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Issues paper

This report is for information

This report provides an overview of the forecast financial health of the HEFCE-funded higher education sector in England. The analysis covers the financial forecasts for the period 2014-15 to 2017-18, based on information submitted by higher education institutions to HEFCE in July 2015. This does not include directly funded further education, or other colleges or alternative providers of higher education.

Financial health of the higher education sector

2014-15 to 2017-18 forecasts

HIGHER EDUCATION FUNDING COUNCIL FOR ENGLAND

Financial health of the higher education sector

2014-15 to 2017-18 forecasts

To	Heads of HEFCE-funded higher education institutions
Of interest to those responsible for	Audit, Estates, Finance, Governance, Management, Planning
Reference	2015/29
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Enquiries to	Nolan Smith, tel 0117 931 7376, email n.smith@hefce.ac.uk, or Annette Wynne, tel 0117 931 7377, email a.wynne@hefce.ac.uk.

Executive summary

Purpose

1. This report provides an overview of the forecast financial health of the HEFCE-funded higher education sector in England. The analysis covers the financial forecasts for the period 2014-15 to 2017-18, based on information submitted by higher education institutions (HEIs) to HEFCE in July 2015. This does not include directly funded further education, or other colleges or alternative providers of higher education.

2. The report has been published to provide HEIs with feedback on the projected financial performance of the sector as a whole. The analysis may also be of interest to others connected with the higher education sector. It supplements our previous analysis published in March 2015 ('Financial health of the higher education sector: Financial results and TRAC outcomes 2013-14', HEFCE 2015/07).

Context

3. The analysis provided in this report is based on financial forecasts submitted by HEIs to HEFCE. The accuracy and reliability of these forecasts depends on the assumptions and strategies adopted by individual HEIs in response to the latest higher education reforms and current prevailing market conditions.

4. Due to the timing of these submissions, however, the impact of the £150 million funding reduction announced by HEFCE in July 2015 is unlikely to be fully reflected in these latest forecasts. Our analysis also indicates that the sector is assuming, in its financial forecasts, no significant changes in public funding within the period to 2017-18.

5. In analysing the current forecasts we have attempted to highlight the limited margins in which the sector operates by modelling the impact of changes in what HEIs are forecasting for the years 2015-16 to 2017-18. For example, a 5 per cent reduction per annum in public funding for the next three years could see the sector in a deficit position by 2017-18. This shows how relatively small changes in key assumptions can have a significant impact on an HEI's ability to generate surpluses.

Forecast financial performance

6. The financial results for the higher education sector in 2013-14 showed a sound position overall but there was significant variation in the financial performance of individual institutions across the sector.

7. The latest forecasts, for the period 2014-15 to 2017-18, show an increasing variation in the financial performance of institutions, with a widening gap between the lowest and highest performing institutions.

8. At a sector level, the projections show that operating surpluses are expected to remain at 3.9 per cent of total income in 2014-15 (the level reported in both 2012-13 and 2013-14). Thereafter, surpluses are expected to fall to 2.4 per cent of income in 2015-16 and 2016-17, before rising to 3.3 per cent of income in 2017-18. These are relatively small margins in which to operate, and mean that even small changes in income or costs could have a material impact on the financial performance of institutions and the sector.

9. In the current climate of lower public funding, HEIs are under greater pressure to generate higher surpluses in order to remain sustainable. The latest Transparent Approach to Costing (TRAC) submissions from HEIs show that, in the medium to long term, the sector still needs to generate larger surpluses to make progress towards covering the full economic costs of its activities and maintaining sustainability. Overall, the sector reported a sustainability gap (the difference between the level of surplus achieved by the sector and the level required to cover the full economic costs of its activities) of £883 million in 2013-14; a deterioration against 2012-13, when the sustainability gap was £870 million.

10. The trend of falling liquidity (cash) and increasing sector borrowing continues in this forecast period. The sector expects its liquid funds to fall from £7.7 billion as at 31 July 2014 to £5.0 billion as at 31 July 2018, equivalent to 67 days of expenditure; the lowest level reported since 31 July 2006. At the same time, the sector expects borrowing to increase from £6.7 billion at the end of July 2014 to £9.2 billion at the end of July 2018, by which time the sector would be in a net debt position of £4.1 billion. The trend of increasing borrowing and reducing liquidity is unsustainable in the long term.

11. As charities, HE institutions are obligated to ensure that they remain sustainable and do not expose themselves to undue risk. Strong liquidity is particularly important given the level of uncertainty and risk that currently exist in the sector, and we continue to monitor liquidity levels to assess whether HEIs are able to maintain sufficient cash levels to manage their risks effectively.

Capital Investment

12. The latest financial forecasts show that the sector is planning on delivering a substantial increase in capital investment over the forecast period (2014-15 to 2017-18). At over £17.1 billion, this represents an average annual investment of £4,264 million, nearly 60 per cent higher than the previous four-year average (2010-11 to 2013-14).

13. Despite this increase, forecasts show that nearly a third of HEIs in the sector are planning to reduce their expenditure on infrastructure over the forecast period.

14. Investment in infrastructure is particularly important given that the Estates Management Statistics show that, as at 31 July 2014, the sector still needed to invest £3.4 billion into its non-residential estate to upgrade it to a sound and operationally safe condition. It should be borne in

mind that these upgrade costs do not fully reflect the level of expenditure needed to bring the estate up to the standard required to benefit the student experience and to attract new students and staff. This will help to ensure that the sector can compete in the increasingly competitive global market.

15. Current public capital funding is now significantly lower than historical levels, requiring institutions to deploy more of their own resources or raise finance through external borrowing to maintain and enhance their infrastructure. This places greater pressure on HEIs to generate higher surpluses to remain sustainable.

16. The latest forecasts show that the sector is expecting to use £10.4 billion from its own cash reserves (equivalent to 9.0 per cent of total income) and borrow an additional £3.5 billion to help fund its capital investment plans. Although projections indicate that this will be affordable in 2014-15, forecast cash inflows from operating activities will be insufficient to fund the planned level of investment for the period 2015-16 to 2017-18. This may indicate that HEIs will either have to change their plans or raise additional funds through cash reserves or additional borrowing.

17. It is important to recognise that the forecasts assume that the capital markets continue to have confidence in the sector, which depends upon their risk assessments of the sector and individual HEIs. Strong surpluses and liquidity are required to achieve this. Without it significant elements of the investment programme are at risk.

Student number projections

18. Student number projections accompanying HEI financial forecasts show that the sector expects full-time home and EU undergraduate numbers (across all years of study) to be marginally lower in 2014-15 when compared with 2013-14, but increases are expected in the period 2015-16 to 2017-18. By 2017-18, the number of full-time undergraduate students is expected to be 8.5 per cent higher than reported in 2013-14, though there continues to be a great deal of variability between institutional projections across the forecast period and with student demand becoming more volatile in the sector, there is an increasing risk that student recruitment projections will not be achieved.

19. In terms of overseas (non-EU) students, projections show that the sector expects numbers to grow between 4.3 and 6.4 per cent per year over the next four years, with overseas fee income projected to rise from £3,316 million in 2013-14 (13.0 per cent of total income) to £4,570 million in 2017-18 (14.8 per cent of total income); an average annual increase of 7.0 per cent over the forecast period. However this overall figure masks significant variation in the assumptions used by institutions in predicting their future overseas income levels.

20. Recruitment of international students is becoming more competitive which increases the risk of a downturn in non-EU students coming to the UK to study. This is happening at the same time as changes are introduced to the UK's immigration regulations. The latest forecasts show that HEIs are becoming increasingly reliant on overseas income to remain financially sustainable so a downturn in overseas recruitment would have a significant adverse impact on the sector's income and surplus projections. For example, just a 5 per cent shortfall per annum in projected income from international students would see the sector in a deficit position by 2016-17.

Value for Money

21. There is continued evidence that the sector is focused on securing value for money from public funds, and (for the benefit of students) from tuition fees. As part of our annual accountability process, we ask institutions to submit value for money reports to us showing how they make the best use of available resources.

22. Our analysis of the data supplied indicates that the sector made an estimated saving of £1.1 billion over the period 2011 to 2014. It is likely, however, that institutions will also be operating value for money initiatives that are not mentioned in their reports. Such initiatives, and any resulting savings, will not have been captured by this analysis. Consequently, the volume of savings reported is likely to be understated.

23. Value for money savings have helped to support the sector's current financial position, and will be increasingly important going forward given the continued uncertainty in the sector and the growing pressure on costs.

24. HEFCE is currently developing a new methodology to collect and assess value for money information in a more systematic way to better determine and report the scale of sector savings in future.

Reserves and Pension Deficits

25. Reserves are an HEI's total assets less its liabilities and, in very broad terms, can be used as a proxy of the overall value of an institution.

26. The main indicator used to assess reserves is the amount of 'discretionary reserves' held on an institution's balance sheet. These are the accumulated surpluses of an institution over its lifetime although they are not the same as cash.

27. In light of the increased risk and volatility within the sector, and the recognition that a higher level of reserves is necessary to respond to capital investment needs and fluctuating cash flow, the sector is projecting its reserves to increase. After taking into account projections for pension deficits, discretionary reserves are expected to increase from £12.3 billion as at 31 July 2014 to £17.3 billion as at 31 July 2018, equivalent to 56.3 per cent of total income. However, the sector position masks a significant spread of financial strength, with a concentration of large discretionary reserves in a small number of universities.

28. While sector reserves currently appear strong overall, from 2015-16 reported reserve levels are likely to be substantially lower following the introduction of a new financial reporting standard (FRS102), which requires institutions to recognise liabilities relating to deficit recovery plans for multi-employer pension schemes in their balance sheets. While not a new liability, it will increase the transparency of the underlying deficits within the relevant pension schemes, which may impact on confidence levels in the financial strength of the sector. The impact of these changes will not be seen until July 2016: when the sector's next set of financial forecasts are due to be submitted to HEFCE.

29. The largest multi-employer pension scheme operating in the sector is the Universities Superannuation Scheme (USS). The latest actuarial valuation for this scheme (as at March 2014) confirms that, after taking into account the revised benefit structure effective from 1 April 2016, the actuarial deficit stood at £5.3 billion. This deficit compares with the last full triennial

assessment, which valued the deficit at £2.9 billion as at the end of March 2011, demonstrating the significant level of volatility and uncertainty in these valuations.

30. The March 2014 actuarial deficit is equivalent to 43 per cent of the sector's discretionary reserves (including pension deficits already recognised in the accounts) as at 31 July 2014 and, if fully reflected in the sector's 2013-14 accounts, would reduce reserve levels from 48 per cent to 27 per cent of total income.

Financial stability

31. Overall, while projections indicate a general weakening of financial performance, the sector is expected to remain financially stable in the forecast period. Evidence attained as part of our annual accountability process indicates that short-term viability of institutions is not a concern presently, and no institutions are forecast to be close to the risk of insolvency. This is supported by independent institutional audits and the sector's own projected continuation of positive cash in-flows and healthy cash-backed reserves – though these are reliant on institutions achieving home and overseas student recruitment targets, and on the level of public funding not deteriorating.

32. Although currently financially stable, reducing surpluses and cash levels and a rise in borrowing, all signal a trajectory that is not sustainable in the long term. Significant challenges including increased uncertainty over future government funding and overseas student recruitment, as well as the need to sustain a higher level of capital investment to respond to growing competition, will require institutions to aim for higher surpluses in future.

33. This uncertainty is likely to lead to continued volatility and growing variability in the financial performance of institutions, together with a widening gap between the lowest and highest performing institutions.

