

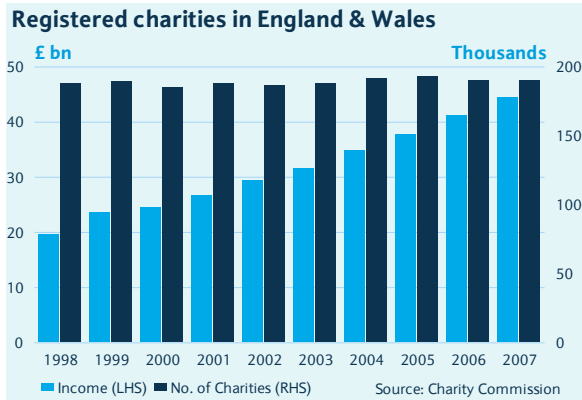
Charities, Social Housing & Education Review

July 2008

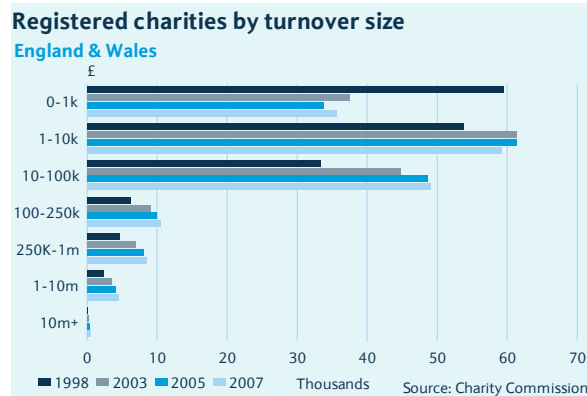
Summary

- The charities sector continues to achieve healthy turnover growth. However, growth in expenditure outpaced that of income in 2005-06, which meant that the sector's surplus declined.
- The concentration of income among a relatively small group of large charities appears to be continuing, as these organisations continue to record faster income growth than their smaller counterparts.
- Income generated through earned income streams, which are typically more stable than voluntary income streams, have experienced relatively strong growth and now account for half of total income.
- The government has also become an increasingly important source of funding for many larger organisations within the sector amid continuing outsourcing of public service provision.
- These trends are helping to drive the increased concentration of income within the largest organisations and the steady 'corporatisation' of the sector.
- Turnover growth remains strong in the social housing sector. However, cost growth has tended to outpace that of policy-restricted rental income in recent years.
- As a result, while the sector continues to generate a healthy aggregate surplus, this has been achieved through the sale of assets in recent years.
- The recent slowdown in the housing market highlights the potential risks of the sector's reliance on property sales to maintain surpluses, especially given the rise in private-sector debt levels and associated leverage.
- Larger housing associations in particular have diversified their activities to include wider public service provision, which has opened up new income streams. However, this is not a viable option for many smaller RSLs.
- Although further reform of state education seems likely, government spending on education is set to grow at a slower pace than in recent years.
- This will benefit fee-charging, independent schools, which will face less pressure, particularly in terms of industry-wide wage growth.
- However, slower economic growth and pressures on household finances are likely to limit growth in both fees and pupil numbers, particularly among less prestigious schools with a greater proportion of pupils from lower income households.
- Looking further ahead, further education providers should benefit from a planned extension of compulsory education to include all those up to 18 years of age.
- However, the shift towards education responsive to employer demand is also likely to continue, which will impact on voluntary adult learning in particular.
- Higher education institutions continue to maintain healthy financial surpluses. More generous funding for domestic students will provide support for the sector, but UK institutions face increasing competition in the more lucrative market for international students.

Charities

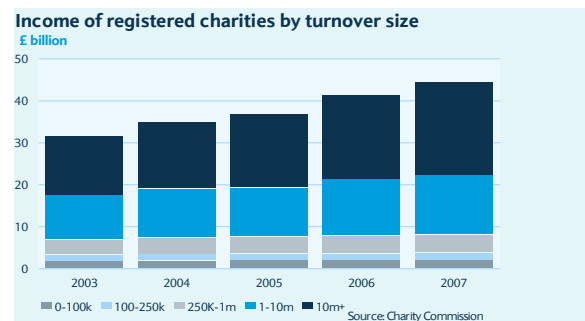


The total number of charities operating in the UK has remained broadly stable over the last decade, while income generated has more than doubled. There were 190,541 registered charities in England and Wales in 2007, according to the Charity Commission, of which 169,297 were 'main' charities. On aggregate, these charities generated income of £44.6 billion in 2007, which represented a nominal increase of 8% on 2006. Although below the 9% rate recorded during the previous year, this nevertheless represented healthy growth.



The majority of charitable organisations are small. In 2007, 85% of charities registered in England and Wales generated annual turnover of less than £100,000. However, these organisations together accounted for less than 1% of total industry income. In contrast, although less than 1% of charities recorded turnover of over £1 million last year, these organisations earned the lion's share (82%) of total industry income.

Survey evidence suggests that even among the relatively small group of 700 charities that generate income of £10 million or more, revenue is highly concentrated amongst the largest, international charities. According to the Charities Aid Foundation (CAF), in 2005-06 the top 10 organisations alone generated some £2.4 billion (5% of total sector income). This represented nominal growth of 19% on the previous year, which was significantly higher than the aggregate growth rates recorded for charities in other income brackets.



According to data from the National Council for Voluntary Organisations (NCVO), which covers some 164,000 'general charities', financial performance remains highly variable across the sector. While the sector as a whole recorded relatively strong income growth, some 20% of the largest charities and 60% of the smallest charities reported a fall in income between 2004-05 and 2005-06.

A breakdown of the NCVO data reveals that 'earned' income is now the largest and fastest-growing source of income. During 2005-06, earned income increased by 15%, in nominal terms, to £15.6 billion. As a result, it now represents just over half of total income, compared to 39% at the beginning of the decade.

'Earned' income is derived from activities such as trading and merchandising, as well as through public service fees and contracts, and is typically more stable and predictable than other income streams. This helps to reduce income volatility (a common problem for many charities), making medium-term financial planning easier. However,

charities are having to become increasingly entrepreneurial in terms of devising strategies to generate earned income

The move towards earned income streams has also been supported by a shift in government support for charities and voluntary organisations from traditional grant funding towards contract based funding over the last decade, as ‘third sector’ providers have increasingly become involved in public sector service provision. At £10.5 billion, income from the public sector, accounted for one-third of ‘general’ charity income in 2005-06. However, the resources required to tender for public sector contracts, and the scale of operation generally required to deliver these services, effectively precludes many smaller charities. Even among the largest charities, levels of public funding are mixed. Around 30% of charities with an income above £1 million rely on government funds for more than three-quarters of their revenue. However, one-third of charities with income above £10 million receive no income from the government.

