CRESC Public Interest Report

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WHERE DOES THE MONEY GO?

Financialised chains and the crisis in residential care

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The citizen's summary of the full report

Big business and organised money have a political advantage in matters of public policy around outsourced services because the average citizen does not have the knowledge or confidence to engage critically with this kind of financial issue. A democracy where business and finance are socially accountable requires citizens with financial literacy who can engage with such issues in specific activities, like adult care, which are important to all of our welfare.

This public interest report is about residential adult care, which has been more or less completely outsourced to private providers. The providers are a diverse group of profit and not for profit providers: the typical business is a small family owned firm operating in a converted house but big business and organised money are represented through chains of purpose built homes so that the five largest chains accounted for nearly 20% of beds in 2015.

What's happened in care is that the big chains speak for the sector and have made an argument about care which is actually about their specific interests. The big chains now tell a trade narrative or story via the media about an urgent crisis in social care which is the result of not enough money from local authorities for publicly funded beds. In our view, this narrative oversimplifies the story: the issue is not simply how much money goes into adult care but where the money goes.

Our alternative story will challenge the preconceptions of readers who understand outsourcing through binary good/ bad oppositions, so that private provision is generically either enterprising and innovative for the right or extractive and exploitative for the left and all for profit providers are therefore good or bad. We are concerned with specifics because our criticism is of chain providers in this welfare critical activity because they pursue profit through debt based financial engineering and complex corporate structures.

The techniques of debt based financial engineering (as developed by private equity) suit high risk and high return activities (e.g. cyclical businesses like commodities, tech start-ups and turnaround of failing businesses) but are here being applied completely inappropriately to an activity like adult care which is low risk and should be low return (e.g. utilities and most kinds of infrastructure). The chains bring return on capital targets of up to 12%; cash extraction tied to the opportunistic loading of subsidiaries with debt; and tax avoidance through complex multi-level corporate structures which undermine any kind of accountability for public funding.

The chains are effectively asking for a bail out when they are squeezed between austerity fees and rising wage costs. Through threats of home closure, they are now trying politically to spook the state into paying a higher price for residential care which will protect them from the losses that are an ordinary risk of capitalist businesses. Their own financial engineering is a major contributor to chain fragility and care quality problems so that private gain comes at the expense of costs for residents, staff and the state.

In terms of policy response, we hope to persuade a broad audience of three key points: first, big chain owners should not be bailed out by the taxpayer but should take the losses that are the consequences of their own actions; second, the state needs to take the lead in the social mobilisation of low cost finance so that it is not only the large chains which are able to build new residential care homes; third, public policy should promote social innovation in the forms of adult care, which requires imaginative rebuilding.

This summary provides an accessible overview of our research; supplemented by a jargon busting glossary that gives short definitions of all the key concepts (which are highlighted in bold in the summary). We start with an overview of the whole report in five bullet points below, before in turn summarising the key arguments and findings of the four main sections.

- In autumn 2015, the large chains claimed that residential adult care was in crisis: the problem was described as local authorities not paying an adequate price for the 60% of care home places which they fund; and their solution was for government to put more money into the system to prevent home closures and bed blocking of the NHS. In our view all this is a **trade narrative** which serves the interests of the chains. It also gives a very partial account of the sector's problems, where several chains are in real enough financial difficulty for more complex reasons.

- Against this we use the follow the money research to show that the large care home chains are adept at taking money out (**cash extraction**) and prone to recurrent crisis because the chains are bought and sold frequently often using **debt leveraged buyouts** which means sale prices are inflated and the chains are loaded with ever more debt until the **cash flow** cannot cover the financing cost. This point is established by analysing the history of the largest chain, Four Seasons, and deconstructing the LaingBuisson cost of care calculation which is often used as a source of authority in the sector. This calculation indicates an appetite for high and risk free returns because it incorporates a 12% rate of **return on capital** (fractionally reduced to 11% in 2016). Those buying care homes at a standard price of 8 times multiples and securing a 12% return on capital are in effect covering the cost of purchase (and as long as the percentage return is maintained the investment is effectively risk free).

- The public interest issue here is about the **financial engineering** of the chains hidden in complex corporate structures with hundreds of connected companies registered in multiple tax jurisdictions. The result is tax avoidance, opacity and uncertainty about what is leaking and where tax payer and private payer money ends up. This makes accountability impossible despite this being an essential welfare service and also a major low wage employer. The problem is that the chain owners have developed **business models** which aim to turn the sector into a high return activity through a combination of financial engineering and political lobbying while shifting the risks and costs onto others including residents, staff, the state and private payers.

- A bail out via a higher price per bed from the state would represent the privatisation of gains and socialisation of losses by owners of the large chains, who sought high returns and now find they have misjudged financing, fees and labour cost. More insidiously, the chains are also re-formatting care because they rebuild care homes in a standard institutional style with 60 plus beds. This is driven by an operating model which requires care homes large enough to pay management overheads and make a **return on capital**. Britain leads in outsourcing residential care to chains, but it lags behind in developing new forms of residential care in more domestic settings which the Dutch and others have experimented with.

- The state needs to take the lead in mobilising low cost finance so that in adult care we can build welfare services while paying 5 per cent return on capital not 12; and then that funding needs to be used for social innovation which develops new forms of residential care in more domestic and community integrated settings. That requires imagination and a willingness to experiment and learn, as much as new funding.

Section 1: Framing the crisis: trade narrative and not enough money

Spin is about telling a media story which frames events, character and conduct in a way that creates a particular mood and may lead to desired political outcomes. Governments do this routinely and so do trade associations of all sorts (from pharmaceuticals to train operators), typically supporting their private lobbying efforts with a public narrative, usually about the many good things that trade has done.

The **trade narrative** of care home operators is different and more apocalyptic about the current crisis in care. They argue that care collapse is imminent because local authorities are not giving them a sustainable price and they cannot absorb the cost increases arising from higher minimum wages that will come into force in April 2016. The implication is that operators will fail, homes will close and (incidentally) NHS beds will get blocked with older patients and fail to provide acute care for the rest of us. The argument is thus that government is causing the crisis in care and should take action to end the crisis by putting more money into the system to allow local authorities to pay more for the beds they fund.

The trade narrative from the large care chains was spread in autumn 2015 through newspaper and radio interviews and stories and in reports by think tanks like ResPublica. It is all the more credible because the trade has enlisted other stakeholders including the Local Government Association, the Association of Directors of Adult Social Services and the trade unions, who would all hope to benefit from some easing of austerity constraints.

In all this, the poster boy for the coming crisis is Four Seasons. With some 23,000 beds, this is the largest of the care chains, currently owned by Terra Firma private equity, and in some financial difficulty as evidenced by recent credit rating downgrades. Moody's and Standard & Poor's are not in the role of the boy crying wolf (see **credit rating agencies**). The financial difficulties of this chain are real enough: the question is how and why the chains got here and what (if anything) the state should now do to bail them out.

Broadsheet newspapers or the *Today* programme on BBC Radio 4 can be relied on to question politicians sceptically in an adversarial way, but in this case they have taken bottom line numbers at face value as validation of the trade narrative about how government needs to pay more to avoid closures. To understand what is happening now we need to look backwards to the early days of the financialised chains and their business model of debt based financial engineering.

To begin with, we need to draw a distinction between different kinds of operators. Until the mid-1990s, care home operators were mostly a combination of small, family firms operating one or a couple of homes, often drawing on the medical or nursing experience of the owners, and local authority run homes, which have been closing over the last two decades. In the late 1990s, new kinds of financialised operators built up chains of homes because the activity generated reliable **cash flow**. Their commitment was financial and limited because, insofar as the business is about generating cash flow, then an owner will sell (or buy more) if the price is right.

The new chains added debt based financial engineering, especially with the spread of private equity ownership in the 2000s. Debt was relatively cheap in this period, because interest rates were low and bond holders required lower rates of return than shareholders. Thus the purchase of care home businesses could be funded by selling debt; this caps returns on that portion of capital to the benefit of the private equity fund which has unlimited equity rights to the upside from operating or selling on.

The aim of the debt based chain owner is to bring earnings forward and pass liabilities on and this has a series of effects.

- Tax avoidance was encouraged because, if the aim is net **yield**, a pound saved from tax avoidance is as good as any other. If a business is **equity financed** with shares, then currently in the UK, 20% corporation tax has to be paid on profits before they can be distributed as dividends; if **debt financed**, then interest is deducted before profit is declared and profit is of course reduced by that amount (see **different tax treatments of debt and equity**).

- Complex multi-level company structures, using **tax havens** like Guernsey or the Cayman Islands, made operations opaque and allow **assets** and **liabilities** (as well as earnings) to be moved about. The business can also easily change form as when, for example, some or all of the property can be sold to create an **op co/prop co** structure, where the care home operator pays rent to a property company for homes which it previously owned. The cash released by selling property can be taken out of the business or used to fund rapid expansion through buying smaller care home businesses.

- Profit became a much less useful indicator of the surplus of revenues over expenses than cash generation, classically calculated using the **EBITDA** measure of earnings before interest, tax, depreciation and amortization. The game is complicated in chains like Four Seasons after 1999 by serial changes of ownership, where at each change over the seller makes a profit from a buyer who loads the business with more debt. The issue then is not only extracting cash from operating care homes, but ensuring resale value or minimising break up losses at **liquidation**, if the business cannot service the increased external debt.

All this raises a series of public interest issues. The **business model** is designed to produce high returns for the equity owner, not to pass on the benefits of cheap debt so that other stakeholders could benefit. Residential care is a **capital** intensive business because of the need for property (whether owned or rented) so that, if target returns are low, then it is easier to pay higher wages and/or reduce the price paid per bed. If **cash extraction** is hard wired in to the business model by burdensome debt and rent payments, then operating businesses become increasingly fragile and vulnerable to down turns in **occupancy rates** and lower than expected fee increases. The internal organisation of the chains is also an issue, even more so than in American corporates like Google and Starbucks: in residential care, British tax payers are providing a substantial part of the revenue stream which sustains an important welfare service, but tax payers get little transparency and accountability in return.

This was briefly an issue when the largest chain Southern Cross failed in 2011, when there was recrimination about a recently floated company which was a pure **op co** with rent obligations that it could not meet. Since then, little has changed. Adult care has continued to attract investment from private equity firms, hedge funds, banks and consortiums of individual investors. Three of the biggest five chains are owned by **private equity** broadly defined (Four Seasons Health Care, HC-One Ltd including Meridian and Care UK).

The end result is what economists call **moral hazard**, because the distribution of potential rewards and punishment is such that one party is induced to take more risk, knowing that others will pay the price if things go wrong. Consider the failure of a care chain whose purchase was largely financed by debt, as in the case of Four Seasons. In the event of liquidation, the owner can walk away after losing only a small amount of equity (offset by any cash extracted since purchase and any claims it has on **assets** from

internal debt); the external creditors (banks and bond holders) get the assets and take over the business and the state is left with responsibility for the residents.

Put another way, financial engineering is problematic because it seeks reward, while minimising risk from a foundational welfare service that is important for those who need care for themselves or family members. Chain owners are attracted by steady (part tax payer funded) revenue streams where they can maximise upside gains and manoeuvre around the downside financial risk of losing their money; but their business model privileges cash for equity over and above the interests of tax payers and care workers; while, crucially, the social risk of looking after the frail and vulnerable stays with the state. Indeed, the trade narrative threat of a bed blocked NHS following home closures implies a trade belief that the state ultimately carries the social risk.

Section 2: A benchmark price?

The technical justification for a higher price is provided by the LaingBuisson model which tells us, for example, that in 2015 provincial local authorities are paying £104 less than the cost of residential care, and £152 less than the cost of nursing care per week? These figures are not so much scientific facts about actual costs in the sector but political claims about the world as the chains would like it to be. But they are important because they circulate widely and have been generally accepted as rigorous and objective in court cases about the inadequacy of local authority fees. They should not be believed but are curiously revealing.

The benchmark calculation (originally labelled a "fair price") is based on a model developed by the leading health consultants LaingBuisson in 2002 and revised regularly since. The model works from a costing of care which includes all direct and indirect costs and an allowance for a set rate of profit, which adds up to a single weekly bed price that care homes should charge and local authorities should accept. This is standard management accounting of the kind routinely used inside individual firms to price new lines and to calculate **margins** on existing products. As with all accounting calculations, it rests on assumptions and specific values. The problem in this case is that both are contestable.

The calculation began by drawing data from the 'largest care home groups' which operate chains of homes with 60 or more beds, each of which can pay management overheads and generate a **return on capital** (and afterwards cross checked on physical labour inputs in smaller homes). But the level and composition of costs is completely different in a small 'mom and pop' run firm with one home of up to 30 beds which is, like a family farm, dependent on family labour this year and on the appreciation of property prices in the long run. If there is no representative firm, the benchmark fair price is an oversimplification because diversity of firm type and cost structure means some can survive on prices which others find inadequate.

The benchmark price should instead be considered as a political attempt, on behalf of the chains, to legitimate a high price. And the most interesting point here is the calculation for **return on capital.** In recent annual calculations, up to and including 2015, the required return on capital is put at 12% which then increases cost in the model because in the case of a nursing care bed whose fair price in 2015 is £776 per week, some £277 is accounted for by cost of capital.

Where does the 12% come from? It is based on purchasers' expectations of return as discovered by a 'telephone survey of major business transfer agents and property funds active in the care home sector'. Post financial crisis, purchasers are prepared to buy care homes for 8 times earnings (**EBITDA**), so arithmetically they must be expecting a 12% return which covers that purchase price (**see purchasing care home businesses**). In other words, if local authorities pay the LaingBuisson price, any financialised

purchaser who buys at the standard sector multiple will earn 12% (provided they maintain occupancy rates and avoid **Care Quality Commission** embargo on taking in new residents because the home fails to meet minimum quality standards).

There is an element of circularity in the calculation, which undermines its own pretensions to rationality and suggests an ambition to fuse capitalism and the state so that financialised business takes profits without engaging in the hard game of competition and risk taking. We could not and should not as citizens accept the care chain version of capitalism where those who pay the standard multiplier of earnings for an asset are guaranteed a return from an administered benchmark price.

As we note, cost of capital can be defined in other ways, most obviously as the cost of borrowing the money to build a care home and that is much lower than 12% because funds will lend for turn-key home construction at 8% and the **Public Works Loan Board** lends to local authorities for less than 5%. If we drop the 12% requirement and substitute 8% and 5% returns in the Laing Buisson model, then the 2015 fair price for a bed for a week drops by £57 and £99 pounds respectively and the saving could be used to increase staff wages and/or reduce the price paid by local authorities.

There is an interesting epilogue to our argument about high return requirements. The 2016 update of the calculation was released by LaingBuisson as our report was being finalised. This dropped the required return to 11% in 'recognition of a modest upward trend in care home values and a corresponding modest downward trend in the yield that investors in care homes are willing to accept in a post-crash, low interest economic environment'. If financially savvy new investors are buying into the sector and bidding up care home prices that surely implies they do not believe the trade narrative about a sector which is in crisis because prices paid do not cover the operating costs.

Section 3: Four Seasons as Poster Boy?

Four Seasons, the UK's largest care home chain with some 23,000 beds, has been owned by Terra Firma private equity since 2012 and is now in some financial difficulty. In media stories Four Seasons is the poster boy for the trade narrative about the unfair price and not enough state funding. Our argument is that the chain is poster boy for several interrelated problems which arise from the practices of successive owners.

Four Seasons from 1999 onwards is an object lesson in how debt based financial engineering and ownership churning creates unsustainable debt burdens whose legacy is operating problems about care quality. Under Terra Firma, since 2012 Four Seasons has been organised for tax avoidance into an opaque group of companies which is not in the public interest when the chain draws large amounts of public revenue. The legacy of financial difficulty is care quality failures resulting in embargo which management has addressed by hiring agency staff whose expense drives the chain's current profits crisis.

From 1999-2006, Four Seasons was a pass the parcel game where each seller made a profit because the next buyer was prepared to pay more and cover the cost by issuing debt (**debt leveraged buyout**). Four Seasons was in 1999 a small Scottish care chain when it was bought by Alchemy Capital which bulked it up and in 2004 passed the chain on to Allianz Capital Partners, who in 2006 sold on to Three Delta. By 2008, the chain had external debt of £1.5 billion and an annual interest charge of more than £100 million which represented an unsustainable claim of £100 per week on each bed in the chain.

Inevitably, Four Seasons then became the subject of a restructuring game as debtors took control and equity holders, bond holders and banks quite properly took losses. The debt was written down so that

just £780 million of outstanding debt was outstanding when Terra Firma bought the chain for £825 million in 2012. And the claim was that a lesson had been learnt about irresponsible debt based financial engineering. Terra Firma claimed it had 'put in place a secure capital structure, de-risking the business and lowering the cost of capital' when it issued £525 million of external debt whose interest charge was some £50 million.

It is not easy to judge these claims because Four Seasons is currently a group of 185 companies in fifteen tiers which are chained upwards towards Guernsey through multiple jurisdictions including several different **tax havens**. This kind of internal organisation facilitates tax avoidance so that Four Seasons pays no corporation tax. The consequence is opacity which is not in the public interest: around half of Four Seasons revenue comes from local authorities, but the complex internal organisation prevents any kind of accountability for tax payers.

We have done our best to understand what is going on by mapping the relation between group companies and then analysing the accounts of one high level holding company, Elli Investments. At Four Seasons, as at other chains, claims about operating losses or inability to meet debt obligations should be read in the context of earlier accounting and finance decisions by the owners which shift the threshold of profitability.

Consider, for example, the issue of **intra group debt** (different from the £525 million of external debt which has an interest cost of just over £50 million). The accounts of Elli Investment are initially puzzling because they show total interest payments of £100 million in 2015. The cause is £300 million of intra-group borrowing which is being charged at no less than 15% so the internal interest charge is £46.7 million. This is not a cash charge but an accumulating **liability** which, like the £300 million **principal,** may have some value in the event of sale or **liquidation** when intra group liabilities would give a claim on assets (behind the secured debt holders).

The overall design of financing is interesting. The external debt is split into two tranches at 8.75% and 12.75% interest and the internal debt is charged at 15% (see **intra-group loans**). The average of these three rates gives a weighted cost of (debt) **capital** of almost exactly 12%. In consequence, the 12% **return on capital** claim in LaingBuisson's model has become the required 12% in the Four Seasons' financing structure because profit can be found only after the firm has achieved a 12% return on more than £800 million of debt.

It was the owner, Terra Firma's accounting and finance decisions which in 2013 and 2014 turned a cash generative group by the EBITDA measure into a loss making group. But Four Seasons is also now close to failure because this chain does have an operating problem about price and cost with revenues not covering increased expenses. However, this does not vindicate the trade narrative because, when explaining rising losses, management admits that the driver of its problem is an increase in labour costs caused by the employment of expensive agency staff in an attempt to fix care quality problems.

This again can be tracked back to the business model because care quality usually deteriorates when firms are in financial difficulty; in our view, this is because financial pressure will increase the attractiveness of squeezing labour costs in an effort to improve returns. Thus Terra Firma inherited a care quality problem and at the peak had 28 homes embargoed by the CQC so they could not take new residents. The employment of agency staff accounts for the entire 6% rise in labour costs as percent of turnover; and does nothing for the regular staff who have had their wages and conditions of employment squeezed.

Giving the **financialised chains** more money is like pouring water into a leaky bucket and more state funding will not prevent crises if the fragility which causes them is an outcome of the debt based engineering that is central to their business model.

Section 4: What is to be done? An agenda for social innovation

Adult care is not only in crisis, it is a complete mess. The public policy response to this mess should be three fold. First, the state should not protect financialised owners from the direct and indirect consequences of their earlier accounting and finance decisions and meanwhile insist on more transparent and responsible group organisation. Second, the state should recognise adult care is properly a low risk/ low return sector which needs not debt based financial engineering but social funding with low cost capital. Third, with this funding, the state needs to sponsor imaginative new experiments in social care rather than simply police the standardised provision by the chains.

The state should deal firmly with the chains that are in difficulty and using the trade narrative to claim a bail out through higher prices. The first rule of capitalism is that owners are largely free to do what they will with their property and the second rule is, of course, that they should accept the consequences of their earlier actions. If a care chain owner loads a business with debt which cannot be serviced out of cash flow, the proper capitalist response is restructuring where the owner will lose their stake or see it substantially diluted. This is what did quite properly happen in Four Seasons under Three Delta ownership in 2008; and is what the trade has been trying to prevent by arguing for more money going into care in 2015.

More broadly, a downward step change in margins is an everyday risk for the capitalist owner operating in a competitive market and, under current accounting rules, is dealt with by writing down the value of the capital. This is what Sainsbury and Tesco have done to their land and buildings, after their expectations of future profit **margins** have fallen from 4% to 2%, largely because of new entrants Aldi and Lidl. In care, the argument is about a local authority administered price but it is not of course the responsibility of the state to maintain the margins that underpin capital **values** and abolish risk for providers.