Action required

34. No action is required: this report is for information.

Summary and headline information

35. This report provides an overview and analysis of the forecast financial health of the HEFCE funded higher education sector in England.

36. The data used come from two main sources:

a. Where available, all data up to and including 2013-14 are from the Higher Education Statistics Agency's Finance Statistics Record, which is completed by higher education institutions (HEIs) each year and is derived from audited financial statements.

b. Data covering the forecast period 2014-15 to 2017-18 are from HEIs' financial forecasts submitted to HEFCE in July 2015.

All financial information is presented in academic years (ending 31 July). For references to real-terms changes in performance we have used HM Treasury's gross domestic product deflator announced in July 2015[1], with the base year set as 2014-15.

37. Given that a large proportion of the sector's income depends on the number of students recruited, we ask institutions to support their financial projections with information on the forecast number of students. Our analysis of these forecasts is included in this report.

38. We have also included aggregate sector data from the 2013-14 Transparent Approach to Costing (TRAC) returns submitted by institutions earlier in the year.

39. The analysis provided in this report is based on financial forecasts submitted by HEIs to HEFCE. The accuracy and reliability of these forecasts depends on the assumptions and strategies adopted by individual HEIs in response to the latest higher education reforms and current prevailing market conditions. Due to the timing of these submissions, however, the funding reductions announced by HEFCE in July 2015 are unlikely to be fully reflected in these latest forecasts. Our analysis also indicates that the sector is assuming, in its financial forecasts, no significant changes in public funding within the period to 2017-18.

40. The section on sensitivity of financial forecasts in paragraphs 113 to 115 demonstrates the potential impact that small changes to key assumptions can have on the projected financial performance of the sector.

41. The financial results for the higher education sector in 2013-14 showed a sound position overall but there was significant variation in the financial performance of individual institutions across the sector. The latest forecasts, for the period 2014-15 to 2017-18, show an increasing variation in the financial performance of institutions, with a widening gap between the lowest and highest performing institutions.

42. Table 1 provides the key headline data from the financial information submitted by HEFCE-funded HEIs in July 2015. Further detail and analysis of the sector's financial performance in 2013-14 can be found in HEFCE 2015/07[2].

[1] See https://www.gov.uk/government/statistics.
[2] Available online at www.hefce.ac.uk/pubs/year/2015/201507/.

Table 1 Summary of key financial indicators

	Actual		Forecast			
	2012-13	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**
Total income	£24,320M	£25,591M	£27,079M	£28,227M	£29,418M	£30,777M
Operating surplus	£943M	£992M	£1,062M	£670M	£709M	£1,009M
as % of total income	3.9%	3.9%	3.9%	2.4%	2.4%	3.3%
Historical cost surplus	£1,208M	£1,273M	£1,245M	£896M	£1,007M	£1,148M
as % of total income	5.0%	5.0%	4.6%	3.2%	3.4%	3.7%
TRAC sustainability deficit*	(£870M)	(£883M)	n/a	n/a	n/a	n/a
Cash flow from operating activities, as % of total income	8.3%	8.4%	8.1%	7.6%	7.7%	8.8%
Net liquidity as number of days' expenditure	123	122	113	93	76	67
External borrowings as % of total income	25.8%	26.3%	28.8%	30.2%	30.4%	29.8%
Discretionary reserves excluding FRS17†, as % of total income	61.8%	64.4%	66.3%	67.7%	68.9%	70.0%
Discretionary reserves including FRS17, as % of total income	47.4%	48.0%	50.8%	52.7%	54.5%	56.3%

* Only actual information was collected.

† FRS17 is the financial reporting standard on retirement benefits.

Assessing future financial sustainability

30. As in previous years, the forecasts show that the sector-wide picture encompasses a broad range of projected financial results between institutions. The main financial strength of the sector remains in a small number of institutions.

31. Up to the end of the forecast period, financial performance is projected to become more variable between institutions, but the sector is likely to remain financially sustainable. Institutions will need to continue to seek greater surpluses to fund the necessary investment in infrastructure to support a high-quality student experience and to remain sustainable in the medium term.

32. In preparing their financial statements and forecasts, institutions identified a number of risks that could adversely affect their financial performance and sustainability. The most significant risk areas relate to:

- fall in home/EU student recruitment and retention in an increasingly competitive market
- failure to achieve overseas student recruitment targets
- further unanticipated public spending cuts in research and/or teaching income
- failure to effectively manage major capital investment programmes and their financial impacts
- rise in the cost of borrowing and availability of lending
- rise in staff and pension costs
- non-compliance with visa regulations.

33. The accuracy and reliability of the financial forecasts relies on what assumptions HEIs have made and to what extent they have taken the risks above into account, as well as the strategies adopted by individual HEIs in response to the latest higher education reforms and current prevailing market conditions. Due to the timing of these submissions, however, the funding reductions announced by HEFCE in July 2015 are unlikely to be fully reflected in these latest forecasts.

34. Our analysis indicates that the sector is assuming, in its financial forecasts, no significant changes in public funding within the period to 2017-18. Uncertainties over future student recruitment (home and overseas), public funding levels and future pension costs are unknown factors that will inevitably reduce the reliability and increase the volatility of forecasts in the sector.

35. It is important to note that HEIs continue to undertake their own scenario planning and sensitivity analysis to assist them in developing their financial forecasts. We encourage institutions to continue to assess the potential impacts of future changes on their operations and, where necessary, to identify mitigating actions. This scenario planning will need to consider potential impacts of changes in home and overseas recruitment levels, the availability of public funding, and pay and pensions costs.

36. HEFCE institutional teams, in their regular engagement with HEIs, will continue to discuss the actions being taken by the sector to mitigate adverse impacts.

Forecast performance 2014-15 to 2017-18

37. The financial results for the higher education sector in 2013-14 showed a sound position overall but there was significant variation in the financial performance of individual institutions across the sector. The latest forecasts, for the period 2014-15 to 2017-18, show an increasing variation in the financial performance of institutions, with a widening gap between the lowest and highest performing institutions.

38. Overall, the forecasts show that the sector is projecting total income to rise by 5.8 per cent, from £25,591 million in 2013-14 to £27,079 million in 2014-15. However, projected increases in expenditure mean that operating surpluses are expected to remain at 3.9 per cent of income (the level reported in 2012-13 and 2013-14).

39. Cash flow from operating activities is expected to be lower, at 8.1 per cent of total income in 2014-15 compared with 8.4 per cent of income in 2013-14. Liquidity levels are also expected to fall, to 113 days of expenditure compared to 122 days in 2013-14.

40. From 2015-16, forecasts show that the sector is projecting expenditure to rise at a faster rate than income, causing surpluses to fall to 2.4 per cent of income in 2015-16 and 2016-17, before rising to 3.3 per cent in 2017-18. Similarly, cash flow from operating activities is expected to be lower in 2015-16 and 2016-17 (at 7.6 per cent and 7.7 per cent of income respectively) before rising to 8.8 per cent in 2017-18.

41. The trend of falling liquidity and increasing sector borrowing continues in this forecast period, with the sector expecting its liquid funds to fall from £7.7 billion as at 31 July 2014 to £5.0 billion as at 31 July 2018, equivalent to 67 days of expenditure; the lowest level reported since 31 July 2006. At the same time, the sector expects borrowing to increase from £6.7 billion at the end of July 2014 to £9.2 billion at the end of July 2018.

42. The following sections look at different aspects of the financial forecasts submitted by institutions, for the whole period 2014-15 to 2017-18:

- income
- overseas fee income
- home and EU student recruitment
- expenditure
- surpluses
- liquidity and cash flow
- capital expenditure and borrowing
- reserves.

Income

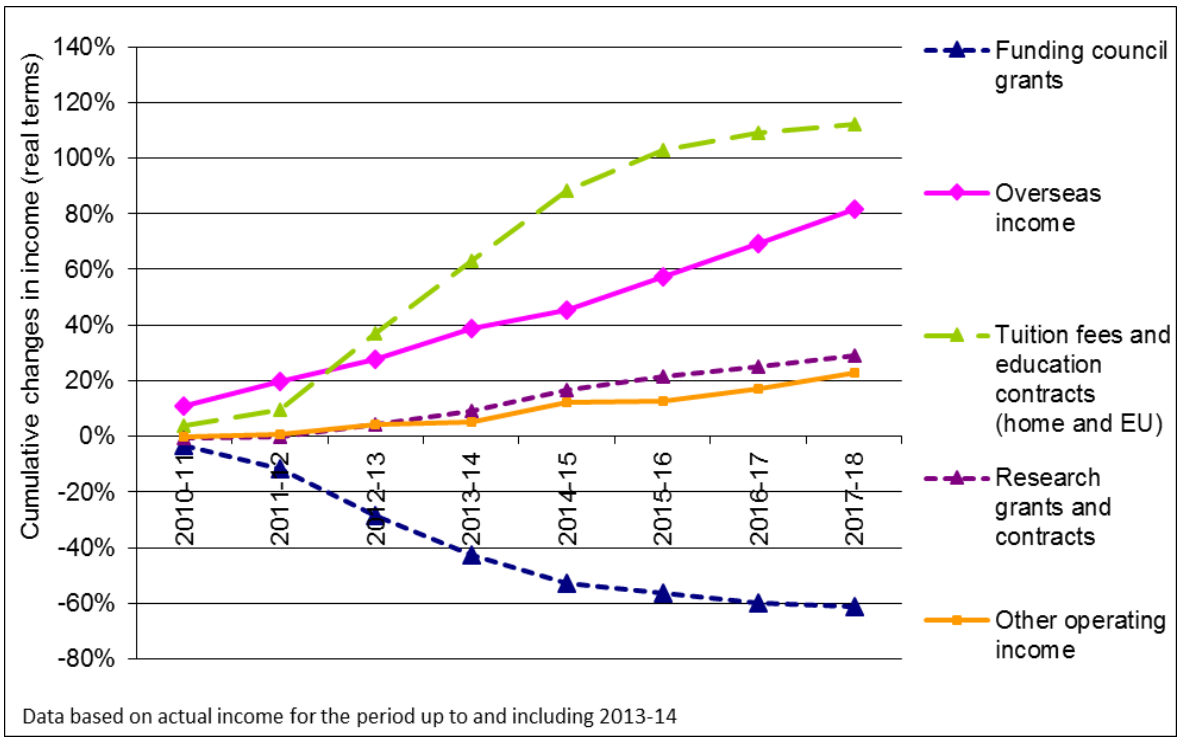
43. At sector level, total income is forecast to rise each year in the forecast period: by 5.8 per cent (cash terms) in 2014-15, 4.2 per cent in 2015-16 and 2016-17, and a further 4.6 per cent in 2017-18. By 2017-18, forecast data shows that the vast majority of students (97 per cent of undergraduate students) will fall under the new funding arrangements. Table 2 provides a breakdown of the income levels forecast.

Table 2 Breakdown of forecast income levels (cash terms)

£M	2013-14 actual	2014-15 forecast	2015-16 forecast	2016-17 forecast	2017-18 forecast
Funding council grants	4,524	3,743	3,496	3,262	3,217
Overseas (non-EU) fee income	3,316	3,504	3,813	4,182	4,570
Tuition fees and education contracts (home and EU)	8,672	10,091	10,933	11,466	11,861
Research grants and contracts	4,124	4,459	4,663	4,887	5,137
Other operating income	4,679	5,046	5,096	5,378	5,747
Endowment income and interest	277	236	227	243	245
Total income	**25,591**	**27,079**	**28,227**	**29,418**	**30,777**

44. While Table 2 shows projected changes in cash terms, Figure 1 shows the cumulative actual and projected changes in income (excluding endowment income) in real terms since 2009-10. This illustrates the fall in funding council grants over the period, which is countered by significant growth in fee income from home and EU students, though much slower growth is expected from 2015-16 to 2017-18.

