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THE FURTHER EDUCATION FUNDING COUNCIL

For information

Circular 01/02

Finance

Further Education Sector: Credit Analysis

Summary

The purpose of this circular is to provide details of the results of a credit analysis of the further education sector undertaken by Standard & Poor's in relation to the establishment of Education Capital Finance plc, a financial intermediary which has been established to provide loan finance to sector colleges on the basis of aggregating the loan requirements of a number of colleges.
The credit analysis is based on a review of general sector documentation, and gives a broad indication only of the likely credit quality of the further education sector. It does not constitute a credit rating of the sector or of any particular institution.
The credit analysis indicates that, based on the information provided, most FE ratings are likely to cluster around the low investment grade (BBB-/BBB).

Contents *paragraph*

Introduction	1
Background	2
Credit Analysis Report	5
Annex	

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Further Education Sector: Credit Analysis

Introduction

1 The purpose of this circular is to provide details of the results of a credit analysis of the further education sector undertaken by Standard & Poor's in relation to the establishment of Education Capital Finance plc.

Background

2 In 1999 the Council set up a small working group consisting of principals and a representative of the Association of Colleges to assess the feasibility of establishing a funding vehicle for further education colleges. A steering group was convened to take forward the necessary work, advised by The Housing Finance Corporation Limited.

3 The steering group held a number of meetings and, following a feasibility study, recommended that a confidential credit analysis of the further education sector should be undertaken in order to provide an indication to prospective funders of the credit strength of the sector.

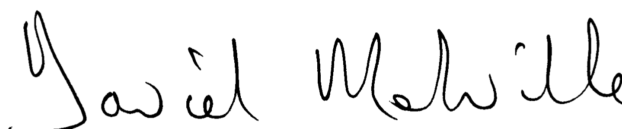
4 Standard & Poor's was subsequently appointed to carry out the credit analysis, and they produced a report in March 2000. Whilst their report was originally provided on a confidential basis, Standard & Poor's has now agreed that its report may be made public. A copy of the report is attached as an annex.

Credit Analysis Report

5 The report identifies, from the credit rating agency's perspective, the credit strengths and weaknesses of the sector, and provides a high level overview of the sector, as well as of the way in which the Council monitors colleges.

6 Investment ratings are intended to give an indication of the likelihood of a borrower defaulting on a loan repayment, and the higher the rating the lower the default likelihood. There is not a significant difference between an 'AAA' rating, the highest rating, with an average default rate of about 1%, and a 'BBB' rating with an average default rate of about 5%. On the other hand, there is a significant difference when compared with a 'BB' rating which has an average default rate of about 16%.

7 Whilst the report does not constitute a credit rating for the sector, it does provide a view from one of the leading credit rating agencies on the likely credit rating of most colleges. The view that most colleges' credit ratings are likely to be of investment grade is welcome news, and should provide comfort to prospective lenders to both individual colleges and Education Capital Finance plc.



Standard & Poor's

Further Education Sector in England: Credit Analysis

Introduction and Executive Summary

This report was written in March 2000 for the Further Education Funding Council (FEFC) and describes the key credit issues associated with the Further Education (FE) sector that Standard & Poor's has identified. It is important to stress that Standard & Poor's credit analysis is based on a review of the general sector documentation and financial analysis provided by FEFC up to March 2000. This credit analysis is only a broad indication of the likely credit quality of the FE sector and does not constitute a credit rating of the sector or any particular institution. Please note that estimations of credit quality are a matter of opinion, and no particular methodology is a guarantee of performance of a particular entity or sector or a prediction of performance in the future. The findings are based on information provided to Standard & Poor's for which Standard & Poor's bears no responsibility for accuracy. This report does not constitute a recommendation to buy, hold, or sell securities.

Standard & Poor's has identified the following features as **credit strengths** of the FE sector:

1. Statutory requirement to provide FE to a local population which has encouraged stability in the numbers of FE institutions;
2. Strong Government support for the sector and the sector's role in delivering wider Government policy objectives;
3. A regulator whose powers include setting financial targets for individual FE institutions, controlling borrowing and capital expenditures as well as being able to appoint members to attend and vote in governing body meetings of FE Colleges;
4. Robust national demand, with historic growth in student numbers and projected further increases;
5. Forecast year-on-year income growth with improved financial flexibility resulting from reductions in annual efficiency targets and an improved financial settlement for the sector;
6. Low debt levels and a net cash position at a sector level.

