

Higher Education

Higher Education Sector in Review

The past year in higher education has been marked by the sector's emergence from the shadow of Covid-19, yet other challenges have surfaced in the pandemic's wake. The sector continues to be pressured by long-standing structural challenges, some of which have been accelerated by changes forced by the pandemic.

1. The challenges of operating in an inflationary environment
2. Athletics cuts to help the operating budget
3. The rising cost of capital
4. Higher yields on cash balances
5. Declining endowments
6. Impending enrollment cliff
7. Increasing prevalence of strategic transaction activity

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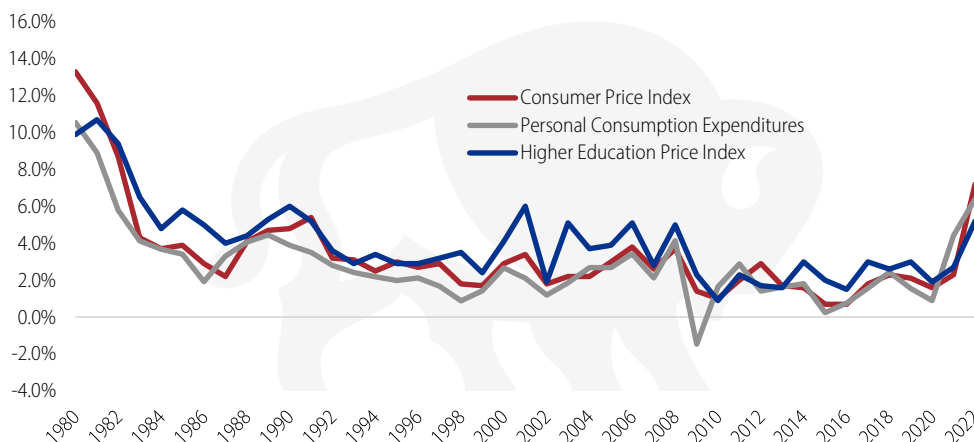
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1. The challenges of operating in an inflationary environment

Inflation has infiltrated the economy in the wake of significant fiscal and monetary stimulus during the height of the pandemic. During this period consumers built up significant savings through fiscal stimulus programs and, for a time, had limited channels for discretionary spending. Firms, meanwhile, took advantage of ultralow interest rates to acquire, expand, and invest. Inflationary pressures, now felt throughout the economy, are a byproduct of these measures. Higher education, owing in part to its labor-driven cost structure, is among the sectors that has felt the acute pinch of rising wages and prices.

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Inflation Trends Since The 1980s



Source: Higher Education Price Index from the Commonfund Institute. CPI and PCE data from St. Louis Federal Reserve Economic Data.

In a typical year, higher education inflation – as measured by the Higher Education Price Index (“HEPI”) – outpaces broader measures of inflation such as CPI and PCE. While broader measures of inflation outpaced the HEPI last year, each measure of inflation has been at its highest level since the early 1980s.

Please see disclosure starting on page 8.

These inflationary pressures make capital projects more expensive to undertake and for those already underway, to complete. Institutions need to acquire any number of supplies in the course of their operations and the costs for this procurement have skyrocketed. Labor is typically the largest line item in an institution's budget and in the current environment new employees are more expensive to hire while faculty poached by competitors require higher packages to retain. Existing staff and faculty are also often demanding higher cost of living increases to match the rising prices they feel in their household budgets. Institutions operating in high cost of living cities (e.g. New York, Los Angeles, San Francisco, etc.) are finding it increasingly difficult to attract and retain faculty and staff.

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These pressures are felt against the backdrop of a structural challenge – tuition and fees cannot increase at the same rate of the high inflation of the current environment due to, among other things, political and stakeholder pressure and already high gross tuition rates. Consequently, higher education leaders and boards must find other ways to respond to these challenges. Some public institutions have sought increased state appropriations while institutions of all types have slowed, modified, or paused capital projects. All institutions are also exercising more caution with discretionary expenses.

2. Athletics cuts to help the operating budget

Some schools have opted to downsize their athletics programs, primarily to free space in their operating budgets from internal subsidies to athletics departments. While athletics programs serve as an important recruitment tool for recruited athletes who would otherwise choose to enroll elsewhere, some schools have weighed this enrollment benefit against the high cost to operate teams. Amid the backdrop of strained budgets and the need to invest in other areas, administrators and boards are more carefully considering scale of loss-making portions of their operations. The decision to cut from athletics is notably rife with political landmines due to the strong connection stakeholders have with teams and the financial support they often offer, either to the athletics program or to the institution more broadly. As such, sector-wide moves are likely to be characterized by fits and starts.

