Browne Jacobson

Investing in distressed care homes: Diamonds in the rough or a lost cause?

The Covid-19 pandemic has given operators and investors in the care home market new factors to consider when assessing acquisition targets.

22 July 2020

Please note: the information contained in this legal update is correct as of the original date of publication.

The Covid-19 pandemic has given operators and investors in the care home market new factors to consider when assessing acquisition targets. Prior to the onset of the pandemic, activity in the care home market across all sectors was at a high level with plenty of interest from established providers and new entrants, including private equity.

The onset of the pandemic had an obvious and immediate impact on M&A activity generally – with potential acquirers and investors looking to keep hold of cash and assess impact, and potential sellers focusing on ensuring their businesses continued to trade profitably and able to mitigate risk of Covid infection.

In the period since lockdown, across much of the care sector, trading has held up albeit in the face of considerable operational and financial challenges. The need for care has not gone away. In fact, in many areas of specialist care, the demand has increased – relatives have needed to accelerate decisions for shielding or other domestic reasons created by Covid. Investors and acquirers on the other hand have, in assessing the market and potential targets, particularly in elderly care, placed greater emphasis on stress-testing the cashflow models of targets in the event that infection enters the home or compromises staffing levels.

At this point in time, only the strongest performing businesses will stand up to such rigorous analysis. This has left many businesses, which would be attractive propositions in ordinary market circumstances, in a state of limbo.

The typical challenges many operators are familiar with, such as tight margins on funded placements, availability of quality staff in certain regions and the ever-increasing regulatory burden, have been exacerbated by the impact of the pandemic. These impacts include:

- needing to spend more on PPE;
- increasing difficulty in replacing residents (particularly if there has been an outbreak in a home or if there is difficulty obtaining a test for a new resident to ensure the continuing Covid security of existing residents);
- increased sick pay and agency costs;
- restrictions on the ability of publicly funded businesses to benefit from the job retention scheme.

The early signs are suggesting this may well push some otherwise profitable and well-run homes into distress. On that basis, and as existing cash reserves dry up, one would expect the number and average quality of distressed opportunities on the market to increase and improve.

As a consequence, those seeking growth through acquisition are exploring new ways of increasing their stock and picking up a distressed business at a price reflective of real value for money. It would come as no surprise if, post-pandemic, many investors increasingly factored distressed opportunities into their investment strategy.

“So how is a business that is losing money an opportunity?”

It is perhaps trite to say it, but businesses don't go bust because they aren't profitable. They go bust because they run out of cash.

There are multiple reasons why a perfectly good care business may find itself in the position of being 'distressed', many of which are not terminal and a number of them are summarised above. This creates opportunities to acquire at a discounted price which can, even when factoring in the expense of fixing what has gone wrong, represent real value for an investor (particularly cash buyers due to their ability to act quickly and possibly even negotiate a lower price reflective of that).

Due diligence on the part of the investor is key to establishing whether the business in question presents such an opportunity. Ultimately, investors need to identify the following and quickly (the risk of the business' position worsening comes with pressures of its own from a transactional and operational/regulatory perspective):

- that the business has a 'clean bill of health' from a regulatory and provision of care perspective (this will be absolutely fundamental);
- the root cause(s) of the current financial position;
- what capital expenditure has been deferred in light of the financial position of the business (which will then need to be invested post-deal to bring the business up to standard);
- whether operational and financial turnaround is a legitimate possibility; and
- critically, whether the buyer is willing and able (financially and operationally) to commit the energy and resource to completing the acquisition and implementing that turnaround plan.

If the assumption that the home has simply been badly run can be put to one side (it is often an oversimplification of broader issues), the potential investor can drill down into the business' underlying challenges. Some key commercial areas of enquiry which are likely to be towards the top of that list are:

- What is the relationship like with the CQC? Does the CQC see a way back? Crucially, will the CQC allow the potential investor the necessary time to implement its turnaround plan? It is better to get these answers from the CQC directly than from the seller and/or the administrators (and they may have their own/different views on issues facing the business);
- What have been the home's historic occupancy levels and what is the service user pipeline? Will commissioners welcome an incoming investor or drive them away?
- Given that private rates tend to be linked to local house prices, how buoyant is the property market in the region?
- Is there an overreliance on agency to supplement the workforce? If so, why is that the case? Are the agency terms even competitive?
- Meet the registered manager – can they help turn the business around or are they part of the problem? It is worth remembering that they may be perfectly competent but have been distracted by dealing with the other issues that you would remove from the equation.
- What is the debt position? If the business is overburdened by it, why is that the case? An asset purchase will not transfer that liability to the acquirer but is that debt the only thing that has been keeping the business alive or is it a symptom of, say, a smaller/owner managed home struggling to manage its working capital requirements?
- What ongoing suppliers are key to the business going forward and will their outstanding debts need to be honoured in some way post deal and factored into cashflow forecasts (rather than be left with an insolvent seller).

