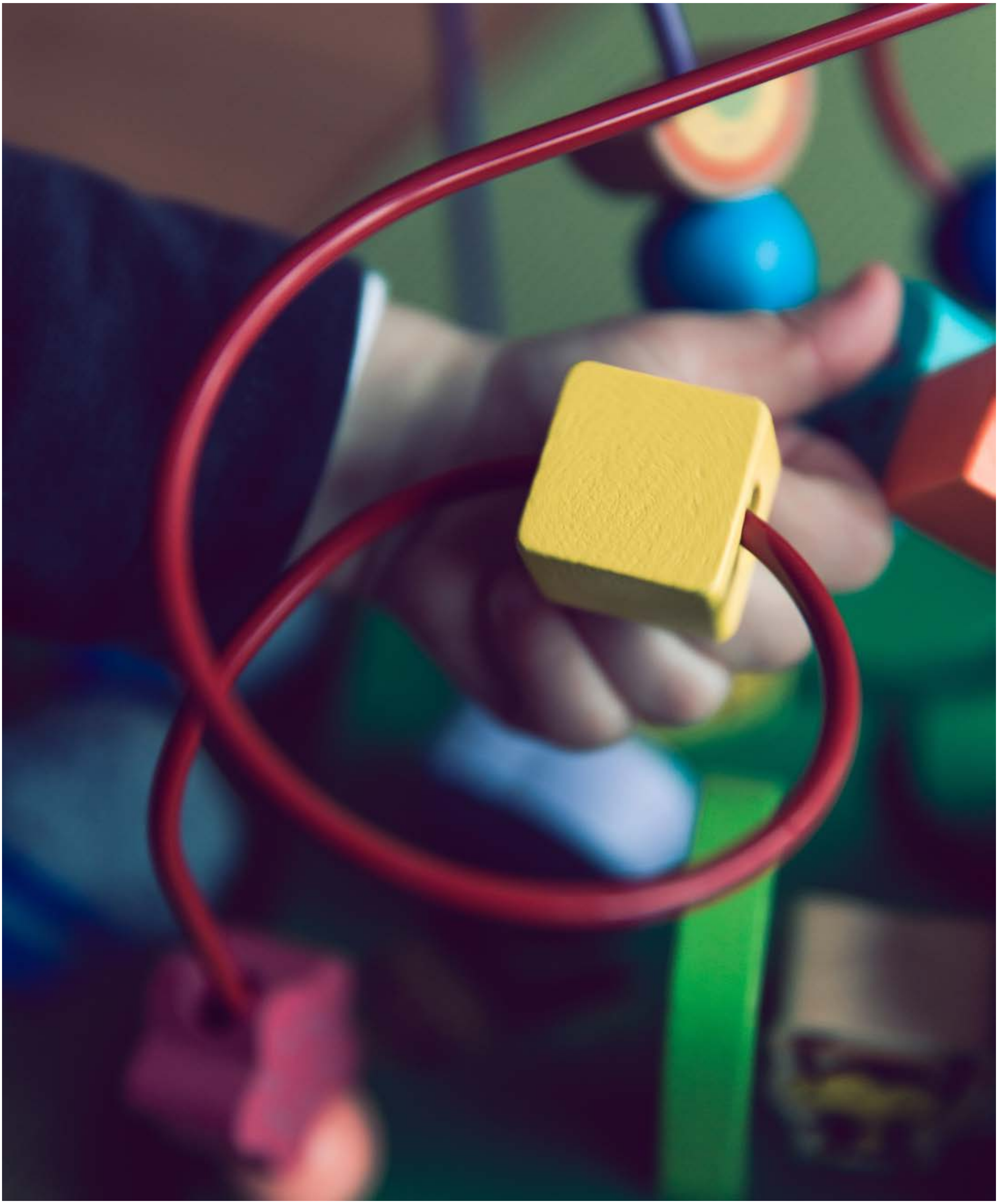
UK Commercial – Autumn 2023

SPOTLIGHT
Savills Research

Children's Day Nursery Spotlight

savills



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Market Update

The Children's Day Nursery sector is estimated to contribute £6.7 billion to the UK economy, a 25% growth since 2020. With over 31,000 Ofsted-registered providers (excluding childminders) in England offering an accumulative 1.4 million childcare places to cater for the early years education of the population, the role of the sector is paramount in shaping the future of tomorrow.

Market consolidation

Over the years, there has been a notable transformation in the structure and ownership of children's day nurseries, shifting from small, single-ownership companies to institutionalised organisations that are increasingly attracting investment. Modern-day nurseries now offer not only childcare services but also a diverse range of educational activities, facilities, and amenities that enrich a child's early years.

