RESEARCH

2012

CARE HOMES

Trading Performance Review

Knight Frank

HIGHLIGHTS

- Care home profit margins increased marginally during 2011 to stand at 30.5% of total income, improving from 30.1% in 2010. However, this followed four consecutive years of declining profits, with 2011 margins down on their level five years ago.
- Care home occupancy rates rebounded in 2011 to stand at 87.8% for the UK as a whole. Occupancy rates are above the UK average in Northern Ireland, Scotland, Greater London and the South East.
- Average fee levels increased by a marginal 0.7% in 2011 following a sharp fall in 2010. In real terms, however, average weekly fees in 2011 were 3% below the 2006 average.
- Our analysis confirms that there is an optimal size of care home. Profit levels, both as a percentage of income and on a per bed basis, are highest for care homes with a capacity of 60-79 beds.

FOREWORD

2011 will arguably be remembered as the care home sector's very own *'annus horribilis'*, a year which saw extensive media coverage on the demise of Southern Cross Healthcare, then the UK's largest single care home operator, and harrowing reports of staff abuse at care homes operated by other providers. However, the media has been less interested in the virtually seamless transition of care services from 750 former Southern Cross operated homes to new incumbent operators. Major landlords such as NHP, Four Seasons Health Care, Bondcare and Prestbury Investments, deserve real credit for the way they have transferred registrations, ultimately ensuring the care of over 30,000 residents.

This year, negative publicity has been superseded by political uncertainty. The much anticipated Social Care White paper, published in July, has disappointed many in the industry as it lacks any concrete decision on long-term funding of social care. While the government agrees with the Dilnot Commission's aspirations of a more equitable approach to funding, in particular a cap on the level of self-funded care, its noncommittal stance in the White Paper demonstrates that the government's chief concern is to curb public spending.

It is clear that some sort of political resolution is urgently needed. The Local Government Association has forecast that the cost of care will double within a generation unless the current attempt to reform the system is a success. Analysts predict that the social care expenditure would have to increase from £14.5bn to £26.7bn in order to fund care for the elderly by 2030.

While the UK care home sector is undoubtedly facing challenges in the medium term in the form of below inflation baseline fee increases and tightening eligibility criteria imposed by local authorities, future growth in demand for elderly care is underpinned by substantial demographic pressures – the population of over 65s in the UK is set to rise by over 50% by 2035. Notwithstanding funding concerns, there is therefore a clear need to meet future demand through the roll-out of modern, fit-for-purpose elderly care facilities which are both profitable and adequately meet the demands of their residents.

In light of the various challenges and opportunities, Knight Frank's Care Homes Trading Performance report provides an insight into how care home operators have performed over the last five years. Encouragingly, it reveals that occupancy rates and profit margins improved in 2011 following several years of falls, suggesting that operators are by and large managing to increase their cost efficiency without compromising standards of care. However, it is also evident that there is a significant disparity in trading performance between the UK regions, which largely reflects the varying penetration of the private pay market.

We would like to thank all the operators who have kindly contributed their management accounts for use in our analysis. In return, we hope that this provides a means through which any care home operator can benchmark the performance of their own facility, while also being of interest to anyone with current or potential involvement in the sector, such as healthcare investors, lenders and public bodies.

Julian Evans, Head of Knight Frank Healthcare

Rutland Care Village, Rutland (Prime Life)

Elm Bank Care Home, Northamptonshire (Avery Healthcare)

INTRODUCTION

The 2012 Care Homes Trading Performance Report is Knight Frank's inaugural annual assessment of the key trends and financial drivers in the UK elderly care homes sector. Standard key performance indicators (KPIs) employed by industry practitioners, including staff costs, occupancy rates, average fee levels and profit margins (EBITDARM) have been analysed in detail to shed light on recent trends in the sector, both over time and between the UK regions. The Knight Frank Care Homes Benchmark Index also contains specific details relating to each care home, such as size, building age and registration, which allows for additional analysis according to the nature of the asset.

