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Annex D: Third party financing

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How third parties can help

Small providers in the care sector face increasing challenges when it comes to obtaining third-party finance. However, this should not stop an exploration of different lending options and holding conversations with lenders and professionals to identify the best deal.

A 2023 survey of care operators found that 38% were looking to expand their portfolio, with 30% of them seeking to achieve this through some form of finance. However, confidence levels were relatively low, with only 48% believing that their current lender would support these expansion plans.

Whether it's considering taking a new loan or refinancing existing debt, having a specialist team on board from the outset will help secure both the most appropriate and sustainable financing to support operational, development and growing needs.

Whilst the idea of increasing debt exposure can be daunting and having a specialist team with relevant experience in the care sector is imperative. They can help navigate the lending process and explain the legal documentation clearly and simply. You will find a list of support in the contribution section at the end of the main paper for this annex. They will keep the process as simple as possible and anticipate any issues which may arise, which may save you time and money.

Before embarking on third-party finance it is key to understand the various forms of injecting funds into your business to achieve the desired result. Each form has its benefits to certain scenarios but can cause issues if deployed incorrectly, therefore it is vital to call on a professional finance expert such as a broker or a commercial debt advisor.

Type of lenders

Short-Term

These types of lenders will view the finance as repaid over typically six to twenty four months. In most instances the initial interest rate can be perceived as high in comparison to medium and long-term arrangements, however, the nature of these facilities is they should not be with the business longer than the desired purpose. Ideally used for short-term projects that mirror the terms such as developments or extensions, then the true value or income can be generated post-completion when these facilities are either repaid or restructured.

This market is vast in the number of firms with varying appetites and offerings, the understanding of what the finance will be used for is key alongside the ultimate repayment vehicle, i.e. is it through the sale of the asset, refinance of lent on asset or other owned assets?

Medium-Term

A medium-term lender, as the term suggests, sits between those in short-term projects and long-term depreciating assets, of which longer-term debt can be utilised. These lenders would ideally be on terms of 12 to 60 months and placed to cover cash flow, refurbishments or repeating programs to defer the initial cash flow outlay over some time. In most instances, these loans will be unsecured, which allows for speed of set up and reduced costs with no requirements for legals, valuation etc.
Medium-term debt can also be used for a more aggressive approach to financing, such as rapid expansion or growth strategies. Some lenders will allow a five-year term whilst the growth stabilises within the business, with the expectation that this funding will move to a longer-term position.

Long-Term

This type of debt is typically the mainstay of commercial funding, with a lender taking the home as security for the debt, providing terms up to 25 years similar to a residential mortgage. Like a residential mortgage, the annual interest rate will be less than that of most other forms of finance due to its secured nature.

This form usually has the most rigorous assessment as all aspects of the operation will be reviewed to decide if the strength is held within to deliver repayment throughout the tenure.

As you will see through this paper, many aspects will dictate how much debt can be achieved, the costs, requirements, and terms and conditions associated with each form.

Lenders focus on the business's ability to meet interest and repayment terms from ordinary operational cash flow. Their criteria include reasonable, logical, and defendable conservative assumptions. Security over business and assets, along with alternative plans in case of unforeseen circumstances, forms a crucial part of their evaluation. A typical lender will carry out an affordability test before making an offer. There are vast options for SMEs beyond high street banks, with challenger and alternative lenders actively lending in the SME market.

Trade (other care providers)

Trade investors seek a strategic fit with existing businesses, emphasising potential synergies. Their interest lies in the alignment of the acquired business with their overall operational goals, culture and objectives.

Equity investors

Equity investors, also known as Private Equity, navigate the landscape with a keen understanding of risk, aiming for medium-to-high returns. They aim to see a return on investment in three to five years and at a maximum of seven years. Their approach often involves value accretion, reinvesting cash to sell the business for more than they bought it for. Evaluating growth potential, strategy for value accretion, and confidence in the leadership team are pivotal considerations.

Real Estate Investment Trusts (REITS)

Investing solely in property, real estate investors seek low-risk with stable returns. Confidence in the operational business's ability to meet rent payments and an understanding of CapEx investments for property maintenance are key. Additionally, they explore alternatives to protect their investment in case of unforeseen challenges.

