

Financial Crisis Creates Big Risks for Private Colleges and Students They Serve

By Richard Kneidler

I can only imagine that you have spent the last three days (after celebrating the Steelers' win – I'm from Western Pennsylvania) talking pretty much non-stop about the financial crisis. You don't need me to bring you the bulletin that there's a lot of trouble out there. If anyone doubted that the U.S. higher education enterprise was involved in the mushrooming financial crisis, the uncertainty ended when, in quick succession in November, a near-quorum of the Ivy League (Brown, Cornell, and Harvard Universities and Dartmouth College) announced that they were planning for substantial budget reductions and other drastic financial actions such as freezing hiring. And that, we now know, was just the start. Public, private, rich, poor – everyone is involved.

Spending cutbacks, staff reductions, hiring freezes, project delays, and limits to student financial aid are just the beginning. Everything seems to be on the table - Miami U. of Ohio just turned its NPR FM station over to a regional network as it attempts to reduce a \$20mm deficit. Brandeis wants to close its art museum and sell its collection. Most bizarrely, Bernie Madoff's Ponzi scheme has touched colleges and universities both directly, through their investments, and indirectly, through effects on donors. Last week Fundfire.com documented endowment freefall from summer through November or December – Dartmouth -18%, Emory -20%+, Harvard -22% and Cornell -27%. And these losses are probably understated, considering private equity and hedge funds. Harvard's failure to obtain acceptable bids for the \$1.5B of private equity investments that it was attempting to market underscores that some such assets now fetch 10-30 cents on the dollar.

It is good that prominent institutions are openly discussing their travails. We can hope that these institutions' openness about financial challenges allows others that are not so comfortably situated to address their own issues with transparency and collegiality. This may in turn permit them to harness the loyalty and intelligence of their communities in meeting their challenges. It is vital that honest and creative private and public discussions on this issue take place on every campus in coming months.

Today I want to try to provide a framework that may help presidents assess where their institutions stand in this mess so that they can help their campuses come to terms with where they are. I also want to explore stakes for colleges and the country should our sector be permanently weakened by the financial debacle, with a particular focus on less-well-capitalized private colleges and universities that may be the first to experience serious threats to their viability, since public colleges and universities, while suffering budget cuts and freezes, are unlikely to be allowed to close and wealthier private institutions will probably have the wherewithal to survive and thrive again.

I base much of what I will say on a financial database I have created of 678 private colleges and universities including bachelor's, master's, doctoral, and research-intensive

institutions for which the *Chronicle of Higher Education* publishes presidential compensation data, plus additional colleges and universities recognized by groups such as Phi Beta Kappa and the American Chemical Society. With the exception of institutions claiming a religious exemption from filing Form 990, the database includes most well recognized private U.S. colleges and universities. The database uses publicly available IRS Form 990s (usually one or two years old) from GuideStar.org and enrollment data from the Department of Education's National Center for Education Statistics' public website.

Institutions Most Likely Inadequate-capital:

While the breadth and depth of the crisis make all institutions vulnerable to some degree, a subset of undercapitalized private institutions is probably most at risk and in need of special attention from trustees, foundations, government and other supporters even though they may not be in the national stories on the crash. Many of them may have gone from a position of apparent security to being in grave danger just since Labor Day 2008.

If you will look at this slide, you will see that, on the basis of the most recent available IRS 990 data, I found that just over half of the colleges and universities in the database had net financial assets to expense coverage that constituted 50% or more of total capital, including long-term debt, but not including the value of land, buildings and equipment, which are usually not fungible. These, I called "adequate-capital" institutions.

The second group, "borderline," includes schools with positive capital ratios of less than 50%. 25% of the sample was in this group.

The third group was the smallest, at 23% of the total sample. These schools, "inadequate capital," had negative capital ratios.

