

HE Matters

Delivering a First Class Estate

Summer 2013

pwc

Welcome to *HE Matters*

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In an increasingly competitive market where all Universities are striving to offer their students, staff and visitors the most positive and rewarding experience possible, the quality of the built environment, the accommodation offering, and the delivery of estates services are playing a more critical role than ever before. In response to this, Universities are developing exciting and ambitious estates plans that propose significant investment in new facilities, and innovative ways of delivering services.

In our work within the higher education sector we are seeing these themes play out at Universities across the UK. Each situation is different and the motivations, objectives and issues need to be considered in the context of each institution's longer term strategic planning. Nevertheless, there is clearly a lot that can be learned from market experience and we therefore believe it is valuable and topical to focus this special edition of HE Matters on Delivering a First Class Estate.

Strategy

Our experience suggests that developing a successful estates strategy requires not only an identification of potentially iconic new build projects, but also recognition that existing assets must be used efficiently and flexibly. As such, creating space that can adapt to changing needs, improve the sustainability and environmental efficiency of the campus, and maximise the third party value of the facilities are all key components of a commercially driven estates strategy. These strategies must be accompanied by a robust financing plan and a realistic implementation programme.

Financing

Improving campus buildings and facilities requires investment, and this in turn requires access to long term finance. Directors of Finance are well aware that the traditional lenders to the sector are unable to write loans with the same duration and pricing levels of the past, and that the level of HEFCE provided capital is also significantly lower now than it was a few years ago. New sources of finance, as well as new commercial models for securing this finance, are therefore needed and are being employed across a variety of projects in the sector.

Student residences

Student accommodation has been one element of the estate which many Universities have, for quite some time, utilised private sector partnering models. These models have, in the past, taken various forms, but we are now seeing an increased interest from the sector in exploring options that might deliver refurbishment expenditure and the third party management of existing University owned stock, and therefore not purely in the development of new capacity.

Given the nature of the asset class, student accommodation is also one element of the estate which has the potential to generate capital value that might play an important role in the context of a University's wider financing strategy.

Services

We are seeing increased interest from Universities and the private sector facilities management industry in developing new models of delivery. Institutions have typically been used to managing an approach consisting of self delivery mixed with a portfolio of service specific contractual arrangements. In the context of seeking efficiencies and savings in their operating budgets, assessing whether value can be created from other delivery models for estates services is an obvious opportunity to explore.

Delivering estates projects and investing at the scale contemplated by many Universities in the current environment is a complex and resource intensive process. Business cases need to be underpinned by robust analysis, implementation plans and procurement strategies need to be developed in a way that will achieve a value for money outcome, and commercial agreements with private sector partners need to be carefully structured. PwC has worked with a number of Universities over recent years providing support across all areas covered by this edition of HE Matters, and we would be delighted to discuss these issues in further detail with you.

If you have any queries on the specifics of any article, please contact either myself or the relevant person listed on the contacts page of this issue. If you have any general queries or comments, please write to Matthew Goldsmith at matthew.r.goldsmith@uk.pwc.com

Delivering estates projects and investing at the scale contemplated by many Universities in the current environment is a complex and resource intensive process.



Daniel Earle

Partner, Higher Education
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Meeting the estate need

*How will changes in the sector
impact the built environment?*



...it is the access to high quality academic staff that sets the leading institutions apart from the rest – which in turn has implications for the built environment.

The challenge for today's Estates Directors is to meet the variable and unpredictable needs of a changing student and staff population, whilst recognising that the built environment is likely to have greater direct and indirect influence on student choice in what is to become an increasingly competitive environment.

The last decade has seen unprecedented growth and change across the University sector. It is perhaps inevitable that the student population will continue to change over time. It is, for example, now possible for students to access funding for part time education – which may lead to an increasing proportion of students aiming to balance their education with other personal and professional commitments.

Estates departments have been trying to keep up with these rapidly changing demands over the last ten years by

investing in fit-for-purpose accommodation and delivering an overall improvement in the condition and suitability of the estate. This investment will inevitably bolster the sector's ability to withstand the effects of future changes in demand for accommodation.