Embarking on Third Party Finance

When you have decided on a project that requires finance, or to refinance the business, engaging a professional with the expertise and detailed knowledge of the sector can be key in unlocking barriers to achieving favourable terms. When approaching funders, it is important to remember the culture that they are working in. Many frontline employees are under constant pressure to only attract new customers and ensure the satisfaction of existing ones through the services they receive. As a result, you should ensure that when you are approaching your lender, you are straightforward and have tangible, empirical evidence for precision and transparency. Diversity in approaches among different lenders necessitates seeking multiple opinions as the market and appetite change frequently.

Social care is seen by lenders as a prosperous and rewarding industry that is also a debt-led sector, with operators borrowing significant amounts. Care homes, for example, are scrutinised based on inspection reports, annual accounts, occupancy levels and current trading performance, supported by up-to-date management information. This underlines the importance of maintaining records and having a robust reporting mechanism in place. Operators need to keep in mind what profits they will generate from borrowing the money against the cost. Lending on a double-digit margin, which enables a profitable project to proceed, is better than no project, or entering a statement to negotiate lower rates. It is important to keep the end goal at the forefront if it creates a great facility and the financial rewards you get with it.

Sub-sectors within the care industry can harbour different terms and appetites from a lender. Therefore, being clear about what service and sub-sector your operations reside in is important because, as an operator, you will be expected to understand your sector and operation intrinsically. The factors considered in the evaluation process range from the age group of residents cared for, to the quality of existing services, fee rates charged, and the financial performance of the facility. The inclusion of a site visit in the evaluation process indicates a hands-on approach by bankers, who wish to judge the quality of provision firsthand. Some lenders who have experience with the sector, will often know what to observe within the service, however, it is important to strategically plan the route of any visit to ensure the service is presented at its best.

Lending approaches are nuanced and depend on various factors, such as the acuity and age of residents. Higher acuity and younger residents may lead to a more cautious lending approach, as larger homes are seen as more stable.

The quality of assets is also important. Whilst operators will argue between themselves about the benefit of en suites in a nursing home, there is a level of expectation by lenders. The preference for freehold over business value in some cases and the consideration of en suites in nursing homes showcase the intricate details that lenders take into account during the decision-making process. The size of the home should reflect the norms in the market, a twenty-bed elderly care home with no ensuites will be a less attractive option to lend to, compared to a 60-bed all en suite.

Ownership types further influence lending decisions. Types of ownership fall into three categories: Freehold, Leasehold or Ground rent. First tier lenders will look to lend against the market value of the home fully trading the ability to step in and run the home to sell as a trading entity. There are secondary lenders (services which offer some banking services but do not offer the usual commercial banking services/accounts) which will look at freehold as the anchor of how much they will lend.

Once lenders understand the trading model, they will then look at the operator. In all types of business, lenders want to lend to those who have a proven track record in the type of business they are looking to borrow against and where they can read their accounts and look at historical 'Good' inspection reports. A proven profitable operator providing quality care from modern facilities should be able to ask more from their lender, however we have seen appetites change across the market. Most high-street lenders have set the benchmark so high that smaller operators have struggled to seek success from recognised names on the high-street.

Whilst the operation of a care home is a highly regulated and complex business the financial model is a lot simpler. Typically, the finances can be simplified to fee income (turnover), staff costs, all other bills and what is left, is profit. To look at the costs in a very simplistic way, staff costs are around 60%, everything else 15% and the balance EBITDA (earnings before interest, tax, depreciation, and amortisation). EBITDA is a measure of profitability and is a statistic used to assess operating profit and is a proxy for the cash flow generated by the operation.

Lenders are attentive to rising bills, particularly in utilities like gas and electricity, and expect informed projections on how these costs will impact profit. They will most likely be unaware of any contracts in place, so informing a lender of contracts in place, as well as providing the same level of intelligence on food inflation and any other rising costs, would be wise.

If you are borrowing, or looking to borrow, a proactive approach to creating financial forecasts, covering the next 12 to 24 months, is advised.

A forecast helps you understand where your fee rates need to be and possibly your drawings. Communication regarding staffing challenges, the use of agencies, or overseas recruitment is crucial for transparency.

The amount of debt that can be achieved will usually be dictated by several basic factors, Loan to Value (LTV), Debt Service Cover, and Leverage. There are further criteria to consider to achieve a positive outcome to a borrowing request. Understanding these three points will give you an idea of the level of debt you could achieve. To get a closer and better understanding providers would be advised to seek out a proven Commercial Care Finance broker.

Starting with Loan to Value (LTV) a typical lender will reflect on the operation of the business and the recent experience of the lender within the sector. Understanding the types of valuations will aid in realising how much the business is worth and what level of debt could be achieved. The two key values lenders will benchmark against are as follows.

