PEER ROUNDTABLE SERIES: MULTIFACETED CHALLENGES FACING UNIVERSITIES

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At NEPC, we are often in a position to help clients and prospects share best ideas. We recently facilitated a series of forums for not-for-profit organizations, via video-conference, to discuss near-term challenges and share potential solutions. In a series of short pieces synthesizing these discussions, we share the insights from the forums. The first in this series focuses on roundtables conducted in April and May with CFOs and CIOs of colleges and universities.

Navigating the abrupt changes brought on by COVID–19 has been a challenge. While the impact was deep for many not-for-profit organizations, colleges and universities are experiencing particularly acute pain across their organizations and with their students as university operations came to a halt in March and remain uncertain for the Fall semester.

IMMINENT CHALLENGE: LIQUIDITY

During our roundtables, two key issues were raised as top priorities for colleges and universities: subsidizing cash flow for the university and its students and preparing for the unknown in Fall semester. As colleges and universities closed, many issued refunds for housing and partial fees. Furthermore, down payments for tuition were coming due, but most colleges and universities extended the deadline for payment. All the while, maintaining facilities and payrolls meant expenses did not slow. As a result, colleges and universities experienced a severe cashflow mismatch.

Participants shared that they were focused on “finding pockets of money” to support day-to-day activity. For these institutions, cash flows felt very strained and uncertainty meant they needed to pull all the potential levers to create liquidity. On their radar was revisiting restricted endowment assets, utilizing donor relations to interpret each endowment’s intention, using legal staff and advice as needed, and going back to donors for clarification and/or revision. The goal was to release restrictions so that funds could be put to general use and directed to areas of need. As the Spring semester neared its end, conversations with donors continued, but fundraising efforts moved to the back burner and the focus shifted to providing student loans to support enrollment/re-enrollment. General use funds are being redirected to support tuition and aid, donors are stepping in to help, and all are looking at ways to use part of the unrestricted endowment for financial aid. The consensus was that donors were being proactive and reaching out to release restrictions and put their money to work. In general, endowments with higher levels of restricted-use assets may have a more difficult time supporting operations. With a little more flexibility, the endowment assets got a temporary reprieve from the need to increase spending rates, but participants expected this discussion to heat up for the Fall semester as enrollment numbers come into focus.

To support additional short-term gaps in cash flows, colleges and universities were also tapping credit lines, which is a routine part of operations to raise short-term capital. Although terms and rates are more onerous today, they continue to go to market to issue new debt. This led to a discussion about the liquidity and debt covenants of endowments, which are a function of how the colleges and universities are rated for debt purposes. Most participants felt that their endowments and cash flow were in good enough standing that this was not a near-term concern. This contrasted favorably with the 2008/2009 experience.

Another gap in funding is student housing. After students moved out in the Spring, room and board refunds created a revenue/expense mismatch and there is concern about this continuing into the Fall semester. Student housing is both an imminent concern and a long-term issue since student housing revenues cover a significant portion of the operating expenses associated with the facilities. Student housing is a real asset and ongoing maintenance is necessary. As a result, universities cannot easily pivot and reduce the cost of housing. In the near-term, that is a large cost pressure for colleges and universities to support. Long-term, universities can sell their campus housing, but location will be a factor. Some rural institutions may have a difficult time changing their housing footprint by selling student housing. Urban universities seem to be in a much better position from this aspect.

Universities have become more dynamic in their funding sources and needs

Today, institutions are asking for additional support from endowment assets. While the smaller institutions qualified for the CARES Act, the money directed to colleges and universities was only part of the equation. More impactful on operations was state funding supported by the CARES Act. Participants thought that State funding would be relatively stable because the CARES Act provided for some support for higher education but noted that the decline in state funding had been a reality for several years. As a result, universities have become more dynamic in their funding sources and needs. With so many moving parts, much of the focus is spent on business management and scenario testing the operating budget with the endowment spend expectation, much like NEPC has done with Total Enterprise Management ("TEM")[1] for several years. As of now, the ask is not crystalized, but endowment officers know they need to be prepared.

PREPARING FOR THE FUTURE

First and foremost, universities are concerned with enrollment.

