October 2013/29
Issues paper

This report is for information

This report provides an overview of the financial health of the higher education sector in England. The analysis covers the financial forecasts for the period 2012-13 to 2015-16, as submitted by higher education institutions to HEFCE in December 2012 and July 2013.

Financial health of the higher education sector

2012-13 to 2015-16 forecasts

HIGHER EDUCATION FUNDING COUNCIL FOR ENGLAND

Financial health of the higher education sector: 2012-13 to 2015-16 forecasts

To	Heads of HEFCE-funded higher education institutions
Of interest to those responsible for	Audit, Estates, Finance, Governance, Management, Planning
Reference	2013/29
Publication date	October 2013
Enquiries to	HEFCE assurance consultants or assurance advisers Contact details for HEFCE staff are at www.hefce.ac.uk/whatwedo/reg/assurance/contacts/

Executive summary

Purpose

1. This report provides an overview of the financial health of the higher education sector in England. The analysis covers the financial forecasts for the period 2012-13 to 2015-16, as submitted by higher education institutions to HEFCE in December 2012 and July 2013.

2. The report is being published to provide universities and higher education colleges with feedback on the sector's projected financial performance. The analysis also provides other stakeholders with information about the sector's current and future financial health. It supersedes our previous analysis published in March 2013 ('Financial health of the higher education sector: 2011-12 financial results and 2012-13 forecasts', HEFCE 2013/04).

Key points

3. Higher education institutions (HEIs) in England are required to send us their annual accountability returns in December each year. These returns form a significant part of the way in which HEIs can demonstrate accountability for the public funds distributed to them. The accountability returns enable HEFCE to reassess HEIs' overall risk assessments and to provide evidence that HEIs are meeting their accountability responsibilities.

4. This year's financial forecast data consist of updates to the 2012-13 forecasts, and forecast data for the academic years 2013-14 to 2015-16.

5. As previously reported, the overall financial results for the sector in 2011-12 showed a sound position overall. The projected sector performance in 2012-13 is not as strong as the results for 2011-12, with projected operating surpluses of £659 million (2.7 per cent of income), which are £314 million less than the level reported for 2011-12 (4.2 per cent of income).

6. Cash flow from operating activities is also expected to be lower at 6.4 per cent of total income, compared with 8.1 per cent of income in 2011-12, although liquidity levels are expected to remain strong at 118 days (the level reported in 2011-12).

7. Overall, across the remainder of the forecast period up to 2015-16, the sector is forecasting sound surplus levels, good cash balances and healthy and increasing reserve levels. However, across the sector there continues to be a wide variation in the financial performance of

institutions. In 2013-14, the second year of the new funding arrangements, forecasts show that the increase in fee income from home and European Union (EU) students outweighs the fall in public grant funding as long as student recruitment levels hold. While total income is expected to rise, the sector is also projecting increases in staff costs in 2013-14 (arising primarily from staff recruitment) which will cause surpluses to fall. Thereafter, surpluses and cash flow from operating activities are expected to increase.

8. Some of the rise in income is attributed to the continued growth in fee income from overseas (non-EU) students, which is expected to remain strong, despite the changes in visa regulations introduced from 2011. This growth is expected to be from higher fees as well as an increase in overseas students from 2013-14 to 2015-16. However, there is a risk that growth will not materialise at the level forecast, particularly as the sector expected overseas numbers to fall in 2012-13. Any reduction in the growth forecasts could have a major impact on the financial forecasts.

9. The sector is forecasting high levels of capital expenditure during the next four years. The average level of annual investment for the period 2012-13 to 2015-16 is expected to be £3,105 million, £580 million greater than the previous four-year average (2008-09 to 2011-12) of £2,525 million. This is despite a significant reduction in public capital funding which has seen HEFCE capital grants falling from an average of £825 million per annum over the period 2008-09 to 2010-11 to £299 million in 2011-12 (a reduction of 64 per cent).

10. Forecasts show that the sector is now funding a significantly higher proportion of capital expenditure from internal cash reserves or through other sources to help maintain the quality of infrastructure. The forecasts may have been influenced by the government spending review announcement of increased capital grants in June 2013. In 2012-13, forecasts show that the sector requires £1,499 million from its own cash reserves, equivalent to 6 per cent of total income, to help fund the capital investment planned for that year. While short-term health is not a concern, some institutions will need to increase surpluses in future years, especially if the increase in public capital funding does not materialise. Any reduction in capital expenditure could risk the quality of the infrastructure in the higher education sector.

11. As well as including assumptions about capital grants, the financial forecasts will have included other public funding assumptions derived from the spending review announcement and previous government announcements of indicative funding levels. These confirmed that funding for research would continue at broadly the same levels as previous years but that in 2015-16 (financial year) there would be at least a £45 million reduction in HEFCE teaching funding. This is in addition to the £300 million reduction in direct grant funding as a result of the substitution of grants for fees following the higher education reforms starting in 2012. There is an on-going risk that future public funding of higher education could be constrained if the overall economic climate does not improve.

12. The sector has shown over recent years that it can deliver efficiencies. For example it has reduced its cost base, with pay costs being curtailed after a period of strong growth. These efficiency measures have helped support the current financial performance of the sector. It will be important for the sector to maintain this efficiency drive in order to deliver long-term sustainability in the future.

13. The sector continues to operate on fine margins, which means that even small changes can have a material impact on its financial performance. Despite the small margins, the short-

term viability of institutions is not a concern presently, and no institutions are 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.

14. Continued uncertainty over future student recruitment, at home and overseas, could result in increased volatility of forecasts and a widening of financial performance between institutions. Strong liquidity is necessary for HEIs efficiently to manage the potential increased volatility and unpredictability of the new funding system and the increasing competition from international higher education institutions.

Action required

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

Summary and headline information

16. The overall financial results for the higher education sector in 2011-12, which we reported in March, showed that results were sound overall, although not as strong as the results reported for 2010-11. Overall, the sector reported sound surplus levels, good cash balances and healthy reserve levels, despite the fall in public funding which caused the first real-terms fall in total income since financial information was first collected across the whole sector in 1994-95.

17. The projected sector performance in 2012-13 is not as strong as in the preceding two years.

18. Operating surpluses are projected to be £659 million, equivalent to 2.7 per cent of income, lower than the level reported for 2011-12 (£972 million).

19. Cash flow from operating activities is also expected to be lower, at 6.4 per cent of total income compared with 8.1 per cent of income in 2011-12, although liquidity levels are expected to remain strong at 118 days (the level reported in 2011-12).

20. While the financial position at sector level is expected to be weaker than in 2011-12, the latest forecasts show that the sector expects to deliver a stronger financial performance than anticipated in December 2012.

21. The projected financial performance for the sector in the remainder of the forecast period (2013-14 to 2015-16) is sound overall, with continued surpluses and healthy liquidity.

22. In 2013-14 forecasts show that the sector is expecting to receive an additional £1,378 million in tuition fees from full-time undergraduate home and EU students, more than offsetting the expected reduction in the HEFCE teaching grant (£891 million). This assumes that student recruitment targets are achieved. However, even if they are achieved, a projected rise in staff costs caused primarily by an increase in staff numbers within the sector will see operating surpluses fall in 2013-14. Thereafter income is expected to grow at a greater rate than expenditure, resulting in a rise in surpluses in 2014-15 and 2015-16. This growth in income is primarily due to higher undergraduate student fees as opposed to projected growth in student numbers.

23. Overall, staff costs are expected to be between 52.9 and 53.9 per cent of total income throughout the forecast period, compared with a high of 58.1 per cent in 2000-01. Pay costs are expected to remain relatively low, with the sector projecting average annual pay costs per employee to rise between 1.0 and 1.2 per cent (in real terms) between 2012-13 and 2015-16.

24. The sector continues to project significant levels of capital investment throughout the forecast period, with the average level of annual investment for the period 2012-13 to 2015-16 expected to be £3,105 million, £580 million greater than the previous four-year average (2008-09 to 2011-12). This increase in the sector's capital spending projections may have been influenced by the Government's spending review announcement in June 2013, which indicated that public capital funding is likely to increase in 2015-16. Despite this, the latest forecasts show that higher education institutions (HEIs) are expecting to finance much higher proportions of capital investment from internal cash and external borrowing than has been seen in the past. In the short term these cash investments are affordable given the cash reserves held by the sector. However, some institutions will need to generate increased levels of surplus in order to sustain this level of investment and maintain their long-term sustainability.

