Issue: Financial Health of Public Higher Education Institutions

In FY 2011-12, six out of 10 of Colorado's governing boards were in relatively weak financial health, based on Composite Financial Index scores commonly used to assess financial health in this sector. Two small institutions—Adams State University and Western State Colorado University—had scores below 0, indicating a need to "assess institutional viability to survive". Both institutions are highly leveraged.

SUMMARY:

- In light of news coverage indicating that private higher education institutions nationwide are struggling financially, staff analyzed the financial health of Colorado's public institutions.

- Using ratios that are commonly used in the higher education sector, staff found that, in FY 2011-12, six out of 10 of Colorado's governing boards had Composite Financial Index scores below the threshold score for "moderate financial health".

- Two small institutions—Adams State University and Western State Colorado University—had scores below 0, indicating a need to "assess institutional viability to survive". A more in-depth analysis of these institutions for the period from FY 2008-09 to FY 2012-13 indicates that both institutions are highly leveraged and financially at risk.

RECOMMENDATIONS:

- Both the executive and legislative branches should continue to carefully monitor the financial health of Adams State and Western State.
- The JBC should implement a more robust process for reviewing requests to issue bonds under the Higher Education Revenue Intercept Bond program.
- The General Assembly should explore whether any of the state's larger higher education systems are interested in merging with the smaller institutions highlighted in this issue, given the larger systems' economies of scale and resources for implementing changes in a challenging financial environment.

DISCUSSION:

A variety of news articles over the past several months have highlighted the financial challenges facing private higher education institutions. Forbes ranked the financial health of 925 private non-profit colleges in August 2013, and gave the majority a "C" or "D".[1] The U.S. Department

[1] "Is Your College Going Broke? The Most and Least Financially Fit Schools in America", *Forbes*, August 13, 2013.

of Education released its FY 2010-11 financial health test results for private institutions in July 2013, on which more than 150 institutions were found to have failed.[2]

Recognizing that Colorado's public institutions are increasingly dependent upon tuition revenue and thus may face issues similar to private institutions, staff began an analysis of the financial health of Colorado's public institutions. **This analysis indicates that Colorado's smaller public 4-year institutions are struggling and raises questions about the long-term sustainability of some institutions.** The General Assembly should be concerned about this, both because these institutions play important roles in their local economies and because these institutions have large debt loads which the State of Colorado is backing via the Higher Education Revenue Bond Intercept program.

Methodology and the Composite Financial Index

- Staff followed an approach outlined in *Strategic Financial Analysis for Higher Education (Sixth Edition)* by Praeger, Sealy and Co., KPMG, and BearingPoint, 2005.[3] The ratios and composite financial index outlined in this report are used by many higher education institutions, as well as accrediting bodies, to assess institutions' fiscal health.

- Staff used institutions' annual audited financial statements for FY 2011-12 to populate a spreadsheet with key variables and then distributed the spreadsheet to the institutions in October 2012 to ensure staff had captured the key data accurately. Corrections were incorporated before final ratios and composite index figures were calculated.

- In this approach, four key ratios are used to measure the public institution's financial resources, debt, and financial performance. These are outlined in the table below. Staff followed the detailed instructions included in the book for calculating these ratios for public institutions. The ratios incorporate the performance of institutions' foundations, as well as the institutions themselves.

Ratio Name	What it Measures	Calculation	As described in *Strategic Financial Analysis for Higher Education, Sixth Edition*
Primary Reserve Ratio	Resource Sufficiency	expendable assets/ annual expenses	"Expendable net assets represent those assets that the institution can access relatively quickly and spend to satisfy its debt obligations. This ratio provides a snapshot of financial strength and flexibility by indicating *how long the institution could function using is expendable reserves* without relying on additional net assets generated by operations." (p. 56)
Viability Ratio	Debt Management	expendable assets/ debt	"The Viability Ratio measures one of the most basic determinants of clear financial health: the *availability of expendable net assets to cover debt* should the institution need to settle its obligations

[2] Blumenstyk, "More than 150 Private Colleges Flunked Financial-Health Test in 2011, U.S. Says", *Chronicle of Higher Education*, July 23, 2013.
[3] http://www.prager.com/Public/raihe6.pdf A 7th edition (2010) is also available, but the key ratios have not changed.