To plot what has happened in the last five months to these schools, I use a model that:

- 1) *Begins with* data on an individual institution's investment assets (stocks, bonds, and mutual funds but not hard-to-value hedge funds and private partnerships);
- 2) *Multiplies* those investments by .65 to estimate changes to their value from a 35% market decline (Moody's estimate);
- 3) *Adds in* institutions' end-of-fiscal-year cash; and then
- 4) *Subtracts* long-term debt such as mortgages and bonds to
- 5) *Estimate* each institution's current capital.

Using this post-crash model (and may it not be "mid-crash"), 207 colleges and universities—31% of the 678 institutions in the database— have, under at least some circumstances, more debts than cash and marketable investments. I designate them "at risk." Because this is only a model whose reliability is global for our sector, but cannot be assumed at the institutional level, I do not identify institutions

In the model these 207 inadequate-capital institutions have projected net financial asset balances ranging from a negative few hundred thousand dollars to nearly a negative \$400,000,000. More than half of the 205 had negative projections from (\$10,000,000) to (\$100,000,000).

At the other end of the scale, 231 adequate-capital institutions (34% of the 678) had positive projections of +50% of net assets, ranging in dollar terms from \$39,000,000 to \$22,000,000,000. More than half of those had a projection from \$39,000,000 to \$100,000,000. The remaining 240 schools had lower, but still positive net assets ratios.

This means that the inadequate-capital institutions (which might include a third or more of NAICU members) are exposed to severe disruption from negative factors such as declines in cash and investments, escalation of interest payments on variable-rate debt, and required accelerated repayment of principle, particularly if several negative factors were to coincide. In those circumstances, any of the inadequate-capital institutions and perhaps some of the marginally positive schools might find themselves unable either to meet their increased payment obligations or to repay their debts. The institution could then be effectively insolvent, even if its operations were otherwise healthy. While the institution might not be bankrupt, creditors could demand control of major operating decisions. This is, essentially, what has been happening to sectors of the business community, such as homebuilders, retailers, and newspapers, that have lost credibility with banks. That has apparently not happened to independent Higher Education, but the warnings from S&P and Moody's about our sector's prospects are ominous and could foreshadow a shift by rating agencies based on enrollment, or other, data. Last week's announcement by Moody's that bond-rating upgrades slowed after the first quarter of 2008 and downgrades accelerated in the final quarter confirms that there are grounds for concern.

Since this study is only a model, some or many of these colleges may weather the crisis well. Conversely, other institutions, especially ones that have taken on new variable-rate debt, off-balance-sheet financing, leases, and partnerships, or investments that, in aggregate, are not well diversified may suffer or already have suffered more financial difficulties than the group described here as "inadequate-capital."

Which Factors Are Associated with Inadequate-Capital Status?

If they were to be named here, the 230 best capitalized and the 207 inadequate-capital institutions in the survey might appear quite similar. Most traditionally operate with balanced budgets and generate operating surpluses. Indeed, the most recent available show 21 of the institutions moving from a negative to a positive operating margin (FY 06 to FY 07), compared to 13 moving the other way. Most have endowments and cash on hand at the end of the fiscal year (a result that will surely change strongly for the worse this year). Almost all have more assets (including land, buildings and equipment) than debts. Many in both groups are well known. However, there is a consistent, large financial gap between high capital and inadequate-capital institutions that is exacerbated in a time of financial trouble. Consider two, composite institutions created by averaging

key numbers for each of the two groups of schools. Major differences and prognoses between the two emerge.

Average adequate-capital institution (Institution A):

Undergraduate enrollment: 3,500

Endowment and other investments: \$986,000,000

End-of year cash on hand: \$52,600,000

Bonds and mortgages outstanding: \$183,000,000

Annual revenues/expenses/margin: \$450,000,000/\$360,000,000/\$90,000,000

Model Post-Market-Drop Score: \$510,000,000 (+74% capital score)

Average inadequate-capital institution (Institution B):

Undergraduate enrollment: 2,800

Endowment and other investments: \$45,000,000

End-of year cash on hand: \$9,000,000

Bonds and mortgages outstanding: \$62,000,000

Annual revenues/expenses/margin: \$102,000,000/\$95,000,000/\$7,000,000

Model Post-Market-Drop Score: (\$24,000,000) (-24% capital score)

To test how the current climate might affect the two schools, I made several assumptions:

- 1) Enrollment will drop by 5%, with a loss of \$20,000/student.
- 2) Interest rates on all debt are variable and rise by five percentage points.
- 3) All debt is called and must be repaid in five years rather than 25.
- 4) Investment income drops by 20%.