Figure 1 Cumulative real-terms actual and projected changes in income since 2009-10



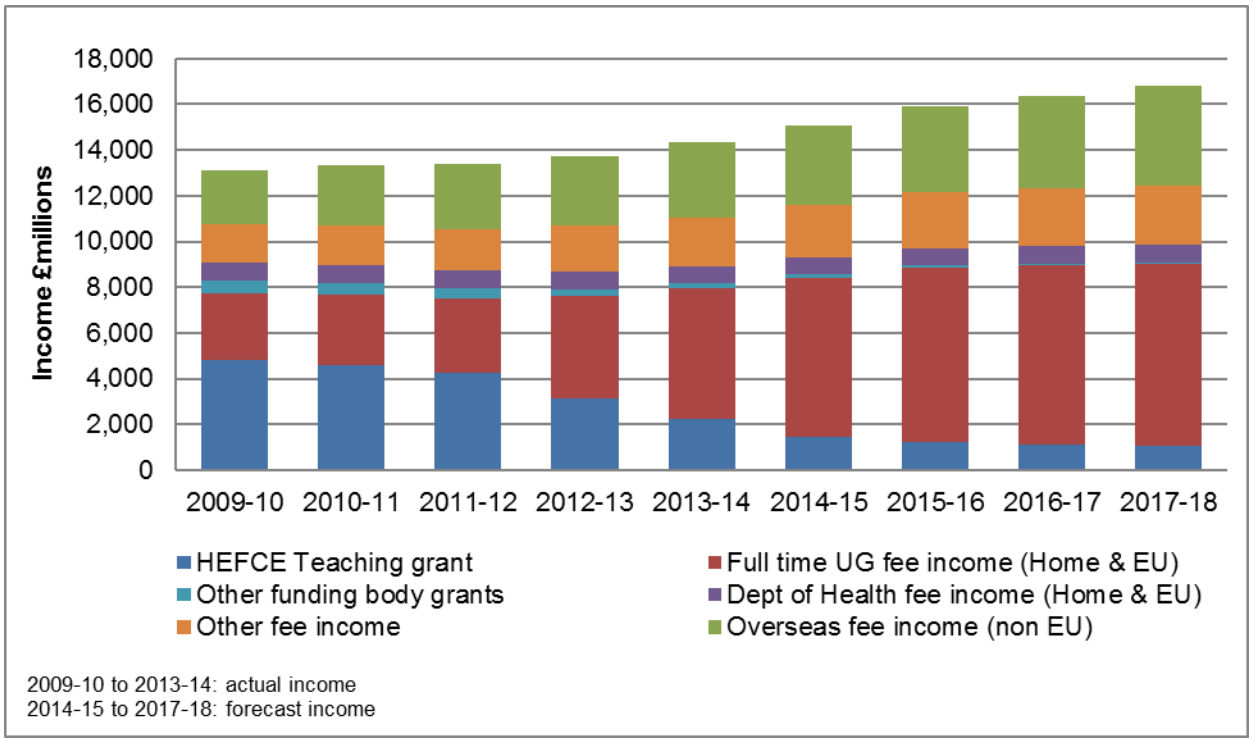
45. HEFCE grant funding for teaching is forecast to fall by 52.2 per cent in the period 2013-14 to 2017-18 compared with fee income from full-time undergraduate home and EU students, which is expected to increase by 38.1 per cent in the same period. Between 2013-14 and 2017-18, additional tuition fee income from full-time undergraduate home and EU students is projected to exceed the fall in HEFCE teaching grant by £1,045 million (real terms), though most of this difference is due to increasing student numbers over the forecast period.

46. Income from part-time home and EU students (for all levels of study) is projected to increase by 18 per cent from £653 million in 2013-14 to £771 million (cash terms) in 2017-18. This is despite the sector projecting a continuing decline in part-time student numbers over the forecast period, which indicates that the growth in fee income is due to the effect of higher part-time fees.

47. Fee income from full-time home and EU postgraduate students is projected to rise by 21.1 per cent from £717 million in 2013-14 to £869 million (cash terms) in 2017-18.

48. Figure 2 shows a breakdown of teaching-related income received in the period 2009-10 to 2013-14 and the income projected for the period 2014-15 to 2017-18 in real terms. This shows that, overall, teaching-related income – which includes public funding and tuition fees – is expected to rise over the forecast period mainly due to fee income from international students. At the same time, total student numbers (full-time equivalents) are expected to be 8.5 per cent higher in 2017-18 compared to 2013-14.

Figure 2 Breakdown of teaching-related income (real-terms) 2009-10 to 2013-14 actual and 2014-15 to 2017-18 forecast



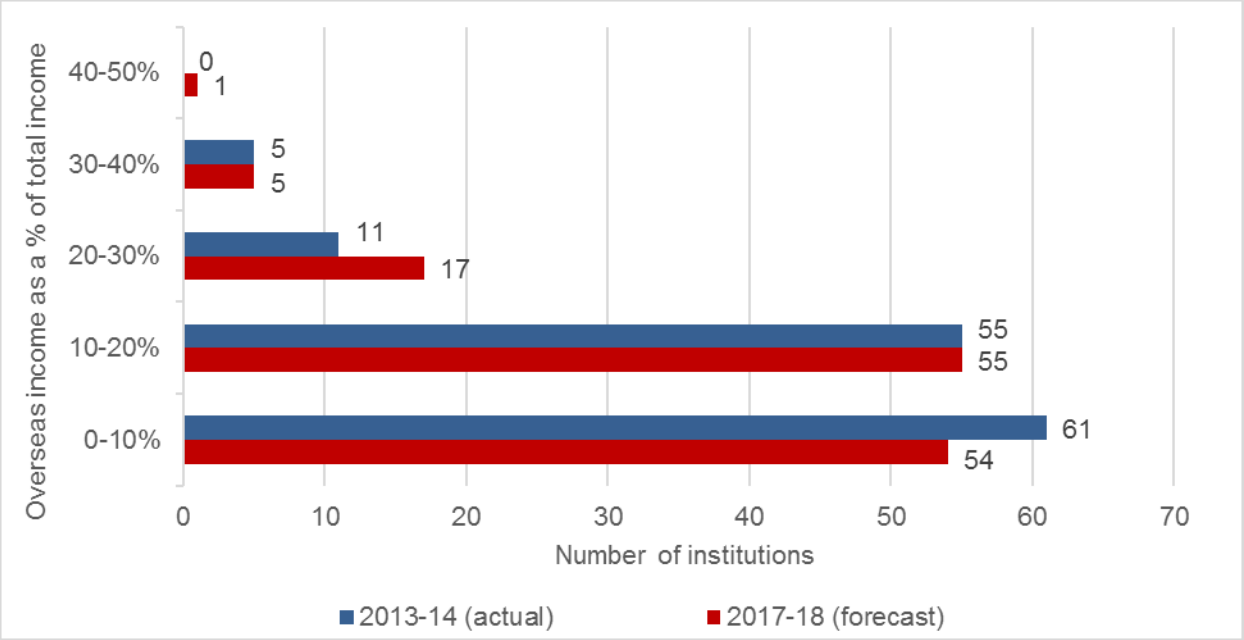
Overseas fee income

49. The income generated through tuition fees from international (non-EU) students in 2013-14 came to £3.3 billion (cash terms). By 2017-18 this is expected to grow to £4.6 billion representing

27.8 per cent of all tuition fee and education contract income and 14.8 per cent of total income projected by English institutions in 2017-18.

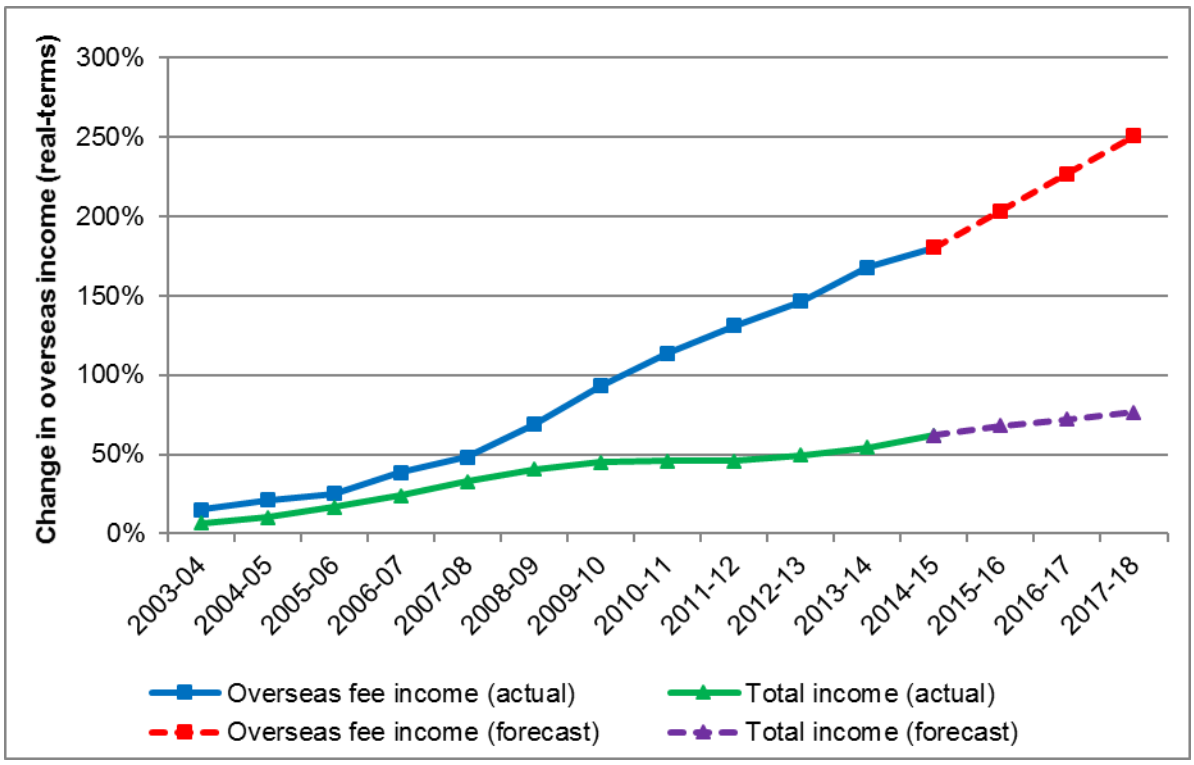
50. Figure 3 shows the actual and projected distribution of overseas fee income (as a percentage of total income) by institutions for 2013-14 and 2017-18. It demonstrates the growing reliance on this income source.