25. One of the key risks to the sector's future financial sustainability is the continued uncertainty over future home and EU student recruitment, and the sector's caution is reflected in the student number forecasts submitted by institutions to support their financial forecasts. These show that the sector is expecting full time home and EU undergraduate student numbers (across all years of study) to be 3.1 per cent lower in 2015-16 compared with 2011-12.

26. While final numbers of new entrants for 2013-14 will not be known until the HEFCE aggregate student number surveys are available later this year, the latest available UCAS data[1] shows that the number of entrants in 2013-14 (home and EU full-time undergraduates) is up by 10 per cent on the previous year.

27. Growth in fee income from overseas students is still expected to remain strong despite the introduction of new visa regulations in 2012. This growth is expected to come from higher fees as well as an increase in overall numbers from 2013-14 to 2015-16. The latest forecasts show that the sector is projecting overseas fee income to rise by 40 per cent, to reach £3,863 million by 2015-16 compared with £2,762 million in 2011-12, although growth in overseas student numbers is expected to be lower at 16.1 per cent. This suggests that some of this growth will arise from an increase in international fees charged by institutions. There continues to be significant variation in assumptions used by institutions in projecting overseas income levels, with some institutions forecasting a real-terms fall in overseas fee income while others are forecasting significant growth.

28. The sector continues to operate on fine margins, with operating surpluses ranging between 2.0 and 3.7 per cent of total income in the forecast period. This means that even small changes can have a material impact on the sector's financial performance. Despite the small margins, the short-term viability of institutions is not a current concern. There continues to be wide variation in the financial performance and health of institutions within the sector. However, positive cash in-flows and healthy cash-backed reserves mean that institutions are unlikely to face solvency concerns in the short term, although this relies on institutions achieving student recruitment targets. Continued uncertainty over future student recruitment, at home and overseas, could result in increased volatility of forecasts and financial performance than in the past.

29. The remainder of this report analyses the financial forecasts for the period 2012-13 to 2015-16. The focus is on the financial health of the whole higher education sector in England. Each institution has been sent benchmarking data in relation to its 2011-12 financial performance and forecast position up to 2015-16.

30. The data used in this paper come from two main sources.

   a. Data up to and including 2011-12 are from the Higher Education Statistics Agency's Finance Statistics Record, which is completed by all institutions each year.

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[1] UCAS data can be found at: www.ucas.com/news-events/news/2013/interim-assessment-ucas-acceptances-intended-entry-year-country-institution-0

b. Data covering the forecast period 2012-13 to 2015-16 are from HEIs' 2012 financial results and forecasts submitted to HEFCE. 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 June 2013[2].

31. 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.

32. Table 1 provides the key headline data from the financial information submitted by HEIs in July 2013. Further detail and analysis of the sector's financial performance in 2011-12 can be found in HEFCE 2013/04[3].

Table 1 Summary of key financial indicators

	Actual		Forecast			
	2010-11	**2011-12**	**2012-13**	**2013-14**	**2014-15**	**2015-16**
Total income	£22,933M	£23,277M	£24,090M	£25,240M	£26,357M	£27,357M
Operating surplus as % of total income	£1,061M 4.6%	£972M 4.2%	£659M 2.7%	£494M 2.0%	£786M 3.0%	£1,024M 3.8%
Historical cost surplus as % of total income	£1,307M 5.7%	£1,138M 4.9%	£910M 3.8%	£656M 2.6%	£897M 3.4%	£1,167M 4.3%
Cash flow from operating activities as % of total income	9.2%	8.1%	6.4%	6.1%	7.8%	8.7%
Net liquidity as number of days' expenditure	109	118	118	93	84	82
External borrowings as % of total income	21.9%	23.5%	25.9%	26.7%	27.5%	26.8%
Discretionary reserves excluding FRS17[†], as % of total income	51.0%	56.0%	59.0%	59.9%	61.5%	64.2%

[†] FRS17 is the financial reporting standard on retirement benefits.

Assessing future financial sustainability

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

34. Overall, up to the end of the forecast period, the forecasts indicate that the sector is likely to remain financially sustainable, though institutions will need to continue to seek greater surpluses to fund the necessary investment in infrastructure and to remain sustainable in the medium term.

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

[3] Available online at www.hefce.ac.uk/pubs/year/2013/201304/

35. In preparing their financial forecasts, institutions have identified a number of risks to the forecasts' accuracy and their financial performance.

Key risks

36. HEIs have identified the following key risks to the sector's financial sustainability:

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

37. The accuracy of the forecasts depends on what assumptions have been made by HEIs and to what extent they have taken the risks above into account. The further uncertainties over future student recruitment at home and overseas, the UK economy and how the new funding system will impact student recruitment in the medium term, are unknown factors that will inevitably reduce the reliability of HEIs' forecasts. Another likely consequence is greater volatility of forecasts and financial performance than in the past.

38. The June 2013 spending review announcement confirmed that funding for research would continue at broadly the same levels as previous years but in 2015-16 (financial year) there would be at least a £45 million reduction in HEFCE teaching funding. This is in addition to the £300 million reduction in direct grant funding as a result of the substitution of grants for fees following the higher education reforms starting in 2012. In the short-to-medium term there continues to be a risk that future public funding of higher education could be constrained if the overall economic climate does not improve.

39. 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 changes in student demand, availability of public funding, and pay and pensions pressures. 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 in 2012-13

40. This is the second year of transition to the new funding environment, and the financial forecasts, at sector level, show that operating surpluses are expected to fall from £972 million (4.2 per cent of income) as reported in 2011-12 to £659 million (2.7 per cent of income) in 2012-13. This is despite the sector projecting total income to rise from £23,277 million in 2011-12 to £24,090 million in 2012-13.

41. Cash flow from operating activities is also expected to be lower at 6.4 per cent of total income, compared with 8.1 per cent of income in 2011-12, although cash (liquidity) levels are expected to remain strong at 118 days (the level reported in 2011-12).

42. While at sector level, the financial position is expected to be weaker than 2011-12, the latest forecasts show that the sector expects to deliver a stronger financial performance than was anticipated in December 2012.

43. Total income is now expected to be £170 million higher than projected in the earlier forecasts which, together with additional expenditure savings, increases operating surplus projections by £278 million. The most significant expenditure savings come from staff costs, which are expected to be £118 million less than predicted in December 2012. The fall in staff costs may be due to institutions returning more cautious forecasts about the results of their cost-reduction programmes earlier in the financial year, a pattern we have seen in previous years.

44. Cash levels in the sector are also expected to be higher than projected in December 2012 because of higher operating surpluses and lower spending on acquiring fixed assets. Increased profits from the sale of fixed assets, higher deferred capital grants and an increase in loans acquired have also contributed to the forecast increase in cash balances.

45. While the majority of institutions are predicting better financial outturns in 2012-13 compared with the December 2012 forecasts, 25 institutions are forecasting a decline in their operating performance compared with their earlier predictions. Of these, seven institutions are forecasting greater operating deficits in 2012-13, and two institutions are forecasting operating deficits where they had originally expected small operating surpluses. The reasons for the decline in forecast operating positions vary among institutions, but largely relate to under-recruitment and higher than anticipated staff costs or other operating costs.

46. Overall the financial outturn for 2012-13 looks manageable for all institutions.

Forecast performance in 2013-14 to 2015-16

47. Across the remainder of the forecast period up to 2015-16, the sector is forecasting sound surplus levels, good cash balances and healthy and increasing reserve levels.

48. The forecasts for 2013-14 show reductions in public funding countered by significant increases in fee income from home and EU students as the second cohort of students enters the new funding system. However, the sector is also projecting large increases in expenditure in 2013-14, causing surpluses to fall in this year. Thereafter surpluses are expected to increase as the new funding arrangements become established and fee income is projected to rise further. Some of this rise is attributed to continued strong growth in fee income from overseas students.

