

Financial health of the higher education sector

2016-17 financial results

This report provides an overview of the financial health of the HEFCE-funded higher education sector in England. The analysis covers the financial results for 2016-17. This does not include further education or sixth form colleges, or alternative providers of higher education.

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Financial health of the higher education sector: 2016-17 financial results

To	Heads of HEFCE-funded higher education institutions
Of interest to those responsible for	Audit, Estates, Finance, Governance, Management, Planning
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Executive summary

Background and purpose

1. This report provides an overview of the financial health of the HEFCE-funded higher education sector in England. The analysis covers the financial results of these higher education institutions (HEIs) for 2016-17. This does not include further education or sixth form colleges, or alternative providers of higher education.
2. The report is being published to provide feedback on the sector's financial performance in 2016-17. The analysis also provides information to other stakeholders about the current financial health of the sector.

Key points

3. The financial results for the sector as a whole in 2016-17 are sound overall, and are more favourable than projected in July 2017. However there continues to be a wide variation in the financial performance and position of individual HEIs.
4. The main outcomes from the analysis of the 2016-17 results are as follows:
 - a. The sector reported a rise in income of 2.9 per cent to £29.9 billion in 2016-17. However, a greater rise in expenditure caused surpluses to fall from £1.5 billion (5.2 per cent of total income) in 2015-16 to £1.1 billion (3.6 per cent of total income) in 2016-17.
 - b. At institutional level, a wide range of results were reported. In total, 24 institutions reported deficits in 2016-17 compared with 11 institutions in 2015-16. The majority (19 HEIs) had already projected deficits in their July 2017 forecasts, some due to the costs associated with restructuring activity.
 - c. In contrast, 15 institutions reported surpluses of over 10 per cent in 2016-17 compared with 17 in 2015-16. The high surpluses reported by some HEIs have been boosted by large one-off income receipts from donations and endowments, while others are due to strong operating performance.
 - d. Cash flow from operating activities remained at similar levels to the previous year: 10.0 per cent of total income in 2016-17 compared with 10.1 per cent in 2015-16.

- e. Home and EU tuition fee income increased by 5.7 per cent: from £11.0 billion in 2015-16 to £11.7 billion in 2016-17. Fee income from non-EU students increased by 5.0 per cent, from £3.8 billion in 2015-16 to £3.9 billion in 2016-17 (equivalent to 13.2 per cent of total income).
- f. Liquidity increased by 8.2 per cent, from £9.6 billion (135 days of expenditure) at 31 July 2016 to £10.4 billion (140 days) at 31 July 2017. This was also higher (by 9.7 per cent) than the level forecast by the sector in July 2017. The reasons why liquidity levels were higher than forecast varied across the sector, but were mainly due to lower capital expenditure, higher surpluses, or higher current investment values compared with earlier projections.
- g. Borrowing increased by 6.9 per cent: from £8.9 billion at 31 July 2016 (equivalent to 30.7 per cent of income) to £9.9 billion at 31 July 2017 (33.1 per cent of income).
- h. Capital investment, to maintain and enhance academic and student facilities, totalled £4.2 billion in 2016-17, an increase of 8.6 per cent compared with 2015-16; but, due to a number of HEIs reporting delays in capital expenditure, this was 12.4 per cent lower than forecast in July 2017.
- i. There is significant variation in the level of capital spend between institutions. 57 reported a decline in capital expenditure in 2016-17 compared with the previous three-year average (2013-14 to 2015-16).
- j. As in previous years, this investment was driven by a small number of institutions, with 15 HEIs contributing 50 per cent of the sector's capital expenditure total in 2016-17.
- k. Pension provisions decreased by 9.1 per cent – from £9.4 billion at 31 July 2016 to £8.6 billion at 31 July 2017 – due to a number of HEIs reporting lower than expected deficits in their Local Government Pension Scheme as a result of the latest actuarial valuations on these schemes.
- l. In contrast, the 2017 actuarial valuation for the Universities Superannuation Scheme (USS) shows an increase in the funding deficit: from £5.3 billion in 2014 to approximately £7.5 billion as at 31 March 2017¹, and a significant rise in the cost of future defined benefits (up by over a third since the last valuation).
- m. The implications of this deficit increase have not yet been reflected in the sector's accounts, and discussions on how these might be addressed by USS employers and members are ongoing. Proposals for USS benefit reform have been set out by the Joint Negotiating Committee, and are the subject of a statutory consultation with representative groups.
- n. The movements in deficit levels and change in the costs of future defined benefits demonstrates the inherent volatility in the valuation outcomes of the sector's pension schemes. This poses potentially significant uncertainty and risk to the ongoing financial sustainability of HEIs. It is expected that this will be reflected in the sector's 2017-18 published financial accounts.

¹ See <https://www.uss.co.uk>.

Financial outlook

5. In our report on the sector's financial projections to 2019-20, published in October 2017 (HEFCE 2017/28), we highlighted a trend of reducing surpluses and cash levels, and a rise in borrowing. All of which signals a general weakening of financial performance and a trajectory that is not sustainable in the long term.
6. We also highlighted some significant uncertainties and risks facing the sector arising from the UK's forthcoming withdrawal from the European Union (Brexit), increasing global competition, the changing policy agenda, as well as upward pressure on costs. This, along with increased competition in the domestic market, will pose challenges to the sector in the years ahead.
7. The sector has a track record of meeting such challenges, showing itself to be adaptable to a more competitive and uncertain environment. However, these risks will need careful monitoring and mitigation if institutions are to ensure their long-term sustainability.
8. The outcome of the latest USS valuation also exposes member institutions to significant financial and operational risks as pressure mounts on both employers and scheme members to agree a plan to ensure the scheme's sustainability.
9. The Government's review of post-18 education and funding announced in February 2018 could potentially have an impact on HEIs in the future. HEIs will need to re-assess their financial strategies and future financial prospects once the outcomes of the review are known and any potential implications become clear.
10. The various elements of uncertainty that currently exist within the sector are likely to lead to greater focus from investors on the financial strength of individual HEIs, with any fall in confidence levels likely to either restrict the availability of finance or result in a rise in the cost of borrowing for those able to secure such funding. This would inevitably put significant elements of the sector's investment programme at risk and could harm the long-term financial sustainability of some HEIs.

Analysis of financial results 2016-17

11. This report provides an overview and analysis of the financial health of the HEFCE-funded higher education sector in England. This does not include further education colleges or alternative providers of higher education.

Data sources and financial reporting standards

12. The data used in this paper comes from the following sources:

- a. Unless stated otherwise, all financial data up to and including 2016-17 is from the Higher Education Statistics Agency (HESA) Finance Record, which is completed by higher education institutions (HEIs) each year and is derived from audited financial statements.
- b. Student number data is from the HESA Student Record.

13. All financial information is presented in academic years (ending 31 July). All financial data is presented in cash terms unless otherwise stated. For references to changes in performance in real terms we have used HM Treasury's gross domestic product deflator, announced in January 2018² (adjusted on an academic year basis).

14. In some cases we have reported analysis by a peer grouping system, which comprises four levels by average undergraduate entry tariff points (high, medium, low, and specialist institutions).

15. Analysis of HEIs' financial forecasts submitted in July 2017 can be found in 'Financial health of the higher education sector: 2016-17 to 2019-20 forecasts' (HEFCE 2017/28)³.

16. Financial Reporting Standard (FRS) 102 is the financial reporting framework for higher and further education providers for reporting periods starting on or after 1 January 2015. All data from 2014-15 quoted in this report conforms to FRS102.

17. This change in reporting standard presents difficulties in comparing results between institutions and against historical (pre 2014-15) trends, because the new rules introduced significant changes in the way financial performance is reported. Some transitional changes reflected in 2014-15 financial data result in further difficulty when comparing years.

18. Financial data submitted by UK institutions as part of the HESA Finance Record is available from HESA⁴.

2016-17 financial results

19. The financial health of the higher education sector in 2016-17 shows a sound position overall. However, there are large variations in the financial performance and position of individual HEIs reported across the sector, with the main financial strength remaining in a small number of institutions.

² See www.hm-treasury.gov.uk/data_gdp_index.htm.

³ Available online at www.hefce.ac.uk/pubs/year/2017/201728/.

⁴ Available online at <https://www.hesa.ac.uk/data-and-analysis/providers/finances>.

20. Table 1 provides the key headline data for the sector from the financial information for 2015-16 and 2016-17.

Table 1: Summary key financial indicators for the sector

	Actual	
	2015-16	2016-17
Total income	£29,080M	£29,928M
Surplus ⁵	£1,519M	£1,092M
Surplus as % of total income	5.2%	3.6%
Cash flow from operating activities	£2,941M	£2,993M
Cash flow from operating activities as % of total income	10.1%	10.0%
Net liquidity as number of days' expenditure	135	140
Net assets/net liabilities ratio	2.2	2.2
External borrowings as % of total income	30.7%	33.1%
Unrestricted reserves ⁶ as % of total income	98.2%	104.9%

21. The remainder of the report looks at different aspects of the financial results reported by institutions in 2016-17.

Income

22. Total income reported by the sector in 2016-17 was £29.9 billion, an increase of 2.9 per cent in cash terms compared with 2015-16, and 0.8 per cent higher than the income previously projected. Table 2 provides a breakdown of sector income for the last two years.

⁵ This is the surplus reported in the 'Statement of comprehensive income and expenditure', before other gains and losses and the share of surplus or deficit in joint ventures and associates.

⁶ This is the unrestricted income and expenditure reserve and revaluation reserve reported in the Consolidated Balance Sheet.

