounting records used in this update are shown in Appendix 2.

## Income and Profitability

Reported fee income (or “turnover”) of provider organisations gives the clearest indication of the level of purchasing of services with each sampled provider by local authorities. With almost no private funding for the services covered by this research, the income of providers is almost exclusively derived from fees invoiced to councils for placements.

The ability of the operations of each provider to deliver their services and to yield a profit or surplus out of the income is of fundamental importance to the sustainability of the providers, to their future investment in quality and growth, and (in the private sector) to their ability to distribute returns to owners. As discussed in Appendix 1 we use EBITDA as the measure to examine the financial performance of the providers in this study.

The results for both measures are set out in the table below for each provider and in aggregate. The providers are listed in column 1.

To provide a degree of comparability between providers and to estimate the total annual activity of the sample in aggregate, we have used calculations of annualised absolute income/turnover (column 2) and annualised profit/EBITDA (column 5), highlighted in orange. More detail of the factors involved in those calculations are set out in Appendix 1.

In addition to the absolute values for income the table also gives indications (columns 3 and 4) of how concentrated the results are towards the very largest providers.

Profitability is also expressed as a percentage of the income level; this is usually referred to as the profit or EBITDA “margin” (column 6). Column 7 indicates if this April 2021 update included new information compared to the January 2021 update.

The final three columns give a trend indicator. For each of the following three indicators:

- Income
- Profit/EBITDA
- Margin/EBITDA %

The comparison is made to the results in the first 2020 study. Indicators are used to show whether the trend for a provider has increased (+), stayed the same (=), or declined (-). Clearly the comparators are only available for organisations studied in both the original report and this update.

The same comparisons are made for aggregated amounts, but the actual percentage increases are calculated in the final three rows of the table.

Comparisons are made for:

- a) The original sample of providers in both 2020 and 2021 studies, and
- b) The same group as in a) but with the Polaris group excluded. (see note following the table for the rationale for this exclusion).

**Fee income and profitability measures and trends for the largest children's social care providers – May 2021.**

	Annualised Children's Services Income	% of Total Sample Income	Cumulative %	Annualised EBITDA	EBITDA %	Apr 21 new info	Income vs. Jan 2020 study	EBITDA vs. Jan 2020 study	EBITDA% vs. Jan 2020 study
	£			£					
Outcomes First	346,644,074			71,266,698	20.6%		+	+	-
Bryn Melyn	16,436,072			498,831	3.0%		+	-	-
1 Outcomes First subtotal	363,080,146	23.0%	23.0%	71,765,529	19.8%				
2 Caretech	293,800,000	18.6%	41.6%	58,295,071	19.8%		+	+	+
3 Polaris	177,202,690	11.2%	52.8%	29,184,693	16.5%		-	-	+
4 Priory	142,906,000	9.0%	61.9%	38,056,000	26.6%		-	-	-
5 Keys	99,951,730	6.3%	68.2%	14,825,146	14.8%	*	+	+	+
6 Witherslack	75,069,319	4.8%	73.0%	14,186,184	18.9%				
7 Compass	71,564,552	4.5%	77.5%	10,117,522	14.1%	*	+	+	-
8 BSN Social Care	46,164,192	2.9%	80.4%	8,150,921	17.7%	*	+	+	-
9 Five Rivers	44,003,673	2.8%	83.2%	3,811,990	8.7%	*	+	+	+
10 Horizon	37,762,653	2.4%	85.6%	5,757,399	15.2%		+	+	+
11 TACT	30,388,000	1.9%	87.5%	265,000	0.9%	*	-	+	+
12 Capstone	33,978,017	2.2%	89.7%	4,425,433	13.0%		+	-	-
13 Together Trust	29,540,000	1.9%	91.5%	1,910,000	6.5%	*	+	-	-
14 Esland	20,360,463			3,836,993	18.8%		+	+	-
Oracle	6,780,700			900,919	13.3%				
subtotal	27,141,163	1.7%	93.3%	4,737,912	17.5%				
15 Hexagon	27,628,540	1.7%	95.0%	4,651,066	16.8%	*	+	+	+
16 SWIIS	17,117,990	1.1%	96.1%	-466,316	-2.7%		+	-	-
17 Sunbeam	17,648,287	1.1%	97.2%	1,364,481	7.7%	*			
18 Care 4 Children	17,472,433	1.1%	98.3%	4,243,055	24.3%	*			
19 Homes 2 Inspire	14,593,000	0.9%	99.2%	-360,000	-2.5%				
20 Sandcastle	12,107,260	0.8%	100.0%	2,662,272	22.0%				
TOTAL	1,579,119,645	100.0%		277,583,356	17.6%				
Total - original sample only	1,435,448,645			254,586,445	17.7%		104.6%	113.7%	108.8%
Total - updated original excluding Polaris	1,258,245,955			225,401,752	17.9%		109.0%	116.7%	107.1%