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Stanford and Dartmouth both engaged in well-covered efforts to reduce the scale of their programs, yet both institutions backtracked amid backlash from stakeholders and, for some teams, a rush of donor support. New Jersey City University announced plans to cut tennis, golf, and men's cross country at the end of the 2022-2023 academic year amid a structural deficit at the institution and the University of Minnesota cut gymnastics, tennis, and indoor track and field amid deficits and the financial impact of the pandemic. More institutions are likely to look closely at athletics in the years ahead.

3. The rising cost of capital

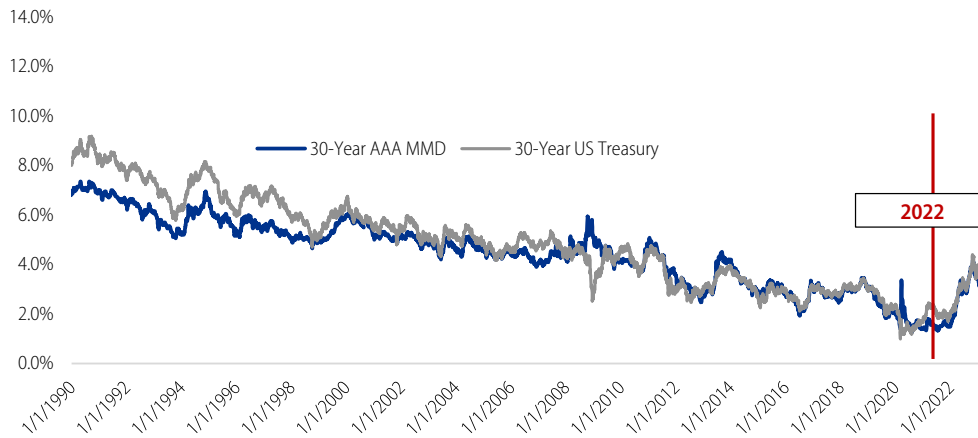
We are exiting a prolonged period of low interest rates and cheap capital into an environment of higher interest rates and more expensive capital. The rapid rate hikes of the last 12 months have come as the Federal Reserve works to rein in inflationary pressures.

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When debt capital is cheap and plentiful, as it was not long ago, the hurdle for undertaking new initiatives and capital projects is low. In 2020 and 2021 many institutions borrowed at historically low long-term fixed rates. In this ultralow interest rate environment, hurdles for measuring project success are likewise low. A higher interest rate environment raises the bar. New capital projects and strategic initiatives require greater levels of consideration and thought, owing to their more expensive nature.

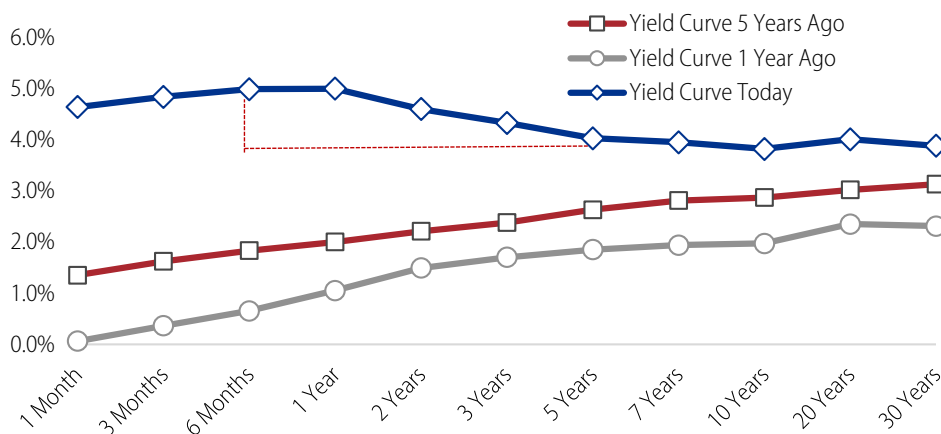
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Tax-Exempt and Taxable Borrowing Costs Have Risen With Fed Tightening



Source: Refinitiv and U.S. Treasury.