However, University estate departments now need to look ahead and reflect on the following factors that will influence the built environment of the future:

- firstly the impact that changes in tuition fees will have on how students view the importance and relevance of the built environment to their student experience – and consequently their choice of where to invest in their higher education experience; and
- secondly, the increasingly competitive environment in which they will operate.

What is known is that Universities continue to operate in an uncertain environment: trying to predict the student population of the future, their educational and wider social and cultural requirements, and how these will influence the estate and facilities needed to attract and retain students is complex.

The 2013 Times Higher Education Student Experience Survey highlighted the importance of the non-academic estate, such as sports and leisure facilities, library and learning resources, and campus environment to student choice. However, the survey states that it is the access to high quality academic staff that sets the leading institutions apart from the rest – which in turn has implications for the built environment. There is an increasing trend for students to access material on-line rather than through

attendance at lectures and using the contact time with academic staff to discuss the content. This in turn has implications for the academic estate – will there be an increasing emphasis on access to tutors in small groups, rather than learning from the seat of a large lecture theatre?

The second factor to recognise is the government's commitment to increased competition in this sector. Where student demand is low and institutions significantly under-recruit then unfilled places will be reallocated to those with stronger recruitment patterns. As well as having to anticipate the potentially volatile demands for accommodation and facilities, the impact of uncertain revenue streams may undermine confidence in capital programmes.

How to respond

What can be done in response to this constantly changing and challenging environment?

Know your students and key users

In our experience, good estate planning comes from having a thorough knowledge of the requirements of the ‘users’ of the property and facilities provided. The focus for all estates functions must be to satisfy themselves that they have the detailed knowledge of the needs of the institution, and are able to understand the academic, cultural, social and environmental requirements of the students, staff, visitors and other external stakeholders. This knowledge is translated into ‘the brief’ that defines the components of a modern campus that will underpin a successful University. There needs to be a significant investment of time and expertise in the process of dialogue, challenge and options analysis with students, staff and other external stakeholders before settling on an estates solution. This should be an ongoing process to keep the strategy current and relevant.

Optimise utilisation

Good practice drives increased utilisation of the estate. This is a very effective strategy for either increasing the capacity for delivering more education through the same estate; or yielding surplus space for alternative use; or releasing capital. It is widely recognised across the sector that utilisation of the academic estate is poor and has been the subject of management focus for some time. In our recent experience there is still scope for significant improvement across the academic estate – with poor use of space on specific days and declining use of space in the afternoon to virtually no use in the evenings. There is clearly capacity to deliver more from a smaller estate and cater for some of the changing student preferences. Access to comprehensive estates, finance and administration data is central to ensuring alignment between demand and supply of accommodation, and driving management change. This is not easy and is dependent on access to good management information linking complex course timetabling to the availability of space across the academic portfolio.

Exploit operational flexibility

Universities must exploit opportunities to reconfigure the estate and ensure that designs for new buildings incorporate sufficient flexibility to allow the institution to flex its accommodation to suit the changing and broadening academic, social and cultural needs of the student population. The built environment is costly, takes time to deliver and can be inflexible to change unless this is captured during the design and reconfiguration of accommodation. Good practice will require Universities to consider the whole-life costs of investing in flexible accommodation, against the backdrop of limited capital which may favour delivering the lowest cost solution.

Collaborate

Collaboration may be counter-intuitive in an increasingly competitive environment – but there will be opportunities to share facilities with other organisations that are mutually beneficial. Much of the accommodation provided by institutions is not unique – there will be other local organisations and potential employers that require facilities similar to student

accommodation, teaching space, sports provision, libraries, or cultural and religious spaces. Collaboration can lead to the provision of better quality facilities that are more cost effective to the providers and more accessible to a wider community of users.

In conclusion, investing in the development of a comprehensive estates strategy, which may take three to six months to complete, will meet one of the sector’s current priorities and enable a University to harness the latent value from its property estate, prioritise capital funding appropriately and maintain a competitive position in the sector.

