IN FOCUS

THE UNIVERSITY CHALLENGE

November 2024

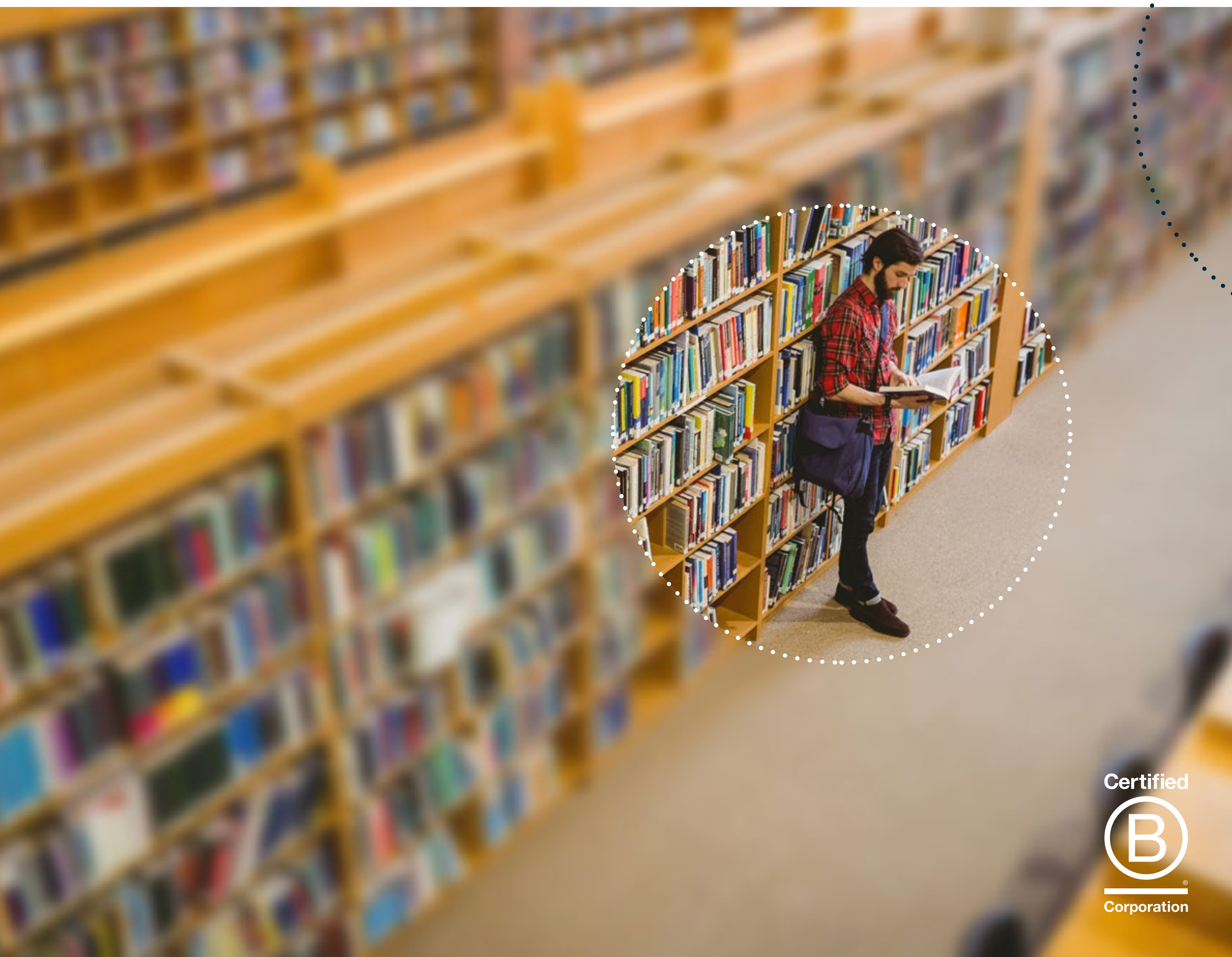
Centrus

Developing a sustainable funding model

Overview

Universities sit at the heart of a nationwide educational and scientific eco-system that is central to future economic growth in the UK. They possess the intellectual heritage and commercial assets that will address some of the biggest scientific challenges of our time.

At first glance the sector appears well positioned to address these challenges. A recent report by London Economics,[1] estimated that the total economic impact on the UK economy associated with the UK higher education sector's teaching, research and innovation activities in 2021-22 was £157.62 billion. In terms of the components of this impact, the value of the higher education sector's research activities alone stood at £54.12 billion.



