IDENTIFYING RISKS AND RESPONSES FOR HIGHER EDUCATION INSTITUTIONS IN TRANSITION

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Strategic Changes for the Future

Higher education institutions are facing the pressure of finding their way in a changing market. The question is no longer, “Should we adapt?” but rather “What is the best way to adapt?” For many, the most important first step in adapting is to understand institutional risks and develop strategies to combat those risks.

Following the onset of the Great Recession in 2007, 30 percent of institutions adopted short-term cost reduction (i.e. hiring freezes, salary freezes and downsizing).

It became clear that those efforts would not suffice. Comprehensive and systemic approaches were needed to keep institutions viable. Those approaches required that institutional leaders should evaluate risk factors including: institution size, operational expenses, tuition discounting and tuition dependence; to project whether or not their institutions are sustainable.

However, changes within each institution are only part of the equation. The entire higher education sector is evolving. The Great Recession hit families, greatly reducing college savings and making college unaffordable for many individuals. Additionally, the increased cost burden has changed their view of college. They once assumed it was a next step. Now, prospective students believe colleges need to prove their long-term benefits before they are willing to commit to them.

On top of these financial pressures, demographics have changed. The number of potential adolescent, undergraduate students has actually decreased. It can be inferred that fewer potential students with less of an ability to pay means price sensitivity is greater than ever. Thus, institutions must have competitive tuition prices.

These trends have led many colleges and universities to revisit their strategic plans and question if they are effectively allocating their limited resources. As part of these efforts, institutional leaders now must focus on:

- Changing the nature of decision making
- Developing deeper understanding of their markets
- Embracing the concept of “academic auxiliaries”
- Relentlessly pursuing an efficient bureaucracy

The reactive fixes that were first implemented following the Great Recession should be reevaluated to implement a sustainable structure. Perhaps the best result from the recession is the impetus for all institutions to look at the big picture and chart a strategic course for the future.

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Understanding the Changing Market

In both the recession and the recovery, there has been no shortage of bleak and dire predictions for the future of higher education. Harvard University business professor Clayton M. Christensen has long emphasized the need to "innovate or die" in the business world. "Fifteen years from now, half of U.S. universities may be in bankruptcy, including state schools," he said.

> "Fifteen years from now, half of U.S. universities may be in bankruptcy.[1]"
>
> **Clayton M. Christensen**
> Harvard Business Professor

When the Great Recession hit, higher education institutions experienced one of the industry's largest disruptions. This is not necessarily because the recession caused complex problems, but because it perpetuated already existing problems.

INSTITUTIONS

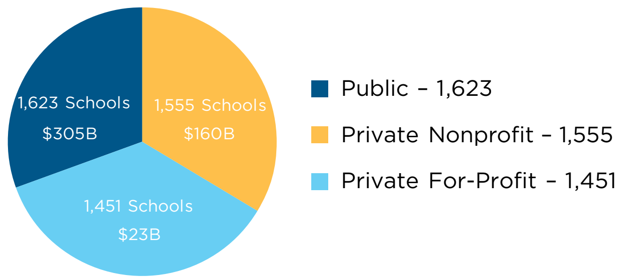
There are more than 4,700 higher education institutions in the U.S. These colleges and universities are categorized as either public, private nonprofit or private for-profit. The private for-profit schools are currently showing the most growth in numbers. However, the smaller private nonprofit institutions are facing the most considerable risk.

Simply put, the historical business model in higher education has been that undergraduate tuition revenue subsidized all other institutional activities.

As costs rise, universities are forced to increase tuition and fees. In the past two decades, those tuition increases accelerated and far exceeded inflation.

Historically, many institutional performance improvement initiatives focused on tuition pricing and incremental efficiencies, with the goal of funding strategic plans.

Higher Education by Landscape By Institution Type (FY2013)[2]



The negative economic and political pressure of the recession that began in 2007 proved to be a considerable catalyst for change; significantly increasing the number of institutions embarking on performance improvement initiatives.

During this period, dozens of university presidents (including those of Harvard, Dartmouth College, Massachusetts Institute of Technology, and University of Chicago) wrote open letters to their campuses announcing revenue enhancement and cost-reduction initiatives.

As financial challenges lingered, colleges and universities moved from temporary changes designed to get them through the rough patch to comprehensive, system-wide reviews, analysis and reorganizations. A number of colleges are now teetering on the brink — the U.S. Department of Education found that 149 private colleges and universities did not pass its measurements for "financial responsibility[3]" in a 2013 report. Colleges must realize that long-term change is not just a good idea, it is essential to continue to function in this rapidly changing industry.

[1] Startup Grind 2013 – February 6, 2013
[2] NCES Digest
[3] US Department of Education Financial Responsibility Composite Scores FY12

STUDENTS

While colleges and universities have been rapidly increasing tuition to pay for operations, they are pricing prospective students out of the market. Shifting the burden of costs to students has been tremendous; they have been made responsible for paying double the percentage of the total cost of education, compared to 1985 totals.