As a result:

Institution A's operating margin decreases by \$51,000,000 to \$39,000,000.

1) $.05(3500)(\$20,000) = \$3,500,000$ revenue loss

2) $.05(\$183,000,000) = \$9,150,000$ cost increase

3) $(\$183,000,000/5) - (\$183,000,000/25) = \$29,300,000$ cost increase

4) $.2(.05)(\$986,000,000) = \$9,900,000$ revenue loss

New annual margin: **\$39,000,000**

Institution B's operating margin decreases by \$16,000,000 to (\$9,000,000).

1) $.05(2800)(\$20,000) = \$2,800,000$ revenue loss

2) $.05(\$62,000,000) = \$3,100,000$ cost increase

3) $(\$62,000,000/5) - (\$62,000,000/25) = \$9,900,000$ cost increase

4) $.2(.05)(\$45,000,000) = \$450,000$ revenue loss

New annual margin: **(\$9,000,000)**

On every dimension except the final margin, the negative numbers are larger for Institution A. However, since A begins with larger revenues, cash position, endowment, and operating margin, as well as better ratios across the board, unless it loses \$40,000,000 annually in gifts and other revenue or has equivalent cost increases, it has the capacity, even after a huge drop in investment values, to pay off all of its secured debt in five years

and emerge debt-free with cash and investments intact. That said, it would probably refinance its debt and avoid the problem because potential lenders would recognize that it had sufficient coverage to make its debt well protected in almost any contingency. In other words, this institution has an excellent credit score to qualify for loans of various kinds.

Institution B, on the other hand, has only one year before its new operating loss of \$9,000,000/year will consume its entire cash cushion and cause it to draw from a credit line or its small endowment to pay bills during low revenue periods. Assuming it continues losing money at this rate, it will exhaust its endowment in 2-3 years, leaving no other internal source of cash and no way to pay summer bills four years hence. It may run out of money and time before it can pay off its debts and enjoy its modest operating margin. This college, were it a person, would have trouble borrowing money to buy a car.

While this example is hypothetical and does not consider many possible scenarios, it illustrates how the financial flexibility of well-capitalized institutions gives them the ability to manage financial stringency and to emerge in a strong position. It also shows, by contrast, how apparently solvent but capital-short institutions may consume their cash and invested capital in a few years, making it difficult for them to remain independent and to continue serving their missions.

Examination of the underlying numbers for the 207 inadequate-capital institutions, suggests most would have less time for a turn-around than “Institution B” because they are smaller and less robust than “B.” Thus, less-capitalized institutions appear to be, truly, “at risk.”

Several demographic criteria show a positive correlation with an institution’s financial resources.

Carnegie classification. Institutions in two Carnegie Foundation for the Advancement of Teaching classifications, master’s and doctoral (non-research-intensive), are prone to be “inadequate-capital.” These two classifications contain 70% of inadequate-capital institutions in the study and, in fact, contain more inadequate-capital than adequate-capital institutions.

The remaining classifications, bachelor’s and research-intensive I and II, contain 75% of the adequate-capital institutions and more adequate-capital than inadequate-capital institutions.

States/Regions. Areas with more inadequate-capital than adequate-capital institutions and, thus, more exposure to the crisis’ effects in Higher Education include:

- 1) Previously high-growth states Arizona, Florida, Nevada, and Washington;
- 2) Appalachian states West Virginia, Kentucky, and Tennessee;
- 3) Rust-Belt states Illinois, Michigan, New York, Ohio, and Pennsylvania., and

4) Two other clusters - Alabama and Mississippi and a final one in Plains States from Iowa to Oklahoma.