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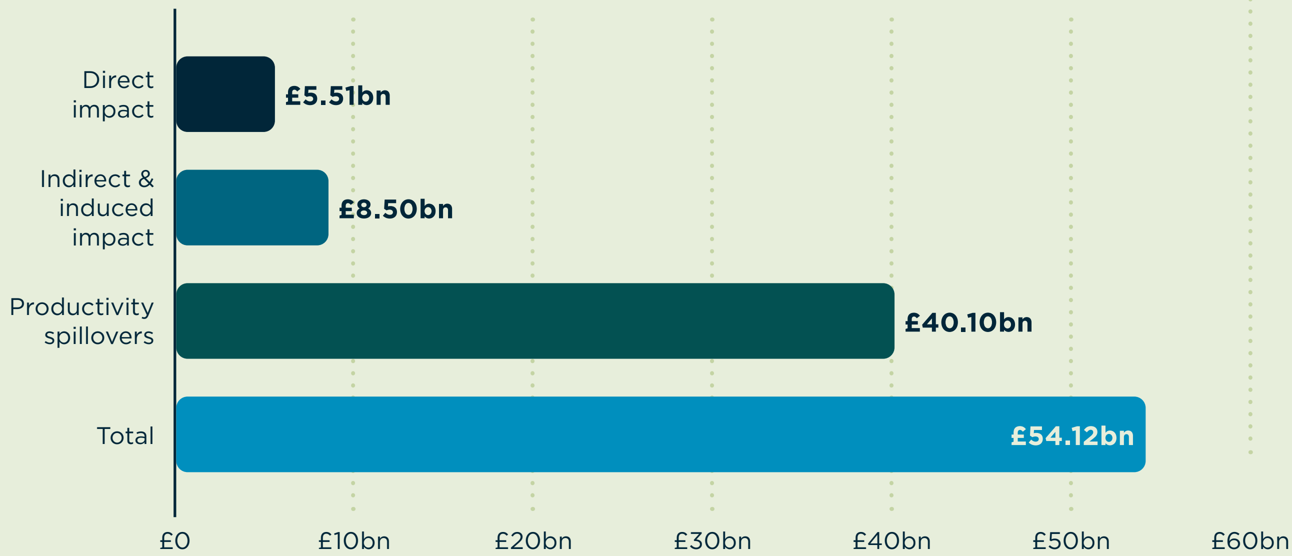
Total impact of higher education providers' research activities in 2021-22



Note: All values are presented in 2021-22 prices, rounded to the nearest £0.01 billion, and may not add up precisely to the total indicated.

Source: London Economics' analysis

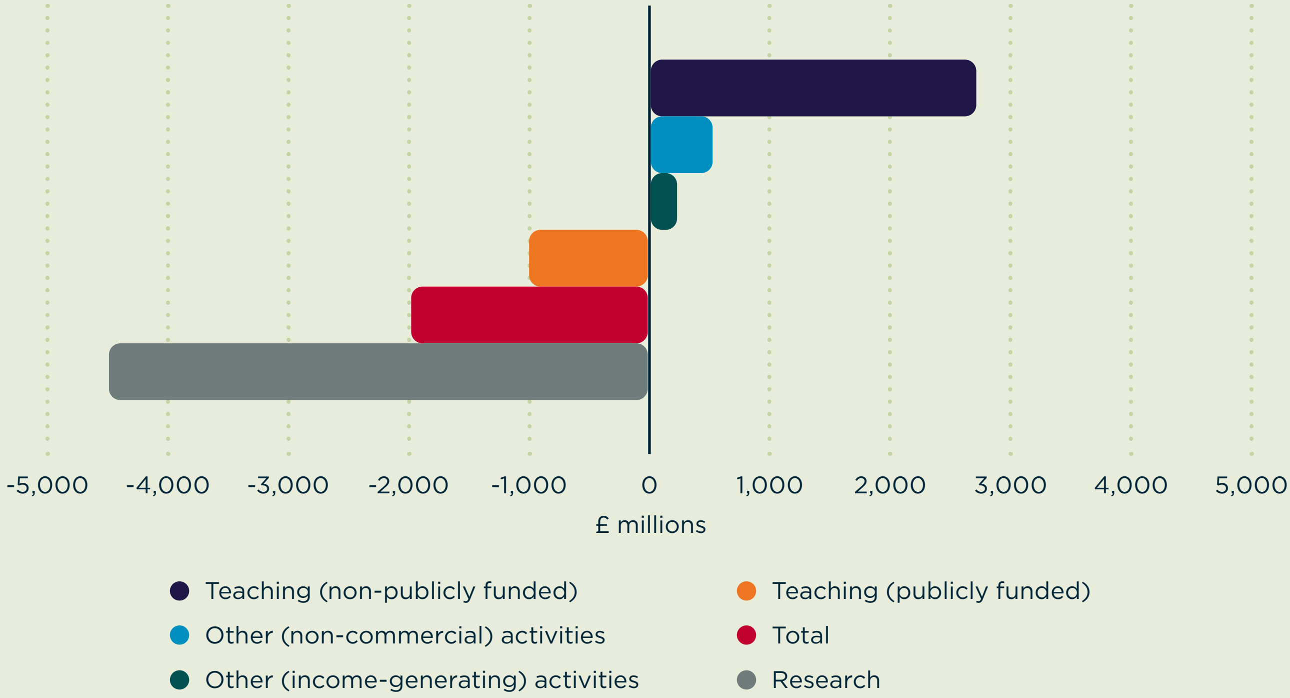
> "As the higher education sector faces a number of financing challenges, the opportunity exists to employ innovative approaches to its real estate, commercial, energy and treasury strategies to provide a stable and robust financial future"
>
> **Phil Jenkins, MD and CEO, Centrus**