Warren Lodge, Kent (BUPA)

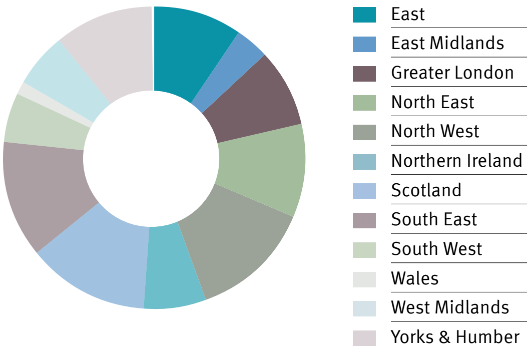
The sample

Knight Frank has the largest share of the market for the valuation of care homes. Consequently, the research findings in this report derive from a large and reliable sample of elderly care homes owned or managed by many of the UK's top 30 care providers. While independently operated homes are contained within the sample, there is a definite bias towards facilities operated by corporates.

A significant proportion of care homes in the sample are either nursing or dual registered (where both professional nursing care and personal care are provided on site). As a result, there is also a bias in the sample towards nursing care, and the results reflect the higher staffing costs associated with this type of registration.

All parts of the UK are sufficiently represented within the sample to provide robust results and allow for an understanding of regional variations (Figure 1). Wales is arguably the least represented, with a little over 2% of the sample, although none of the UK's regions are over-represented, with Scotland and the North West sharing the highest proportion of the UK sample, each with 13% of the care beds.

Figure 1
Regional share of the sample
% of total care beds



Various forms of elderly care explained

1. **Nursing care** – Residential care home with care provided by professionally qualified nursing staff.
2. **Personal care** – Residential care home with carers who are not professionally qualified nurses. Fees are typically cheaper reflecting the lower staff costs.
3. **Dual Registered care** – many care homes are Dual Registered, where both nursing and non-nursing are provided on site according to the resident's needs.
4. **Extra care** – a small but growing form of retirement housing, where residents live independently but with care services attached as required.
5. **Domiciliary care** – care provided at the resident's own home.

1, 2 & 3 are the forms of care which are assessed in this report, with a bias towards Nursing and Dual Registered homes.

OCCUPANCY AND INCOME

Occupancy

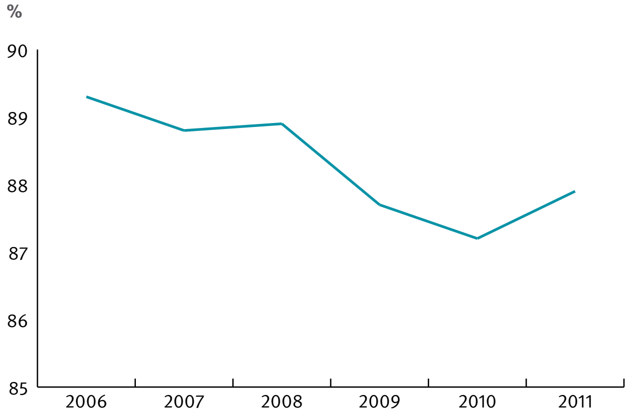
In an environment where care home fees have come under considerable pressure in light of reductions imposed on local authority funding, occupancy rates have an important bearing on a home's income and therefore profitability. Following three years of successive declines, occupancy rates improved slightly in 2011, rising from 87.1% to 87.8% (Figure 2). This may be partly explained by an increase in home closures noted over the last 12 months, which has had the effect of reducing the overall bed supply, and boosting occupancy levels at other homes as a consequence.

Until last year's rise in occupancy, the drive towards alternative methods of care – namely diversification to 'extra care' residential settings and increased emphasis on providing domiciliary care by local authorities – undoubtedly impacted on occupancy rates. In 2006 occupancy peaked at 88.8%, before falling steadily throughout the 2008 recession to hit a low of 87.1% in 2010. The period up to 2010 also saw an increase in the supply of care facilities, where the completion rate of care homes rose in response to a sharp drop in residential land values in most UK regions.

Occupancy rates differ markedly between the UK regions (Figure 3). Northern Ireland stands out with an average occupancy rate of 92% in 2011. Northern Ireland's strong performance is likely to be due to the corporate nature of the sample. Generally, the build quality of care homes in Northern Ireland has lagged behind the rest of the UK, with the effect that those homes operated by corporate providers and contained within our sample provide better quality care and therefore possess relatively strong levels of occupancy.