Source of ‘general’ charity income (£ billions)

	2005/06	2004/05	% change*
Total Income	31	28.3	9.5
Voluntary income	12.9	12.5	3.2
Earned income	15.6	13.6	14.7
Investment income	2.5	2.2	13.6
Income from individuals	11.5	10.7	7.5
Income from government	10.5	9	16.7
Income from national lottery	0.6	0.5	20.0
Income from other sources	8.4	8.1	3.7

* Nominal

Source: NCVO

In contrast to earned income, voluntary income has experienced relatively sluggish growth, increasing by just 3% (to £12.9 billion) in 2005-06. This is due in part to the shift away from government grants, towards fees for service contracts. However, income from individuals, which represents 39% of voluntary income, fell by 5.9% in 2005-06. This likely reflects the impact on consumers of slower economic growth, a cooling housing market and pressure on real disposable incomes during this period, as evidenced by slower growth in consumer spending.

Nevertheless, initiatives to increase awareness of tax efficient giving have helped boost income from donations in recent years. In total, tax efficient donations grew to £3.8 billion in 2006/07 up 11% on the previous period, following a 20% increase the previous year. Approximately one-third of donors used Gift Aid in 2005-06, compared to less than 1% in 1999-2000. As a result, the value of Gift Aid to charities has increased to £830 million, although there is still the potential for charities to realise significantly more via the Gift Aid scheme. Donations given through Payroll Giving schemes raised nearly £90 million 2006-07, according to HMRC, up 5% on the previous year. Although the standard rate of income tax has been cut from 22% to 20%, charities will be able to claim back 22% on Gift Aid donations until 2011. This will prevent a shortfall in funding, estimated at around £300 million, that would otherwise have occurred during this period.

Income from other ‘voluntary’ organisations has also become an increasingly important source of funding, having increased by 34% in 2005-06 to £2.1 billion. The increase reflects the award of grants between organisations, as well as an increase in contracts for service provision.

‘General’ charities earned investment income of £2.5 billion in 2005-06. This represented growth of 14% compared to the previous year. However, while the rate of return on assets held by individual organisations was highly variable, it also represented an average yield of just 3.4%, on an overall asset base of £97 billion (of which £56 billion is classified as ‘investment assets’). Just 15% of charities hold investment assets, but these organisations are increasingly looking to manage their asset bases more effectively to reverse the decline in yield evident in recent years and generate higher returns. As a result, spending on investment management services more than trebled in 2005-06 to £334 million. Although more active investment strategies are likely to be required to boost returns in the long run, recent financial market turbulence and weakening property markets over the last year underline the potential risks (in the short term at least). However, for organisations with a large proportion of their assets in cash, returns on

deposits have held up despite falling base rates, amid greater competition amongst banks to attract deposits.

According to the NCVO, 'general' charities had total liabilities of £11.22 billion in 2005-06. Of this, some £5.95 billion was short-term debt (due for repayment within one year), although this represents a fall of 9% on the previous year. Longer-term debt, which tends to be taken on by larger organisations, totalled £4.65 billion, with provisions of £422 million accounting for the remainder.

Expenditure and costs

Spending by charities increased to £29.1 billion in 2005-06, according to NCVO data. At 13%, nominal growth in expenditure outpaced that of income. As a result charities spent 94% of their income compared to 90.7% in 2004-05, which meant that the surplus declined from £2.6 billion in 2004-05 to £1.9 billion in 2005-06. However, as with income, expenditure growth was highly mixed with a significant proportion of charities across all income bands reporting a fall in spending. The proportion of organisations reporting a fall was greater amongst smaller charities, although 19% of those in the plus £10 million income bracket and 27% of those in the £1-10 million band reported a decline in expenditure.

'General' charity expenditure (£ billions)			
	2005/06	2004/05	% change*
Total current expenditure	29.1	25.7	13.2
Expenditure on charitable activities	21.1	18.1	16.6
Expenditure on grants	3.8	3.5	8.6
Expenditure on generating funds	3.3	2.5	32.0
Expenditure on management and administration	1.0	1.6	-37.5
Net assets	86.1	79.5	8.3

* Nominal
Source: NCVO

Unsurprisingly, spending on charitable activity remains the major cost for charities, accounting for over 72.5% of total expenditure (at £21.1 billion) in 2005-06. This represents both an absolute and a proportional increase on 2004-05,

when charities spent £18.1 billion (70.4% of total expenditure) on their core activity. In contrast, growth in expenditure on grants to other organisations has been subdued, relative to total spending, in recent years. As a result, this type of expenditure has declined as a proportion of total expenditure, which is likely to have made securing this type of funding more difficult for some organisations.

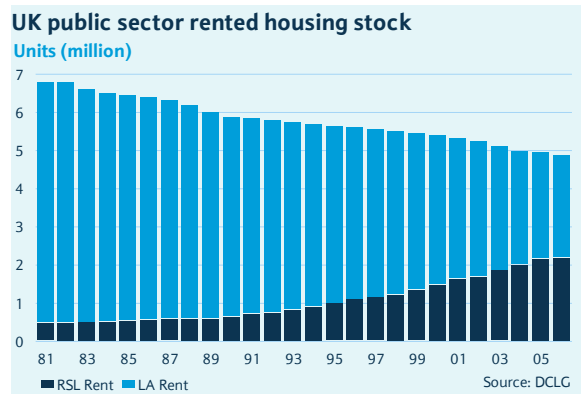
At 32%, expenditure on activities aimed at generating funds saw the biggest increase in 2005-06. Fundraising events/activities and publicity account for the majority of expenditure used to generate funds, with spending on 'investment management' accounting for a growing proportion (see above). Although aggregate spending on fundraising grew by 19.8%, to £2 billion in 2005-06, the vast majority of charities actually reduced spending on these activities, with three-quarters of those earning over £1 million and 90% of those with income below £100,000 reducing spending. Charities must justify any money not spent directly on their charitable purpose, and may feel allocating a higher proportion of funds to their core activity is a better way of securing future income.

The increased proportion of aggregate expenditure allocated to generating funds in 2005-06 was partly offset by a 38% reduction in spending on management and administration. This suggests that efficiency gains and economies of scale are allowing larger charities in particular to make cost savings.

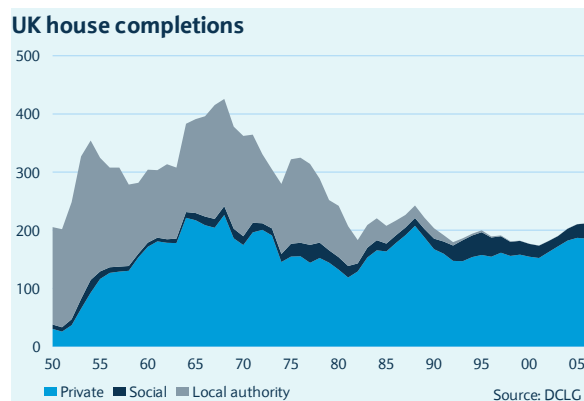
In addition to cyclical changes, a number of more structural shifts are also taking place within the sector, in particular the continuing 'corporatisation' of the largest organisations. This is driven by, and is in turn helping to fuel, the increasing concentration of income among the largest organisations. Looking ahead, with smaller charities generally unable to compete with their larger counterparts for public service contracts and lacking the resources, economies of scale and 'brand awareness' of the largest charities among corporate and individual donors, this trend seems likely to continue.