Figure 3 Distribution of overseas fee income as a percentage of total income by number of institutions 2013-14 actual vs 2017-18 forecast



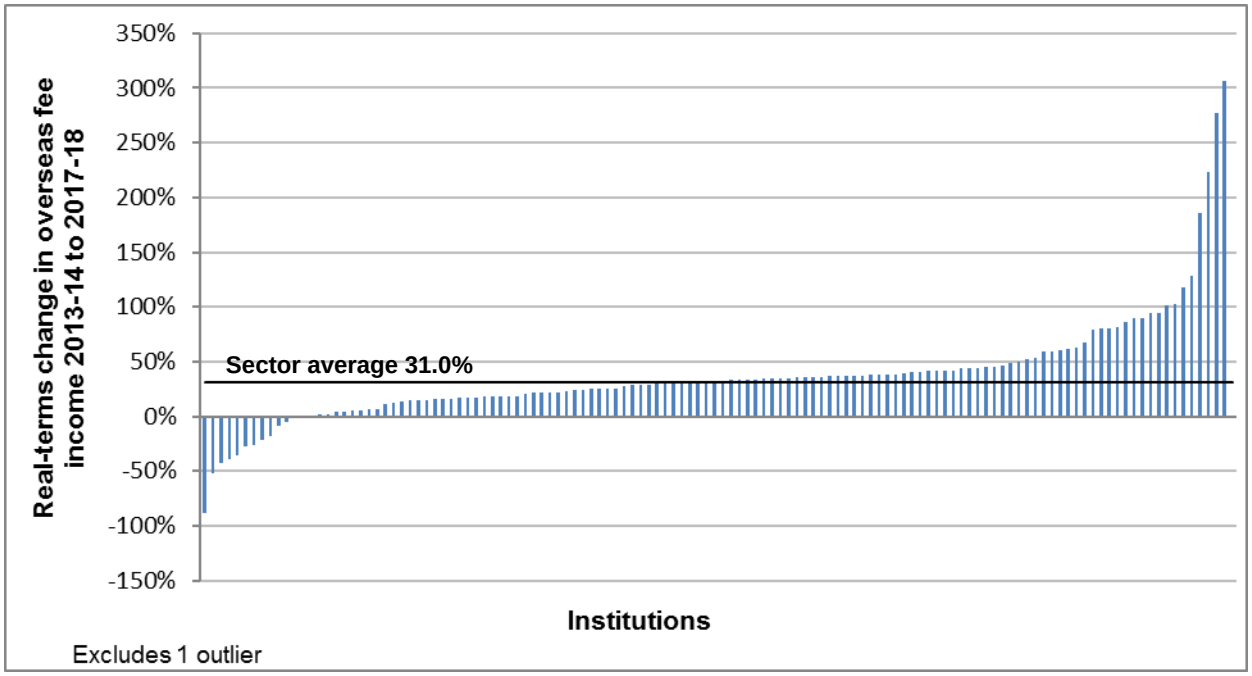
51. Figure 4 shows the actual and projected changes in both overseas fee income and total income for the period 2003-04 to 2017-18. On average, fee income from overseas students has increased by 8.8 per cent (in real terms) per year over the 10 years to 2013-14, whereas total income has increased by an average of 3.8 per cent per year over the same period.

Figure 4 Real-terms increase in total income and overseas fee income (cumulative increases since base year of 2002-03)



52. Going forward, the sector is projecting a real-terms rise in overseas income of 31.0 per cent (comparing 2017-18 with 2013-14), equivalent to an average annual increase of 7.0 per cent – though this disguises significant variation in assumptions used by institutions in predicting their future overseas income levels. This variation can be seen in Figure 5, which shows the projected changes in overseas fee income by institution between 2013-14 and 2017-18.

Figure 5 Forecast real-terms change in overseas fee income between 2013-14 and 2017-18



Student recruitment

53. Given that a large proportion of the sector's income depends on the number of students recruited, institutions were asked to send us their student number projections for each of the forecast periods (2013-14 to 2017-18). These forecasts show total projected student numbers for all years of study broken down by mode and level of study.

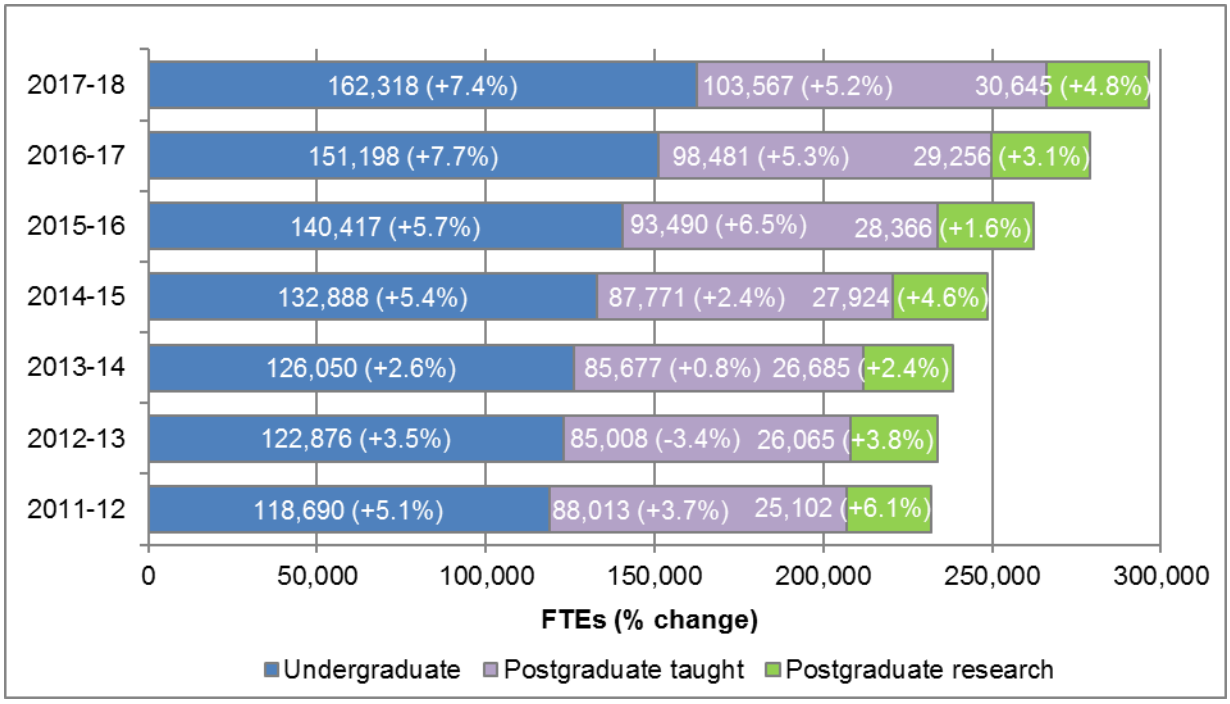
54. Further analysis of student number projections for overseas (Non-EU) and Home and EU students is shown below.

Overseas

55. The projections for overseas (non-EU) student numbers show that the number of non-EU students studying at English institutions (for all years of study) is expected to rise between 4.3 and 6.4 per cent per year between 2013-14 and 2017-18.

56. Figure 6 shows the total number of full and part-time overseas students (expressed as full-time equivalents) that were either reported or projected by the sector for the period 2011-12 to 2017-18, together with the percentage change in numbers compared to the previous year (in brackets).

Figure 6 – Overseas (non-EU) student numbers 2011-12 to 2017-18



57. While total non-EU student numbers are expected to rise, forecasts show that the sector is expecting part-time non-EU students numbers to fall in 2014-15 and 2015-16 (by 8.4 per cent and 8.7 per cent respectively) before rising by 11.5 per cent between 2015-16 and 2017-18.

58. Recruitment of international students is becoming increasingly competitive, which increases the risk of a downturn in non-EU students coming to the UK to study. This is happening at the same time as changes are introduced to the UK's immigration regulations.

59. According to the 2013-14 HESA student record, 30 per cent of non-EU students registered at publicly funded English HEIs were domiciled in China, and so a downturn in the recruitment of Chinese students would have a particular adverse impact on the sector. This risk increases with the slowdown in the Chinese economy, and the prospect that the Chinese currency could be further devalued to boost exports, as this would make it more expensive for Chinese students to study abroad.

60. Overall, there is a growing risk that the sector will be unable to deliver the level of growth of overseas student numbers projected in their forecasts. This would have a significant adverse impact on the sector's income and surplus projections.

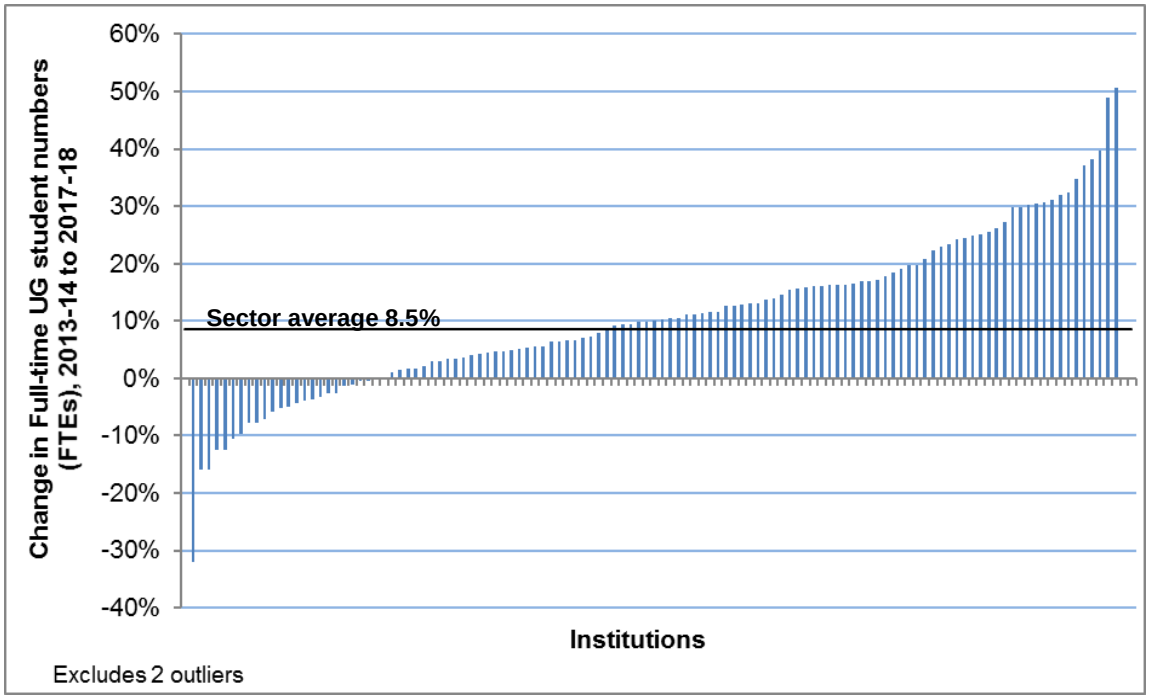
Home and EU

61. Despite the Government's announcement in 2013 of 30,000 additional student places in the academic year 2014-15, overall student number projections show a marginal decrease in full-time home and EU undergraduate numbers (across all years of study) in 2014-15, which indicates that some HEIs remain cautious about student recruitment. Increases are expected in the period 2015-16 to 2017-18, though there is a great deal of variability between institutional projections.

62. At an aggregate level, full-time home and EU undergraduate student numbers (across all years of study) are expected to rise by 8.5 per cent by the end of the forecast period (comparing 2017-18 with 2013-14).

63. Figure 7 shows the forecast changes in full-time home and EU undergraduate student numbers (expressed as full-time equivalents) between 2013-14 and 2017-18 for all institutions and across all years of study. This shows the variation in assumptions used by institutions in developing their financial forecasts.

