TOPIC:

Mid-Year Financial Report

CONTEXT:

The purpose of this report, in general, is to identify areas of financial risk and how they are being addressed.

This second quarter report focuses on those items identified as higher risk in November.

SUMMARY:

Finances overall are stable, but there are eight areas that were identified in the First Quarter Report for special attention:

1. State Support
2. Stabilization of Financial Aid
3. College of Math and Physical Sciences
4. Health System Patient Volume
5. Key Affiliates
6. Agricultural Technical Institute
7. Key Capital Campaigns
8. Updated Financial Goals

In addition, four other areas have been added:

9. SIS Installation
10. Endowment Performance
11. Deferred Maintenance
12. Long Range Financial Planning

CONSIDERATIONS:

- Have key risks been identified?
- Have they been appropriately addressed?
- What additional information would the Committee like to have?

REQUESTED OF FISCAL AFFAIRS:

No vote required; for discussion and advice only.
Subject: Mid-Year Financial Report

Date: January 22, 2008

From: William Shkurti

To: Gordon Gee

The purpose of this report is to provide a mid-year review of the University's finances. This is an update to my October 25, 2007 report which examined at length FY 2007 year end results and results for the first quarter of FY 2008. That report was generally positive, concluding the University was in "good shape financially." However, it did identify eight key issues that needed special attention in the year ahead.

The remainder of this report will concentrate on those eight items, as well as four new issues that have emerged since then.

Consistent with your earlier instructions, this report is also being shared with the Integrated Financial Planning group.

1. State Support – on December 12, Governor Strickland announced state revenues were trending below estimates, while spending was trending above estimates. Concurrently, there is a growing body of evidence that the state and national economies are slowing down. Since the undergraduate tuition freeze is dependent on a given level of state support, this is a cause for concern. The Governor has not yet announced what he intends to do. Meanwhile, we have advised units to continue to fill critical vacancies, but to be cautious about making other commitments until the picture for FY 2008 and FY 2009 becomes clearer. The University is also closely monitoring the proposed University System of Ohio and the progress of the FY 2009 – FY 2010 Capital Appropriations bill.

2. Stabilization of Financial Aid – in my November 2 report, I identified a continuing need of between $14 and $15 million in this account for FY 2008. A recovery plan has now been developed and approved by the Integrated Financial Planning Group on January 11. This plan identifies $14.3 million in one time funds necessary to fund the account in FY 2008. It also identifies up to $15 million in continuing funds to be allocated in phases of $3 million each over the next five years. Another $12 million in one time funds has been reserved for FY 2009, at which point the situation will be re-evaluated. This will fund all current commitments, plus allow the University to achieve its recruitment goals.

3. College of Math and Physical Sciences – the College reported a cumulative debt of $8.8 million at the end of FY 2007. A new Dean and Chief Business Officer are now in place and are in the process of improving internal budget processes and developing a budget recovery plan. We expect the plan to be in place before the end of April.
4. **Health System** - The financial performance for the Health System was well above budget for the first six months of this fiscal year. For example, the net gain from operations was $11 million, or nearly 28% above budget of $40 million.

   However, inpatient admissions, though still above last year, were 1.2% below budget projections, while outpatient visits were 1.8% above budget projections.

   Since this could have a significant influence on the projections driving the revised master facilities plan, I have asked the Medical Center to provide additional analysis on the causes and implications of these variances, which I will share with the Integrated Financial Planning Group. We will also share that information with you once we have reviewed it.

5. **Key Affiliates** – Med Center Partners has now been officially dissolved. The $5.2 million outstanding debt will be repaid by the Medical Center. The financial review of SciTech is continuing. The long range business plans and financial goals for Campus Partners should be completed by the end of April.

6. **Agricultural Technical Institute** – ATI achieved its financial targets in FY 2007, but Fall enrollments are below FY 2008 projections by 56 students or 5.9%. ATI has taken a number of steps to reverse this trend, including a new turf management program, but results won’t be clear until next Fall. Meanwhile, the unit does have sufficient cash reserves on hand to meet commitments. We will continue to closely monitor projected enrollments for next year.

7. **Private Fund Raising** – The Thompson Library Campaign reported another $1.9 million in new gifts and commitments over the last six months. If that trend continues, the campaign goal will be reached before construction is completed in Summer 2009.