49. We will continue to monitor the impact of the funding reforms on the financial prospects of institutions. In the meantime, the following sections look at different aspects of the financial forecasts submitted by institutions, for the whole period to 2015-16:

- income
- overseas fee income
- home and EU student recruitment
- expenditure

- surpluses
- liquidity and cash flow
- capital expenditure and borrowing
- reserves.

Income

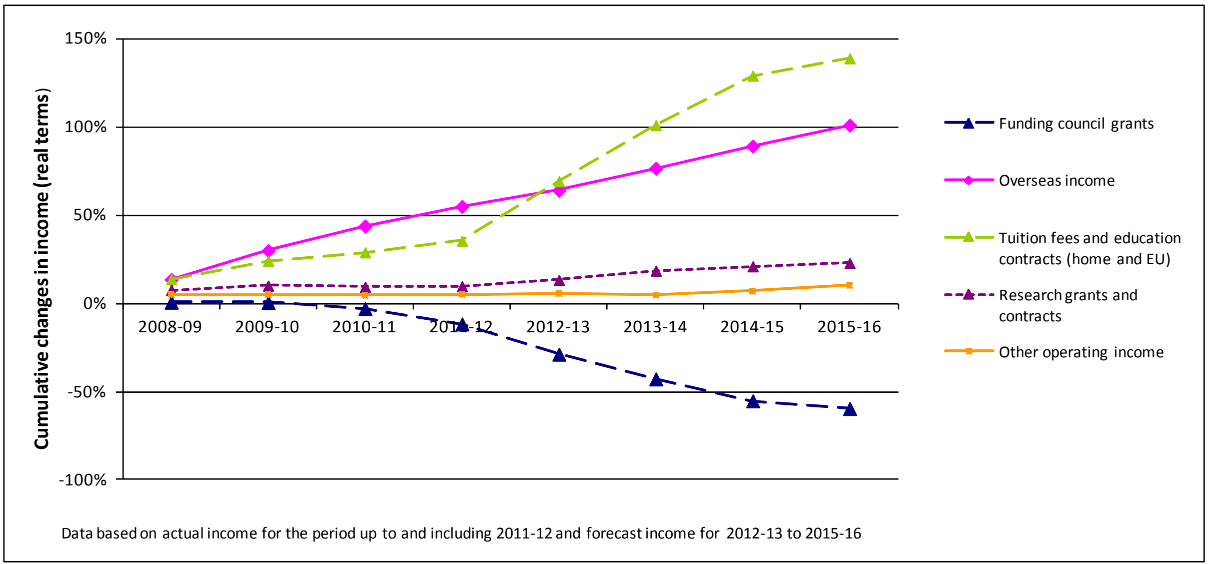
50. At sector level, total income is forecast to rise by 4.8 per cent (in cash terms) in 2013-14, 4.4 per cent in 2014-15, and a further 3.8 per cent in 2015-16. These rises reflect the expected increases in tuition fee income. Table 2 provides a breakdown of the income levels forecast.

Table 2 Breakdown of forecast income levels (cash terms)

£M	**2011-12 actual**	**2012-13 forecast**	**2013-14 forecast**	**2014-15 forecast**	**2015-16 forecast**
Funding council grants	6,690	5,486	4,500	3,588	3,298
Overseas (non-EU) fee income	2,762	2,977	3,273	3,572	3,863
Tuition fees and education contracts (home and EU)	5,614	7,136	8,659	10,052	10,670
Research grants and contracts	3,647	3,833	4,099	4,262	4,401
Other operating income	4,328	4,418	4,485	4,659	4,891
Endowment income and interest	236	241	224	224	235
Total income	**23,277**	**24,090**	**25,240**	**26,357**	**27,357**

51. Within the forecasts for funding council grants, institutions are expecting HEFCE funding for teaching to fall by £891 million in 2013-14, with further reductions in funding of £868 million and £218 million in 2014-15 and 2015-16 respectively. These projections appear reasonable given what the Government has announced so far about future funding of the sector. 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 2007-08. 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.

Figure 1 Cumulative real-terms actual and projected changes in income since 2007-08

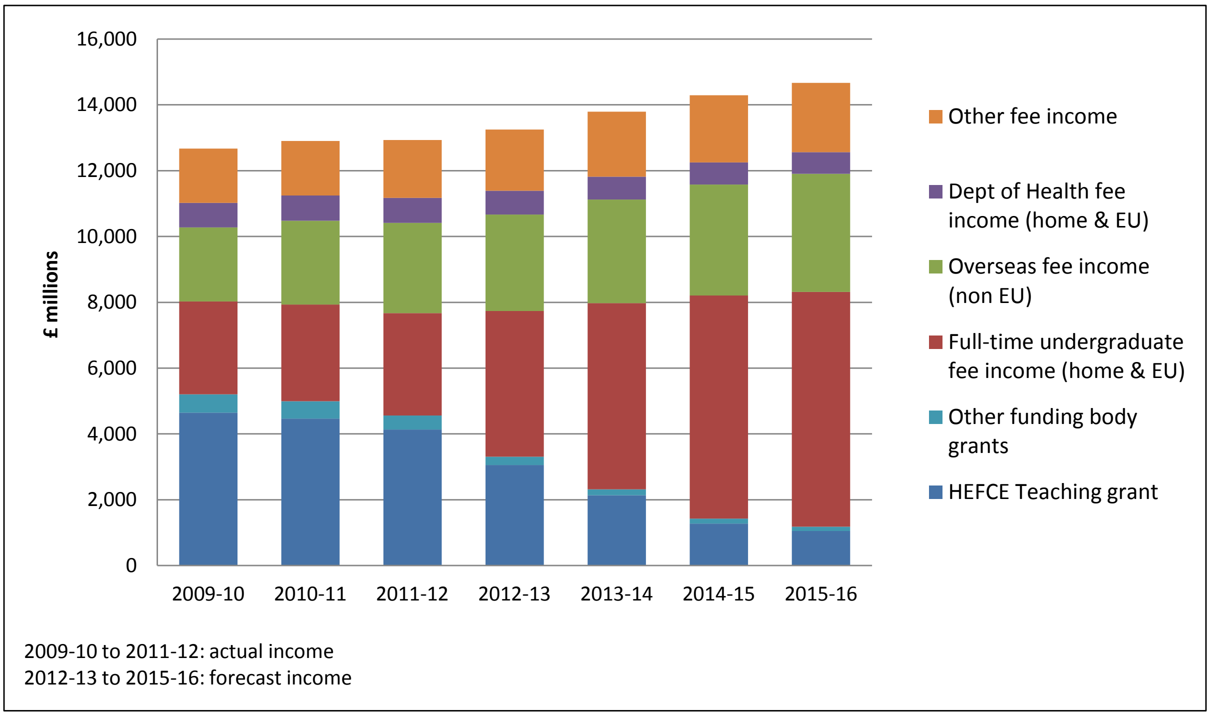


52. Fee income from full-time home and EU undergraduates is expected to increase by £1.4 billion (30.6 per cent) in 2013-14, with further increases of £1.3 billion (22.0 per cent) in 2014-15 and £509 million (7.1 per cent) in 2015-16 (cash terms). Meanwhile, fee income from full-time home and EU postgraduate students is projected to rise 24.7 per cent from £672 million in 2012-13 to £838 million in 2015-16 (cash terms).

53. The forecasts also show that income from part-time home and EU students (for all levels of study) is projected to increase by 26.6 per cent from £604 million in 2012-13 to £765 million in 2015-16 (cash terms). While fee income is projected to increase for part-time students, HEFCE grant funding levels will be reducing over the forecast period. At the same time, the sector is projecting a fall in part-time student numbers. Although some of the growth in fee income will be due to the effect of higher part-time fees, sector fee income projections look high when compared with student number forecasts, and there is a risk that part-time fee income will be lower than forecast.

54. Figure 2 shows a breakdown of teaching-related income (real terms) received in the period 2009-10 to 2011-12 and the income projected for the period 2012-13 to 2015-16 (real terms). This shows that, overall, teaching-related income – which includes public funding and tuition fees – is expected to rise over the forecast period.