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Financing the ambition

The higher education sector financing environment for Directors of Finance has become increasingly complex over recent years. Whilst it is true that the sector remains in a relatively cash rich position (current HEFCE estimates of net liquidity is c.£6.8 bn across the sector), accessing third party debt finance for investment has become more challenging.

Beyond their own reserves, the majority of Universities have previously sourced capital from either HEFCE funding (that has reduced by c.64% when comparing 2011-2012 against the previous three year period) or commercial banks.

Fundamental changes in the banking market over the past five years now mean, however, that margin pricing is significantly higher and long tenors may not be a realistic option for University borrowers.

What does this mean for estates investment?

This creates a problem when seeking to raise finance to fulfil estates investment strategies which rely on certainty of finance over a long period of time. Shorter term bank debt may still be a viable option, and may indeed have some flexibility benefits, but it does introduce refinancing risk that needs to be managed. It is this risk that is driving Universities to consider alternative sources and forms of finance that might provide a substitute for long term bank debt.

Institutional investor appetite and alternative sources

Bond issues on the public capital markets such as those launched by Cambridge University and De Montfort University serve to demonstrate that institutional investors are interested in buying highly rated University paper, but this is not a route open to, or appropriate for all. Not all potential University issuers will be able to achieve the same rating, and unless the financing requirement is at least, say, £100m, a listed bond may not be efficient.

We are, however, seeing significant interest from certain large investors keen to increase their exposure to the higher education sector through property-related income that is backed by a strong covenant.

Using lease based structures, Universities have been able to access institutional funding for specific property assets at acceptable yield levels, but, more importantly, over long maturities (e.g. 25-40 years). Given the lack of appetite for these types of maturity in the conventional bank markets, we expect to see more of these transactions playing a role in the delivery of estates investment.

We also expect to see more development partnerships and joint ventures between Universities and private sector developers emerge as a significant delivery mechanism for large, complex projects. Typically, these projects will be of mixed use with University facilities, commercial, retail and residential accommodation all being developed within the masterplan of a particular locality or campus.

This model allows Universities to share the cost of development, and to allocate certain development risks to the private sector that they would not typically be prepared to take themselves.