Observations and comments:

- A. The total income for this expanded sample is **£1,579 million**.
- B. The total profit/EBITDA of the updated and expanded sample is **£278 million**, and this represents a profit margin of **17.6%** in aggregate.
- C. The addition of new providers into the sample clearly invalidates direct comparison of these aggregates to the first study, but the overall profit margin can be compared and has increased from 16.3% in the original 2020 study.
- D. To achieve a valid like-for-like comparison only those providers in the original study should be compared. For specific reasons set out in point E below exclusion of the results of the Polaris group is also required to enhance accuracy of comparison. The most accurate indications of trends compared to the first study are therefore:

**Income levels of the large providers have increased by 9.0% since the original 2020 study.**

**EBITDA Profit levels have increased by 16.7% since the original 2020 study.**

**This is partly due to the increase in EBITDA Profit margins to 17.9% compared to 16.7% in the original 2020 study.**

- E. The information available for this update study in relation to Nutrius (the Polaris Group) is the first consolidated set of financial statements that has been published for this newly formed group. Information for Nutrius was estimated from the constituent parts of the predecessor subsidiaries in the original report in January 2020. The new information now available indicates that not all the worldwide operations were transferred from Core Assets into the ownership of Capvest, and that substantially all the Polaris income is derived only from the UK. Hence the estimated figures constructed for the first report were overestimated. For greatest accuracy it is therefore necessary to exclude the Polaris figures from the comparison indicators. This is achieved in the final row of the table.
- F. The largest 4 providers are unchanged from the first study and now make up 61.9% of the income in the whole expanded sample. This is lower than in the previous study due to the expanded sample. On a like-for-like basis these 4 largest providers would have marginally increased their share of the total to 71%.
- G. The largest 8 providers represent 80% of the income in this updated study.
- H. The largest 4 providers are also the most profitable, making up 71.1% of the total profit of the sample despite only making 61.9% of the income. Economies of scale and successful integration of newly acquired businesses continue to be key factors driving this.
- I. Growth in income and profitability is not uniform across the sector or in this sample. The Caretech group was the most substantial driver of growth along with the newly formed Outcomes First group. In this most recent update Keys Group also reported substantially improved profits. In contrast, Priory Group

reported a slight decline in revenues and profits.

- J. Where profitability is shown as reducing for several providers the underlying reasons indicated in the details of their financial reporting are often due to investments being made in new capacity where costs of those developments are incurred ahead of income being earned. However, some providers are concerned about the economic pressures on local authorities.
- K. It should again be stated that the profit levels reported by smaller providers is usually at materially lower levels (absolute and margin %) than for this large provider group. Surveys of members of the Independent Children's Homes Association by Revolution Consulting confirm this for children's homes services.
- L. Loss making would generally be an early indicator of solvency or sustainability issues for an organisation. In this update study the loss-making organisations are:

SWIIS. Investment in an expansion is partly responsible. The overall SWIIS International organisation appears able to subsidise the fostering expansion.

Homes 2 Inspire. Also investing in new capacity and new contracts in both homes and leaving care services. A relatively small part of the overall operations of the Shaw Trust.

The growth and increasing concentration of children's services sectors continues to be a combination of organic growth via investment in new capacity and through acquisitions and economies of scale. Appendix 3 is a list of all acquisitions disclosed in financial statements examined as part of this update and a short discussion of the trend that looks like it is set to continue.

## **Sustainability and Solvency risk indicators**

The indicators used in these studies to give insight to debt and solvency issues are described more fully in Appendix 1 and are unchanged from the original study. The table below includes the results for these indicators for all providers in the sample.

The providers are again listed in column 1.

Columns 2 and 3 are derived from the balance sheet of the provider and indicate if, at the balance sheet date, the provider is reporting net assets or net liabilities. The second indicator excludes intangible assets (e.g., goodwill) from the calculation.

Fundamentally these measures give indication if the provider has enough assets with which to meet its liabilities. A negative measure requires further investigation into the relative timing of future transactions in order to judge if the provider has a reasonable expectation of being able to meet its liabilities as they become due.

As discussed in Appendix 1 it is critical to be able to access the full funding picture from the top level of the consolidated group in which the children's services sits in order to assess solvency issues.

In addition, off-balance sheet financing of assets via operating leases can impact on the balance sheet indicators. A discussion of the impact of IFRS16 is also included in Appendix 1.

Column 4 of the table extracts from the provider balance sheets the debts due to third party banks, excluding those amounts that are also loaned by owners/shareholders. Column 7 adds back into the total debt the loans from shareholders.