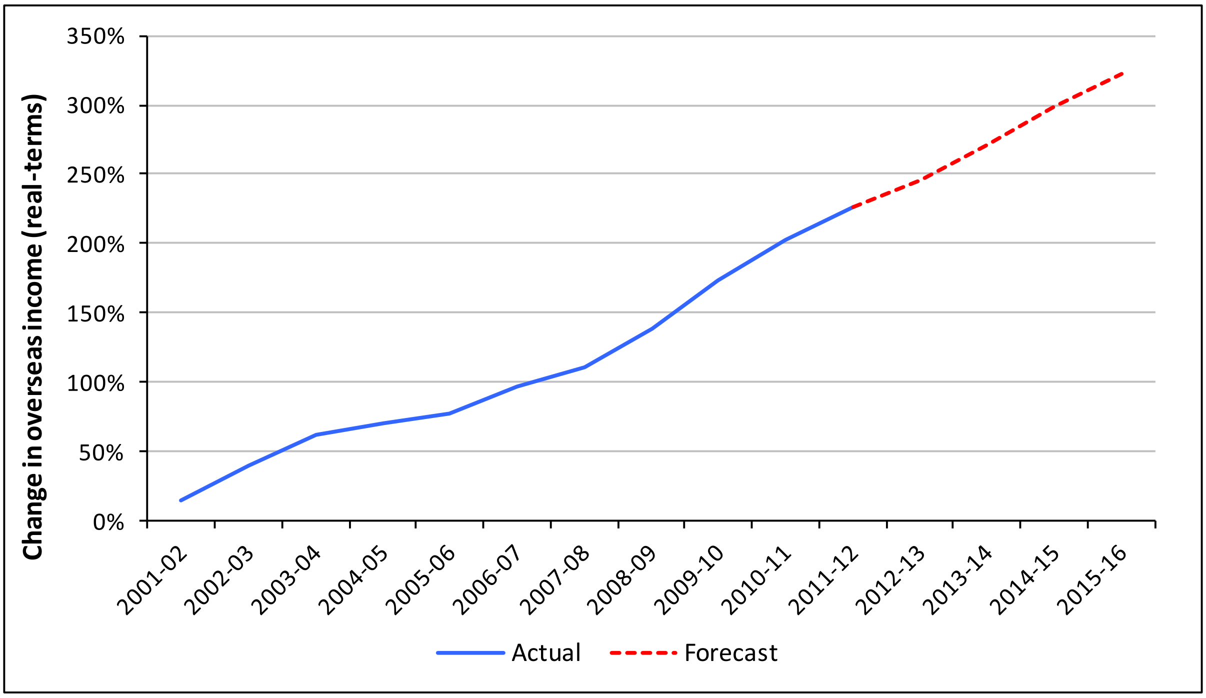
Figure 2 Breakdown of teaching-related income 2009-10 to 2010-11 actual and 2011-12 to 2014-15 forecast



Overseas fee income

55. As in previous years, the sector is expecting strong growth in income from overseas (non-EU) students in the forecast period. Figure 3 shows the real-terms percentage increase in overseas fee income reported by the sector since 2000-01, together with the projected overseas fee income for the forecast period. On average, fee income from overseas students has increased by 11.0 per cent (real terms) per year over the last 10 years.

Figure 3 Real-terms increase in overseas fee income (since base year of 2000-01)



56. In cash terms, the sector is expecting overseas fee income to rise from £2,513 million in 2011-12 to £3,863 million in 2015-16. In real terms, this is equivalent to an increase of 32.0 per cent (comparing 2015-16 with 2011-12), although this disguises significant variation in the assumptions used by institutions in predicting their future overseas income levels. Figure 4 shows the variation between different institutions' predictions.

Figure 4 Forecast real-terms change in overseas fee income between 2011-12 and 2015-16

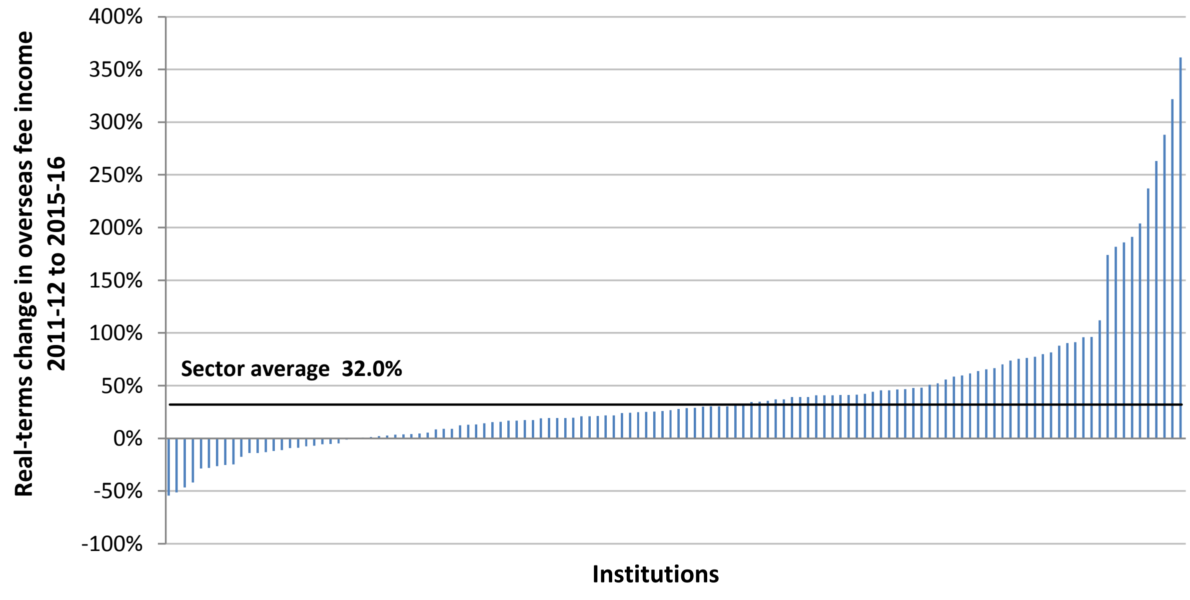


Chart excludes one outlier result

57. In 2011-12, the sector reported total overseas fee income of 11.9 per cent of total income. In 2015-16, this is expected to increase to 14.1 per cent. This shows that the sector is becoming increasingly reliant on this source of income.

58. Although projections show a continuation of strong growth in overseas fee income, the student number forecasts show that the number of non-EU students studying at English institutions is expected to decline by 0.5 per cent in 2012-13 before rising again between 2013-14 and 2015-16 (between 5.0 and 5.5 per cent). Overall, the rise in student numbers in the latter period is expected to be much lower than the growth in income, suggesting that some of this growth is due to a rise in the fees payable by overseas students.

59. The projected decline in non-EU student numbers in 2012-13 is due to a decline in part-time student numbers, which are expected to fall by 13.4 per cent compared with an increase in full-time numbers of 0.7 per cent. This decline is expected to span all levels of study, with the greatest falls expected in the part-time undergraduate and postgraduate taught student groups. A further fall in part-time students is expected in 2013-14, although the decline this year relates to undergraduate and postgraduate research students. Thereafter, part-time student numbers are expected to increase but not to the level reported in 2010-11 (which is 14.0 per cent higher).

60. The overall decline in non-EU student numbers in 2012-13 may be due to the impact of the visa reforms introduced by the Government from 2011. If this is the case, there is a risk that

the sector will be unable to achieve its overseas fee income growth projections in the forecast period, which would have a major impact on the financial forecasts.

Home and EU student recruitment

61. 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, including the latest projections for 2012-13, is summarised below.

62. The latest projections for home and EU student numbers show that the sector remains cautious about student recruitment in the forecast period. At an aggregate level, full-time home and EU undergraduate student numbers (across all years of study) are expected to fall by 3.1 per cent (comparing 2015-16 with 2011-12), albeit with a marginal increase in student numbers in 2015-16, up 1.1 per cent on projected numbers for 2014-15.

63. Figure 5 shows the forecast changes in full-time home and EU undergraduate student numbers (expressed as full-time equivalents) between 2011-12 and 2015-16 for all institutions and across all years of study. This shows the variation in assumptions used by institutions when developing their financial forecasts. This variation has been greater in the last two years, since the new funding arrangements were introduced.

