Chapter 3. Developing better commissioning activities

Paper 2: Assessing the strength of the marketplace of children's service providers for looked-after children

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Commissioning Support Programme ebook

Better Outcomes
COMMISSIONING FOR CHILDREN AND YOUNG PEOPLE

Introduction

The economic recession has brought in its wake an expectation that the coming years will emphasise the need for restraint in all areas of the public sector. In this environment, the role of commissioning will be of critical importance. The Commissioning Support Programme, launched in 2008, is already established with the remit to support local authorities in their commissioning of children's services.

There is a blizzard of activity looking at best practice; at frameworks for commissioning processes; at commissioning principles, strategies and plans; at governance structures, commissioning resources, leadership and culture. The core drive of this activity comes from a central and local government perspective, that is, essentially from the commissioner's point of view.

The principal purpose of undertaking this study is to provide commissioners with a view of the marketplace; in particular to examine the evidence contained in the audited financial statements of providers to establish whether they are robust enough to respond to, and engage with, the aspirations of commissioners.

Three sectors have been examined:

- **Residential special schools**, which provide special education for children unable to attend mainstream state maintained schools. These children include those with autism, speech and language difficulties, and learning difficulties.
- **Fostering agencies**, who assess and approve carers, and support them when a local authority places a child with them.
- **Children's homes providers**, many of whom also provide education for the children and young people placed with them.

The sectors provide residential and education services for children in care and for children with special educational needs. Placements made with these services may be funded from pooled budgets previously accounted for as separate external placement budgets in education and social care, perhaps with contributions from local primary care trusts.

The sectors have come to be seen as separated by their model of service delivery, although some children and young people clearly move about between them, creating overlaps.

Main findings

This study examined the most recently audited financial statements of a range of providers in each of three distinct service segments – fostering agencies, children's homes and residential special schools.

Performing the tasks of identifying the larger provider organisations, and accessing what is essentially publicly available information, reveals a number of important issues:

- The results of the study highlighted some large disparities in performance between sectors, and between providers within those sectors. Commissioners must be aware of these differences when formulating strategies for commissioning services.
- The residential special schools segment appears to have enjoyed the most financially successful recent past, with strong profitability and growth. However, the solvency of providers in this sector cannot be assessed without further investigation of parent company information, which is sometimes based abroad (including Jersey, Isle of Man and the Cayman Islands). Strategies for this segment should include a detailed understanding of the capital intensity and returns that that requires. Aggregation of demand across more than one authority may also be worth consideration.
- Fostering agencies also appear to be benefitting financially, perhaps from the strong drive in the last five years through the Every Child Matters and Change for Children agendas to promote fostering. Whilst profitability and growth is also strong in this segment, there is greater visibility of private equity interest and the accompanying high bank-debt levels that some of the largest agencies have acquired in the last three years. Commissioners in this segment need strategies to ensure appropriate understanding and engagement with these new owners, whilst also promoting competition, contestability and growth in capacity and choice.
- The children's homes segment by comparison is displaying more signs of weakness. The turnover growth figures in the organisations researched have come about through one or two providers rapidly acquiring their competitors, sometimes when those competitors have run into financial difficulties. Profitability in this segment is the lowest of the three segments and some of the providers are faced with challenging levels of private equity and bank debt.
- The children's homes sector is especially sensitive to occupancy rates, and commissioners should adopt strategies to bring stability of demand to the sector, perhaps through aggregation of demand from more than one authority, and the use of more substantial contract arrangements. The overall aim must be to support a recovery to a more sustainable position.

On a more generic level, this short study has shown:

- Attention to the detail of the financial risk provided by each individual provider is required, as not all providers are performing in the same way in the same segment.
- Further study is recommended. This study, while identifying providers with annual turnover in their latest accounts of over £500 million, is based on just 15 organisations. There are hundreds of smaller providers in these segments and an extension of the study to a wider number of providers is recommended to ascertain whether the segmental picture is the same when this additional tier of providers is included.

