CHANGING BUSINESS MODELS IN HIGHER EDUCATION

2020 REGENTS EDUCATION PROGRAM

October 5, 2020

HURON

Agenda

1

State Regent Duties
Reviews financial leadership duties of State Regents

2

COVID-19 Impacts & Responses
Addresses recent institutional responses to financial pressures

3

Resource Allocation Trends
Summarizes strategic resource allocation practices adopted by institutions

Changing Business Models

The COVID-19 pandemic has exacerbated and accelerated the revenue and expense pressures felt by institutions over the past few years.

Although institutional leadership spent the years following the Great Recession identifying ways to trim expenses, recent declines in enrollment, diminished state support, limited pricing power, and volatility in key revenue streams like auxiliaries and athletics are forcing institutions to reevaluate fundamental elements of the business model.

This presentation contextualizes the role of State Regents, identifies significant COVID-19 impacts and responses, and identifies several sweeping trends in resource allocation management.

STATE REGENT DUTIES

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State Regent Duties
Role of State Regents

Although the State Regents do not direct day-to-day operations of colleges and universities, they play a critical role in shaping the strategic direction and outcomes at institutions.

Fiduciary Role

- Allocate funding and approve tuition and fees
- Act as a steward of financial resources and investment of public dollars
- Encourage the realization of cost savings and revenue growth

Quality Assurance

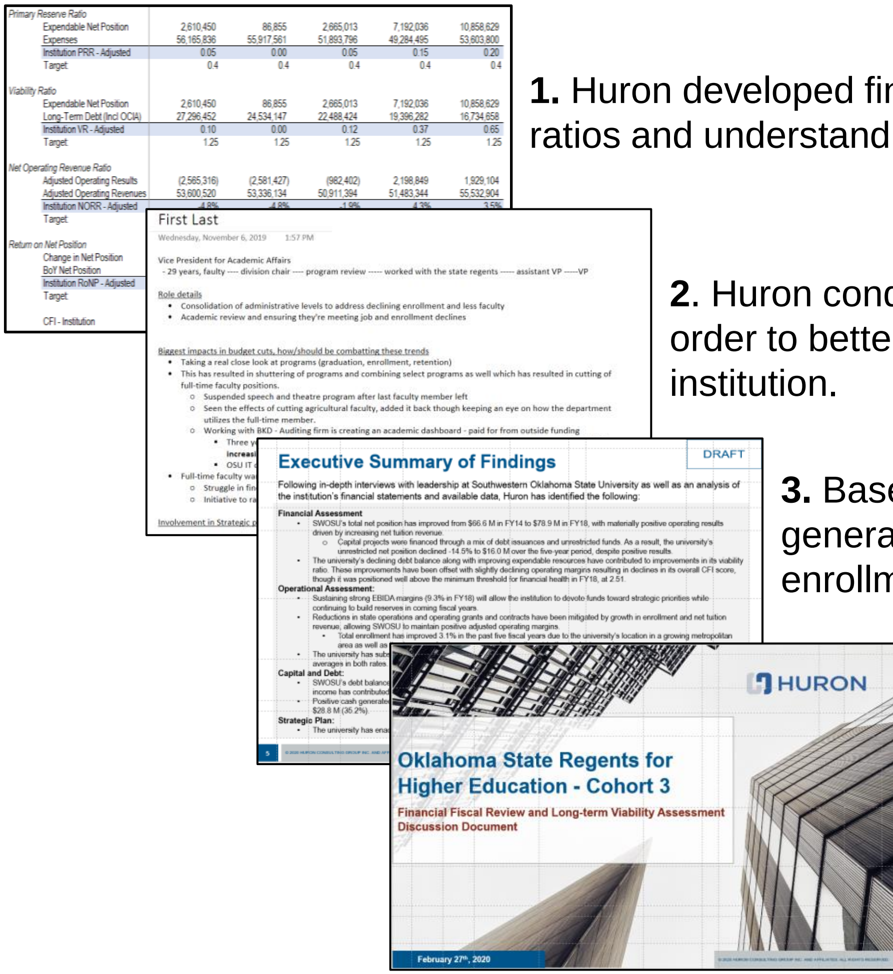
- Prescribe academic standards
- Grant degrees and determine academic functions and courses of study
- Provide oversight and direct reviews of performance, savings, and alignment with student and workforce needs

Long-Term Strategy

- Identify opportunities to support partnerships, alliances, and collaborative activities across the State
- Convene committees, task forces, and other subject matter experts to help develop and implement recommendations to best position the State System of Higher Education to meet the needs of the State

State Regent Duties
Financial Review

Recent institution-level financial reviews were carried out as part of the Regents' fiduciary, quality assurance, and strategic direction responsibilities.



1. Huron developed financial models to study key performance ratios and understand institutional trends.

2. Huron conducted interviews with key stakeholders in order to better understand the current state at each institution.

3. Based on the financial model and interviews, Huron generated a robust report broken out into financial, enrollment, and capital trends.

4. For each cohort (4-5 institutions), Huron presented key findings and conclusions from each of the institutions.

State Regent Duties
Identification of Risk Factors

The State Regents-led financial review identified that, at the conclusion of FY19, several risk factors were common across a range of institutions.

Established Risk Factors			
Institutions that have already cut expenditures significantly have less capacity to respond to revenue shortfalls in the absence of significant reductions in force and/or extended furloughs			Increasing debt burdens will constrain liquidity through higher principal and interest payments
Expendable Reserve Risk Factors	**Operating Performance Risk Factors**	**Net Position Risk Factors**	**Debt Leverage Risk Factors**
Below-target Primary Reserve Ratio & operating expenditure reductions greater than the average of 5.8%	Below target Net Operating Revenue ratio & operating expenditure reductions greater than the average of 5.8%	Below target Return on Net Position ratio & operating expenditure reductions greater than the average of 5.8%	Below-target viability ratio & increasing debt balance
Number of institutions at risk: *4 Institutions*	**Number of institutions at risk:** *9 Institutions*	**Number of institutions at risk:** *8 Institutions*	**Number of institutions at risk:** *8 Institutions*

Institutional responses to common risk factors will vary based on region-specific demographic and enrollment trends, debt burden, foundation support, and other other factors.