Astbury Mere Care Home, Cheshire (Porthaven)

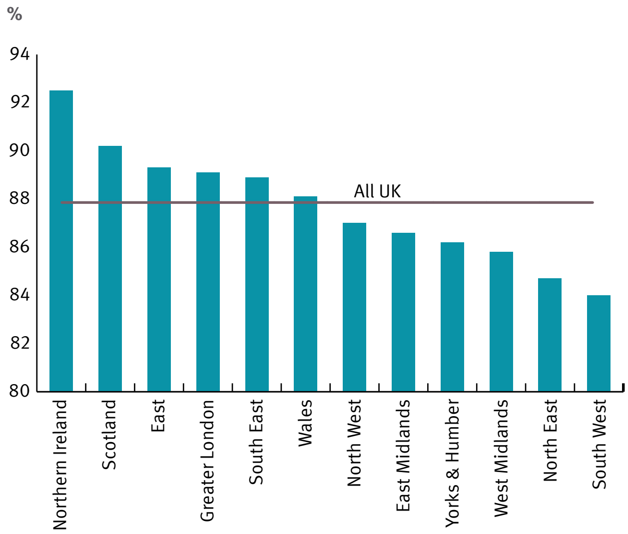
Figure 2
Occupancy rates



Source: Knight Frank

FOLLOWING THREE YEARS OF SUCCESSIVE DECLINES, OCCUPANCY RATES IMPROVED SLIGHTLY IN 2011

Figure 3
Occupancy rates by region (2011)



Source: Knight Frank

The South East (88.9%) and Greater London (89.1%) also have occupancy rates which are above the all-UK average. It is in these regions where competition with residential uses is strongest and the supply of care beds is consequently under greatest pressure. Conversely, the relatively low occupancy levels seen in the North East (84.7%) are a consequence of over-provision. Here, land has been relatively cheap and readily available, with more modern purpose-built homes delivered in this part of the UK than anywhere else over recent years. The low occupancy rates seen in the South West, at 84.0% in 2011, is explained by the clear underperformance of a number of homes in our sample for the region. If these are excluded, the region's occupancy rate rises to 87.5%, closely in line with the all-UK average.

Income

The impact of public spending cuts in recent years has been reflected in the fall in real terms fees that operators have charged their residents. Following a four year period of consistent, above inflation increases up to 2009, average fees declined during 2010, before recovering partially in 2011 (Figure 4). Average weekly fee levels rose by a marginal 0.7% in 2011, to stand at £616 per week. However, in real terms, the change amounts to a fall of 3.7% during 2011, following a sharp fall of 6.3% in 2010.

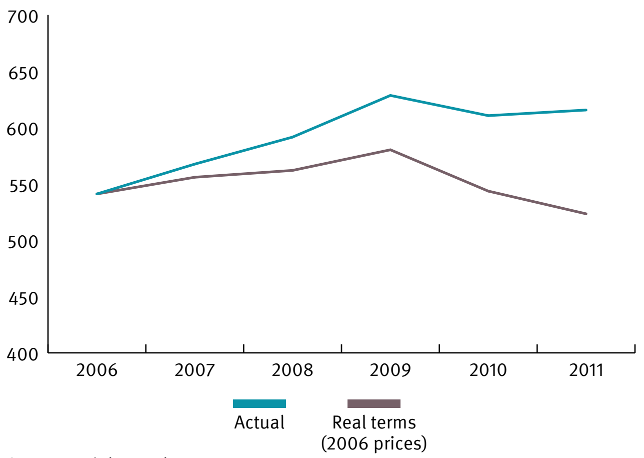
Laing & Buisson's 2011/12 survey of local authority baseline fee rates lends support to these findings. It reveals that the vast majority of UK local authorities elected to freeze fee levels for elderly care, with the average increase across all local authorities amounting to just 0.3%, corresponding closely with the findings from the sample. Arguably, the fact that the actual average fee rise in 2011 was slightly higher, at 0.7%, suggests that operators have been able to source a greater share of their revenues from private pay residents.

Unsurprisingly, analysis at the regional level reveals that average care home fees in Greater London (£766 p.w.) and the South East (£765 p.w.) far exceed those from elsewhere around the UK (Figure 5). Care homes in these relatively affluent regions typically show a higher percentage of private paying residents, which in turn supports the higher fee levels necessary to cover the higher staff costs and land values associated with these regions.

Average weekly fees are correspondingly lower in England's Northern regions, where the private pay market is less prevalent and local authority fees regularly account for the majority of a care home's revenues. Of all the regions, average fees are lowest in the North East, at £529 p.w, where fee pressures have been compounded by issues of over-supply of bed capacity following a glut of new care home development over the last decade.