U.S. Treasury Rates Today In The Historical Context



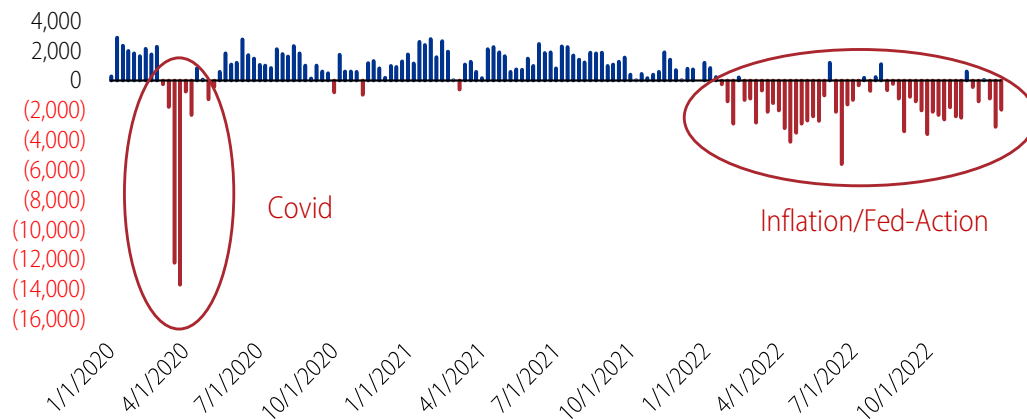
Source: U.S. Treasury. Data are as of February 17, 2023.

The higher rate environment separates institutions with prudent and thoughtful strategy from those that undertake initiatives without sufficient evaluation.

The foregoing charts depict the prolonged fall of borrowing costs over the last three decades and the ultralow borrowing costs available in 2020 and 2021. Furthermore, the current yield curve is inverted, signifying an increased likelihood of economic disruption. Meanwhile, municipal bond fund flows, which were positive nearly universally in 2020 and 2021 (except for during the immediate emergence of Covid) were negative for most of 2022. Higher inflows into municipal bond funds signals higher demand for debt and translate to lower cost of capital for issuers. All of this is indicative of a more challenging rate environment, and one in which cost of capital will look different today than it did in the recent past.

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Municipal Bond Fund Flows



Source: Refinitiv.

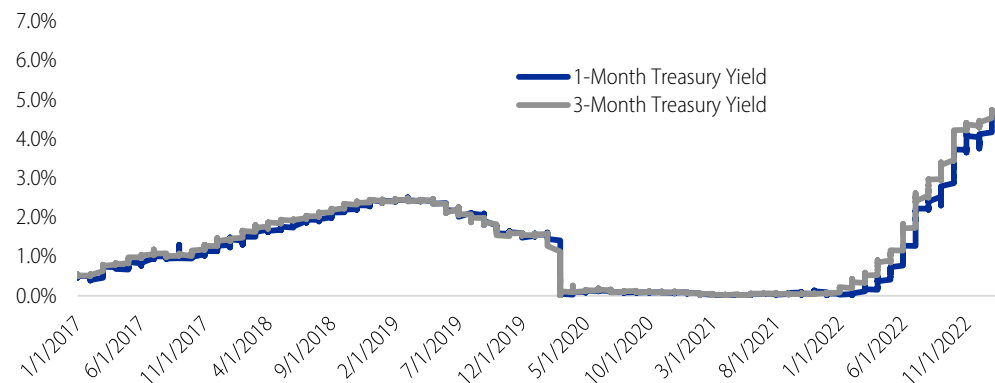
4. Higher yields on cash balances

While higher rates mean higher cost of capital for issuers, they also mean higher yields on cash and liquid investments held in banks, money market funds, and other fixed income vehicles. In higher interest rate environments, cash forecasting and scrutiny over managing liquidity can provide material incremental returns. The following chart depicts the precipitous rise in short term treasury yields consistent with the current rate hiking cycle. An institution's return on cash holdings will vary with its strategy, risk tolerance, and thoughtfulness around planning – and is subject to constraints such as arbitrage rules on tax-exempt financing, for example – but higher yields on safe, short-term fixed income vehicles are an opportunity to mitigate the increases in cost of debt financing.