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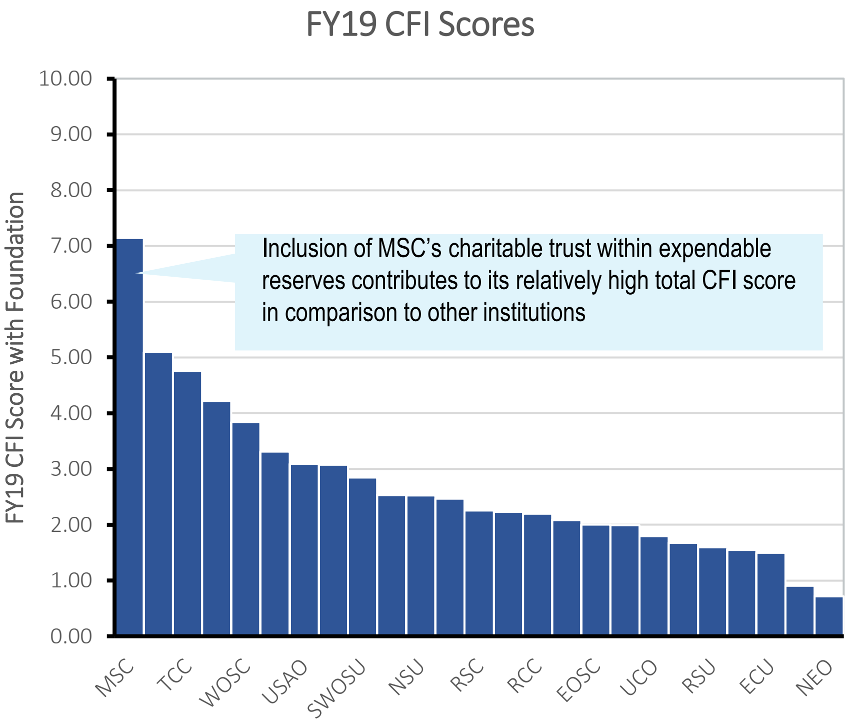
State Regent Duties
Determining Future Strategy

Prior to COVID-19, OSRHE institutions had generally seen improvements in CFI scores and recovery from state appropriation cuts, although enrollment and growth concerns remain.

Forward-Looking Consideration:

- **Pricing Strategy**: Between FY14 and FY19, two-year institutions experienced the greatest increase in tuition rates and the sharpest declines in enrollment
- **Liquidity**: Institutional liquidity, as measured by unrestricted days cash on hand, varied widely at the conclusion of FY19
- **Declining Margins**: The majority of regional universities experienced declining operating margins between FY14 and FY19



Ongoing monitoring of financial indicators, to reflect FY20 and first quarter FY21 performance, will be essential to understand how institutions have been impacted by COVID-19.

FINANCIAL IMPACTS OF COVID-19 & INSTITUTIONAL RESPONSES

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COVID-19 Impacts
Financial Pressures

Institutions have continued to face financial pressures through the Fall term. The following examples highlight constrained revenues and impacts to expense budgets.

REVENUE IMPACTS

STATE SUPPORT

Legislative actions and mid-year state budget cuts could exacerbate existing trends of declining state support

ATHLETICS REVENUE

Continued restrictions and cancellations of conference seasons will curb critical athletics income like ticket sales and conference distributions

STUDENT TUITION

Institutions must remain creative and strategic to attract students and solidify much-needed tuition revenue streams

EXPENSE IMPACTS

ATHLETIC ELIMINATIONS

Program cuts will continue, particularly for non-revenue-generating sports or programs with high overhead

EXECUTIVE PAY CUTS

Both public and private institu-tions have cut leader salaries to limit personnel costs and signal benevolence

FURLOUGHS AND LAYOFFS

Institutions will avoid layoffs as long as possible, focusing on furloughs in areas with reduced activity due to remote learning

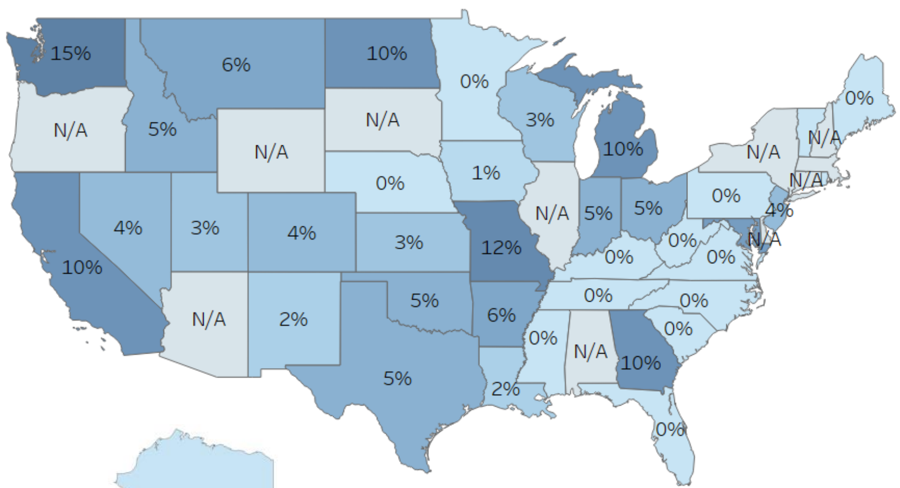
The analysis of institutional actions that follows highlights broad trends to-date, specific examples and anecdotes, and Huron's perspective on trends to anticipate moving forward.

COVID-19 Impacts
Reductions in State Support

Institutional leaders are closely watching legislatures to assess the impact of changes in state support. At least 45% of states have announced higher education funding cuts.

Estimated Budget Reductions (% Change from Pre-Covid-19 Budgets)

*Based on announced **budget cuts**, **requests** for agencies to model cuts, and **% reductions**[1] from pre-COVID-19 budgets*



$3.5 billion estimated total of announced cuts across all states

BORROWED FUNDS

Facing a budget deficit, the state of **New Jersey** is borrowing upwards of $9.9 billion to balance its budget.

DELAYED DECISIONS

Washington state has tentatively asked institutions to anticipate a 15% reduction in state funding.

CONTINUED REDUCTIONS

Despite historically low funding levels in FY20, **Georgia** announced it would reduce higher education funding by an additional 10%.

Reductions in state funding are forcing public institutions to turn to other revenue streams; state funding declines have historically led institutions to rely more heavily on tuition.

Note: For those states that included higher education in their budget cuts; states with unavailable data or pending announcements are shown as N/A

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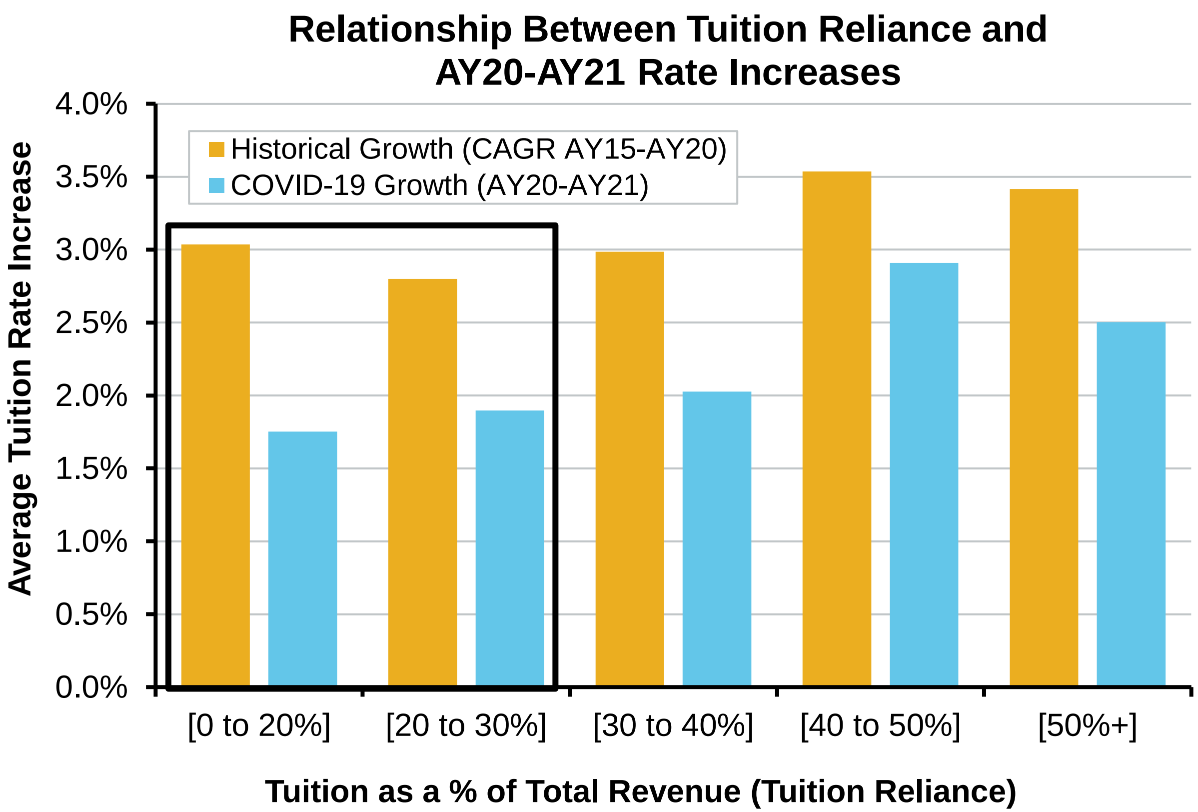
COVID-19 Impacts
Tuition

