CONAGHAN
HEALTHCARE CORPORATE FINANCE

UK Budget 2016

- ***Positive for healthcare business owners and investors, who will benefit from the cut to corporation tax and capital gains tax; and from extended entrepreneurs' relief***
- ***Confirmed introduction of the National Living Wage, already impacting the care industry and causing upward wage costs pressure***
- ***Negative for healthcare businesses acquiring real estate, such as care homes and hospitals, above GBP 1.05m, who will pay more in Stamp Duty***

17th March 2016

Key Points

- Confirmation of National Living Wage, introducing a GBP 7.20 per hour for over-25's from next month
- Corporation Tax cut to 17% by 2020; capital gains tax allowance increased; extended entrepreneurs' relief
- Healthcare real estate investors will be hit by new SDLT rates for acquisitions or land developments above GBP 1.05m
- Levy on soft drinks industry to combat childhood obesity, effective 2018; GBP 520m to fund school sports
- Confirmation of 2017-2018 start for the GBP 40m National Centre for Ageing Science and Innovation (NASI).

Healthcare – Osborne and Very Little

Against a background of an NHS funding crisis and the imminent introduction of the National Living Wage, there was precious little in the form of support for the healthcare sector in yesterday's Budget. Along with the wider business community healthcare operators and investors will benefit from a more benign corporation tax regime, but acquisitive companies – care home groups seeking to expand their portfolios, for example – face higher Stamp Duty in the new, banded system. A care home costing GBP 10m will now incur SDLT of GBP 489,500, as opposed to GBP 400,000 under the previous system, an increase of 22%.

The macro picture remains a bleak one, with the prospect of a bigger-than-expected hole in the public finances of some GBP 56bn and a concomitant longer programme of austerity. The NHS was barely mentioned yesterday, despite the threat of continued industrial action and this week's damning verdict from the Public Accounts Committee that the finances of NHS hospitals has 'significantly worsened'. Overall, Trusts have a net deficit of GBP 843m in 2014-15, compared to a GBP 91m deficit in 2013-14 and a surplus of GBP 592m in 2012-13. The prognosis for overspend in 2015-16 is GBP 2.5bn.

The private healthcare sector can take some comfort from the business-friendly package of corporation tax cuts (down to 17% in 2020) and more flexible use of business losses carried forward. But many healthcare operators with growing real estate portfolios will be caught by the **new SDLT bands for commercial property**, effective from today. Previously, SDLT was charged at 4.0% above GBP 0.5m. The new banded system may well slow activity in healthcare real estate, where the bulk of transactions are in excess of GBP 1.05m, above which the new rates mean an overall increase SDLT payable. Although recent care home portfolios coming to market from the likes of BUPA and Four Seasons Health Care have attracted strong interest and land values for development remain at an all-time high, the new rates will likely give pause for thought for those operators planning large transactions or bulk-buys. Developers of turn-key projects, notably care homes and retirement villages, may offer further incentives to customers such as 'golden-brick' construction programmes.

The introduction of the much-debated **National Living Wage** is confirmed in the Budget. The Local Government Association estimates this will cost £330 million to implement across publicly-funded social care in 2016-17 alone and £1 billion by 2020. The Resolution Foundation estimates total public investment in social care required to meet NLW commitments are even higher, at £2.3 billion by 2020. These predictions have caused consternation in the care sector, particularly in businesses reliant on local authority fee settlements to match, or part-match, wage increases. Domiciliary care, which ironically might have been in the vanguard of providing hospital-at-home services to help unblock NHS Trust beds, is the first sub-sector effectively to be torpedoed by the NLW.

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In **elderly residential care**, we expect the local authority / private pay mix to bifurcate further, with providers becoming increasingly dependent on private funding or, at the least, family-funded top-ups to cover their costs. We show our own analysis of how NLW will affect a typical care home overleaf. Our analysis is as follows: an increase in NLW from £7.20 per hour in April 2016 to £9.00 per hour in April 2020 implies an average salary increase of 5.7% per annum. The implementation and the increase of NLW will not only affect employees paid under £7.20 but also employees who will want to keep a premium in their remuneration. We estimate that for a care home where total staff costs is GBP 1.25m per year as of today, staff costs will reach GBP 1.51m in 2021 – representing an average increase of 3.9% per annum. To maintain its margins an operator would have to increase its revenue by 3.6% on average per annum. Research by Knight Frank (Oct 2015) showed that the NLW will hit hardest in the south – counties such as Buckinghamshire, Hampshire, Cornwall, Dorset and Berkshire are those with the highest staff costs per occupied bed at c.£28,000 per annum (the lowest are Wales and East Yorkshire at <£18,000 per annum). Sub-scale homes – less than 30 beds – will be most at risk of closing and there are 7,300 such homes across the country, accounting for 117,000 beds. Council Tax increases of 2% will only partly ameliorate the situation.