Ratio Name	What it Measures	Calculation	As described in *Strategic Financial Analysis for Higher Education, Sixth Edition*
			as of the balance sheet date." (p. 63)
Return on Net Assets Ratio	Asset Performance	change in net assets/ total net assets	"This ratio determines *whether the institution is financially better off than in previous years* by measuring total economic return. This ratio furnishes a broad measure of the change in an institution's total wealth over a single year and is based on the level and change in total net assets, regardless of asset classification." (p. 73)
Net Operating Revenues Ratio	Operating Results	Net income or loss/ total annual revenues	"This ratio is a primary indicator, explaining how the surplus from operating activities affects the behavior of the other three core ratios. *A large surplus or deficit directly impacts the amount of funds an institution adds to or subtracts from net assets…*" (p. 84)

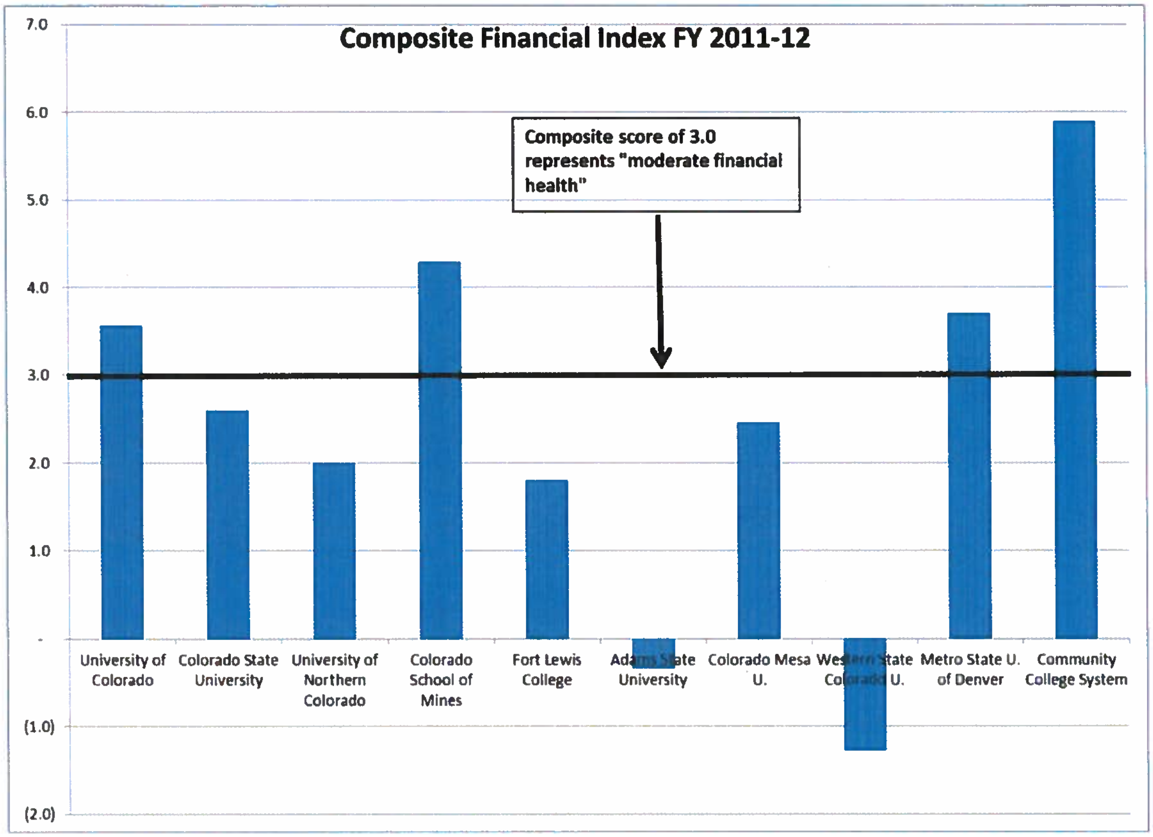
- Staff has included the raw ratio results in some of the analysis below. However, staff also calculated a Composite Financial Index (CFI) for each institution following the methodology outlined in *Strategic Financial Analysis for Higher Education.* To arrive at the CFI, each of the four ratios is converted to a strength factor along a common scale. Then, each of the strength factors is weighted to provide a total index score.

