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Demand-driven system fallout: it'll hurt some

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Greater competition for students under the demand-driven funding system meant some universities lost market share and suffered financially. Picture: iStock

The federal government's funding freeze has prompted much push-back from universities worried about the impact on their finances.

Less discussed has been the impact of the demand-driven system on university finances in the first place.

Keith Houghton and Mark Clisby have published research in these pages (March 20) showing that the demand-driven system has not affected university efficiency. But what about university profitability?

With the recent release of 2017 university financial performance across the sector, we now have the ability to do multi-year trend analysis of finances before and after the introduction of the demand-driven system.

We also can look at the financial resilience of individual universities and their vulnerability to potential shocks. The picture that emerges is revealing, especially with Labor promising to reintroduce the demand-driven system.

The federal government releases financial data for 39 Australian universities: the 38 table A providers plus the University of Notre Dame.

These 39 universities generated a combined surplus of 8.7 per cent of revenue in the three years before the introduction of the demand-driven system in 2012. In the most recent three years the combined surplus was 5.7 per cent, a decline of more than 34 per cent.

There has been a steady decline since 2010, with a notable upswing in 2017. What may have caused these declines? Can we attribute them to the introduction of the demand-driven system? How can we explain the strong result in 2017? The short answer is we cannot point the finger of blame at the demand-driven system without picking apart year-by-year fluctuations in individual line items.

In the period 2009 to 2011, for example, Education Investment Fund capital grants were a major income stream to universities — $1.7 billion across the three years — compared with an almost negligible $100 million in the most recent three years. However, even if we remove the effect of EIF funding, sector-wide profitability is still lower now than it was at the start of the decade.

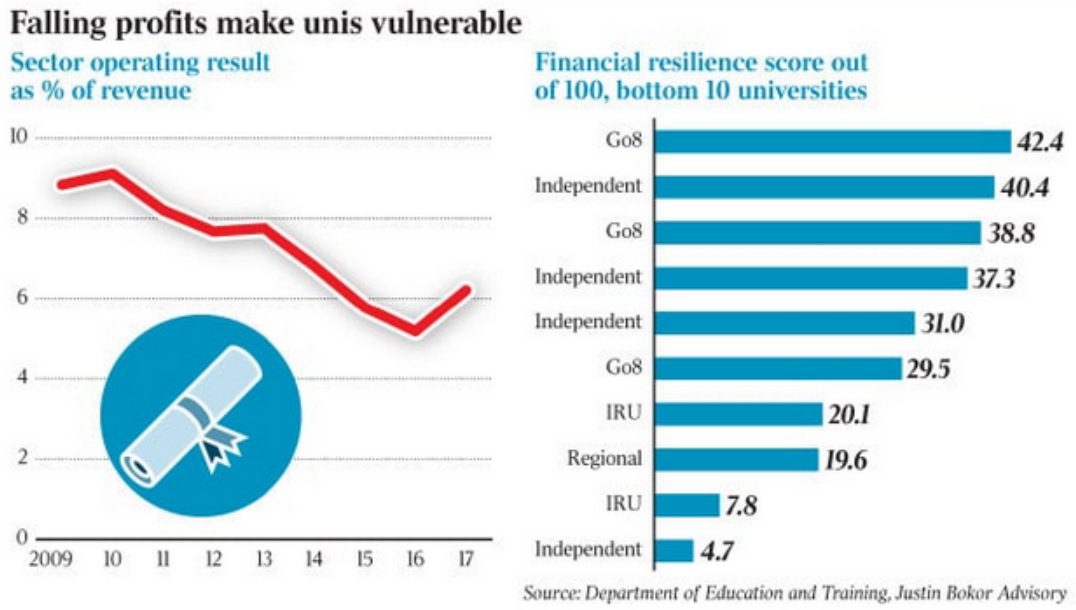
What happens if we turn our attention to individual universities? It turns out that the spread between the highest and lowest performing universities, in terms of financial returns, has widened considerably since the introduction of the demand-driven system.

The average surplus of the top 10 universities has increased by 8 per cent, compared with a decline of nearly 20 per cent for the bottom 10.

This makes sense. The demand-driven system, while opening up more places, also unleashes a much greater level of competition for students. Universities with stronger brands and performance take share in this market. Others lose share, or have to spend more to hold their ground.

Last year, I developed an index for measuring universities' readiness for a range of potential future scenarios (University Future Readiness Index™). The index includes a composite measure of universities' financial resilience, combining operating margin, adjusted for fluctuations in investment income and donations, liquidity, cashflow, earnings before taxes, depreciation and amortisation and growth in EBTDA. Each of the 39 universities is scored against a set of benchmarks, with scores on individual measures summed to an aggregate tally out of 100.

Two universities scored less than 10 out of 100 for financial resilience. The average of the bottom 10 universities — a mix of institutions, including three Group of Eight universities — was just 27 out of 100. Given the bundle of measures used, I classify any university scoring 25 or less as "highly vulnerable".



But we can go further. We can turn this into a real-world exercise by looking at what might happen in the case of, say, a decline in the international student market.

The international market has enjoyed unprecedented growth in recent years, including nearly 20 per cent revenue growth in 2017 — a major factor behind the upswing in profitability that year. But the sector knows the good times can't last forever.

To choose a realistic scenario to model, we can look at the last shock in the international student market. That was 2012, the year following several incidents of violent crime against international students. In that year, 19 Australian universities suffered a decline in international student income. The average decline was 5.6 per cent. Only two universities made an overall loss in 2012. An equivalent decline in the international student market today would turn nine Australian universities into loss-making institutions.

Another potential shock we could model would be a downturn in the global economy. In addition to affecting international student numbers, this would affect investment income and donations. Investment returns and donations are often considered non-core income. But take them away and 14 Australian universities would be loss-making.

Investment income and donations are highly volatile sources of funds. We can test university exposure to them by modelling each institution's financial result after subtracting one standard deviation from these income streams.

Statistics tells us that 33 per cent of events occur within one standard deviation of the average. In simple terms, we can expect this scenario to happen once every three years or so. Applying this scenario to Australian universities, we find that six of them turn into loss-making institutions.

In other words, a realistic down year on global markets and a set of Australian universities can't cover their operating costs.

What can we take away from this research? University finances declined considerably in the years after the introduction of the demand-driven system.

We can't definitively point the finger at that reform itself and, from the government's perspective, the policy has delivered important system-wide and community benefits. But there are several individual universities that are considerably more exposed to external shocks than they were at the start of the decade.

The sector wants the return of the demand-driven system. No doubt chief financial officer teams are testing the exposure of their institution to the downside scenarios. Be careful what you wish for.

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