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Restructuring Services Sector Outlook Series

Bringing industry challenges to the surface

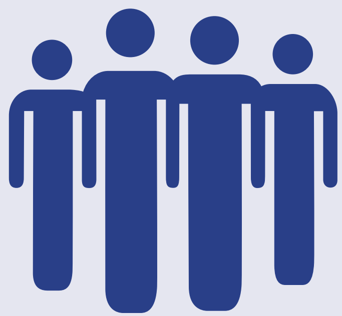
Education – Uncharted Waters

June 2016

Contents

Significant changes are anticipated in the Education sector from primary and secondary State Schools (SS) to Further Education (FE)[1] and Higher Education (HE)[2] institutions.

Uncertainty on funding and **government policy** implications is further exacerbated by **reducing student numbers** which together are putting both financial and operational pressure on institutions. At best, these changes will require a shift in management skills and adjustment in operations but could result in some institutions being no longer viable.



1 FE includes Colleges and Sixth Form for students aged 16-19 plus adult education
2 HE includes universities

Schools and Academies

In March 2016, the Government made an announcement that caused controversy in the Education sector. They declared that all local authority controlled primary and secondary schools in England are required to become academies by 2022.

The objective of transforming schools into academies is to create independence from local authorities. Therefore, the Government will provide funding directly to the schools, allowing head teachers to shape the curriculum, prescribe pay grades and essentially handle the day-to-day running and operations. Overseeing the academies will be individual bodies known as trusts, who will provide support, expertise and a strategic overview, as well as control of the admissions process. Currently, 15% of primary schools and 61% of secondary schools have academy status.

The reason this announcement caused a great deal of uncertainty is due to:

- The **limited evidence** to suggest academies drive improved learner outcomes and financial management;
- **There not being enough academy chains** (multi academy trusts) to support the conversion of the remaining schools; and
- The risk of **insufficient experience** in the sector to manage large numbers of ‘subsidiary businesses’.

Consequently in May 2016, the Government announced that it is adjusting its plans for academisation of all state schools. Rather, the Department for Education (DfE) will force only those schools graded ‘inadequate’ or ‘requiring improvement’ to convert to academy status, allowing councils to continue to maintain schools with successful track records.

The true impact of academisation is yet to be seen but we believe there is a **significant risk of failure** in the sector as chains take on more than they can handle. Given an academy’s ability to raise external debt, this is also likely to have **implications for lenders** – and could attract PE-type investment if supported by the right management teams. Where debt, private equity, and profit meet, there will likely be the inevitable debate between return on investment vs leaner outcomes.

16%[3] of local authority maintained schools are graded ‘inadequate’ or ‘requires improvement’ and may need to convert to academies by 2022.

3 Ofsted Annual Report 20/4/2015

Further Education

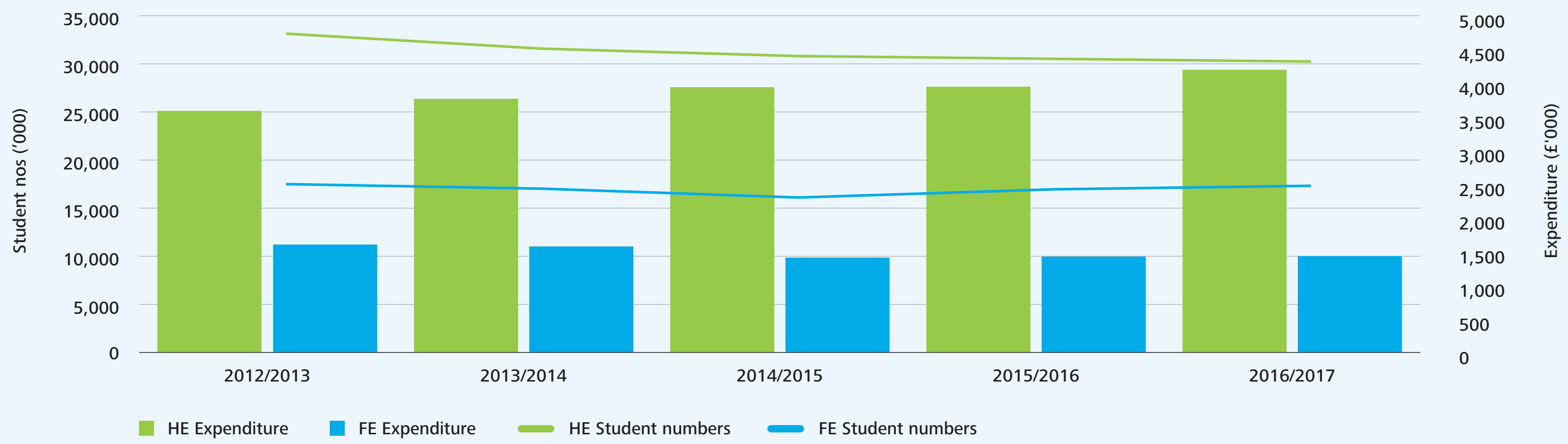
From January 2015, the age that young students are required to stay in some form of education or training, at least part-time, increased from a student's 17th birthday to their 18th birthday.[4]