	Conversion to common scale "strength factors" (divide raw ratio by value below)	Weight factors for CFI (weights allocated to each scaled value to produce the composite CFI)
Resource Sufficiency: Primary Reserve Ratio	0.133	35.0%
Debt Management: Viability Ratio	0.417	35.0%
Asset Performance: Return on Net Assets Ratio	0.020	20.0%
Operating Results: Net Operating Revenues Ratio	0.013	10.0%

Strength factors and the CFI are numbers are on a 10 point scale, described as follows:

1.0 = very little financial health
3.0 = the "threshold value", a relatively stronger position
10.0 = the top score within range for an institution

The chart below summarizes the results for all of the governing boards.



As reflected in the chart, many of Colorado's institutions appeared, as of FY 2011-12, to be in moderate financial health at best, but **two institutions stand out for CFI's in the negative range: Adams State University and Western State Colorado University. As indicated in *Strategic Financial Analysis*, for an institution with a CFI ranging from (1.0) to 1.0, the analyst (and the institution's Board of Trustees) should "assess institutional viability to survive".**

An additional, separate measure of institutional financial health is the credit rating for the institution by the bond ratings agencies Standard and Poor's and Moody's. The chart below shows current ratings. Notably, *Western State Colorado University was recently downgraded by both ratings agencies.*

	Moody's	S&P
University of Colorado	AA2	AA-
Colorado State University	AA3	A+
University of Northern Colorado	A1	A
Colorado School of Mines	A1	A
Fort Lewis College	A2	no rating available
Adams State University	A2	no rating available
Colorado Mesa U.	A1	no rating available
Western State Colorado U.	**Baa1**	**BBB+**
Metro State U. of Denver	A1	A
Community College System	AA3	no rating available

Recognizing that a single year's financial data might provide a skewed picture, staff collected data from prior year audit statements and requested unaudited FY 2012-13 financial statement data from Adams and Western. **Based on this preliminary information (which does not include foundation data), financial problems appear to have continued in FY 2012-13 for both Adams and Western.**

Additional Background on Adams State University and Western State Colorado University
Adams State University is located in Alamosa, Colorado and draws many of its students from the region. Founded in 1921 as a teacher's college, it focuses on undergraduate students, with a total FY 2012-13 enrollment of 2,442, including 1,903 Colorado residents. Compared to other Colorado institutions, Adams has a relatively high percentage of students qualifying for a federal Pell grant (56 percent), and it was Colorado's first higher education institution to be federally designated as a Hispanic Serving Institution.

Western State Colorado University is located in Gunnison, Colorado and offers a liberal arts program in a scenic mountain location. It is Colorado smallest 4-year institution, with a student population of 1,792 in FY 2012-13, including 1,336 Colorado residents. Western's student population is, on average, more affluent than Adams, with 31 percent qualifying for the federal Pell grant.

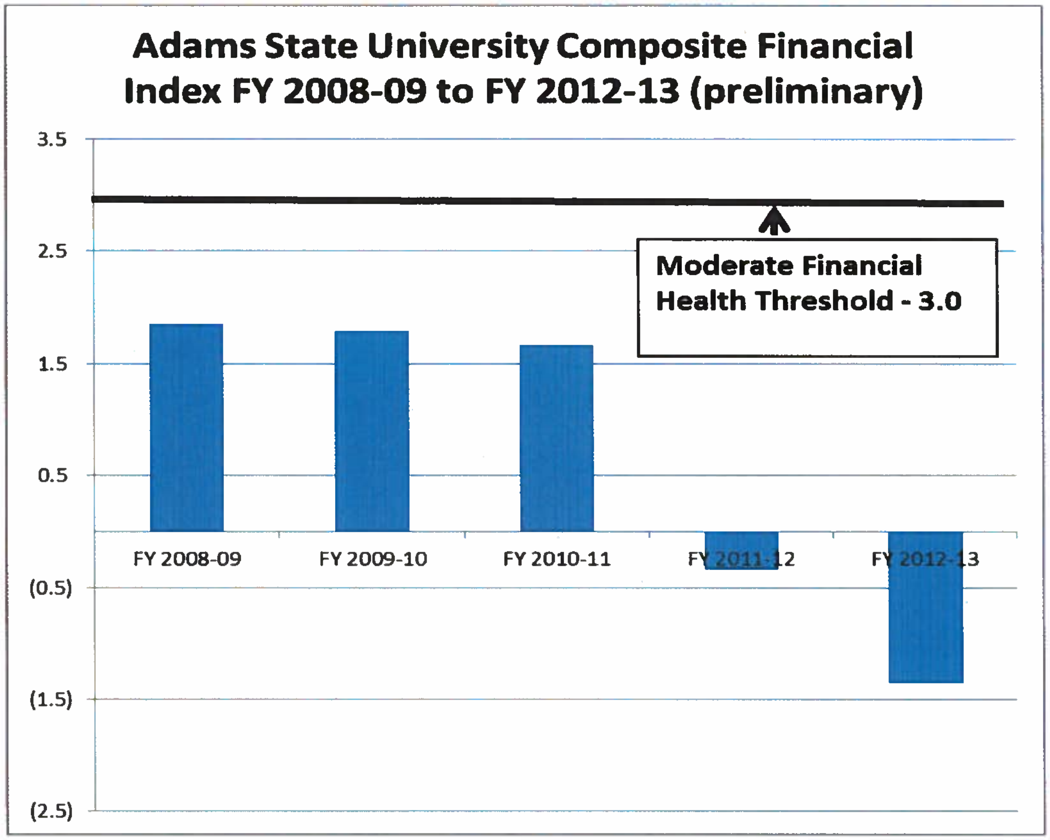
As Colorado's two smallest 4-year schools, Western and Adams depend more heavily on the General Fund than other state institutions. In FY 2012-13, General Fund comprised 35.9 percent of Adams general educational budget and 39.6 percent of Western's general educational budget. The General Fund appropriation for Adams in FY 2013-14 was $11.6 million and the appropriation for Western was $9.5 million. These figures represent reductions in state support of 20.7 and 21.7 percent, respectively, since FY 2008-09.