The reason for the distinction is that the bank debts are more likely to require fixed repayment of interest and debt capital and, if defaulted against, may grant the bank rights to step in and assume control of the provider operations. Bank debt is therefore generally monitored ahead of the total debt structure. Shareholder loans and other financing are discussed in more detail in the following section of this report.

Absolute values for debt are of limited value in their own right and need to be related to the ability of the underlying business to pay off the interest and principal amounts of the loans.

Columns 5 and 6 of the table below offer two straightforward indicators to begin to test the manageability of debt. 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 (column 5) calculated this way would ideally need to be above 1.0.

The number of years to repay debt (column 6) gives an initial insight into how indebted the group is. A high figure suggests the need to investigate further the timing of the scheduled repayments of that debt and to assess the ability of the provider to make those repayments. Such information is not automatically available in the statutory financial statements of providers.

**Solvency and debt measures for the largest children's social care providers –  
May 2021.**

		Net Assets/ (Liabilities)	Net Tangible Assets/ (Liabilities)	External debt: latest accounts	Interest Cover (External Debt)	Years to repay external debt		Total Debt: latest accounts
		£	£	£				£
1	Outcomes First Bryn Melyn	(152,075,000) 787,773	(514,275,000) 787,773	489,621,000 1,748,424	1.7 6.0	6.7 3.4		731,428,000 1,748,424
2	Caretech	364,216,000	196,528,000	318,955,000	7.8	3.1		318,955,000
3	Polaris	49,530,000	(119,535,000)	146,679,000	4.0	4.2		146,679,000
4	Priory / Acadia Healthcare Inc (\$)	2,606,639,000	55,894,000	3,118,101,000	3.7	5.4		3,118,101,000
5	Keys	(38,722,000)	(119,004,000)	94,500,000	2.6	5.6		151,653,000
6	Witherslack	33,330,870	3,545,972	100,398,968	1.6	8.3		124,224,007
7	Compass	(4,969,821)	(62,908,899)	49,690,525	3.5	4.3		74,243,453
8	BSN Social Care / Lindale Holdings	10,858,000	4,409,000	3,544,000	64.2	No net debt		0
9	Five Rivers / Midhurst	10,070,645	8,296,251	452,854	187.4	No net debt		0
10	Horizon	NA	NA	NA	NA	NA		NA
11	TACT	3,182,000	3,182,000	0	53.0	No net debt		0
12	Capstone	9,501,466	(8,432,544)	8,500,000	6.8	1.7		8,500,000
13	Together Trust	25,575,000	25,575,000	1,000,000	26.5	No net debt		0
14	Esland Oracle	(3,317,405) (98,258)	(23,690,567) (2,232,715)	25,447,295 2,331,000	2.1 4.6	6.1 1.6		42,334,421 7,092,327
15	Hexagon	6,493,578	5,844,876	3,292,519	15.9	0.3		6,324,755
16	SWIIS / SWIIS International	3,076,858	3,076,858	57,633	21.4	-1.2		57,633
17	Sunbeam	5,914,998	5,903,370	906,087	No Interest	0.0		2,426,087
18	Care 4 Children	5,459,065	4,491,914	1,661,456	12.7	No net debt		5,715,202
19	Homes 2 Inspire / The Shaw Trust	82,081,000	59,709,000	7,062,000	12.8	No net debt		7,062,000
20	Sandcastle	17,118,955	1,193,108	18,075,000	3.4	6.6		18,075,000

Observations and comments:

- A. The 2021 update benefits from greater visibility of the impact of the financing arrangements used in the acquisition of Outcomes First by SSCP and in the formation of the Polaris group from predecessor groups by Capvest.

The effect of the subsequent acquisitions into Outcomes First will only be available in subsequent reporting.

- B. The proportion of debt that is accessed from banks or debt markets to finance the sector has increased. Two drivers of this trend are that the sector appears to remain attractive to lenders, and changes to the tax treatment of shareholder loan notes has made their use less attractive to investors. There is evidence of the increased use of preference and ordinary share structures by investors as a result.
- C. Four of the providers reported negative net assets in this study period, and that number increases to six if intangible assets are excluded. All except privately owned Capstone have private equity ownership.
- D. The table highlights the eight providers where the indicator for number of years to repay external debt is above 4 years. Several of the same highlighted group also have the lower levels of interest cover.

All are private equity investments except Priory, and the total external bank debt for the private equity only investments is **£927 million**.

In some cases, the higher ratios also relate to high levels of tangible assets (e.g., properties) against which lending can be secured.

This re-confirms the understanding that the financing models used by private equity owners tend to create these effects, as was discussed and illustrated in the original report.