Many institutions have adapted their tuition pricing strategies to reflect modified operations and remote Fall instruction.



PRICING FLEXIBILITY

Lower tuition dependency allows for greater pricing flexibility. Nearly half of the boxed institutions increased their rates by less than 1.0%.

CREATIVE STRATEGIES

Institutions have announced targeted discounts, tuition-free terms, & other tactics to signal affordability and retain students while still ensuring revenue.

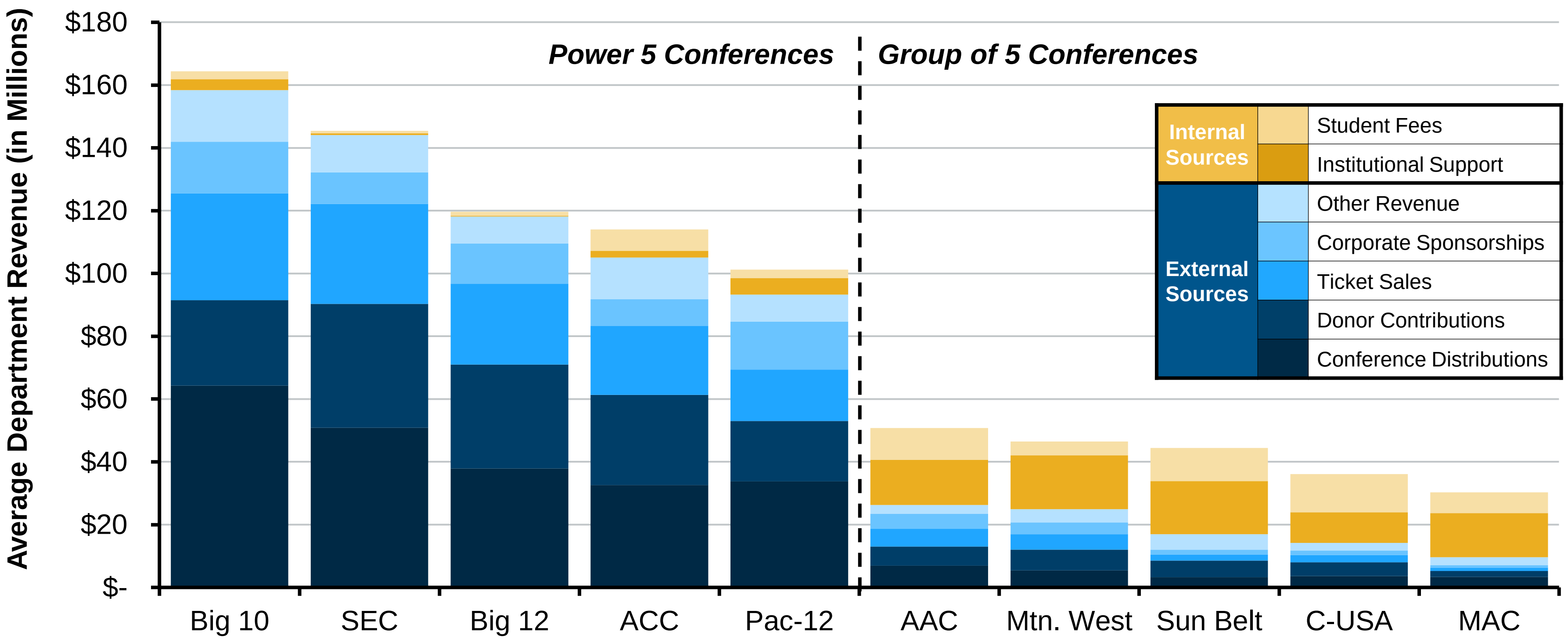
Tuition revenue will be more important to institutions than ever as COVID-19 constrains other revenue streams (e.g., state appropriations and athletics).

Analysis includes both public and private 4-year institutions. The AY15-AY20 rates presented reflect compounded annual growth rates (CAGRs). Tuition dependency is calculated as tuition revenue/total revenue.

COVID-19 Impacts
Athletic Cuts and Cancellations

Additional conference-wide sports cancellations could be devastating for institutions that rely heavily on athletic department revenues like conference distributions and ticket sales.

Division I Football Bowl Subdivision (FBS)
Average Athletic Revenue Sources by Conference (FY18)



Power 5 Conference schools are at risk if conference cancellations continue, limiting their external revenues. Group of 5 institutions may suffer if institutions target athletics for internal cost cuts.

Source: Knight Commission, 2018; only includes public institutions

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COVID-19 Impacts
Enrollment Management Challenges

The pandemic has created unprecedented challenges for students, and in turn, ongoing enrollment risks for many institutions.