Elsewhere in the Chancellor's Budget, we note the continuing commitment to release further **public sector land** for housing, augmenting last autumn's announcement for increased capacity for at least 160,000 homes. Housebuilders are increasingly turning to the care sector to work on carving out plots on large residential sites for care homes, independent living units and retirement villages and we expect this to gather pace as further land is released. An acceleration of disposals of surplus NHS Trust land would be a further boost to development, as would co-location and sharing of much-needed step-down facilities or Intermediate Care Units.

There was one major announcement to address the need for healthier lifestyles and curb childhood obesity. A headline-grabbing **'sugar tax'** – a levy on producers and importers of sugary soft drinks – will be payable from April 2018. The money raised, an estimated GBP 520m a year, will be spent on increasing the funding for sport in primary schools. This will, in our view, do little to address the GBP 27bn cost of obesity (its contribution to the prevalence of cancer, diabetes and heart disease) cited by the Chancellor. This announcement apart, his speech contained no new news about funding for research, support for the life sciences sector or any new major public health initiative.

Finally, in the footnotes, there were some modest announcements for the healthcare in the form of an extension of the **defibrillator grant scheme** (a further GBP 1m), a government investment of GBP 1.5m in **sports prosthetics for children** and to create a fund to develop innovative prosthetics for the NHS. There was confirmation, too, of a 2017-2018 start for the GBP 40m **National Centre for Ageing Science and Innovation** (NASI), which will bring much-need expertise together in a new facility under the aegis of Newcastle University.

Looking Ahead…

Retirement living and 'Event Fees' – Extracare providers who charge 'event fees' (also called exit or assignment fees) for residents buying leasehold interests in units in retirement villages and communities will soon get a clearer picture of the government's view of such fees. The Law Commission will publish a summary of responses to its consultation on *Transfer of Title and Change of Occupancy Fees in Leaseholds* at the end of April and make its interim recommendations in July. The Department for Communities and Local Government, the sponsoring government department, will then decide whether to act on the Commission's recommendations.

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Impact of National Living Wage – Care Home Example

Metrics	GBP
Nb of beds	65
Occupancy	90.0%
Average weekly fee	£ 700
Staff cost per residents	21,400
Staff cost % of t/o	59%
EBITDA per residents	10,300
EBITDA margin	28%
National Living Wage	£ / hour
Apr-16	7.2
Apr-17	7.6
Apr-18	8.0
Apr-19	8.5
Apr-20	9.0

Maintaining margins (i.e. 28% EBITDA margin)

GBP	Actual	Forecast					CAGR
12 months period / FYE	Mar-2016	Mar-2017	Mar-2018	Mar-2019	Mar-2020	Mar-2021	2016-21
National Living Wage	n/a	£7.2 / hour	£7.6 / hour	£8.0 / hour	£8.5 / hour	£9.0 / hour	
Turnover	2,130,000	2,202,734	2,266,589	2,337,027	2,434,179	2,538,517	3.6%
Increase per annum		*3.4%*	*2.9%*	*3.1%*	*4.2%*	*4.3%*	
Staff cost	1,250,000	1,296,575	1,336,683	1,381,391	1,445,112	1,513,861	3.9%
Increase per annum		*3.7%*	*3.1%*	*3.3%*	*4.6%*	*4.8%*	
Overheads (cleaning, food commodities, etc)	275,000	280,500	286,110	291,832	297,669	303,622	
Increase per annum		*2.0%*	*2.0%*	*2.0%*	*2.0%*	*2.0%*	
EBITDA	605,000	625,659	643,796	663,803	691,398	721,034	
EBITDA margin	*28%*	*28%*	*28%*	*28%*	*28%*	*28%*	

Maintaining profitability (i.e. EBITDA GBP 605k)

GBP	Actual	Forecast					CAGR
12 months period / FYE	Mar-2016	Mar-2017	Mar-2018	Mar-2019	Mar-2020	Mar-2021	2016-21
National Living Wage	n/a	£7.2 / hour	£7.6 / hour	£8.0 / hour	£8.5 / hour	£9.0 / hour	
Turnover	2,130,000	2,182,075	2,227,793	2,278,223	2,347,781	2,422,483	2.6%
Increase per annum		*2.4%*	*2.1%*	*2.3%*	*3.1%*	*3.2%*	
Staff cost	1,250,000	1,296,575	1,336,683	1,381,391	1,445,112	1,513,861	3.9%
Increase per annum		*3.7%*	*3.1%*	*3.3%*	*4.6%*	*4.8%*	
Overheads (cleaning, food commodities, etc)	275,000	280,500	286,110	291,832	297,669	303,622	
Increase per annum		*2.0%*	*2.0%*	*2.0%*	*2.0%*	*2.0%*	
EBITDA	605,000	605,000	605,000	605,000	605,000	605,000	
EBITDA margin	*28%*	*28%*	*27%*	*27%*	*26%*	*25%*	

Source: Conaghan & Co.

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