- E. Whilst the debt levels of some of this group of providers are substantial in actual terms the sector has not experienced any corporate failures during the period of study. The following section of this report below looks more closely at how this model works in practice.
- F. The interest cover indicators are above the benchmark value of 1.0. This is consistent with the statement in E. above.
- G. Stock markets tend not to support the higher levels of external debts that are seen amongst the private equity owned organisations. Caretech and Priory (in the top 4 by size of operations) are not therefore amongst the top four organisations with either the lowest interest cover or the highest indicator of years to repay debt. However, Priory was acquired by Waterland Private Equity in January 2021. We do not yet have visibility of the financing structure employed in that change of ownership.
- H. The Horizon group was sold by NBGI to Graphite Capital in August 2019 and the first accounts of the group under new ownership and financing structure are not yet available.
- I. Organisations such as BSN Social Care, Five Rivers, Capstone, Hexagon,

SWiIS, Sunbeam and Care 4 Children are predominantly privately owned and do not carry the high debt or risk levels of their private equity owned peers.

- J. We have previously reported the financial impact experienced by TACT in relation to the early termination of a contract with Peterborough City Council. Their latest financial statements are beginning to show a reversal of the deficit and the negative impact on reserves that was experienced.
- K. Although the presence of charitable organisations (TACT, Together Trust and The Shaw Trust) in the study is justified by the size of their operations and their particular focus on fostering and/or children's homes operations, the structure of charity reporting does not always facilitate the analysis approach in this study as it is primarily designed for private sector organisations. This adds to the potential need for a separate study of charities and voluntary sector organisations.

## Private equity shareholders, debt management, and value extraction

The solvency indicators discussed in the previous section identify private equity financing structures and the particular impact they have on the indicators. It is therefore important to understand more of the detail as to how, despite the high levels of debt, private equity owners are able to manage debt levels, continue to invest further, and to achieve returns on their investments.

There are useful examples in the accounts of providers accessed during this update study that help to illustrate how this form of financial management works in practice:

1. Both the directors of the provider organisations, and the external banks that lend to them alongside private equity investment are inherently cautious and carefully monitor the continuing ability of the operating business to be able to meet its interest and loan repayments to the bank(s).<sup>1</sup>

Comfort can be taken by any party dealing with the provider organisations from this stewardship of the bank debts, albeit that the real-time monitoring is currently a private exercise between provider, investor, and bank. An insight is however gained from the subsequent financial reporting analysed in this study.

Below is one example, an illustration from the most recent accounts of the Keys Group. The extracted note below recognises the same net liability position that we have included in our analysis above. It further sets out details of the group's debts and recognises the need to monitor the due date for repayment of those debts. The note describes the cash flow forecasting and modelling that the group performs to analyse the group's ability to meet its repayment obligations. It also provides insight that, if a rescheduling of debt repayments is indicated by the modelling, that the group would consider a refinancing via renegotiated bank debt or further capital restricting by owners.

### 1.4 Going concern

Notwithstanding net liabilities of £38.7 million as at 31 March 2020 and a loss for the year then ended of £10.7 million the financial statements have been prepared on a going concern basis which the directors consider to be appropriate for the following reasons:

The Group, of which the Company is a member, is funded through a combination of Shareholders' Funds, Unsecured Shareholders Loans, Senior Secured loans, and cash generated through operating profits. These comprised £57 million of 12% preference shares, £87.5 million of 6.0% Secured Loans, due in 2024, and a Revolving Credit Facility of £7.5 million, due 2024, of which £7.0 million was drawn at 31 March 2020. The Directors are mindful of the due date of the external financing arrangements and recognise the need to review refinancing or capital structure options at an appropriate time. The Investor and Management Fixed Rate unsecured preference shares are payable at the earlier of an exit, or 2027.

Management have prepared cash flow forecasts and accompanying covenant compliance calculations for the period of 12 months from the signing of these financial statements, including what they consider to be reasonably possible downside scenarios. The cash outflows associated with the Group's debt in this period are limited only to bank interest payments, limiting the size of required cash outflows on the Group's financing. These cash flow forecasts indicate that the Group will have sufficient funds to meet its liabilities as they fall due for that period. Whilst the UK's economic outlook resulting from the global COVID-19 pandemic remains uncertain, the Directors have considered the impact to the Group by conducting extensive scenario analysis on the Group's profitability, the availability of cash to meet liabilities as they fall due and its compliance with the debt covenant. Additionally, the Directors continue to assess the ability to refinance in each scenario.

Therefore, the directors consider, after making appropriate enquiries and taking into consideration the risks and uncertainties facing the Group, on page 2, that the Group has adequate resources to continue in operation as a going concern and that Group will be able to meet its obligations linked to the borrowings in place for the period covered by the Group's cash flow forecasts. Accordingly, the directors continue to adopt the going concern basis in preparing these consolidated and parent company financial statements. The financial statements do not include any adjustments that would result from the basis of preparation being inappropriate.