Enrollment Unpredictability

Students are **keeping options open** as re-opening plans continue to shift

Students have sought options **closer to home**

Lower income and rural students have **limited access to technology** and high-speed internet

International students are more likely to stay home or go elsewhere due to uncertainties

Financial Uncertainty

High unemployment rates have severely impacted students' **ability to pay for education**

High numbers of appeals are placing a **great strain on institutional financial aid budgets**

Guidance on CARES Act aid was **confusing and delayed its distribution**

Student Satisfaction

Limited engagement and **overall dissatisfaction** with the remote learning **may sway current students to stop out** come August/September

Limited course offerings, course enrollment caps are **limiting the number of credit hours students can take**

Remote learning has impacted **students' access to support services**

Looking to 2021

Social distancing continues to **limit options to visit campuses**

Reduced access to ACT/SAT testing is impacting recruitment, admissions and aid policies

Nearly **100,000 fewer high school seniors have completed FAFSAs** compared to 2019[1]

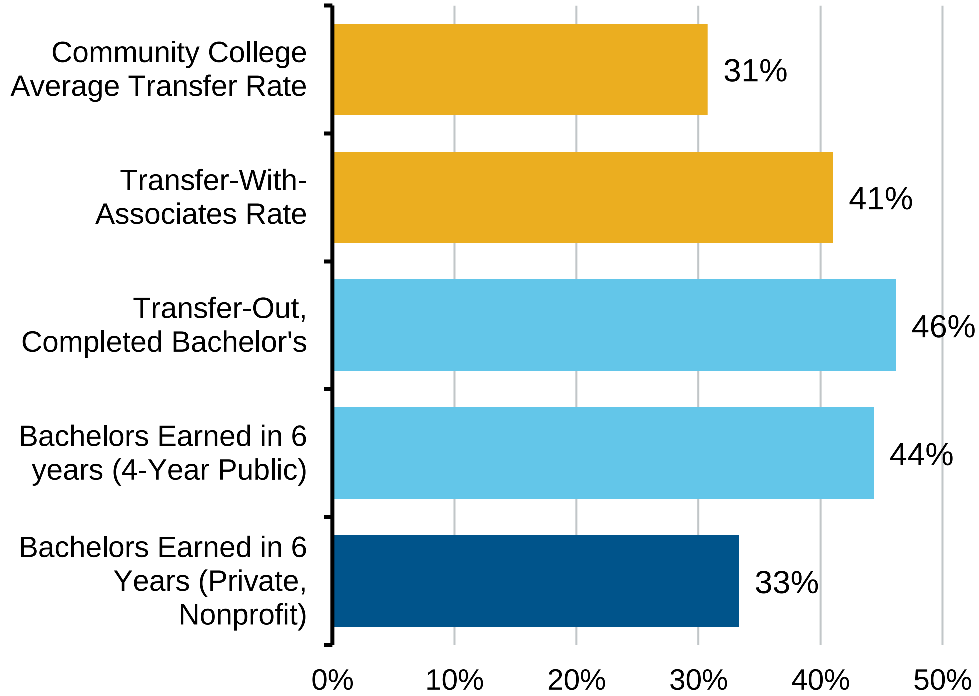
The outlook for the Spring 2021 term remains uncertain for many institutions, and the impact of limited and virtual recruiting for Fall 2021 admissions is unknown.

[1] National College Attainment Work: #FormYourFuture FAFSA Tracker through 8/28/2020

COVID-19 Impacts
Transfer Student Volatility

The transfer market promises to be extremely volatile this year, not only due to the uncertainty of COVID-19, but also due to the lifting of recruitment restrictions on current students.

Tracking Transfers (Entering Fall 2013)
US Community College Students who Transferred Out



Feeder Institutions | *Enrollments at 2-Year public institutions have declined on average 2.6% over the last four years, ranging from -1.7% (2017) to -3.2% (2018).*

REDUCING BARRIERS
Speed and simplicity remain critical for attracting and supporting transfer students

FLEXIBILITY ON CREDITS
Lower academic performance and pass/fail grading policies need to be accounted for in transfer evaluations

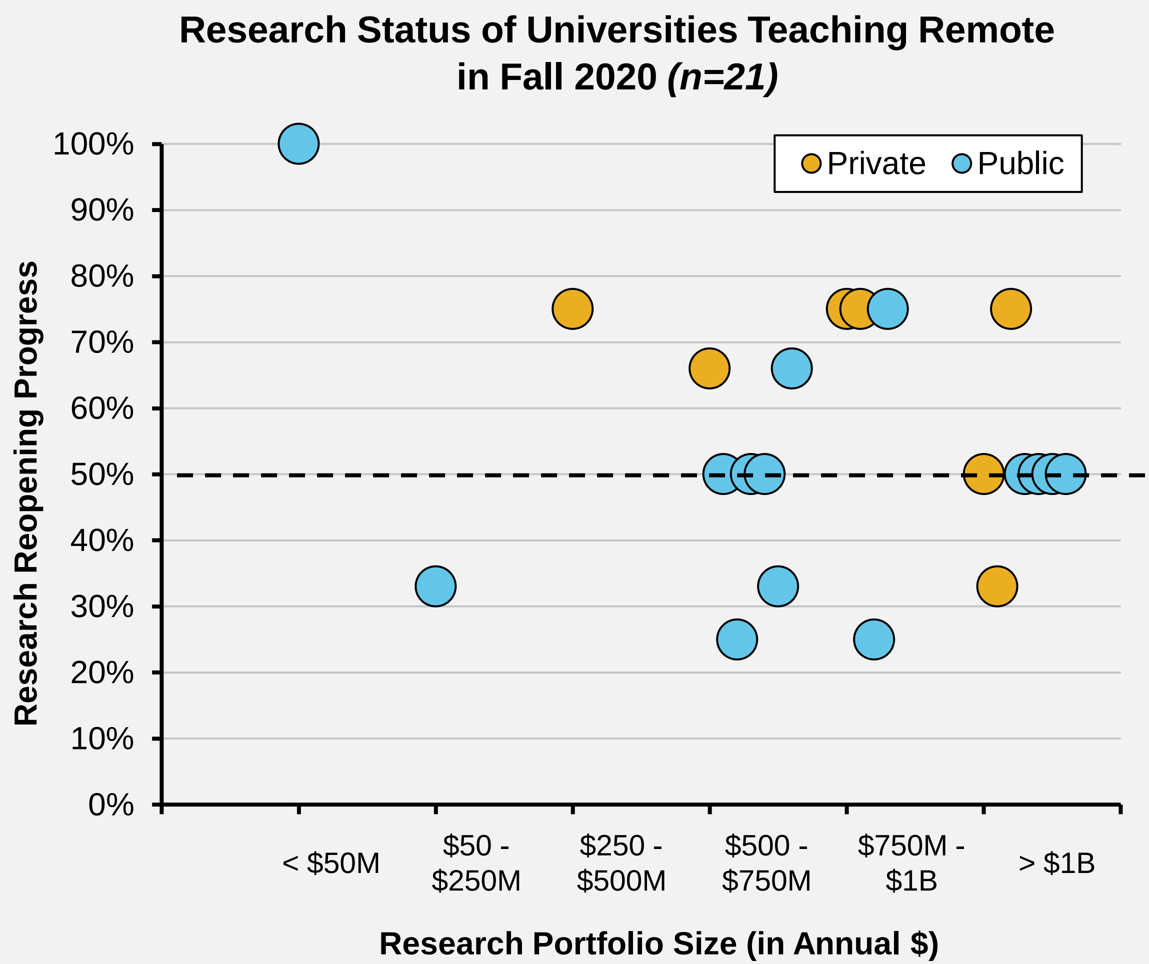
FINANCIAL INCENTIVES
Limited term grants may attract students facing short-term financial difficulties

To ensure positive and sustainable change in transfer student outcomes, institutions should map the current student *digital and on-campus* experiences to identify gaps and opportunities for innovation.

Source: National Student Clearinghouse Research Center, Tracking Transfer Report, 2020; Trends in Community College Enrollment and Completion Data, Issue 5, American Association of Community Colleges

Responses to COVID-19
Research Carries On

Even at institutions which have pivoted to be primarily or fully remote, research institutions have proceeded with reopening research facilities.