- Most service providers have placements from multiple local authorities, often from different regions. While there are some regional databases that, to varying degrees, map usage of provider services, there is no central national picture, unlike in Wales, where there is one Children's Commissioning Support Resource that offers a model from which a database of supply could be developed. Such a database would help to eliminate the potential replication of supply-side mapping by individual local authorities and would provide greater potential for tracking outcomes in the future.
- Operating to Companies Act 2006 rules that dictate what disclosure requirements are for providers creates a number of issues that make the analysis of supply-side performance more difficult. These issues include the use of complex group structures, foreign parent companies, the relative timing of information delivery, differences between charity and commercial reporting, the level of detail available, and relatively complex accounting treatment of acquisitions and related funding. The message for commissioners is that their teams will need expertise in understanding the public financial statements of providers.

This study also calls for the sector to consider developing additional disclosure rules and requirements for all providers in the sector. A fundamental reason for this is a desire to avoid situations where some of the most vulnerable children and young people in the country are faced with the potential breakdown of a stable placement if their service provider runs into financial difficulty.

What the findings mean for commissioners of services for looked after children

Residential special schools

Of the three segments, residential special school providers appear to be experiencing the highest level of profitability and strong growth, and have fewer concerns about solvency (although only limited information on this was available). It may be tempting for commissioners to assume therefore that targeting of better prices and tougher negotiations is worthwhile in this sector.

However, further debate and analysis is worth doing before reaching such simplistic conclusions. Residential schools involve both capital intensity (e.g. the need to purchase large and expensive buildings) and substantial start-up investment.

Looked at over the life of the investment as a whole, the overall return made by the risk taking investor will take into account these factors as well as profit levels achieved during any given year (which is essentially what we have looked at in the accounts examined in the study).

Commissioners are advised to take similar broader views before concluding if returns and profit levels are enough to fund ongoing service development and innovation in practice, as well as ensuring sustainability of the provider.

The use of foreign parent companies restricts the transparency of results of some providers in this segment, and the call for greater clarity is particularly relevant here.

Fostering

Fostering agencies are also showing growth and profitability, although the results of different providers vary widely. Two of the five largest providers have seen the introduction of new owners from the private equity sector in the last three years. This has introduced high levels of bank and other debt which have heightened the need for commissioners to examine more closely the providers they are dealing with in this segment.

Commissioners need to build into their processes, such as pre-qualification, tendering, and contract monitoring, more sophisticated consideration than simple bank references or credit checks, and placing authorities may need to develop contingency plans for worst-case scenarios.

Equally, new investors in the sector can represent opportunities. They can offer access for the commissioner to capital sources in the independent sector and to innovative approaches to service delivery.

Fostering is historically an area of under-supply and providers have therefore generally managed to increase both volumes of carers and unit prices. This study does nothing to disprove the continuance of that picture. Commissioners may therefore need to look to ways to increase competitiveness and contestability in the segment.

Children’s homes

This study identifies the children’s homes providers as the weakest segment of the three. Despite there being some substantial providers, it remains a fragmented supplier base. Profit levels are low in the segment, and indeed some substantial losses are evident. The weakness in indicators is exacerbated by the presence of private equity-related ownership and accompanying debt levels. Again, care should be taken as this is not the case with all providers in the sector. Diversification (into the parallel fostering marketplace) by one provider was a particularly successful strategy during an otherwise difficult trading period.

Purchasers and commissioners might assume simplistically that they should not target children's homes providers as they already face some significant challenges. However, the challenge for commissioners is to develop strategies that can help this segment successfully move into a more sustainable state. The segment has a high level of medium and long-term fixed costs, and has traditionally experienced volatile demand patterns. Commissioning strategies and tools that bring about more predictable and sustained revenue streams would help it to develop healthily.