From this point of view, the trade narrative can be seen as an attempt to manage political risk, making it endogenous and controllable in a way that is not in the tax payer interest. We might add that is also not in the interest of private payers. In many cases, the private fees are being paid out of family capital tied up in a house that the children will not now inherit. There is grumbling discontent about how family capital can be wiped out with a hefty care bill; which would increase if citizens realised that their family capital was propping up the margins of financialised chains and being sucked out of the UK economy into tax havens.

At the same time, we must recognise that we do not live in a world of smooth adjustment. Financial difficulty impacts on care quality, mainly through pressure on wages and conditions, so capitalist adjustment is never costless for other stakeholders. The situation is greatly complicated by the diversity of firm types, so that it would be sensible to institute some kind of open book accounting to provide assurance that cash strapped local authorities were paying a price that covered operating costs of different firm types (without aggressive 11 or 12% return on capital targets and with recognition that owners must bear the consequence of their financing decisions).

Open book accounting requires more transparency and social responsibility at group level. As part of the larger struggle against corporate tax avoidance, it should be possible to move towards the principle that taxpayer money and outsourcing contracts should not go to companies or groups which have

parents or subsidiaries in **tax havens** like the Cayman Islands or the Channel Isles. And it is worth considering general rules that reduce the scope for gaming **limited liability**; as the OECD has already done with its proposals to outlaw intra group loans at high rates of interest from companies in low tax jurisdictions to companies in high tax jurisdictions. If the chains do not want these kinds of rules, then they should propose alternatives to ensure that revenues are fairly taxed at the point at which they originate.

But raising the social ask is not enough because the state needs to recognise that the characteristics of adult care make it low risk/ low return; and the fundamental problem here is that financialised owners are behaving inappropriately by applying the practices appropriate to a high risk/ high return activity (and then trying to pass the risk onto the state). Rather than blaming the owners, the state should constructively mobilise low cost finance. This is immediately socially important because lowering the rate of return is a way of finding the headroom to pay staff more. Under the present system, care quality is undermined by both the rapid burn out and turnover of an under qualified and ill paid workforce and the lack of support for, and recognition of, the importance of good managers. The mandated rise in the legal minimum wage on 1st April 2016 is likely to aggravate problems about the rise of unpaid breaks and handover times.

Equally, low cost finance is not enough. We also need to reinvent and reimagine adult care because the chains not only fail to deliver consistent care quality but increasingly reformat residential care in one particular institutional mode.

The rationale for chain organisation in many kinds of retail, like fast food, is that the chain delivers consistent quality because procedures can be standardised. But in this respect a care home is not like a fast food franchise because care involves complex human relations, judgement and discretion. Chain organisation appears to deliver few benefits in care because the chains have been unable to proceduralise excellence: all have branches which range from excellent to awful.

More insidiously, our research on the care sector in Wales shows that the chains are reformatting residential care because they account for most of the rebuilding, while many of the homes operated by mom and pops will be retired in the next decade or so. The mom and pops typically operate older, converted houses while the chains rebuild in a standard format with 60-70 beds as two storey, en-suite blockhouse hotels for older people.

An unintended consequence of the chain business model is a future in which care homes are increasingly alike. By default, society must then accommodate its older people in large, full service hotels of single rooms with en-suite, in a setting which is more institutional than domestic. We urgently need public debate about whether it is socially desirable to standardise care in this format and how much of this accommodation we can afford, given a rapidly ageing population and diminishing social care budgets.

Public policy since the Dilnot Report of 2011 has fixed on the idea of finding new sources of care funding; which the financialised chains would no doubt happily spend. Instead, we need to focus on, first, how to access low cost finance for rebuilding and, second, what kind of homes to rebuild. Moreover, how can we sustain and encourage diversity amongst operators to ensure that there is a wider range of providers beyond the large chains.

Formally, local authorities can borrow at 4-5% from the **Public Works Loan Board** which would reduce the cost of capital in the price per bed. In practice, **HM Treasury** has had a long standing aversion to public investment in any kind of economic or social infrastructure, even where it would be manifestly

cheaper and would be likely to block such moves. European Union rules limiting public borrowing provide a further barrier. In the absence of an institution like a National Investment Bank, it would be important to redirect existing sources of finance, especially local authority pension funds. Currently many local authority pension fund investments earn no more than 5% net return (interest and capital gain) annually. Why not a national scheme in which local authority pension funds invest in the building of care homes which could provide 5% returns at very low risk?

Rebuilding at low capital cost is the key to sustaining a diverse group of operators and constructing a system which is inherently unattractive for financialised players. Because low cost public funding of rebuilding would logically allow a socially responsible use of op co and prop co structures. The property could be publicly owned and rented to a variety of operators or, more imaginatively, the cost of land and buildings could be directly charged on a per bed basis, with operators working on a fee for management service.

But the full social benefits will only be obtained if that rebuilding is tied to social innovation through experiment with and evaluation of housing with care in a variety of new formats. Currently adult care is provided across the UK in two standardised formats: home care, which is mostly provided in short time blocks of 15 minutes or so, and residential care which involves group living in increasingly large institutions. In this system the barriers between formal and informal care, or between institution and community are too often fixed and unquestioned.

Thus social innovation should involve thinking creatively about how care can be reimagined for 21st century Britain given the particular challenges it faces. This task is essential because the combination of projected increases in the numbers of older people over the next 20 years and the limitations on public funding means that the current system is unsustainable on a fiscal basis, leaving aside the problems created by the financialised chains.

Social innovation in housing with care is about whether, how (and at what cost) it is possible to break with the dominance of the care home model of institutionalised group living which few of us find attractive in prospect. There are several different models of more domestic provision which have been tried in countries including the Netherlands and the US, as well as in the UK, in smaller scale buildings often with multi skilled staff We need to study these in more depth with the aim of finding moderate cost alternatives and also experiment with the reuse of existing care home facilities in different ways.

Even with low cost rebuilding, there will always be funding constraints. But the crisis in care is ultimately less a crisis about funding and more a crisis of social imagination. The state has outsourced the future of the social care sector to large financialised businesses which want to be paid more for doing the same (with no questions asked about their accounting and finance decisions). These businesses manoeuvre politically to reduce risk and avoid consequences, while threatening to hand back vulnerable residents when they go bust. After challenging the false necessity of the trade narrative, we should recognise adult care is an exciting opportunity for innovation because how we care for our older people is a measure of our civilisation.

Jargon busting the citizen's summary

Asset: Assets are all the things that the company owns and expects to use in its business to create cash flows in the future. These are usually divided between: a) fixed assets such as property, plant and machinery; b) intangible assets such as goodwill (e.g. things like the value of a company's brand name, a solid customer base and good employee relations) and intellectual property; and c) current assets such as cash and stock used in day to day trading.

Bank of England base rate: Is the rate of interest at which the UK's central bank will lend to commercial banks such as Barclays, HSBC, RBS and Lloyds. It generally indicates a base cost of borrowing across the wider financial sector. The base rate is set by the Bank of England Monetary Policy Committee and is currently 0.5% (February 2016).

Bonds: Governments and large corporations borrow money by issuing bonds which investors, such as pension funds and insurance companies, buy. In return, investors are paid interest for a given length of time before the fixed **principal** is repaid when the bond matures. The purchase of care home chains, such as Four Seasons, is often financed by selling bonds to cover most of the purchase price. The bonds are part of the debt in the leveraged buyout transaction.

Business model: This describes the way in which a firm carries out its business, with emphasis on how it creates value for its shareholders (and other stakeholders) through the provision of goods and/or services.

Capital: The capital of a firm comprises the financial resources used in the business. It is normally made up of equity or share capital, provided by the investors, and debt capital, provided by banks and bond holders. Businesses such as care homes are often described as capital intensive because they need relatively large amounts of fixed assets, including property, to operate; these assets can be financed in different ways through a combination of debt and equity. Businesses that require mainly trading or current assets, such as an IT software firm, are not capital intensive.

Care Act: The Care Act is UK legislation passed in June 2014, setting out Government social care policy. The first parts of the Act came into effect in April 2015 and a second stage, setting a cap on maximum amounts individuals would be expected to spend on care in their lifetime, was due to be introduced in 2016 but now is being delayed until April 2020.[1]

Care Quality Commission (CQC): The Care Quality Commission inspects care homes and acts more broadly as the regulator for health and social care in the United Kingdom. After the failure of Southern Cross in 2011, it was given responsibility for market oversight and assessing the financial sustainability of 'difficult to replace' providers.

Cash extraction: The process of taking surplus cash out of a business. This can be done by paying a dividend, paying interest on intercompany loans, or paying fees, such as for administrative services, or royalties on the use of intellectual property rights.

Cash flow: Cash flow is the net amount of cash generated or used by a business over a period of time. It covers the cash earned from trading (i.e. before non-cash accounting charges such as depreciation of fixed assets), the cash absorbed in working capital (stock, debtors, and amounts owed to creditors), and

[1] For more information see http://www.ageuk.org.uk/home-and-care/the-care-act/ or https://www.gov.uk/government/publications/care-act-2014-part-1-factsheets

the amounts invested in fixed assets such as plant and property. Surplus cash can be used to pay down the company's loans or to pay shareholders a dividend. In the event that there is a deficit then this needs to be funded by further borrowing or by raising more share capital from investors.

Costs: Costs are the total amount paid by a company to allow it to carry out its operations. They are often divided into fixed and variable costs. Fixed costs are longer-term commitments such as rents and interest payments, and other overheads including staff, which cannot be cut in the short term. Variable costs are those that go up or down with the volume of trading. These include consumption of raw materials or production staff on piece work contracts. An example would be a zero hour contract where the employee is only paid for the actual hours worked with no minimum commitment from the employer.

Credit rating agencies: These are organisations that provide credit ratings for companies and other entities, including governments, which issue significant amounts of debt such as bonds in public markets. The rating is intended to help creditors (and equity investors) assess the potential risks of lending to (or investing in) a particular business. The three largest credit rating agencies are Moody's, Standard and Poor's and Fitch. There is a sliding scale of ratings: the highest rating is described as AAA; lower grades are referred to as 'junk'.

Debt financing: Cash obtained by incurring debt, including through loans from a bank or the sale of bonds to other investors. The terms of the funding cover: an interest rate payable; a maturity date by which the principal must be paid back; and security for the loan in the event of a default. Security varies from a mortgage charge on the property to what is known as junior debt, which has a lower priority than other debt or may be unsecured. The level of security will affect the risk and interest rate charged. Debt financing via bonds is historically cheaper than equity funding because it is more secure with lower risk.

Debt financing became increasingly complicated in the years leading up to the Financial Crisis in 2008 with banks securitising care home debt. This involves a number of loans being packaged together and sold as investment bonds. As a result, the debt of care homes in the UK can end up being held by international investors who have no direct interest in or knowledge of the underlying businesses.

Debt leveraged buyout: The acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. Often, the assets of the company acquired are used as collateral for the loans in addition to the assets of the acquiring company.

Different tax treatment of debt and equity: There is a bias in UK and other tax systems which favours debt financing over equity financing. If a business is equity financed with shares, then in the UK currently 20% corporation tax has to be paid on profits before they can be distributed to shareholders as dividends. With debt finance, interest is deducted as a business cost before taxable profit. Debt financing therefore offers the benefit that the net financing cost to the investor is reduced by the tax deduction.

EBITDA (earnings before interest, tax, depreciation and amortisation): EBITDA is a measure of profit (also referred to as earnings) before charges for capital items. It shows the cash generated from operating the business before charging interest on debt and taxation (both of which are cash costs), and depreciation charge on fixed assets and amortisation of goodwill (which are book keeping adjustments to write down fixed assets over their useful life). EBITDA can be used to compare businesses and sectors because it eliminates the effects of accounting and financing decisions: for

example, how to depreciate care homes requires a judgement of useful working life and how much debt is used to finance businesses.

Equity financing: Equity is the share capital subscribed by investors. Share capital has the sole claim to receive the profits of a company. In contrast to loan capital where there is an obligation to repay the loan on a specified date, whatever the profitability of the business, shareholders only receive a return if the business makes a profit.

Financial engineering: In this case, this refers to the financial strategies companies use to maximize cash flow or other important performance metrics.

Financialised chain: A business where its primary activity (e.g. providing care or selling widgets) has become secondary to its capacity to generate cash flow; and the commitment to staying in the activity is limited because, insofar as the business is cash flow, then the owner will buy or sell if the price is right.

HM Treasury: HM Treasury is the government's economic and finance ministry, maintaining control over public spending, setting the direction of the UK's economic policy and committed to achieving economic growth.

Interest rate: The proportion of a debt (loan, bond etc.) that is charged typically per annum as the cost of borrowing. For example, if the interest rate is 3% and I borrow £100,000 then I must pay £3,000 a year in interest.

Intra-group loans/charges: When one company in a corporate structure lends money to another company in the same group, an interest charge will result. Intra-group loans can be used as part of the financial engineering of group structure in order to minimise the parent company share capital tied up in a subsidiary. Intercompany loans permit interest to be paid by the subsidiary (i.e. cash to be extracted) even if the subsidiary is loss making. The same applies to administration charges, licensing arrangements or royalty payments which can be applied to shift money from one subsidiary which is earning revenues in the UK and other subsidiaries which may be based offshore in lower tax jurisdictions.

Liability: A liability is a legal debt or obligation. Liabilities include the interest and principal incurred when borrowing, rent on property or other leased assets, amounts due to suppliers, and liabilities to the state such as taxes and social security costs of employees.

Limited liability company: A company whose shareholders' risk of loss is limited to the amount they have subscribed for their shares. (With unlimited liability, for instance in a partnership or as a sole trader, the partner or sole trader is liable personally for all the liabilities of the business.) In a limited company, for instance, if the investors finance the acquisition of a business with £1 of share capital and £4 of borrowing all the upside goes to the investors, but their loss is limited to their investment of £1.

Limited liability company accounts: Limited liability companies are obliged to publish financial statements. These accounts must be in a format which conforms to International Financial Reporting Standards (IFRS), which are used by larger entities, or Generally Accepted Accounting Practice (GAAP), which is a UK standard used by most UK companies. There are significant exemptions for small companies in the UK which simplify reporting.

For larger firms the financial accounts will comprise of 3 parts:

- **A profit and loss statement**, showing the trading results for the business over a specific time period (e.g. one year).
- **A balance sheet**, which records a company's assets, liabilities and shareholders' equity at a specific point in time.
- **A cash flow statement**, which records the amount of cash and cash equivalents entering and leaving the company during a specific time period.

Liquidation: Liquidation is the process by which a company's life is brought to an end when it becomes insolvent and cannot meet its obligations as and when they fall due. The company's assets are sold and the surplus is used to pay the creditors, with anything left over paid to shareholders. The order in which the creditors are paid will depend on the priority they have. Those with security such as a mortgage on the property will be paid first from the proceeds of sale of the secured asset. Unsecured creditors have a lower priority.

Margins: Margins are the difference between the revenue and costs of a particular business activity like running a care home. If a care home's annual revenue is £1 million and its costs are £800,000 then its margin is 20%: that means a profit of 20p in every pound of revenue.

Moral hazard: is lack of incentive to guard against risk where one is protected from its consequences. This can arise for banks with deposit insurance or implicit/explicit guarantees of Government bailout.

Occupancy rates: Occupancy rates refer to the percentage of beds in a care home that are occupied on average over the course of a year. They are an important driver of profitability in a care home chain because most profits are made in the last 15% of occupancy and normal occupancy rates would be in the range of 85-90%.

Oligopoly: An oligopoly is a market structure in which a few large firms dominate and this gives such firms market power which they can use to increase prices. Market concentration is usually measured either by revenue or output. In the care home sector, the number of beds operated by the top 4 or 5 providers as a percentage of all beds operated at both national and regional levels is a common measure of market concentration.

Op-co/Prop-co: This term describes a business model, such as in residential care, where the firm needs two types of business activity to provide its services. In the residential care sector there is a business of owning and operating the property assets (which is capital intensive), and the daily care operations of looking after the residents (which is a labour intensive activity). Caring for residents requires different skills and financing from property ownership. This business model is not unusual and is found in other industries such as hotels, retailing and airlines, where the hotels, shops and planes are rented or leased. The two activities are organised through separate legal entities, often with the property company a subsidiary of the main operating company; this also allows the property company to be subsequently sold to another owner.

Principal: This is the capital amount of a loan or bond excluding interest accrued. The principal is either repaid in tranches or in a lump sum at the end of the loan.

Private equity: Private equity is equity capital that is not quoted on a public exchange. This is in contrast to public company shares which are openly traded on stock exchanges such as the London Stock Exchange and the New York Stock Exchange. Private equity is finance provided in return for an equity stake in the target company. Private equity is generally invested through Private Equity Funds

where the investment comes from pension funds, insurance companies and other savings institutions. The private equity funds are generally managed by partners in the funds who receive a fee for management and an incentive by way of a share (frequently 20%) of the profits and capital gains made by the funds. The private equity fund aims to have an investment period of between 3 to 7 years within which it aims to increase the capital value of the businesses it invests in. At the end of this time the investments will be sold.

Public Works Loans Board: The Public Works Loan Board (PWLB) is a statutory body operating within the United Kingdom Debt Management Office, an Executive Agency of HM Treasury. The PWLB's function is to lend money from the National Loans Fund to local authorities and to collect the repayments.

Purchasing care home businesses: The value of care home businesses is often expressed as a multiple of earnings (EBITDA). If a care home's EBITDA is £1 million and it is sold for £4 million, then the purchase is 4 times earnings.

Return on capital: Return on capital is a financial ratio which indicates the profit earned from deploying the capital in the business. It is generally measured as a percentage with the earnings as the numerator and capital (debt plus equity, or only the equity depending on what the user wishes to show) as the denominator. For example, if I spent £1 million on buying land and building a care home and the earnings before interest and tax was £100,000 in my first year, the return on capital would be 10% (£100,000/£1,000,000). In the context of this report, the relevant definition of capital is the financial investment made by investors and lenders. Capital invested is the sum of equity invested by shareholders and debt (bonds and loans) in the business.

Revenue: Revenue is the total amount of money a company receives for providing its services during a given period (also called turnover in the UK). It is the top line in a profit and loss statement from which costs are deducted to give profit (earnings).

Tax havens: A tax jurisdiction (a country or independent area) with a stable economic and political environment that offers foreign individuals and investors low or no tax charges on profits. Examples of tax havens include Channel Islands like Guernsey, the Cayman Islands, Netherlands, Luxembourg and, many argue, the UK.

Trade narrative: A trade narrative is a description or account of how an industry operates, usually developed by a trade association or lobbying group. The narrative aims to put a positive light on the benefits of the industry's contribution to the economy or social agenda. The positive agenda may often distract from the underlying economic and financial dynamics of the industry, which may be less beneficial to society but represent the true interests of the industry players. A common narrative may focus on job creation and entrepreneurship in order to influence government and other policy makers to support the industry interests.

Value: Assets and liabilities are priced according to various accounting conventions. Often these are based on their market value, or if they don't have market values, on other proxies. While assets like property are depreciated over time, as a way of allocating their cost over their expected useful life in the financial accounts, they can also be revalued, for example to reflect changes in the market value of the property.

Yield: The income return on an investment (interest or dividends) usually expressed annually as a percentage based on the investment's cost or its current market value.

WHERE DOES THE MONEY GO?
Financialised chains and the crisis in residential care

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Introduction

This report challenges the generally accepted framing of the crisis in adult social care. This framing focuses on the urgent problem that underfunded local authorities are not paying the big chains of residential and nursing homes 'a fair price' for looking after frail, chronically ill and confused older people; this account then goes on to assert that the first constructive step is to pay the chains substantially more per bed per week. We present an alternative analysis, with supporting financial evidence, focusing on the problem of where the money goes in a system increasingly dominated by large financialised chains.

Our alternative account emphasises the role played by the business models of the large chains which now operate 20% of the beds in the system. We argue that major problems are created by the normalisation of an expected 12% rate of return on capital, as well as by financial engineering which makes operating subsidiaries more fragile by extracting cash and piling up liabilities. This kind of financialisation of care inflates the price paid by local authorities, reduces system resilience and distracts from the urgent need for more social imagination about new forms of social care for older people (as well as for adequate funding).

Adequate low cost funding (to rebuild homes and pay living wages) is a necessary but not sufficient precondition for better social care: this crucially depends on more imagination applied to how we provide housing with care for older people. What we have at present is too much financial innovation applied to benefit the financialised owners of nursing home chains; instead, we need to recognise this is properly a low risk/ low return activity and invest in more social innovation that benefits us all as citizens.

Residential care for older people is mired in multiple crises about demographics, care funding and government austerity cuts, in a system already levered on poverty wages for the workforce. The UK has an ageing population with no adequate system of funding residential care for the majority of older people who cannot pay for themselves. The funding gap has been filled by local authorities, but austerity has forced local authorities to cut services and funding. Care quality will remain low as long as the workforce is under resourced, ill paid and ill trained. Against this background, our argument is that the large financialised chains are an important part of the problem. Their self-interested framing of the

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crisis needs to be challenged because handing over more state funding to them exacerbates the problem and solves nothing.

To set the scene for this argument, readers need to know six basic facts about the current system of residential care and how we got here.

