Goodwill: taking care of the numbers is no easy task

How do you value the goodwill of a care home business, and will it acceptable to HMRC? Mark Ridout has the answers

Over 415,000 people now live in care homes in the UK, representing 4% of the population aged 65 and over and rising to 16% of those aged 85 or more. The average length from admission to death is approximately 15 months, although about 27% of people live in a care home for a period of more than three years.

The phrase care home is an umbrella term to encapsulate nursing homes (care homes with nursing care) and residential homes (care homes without nursing care). Homes typically range in size from 10 beds to over 100, with an estimated 75% of homes having between 40 and 80 beds in total.

Significant payroll costs and a high level of staff turnover, plus economies of scale, mean that small independent care homes often operate with disproportionally weighted overheads. While NHS funding per home has recently increased – backdated to April 2016 – there is a pattern whereby small or unprofitable care homes are closing in increasing numbers.

That said, care homes tend to have high occupancy rates and are very often successful and profitable businesses to own. A modern, tightly managed care home in a respectable area can expect to achieve a healthy profit margin; it is commonplace for operating profits (excluding property costs) to exceed 50%.

Evidence implies that an operational care home will sell on the open market for a premium above a hypothetically identical closed home. The value of a care home is highly dependent upon its geographical location and the proportion of local authority residents. Care home businesses located in the south and south east typically achieving higher prices than their counterparts in other areas of the UK.

There is also a pattern – as previously seen in the pharmacy and veterinary sectors – whereby larger and successful homes and organisations are forming multiple groups by acquiring smaller homes, especially vulnerable care homes that have struggled with staff retention/recruitment, bureaucracy and so on.

The market for investment and acquisition is highly active, with increasing interest from overseas. Values of homes – particularly those that are well operated and in good areas – are healthy.

THE CARE HOME SECTOR IN NUMBERS

- Averages national fees per resident are in the region of £700 per week although they vary by region with London and the South – with the highest level of self-funding residents – typically having the highest fees and the North West and North East the lowest.
- Occupancy rates also vary per geographical region, although not in relation to affluence or to the same extent, with the national average being a little shy of 90%. In the south east, over 50% of income is derived from self-funding residents.
- Staff costs – typically the largest cost component for a care home – average, around 60% of turnover. Most staff have historically been paid in relation to the National Minimum Wage – replaced in April 2016 with the National Living Wage – and inherently labour costs are increasing at most care homes during in the current financial year. A high level of staff turnover is commonplace, especially among junior care assistants who provide the majority of the day-to-day care. Many owners and managers of homes already face staff retention and recruitment issues and, particularly subsequent to the EU referendum, there is likely going to be more reliance upon agency staff, resulting in higher payroll costs and which may adversely affect the businesses financially in the medium term.
- NHS funding to care homes has increased. Whilst only an interim measure, the independent review of the staff cost per resident rate paid by the NHS to nursing homes, has led to a rise from £112.00 per week to £156.25, a 40% increase, accepted by the government and back-dated to 1 April 2016.
- A moderately profitable open care home will typically achieve an open market premium of between 2.5 and four times higher on a per bed basis, than a comparably located and fitted closed home.

What does this mean in terms of goodwill?

The open market value of goodwill of a business is a separate asset that can be taken onto the market and sold there between a willing vendor and purchaser; it is the earnings stream that will become available to the purchaser that generates the value of goodwill in any trading business. Where the business operates out of a commercial or retail class of property, the property has no impact on the goodwill valuation other than including, if applicable, an adjustment for a market level of rent.

However, care homes – as with hotels, restaurants, pubs, childcare nurseries, garden centres and so on – are housed within trade related properties (TRPs). It may be considered appropriate therefore to assess the goodwill based on The Royal Institution of Chartered Surveyors (RICS) assumptions involving a reasonably efficient operator (REO). The approach is effectively to establish

whether the business in question has achieved a premium in trading performance above that achievable by an REO, and consequently to capitalise that premium by an appropriate market multiple. Comparable market data, however, demonstrates considerably more activity and higher non-property values in the care home sector than the majority of other TRP sectors; a 'one size fits all' approach, or like-for-like comparison, is likely to be equivocal.

As the majority of care homes are owned on a freehold basis, a care home's sale value can be equated simply as:

Sale value = value of land and buildings + value of chattels + goodwill

And likewise:

Goodwill = sale value – (value of land and buildings + value of chattels)

For example, a care home may sell on the open market in an arm's length transaction for a total of £1,000,000. The value of the land and buildings is valued at a current market value of £650,000 and the chattels at £100,000. The remaining value of £250,000 is simply attributable to goodwill.

HMRC's opinion

If there is a potential benefit to a taxpayer in respect of a business' value of goodwill, HMRC will naturally take fervent interest in it. Those that have entered into negotiations with HMRC regarding the goodwill value of a care home, or other TRP, note that a blanket opinion usually exists to the effect that the property valuation already takes into account the 'trading potential of the property' including any earnings streams. This stance – i.e. that there is little or no goodwill – is argued on the basis that businesses in TRPs are incapable of being sold separately from the property. A moot point, and certainly one that contradicts market evidence.

Many observe, on this basis, that HMRC's assessments consequently inflate the value of land and buildings e.g. in the above example of a total sale price of £1,000,000, HMRC might value land and buildings at £900,000 and chattels at £100,000, leaving no value of goodwill.

It has also been argued that goodwill in TRPs is not necessarily free and transferable. It may be attributable, in whole or part, to inherent goodwill and/or adherent goodwill – the former relating to the increased value of the property over and above its pure bricks and mortar value by virtue of its location; the adherent value being the licences or agreements that allow the property to be used for a specific business purpose. As both effectively form part of the property asset, neither are technically goodwill.

However, HMRC state in a form of concession to the existence of goodwill that: "[HMRC] accept that if a business is sold as a going concern the sale may include some element of goodwill. The question to be answered is not whether goodwill exists, but what is the value of that goodwill? The question has to be decided on the facts of each individual case and will vary depending on the type of property and use. In some cases the value of the goodwill may be nominal but in some it may be substantial."

The author – who has achieved favourable outcomes in negotiations representing clients with HMRC – suggests HMRC will accept a quantifiable level of goodwill if the evidence implies it exists, albeit it is likely to be lower than market trends imply and, despite the above statement, a very formulaic approach applies. HMRC's accepted approach, put in its simplest terms, is:

Goodwill = (actual business surplus – surplus achievable by an REO) x capitalised multiple

Conclusion

Including care homes within the wider TRP sector is understandable for the purpose of simplicity. However, when it comes to goodwill valuation the different sub sectors are evidently quite different regardless of whether if is possible to dispose of the asset separately from the property – pubs do not have transferable contracts with their customers whereas care homes do with their residents (whether formal or implied). Staff at care homes are also typically qualified and regulated.

Despite an active market and mounting comparable evidence, HMRC's stance on the acceptable value of goodwill with most care homes may appear to be onerous, formulaic and out of touch with comparable market figures.

There are a number of unresolved cases and a tribunal may be inevitable to reach an agreement and set any official precedent for the future. Consequently, until this point occurs, many experts from either accounting or surveying backgrounds are wary about pinpointing a goodwill figure for particular care homes.

The author's experience is that there is some flexibility and recognition of transferable goodwill by HMRC. It requires a sound argument and strong negotiating skills together with extensive knowledge of the sector and comparable data/information to justify a quantifiable value of transferable goodwill.

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