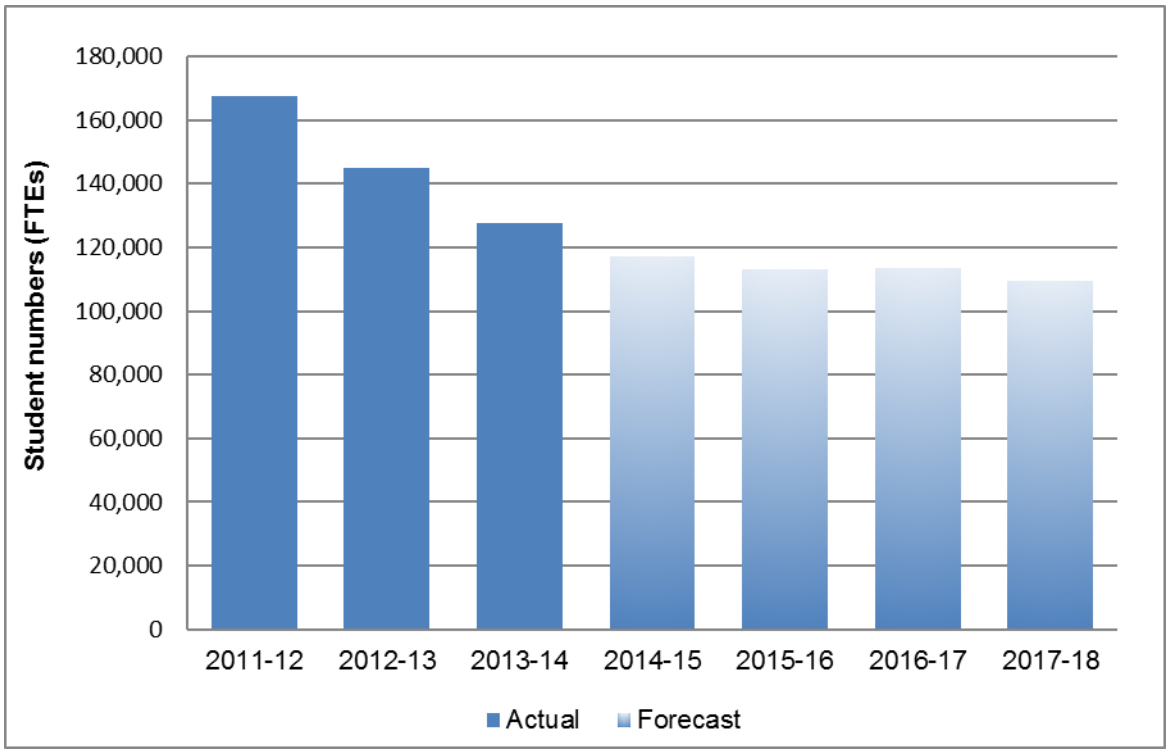
Figure 7 Forecast change in full-time home and EU undergraduate student numbers between 2013-14 and 2017-18



64. Despite a projected increase in numbers of full-time undergraduate students, the sector expects the decline in part-time undergraduate student numbers to continue, with part-time student numbers expected to be 14.1 per cent lower in 2017-18 compared with 2013-14.

65. Figure 8 shows the number of part-time undergraduate students for all years of study (expressed as full-time equivalents) reported or projected by the sector for the period 2011-12 to 2017-18.

Figure 8 Part-time home and EU undergraduate student numbers 2011-12 to 2017-18

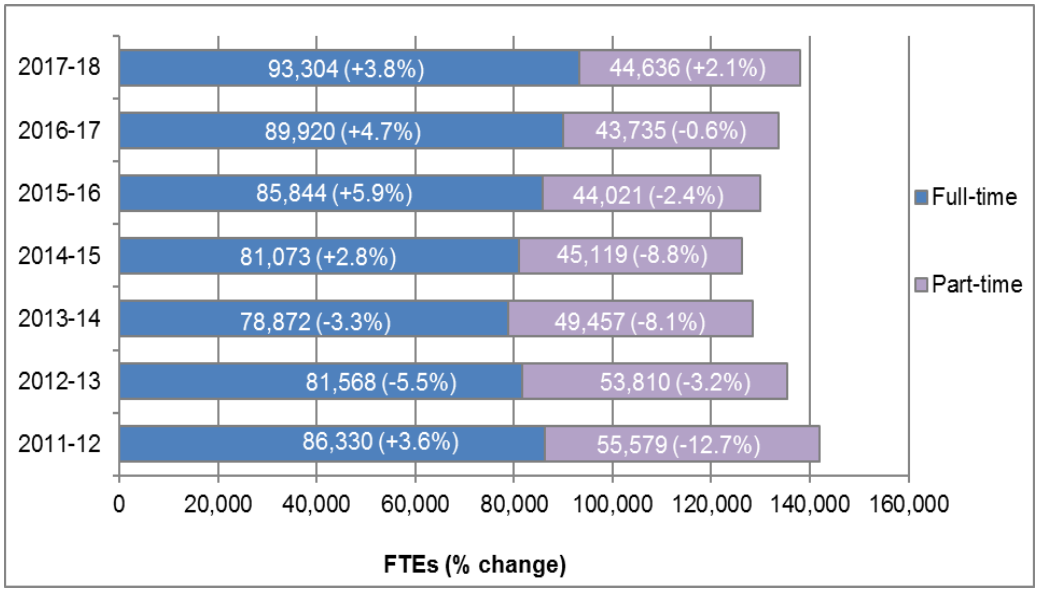


66. Full-time home and EU postgraduate taught (PGT) student numbers are expected to rise by 2.8 per cent in 2014-15, followed by increases of between 3.8 and 5.9 per cent per year between 2015-16 and 2017-18. By contrast, part-time home and EU PGT student numbers are expected to fall by 8.8 per cent in 2014-15, followed by falls of 2.4 per cent and 0.6 per cent in 2015-16 and 2016-17, before rising by 2.1 per cent in 2017-18.

67. It is yet to be seen whether these forecasts will be borne out as the impact of the 2012 reforms in undergraduate education on the take-up of postgraduate education will not be known until 2015 at the earliest, when the first students who have paid higher fees at undergraduate level begin to apply.

68. Figure 9 shows the number of full and part-time postgraduate taught students for all years of study (expressed as full-time equivalents) reported by the sector in 2011-12 to 2013-14, as well as the student numbers projected by the sector for the period 2014-15 to 2017-18. The percentage change in student numbers compared to the previous year is also shown (in brackets).

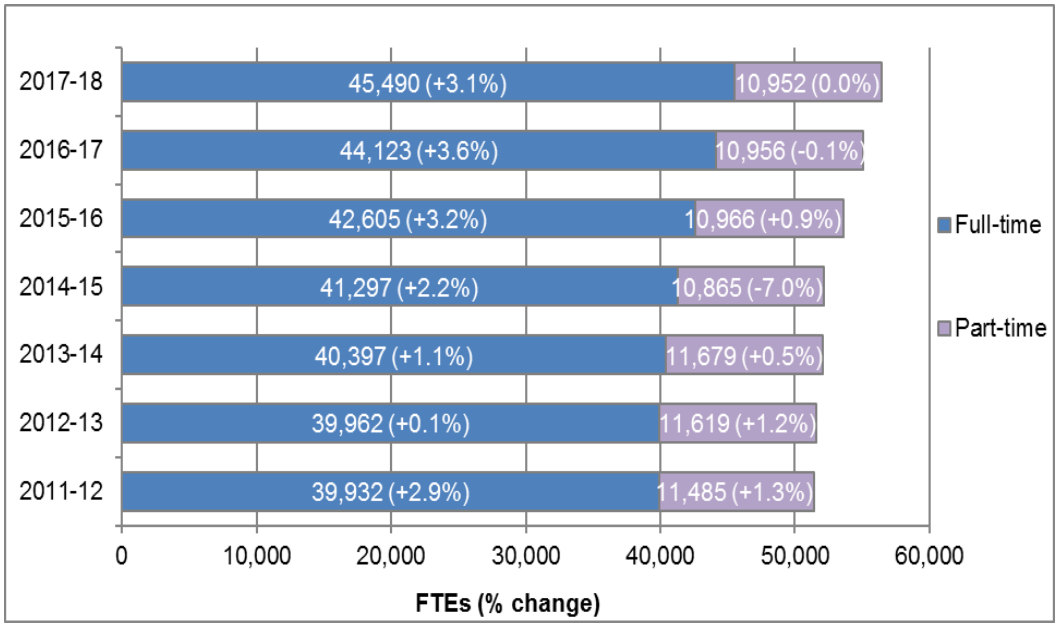
Figure 9 Postgraduate taught home and EU taught student numbers 2011-12 to 2017-18



69. Projections for postgraduate research study show that the sector is expecting full-time student numbers to increase by 2.2 per cent in 2014-15, followed by rises of between 3.1 per cent and 3.6 per cent per year in 2015-16 to 2017-18. In contrast, part-time postgraduate research student numbers are expected to fall by 7.0 per cent in 2014-15, followed by marginal changes to student numbers in the remaining forecast period.

70. Figure 10 shows the number of full and part-time postgraduate research students (expressed as full-time equivalents) reported or projected by the sector for the period 2011-12 to 2017-18, together with the percentage change in numbers compared to the previous year (in brackets).

Figure 10 Postgraduate research home and EU taught student numbers 2011-12 to 2017-18

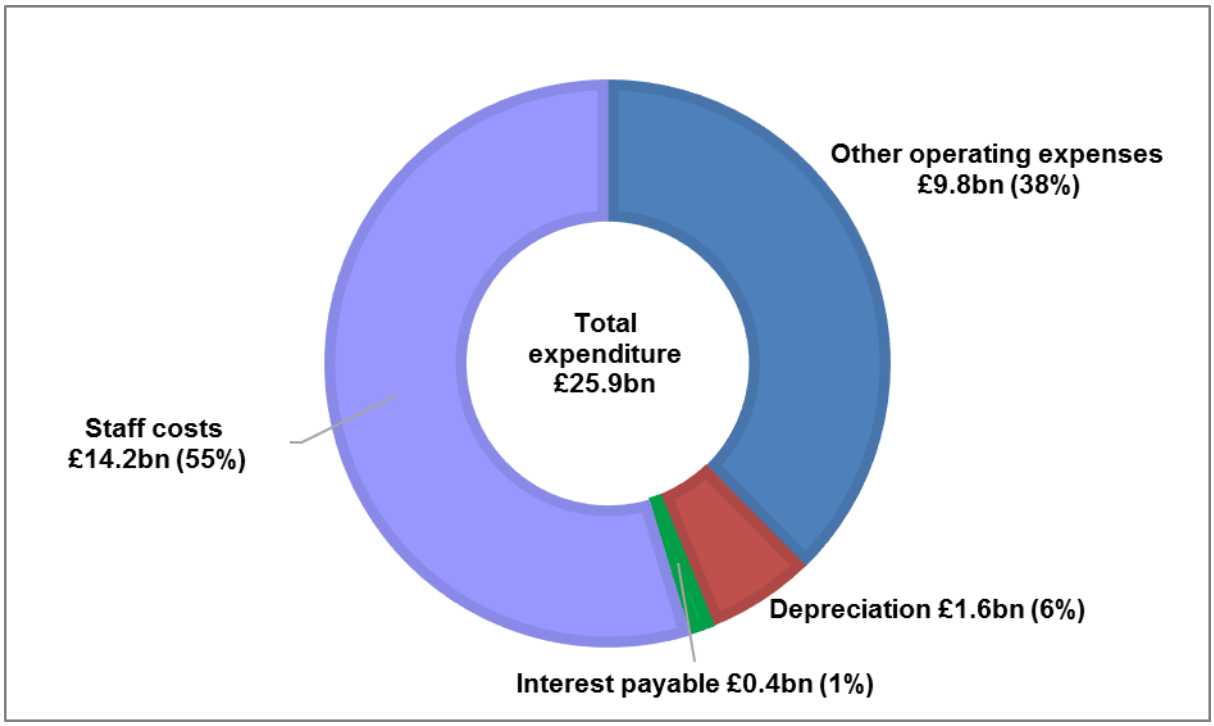


71. Final numbers of home and EU student new entrants in 2014-15 will not be known until the HEFCE aggregate student number surveys are available later this year. However, the interim UCAS figures published in September 2015[3] revealed an overall three per cent increase in acceptances to English institutions for the 2015-16 entry year compared to the equivalent point in the 2014 cycle. These figures are consistent with the institutional forecasts shown above.