Getting an answer on the above is at least a start for a potential investor to determine whether the business is 'a diamond in the rough' in need of a little investment or one to be avoided. The investigations should also help distinguish between chronic or recurring issues and those issues which are attributable to unusual events, such as Covid-19.

"I suppose I can always fall back on a claim under the warranties if worst comes to worst?"

The extent to which you can rely on warranties and how valuable they are will depend on a number of factors including:

1. Whether or not the business being sold is in administration.

2. The structure of the transaction (is it a business and assets deal where you are taking the business but leaving the liabilities or is it a share acquisition where you are buying the company which 'houses' the trading business in which case you will be acquiring all assets and liabilities which sit in the company).

3. A seller's willingness to give warranties.

4. A seller's covenant strength for the warranty period – for example, if it's a business and assets transaction where the seller is a corporate entity and on completion of the transaction it will distribute the proceeds to its shareholders and be wound up, warranties will ultimately be worthless as there will not be a 'warrantor' in existence.

5. The price - often with distressed M&A a buyer will negotiate a lower price on the basis that it will take the business without the benefit of warranties.

Warranties are an important part of any corporate transaction. For an investor/acquirer it provides them with a form of retrospective price adjustment in the event that the business or company they are buying is not as it was presented to them.

As the investor/acquirer, if you are able to negotiate a reasonable set of warranties and you are satisfied that the seller will be able to meet any resulting liability, you may be satisfied that you can 'fall back on a claim under the warranties'. In any other situation (i.e. you pay a little less on the basis that you will not get the benefit of warranties, you are not satisfied with the covenant strength of the vendor or you are not comfortable with the extent of the warranties offered), the evolution of warranty and indemnity insurance (W&I Insurance) could provide you with a neat solution.

Historically, whilst the M&A market was strong, insurers did not tend to look to provide W&I Insurance on accelerated or distressed M&A as the product needed to be adapted to fit and margins would likely be lower than higher value, non-distressed deals. However, with deal volumes down across all sectors, and awareness and availability of W&I Insurance as a product probably at an all-time high, insurers have expressed a willingness to support accelerated or distressed M&A and have generated a product which is aimed at transactions of that nature. Insurance could be used to either:

1. Stand behind the warranties you negotiate with a seller (which might be appropriate where your concern around the warranties is limited to a seller's covenant strength). This is more akin to a typical W&I Insurance policy; or

2. Replace the absence of warranties which you would expect, or you require from a seller.

The second alternative is a relatively new concept and has been created to support accelerated or distressed M&A. Certain insurers have generated a set of 'synthetic' warranties and tax indemnity together with a form of due diligence scope. If an investor/buyer can do the due diligence in the scope it should be able to secure the benefit of the 'synthetic' warranties/indemnity. Unlike typical W&I Insurance, the 'synthetic warranties/indemnity' are negotiated directly between the investor/acquirer and the insurer (and there is no need for a seller to go through a disclosure process in respect of the 'synthetic' warranties). Of course, like any insurance, there is a premium to pay which could start at £40,000-50,000. However, it may be a critical piece in effecting the acquisition of a distressed but otherwise potentially viable business (and the consequent preservation of jobs and continuity of care for residents).

The jury is out as to whether or not there will be an appetite for the 'synthetic' warranties as they do not avoid the need to do due diligence (which may be a barrier to securing such a policy particularly where the business being sold is in administration or being sold as a 'pre-pack') but insurers are keen to deploy these policies and enter the 'proof of concept' phase with them.

Through our sector specialist M&A lawyers acting for multiple clients taking advantage of the opportunity to acquire distressed homes, we have a wealth of experience in working to ensure that the acquisition works for them and their growth strategy. Feel free to contact Clare Auty, Joel Nixon, Peter Allen or Ryan Brown to discuss your needs.

Contact

Clare Auty

Partner

clare.auty@brownejacobson.com

+44 (0)121 237 3943

Related expertise

Sectors

Health and care regulatory

Independent health and care

Health and life sciences

Later living