Revolution Consulting has recently experienced a number of projects where children's homes providers have been willing to reduce prices in exchange for guaranteed revenue, which would indicate that providers would welcome further activity of this type.

Generic learning

The relatively technical analysis required to produce these results illustrate the need for commissioners to have the necessary skills and experience to carry out this type of analysis.

Assumptions that all provider sectors are experiencing the market conditions in the same way are comprehensively disproved by the information analysed in this study. The corollary of this is that commissioners are recommended to look at service segments separately and to adopt strategies developed to address the issues arising in different segments. Further, there are clear grounds for examining the information available about each provider separately. This is particularly pertinent if there are solvency concerns. No one would wish to see vulnerable children placed in situations that may break down rapidly if, for example, a bank were to step in and liquidate the provider.

Commissioners and commissioning bodies need to get to know owners and their likely motivations, especially when there is a need to support the business for a protracted period, in order for it to trade well enough to service external debt to banks. For example, if a large part of the debt is owed to the owner, then their attitude to risk and the time frame over which they are willing to support the business by not asking for repayments of loans, or even interest, could significantly change the perspective.

For all three segments, we must remain acutely aware that we have examined the largest providers in the sector in this study. It would be dangerous to assume that the further tiers of medium and small providers (of which there are many) are exhibiting the same trends. Certainly the presence of private equity investors is unlikely at the smaller end of the spectrum, so the levels of debt and amortisation will almost certainly be very different. A follow-up to this study could therefore examine a much wider provider base. Revolution Consulting has commenced work on this database.

This was also a point-in-time study. At most, it compared the most recent year to the one before that. It would seem worthwhile to establish the collection and analysis of this data on a regular and continuing basis in one place where all commissioners could access it.

The vulnerability of the children and young people placed with the provider base is such that there is an argument for increased disclosure rules for providers. This study calls on legislators to consider this, and on the provider base itself to consider establishing a self-monitoring protocol, including rules on the timeliness, details and openness of financial reporting.

Beyond service-segment thinking

The above conclusions are based on the interpretation of a relatively narrow set of indicators, but contribute to the wider challenges of commissioning for this particularly vulnerable group of children and young people.

Other factors that commissioners must take into account in their commissioning activity

Segmentation of the marketplace would be best performed on the basis both of needs and proven services to meet need. Ultimately every child is unique and deserves the State to look for services that most enhance their wellbeing and life chances. Commissioners face a hugely complex and detailed challenge to understand the marketplace and how to commission services for it, so their teams must include professionals and practitioners with equal voices.

Children in care and most practitioners would welcome a choice of placement. There is a natural tension between a service provision marketplace that has sufficient surplus capacity in each segment to be able to offer choice, and the drive towards a more efficient use of financial resources.

The most influential factor that drives the profitability of providers is occupancy. This is especially true where there is capital intensity, such as in children's homes and schools, but is also true of fostering. Commissioners should consider what they can do to help providers experience more predictable and sustained occupancy rates. Such an approach will be beneficial irrespective of the underlying market dynamics of the sector. Approaches to consider include taking sub-regional, regional and perhaps even national views about aggregating demand for needs that are rare at a local, individual authority level.

A focus on outcomes is essential, as recent initiatives by central government have been at pains to stress. As this study has demonstrated, the financial outcomes can be accessed and measured. Measuring the value for money requires a robust and consistent application of outcomes measurements. These sectors are striving towards this goal but there remains much potential for further developments in outcomes measurement.

Examining statutory accounts that are subject to statutory, independent audit, throws into sharp relief that we currently have no parallel statutory framework for outcomes measurement or annual reporting and independent audit of outcomes. This begs the question: do we value the outcomes in the lives of society's most vulnerable children as highly as we value the need for financial investors to have monetary measures reported and audited?

Only one of the 15 organisations examined in this study was a charity. The voluntary sector would seem to offer the potential for an increased role in the sectors discussed. Further work to ascertain their current scale through the unwinding of their overall results is recommended. Other areas worthy of study would be the appetite and capabilities of the voluntary sector both to provide these services, and to engage with the commissioning effort in a way that would increase their participation.