<sup>1</sup> From interviews with three CEOs/CFOs of PE backed providers.

2. The Private Equity investment itself is often via investor loan notes, and these often do not result in either interest or loan capital being repaid to the lender until the eventual sale of the business in its entirety, or until the debt structure is refinanced.

SSCP offers an example of this in the August 2019 accounts:

**Investor loan notes**

£41.0m (2018: £62.5m) of unsecured investor loan notes in the Group are held by SSCP Spring Holdings SCA, the ultimate parent undertaking. These loan notes carry an interest rate of 14% and are repayable on 24 April 2025. Interest is capitalised and added to the outstanding loan balance on an annual basis. At 31 August 2019 the value of capitalised interest was £38.4m (2018: £29.4m) with a further £3.7m interest accrued (2018: £5.4m).

£9.4m of unsecured investor loan notes in the Company are held by management and the EBT. At 31 August 2019 £2.0m of loan notes are held by the EBT (2018: £1.4m). The loan notes carry an interest rate of 14% per annum and are repayable on 24 April 2025. Interest is capitalised and added to the outstanding loan balance on an annual basis. At 31 August 2019 the value of capitalised interest was £6.5m (2018: £4.6m).

Note how the interest accruing is added to the growing loan balance (“capitalised”); it is not paid out of the provider’s cashflow.

The sale of Horizon to Graphite is an example of the moment when loan notes and accrued interest are ultimately settled from the incoming resources of the new owner and the banks they use as co-funders:

**19. Loans (continued)**

On 15 August 2019 the Horizon 2918 Limited Group was acquired by Graphite Management LLP. On the same date, all outstanding bank loans, loan notes and accrued interest was repaid.

3. While substantial external debts are present it is likely that no dividends can be extracted and paid to the private equity owners.

This is confirmed in the accounts examined in this update study for private equity held providers in the sample.

4. Owners are able to extract limited monitoring fees in relation to their activities in overseeing the provider and their investment. This may involve participation at the operational board meeting level.

Oracle’s March 2019 accounts include both a further example of loan interest accrual and an example of a monitoring fee disclosure.

## 21 Related party transactions

### Group

#### Summary of transactions with other related parties

During the year the group paid rent of £35,490 (2018 - £34,625) including VAT to the director shareholder C Bianco for the use of a property from which the group operates.

During the year, loan note interest of £496,391 (2018 - £310,958) was accrued at a rate of 10% per annum, plus an additional default interest rate at 10% on the loan notes owed to the company's minority shareholder Bestport LP Fund.

During the year, loan note interest of £370,442 (2018 - £230,088) was accrued at a rate of 10% per annum, plus an additional default interest rate at 10% on the loan notes owed to the parent company's minority shareholder Catapult Growth Fund LP.

During the year, loan note interest of £123,406 (2018 - £98,828) was accrued at a rate of 10% per annum, plus an additional default interest rate at 10% on the loan notes owed to the parent company's management shareholders that do not have a controlling interest.

During the year the group paid monitoring fees of £34,711 (2018 - £32,700) and £30,661 (2018 - £29,400) to Bestport Ventures LLP and Catapult Venture Managers Limited respectively.

5. The use of these methods results in private equity owners extracting minimal amounts from the operating businesses during the period of their ownership. In this way the profit and cash generation of these providers can be applied to the further development of the services and to payment of interest and scheduled repayments of the external (bank) debt.

It is only when the private equity owners sell to another owner, or refinance the debt structure, or float the provider business on a stock market that they realise the value of their investment. That would normally include the settlement of loan notes and accrued interest amongst the total consideration paid.

So long as those sources of exit for the private equity owners continue to be available then this model of ownership and financing, properly monitored, appears not to be extracting significant funds from operating cashflows. The model also appears to be offering investment returns that continue to attract investor interest.

## 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<sup>2</sup>. 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. Ofsted reporting<sup>3</sup> in relation to the largest providers of services was also used to illustrate the representativeness of the sample of providers in this update.

2. The largest provider organisations were identified utilising a model that was primarily based on data provided by Ofsted in relation to the capacity of children's homes and fostering agency organisations operating registered services.

The model applies estimated average income per unit of capacity to rank providers by a calculated national financial income capacity.

Trade associations (ICHA and NAFP) were further consulted to triangulate the list of providers with their membership knowledge, and previous Revolution Consulting projects and databases involving these sectors were referenced. 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. Two large charitable bodies, Barnardos and Action for Children were initially identified by the model described in 2. above. However, the visibility of the financial impact of their fostering and children's homes activity amongst the wide and varied operations of those groups was poor, and these organisations were therefore excluded from the study. There are issues related to the solvency of charities that have large pension scheme deficits that would be worthy of separate study.