However, while clearly benefiting the largest charities, this process is also likely to impose costs, especially given the wage implications of the increase in, and continuing 'professionalisation' of the charity workforce that has accompanied the increased 'corporatisation' of the sector. Costs and risks may also increase if the emerging trend among the largest charities to manage their portfolio of assets actively in search of higher returns continues.

Social housing



The proportion of public sector rented housing that is owned and/or managed by Housing Associations/Registered Social Landlords (RSLs) continues to rise, reflecting both the steady decline in the total stock of public sector rented accommodation and the longer-term transfer of stock from direct local authority control to RSLs, as well as the concentration of new build social housing within the RSL sector.



In 2006 RSLs owned and/or managed 45% of the UK's stock of public sector rented housing,

compared to just 19% a decade earlier. Of this, around 45% is now controlled by large-scale voluntary stock transfer associations (LVSTAs). The proportion of RSL-controlled social housing is likely to have increased since then. In 2006-07, RSLs added some 40,000 new homes to the social housing stock (with a similar number planned for 2007-08), while almost 70,000 more homes were transferred from local authorities to RSLs.

The RSL sector is highly fragmented, with around 1,950 housing associations registered with the Housing Corporation in 2006-07. Together, these organisations manage some 2.2 million homes in the UK. The main activity of the majority of associations is the provision of rental accommodation (often with a specialist care function). However, a growing number of associations also provide home-ownership products. These rely (to varying degrees) on the proceeds of asset sales, which in turn exposes them to a different financial and/or risk profile than 'traditional' RSLs/HAs. There is also a small, but not insignificant, number of service-based (rather than property-based) organisations, which face competition for contracts from other service providers.

The vast majority of RSLs are relatively small, with around 80% of organisations owning and/or managing less than 1,000 units in total. This represents just 3% of the total sector stock of RSL properties. In contrast, while only 20% of housing associations have more than 1,000 properties, they control 97% of the current stock. Even within this segment, there is a high degree of concentration, with the 20 largest associations controlling some 28% of the total stock.

The increasing concentration of the sector is due in part to the consolidation evident within the sector in recent years, which has been driven by a combination of large scale stock transfers from local authorities, as well as merger and acquisition (M&A) activity, which has resulted in the emergence of a growing number (49 in 2007) of associations with more than 10,000 homes under their control.

RSL performance and key financial ratios

FY Ending	2005	2006	2007
Turnover (£ million)	7,568	8,334	9,117
Operating costs and costs of sales (£ million)	6,312	7,055	7,685
Operating surplus (£ million)	1,250	1,268	1,417
Surplus on social housing lettings (£ million)	1,247	1,262	1,397
Net interest payable (£ million)	1,400	1,476	1,596
Profit on sales of assets (£ million)	419	499	542
Surplus for the year (£ million)	364	241	257
Operating margin (%)	16.5%	15.2%	15.5%
EBITDA interest cover (%)	111.9%	105.8%	106.9%
Growth in total assets (%)	N/A	9.7%	10.7%
Debt per unit (£)	12,849	13,658	14,111.0
Management cost per unit (£)	695	730	780

Sources: Housing Corporation; National Housing Federation

The latest Housing Corporation/National Housing Federation Global Accounts survey¹ reveals that the aggregate turnover of housing associations increased by 9.4% in 2006-07 to £9.1 billion. 'Traditional' associations accounted for 65% of total turnover, with LVSTAs accounting for the remainder. At £7.8 billion, revenue from social housing lettings is the main source of income for RSLs. However, growth in rental income is constrained by the Housing Corporation's Rent Influencing Regime. The Housing Corporation has recommended a cap of 'RPI plus 0.5 percentage points' in recent years. Partly as a result, rent and service charge income increased by just 2.3% on a per unit basis during 2006-07.

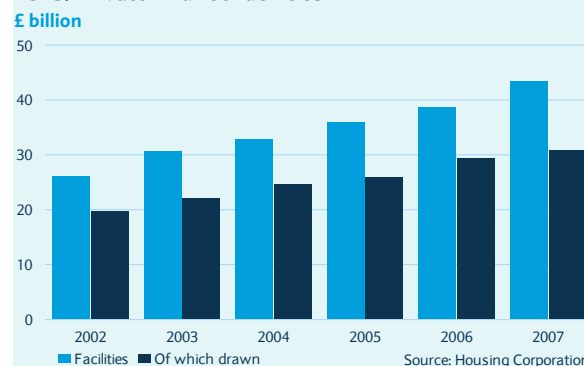
At £1.3 billion, income from non-social housing letting activities continues to account for around 14% of total income. Larger RSLs in particular are involved in an increasing range of activities, including involvement in regeneration activities, provision of community centres, training facilities and other community services.

In contrast to lettings income, expenditure tends to be market-led. Management costs, which account for about a quarter of social housing lettings costs, grew by 5.7% on a per unit basis, although this was partly offset by a relatively modest 1.7% rise in the cost of planned and routine repairs, which accounts for a similar proportion of costs.

¹ Due to methodological changes, this survey no longer includes organisations with less than 1,000 housing units, which means that direct comparison with previous surveys cannot be made. Historical data shown here have been revised.

Nevertheless, with the cost base growing faster than income, operating margins are coming under increased pressure. Although the sector's aggregate pre-tax surplus increased by 8.4% to £270 million in 2006-07, the surplus was achieved entirely by the sale of property. Indeed, without assets sales, the sector would have recorded a deficit. In 2006-07, the aggregate Gross Book Value (GBV) of RSL properties (at cost and valuation) increased by 10.1% to £77.4 billion which enabled RSLs to record a profit of £542 million on asset sales (up 8.6% on the previous year). This highlights the growth in shared ownership schemes and emphasises the importance of property sales to the sector. However, along with the recent slowdown in the property market, this also highlights the risks associated with the sector's reliance on continued house price growth as a means of maintaining operating margins.

RSLs: Private finance facilities



Growth in turnover is fundamentally driven by the construction of new homes and the transfer of stock from local authorities, both of which tend to require external finance. The two main sources of capital finance for RSLs are the Social Housing Grant (SHG) and privately-financed debt. Sector debt has outweighed SHG funding over the last two years, largely as a result of the need to finance stock transfers from local authorities. In 2006-07 sector debt rose by 9.2% to £30.9 billion, with the total value of arranged facilities standing at £43.5 billion. This compares to SHG funding of £30.4 billion (up 9.9% on the year), although it should be noted that total, capital grants (combining SHG and other capital grants) increased by 10.1% to £31.8 billion. The increase in debt coincided with a 125bps increase in the

Bank of England base rate during 2006-07, suggesting that debt service costs are likely to have risen.