Standard & Poor's has identified the following features as **credit weaknesses** of the FE Sector:

1. Weak financial profile, in particular very tight operating margins with negligible surpluses;
2. Severe recent fiscal pressures which have limited financial flexibility and forced significant cutbacks in many cases – including staff pay freezes;
3. Individual colleges can experience quite significant volatility in student numbers and Government policy objectives to achieve wider participation may serve to exacerbate this problem;
4. The small size of many FE colleges can result in relatively weak financial, governance and administrative infrastructures;

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5 Changes to the regulatory system are as yet untested and there may be transitional problems associated with the change in regulation;

6 The uncertain impact of possible increasing competition on FE institutions’ business under the new regulatory environment.

It is the view of Standard & Poor’s that based on the information provided, the majority of FE ratings are likely to cluster around low investment grade (BBB-/BBB). A number of FE institutions, particularly those in financial health category C, are likely to be non-investment grade. It is unlikely, given the current financial position and general operating environment, that FE institutions will be rated in the high investment grade categories.

Further Education credit issues are set out in more detail in the following sections:

- **Government Policy**
- **Regulation**
- **Demand**
- **Financial Analysis**

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Government Policy

Key points

- *The development of further education is a key Government policy objective and fits with wider Government philosophy and policy objectives.*
- *The FE sector will be the main platform for growth in student numbers (although wider participation initiatives may increase the risk of student number volatility at an individual college level).*
- *Improved financial settlement has been agreed for the sector that should alleviate, although not remove, some of the considerable financial pressures experienced by the sector in recent years.*

Philosophical Approach

The Labour Government elected in 1997 has made education a high priority. Relative to other major economies, the UK's labour productivity is low and there are low skill levels at intermediate and technician levels. With low skills increasing the risk of unemployment and social exclusion, encouraging a culture of learning across all elements of society is seen as a way of increasing national competitiveness and reducing the burden of the dependency culture.

'Fit' with other Government Initiatives

The Government's policy objectives for FE fit into a wider programme of government initiatives. *The Learning Age* Green Paper set out the Government's vision for inclusive lifelong learning that would enable people to reach their full potential and deal with rapid economic and social change. Key to this is the creation of a single body to oversee national strategies for post-sixteen learning to include further education and training.

The Government gives particular emphasis to inclusiveness and wider participation. This fits with a wider programme of initiatives aimed at tackling social exclusion, such as the New Deal programme aimed at getting long-term unemployed people back to work.

Strategy for Growth

In the five years following the 1992 Act student numbers in FE increased by approximately one third from three to four million and the Government is planning to have 700,000 additional students in further education by 2001/2.

The Government has stated its commitment to investing in the institutional framework that supports continual learning. The FE funding settlement for 2000/01 and 2001/02 will add £365 million to spending levels. This will help alleviate, although certainly not remove, the current financial pressures being felt within the sector. The additional funding is specifically targeted at ring-fenced Government policy objective areas and will include:

- doubling of the Standards Fund in 2001/2
- increased access funding
- widening participation funding.

The Standards Fund is designed to encourage the spread of best practice across the sector. Access funding allows for students disadvantaged by financial hardship to be partly compensated to

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encourage their continued involvement in further education. This may involve some financial assistance with, for example, high transport or childcare costs. Widening participation funding encourages the enrolment of students from socio-economically deprived areas, where educational attainment levels and educational ambition are typically low.

A possible consequence of wider participation is that the planned increase in students increases the risk of volatility of student numbers for individual institutions. The earmarking of additional funds to meet specific objectives also means that inevitably there will be an uneven distribution of this additional funding to individual FE institutions, with some FE institutions unlikely to gain much financially from the additional funding.