While this legal change should have led to an increase in demand for FE, instead, FE student numbers are on the decline experiencing a 9% reduction between 2012/2013 and 2016/2017 (Figure 1). The reasons for the decline reflect an overall **reduction in the 16-18 year old population** in the UK[5] together with **increased competition** from schools, universities and the job market which are offering alternative options to FE institutions.

As competition for fewer students increases, FE institutions need to adapt how they target the market which will, for some, become increasingly challenging due to funding cuts and the Government's focus on restructuring the sector.

According to the NAO, between autumn 2013 and summer 2015, the further education commissioner had to intervene in 22 colleges because of financial problems.

Figure 1. FE and HE Forecast Student Numbers and Expenditure (2012-2016)



Source: BIS 2014/2015

4 Government's Education and Skills Act 2008

5 Fertility levels fell during 1990s recession

Ongoing funding cuts

As the key provider of finance to FE institutions, the Government is typically responsible for approximately 85% of an FE institution's funding. The remaining 15% is earned from international students and/or commercial activity such as dining and café facilities. Between 2010/2011 and 2014/2015, the Government cut funding to FE institutions by an estimated 20%[6]

- The **UK skills gap** is impacting the type of courses the Government is willing to fund at FE institutions. Courses considered 'non-contributory' to the UK economy are being cut, sometimes mid-year.
- In Feb 2015, the Government announced **further funding cuts** to adult education of up to 24% in 2015/2016 while protecting the apprenticeships budget.
- This position evolved in November 2015 when the Chancellor announced plans to **protect funding** (in cash terms) for the core adult skills budget. To date, no further clarity has been provided on how this protection will be reflected in the level of funding that FEs receive.

Area reviews

Alongside 2015 funding cuts, the Government introduced local "Area Reviews" (ARs) for all UK FE institutions as a means to make the sector more **financially resilient**. The purpose of the ARs are to identify synergies across FE institutions to **create fewer, larger, more resilient and efficient colleges** with greater specialisations.

- ARs were originally planned to be rolled out on a quarterly basis between July 2015 and March 2017 and led by a steering committee comprised of local FE stakeholders.
- The first wave of ARs started in September 2015 covering the regions of Birmingham & Solihull, Greater Manchester and Sheffield City who together had 38 institutions.
- Since this first wave started, the roll-out of the programme has faced delays, pushing back output and the merger timetable. These delays have given FE institutions time to seek merger partners ahead of the game.
- While the Government will not be responsible for ensuring that the local AR recommendations are implemented, we expect that the amount of ongoing government funding will be connected to the changes each area implements.
- The Government has not yet published a target for the 'ideal' number of colleges for each local area nor has it communicated in detail how M&A and cost rationalisation activity will be funded. We anticipate that up to 1/3 of FE institutions could disappear as a result of the local ARs.

Challenges we are seeing as we advise on a number of existing mergers include:

- a lack of credible, fully costed turnaround plans;
- unrealistic timetables;
- a lack of consideration on how mergers will impact key stakeholders.

6 Institute for Fiscal Studies

Higher Education

Since 2012, a significant proportion of the cost of university education has transferred from the state to the student, with universities now able to charge students up to £9k per annum for tuition.

Aside from the social impact this has had, it has ensured that HE institutions have had the scope to maintain levels of funding, and as a result, the sector has not experienced the same level of stress as FE.