Table 2: Breakdown of total income

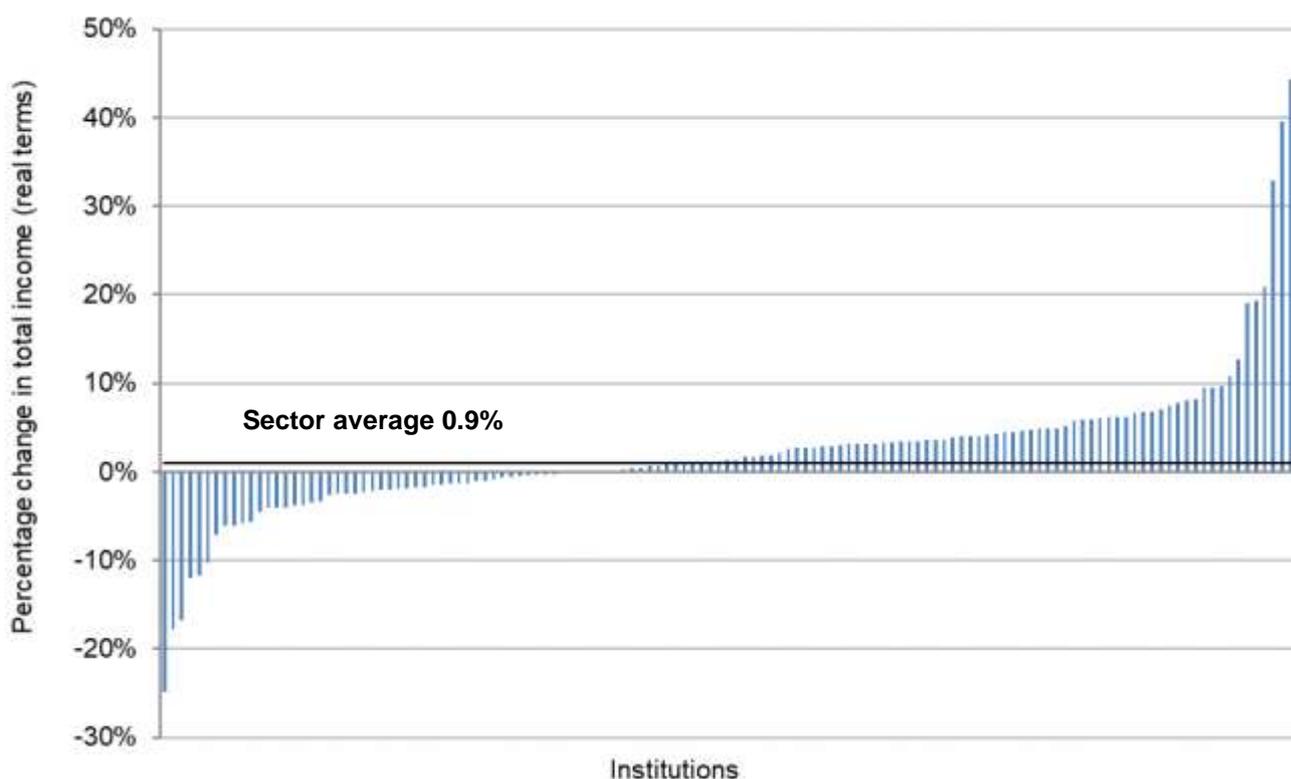
	Actual		Change	
	2015-16	2016-17	£M	%
Funding council grants	£3,661M	£3,568M	-£92M	-2.5%
Tuition fees and education contracts (home and European Union)*	£11,040M	£11,664M	£624M	5.7%
Overseas fee income*	£3,761M	£3,950M	£189M	5.0%
Research grants and contracts	£4,793M	£4,846M	£53M	1.1%
Other income	£5,077M	£5,169M	£91M	1.8%
Investment income	£216M	£198M	-£19M	-8.6%
Donations and endowments	£531M	£533M	£2M	0.3%
Total income	£29,087M	£29,928M	£848M	2.9%

* Home and EU tuition fee income for 2015-16 is sourced from total tuition fees and educational grants (restated for 2015-16 and reported in the December 2017 HESA Finance record) less 2015-16 overseas fee income (reported in HEI financial tables submitted in July 2017).

23. In real-terms, sector income increased by 0.9 per cent, although, across the sector, 50 HEIs recorded real-terms reductions in income in 2016-17; almost double the 27 HEIs that experienced such as reduction between 2014-15 and 2015-16. The reasons were varied, but were primarily due to falls in funding body grants, fee income and other income.

24. Figure 1 shows the varied distribution of real-terms changes to total income across the sector between 2015-16 and 2016-17, which shows an average increase of 0.9 per cent.

Figure 1: Real-terms percentage changes in total income (2015-16 to 2016-17)



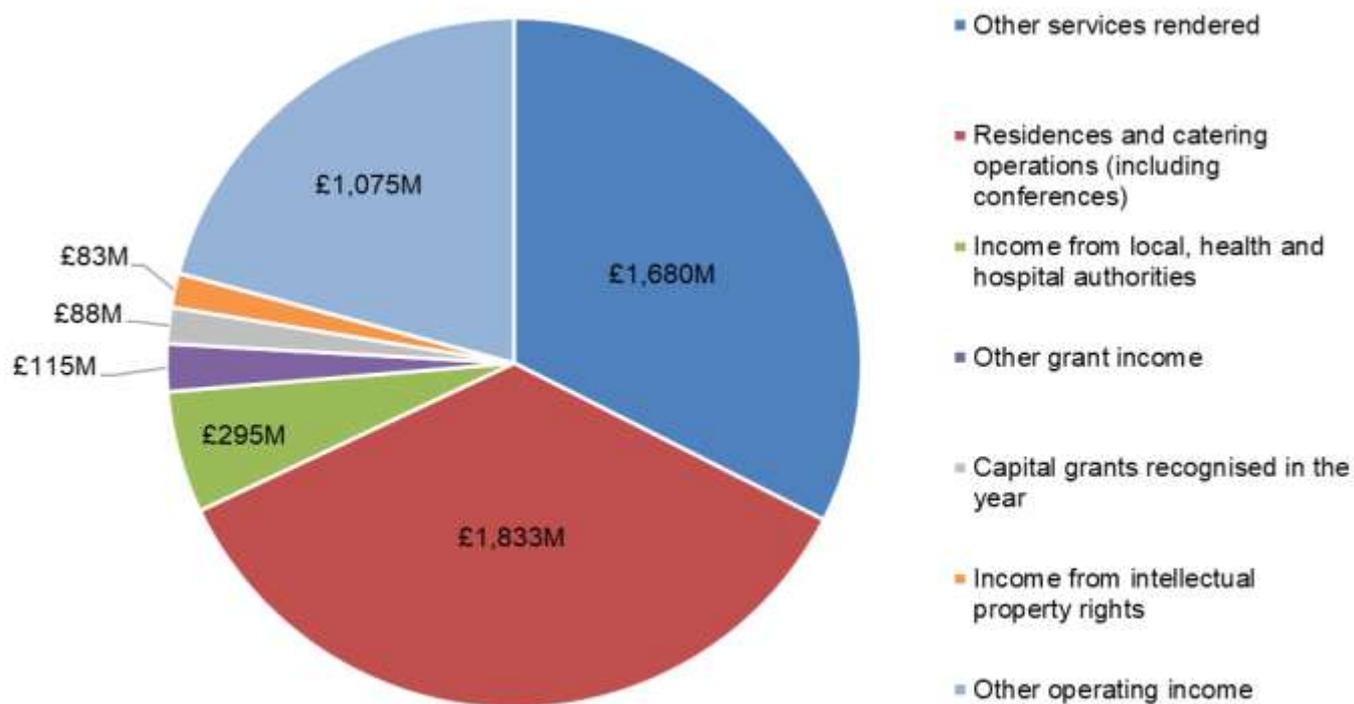
25. In cash terms, tuition fee income from Home and European Union (EU) students increased by £624 million in 2016-17, equivalent to a 5.7 per cent increase on 2015-16 levels.

26. In 2016-17, data from the HESA student record indicates that there was an increase of 3.0 per cent in home and EU full-time undergraduate students (expressed as full-time equivalents (FTEs)) from 1,025,091 to 1,055,614. This indicates that much of the corresponding increase in income is due to the increase in student fees from 2012-13 as opposed to increased student numbers.

27. Income from research grants and contracts grew by £53 million to £4.8 billion in 2016-17. This was 1.1 per cent higher than the income reported in 2015-16 and 1.2 per cent higher than the level forecast in July 2017. The largest increase relates to income from UK-based charities, which increased by 2.2 per cent in 2016-17.

28. The sector also reported an increase in 'other income' over the year; from £5.1 billion in 2015-16 to £5.2 billion (equivalent to a rise of 1.8 per cent) in 2016-17. Within this, income from residences and catering operations grew by £75 million and income from other services rendered grew by £72 million. A breakdown of 'other income' received in 2016-17 is shown in Figure 2.