The market maintains a fragmented structure, as 80% of day nurseries are currently owned by independent operators. Certain super-groups, however, continue to grow and consolidate within the market, whilst the remainder of the market activity derives from smaller to mid-size operators. Figure 1 outlines the largest nursery operators by total number of settings, with the top three operators being Busy Bees, Bright Horizons and Kids Planet. These providers have all continued to be active this year, acquiring clusters of independent nurseries in most instances such as Kids Planet's acquisition of Hillside Childcare in June 2023, a group of three nurseries plus a separate out-of-school club in Wakefield.

Mid-tier operators that have been similarly active in the market include N. Family Club, which reportedly aims to grow to over 80 settings by 2025, and received the highest proportion of 'Outstanding' Ofsted ratings of the biggest 25 groups (2023). Thrive Childcare and Education has also acquired 11 sites in the past year.

The expansion of private equity-supported groups show signs of further growth over the coming years, with a significant number of private equity transactions recorded in 2022 including Oakley Capital's acquisition of ICP Nurseries (subsequently rebranded as Bright Stars). It's apparent that the sector remains an attractive investment class with recent transactions securing prime yields of 5.0-6.0%, placing the market alongside retail warehousing developments (currently at 5.75%). This is primarily attributed to the opportunity for scalability and consolidation of assets, the developmental potential of land, and the government regulation and support towards the sector, despite market challenges.

Economy and policy

In April 2023, the government announced that hundreds of thousands more working parents would be supported through the expansion of the current free childcare offering, more than doubling the current support as part of the spring mini-budget. All children over the age of nine months will become eligible for 30 free hours of childcare a week (38 weeks per year), which will be phased in a three-stage process by September 2025.

Staff-to-child ratios were also modified from 1:4 to 1:5 for two-year-olds, effective from September 2023. Although initially met with some trepidation and concerns that changes to staff ratios would negatively impact the quality of care provision, this may support additional demand and help soften operational staff shortages. These changes are in addition to £204m of funding aiming to support the delivery of the outlined provision. This funding, however, is not in line with cost of living and inflationary provision, and no additional capital funding has yet been announced to support providers in establishing new provisions, which raises questions surrounding how the sector will cope with the additional demand given the already challenging economic climate alongside staffing issues.

Closures induced as a result of economic challenges appear to be concentrated within more deprived areas of the country, which accounted for 16% of total closures in the past year, such as in East Manchester and Bradford (National Day Nurseries Association). Children and families residing in disadvantaged areas therefore face greater impact, widening the attainment gap compared to peers in more advantaged areas. Both insufficient income and staffing-related issues are among the key drivers behind closures.

The systematic underfunding of the early years sector has been further exacerbated by inflationary and cost of living increases, worsening the operational challenges providers face to maintain financial security whilst delivering quality and accessible childcare provision. It is, therefore, likely the government's expansion of free childcare will be a challenge to deliver universally.

Sector worth £6.7bn to UK economy

31,000 providers in England

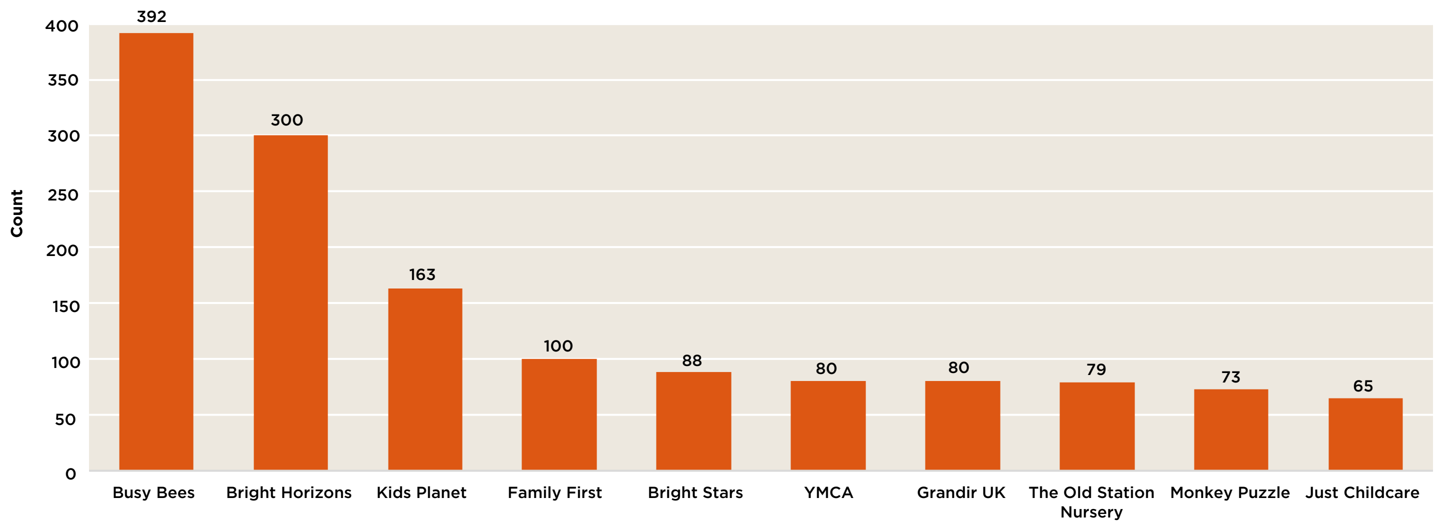
1.4m Ofsted-registered childcare places in England