4. The latest available public accounts of the identified providers were downloaded from Companies House for the sample of providers between December 2020 (for the first update) and April 2021 for this second update. One parent company organisation is USA based and the group financial information was accessed from NASDAQ disclosures for Acadia Healthcare Company Inc. However, subsequently in January 2021 the Priory Group was sold by Acadia to Waterland Private Equity. The most recent Caretech figures are from the preliminary results declared to the London Stock Exchange.

5. One of the providers added to this update study, the Witherslack Group has a parent company based in Jersey, which potentially limits public access. However, we are grateful to the group as they voluntarily shared a copy of those accounts with us to enable validation of assumptions made.

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<sup>2</sup> <https://www.gov.uk/government/collections/section-251-materials>

<sup>3</sup> <https://www.gov.uk/government/publications/inspection-outcomes-of-the-largest-childrens-social-care-providers/inspection-profiles-of-the-largest-private-and-voluntary-providers-of-childrens-homes-and-independent-fostering-agencies-march-2020#summary>

6. Due to very recent acquisition activity it was necessary to include in the sample the accounts of predecessor companies for pre-acquisition periods. This particularly relates to the acquisition of Bryn Melyn by Outcomes First in 2020 and the acquisition of Oracle by August Equity who also own Esland.

7. Key information and indicators from the downloaded financial statements (see details in Appendix 2) were extracted.

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.

8. 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 again severely limited. Results presented in this report are therefore predominantly a mixed or blended aggregate of each provider's children's services combined.

9. To normalize results to an annual measure, adjustments to reported results are made in a number of ways to produce the analysis presented in this report. For example:

- Periods of reporting that differ from 365 days are adapted on a pro-rata basis to produce annual estimates.
- Part year acquisitions disclosed in parent group accounts are similarly estimated to a pro-rata annual equivalent.
- Acquisitions made subsequent to the last reported period for a group are added to the group as separate amounts shown in the main tables of this report, using the last available accounts of the acquired entity from the pre-acquisition period. Any additional debt related to the acquisition will not be seen until subsequent reporting that consolidates the newly acquired group into the larger parent group. Examples in this update include Bryn Melyn and Oracle.
- A majority of the provider groups in this study are solely engaged in children's services and hence the whole result of the parent group is used in this report. However, for some the children's services results are only part of the results of the wider group and are extracted from those of the larger groups in different ways, for example:

Caretech provide segmental data in their reporting allowing children's services to be separated from adult services.

Priory children's services performance is extracted from the Priory Group UK 1 Limited accounts that also provide a segmental analysis. Solvency related information was accessed from the parent US group reporting prior to the subsequent sale to Waterland.

SWIIS Foster Care results are from the company of the same name but solvency information is taken from the parent SWIIS International entity.

Homes 2 Inspire children's services performance is accessed via the entity bearing that name, but solvency data is accessed via the Shaw Trust parent entity.

## 10. 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, and we seek to use that calculation where possible.

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 annual 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. In addition, these calculations often seek to eliminate any exceptional, non-recurring costs from the EBITDA measure to illustrate the true underlying result of the operational performance. Such further

adjustments may include one-off integration costs following a large acquisition, or exceptional one-off adjustments for example in relation to a large asset sale. The majority of providers do not however self-disclose the calculation, so it is 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 this study has not taken that further step. Several providers report sizeable operating lease costs, often in relation to rental of property used by the provider. These costs raise the possibility that and profit or loss on renting property to the operating business is not included in the reporting we have accessed. It remains a possibility to extend this type of study in a way to examine this factor further.

## 11. IFRS16

A new international accounting standard, IFRS16 has been brought in to apply to accounting periods commencing after 1 January 2019.

This has the potential to disrupt some of the measures used in this study.

It relates to leasing by the reporting entity. Certain leasing or renting (for example of properties used by the operating entity as discussed above) may be reclassified as a finance lease under the new standard. This can result in adjustments to the EBITDA result.

Many of the accounts studied in this update do not yet apply the new standard or, where they do, there is no material impact. However, two groups have detailed disclosure of the impact:

- Caretech usefully discloses the results both before and after the impact of IFRS16, and we have utilised the pre-IFRS16 version as these are most consistent with the previous report and the accounting of the other groups in the sample.
- Priory has also applied the new standard. We are unable to estimate the impact on the children's services figures extracted but believe the effect has been to increase the reported EBITDA level compared to the pre-IFRS16 method.

The impact of IFRS-16 will need to be considered more widely as further periods of accounts are reported.

## 12. 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 owed 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 organisations 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.

As indicated above, where the children's services operations of a group are only part of the activity of the wider organisation, or where funding comes from a parent group then the solvency indicators used are those of the group as a whole, as any subsidiary level analysis is relatively meaningless.