However, since the introduction of the £9k tuition, the HE market has become highly competitive. League tables measuring everything from student satisfaction to career prospects are readily available and students are able to vote more with their feet. In addition, quotas are being abolished allowing top universities to attract more and more students, to the detriment of less successful ones. As a result, HE institutions are having to adjust their strategies in this buyer's market in order to compete.

The key challenge facing HE institutions over the next few years is how to balance increased investment alongside funding cuts, all in an increasingly competitive environment.

Increased investment

In order to attract more students, HE institutions are having to:

- **Increase investment** in infrastructure, technology and student accommodation.
- Invest in **teaching programmes** in order to achieve teaching excellence which allows for institutions to charge more than the historical £9k/year cap.
- Focus on investment in more **online and home study programmes** in order to drive longer term cost efficiencies which can be reinvested.
- Invest **overseas** to keep up with globalisation of the sector at the same time as they face increased competition from international institutions looking to invest in the UK.

Funding cuts

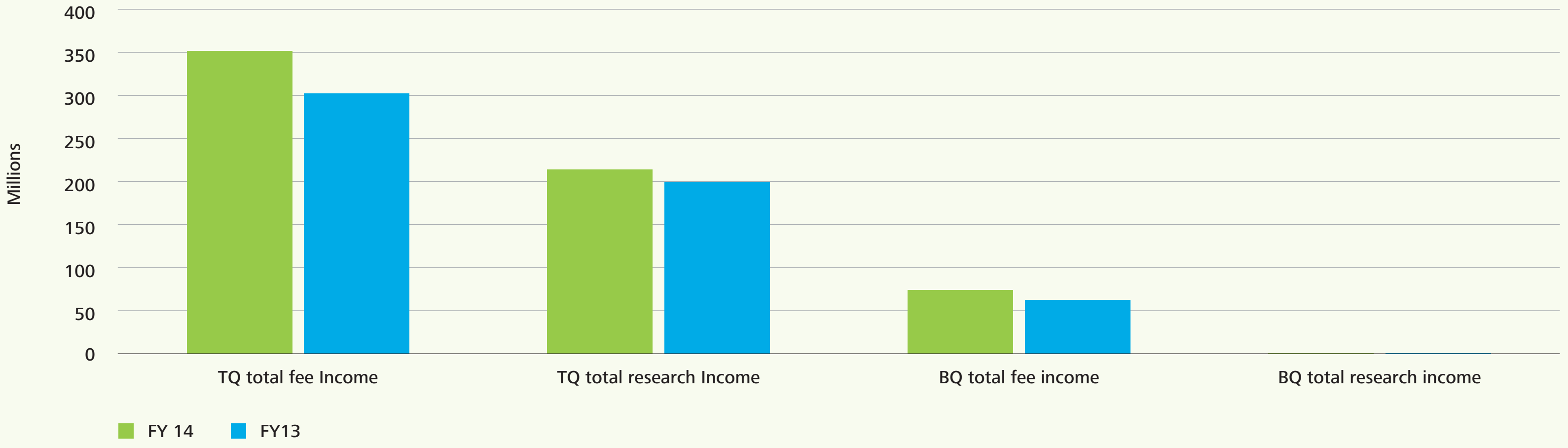
- Tuition fees account for approximately 70% of revenue earned by HE institutions with the remaining 30% in the form of research grants, which is split 50:50 between the UK Government and the private sector.
- In 2015, BIS was asked to make £450m of savings, including from HE budgets which will impact their research funding. The extent and nature of these cuts is still unclear.
- Funding from charitable and corporate bodies for research is declining as they demand quality output for their investment at the same time as top-up funding from the Government is reducing. This is profoundly noticeable in the lower ranked HE institutions who are seeing their research grant income stream diminish, as outlined on Figure 2 overleaf.[7]
- On 25th May 2016 university lecturers staged a 48 hour strike across the UK due to salary disputes. Following six years of real term pay cuts equating to 14.5%, the University and College Union (UCU) rejected a pay rise offer of 1.1% amid growing anger that vice-chancellor pay rose by 5.1% in 2015[8]. If this dispute remains unresolved, members have agreed to future strike action that will disrupt graduate ceremonies, open days and clearing processes.

Since the introduction of £9k/year tution fees in HE, there is increased competition as students demand higher quality education.