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Regulation

Key Points

- *FE institutions are incorporated as autonomous, independent charitable institutions, separate from both Central Government and the Local Education Authorities that had previously managed them. Neither the Government nor FEFC will guarantee the obligations of any FE institution, nor will they necessarily provide additional funding in times of financial distress.*
- *The statutory requirement to provide FE to local populations is a strong incentive for the continued support of the regulator for FE institutions.*
- *There are strong systems for controlling the financial management of individual FE institutions, approving capital investment, and monitoring educational achievement and financial performance. The increased statutory powers recently given to FEFC give more scope to address FE institutions that are failing to meet financial and educational performance targets.*
- *The change in regulation provides both opportunity and potential threats. Opportunities include FE institutions being able to provide a wider range of services. Threats include the risk associated with the process of change and the uncertainty regarding the new regulator's monitoring arrangements, as well as the risk of increasing competition for contracts.*

Background

The 1992 Act established the Further Education Funding Council (FEFC) to administer the central government grant for further education. The Act requires FEFC to secure the provision of sufficient and adequate facilities for further education and to make provision for assessing the quality of further education and monitoring the financial health of individual institutions. This statutory obligation to ensure adequate FE provision is a key safety net for individual institutions, especially where the FE college effectively has a local monopoly position or there is no over-capacity within a defined geographical area, as Government would find it hard to step away from a failing institution.

FEFC Statutory Powers

FEFC was given additional statutory powers in October 1999 to nominate up to two representatives to attend and vote in the governing body meetings of an FE institution. Previously, FEFC could only recommend to the Secretary of State the removal of members from the governing body of an FE institution. This reduced the immediacy of impact following action taken by FEFC regarding FE institutions that appeared to be failing.

These new powers tighten the central control over the institutions, and highlight a difference in emphasis between the current Labour administration and the previous Conservative administration, with less weight placed on autonomy and more weight placed on a planning and partnership approach to see policy objectives delivered.

Dissolution of Institutions

Because institutions are statutory corporations they can only be wound up by order of the Secretary of State – who will determine (following consultation with FEFC) the transfer of assets and liabilities. Standard & Poor's is not aware of institutions that have become insolvent and as a consequence have been dissolved.

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FEFC Step-In

FEFC can give additional support to assist the transfer of assets and liabilities to another institution. FEFC cannot guarantee the obligation of institutions and is not bound to offer support in an insolvent dissolution. If FEFC did not step in, then creditors would have the usual rights to realise assets to try and repay debts.

In the case of Bilston College in the West Midlands, public sector debts were transferred to FEFC as part of a merger settlement. The College, considered an essential asset, continued to provide FE to its local population under new management. Although this does not guarantee the repayment of private sector debt, the supporting actions of FEFC should give some comfort to potential lenders.

Given FEFC's continual involvement in reviewing strategic plans and finances, it is difficult to envisage a situation where, having received support over a period of time, an institution is suddenly deemed not to be essential in providing FE services to its local population. However, despite FEFC's ongoing support, there is no guarantee of timely repayment of debt from a financially troubled FE institution nor will FEFC undertake to guarantee the debt obligations of FE institutions.

Controls over Financial Management

FEFC allocates funding to institutions under the terms of a financial memorandum which is agreed with individual institutions and helps ensure that each institution has appropriate financial management controls in place and is working to agreed business plans. Ultimately however, this control does not guarantee that financial targets are met by individual institutions, and FEFC's power to withhold funding because of failure to comply with the terms of the financial memorandum, under certain circumstances may conflict with the statutory duty to ensure that FE services are provided to a given locality.

Controls over Borrowing and Approving Capital Investment

Governing bodies of FE institutions require FEFC consent for transactions over £1 million or 5% of annual revenue. Institutions are also required to set aside 2% of their funding allocation to spend on capital purposes. Whilst FEFC does also make available some funds for capital investment purposes, the FE college will often still need to close the funding gap through borrowing or reducing its cash balances.

Governing bodies of FE Institutions must seek prior written consent from FEFC for any secured or unsecured borrowing, and also for land and buildings transactions. Consent is given for up to 5% of annual revenue on an unsecured basis, and for 5% of annual revenue (or £1 million) on a secured basis for estate development purposes where the new development is the security. The proposed project should generate a real rate of return of at least 6%, and should demonstrate that when the project is operational a surplus will be generated and sufficient cash will be generated to meet debt charges.