One participant guessed that enrollment would be down 20% in September and noted that this would vary based on the enrollment of international students, who tend to pay full tuition – a double blow to revenues. In the near-term, universities extended payment due dates from May 1 to June 1 and would even take payments after that. This resulted in their near-term cash flow tightness; longer-term, universities needed to convince students that online education is equivalent to an in-person experience, which will hopefully broaden their student base.

[1]Our proprietary Total Enterprise Management ("TEM") model considers investment decisions in connection with spending/operating priorities. This model integrates the short-term operational needs with the long-term goals of an organization.

To support enrollment, colleges and universities need to attract students. Many do this through tuition reduction incentives. While exacerbated by COVID-19, attracting students and supporting their tuition needs is not a new conversation at colleges and universities. Interestingly, one participant did an independent study that found that Millennials and Gen Z thought that student loans were taboo and instead had turned to using credit cards to pay college expenses. <<GASP>> This university mitigated the student loan gap by issuing floating-rate loans from the endowment to supplant private and public sponsored student loans. They found that the default rate was relatively low and therefore the risk was worth supporting enrollment. Another institution earmarked up to $2 million of the non-endowed pool to improve diversity and stabilize enrollment. In general, it has been a common discussion at universities to lend some portion of their endowment.

Participants also discussed the upcoming Fall semester. If COVID-19 persists, many believe education will shift to online classrooms. Guessing that families will want their student(s) home or nearby, participants expected the student body to shift noticeably, with a trend toward a local presence for universities whose students are on campus and the remaining students online. Participants expected COVID-19 to be a catalyst for, as one participant stated, "higher education going through a needed fundamental change". Recognizing that even in an online world, universities will need to support ways to deliver the college experience, they will likely keep some part of their current footprint. Importantly, they are all learning the lesson that online education, which is more profitable, is less attractive if it doesn't seem collaborative and engaging for students. Many of the participants currently offer online courses but agreed that an entirely online platform is difficult to accomplish for most universities. Additionally, they recognized that there is still a place for a university footprint, since some classes require in-classroom instruction, like science labs and performing arts. While the shift toward online learning has sped up, some of the hurdles will exist for a few years.

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As a way to address the fundamental shifts in higher education, one participant shared that his organization integrated a financial analysis model that includes endowment assets, operating assets, and the operating budget (much like NEPC's TEM model) as a way to build transparency across departments. In developing this tool more than a year ago, the university developed a "crisis playbook", whereby they would measure certain triggers and act based on the environment. As operations came to a halt in March, and while markets were in decline, their crisis playbook was triggered. The result was a pause in private market commitments until fiscal year end, at which point commitment pacing would be reassessed. Overall, he was comfortable with the decision and expected opportunities in private markets to last well into the Fall semester. The other participants expected to remain largely on target with their commitment pacing for 2020, but agreed that slowing the actual commitments by a few months until there was more clarity about the Fall semester seemed prudent.

KEY LEARNINGS

Based on our conversations, it is clear that all hands are on deck to support enrollment. Unlike 2008/2009 where there was a liquidity crunch in endowments and an ensuing recession slowed enrollment, the pandemic has universities shifting to survival mode, and then pivoting to their long-term plan where higher education fundamentally shifts. The pandemic has accelerated the shift, but universities need to buy time to adapt infrastructure. In recent years, state funding has been declining and needs have been shifting, so innovation was and still is happening at universities. In the end, the landscape will change with the survivors being the ones who can transition most effectively. While endowments are facing some near-term pressure, they are likely to continue to see higher demand to support the organization as strategic initiatives play out over the next few years.

As a result, endowment management will need to echo the flexibility and shifting needs of colleges and universities. From the forums, it doesn't seem likely that spending rates will increase permanently, but our participants expected a higher demand from endowment assets in the near term. Additionally, from an investment point of view, illiquidity remained a low risk, but universities that issue debt must consider illiquidity – it is a covenant on their debt and a metric that drives their debt rating. Finally, as we saw in 2008/2009, we are likely to see a renewed focus on strengthening governance as a way to prepare for the future. One failing of the current model remains information flow across the organization, which participants believe slows decision making.

As we move through the summer months, the status of the Fall semester remains murky and colleges and universities are moving at break-neck pace to support operations. Reflecting on the Spring semester, choices were made, but participants agreed that it was hard to determine which actions would be best for the university in balancing the near-term with the long-term. We expect the role of the endowment to come into focus over the coming months and will share information as it become available.

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