### **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)?

## Appendix 2

### Provider sample

	Legal entity	Brand	Jan-Mar 2018	Apr-Jun 2018	Jul-Sep 2018	Oct-Dec 2018	Jan-Mar 2019	Apr-Jun 2019	Jul-Sep 2019	Oct-Dec 2019	Jan-Mar 2020	Apr-Jun 2020	Jul-Sep 2020	Oct-Dec 2020	Published since Feb 2020 report
1	SSCP Spring Topco Limited	Outcomes First													Aug-19
	Bryn Melyn Care Limited	Bryn Melyn													Mar-20
2	Cambian Group PLC	Cambian													
	Caretech Holdings PLC	Caretech													Sep-20
3	Nutrius UK Topco Limited	Polaris													Dec-19
4	Priory Group UK 1 Limited	Priory													Dec-19
	Acadia Healthcare Company Inc														9m Sep 2020
	Waterland Private Equity														Sold 19 Jan 2021
5	Keys Group Limited	Keys													Mar-20
6	Advent Topco Limited	Compass													Mar-20
7	Midhurst Child Care Limited	Five Rivers													Sep-19 & Sep-20
8	The Together Trust	Together Trust													Mar-20
9	Lindale Holdings Limited/Alderbury Holdings	BSN Social Care													Mar-20
10	Capstone Foster Care Limited	Capstone													Mar-20
11	The Adolescent and Children's Trust	TACT													Mar-20
12	SWIIS Foster Care Limited	SWIIS													Sep-19
	SWIIS International Limited	SWIIS													Sep-19
13	Horizon 2918 Limited	Horizon/Educare													Aug-19
14	HCS Group Limited	Hexagon													Mar-20
15	Picnic Topco Limited	Esland													Nov-19
	The Esland Group Holdings Limited	Esland													Nov-19
	Oracle Care and Education Holdings Limited	Oracle													Mar-19
															Sale to August Jul 2020
															Sale to August Feb 2019
16	Wordsworth Midco 1 Limited	Witherslack													Aug-19
17	SC TopCo Limited	Sandcastle													Aug-19
18	Sunbeam Fostering Group Limited	Sunbeam													Mar-19 & Mar-20
19	Care 4 Children Holdco Limited	Care 4 Children													Dec-19
20	The Shaw Trust	Homes 2 Inspire													Aug-19

The list above shows all twenty provider groups studied, including identification of the legal entity at the top of the ownership chain. In addition, a brand name for each group is allocated as these may be more recognisable to readers. Appendix 3 lists recent acquisitions into these groups.

Each blue block in the figure above represents financial information retrieved for this study. For the UK based companies, 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). However, in 2020 a temporary three-month extension to filing deadlines was introduced as part of the Coronavirus pandemic response.<sup>4</sup>

Companies can select the annual start and end date for financial reporting; hence companies report to a variety of different schedules. As can be seen in the figure above, companies use a variety of start/end periods for their reporting, and in certain circumstances can alter the length of the period reported to a longer or shorter period than the usual annual reporting.

The dark blue blocks are the most up to date information that has been published

<sup>4</sup> Not all providers wait until the end of the filing period, for example Capstone reported results to March 2020 in November 2020, and Midhurst have filed September 2020 accounts early.

since the first report and used in this update report.

The red dotted blocks represent the expected next set of accounts for each provider at the time of this report.

The figure above is organised vertically to group those legal entities that have most recently merged or come together through acquisition. In the first report the noticeable level of consolidation of the larger provider sector through acquisitions was highlighted. 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 the previous study we were awaiting the first insights into some of the effects of the combination of the very largest consolidated providers, and some of our analysis was based on estimates taken from the predecessor and separate organisations.

All four of the largest groups have disclosed more up to date information since the first report, so we can begin to see the financial impact of:

- Outcomes First being added to the SSCP Spring Topco (Stirling Square Capital) group that also includes NFA and Acorn.
- The continued integration of Caretech and Cambian.
- The first reports of the fostering group branded Polaris including FCA/Core Assets, Orange Grove and Partnerships in Children's Services under the ownership of Capvest Equity.

However, as further illustration of the time-lag effect in reporting the impact of the sale of Priory Group to Waterland will not be visible for some time.

## Appendix 3

### Acquisition activity noted.

The activity listed below has come to light during this update exercise. The primary source of information about acquisitions are the disclosures made in the specific financial statements that form the basis of the whole report, although these are supplemented by additional information discovered in the public domain during the course of this update. It is not intended to be a comprehensive list of all activity in the sector.

Accounts based disclosures provide extensive detail of consideration paid for acquired entities, finance structures used to fund acquisitions, and insight to the value of intangible assets recognised by the accounting methodologies adopted. The detail of each transaction of this type would be a worthwhile area for more detailed study and reporting but is beyond the scope of this particular exercise.

