Finding Liquidity for Updating Programs and Facilities for Tomorrow: Options for Consideration

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The Problem

Many schools in the private and public higher education market have found recent years since the Great Recession of 2008 to be devastating upon their financial condition. Increased competition, higher unfunded tuition discount rates, struggling enrollments, and increased endowment spending have collectively put many schools at the brink of their existence. They lack the economic resources to face the necessary retooling of their business model and academic programming to push forward for the next 10-20-30 years. For many, the lack of liquidity in the short and near term are preventing them from re-engineering their business model and academic offerings required to make themselves more competitive and relevant in the region they serve. To look at this alternatively, a great strategic plan is a good thing, a practical strategic financial plan is required in order to make it happen. This whitepaper intends to outline a few possible financing options which might be available to a school to provide the funding required to support the strategic plan execution.

The Options

For those colleges/universities with large (I mean *really large*) endowments, the ability to fund a strategic turnaround plan or other significant set of changes to their organization is not a huge issue. I am aware of one institution in the eastern part of the country who discovered they were operating at a $3 million annual deficit. Their plan to fix it? They decided to do an Endowment fund drive and raise another $75 million. Problem solved. So, tell me, how many schools do you know that could execute such an option? I know very few.

To find other sources of liquidity such as loans, mortgages, bonds, and other such funding in today's credit market is very difficult, and to many, simply impossible. The credit markets are generally "anti-higher education" as more and more schools, well over 50% according to recent NACUBO surveys, are showing operating deficits and declining/stagnant enrollment levels.

So, what are some options for these schools? Let me list a few along with their respective Pros and Cons:

1. **United States Department of Agriculture [USDA] for rural schools**. For those located in a town or area under 20,000 population, the Community Development 'Direct' Loan program is a possible option. These loans can be upward of $100 million or as low as $1 or $2 million.
    a. Pros: interest today is around 2.2%; term up to 40yrs; interest only option for first 2 years. Limited loan covenants are also seen as a positive.

   b. Cons: lots of red tape; it generally takes 8 to 15 months to gain approval; Collateral can be all or a major part of campus; USDA only funds brick/mortar projects and will not lend money related allows 100% refinancing of existing debt for otherwise USDA-eligible projects, such as a to operating losses.

2. **USDA 'Guarantee' Loan program**. These loans are made via a local lender and are for those schools in areas under 50,000 population. The local bank underwrites the loan, but USDA guarantees 90% of the risk, much like an SBA loan for small businesses.

   a. Pros: not as much red tape as USDA Direct loans; local banker is part of support for the school; Collateral can be less than that required of a Direct loan. Since October 2020, this loan program mortgage or bond originally used to fund a new dorm or other building construction/remodeling. Loan covenants are less restrictive than traditional bank loans.

   b. Cons: still takes 8 to 12-months to gain approval, terms are set by the local bank so interest rate and repayment term will be altered, likely 100-150 basis points higher than USDA Direct loans and generally limited to a 25-30-year term maximum.

3. **Sale/Leaseback/Donation with a 3rd party**. With colleges/universities owning a significant amount of Real Estate [Land and Buildings] which has accumulated and gained market value over the years, it is now somewhat common to see schools Sell all or part of these holdings to a third party and lease it back over a 25-30-year period during which time the asset is entirely donated back to the institution. This allows a school to tap into this 'equity' much like a homeowner takes out a home equity loan, using the proceeds for immediate cash needs while retaining total control and use of the asset. For the school, those immediate cash needs can be used for operating deficits, ramping up new and highly-relevant academic programming and remodeling/constructing buildings to update and make older campus facilities more attractive.

   a. Pros: funding can happen within 45-60 days; ability to fund through weak financials, flexibility in use of loan funds-no restrictions, ability to utilize any institutional asset, off-balance sheet transaction using a valid FASB compliant one-year lease, no equity or debt required. Underwriting plays a role in setting the interest rate but not necessarily denying the loan by emphasizing general receipts, strength of master lease and strategic plan; enables the cash to meet immediate needs, including operating deficits; typically, only the individual buildings and/or land being sold are collateralized; it is an innovative and entrepreneurial source of cash without tapping the Endowment or other restricted assets; Use of these cash funds is entirely at the discretion of the school. [Note: Interest Rates we have seen vary from low 2.9% range for generally good credit; and as high as 7.5% for generally poor credit; funding can be from a single building upwards to the entire campus, there really is no upper limit on this funding option.]

   b. Cons: the lease payments are a budget consideration going forward, a new payment not existing previously. Interest rates can be higher than desired.

4. **Bank loans and Bond issuances**. These sources of cash may be options for some schools, but credit limitations have rendered this option out of the picture. In fact, many such lenders have

left the higher ed market and many wish to have their credit risk reduced by having their loans repaid.

a. Pros: Makes use of existing banking relationships from the past; important to keep local ties in the community.

b. Cons: lending limits and credit rules of local banks are hard to satisfy given the current business model dependent on tuition and strong enrollments; availability of ample funds to support multi-million-dollar initiatives will be hard to acquire for many schools.