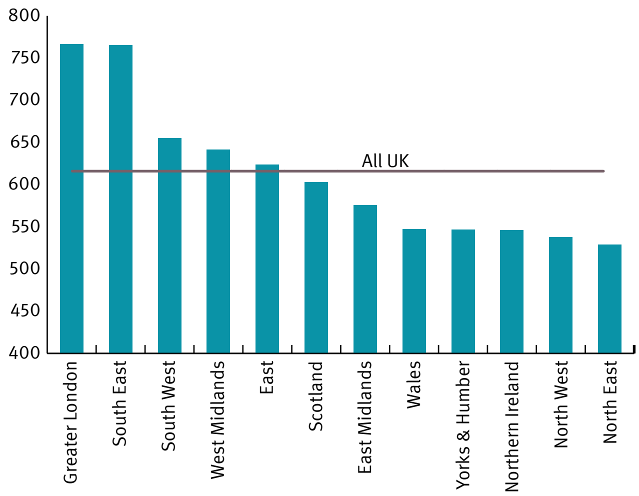
OF ALL THE REGIONS, AVERAGE FEES ARE LOWEST IN THE NORTH EAST

Figure 4
Average weekly fees
£ per week



Source: Knight Frank

Figure 5
Average weekly fees by region (2011)
£ per week



Source: Knight Frank

Table 1
Average weekly fees by registration type

	Average weekly fee (2011)	2006 – 2011 change (% p.a.)
Personal Care	£528	4.1
Nursing	£646	2.8
Dual registered	£555	2.9
All care homes average	**£616**	**3.0**
RPI /CPI		*3.6/3.4*

Source: Knight Frank

COSTS

Staff costs

In addition to income and occupancy, staff costs have an important bearing on a care home's profitability. Our analysis shows that care home staff costs have been on a broadly upward trend over the past five years - staff costs equated to 55.7% of total revenue in 2006, whereas in 2011 they equated to 57.1% of income (Figure 6). Over the five-year time series, the strongest rate of increase in staff costs (as a percentage of income) occurred in 2011, with one possible explanation being the uplift to the national minimum wage, which took effect in October 2010, compounded by an increase to National Insurance contributions.

Viewed on a per resident basis, care home staff costs are considerably higher in the UK's southern regions (Figure 7). Staff costs are highest in the South East, averaging £21,532 per resident followed by London, where staff costs are £20,599 per resident. Staff costs in Wales, at £20,354 per resident, appear high considering it sits among a group of five regions with low average fee levels of c.£550 per week (Figure 5).

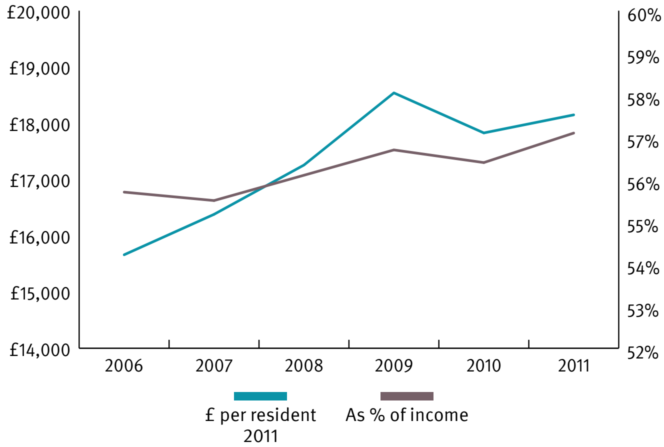
Staff costs in the northern regions of England are amongst the lowest in the UK, with average annual staff costs of £15,322 per resident in the North East standing at 40% below the South East, the UK's most costly region. However, it is important to note that while staff costs are relatively higher in absolute terms in the more affluent regions, they are lower as a proportion total revenue, implying that care homes in less affluent parts of the UK are much more exposed to upward pressure on staffing costs (Table 2).