1. The system of residential care was once dominated by state provision so that, as late as the 1980s, more than 90% of beds were in local authority homes. However, residential care has been outsourced over the past 25 years so that more than 90% of beds are now offered by independent (profit and non-profit) providers.

2. The sector contains more than 400,000 beds and remains substantially dependent on the state for about half of its funding with 60% of beds paid for by local authorities. Residential beds cost more than £500 per week, which means that many cannot afford to pay for themselves.

3. Outsourced residential care was cheaper because it paid lower wages (which brought problems about workforce turnover and increased demands for wage subvention through housing benefit and tax credits). According to the Labour Force Survey, for-profit care homes pay wages per hour which are on average £2 lower than local authority homes.

4. For-profit operators with large chains of more than 50 homes entered the sector in the 1990s and grew in the 2000s with private equity backing; now three of the five largest chains are owned by private equity.

5. The sector is now dominated by for-profit providers (corporates and small businesses combined) which operate 387,900 beds (86% of non-statutory supply) in 2014, while the not-for-profit sector operates the remaining 65,000 beds (14%).

6. The biggest five providers in the sector are all large chains, which typically operate larger, modern, purpose built homes and provide 19.8% of beds. There are still a large number of smaller 'mom and pop' family owners in the sector, with one to four homes, typically in old, converted houses.

7. The chains are placed to expand their share because recent building of new homes, in a standard format with 60 or more en-suite beds, has been dominated by chain operators; and many of the smaller mom and pop businesses are likely to exit in the next decade by selling homes which are valuable property.

The rest of this report aims to clarify what's going on in this sector.

Section 1: Framing the crisis in residential care

'One minute to midnight for the care home sector'

On the 11th November 2015 the GMB Union's national officer declared that 'it is one minute to midnight for the care home sector'.[8] He was commenting on a report by ResPublica which predicted that 10% of care homes would fail by 2020 and that it 'will cost the NHS £3 billion'.[9] A broad and growing alliance in the social care sector has been warning of 'imminent crisis' and 'potentially fatal' consequences since July 2015, when George Osborne announced that the national minimum wage would rise to £7.40 an hour in March 2016 for over 25s who constitute 89% of the care workforce.[10] The leading voices in this alliance are the biggest five private providers who operate chains of nursing and residential homes (Four Seasons, Bupa, HC-1, Barchester and Care UK), along with their trade body (Care England UK).[11] But they have been joined by other stakeholders including the Association of Directors of Adult Social Services[12], the Local Government Association[13], the GMB Union and the Care and Support Alliance.[14]

All of these groups repeat a very similar narrative about the causes, consequences and solutions of an urgent crisis in residential care. This narrative about an unfair price and not enough money goes as follows. Under the austerity regime social care expenditure has already been cut since 2010 and the minimum wage increase will now tip the system towards failure because it will add £1 billion to operator costs by 2020.[15] The troubles of Four Seasons, the biggest care provider in the UK with around 460 homes, provides early warning of this crisis because it has to pay £52 million in debt repayments annually; and Standard and Poor's has warned it will run out of money by early 2016.[16] The crisis is caused by Local Authorities already paying £104 and £152 per week less than the 'true' cost of care for residential and nursing care respectively and further rises in staff costs cannot be absorbed in an activity where staffing already represents 60% or more of operating costs. When social care fails there will be considerable human suffering and great financial cost; the apocalyptic scenario is that the NHS goes into crisis because of bed blocking in hospitals where care costs £1,575 per week, not £500 per week as in a residential care home.[17] On this analysis, the crisis must be solved immediately by government injecting more funds into the system so that local authorities can pay more.

This orthodox *not enough money* framing has been reported extensively (without criticism or challenge) in broadsheets, including the *Financial Times* and the *Guardian*, as well as on BBC Radio 4, so that the

[8] GMB Union, (2015), 'Crisis In Care Homes Looms', 11th November.
[9] Crawford, Amy and Read, Claire, (2015), 'The Care Collapse: The imminent crisis in residential care and its impact on the NHS', Interim Report, ResPublica, 11th November.
[10] Skills for Care, (2015), 'The state of the adult social care sector and workforce in England', pg37.
[11] See for example Carter, Rachel, (2015), 'Care sector issues second warning to government on costs of 'living wage' policy', Community Care, 20th August.
[12] Local Government Association and Association of Directors of Adult Social Services, (2015), 'Adult social care, health and wellbeing: A Shared Commitment', 2015 Spending Review Submission, September.
[13] ,,
[14] McDermott, Vicky, (2015), 'David Cameron is presiding over the biggest crisis ever seen in social care', *The Mirror,* 18th November.
[15] GMB Union, (2015), 'Care Living Wage To Cost £1 Billion', 20th August.
[16] Ruddick, Graham, 2015, 'UK's biggest care home operator risks running out of cash, says S&P', *The Guardian,* 2nd November.
[17] Crawford and Read, (2015). pg. 11.

unfair price narrative has undoubtedly framed public understandings of the crisis in social care. Its immediate aim was to secure extra funding from the Government at the Spending Review in November 2015. The arguments about the repercussions of crisis in social care for the NHS were clearly designed to gain the attention of ministers; and the media reported a lobbying offensive in autumn 2015 in the form of interviews with key industry figures, open letters, think tank reports and public requests for meetings with ministers. In the November 2015 Spending Review, George Osborne gave Local Authorities the power to add a 2% precept to Council Tax to generate extra funding for adult social care, claiming that if every Council made full use of this power it would put £2 billion into the social care system.[18] The trade has responded by arguing that the precept will not raise enough to stabilise the system. As the Institute of Fiscal Studies notes, Osborne's fix will also further intensify inequalities in local spending on care because poorer local authorities will raise less.[19]

In this report we argue that the standard framing of crisis is a trade narrative because it reports selectively and constructs confusingly so as to serve the financial interests of the large chains (and enlist others like local authority service directors and trade union officers who hope their lives would be easier if the central state paid more per bed). And, as we would expect, the trade narrative does not raise the issue of the business models employed by the financialised chains nor the debt based financial engineering practices that increase their operating fragility.

The self-interest of the chains is not obvious partly because other stakeholders, like the local authority directors and independent think tanks, have been enlisted to repeat the claims. This unfair price argument is also different from the usual kind of trade narrative deployed in other sectors. In the trade narratives of the pharmaceutical industry or privatised railways, trade associations justify private profits by counting the benefits which society has received, classically by making claims about public benefits which accentuate the positive and attribute all benefits to the agency of the corporates.[20] The trade narrative in residential care is different in that it spreads alarm about imminent system failure and then lays both responsibility for, and the agency to solve, the crisis squarely with the Government. The big chains have, in effect, adapted the alarmist tactics of 'shroud waving'.

The doom laden trade narrative of the care chains gains plausibility because residential care is beset by significant multiple crises, which do have interlinked causes in central and local government policy.

1. First, the UK has a demographic crisis about a rapidly ageing population and an unsustainable adult care funding model which cannot easily expand supply to meet this demand. The number of people aged 65+ is projected to rise by 40.77% in the next 17 years to over 16 million[21] and central government has postponed the Dilnot report recommendations of 2011 which would create a new national funding regime.[22] Hence, the infamous Barnet council 'graph of doom' projects that the increasing costs of adult care and children's services will absorb all of the Council's budget within 20 years.[23]

[18] Russell, Vivienne, (2015), 'Spending Review: council tax hikes to shore up social care funding', *Public Finance*, 25th November.
[19] Innes, David and Phillips, David, (2015), 'Council tax rises to ease the pace of cuts to local government budgets', The Institute of Fiscal Studies, 18th December.
[20] Bowman, Andrew, Froud, Julie, Johal, Sukhdev and Williams, Karel, (2016), 'Trade narrative, elites and the "policy-based evidence"'. Unpublished paper, (available from the authors).
[21] Age UK, (2015), 'Later Life in the United Kingdom', December.
[22] Humphries, Richard, (2015), 'Paying for care: back to square one?', The Kings Fund, 20th July.
[23] Brindle, David (2012) 'Graph of doom: a bleak future for social care services' *The Guardian* 15 May 2012.

2. Second, the UK has an immediate austerity crisis about local authority funding cuts because, under the current Treasury spending regime, health expenditure is safeguarded but social care expenditure has already been cut by nearly 15% with more to come.[24] The National Audit Office has found that three quarters of cuts are met by reducing services, so 85% of councils now only meet 'critical' or 'substantial' needs.[25] Various forms of service rationing are already being applied by local councils which cannot however withdraw completely from adult care because they have statutory responsibilities to provide support.

3. Third, there is also a care quality crisis which is related to the low wages paid by the dominant private providers. An update given to the board of the Care Quality Commission (CQC) in October 2015 showed that 41% of community-based adult social care services, hospice services and residential social care services inspected since last October were inadequate or required improvement[26]; and the CQC has received more than 150 allegations of abuse of the frail and elderly in social care settings every day.[27] Many of these problems relate to inadequate management at home level and rapid turnover of care staff caused by low pay which is endemic amongst private providers. According to Labour Force Survey calculations, these providers pay an average of £2 per hour less than the remaining council operated homes.[28]

On any broad view of these multifaceted crises, central and local government must bear a large part of the responsibility for contributing to intractable problems and then not identifying and implementing solutions. The trade narrative in residential care abridges all this to create a highly simplified world which claims that local authorities are not paying enough and must now pay more if system collapse is to be avoided.

Financialised business models

If we wish to develop a more adequate account of the role of private providers in the sector's ongoing crises, the starting point has to be a basic analysis of the history and current business models in the sector's large chains. The five largest chains of homes biggest providers operate 19.8% of care home beds nationally: three of these are owned by private equity broadly defined; another is owned by a consortium of private individuals; and the fifth, BUPA, is a not for profit but operates in a very similar way (see exhibit 1). All of these chain providers have developed business models that rely on financialised practices which, when combined, are a matter of public concern and contribute to the unsustainability of the sector. There was some indignant criticism of the Southern Cross business model after that chain collapsed in 2011 but subsequent policy discussion has never focused on the common business model and pervasive financialised practices which we describe below.

[24] Burchardt, Tania, Obolenskaya, Polina, and Vizard, Polly, (2015), 'The Coalition's Record on Adult Social Care: Policy, Spending and Outcomes 2010-2015', Working Paper 17, Centre for Analysis of Social Exclusion, London School of Economics, January.
[25] National Audit Office, (2014), 'Adult social care in England: overview', HC 1102 SESSION 2013-14, 13th March, pg. 7.
[26] Boffey, Daniel, (2015), 'Half of all services now failing as UK care sector crisis deepens', *The Guardian,* 26th September.
[27] Casalicchio, Emilio, (2015), 'Social care system failing workers - CQC chief inspector', *Politics Home,* 9th August.
[28] Bowman, Andrew *et al* (2015) *What a Waste. Outsourcing and How it Goes Wrong,* pp.54-5.

Exhibit 1: Top five major for-profit providers of care homes for older and physically disabled people, July 2015[29]

Rank	Organisation	Total Homes	Total Beds	Registered beds as % of all for-profit homes	Cumulative	Ownership
1	Four Seasons Healthcare	440	23,488	6.1%	6.1%	Private Equity
2	Bupa Care Homes	285	20,862	5.4%	11.4%	Provident Association (for profit division)
3	HC-One Ltd (Including Meridian Healthcare)	246	12,887	3.3%	14.8%	Private Equity
4	Barchester Healthcare	195	12,445	3.2%	18%	Public company with ultimate shareholder registered in Jersey[30]
5	Care UK	112	7,092	1.8%	19.8%	Private Equity
Total			**76,774**			

Financialised providers buy care businesses with small amounts of their own equity and larger amounts of publicly issued fixed interest debt which has to be serviced by the operating business: this funding mix produces an attractive upside and a limited downside for the new owner. If the deal comes good, the capped returns on debt lever up the return on equity for the owner; if the deal goes wrong, the operating business fails because it cannot meet debt payments and the business passes to the debt holders with the owner losing the equity stake. When buying Care UK, Bridgepoint contributed £130 million of its own equity and raised £250 million of debt. When Three Delta bought Four Seasons in 2006 (before it went to Terra Firma in 2012), 80% of the £1.4 billion cost was funded by debt.[31]

For the operating business, interest payments on debt are ordinarily a fixed cost which a care home chain will try and pass on to customers (both individuals and the state). If the cost of servicing debt cannot be passed on to customers, the businesses' vulnerability to risks (such as falling occupancy rates and below inflation fee increases) increases and default becomes more likely. All this creates a moral

[29] LaingBuisson, (2015 B), 'Care of Older People UK Market Report', 27th Edition, 30th September.
[30] Fame, BvDep
[31] Sakoui, Anousha and Yuk, Pan, (2015), 'Four Seasons counts down to a crisis of financing', *The Financial Times*, 30th May.

hazard problem because owners and operating business managers have a limited incentive to guard against default. Private equity owners can walk away losing only the small amount of equity they invested (less anything extracted since the original investment), debt holders get the assets their investment was secured against and effectively acquire the operating business and operating managers know that care homes will mostly stay open under new ownership. The hazard is increased because the state has back stop responsibility for continuity of care for home residents when local authorities have a statutory duty to provide care for vulnerable adults.

Meanwhile, loading the business with debt provides the foundation for financial engineering to reduce obligations like tax and maximise the value which can be extracted from the operating business so as to benefit the owner. Here are three ways in which financialised owners minimise tax obligations and extract value from operating businesses in care.

- Financialised owners in the UK minimise tax by using debt finance and benefiting from the difference in tax treatment of debt and equity. They have historically paid corporation tax of more than 20% on the profits of subsidiary companies, but the subsidiary's interest payments are a non-taxable item which is deducted before profit is declared. The Care UK chain for example has reduced its tax liability by shifting from equity to debt finance in the past decade; in 2005 debt accounted for 33% of its capital but by 2014 this had risen to 85%. On our calculations, this shift in financing has saved the chain's owners - and therefore cost the Treasury - tax payments of some £25 million a year in 2012-14.[32]

- Tax is further reduced in financialised chains and value can be extracted through complex corporate structures which funnel cash upwards from operating subsidiaries through chains of limited companies towards ultimate beneficiaries registered in tax havens. For example, Barchester Healthcare is a subsidiary of Grove Ltd, which is registered as a public company in the Bailiwick of Jersey; and Four Seasons Healthcare is a subsidiary of London 58 which is registered in the Cayman Islands.[33] The movement of cash upwards (or the burden of non- cash obligations crystallised at sale or liquidation) can then be arranged at the convenience of the owner through devices such as special dividends or interest payments on intra group loans at artificially high rates.

- Another basic way of extracting value is by separating the operating business from fixed assets, especially in capital intensive, property based businesses like care homes where private equity is accustomed to taking over conservatively run, asset heavy businesses whose previous owners preferred the security of owning not renting property. Sale and leaseback is commonly used to break one business into two separate operating and property companies (op co and prop co). Selling the property on in this way allows lumps of cash to be extracted in dividends and/or allows rapid growth through serial acquisitions. Alternatively, the property can be split off into another group subsidiary, which may be registered in a tax haven, so the owner holds both businesses but can use rental costs as a variable means of extraction which allows the owner to take profit where he chooses. If pure op cos are the exception, chains like Four Seasons routinely do not own many of the homes they operate.

[32] Calculations from Care UK annual report and accounts 2005-2014 for company number 01668247 and company number 07158140. Care UK was acquired by Bridgepoint Capital on 11th May 2010.
[33] Based on our research of Four Seasons' accounts (see section 3)

The net result is that the declared profit of operating subsidiaries in financialised chains is not a hard indicator of surplus in one year accrued after necessary expenses. Rather, it is the malleable result of manoeuvring over several years to reduce tax, extract cash and rearrange obligations with an eye to exit. At the simplest, profit is the residual appearing after various interest payments, so that, for example, £41 million was removed for interest payments in 2010 when Care UK did not make an operating profit. However, it paid £25 million interest on the £250 million of bonds through which Bridgepoint raised most of the money to buy the company (external repayment). Care UK also paid £8 million interest on loan notes it issued on the Channel Islands stock exchange (external repayment) and £8 million interest to Bridgepoint as dividends on £126m of 'cumulative preference shares' in the company (intra group transfer). When the Bridgepoint fund bought Care UK, it invested £130m into the company but £126m of this was via preference shares (which guarantee its owners a return whether or not the company is profitable), with only £4m going into ordinary shares.[34]

The profitability of debt burdened businesses is further complicated because cash can be realised not just from operating but also from capital gains: for example, an operating business can be sold on at a higher multiple of earnings. This is always possible with luck and good timing if market valuations rise and, in the early 2000s, such gains were semi-automatic. When private equity first entered the adult social care sector in the early 2000s, a rising stock market offered easy gains amplified by the process of corporatisation: private equity could then buy family owned businesses at a lower multiple than they were typically valued at when part of a chain which sold at a higher multiple. For example, Blackstone paid around 6 times EBITDA (earnings before interest, tax, depreciation and amortisation) for care homes bought in 2004 and sold them for 9 times in 2006.[35] This was made possible because Southern Cross bought family run homes or small chains before integrating them as part of a larger corporate entity and selling them on as a package on a rising market.

The Southern Cross chain which failed in 2011 was a public company (floated by private equity in 2006) that resulted from such practices. They allowed extraordinary growth so that, for example, Southern Cross more than tripled in size in a little over a year from 8,200 beds in September 2004 to 28,000 beds by November 2005.[36] Under private equity ownership, Blackstone had effectively sold off the property and turned Southern Cross into a pure operating company which was inherently fragile and vulnerable, for example, to falling occupancy rates; and, in the event, it is widely accepted that Southern Cross failed because it could not pay rents which had been set ambitiously.[37] After the collapse of Southern Cross, op-co/prop-co structures were discredited but within a couple of years were quietly rehabilitated. In 2006 Barchester split its operating and property companies but it retained ownership of the property company and in the same year took out a £970 million loan secured on 160 care home properties. Then, in 2013, Barchester sold off all of its properties and leased them back for 23 years in order to repay its outstanding £900 million debt.[38]

[34] Corporate Watch, (2012), 'Care UK Corporate Watch fact sheet', May.
[35] Ford, Greg, (2011), 'How Blackstone made its £600m from Southern Cross', 11th July.
[36] See Dyer, Geoff, (2004), 'Blackstone expands with £162m Southern Cross purchase', *The Financial Times,* 17th September and Smith, Peter, (2005), 'Blackstone adds Ashbourne to its health portfolio', *The Financial Times,* 12th November.
[37] Care Quality Commission (2014), 'The Stability of the Care Market and Market Oversight in England', Institute of Public Care, February, Pg. 7.
[38] 'Miecamp, Julie and Freke, Tom, (2013), 'Barchester Repays Debt After Sale-Leaseback of U.K. Care Homes', Bloomberg, 4th September.

If financially engineered returns are important, operating returns also matter and that means controlling labour costs, which are the largest single cost item or all providers of residential care. But the scope for any kind of 'efficiency' gains is limited and the emphasis is therefore on reducing wage costs and sweating the workforce. A recent ethnographic study of UK residential care documents erosion of pay and conditions in care homes following takeover by various corporate owners. Such changes included restricting annual leave, reducing the numbers of qualified nursing staff, increasing resident: staff ratios, removing sick pay, moving to unpaid on-line training to be completed at home, removing paid breaks and no longer paying for handover meetings at the start and end of shifts.[39] The sweating of labour generates financial gain for operators, but comes at a cost in terms of recruitment, retention and safeguarding which certainly reduces care quality and probably makes operating businesses more fragile. As the CQC points out, financial and care quality crises are often closely interlinked and mutually reinforcing: when care quality crises result in embargoes or public mistrust they lead to reduced occupancy rates which impact profit margins while financial difficulties increase pressures on staff and reduce the resources to improve care quality.[40]

The responsibilities of the CQC as regulator include financial oversight of large chains[41] but the regulatory focus is on care quality not financialised business practices; and the interface between care and ownership is poorly policed when the CQC is apparently incapable of preventing failed homes reopening under new names.[42] There was widespread media criticism of financialised practices in 2011 when the op-co Southern Cross collapsed, along with reassurances that financialised providers had learned their lessons about fragility. But after 2011, as before, there was no clear public focus on the business models of financialised providers which limit tax liability, load the company with debt and conjure away profit from operating businesses where labour is sweated and assets are often sold off. The net result is more fragile operating businesses where profit acquires a 'now you see it, now you don't' quality. *Putting more money in to the system via higher weekly payments per bed will not produce a robust and sustainable care home sector when the financialised providers are so adept at taking money out*. More revenue is necessary for a sustainable sector but it is not sufficient without knowledge of where revenue goes and action against irresponsible business models and practices.

The absence of scrutiny

Why do the mainstream print and broadcast media not see that the practices of financialised operators raise all kinds of social issues about whether and how we should put more public money into the sector? After all, around half the sector's revenue comes from public funds (via local authorities) and much of the rest is from citizens funding their own care and, if that is our money, there is a public interest in ensuring the owners of the chains pay taxes and do not levy imposts on their operating subsidiaries which make them unprofitable and fragile. This has not become a public issue because the care trade has played on the financial illiteracy of the media and political classes and the underfunding of investigative journalism.