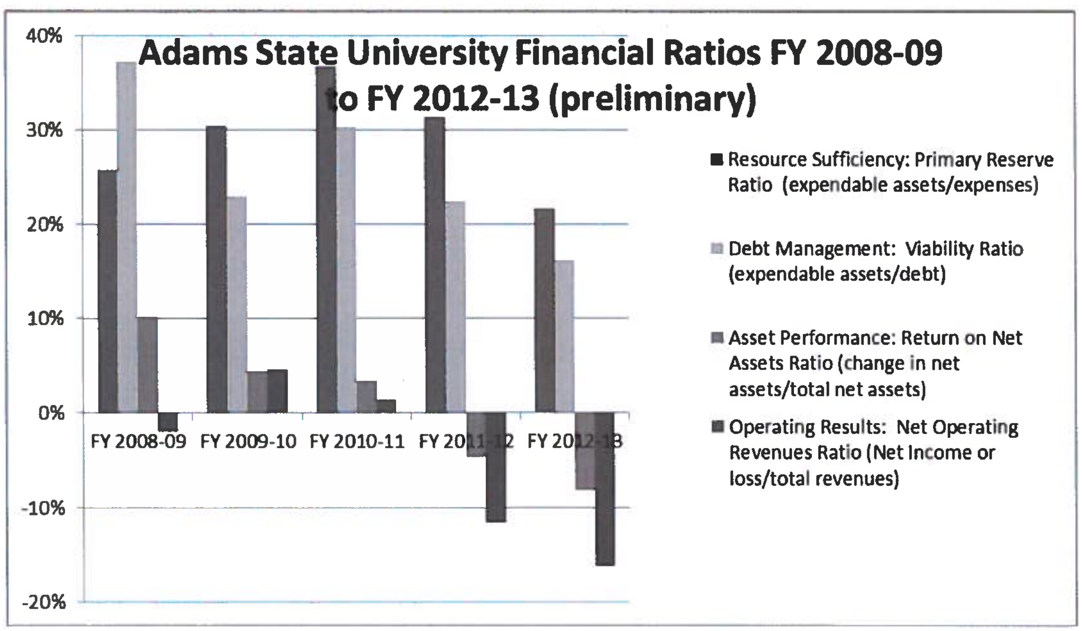
A notable difference between the two institutions is that Adams enrollment increased by 27 percent between FY 2008-09 and FY 2012-13, while Western's declined by 4.4 percent. However, Adams enrollment has begun to slip as the peak of the recession has passed: enrollment fell slightly in FY 2012-13 and also appears to be down for FY 2013-14. *In contrast with virtually every other institution of higher education, Western's enrollment has been in decline since the mid-1990s.* Between FY 1996-97 and FY 2012-13, enrollment fell by 488 (21.4 percent).