Since 2021 there has been a 275% increase in childcare businesses sold in the UK

Prime yields are in the order of 5.0– 6.0%

*Note figures exclude childminder providers/places

Figure 1: Major nursery providers by number of settings



Note site numbers as of July 2023

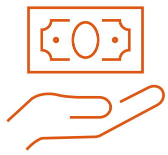
Source: Savills

Demand and fees

Fluctuations in consumer demand are also impacting the children's day nursery market, due to changes in lifestyle and increased costs. The annual cost of having a child is continually rising, with the UK being the second most expensive OECD country for childcare costs, as care-related expenses consume a third of family income for an average couple with two children. This, coupled with societal changes in which women are having children later in life, is significantly reducing fertility rates in the UK, which has fallen from 1.93 in 2011 to 1.61 in 2021 (ONS).

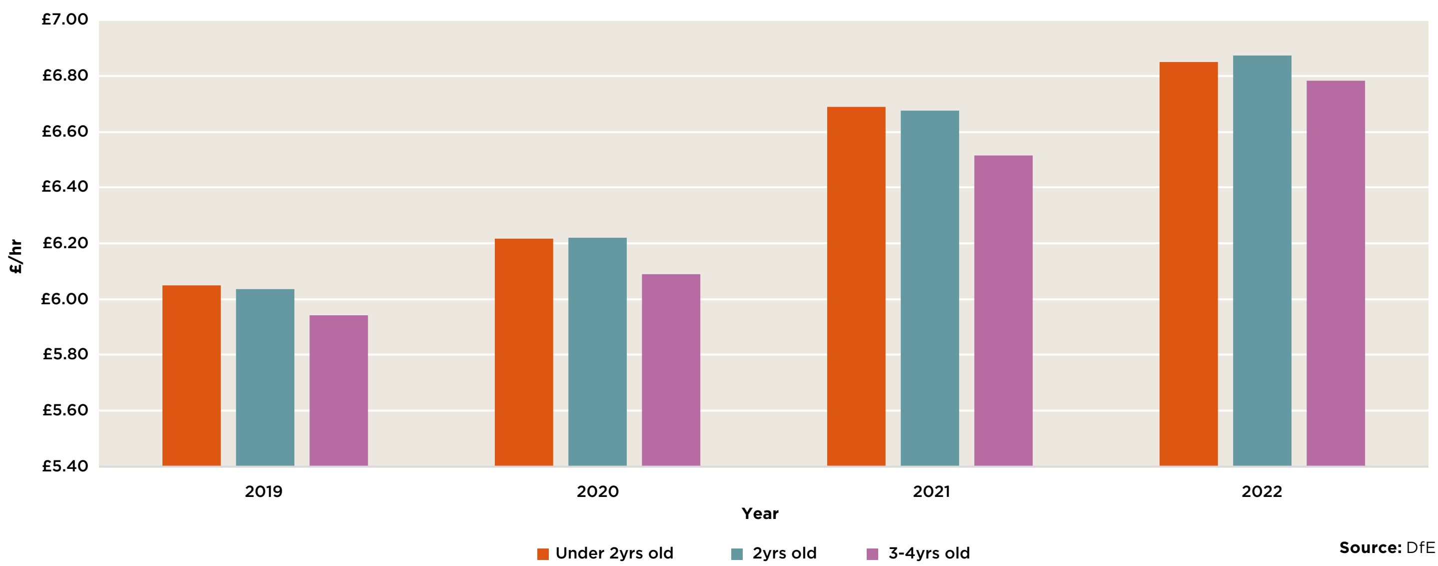
For those who do have children, many are left in a paradoxical scenario in which the annual cost of childcare is near aligning with their annual salary, thus causing families to question if one parent should stop working to take on full-time childcare responsibilities. This raises questions surrounding the indirect encouragement of sacrificing career aspirations in pursuit of raising children – an unfair outcome of the growing cost of childcare.