The sectors also tend to operate to commissioning activity that is compliant with full blown EU procurement rules whenever anything other than spot purchasing is in operation. These rules bring a huge burden to commissioner and provider alike and can add greatly to the time frame of commissioning activity.

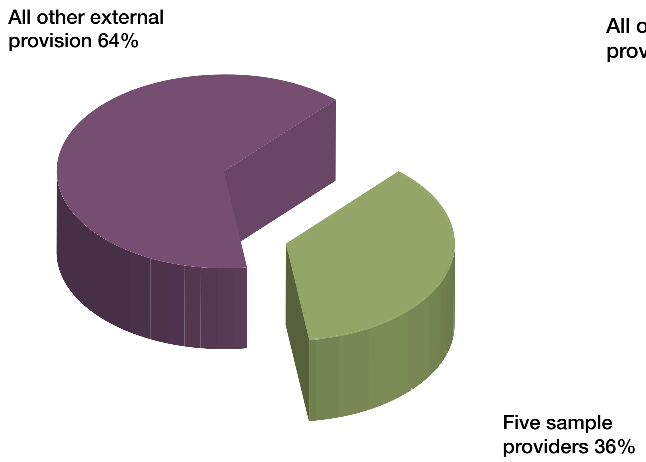
There is a logical argument for more relaxed approaches that allow the best professionals and practitioners to mould services around individual need in many instances.

The presence of private equity and venture capital is a relatively new factor in the sector. As discussed in the earlier sections, this tends to bring new solvency and funding considerations to be dealt with. Equally, it has the potential to bring highly professional business people with private-sector funding and innovation into play. Whether the overall effect of the involvement of these new owners is positive or negative, only time will tell, but their presence reinforces the need for commissioners to be conversant and knowledgeable about the implications.

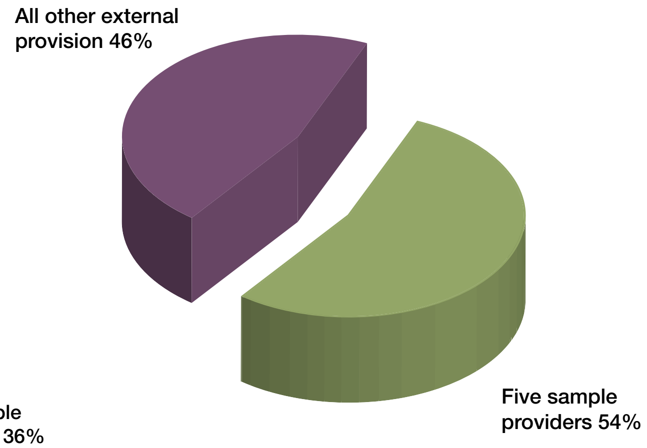
Results – How representative were the samples?

The five large providers studied in each segment are estimated to represent between 32 and 54 per cent of all external placement activity (i.e. placements made by authorities outside of their own in-house provision).

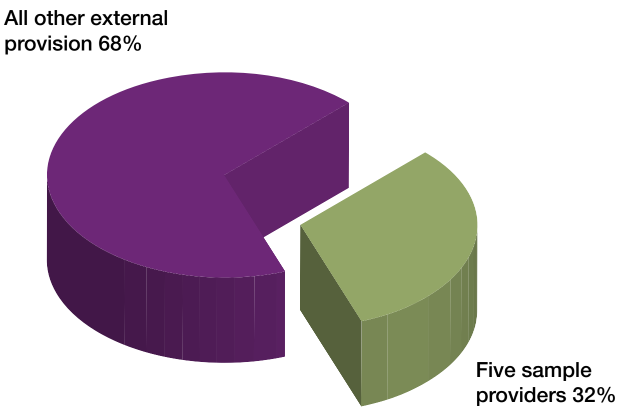
Children's homes



Fostering



Residential special schools



PriceWaterhouseCoopers[1] noted the wide fragmentation of both fostering and children's homes markets in 2006. In this study, the large providers have made some ground in terms of consolidating the supply base through acquisition and organic growth, but markets remain very fragmented.