Since 2014 student numbers in the UK have grown by 37% to 1.365 million.[2] Real-term income has grown by one third to £52 billion[2] and in the latest global rankings, there are four UK universities in the world's top ten and 15 in the top 100.[3]

Despite this world-leading position, UK universities are currently experiencing an existential funding challenge. Cuts are being made across the sector, as frozen tuition fees, high inflation and interest rates combined with falling international student numbers create a perfect storm for university finances.

Though the UK invests a higher proportion of higher education R&D than any other G7 nation[5] university, income is unable to keep up with cost pressures. Research grants and income from contracts have also remained largely static.[2] As a result, universities increasingly rely on tuition and fee income to fund core activities, with an increasing dependency upon postgraduate fee income from non-European Union students.

Funding dependency: The economic cost imbalance between fee income and research



Source: Office for Students

The relatively high inflation experienced in 2022-23 has meant running costs continue to rise whilst revenues remain relatively static. According to the Office for Students (OfS)[5] data, total expenditure, without pension cost adjustments, was expected to increase by 6% in nominal terms from 2022-23 to 2023-24. In contrast, total income was expected to grow at a rate of only 3.7% in nominal terms, representing a fall of 2.6% in real terms.

At Centrus, we are on a mission to build a better society, by delivering the sustainable funding system that essential services – such as universities – need to thrive in the long term. In an environment where leading commentators are asking fundamental questions about the future purpose, shape and organisation of higher education, universities need a trusted partner to provide sector-leading advice and support in difficult times.

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Financial challenges

The financial crisis in UK universities is characterised by a widening funding gap, rising operating costs and increased competition for students.

In aggregate, the forecasts submitted by providers to the OfS[5] assume growth of 35% in international student entrants and 24% in UK student entrants from 2022-23 to 2026-27. The latest data on undergraduate applications and student sponsor visa applications indicates that there has been an overall decline in student entrants this year, including a significant decline in international students of up to 16%. The OfS has modelled a 35% reduction in entrants to the sector per year by 2026-27, compared with forecast entrants for the year (2023-24). In this scenario, total forecast income for the sector could fall by 21% (£9.283 billion) leaving 89% of all higher education providers in deficit, with 74% of providers experiencing year-end liquidity problems.

Looking more closely at the OfS data, provides some broader context behind the financial headwinds of the sector. The graph below shows that net operating cash flow has fallen from 11.6% of income in 2021-22 to 6.5% in 2022-23.[6] Overall surplus levels have fallen from 5.6% in 2021-22 to 2.9% in 2022-23. Given the sector headwinds, and, despite some of the optimistic projections from universities included in the OfS data, it is expected that this trend will continue.