Monitoring

The FEFC inspectorate assesses aspects of a college's operations under eight areas including responsiveness and range of provision, governance and management. Institutions are formally inspected approximately once every four or five years. Each area is graded on a scale of 1 to 5. These gradings are made public.

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Financial health is monitored through the financial and operating returns made by institutions. Each institution is graded annually from A to C (with C the lowest). Financial health grades are not made public.

Financial health group criteria include the following broad categories:

- Short-term solvency
- Ability to generate cash and
- Indebtedness.

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The key ratios used in the assessment of financial health are shown in the table below, together with the average ratios for FE institutions in each financial health category:

	Group A	Group B	Group C
Average current ratio	2.52	1.50	0.71
Average cash days	73	43	18
Average reserves	£2.35 m	£1.05 m	£0.17 m
Average cash flow from operations	£297,000	£271,000	£296,000

Overall, on a purely financial standalone basis, it is likely that even Group A institutions would be rated as non-investment grade. However when the financial statistics are viewed within the context of government support, core and relatively stable government funding and the strong regulatory role provided by FEFC, it is likely that many FE institutions (particularly in Groups A and B) could be rated at a low investment grade level.

Comparative Financial Performance between Institution Types

Based on the financial health categories, broadly speaking, sixth form colleges' financial performance tends to be above the sector average and agricultural colleges' performance tends to be below the sector average.

Sixth form institutions traditionally have relatively more stable student types compared to FE institutions that have comparatively more volatile student populations (with more part-time students likely to be less compelled to complete their courses).

Agricultural institutions were historically highly funded and have suffered particular financial pressures as a result of convergence and their limited ability to diversify into other areas. A number of agricultural institutions have merged (both together and with universities) in response to their financial situation or to improve their business position. All mergers are approved by FEFC and the Secretary of State.

Proposed Regulatory Changes

The Government is proposing to create a single body to oversee national strategies for post-sixteen learning. Currently, institution based learning is largely provided by FE institutions and is funded through FEFC. Workplace training is secured by the Training and Enterprise Councils (TECs) and is funded separately. There are 74 TECs, autonomous entities funded by Government that are responsible for assessing local training needs and purchasing training programmes.

A national Learning & Skills Council (LSC) is to be established to replace FEFC and the TECs in 2001. LSC will be responsible for administering a £5 billion budget and will operate through a network of 47 local LSCs. The local LSCs will have a degree of flexibility and autonomy and limited scope to vary the national funding tariff.

The powers of LSC are to be 'no less rigorous' than the existing powers of FEFC. However, the precise powers of the local LSCs are yet to be fully defined, as is their relationship with the national LSC body.

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It is likely that the local LSCs will have a degree of financial autonomy and may have discretion over as much as 10 to 15% of annual budgets for student support funding aimed at students living in relatively deprived areas. FE course provision at FE institutions and associated funding allocation is still likely to be determined at a national level. However, given the narrow operating surpluses, any local discretionary shift of funding over time may have a material impact on the financial position of individual FE institutions.

While many FE institutions may be well placed to compete for additional training contracts, there is a risk that private training companies may cherry-pick the more lucrative training courses following the change in regulation, as local LSCs are likely to be encouraged to diversify training provision.

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Demand

Key Points

- *Student demand has increased historically and is expected to continue to increase in the future.*
- *While there are alternative providers of FE services, the competitive threat posed is somewhat unproven.*
- *The stability of institution numbers recorded by the sector supports the key role played by institutions in the delivery of FE, however, at an individual level there are a number of factors that may result in volatility of student numbers.*

Growth in Student Numbers

Growth in FE students is shown in the table below:

	1994/95	**1995/96**	**1996/97**	**1997/98**	**1998/99**
FE Students	2,999,500	3,505,600	3,920,900	3,948,700	3,835,800

N.B. Figures above are absolute student numbers ***not*** *full-time equivalents.*

Absolute student numbers have increased by almost a third over the past five years. The proportion of part-time students has increased during this period from 76% to 81%. The proportion of over 19 year-old-students has also increased during this period from 76% to 80%.