A full explanation of how these shares were calculated can be found in Appendix 4.[2]

1 DfES Children's Services: Children's Homes and Fostering, PriceWaterhouseCoopers, 2006.

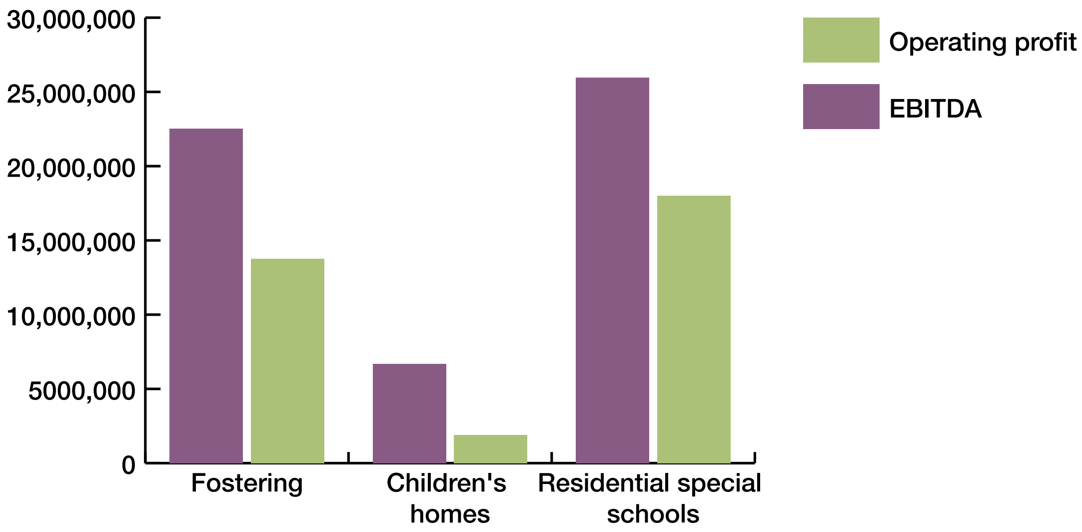
2 The appendices for this paper are in a separate document, see the commissioning support ebook at: http://www.commissioningsupport.org.uk/resource_bank/commissioning_e-book.aspx

Results – financial performance

Financial performance is markedly different when comparing sectors. There are several indicators to look at, and these are explained more fully in Appendix 5.

The absolute levels of profit being generated by the organisations in this study are represented in the following charts:

Financial performance by sector



How are the providers performing financially?
Profit and growth

	Aggregated turnover	Growth turnover	Operating profit	Operating profit	Operating profit growth	Profit/(loss) before tax	EBITDA	
	£	%	£	%	%	£	£	%
Fostering	232,645,891	14.1	13,752,359	5.9	39.0	1,957,761	22,532,114	9.7
Children's homes	107,808,677	27.2	1,911,930	1.8	6.0	(3,481,449)	6,680,035	6.2
Residential special schools	186,831,624	19.1	18,006,185	9.6	590.0	NA	25,954,034	13.9

Commentary on the wider performance indicators

Turnover

Turnover growth is evident in each of the three segments. This indicates that the top tier of providers is growing operations. The routes to this growth are, however, notably different from segment to segment.

Residential schools are all growing, with organic growth a strong theme, for example expanding existing schools or opening new schools.

Fostering is growing strongly both organically (more carers recruited in existing regions and expansion into new regions), but also via acquisition and some consolidation in the segment.

Children's homes' growth is heavily influenced by one provider that reported a high level of acquisition driven growth. The other providers showed variable growth, including the only provider out of the fifteen that contracted operations.