   I have had extensive discussions with Interim Vice President Jeff Kaplan and Vice President Designate Peter Weiler and we have agreed to work collaboratively with all stakeholders, including the Integrated Financial Planning Group, to review how we count and report private giving so that we have a system that is clear, fair and credible. Our goal is to have this in place well before the start of the next campaign.

8. **Updated Financial Goals** – updated financial goals and a policy for investment of operating funds were presented for a first reading to the Fiscal Affairs and Investment Committees on September 21, 2007. Further action was delayed until completion of the Presidential transition and restructuring of the Board committee structure. Now that these steps have been completed, final recommendations are expected at the April Board of Trustees meeting.

   Enrollments continue to exceed projections. Auxiliaries and other units continue to meet budget targets. Overall, the University's finances continue to be stable. There are four other financial issues that merit special attention at this time.

9. **Student Information System (SIS)** – the $50 million SIS installation project is now entering the implementation phase. The first module is scheduled to go live in May. Four more will follow over the next 18 months (through June 2009). The project is currently on time and on budget, but
timetables are tight, so there is not a lot of margin for error. This project will continue to be monitored closely.

10. Endowment Performance – the Long Term Investment Pool (which includes the gifted endowment) continues to generate positive returns, but those returns remain in the bottom quartile of our benchmark institutions. A number of changes have been made and will be made that should improve performance, while protecting principal. These include:

- More stringent reporting
- More diversified asset mix
- Sale or transfer of assets that are not appropriate for investment purposes
- Strengthening the investment management function, including the hiring of a Chief Investment Officer.

11. Deferred Maintenance – Facilities Operations and Development is leading a process to verify the cost estimates presented at the December Board meeting. An outside consultant is being used and a final report is expected by late summer. Meanwhile, plans are underway to better leverage existing resources to address this challenge. They will be brought forward this Spring as part of the FY 2009 Operating and FY 2009-FY 2010 Capital Budget processes.

12. Long Range Planning - In addition, I wanted to make you aware of a strategic financial planning exercise the Integrated Financial Planning Group will be initiating. Moody's Investor Services has just released it 2008 Industry Outlook for US Higher Education. That document identifies five "key factors" driving the future outlook for higher education (see attached materials).

   It is our plan to use those five factors as a benchmark to evaluate our strategic financial planning as part of the FY 2009 budget process. We will share additional information with you as this process unfolds.

   I will present an updated report after the end of the third quarter (March 30). Meanwhile, if you would like any additional information, do not hesitate to contact me.

c: Joe Alutto
   Mike Sherman
   Chip Souba
   Lee Walker
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January 2008

2008 U.S. Higher Education Outlook:

Stable Outlook for 2008 as Both Challenges and Strengths Intensify in the Longer Run

Summary

Moody's rating outlook for the U.S. higher education sector is stable for 2008. Although the US economy is showing signs of weakness, the higher education sector has both cyclical and counter-cyclical elements and generally does not closely follow the national economic cycle. Our outlook is based on continued recent strength in financial performance, driven by stable to growing enrollments, strong investment returns in recent years that have built reserves, and generally balanced operating performance. These strengths are off-set by growing political scrutiny, a greater likelihood of public policy changes that impact the sector and challenging demographic trends in some areas.

Beyond 2008, we believe both the sector's strengths and challenges are intensifying. Challenges from federal and state governments are growing as policymakers focus more on higher education's ability to demonstrate accountability, affordability and transparency at a time when the broad economic outlook is weakening and long predicted demographic challenges arrive. However, the sector has core credit strengths that have also intensified in recent years and should help off-set rising challenges. These include strong balance sheets, robust philanthropic support and consistently improving student demand that is often counter-cyclical to the performance of the economy.

We expect rating changes in 2008 to be relatively balanced, with upgrades potentially outpacing downgrades by a small margin.
Table 2: Medians Demonstrate Continued Financial Strength of Higher Education Institutions

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Overview of Key Factors Driving Industry Outlook

Below we have outlined five key macro factors impacting the outlook for the sector. In general, we believe each of these factors carry both positive and negative attributes that will impact universities based in the U.S. After outlining these factors below, we discuss each in more depth later in this report.