"Navigating key treasury risks such as cashflow and liquidity management while building a robust capital structure, will enable universities to manage challenges and take advantage of the significant opportunities ahead"

Jason Murphy, Group Chief Strategy Officer

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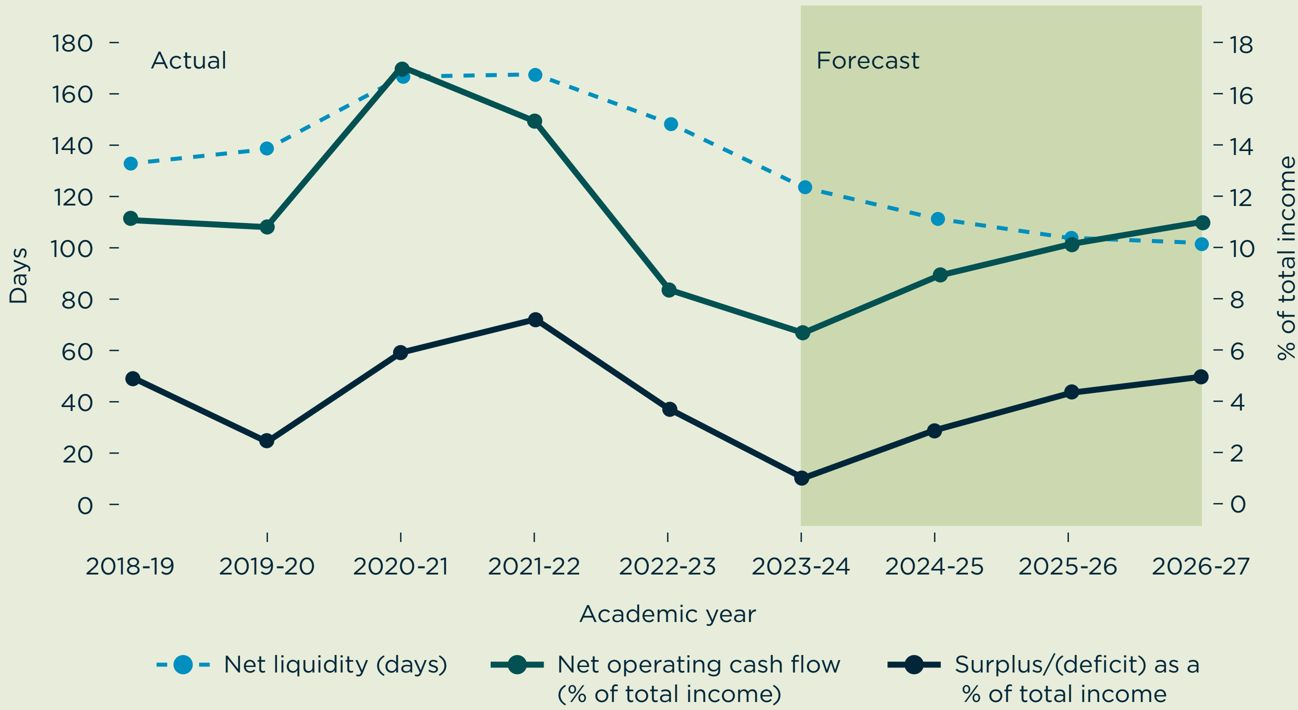
Expectation versus reality: The declining state of university finances



Source: Office for Students

Therefore, it is imperative that finance teams within universities can accurately model and stress test their long-term financial plans, to pre-empt expected or potential covenant breaches, liquidity constraints or refinancing risk.

The headwinds noted above are giving rise to increased pressure on financial covenant compliance, and universities are also experiencing a greater level of scrutiny from auditors concerned with going concern assessments.

"This financing provides us with the resources we need to realise our ambitions and we are delighted. Centrus advised us throughout this project both with our financial modelling and forecasting as well as assisting us in negotiating very competitive terms for the financing"

John Ford, Treasurer, St Anne's College, Oxford

Developing a sustainable financial plan

Changing demands

The changing demands on higher education, shifting employer needs and the deepening financial crisis facing many universities, combined with the distinct possibility of mergers, joint ventures and wider sector restructuring, make the ability to accurately develop and stress test a robust financial model imperative for effective financial planning.

The model should be able to consider changes in capital expenditure and the possible utilisation of off-balance sheet capital financing solutions; the rationalisation of debt profiles and renegotiation of existing facilities; and any operational changes to the business model that may envisage staff redundancy schemes and pension renegotiations.