Pre-tax profits

Pre-tax profits have some limited use in this study.

Residential special schools' group accounts were not accessible so no measure could be included.

Most evident amongst the pre-tax profit result are the £3.5 million losses made by the children homes segment where three of the five reported losses, one in particular was a heavy loss.

The fostering total masks a wide variation in results, with one company reporting over £4 million of pre-tax profit, and one reporting over £3 million of losses.

As explained in the appendix, this measure of profitability includes the impact of the finance charges on the business. When these are added back to give the operating profit it is again possible to detect differences in the segments.

Operating profit (or loss)

Residential special schools report the highest operating profits, aggregating at £18 million, with all five in the sample reporting positive results and improved operating profits on the previous year.

There is some variability of the rate of operating profitability, ranging between 4.6 per cent and 22.4 per cent of turnover.

Fostering operating profitability is substantially improved when finance charges are omitted, aggregating to £13.8 million. This includes one provider reporting a moderate loss related to investment and development activities that are expected to deliver more growth in future periods. The top rate of profitability reported by a provider in this sector is 11.4 per cent.

Children's homes are reporting some widely varying operating results, ranging from a £2.4 million loss for one provider and up to a 10.1 per cent operating profit rate for another, although that may have been driven by the acquisition of business which creates a mixed trade picture. Between those two extremes, operating profit levels of the other three providers are the lowest of the three sectors, at between 2.0 and 4.2 per cent.

Where a segment's result is skewed by one large outlying result, it is useful to have additional measures to examine for further insight. The remaining measure in this section is EBITDA (explained in Appendix 5). One of the items that this measure removes is the amortisation of goodwill. Goodwill arises in company accounts when the company has acquired another provider and paid for the intangible value of the brand and, to an extent, its future earning potential. The amount paid is then written off against operating profits across a number of years (generally up to 20). Adding back this accounting adjustment allows a purer focus on the operating result for the year.

EBITDA (earnings before interest, tax, depreciation and amortisation)

Of the three segments, residential special schools again appear to produce the highest level (£26 million) and rate (13.9 per cent of turnover) of EBITDA. All five providers are producing multimillion pound EBITDA at rates of 10.8–23.5 per cent.

EBITDA in the fostering sample improves by £8.8 million from the operating profit level to £22.5 million and reaches a rate of 9.7 per cent, clearly benefitting from the amortisation add-back in particular, indicating that this is a segment where significant acquisition related goodwill has arisen. The same provider that reported an operating loss also has a loss at the EBITDA level, but the other four providers produce multimillion pound EBITDA at rates of 4.4-16.5 per cent.

Similarly, the children's homes provider segment shows a substantial £4.6 million improvement in EBITDA over operating profit. In this case, it is both a mixture of acquisition goodwill and depreciation of property assets that makes the difference. The total EBITDA of £6.7 million includes a loss at EBITDA level of one provider, depressing the average rate to just 6.2 per cent, the lowest of all three segments again. Of the four positive EBITDA results, the rates are between 4.6 and 12.5 per cent, with the highest rate gained by a provider with an increasingly mixed trade.

Results – solvency and funding

Results in the previous section indicate that there are complexities brought to examining performance by the interest burden on borrowings and in relation to acquisition related accounting. These two factors are not unrelated. Business owners may well be financing acquisitions of other providers both through their own investment resources, but also by raising funds from third parties such as banks. Such transactions sometimes come with technical titles such as 'leveraged buyouts', but essentially are the borrowing of money to buy another business.