Figure 2: Breakdown of Other income (2016-17)



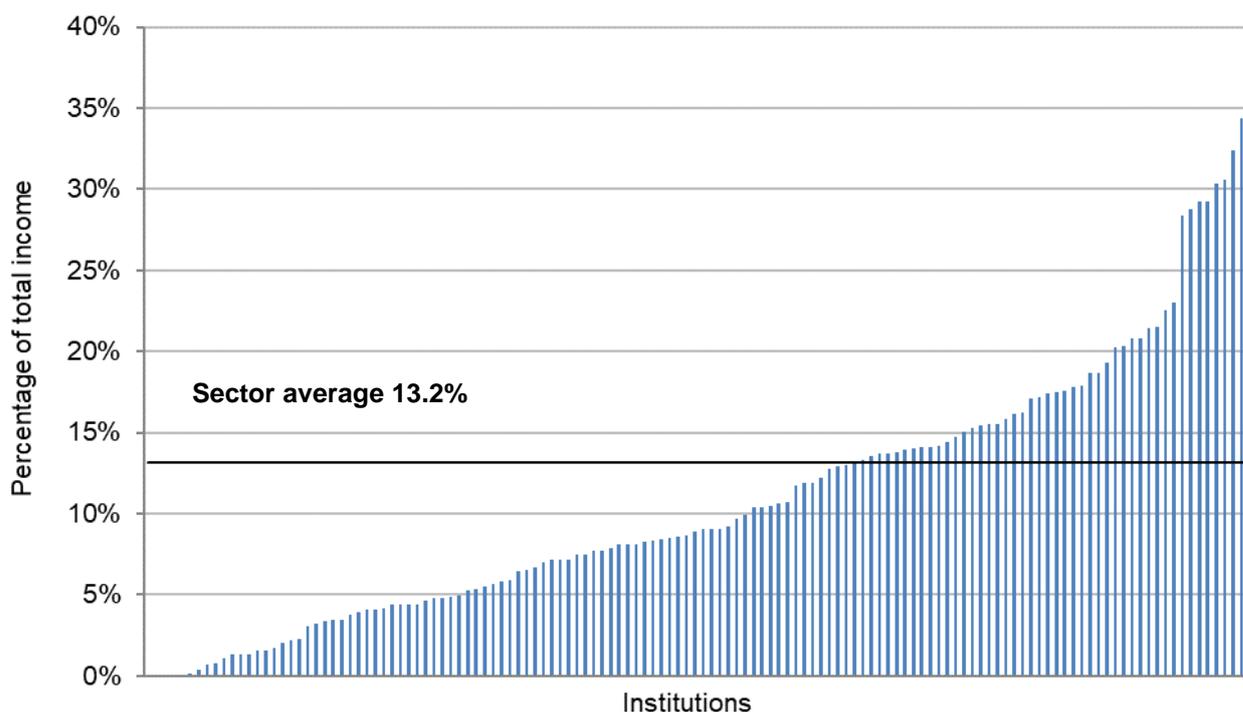
29. Institutions are increasingly focused on maximising their other income streams to support their teaching and research operations and to generate the cash inflows needed to support capital investment and meet finance costs. Institutions failing to maintain these income streams are at greater risk of financial instability.

Overseas (non-EU) income

30. In 2016-17 the sector reported fee income from overseas students of £3.9 billion, an increase of £189 million and equivalent to a rise of 5.0 per cent compared with 2015-16. In 2016-17 this represented 13.2 per cent of total income across the sector.

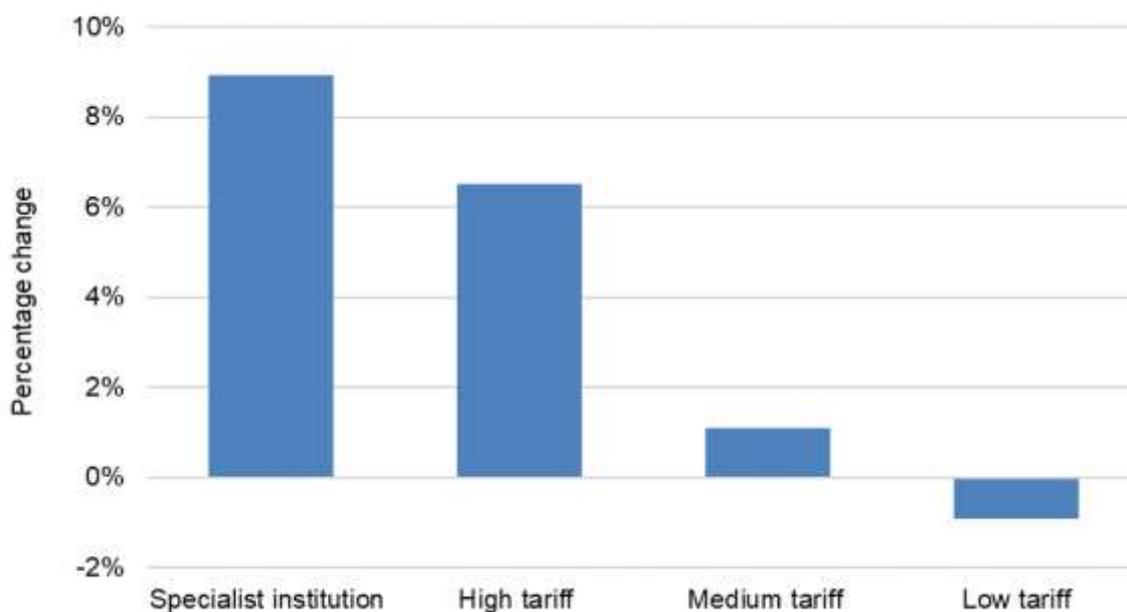
31. Figure 3 shows how the distribution of overseas fee income levels in 2016-17 (expressed as a percentage of income) varies across the sector.

Figure 3: Overseas fee income as percentage of total income (2016-17)



32. Figure 4 shows the percentage change in overseas fee income levels between 2015-16 and 2016-17 by tariff group. This shows an increase in overseas fee income in specialist, high-tariff and medium-tariff HEIs of 8.8, 7.8 and 2.6 per cent respectively. Low-tariff institutions experienced a decline of 5.8 percent between the two years.

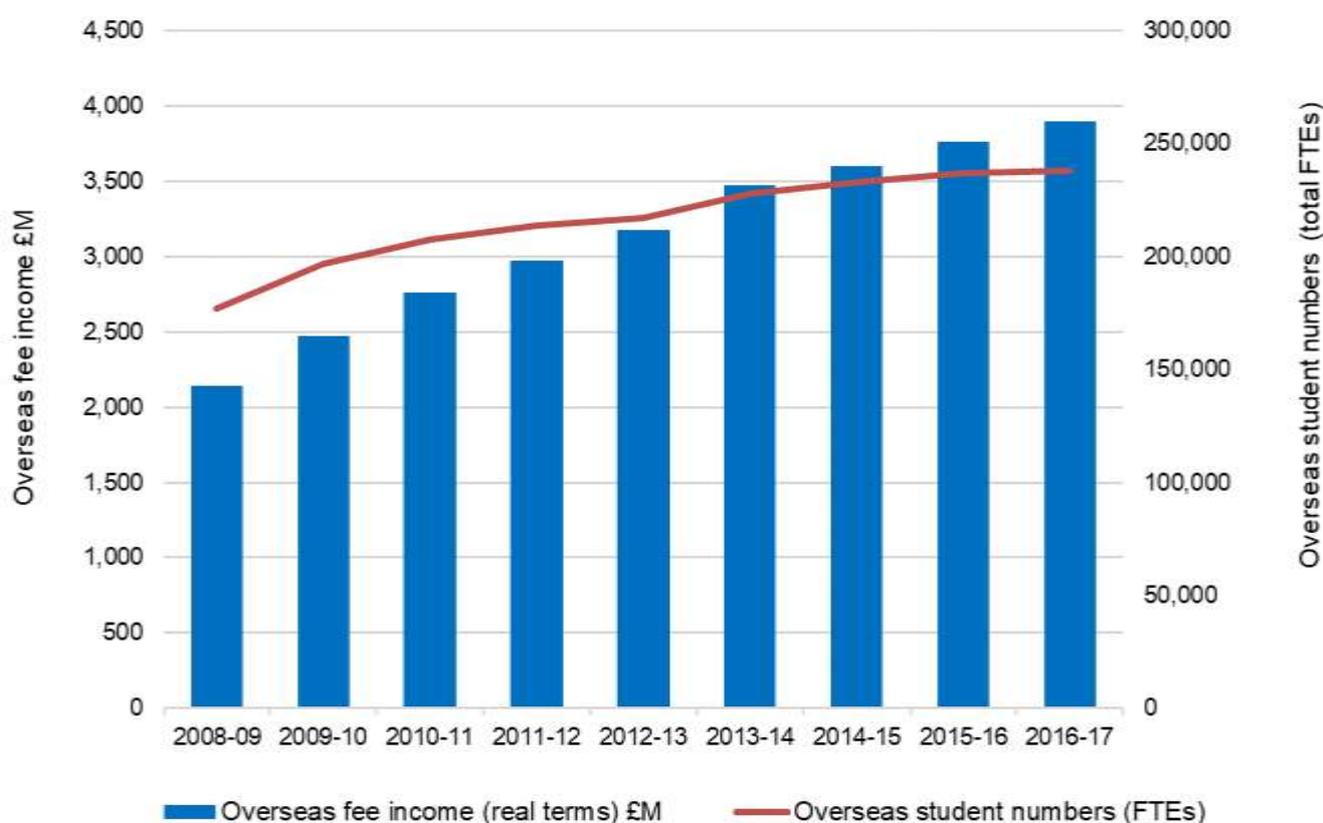
Figure 4: Percentage change in overseas fee income by tariff group 2015-16 to 2016-17



33. The HESA student record data shows that, in 2016-17, total overseas (non-EU) student numbers (FTEs) increased by 0.5 per cent compared with 2015-16, increasing from 237,089 to 238,158 FTEs.

34. Since 2008-09, both overseas student numbers and overseas tuition fee income have increased. Figure 5 highlights that the increase in overseas fee income is greater than the increase in student numbers, indicating that the rise in income is largely due to an increase in fees charged.

Figure 5: Overseas fee income (real terms) and overseas student numbers (total FTEs) (2008-09 to 2016-17)



35. Price sensitivity is a key factor in a competitive global market, and there will be a limit to the extent to which fees can be raised further, even with the current weakening in sterling.

36. A significant risk to the sector is the impact a decline in overseas students would have on associated fee income and the longer-term financial sustainability of HEIs at their current level of activity. Areas of potential risk currently facing the sector include the tightening of UK immigration policy; uncertainty surrounding Brexit; a downturn in the global economy, including that of the UK; and increasing competition from worldwide markets for outwardly mobile students.

37. The higher education sector is particularly vulnerable to changes in the Chinese student market, as Chinese-domiciled students continue to make up the largest proportion of the overseas student population (31.4 per cent), increasing from 71,267 FTEs in 2015-16 to 74,825 FTEs in 2016-17.

Student recruitment 2016-17 and 2017-18

38. Data from the Higher Education Students Early Statistics (HESES) Survey for 2017-18 indicates a 0.8 per cent increase in the number of undergraduate entrants compared with 2016-17. This however masks considerable variation across the sector, with an average decline of 8 per cent for those 60 institutions where data indicates that recruitment has declined this year.