Expenditure

72. Forecasts for 2014-15 show that the sector is projecting a rise in expenditure of 5.9 per cent compared to the level reported in 2013-14. Figure 11 shows the breakdown of projected expenditure (in cash-terms) in 2014-15.

Figure 11 Forecast expenditure by type 2014-15 (cash terms)



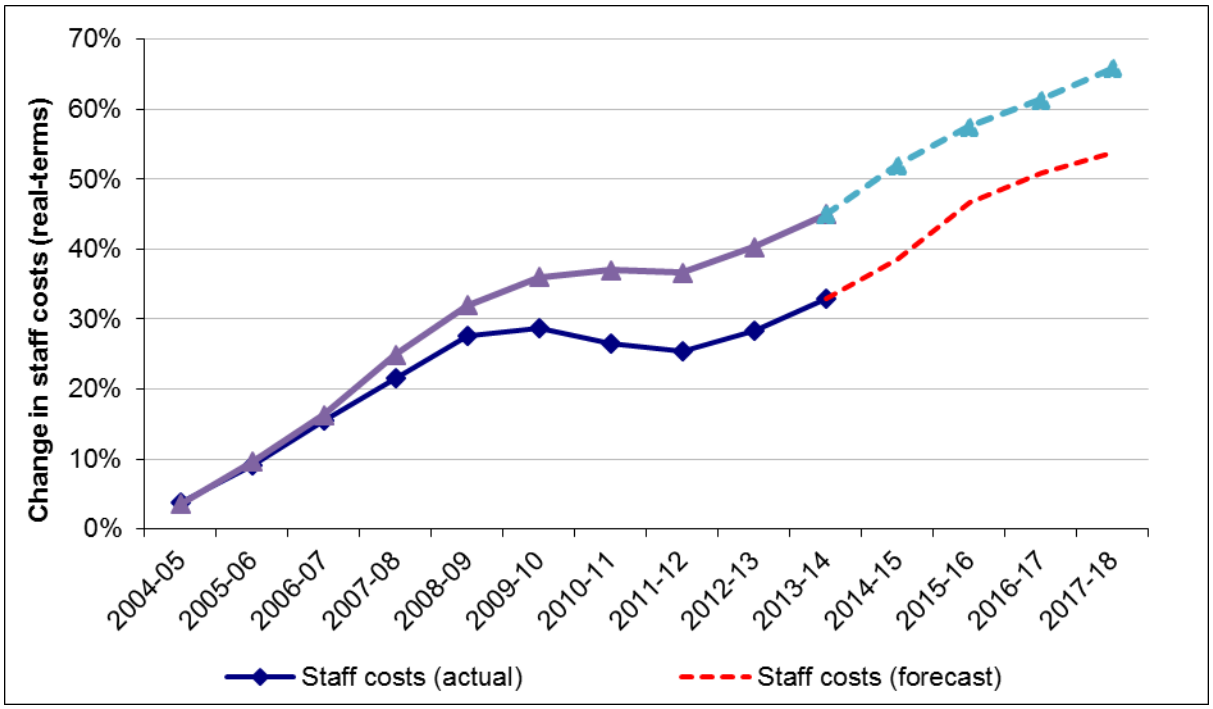
73. The sector's biggest expenditure is staff costs, which in 2013-14 totalled £13,460 million, equivalent to 52.6 per cent of total income. The latest forecasts show that the sector is expecting staff costs to rise by 5.2 per cent to £14,158 million in 2014-15 and by a further 15.6 per cent in the remaining forecast period, to reach £16,366 million by 2017-18.

74. As a percentage of total income, staff costs are expected to vary between 52.3 and 53.6 per cent of total income throughout the forecast period, compared with 52.6 per cent in 2013-14 and a high of 58.1 per cent in 2000-01.

[3] See 'Interim assessment of UCAS acceptances by intended entry year, country of institution and qualifications held', https://www.ucas.com/corporate/data-and-analysis/ucas-undergraduate-releases/ucas-undergraduate-analysis-reports.

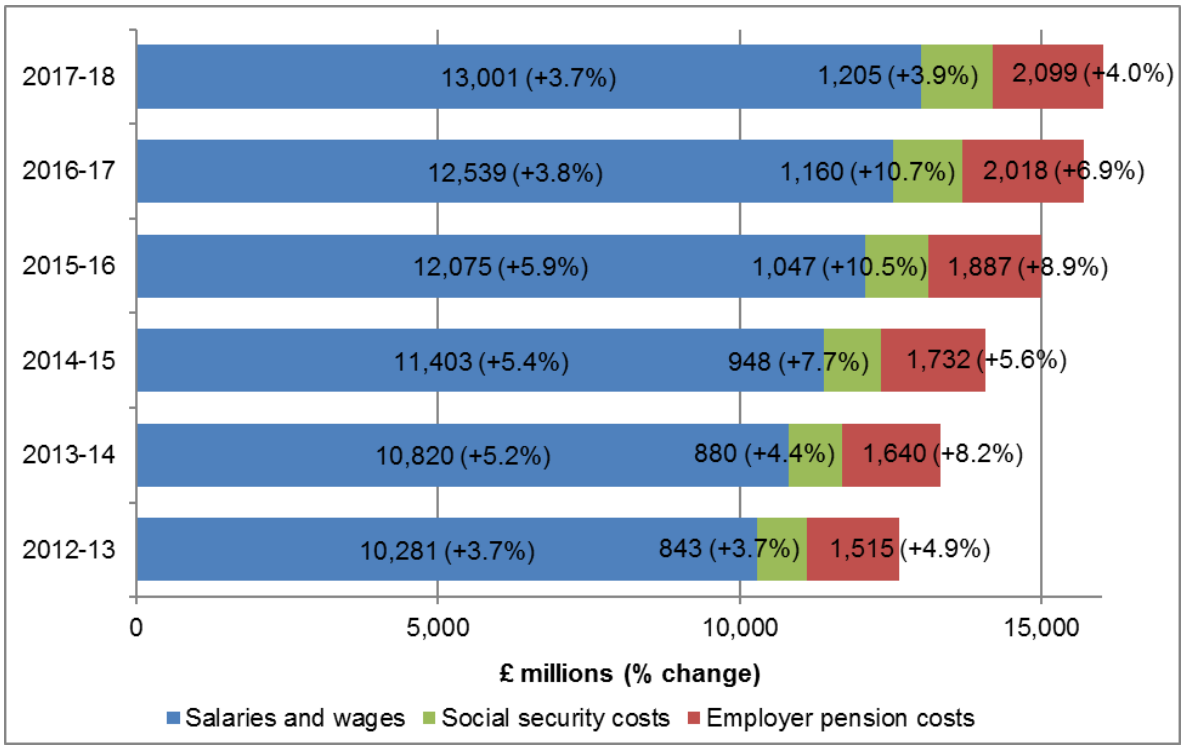
75. Figure 12 compares the level of real-terms increases in total income and staff costs over the past ten years, plus what the sector is forecasting to happen over the next four years.

Figure 12 Real-terms increases in total income and staff costs (cumulative increase since base year of 2003-04)



76. Figure 13 shows the amounts (in cash terms) and the breakdown between salaries and wages, pension costs and employer national insurance contributions for the period 2012-13 to 2013-14 and forecast for 2014-15 to 2017-18, together with the percentage increases compared to the previous year (in brackets).

Figure 13 Changes and breakdown of staff costs 2012-13 to 2017-18



77. The projected rise in staff costs over the forecast period is caused by a combination of increasing pay costs and rising staff numbers, with forecasts showing that staff numbers will be 7.1 per cent higher in 2017-18 compared to 2013-14.

78. Annual pay costs per employee are forecast to rise between 0.8 and 3.0 per cent per year (in real terms) in the period 2014-15 to 2017-18, following a period of curtailment between 2009-10 and 2011-12.

79. The highest percentage rises relate to pension costs and national insurance contributions. In real-terms, average pension costs and national insurance contributions (per employee) are expected to rise between 1.0 per cent and 5.8 per cent per year. This reflects the rising pension contributions required to fund the sector's pension deficits, and the increases in national insurance contributions as a result of the new single-tier pension reforms effective from April 2016.

80. The sector is forecasting other operating expenditure to rise between 2.6 per cent and 6.9 per cent (cash terms) per year in the period 2014-15 to 2017-18, with the greatest rises expected in the next two years. Depreciation and interest payable are expected to increase at a faster rate, with depreciation rising between 6.7 per cent and 8.8 per cent per year, and interest payable rising between 2.2 per cent and 11.1 per cent (cash terms) per year in the same period. These increases reflect the sector's rising investment in physical infrastructure and increasing levels of external borrowing.

81. Given the current economic environment, and the resulting staff cost and pension pressures, the sector is increasingly focused on securing value for money from public funds, and (for the benefit of students) from tuition fees. As part of our annual accountability process, we ask institutions to submit value for money reports to us showing how they make the best use of

available resources. The nature and content of the value for money reports vary from institution to institution. However, many of the reports set out details of the savings that institutions have achieved over the course of the year, either in aggregate or in detail. These savings can be categorised as cost savings, efficiency savings or income generation measures.

82. These reports set out details of the value for money activities and resultant savings that institutions have achieved over the course of the year. Our analysis of the data supplied indicates that the sector made an estimated saving of £1.1 billion over the period 2011 to 2014. It is likely, however, that institutions will also be operating value for money initiatives that are not mentioned in their reports. Such initiatives, and any resulting savings, will not have been captured by this analysis. Consequently, the volume of savings set out in this report is likely to be understated.

83. These savings have helped to support the sector's current financial position but will be increasingly important going forward given the continued uncertainty in the sector and the growing pressure on costs.

84. HEFCE are currently developing a new methodology to collect and assess value for money information in a more systematic way to better determine and report the scale of sector savings in future.

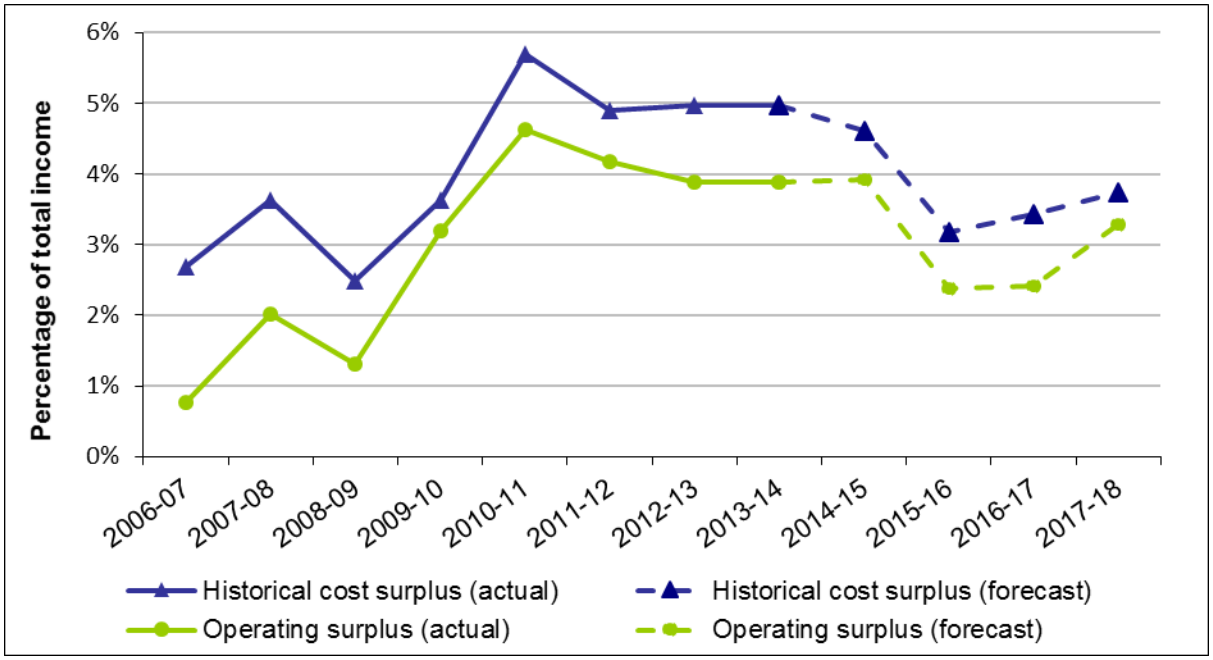
Surpluses

85. The forecasts indicate that, at an operating level (that is, total income less total expenditure, before any exceptional items), the sector expects surpluses to remain at 3.9 per cent of total income in 2014-15, the same level as reported in 2012-13 and 2013-14. Thereafter surpluses are expected to fall, to 2.4 per cent of total income in 2015-16 and 2016-17, before rising to 3.3 per cent of total income in 2017-18. On a historical-cost basis the average level of surpluses is projected to be between 3.2 per cent and 4.6 per cent of total income over the forecast period.