[39] Burns, Diane., Hyde, Paula and Killett, Anne, (2016), 'How financial cutbacks affect job quality and care of the elderly.' Work and Employment Relations in Healthcare. *Industrial Labor Relations Review*. (Forthcoming).
[40] Care Quality Commission, (2014).
[41] Care Quality Commission, (2015), 'Market Oversight of 'difficult to replace' providers of adult social care', Guidance for Providers, March.
[42] Hudson, Bob, (2015), 'Dealing with market failure: A new dilemma in UK health and social care policy?', Critical Social Policy, vol. 35 no. 2 pp.281-292.

A fundamental lack of transparency and accountability is also built into those chains which combine a multiplicity of operating subsidiaries and holding companies in one group so that it is difficult even for accounting experts to understand intra group transactions. As we shall see in section 3 of this report, this is certainly the case in the Four Seasons chain under the ownership of Terra Firma. Meanwhile, attention is diverted from the accounts of individual chains by reinforcing the claims for more funding with 'fair price' calculations which are arrived at by adding up the costs of business for an ideal type firm. As we shall see in section 2 of this report, such calculations are not so much a measure of costs as the trade's bid for generous returns.

Meanwhile, the trade itself has been on a charm offensive as leading chain owners and home operators emphasise that their ethic is social responsibility and their altruistic concern is for people (not profits) as they deliver better quality care. Significantly, much of this placement has been in the *Guardian* newspaper which carries stories that read as though written by a PR firm to reassure the public sector readers of that broadsheet. In one *Guardian* article Guy Hands, the Chief Executive of Terra Firma which owns Four Seasons, claims that Four Seasons financial difficulties stem from 'mixing social responsibility with business, [when] in some ways it would have been better to focus on business. But the second you commit to buying into the industry you have to think about your social responsibility.'[43] Chai Patel, Chair of HC-1 claims similarly that 'It hasn't been about the money… This is my passion and it has always been my passion.'[44] Both assert (without evidence) that care quality is now 'in a better shape' and 'a million miles' better than in the past. The only dissent has been about personality not business practice when Polly Toynbee in an op ed *Guardian* column pointed out the cognitive dissonance at play when Guy Hands, who is a tax exile in Guernsey, complains of inadequate government funding.[45]

Apart from this, the trade strategy has been to invoke expertise, enlist independent support and enrol all stakeholders. Chai Patel and Martin Green, Chief Executive of Care England the trade body for care home providers, are often given expert status in media coverage; and this is authenticated by their established role in policy making when for example, Chai Patel, was a Commissioner on the 2014 Burstow Commission on the future of residential care. Burstow's report was published by the Demos think tank,[46] just as a more recent report endorsing the trade framing came from ResPublica, another respectable, independent think tank.[47] This last ResPublica report was co-published by Four Seasons, HC-1 and the GMB. One might expect the trade framing to be challenged by institutions like the GMB union and local authority groups like the Association of Directors of Adult Social Services (ADASS); but, in this case, they are signed up to the standard narrative about the unfair price. Both parties, of course, stand to gain from more funding: ADASS because more funding is a lubricant in any commissioning system, while the GMB hopes that more funding will make wage increases sustainable. When another stakeholder is pressing for changes that could benefit you, the easy response is to endorse the case and not scrutinise the claims.

[43] Ruddick, Graham, (2015), 'Guy Hands warns Four Seasons could be forced to sell or close care homes', *The Guardian,* 6th November.
[44] Brindle, David, (2015), 'Chai Patel: social care is 'an essential public good'', *The Guardian,* 14th October.
[45] Toynbee, Polly, (2015), 'Who will champion the need to pay for social care?', *The Guardian*, 12th November.
[46] Burstow, Paul et al (2014) *The Commission on Residential Care*, Demos.
[47] Crawford, Emily and Read, Claire (2015) *The care collapse. The imminent crisis in residential care and its impact on the NHS'*, ResPublica.

Section 2: Deconstructing the benchmark price of care

Institutionalising a 12% return

The care trade narrative claims that, after austerity cuts, local authorities are not paying enough to cover the cost of care. Government is therefore directly responsible for impending system collapse as operators will, in the next phase, fail or withdraw from the business. The apparently independent justification for this claim about an unfair price is provided by an authoritative set of cost calculations which attempt to set a benchmark for the fair price of care. So far these calculations have been accepted, rather than deconstructed and scrutinised as they are in this section. Our analysis shows that the calculations are favourable to the chains because the fair price institutionalises a 12% return on capital which is both unjustified and unjustifiable.

The first calculation of a 'fair price of care' was commissioned in 2002 by the Joseph Rowntree Foundation (JRF) and has since been developed by the health consultants LaingBuisson. The aim was to construct a management accounting model of the costs of care for an ideal type residential care firm and then formulate a fair price which reflected those costs plus an acceptable profit margin. The model and calculation were updated in 2004 and 2008 under the auspices of JRF and then, from 2012, annually revised by LaingBuisson independently of JRF. Over time, this has become *the* authoritative source on the costs of residential and nursing care. It provides the basis for the current claims that, on average, Local Authorities pay £104 less than the true cost of care in residential and £152 in nursing a week.[48]

In media coverage of the current care crisis these claims derived from 'fair price' calculations have been reported as facts.[49] More broadly, the fair price calculations have been institutionalised in ways which close off debate about the actual costs of care. The fair price model has in the past five years figured in legal cases, in which providers have successfully sued Local Authorities over allegedly inadequate fee payments. In a number of judgements, beginning with Sefton Providers vs Sefton County Council (2011), the courts have consistently supported operator plaintiffs against local authority defendants who have been forced to reconsider the price freezes or below inflation rises they had imposed. In the Sefton case, Judge Raynor then ruled:

> *Laing and Buisson are the UK market leaders in the provision of information and marketing intelligence on the independent Health and Community Care sectors. They have developed a costing model entitled 'Fair Price for Care' with the object of enabling a fair price to be calculated, taking account of the actual cost of the provision of care…. Whilst there is no suggestion that the Defendant (Sefton Council) was in any way obliged to follow the Laing and Buisson Guidelines (and indeed the guidelines applicable to the Wirral were not in existence at the time of the decision in December 2010), those Guidelines (both local and national) suggest that the fees being paid by the Defendant may not provide adequately for the actual costs of care (2011).*[50]

[48] LaingBuisson, (2015 D), 'County Care Markets: Market Sustainability & the Care Act', County Councils Network, July, pg.12.
[49] See for example Hands, Guy, (2015), 'Care homes are struggling – Osborne must act to protect the vulnerable', The Guardian, 10th November and Brindle, David, (2015).
[50] Judge Raynor QC, (2011), 'Judgement in the case of The Sefton Care Association, Melton Health Care Limited, Westcliffe Manor Nursing Home, Benridge Care Homes Limited, Craignare Care Home v Sefton Council', EWHC 2676, Manchester, 9th November.

In this section we deconstruct the *fair price of care* model, focusing particularly on how it calculates returns for operators and those who provide capital. The concept of return on capital is ambiguous because it means different things to various actors like business purchasers or care providers who can use the same word but have very different measures of what a reasonable and necessary profit is. Moreover, if the rate depends on adjustments for risk, the nature of the market and the risk needs to be examined rather than assumed. The complexities here are such that we doubt whether one fair price for care can be determined by technocratic calculation; instead, the complexities need to be laid out so that we can have a political discussion about how we organise care and what level of returns to capital and labour are both reasonable and necessary for different kinds of operators. At present, unjustifiably high returns to capital are hidden within the fair price model and accepted without scrutiny or debate.

Return on capital as purchaser's expectation

Let us begin by distinguishing three separate measures of return on capital (ROC) which are likely to give different readings of reasonable return: ROC can be the normal expectation of returns for business purchasers; or the actual cost of start-up borrowing given lenders' preferences; or the theoretically necessary rate which covers risk.

- Return on capital can be taken to be the normal expectation of returns for purchasers who wish to buy into an established business: and this would ordinarily be calculated by finding the price that purchasers are prepared to pay for a business as a multiple of earnings and then working back to the percentage return required to cover that cost. What price will the purchaser of a care home pay?
- Return on capital can also be calculated as the lender's rate which sets the cost of start-up borrowing to build a business (in this case to buy land and build a home); this would ordinarily be calculated as the relevant market cost of borrowing which is in effect an opportunity cost measure of a lender's preferences; and it will be complicated by the identity of the lender because various private and public lenders are likely to charge different rates. What rate could a start-up borrow at?
- More academically, return on capital is the theoretically necessary return which is the risk free return on capital (usually proxied as the rate of interest on US Treasury bonds or British gilts plus an adjustment for risk). If risk is priced accurately, the necessary return should ensure efficient capital allocation; but, of course, risk can be mispriced and markets are often characterised by monopoly or monopsony. What kind of adjustment for risk should be factored in?

The problem with the LaingBuisson calculations is that they choose one measure (purchaser expectations) which gives a high required rate of return without considering the limitations of this chosen measure; at the same time, they conjure away complexities about the nature of risk in a market where the state has monopsonistic purchasing power and ultimate responsibility for the service.

For LaingBuisson, 'care home development and operation is viewed by the business community as a moderately risky activity' and a reasonable 'whole business' rate of ROC is necessary to attract new investment in care home capacity, incentivise existing providers to continue in business and upgrade their physical assets where appropriate and to encourage providers to make services accessible to

publicly as well as privately funded residents.[51] LaingBuisson argue that market behaviour is the best indicator of what the benchmark for a reasonable 'whole business' ROC should be. They therefore conducted a 'telephone survey of major business transfer agents and property funds active in the care home sector' which sought to gauge 'recent experience on care home sale prices as a multiple of operating profits and on current yields expected by property investors for leasing turnkey care home assets to operators.'[52] Based on surveying major business transfer agents and property funds they argue in their 2015 report that:

> *The consensus (surprisingly, unchanged since 2008) is that good quality, modern care homes sell at a multiple of about 8 to 8.5 times sustainable operating profits National Benchmarks at the home level (i.e. EBITDARM). A 'profit purchase' multiple of 8.0 to 8.5 implies in turn that purchasers are willing to invest in good-quality care homes in the expectation of a gross 'whole business' ROC of 12% per annum (that is, the reciprocal of 8.0 to 8.5). Thus 12% comes as close as possible to an objective, market related norm for expected ROC at the individual home level.*[53]

LaingBuisson's 12% is therefore a purchaser expectation of return and their claim is that this is 'as close as possible to an objective, market related norm for expected ROC at the individual home level.'[54] We would not dispute that claim because a 12% expectation of ROC has been normalised across the sector: for example, the Knight Frank market overview of health care property in spring 2015 reported gently increasing purchase multiples so that prime care homes were selling at purchase multiples of 9-10 and less desirable property at 7.5 to 8.5[55] But, if this expectation is factored into a fair price calculation, the implication is that a substantial part of the total cost and fair price per bed is accounted for by relatively expensive capital. In the case of a nursing care bed charged at £776 per week[56] some £277 is accounted for by cost of capital for land and building (36% of the total cost). If the cost of capital were substantially less than 12%, the fair price would be substantially lower, or wages (as the other major cost) could be substantially higher.

The purchaser expectation measure has inherent limitations because it basically reports what fund backed corporate purchasers will pay for larger homes: 8-9 times earnings is what a private equity backed chain is prepared to pay to buy the kind of 60 -70 bed homes which they can operate profitably. The multiple of course tells us as much about the overhang of un-invested private equity funds and the trend of asset prices as about the characteristics of the businesses bought. In the later stages of each credit cycle, private equity funds typically compete amongst themselves and drive up the earnings multiple paid and lever up their deals: in autumn 2015, for example, Standard and Poor's warned that the excesses last seen in 2007 were happening all over again in private equity.[57] And in the latest 2016 revision of the Laing Buisson calculation, the target return has been revised downwards by one per cent to 11 per cent because purchasers are now buying at a higher multiple. Corporate chain purchasers will compete for larger purpose built homes (and have no interest in small homes) because they pay separately in cash on an ongoing basis for management services and ownership claims. Each of a chain's homes has to pay a manager who earns around £30-35,000 and has to service debt capital typically

[51] LaingBuisson, (2015 A), 'Fair Price for Care: Calculating a fair price for nursing and residential care for older people and people with dementia October 2014 – September 2015', Sixth Edition, pg. 36.
[52] LaingBuisson, (2015), pg. 14.
[53] LaingBuisson, (2015), pp. 36-37.
[54] LaingBuisson, (2015), pg. 37.
[55] Knight Frank, (2015 B), 'Market Overview UK Healthcare Property', pg. 5.
[56] Provincial and excludes London.
[57] Platt, Eric, (2015), 'Growth in leveraged deals prompts credit risk warning', The *Financial Times*, 4th November.

requiring regular interest payments; smaller homes with less than 50 beds simply cannot generate a large enough lump of cash to cover both costs.

But, the majority of care homes in the UK – more than two thirds –are typically smaller, older homes run by mom and pop firms. LaingBuisson have checked that their physical staff hours input is like that in larger homes[58] but do not recognise that mom and pop firms make very different calculations which are more like those of owner occupier farming families and other kinds of small businesses which cannot afford to pay for a professional manager and take a return for capital from the limited lump of earnings which a small firm can generate. In the small care home, the family as owner/manager provides management and all kinds of labour before each year taking out what they can as income, after first paying down the loan on the property. The loan or mortgage buys the property, an appreciating asset which is the retirement fund or stake in the next business when the family cashes out. For the mom and pops, long run appreciation of house prices is more important than year by year return on capital; and that appreciation on large, old houses (often subsequently converted into flats) has of course nothing to do with margins in care home operation.

LaingBuisson present their measure of ROC as though it is something neutral which was discovered 'out there' by phone survey; in fact, it is a construction which is the result of a specific set of interests, values and assumptions. The characteristics of the provider have been abstracted out of the return on capital calculations; but if these characteristics are added in we see that they reflect the business model and practices of the financialised chain which are irrelevant to many smaller operators. At the very least, this implies there should be two different fair prices for large and small operators.

Return on capital as cost of borrowing and risk premium

Matters are further complicated if we shift from purchaser expectations of return measures to actual costs of borrowing to build a business. Since the 2008 financial crisis, there has been a substantial fall in the actual costs of all kinds of borrowing: the Bank of England has maintained the base rate at 0.5% since 2009. Private equity sources told us in autumn 2015 that US pension funds are currently willing to lend to finance the building of care homes (for others to operate) at rates of around 8%; which is plausible because the higher grade bonds used to finance business purchase by private equity currently yield about 8%. It is also true that the public sector could borrow much more cheaply and further substantial savings in capital cost could be made if, for example, local authorities borrowed to build homes which were leased to private operators. UK local authorities, for example, can borrow at 4% for 50 years from the Public Works Loans Board.

If this is the case why should the fair price offer providers a return of 12%? The LaingBuisson calculation indirectly admits that the cost of borrowing to build is much lower than 12%; because the 12% return is decomposed into an imputed rent of 5-6%, an imputed central management cost of 1.5% and the balance of 3.5% or more as operator's profit. So a substantial part of the return is some kind of pure profit, a reward for the operator after all costs have been charged. This kind of operating reward (with no investment) is achieved in many capital light outsourcing service activities.[59] But 5% or more after covering cost of fixed capital would never be seen in competitive markets except those which were highly risky because of severe cyclicality, rapid technical change etc. None of these considerations apply in care homes. Intellectually, any argument about risk premia then raises all kinds of issues about the

[58] LaingBuisson (2015), Fair Price for Care Explanatory Guide, pp 8-9
[59] Bowman et al, (2015), pp. 40-58.

nature of private and social risk and what kinds of compensation for risk are sensible for private operators when operating both in a free market and, in the rather different case of residential care, where the state has substantial monopsonistic purchasing power. Let us develop these arguments.

Weakness on the revenue line and pressure on margins is an ordinary vicissitude for private firms which provide goods and services on the open market. In this case no form of compensation or restoration can be claimed, and the problem of reduced earning prospects is recognised as impairment of the firm's assets. This is properly dealt with by writing down the value of the firm's capital which (under current accounting regulations) involves taking a once and for all hit in the profit and loss account. Thus, the entrance of two hard discounters (Aldi and Lidl) means that Sainsbury and Tesco are likely to earn something like 2% return on sales going forward not their customary 4% return on sales[60]; and both supermarket chains have responded by writing down the value of their land and buildings which no longer have the expected future earning power that they once did. In the rather different case of care, if the state provides half the sector's revenues and is the source of the revenue squeeze, the care chains could appeal to have their margins restored; but it is hard to see why the state should respond positively if the request was for a 'fair price' that included a margin of 12% which covers the original purchase price and includes a hefty pure profit.

The trade narrative or the supporting fair price calculation are both ways of appealing for the restoration of margins. But that raises questions because it underscores the difference between economic and political risk in the two cases of care and supermarkets. Lower returns in supermarkets are a materialisation of market risk (arising from new entrants prepared to accept lower profit margins), whereas lower returns in adult care are a materialisation of political risk (arising from local authorities being squeezed by Treasury imposed austerity cuts). From the existing firms' point of view, market risk through new entrants is clearly exogenous because it is beyond the control of the individual firm. But the trade narrative and the fair price calculation are an attempt to turn political risk into an endogenous variable: from the existing firms' point of view, narrative and fair price calculation is an investment in framing the problem so as to influence public and policy makers. The working assumption is that, if the care trade makes enough fuss, the state will give them more. For that reason, we should regard 12% as a political target not an economic calculation.

In the provision of foundational goods and services, including adult care, there is also the more fundamental question about how private operators incur a different kind of (purely financial) risk from the state which cannot avoid final responsibility for maintenance of service; and that discussion takes us towards an argument about whether and when the state should seek compensation or at least guarantees from financialised operators. Foundational services (like adult care, or energy and water supply) represent a special case because continuity of supply and maintenance of an essential service is always ultimately guaranteed by the state. This is quite explicit in the case of care, where the Care Act 2014 gives Local Authorities 'a temporary duty to ensure that the needs of people continue to be met if their care provider becomes unable to carry on providing care because of business failure, no matter what type of care they are receiving. Thus local authorities have a responsibility towards all people receiving care.'[61] If care homes do fail, it is not the private trade association but the state as provider of last resort which will (one way or another) ensure that frail or confused residents are not left on the street. The private sector bears the rather different, purely financial risk of losing its money, a risk

[60] A return on sales (or profit margin) is calculated as the profit divided by the sales revenue, expressed as a percentage. It indicates how much profit result from sales revenue.
[61] Department of Health, (2014), 'FACTSHEET 10 The Care Act – market oversight and provider failure'.

which can be addressed by financial engineering to limit downside risk to the equity owners of the business. Insofar as financialised practices (like high gearing, prop co/ op co splits and arbitrary extractions) make operating businesses more fragile, it is surely the private sector that should be compensating the state for increased risk of failure requiring state intervention.

Under the present system, there are few incentives which motivate private owners to minimise the risk of chain failure. The private equity owners of a failed care home have a straightforward 'stop loss' option of exit if they have through dividends and other transfers already recovered all or most of their equity stake; the reputational damage will then be negligible if they have successfully employed trade narrative to shift responsibility onto the *unfair price*. As for the bondholders and lenders, the tranches most at risk in default will have from the beginning obtained higher returns on account of this risk; and many of the original bondholders will have exited as hedge funds buy in at a discount because they see opportunity. After all, if a private equity owned business fails, the bond holders will usually take hold of the operating business and the assets; without of course any responsibility to carry on operating all the branches of a chain business. Altogether, this looks like moral hazard through financial engineering, because those who create the internal conditions of fragility and crisis are not those who have to pay for it.

Exhibit 2: Calculating the savings from a reduction in the 12% return on capital employed[62] (2012 prices)[63]

	Per resident per week (PRPW) @ 12% ROCE		Per resident per week (PRPW) @ 8% ROCE		Per resident per week (PRPW) @ 5% ROCE	
	£	%	£	%	£	%
Staff costs	251	45.6%	251	50.9%	251	55.7%
Repairs and Maintenance	34	6.2%	34	6.9%	34	7.5%
Other (home) non-staff costs	95	17.3%	95	19.3%	95	21.1%
Capital costs (12% return)	170	30.9%	113	23.0%	71	15.7%
Bed price	550	100.0%	493	100.0%	451	100.0%
No. of beds	50		50		50	
REDUCTION IN PRICE PER BED PER WEEK	**£0**	**0%**	**-£57**	**-10.3%**	**-£99**	**-18.0%**

If the 12% target return on capital in the fair price model is not justified, then this has dramatic implications for the argument that local authorities are not paying enough. Because capital is a major cost item and the fair price that the model generates varies dramatically according to the imputed cost of capital. We demonstrate this below with a table that compares the cost of capital at 12% which meets purchaser expectations, with cost of capital at 8% and 5% which represent the actual cost of

[62] Source: 'Bridging the gap', BUPA, 2012 www.bupa.com/media/479673/bridging_the_gap_final.pdf

[63] Note: Illustrative calculation based on 2012 data as presented in BUPA publication. The 2012 price was then calculated as a 'ceiling fair price' for good quality accommodation. Data refers to provincial LA's not London and the methodology is from LaingBuisson.

private and public borrowing. As exhibit 2 shows, the fair price drops by £57 and £99 per resident per week at 8% and 5% ROC respectively. Thus the model shows an ideal 50 bed type home where lower price or higher wages or some combination of the two could be afforded if the cost of capital is lower.