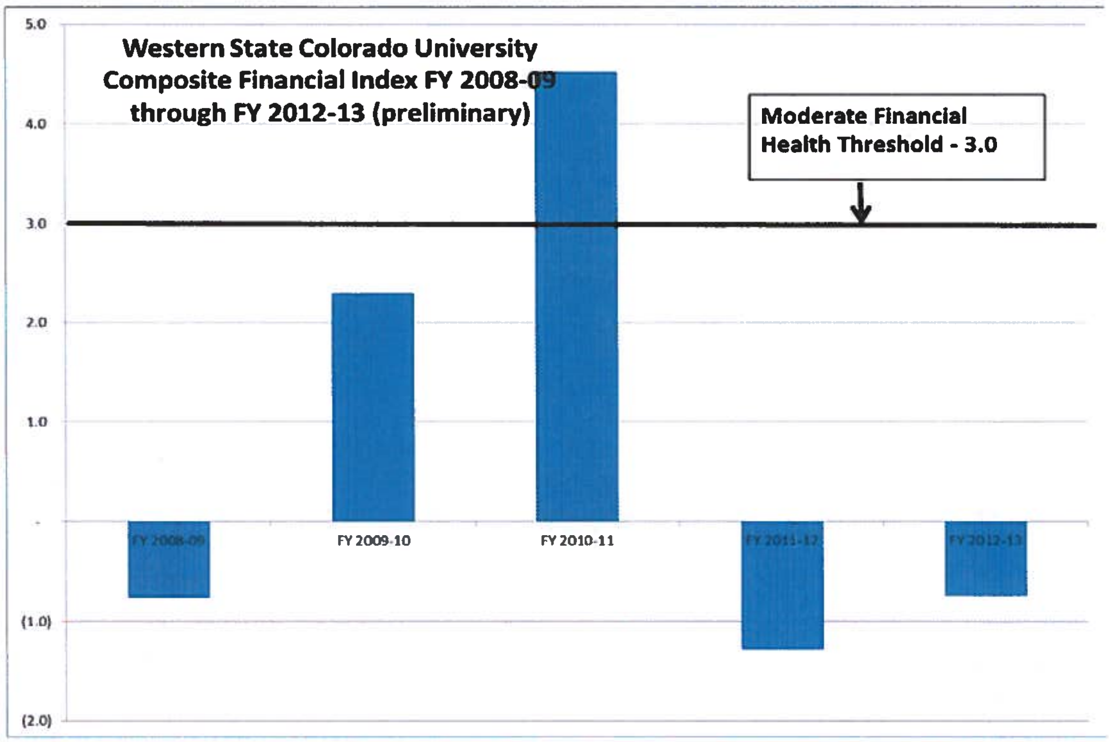
New construction, as well as reductions in state support, have driven substantial tuition increases at both institutions. For both institutions, tuition and fees in FY 2013-14 are almost double tuition and fees in FY 2008-09. At Adams, tuition increased from $3,790 in FY 2008-09 to $7,449 in FY 2013-14. Western's tuition and fees similarly increased from $3,778 in FY 2008-09 to $7,343 in FY 2013-14. These increases are heavily based on increased student fees. By FY 2013-14, $2,577 of Adams overall tuition and fees was based on fees, while at Western the figure was $2,068. For comparison, student fees at CU Boulder and CSU Ft. Collins were $1,587 and $1,779 respectively, with tuition representing a far larger share of overall per-student charges.