"The UK university sector is at an inflexion point. A new funding and policy framework is now needed to ensure universities continue to be a vital engine for economic and social prosperity"

Russell Schofield-Bezer, Senior Advisor, Centrus

If the outlook for operating cash flow and overall surplus levels in the medium term is poor, then the affordability of necessary estate maintenance and the significant cost of investment needed to reduce carbon emissions as part of providers' commitments to achieve net zero, is also cast into serious doubt.

In 2021, over 160 universities and higher education colleges in the UK pledged to become completely carbon-neutral by 2050,[7] with some institutions aiming to decarbonise as quickly as 2030. The cost of simply maintaining physical infrastructure and meeting the regulatory and environmental demands imposed by this commitment is substantial. A recent report by Grant Thornton[8] calculates the cost of decarbonising the UK's higher education sector at £37.1 billion. £25.4 billion of this will be spent on decarbonising supply chain emissions, while £6.56 billion will go towards built environment emissions and £5.14 billion for transport and travel.

Funding considerations

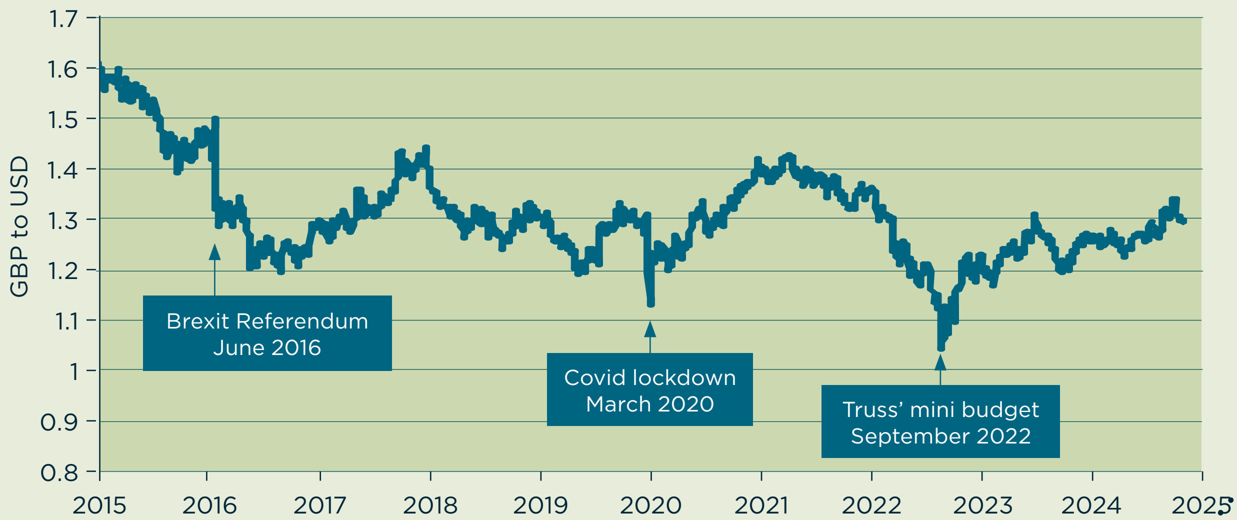
At Centrus we are incredibly proud to be a certified B Corp, reflecting our commitment to community and the environment. Specialist financial solutions will be key to helping meet the financial demands of net zero with financing solutions that can be tailored to the specific needs of an organisation.

For those universities that are cutting back on capital expenditure, as well as assessing the viability of specialist project-finance solutions, a comprehensive review of their existing medium-term funding and refinancing could be beneficial.

For those universities that have previously issued private placements in US dollars, a review of pre-payment options could be considered especially as any "make-whole" payments may now be low, given the higher interest rates we are now experiencing. Pre-payment clauses may include the unwind proceeds from any cross-currency swap entered into by the investors, so depending on foreign exchange rate moves since issuance, there could be a principal saving for early repayment. The old Higher Education Funding Council for England guidelines for universities, used to require that debt service be annualised when calculating covenants. If these requirements were included in the covenants of some of the older private placements, it may also be wise to look at pre-payment, to reduce the accounting impact of principal repayments.

In the case of traditional bank lending, the sector continues to offer an attractive proposition. It is imperative that borrowers utilise effective financial modelling to regularly engage with lenders, to highlight any potential changes in financial performance, detailing the mitigating actions being taken.