This growth in part-time adult education fits with the Government's wider agenda of widening participation in education and encouraging lifelong learning. Targeted funding is aimed at continuing to grow student numbers through access funds (to help students on a discretionary basis with travel, childcare costs etc.), and widening participation funding (additional funds for students from socio-economically deprived areas). The Government has set an ambitious target of increasing FE student numbers by an additional 700,000 students by 2002.

Competition

The FE sector faces potential competition from a number of sources:

- School Sixth Forms

A growth in school sixth form provision could attract students from sixth form institutions. The establishment of new school sixth forms requires approval from the Secretary of State. Given the wider Government policy objectives associated with FE it is unlikely that the Secretary of State would support significant growth in school sixth forms that would be in direct competition with sixth form colleges. However, individual FE colleges could still be adversely affected by increasing school sixth form provision. School sixth form provision is planned to come under the FE sector regulator's jurisdiction following the proposed regulatory changes and this is likely to further reduce the competitive threat.

- Higher Education (University) Sector

In recent years there has been a blurring of the boundaries between FE and HE. HE institutions traditionally are stronger with more political weight and are more likely to protect their particular area. There is a risk that some HE institutions may move into FE territory. Given their stronger academic and 'brand' reputation, this should be seen as a real risk for certain FE colleges,

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especially those that also have HE provision. However, the majority of HE institutions are unlikely to compete directly with FE colleges for specific vocationally-based courses because of their desire to differentiate themselves on their academic reputation.

- Private Training Companies

Some TEC-funded FE institutions are already in competition with other training providers and have been competing for TEC-funded training for nearly seven years. When TEC-funded training and FE merge as is proposed by the Government, FE institutions may be subject to further competition with private training companies for industry training contracts. Given the potential for local purchasing flexibility, private companies may seek to cherry-pick the most lucrative contracts leaving the low margin work for FE institutions. Certainly, one would expect private sector companies to have a lower cost base, and therefore the size of their threat really depends on how well quality is measured and taken into account (one would expect the FE institutions still to differentiate themselves in terms of quality).

Stability of Sector

The number of institutions has remained fairly stable for a number of years. Since 1992, the number of institutions has declined from approximately 460 to 428 through a process of merger. The statutory requirement to provide further education to a given locality militates against any significant rationalisation in the sector.

The geographical distribution of FE institutions is a historical legacy left over from local authority provision. FEFC has not indicated a particular area where, in its view, there is specific over-provision. However, there are examples where FEFC has encouraged the merger of an institution that was facing financial difficulties with another nearby institution, rather than agree to an individual rescue plan. Standard & Poor's is not aware of any examples where funding was withdrawn from an institution specifically because of perceived over-provision in any one area.

The delivery of FE objectives is clearly seen by FEFC as a college-based activity. There are no significant alternative approaches to delivering FE proposed for the foreseeable future.

Stability of Individual Institutions

While there are features of stability at a macro level, at individual institution level there is potential for volatility of student numbers, especially when compared to Universities. Factors affecting stability of student numbers include:

- academic standards in the sector are lower and pass rates are low
- student attrition rates are higher than in the HE sector
- students typically have low educational attainment levels and come from socio-economic backgrounds where educational achievement is given low priority
- there is also a counter-cyclical element to the conventional training provided by FE institutions, whereby training is more likely to be sought when job prospects are poor and given a lower priority when the economy is booming.

Because FE institutions in general operate with students with low academic attainment levels there is little scope for flexibility to respond to the potential volatility in demand by, for example, reducing academic attainment levels to increase student numbers. However, widening participation may help offset this limited flexibility.

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Financial Analysis

Key Points

- *Year on year income levels are forecast to increase.*
- *Increases in the target convergence level of funding and reduction in annual efficiency savings should help alleviate financial pressure and volatility in income within the sector.*
- *Overall, the sector remains under some considerable pressure, only just breaking even year-on-year, and operating within extremely tight margins.*
- *Very low levels of debt with modest proposals for increasing debt burden and relatively high cash balances (somewhat offsetting the volatility in income at individual college level and the tight operating margins).*

Funding Sources

The sector receives some £4 billion in funding annually. Approximately three quarters of this funding is from the Government via FEFC. The remainder comes from a number of sources including tuition fees, higher education funding (HEFC), Training and Enterprise Councils (TECs), EU funding, and Local Authorities. The vast majority of funding to the FE is therefore from the Government.