Table 2
Staff costs (2011)

Region	Staff cost per resident	Costs as a proportion of income
South East	£21,532	54.1%
Greater London	£20,599	51.7%
South West	£20,387	59.8%
Wales	£20,354	70.3%
West Midlands	£19,678	59.0%
East	£18,478	57.0%
Scotland	£18,223	58.1%
East Midlands	£17,610	58.9%
Northern Ireland	£16,743	59.0%
Yorks & Humber	£16,299	57.3%
North West	£15,917	56.9%
North East	£15,332	55.8%
All UK	**£18,148**	**57.1%**

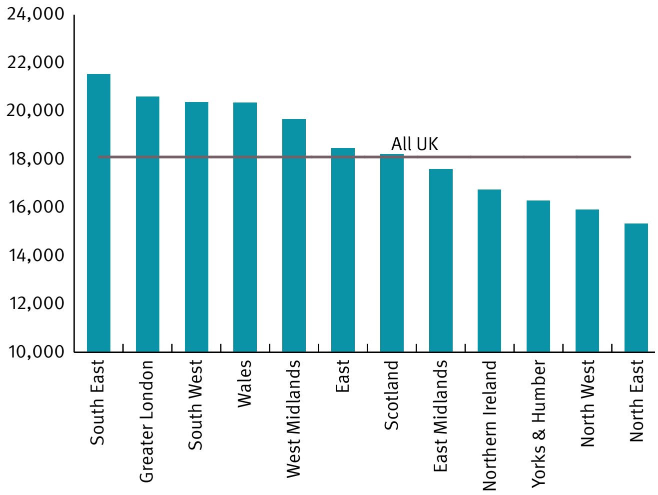
Source: Knight Frank

Figure 6
Staff costs (2011)
As % of income vs £ per resident



Source: Knight Frank

Figure 7
Staff cost per resident
£ per resident



Source: Knight Frank

Westbury, Wiltshire (Four Seasons Health Care)

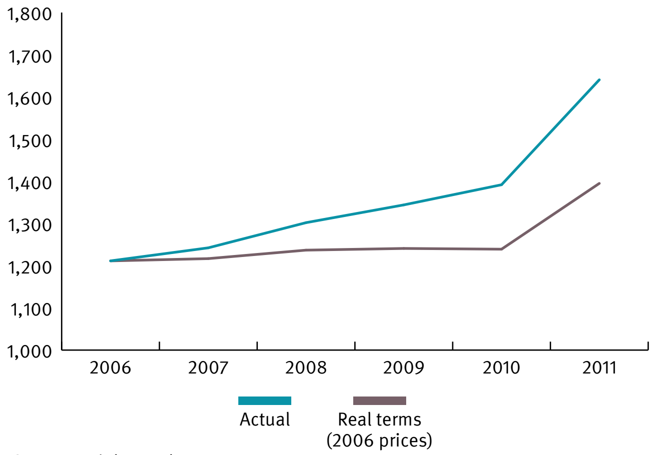
Property costs

Property costs, which include utilities expenses, council tax and repairs & maintenance but exclude rent, represent a small but nevertheless important share of a care home's expenditure. Our analysis of property cost trends over the past five years reveals that property costs typically equate to just under 5% of a care home's outgoings. However, property costs have increased over the last two years to stand at 6% of total revenues in 2011.

The increase in property costs has been even sharper when viewed on a per bed basis, rising by 17% in 2011. This sharp rise is more specifically related to expenditure, or the 'repairs and maintenance' element of property costs. Anecdotally, We have seen many cases of care home operators recently taking a strategic decision to invest in their current portfolios in order to maximise revenues, particularly as the option of developing new facilities has been severely constrained by the absence of development finance.


Wadhurst Manor, East Sussex (Barchester)

Figure 8
Property cost per bed (2011)
£ per bed



Source: Knight Frank

STAFF COSTS IN THE NORTHERN REGIONS OF ENGLAND ARE AMONGST THE LOWEST IN THE UK


Mulberry Court, Bedfordshire (Runwood Homes)

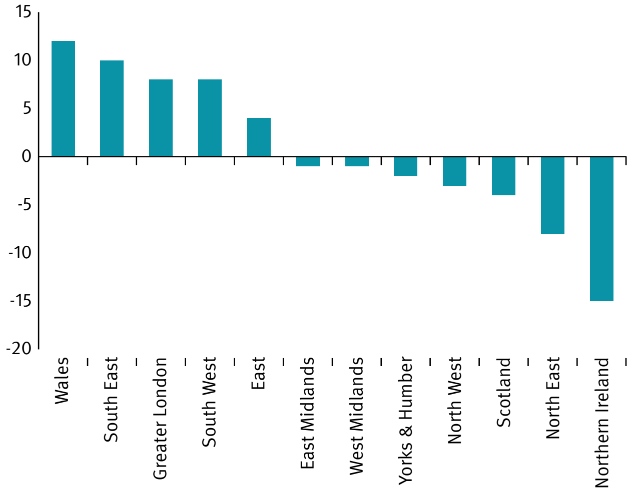

Bentley Court, West Midlands (Priory Group)