How are the providers performing financially?
Solvency and funding

	Operating profit	**Profit/(loss) before tax**	**Net interest payable**	**Actual net interest paid**	**Debts due to banks**	**Interest cover** (operating profit:int payable)	**Interest cover** (EBITDA: int paid)	**Years to pay off debt** (debt: after tax result)	**Years to pay off debt** (debt: EBITDA)
	£	£	£	£	£				
Fostering	13,752,359	1,957,761	(11,794,598)	(6,255,072)[1]	59,002,710[3]	1.20	3.67	(36.00)	2.62
Children's homes	1,911,930	(3,481,449)	(5,438,378)	(2,188,275)[2]	67,095,654[4]	0.35	1.90	(15.95)	10.04
Residential special schools[5]	18,006,185	NA	NA	NA	NA	NA	NA	NA	NA

1 Top 4 providers only, one does not disclose sufficient detail on interest paid/payable, but based on low level of bank debt of that provider, the amount involved will not be material.

2 Top 4 providers only, one based on management report that excludes required detail.

3 Debt is for all 5 providers but ratios that follow are only for 4 where interest is used in the ratio formula.

4 Debt is for all 5 providers but ratios that follow are only for 4 where interest is used in the ratio formula.

5 Three of the five providers are owned by parent companies based in the Cayman Islands, Jersey or the Isle of Man. No group accounts showing the full consolidated balance sheet, debt and funding costs was therefore available.

Solvency by segment

Residential special schools

As noted in Appendix 6, the funding of three of the residential special schools was not available to the study at this point. Some comfort may perhaps be drawn from the preceding indicators, which illustrate this segment as performing more strongly than the other two, with a theme of organic growth that would tend to mean that debt levels are more manageable. However, it is recommended that each provider be investigated on their own merit in this area, and this may be the focus of follow-up work to this study.

Fostering

The one provider organisation registered as a charity in the study is in the fostering segment. Charity accounts have much of the same disclosure requirements as commercial companies, but there are some differences, one of which means that interest payable and paid are not readily accessible. Hence the conclusions on this segment are based more on the other four providers.

Interest cover (see Appendix 6 for explanation of this indicator) for those four providers is above the minimum indicator threshold level of 1.00 but this is an average and there is one of the providers dipping below that level on the more stringent of the two indicators.

The two indicators of ability to pay off debt show dramatically different results. As noted in the appendix, care should be taken to look at these indicators in relation to the actual terms of the bank debt. However, what the results show broadly is that there are some fostering providers where the accounting amortisation of goodwill charge is creating an accounting loss. When that charge in particular is added back, the picture is improved and there is more optimism that all of the four providers have EBITDA levels that are more able to service bank debt interest and begin to repay bank debt.

At the risk of repetition, this is an area where individual provider results should be examined closely to test the solvency levels of each.

Children's homes

As three of the five providers in the segment report both before and after tax losses, this results in both interest cover and solvency indicators looking weak across the sector. It is again important to note that this is not the case for each individual provider, and indeed two of the providers do not carry burdensome debt to the same degree as the other three and consequently their individual versions of the indicators are much stronger.

Even at the EBITDA level there are some providers in this segment who would need further individual analysis to investigate their solvency further.

General comment on solvency

Interest rates have been set at extremely low levels as the economy recovers from the credit crunch of 2008. Although rates seem set to stay low for some time to help business recovery, they will almost inevitably rise again. When rates increase there is potential for the highly indebted providers to feel this additional debt-servicing stress acutely. Commissioners need to consider this risk, especially when contracting with providers over a number of years into the future.

About the author

Andrew Rome is a Fellow of the Institute of Chartered Accountants in England and Wales and has wide range of accounting, financial and commercial experience. He has particular sector expertise gained from 2000 as Commercial Director and then Managing Director of Sedgemoor until 2005, an organisation that provided children's homes, special schools and fostering services.

Andrew's consultancy, Revolution Consulting, has offered consultancy services targeted at improving the commissioning of children's services since 2006. Andrew is also co-owner of Signpost Care Services, a specialist provider of services for deaf children and young adults. He was commended in 2008 by the National Teaching Awards for his work as a school governor.

Appendices are provided separately, see the links in the ebook
http://www.commissioningsupport.org.uk/resource_bank/commissioning_e-book.aspx