More alarmingly, as we will see in the next section, 12% is not simply the trade's political demand but a built-in requirement for some firms like Four Seasons. In the next section we will show how the largest provider of residential care in the UK has financially engineered a business which requires 12% return on capital before any profit can be declared.

Section 3: Four Seasons as Poster Boy

Media stories give us the agreed facts about the current position of Four Seasons, which is the biggest UK residential care home chain with more than 400 homes of various kinds and has been owned since 2012 by Terra Firma private equity. By late 2015, Four Seasons was in some financial difficulty, with the chain disputing Standard and Poor's claim that it could run out of money in early 2016 and hedge funds buying into its debt in anticipation of trouble; the group was down-rated by Moody's in January 2015.[64] The media have reported problems about growing operating losses which were running at £100 million a year by late 2015. Four Seasons' third quarter pre-tax losses in 2015 had risen year on year by 57% to £25.5 million on turnover, down nearly 3.8% year on year to £172.5 million.[65] These *Guardian* and *Financial Times* stories also scrupulously note that Four Seasons services £525 million of external debt and has to pay a £52 million interest charge before profit is found, because Terra Firma financed most of its 2012 purchase by issuing bonds. But the media do not challenge the claims of Four Seasons management that an unfair price is the main driver of 'existential crisis' in the sector or that the chain operates in a market which is 'extremely challenging for all independent care providers who look after council funded residents.'[66]

Four Seasons has thus become the poster boy for a crisis in residential care caused by an unfair price; and if the chain were to collapse, that would surely prove the point of the trade narrative. Four Seasons can serve as poster boy but for a crisis which is altogether more complex in its causes and symptoms. To begin with, there is a back story of debt based financial engineering in the decade before 2012 as successive private equity purchasers of Four Seasons 'loaded the donkey' with debts to the point of unsustainability. There are then a series of questions about the business practices of Terra Firma on group organisation and debt, as well as about the quality of operating management and labour practices. Terra Firma has constructed a complex network of related companies and intra group transactions which are tax efficient for the owners and opaque to outsiders including tax payers who are being asked to put more money in. Since 2012, the burden of external debt has been reduced but there are substantial intra group debts and exceptional charges which confuse discussion of profitability and raise the question of whether the owner is positioning for exit. Beyond this, there are questions about operating management which is dealing with ongoing problems about care home embargoes by hiring expensive agency staff and has (at the very least) promised more than it has delivered to regular staff. If anything, Four Seasons is a poster boy for opacity and the kind of financial and operating mess which is the legacy of debt based financial engineering in a foundational activity like adult care.

Pass the parcel: from profitable exit to write down 1999-2012

Private equity built up the Four Seasons chain to 400 homes over a dozen years and through four changes of ownership, from the founder selling out in 1999 to the most recent change, which was Terra Firma's purchase of the chain in 2012. In between those dates, the sale of the chain made handsome profits in 2004 for Alchemy and in 2006 for Allianz Capital Partners. But, in each case, the private equity profit came from the willingness of the next purchaser to issue more debt so that, by 2008, 400 homes

[64] See Pooler, Michael, (2015), 'Four Seasons insists it can make £26m interest payment', *The Financial Times*, 25th October and Bow, Michael, (2015), 'Care home sector in 'meltdown' with UK's largest provider threatened by US vulture fund', *The Independent*, 6th November.
[65] Frost, David, (2015), 'Losses Widen at Four Seasons Healthcare', Insider Media Limited, 23rd November.
[66] Plimmer, Gill, (2015), 'Four Seasons losses widen as costs rise', *The Financial Times*, 23rd November.

with 20,000 beds were servicing a debt mountain of £1.5 billion. On reasonable assumptions about the rate of interest across 12 tranches of debt, the interest charge on £1.5 billion was more than £100 million per annum on the whole chain and the external debt had a claim of £100 per week on the revenue from each bed. This interest burden of around 20% of income appears unsustainable. [67] Thus, when creditors took control of the chain, in a protracted and untidy process (with creditors in control), debt was written down so that less than £800 million was outstanding when Terra Firma bought Four Seasons in 2012, and it issued just over £500 million of new external debt.

The pass the parcel story begins as one of profit taking in the credit fuelled financial markets before the crisis of 2008: after seven years, the first private equity firm Alchemy in 2004 realised an exit profit of £250 million or more, which was three or four times its original stake. Alchemy founder Jon Moulton described it as 'our best deal'[68]; the next private equity owner Allianz Capital Partners in 2006 took another, larger profit by selling on after two years.

Four Seasons was originally founded in 1987 by the serial entrepreneur Robert Kilgour, who built a chain in Scotland before in 1999 selling on to Alchemy Partners who bought Four Seasons and another chain CrestaCare for a consideration of £133 million, with £44.5 million in cash from Alchemy.[69] The merged operations retained the name Four Seasons[70] and provided 5,300 beds at 100 nursing, residential and specialist care homes throughout Scotland, England and Northern Ireland.[71] In 2002 Alchemy bulked up the chain by buying Omega Worldwide, which operated 127 care homes in the UK, and Principal Healthcare Finance, which owned 231 care homes in the UK many of which were operated by Idun.[72] The purchase cost £313 million but again Alchemy funded most of that by selling external debt and put up just £25 million in cash. Alchemy exited in 2004 by selling Four Seasons for £775 million to Allianz Capital Partners who bought a chain with 400 care homes and more than 18,000 beds;[73] Allianz added more by buying Bettercare Ltd from 3i for £116 million, which added 26 homes and nearly 2,000 beds to the chain. Within two years of initial purchase, in 2006, Allianz sold a slightly larger Four Seasons chain which then operated 19,800 beds in 416 homes and facilities[74] for £1.4 billion to another private equity firm, Three Delta. The purchase price was then nearly twice the price which Allianz had paid two years previously.

As the conjuncture changed after 2008, the pass the parcel story continues as one of write downs of excessive debt as creditors take over the company and squabble noisily about different claims, while inexorably the external debt is one way or another written down towards more sustainable levels. When the credit markets froze in autumn 2008, Three Delta was holding the parcel after paying a fancy multiple of earnings on a highly leveraged deal where it provided £280 million in equity with debt financing the other £1.12 billion of the total purchase cost. The 400 or so homes which had been servicing some £500 million or thereabouts of debt under Allianz in 2004-5 were burdened with close to

[67] In 2008 LaingBuisson listed for 'frail elderly' non-nursing care a ceiling price of £538 and a floor price of £463 outside London and £648 and £574 for London based homes.
http://www.communitycare.co.uk/2008/09/22/calculating-a-fair-price-for-care/
[68] Real Estate Capital, (2012), 'Terra Firma deal spells end to storms for Four Seasons', Brookland Partners, May.
[69] Griffiths, Katherine, (2004), 'Care homes net Alchemy Â£200m', *The Independent,* 5th July.
[70] Real Estate Capital, (2012), pg9.
[71] Dow Investments Ltd, (2004), 'Alchemy's rivals bid for Four Seasons', 15th January.
[72] Care Info, (2004), 'Four Seasons in bid for Omega-Principal', 1st July.
[73] Care Info, (2004), 'Four Seasons is now the biggest operator', 1st September.
[74] Insurance Journal, (2006), 'Allianz Sells Four Season Healthcare for $2.67 Billion', 1st September.

£1.5 billion of debt by September 2008 when Three Delta's creditors agreed to a debt standstill so that talks could be held on restructuring.

The immediate problem was the need for short term refinancing of debt in autumn 2008, just when the credit markets froze. In line with standard practice, Credit Suisse had funded the purchase with £1.2 billion of bank bridging finance expiring in September 2008, but only half of that had been recovered by securitisation before the credit crunch.[75] Four Seasons was left trying to refinance an unsustainable debt in a market with no appetite for risks. Discussions were complicated due to the involvement of about 30 lenders and the way the debt was structured; these lasted 15 months until December 2009, when around half of the (unsecuritised) debt was swapped for equity, leaving Four Seasons with £723 million of senior loans outstanding. Three Delta lost its equity stake, bank creditors took equity ownership of Four Seasons and Four Seasons' £1.5 billion debt was halved: Royal Bank of Scotland, which had been effectively nationalised a year earlier, became the single largest shareholder with 38% of shares in return for writing off about £300 million of debt claims. However, in 2010, Four Seasons was forced back into talks with bondholders of the outstanding £600 million of debt which had been securitised by Credit Suisse in 2008. Hedge funds specialising in distressed debt had bought up Four Seasons debt at a discounted rate in 2008 and were now insisting on repayment after refinancing.[76] But this kind of restructuring was delayed to 2012 by a majority vote and collapse was narrowly avoided again. In February 2012, the Chief Executive of Four Seasons, Pete Calveley, was reported in the *Financial Times* saying that the (securitised) 'debt of £780m, which falls due in September, is still too much to refinance in the current weak debt market.'[77]

Four Seasons did not let the crisis go to waste because it took advantage of new opportunities for acquisition. In 2011, Southern Cross, the largest care home operator in the country, collapsed as described in section 2, and Four Seasons took over 140 of its homes, becoming the largest operator in the country. In the same year Four Seasons bought the operating company Care Principles, while the previous owner Barclays Capital kept the properties, for an undisclosed sum. Care Principles ran some 430 beds in 16 medium and low secure hospitals, community hospitals and care homes. But the future of the bulked up chain was uncertain and another round of debt restructuring was avoided when Terra Firma bought Four Seasons in April 2012 for £825 million. At this point it was reported Four Seasons operated 445 care homes, with 22,364 beds, and 61 specialist care centres, with 1,601 beds.[78] Terra Firma invested £300 million of its own capital as equity and took out two tranches of debt to the value of £525 million. This reduced external debt because £780 of old debt was repaid and £525 million of new debt was issued by Terra Firma. This is the source of Guy Hands' claim that 'by investing new equity, Four Seasons' debt has been substantially reduced and Terra Firma has brought stability to the company'.[79] The broader implication was that a lesson had been learnt about financial sustainability and Four Seasons would never again be embarrassed by an unsustainable debt burden and interest payments of £100 million which a chain of 400 homes could not service.

[75] Real Estate Capital, (2012), pg9.
[76] Scarr, Barry and Johnston, Paul, (2011), 'Four Seasons Care Homes Viability Analysis', Impact Change Solutions, August, pg6.
[77] Mundy, Simon, (2012), 'Four Seasons races to refinance £780m in debt', *The Financial Times*, 8th February.
[78] Thompson, Jennifer, (2012), 'Terra Firma to buy Four Seasons for £825m', *The Financial Times,* April 30th.
[79] Real Estate Capital, (2012), pg9.

Internal organisation under Four Seasons

As we have already noted, the media report that Four Seasons is making substantial and increasing operating losses (in a profit and loss account where profit is only found after paying some £52 million of interest on the £525 million of debt held by external bond holders). But all have accepted Terra Firma's claim in its 2013 Annual Report that newly responsible private equity owners have 'put in place a secure capital structure, de-risking the business and lowering the cost of capital'.[80] The 2012 deal which established this structure was greeted in one headline as 'an end to storms for Four Seasons'[81] and, if the company is struggling now, the implication is that the state is not putting enough money in. As we shall argue, there are just as many issues about where and how the money is going under Terra Firma and also questions about operating management in the struggling Four Seasons chain.

This section makes the point that it is very hard to see where the money goes because the Four Seasons group is internally organised as a labyrinthine group of companies based partly in Guernsey and other tax haven jurisdictions, with intra group transactions that are hard to understand. The media report Four Seasons as though it had a simple, unitary existence as a British care home operator which owns around half its property and is majority debt financed, so that it has external (partly international) linkages to bond holders and various funds and banks who own homes. This glosses over the complication that Four Seasons has a dispersed existence as a network of 185 companies in many jurisdictions. While this opaque structure has advantages for Terra Firma, most obviously in reducing tax liabilities, this internal organisation is manifestly not in the public interest specifically because public revenues account for a substantial proportion of group revenues and generally because such complex structures represent an arbitrage of limited liability which is a socially granted privilege.[82]

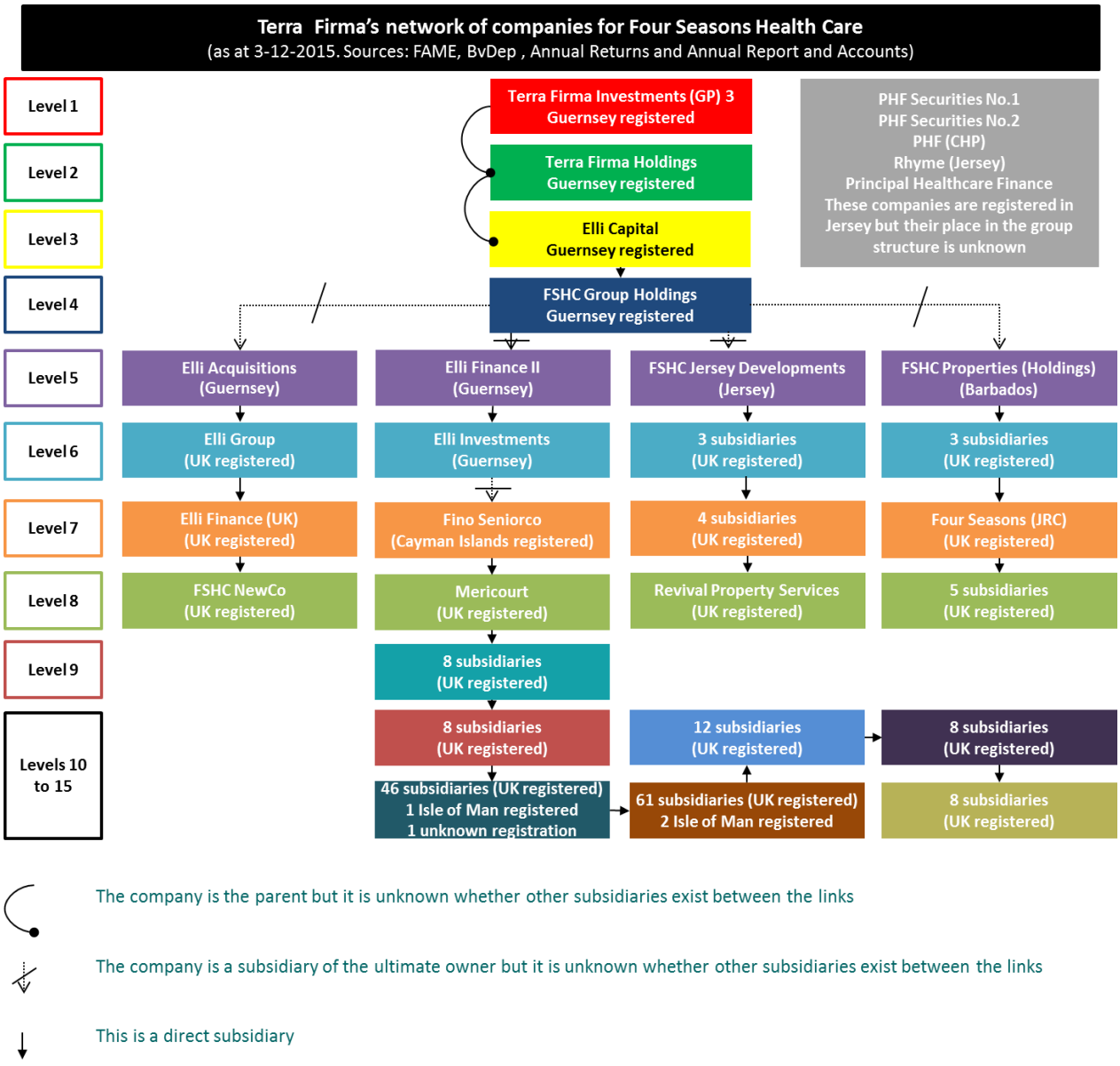
Terra Firma reports that the operations of Four Seasons Healthcare Group operations have been divided so as to create three divisional subsidiaries with different core businesses: the largest, Four Seasons, provides state funded care, increasingly of dementia; Brighterkind caters for privately funded care home residents; and Huntercombe provides NHS funded specialist acute care and rehabilitation. The subsidiaries have been designed to operate as autonomous units because Terra Firma has recruited separate management teams for each of three businesses which it claims will 'allow the teams to focus on the needs of their individual customer groups and develop the appropriate offering.'[83] The explicit operating rationale is thus to focus on significant growth sectors[84] and (we might add) to focus on more profitable sectors because providers are paid more for residents with dementia: Four Seasons aims to expand its award winning PEARL dementia programme to 150 of its homes by the end of 2017.

But the compartmentalisation has a second financial rationale insofar as it puts the main (predominantly public funded) care home business on a more stand-alone basis in ways which also inhibit or at least make more visible internal cross subsidy from (private fee paying) residents who pay more per week than councils do. There is an ongoing argument about the injustice of private fee paying residents paying more and the care trade always argues that such cross subsidy is wrong.[85] But that is a very peculiar position to take when other businesses like hotels or airlines routinely cross subsidise and

[80] Terra Firma, (2013), 'Terra Firma Transforming Businesses Delivering Value Annual Review 2013', pg80.
[81] Real Estate Capital, (2012), pg9.
[82] Bowman et al, (2015), *What a Waste: Outsourcing and How it Goes Wrong*, pp.77-93.
[83] Terra Firma, (2013), pg8.
[84] Terra Firma, (2013), pg15.
[85] http://www.telegraph.co.uk/news/health/elder/11815119/Middle-class-care-home-residents-charged-unfair-50pc-subsidy-to-prop-up-teetering-system.html

never sell adjacent rooms or seats at the one fixed price. Cross subsidy is the logic of the standard marketing practice of yield management through variable rates to increase occupancy and revenue contribution. Corporate customers who bring volume business (as local authorities do) would of course ordinarily expect preferential rates and discounts for block bookings or guaranteed occupancy. Meanwhile, compartmentalisation makes it much easier to argue with local authorities about the price paid or to restructure the portfolio by closing 'unprofitable' homes and selling the property: in 2015 Terra Firma announced it was planning to close 19 homes in the Four Seasons portfolio. Compartmentalisation also opens up options for Terra Firma in the event of selling on or liquidation, because the different operating units can go off in different directions.

Exhibit 3: Terra Firma's[86] network of companies for Four Seasons Health care[87]



[86] The subsidiary accounts reveal that the "ultimate controlling party is Guy Hands", Four Seasons Group Holdings 2014 annual report and accounts, note 26, p.60.

[87] The sources used are FAME, BvDep, Annual Returns to UK Companies House and Annual Report and Accounts. The FAME data was collected on 3rd December 2015 and Annual Returns relate to 2015.

The further complication is that Four Seasons does not consist of one holding company with three operating subsidiaries. On closer, 'who owns what' inspection, as of December 2015, Four Seasons is a complex group of more than 185 companies in fifteen tiers, registered in multiple jurisdictions including the UK and many tax havens.

Everything is chained upwards to Guernsey so that control comes downward and cash moves upwards; assets and liabilities are hard to track because of the complexity of intra group transactions. The corporate structure is not fixed over time and has changed considerably in the last five years, making it very difficult to make sense of changes (in for example, the asset base or rents charged) before and after the Tera Firma purchase in 2012. A UK based chain of largely publicly funded care homes apparently needs as many operating subsidiaries as a giant car company selling volume product in 20 European markets. Moreover Terra Firma shows more judgement than many multinationals in its choice of low tax jurisdictions like the Cayman Islands. Such jurisdictions are unlikely to challenge artificial arrangements of profit shifting through transfer pricing, as the EU did in the case of the Fiat and Starbucks tax avoidance deals with the Luxembourg and Netherlands authorities.[88]

There is no operating rationale for this complex group structure whose primary purpose appears to be tax avoidance; and that observation raises public interest questions about whether this should be accepted as the way of the world when so much of the group's revenues are provided by local authorities out of tax revenues. The tax payer has a legitimate interest in ensuring that corporations pay their share of taxes, especially if they draw public revenues and pay wages which require social subvention, (as well as generally benefitting from social overhead expenditures on everything from roads to schools). The logic of this is that care home groups and other outsourcers who depend on public revenue should be obliged to simplify their structures and register in the UK. The secondary effect of the complex group structure is opacity because it becomes exceedingly difficult to follow the money and see where revenue goes when it moves round a complex (part secret) network with multiple internal and external connections and moving parts. Profits and cash, assets and liabilities can be shifted around inside the group so that it is very difficult to justify or challenge any figure of profitability or unprofitability at a point; equally it is impossible to make a judgement about sustainability because of limited public disclosure of many items of information (like the conditions about rent increase and the lease arrangements).