Food costs

Naturally, food and drink costs are another important part of a care home's outgoings and the quality of food provision can be an important determining factor in a resident's choice of care home. Analysis of data for the last five years shows that care home food costs have been rising by 4.5% per annum since 2006, which is closely in line with food inflation over the period, at 4.6% per annum.

Food costs vary between the regions, although arguably to a lesser extent than one might expect (Figure 9). Food costs are highest in Wales, running at 12% higher than the UK average in 2011, and lowest in Northern Ireland, running at 15% below the average.

Figure 9
Food cost index (2011)
% difference from all UK



Source: Knight Frank

FOOD COSTS HAVE BEEN RISING BY 4.5% PER ANNUM SINCE 2006

The Oakes, West Yorkshire (Meridian Healthcare)

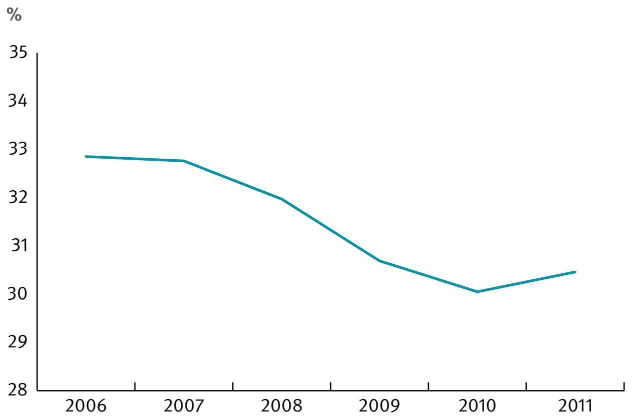
The Oakes, West Yorkshire (Meridian Healthcare)

PROFITABILITY

For all types of care combined, gross profit margins increased marginally during 2011 to stand at 30.5% of total income, improving from 30.1% in 2010 (Figure 10). While our analysis shows that average fee levels have decreased notably in real terms over the last two years, it would appear that its impact on revenues has been offset by the notable pick-up in occupancy rates during 2011.

Despite the slight improvement in profitability in 2011, profit margins remain narrower than they were five years previously, having been squeezed by higher staffing costs on the one hand, set against lower occupancy levels and declining weak fee income growth on the other.

Figure 10
EBITDARM as a % of income



Source: Knight Frank

EBITDARM

EBITDARM stands for Earnings before Interest, Tax, Depreciation, Amortisation, Rent and Management (head office costs).

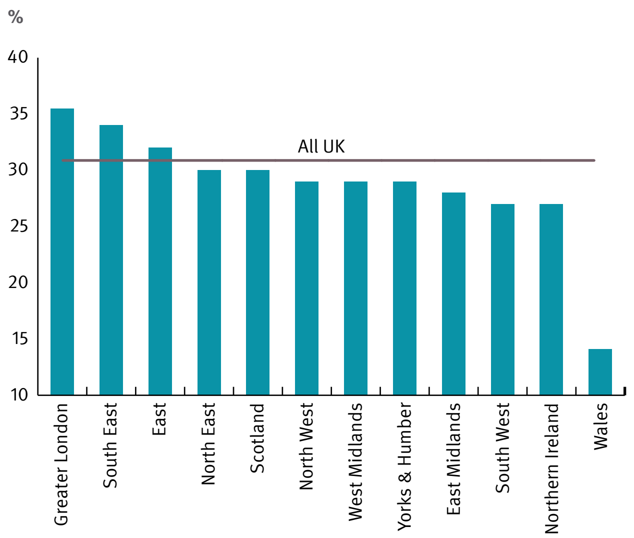
This is a particular measure of profitability which allows for direct like-for-like comparison between individual care homes, before costs of rent and management charges are accounted for.

In 2006, EBITDARM as a percentage of income stood at a more robust 33.1%, with both fee levels (in real terms) and occupancy rates higher than they were in 2011.