Despite the rise in the level of aggregate debt, there was a slight reduction in the adjusted net leverage of the sector from 39.8% to 39.5%. However, there remains a fundamental difference between LVSTAs, which tend to be more dependent on debt and which face significant capital improvement costs, and traditional associations, which tend to benefit from greater SHG funding. As a result, adjusted net leverage for LVSTAs was 57.7%, but only 33.5% for traditional associations.

At 106.9%, EBITDA interest cover was up slightly on the previous year. However, again there was a significant difference between LVSTAs, which had an EBITDA interest cover of 86.3% and traditional RSLs, which had an EBITDA interest cover of 117.6%.

According to the Housing Corporation, 35% of sector debt is unhedged at variable rates. Although the Bank of England has cut interest rates by 75bps since December 2007, the continued turmoil in credit and financial markets, and resultant rise in whole sale funding costs, has meant that these cuts have not been passed on in full (indeed, Bank of England surveys suggest that credit conditions have tightened). This also suggests that debt servicing costs may have risen.

Pressure to meet the government's Decent Home Standards (DHS) also continues to add to cost pressures facing RSLs. In 2006-07 investment on planned and major repairs (including both capital and revenue) grew by 10%, amounting to £2.5 billion. Although increased capital spending has helped reduce the DHS failure rate from 15.8% in 2005-06 to 13% in 2006-07, there is a marked difference between the success rates of those associations in the highest and lowest quartiles and further investment is clearly required to ensure compliance.

While the sector will continue to deliver significant amounts of SHG-funded development, constraints on public finances, the continuing

demand for new affordable rented property and the backlog of repairs and improvement in the existing social housing stock to meet the government's aim, of 95% of social housing meeting DHS by 2010, mean there will continue to be a significant appetite for private finance from the sector. The Housing Corporation forecasts that development programmes and further stock transfer will see the total amount of debt drawn down increase by a further £17.2 billion between 2006-07 and 2011-2012.

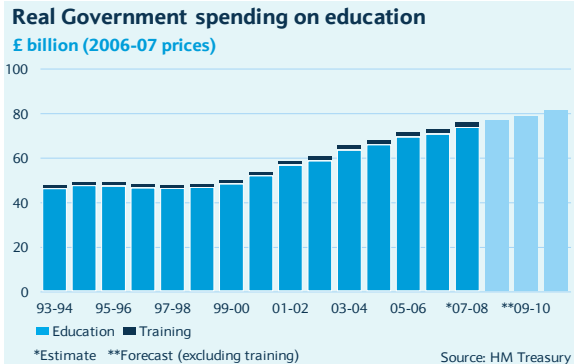
The sector also has a key role to play in the government's plan to build 3 million new homes by 2020, details of which were included in the 2007 Comprehensive Spending Review (CSR). This will require the number of new homes built each year to rise to 240,000 per annum by 2016. As part of the plan the government has also set a target of creating 70,000 more affordable homes per year by 2010-11, including 45,000 social homes for rent. This will clearly require significant investment.

Recent trends have cast doubt over the government's plans, with the rate of new house starts in England has been falling since the middle of last year, and the latest data from the Department for Communities & Local Government (DCLG) shows that house starts in the first quarter of this year were down 24% on the same period last year. Nevertheless, the Local Government Association (LGA) predicts that high house prices and restricted access to credit will mean that there will be a significant increase in demand for social housing, with up to 5 million people (2 million households) waiting for a local authority or housing association home by 2010, up from 4 million in 2008.

Education

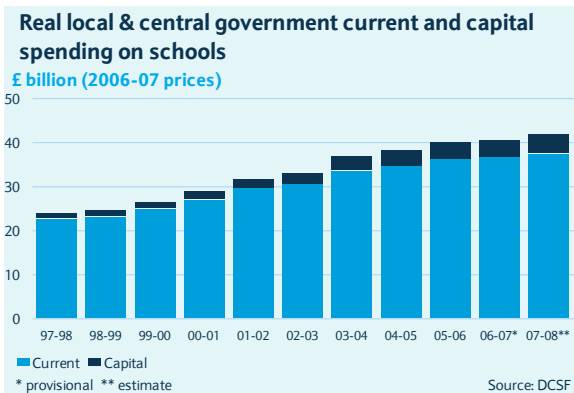
Education has benefited from significant growth in government spending since 1997. According to HM Treasury data, spending on education and training increased to an estimated £72.9 billion in 2006-07 (of which £70.7 billion was spent on education). This represents an increase of over 50% in real terms compared to the £37.8 billion spent on education and training in 1996-97 (of which £36.4 billion was spent on education). As a

result, public spending on education and training increased from 4.8% of GDP in 1996-97 to a peak of 5.6% by 2005-06.



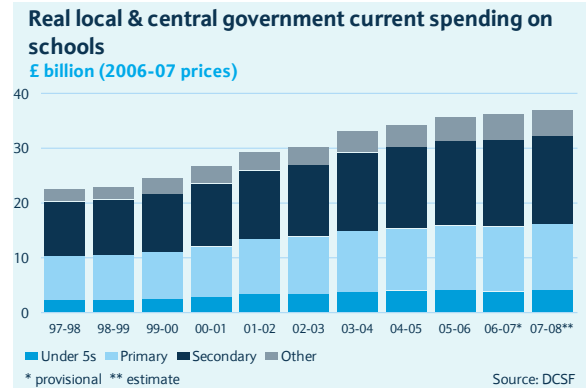
However, the bulk of the increase in spending occurred during the period 2000-01 and 2003-04, when real spending growth averaged 7.1%. Growth has since slowed, averaging 3.4% in real terms in the three years to 2006-07 (with growth of just 1.8% recorded in 2006-07). According to projections set out in the 2007 CSR, real growth in spending on education and training is set to slow further, averaging 2.8% during 2008-11. Although this still compares favourably with growth in government spending as a whole, which is set to almost halve to 2.1% on average over the period, it means that spending on education and training will remain essentially unchanged as a proportion of GDP.

State Schools



Spending on schools accounts for over half of total government spending on education and training. There has been significant growth in government spending on schools over the last

decade. Overall spending growth accelerated much faster in the first half of the decade. According to estimates from the Department for Children, Schools and Families (DCSF), total spending on schools (including both capital and current expenditure) was £41.2 billion in 2007-08. This represents an annual increase of 3.4% in real terms.