5. **Using the Endowment**. While accessing or borrowing against the Endowment are generally considered sacrosanct by many boards and those in governance, during these trying times where liquidity and cash for transformational reshaping of the institution, access to these funds must be considered. Here are few options for accessing/using these funds.

    a. Take on a higher annual draw from undistributed prior year endowment earnings, formerly known as Temporarily Restricted funds. Instead of a 4 or 5% annual draw to support funded scholarships for students, consider a higher draw down for a few years to help fund needed projects. This action has the impact of being budget neutral as these drawdowns are taken as additional Revenue and serve to offset additional expenditures such funds are used for.

        i. Pros: Immediate Cash can be acquired: Repayment is not necessary; and this provides needed cash without operating budget negative implications

        ii. Cons: Reduces the size of the Endowment more quickly

    b. Another option is to draw down quasi or unrestricted endowment funds. These funds were put into the endowment primarily to enable professional management of the funds along with the other endowment funds. Really, this is a Savings Account for the institution and can be tapped into any time and for any purpose.

        i. Pros: Immediate Cash can be acquired; No pay back is required

        ii. Cons: The Endowment size will shrink

    c. Yet another option is to consider a 'Margin Loan' with the investment bankers who are managing these invested funds. Typically, such loans are made at very low interest rates, like 1.5-2%, and they use the funds themselves as collateral. If the invested funds are Unrestricted, such borrowing of up to 70-75% of this balance can be realized. No principal payments, just interest only. If the invested funds are Restricted, the donor or trustee of such funds will have to approve such loans before this collateral can be used. This option is attractive for institutions which have either large amounts of Unrestricted endowment funds, and those with large donor components who will provide such use as collateral. Inquiries to those managing the endowment funds are easy to make and may result in several million dollars of liquidity possibly being available at very low interest rates.

i. Pros: Very low interest rates; leverages endowment funds; can access funding fairly quickly

ii. Cons: Market value shifts can result in inadequate safety margins and the requirement of paying back part of the loan; Be careful as to state law as to collateralizing restricted endowments, check with your legal advisors and auditors.

Tough times call for creative problem-solving. If your school is struggling and has endowment funds, there may be hidden opportunities to increase funding, but careful due diligence is required to ensure any increase in spending, modifications of restrictions, or borrowing is within the bounds of the law.

Blending the Options

Another Option we see is to look at blending the above options. For example, we have seen schools which are looking to use a Sale/Leaseback tool to gain immediate cash. This can be extremely important to fund current operating losses and to implement important strategic plan initiatives. Within 5 years most of these arrangements allow for a prepayment, so utilizing a USDA lending option at that time would allow for paying off higher interest sale/leaseback funding with lower interest and longer-term USDA funding. The one thing to remember however is that USDA will only fund [both under their Direct and Guarantee programs] refinancing of projects which they would have been otherwise fundable by USDA, such as building construction and/or remodeling. USDA does NOT fund operating losses and losses due to ramp up of new initiatives.

Implementation and Execution

We believe there is a set of 'best practices' for executing these funding options. We have seen several schools attempt to get USDA funding using their own staff and local personnel who have done a few of these types of loans. We have seen mixed success in obtaining USDA approval and extremely long application process times, many well over 2 years.

There are several complex components to the entire USDA loan process. This includes managing the communication and flow of information with local/regional USDA staff, making sure the Preliminary Architectural Report [PAR] and Feasibility Study [FS] are meeting all necessary USDA detail requirements, and managing the political support network of local, state, and national political representatives to the school. In summary, this is a complex process which requires both knowledge of the process as well as the skill to navigate it to a successful conclusion. Further, we have seen greater success by using those very skilled in this process, who do hundreds of such loans, and who can expedite these complexities with great speed. For example, note the following:

1. As VP for Finance at Emory & Henry College in Virginia, we secured a $51 million USDA package [$46M Direct and $5M Guarantee] which enabled both the building of some new and attractive housing while also paying off existing high-interest bank loans. This process in 2016 took about 9 months from start to finish.

2. As a consultant for Lakeland University in Wisconsin, we are in the midst of a $30+ million loan package [$25M Direct and $5M Guarantee] for building two state-of-the-art dorms [and tearing down 3 old dorms] and refinancing a recent remodeling project having higher bank loan interest

rates and a shorter loan term. This process has taken longer, due mostly to the shifting and changing definition of the new project details. Overall time to gain USDA application approval once the board approved the final project scope, under 12 months.

3. For another school in North Carolina, we are in the final stages of securing a $35 million package [$30M Direct and $5M Guarantee] for a project to update older buildings and dorms. This project will greatly improve recruiting and retention by making a more positive initial impression to prospective and new students. Time to completion looks to be in the 12-14-month range during this unusual time of COVID-19.

An important note to consider: The overall cost of securing the USDA loan package using a skilled team is in the range of 1.5-2.5% of the project value, an amount fundable through the project and amortized over the life of the loan.

In closing, we are seeing some very positive and outstanding strategic plans for making change to the dated business model, including developing strategic partners for expense sharing, developing new revenue streams by adding new course offerings, selling badges and certificates to alumni, and creating teaming agreements with post graduate schools for generating a pipeline of future students. We are seeing some very intriguing and important work being planned and implemented. It is most important for senior administrators and the board to support such good plans by finding adequate liquidity for these plans to succeed. If donors, grants, and other funding is not readily available, these plans can be funded alternatively. We hope this paper is helpful in this regard.

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About Rick Gaumer: *Rick has 25 years as a finance professional and executive in industry before teaching full time for a dozen years at Lakeland University in WI. Over the last 10 years he has been a finance executive in higher education serving as VP for Finance for two institutions, Emory & Henry College [VA] and Lyon College [AR]. We hope this short paper offers insight to help schools how to find and to secure necessary funding for your institution during these trying times. I may be contacted at rgaumer@academicinnovators.com or via my cell phone at 920-918-3902 for more information.*

About Academic Innovators: *At Academic Innovators our goal is to re-imagine how higher education works by respecting campus culture, historic traditions, and the capacity of college and university campuses to adapt, change and evolve. If a college faces a challenge, we work with the institution as thought partners to meet their challenge and turn it into an opportunity.*

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