Funding from FEFC is based on funding units, calculated by individual institutions and independently audited. Units reflect the resource input required to meet the delivery of particular courses, as well as a headcount. The calculation of units and associated allocation is complex, and requires detailed data collection by institutions. On occasions, poor IT infrastructure has lead to the inaccurate collation of student numbers by an individual FE institution and a consequent claw back in income. In general the quality of IT appears to have improved in recent years, however, IT may still be an issue with particular individual colleges.

The split between FEFC income and other income, both actual and forecast, is shown in the table below.

FE Sector Actual and Forecast Income Sources (%)

	1995/96 Actual	**1996/97 Actual**	**1997/98 Actual**	***1998/99 Forecast***	***1999/2000 Forecast***	***2000/01 Forecast***	***2001/02 Forecast***
FEFC Income %	71	71	69	*68*	*68*	*68*	*68*
Other Income %	29	29	31	*32*	*32*	*32*	*32*

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Income & Expenditure Analysis

The table below shows the actual and forecast annual income and expenditure for the FE sector:

I&E Actual and Forecast (£ billion)

	1995/96 Actual	**1996/97 Actual**	**1997/98 Actual**	***1998/99 Forecast***	***1999/2000 Forecast***	***2000/01 Forecast***	***2001/02 Forecast***
Income	3.77	3.86	3.71	*4.02*	*4.25*	*4.33*	*4.40*
Expenditure	3.90	3.89	3.67	*3.99*	*4.25*	*4.30*	*4.40*
Surplus/ (deficit)	(0.12)	(0.03)	0.04	*0.03*	*0.01*	*0.03*	*0.00*

Income

Income levels fell in 1997/98 because the Government withdrew the recurrent grant demand-led element. In the previous year this element amounted to approximately £200 million. In 1998/99 the Government increased the recurrent grant main allocation. The main allocation from FEFC is projected to increase year-on-year.

Funding levels (based on an allocation per unit) were set based on funding level legacy from local authorities. This led to a disparity of income allocation per unit between FE institutions. In order to address this, convergence levels have been set to get FE institutions on an even funding basis. As funding is equalised through the process of moving towards a convergence level of funding, a number of FE institutions have had to and will have to budget for reducing income.

The convergence level has been set at approximately £17 per unit (the equivalent for universities is around £35 per unit). Convergence has resulted in huge financial pressures for those FE institutions historically over-funded. Examples include institutions that historically were funded at £25 per unit, having to reduce in real terms by over 30% to £17 per unit. However, this volatility and financial instability is likely to reduce as the gap in average funding levels between different FE institutions closes over time. FEFC has also agreed to extend the convergence period for FE institutions in certain instances to ensure their financial stability.

FEFC guarantees that 90% of the previous year's funding allocation will be made available to individual institutions in the following financial year. However, given the extremely tight operating margins, a loss of 10% of income could cause severe difficulties to an individual institution.

Relatively over-funded institutions may experience significant reductions year-on-year. Where expenditure cannot be reduced easily this could result in short-term financial difficulties.

Where institutions do not provide for the expected number of courses and/or student numbers in any one year, unused income allocated to the institution can be recovered by FEFC.

In recent years, the sector has been put under considerable financial pressure by the Government's requirements for it to achieve 5% per annum efficiency savings, a steeper target than that applied to many other UK public sector bodies. Recently the Government has loosened the annual savings target level, and FE institutions are now required to make 1% annual efficiency savings. This 1% annual real reduction therefore should bring some financial relief and brings the efficiency savings targets more in line with other public sector bodies.