FACTORS DRIVING RESEARCH REOPENING

Leading research institutions have developed phased reopening plans. Decisions guiding their progress through these plans have been driven by several factors:

COVID-19 TRIALS

Institutions responding to a large demand in COVID-19 studies have been challenged to rapidly open trials

FINANCIAL MANAGEMENT

Approximately 70% of research institutions implemented strict financial measures to mitigate the economic impact of COVID-19

ENSURING SAFETY

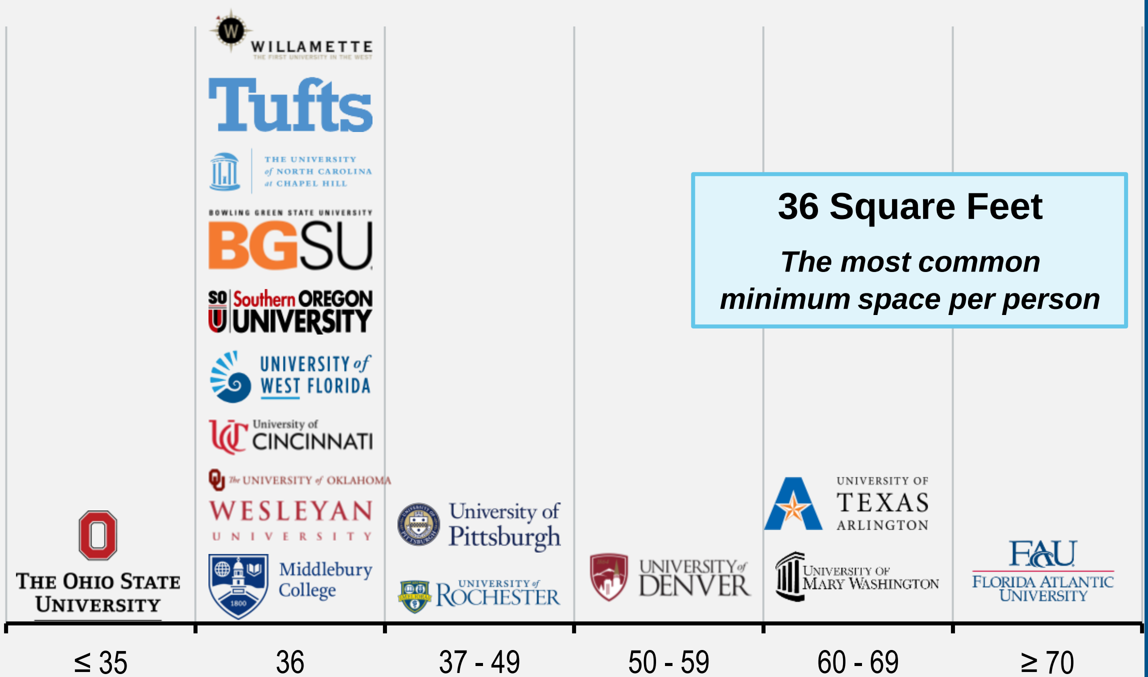
Over 80% of institutions required Principal Investigators to submit return to research plans that required approval prior to execution

Data as of 8/28/20
Source: 2018 NSF Herd data, Davidson College 'College Crisis Initiative' COVID-19 dashboard

Responses to COVID-19
Classroom Optimization

Social distancing requirements have led to dedensification of classrooms, requiring modifications to course schedules and physical space.

Social Distancing Benchmarking
Minimum Square Footage per Person for Instructional Space



36 Square Feet

The most common minimum space per person

Typical Pre-COVID-19 Classroom Utilization Target[1]

80%

Typical Pre-COVID-19 Physical Square Footage per Student[2]

15 – 20 Square Feet

OPTIONS FOR OPTIMIZING UTILIZATION

To ensure safe on-campus instruction, institutions have had to consider several options to optimize their instructional space across campus.

SPLITTING SECTIONS

Institutions have addressed the limited supply of high capacity classroom spaces by splitting some courses into several smaller sections

REPURPOSING SPACES

Campuses have reallocated and repurposed non-instructional space across campus for instructional use

BALANCING SECTIONS

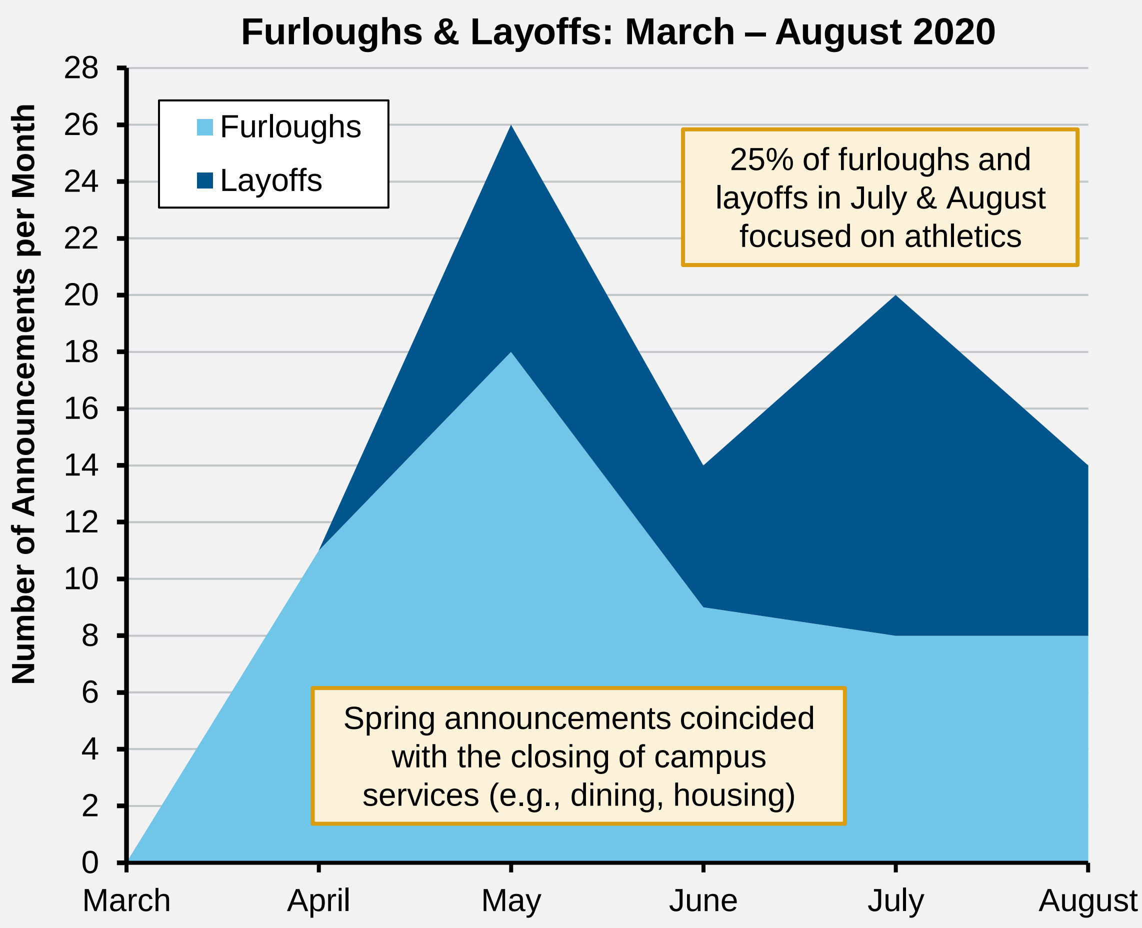
On-campus sections have been subdivided into smaller groupings (by day or week) to level-out and limit the number of students in classrooms

[1] Classroom utilization is calculated as a percentage of time that an institution's instructional space is used for instruction within a defined timeframe – typically 8:00AM – 6:00PM, Monday through Friday.