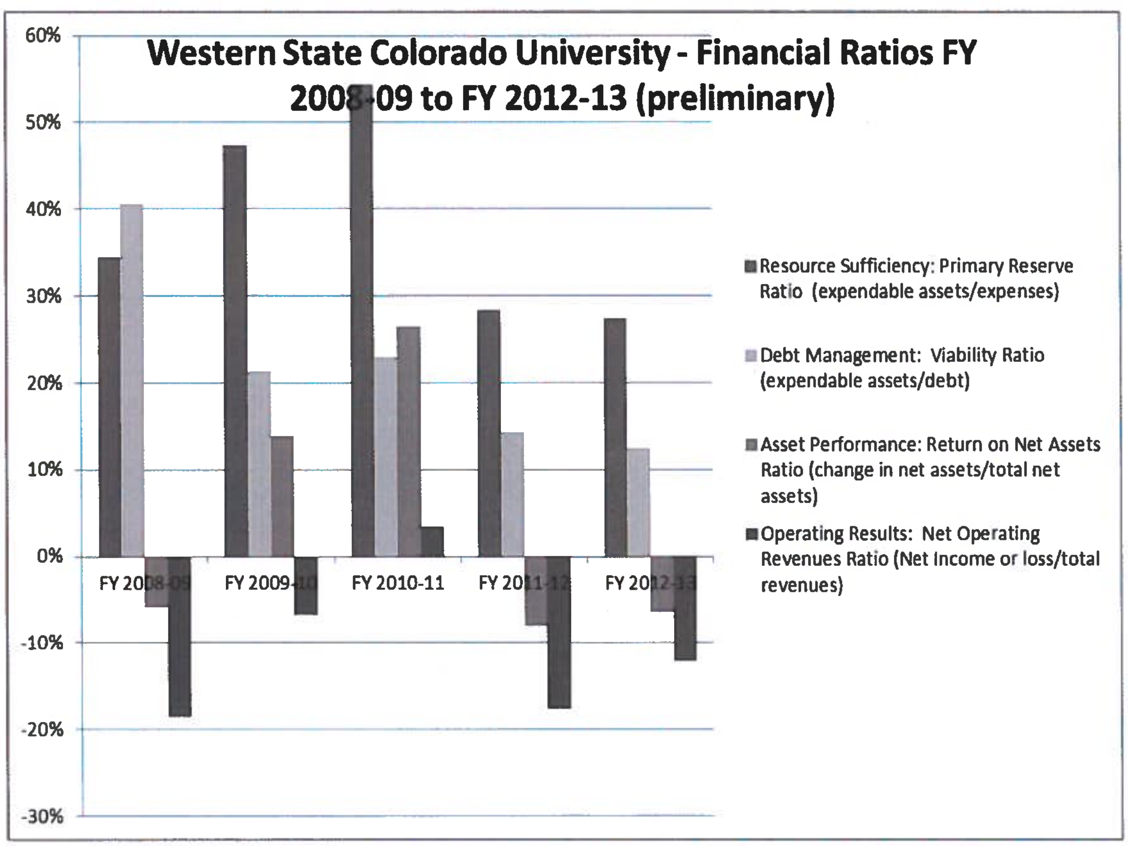
Both Western and Adams have spent aggressively on cash-funded new construction in recent years. Adams touts $65 million in recent new infrastructure investments, and its financial statements reflect $73.4 million in bonds and leases payable issued between 2009 and 2012. This represents about $30,000 per Adams State student. The Western State campus is also filled with handsome new buildings. Western's financial statements reflect $96.5 million in bonds payable as of June 2012, when foundation debt is included. This represents almost $54,000 per student. Virtually all of this debt was issued between 2009 and 2011, with additional bonds issued in 2012 through arrangement between the City of Gunnison and the Western State College foundation. Payments on Adam's debt extend through 2042 and on Western's through 2047.

The charts below reflect the CFI for each institution over a period of five years, as well as the raw component ratios that feed into the CFI. Note that the FY 2012-13 figures are based on *unaudited* end of year statements and that, unlike the figures for the prior years, do not include data for the institutional foundations. *Though final ratios for FY 2012-13 will be somewhat different, staff expects that they will be similar to those shown.*


Adams State University Composite Financial Index FY 2008-09 to FY 2012-13 (preliminary)
3.5
2.5
1.5
0.5
(0.5)
(1.5)
(2.5)
Moderate Financial Health Threshold - 3.0
FY 2008-09
FY 2009-10
FY 2010-11
FY 2011-12
FY 2012-13


Adams State University Financial Ratios FY 2008-09 to FY 2012-13 (preliminary)
40%
30%
20%
10%
0%
-10%
-20%
FY 2008-09
FY 2009-10
FY 2010-11
FY 2011-12
FY 2012-13
Resource Sufficiency: Primary Reserve Ratio (expendable assets/expenses)
Debt Management: Viability Ratio (expendable assets/debt)
Asset Performance: Return on Net Assets Ratio (change in net assets/total net assets)
Operating Results: Net Operating Revenues Ratio (Net Income or loss/total revenues)