39. 2017-18 HESES data also indicates a continuing decline in the number of part-time undergraduate entrants, falling by 1.1 per cent.

40. However the number of overseas (non-EU) undergraduate entrants increased by 4.5 per cent across the same period.

41. Latest UCAS data indicates a decline of 1 per cent in applications to English HEIs for 2018-19 entry. This includes a 3 per cent decline from UK applicants. However there was an increase in EU and overseas applications, of 4 and 12 per cent respectively.

42. The data highlights a continuing growing disparity between HEIs of different tariff groups. High-tariff institutions experienced an increase of 2 per cent in applications, while low- and medium-tariff HEIs saw declines of 5 and 2 per cent.

43. The changes in student recruitment highlighted in the latest data demonstrate resilience by the sector in achieving recruitment targets in an unsettled and changing environment. However the impact of many of the risks are still to play out across the sector fully, and it is anticipated that the financial stability of HEIs across the sector will continue to be impacted by Britain's forthcoming exit from the European Union, increasing global competition in the higher education market, changes to funding arrangements and a volatile economy both in the UK and internationally.

Expenditure

44. In 2016-17, the sector reported total expenditure of £28.8 billion, an increase of 4.6 per cent in cash terms compared with 2015-16 and equivalent to 96.4 per cent of total income. Table 3 shows a breakdown of the sector's expenditure in 2015-16 and 2016-17.

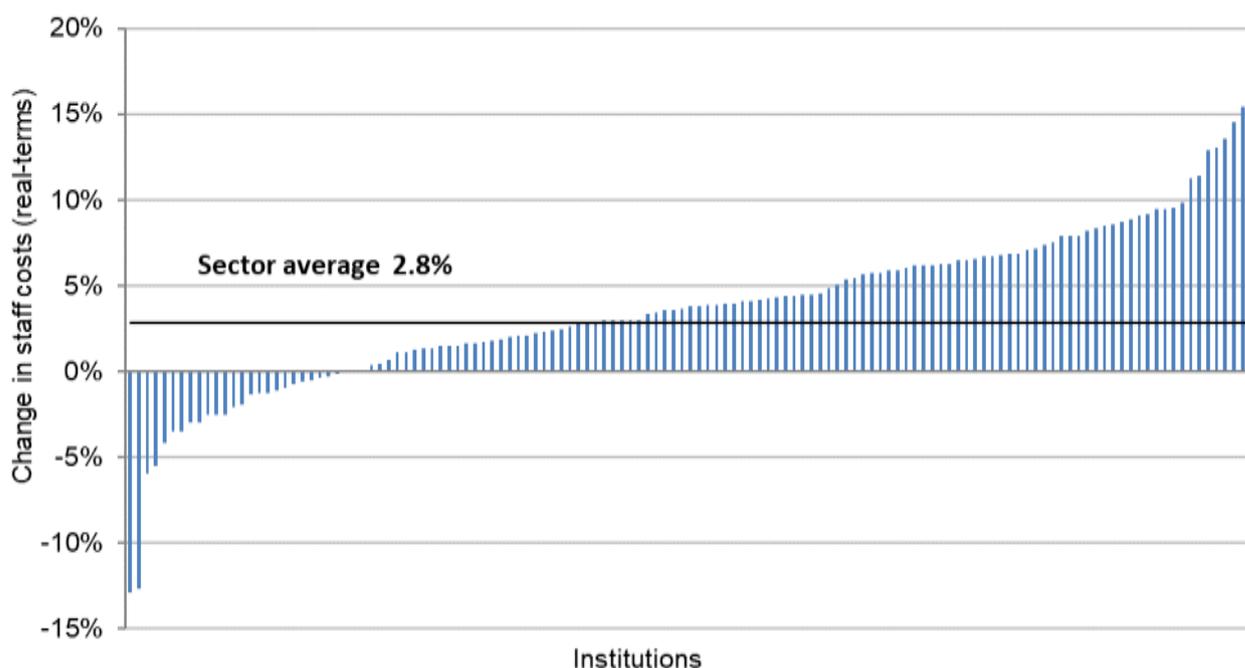
Table 3: Breakdown of expenditure

	2015-16	2016-17	£ change	% change
Staff costs	£14,984M	£15,715M	£730M	4.9%
as a % of total income	51.5%	52.5%		
Other operating expenses	£10,163M	£10,560M	£397M	3.9%
as a % of total income	34.9%	35.3%		
Depreciation	£1,722M	£1,890M	£169M	9.8%
as a % of total income	5.9%	6.3%		
Fundamental restructuring costs	£44M	£61M	£17M	39.5%
as a % of total income	0.1%	0.2%		
Interest and other finance costs	£648M	£610M	-£38M	-5.9%
as a % of total income	2.2%	2.0%		
Total expenditure	£27,560M	£28,836M	£1,275M	4.6%
as a % of total income	94.8%	96.4%		

45. The sector's largest category of expenditure relates to staff costs, which totalled £15.7 billion in 2016-17, equivalent to 52.5 per cent of total income.

46. In real terms, total staff costs increased by 2.8 per cent, and average staff costs per employee rose by 0.2 per cent, between 2015-16 and 2016-17. As in previous years, there was considerable variation in the changes to staff costs reported by institutions. Figure 6 shows the distribution of changes in staff costs across the sector from 2015-16 to 2016-17.

Figure 6: Real-terms percentage changes in staff costs (2015-16 to 2016-17)



47. With continued pressure on costs, it will be important for the sector to continue the drive for operational efficiencies in order to deliver long-term sustainability.

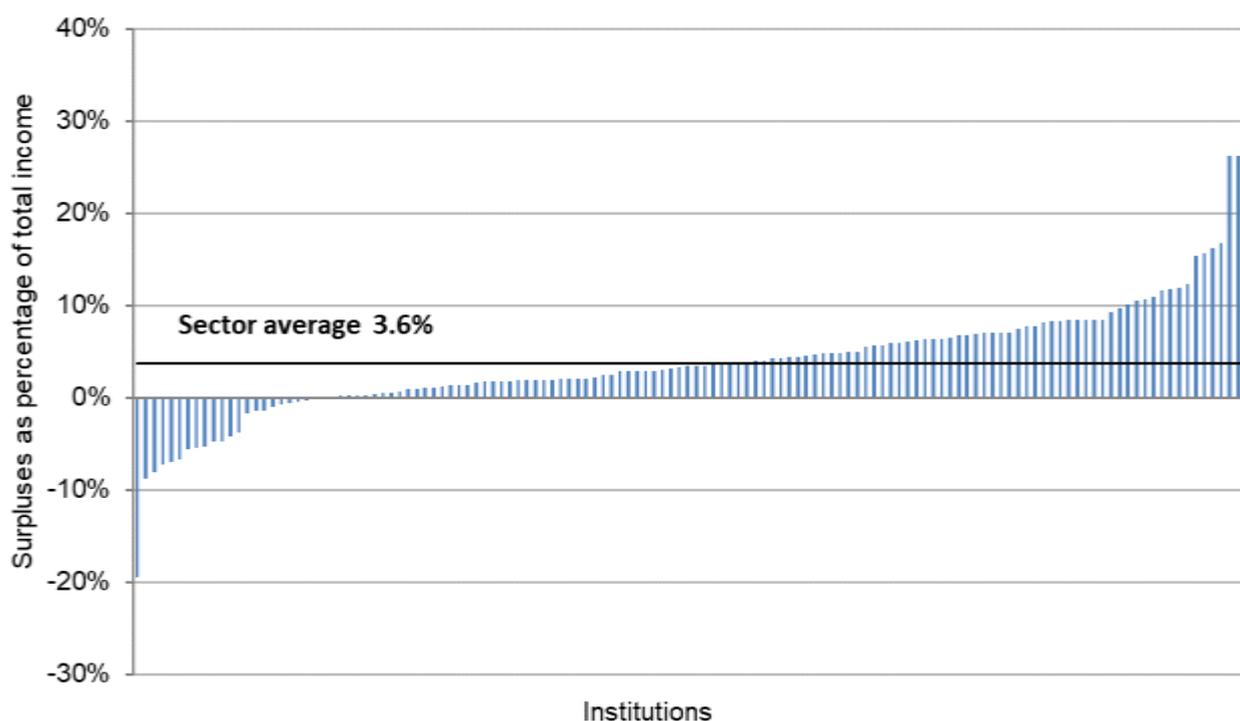
Surpluses and cash flow

48. The sector's surplus⁷ fell by 28.1 per cent from £1.5 billion in 2015-16 to £1.1 billion in 2016-17. This was equivalent to a sector average of 3.6 per cent of total income, compared with an average of 5.2 per cent in 2015-16.

49. Figure 7 shows the level of surpluses as a percentage of total income reported by institutions in 2016-17.

⁷ Total income less total expenditure, excluding other gains or losses (from investments and fixed asset disposals) and the share of surplus or deficit in joint ventures and associates.