All we can do is consider what can be pieced together from the publicly available accounts of companies at key nodes in the structure, like the holding company Elli Investments which is analysed in the paragraphs below. This analysis raises many questions about intra group accounting and financing decisions: the recent losses in Four Seasons are not operating losses because more than half the total apparent loss in 2014 is the result of exceptional costs arising from property write downs and the burden of internal debt which casts in doubt the claims about responsible recapitalization to lower the debt burden.[89] The write down and the internal debt interest are not cash charges but represent a rearrangement of claims on the business; and the claims for accumulated 'related party' interest are there because they may in due course benefit Tera Firma in the event of sale or liquidation of the group. In sum, conjunctural changes since 2008 has altered the private equity game from load the

[88] European Commission, (2015), 'Commission decides selective tax advantages for Fiat in Luxembourg and Starbucks in the Netherlands are illegal under EU state aid rules', Brussels, 21st October.

[89] Many of the companies within the Four Seasons network accounting year end falls on 31st December and there is often a time lag before the accounts are filed at Companies House. If the accounts filing follows previous patterns then the next set of annual reports will become available in September 2016.

donkey, but Terra Firma continues to use all kinds of financial engineering which add layers of opacity and complexity so that what was still a cash generative business in 2013 and 2014 (the two years for which we have Terra Firma accounts) becomes a loss making care home chain. We could settle the issue of whether the whole network of companies are cash generative if Terra Firma Holdings provided a whole group cash flow statement. But that is not required by the CQC nor provided by Terra Firma. Elli Investments is a Guernsey registered holding company (at level 6 in our diagram) which consolidates the results from the Four Seasons operating subsidiaries which it controls. The annual report and accounts show that in 2014 Elli Investments had £709 million of turnover more or less entirely in 'care homes and specialized services' with just over 23,000 beds, nearly 30,000 staff and £790 million of assets. On this basis, given what we know about the size of the chain, price of care and staffing levels, Elli Investments must include operating results from almost all of the homes in the Four Seasons chain. But, equally, a large part of the (property) assets are held elsewhere, either inside or outside the company because this kind of property based capital intensive business needs more than one pound of assets to generate one pound of turnover each year. This is a complication but not a road block if we wish to carry out a simple analysis which outlines the operating position of the Four Seasons chain before considering how it is complicated by the accounting and financing decisions of Terra Firma.

To begin with, let us consider the operating position of Four Seasons using the EBITDA (earnings before interest, tax, depreciation and amortisation) metric. This is a metric of the business' ability to generate cash surplus over operating expenses and it serves as a benchmark because it strips out the effect of financing and accounting decisions and the external tax regime; for these reasons, EBITDA is routinely used by financialised purchasers in deciding whether to buy homes and how much to pay. To make the results more intelligible to non-accountants, we have presented the results for the two available years since Terra Firma's purchase of the chain and expressed the results as aggregates and as EBITDA per bed (in exhibit 4) (with a cross tabulation to occupancy rates to show they are within the normal 85-90% range for a financialised chain in exhibit 5).

Exhibit 4: Elli Investments Limited -Turnover and EBITDA per bed[90]

	Turnover £m	EBITDA[91] £m	Effective beds No	Turnover per effective bed £	EBITDA per effective bed £	EBITDA margin per effective bed %
2013	710	94	23,759	29,875	3,952	13.2%
2014	713	64	23,098	30,860	2,775	9.0%

[90] Source: Annual report and accounts, Elli Investments Limited, various years. Note: Before exceptional expenses but after ordinary expenses.
[91] EBITDA refers to earnings before interest, tax, depreciation and amortisation.

Exhibit 5: Elli Investments Limited beds data[92]

	Effective beds No.	Occupied beds No.	Effective[93] beds occupied %
2013	23,759	20,629	86.8%
2014	23,098	20,069	86.9%

On an ordinary operating basis, the business is nicely cash generative with EBITDA of nearly £3,000 per bed per annum or £60 per week in 2014; margins are declining but the headroom is such that they could be further squeezed without leading to operating problems about cash burn. One measure of operating health is the fact that the business has a substantial re-sale value, using the 8 times EBITDA purchase multiple which the trade used to value chains: by this measure, in 2013 the Four Seasons chain was worth the £800 million which Terra Firma had paid in 2012; and, on lower earnings in 2015, the chain was still worth more than £500 million. What then kills profitability and produces the large losses which figure in media reports? Accountants joke that 'EBITDA is profit with the nasty bits left out' and profit is EBITDA minus various, often inescapable charges; for example, some kind of provision for depreciation is inescapable for a chain like Four Seasons. But the problem here is not depreciation because the large losses are produced by more discretionary accounting and financing decisions by Terra Firma about what should be charged against profit.

Exhibit 6 shows how three charges turned a cash generating business into one which made a loss of more than £170 million in 2014.

- The largest of the charges against profit in 2014 was a one off 'exceptional administrative cost' of £99 million; cross reference shows that this is occasioned by a write down of property values because tangible assets are valued at £882 million in 2013 and £790 million in 2014. Under current accounting regulations, when property is written down the firm must take the charge against profit in that year. But, equally, management has considerable discretion about when to revalue property and this can be done on a conservative or radical basis. This is not science but judgement about the earning power of those homes within the Group which Elli Investment owns; and those outside the group who own other Four Seasons homes may not have recognised the impairment of assets or put a different value on it.

- The second large charge is a recurrent one for interest payable on intra group lending. This is immediately a puzzle because the media repeat the assertion that Four Seasons has £52 million of interest due on £525 million of bonds but the Elli Investment accounts show interest payable of £102 million on long term debt of £852 million in 2014 and £97 million on £780 million of long term debt in the previous year. The discrepancy arises because, as well as £525 million of external debt on which interest is payable at 8.75 and 12.25%, Elli Investments has more than £300 million of internal debt on which interest is payable at 15% compounded. The financing structure of Elli Investments, as described below, is clearly the result of discretionary management decision and three points are striking about this debt. First, Terra Firma's

[92] Source: Annual report and accounts, Elli Investments Limited, various years.
[93] Effective beds refer to beds that are available to use. An example of an 'ineffective' bed is a room that is being refurbished.

acquisition of FSHG reduced external debt but the combined £836 million total of internal and external debt in 2014 is actually larger than the £782 million of external debt redeemed when Terra Firma took over. Second, the £300 million of internal debt is being charged at a punitively high rate of 15% so that the overall burden of interest charges is £100 million (external + internal) which is nearly twice as large as the much cited figure of £52 million (arising from external debt). Third, the higher rate of interest on the internal debt is set so that the overall rate of interest on external and internal debt is almost exactly 12%: in effect, LaingBuisson's recommended 12% in the fair price has become the required 12% in the Four Season's financing structure. Profit can appear only after the debt holders have cleared a 12% return on more than £800 million of debt. Readers can decide for themselves whether all this is responsible.

Exhibit 6: Elli Investments Limited –Basic data

	Turnover £000s	Ordinary Admin expenses £000s	Exceptional admin expenses £000s	Operating profit/loss £000s	Operating profit split by: **Ordinary activities** £000s	Operating profit split by: **Exceptional activities** £000s
2013	709,793	41,389	9,516	52,297	61,813	-9,516
2014	712,876	45,585	98,762	-69,111	29,651	-98,762

Exhibit 6 cont.: Elli Investments Limited –Basic data[94]

	Interest payable £000s	Interest receivable £000s	Net interest £000s	Pre-tax loss/profit £000s	Tax £000s	Retained loss £000s
2013	96,449	52	-96,397	-44,100	-694	-44,794
2014	101,969	168	-101,801	-170,912	-434	-171,346

- The third rather puzzling (and maybe discretionary) charge is for 'ordinary administrative expenses' which amounted to £41 million in 2013 and £46 million in 2014. As we do not know what exactly is being expensed where in the group, we do not know whether this charge recognises costs incurred and now being recovered or is, in part or in whole, a special dividend paid to Terra Firma. All we can say is that it is remarkable that a relatively simple operating business should incur such large overheads. The ordinary administrative charge in 2014 was 6.5% of sales revenue, or around £2,000 per bed.

[94] Source: Annual report and accounts, Elli Investments Limited, various years.

Exhibit 7: Financing structure of Four Seasons Health Group[95]

	8.75% Senior secured notes		12.25% Senior notes		Total external debt	
	Amount £m	Annual interest £m	Amount £m	Annual interest £m	Amount £m	Annual interest £m
2013	350.0	30.6	175.0	21.4	525.0	52.1
2014	350.0	30.6	175.0	21.4	525.0	52.1

Exhibit 7 cont.: Financing structure of Four Seasons Health Group[96]

	Related party debt @ 15% interest		Total debt	
	Amount £m	Annual interest £m	Amount £m	Annual interest £m
2013	270.7	40.6	795.7	92.7
2014	311.0	46.7	836.0	98.7

The case of Elli Investments shows how the rules of capitalism have been changed through the construction of opaque, complex groups of companies with financialised parents. Four Seasons is a black box and only Guy Hands and a few close associates understand what is going on. Companies like Elli Investments are neither standalone going concerns nor subsidiaries of a benevolent parent allocating capital at market rates to profitable subsidiaries and covering short term losses in downturns. The end result of intra group transactions and the charges at Elli Investments is that profit has a 'now you see it, now you don't' quality and as shown in the tables below, the accounts are a construction which can be presented in different ways depending on the message to be conveyed. The first presentation in exhibit 8 supports the Terra Firma line because the bottom line pre-tax loss is £171 million and, even before the £100 million internal debt burden kicks in, the care homes business is by 2014 making significant losses of more than £70 million. The second presentation in exhibit 9 shows that much of the problem is caused by charges. The loss is only £31 million in 2014, if £140 million of exceptional administrative charges and related party interest charges are added back; remove half or more of the ordinary administrative charge and Elli Investments is close to breakeven (even after paying £52 million of interest on external debt). Without the charges and with equity finance, the firm would be robustly profitable.

[95] Source: Elli Group (UK) annual report and accounts. Note: The related party debt attracts 15% compounded interest. This exhibit does not compound the interest. A revolving credit facility converted into a £40m loan is excluded.

[96] Source: Elli Group (UK) annual report and accounts. Note: The related party debt attracts 15% compounded interest. This exhibit does not compound the interest. A revolving credit facility converted into a £40m loan is excluded.

Exhibit 8: Elli Investments Limited -How the company presents its results[97]

	Care homes and specialised services		Property leasing		Net interest payable	Pre-tax loss
	Turnover £000s	Result £000s	Turnover £000s	Result £000s	£000s	£000s
2013	706,790	49,913	3,033	2,394	96,397	-44,100
2014	709,061	-72,344	3,815	3,233	101,801	-170,912

Exhibit 9: Elli Investments Limited - An alternative way of presenting the results[98]

	Pre-tax loss £000s	Add back - Exceptional admin costs £000s	Add back - Related party interest £000s	Alternative pre-tax loss £000s	Add back ordinary admin costs £000s	Alternative pre-tax profit/loss[99] £000s
2013	-50,905	9,516	35,709	-5,680	41,389	35,709
2014	-170,912	98,792	41,030	-31,090	45,585	14,495

The final point has to be that in the Terra Firma world of charges within the Four Seasons group, all the deductions reduce profit but many of them are not (and indeed cannot be) cash charges: the business may be cash generative but in 2014, the £64 million of EBITDA would not cover the three charges listed above which run towards £200 million. What then is the point of such charges, if they are not the basis for year by year cash extraction? It is not just book keeping. The £41 million internal 'related party' interest charge in 2014 is added to the £36 million internal interest charge of 2013 as an accumulating liability so that the obligation would have to be discharged (in part or in full) when Four Seasons is sold on or liquidated. In the event of liquidation, Four Seasons would lose the £300 million of equity it put in at point of purchase in 2012; but the £300 million of internal debt gives it claims for unpaid interest and a place in the queue of creditor claimants behind the secured creditors. Thus, Elli Investments is not a going concern which operates within an accruals framework, where profit is a year by year indicator of surplus. Rather, it is a financial work in progress within a group which uses accruals and much else instrumentally for the advantage of an ultimate owner seeking a cash multiple on an upfront equity investment, by operating and (probably eventually) selling on. If that is not possible, the fall back is to recover as much as possible of the equity stake by extracting cash meanwhile and positioning the owner with claims in the event of liquidation.

Whatever the rationale, it is clear that Terra Firma as parent stands to benefit from its accounting and financing decisions which have not improved the resilience and sustainability of the operating business. Profit at one point in the group is no longer a meaningful indicator; like other private equity owners, Terra Firma's aim is not simply to make an operating surplus by working its care home assets; the

[97] Source: Annual report and accounts, Elli Investments Limited, various years.
[98] Source: Derived from annual report and accounts, Elli Investments Limited, various years.
[99] Alternative basis refers to profit defined in a conventional profit and loss account

imperative is to sell the business (exit) with profit or with minimum loss. The group structure allows Terra Firma to move around assets, liabilities and cash, including in and out of UK tax jurisdictions, with many possibilities of extracting cash at or before exit. Viability is then not a clear cut matter decided by obdurate externals of operating cost against revenue and that creates a major public problem. If the care chains were given more public money (after complaining of an unfair price) that would be like pouring water into a leaky bucket. And the problem is that in each chain nobody except the upper tier owners knows where the holes in the bucket are, so that public money can disappear without political debate or social accountability.

Operating management under Four Seasons

When all this has been said, the credit rating agencies Standard and Poor's and Moody's are not crying wolf. After the accounting and financing decisions of Terra Firma, Four Seasons is financially embarrassed. That makes it all the more important to have good operating management in the homes: in a labour intensive activity the primary responsibility is to manage wage costs and workforce relations while delivering high quality care. The problem is that, as we shall see, it is very difficult to deliver good quality care in financially embarrassed chains where a tough-minded approach to wages and conditions can increase workforce turnover, undermines morale and leads to poor quality care. Churning of ownership means passing on the operating problem as well as the ownership parcel. So Terra Firma's operating managers inherited a care quality problem manifested by CQC embargoes on taking new residents in a tail of low quality homes; they have tackled the problem with high cost agency staff. Losing control of labour costs is as much a part of their problem therefore as revenue squeeze by local authorities.

Financial troubles tend to have knock on effects for quality of care. The Institute for Public Care's 2014 Market Oversight report for the Care Quality Commission observes that 'as a provider's financial position deteriorates, for whatever reason, the quality of care it provides tends to be reduced and maintenance is also affected'.[100] This was certainly the case in the Four Seasons care homes that Terra Firma bought in spring 2012 after several years of turmoil caused by debt based financial engineering. By autumn 2013, some 28 Four Seasons care homes had been embargoed by the CQC regulator. Operating managers had to get the embargoes lifted because embargo prevents the home taking new patients and 28 embargoed homes threatened the group's revenue line. Their improvement plans involved recruiting new staff and this was done at high cost using agency staff. So management lost control of labour costs (but without significant pay and conditions improvements for existing staff). This operating mess is as much the cause of Four Seasons problem as the failure of local authorities to pay more; and this reinforces our view that the central state should not bail out financially embarrassed chains.

Out of control payroll cost was admitted to be the chain's problem when in May 2015 Elli Investments announced its annual results for the year ending December 2014 and the Chairman then said:

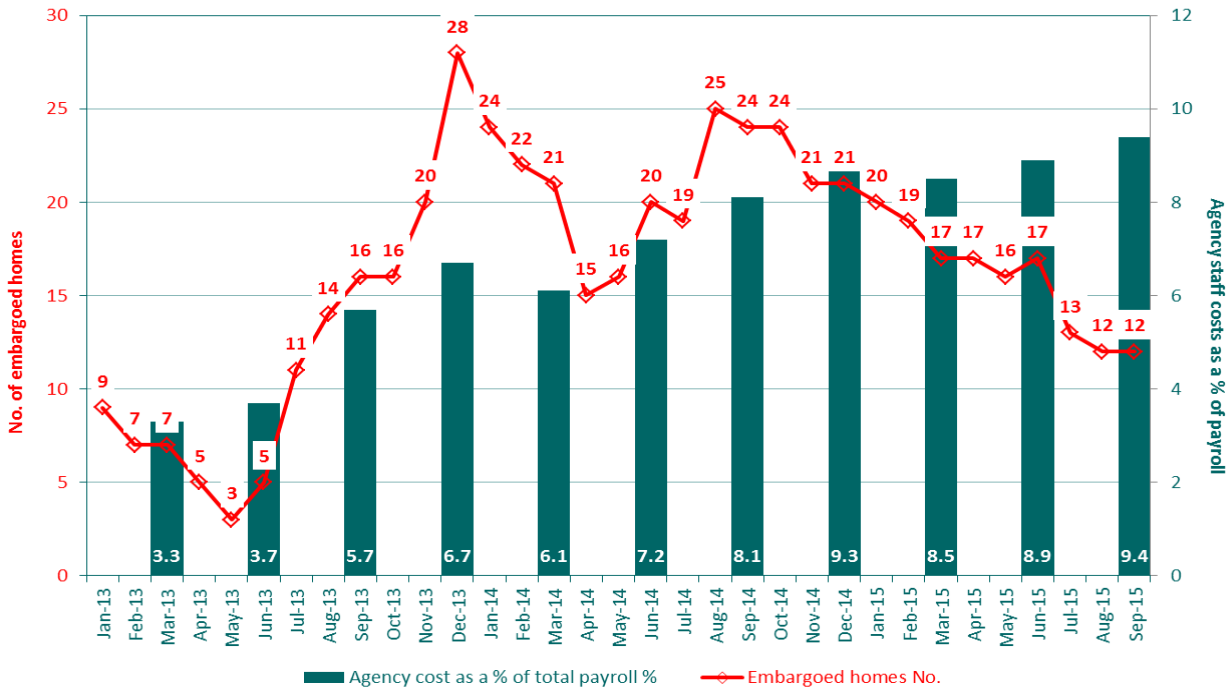
> *Despite steady occupancy rates and fee income, 2014 was also a challenging year for the group- having started the year with almost 30 embargoes a number of care homes were restricted as to the number of residents they could admit whilst at the same incurring punitive payroll costs, largely driven by the need to hire agency staff. Indeed, the ongoing industry wide regulatory*

[100] Care Quality Commission, (2014).

pressures, and agency usage driven by the significant shortage of nurses across the wider health care sector, meant that increased payroll costs was the defining driver of the year's results.[101]

His analysis is confirmed by the evidence summarised in exhibits 10 and 11. The number of embargoed homes peaked at 28 in December 2013 and again at 25 in August 2014; the number of embargoed homes had been reduced to 12 by September 2015 while agency costs as a percent of payroll increased from 3.3% in Q1 2013 to 9.4% in Q3 2015. This accounts for all of the 6% rise in payroll costs as a share of turnover over the same period, an increase which would be threatening in most labour intensive services. And as a percent of turnover, this increase in labour costs is as large or larger than the austerity squeeze on revenues which according to management in November 2015 was '5-6 per cent over the last three years'.[102] It was also admitted in May 2015 that 7 embargoed homes had been sold[103] so the large 6% rise in payroll costs had achieved the modest net effect of reducing the number of embargoed homes by nine. The fact some embargoed homes were sold not fixed is further cause for concern given the ineffectuality of the CQC in preventing homes re-opening under new names. As such policing is difficult, the obvious public interest policy would be to insist that large chains fix embargoed homes before selling them on.

Exhibit 10: Four Seasons Health Care embargoed homes and agency staff costs[104]



[101] LaingBuisson, (2015 C), 'Staffing costs lead to big losses for Four Seasons', Community Care Market News, 13th May.
[102] Learner, Sue, (2015), 'State of social care makes Four Seasons care homes boss 'embarrassed to be British'', *Carehome.co.uk*, 13th November.
[103] LaingBuisson, (2015 C).
[104] Source: Four Seasons investor presentations 2014 and 2015

Exhibit 11: Four Seasons selected performance measures[105]

	CHD[106] Occupancy %	THG[107] Occupancy %	CHD Average weekly fee £	THG Average weekly fee £	CHD payroll as a % of turnover %	THG payroll as a % of turnover %	Agency cost as a % of total payroll %	Central costs as a % of turnover %
2013 Q1	87.8	74.6	569	1,944	59.9	68.4	3.3	4.2
2013 Q2	87.2	75.5	579	2,076	59.7	66.9	3.7	4.0
2013 Q3	88.0	75.3	579	2,077	59.3	67.5	5.7	4.1
2013 Q4	87.4	75.2	580	2,056	63.2	71.3	6.7	4.4
2014 Q1	87.4	75.8	587	2,060	63.2	72.3	6.1	4.8
2014 Q2	87.5	75.1	596	2,071	63.3	71.1	7.2	4.6
2014 Q3	88.0	76.0	599	2,097	62.6	69.3	8.1	4.9
2014 Q4	87.5	75.2	602	2,104	66.4	72.3	9.3	5.3
2015 Q1	85.7	78.9	608	2,137	66.9	70.5	8.5	5.3
2015 Q2	84.9	79.6	619	2,134	66.4	71.6	8.9	5.8
2015 Q3	85.2	81.0	619	2,174	65.4	70.4	9.4	5.5
Nominal change in fees between 2013 Q1 and 2015 Q3			8.8%	11.8%				

All this needs to be read in context because Four Seasons likes to present itself as a responsible owner that values its regular staff. But, here again, there is ambiguity and an awkward discrepancy between promise and outcome. In 2013 Four Seasons Healthcare Group signed an agreement with Unison, GMB and the Royal College of Nursing recognising the three unions and committing to individual unit wage negotiations. At the time, Guy Hands, writing in *The Guardian*, claimed that the deal showed Terra Firma was taking a 'long term' approach and putting quality at 'the centre of our business' by developing a 'well-trained, stable and motivated workforce'.[108] However, documentation on 2014 and 2015 pay claims, prepared by the unions on behalf of members, show acute frustration about how repeated requests have been refused or ignored and then document an almost complete lack of progress on improving the basics. The 2015 claim asks for the lowest wage level to be set above the minimum wage, for paid handovers and breaks and improved rates for overtime, weekends, nights and bank holidays; all of these had been asked for previously in the 2014 pay claim.