INCREASING PRICE SENSITIVITY

The dramatic shift in financial status of incoming students has not only removed the assumption that attending a traditional four-year college or university was the next step after high school, but it shifted the onus of responsibility to prove value to higher education institutions.

The Old Approach

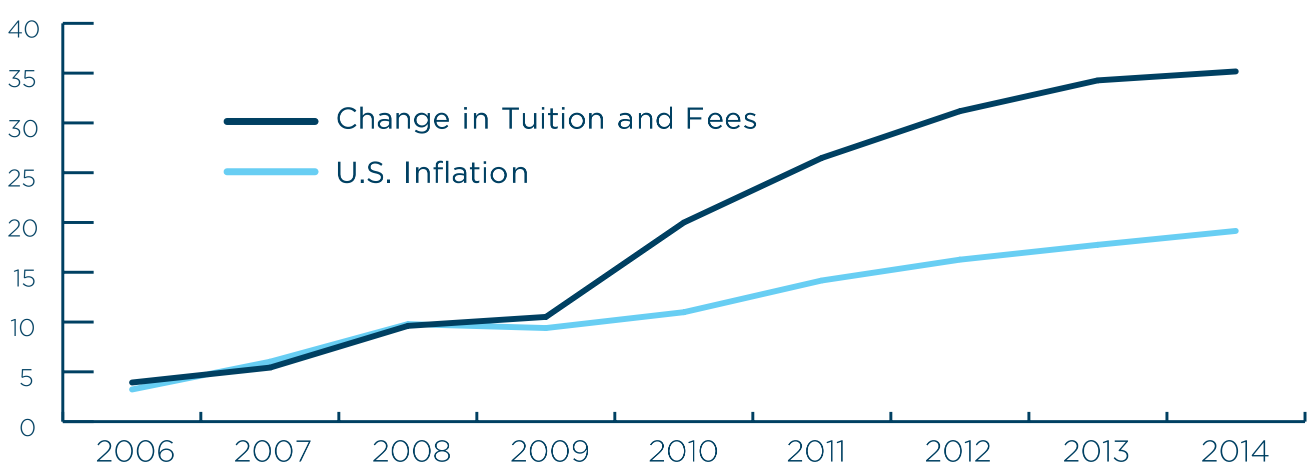
46% Hiring freezes

37% Salary freezes

14% Planned furloughs

11% Downsizing or reorganization efforts

US Inflation vs Change in Tuition and Fees[4] (2006-2014)



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DECREASING MARKET POPULATION

After years of increasing numbers of potential college students ages 18-25, the numbers have reached a turning point. The amount of high school graduates has declined and the population of potential students is expected to fall to levels not seen since 2006 (Source: U.S. Census Bureau).

In other words, there is less demand, which means that either the supply must decrease (closing institutions), the cost must decrease (cheaper tuition) or a paradigm shift is needed to re-invent the market.

Tuition Discounting and Operating Losses

FUNDING GAP

Colleges and universities are being forced into a position where they must increase their grants and scholarships to bridge the funding gap. From 2010 to 2013, institutional grants and scholarships increased by 30 percent. Essentially, institutions are forced to fund their own mini "bailouts" each year to make the numbers work.

[4] Collegeboard.org, data compounded
[5] Inside Higher Ed Survey of College and University Business Officers 2014
[6] TICURA.org - Learning from Closed Institutions: Indicators of Risk for Small Private Colleges and Universities. July 2013

"Essentially, institutions are forced to fund their own mini 'bailouts' each year to make the numbers work."

Institutions by the Numbers

- **80%** Number of private nonprofit colleges and universities with annual expenditures less than $75 million
- **37%** Number of institutions reporting cost-reducing initiatives in 2010[5]
- **57** Number of college and university closures since 2005[6]

Students by the Numbers

- **$7,000** Average decrease in family savings per student from 2009–2013[7]
- **116%** Inflation adjusted increase in median student debt since 1993[8]
- **52%** Increase in Stafford loan recipients from 2004–2014[9]
- **125%** Increase in number of low-income students receiving Pell grants in 2014 compared to 2004[10]

TUITION DISCOUNTING

In 2013, the average discount rate for freshman students reached 46.4 percent at private not-for-profit colleges and universities.[11] While tuition rates are continually climbing higher, the discounts are increasing as well.

Tuition discounting is a short-term remedy, as it helps get students in the door but does not address financial challenges by adding net tuition revenue. Excessive discounting may also undermine the sense of value and desirability of an institution. At some point, the large grant or scholarship cannot be offered, leading to student dissatisfaction and disillusionment.

Given the increased competition and reduced ability to pay, institutions with higher tuition dependence are more vulnerable to the changes in higher education. Tuition dependence among private nonprofit institutions varies by level of expenditures.

Mid- and low-tier institutions (those with less than $300 million in annual expenditures) are more dependent than ever on tuition for revenue. This increase in tuition dependence is particularly concerning in light of declining enrollment trends.