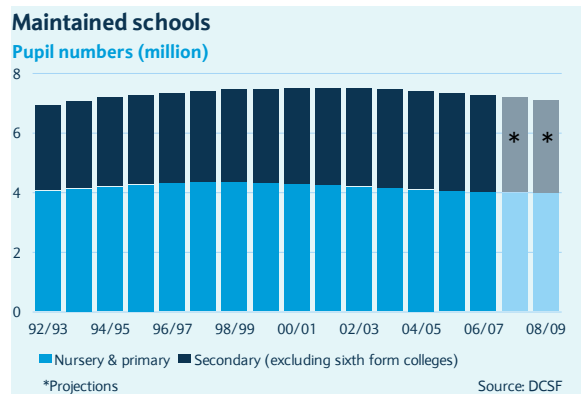
Estimates for 2007-08 show that secondary schools account for the largest share of current spending 43%, followed by primary schools, which accounted for 32% with spending on education for the under-5s accounting for 11%.

Expenditure on staff represents the major component of schools' costs, accounting for around two-thirds of total expenditure. Having risen relatively rapidly earlier in the decade, headline teachers' pay awards in the public sector have since moderated, with an increase of 2.5% recorded in both 2006-07 and 2007-08. This trend is expected to continue. The three year pay plan advised by an independent body and effective from September 2008 recommended a 2.45% increase in September 2008 and a 2.3% rise in 2009 and 2010. However this is below both the rate of wage growth in the wider economy and RPI inflation, and has already resulted in industrial action.

In addition to increased operational expenditure, the last decade has seen a significant increase in capital investment in school infrastructure. In 2003, the Building Schools for the Future (BSF) programme was launched, which has resulted in the construction of 1,100 new or replacement schools. Some 1,850 schools have had at least

half of their buildings replaced in the ten years to 2007, according to the DCSF. In 2007-08 an estimated £4.0 billion was invested in school buildings, this compares to £3.3 billion in 2006-07. According to the DCSF Departmental Report overall capital expenditure on schools increased by an estimated 12.7% in real terms in 2007-08. Economies of scale are also being better utilised, as the DCFS continues to support the co-location of school services.

Programmes designed to improve and extend education facilities for under-fives have also resulted in substantial capital investment in facilities such as Sure Start Children’s Centres. The number of Children’s Centres is expected to increase by 40% (to 3,500) between 2008 and 2010.



While public spending on education has increased, the population aged between 5-16 has been falling since 2000. Changing demographics are reflected in pupil numbers in state maintained nursery and primary schools, which have steadily fallen since 1998-99, according to the DCSF. The number of secondary pupils, which had been steadily rising, began to decline in 2004-05 as falling nursery and primary school numbers began to feed through into secondary pupil numbers. This trend is expected to continue, with the government expecting the rate of decline to accelerate to 2.4% in the secondary sector. However, at just 0.1%, the rate of decline in the nursery and primary sector is expected to slow.

Reflecting trends across public services, increased government spending on state education sector has been accompanied by significant reforms.

Many of these were included in the government’s five-year reform plan for education, which was announced in 2004. A key factor in these reforms has been the steady shift in role of local authorities from supplier of education to commissioner.

Educational reforms have also meant that building long term relationships with external partners has become increasingly important, with schools being encouraged to seek sponsorship and educational support from charities, businesses and other educational institutions. Relationship building is also a key component in the longer-term shift towards the creation of a system of trust schools. These are maintained foundation schools which are supported by a charitable trust and operate on a not-for-profit basis. The trust has ownership of the school’s assets (such as buildings and land), employs staff and sets admission arrangements (although selection by ability and interviews is not allowed). There are currently 42 trust schools in operation, with a further 390 currently working towards trust status. The results of a further round of applications for trust status will be announced later in the year. However, concerns have been expressed about the ability of both staff and trustees in many schools, in terms of assuming such a high level of financial control. A recent survey suggested that, at present, the boards of governors of a large proportion of schools lacked the requisite financial skills.

In addition to trust schools, there are also currently some 83 city academies in operation. Academies are state-funded schools, established by private sponsors and managed by independent governors. The government has set a longer term target of opening a total of 400 academies and, following plans to accelerate the programme, hopes to exceed its target of opening 200 by 2010.

Working with external partners and private sponsors (e.g. educational institutions, businesses and local communities) is also helping many schools achieve specialist status. Following the addition of 79 schools onto the programme from June 2008, 92% of all maintained secondary schools are now specialist, with 33 local

authorities now offering 100% specialist provision.

Reforms are also helping schools to become increasingly responsive to employer demand. Diploma programmes have been expanded to introduce more vocational education for 14-16 year olds, responding to skills gaps as identified by UK employers. From September 2009 72% of secondary schools and 88% of colleges will be offering diplomas.

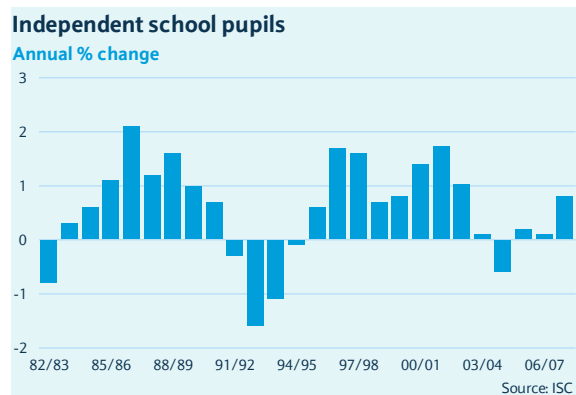
Improving standards and turning around schools deemed to be failing is also a key part of government policy. In June 2008 the DCFS launched the 'National Challenge: Raising standards, supporting schools'. Some £400 million has now been allocated to improve standards in 638 schools, in which less than 38% of pupils achieve five 'good' GCSEs. National Challenge Advisors will work with these schools to improve standards. Those that fail to meet the requisite standards by September 2010 will be closed and either re-opened as an academy (in line with the planned acceleration of the academies programme), or replaced with a National Challenge Trust school, in partnership with a higher performing school, university or local business.

Independent Schools

According to the Independent Schools Council (ISC), there are 2,600 independent schools in the UK, educating 671,000 children. An independent school will tend to fall into one of two sizes, according to the National Council for Voluntary Organisations (NCVO). Around 43% of independent schools earn an annual income of £1-£10 million, with 49% earning £10,000-£100,000. There are very few schools falling in the middle income bracket (£100,000 to £1 million per annum) or earning over £10 million. Those in the smaller income band tend to be those using alternative educational systems, such as specialist schools for children with learning difficulties and religious schools.