Figure 5 Forecast change in full-time home and EU undergraduate student numbers between 2011-12 and 2015-16

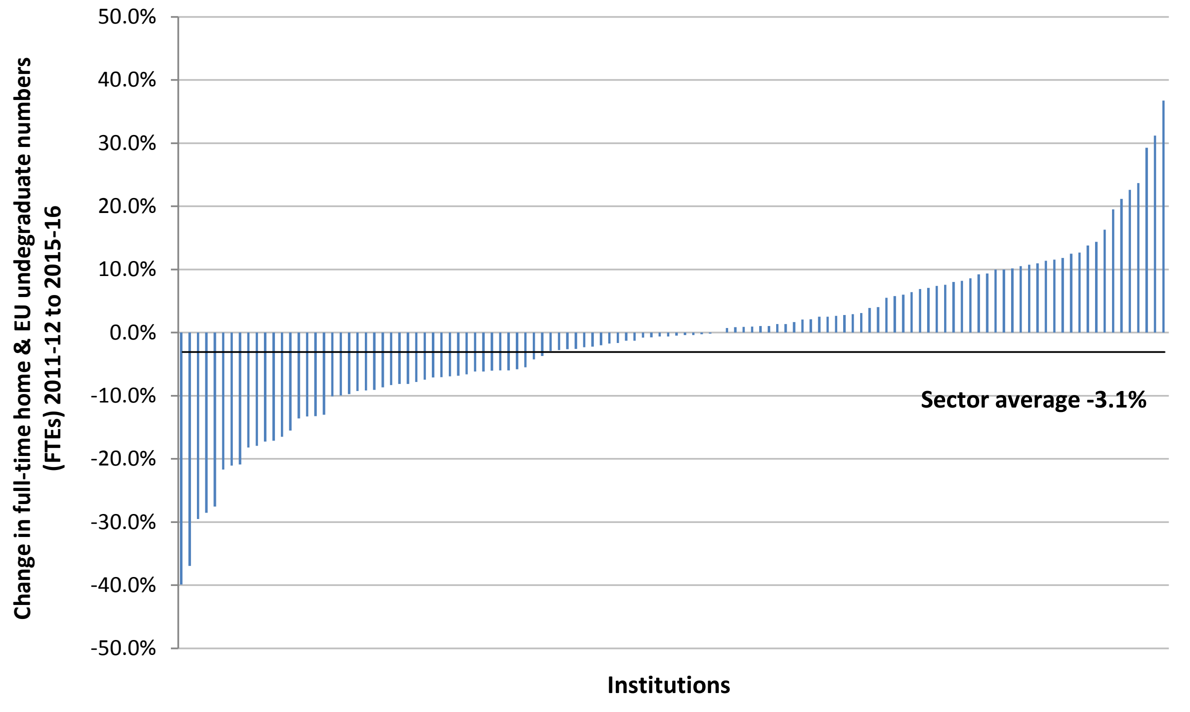


Chart excludes three outlier results

64. Much larger reductions are forecast for part-time undergraduate student numbers, with the sector expecting these to drop by 15.4 per cent in 2012-13 across all years of study, followed by a further fall in 2013-14 of 12.4 per cent. Thereafter, part-time undergraduate student numbers are expected to remain constant.

65. Full-time home and EU postgraduate taught student numbers are expected to fall by 4.5 per cent in 2012-13, followed by increases of 9.2 per cent in 2013-14, 1.6 per cent in 2014-15 and 1.4 per cent in 2015-16. Meanwhile postgraduate research student numbers show an increase in full-time numbers for all forecast years (averaging between 0.8 per cent and 3.5 per cent per year). In terms of part-time provision, postgraduate taught student numbers are expected to be 14.5 per cent lower, and postgraduate research numbers 6.8 per cent lower, in 2015-16 compared with 2011-12.

66. While final numbers of new entrants for 2013-14 will not be known until the HEFCE aggregate student number surveys are available later this year, the latest available UCAS data shows that the number of entrants in 2013-14 (home and EU full-time undergraduates) is up by 10 per cent on the previous year.

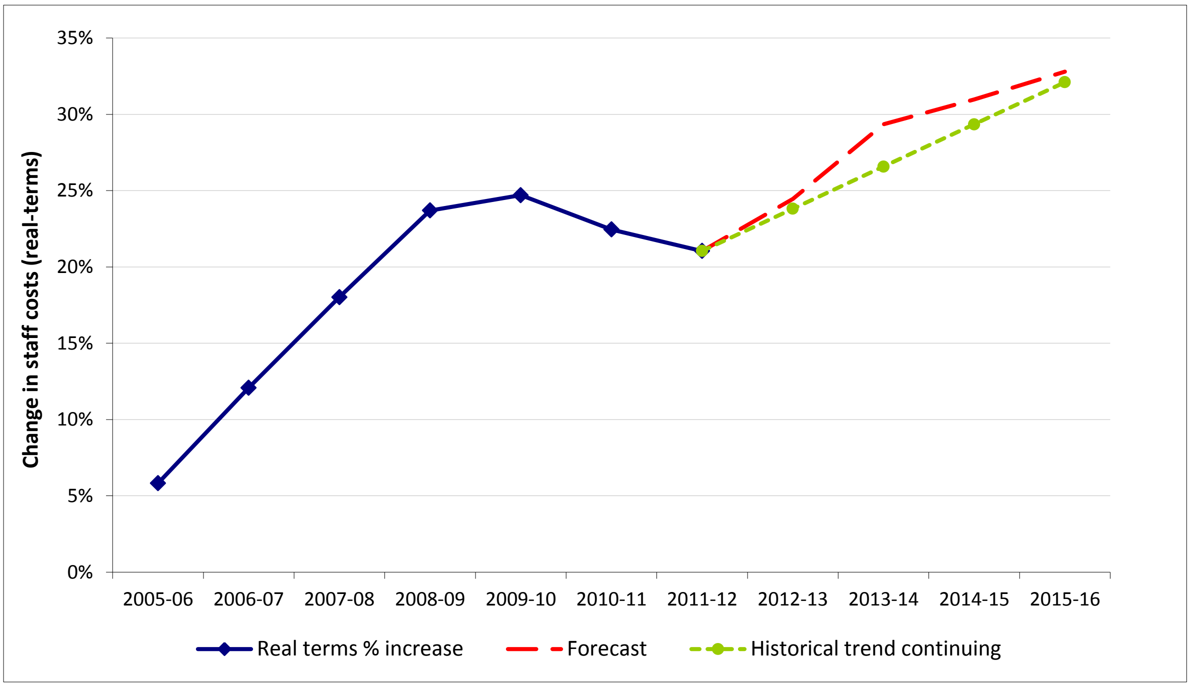
67. We are in close contact with UCAS and receive regular updates on the progress of clearing. We continue to monitor the impact on the financial forecasts, and discuss with institutions the actions being taken to mitigate adverse impacts.

Expenditure

68. The sector's biggest expenditure is staff costs, which in 2011-12 totalled £12,248 million, equivalent to 52.6 per cent of total income. The latest forecasts show that the sector is now expecting staff costs to rise by 4.6 per cent in 2012-13.

69. Figure 6 shows the level of real-terms increases in staff costs over the past eight years, plus what the sector is forecasting to happen over the next four years. It shows that the sector is expecting the increase in staff costs in 2013-14 and 2014-15 to be higher than the historical trend, before returning to a level consistent with the historical trend by 2015-16. This indicates that the sector is making reasonable projections in terms of staff cost increases over the forecast period.

Figure 6 Real-terms increases in staff costs (cumulative increase since base year of 2004-05)



70. In 2013-14, the sector is projecting an increase in staff costs, equivalent to 6.2 per cent, which is above the average annual increase between 2004-05 and 2011-12 of 5.3 per cent per year (cash terms). This rise in costs is primarily due to an increase in staff numbers in the sector as opposed to an increase in pay levels.

71. Overall, staff costs are expected to be between 52.9 and 53.9 per cent of total income throughout the forecast period, compared with a high of 58.1 per cent in 2000-01. Pay costs are expected to remain low, with the sector projecting average annual pay costs per employee to rise between 1.0 and 1.2 per cent in real-terms between 2012-13 and 2015-16.