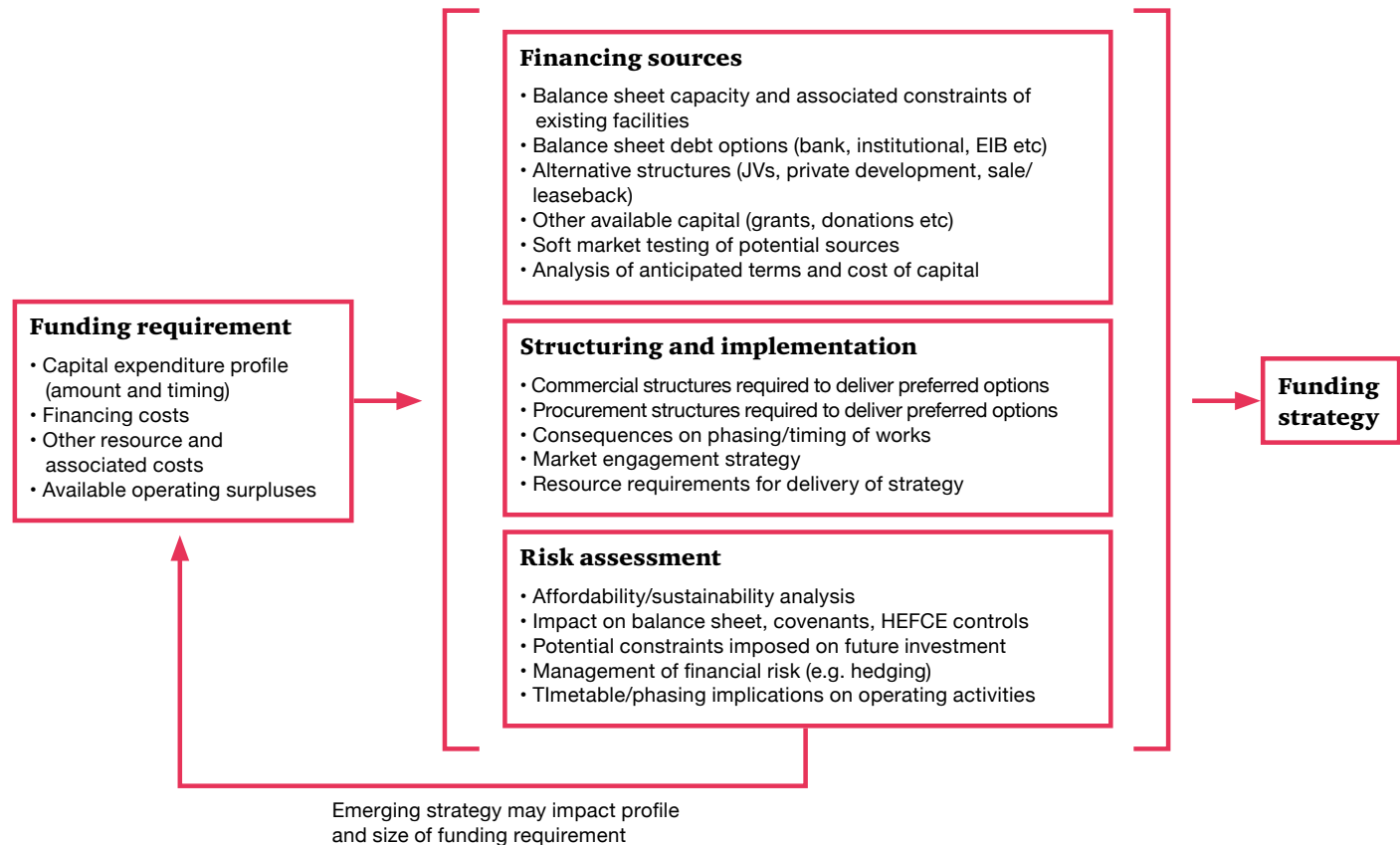
Other potential higher education focused or investment-specific sources of funding may also be available. This will depend upon the detail of the related expenditure, and fulfilling qualification criteria that will have been developed by the various providers. Such sources may include the European Investment Bank through its sector focused programme called the UK Knowledge Economy Loan Programme that is available for campus redevelopments, and other regional sources such as the London Energy Efficiency Fund which has a focus on investing in the retrofit of buildings for energy efficiency purposes.


Developing a strategy

Given the scale of some institutions' investment ambitions it is clear that Universities will need a well developed financing plan to sit alongside their estates strategies in order to be confident in delivery. Different financing models

will have different impacts on existing University gearing and annual debt service related covenant structures (including HEFCE's 4% approval limit on annualised servicing cost), and feasibility of the phasing and timing of various investments will also be impacted by the availability of finance.

The diagram below illustrates the way in which a financing strategy might be developed having regard to the anticipated capital expenditure profile that an estates strategy might demand.





Our experience shows that developing a robust financing strategy is a key activity that needs to be completed in parallel with developing the ambitions of a successful estates investment strategy.

Key questions

- What are the optimal sources of finance in the current market to ensure long term certainty of funding and an optimised cost of capital across a balanced portfolio of financing sources?
- How should a University balance the use of its institutional 'corporate' strength to raise traditional finance with the potential to use other financing structures?
- What does the funding strategy mean for the nature of the commercial structures and procurement processes that will need to be adopted to deliver the investment and how should the market be approached in order to achieve the best terms available?
- Will the proposed financing strategy have any implications on the timetable for delivery of the estates strategy?
- What long term risks and constraints are imposed by adopting the proposed financing strategy and how can these be managed through the life of the financing arrangements?

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Student residences

The quality and perceived value for money of available student accommodation is a critical element of the student experience.

Getting it right can therefore be a significant factor in the decision making process of a potential undergraduate, and in the level of advocacy that might be achieved from current and past students.