[2] Based on standard architectural guidelines for higher education institutions across the U.S.

Responses to COVID-19
Furloughs & Layoffs

Between March and August 2020 dozens of institutions announced furloughs, layoffs, and pay cuts to mitigate the financial impact of COVID-19.



TRENDS IN PERSONNEL EXPENSE REDUCTIONS

Many institutions have focused on reducing personnel expenses to address their FY21 budget shortfalls.

LAYOFFS

20% of institutions reported lay-offs – over half of which were announced in July and August

FURLOUGHS

33% of institutions have announced furloughs, the vast majority of which were mandatory

EXECUTIVE PAY CUTS

Pay cuts range from 5%-50%, with executives taking an average FY21 pay reduction of 10%

Data sourced from institution websites and public media announcements. Institutional actions data current as of (8/31/20); statistics based on the 150+ institutions in Huron sample.

RESOURCE ALLOCATION TRENDS

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Resource Allocation Trends
Recent Business Model Trends

Revenue constraints and demands to reduce expenses have further challenged institutions to adapt their business models to changing times. Recent trends have included:

Incentive-Based Budget Models

Decentralized, incentive-based resource allocations models empower deans, department chairs, and faculty to take greater ownership of revenue-generation and monitor and influence overhead costs

Academic Portfolio Assessments

A campus-engaged review of academic portfolio offerings can help set and achieve goals of optimizing the mix of high-cost, mission-centric programs and higher-margin programs

Collaborative Ventures

Strategic ventures have ranged from auxiliary outsourcing to administrative consolidation and institutional mergers

Resource Allocation Models
Recent Trends in Budgeting

The changing needs of higher education have resulted in increased economic pressures and evolving student desires force institutions and leaders to act differently.

- Institutions are working diligently to reframe budgeting as a way to develop new resources, promote desired activities, and funnel resources to strategic priorities
- Recent changes have resulted in more inclusive strategies that acknowledge the powerful impact engaged faculty and staff can have on institutional resources
- With enhanced inclusiveness, universities have needed to produce more timely, comprehensive, and insightful data and reports
- Ultimately, universities appear to be adopting hybrid budgeting models that are highly customized to institutional cultures and goals

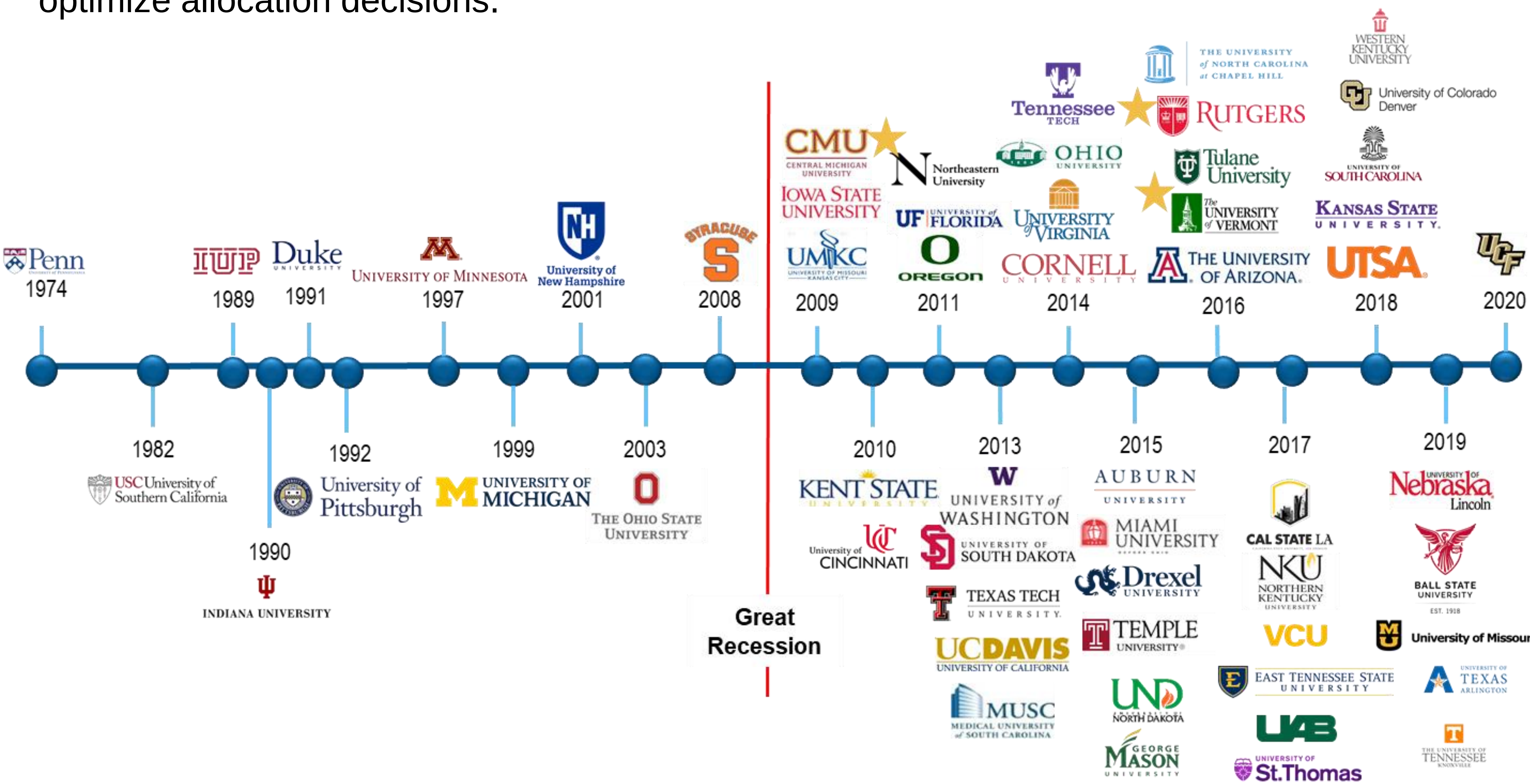
Resource Allocation Models
Shifting Focus of University Budgeting

University budgeting initiatives often begin with an attempt to reframe traditional campus budgeting perceptions by highlighting the strategic importance of resource allocation.