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Short-Term Treasury Yields



Source: U.S. Treasury

5. Declining endowments

Fiscal 2021 endowment returns were the type of returns seen rarely in an endowment manager's career. For some schools, endowments swelled more than 50% in one year, offering such schools a permanently higher corpus from which to draw. The median endowment return for fiscal 2021 was ~30.1% in a survey by NACUBO and TIAA.

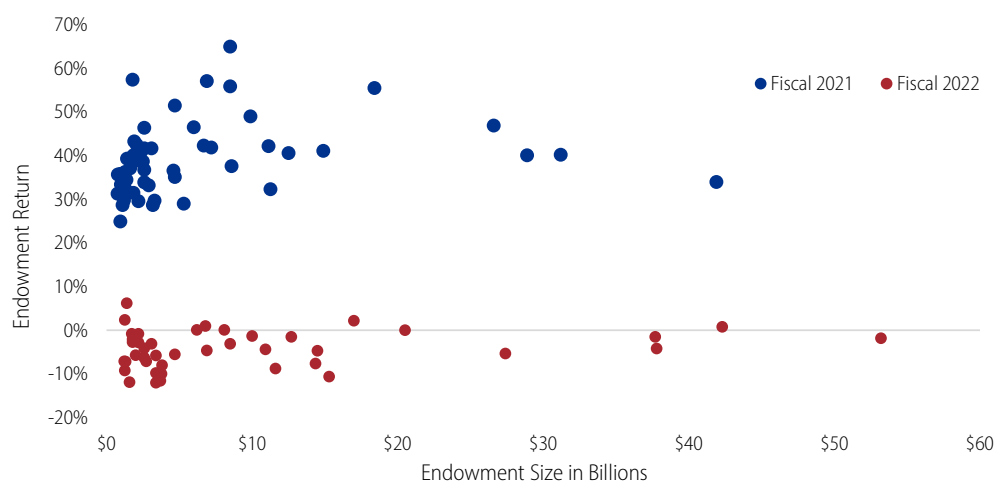
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Fiscal 2022 endowment return reporting to-date has been the inverse, with many

endowments earning flat or negative returns. Fiscal 2023 still has several more months to run but year-to-date returns likely remain similarly flat and negative based on public market returns. Endowment smoothing formulas mean that spending from the funds will remain stable year to year – absent one-time draws – but continued growth of endowments a la 2021 is unlikely to be the ingredient to solve higher education's fiscal challenges.

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Select Fiscal 2021 Versus Fiscal 2022 Endowment Returns



Source: Pensions & Investments and university financial disclosures and press releases.

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6. Impending Enrollment Cliff