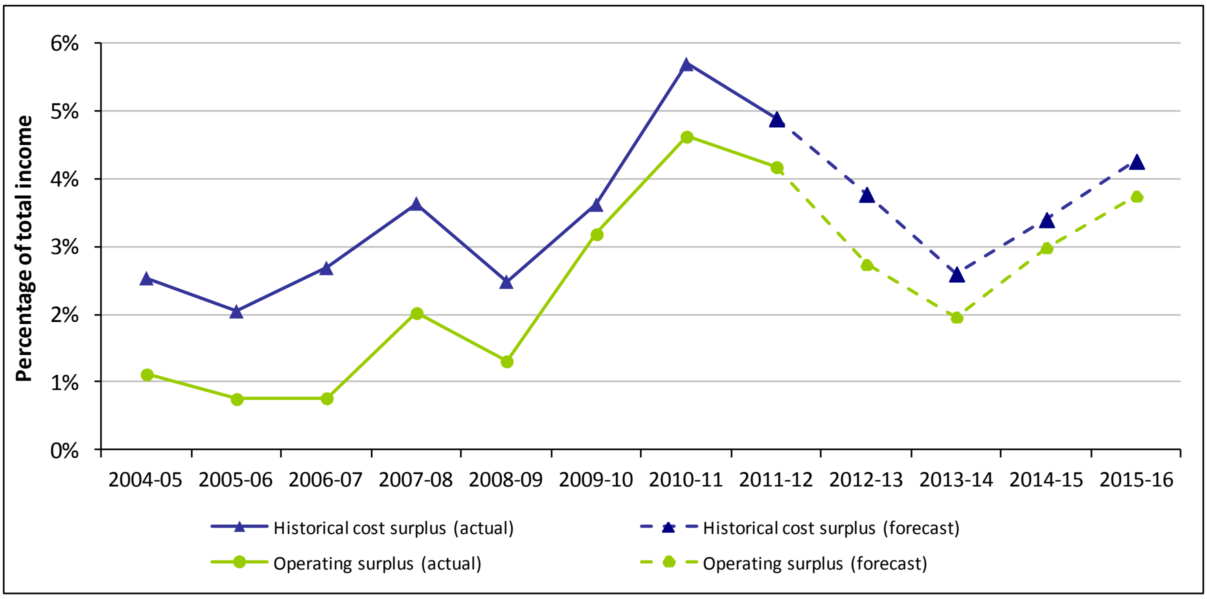
72. The sector is forecasting other operating expenditure to rise between 2.1 per cent and 6.0 per cent (cash terms) per year in the period 2012-13 to 2015-16, with the greatest rises expected in 2012-13 and 2013-14. Depreciation and interest payable are expected to increase at a faster rate, with depreciation rising between 4.3 per cent and 7.4 per cent per year, and interest payable rising between 3.8 per cent and 7.6 per cent (cash terms) per year in the same period. These rises are understandable since the forecasts project greater investment in physical infrastructure and a rise in external borrowings.

Surpluses

73. The forecasts indicate that, at an operating level (that is, total income less total expenditure, before any exceptional items), the sector expects surpluses to fall from 2.7 per cent of total income in 2012-13 to 2.0 per cent of total income in 2013-14. Thereafter surpluses are expected to rise, to 3.0 per cent of total income in 2014-15 and 3.7 per cent of total income in 2015-16. On a historical-cost basis the average level of surpluses is projected to be between 2.6 per cent and 4.3 per cent of total income over the forecast period. Historical-cost surpluses are expected to follow a similar pattern to operating surpluses, falling in 2012-13 and 2013-14 but then recovering from 2014-15.

74. Figure 7 shows the actual and expected operating and historical cost surpluses for the forecast period. The larger difference between the operating and historical position forecast in the year 2012-13 is partly accounted for by exceptional items of £145 million and, although the exceptional items do not substantially distort the analysis of the sector’s financial performance, much of this amount is accounted for by six institutions expecting substantial capital receipts following disposal of assets.

Figure 7 Operating and historical cost surpluses 2004-05 to 2015-16

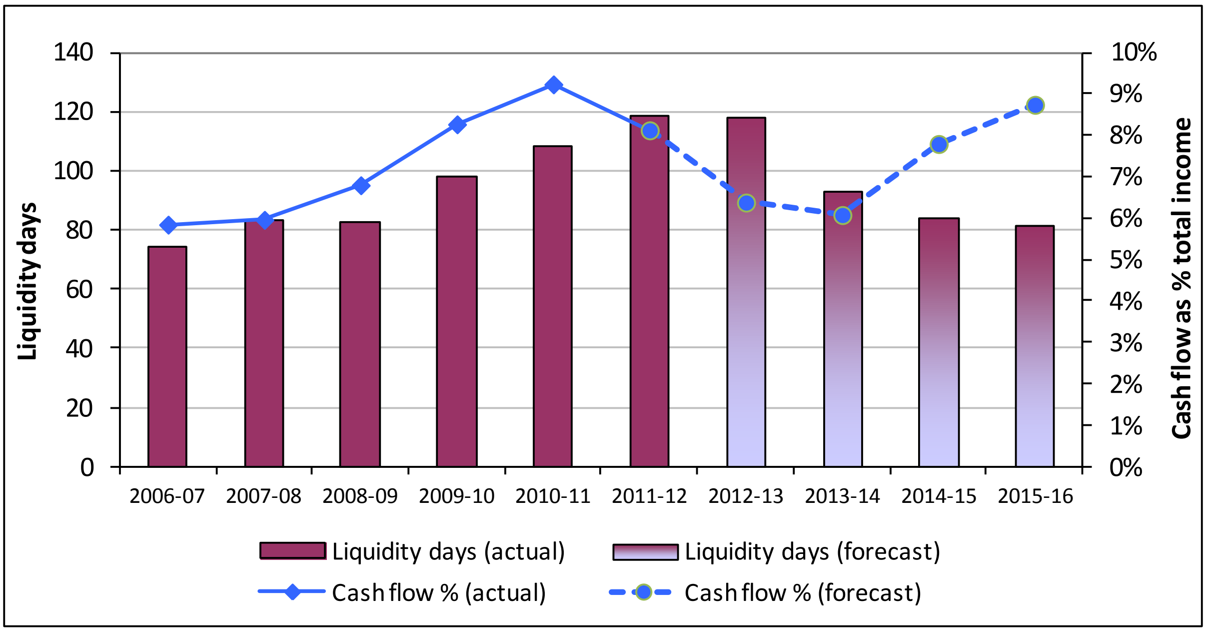


Liquidity and cash flow

75. The level of liquidity (that is, the number of days that liquidity covers expenditure) reported for the sector in 2011-12 was 118 days; the highest on record. The sector now expects liquidity to remain at this level in 2012-13, before falling over the remaining forecast period (though staying at a satisfactory level throughout).

76. Figure 8 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 percentage of total income). This shows that the level of liquidity is forecast to reduce to 82 days by the end of 2015-16, whereas cash flow from operating activities is expected to fall in 2012-13 and 2013-14, before rising again in the 2014-15 and 2015-16 as fee income rises.

Figure 8 Net liquidity and cash flow 2006-07 to 2015-16



77. Six institutions reported negative cash flows in 2011-12. This number is expected to rise to 12 in 2012-13, before falling to four institutions by 2015-16.

78. Only five institutions had liquidity of less than 20 days in 2011-12 (compared with six in 2010-11) but this number is expected to rise in the forecast period to nine. Despite this, the risk of solvency problems in the sector remains low.