Open Market Value (OMV) - which is a multiple of EBITDA, taking into account the property and operations, this is commonly known as Market Value 1 (MV1). The alternative key valuation has numerous terms such as Freehold, Market Value 3 (MV3) Vacant Possession (VP). Ultimately, this is the value of care home building closed.

Typical LTVs - can vary widely across the finance market and can quite often be misunderstood as to what is being asked, so levels of debt can be incorrectly offered to agree when valuations are requested. Looking at each type of value, the LTV can be between 55% to 70% against MV1 and 80% to 125%+ against MV3.

The ultimate lend will be subject to a suite of covenants. The Debt Service Cover (DSC) and leverage will be the key parameters that banks will set. In essence, these covenants establish a boundary, wherein if it is crossed, debt will be reviewed. When negotiating with a lender, you must work within the agreed parameters. Typically, debt service cover can be anywhere between 1.1 to 3 times cover depending on risk, quality of asset, operator number of units, regulatory grading, plus many more.

In addition to DSC, lenders may also use a Leverage Calculation. This calculation is a multiple of EBITDA. For example, if a business produces an EBITDA of £300,000 and has a value of £2.7 million and borrowing of £1.6 million, the leverage is 5.3x and LTV 59%. Leverage will reflect the quality of the asset or portfolio and the appetite of the lender in the sector. Much like LTV leverage multiples will be influenced by external factors on a lender these are similar to those of LTV. influenced Typical ranges of leverage can range from 3 to 6 times EBITDA, with a lesser range for leasehold between 2 and 4.5 times EBITDA.

As whole, the greater level of experience that can be demonstrated will favour higher levels of support or better terms. A robust business plan should include forecasting covering a one to three year period.

This plan should also identify when breakeven will be hit, i.e. on expected costs and resident numbers. Depending on circumstances, there should be an expectation of an interest-only period covering the build and fill for a certain period, typically around 30 months.

If the project requiring funding, is a large extension or new build, the pack delivered to the lender, in addition to financial forecasts, should include a quote for the build, from a trusted source that has experience in the sector. This should include the architect's drawing(s) to show what is being built. It is advised, to use an architect who has designed similar services before. Small extensions to a home can make great sense, where the home is well-run and profitable. These requests should be straightforward for the bank, as the resident fee rate and other costs are known.

With a new build, leverage will spike at a high level, typically just after the home is complete, registered with the regulator and incurring staff costs, when residents start arriving income picks up and over a period EBITDA improves reducing leverage.

Several lenders will fund a standalone care home for the right operator(s). With risk reliant on just one unit, the LTV may be lower and pricing higher. Debt is normally repaid over 15 to 20 years with a bank commitment of three to six years.

Some consultancies see an alternative funding market taking a more pragmatic approach to supporting the care sector. One consultancy, for example, has seen more single or standalone acquisitions in 2023 with 70% of their completions being in a single purchase, versus 20% in 2022. Refinance remains strong as operators seek to reset their debt or are looking for alternative funders to support them with 15% of their transactions this year being straightforward refinances of existing operators.

Loan document support

Below are some key clauses in the loan document which often need particular attention (and are normally negotiated) and those which are completely standard:

Event of Default

A loan agreement will set out circumstances or events, that if they occur, will give the lender a right to demand early repayment. These circumstances or events are called 'events of default'.

Events of default will vary for each loan and will need to be tailored and are usually heavily negotiated. Some typical events of default include, but are not limited to:

- Non-payment of the loan
- Breach of covenant under the loan agreement
- Misrepresentation in respect of the loan agreement
- Insolvency, insolvency proceedings and creditors' process
- Material adverse change of the business

Financial covenants

Financial covenants set out the parameters (mainly in the form of financial ratios or limits) within which the borrower will have to operate during the term of the loan. They are used by a lender to monitor financial health through calculations based on the business's accounts. The financial covenants are generally tested during the term of the loan against financial information provided by the borrower. The facility agreement will typically impose extensive obligations regarding the provision of information, against which the financial covenants can be tested.

Financial covenants require special attention because they are highly technical - relating to the financial condition of the borrowing entity and involve accounting/financial terms such as EBITDA, Financial Indebtedness and Financial Charges.

Representations and Warranties

There is an expectation to provide several representations and warranties. These are statements of current or past facts in respect of the business. These need to be renewed to ensure that they are standard for a loan but also to check they are correct.