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In recent years, fiscal pressures across the sector have increased, with both convergence and efficiency savings targets requiring many institutions to make significant cost reductions and to look to improve their operational efficiency. The new money announced in the financial settlement for the sector will go some way to relieving pressures on individual institutions, but because of the targeted nature of this additional funding towards key policy objectives, the flexibility of this additional resource is somewhat limited.

Expenditure

Approximately two thirds of all expenditure is on pay. Given the recent fiscal pressures, staff pay has remained fairly static, despite increasing student numbers. A number of institutions have had pay freezes and the differentials in pay which encouraged teachers from other educational establishments into the FE sector have been in many cases eroded. With the pay gap closing, there is a risk that staff recruitment and retention could become a significant issue. Pressure may mount for a pay increase that would reinstate differentials. Therefore the on-going flexibility of FE institutions to reduce costs through pay cuts must be seen as very limited.

Non-pay expenditure includes teaching department costs (materials, equipment etc.), administration and premises related costs. Given the very low levels of debt, interest payments are negligible.

Financial Ratio Analysis

The financial ratios show the sector to have the following key financial characteristics:

- **Low operating margins**

The sector pretty much breaks even each year without making any significant surplus (it made small deficits in 1995/96 and 1996/97). The trend in surpluses is within plus or minus 1%. Low operating margins are primarily a consequence of the Government funding system that requires significant efficiency savings to be made, which has historically led to real reductions in funding levels.

- **Low debt**

Gross debt levels are low (less than 5% of total income). Forecast debt levels are expected to increase to 6% of total income. Interest payments are consistently well below 1% of total income. This low level of debt is a key credit strength, especially as high cash levels mean that the sector has a positive net cash position (i.e. gross debt less investments and cash at bank). This goes some way, but not all the way, towards alleviating the very thin operating margins that the sector works within.

- **Cash flow position is not strong, but still better than I & E performance**

The sector has a positive cash position with an annual net cash position in excess of £300 million. Interest covers are high and net cash flow as a percentage of debt is high. Annual positive cash flow after debt service is approximately 5% of total revenue which, whilst not strong, is certainly an improvement on the I & E performance of around 1%. The key concern would be if these institutions increased their debt burden too much through finally being able to tackle pent-up capital investment plans.

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Table of Key Financial Ratios for the FE Sector

	Actual Year Ended 31/7/96	Actual Year Ended 31/7/97	Actual Year Ended 31/7/98	*Forecast Year Ended 31/7/99*	*Forecast Year Ended 31/7/00*	*Forecast Year Ended 31/7/01*	*Forecast Year Ended 31/7/02*
Financial Summary							
Income Ratios							
FEFC Grant as % of Total Income	71%	71%	69%	68%	68%	68%	68%
Staff Costs as % of Total Income	68%	65%	62%	62%	62%	63%	64%
Interest Payment as % of Total Income	0.3%	0.5%	0.6%	0.6%	0.6%	0.7%	0.7%
Net Operating Surplus as % of Total Income	-3.3%	-0.8%	1.1%	0.7%	0.2%	0.7%	0.0%
Interest Cover	-9.6	-1.7	1.8	1.1	0.3	1.0	0.0
Cashflow Ratios							
Net Cash Inflow from Operating Activities as % of Debt	2.7%	91.7%	91.7%	59.5%	42.6%	54.9%	54.7%
Net Cash Inflow from Operating Activities interest cover	0.2	7.7	7.2	4.8	3.8	4.8	4.6
Cash interest cover	6.8	14.7	13.2	9.5	6.9	7.8	7.5
Balance Sheet Ratios							
Total Debt/Total Income	3.2%	3.8%	4.8%	5.0%	5.8%	6.0%	5.8%
Current Ratio	0.78	0.84	0.91	0.94	1.00	1.03	1.13
Key Figures and Trends							
Total Income (£m)	3,772.4	3,858.6	3,714.5	4,022.8	4,254.2	4,334.0	4,397.7
Total Debt (£m)	119.5	147.9	178.2	200.2	246.4	260.9	253.0
Net Cash (Debt) position (£m)	324.0	347.6	408.9	413.4	351.0	344.5	413.2
Total annual Financing Need (£m)	111.0	34.2	53.9	34.3	24.2	33.1	42.7

Source: FEFC

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