Date	Target	Acquiring Group
Sep 2018	Safehaven	Five Rivers
Oct 2018	Reach Out Care	SSCP/Stirling Square
Oct 2018	Core Assets Group	Nutrius/CapVest Equity
Nov 2018	Safehouses North	Five Rivers
Nov 2018	The Fostering Company North East	Five Rivers
Dec 2018	Sandcastle Care	Waterland Private Equity
Jan 2019	PiCS and Boston Holdco B	Nutrius/CapVest Equity
Feb 2019	House of Falkland (Westfield Jacob)	SSCP/Stirling Square
Feb 2019	Esland Group	August Equity
Apr 2019	Family Placement.com	SSCP/Stirling Square
Apr 2019	SFS	TACT
May 2019	Aurora Care Young People's Services	Horizon/NBGI
Jul 2019 (Dec 2019 – CMA clearance)	Outcomes First Group	SSCP/Stirling Square
July 2019	Queensmead Property	Witherslack/Charme Cap
Aug 2019	Pathfinders (Childcare)	Sandcastle/Waterland
Aug 2019	Horizon	Graphite Capital
Aug 2019	Help Me Grow Fostering Services	BSN/Alderbury
Sep 2019	Ferndale Child Care Services	Compass/Graphite
Sep 2019	Cressy Oasis Ed	Horizon/Graphite
Oct 2019	Portixol (UK)	Sandcastle/Waterland
Oct 2019	Sussex Fostering	BSN/Alderbury
Dec 2019	Tumblewood Project	Witherslack/Charme Cap
Dec 2019	Build-A-Future	Keys/G Square
Dec 2019	Cornerways Fostering Services	BSN/Alderbury
Feb 2020	Gillmourbanks & High Trees	SSCP/Stirling Square

Feb 2020	AS Investments (UAE)	Caretech
Feb 2020	Artemis/Unique Care Homes	Keys/G Square
May 2020	SWCS	Keys/G Square
July 2020	Oracle Care & Ed	Esland/August Equity
Oct 2020	Bryn Melyn	OFG/SSCP/Stirling Square
Oct 2020	Smartbox	Caretech
Nov 2020	Huntercombe services	Caretech
Nov 2020	Enhanced Children's Services	OFG/SSCP/Stirling Square
Dec 2020	North Lakes	Polaris/Nutrius/CapVest
Jan 2021	Priory Care & Ed	Waterland Private Equity
Mar 2021	Dove Adolescent	Polaris/Nutrius/CapVest

#### Observations on acquisition activity:

- Despite the Coronavirus pandemic, and the uncertainty it brought, corporate transactions in the UK children's services sector have continued to complete during 2020 and early 2021. This comes against a background where Bloomberg report a collapse in mergers and acquisitions across the globe to levels not seen since the aftermath of the 2008/9 financial crisis, and Pinsent Masons were reporting corporate offer activity down by almost 2/3rds in the first half of the year.
- The acquisition activity continues amongst the larger providers and those private equity backed groups following buy-and-build strategies. Some of the financial statements published express the intent to continue the acquisition approaches.
- The last 2-3 years have also seen new investors (e.g., Bridges/Reflexion, Ardenton/Pebbles, Waterland/Sandcastle) entering the sector with acquisitions of more moderately sized providers, indicating an appetite in the investor community for smaller transactions than some of those seen amongst the largest providers in the periods covered by these studies.
- The appetite for further acquisition activity amongst investors in the children's sector appears to be maintained. Some investors (e.g., Graphite, Sovereign) are repeat investors having realised substantial gains from earlier investments in the sector. However, the current market study of children's services by the Competition and Markets Authority, and the recommendations emerging from it, may have an impact in both the short and longer term on investor appetites.
- The appetite for acquisitions extends into the non-private equity owned parts of the sector, including the voluntary sector (e.g. TACT).

## Appendix 4

### Limitations of data and areas for potential further study

Limitation	Further study
Statutory accounting information includes some useful details in relation to debt repayment schedules, but the accounts are historical and do not offer information to assess ability to pay.	The detailed ways that directors, owners and external banks monitor the ability of providers to meet debt could potentially be shared with an appropriately qualified and independent professional oversight regime in order to assess risk.
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 and for corporate bodies only (i.e., excludes partnerships)	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 or use of partnership structures.	Carry out EBITDAR analysis and interview providers. Consider development of a sector-led transparency code.
Charity accounts are not always suitable for this type of analysis and other issues arise for charities (e.g., pension liabilities)	Consider development of a charities-sector specific study.
Monitoring of return on investment made by private ownership is not a statutory requirement and sometimes not possible through reconstruction.	Consider development of a sector-led transparency code or increased disclosure regulation.