EI article

Child's play

The nursery sector faces numerous difficulties, so why are investors flocking to it? Sunniva Davies-Rommetveit investigates

National headlines about nursery provision in the UK have been far from flattering in the past few years. Over the last decade fees have shot up in some areas, especially London and the Home Counties, leaving many feeling short-changed. To help, the government increased the number of state-subsidised childcare hours for three and four-year-olds from 12.5 to 15 hours back in 2010, but few think it's gone far enough.

You'd be forgiven for thinking operators have benefited from all of this; after all, about 75% of the nursery sector comprises of for-profit entities. However, according to the National Day Nurseries Association (NDNA), providers have had a tough time of it too. Government subsidies don't actually cover the true cost of provision, it argues, leaving many struggling to provide quality teaching and facilities. There are business rates to contend with as well.

For investors, it all might seem to amount to a flashing red light. But in fact the opposite appears to be true. Lured by favourable demographics and employment trends, many are watching the sector closely and there have been a rash of deals.

Recent examples include Phoenix Private Equity's November investment in Just Childcare, a chain of nurseries in the North West, which Phoenix intends to build into a much larger group. Ontario Teachers' Pension Fund bought Busy Bees, the UK's largest nursery provider, in 2012 for about £220 million (and Busy Bees has since acquired Caring Daycare in Surrey and the Kent-based Kinder Nurseries). The chains Treetops, Bertram and Asquith Day Nurseries also acquired sites in 2014, and sources say we can expect the flurry of activity to continue this year.

There are a number of factors driving the trend, the first being that the market is highly fragmented. Courteney Donaldson, corporate childcare director at Christie + Co, says that the top 10 nursery chains account for about 9% of the market. "Around a further 15% of provision is supplied via groups with three or more settings and the remaining 76% of the market comprises 'ma and pa' style operators," she says.

Investors therefore see real opportunities in following a buy and build strategy, acquiring a small chain and growing it through acquisitions – the aim being to suck up customers and drive economies of scale.

Another driver is that the underlying demand for childcare is increasing. The population of zero to five-year-olds grew at 2% per annum between 2008 and 2012, according to analysis by Parthenon-EY. Households increasingly have both parents working too, due to rising living costs, and employment levels have also risen. That means disposable income and the need for professional childcare have both climbed.

It would seem that the only potential dampener on demand would be those pesky rising fees. But contrary to popular belief, nursery costs have only been rising in some parts of the UK in the past three to four years. Matthew Webster, vice president at Parthenon-EY, says that average costs across the country have actually been "pretty flat".

A consolidation play

What this all boils down to is a major consolidation opportunity. In the struggles faced by the sector, it seems investors see a golden opportunity.

Those struggles are a long way from being fully resolved, too. The increased hours of state-funded childcare for three and four-year-olds, while a positive for parents, have put many nurseries – particularly standalone operators – in a difficult position. According to the NDNA, the rates paid by local authorities (LAs) to subsidise childcare do not reflect the true cost of providing it. On top of that, while state-maintained and non-profit nurseries get relief on business rates, for-profit nurseries do not. Together these factors have led to price inflation for many providers, and more unhappy parents as a result.

The NDNA has long criticised the government for not fixing the problem. Its Annual Nursery Survey 2015 states that "funding for free 15 hour-per week nursery places falls short of costs by £800 per child per year for every three and four-year-old place, and £700 for every two-year old". This "chronic underfunding" skews nurseries' business models, it says.

There may be a light at the end of the tunnel, though. Last month childcare and education minister Sam

Gyimah said that the Department for Communities & Local Government would write to all councils, urging them to give nurseries relief on business rates. To incentivise them, half the costs would be covered by central government.

Gyimah also called on councils to disburse state subsidies for childcare more promptly, as many operators complain of tardiness in this area. "I'll also be urging them to work closely with you to understand your business models and how they could provide further support," he said.

Claire Schofield, director of membership, policy and communications at the NDNA, welcomes the statement, saying that it's very much a "step in the right direction". More work needs to be done though. "Nurseries make a social contribution to the community and provide an essential service to the working population, so the NDNA thinks they should be [completely] exempt from business rates and VAT," she says.

Exemption or no exemption, Webster expects investor interest in the nursery sector to remain strong, with consolidation being the common theme. Recent strategies have ranged from "small chains building scale and professionalising to drive value, through to larger operators acquiring such chains to grow quickly.

Successful growth also seems to be linked to geography. Webster says that growth often derives from "micro clusters" of sites, which allow a company's staff to easily move between one nursery and another. The benefits of this are threefold: it creates a pool of labour if staff are needed at short-notice, helps build a reputation as a high-quality, professional provider in a local area, and enables operators to offer more career development opportunities to their employees.

Where in the UK you choose to invest is dependent on your goals, says Donaldson. She points out that there's been more happening outside of London and the Home Counties, because the barriers to entry in terms of initial capital outlay are lower, opportunities are more plentiful and rates of return remain high.

Like Webster, she expects the sector to remain attractive to investors and she thinks we'll see more acquisitions this year. That'd be good news for investors and potentially the sector too: as chains proliferate, we should see fewer struggling single operators and greater economy of scale (although let's hope that's not at the expense of staff wages). Whether providers can keep parents happy with acceptable prices remains to be seen, though.

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