The financing and operating story of Four Seasons since 2012 is complicated and raises all kinds of public issues where no doubt we need debate with all parties contributing. But it is regrettable that these issues are not being sensibly addressed by trade representatives in their public speeches. The chair of Elli Investments, Ian Smith, was recently and understandably indignant about the 'pathetic' shortage of trained nurses which drives use of agency staff; but he did not register the point that nurse

[105] Source: Four Seasons Health Care 2014 and 2015 Q3 Investor presentations.
[106] Care Homes Division
[107] The Huntercombe Group
[108] Hands, Guy (2013) 'Care provider Four Seasons is taking action to reduce staff churn'. *The Guardian* 19 February 2013.

training has been paid for or subsidised by the NHS out of tax revenues and a large care group organised for tax avoidance might begin by reflecting on its own contribution (financial and practical) to the social pool of medical skills.[109] Mr Smith also took up the not enough money theme, complained about austerity cuts and reductions in the fees paid for local authority funded residents and suggested the appropriate policy was 'a mandatory minimum fee rate for care homes and a regulator put in charge to monitor this'.[110] As we have seen, any problem about not enough money for the chains is embedded in larger problems about their business models and their practices on social responsibility issues. Any attempt to set minimum fees would have to confront the issue that various kinds of providers have different cost structures and a minimum price for the chains could not be set without public debate about the cost of capital which would raise existential questions about whether it is economically and socially desirable to provide care through chains which expect or assume high returns.

In sum, Four Seasons is a poster boy but not for the unfair price framing of the crisis promoted by the trade narrative which confuses matters by arguing that government is responsible for causing the crisis and can resolve the crisis by putting more money in. The story of Four Seasons, from Alchemy's purchase in 1999 to Terra Firma's purchase in 2012, is a depressing story about ownership churning, with debt based financial engineering loading the operating business with an unsustainable burden until profit taking turns into write downs. As we have seen, the ongoing legacy of financial embarrassment is operating problems which reverberate for years. As for Four Seasons under Terra Firma since 2012, that is an unclear story about internal organisation which sustains tax avoidance and creates opacity which is not in the public interest; and if the group is a leaky bucket, there can be no assurance that putting more money in will solve any problems about care. The next chapter tackles what we should do.

[109] Learner, Sue, (2015).
[110] Learner, Sue, (2015)

Section 4: What is to be done? Towards social innovation

What the chain owners seem to want is a fusion of capitalism and the state, which gives them the reward of profit without significant risk. Outsourcers have achieved this in other activities, most notably in train operating, where they have an option on profit which can be taken without investment or risk on the revenue line because they can walk away from their franchises.[111] At this stage in the argument about adult care, our readers should understand how and why profit without risk is doubly undesirable in a welfare critical foundational activity like care homes where cheap debt is being used to lever returns for equity held by financialised owners not for the benefit of all stakeholders. If the financial engineering is basically simple because it is directed to making money from cash flows, the policy response needs to be subtle and multidimensional because it should be directed to doing adult care better.

The chains should be controlled, under open book accounting of group and operating subsidiaries, with an insistence that their internal organisation is transparent and recognises their social obligation to pay tax. And, of course, the state should not protect financialised owners from the direct and indirect consequences of their earlier accounting and finance decisions: that means insisting that they accept losses, including write downs of capital values. But it is not enough to insist on capitalist adjustment without rectifying the category mistake that makes this an unsuitable field for private equity whose practices fit high risk/ high return activity. The state needs to explicitly redefine investment in residential adult care as a low risk, low return activity. We could then grasp the social opportunity of *welfare with 5%* by mobilising public funds to rebuild at low cost so that publicly owned homes could be operated on a socially responsible prop co/op co basis by diverse operators, including mom and pop firms and not for profits.

Beyond welfare with 5%, the state needs to sponsor imaginative new experiments in social care rather than simply rebuild unimaginatively as the chains do. We need to question chain organisation of residential adult care which does not ensure consistent, high quality care in all branches and challenge the formatting of care around newly built care homes in the standard 60-70 bed format which is financially favoured by the chains. Society urgently needs to use welfare with 5 per cent for experiment and social innovation in the provision of housing with care.

Chain (re)building formats care

Throughout this report, we have focused on the big chains because they noisily claim to represent the care sector and have the capacity to promote a trade narrative which covers their sectional interests. But, when the big chains control no more than 20% of beds, they are currently a relatively small part of a mixed ecology of different types of provider where the mom and pop firms are currently dominant. So that, at present, if more money goes into the residential system, our consolation is that most of it would be disbursed to mom and pop firms with one to four homes. But this is not very reassuring because the chains are likely to expand by rebuilding as well as acquisition; and many of the small family firms in old, converted houses will exit over the next 10-15 years. So the chains are important not only because of their place in the present system but because their expansion in future would mean care would be increasingly formatted around 60-70 bed homes that fit their financial model; and many such homes would be organised by chains in branch systems which have no quality advantages.

[111] Bowman, Andrew. et al, (2013), 'The Great Train Robbery: rail privatisation and after', CRESC public interest report.

Our research on the Welsh care home sector[112] shows that mom and pops typically own older, smaller homes which are out of date, while financialised chains dominate rebuilding. We analysed the ecology of existing care home provision, new construction and retiring capacity in the 'Greater Cardiff Area' (comprising five Local Authorities: Caerphilly, Cardiff, Newport, Rhondda Cynon Taff and Vale of Glamorgan). We used online directories and Google maps to research who runs what in Cardiff, and found that two tranches of older accommodation were held by small 'mom and pop' firms and local authorities. To begin with, there are local operators with a single home or up to four homes in one locality, operating a total of 53 homes with 1,578 beds in Greater Cardiff. Two-thirds of these homes, and more than half their beds, are in converted houses which make small homes of around 30 beds where only 27% of beds were en-suite. The other vulnerable operators in Greater Cardiff are local authorities which have older, purpose built homes from the 1960s and 1970s which are typically all single rooms but with no en-suite. They will, like 1960s university halls of residence, all need decommissioning because standards and expectations are rising; and Welsh local authorities cannot at present rebuild as they do not have spare income or clear borrowing powers.

The future of residential care then belongs to operators who can replace retiring capacity with larger new homes which meet modern standards (and are relatively cheaper to operate). There is no available data series on new build, but we can proxy new build over the past five years in Greater Cardiff by considering who operates newly-registered homes. We find that rebuilding is dominated by larger operators, which increasingly will be financialised chains, with access to finance from capital markets and a plan to build in units of 60 or more beds. If we consider new home registrations in Greater Cardiff since 2009, chain operators with five or more homes have added 21 purpose-built homes and 1,210 beds; local 'mom and pop' operators with four or fewer homes have added just five purpose-built homes with 171 beds.

Rebuilding is currently slow and Knight Frank estimates that only 6,000 new beds are constructed each year in the UK[113] because (like other franchise operators) care home owners are averse to investment in new capacity when they can make money by operating and trading existing capacity. But the Cardiff pattern of new development is likely to be UK wide and will continue. The barriers to building are high for small chains and family run homes and include lack of technical expertise in new home design, limited access to capital and unfamiliarity with the business case mode of argument. Family providers who operate out of converted Victorian houses will find it increasingly difficult to compete with providers who offer en-suite rooms and modern amenities. The buoyant nature of the UK housing market provides a strong temptation for family providers to sell up and cash in; while life events like divorces and deaths provide further points at which family providers exit the market. In contrast, financialised chains have the technical expertise, can access capital and have the motivation to build as part of scaling up and increasing the resale value of the business. For these reasons we believe that over the next twenty years older accommodation will be retired and replaced and providers who can build will take a much larger market share.

Debt finance and acquisition (of smaller chains) also allows deal making chains to expand rapidly and reinforces the logic of re-building. Four Seasons expanded from a workforce of almost 6,000, providing 5,300 beds at 100 care homes, in 1999 to employing 30,000 staff and running over 500 homes with 23,961 beds in 2012. During 2011 alone Four Seasons increased its bed capacity by 40% by acquiring

[112] Brill, Lucy. et al, (2015), 'What Wales could be', CRESC public interest report.
[113] Knight Frank, (2015 A), 'Care Homes Trading Performance Review 2015', pg. 11.

the business of Care Principles and taking over homes from Southern Cross.[114] Growth at Southern Cross was even more aggressive. It grew astonishingly so that it more than doubled in size in one year from 8,200 beds in September 2004 to 28,000 beds by November 2005. By its collapse in 2011, Southern Cross was operating 750 care homes with 37,000 beds and 41,000 staff.

The instability (which is a by-product of debt based financial engineering) has so far prevented sustained increases in overall concentration. In January 2011, the 10 largest providers operated 111,757 beds and, because of the collapse of Southern Cross, that total had dropped to 103,114 by January 2014. But, the financialised chains already have oligopoly positions in nursing beds in several big cities. For example, in one outer London Borough the biggest six providers already control 70% of nursing beds. This combined with a shortage in nursing home beds in the Borough enables the financialised chains to play off local authorities against each other and push up fees to cover the desired return on capital and more. This market power is reflected in the profitability of nursing homes in Greater London in 2014/2015, which was second only to the South East, and in the fact that, on the EBITDA metric, London nursing beds earned over £5,000 more than residential care beds.[115] Of course this lack of diversity in London nursing care has many negative consequences. This increases the risks to Local Authorities who are increasingly dependent on the large, fragile financialised chains to provide the majority of their nursing care.

Rebuilding by the chains has a second more insidious consequence because the chains build new homes to a standard format typically with 60 -70 beds so that the physical capacity is reconfigured in a Travelodge kind of way as two or three story, en-suite blockhouse hotel for older people. The Knight Frank 2015 Care Home Trading Review shows how important size and building specifications are to care home profitability because larger size allows payment of a manager's salary as well as a return for capital. One size fits all for financialized providers because there is a format that maximises cash generation. As exhibit 11 (based on data in the Knight Frank review) shows, the 80-99 bed homes (slightly larger than the current norm) are actually most cash generative per bed with 60-79 bed homes not far behind.

Exhibit 12: Key Performance Indicators by size of care home (Financial year 2014/15)[115]

	Average weekly fee £	Occupancy %	Staff cost per bed £	EBITDARM[116] per bed £
< 40 beds	£651	90.0	£21,292	£8,400
40 – 59 beds	£657	89.2	£21,503	£8,868
60 – 79 beds	£697	87.3%	£22,282	£10,370
80 -99 beds	£729	87.6%	£23,108	£11,903
100+ beds	£653	86.5%	£20,790	£8,850
All care homes	£675	88.3%	£21,756	£9,500

[114] Care Quality Commission, (2014), pg. 8.
[115] Knight Frank, (2015 A), pg. 9.
[116] Earnings before interest, taxes, depreciation, amortization, rent and management fees.

Design is important too with homes often built on two or three floors to make more efficient use of land; and with floor plan layouts that minimise the number of staff needed per bed. The financialised providers that we interviewed in the course of our research had an in-depth and precise knowledge of the layouts and measurements which would minimise staffing costs; and factored that into purchase decisions and resale value.

So the big chains will, on present trends, not only expand their share as mom and pops exit but they will also rebuild the care homes in a standardised blockhouse format so that one home is much the same as another and all homes are increasingly alike (apart from their faux vernacular detailing). By default, society must then increasingly accommodate its old in large full service hotels of single rooms with en-suite and TV in every room of a setting which is more institutional than domestic. No doubt good care can be delivered in a variety of material contexts but the new care homes put the onus on home management to add activities and environmental stimulus which more domestic settings could generate from the everyday activities of self-management. Alternative models of care would need to be defined and costed, but we would note that the full service hotel format of care home is inherently labour and capital intensive. We urgently need public debate about whether it is socially desirable to standardise care in the blockhouse format and how much of this accommodation we can afford, given a rapidly ageing population and diminishing social care budgets.

Even if it were decided that society needed individual homes in the format that suits the chains, there are more existential questions about the benefits of large scale chain organization where service is delivered by a multiplicity of branches. The rationale for chain organisation in many kinds of retail, like fast food, is that the chain delivers consistent quality because procedures can be standardised. But in this respect a care home is not like a fast food franchise because care involves complex human relations, judgement and discretion.[117] Chain organisation appears to deliver few benefits in care because the chains have been unable to proceduralise excellence: all have branches which range from excellent to awful and their average performance is nothing special. Why then do we need chains in adult care?

The trade narrative demand for more money needs to be read in this context. The demand is for increased funding for residential care without positive measures to support building for smaller operators; without provision for maintaining or increasing diversity of format; and without any safeguards to prevent financialised providers expanding along the most cash generative path through expanding the number of branches. The dystopian prospect is of an oligopolised sector dominated by financialised chains whose operating subsidiaries are financially fragile as they provide institutional care in a high cost format which is socially unaffordable and of inconsistent quality because their workforce is under resourced, ill paid and ill trained.

Welfare with five per cent

There is a better way and that can be found through new kinds of policies: these could start by controlling financialised providers but should not stop there. When thinking about what's gone wrong in adult care, we should not lapse lazily into booing the villain and demonising the private equity general partner who is the typical financialised chain owner (and does no more or less than what he or

[117] Himmelweit, Susan, (1999), 'Caring Labor', *The ANNALS of the American Academy of Political and Social Science*, Vol. 561, No. 1, pp27-38.
Folbre, Nancy and Nelson, Julie, (2000), 'For Love or Money - or Both?', *Journal of Economic Perspectives*, 12(2), pp123-40.

she is incentivised to do). The private equity partner is present because, against a background of general financial illiteracy, successive pro outsourcing governments have made a kind of social category mistake by not recognising that residential care is a low risk, low return activity. We need to recover the insight of the Victorian philanthropists who expected a five per cent return on their investment in model housing for the working class.[118] If the Victorians believed in what Tarn called "five per cent philanthropy" we need to see that five per cent welfare should be the framework for socially re-thinking investment in residential care.

The financialised care home providers have recently shown some enthusiasm for new kinds of regulation which would extend into financial matters. Chai Patel, as chairman and acting CEO of the HC-One care home chain, wants a regulated utility like sector: 'I'd be very happy if the government wanted to have a price regulator, like we have in utilities, because this service is a public good, an essential public good. Let's have somebody tell us the fair margin that you should make in this sector and then see if we can, open-book, confirm that we're doing that but no more than that.'[119] All this is being floated on the tacit assumption that a new regime (replacing local authority commissioning) would serve private advantage as it is more likely to give financialised providers their congenial price with prospects of an 11 or 12% return on capital which covered their purchase costs and immunised against risk.

Any public policy on rates of return in residential care should start from public hostility to complex group structures which make returns hard to police. This is part of a larger problem because in many public companies we find complex group structures and financing and accounting decisions (on debt finance and tax havens) which are entered into not only to avoid tax but also to extract cash, manage liabilities and everything else. Public attention focuses narrowly on the loss of tax revenue from artificial transactions and the use of tax havens, but as we have argued elsewhere there are larger problems about the arbitrage of limited liability which is a social privilege originally granted so that small savings could be mobilised for large projects;[120] limited liability is now being used cynically as a facilitator of financial engineering for private advantage. And one central device in that financial engineering is exploitation of the privilege of tax relief on debt interest originally intended (along with the hierarchy of claims) as a way of creating an asset class which offered limited but more secure returns than equity; debt is now being used to avoid tax and move cash and liabilities around complex corporate structures.

If group structures are simplified, open book accounting for all home operators does make sense, on condition that it is developed so that we have different models for various kinds of firms. This sophistication is necessary to identify the cost drivers and expenses which would be different in financialized chains and mom and pops. This would be very much more useful than a fair price calculation for one imaginary ideal type firm, which works by fixing values so that cost drivers and the range of variation in cash generation becomes completely invisible. The supermarkets have current expertise in open book from their struggle to capture supplier margins; agricultural economics is a source of legacy expertise on family business from their work on farm accounts. Much of this expertise could be transferred and applied to adult care. The corollary would be a national training programme for officers in local government and regional governments, where there are much broader problems

[118] Tarn, John Nelson, (1973), *Five Percent Philanthropy. An Account of Housing in Urban Areas Between 1840 and 1914*, Cambridge: Cambridge University Press.
[119] Brindle, David, (2015).
[120] Bowman et al, (2015), *What a Waste: Outsourcing and How it Goes Wrong, pp.*79-82.

about inability to challenge the claims and assumptions about required rates of return made by financialised providers in care homes and also in other kinds of outsourcing like waste processing.

The logical result of any such regime will be a normalisation of lower benchmark returns for financialised providers. If the return was set at the (private) cost of borrowing, that would quite likely frustrate owners who expected 11-12% to validate purchases at 8-9 times EBITDA. The first rule of capitalism is that owners are largely free to do what they will with their property and the second rule is, of course, that they should accept the consequences of their earlier actions. If a care chain owner loads a business with debt which cannot be serviced out of cash flow, the proper capitalist response is restructuring where the owner will lose their stake or see it substantially diluted. This is what did quite properly happen in Four Seasons under Three Delta ownership in 2008 and what the chains are trying to prevent by arguing for more money going into care in 2015-16.

More broadly, a downward step change in margins is an everyday risk for any capitalist owner operating in a competitive market and, under current impairment rules, is properly dealt with by writing down the value of the capital and taking the hit in the profit and loss account. This is what Sainsbury and Tesco have done to their land and buildings, after their expectations of future profit margins have fallen from 4% to 2%, largely because of new entrants Aldi and Lidl. In care, the argument is about a local authority administered price but it is not of course the responsibility of the state to maintain the margins that underpin capital values and abolish risk. Thus, Four Seasons has recently and quite sensibly written down its assets.

From this point of view, the trade narrative can then be seen as the chains' attempt to manage political risk by making it endogenous and controllable in a way that is not in the taxpayer interest. We might add that it is equally not in the interest of private fee payers. In many cases, the private fees are being paid out of family capital which was tied up in a house that often represents accumulated family savings. There is public discontent that family capital is being eroded by eligibility rules about assets which ration free care; that discontent would increase if citizens realised that their loss of family capital was levered on the search for returns on organised money's capital. This should be more of an issue for the private fee payers than the dual pricing structure whereby they pay more per bed. And regardless of questions about caps on how much families should pay for care, all citizens have an interest in the provision of high quality care, which treats the workforce fairly, at a reasonable cost.

The big chains aim to extract high returns for capital and that ambition needs to be limited by public policy but, at the same time, controls over returns to financialised owners should not in themselves be cause for celebration. We need more fundamentally to ask how and why the private equity partner has inserted him/herself into an activity where what (s)he is generally incentivised to do for the benefit of equity owners is completely inappropriate. From this point of view, what we have here is a kind of social category mistake which underpins much outsourcing of foundational activities (utilities as much as welfare services) because they are not being socially framed as low risk/ low return and therefore unsuitable for organised money and debt based financial engineering.

What fundamentally prevents private equity from producing socially satisfactory outcomes in tax payer funded welfare services like adult care? The general partners of private equity funds respond to their investors (portfolio managers of private savings, pension funds, insurance companies etc.) who categorise private equity as a high risk asset on which high returns are expected. The incentives offered to general partner managers of PE as managers of investors' money are designed to produce such returns because investee companies are regarded as financial machines with no long term commitment to engage in or avoid any specific activity but a lively interest in the potential of any activity to generate

cash flow returns from operating, leverage and buying low/selling high. The financialised gaze is not activity specific, and debt based financial engineering techniques can be applied wherever there is a cash flow; it is therefore not surprising that welfare services and utilities with steady cash flow have attracted private equity.

But the consequence is that successive firms in a chain like Four Seasons apply the techniques acceptable in high risk/ high return activities to what is (or should be) a low risk and low return activity given its characteristics. Residential adult care is low risk because demand does not fail or vary cyclically and tax payers cover the price paid on half the beds; it should be low return because only a financially illiterate tax payer or an ill- informed private fee payer would unwittingly offer the care home owner a handsome and guaranteed margin. As we have seen in Four Seasons, the intrusion of high risk/return techniques into a low risk/ low return activity produces results which are cyclically self- defeating for private equity and often dysfunctional inside the firm. Pass the parcel profits turn into hold the parcel losses when the music stops and debt is written off so that the cycle of opportunism can start all over again; while, inside the firm, ownership churning and recurrent financial difficulties increase pressure on the workforce which may undermine the firm's ability to deliver care quality.