1). Dramatic Changes in the Population of Prospective Students

Although national forecasts for enrollment in higher education institutions remain fairly positive over the next decade, the regional location and makeup of the pool of prospective college students is shifting quickly:

- The projected change over the next decade in the number of high school graduates nationally is positive, but large declines are concentrated in the northeast and northern-midwest while the south and west expect large increases in high school graduates
The socio-economic, gender and ethnic backgrounds of college students is rapidly changing, presenting distinct challenges and opportunities for higher education institutions;

Growing globalization of student demand, with students showing an increased willingness to enroll outside of their home country; U.S. institutions remain in lead for attracting international students but face growing competition from Australia and the European Union in particular;

U.S. colleges and universities are entering this period of intensified change in student demand from a position of market strength, as student acceptance rates are at all-time lows and the participation rates in higher education continue to rise across the nation and internationally.

2). New Public Policy Proposals and Political Oversight

Although federal and state policies and regulations have long affected higher education, the number of areas poised for significant change has grown dramatically as political scrutiny has increased:

Political scrutiny of endowment spending and tuition setting has grown more intense with ongoing studies by federal agencies likely to result in greater probability of regulation and mandated reporting that could impact financial performance;

Governmental funding of financial aid is expected to follow historical patterns of periodic increases, but long-term gradual erosion of purchasing power;

Federally sponsored research funding for universities is lagging in real dollar terms, with changing priorities, including a shift in incremental funding to NSF from NIH and focus on interdisciplinary and translational research;

State funding for public institutions grows more uncertain in many states as the outlook for state budgets diminish in some regions.

3). Weaker Economic Outlook and Housing Pressures

While higher education credit quality is not generally correlated with economic cycles, a weaker economy can impact higher education in a number of ways:

Economic projections often change rapidly, however compared to a year ago, most economic forecasts are more tepid and the number of predictions of recession have grown significantly.
2008 Higher Education Outlook

- Downward economic cycles often create growing demand for higher education, especially at community colleges and in professional graduate programs as individuals take the opportunity for job change and an upgrade in credentials;
- Economic and capital market downturns have potential to shift some student demand from private institutions to four-year publics and from four-year publics to community colleges as perceptions of affordability decline. In particular, for families that had planned to utilize home equity or part of a stock portfolio to finance education, college choice may be affected by the housing and stock market declines as well as broader economic declines;
- Investment market performance impacts higher education to a greater degree than most other public finance sectors, as large endowments are a key credit strength and portions of operating budgets are typically funded based on trailing performance of these funds;
- Philanthropy has grown increasingly reliant on major-gift donors making large multi-million dollar gifts to capital campaigns. These donors are often less impacted by typical economic cycles, although giving has historically fallen after periods of weak investment markets.

4). Operational Efficiency and Effectiveness Will Grow Increasingly Important

As boards and management increasingly focus on strategic questions of tuition affordability, student access and learning outcomes, increased efforts to improve transparency in reporting on institutional efficiency and operational effectiveness are likely to bear results:

- Efforts are likely to focus on space utilization, benefit structures, salary competitiveness, and appropriate average class size;
- With large balance sheet and financial reserves, many institutions have begun focusing on liquidity management as an area of potential gain, primarily through improved analysis of cash flow needs and investment of excess operating funds in higher yielding investments;
- These reviews are likely to enhance operational practices, including more transparent budget models, links between internal financial reporting and audited financial statements;
- Accrediting processes are likely to emphasize results and student learning outcomes (eg. graduation rates, career placement, etc.) to a degree not seen previously, forcing institutions to alter reporting and even curriculum in some cases

5). Balance Sheet Management Improving, But Becoming More Complex

Higher education institutions increasingly utilize sophisticated methods of asset and liability management in addition to long-term capital planning:

- Investment management generally remains a strength in the sector, with many institutions’ portfolios better structured to reduce down-side risk than a decade ago;
- However, these portfolio strategies require increasingly professional investment management practices and highly complex oversight, which may be ramping up more slowly than the allocation to the investments themselves;
- Capital spending is likely to remain significant unless a confluence of factors, such as declining investment markets, reduced philanthropy and rising borrowing costs, change the sector’s focus on spending to enhance competitiveness and attractiveness of their facilities;
- With large recent investment and philanthropic gains, balance sheets of most institutions have gained considerable debt capacity and could withstand moderate balance sheet declines without sacrificing credit quality.