86. Figure 14 shows the actual and expected operating and historical cost surpluses for the forecast period. The large differences between the operating and historical position in the year 2016-17 are partly accounted for by exceptional items of £204 million. Many of these exceptional items relate to capital receipts following disposal of assets.

87. Some HEIs have also projected Research and Development Expenditure Credits (RDEC) from HMRC in their 2014-15 forecasts, which increase their surpluses for this year. The value of these credits vary among institutions, with the highest credit valued at £53 million.

Figure 14 Operating and historical cost surpluses of HEIs, 2006-07 to 2017-18



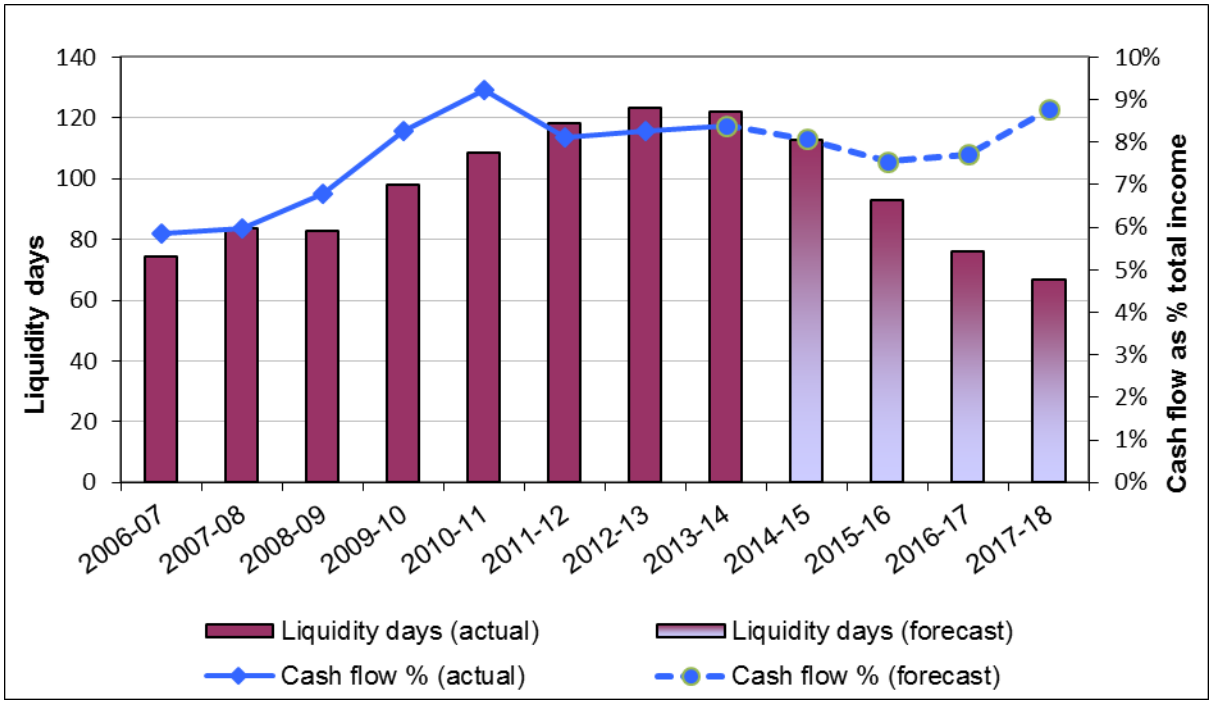
Liquidity and cash flow

88. The level of liquidity (that is, the number of days that liquidity covers expenditure) reported for the sector was 122 days in 2013-14; the highest on record. However, the sector expects liquidity to fall to 113 days in 2014-15, before falling further in the remainder of the forecast period, to reach 67 days by the end of 2017-18 (the lowest level since 2006-07). This coincides with a rise in the level of borrowing, which is expected to reach record levels by the end of 2017-18.

89. The liquidity data is taken as a snapshot of bank and investment balances, as at 31 July. For most institutions their main period of capital spend happens during the summer months, after 31 July, and therefore the available cash, not committed to capital spend, is likely to be much lower.

90. Figure 15 shows actual and forecast levels of net liquidity (expressed as liquidity days), together with the actual and forecast levels of cash flow from operating activities (as a percentage of total income). This shows that the level of liquidity is forecast to reduce over the forecast period, whereas cash flow from operating activities is expected to fall in 2014-15 and 2015-16, before rising again in 2016-17 and 2017-18.

Figure 15 Net liquidity and cash flow 2006-07 to 2017-18



91. Six institutions reported negative cash flows in 2013-14. This number is expected to rise to ten in 2014-15 and is projected to range between five and seven institutions in the remainder of the forecast period.

92. Only five institutions had liquidity of less than 20 days in 2013-14 (compared with six in 2012-13). Although the number of institutions is expected to rise to 11 in the forecast period, the risk of solvency problems in the sector remains low.

93. While liquidity is not a concern at this time, as charities HEIs are obligated to ensure that they remain sustainable and do not expose themselves to undue risk. Strong liquidity is particularly important given the level of uncertainty and risk that currently exist in the sector, and we continue to monitor liquidity levels to assess whether HEIs are able to maintain sufficient cash levels to manage their risks effectively and to finance investment in infrastructure.

Capital expenditure and borrowing

94. Since 2002 the sector has spent £28,676 million on improving its physical infrastructure, excluding expenditure on general day-to-day maintenance.

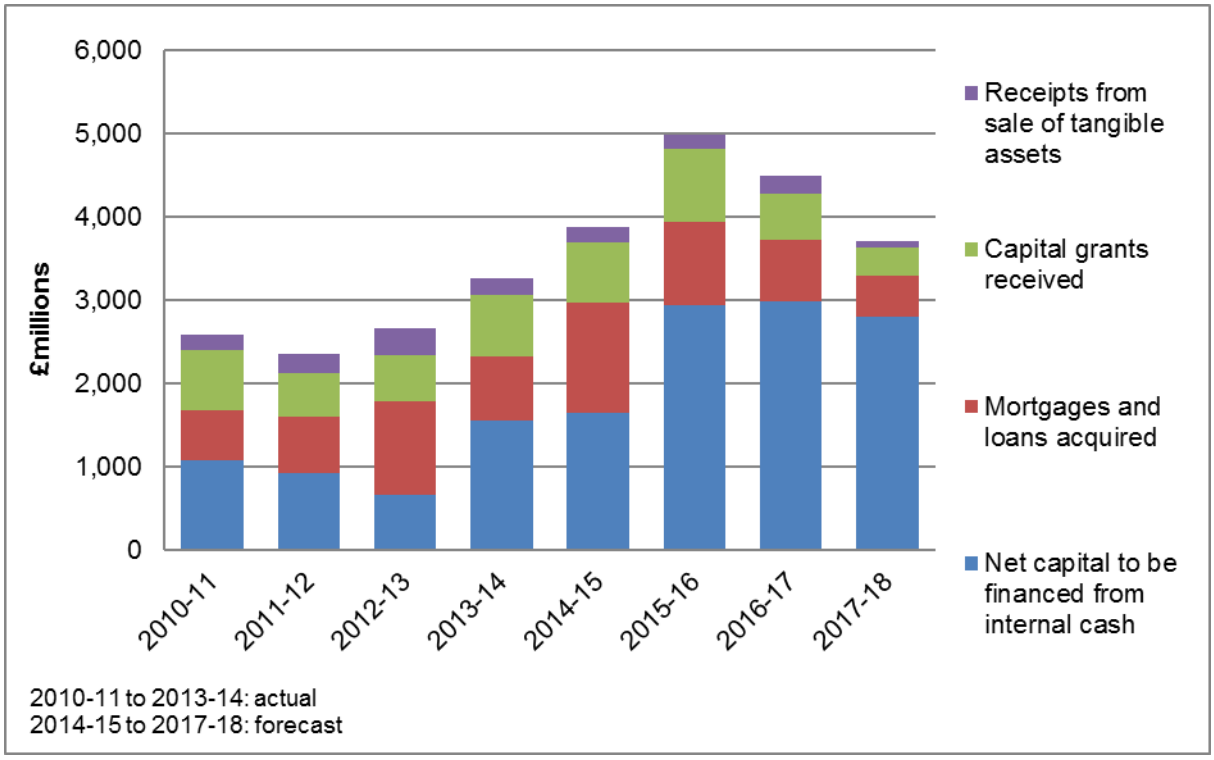
95. Although this is a significant level of investment, Estate Management Statistics data, as at 31 July 2014, showed that the sector still needed to invest £3,447 million to bring its non-residential estate up to a sound and operationally safe condition. However, it is important to note that even more investment is needed to bring the estate up to the standard required to benefit the student academic experience and to attract new students and staff. This helps ensure that the sector can compete in the increasingly competitive global market.

96. These latest forecasts show that the sector is projecting capital expenditure of £3,877 million in 2014-15, 19.1 per cent higher than the expenditure level reported in 2013-14. Even higher levels of capital expenditure are projected over the next three years, averaging £4,393

million per annum (2015-16 to 2017-18) with the largest capital investment expected in 2015-16, totalling £4,986 million.

97. Figure 16 provides a breakdown of how capital expenditure was funded from 2010-11 to 2013-14, together with an indication of how the sector is expecting to fund its capital investment plans for the period 2014-15 to 2017-18 (based on institutional forecast data). This shows a large increase in new mortgages and loans in 2014-15, alongside a sharp increase in the level of net capital to be financed from internal cash from 2015-16 onwards.

Figure 16 Funding breakdown of capital expenditure 2010-11 to 2017-18



98. Cash inflows from operating activities projected by the sector for 2014-15 are sufficient to finance any expenditure plans not financed by capital grants or borrowings. However, expenditure projections in the following three years will require close cash flow management, as forecasts indicate that the sector requires another £1.6 billion from its own cash reserves (in excess to the projected surpluses and cash inflows) to fund the capital expenditure shortfall for those years. In the absence of alternative financing, this will result in the sector's projected cash levels to fall further.