Traditional Budgeting Perceptions	Strategic Resource Allocation
▪ **Inventory** of anticipated expenditures ▪ Mechanism to **control** expenditures ▪ **Independent activity** performed by department managers ▪ **Backroom operation** performed by accountants ▪ **Spreadsheet** indicating resource availability ▪ Performance measures that **reset annually**	▪ **Plan** for developing resources ▪ **Prioritization** of resource allocations for strategic initiatives ▪ **Explanation** of the internal economy ▪ Mechanism to create institutional **incentives** ▪ Tool to empower departments to engage in **entrepreneurial** activities ▪ **Predictor** of annual financial statements ▪ Baseline measure of **accountability**

Resource Allocation Models
Budget Redesign Initiatives

While budget redesign efforts focus on the allocation process – not the amount of resources allocated – fiscal pressures are inherent drivers of recent initiatives as institutions look to optimize allocation decisions.



Note: This illustration depicts institutions who have announced/undertaken a budget model redesign and does not reflect Huron-only budget redesign clients.

Resource Allocation Models
Budgeting Alternatives

Incremental budgeting is the most common approach to university resource allocation, though an array of alternative and hybrid models exists.

Traditional Budgeting Perceptions			
Incremental Budgeting	**Formula Funding**	**Performance Funding**	**Incentive-Based Models**

▪ Centrally driven
▪ Current budget acts as "base"
▪ Each year's budget increments (decrements) adjust the base
▪ Focus is typically placed on expenses
▪ Common modifications:
  ▪ Block-grant models bucket line-items together to promote local control
  ▪ Revenue incentives may be incorporated for the allocation of resources above-and-beyond the base
▪ Approximately 60% of institutions and 79% of public doctoral institutions report using this model
	▪ Unit-based model focused on providing equitable funding
	▪ Unit rates are input-based and commonly agreed upon
	▪ Annual fluctuations are driven primarily by the quantity of production and not from changes to rates
	▪ Common modifications:
	  ▪ Weighting schemes to control for local cost structures
	  ▪ Used only for select activities (e.g., instruction)
	▪ Approximately 26% of institutions and 45% of public doctoral institutions utilize a formula funding model
		▪ Unit-based model focused on rewarding mission delivery
		▪ Unit rates are output based and commonly agree upon
		▪ Annual fluctuations are driven primarily by changing production and not from changes to rates
		▪ Common modifications:
		  ▪ Weighting schemes to control for local unit mission
		  ▪ Used only for small portions of overall resources (as little as 1-5%)
		▪ Approximately 20% of institutions and 26% of public doctoral institutions utilize a performance funding model
			▪ Focus on academic units
			▪ Incorporates a devolution of revenue ownership to local units, as generated
			▪ Allocates costs to revenue generating units
			▪ Utilizes a centrally managed "subvention pool" to address strategic priorities
			▪ Common modifications:
			  ▪ Revenue allocation rules
			  ▪ Number of cost pools
			  ▪ Participation fee (tax rate)
			▪ Approximately 21% of all institutions and 24% of public doctoral institutions use an incentive-based model

It is very common to find institutions that are utilizing multiple budget models simultaneously, resulting in hybrid models or dedicated models to support various university missions.

Resource Allocation Models

Spectrum of Incentivized Models

While incentive-based budgeting is commonly perceived as requiring an entirely decentralized budget model, several incentive-based iterations exist.

Incentive-Based Budget Model Iterations			
Margins-Based Budgeting	**Contemporary Decentralized Budgeting**	**Responsibility Center Management**	**Each Tub on its Own Bottom (ETOB)**
▪ A moderate degree of central control ▪ Allocated revenues follow costs and institutional priorities ▪ Focuses Deans' attention on thing within their control/ways to grow revenue or reduce direct costs ▪ Central strategic investment/ support pools are used to cover institutional operations ▪ Units are incentivized to exceed margins; but must develop plans to cover missed targets	▪ A higher degree of central control ▪ Local units keep a majority of their revenue but give up more than in the traditional incentive-based budgeting model through a higher subvention "tax" paid ▪ Through increased tax revenue, central administration has greater ability to subsidize colleges, fund strategic initiatives, and support mission-related programs ▪ Higher tax rate, typically between 15 and 20% (in addition to indirect cost rates) ▪ This iteration has been the most commonly implemented since 2005	▪ Some centralized control ▪ Local units keep most of the revenue they generate, but give up some to a central pool through a subvention "tax" paid ▪ Taxes generated can be used by the central administration to subsidize colleges, fund strategic initiatives, and support mission-related programs ▪ Generally low tax rate of less than 10% (in addition to indirect cost rates) ▪ These models were most frequently implemented from 1990 to 2004	▪ Extremely de-centralized model ▪ Academic units essentially operate as their own financial entities ▪ Very little strategic control held by the central administration ▪ No sympathy for market forces ▪ Under-performing units must cut costs or generate more revenue to cover any losses incurred ▪ Only three U.S. institutions use this extreme iteration, one of which is shifting away

More centralized ***Less centralized***

In order to optimally tailor a budget model for a given institution, it is critical to identify and create an appropriate balance of centralized and de-centralized control.

(1) Adoption rates from the 2011 Inside Higher Education Survey of College and University Business Officers; Percentages do not add to 100% due to hybrid budgeting models. Incentive-Based Numbers are from the 2016 Survey.

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Academic Portfolio Management
Evolution of Academic Programs

For most institutions, their collection of academic programs is the result of historical offerings combined with newer programs that reflect market trends and faculty interests.

- Too often, institutional approaches to managing academic programs lack comprehensive, objective assessments of program viability
- Furthermore, when program prioritization efforts are undertaken, they are often met with high levels of skepticism and resistance from campus constituents

How did we get here?

ORGANIC PROGRAM GROWTH

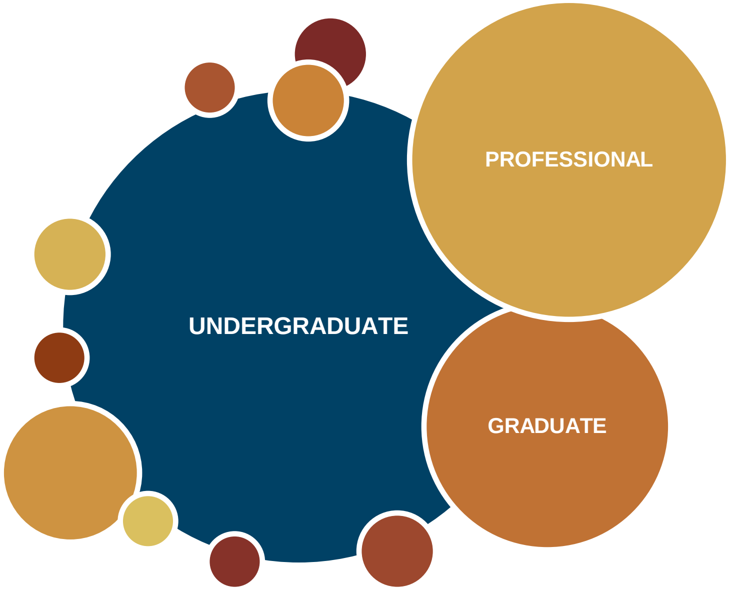
- Historical approach, limited goal alignment
- Grown out of mission, altered by local needs
- Programs created from internal interests