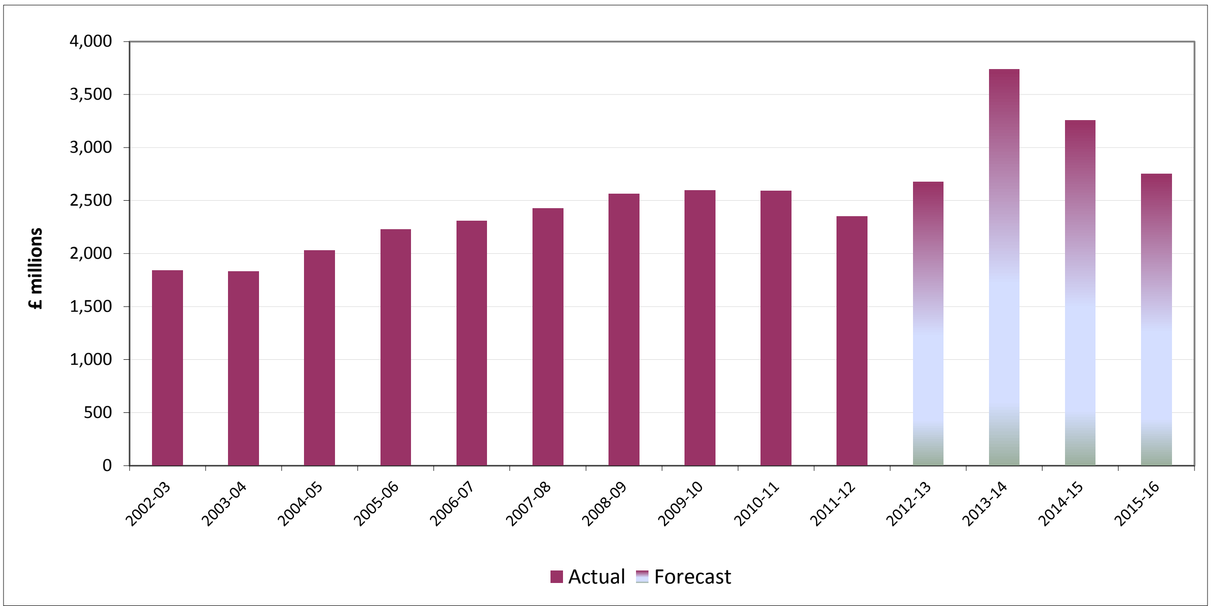
79. Strong liquidity is necessary for HEIs to efficiently manage the potential increased volatility and unpredictability of the new funding system and the increasingly competitive overseas markets.

Capital expenditure and borrowing

80. Since 2002 the sector has spent £22,765 million on improving its physical infrastructure, excluding expenditure on general day-to-day maintenance. Although this is a significant level of investment, Estate Management Statistics data show that on 31 July 2012 many institutions still had large amounts of non-residential space in poor condition, with the sector reporting a backlog of under-investment of £2,800 million (compared with 2,714 million on 31 July 2011).

81. Figure 9 shows the actual levels of investment (payments to acquire tangible assets) over the period, together with the projected level of capital expenditure forecast by the sector.

Figure 9 Capital expenditure 2002-03 to 2015-16



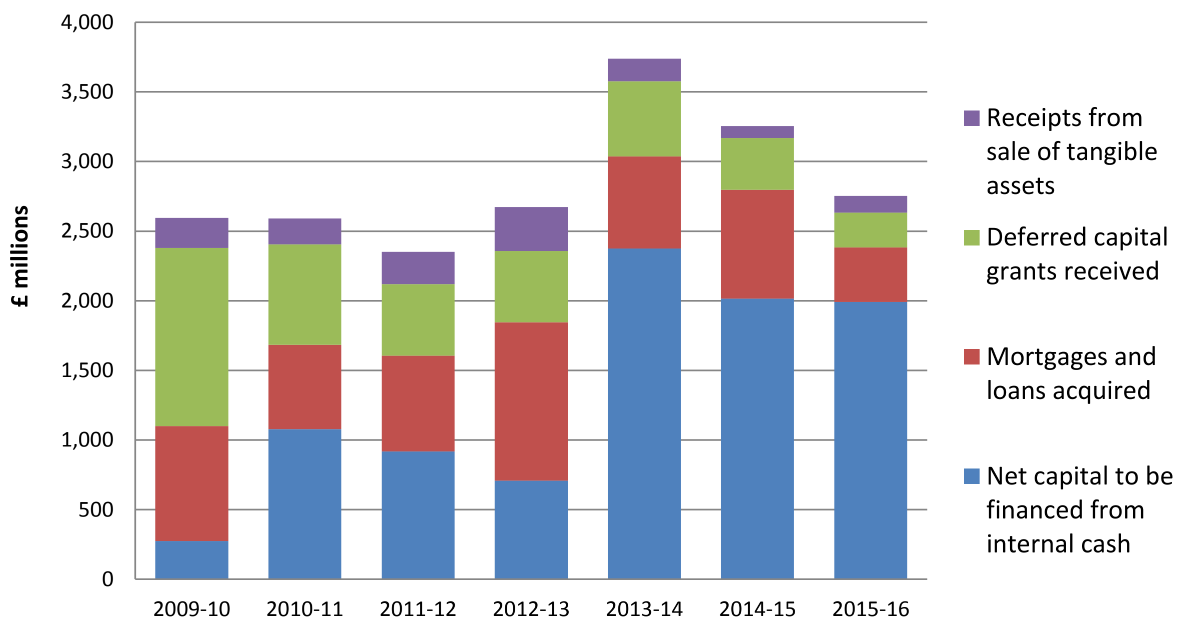
82. Capital expenditure in 2012-13 is projected to be £2,674 million, which although lower than forecast in December 2012, is 13.7 per cent higher than the level reported for 2011-12 and above the highest level recorded, £2,596 million in 2009-10.

83. The sector continues to forecast high levels of capital investment in the next three years, averaging £3,249 million per annum between 2013-14 to 2015-16. However, historical capital forecasting trends indicate that actual expenditure may be lower than projected for this period.

84. Figure 10 provides a breakdown of how capital expenditure was funded in 2010-11 and 2011-12, together with an indication of how the sector is expecting to fund its capital investment plans for the period 2012-13 to 2015-16 (based on institutional forecast data). This shows a

diminishing level of capital grants, alongside an increase in the level of net capital to be financed by internal cash, particularly from 2013-14 onwards.

Figure 10 Funding breakdown of capital expenditure 2009-10 to 2015-16



2009-10 to 2011-12: actual
2012-13 to 2015-16: forecast

85. Cash inflows from operating activities projected by the sector for 2012-13 are sufficient to finance any expenditure plans not financed by capital grants or borrowings. However, the large expenditure forecast in the next three years will require close cash flow management, particularly in 2013-14 as forecasts show that the sector requires £2.4 billion from its own cash reserves, (equivalent to 9.4 per cent of total income) to help fund the capital investment planned for that year.

86. In an increasingly competitive environment, and with significantly reduced levels of publicly funded capital grants, institutions will need to generate surpluses and operating cash inflows to finance future investment in facilities sufficient to attract home and international students. Otherwise there is a risk that the quality of the infrastructure in the higher education sector will reduce, which will harm its long-term sustainability. In the short term this level of capital investment is affordable given the cash reserves held by the sector; however, investment in infrastructure will not be able to continue at this level unless institutions generate increased surpluses.

87. The reduction in cash balances, the increase in borrowings, the reluctance of banks to offer loans with long maturity and the increasing volatility of income streams point to an increase in finance risk. We are currently seeking views on how we can best monitor the affordability of financial commitments as part of our consultation on the proposed revisions to the financial memorandum between HEFCE and institutions[4].

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[4] Financial memorandum: conditions of grant payments to institutions: Consultation on arrangements for 2014-15 onwards.

88. In terms of borrowing, institutional forecasts show that the sector expects its borrowings to rise to £7,338 million by the end of 2015-16, which is £1,847 million more than at 31 July 2012. Given that the sector already has access to over £897 million of additional financing agreed with lenders but not yet all drawn down, the availability of financing should be less of an issue compared with other sectors. However, changes in the banking market have meant that lenders are reducing the period of loans and requiring more restrictive covenants, as well as introducing higher rates of interest.

89. Records show that the average level of borrowing is rising within the sector. In 2001-02, the level of borrowing was 18.4 per cent of total income and by the end of 2010-11, this had risen to 21.9 per cent. This is projected to rise further to a high of 27.5 per cent by the end of 2014-15, before falling to 26.8 per cent by the end of 2015-16.

90. As borrowing rises in the sector, interest payments are expected to increase, from £348 million in 2011-12 to £430 million in 2015-16. 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 or to increase income.