Although changes announced in spring's mini-budget may encourage parents to have children due to widening the free hours of childcare provision, it is unlikely this will dramatically increase the fertility rate. In consequence, there will likely be a negative impact on economic growth as the future workforce will be significantly reduced. Regional differences are also evident between the cost of fees, with Inner London being the most expensive area for 25 hours of nursery care for under-twos, where care is 54% higher than the lowest price in Yorkshire and Humberside (Coram Family and Childcare Survey 2023). This is evidenced by all three London nurseries under Hillingdon Council closing in summer 2022, which collectively offered 102 childcare places (Nursery World).



The cost of 25 hours of nursery care for under-twos is 54% higher in Inner London than the lowest price in Yorkshire and Humberside

Figure 2: Average hourly fees in England by age group



Source: DfE

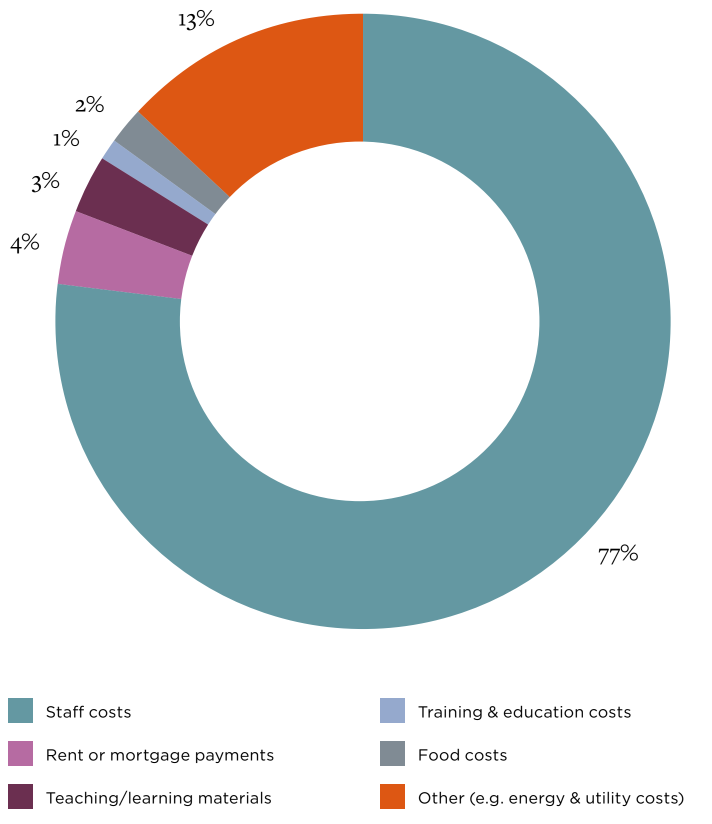
Operational Overview

Need for adaptation

With margins being squeezed, operational efficiency is key to the long-term performance of day nurseries due to a number of fixed-cost increases. However, there are several ways that operators can invest or otherwise mitigate against certain costs. Savills has analysed various children's nurseries and found that staffing, rent/mortgage and energy costs were among key barriers to increased revenue.

In recent years, operators have also had to adapt their operations to facilitate changes in demand, as lifestyle habits that emerged during Covid-19 have been maintained beyond the pandemic – as of February 2023, around 40% of working adults reported having worked from home at some point each week (ONS). Operators continue to manage increased demand in the mid-week period when more workers go to the office, which poses difficulty for staff allocation and opening hours.

Figure 3: Total costs of providing childcare for operators (2022)