There are marked variations in care home profitability between the UK regions, following as a consequence of prevailing average fee levels and / or occupancy rates. The three UK regions regarded as the most affluent in the UK – London, the South East and East – reveal profit margins in excess of the UK average, with EBITDARM as a percentage of income running at over 32% (Figure 11). As with fee levels, this result is inextricably linked to the prevalence of the private pay market in these regions, with care home profit margins in the less affluent regions relatively more dependent on local authority funding.

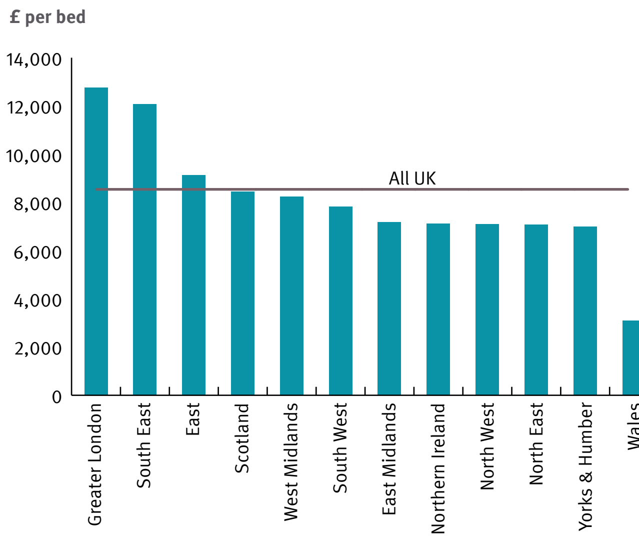
While the North East and Scotland are closely in line with the UK average position, the remaining regions of the UK show below average profit levels. Wales lags all the UK's other regions by a clear margin, with EBITDARM equating to just 14.1% of total income, or £3,095 per bed. This paints a rather bleak picture for Wales, at least for the homes in our sample, with weak profit levels resulting from a combination of low average fees levels relative to high staffing costs.

Figure 11
EBITDARM as % of income (2011)



Source: Knight Frank

Figure 12
EBITDARM per bed (2011)



Source: Knight Frank

Care home size and profitability

An important influence on operational efficiency and, consequently, profit levels is the size of the care facility. There is clear evidence that there is an optimal size of care home, with EBITDARM averaging well over £9,000 per bed at homes with a capacity of 60-79 beds. For the larger care home categories, the principle of economies of scale is apparently replaced by the law of diminishing returns, with EBITDARM averaging £8,316 per bed for homes with a bed capacity in excess of 100 (Table 3).

A number of factors acting together explain the optimum profit margins apparent in the 60-79 bed care home category. The most important of these is staff costs, which stands at £17,776 per resident for the 60-79 bed care home, a lower level than for the smaller care home categories. While staff costs are actually lowest for the 100+ bed care homes (£17,721), this advantage is counter-balanced by weaker occupancy levels and relatively lower fees.

Although property costs are less substantial than payroll costs, there is still evidence of clear differences in costs according to the size of the care home. The lowest average property costs are in the largest 100+ bed size category, at an average of £1,401 per bed in 2011 while, perhaps unsurprisingly, the smallest homes (under 40 beds) have the highest average property costs, at £1,979 per bed.


Coupar Angus, Strathmore (Balhousie)

THERE IS CLEAR EVIDENCE THAT THERE IS AN OPTIMAL SIZE OF CARE HOME

Table 3
Key costs and profitability by size of care home (2011)

Bed Size category	Staff cost as % of income	Staff cost per resident	Property cost per bed	EBITDARM as a % of income	EBITDARM per bed
under 40	58.9%	£19,507	£1,979	27.1%	£8,023
40 - 59	56.0%	£18,008	£1,714	30.6%	£8,664
60 - 79	55.1%	£17,776	£1,591	31.8%	£9,092
80 - 99	57.7%	£18,290	£1,559	30.0%	£8,239
100+	57.4%	£17,721	£1,401	30.9%	£8,316
ALL UK	**56.7%**	**£18,148**	**£1,640**	**30.5%**	**£8,582**

Source: Knight Frank


Admiral Court, Essex (Hallmark)