According to the ISC, whose 1,276 member schools educate around 80% of all independent school children, the number of pupils attending

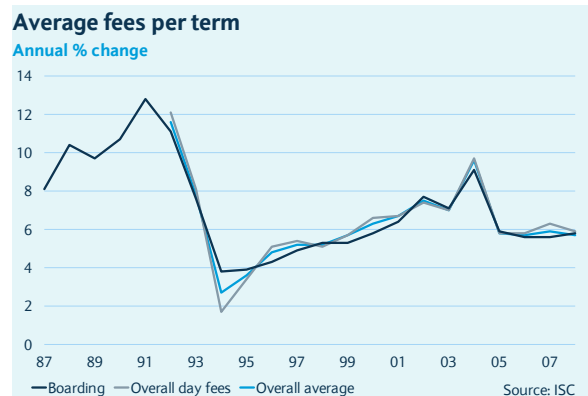
independent schools continues to grow. Although pupil numbers increased by just 0.8% in 2007 and by 0.1% the previous year, this has been achieved during a period of continued decline in the school-age population (see earlier). At the same time, the average class size in the independent sector has continued to fall, slipping to an average of 9.71 children per teacher in 2007 (down from 9.88 in the previous year).



According to GuideStar UK/NCVO, independent schools had an annual income of £5.2 billion in 2005-06. On average this represents £8,460 per pupil, although fee scales differ significantly between schools, with larger schools generally able to achieve higher income per pupil than smaller schools. Those in the top income band (with annual turnover of over £10 million) earn nearly 50% more per pupil than those in the £1 million-£10 million per annum income band and over ten times more per pupil than those generating less than £100,000 in annual income.

The ISC estimates that overall average fee growth has remained relatively steady for the last four years, at around 6% per annum, following a period of much stronger growth during the first half of the decade. However, research conducted by Halifax Financial Services suggests that parents on the margin are increasingly unable to afford fees, with private education found to be beyond the financial reach of 23 professional occupations in 2007, compared to 13 in 2002. The slowing economy, which is likely to exacerbate existing pressures on household finances generally, and which may impact on financial services-related professionals in particular (at least in the short term), may restrict

the ability of independent schools to grow fee income at current levels.



According to the NCVO, independent school expenditure totalled £5.1 billion in 2005-06, (comparable historical data are not available). The salaries of teachers and other staff account for over two-thirds of schools' total costs. However, with the government aiming to keep public sector wage growth in line with the CPI target, competitive wage pressures in the independent sector are likely to moderate. This may at least partly help to alleviate other operational cost pressures, such as rising utility bills.

At the same time, capital expenditure amongst ISC member schools fell to £690million, from £700 million, representing a 2.6% fall per pupil. According to the NCVO, over two-thirds of fixed assets held by independent schools are tangible assets, made up of school buildings and grounds. However, they also collectively own investment assets worth some £2.7 billion, which is equivalent to almost one-third of their total asset base.

Economic and demographic trends mean that many schools, particularly those at the top end of the market, are increasingly looking to overseas markets (particularly in high-growth emerging markets). Several top schools have also utilised their brand by setting up satellite institutions abroad, with more schools expected to adopt this strategy in the medium term. As a result, although only around 4% of pupils attending ISC member schools are from overseas (and they are concentrated among a relatively small number of

top boarding schools) the number of new, non-British pupils whose parents live overseas, entering education in UK independent schools increased by 5.0% in 2007, according to the ISC. At around 3%, growth in the enrolment of expatriate British children also significantly exceeded growth in pupil numbers as a whole.

Regulatory pressures are also impacting on independent schools. Following the 2006 Charities Act, independent schools will now have to justify their charitable status by demonstrating that they are benefiting the wider public and not, as was previously the case, merely providing educational services. As a result, more schools are looking to provide bursaries and other financial assistance for those on low incomes and/or seeking partnerships which would allow other schools access to sports and other facilities. However, this clearly represents a resource cost to independent schools participating in such programmes, which for some could prove to be unaffordable and/or impractical (especially for those in remote locations).

Further Education

There are over 400 further education (FE) establishments according to the latest data from Caritas. This figure does not include schools providing sixth form education. There has been some blurring of the traditional dividing line between further and higher education (HE) in recent years, with a number of FE establishments also offering higher education courses validated either by a HE institution or a national body. A number of HE institutions, particularly former FE colleges, also offer courses traditionally provided by FE establishments. New regulation introduced in May 2008 also means that FE colleges will now be able to apply for the right to award their own foundation degrees (degrees combining academic study with workplace learning), which is likely to further blur the distinction between FE and HE institutions.

The government allocates funds to the sector through the DCSF and the Department for Innovation, Universities, and Skills (DIUS). The Learning and Skills Council (LSC) is the major distributor of government funds for young people

and adult learners. The LSC funds an increasing range of programmes for young and adult learners, including apprenticeships as well as traditional FE programmes and qualifications. Partly as a result, it also receives funds from employers and individual learners themselves and has been encouraged to be more active in growing these income streams.

In the 2007 LSC Grant Letter, some £11.4 billion was allocated for post compulsory education and training in 2007-08, of which £0.6 billion was allocated as capital grants. This compares to £10.5 billion in 2006-07. Spending on 'young learners' for 2007-08 was £6.1 billion, compared to £3.1 billion allocated for 'adult learners'. LSC spending is expected to grow by just 1.9% to £11.6 billion in 2008-09 (this is likely to represent a decline in real terms), but growth is expected to accelerate at 3.6% in 2009-10 and 4.8% by 2010-11.

Trends in FE student numbers are likely to be subject to regional variability, particularly in non-specialist colleges. Although some specialist establishments tend to attract students from further afield, FE colleges tend to have stronger local student enrolment than their higher education counterparts and are therefore influenced more by local trends. Nevertheless, across the sector as a whole, demographic trends have been broadly supportive of sector demand with a steady increase in 17-19 year old population.

Although the number of UK citizens within this age bracket is expected to peak in 2009 and decline thereafter, government plans to extend full participation in some form of further education up to the age of 18 by 2015, means that participation of 16-18 year olds is projected to rise from 73.6% in 2007-08 to 78.3% in 2010-11. This would see the number of young students rise by 3.0% from 1.47 million to 1.52 million. The number of 16-18 year olds enrolled on FE courses is expected to remain unchanged at 773,000 in 2010-11, with a growing number undertaking Apprenticeships and Entry to Employment programmes.

According to the latest LSC Statement of Priorities, spending on 'young people' (those aged under 19) will be focused on improving the educational achievements of children from low-income families, with reforms aimed at developing skills responsive to employer demand. Student in this age group are more likely to study full-time and are typically government-funded.

The number of adult learners' (those aged 19 and above) is expected to remain broadly stable over the next few years, at around 3 million. However, funding for adult learning is shifting from a higher number of shorter courses towards fewer but longer and more accredited courses, with a growing emphasis on programmes such as Train to Gain. Adult learners typically study part time and there is a growing expectation for employers and learners themselves to contribute towards the provision of certain courses. Following its launch last year, take up of the Adult Learning Grant (ALG) has exceeded expectations and, looking ahead, a growing number of students in this segment will be supported by the expansion of FE grants to include 19-25 year olds.