Figure 7: Surpluses as a percentage of total income (2016-17)



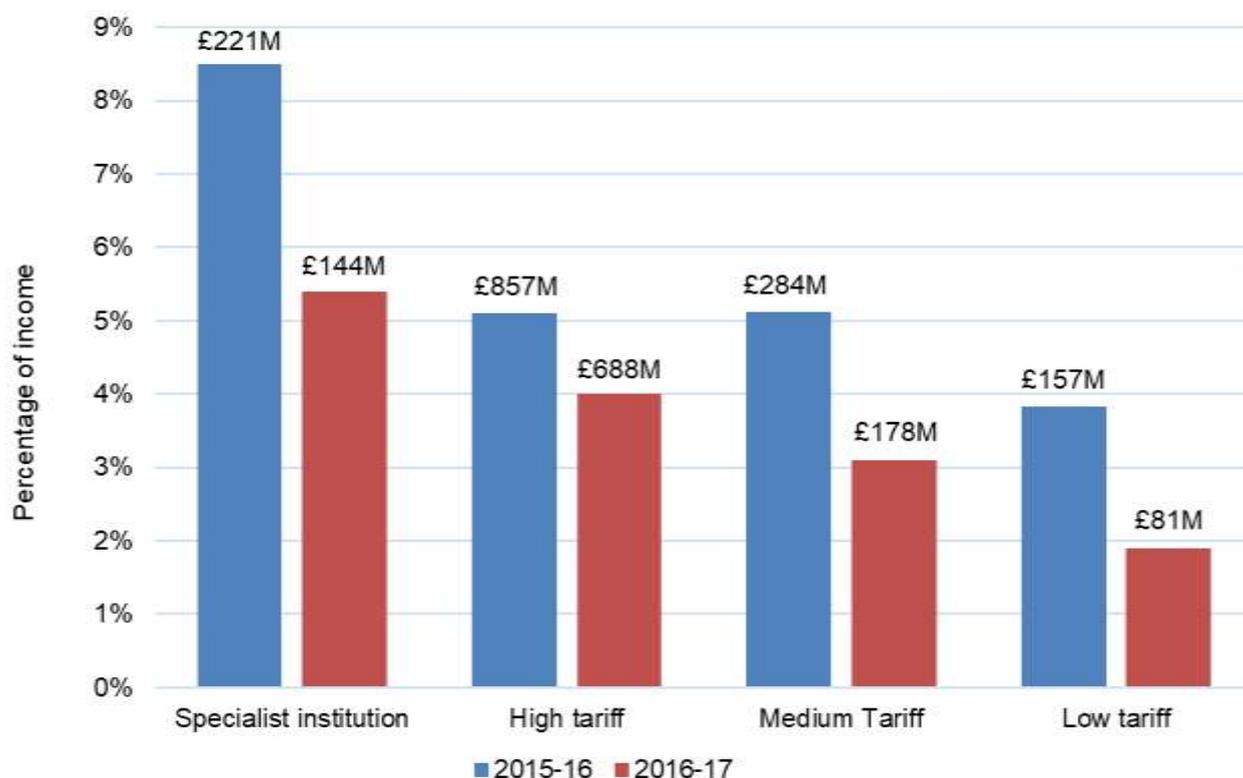
50. At institutional level, results range from a deficit of 19.5 per cent to a surplus of 30.0 per cent, equivalent to a range of 49.6 per cent, compared with a range of 42.4 per cent in 2015-16.

51. Twenty-four institutions reported deficits in 2016-17, compared with 11 institutions in 2015-16. The total value of deficits reported by these institutions was £90 million in 2016-17 and £38 million in 2015-16. The majority (19 HEIs) had already projected deficits in their July 2017 forecasts, some due to the costs associated with restructuring activity.

52. In contrast, 15 institutions reported surpluses of over 10 per cent in 2016-17 (totalling £149 million), compared with 17 in 2015-16 (totalling £365 million). The high surpluses reported by some institutions have been boosted by large income receipts from donations and endowments, while others are due to strong operating performance.

53. Figure 8 shows that surplus levels (as a percentage of income) have fallen for all tariff groups between 2015-16 and 2016-17, with the highest surplus levels reported by specialist institutions.

Figure 8: Surpluses as a percentage of total income by tariff group (2016-17)

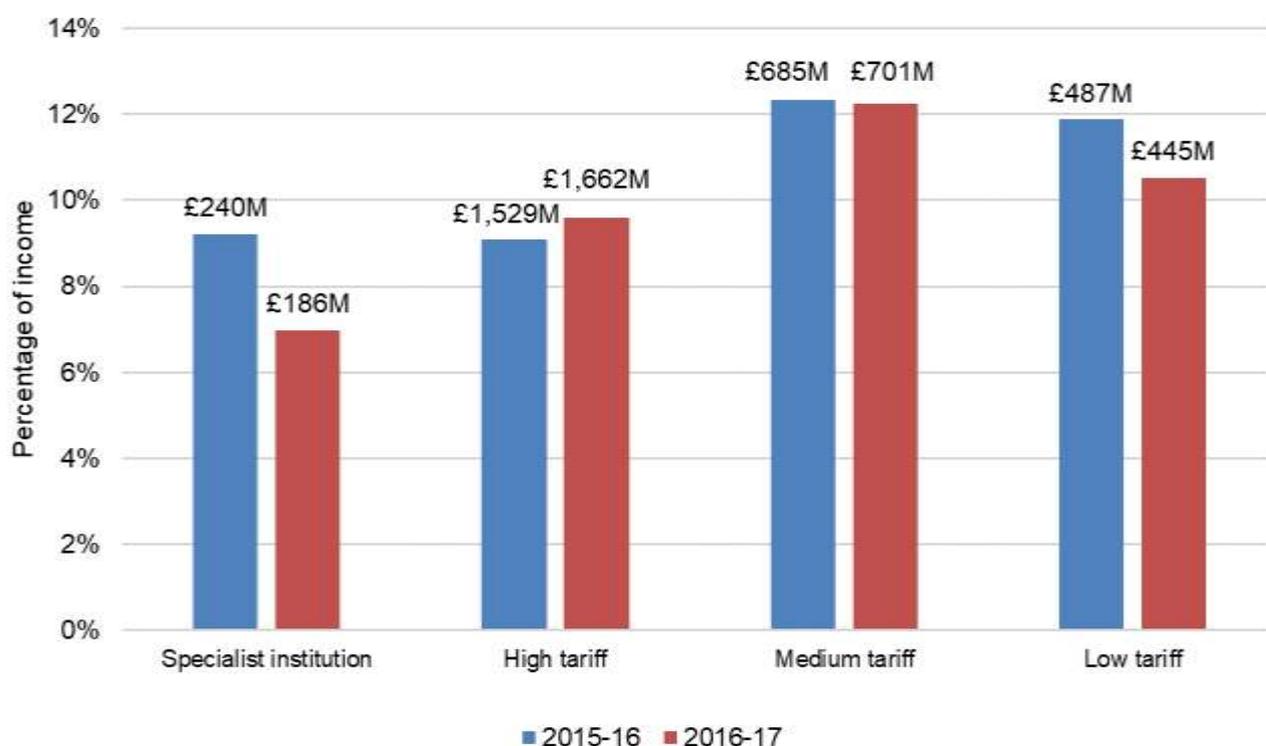


54. Following the introduction of new accounting standards in 2014-15 (see paragraphs 16 and 17), surplus levels can appear more volatile than previously. Surpluses can now be impacted by non-operational influences such as receipts from donations and endowments or receipts from capital lump sums. Cash flow from operating activities arguably represents a more reliable indicator of financial operating performance. Cash flow here means an HEI's cash resources that have been generated from operations to meet day to day obligations.

55. At sector level, cash flow from operating activities increased from £2.9 billion in 2015-16 to £3.0 billion in 2016-17, equivalent to 10.0 per cent of total income (compared with 10.1 per cent of income in 2015-16). At institutional level, however, results range from negative cash flow of 17.6 per cent of income to positive cash flow of 29.2 per cent of income. Ten HEIs reported negative cash flows in 2016-17 (compared with seven HEIs in 2015-16). For some HEIs, this is as a result of strategic investments made to change the HEI's operating model. For others, this is due to the HEI's reliance on endowment income as an ongoing part of its operating model.

56. Results also vary by tariff group. Figure 9 shows cash flow from operating activities as a percentage of total income by tariff group for the years 2015-16 and 2016-17. This indicates that the increase in cash flow for the sector is primarily driven by a rise in cash flow generated by the high-tariff group. While the medium-tariff group reported an increase in cash flow in absolute terms (£701 million in 2016-17 compared with £685 million in 2015-16), the level remained at 12.3 per cent of total income for both years. Cash flow generated by the low-tariff and specialist institution groups fell, both in absolute terms and as a percentage of total income.

Figure 9: Cash flow from operating activities as a percentage of total income by tariff group 2015-16 and 2016-17



Liquidity and borrowing

57. At the end of 2016-17 the sector had net liquidity of £10.4 billion, equivalent to 140 days' expenditure (that is, the number of days' expenditure that the liquidity covers). This is £782 million higher than the level reported at the end of 2015-16, which was £9.6 billion (135 days) and £912 million higher than the sector's July 2017 forecasts, which was £9.5 billion (128 days).

58. Sixty-one institutions reported lower liquidity at 31 July 2017, compared with the same point in 2016. Five institutions reported liquidity of less than 20 days, compared with three institutions at 31 July 2016.

59. It is important to note that data on liquidity is likely to report a more positive view of the health of the sector than exists in reality. This is due to fluctuations in liquid funds throughout the year. The sector's liquidity position is captured at 31 July – the HEI's year end. However, the main period of capital spending at most institutions happens during the summer months, after 31 July; therefore the available cash, not committed to capital spending, is likely to be much lower.