TRADING PERFORMANCE OUTLOOK

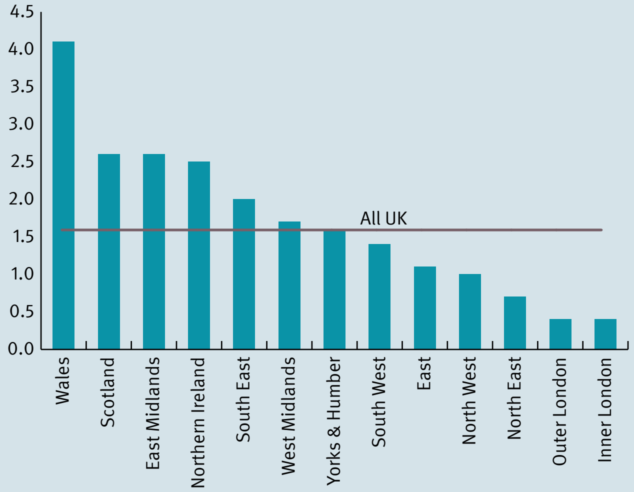
So, how can we expect the sector to perform moving forward? Firstly, care home operators with high exposure to publicly funded care residents will welcome Laing & Buisson's latest survey of baseline fee rates. It reveals that, on average, local authorities have budgeted for a 1.6% increase in fee contributions for the financial year 2012/13, a notable improvement on the 0.3% increase budgeted for in 2011/12 (Figure 13). The fact that Welsh local authorities have responded with the highest average increase in fee rates, at over 4%, is particularly welcome in light of this report's findings which indicate that fee levels and profit margins in Wales significantly lagged the UK average in 2011.

Although the fee increases are welcome, the majority of UK regions nevertheless face another year of falling fee rates in real terms, with inflation currently running at just under 3%. Consequently, in an effort to counter ongoing fee challenges, operators will continue to seek cost efficiencies, including reducing agency staff costs, sourcing more competitive energy suppliers and more innovative IT systems. We also expect management contract arrangements to become increasingly utilised, emulating the hotel sector. Maria Mallaband Care Group, Minster Care Group and Bondcare have been exponents of management contracts, increasing their EBITDA without capital outlay.

Figure 13

Regional baseline fee increases (2012/13)

% change 2012/13



Source: Laing & Buisson

Another factor affecting operators' income is of course levels of occupancy. While predicting how the occupancy rate will change is no easy task on an aggregate level, we are relatively optimistic of a slight improvement in overall occupancy rates. Firstly, Laing & Buisson's recent survey shows that 42% of local authorities expect to fund the same number of older people in care homes in the current financial year as last year, while 33% expect to fund more residents. Secondly, occupancy rates may be boosted by a reduction in the UK's circa 500,000 bed supply. We anticipate a number of home closures in areas currently oversupplied with beds, such as in the North East, while toxic property debt on noncompliant period conversions is likely to force lenders to close care homes which are no longer viable businesses. In essence, the best care facilities will survive and prosper.

One thing we can be certain of is the continuing polarisation in trading performance between the regions. While there are many local exceptions, the South East, M4 corridor and parts of the South West should remain resilient as it is these areas where the private pay market is most prevalent. Major care providers will continue to target these areas when development opportunities arise, as they offer sound demographics and good underlying security to lenders due to strong alternative use values. So, while investors can obtain a good return on capital in the South of England it must raise fundamental questions about more exposed regions in the North of England.

The Local Government Association is calling on the government to introduce the Dilnot Commission's recommendations but, even if they are implemented, the costs of caring for adults with social care needs in London for example could potentially increase in real terms by £330m within the first year, to £3.16bn. Clearly, there are a number of elements within the care home sector that are creating longer-term uncertainty, not least the new GP clinical commissioning groups to ensure they are informed by the views of the local community.

As with most sectors, the care home arena has experienced tough trading conditions since the UK entered recession. However, notwithstanding their debt structure, most operators have demonstrated robust trading positions. In fact many of the UK's major care home operators continue to trade exceptionally well, even in the face of austerity measures. In addition, Terra Firma's recent £825m acquisition of Four Seasons Health Care is an extremely positive development, effectively resolving four years of debt struggle for what is now the UK's largest care provider and demonstrating the robust investment appetite which exists for major care portfolios.

While we do not foresee an *annus mirabilis* on the immediate horizon, the dynamics of the care home sector present a fantastic opportunity to investors and lenders alike.

RESEARCH

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