GROWING FINANCIAL PRESSURES

The net result of the financial and demographic trends increases the competition among colleges for a smaller populations of students, who have a reduced ability to pay. This reality raises legitimate concerns about the long-term sustainability of many institutions.[12]

Public university operating margins fell from 4 percent in 2011 to 2.2 percent in 2013.

Public regional universities demonstrated particularly high levels of distress, with over one-third running operating deficits in 2013. It has become clear that, for many institutions, change is essential to remain viable but with each opportunity for change there are great risks.

Ultimately, these mounting challenges are forcing colleges and universities to rethink strategies, markets and operations to ensure they can achieve their missions in sustainable ways.

[7] Sallie Mae: How America Saves for College 2014
[8] Pew Research Center - The Changing Profile of Student Borrowers - October 6, 2014
[9] CollegeBoard: Trends in Student Aid 2014
[10] CollegeBoard: Trends in Student Aid 2014
[11] NACUBO 2013 Tuition Discounting Study
[12] Moody's Investor Services FY2013 Public University Medians, July 11, 2014 and Moody's Investor Services United States Higher Education — Public Universities Sector Comment, October 16, 2014

While specialized programs or services may be helpful, they will not be the right approach for every institution. Financial pressures compel many colleges and universities to look for a straightforward and simple implementation approach, but each institution needs an approach tailored to its specific strengths and needs.

Average Tuition Dependence in Low-Tier Private Nonprofit Institutions

55% Tuition dependence in schools with fewer than 2,000 students

93% Tuition dependence in schools with more than 10,000 students

Average Tuition Dependence in Mid-Tier Private Nonprofit Institutions

37% Tuition dependence in schools with fewer than 2,000 students

89% Tuition dependence in schools with more than 10,000 students

Average Tuition Dependence in High-Tier Private Nonprofit Institutions

3% Tuition dependence in schools with fewer than 5,000 students

45% Tuition dependence in schools with more than 15,000 students

Risk Indicators for Higher Education Institutions

1. Tuition discounting > 35%
2. Tuition dependency > 85%
3. Debt service > 10% of annual operating budget
4. Tuition increase has been > 8% for five years
5. Conversion yield is 20% lower than primary competitors

Charting Course: 4 Best Practices for Evaluation and Adaptation

KEY ASPECTS OF SUCCESSFUL ADAPTATION

In a time of rapid change, every higher education institution is forced to evaluate its methodology and determine the best course of action. For this reason, many institutions are conducting assessments that can act as a map, helping them chart their best course of action.

The following areas need to not only be evaluated, but a tailored action plan must be implemented to get out of crisis management mode and set an institution up for long-term success:

Best Practice 1: Changing the Nature of Decision Making

Traditionally, institutional decision making is a complicated and lengthy process that ensures options are thoroughly vetted and approved by all invested parties before action is taken. The institutional bureaucracy is effective in preventing many bad decisions, but many levels of approval are have limitations or are prone to risk.

Therefore, the approval process for colleges and universities needs to be streamlined to allow for more direct leadership that can review current data and evaluate market changes.

Best Practice 2: Develop a Deeper Understanding of Markets

The decreasing demand for traditional higher education options prompts colleges and universities to become more knowledgeable about their industry than ever before.

Intentional market-driven differentiation is a key aspect of long-term success. How well a college or university understands its target market demonstrates its ability to remain competitive.

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Best Practice 3: Embrace the Concept of "Academic Auxiliaries"

Historically, the concept of "auxiliaries" in higher education has been confined to transportation, bookstores, residence halls, dining halls and the like. However, the economics of higher education require that some programs are "profitable" such that other programs can be subsidized. Until recently, institutions have not actively managed academics as a portfolio and profitable programs have been an unspoken secret in higher education.

As business models evolve, institutional leaders must be knowledgeable of costs and comfortable with balancing activities that provide net operating revenues.

While pursuing profit is unconventional for most educational institutions, particularly nonprofit colleges and universities, it is important to recognize revenue-generating streams as an essential part of sustainability plans. Reliable sources of income keep the entire institution viable.

Best Practice 4: Relentlessly Pursue an Efficient Bureaucracy

University leaders need to ensure resources are spent on critical activities. Effective management requires the relentless pursuit of more efficient business and administrative operations so quality investments can be made in academic operations.

While any cuts are painful, they may be necessary to free up money and give breathing room so leaders can focus on going deeper with the most important programs and services offered by the college or university.

The more income institutions are able to generate and save, the more resources they will have to pour back into providing the highest caliber of education possible.

Moving Beyond Assessment Into Action

Institutions are more at risk of failing than ever before. This need to adapt cannot be exploited by singular, short-term fixes. Many institutions are undergoing enterprise-wide assessments to grow revenues and decrease costs. This a good start, but true sustainability requires a complex analysis of costs, benefits and risks.

To learn how Huron can be your guide, please contact:

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