All Universities recognise this, but given competing demands for capital, other academic priorities, and the constantly changing demands of students, prioritising this is not easy. Those Universities that invest time developing a holistic residences strategy which recognises the need for long term capacity planning, considers and assesses the requirement for investment and development, and provides for a consistently high level of service, will be those most likely to succeed.



Key strategic issues

- What is the nature and scale of the University's accommodation requirements?
- Which student demographic is the new accommodation being targeted at?
- What operating platform will be put in place?
- Does the existing stock have significant refurbishment requirements?
- Does the University have sufficient available land to meet the potential long term development requirement?
- Is there a local third party market that can meet undersupply of University-owned stock?
- What is the medium term financing requirement to ensure sustainable residences provision?
- What are the potential sources of funding that could be tapped?
- What will be the impact on student rents and the overall rental mix as a result of implementing the proposed strategy?
- How much control over the rent setting process does the University want to retain?
- How can the value of the existing portfolio be maximised?

Involving the private sector

Strategies will naturally vary across the sector in response to individual University circumstances and preferences; however, one of the key strategic decisions that Universities have to make in the context of their residences portfolio is the level to which they involve private sector partners in the development and operation of University provided stock.

Historically, many of the partnership deals done by the sector have been driven by the need for additional capacity, and the desire to access private sector finance to do this. By using these privately financed models, certain risks (including occupancy risk) have been transferred to the private sector operator, and this has proven to be valuable to Universities looking to manage their own liability to this aspect of their business.

Whilst this motivation continues to be important in driving some Universities to procure private sector investment, there are certainly challenges in the current market that mean this model is not

appropriate for all. Other motivations are increasingly driving discussions with the private sector provider market and specifically around desired improvements and efficiencies in service provision. Some of the well established private sector providers have developed the capacity to manage and operate large residences portfolios, and there is clearly an opportunity for Universities to consider whether there is value in accessing this experience.

Such models could potentially be helpful in situations where existing University stock requires some degree of strategic refurbishment, alongside the desire to improve operational performance. Whilst some Universities have sought to achieve this through longer term transactions designed to transfer ownership, others may not wish to surrender this level of control over the estate. This, however, should not preclude the use of well structured arrangements with the private sector but they must be crafted in a way that meets the objective of the strategy and the wider investment plans of the institution.

Financing

In this edition of HE Matters we have already discussed some of the financing challenges that Universities face in the current market. The student residences estate does, however, have the ability to generate third party value and this characteristic allows Universities to consider the use of privately financed models for the refurbishment, development and, indeed sale, of University provided stock.

It is well documented however, that obtaining funding for new developments has been far more of a challenge over the last few years. Developments which are outside London or prime student locations, and which are not operated by an operator with a proven track record of running student residences, are likely to find it challenging to obtain finance on terms which will make developments viable at competitive rents. Notwithstanding this, there are options available for funding student accommodation schemes as long as schemes are well thought through and properly structured.

Traditionally, the private sector has financed new developments through bank funding using a range of structures with a variety of tenors and gearing levels. Strong relationships and nomination agreements with Universities allowed developers to obtain better value funding and helped make student accommodation schemes viable. However, these banks have been affected by global changes in financial markets and, despite the overall robustness of the student accommodation sector, are generally now only willing to provide shorter term debt for projects at lower loan to value ratios than has previously been the case.

Increasingly private sector providers have been looking at alternative sources of funding. For instance, there has been a significant increase in transactional activity where institutional investors (predominantly large insurance related investors) have bought into operational assets which, in many cases, have long term nominations or lease-type agreements in place with Universities. These institutional investors have also

shown an increased willingness to consider funding student accommodation schemes during the development phase although most projects are still requiring relatively comprehensive risk mitigation during the construction period.

Navigating complexity

Whilst certain financing challenges exist in the current market, the range of potential providers and offerings in the private sector market has continued to develop. This provides Universities with real choices to make around how to pursue their residences strategy. Evaluating the options, implementing the preferred solution and getting the most of what is already in place can therefore be a complex exercise, but also one that provides the opportunity to make a step change in the student experience.