The underlying problem is not so much misconduct by private equity as a misunderstanding of the characteristics of the activity, which results in high return expectations and engineering techniques being applied inappropriately. If it is the responsibility of intermediary money managers to solve such problems by devising suitable products, the fault is with the fund management industry which has failed to devise an investment structure for this activity of residential care (as it has failed to do so for other low risk/ low return activities like utilities and infrastructure). From this point of view, portfolio managers and savings institutions then need to think in a more discriminating and creative way about how they align demand for return yielding assets with risk and time horizon. Meanwhile, fund managers seeking returns (like private equity general partners buying cash flows) are unlikely to ask whether those returns have been obtained from activities with appropriate risk/ return characteristics.

However, the culpable failure is by the state which has failed to note that financial engineering techniques are being applied to unsuitable activities and which has the power to devise an investment structure for the activity of residential adult care under the banner of welfare with 5 per cent. That 5% is relevant in three ways. First, when inflation is no longer a problem for us, 5% is now (as it was for the Victorians) adequate as a long term, steady income from a low risk investment which is here underwritten by the state because the risk of looking after older people never really shifts. Second, most pension funds have diversified but they have not since 2008 achieved annual returns higher than 5%: the stock market has provided no sustained capital gains since 2000; and gross returns on many classes of asset are subject to significant deductions for fees and expenses. Third, in an era of ultra- low or negative central bank base rates, 5% is near enough the cost of borrowing for a solvent state.

If we want to capture the future of residential adult care for social benefit, we have to find a source of 5% funding which could be applied to rebuilding for the benefit of diverse providers, including mom and pops as well as not for profits, and would help create the headroom to pay living wages.

If 5% capital could be found for a publicly funded rebuilding of care homes, then the prop co/op co division could be applied for a social purpose. At present, the prop co/ op co structure serves the private advantage of the group owner because sale of assets allows release of a slug of cash at the cost of rents on whatever terms have been agreed. But prop co/ op co could be used instead by local authorities to build care homes with low cost public capital to be let at moderate rents which would encourage a variety of operators - for profit and not for profit - who would not need access to capital

for building or the resources of big balance sheets to cope with downside risk. The rent on publicly owned care homes would then be paid by those providing management and labour services, on the understanding that the aim (in larger homes) was to build up a cadre of effective managers and committed, well trained, workers. Management could charge a fee for service but the opportunities for profit taking through financial engineering would be negligible and the huge advantage would be that the rebuilt sector would be of little interest to private equity.

At the same time, 5% welfare could create the headroom to pay the workforce a living wage. As we have seen, the LaingBuisson model is no guide to a fair price but it does show conclusively that cheaper capital would allow higher wages. In our view, the social gain from 5% welfare should not be taken out in the form of lower prices for local authorities and private payers. A substantial part of any surplus realised by paying capital less should be applied to improved staffing and paying labour more in each home, because care quality is undermined by the rapid burn out and turnover of an under qualified and ill paid direct workforce, as well as by the absence of a cadre of career managers at home level. A higher national minimum wage will raise the hourly wage rate but there is much more that needs to be done about unpaid breaks, handover times and such.

The obstacle which stands in the way of 5% welfare is the Treasury, backed by EU rules about the limits on government deficits. The Treasury has a long standing aversion to public investment in any kind of economic or social infrastructure even where it would be manifestly cheaper. The Treasury justified privatisation in the UK, from BT onwards, on the grounds that it would bring private capital into utilities; the rationale for PFI rebuilding of schools and hospitals under New Labour was that it was a way round EU rules which limited public borrowing; and, predictably, devolution does not mean granting large borrowing powers to the Celtic nations or any borrowing powers to city regions like Manchester. The argument changes but the prejudice against public funding is maintained and the Treasury is the controlling central finance ministry which dominates all other Whitehall departments and will not easily cede borrowing powers to others. Formally, local authorities can borrow at 4-5% from the Public Works Loan Board[121]; practically the Treasury stands in the way. Hence the importance of redirecting existing flows, especially local authority pension funds. Currently the flow here is from the provinces to paper investments in London where dealing expenses and intermediary fees are such that most local authority pension funds earn no more than 5% net for their beneficiaries.[122] Why not cut out the intermediaries and apply the funds directly to building care homes which would provide 5% returns and almost no risk.

Towards social innovation in care provision

Rebuilding at low capital cost is the long term key to sustaining a diverse group of operators, rewarding the workforce fairly and constructing a system which is inherently unattractive for financialised players. But the full social benefits will only be obtained if that rebuilding is tied to social innovation through

[121] http://www.dmo.gov.uk/index.aspx?page=PWLB/PWLB_Interest_Rates

[122] A Department for Communities and Local Government report conducted a study and found that "There are some funds which have performed consistently well relative to their peers. However, for the LGPS [Local Government Pension Schemes] taken in aggregate, equity performance before fees for most geographical regions has been no better than the index." This outcome is consistent with wider international evidence which suggests that any additional performance generated by active investment managers (relative to passively invested benchmark indices) is, on average, insufficient to overcome the additional costs of active management. See Selman, Linda and Wright, John, (2013), 'Local Government Pension Scheme Structure Analysis', Department for Communities and Local Government, prepared by Hymans Robertson LLP, December, pg2.

experiment with and evaluation of housing with care in a variety of new formats. Just building more of the same 60 bed care homes in the standard format (but without financialised owners) is not enough because that limits social innovation and experiments in care.

If we stand back from the residential care sector, the problem is an imbalance between the three different kinds of innovation: technical, financial and social. Technical innovations for continuous increases in labour productivity are largely irrelevant: changes in floor plan after rebuilding only yield a modest once and for all reduction in staff per bed. Financial innovation is grossly over developed as the Four Seasons case illustrates: just think how many billed hours of professional services must have since 1999 gone into constructing and operating the devices of financial engineering across this group. Social innovation lags because adult care is provided right across the UK in two standardised formats (home care short visits and residential care which involves group living now in increasingly large institutions). The official language about markets, personal budgets and choice suggests an open process which is in reality closed, because the same standard care menu is on offer across the UK.

It is no accident that that the UK has led the way in outsourcing adult care to financialised providers but it has lagged in experimenting with different formats. The high level brain power in the chains is applied to financial engineering: in financialised firms, operations are the unproblematic base which (until they go wrong) generate the cash flow on which financial devices and superstructures are built; and the returns to financial engineering are usually much higher than anything that can be wrung from operating efficiency. Neglected operations do go wrong in financialised businesses; but the response is usually reactive and problem specific, with service quality fixed in an instrumental way. Standardisation of format around 60 beds or more is then encouraged by the requirement for a lump of cash flow from each home which will pay the salary of a manager at £30-35,000 a year and cover the owner's requirement for a return on capital tied up in the business. On this logic, whatever the question, the answer for financialised owners is to rebuild bigger institutions because 80-100 bed homes generate more cash per bed on the EBITDA metric.

From a social point of view, these institutions are the destination in a career for older people, which moves them from independence through domiciliary care to group living and institutionalisation. Public policy is often biased towards supporting older people in their own homes because that is so much cheaper than hotel service in a care home. However, the resources typically allow only for a fragmented 'package' with short, often 30 minute visits, during a day to help with dressing, ensure a meal is available or that medications have been taken. This often inadequate support is increasingly unavailable because of care rationing: with budget cuts since 2010, 87% of English councils have raised their home care eligibility threshold to substantial or critical needs only.[123] Home care continues until it is typically interrupted by crisis, with a fall or medical emergency, often resulting in a hospital admission. Care homes then take local authority funded residents who are all high need at the point of admission so that the care home is group living but not a mixed community of older residents with different needs and capabilities.

The UK's formal care system which has always been defined by its internal barriers and is now increasingly defined by load shedding onto informal systems. There is an internal barrier between two forms of paid care (domestic and residential) completely separate from informal care; the workforce in both domiciliary and residential care is required to deal with higher needs but the semi-skilled direct workforce has not been adequately upgraded. The main trend in the past few years has been local

[123] National Audit Office, (2014), pg. 4.

authority load shedding onto informal carers as family and friends have to cope with an ever larger number of the frail and confused; this puts more burden on work life balance for informal carers, predominantly women. A recent report from Carers UK shows that 6.8 million people provide unpaid care for a disabled, seriously-ill or older loved one in the UK which is an increase of 16.1% since 2001. Carers are also caring for longer: since 2001, the number of people providing 20-49 hours of care a week has increased by 43% and those providing 50 hours of care or more a week has increased by a third (33%).[124]

The care trade narrative plays on a widespread fear that this ramshackle bricolage will fall apart in a way that makes the NHS bed blocking problem much worse. Policy makers recognise that the finances of adult care and NHS are interconnected and they hope that integration of social care and health and intermediate 'step down' beds can deliver measurable benefits for the over stretched health care system.[125] But the problem of social care is here very narrowly framed by policy makers as a matter of limited coverage and inconsistent quality, with knock on effects for the NHS; neither policy makers nor citizens have registered our collective failure of social imagination in providing housing with care. While residential care reform proposals from experts and think tanks have sometimes only confused matters.

LaingBuisson, the leading consultancy in the field of social care constructs the problem of social care narrowly as one of 'market failure' when monopsonistic local authority purchasers encounter silo providers. Laing's claim is that society can now get more for less, while providers can get their required return by outsourcing everything on an outcome related per capita basis to massive new 'social care maintenance organisations'[126] (which would of course have to be for profits with balance sheet resources if there were to be penalties for failure). Other reports present a broader range of proposals for funding and organising care,[127] with some rooted in more traditional visions of how planning to end fragmentation and promote integration of health and care could deliver more collectivist values. Thus, the Barker report has called for more generous funding of social care based on the principle of solidarity.[128] Highly critical of attempts to encourage take up of insurance for social care by individuals, Barker calls instead for free access to personal care funded through changes in taxation, benefits, prescription charges and national insurance. Under its proposals services would be organised and funded through a single ring-fenced budget made up of NHS and Local Authority funds with a single commissioner. A follow up statement to the Barker report in November 2015 was highly critical of the Conservative government's policies in the field of social care.[129] Taking a broader view of health and social care and calling for a 'whole person care' the Oldham report[130] comes from an independent commission for the Labour Party and recommends that NHS England be revised to become Care England based on whole system strategic planning and delivery.

[124] Carers UK, (2015), 'Unpaid carers save the UK £132 billion a year – the cost of a second NHS', 12th November.
[125] Humphries, Richard, (2015), 'Integrated health and social care in England – Progress and prospects', *Health Policy*, Volume 119, Issue 7, July 2015, Pages 856-859.
[126] LaingBuisson, (2014), 'Strategic Commissioning of long term care for older people, can we get more for less?', LaingBuisson White Paper, September 2014.
[127] Iliffe, Steve and Manthorpe, Jill, (2014), 'A new settlement for health and social care?', *British Medical Journal*,349, 4818.
[128] Barker, Kate et al, (2014), 'A new settlement for health and social care', Final report of the Commission on the Future of Health and Social Care in England, King's Fund.
[129] King's Fund, (2015), 'Statement, Commission on the Future of Health and Social Care in England'.
[130] Oldham, John, (2014), 'One Person, One Team, One System', Report of the Independent Commission on Whole Person Care for the Labour Party, February.

These are all constructive and important documents which show how progressive policy makers want to break down the barriers between social care and the NHS; but the barriers between formal and informal care, between institution and community are too often fixed and unquestioned. The Burstow Commission report for the Demos think tank illustrates the limits of what is currently thinkable and how rethinking on residential is received.

Burstow's report is well researched, based on evidence of what people want from housing with care and recognises the scope for delivering care in different formats. Indeed, Burstow devotes a whole chapter to vignettes of housing with care in different settings[131]and provides the best available short ethnographic guide to the range of experimental provision in Denmark, the Netherlands, the UK and the USA. But four of the nine commissioners come from care trade backgrounds and Burstow's rhetoric is then about creating 'a flourishing market of supply'[132] with all the different interests 'working together to develop a shared vision of housing with care'[133] in a sector which would pay the living wage[134] from a fair price (without curbs on profit or safeguards against financial engineering). Significantly, in the Demos press release announcing Burstow, the report's analysis was glossed over and its recommendations were presented as an opening for profitable property development. In the press release, Burstow's big idea was apparently that housing with care (apartments and care homes) should be co-located with public facilities like colleges and hospitals; the headline recommendation then was that public institutions like NHS trusts would be obliged to sell land to care providers who would be subject to 'affordable housing quotas'[135] (presumably of the kind which are routinely waived in other kinds of property development when developers argue that it compromises their ability to get the required rate of return). The think tank's vision of the future was one where McCarthy and Stone retirement apartments could joint venture with a chain like Four Seasons to develop publicly owned land.

Against this background, it is important to emphasise that social innovation in housing with care is about whether, how (and at what cost) it is possible to break with the dominance of the care home model of institutionalised group living which few of us find attractive in prospect. There are several different models of more domestic provision, in smaller scale buildings often with multi skilled staff. In the Netherlands, for example, there are experiments with dementia care that follow a small home or family living type approach. In Wiekslag Krabbelaan,

> *Dinner is cooked within the household and shared at a single large dining table, as in a family. Multitasking staff help residents to wash and dress, as well as doing the laundry and cleaning. Residents can help with these latter tasks if they wish. The small size of the home and location near to shops are intended to encourage residents to go out shopping with staff or family. Also, the neighbourhood activity can be seen from large windows, allowing residents to watch and feel part of it. The care focus is on 'adding life to the days' of residents. Schoolchildren aged 15-19 work with staff after school until 7pm; they may help prepare dinner, stay to eat with residents and get them ready for the evening, providing some intergenerational mingling. Family members*

[131] Burstow, Paul et al, (2014), 'The Commission on Residential Care, Demos.
[132] Burstow, Paul et al, (2014), pg27.
[133] Burstow, Paul et al, (2014), pg33.
[134] Burstow, Paul et al, (2014), p31.
[135] Demos, (2014), 'Push NHS to build more residential care, says former care minister', 2nd September.

> *of former residents often act as volunteers and more are being sought, to strengthen links with the neighbourhood.*[136]

This facility opened in 2010, is a not for profit organisation, which provides homes for 13 people with dementia in two households on the ground floor and 16 apartments for people needing less assistance, on an upper floor. At another example, Hogewyk village, care is available 24 hours a day, people at all stages of dementia are catered for in 'homes within homes', which aim to cater for 7 different lifestyles related to factors including religion, ethnicity and social cultural background. There are 23 self-contained homes providing homes for 152 people. A housekeeping team cook meals and do laundry.

'More research is needed' is both an academic cliché and an urgent necessity in this case. What needs to be clarified is whether one or more of several different more domestic experiments in housing with care have capital and labour costs that make them competitive with larger scale institutions; or whether this kind of alternative provision can be made to work practically and financially as part of a larger community hub which provides housing with care, neighbourhood facilities and peripatetic domiciliary care within a fixed radius of the hub. The provisional answer about outcomes is encouraging because well thought through alternatives can score well on care, stimulus and social engagement criteria. Canada has 'specialized care facilities' in which six bungalows each house a group of ten people. An ethnographic study compared the effect of a specialized care facility (SCF) on quality of life for residents with middle-to late-stage dementia over a one year period with residence in traditional institutional facilities. Reimer *et al*, then concluded the SCF environment helped residents to better maintain activities of daily living and interest in the environment with less low mood.[137] There are no corresponding studies of capital and labour costs although these issues are researchable; answers are likely to be complicated because the labour process is differently organised in various experiments.

If alternative formats are high cost, there are a whole series of very interesting questions about whether it is possible to have many of the benefits of smaller scale settings within existing care homes, as in the experiment at Glendale Lodge in Kent where innovative use of space creates small group living within a traditional care home.[138] Furthermore, although experiments with new forms of provision are essential, it is important to remember that, on any conceivable scenario, chains operating traditional homes are likely to remain important. Therefore, it is also necessary to evaluate the effectiveness of different care programmes in financialised chains like Four Seasons, which is currently rolling out an innovative dementia care programme which seeks to improve care and quality of life for residents. The evaluation here needs to consider not only the results in quality of life but the constraints imposed by the standardisation and scale of the built environment in which the care takes place and the squeeze on terms and conditions for staff. There are also questions about how many homes in the portfolio these schemes cover, whether programmes can be maintained in financial difficulties and whether innovation in Four Seasons is effectively confined to high margin activities like care for people with dementia which secure a higher fee per bed from Local Authorities.

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[136] Tinker, Anthea, Ginn, Jay and Ribe, Eloi, (2013), 'Assisted Living Innovation Platform Scoping Report: A study of innovatory models to support older people with disabilities in the Netherlands', Technology Strategy Board, London: Kings College London.

[137] Reimer, Marlene., Slaughter, Susan., Donaldson, Cam., Currie, Gillian., and Eliasziw, Michael., (2004), 'Special care facility compared with traditional environments for dementia care: a longitudinal study of quality of life', *J Am Geriatr Soc*, Vol. 52, pp. 1085-1092.

[138] Burstow, Paul et al, (2014), pp. 159-60.

But, one way or another, a new kind of experimentation sponsored by a learning state is central to the future of housing with care. This may seem paradoxical because, across the high income industrial developed economies much of the retrenchment and revision of welfare rights and the subjection of services to marketization has been undertaken under the guise of experiments. In America for example, during the 1990s and 2000s experimental narratives were used to legitimate political agendas and constrain debate.[139] The UK has, for nearly 40 years, experienced a cycle of repeated experimentation in welfare, health and education based around the construction of markets, contracting out and private finance initiatives. The mantra 'what works' has informed the political legitimation of these experiments and fostered approaches based around notions of consumer choice, while closing down criticisms of increasingly centralised government, promotion of corporate interests and population control and surveillance. [140, 141]

Against this background, we are calling for a new and different kind of experimentation that draws on forms of social licensing and social enterprise at local levels.[142] Moreover, such experimentation needs to be based on a rejection of top down state and corporate structural reforms and an engagement with the promotion and evaluation of local initiatives that encourage third sector and social science research commitments to experiment and innovation (for example funding evaluations of complex interventions[143] through the activities of What Works).[144] Such experimentation can only be consolidated into innovative and large scale welfare services if we have a 'learning state' that is at odds with the current mainstream policy environment. This will require a concerted shift in Local Authority commissioning policies so that social innovation in the social care sector is supported. To do this however there is a need for alternative state/ local authority capital investment to build the material basis for change.

Examples of innovation at local level exist and suggest that social care can be delivered in stable and sustainable forms based on co-production, mutualism and localism. But analyses of local case studies also suggest that there are problems of scale and the mainstreaming such approaches can only be achieved with strong leadership, long-term thinking and meaningful incentives.[145, 146] Moreover, there is a need to look carefully at how social value is incorporated into evaluations of social care delivery. The challenge for commissioners of services is to be able to assess efficacy and success in the context of a mixed economy of care where the goals of providers are broader in scope and make reference to a wider community of stakeholders. Outcomes in terms of the quality of care delivered and the well-being of individuals being cared for are paramount. But, in addition to the economic costs and inputs to

[139] Rogers-Dillon, Robin, (2004), *The Welfare Experiments: Politics and Policy Evaluation*, Stanford, Stanford University Press.
[140] Faucher-King, Florence and Le Galès, Patrick, (2010), *The New Labour Experiment: Change and Reform Under Blair and Brown,* London, Stanford University Press.
[141] Crouch, Colin, (2013), *The Strange Non-death of Neo-liberalism*, Cambridge, Polity Press.
[142] Bowman, Andrew., Froud, Julie., Johal, Sukhdev., Law, John., Leaver, Adam., Moran, Moran., and Williams, Karel., (2014), *The end of the Experiment? From competition to the foundational economy*, Manchester, Manchester University Press.
[143] Bonell, C. Fletcher A, Morton M, Lorenc, T. and Moore L, (2012), 'Realist randomised controlled trials: a new approach to evaluating complex public health interventions', *Social Science & Medicine*, 75(12), pp2299-2306.
[144] See website for further details https://www.gov.uk/guidance/what-works-network
[145] Evans, Simon, Hills, Sarah and Orme, Judy, (2012), 'Doing More for Less? Developing Sustainable Systems of Social Care in the Context of Climate Change and Public Spending Cuts', *British Journal of Social Work,* 42(4), pp744-764.
[146] Dickinson, Helen, Allen, Kerry, Alcock, Pete, Macmillan, Rob and Glasby, Jon, (2012), 'SSCR Scoping Review: The role of the Third Sector in Delivering Social Care', London, National Institute for Health Research.

services, consideration should be given to a wider range of key indicators including potentially social licencing based on the adoption of decent pay and working conditions for staff, principles of co-production, sustainability, engagement with short supply chains, and compliance with ethics and governance and impact on local community well-being.[147]

The crisis in care is ultimately a crisis of social imagination. The state has abdicated responsibility for the future of the social care sector and the financialised owners of the chains now want higher fees for doing more of the same and, if they do not get the fees, through trade narrative threaten to hand back responsibility for vulnerable residents to the state. It is important to challenge the false necessity created by the care trade narrative, because that opens up an exciting opportunity for innovation which is important for all our futures because how we care for our older people is an important test of our civilization. We can and must do better.

[147] Bagnoli, Luca and Megali, Cecilia, (2011), 'Measuring Performance in Social Enterprises', *Nonprofit and Voluntary Sector Quarterly*, 40(1), pp149-165.

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