Volatile times: the impact of foreign markets on university balance sheets (GBP to USD FX rate)



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Case Study: University of London

£50 million new sustainability-linked funding for UoL

UNIVERSITY OF LONDON

Engagement Overview:

- **University of London (UoL),** is the UK's leading provider of digital and blended distance education internationally, with **45,000 students** in **190 countries**
- Centrus supported UoL, arranging a new **£50 million sustainability – linked five-year RCF with Lloyds,** featuring flexible covenants and enhancing the university's liquidity and credit risk profile

Centrus Solution and Value-Add:

- Centrus worked closely with UoL through engaging with and obtaining terms from lenders to the higher education sector
- This included preparation of comprehensive materials to position the university's credit and operating strengths. Centrus utilised our market insights to enable strong terms to be negotiated from a range of potential lenders
- A report was prepared for Committee evidencing Lloyds' offer as providing the most flexible and cost-effective solution, best achieving the funding objectives, while also aligning with UoL's commitment to ESG

Client Outcomes:

- £50 million RCF arranged, enhancing UoL's liquidity position with flexible covenants that provide greater freedom to enable future ambitions
- The funding is sustainability linked (ESG), an innovation for the sector, enabling UoL's ongoing commitment to sustainability to be aligned with funding
- Through achieving set ESG KPIs, the university benefits from reduced funding costs, with cost savings able to directly support UoL's students, stakeholders and wider ESG commitments
- UoL has retained Centrus as its treasury advisor and recently renewed its contract

> **"Centrus' support has been invaluable, driving the best terms possible for UoL, providing assurance throughout the process, guiding us in a challenging market environment and helping us achieve this great outcome"**

Rita Akushie
Pro Vice-Chancellor Finance & Operations, University of London

Case Study:
Queen's University Belfast – FX Hedging

QUEEN'S UNIVERSITY BELFAST

Transaction Overview:

- Centrus worked with QUB to develop an appropriate hedging strategy, to allow the university to offer its international students cost certainty by allowing them to pay tuition fees in their local currency at a fixed rate
- QUB aimed to increase international student numbers by providing a stable, predictable tuition fee in their local currency
- To achieve this, the university needed a robust FX hedging solution to lock in exchange rates for the entire academic year

Centrus' Role:

- Assessed QUB's requirements and understanding of the importance of providing a fixed-price option for international students
- Set up and co-ordinated QUB's hedge provider to structure a non-deliverable forward (NDF) to hedge against currency fluctuations in foreign currencies such as MYR
- Developed a tailored strategy aligning with the university's payment schedule, ensuring cost certainty and managing FX risk
- Participated in and co-ordinated dry runs and execution exercises
- Co-ordinated with the hedge provider, payment platform and university for seamless hedging integration

Client Outcomes:

- The hedging strategy was successfully implemented, allowing the university to offer international students a fixed price for their tuition fees in local currencies
- This gave students cost certainty and protected the university from adverse currency movements

"**Centrus guided us through each step of the FX hedging process, ensuring we implemented the best strategies to offer our international students cost certainty. Their clear, transparent advice helped us navigate complex decisions with confidence. We look forward to future collaborations**

Patrick Anderson CFO, QUB

Working with QUB on this important FX hedging strategy was a pleasure. We were proud to assist in implementing a tailored solution to provide cost certainty for international students in a volatile currency market. It was a complex transaction, but the collaboration between the university, hedge provider and payment platform was crucial to its success"

Jason Murphy Co-Founder, Centrus

Pensions liabilities

As well as the operational challenges facing the sector, many universities face challenges related to pension liabilities, which continue to grow and exert additional pressure on balance sheets. Most staff working in pre-1992 higher education providers in the UK are members of the Universities Superannuation Scheme (USS). Staff working in the post-1992 higher education institutions in England and Wales, are normally offered membership of either the Teachers' Pension Scheme (TPS) or a Local Government Pension Scheme (LGPS).

The USS is a funded hybrid final salary and defined contribution pension scheme. Given that the liabilities of the USS are mutualised across its members, any concern regarding the financial strength of its members creates a contingent liability on those left standing. It was this concern that led Trinity College Cambridge to withdraw the college unilaterally from the USS in May 2019, replacing the USS scheme with a defined benefits scheme. The buyout cost the college £30 million. Trinity was followed by the University of Coventry in 2021, when it made a £35.9 million payment to settle outstanding pension liabilities following withdrawal from the USS scheme.