Western State Colorado University Composite Financial Index FY 2008-09 through FY 2012-13 (preliminary)
Moderate Financial Health Threshold - 3.0
5.0
4.0
3.0
2.0
1.0
-
(1.0)
(2.0)
FY 2008-09
FY 2009-10
FY 2010-11
FY 2011-12
FY 2012-13


Western State Colorado University - Financial Ratios FY 2008-09 to FY 2012-13 (preliminary)
60%
50%
40%
30%
20%
10%
0%
-10%
-20%
-30%
FY 2008-09
FY 2009-10
FY 2010-11
FY 2011-12
FY 2012-13
Resource Sufficiency: Primary Reserve Ratio (expendable assets/expenses)
Debt Management: Viability Ratio (expendable assets/debt)
Asset Performance: Return on Net Assets Ratio (change in net assets/total net assets)
Operating Results: Net Operating Revenues Ratio (Net Income or loss/total revenues)

In response to staff questions, staff at the two institutions have noted that:

- Some of the operating losses within the last few years have been planned. Faced with sharp declines in state support, both institutions recognized that they would rely more on tuition revenue in the future but could only increase tuition revenue so much in a particular year. Thus, they first built up and then spent down cash reserves. This can be seen in strong primary reserve ratios in FY 2010-11, followed by operating losses in FY 2011-12 when state support fell sharply, tuition could not fully make up the difference, and the institutions relied on the cash they had set aside.

- Both of these institutions were particularly reliant on General Fund before the recession, making the adjustment to lower state support harder.

- Small institutions must still face many of the fixed overhead costs of larger institutions, without the economies of scale.

- Higher education institutions have been in an "arms race" to attract students, leading to heavy spending on new buildings. Because state support has not been available for maintenance or new construction, they have leveraged themselves, issuing bonds in large amounts. As they begin to depreciate their new construction, their books show operating losses because they cannot raise sufficient additional revenue to cover the depreciation. At the same time, they must cover capital debt payments. *For FY 2012-13, Adams reflects depreciation of $6.4 million and interest expense on its capital debt of $3.4 million. These two components represent about 18 percent of Adam's total operating and non-operating expenditures of $54.1 million for the year. For FY 2012-13, Western reflects depreciation of $5.4 million and interest expense of $2.6 million, representing 20 percent of total operating and non-operating expenditures of $40.1 million (excluding foundation debt).*

- At least at Adams, falling enrollment in FY 2012-13 exacerbated the problem, as it did not hit enrollment targets. Enrollment at Western State has been falling since the mid-1990s. Staff assumes that substantial new plant investments at both institutions were expected to stabilize or build enrollment, but do not appear to have had that effect to-date, particularly at Western.

Staff Recommendations
Continue to Monitor. The General Assembly (and CCHE and the Governor) need to watch this situation carefully. Both institutions have "unqualified" financial statements, *i.e*, they are going concerns and are certainly not facing imminent collapse. However, they both appear to be at significant risk.

Both institutions are highly leveraged and have student populations and financial profiles that are "squeezing" them. They are not unique in this. The *Wall Street Journal* recently reported that Moody's Investors Service survey of 300 schools found that nearly half of the nation's colleges and universities are no longer generating enough tuition to keep pace with inflation.[4] Students and families are conscious of growing debt loads and have become price-sensitive, making it harder for mid-level, regional institutions to continue their rapid tuition increases. There have also been declines in enrollment nationwide.[5] As the economy improves, some of the unemployed population that had returned to higher education for retraining may go directly into the job market. The national cohort of high school graduates is also somewhat smaller than in prior years, reducing the pool of potential students.

The JBC Should Pay More Attention to Revenue Bond Intercept Program Requests
Arguably, neither Western nor Adams should have become as leveraged as they currently are. Higher education cash-funded construction projects are subject to review and approval by CCHE and the Capital Development Committee (CDC). Projects supported under the Revenue Bond Intercept program are also subject to review by the JBC. *At the JBC, the process for approving Revenue Bond Intercept Program requests has often seemed perfunctory. It should not be.*

Pursuant to Section 23-11-106 (10) (b), C.R.S. (most recently modified in S.B. 13-099), to qualify for the Revenue Bond Intercept Program, an institution must have:

(1) A credit rating in one of the three highest categories from a nationally recognized statistical rating organization
(2) A debt service coverage ratio of at least 1.5x (net revenue available for debt service/annual debt service subject to this article)
(3) Pledged revenues for the issue of not less that the net revenues of auxiliaries; 10% of tuition if an enterprise; indirect cost recovery revenues; facility construction fees designated for bond repayment; and student fees and revenues pledged to bondholders.