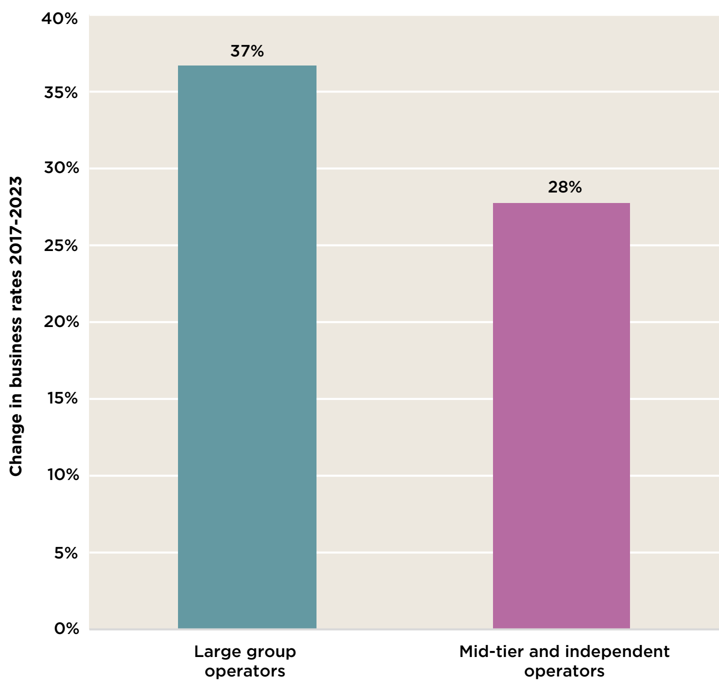
Source: DfE

Business rates

In April this year, the revaluation of business rates heavily affected properties operating in the childcare industry. The valuation approach altered dramatically, from a typical price per sqm (based on property values for nursery premises), and is now generally based on a price per child space. Given the government's recent expansion of phased free childcare provision, a question surrounding whether a government-funded childcare space is worth the same as a privately funded one in property valuation terms has arisen. This is because funded spaces generally require additional top-up from parents for the nursery to cover its total costs.

Between 2017 and 2023, larger group-based operators have seen, on average, a +37% increase in business rates, compared to mid-tier and independent operators (< 10 settings) at +28%. Although this is generally reflective of the change in valuation methodology using price per child space (as larger groups typically operate with a higher operational capacity within larger settings), it is unlikely the changes in ratings are realistic due to the gap between published registered places and actual occupancy numbers. Valuations also occurred during April 2021 - a heavily Covid-influenced period.

Figure 4: Average change in business rates between group and independent operators



Source: Savills

+37%

Average rateable value increase for large group operators

+28%

Average rateable value increase for mid-tier and independent operators

16°C

Minimum temperature threshold for a nursery in the UK

57%

Local Authorities reporting that increased energy costs are decreasing the viability of childcare

Building and energy use

Notwithstanding the need to reduce energy usage as part of MEES regulations, ESG and net-zero strategies, temperature control within nurseries also poses a significant operational cost. The minimum temperature for a nursery in the UK is 16 degrees (The Workplace Regulations 1992), and whilst there is no specific legal maximum working temperature, the Department for Education recommends a maximum of 35 degrees. This means that for a significant proportion of the year, nurseries have to maintain temperature through either heating or cooling costs.

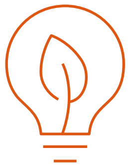
This has a detrimental effect on operators' margins; as 57% of Local Authorities reported that the cost of energy was a key factor in decreasing the sustainability of childcare in their area (Coram Family and Childcare Survey 2023). Due to the recent increase in energy, staffing and business rate costs and the lack of additional funding until September 2023, for some operators, this will likely be too late.

Lease advisory/property tenure

Traditionally, children's day nurseries have been located in refurbished and repurposed residential and office buildings, with a limited supply of purpose-built facilities. In recent years, however, there has been an increase in purpose-built centres designed to optimise space and functionality and to meet ESG credentials. Changes in ownership structures have also arisen through this development. Historically, many operators held their properties freehold (meaning a high proportion of value was held in the physical asset), but following commercial growth in the sector, ownership structures are changing.

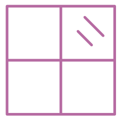
Sale and leaseback and ground rent deals now provide a method for operators to release capital to re-invest in their business - which has historically been tied up in the property assets. This is fuelling reinvestment in the sector, and, in turn, producing a higher quality of stock. For the best rates and deals, investors are looking at groups of assets so they can deploy capital efficiently and capitalise off more corporate structures. Thus, although such methods may only be feasible for operators with multiple settings, it is clear if applicable capital can become available that could be used to increase long-term profit margins, such as implementing energy-saving measures or investing in educational courses for staff.

How can operators reduce energy costs?



Install time and light sensors in nurseries alongside low-energy LED light bulbs

Solar panels will reduce energy bills in the long term, with some operators even receiving a sum of money in exchange for energy exported to the grid



Solar window films reflect radiant heat back to its source, improving the insulating properties of the glazing system. In summer, coatings reflect a large amount of the sun's rays before entering the building, and in winter, over 90% of radiant heat can be reflected back into the room

Improve insulation and make heating systems more energy efficient, as implemented by Tops Day Nurseries as part of their efforts to become carbon-neutral by 2025

Auto-taps, reduced flush cisterns and aerating taps reduce water wastage

The Challenges of Staffing

Staffing is often cited by operators as the biggest operational challenge the sector faces, with 84% of respondents in a survey conducted by the Early Years Alliance in 2021 reporting that were finding it difficult to recruit new staff. Given the increase in staffing required to support the government's expansion of free childcare, there are serious concerns surrounding how this will be enacted considering the current state of the labour market and operational challenges in this sector.