A review of the White Paper 'Further Education: Raising Skills, Improving Life Chances' published in July 2007, reiterated that the FE system should be focused on improving employability and strengthening links with businesses, with all colleges developing in at least one specialist area to become part of new national sector-based network. According to the National Employer Skills Survey 2007 (NESS07), employer investment in employee training grew to £1,750 per employee up 11% between 2005 and 2007, suggesting that colleges could gain access to significant funding by providing more employer-focused courses.

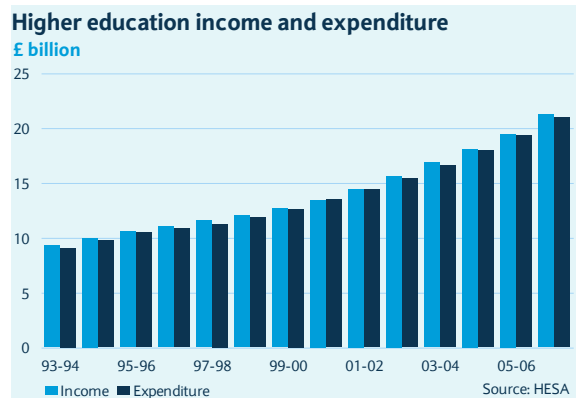
Like other educational institutions, lecturers' salaries represent the major cost for FE institutions. In 2004 agreements were made, to move lecturers onto the same length pay scale as school teachers, over half of colleges have now done this. However, this has had a significant impact on costs for some institutions. Nevertheless, pay pressures persist. Following rejection of an initial 2.5% offer, the latest pay

offer for October 2008 stands at 3.3% or £550 per annum (whichever is greater).

Research conducted by the Commons Public Accounts Committee (CAPC), November 2007, suggests that improvements in efficiency could see FE colleges realise significant cost savings, suggesting that up to 3% of expenditure (£75 million) could be saved. However, the extent to which what are likely to be one-off savings can offset other cost pressures remains to be seen.

Higher Education

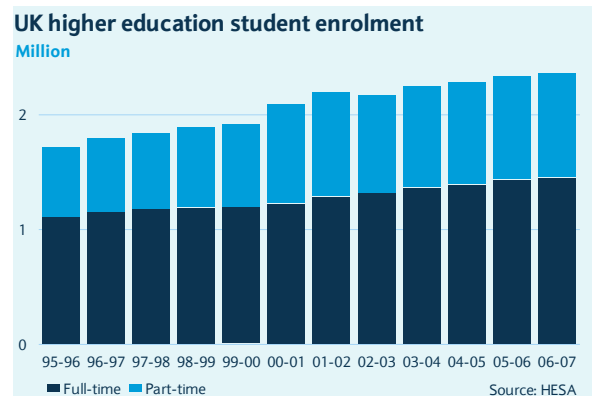
According to the DIUS, there are over 166 higher education institutions in the UK with degree awarding powers on a wide variety of courses as recognised by UK authorities. This figure includes the various University of London and University of Wales institutions, as well as Buckingham University (a private institution).



The sector generated total income of just over £21.3 billion in 2006-07, according to the Higher Education Statistical Agency (HESA), a nominal increase of 9.0%. Expenditure increased by 8.8% to £21.0 billion. This is in line with the longer-term trend, which shows that 90% of universities typically spend within 5% of their income. However, in terms of their overall wealth, institutions have benefited from the rise in property, equity and other financial asset prices in recent years. According to HESA/NCVO in 2005-06 universities owned nearly £26 billion worth of assets, the majority of which was contained in the value of land and buildings. They held nearly £900 million worth of investment assets, and overall were able to generate healthy returns.

The pattern of both income and expenditure has changed little over the past decade, according to HESA. Funding Council grants remain the largest source of income, accounting for 38% of total income in 2006-07, although income from tuition fees, (25%) and research grants and contracts (16%) also account for a significant proportion of total income. According to the NCVO, larger institutions are typically more successful in securing funding for research, whilst smaller universities are typically more reliant on direct public funding from the government. Attracting further funding will depend on institutions' success at widening participation and improving research.

Staff costs, non academic as well as academic, account for the lions' share (58%) of HE expenditure, according to HESA, and grew by 8.7% in 2006-07. However, the total number of staff employed grew by just 2.6% to 364,000, suggesting that most of the additional expenditure on staff was allocated to higher wages rather than increasing staff numbers. Academic staff represent 47% of HE employees and around two thirds of those in academic roles are in full time positions. The remainder are employed in management, technical, or clerical roles.



The number of students enrolled at UK higher education establishments increased by 1.1%, to 23.6 million in 2006-07. According to HESA, this is the slowest rate of growth since 2002-03 when the number of students enrolled fell by 1.1%. The majority, 1.8 million were undergraduates, with 559,000 postgraduates registered. The

number of students studying part-time has risen from 36% in 1997-98 to 39% in 2006-07, which may reflect the growing cost pressures on students (see below). According to UCAS, University applications for entry in 2008-09 increased by 7%, a faster increase than had been previously been expected following record applications in 2007-08.

Variable tuition fees of up to £3,000 per annum were introduced for the 2006-07 academic year, although this was partially offset by the provision of maintenance grants for poorer students. Indeed, this may explain why the proportion of 2008-09 applicants aged under 18 from lower socio-economic groups actually rose slightly, from 28.2% for 2007-08 to 28.9% for 2008-09.

An increasing number of students are now eligible for maintenance grants. For students starting in 2008, the threshold for a full grant will increase to include students whose families earn less than £25,000 up from the previous threshold of £18,000. Partial grants are also available for students whose parents earn up to £60,000. This has increased the proportion of students eligible for a full grant from 29% to 33%. In total, around two-thirds of students now eligible for some form of grant, (compared to around half in 2006).

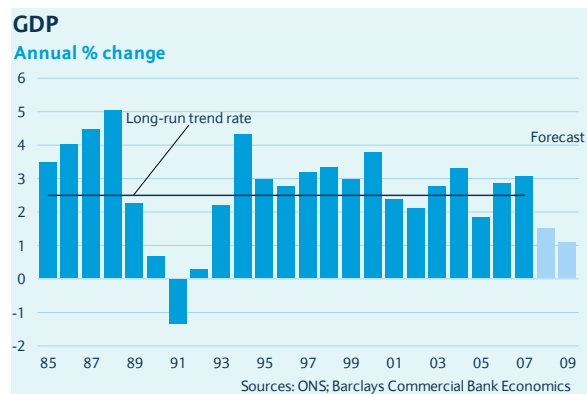
Overseas students (from outside the European Union) are subject to higher tuition fee structures in UK institutions than domestic and EU students. As a result, they have become an increasingly important source of income for UK higher education establishments. Indeed, this has provided an effective means of cross-subsidising UK-resident students in recent years. Like the UK's top independent schools, some leading UK universities are also setting up satellite and/or partnership organisations abroad to maximise income growth.