99. With significantly reduced levels of publicly funded capital grants, institutions will need to generate surpluses and operating cash inflows to sustain the level of capital investment needed to attract students and staff, and ensure its long-term sustainability. In the short term this level of capital investment is affordable given the cash reserves held by the sector; however, the sector will be unable to sustain it unless institutions generate increased surpluses.

100. The reduction in cash balances, the increase in borrowings, and the increasing volatility of income streams point to an increase in finance risk. As part of the Memorandum of Assurance and Accountability (MAA) between HEFCE and institutions, we introduced an approval process

to assess whether increases in financial commitments by an HEI above a threshold (based on earnings before interest, tax, depreciation and amortisation) would increase the risk to its future financial sustainability, and therefore to the public and collective student interests. This new approval process has been operating since 1 August 2014.

101. Forecasts show that the sector expects its borrowings to rise by £2.4 billion over the forecast period, to reach £9.2 billion by the end of 2017-18. Although the sector already has access to over £1.1 billion of additional financing agreed with lenders but not all drawn down at 31 July 2015, a significant amount of borrowing is yet to be financed.

102. Availability of finance has not been an issue for the HE sector over recent years. The changes in the financial markets in 2012 led to lenders reducing the repayment periods on new loans, though there are now signs that repayment periods are increasing. The sector continues to look at different options for financial investment, including private and public bonds. The number of financial covenants attached to borrowing agreements appears to be increasing, with covenants covering both financial performance and balance sheet strength. Interest rates overall remain low for the sector, reflecting the confidence of lenders to the sector, but the spread in margins between different types of institution has increased considerably.

103. The average level of borrowing has been rising within the sector for some time. In 2001-02, the level of borrowing was 19.6 per cent of total income, and by the end of 2013-14 this had risen to 26.3 per cent. This is projected to rise further to a high of 30.4 per cent by the end of 2016-17, before falling to 29.8 per cent by the end of 2017-18.

104. As borrowing rises in the sector, interest payments are expected to increase, from £359 million in 2013-14 to £453 million in 2017-18. The increase in payments to service borrowing costs (interest and capital payments) will be affordable as long as income and cash projections are as currently forecast. However, this rise in ‘fixed costs’ could put pressure on any institution that fails to constrain other costs and/or to increase income.

Reserves

105. Reserves are an HEI’s assets less its liabilities and, in very broad terms, can be used as a proxy of the overall value of an institution.

106. The main indicator used to assess reserves is the amount of ‘discretionary reserves’ held on an institutions balance sheet. These are the accumulated surpluses of an institution over its lifetime although they are not the same as cash. In order to convert all reserves to cash an institution would have to sell all its assets.

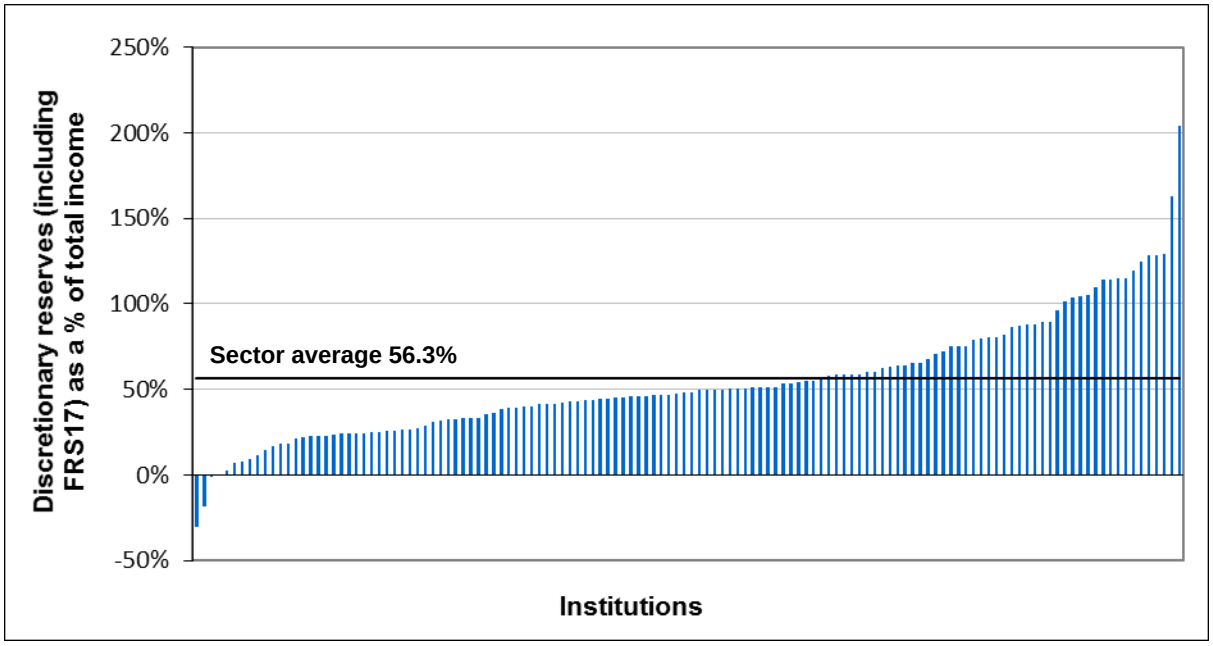
107. At the end of 2013-14 reserves totalled £12,292 million, after taking into account the impact of the financial reporting standard on retirement benefits (FRS17). This reporting standard, which requires pension scheme surpluses or deficits to be included in the balance sheet (but not currently those of multi-employer schemes such as the Universities Superannuation Scheme (USS)), makes comparisons with previous years difficult. Without pension scheme deficits the sector would have reserves of £16,472 million at the end of 2013-14, equivalent to 64.4 per cent of total income. Including FRS17 pension scheme deficits of £4,180 million, though, reduces the reserves to 48.0 per cent of income.

108. Discretionary reserves are forecast to increase each year in the forecast period as the sector continues to generate surpluses. By the end of 2017-18, the sector expects to have built

reserves (including FRS17) of £17,315 million. However, the aggregate sector position masks a significant spread of financial strength: there is a concentration of large discretionary reserves in a small number of institutions, and this concentration is likely to continue throughout the forecast period.

109. Figure 17 shows the forecast level of discretionary reserves including FRS17 as a percentage of total income,

Figure 17 Forecast discretionary reserves including FRS17 as a percentage of total income 2017-18



110. While sector reserves currently appear strong overall, from 2015-16 reserve levels and pension deficits are likely to be substantially lower following the introduction of a new financial reporting standard (FRS102), which requires institutions to recognise liabilities relating to deficit recovery plans for multi-employer pension schemes in their balance sheets. While not a new liability, it will increase the transparency of the underlying deficits within the relevant pension schemes, which may impact on confidence levels in the financial strength of the sector. The impact of these changes will not be seen until July 2016: when the sector's next set of financial forecasts are due to be submitted to HEFCE.

111. The largest multi-employer pension scheme operating in the sector is the USS and the latest actuarial valuation for this scheme (as at March 2014) confirms that, after taking into account the revised benefit structure effective 1 April 2016, the actuarial deficit stood at £5.3 billion. This compares with the last full triennial assessment, which valued the deficit at £2.9 billion as at the end of March 2011, demonstrating the significant level of volatility in these valuations.

112. The March 2014 actuarial deficit is equivalent to 43 per cent of the sector's discretionary reserves (including pension deficits already recognised in the accounts) at 31 July 2014 and, if this deficit was fully reflected in the sector's 2013-14 accounts, would reduce reserves from 48 per cent to 27 per cent of total income.

Sensitivity of financial forecasts to changes in key assumptions

113. In analysing the current forecasts we have attempted to highlight the limited margins in which the sector operates by modelling the impact of changes in what HEIs are forecasting for the years 2015-16 to 2017-18. In particular, we have modelled the cumulative impact of a 5 per cent cash reduction in public funding, full-time home and EU undergraduate fee income and overseas fee income, together with the cumulative impact of a 2 per cent increase in staff costs (which include pension costs). Table 3 shows the level of operating surpluses in each year under the various scenarios.

Table 3 Operating surpluses under modelled scenarios

Scenario	2015-16	2016-17	2017-18
Current forecasts	£670M 2.4%	£709M 2.4%	£1,009M 3.3%
Cumulative public funding reduction (5% per year)	£325M 1.2%	£59M 0.2%	(£39M) (0.1%)
Cumulative reduction in full-time Home and EU undergraduate fee income (5% per year)	£284M 1.0%	(£55M) (0.2%)	(£22M) (0.1%)
Cumulative reduction in overseas fee income (5% per year)	£479M 1.7%	(£40M) (0.1%)	(£303M) (1.0%)
Cumulative increase in staff costs (2% per year)	£368M 1.3%	£385M 1.3%	£670M 2.2%
Combination of above four scenarios	**(£552M)** **(2.0%)**	**(£2,434M)** **(7.9%)**	**(£4,464M)** **(16.8%)**

114. The above scenarios assume no mitigating action is taken by institutions, which is unlikely. However, Table 3 does highlight the fine margins with which the sector operates, and how quickly small changes can have a material impact on the financial performance of the sector.

115. If the four scenarios outlined all came to pass, the sector would be in deficit in all three years and, by 2017-18, the £1,009 million projected operating surplus would turn into a deficit of £4,464 million (a fall of £5.5 billion).

116. HEIs need to generate surpluses to provide the positive cash flow to fund future investment in infrastructure, to the extent that these are not met from capital funding. The actual levels of surplus needed will vary, depending on the circumstances of individual HEIs. Overall the sector is in a financially sustainable position in the short term. However, the above analysis highlights the tight margins in which HEIs are operating, and mean that small changes in income or costs could have a material impact on financial performance of institutions and the sector.

Conclusion

117. The expected financial outturn for the sector in 2014-15 is expected to be similar to that reported in as 2013-14.

118. The projected performance for the sector in the remainder of the forecast period (2015-16 to 2017-18) is sound overall, with the sector forecasting continued surpluses and healthy reserve levels, though reported reserve levels will fall substantially once USS actuarial deficits are recognised in balance sheets (from 2015-16).

119. Although sound overall, the projected financial outturn for the sector is weakening, with the sector expecting its liquid funds to diminish and its borrowing to increase to record levels; an unsustainable trajectory.

120. Projections across the forecast period show an increasing variation in the financial performance of institutions, with a widening gap between the lowest and highest performing institutions.

121. Strong liquidity is particularly important given the increasing level of uncertainty in the sector over future government funding and student recruitment. The latest forecasts show that HEIs are becoming increasingly reliant on overseas fee income to remain sustainable so a downturn in overseas student recruitment would have a significant adverse impact on the sector's financial projections.

122. While the latest forecasts indicate that the sector is responding to the need to increase capital expenditure to respond to growing competition, without higher surpluses or increased borrowing, there is a risk that HEIs will be unable to deliver the level of investment needed to secure their long-term sustainability.

123. Institutions failing to invest sufficiently in infrastructure could find themselves in a weaker market position and at higher risk of financial instability.

Disclaimer

124. This report, which is based on information provided by HEFCE-funded institutions, has been prepared for the benefit of higher education institutions and their stakeholders in general terms. HEFCE cannot reasonably foresee the various specific uses that may be made of this report, and therefore no responsibility is accepted for any reliance any third party may place upon it.

List of abbreviations

EU	European Union
FRS	Financial Reporting Standard
FT	Full-time
FTE	Full-time equivalent/equivalence
HEFCE	Higher Education Funding Council for England
HEI	Higher education institution
HESA	Higher Education Statistics Agency
PG	Postgraduate
PT	Part-time
RDEC	Research and Development Expenditure Credits
TRAC	Transparent Approach to Costing
UG	Undergraduate
USS	Universities Superannuation Scheme