Cost of staffing

Between February and April 2023, average pay rose +7.2% – the strongest growth rate outside of the Covid-19 pandemic. However, average pay fell by -1.3% when adjusted with inflation (ONS). This demonstrates the squeeze on margins imposed by rising costs of labour, as wages have typically consumed 50%-60% of operators' turnover since 2020, thus illuminating the gravity of the problem faced by operators in the children's day nursery sector.

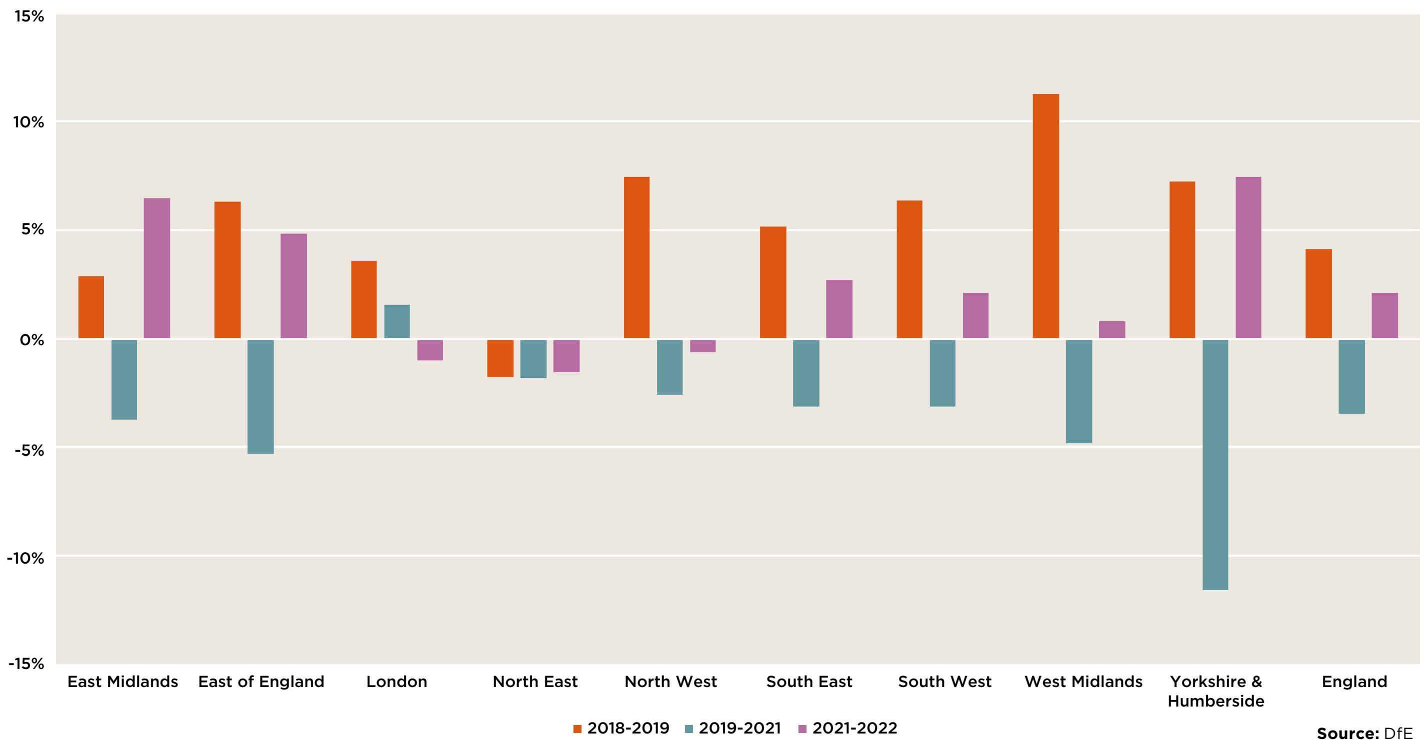
As the impact of the spring mini-budget is likely to increase demand for childcare provision, given the expansion of free entitlement, further staff will need to be recruited to ensure provision is met. The government has stated that it will provide £204 million of funding to help cater for the increased demand, and have modified staff-to-child ratios from 1:4 to 1:5 for two-year-olds effective from September 2023. Over half of early years staff, however, feel that this relaxation will not be 'workable' (Early Years Leadership Survey 2022). It's also probable further funding allocation will be integral in ensuring staff costs do not transgress further into turnover margins, and to help support the sector to recruit, train, and incentivise roles.