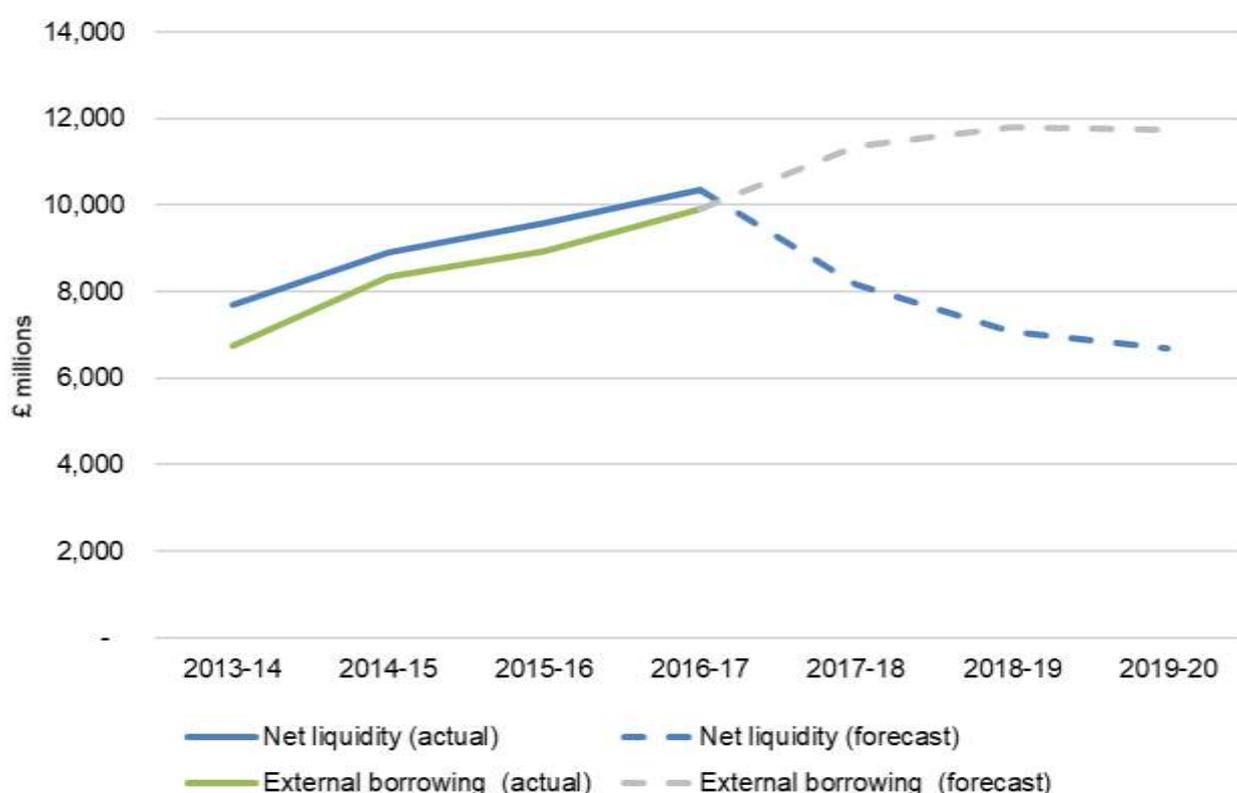
60. As charities, HEIs are obliged to ensure that they remain sustainable and do not expose themselves to undue risk. Strong liquidity is particularly important given current levels of uncertainty and risk in the sector, and as part of our accountability process, we monitor liquidity levels, to assess whether HEIs are able to maintain sufficient cash levels to manage their risks effectively.

61. Forecasts from July 2017 predicted that the sector would enter a period of net debt (where the level of borrowing exceeds the level of liquidity) by the end of 31 July 2017, with the sector projecting its net debt to be £577 million. However, the latest data shows that the sector's liquidity at 31 July 2017 exceeded total borrowing by £464 million; so, at this point, the sector did not report a net debt position. This arises from a combination of higher than expected liquidity and lower than expected borrowing.

62. Liquidity levels were higher than earlier forecasts due to lower capital expenditure and higher investment values.

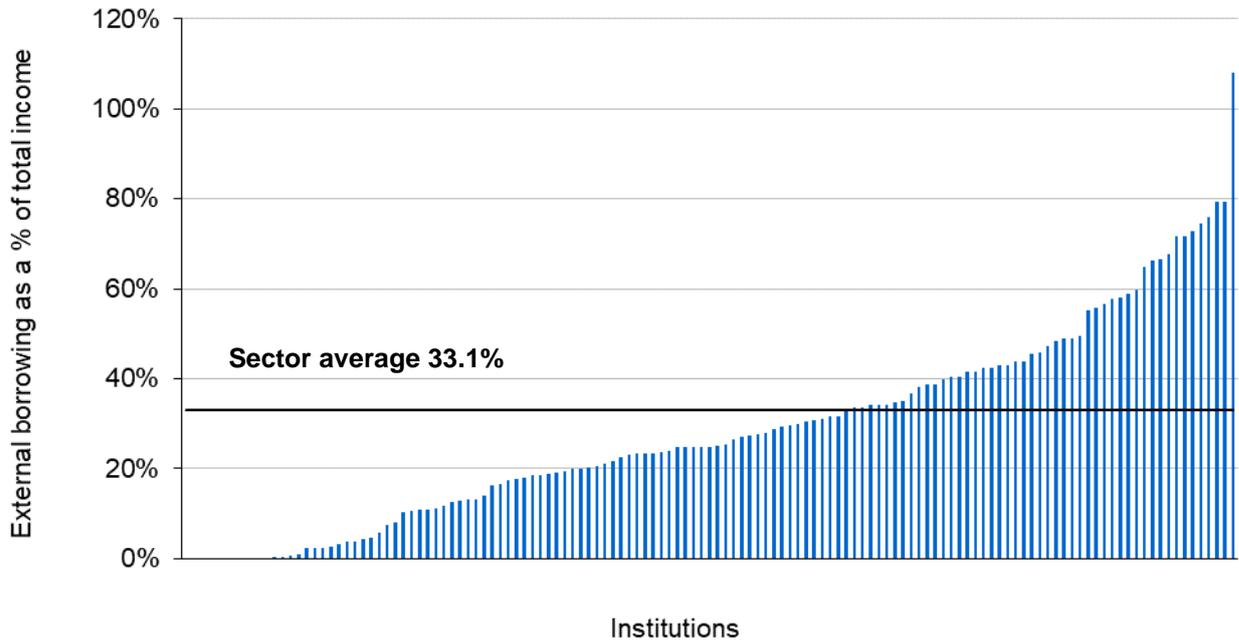
63. Figure 10 shows actual and forecast levels of net liquidity and borrowing for the period 2013-14 to 2019-20 (at 31 July).

Figure 10: Liquidity and borrowing for the period 2013-14 to 2019-20



64. At the end of July 2017, the sector reported borrowing of £9.9 billion (equivalent to 33.1 per cent of income). This is £980 million higher than the level reported at the end of 2015-16, which was £8.9 billion (30.7 per cent of income), but £129 million lower than July 2017 forecasts. Figure 11 shows the wide variation in the level of borrowing across the sector at 31 July 2017.

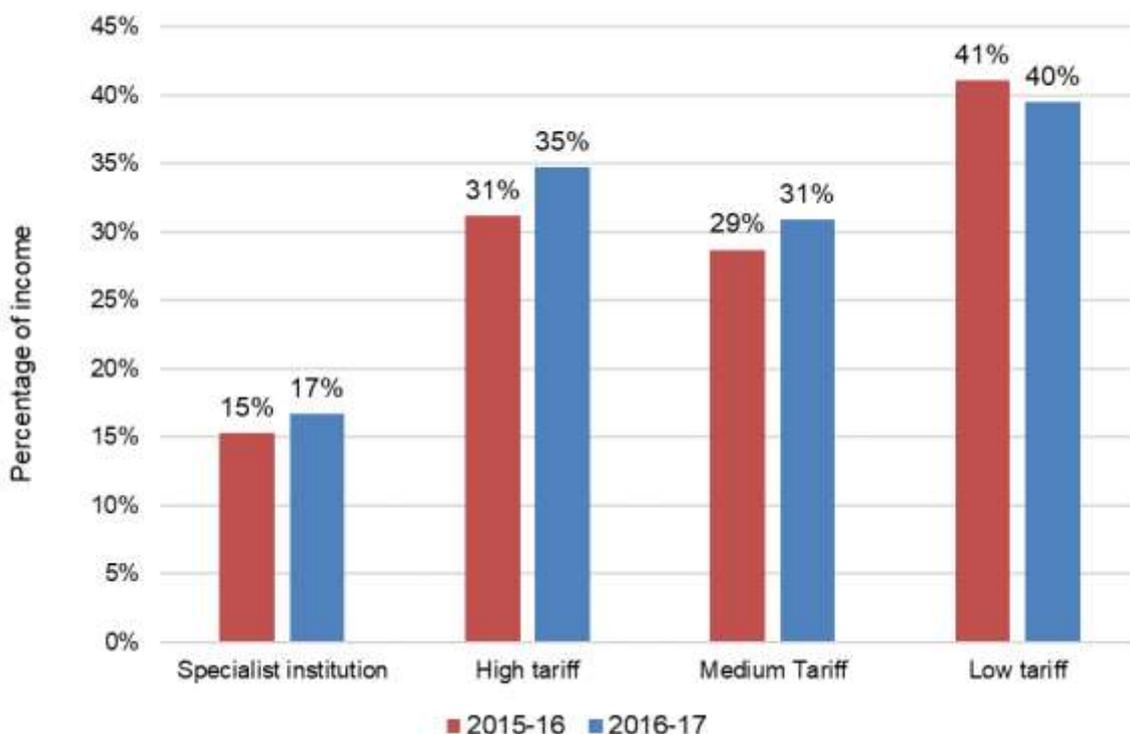
Figure 11: External borrowing as a percentage of total income (2016-17)



Note: Excludes one outlier.

65. Borrowing levels also vary by tariff group. Figure 12 shows borrowing levels by tariff group for the years 2015-16 and 2016-17. This shows the specialist institution group has reported the lowest level of borrowing when compared with income, and the low-tariff group reporting the highest level. The low-tariff group was also the only group reporting a fall in borrowing at 31 July 2017 compared with 31 July 2016, from 41.4 per cent of income to 39.5 per cent of income (equivalent to a decrease of £17 million).

Figure 12: External borrowing as a percentage of total income (2016-17)



66. As borrowing rises in the sector, total interest payments will increase. This rise in ‘fixed costs’ could put pressure on any HEI that fails to constrain other costs or to increase income.

67. The cost of increased borrowing has, to date, largely been mitigated by the exceptionally low interest rates available to the sector. However, a rise in interest rates could add significant costs, placing increasing financial burden on individual HEIs’ sustainability if not well managed.

68. As part of the financial forecast returns to HEFCE in July 2017 the sector forecast that it would have around 800 separate financial commitment arrangements by the end of 2016-17, including leases, service concessions and hedging instruments, among other non-standard borrowing arrangements. A total of 140 of these commitments were reported to be on variable rates with a drawn-down balance of £1.4 billion.