Some 351,000 overseas students were enrolled on UK higher education courses in 2006-07. This represents an annual increase of 6.5%. Growth in overseas students has been most evident on postgraduate courses, where the number of students has exceeded that of overseas students on undergraduate courses since 2002-03.

According to the OECD, nearly 12% of the estimated 2.7 million students studying abroad worldwide were enrolled in UK institutions in 2005, the latest period for which data are available. Although the UK is second only to the US as destination of choice for students studying abroad, and the number of overseas students studying in the UK continues to rise, UK institutions have begun to lose their share of the rapidly growing overseas student market, which increased by almost 50% worldwide between 2000 and 2004, and by 5% between 2004 and 2005 (the latest period for which data are available).

In line with its policy of widening participation, the government is looking to increase the number of institutions offering HE courses. In March 2008, the DIUS published details of its 'New University Challenge'. The new initiative, which will be led by HEFCE, will expand opportunities for towns and cities to bid for new university campuses and centres of higher education. Since 2003, 17 new HE centres have opened or had funding committed and the government expects that, over the next six years, 20 more new establishments will be opened or approved. The scheme will be part-funded from HEFCE's strategic development fund, but the government expects the scheme to attract financial support from local people, businesses, authorities and other stakeholders.

Outlook



Having increased at an above-trend rate of 3% in 2007, the UK is expected to experience significantly slower growth over the next couple

of years as the credit crunch feeds through into the 'real economy'. Consensus forecasts suggest that the UK economy will grow at a below-trend rate of 1.5% in 2008, with growth forecast to ease further to 1.1% in 2009. The Bank of England is unlikely to be able to respond immediately with interest rate cuts because high commodity prices are likely to ensure that inflation remains above target for at least the remainder of 2008.

The slowdown is expected to be led by slower growth in consumers' expenditure, although growth in corporate spending and investment are also likely to slow. With a tight fiscal position, the government's latitude with public expenditure is increasingly constrained and growth is expected to slow appreciably from the rates enjoyed in recent years. This will clearly have an impact on the charities, social housing and education sectors.

Evidence suggests that voluntary donations from individuals have already begun to slow, despite the fact that overall consumer expenditure has remained relatively strong. As disposable incomes have come under pressure in recent years, debt growth and positive wealth effects have supported consumer expenditure. However, restricted access to credit and a slowing property market are expected to put pressure on household finances. As a result, spending on discretionary items, such as charitable donations is likely to be squeezed further.

The outlook for charitable funding from the corporate sector also appears to be deteriorating. As companies see their profit margins squeezed by a combination of rapid costs increases and slowing demand, charitable donations are likely to slow.

Although the government remains committed to 'third sector' involvement in public service provision, pressure on government finances means that growth in government spending will slow during the current CSR period (2008-11). This is likely to impact on the income of those relying on public service grants and contracts, although the shift away from grants towards

contracts should help reduce income volatility in the longer term.

Looking further ahead, proposals to transfer funds in dormant bank and building society accounts to charities could (if implemented) provide the sector with additional funds. A similar principle could also be applied to compensation funds. These are funds set up to distribute compensation funds to claimants following law suits. At present, unclaimed funds are retained by firms in the UK, but US charities receive millions of dollars of transferred funds under an existing scheme across the Atlantic. However, the former scheme is likely to provide an essentially 'one-off' income boost and the latter is at an embryonic stage at present.

The increasing 'corporatisation' of the charities sector and the concentration of growth among the largest charities are likely to continue. This may result in higher costs as the proportion of professionals in the sector's workforce increases. It may also result in larger charities taking on more risk, in terms of adopting riskier investment strategies in search of higher returns and/or increasing their long-term debt to fund projects, as well as consolidation among smaller charities.

Although property prices have fallen in recent months and are expected to continue to do so, demand for social housing is expected to accelerate over the next few years, as constraints on credit availability restrict borrowing opportunities for individuals looking to get onto the property ladder, while other potential entrants to the market are deterred by falling house prices.

At the same time, the RSL sector is exposed to a large amount of debt, in particular those associations involved in large scale transfer of property from local authorities. Given that a large proportion of this debt is unhedged, some associations may now be facing increased debt servicing costs, further pressuring margins.

However, a combination of regulatory restrictions on income growth, pressure on public finances and a growing cost base continue to put pressure on RSL finances. This will pose a major challenge to the sector over the longer term, especially as

funds from property sales, which have been increasingly important in helping the sector maintain financial surpluses over the last few years, are likely to decline in the face of a slowing housing market.

Nevertheless, RSLs remain central to the government's housing policy, which plans for an extra 45,000 social homes to be available for rent by 2010. There remains a high degree of uncertainty over whether this target will be met but, although clearly not a panacea, the new initiative announced by the government to buy new-build homes from housebuilders on attractive payment terms, with social landlords paying more upfront, should provide some support for the planned expansion.

Government spending on education is expected to grow at a much slower rate over the next few years (albeit from very high growth rates compared to the first half of the decade). This will clearly have an impact across the state education sector.

Reforms within the compulsory education segment aimed at giving institutions greater financial independence, instilling market discipline and securing more private sector backing may ultimately improve state education provision. However, it is unclear how well many schools will cope with the additional pressure of managing budgets, especially as research shows that many head teachers and governors lack the required financial and management skills.

Over the last few years, independent schools fees have been steadily growing above the rate of inflation. However, research suggests that while more parents would choose private education, it is becoming less affordable, which is likely to have an impact on effective demand. As the economy slows and household incomes come under increased pressure, schools may find it difficult to attract new pupils without slowing fee growth. Indeed, those at the margin may see pupil numbers slow, as parents find themselves unable to afford fees.

Compulsory education is expected to be extended so that, by 2015, all young people will

be required to undertake some form of recognised education and training up until the age of 18. Initiatives are also in place to boost the number of adult learners and expand further education for 19-25 year olds. This is likely to boost FE student numbers, but will result in additional costs as well as income.

FE colleges are also expected to be able to devise courses and award degrees by 2010. This is likely to result in further mergers and partnership arrangements between HE and institutions, as well as further blurring of the traditional FE/HE dividing line. Government plans to ease barriers to University status should also result in the emergence of new universities. However, there is likely to be a growing divide between research and teaching-orientated institutions as a result of current government policy, which will have an impact on funding within the sector.

An increase in the options available for adult learners, centred on opportunities within further education, could have an adverse impact on the demand for higher education places, especially given the recent rise in university fees. Conversely, the opportunity for merger activity and expansion of HE courses to incorporate FE fundamentals could present new opportunities for the higher education institutions.

The international market remains a potentially lucrative source of income, given the rapid growth in students studying abroad worldwide. However, the market is rapidly evolving, with emerging markets accounting for an increasingly important share of student numbers. As a result, UK institutions will have to remain competitive against overseas institutions offering quality higher education.

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All data and factual information referred to in this report were correct as of 28th July 2008.

Source of ONS data: National Statistics website:
www.statistics.gov.uk

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