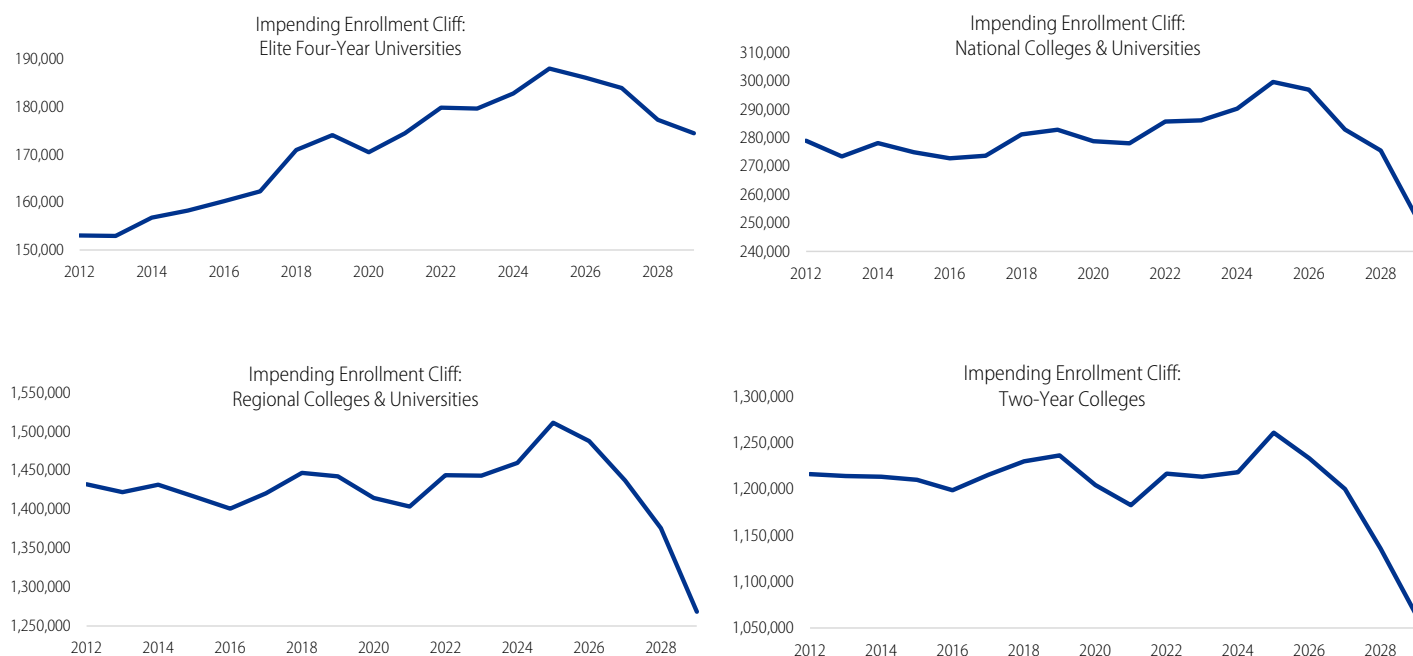
As is well-known by those in the sector, the approaching enrollment cliff will squeeze budgets and present pressures at many institutions. The cliff emanates from the low birth-rate around the time of the 2008 financial crisis, a period during which many people struggled financially and family sizes lagged. As a result, the number of graduating seniors in 2025 is expected to begin a steady decline from its peak. Projections indicate the cohort of U.S. high school graduates will fall 11.6% by 2037 from its peak of ~ 3.93 million in the 2025 graduating cohort. Populous regions with high concentrations of colleges will suffer some of the largest impact. New York's cohort of high school graduates is expected to decline 14% from 2025 through 2037 from 213,000 graduates to 184,000 graduates, while California's will decline 16% from 491,000 graduates to 411,000 graduates over the same period; the Northeast, California, and Illinois will bear some of the largest declines.¹

Against the backdrop of a declining cohort of annual high school graduates, economist Nathan Grawe estimated the likely change in college attendance by type of institution through 2029. The results are similarly dim and show that many institutions will struggle to enroll target size classes at palatable discount rates.²

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¹"Knocking At The College Door: Projections of High School Graduates," December 2020, Western Interstate Commission on Higher Education.

²"Demographics and Demand for Higher Education," January 2018, Nathan D. Grawe.



Source: Demographics and Demand for Higher Education, January 2018, Nathan D. Grawe.

While some marquee schools are supported by endowments and benefactors – and other institutions may have public funding, medical systems, and other diversified operations to support them – most institutions are tuition-driven and tuition-dependent. Absent significant efforts to change the business model, such as catering to non-traditional students or internationalizing the student body, institutions will feel the blow of looming enrollment pressures.

Increasingly, higher education leaders and boards are contemplating business model adjustments to meet these challenges head-on.

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7. Increasing prevalence of strategic transaction activity

Amid the structural challenges – looming enrollment cliff, inflation, high discounting, and a fixed cost base that is difficult to adjust (e.g. due to tenure, cultural resistance to change) – more institutions are seeking scale and transformation through a combination or partnership with another institution. In some cases these partnerships come in a familiar form such as a merger or acquisition, but increasingly institutions are creating joint ventures, affiliations, shared services agreements, and other bespoke partnerships.

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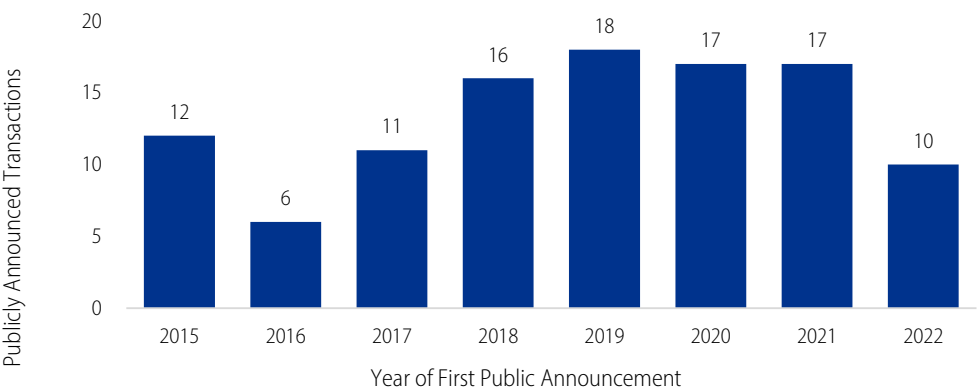
Combining or partnering offers the institutions scale, which helps alleviate the issues with a fixed cost base and provides enhanced visibility and eminence. For those institutions seeking to alter their business model – such as by serving a different student population or internationalizing – a partnership may offer a quicker route to achieving