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Facilities Management: rising student expectations

Rising expectations

As changes to the funding arrangements take effect and the higher education sector becomes more competitive and international, students are increasingly behaving like customers. Customers who have high expectations about the quality of the buildings and campuses that they learn and live in, and specifically the quality of the facilities management services that they consume. The student and campus experience is influenced by many factors including the quality of residential accommodation, teaching and social space, grounds, sports facilities, catering, cleaning, security and IT. Students care about the services they receive. This includes the quality and range of food on offer; the cleanliness of the residences; heating, cooling and ventilation in teaching spaces; and the ease of receiving deliveries from on-line shopping.

Institutions need to respond to these higher expectations by ensuring that they have access to the skills and resources required to deliver the vision and to implement any transformation required. In our experience, with the right leadership, and an improved environment, more customer focused services can be achieved.

Assessing new models

Most Universities manage and deliver facilities management in-house, supported by some discrete service outsourcing. Traditional delivery models need to be tested, however, to assess whether they are agile enough to meet modern demands, and to ensure that the commercial incentive structure is fit for purpose. Experience shows that many public sector organisations and private sector companies have sought to replace these models with more comprehensive outsourced facilities management arrangements that may be just as applicable in the higher education sector.

Institutions should be asking themselves:

- Do they know what their students want and whether they wish to have an involvement in their delivery?
- Do they have a clear vision for the delivery of services, with realistic long term strategic objectives?
- Do their buildings-related facilities management services offer a quality experience?
- Is their campus a place where students want to be, or a place where they have to be?
- Are improvements in the quality of services to student residences being reflected in other buildings?
- Are the academic services enhanced by a quality learning environment and first class support services?
- Are current suppliers and associated supply arrangements flexible enough to respond to rising expectations?
- Do catering outlets, sports facilities and other leisure and commercial facilities match the high street in terms of quality and value for money?
- How can the University create loyalty from its students with its University-provided services?

... many Universities are now beginning to consider how they can work with private sector partners to transform the delivery of services.

Working in partnership with the private sector can bring efficiencies, investment, skills and experience from other sectors to support Universities as they transform their campus environment and services. There is strong interest in the higher education sector at the moment from the private sector, and market penetration is low compared to other sectors. In our experience many facilities management companies are targeting the sector and opportunities that have come to the market have received a significant number of potential applicants. In this context, Universities have the opportunity to benefit from their buying power in a competitive market that can deliver the improvements they need.

Institutions who are thinking of working with the private sector, should consider the following key points to help ensure a successful partnership:

- What does your existing staff structure and supply chain look like from a delivery model perspective?
- Is there interest in the market for partnering with you?
- What resources do you need to develop a strategy, business case and implementation plan?
- Do you understand the process that you will have to follow?
- What commercial structure will best meet your requirements?

One obstacle to a more ambitious use by Universities of private sector contracting models has always been the risk of incurring structural VAT inefficiency. From July 2013, however, new 'cost sharing group' legislation (providing for potential structures that relieve Universities from irrecoverable VAT on services supplied), now provides scope to consider new, more efficient ways of establishing supply arrangements. This could have application across estates management services and could therefore provide further impetus for assessing the potential of cost sharing and private sector contracting.

Although the private sector may have an important role to play, it is not necessarily the right model for all. Recent high profile outsourcing failures demonstrate that outsourcing is no panacea. However the fact remains that the private sector has a lot to offer. Your in-house management and delivery staff know your campus, your buildings, your culture and how to interact with your community.

Harnessing this knowledge to work together with the private sector is the key to success. In our experience many Universities are now beginning to consider how they can work with private sector partners to transform the delivery of services.

Selecting and contracting with suitable service partners is not easy. It is a complicated procurement, commercial and legal process. Best practice is to underpin the process by developing a robust business case and obtaining the necessary stakeholder support. In our experience, with proper planning and governance, procuring private sector partners is achievable and has the potential to deliver significant benefits over the long term, both financial and non-financial.

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