Capital expenditure

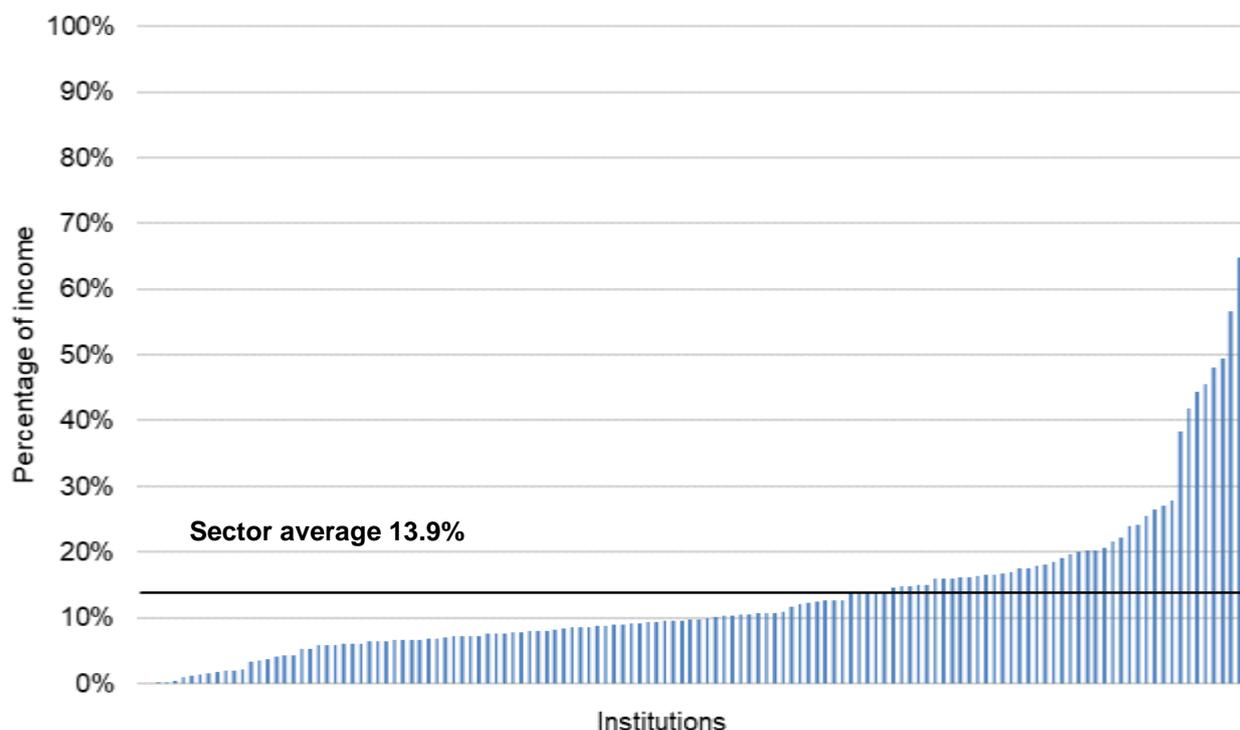
69. The sector continues to make a substantial investment in infrastructure to maintain and enhance the academic and student facilities. In 2016-17, capital expenditure totalled £4.2 billion, the highest annual capital spend ever reported by the sector. This represents an increase of 8.6 per cent compared with 2015-16, but due to a number of institutions reporting capital expenditure delays, this was 12.4 per cent lower than the level forecast in July 2017.

70. Despite the substantial level of investment overall, there is significant variation in the level of capital spend between institutions. Data shows that a large proportion of the sector (57 institutions) reported a decline in capital expenditure in 2016-17 compared with the previous

three-year average (2013-14 to 2015-16). Also, while the sector's overall investment was equivalent to 13.9 per cent of total income, at institutional level this ranged from 0 to 94 per cent.

71. Figure 13 highlights capital expenditure as a percentage of total income in 2016-17, at an institutional level.

Figure 13: Total capital expenditure as a percentage of total income (2016-17)

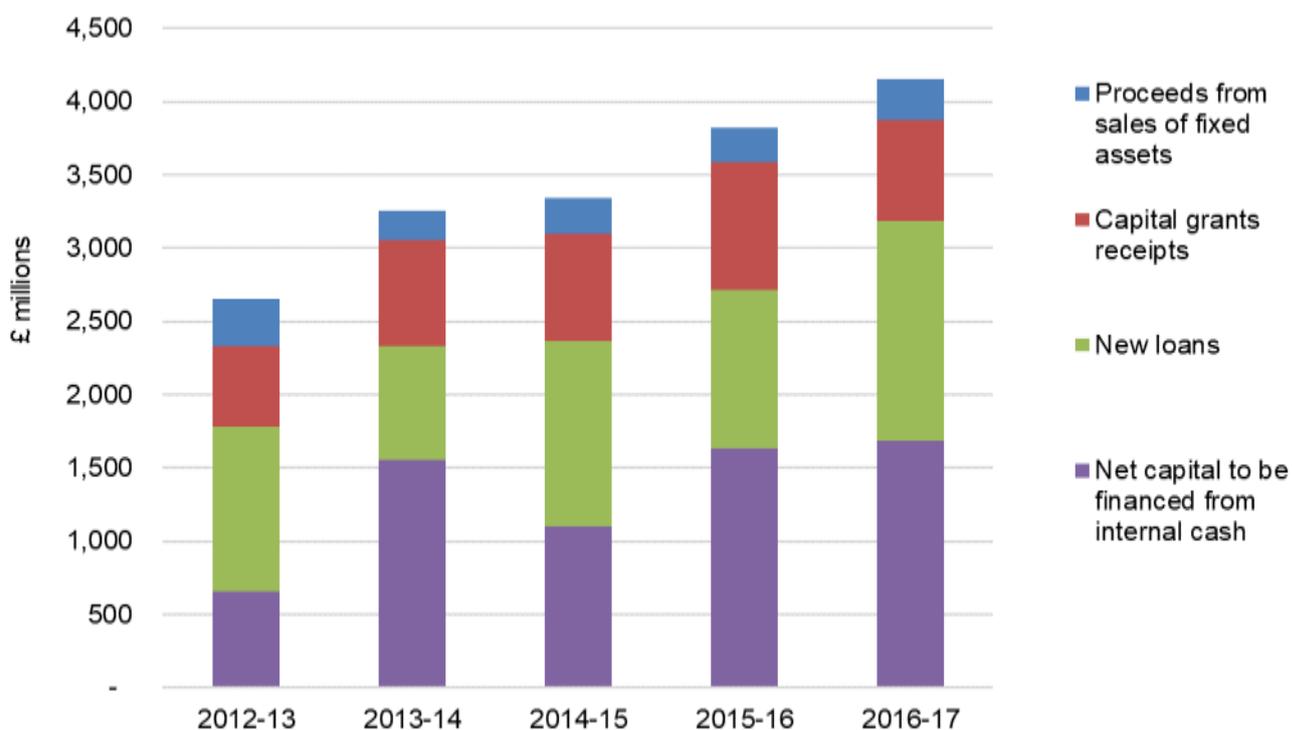


72. Over the last 10 years, the sector has spent nearly £28 billion on improving its physical infrastructure, excluding expenditure on general day-to-day maintenance. This expenditure has been not only to support the growing student population – which has increased by 12.3 per cent since 2007-08 – but also in response to rising student expectations linked to increasing tuition fees.

73. Despite this, we are expecting Estate Management Record (EMR) data as at 31 July 2017 (currently under collection) to show that the sector still needs to invest £3.8 billion to bring its non-residential estate up to a sound and operationally safe condition. This cost reflects the investment required to restore the estate to a sound baseline condition, not to achieve the standard required to satisfy rising student expectations. This latter investment is essential for enabling HEIs to compete in the increasingly competitive domestic and global market.

74. Figure 14 provides a breakdown of how capital expenditure was funded in the period from 2012-13 to 2016-17.

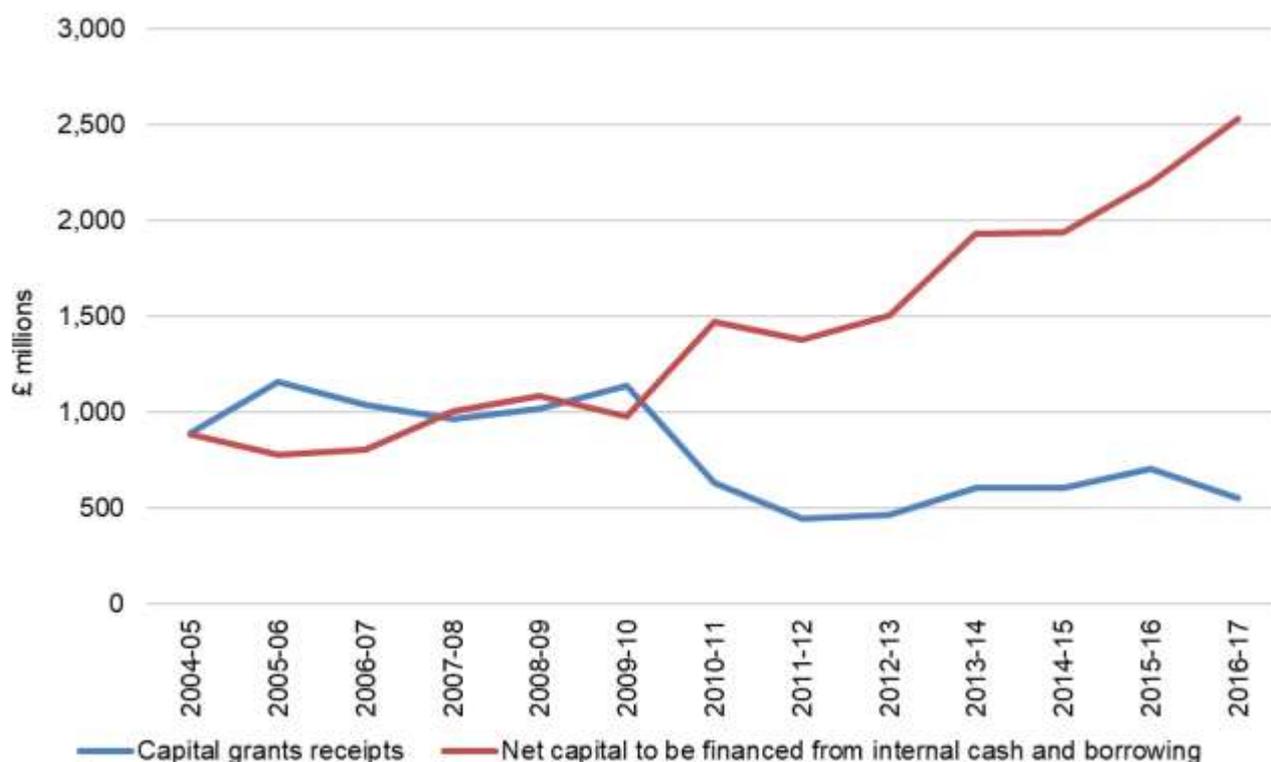
Figure 14: Funding breakdown of capital expenditure (2012-13 to 2016-17)



75. With reduced levels of publicly funded capital grants, HEIs are increasingly focusing on generating surpluses and operating cash inflows in order to sustain the level of capital investment needed to attract students and staff, and ensure their long-term sustainability. Increased surpluses provide the positive cash flow needed to fund future investment and meet finance costs.