these goals than a go-it-alone approach. Some institutions are already bearing significant financial challenges. For this set of institutions, rather than closure, a combination may offer a viable path to preserve legacy and mission.

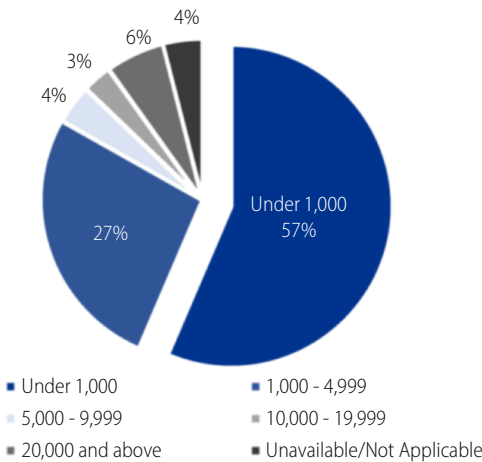
Strategic transaction activity in the sector has grown since 2015 and while last year saw fewer institutions announce a combination or partnership, we expect this type of activity to continue and grow. Consistent with the challenges of a fixed cost base and the structural pressures impacting the sector, many institutions seeking a partner are smaller. We estimate 57% of acquired institutions were under 1,000 students, while 38% of all accredited institutions are of a similar scale.

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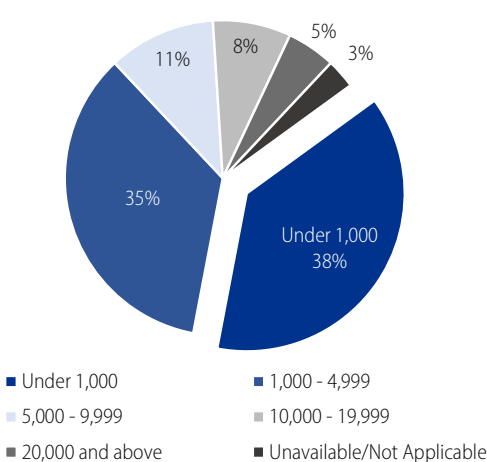
Higher Education Strategic Transactions Since 2015



Deals By Size of the Acquired College



U.S. Accredited Degree-Granting Institutions By Size



Source: HilltopSecurities.

The past year saw several notable transactions. Antioch University, which has a national presence, and Otterbein University, which is based in Ohio, announced their intention to form a system in which the institutions will partner on graduate and adult-learner programs and share certain support costs, while retaining their distinct undergraduate programs and brands. Bloomfield College, a private, predominantly Black and Hispanic serving four-year institution in New Jersey announced its agreement to merge into

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the nearby public Montclair State. Bloomfield had been facing significant financial challenges and put out a public appeal for a partner. The merger agreement, due to close in June 2023, contemplates that Bloomfield will continue as Bloomfield College of Montclair State.

Conclusion

Higher education has emerged from the shadow of Covid-19, yet it has also lost the safety outlet of Covid-19 related stimulus funding, cheap capital and outsized endowment returns. For many institutions, the higher education business model has been broken for years. Budgets can no longer be balanced by tuition rate increases that have outpaced inflation for decades and have now reached a breaking point. The higher education value proposition has been eroded, particularly for undifferentiated, non-focused institutions. Online competition has melted barriers, further accelerating disruption in the sector.

New challenges have emerged in the pandemic's wake including inflationary pressures, muted endowment returns, and increased cost of capital, all precipitating the forthcoming disruption of the enrollment cliff. S&P pointed to increasing bifurcation of the sector in its 2023 outlook and that is what these structural challenges are driving within higher education – a greater wedge between the 'haves' and the 'have-nots'. However, as Winston Churchill famously said, "Never let a good crisis go to waste;" institutions prepared for the coming disruption will emerge stronger, more focused and with less competition.

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