The latest USS valuation,[9] based on the funding position on 31 March 2023, was concluded in December 2023. This found that the value of the scheme's assets exceeded the value of its liabilities. This means that the deficit recovery plan (reflecting the increased employer contributions needed to reduce the deficit), agreed because of the previous valuation, is no longer required. As a result, the employer contribution rate has decreased from 21.6% to 14.5% (with effect from 1 January 2024).

The TPS provides pensions for academic staff in post-1992 institutions (the "new" universities, many of which were formerly polytechnics). In contrast to the USS scheme the TPS is "notionally funded" – that is, contributions are assessed on a quasi-actuarial basis, but in reality no funds are built up and the liability for future pensions is ultimately borne by the taxpayer.

The latest OfS data[4] shows that 86 providers contributed to the TPS, with employer contributions rising from £484 million in 2021-22 to £519 million in 2022-23. The employer contribution rate rose by 5% from 23.6% to 28.6% from 1 April 2024. By 2026-27, forecasts show that providers expect TPS employer contributions to total £725 million, 40% higher than reported in 2022-23. Unlike the USS scheme, members of the TPS scheme are unable to exit, as they are legally bound to offer the TPS, restricting the flexibility of the pension arrangements they offer and placing a further burden on finances.

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In addition to the accounting complexities of pensions, if universities are already looking to renegotiate their banking covenants and the lender looks for security against the loan, then the university may have to engage with the trustees of its pension scheme. With respect to the largest USS scheme, the trustees have a debt monitoring framework, which sets out how universities, as employers, and the trustees will monitor sector debt and, if necessary, work together to protect the covenant to the scheme in the case of financial difficulty.

Increasingly, universities are looking to alternative revenue streams to bolster their balance sheets. Of particular focus recently has been the opportunities available from commercialising the intellectual property developed through academic research. HSBC Innovation Banking's Q2 UK Innovation Update[10] in partnership with Dealroom, found that UK universities create more spinout value than anywhere else in Europe, more than double second-placed Germany. Yet despite the UK's inherent advantages as a global leader in science, innovation and finance, the university sector has struggled to effectively leverage these strengths to support its commercialisation and growth activities.[11]

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Addressing the challenges

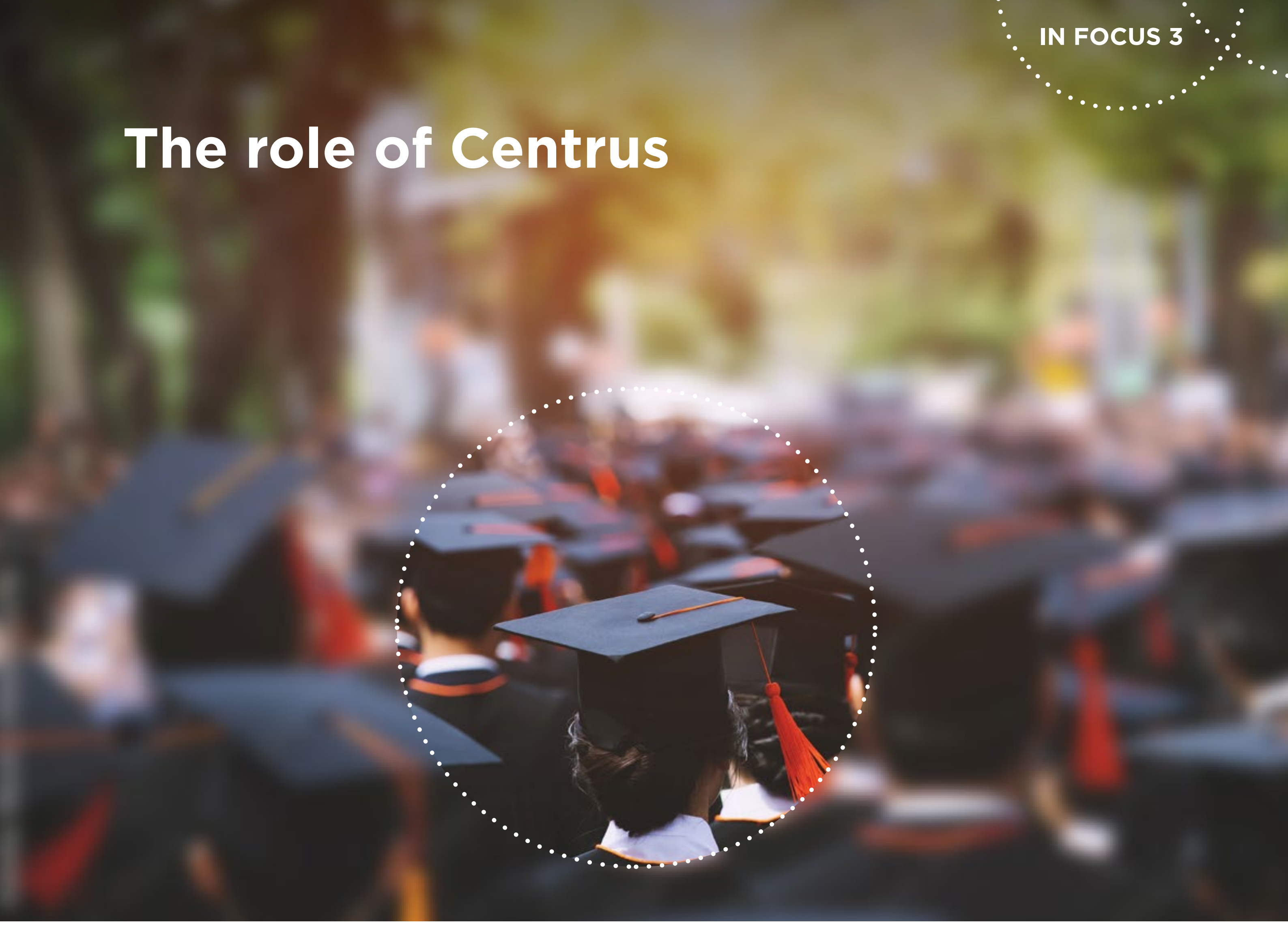
Several key issues have been identified that are limiting the success of university spinouts and commercialisation efforts. These include limited institutional investment, a lack of standardisation in spinout structures, insufficient commercialisation resources at some universities, and a lack of regional co-ordination among university clusters.[12] The combination of these factors has created a funding gap, particularly at the seed and early stages of spinout development, when uncertainty is highest.[13]