Geographic areas with more adequate-capital than inadequate-capital institutions include:

- 1) New England states Connecticut, Maine and Massachusetts;
- 2) Several states below the Mason-Dixon line—Georgia, Maryland, South Carolina, and Virginia;
- 3) Several upper Midwest states - Indiana, Minnesota, Nebraska and Wisconsin; and
- 4) Several Western states—California, Colorado, and Oregon.

While the latter states may look stronger than the first group, all states with private colleges or universities have at least some inadequate-capital institutions according to the model.

Students' Aid Eligibility. Financially-at-risk students disproportionately enroll at financially-at-risk private colleges. 63% of our inadequate-capital institutions had student populations in which 25% or more of full-time undergraduates were eligible for financial assistance under Title IV of the Higher Education Act. By contrast, only 14% of adequate-capital institutions in the study did. Inadequate-capital private institutions play a critical role in giving low-income students access to college. This is a major national policy issue that our entire sector needs to continue to work hard to resolve.

Minority Enrollments. The data show that, looking at full-time undergraduates, while both groups of institutions enroll significant numbers of minority students, inadequate-capital institutions have somewhat higher levels. 81% of inadequate-capital institutions, compared to 71% of adequate-capital institutions, have minority enrollments of 10% or more.

IPEDS data for 2007-8 show inadequate-capital schools in the model enrolling 135,000 minority and 168,000 Title IV undergraduates, 23% and 28%, respectively of their 590,000 full-time undergraduates. Adequate-capital institutions enrolled 165,000 minority and 121,000 Title IV undergraduates, 22% and 16%, respectively, of their 735,000 full-time undergraduates. Since these data are not unduplicated headcounts, numbers and percentages of minority and Title IV students should not be added together.

Potential Consequences of the Inadequate-capital Institution Crisis

All higher-education institutions are at some risk in the current crisis, but it is nonetheless easier for institutions with healthy financial resources to find relatively satisfactory ways forward. They can have some confidence that averaging formulas for drawing income from endowments will help shield their operations from too abrupt a downturn. While these formulas may, for a while, cause them to draw down capital to protect educational priorities, these institutions have until last fall enjoyed historic increases in endowments and endowment income. Now is the “rainy day” they prepared for. While they may face increases in expenses and decreases in revenues as their poorer brethren do, they also

begin with significant cash on hand, investments to sell, and richer cost structures that can be trimmed.

Inadequate-capital institutions are less prepared to absorb potential revenue losses from drops in enrollment, alumni giving or investment income. They are less able to meet increased demands for financial aid for students or higher interest payments on variable rate debt. From whatever direction trouble arrives, these colleges may lack resources to weather the crisis, and their difficulties will tend to compound faster than will those of their better-off peers because they have less cash to spend, fewer assets to sell, and less budget “fat” to trim.

Adequate-capital institutions also benefit from being able to access capital at a lower cost and are less likely to have their access to capital cut off, due to strong credit worthiness. Adequate-capital institutions typically issue tax-exempt bonds on the basis of their Moody’s and S&P credit ratings, while less-well capitalized institutions must purchase bond insurance (if available!) to guarantee a good rating for debt offerings. Inadequate-capital institutions more often use bank credit lines, loans from trustees or vendors, and other arrangements vulnerable to cancellation or repricing to obtain capital and operational financing.

This discussion indicates that there is a significant subset of inadequate-capital private colleges and universities that provide essential access to higher education for low-income and minority students, access that could be denied if these institutions are damaged. In a time of severe economic challenges for the country, this access to higher education is an important national priority and needs to be considered as the country works its way through and out of the present crisis.

Since the beginning of the financial crisis, attention has understandably been focused on the health of the financial system, and the federal government has taken steps that may eventually aid colleges—e.g. unlocking credit markets undergirding student loans and helping to restore the stability needed for the stock market to recover. Should the downturn become an extended recession, extended honest discussion and creative action will be needed from governing boards, administrators, and supporters in and out of government to assist vulnerable and valuable inadequate-capital private colleges and universities.