76. Figure 15 shows capital grants received by the sector since 2004-05, alongside the level of capital expenditure financed by additional borrowing and the sector's own cash reserves (internal cash).

Figure 15: Real-terms capital expenditure funding (from base year 2004-05 to 2016-17)



77. To help fund capital expenditure in 2016-17, the sector used £1.7 billion from its own cash reserves (equivalent to 5.6 per cent of total income) and committed to new borrowing of £1.5 billion.

78. Capital grants totalling £692 million were also received in 2016-17, the majority of which were funded by Government. This funding helps the sector achieve its capital investment plans, as well as fostering confidence among other investors, including the appetite of banks to lend money to the sector. However, the sector’s capacity to lever in funding from other sources, including additional borrowing, is limited, and may not be sufficient on its own to meet the sector’s long-term investment needs.

79. Institutions failing to invest sufficiently in infrastructure over the longer term are likely to find themselves in a weaker market position and may therefore expose themselves to a greater risk of financial instability.

Reserves

80. Reserves are an HEI’s assets less its liabilities. In very broad terms, reserves can be used as a proxy for the overall value of an institution: they are the accumulated value of surpluses of an institution over its lifetime. Reserves are not the same as cash, although an institution could dispose of an asset if it was surplus to operational requirements (thereby converting it to cash).

81. Under the FRS102 financial reporting framework (used since 2014-15, see paragraph 16), reserves are categorised as restricted or unrestricted. Restricted reserves apply where there are restrictions on how an institution can use the funds, such as endowments and donations

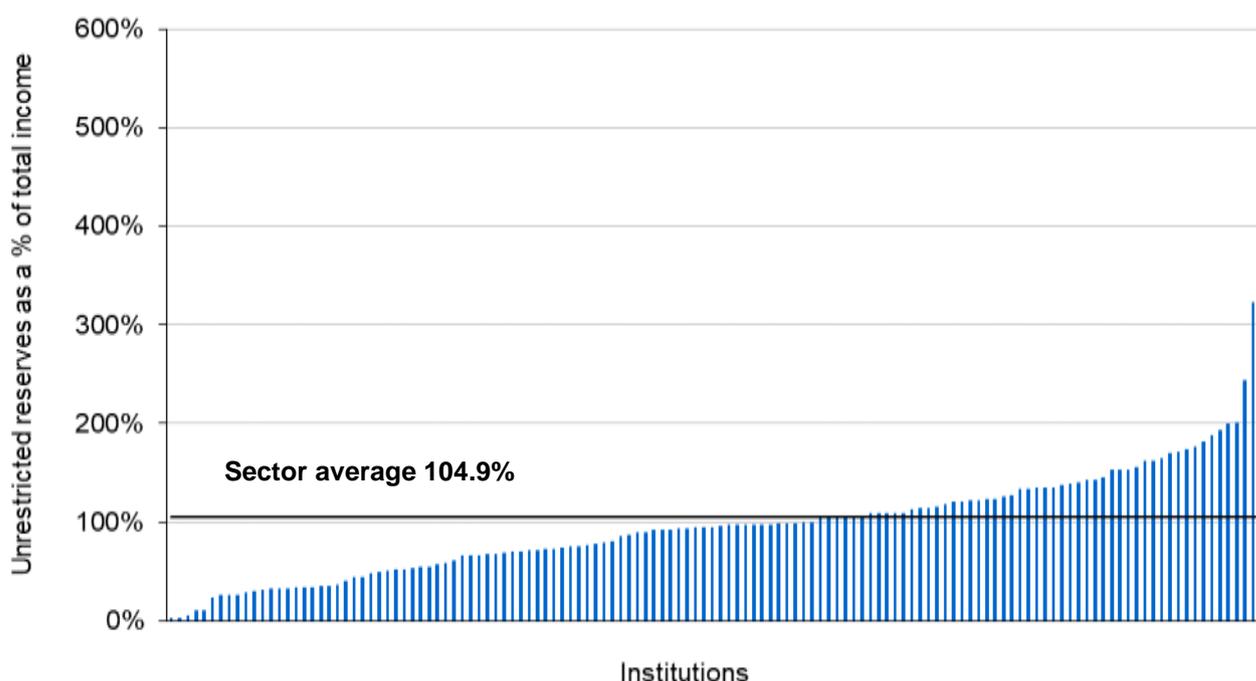
designated for a specific purpose. Unrestricted reserves represent the value of the HEI's accumulated performance through surpluses reported in its income statement⁸, on whose use there are no restrictions, as well as an HEI's revaluation reserves.

82. After taking into account pension liabilities, the sector's unrestricted reserves rose from £28.6 billion as at 31 July 2016, (98.2 per cent of total income) to £31.4 billion (104.9 per cent of income) as at 31 July 2017. Of this, £26.7 billion represents accumulated surpluses, and £4.7 billion reflects the revaluation of fixed assets.

83. The aggregate sector position masks a significant spread of financial strength and a concentration of large unrestricted reserves in a small number of institutions, with 16 institutions reporting 50 per cent of the sector's unrestricted reserve balance at 31 July 2017.

84. Unrestricted reserves as a percentage of total income also varied considerably at an institutional level. Figure 16 shows the level of unrestricted reserves as a percentage of total income in 2016-17. This shows results ranging from 3 per cent to 496 per cent at 31 July 2017.

Figure 16: Unrestricted reserves as a percentage of total income (as at 31 July 2017)



Pensions

85. The latest financial data shows that overall, pension provisions (the amount set aside by HEIs to fund future pension liabilities) decreased by 9.1 per cent from £9.4 billion at 31 July 2016 to £8.6 billion at 31 July 2017. This compares with a rise of 33.1 per cent reported in 2015-16.

⁸ This is the unrestricted income and expenditure reserve reported in the institution's balance sheet.

86. This decrease in pension provisions is due to a number of HEIs reporting lower than expected deficits in their Local Government Pension Scheme (LGPS) as a result of the latest triennial valuations on these schemes, carried out in 2016.

87. These LGPS valuations show that the 2016 funding levels are broadly higher than those from the last valuations in 2013. In cash terms, deficits for the scheme as a whole decreased from £47 billion in 2013 to £37 billion in 2016. However this overall picture is not reflected across the sector, where there have been significant variations in funding levels and costs.

88. In contrast, the 2017 actuarial valuation for the sector's largest multi-employer pension scheme, the Universities Superannuation Scheme (USS), shows an estimated increase in the funding deficit from £5.3 billion in 2014 to approximately £7.5 billion in 2017⁹. Alongside this, there has been a significant rise in the cost of future defined benefits in USS, which have risen by over a third since the last valuation. This is primarily due to lower expectations for economic growth, and specifically lower expectations for future investment returns.

89. As a result, changes have been proposed to future pension benefits to address the scheme's funding challenges and ensure USS remains sustainable. These reform proposals, set out by the Joint Negotiating Committee, are the subject of a statutory consultation by employers with all affected employees (active members and employees eligible to join). This represents both a financial and operational risk to the sector as pressure mounts on both employers and scheme members to agree a plan to ensure the scheme's sustainability.

90. The movements in deficit levels and the change in the cost of future pension benefits, as described above, demonstrate the inherent volatility in the outcomes of the sector's pension scheme valuations, which pose significant uncertainty and risks to the ongoing sustainability of HEIs.

Conclusion

91. The financial results for the sector in 2016-17 are sound overall, with results showing that, on average, the sector outperformed the financial forecasts submitted to us in July 2017. However, there is considerable variability in the performance of individual HEIs.

92. The projected results for the period up to 2019-20, submitted to us in July 2017, indicated a trend of reducing surpluses and cash levels, and a rise in borrowing, signalling a weakening of financial performance.

93. The sector is also facing significant uncertainty as a result of Brexit, increasing domestic and global competition, the changing policy agenda, as well as pressure on costs, including the outcome of the USS reform proposals.

94. The Government's review of post-18 education and funding announced in February 2018 could potentially have an impact on how future financial sustainability will be achieved by the sector. HEIs will need to re-assess their financial strategies and future financial prospects once the outcomes of the review are known and the potential impacts become clear.

⁹ See <https://www.uss.co.uk>.

Disclaimer

95. This report, which is based on information provided by HEFCE-funded higher education institutions, has been prepared for the benefit of HEIs 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
FTE	Full-time equivalent or equivalence
HEFCE	Higher Education Funding Council for England
HEI	Higher education institution
HESA	Higher Education Statistics Agency
HESES	Higher Education Students Early Statistics Survey
LGPS	Local Government Pension Scheme
USS	Universities Superannuation Scheme