Reserves

91. At the end of 2011-12 reserves totalled £8,965 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 more difficult. Without FRS17 the sector would have reserves of £13,032 million at the end of 2011-12, equivalent to 56.0 per cent of total income. Including pension scheme deficits of £4,066 million, though, reduces the reserves to 38.5 per cent of income.

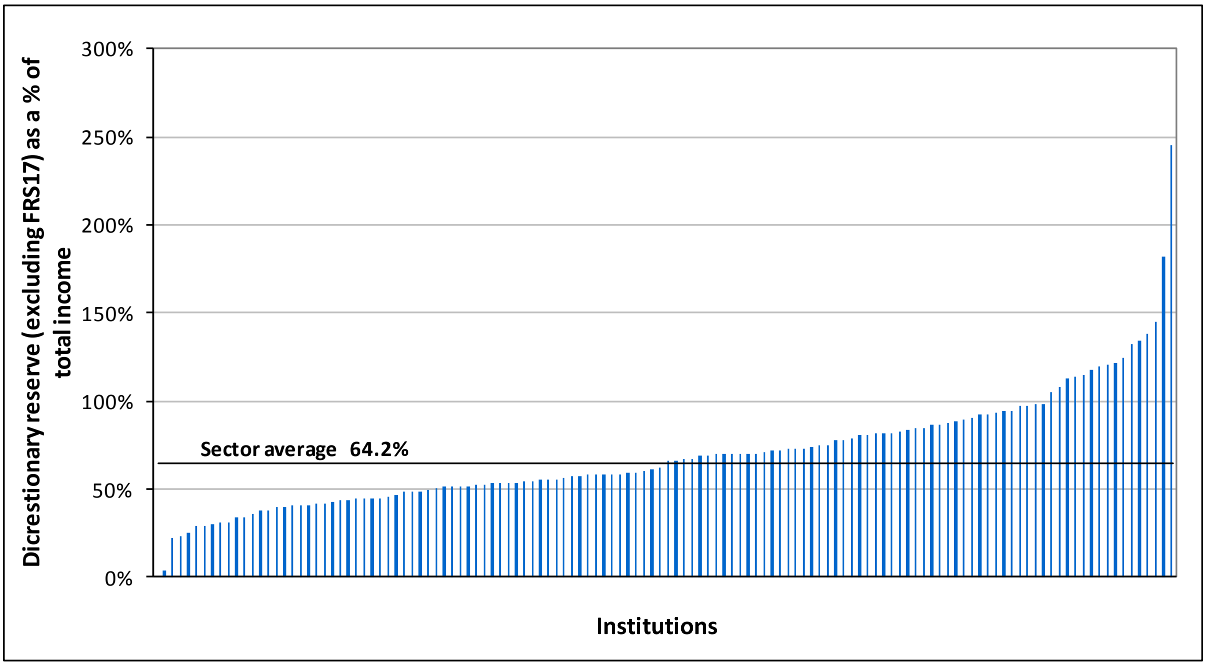
92. Discretionary reserves are forecast to increase each year in the forecast period as the sector continues to generate surpluses. By the end of 2015-16, the sector expects to have built reserves (including FRS17) of £13,398 million. However, uncertainty over pension deficits, which depend on actuarial assumptions, could significantly increase or reduce this figure.

93. As in previous years the sector is not forecasting any material changes in the pension liabilities on its balance sheets. While this has been an understandable position in the past given the inherent difficulty in forecasting pension assets and liabilities, a new financial reporting standard, FRS102, due to be implemented from 2015-16, will require institutions to recognise liabilities relating to deficit recovery plans for multi-employer pension schemes (such as USS) in its balance sheets.

94. The USS Members' Annual Report published on 10 October 2013 confirms that the USS scheme deficit stood at £11.5 billion as at the end of March 2013, but had reduced to £7.9 billion as at the end of June 2013. This compares to the last full triennial assessment, which valued the deficit at £2.9 billion as at the end of March 2011. The next full financial assessment is not due until March 2014 but the movement in the deficit value demonstrates the significant level of volatility in these valuations. Although reserves are strong overall, there is a risk that the sector reserves could be significantly overstated depending on the value of the USS deficit.

95. The aggregate sector position masks a significant spread of financial strength: there is a concentration of large discretionary reserves in a small number of universities. Although this concentration is forecast to continue, four more institutions are expecting to report reserves higher than the sector average in 2015-16 than in 2011-12. Figure 11 shows the forecast level of discretionary reserves (excluding FRS17) as a percentage of total income for all institutions in 2015-16.

Figure 11 Forecast discretionary reserves (excluding FRS17) as a percentage of total income 2015-16



How realistic are the sector's forecasts?

96. Historically the sector has been pessimistic in its short-term (one-year) forecasting, with the actual results always better than expected. Taking the current forecasts we have attempted to highlight the limited margins in which the sector operates. Looking at the first three areas of risk (public funding, full-time home and EU undergraduate fee income and overseas fee income) we have modelled the cumulative impact of a small (2.5 per cent) cash change in what HEIs are forecasting for each of the last three years. We have also modelled the cumulative impact of a 1 per cent increase in pay costs. Table 3 shows the level of operating surpluses in each year (as a percentage of total income) under the various scenarios.

Table 3 Operating surpluses as percentage of total income

	2013-14	2014-15	2015-16
Current forecasts	2.0%	3.0%	3.7%
Cumulative public funding reduction (2.5% per year)	1.2%	1.6%	1.9%
Cumulative reduction in full-time Home and EU undergraduate fee income (2.5% per year)	1.4%	1.7%	1.8%
Cumulative reduction in overseas fee income (2.5% per year)	1.6%	2.3%	2.7%
Cumulative reduction in pay costs (1% per year)	1.4%	1.9%	2.2%
Combination of above four events	**-0.3%**	**-1.4%**	**-2.7%**

97. 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. In the event of all four changes happening, the sector would be in deficit in all three years of the forecast period.

98. HEIs need to generate surpluses to provide the positive cash flow to fund future developments, 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, in the medium to long term, some institutions will need to generate larger surpluses to make progress towards covering the full economic costs of their activities and maintaining sustainability. This is particularly important given the present and future economic conditions. The above analysis highlights the tight margins within which some institutions are operating.

Conclusion

99. The expected financial outturn for 2012-13 is not as strong as 2011-12, although better than forecast in December 2012

100. The projected performance for the sector in the remainder of the forecast period (2013-14 to 2015-16) is sound overall, with the sector forecasting continued surpluses, healthy liquidity and reserve levels, although cash balances are forecast to reduce.

101. Across the sector there continues to be a wide variation in the financial performance of institutions.

102. The sector's financial projections assume steady growth in total income as the new funding arrangements become established, although growth projections are reliant on institutions being able to achieve their student recruitment targets at home and overseas. International fee income is becoming increasingly important to the sector, with the forecasts showing that the sector expects fee income from non-EU students to rise from 11.9 per cent of total income in 2011-12 to 14.1 per cent of total income in 2015-16.

103. The key risk facing the sector's future financial sustainability continues to relate to the uncertainty of future home and EU student recruitment, and the sector's caution is reflected in the latest student number projections submitted by institutions, to support their financial forecasts. These show that that, at an aggregate level, the sector expects full-time home and EU

undergraduate student numbers (across all years of study) to be 3.1 per cent lower by 2015-16, compared with 2011-12. This is despite latest data from UCAS, which indicate that the number of entrants in 2013-14 (home and EU full-time undergraduates) is up by 10 per cent on the previous year.

104. To increase competiveness and enhance the student experience, the sector is planning to invest in its capital infrastructure at significant levels in the forecast period. This is despite large reductions in public capital funding which have seen HEFCE capital grants falling from an average of £825 million per annum over the period 2008-09 to 2010-11, to £299 million in 2011-12. The increases in capital expenditure projected by the sector may have been influenced by the government spending review announcement which indicated a rise in capital grant funding. If publically funded capital grants do not increase, institutions will need to deliver strong surpluses in order to finance these investments and maintain long-term sustainability.

105. In the short-to-medium term there continues to be a risk that future public funding of higher education could be constrained if the overall economic climate does not improve. This, together with the uncertainty about student recruitment, could result in increased volatility of financial performance. This volatility could impact institutions in different ways. As a result, the wide variation in financial performance across the sector could widen in the medium term.