Geographical discrepancies

Geographical differences in the cost of living (for example, housing and transport costs) are also hampering the distribution of staff across the country. Childcare is typically a low-paying sector, with workers earning, on average, 40% less than the average female worker, and almost half of childcare workers claim state benefits (Education Policy Institute). The cost of living between UK cities also varies, with London, Bristol and Edinburgh ranking among the most expensive cities, whilst Aberdeen, Leicester and Coventry are the cheapest. This is causing a stark mismatch in the provision of childcare staff, as limited discretionary income deters staff from living in more expensive areas which are not financially viable.

A childcare crisis has henceforth emerged in London, with two children for every childcare place available as operators struggle to survive amid high operational costs and staffing shortfalls. In consequence, staffing issues in recruiting and retaining staff are decreasing the sustainability of local childcare provision, as agreed by 69% of Local Authorities (Coram Family and Childcare Survey 2023).

Figure 5: Change in total number of paid staff across nursery settings by region



Source: DfE

Improving staff retention

Low pay is not only catalysing geographical discrepancies in staffing, but is also inducing a recruitment and retention crisis as staff are leaving to start roles in alternative higher-paid sectors, such as retail. It is clear insufficient value is being attributed to the industry which cares for the early years education of our children, as the low-status of roles is similarly reported as a cause behind why staff are leaving the sector, with 59% of staff believing there is poor recognition of about the value of early years education (Early Years Leadership Survey 2022).

There is also a shortfall of high-quality staff, who, in some instances are being poached as the pool of qualified recruits continues to narrow. Operators are looking to provide education and training to develop a more qualified workforce, whilst also attracting new and diverse talent, and ensuring employees feel valued as they are being invested in. N Family Club, for example, have launched a new 50-plus apprenticeship programme, aiming to attract an experienced cohort of career returners and new educators to the sector (although applicants can be of any age).

How can operators improve staff retention?

1. **Provide clear career progression and targets/ transparency surrounding pay**
2. **Ensure frequent training and educational courses are available to staff so they feel valued and continue their professional development**
3. **Conduct regular progress meetings and encourage feedback to aid staff satisfaction**
4. **Introduce quiet, restorative, and inviting staff spaces to practice mindfulness and support staff socialisation**

Benefit of social value

Offering educational training and wellness programmes are prime examples of how operators can enhance ESG within their business, with particular focus on social value. This helps increase staff retention as employees are more stimulated, whilst stress levels and burnout are reduced due to wellness strategies. A more educated workforce with lower stress levels is beneficial to employees and operators alike, in addition to the UK economy at the macro level.

Understanding the demographic profile of recruits is similarly an emergent theme to help target, recruit and retain the right staff and within the right locality. With around a quarter of childcare staff being part of the Gen Z cohort (DfE), research suggests this generation is exposed to different marketing strategies to their predecessors. Building presence on a variety of social media channels is therefore likely to increase exposure, as 71% of Gen Z social media users in the UK check Instagram daily and 68% use TikTok daily (Statista). This may help attract younger generations, whom may not be aware of roles if advertised solely on company websites.

Health and Wellbeing frameworks, such as the WELL Building Standard and RESET Air for Indoor Air Quality, offer a comprehensive tool to review the health and wellbeing performance of a built environment and can be applied to the early years sector. Through modifying the built environment in pursuit of health benefits, operational costs can also be reduced, such as the enhanced utilisation of natural light, enabling better sleep and improvements in mental health. This, however, is more applicable to new developments rather than existing sites due to cost.

> “Wages have typically consumed 50% - 60% of operators' turnover since 2020”

Future Growth Prospects

Implications on investment/ development

Although there are operational challenges for business owners, the reality is a polarisation in the market where larger schemes and nursery groups benefit from operational efficiencies via critical mass, compared to smaller, independently owned businesses. This has resulted in an increase in market activity since the pandemic, with a 35% increase in completions in 2022 which created a bumper year in 2022 for investment sales, with offers reaching almost 20% above asking price.