DECENTRALIZED DECISIONS

- Bottom up, case-by-case approach
- Inconsistent methodologies
- Common lack of accountability/measurement

PROGRAM PRIORITIZATION

- Reactionary, top-down approach
- Limited campus buy-in/participation
- Fiscal realities limit re-investment in priorities

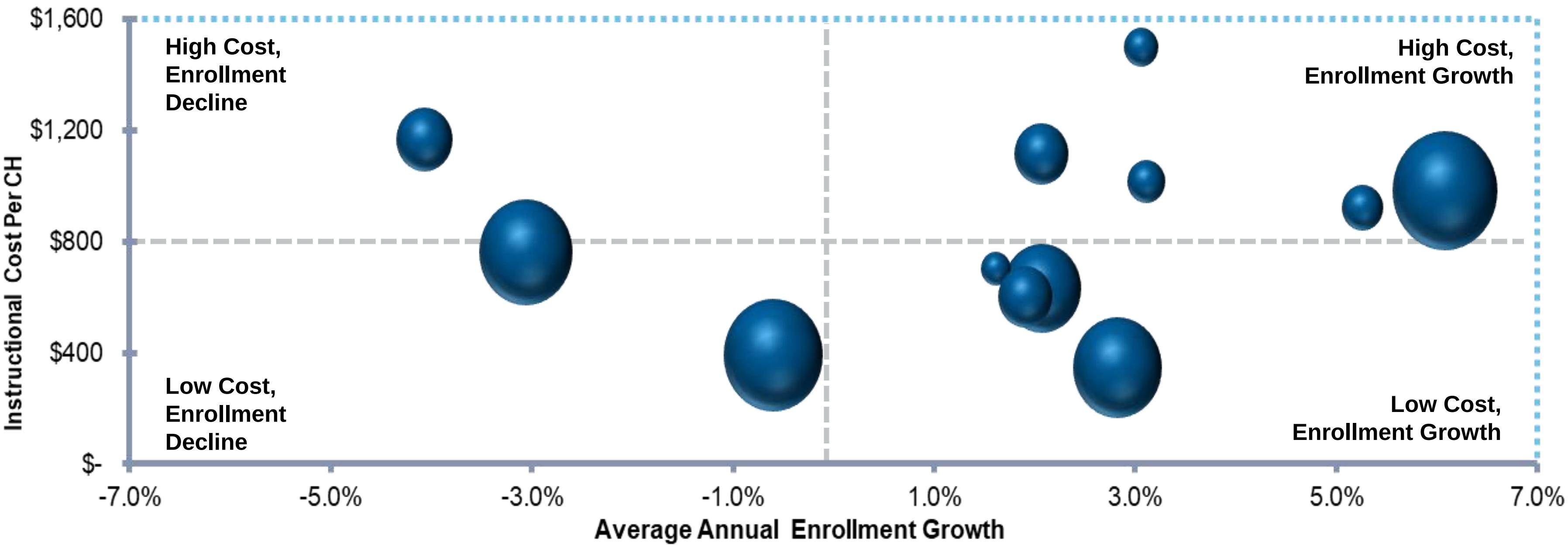


Academic Portfolio Management

Defining the Portfolio

Huron recommends that institutions think of their academic programs as a portfolio, in which academic leaders recognize the need to maximize resources, market relevance and mission-driven activities.

- The array of academic programs an institution offers, when strategically designed, powerfully supports its competitive advantage in the marketplace, leading to distinctiveness and long-term financial sustainability.
- The illustrative portfolio below raises questions about the institution's financial sustainability, as the institution's primary low-cost areas are in decline, while the majority of high-cost areas are experiencing growth.



Academic Portfolio Management

Guiding the Portfolio

Once tools are in place, programs should be guided or shifted over time, and in alignment with strategic priorities, through investments, contractions, consolidations, etc.

Instructional Cost Per CH

High Cost, Enrollment Decline

- Has a decision been made to reduce enrollment due to high cost of instruction?
- Has enrollment suddenly declined from an expensive offering that was strategically being pursued?
- Have costs unexpectedly increased?

High Cost, Enrollment Growth

- Are increases in program enrollment desired despite high costs of instruction?
- Was a decision made to actively invest in offering?
- Is the result of the high cost of instruction due to unexpected cost increases?

Low Cost, Enrollment Decline

- Has enrollment decline been the result of right-sizing?
- Are there reinvestment considerations required to make offering more appealing to enrollment demand?
- Are offerings able to cover their cost of operation given declining enrollment?

Low Cost, Enrollment Growth

- Is enrollment growth the result of program expansion?
- Is program quality being diminished as a result of enrollment growth?
- Are there opportunities to share potential efficiencies to delivering instruction across program offerings?

-7.0% -5.0% -3.0% -1.0% 1.0% 3.0% 5.0% 7.0%

Collaborative Ventures
Spectrum of Options

Universities can explore strategic ventures with other academic-related institutions on a variety of partnership arrangements, of which traditional mergers and acquisitions are one type to consider.

	Outsourced Auxiliaries	Study Abroad, Procurement, Economies of Scale	Third Party Academic, Recruitment, etc. Services	Back Office and Administrative Function Mergers	Institutional Mergers and Partnerships
Description	Use third party to fully operate or manage auxiliary operations (dining, bookstore, housing, campus safety, etc.)	Partner with firm(s) or other institutions(s) to operate study abroad, procurement, and other scalable activities	Hire third party to provide administrative, curricular, or student services, like recruitment or online course development	Merge administrative functions with local institution(s) to reduce costs for all parties involved; implement shared service model	Consolidate operations with, or be absorbed by, another institution; satellite campus model or complete merger
Benefits	• Usually more profitable • Less management complexity	• Lower costs through economies of scale • Greater offerings	• Reduced personnel costs • Greater offerings	• Economies of scale • Leveraged technology and expertise	• Creates growth and allows for campus operations to continue
Challenges	• Less operational and service level control • Potential revenue loss	• Less flexibility to customize offerings, purchases, etc.	• More challenging to tie class or courses to university's identity	• Complex to manage • Lack of personal or tailored services	• Potential loss of identity • Headcount reductions

Least Aggressive Partnerships ←→ ***Most Aggressive Partnerships***

A wide range of strategic ventures can exist on the right side of this spectrum, including resource sharing arrangements, joint ventures, partnerships, mergers, acquisitions, and other arrangements.

Collaborative Ventures
Drivers & Obstacles to M&A

As consolidation becomes more imperative within sectors of higher education, key drivers are pushing institutions to explore M&A opportunities that will force leaders to face long-standing obstacles at many universities.

Drivers For Change

- **Growth** through access to new student pipelines, talent, academic programs, and/or technologies
- **Market demand** for new academic pathways
- **Declining sustainability** and waning public support of long-standing business models within higher education
- **Assets available** (e.g., endowment funds and facilities) for acquisition from universities facing operational challenges

M&A Considerations in Higher Education

Obstacles

- Ability to **stretch out operating deficits** for many years
- **Shared governance**
- **Accreditations and Title IV** requirements
- **Constituency groups**
- **Culture** and social contracts/commitments
- **Entrenchment** in existing academic and business models
- **Complex fund flows** and operations
- **Lender relationships**