To address these challenges, experts have proposed a range of recommendations. These include increasing the supply of patient capital from UK institutional investors such as pension funds and insurance companies,[14] establishing innovation accelerators and collaboration zones to support regional growth,[15] and providing greater funding for proof of concept, market readiness and early-stage spinout support.[13] Initiatives to improve standardisation, commercialisation resources and regional co-ordination have also been suggested.[12]

"Centrus' support has been invaluable, driving the best terms possible for UoL, providing assurance throughout the process, guiding us in a challenging market environment and helping us achieve this great outcome"

Rita Akushie, Pro Vice-Chancellor Finance & Operations, UoL

The role of Centrus



The financial challenges facing the UK university sector are severe and complex, with significant implications for students, staff and the broader economy. Addressing these challenges requires a combination of institutional strategies and sector-wide interventions. Universities must focus on diversifying their income sources, improving cost-efficiency and enhancing risk management. Meanwhile, the government and sector regulators must develop policies that promote financial stability, support collaboration and create a framework for managing financial distress.

By taking proactive measures at both the institutional and sector levels, the UK can safeguard its higher education system, ensuring it continues to deliver high-quality education, contribute to economic growth and maintain its global standing, in an increasingly competitive environment.

"We are delighted our new borrowing arrangements link to our inclusion and equality commitments, given these commitments to the university's strategic agenda"

Craig Jones, former Chief Finance and Commercial Officer, Derby

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Centrus has an experienced team of recognised corporate finance experts who can offer universities a complete advisory service across the full spectrum of treasury, real estate and energy needs. We have arranged private placement, bank restructurings and real estate financings for a range of universities, and our extensive market coverage means that we can provide you with business planning and governance support to address the full range of financing options. We pride ourselves on our market-leading treasury advisory services, covering:

- Modelling and financial analysis
- Credit analysis and credit ratings
- Business plan analysis
- Financing strategy
- Student accommodation
- Campus development
- Equity investment and joint ventures
- Sale and leaseback structures
- Onsite energy generation opportunities
- Decarbonisation and retrofitting
- Specialist financing structures and joint ventures mentioned above
- Power purchase agreements
- Bank and bond market financing
- Investor relations

Centrus is a financial services business that believes in finance with purpose. We are a leading corporate finance advisory firm focused on real assets, sustainability and essential services.

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