Conditions precedent

Conditions precedent are the lender's requirements which need to be satisfied before the loan is drawn down. They typically include the loan and security documents being signed and other matters, such as insurance being in place and a valuation of any property being acquired or forming part of the security package.

Where finance is required for a substantial refurbishment or a new build, known as development finance, the lender will require various representations, warranties and covenants concerning the quality of the building contractor and their professional team, their insurance, the quality of their work and the construction documentation. The events of default are likely to include the insolvency of the construction team. The lender will require collateral warranties from the building contractor and each sub-contractor they regard as essential to the project. A collateral warranty allows the lender to seek damages directly against the building contractor or sub-contractor for defects in the construction of the buildings.

For loans over £10 million, lenders will typically use a standard loan agreement produced by the Loan Market Association (LMA). LMA loan agreements can also be used for smaller loans. The LMA agreement can be daunting at over 100 pages but an experienced broker can help you focus on the salient provisions such as interest rate and fees, the representations and warranties, and the covenants, including the financial covenants and the events of default.

Some lenders have their own shortened version of the LMA loan agreement known as "LMA Lite". These agreements are much shorter because they are generally bilateral (so just one lender and the borrower) and do not include lengthy syndicate and other standard wording.

Facilitating financing for smaller providers

Introduction

In a sector where balancing quality care and financial viability is a delicate endeavour, access to funding is pivotal for the development and growth of care homes. Care providers often turn to consultancy firms, which bring operational due diligence expertise and a profound understanding of the care sector, to navigate these challenging waters. Their bespoke support not only facilitates the securing of new financing or refinancing options but also ensures operational integrity, providing reassurance to banks, financial entities, and investors.

The Challenge

Small and medium-sized enterprise (SME) care providers frequently encounter difficulties when seeking external finance. The twin challenges of proving operational excellence and meeting the strict criteria of financial institutions are formidable. The current regulatory environment, marked by sporadic inspections and the risk of care homes being undervalued due to outdated regulatory assessments, complicates matters further. Consequently, many care homes remain with less-than-ideal ratings, struggling to make a compelling case for their financial viability and operational robustness to funders.

Strategy and Implementation

The strategy was comprehensive, aiming to showcase the operational robustness of care homes to financial backers:

- **Operational Due Diligence**: Thorough evaluations were carried out to assess operational efficiencies, compliance with regulatory standards, and quality of care. This exercise not only pinpointed strengths and areas for improvement but also positioned care homes favourably for financing discussions.

- **Regulatory Rating Enhancement**: Guidance through the regulatory maze was crucial, especially for homes awaiting reinspection. This assistance was instrumental in securing ratings that accurately reflected their operational quality.

- **Facilitating Financial Negotiations**: Offering lenders a transparent, objective view of a care home's operational health was key in easing financing discussions. This expertise not only helped in obtaining loans but also in securing favourable funding terms, vital for SME care providers' growth and sustainability.

- **Governance and ESG Strategy**: Including advisors in a care provider's advisory panel significantly bolstered their standing with financiers, particularly regarding governance and Environmental, Social, and Governance (ESG) standards. As the financial sector increasingly emphasises governance and ESG, guiding care homes in adopting robust governance frameworks aligned with these values positions them well for financing, promoting long-term sustainability and operational excellence.

Outcomes

The partnership between consultancy services and SME care providers has yielded numerous success stories. By providing banks with the needed assurance about the operational robustness of care homes, consultancies have played a pivotal role in enabling these homes to secure funding. This support has been critical during growth phases, whether for refurbishments, expansions, or overcoming operational challenges, improving financial terms and access to funding, thus empowering care providers to upgrade their facilities, invest in quality care, and confidently address the care sector's complexities.

Recognition

The impact of consultancy interventions has been acknowledged by financial institutions supporting the care sector, cementing their status as an essential ally for SME care providers in securing both their financial and operational futures. The ability to convey the true worth and potential of care homes to financial bodies has not only eased significant financing arrangements but has also helped raise care standards industry-wide.

Conclusion

This case underscores the importance of specialised guidance for SME care providers facing financing obstacles, contributing to the dialogue on the significance of operational robustness and strategic financial planning. Through focused operational due diligence and expert advisory, a pathway has been established for care homes to achieve financial sustainability, guaranteeing the continuation of quality care services. The role of consultancy exemplifies the vital link between operational excellence and financial viability, fostering a stable and thriving future for the UK care sector.