The trend of consolidation is set to continue with the best-performing locations increasingly being acquired by regional and national operators. This polarisation will result in attrition at the lower-quality end of the market, but create further investor appetite for well-managed, high-standard, market-dominant schemes, with increasing interest from private equity. An investigation by The Guardian has found that in 2022 7.5% of all nursery places were fully or partially controlled by investment companies, up from 4% in 2018; this translates to 81,500 childcare places in England which are owned by investment funds – epitomising the attractiveness of the sector as an investment class.

The sector similarly provides long-term security to investors and occupiers compared to other asset classes, due to the continued demand from parents requiring childcare for the first four years of children's lives. This, in addition to lease structures becoming longer in length (20-25 years), has helped bring nurseries into the commercial market.

Development potential

The broadening uses of land at strategic locations has provided greater opportunities for children's day nurseries. This has been aided by the changes to the Use Class Order in 2020, which moved nurseries from Use Class D1 to E, thus placing them alongside commercial property assets such as shops, offices and restaurants. This alteration has enabled changes between these uses without requiring planning permission.

As nurseries are typically located near to populous areas and in strategic locations, there is often strong demand for development and re-purposing opportunities for alternative uses. Although the original planning permissions of sites may include conditions controlling or specifying the uses, the widening of Use Class E to include children's day nurseries has provided greater scope for sites to facilitate a broader range of property assets. The need to repurpose large swathes of retail and office space post-Covid means that in recent years, new opportunities have become available in urban centres, with landlords keen to identify alternative long-term uses.

Co-location and partnerships

Outside of this, other facilities are locating alongside nurseries due to cross-pollination of footfall between various uses and the benefit this can have in increasing demand, for example, retail and office supply located alongside children's day nurseries, or the co-location of children's day nurseries and garden centres. Other developmental opportunities include where there are areas of significant demand but insufficient provision, , of which, Savills is currently exploring on a number of opportunities.

The co-location of nurseries alongside care homes similarly evidences this trend. Outside of social benefits, intergenerational care also attracts commercial benefits, as co-location of facilities means services are shared and facilities are more cost-efficient (such as energy bills, catering, and maintenance costs). This is evident at Ready Generations in Chester; a 25-place early years setting within the Belong care village, which offers supported residences for older generations.

Figure 6: Future trends in the children's day nursery sector

Growing importance of nature, outdoor learning and nature-based learning accreditations

Intergenerational care and merging of facilities

Changes to staffing due to policy adaptions announced in the spring mini-budget

Further market consolidation due to mergers and acquisitions

Sustainability

Sustainability within children's nurseries is likely to receive greater attention in future years, as companies that demonstrate strong sustainability practices and ethical standards are perceived as better-managed and less exposed to potential liabilities, making them more attractive investment targets. Savills has advised on various strategies to enhance the sustainability performance of children's day nurseries, with some strategies also extending to employee wellbeing and development. Nurseries that prioritise sustainability can look to create a positive and meaningful work environment, leading to higher employee satisfaction, retention, and productivity.

Sustainability and social value are also increasingly important for the children that attend. The industry is taking inspiration from Danish teaching methods, such as the Bonsai Institute outside of Copenhagen, where a converted building backs onto a forest and children spend the entire day in the forest. Such methods have led to the development of the Udeskole qualification ('outdoor school' in Danish) introduced by Kids Planet. In April 2023, the first two Kids Planet nurseries completed their Udeskole accreditation, with the hope that all 160+ settings will eventually complete the course. This may be rolled out to other operators in the sector in the coming years as recognition of outdoor learning continues to grow.

Although forests will not always be located immediately adjacent to nurseries, the larger site areas offer excess space which can be developed into outdoor facilities such as allotments. Wendy House Day Nursery in Cambridge has developed an allotment at their site; providing fresh produce for the nursery, thus reducing their operational cost, whilst educating children on growing processes and, in turn, increasing the value of childcare provided.

Future policy

As the children's nursery market is likely to be strongly influenced by legislative changes, future government policy is a key driver behind the operational competency of the sector, with funding allocation paramount to enabling growth within the sector.

The role of government funding is to reduce childcare costs for parents, while improving operational efficiency and increasing staff wages to attract (and retain) new talent. For many businesses, this will be the difference between being viable businesses. This is something that the current shadow government is keen to see as an important electoral pledge and is likely to be mirrored by the current government ahead of the next election.

All of this requires a significant contribution from the public purse, but the economic implications reach beyond the children's day nursery market as it enables parents who struggle to justify childcare payments to return to the workforce, or increase consumer spending elsewhere. It isn't clear how much funding will be made available, or how this will delivered, but either way will be welcome news to the sector.

"Nurseries that prioritise sustainability can look to create a positive and meaningful work environment, leading to higher employee satisfaction, retention, and productivity"

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