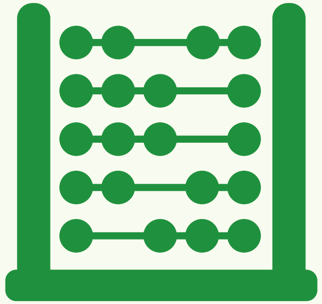
7 The Guardian league tables and University's financial statements

8 UCU.org. UC/HE 2016

Figure 2. Top Quartile (TQ) vs Bottom Quartile (BQ) HE Performance in 2013/2014



Source: University Financial Statements



Due to the low levels of research income earned by BQ HE institutions in FY13 and FY14, levels cannot be seen in the graph. Actual levels amounted to 321k and 293k, in FY13 and FY14, respectively.

"The HE sector includes more than 150 separate institutions, all with their own circumstances, budgets and strategies. If each of these institutions can reshape its operating model and find its own solution, then it will not only strengthen itself but the HE sector as a whole. And that sector in turn will bolster its hold over the international student market and continue to define itself as a global leader."

Julie Mercer, Head of Education, Deloitte

Key considerations for stakeholders

The combination of academisation, funding cuts, cost rationalisation and diminishing student numbers is creating a very difficult environment for the education sector.

Institutions

- **Management skills:** Across SS, FE & HE, the mix and nature of management skills will need to evolve to adapt business plans and offerings as the structure of institutions change and funding is reallocated. Management teams will face, sometimes for the first time, the challenge of both merging and then integrating institutions, requiring special skills and experience which many teams may not have. They will also need to focus on maintaining profitability through cost control and efficiencies and increasingly focus on cash and working capital management.

- **Investment and innovation:** In order to attract both students and funding, investment and innovation will become increasingly important as it will determine the winners and losers.

- **Financial stress and distress:** Financial pressure is expected to result in stress and distress across the sector. In addition, local ARs of FE institutions are intended to identify financially unviable institutions and provide opportunities for consolidation and rationalisation.

- **Integration:** Academisation and mergers are only the first phase of the journey. Real challenges exist post consolidation: the integration of two or more different cultures, operating systems, and estates will require a detailed plan and precise execution. Management teams should not think the hard work is done at the time of the legal merger or acquisition.

- **Self-help:** In the absence of access to debt, management teams will have to turn to estate rationalisation, working capital improvements and cost cutting exercises to generate headroom.

Lenders

- **Restructuring activity:** Restructuring activity will increase in a number of forms, from mergers to cost reductions to insolvencies. There is currently no insolvency regime in place for FE institutions. Many are wondering if and when new legislation will be drafted to assist with the wind down and closure of underperforming colleges and the clarification about who will pick up the costs of the closures. Engagement between government stakeholders and lenders will be key and may require cooperation on emergency funding and security to support institutions.

- **Shift in sources of debt:** Uncertainty in the sector is expected to result in cautious bank lending and we expect banks to restrict provision of new money to only the top financial performers in the sector. The North-South divide is likely to become an important factor as institutions with valuable campuses are more likely to be able to raise funding while those in tertiary locations may struggle. To date, banks have been the primary source of funding into the education sector given the sector's heavy reliance on government funding and policy. However as the sector evolves, an appetite for lending with greater risk may appeal more to the fund community and recently several HE institutions with robust business plans and balance sheets have raised capital on the bond market (e.g. Cambridge, de Montfort and Northampton Universities).

Both FE and HE institutions face significant financial risk as levels of required investment outstrip growth in income.

Education credentials

First 4 Skills	Project Peregrine	Project Scroll
Insolvency Private training provider	Merger Diligence FE College	University-side Advisory HE Institution

Elmfield Training	Project Star	Project Bill
Insolvency Private training provider	Creditor Advisory FE College	Forecast Review Secondary School

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"Over the next 12-24 months we expect to see a number of changes across the education sector. These changes will place significant demands on management teams as they need to develop new skills which will be critical to ensuring the survival and success of their institutions. M&A, working capital management, merger integration, project transformation and stakeholder management skills will be required across the board.

Lenders will need to keep an eye out for new failure regimes. Attitudes towards supporting the sector may change if lenders begin to lose money, or perceive that there is a greater risk of losing money in the future."

James Clark, Education Director, Restructuring Services

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