If an institution meets these requirements and participates in the Program, and if the institution indicates that it will fail to meet the required payment, the State Treasurer makes the payment, and the amount owed is then withheld from the institution's fee-for-service contract, from any other state support for the institution, and from any unpledged tuition moneys collected by the institution. Revenue Bond Intercept projects receive lower interest rates because they use the state's credit rating—rather than the institution's—when issuing bonds.

Statute regarding the Revenue Bond Intercept Program was tightened in 2013, with changes that will exclude Western from further borrowing under the program. However, Adams and other institutions still have access to the program. To staff's knowledge, the CDC has never focused its attention on issues such as how leveraged an institution is when determining whether to approve a project on an institution's cash-funded list. *As the JBC has specific statutory authority to review these projects, staff recommends that JBC staff and the JBC apply a more robust process for reviewing requests that includes examining the institution's existing debt load, enrollment trends, and credit rating before approving additional borrowing on the state's credit.*

[4] Belkin, "Tuition Crunch Takes Big Toll: Net Revenue at Nearly Half of Colleges Loses Ground to Inflation in New Survey, Wall Street Journal, November 22, 2013.
[5] Lederman, "Enrollment Decline Picks Up Speed", Inside Higher Ed, May 17, 2013. http://www.insidehighered.com/news/2013/05/17/data-show-increasing-pace-college-enrollment-declines

Explore Whether Small Institutions Can or Should Be Merged Back into Larger Systems
Prior to 2003, Colorado operated a system of state colleges that included Adams, Mesa, and Western. House Bill 03-1093 broke apart this system so that each institution operates under its own board of trustees. One year earlier, via H.B. 02-1419, Fort Lewis College was spun off from the CSU system.

Staff understand that, at the time, it was anticipated that independent colleges might be stronger and better able to access private donations. However, in the current environment, the problems associated with small scale, independent entities are more apparent. Adams and Western are both in relatively weak financial states, and Fort Lewis has the next weakest CFI of all the state's institutions. As management at Adams noted, *one of the problems these institutions face is simply economies of scale*, *i.e.*, each institution must employ its own chief financial officer and cannot spread the cost to as many students as is feasible at a large institution. Costly information technology systems, marketing campaigns, and many other services can be contracted at a lower per-student cost when the institution is larger.

A larger system may have the financial resources to serve as a financial back-stop for smaller, weaker institutions in its system. For example, small rural community colleges receive a larger share of the total General Fund allocated to state system community colleges than do their larger, urban counterparts. The community college system administration recognizes that smaller rural institutions have higher costs that cannot be covered as effectively by tuition as the costs of large, urban community colleges. It thus subsidizes them. Similarly, staff understands that CSU Fort Collins has been providing support to CSU Pueblo during the recent period of financial difficulties.

The higher education system nationwide is under financial pressure, and there is widespread recognition that *structural changes and innovations may be needed for "second tier" institutions to remain viable. Larger systems are likely to have more resources and capacity to make necessary changes in a challenging financial environment.* In light of this, it is worth exploring whether any of the state's larger institutions are interested in merging with the smaller institutions highlighted in this issue.

	University of Colorado	Colorado State University	University of Northern Colorado	Colorado School of Mines	Fort Lewis College	Adams State University	Colorado Mesa U.	Western State Colorado U.	Metro State U. of Denver	Community College System
Higher Education Institution Ratio Analysis, FY 2011-12 **RATIOS - As defined in KPMG, Prager, Sealy & Co, Bearing Point, "Strategic Financial Analysis for Higher Education, Sixth Edition"**										
Resource Sufficiency: Primary Reserve Ratio (expendable assets/expenses)	**68%**	**45%**	**49%**	**88%**	**57%**	**31%**	**40%**	**28%**	**45%**	**59%**
Numerator: All unrestricted net assets+all expendable restricted net assets, excluding those to be invested in plant+unrestricted and temp restricted assets for foundation	1,891,809	463,197	99,383	181,400	39,304	16,418	38,376	13,833	71,374	331,130
Denominator: all expenses including operating and non-operating plus component unit (C U) total expense. Exclude investment losses and funds to be invested in plant	2,782,612	1,022,378	204,474	206,795	68,378	52,339	95,147	48,784	160,203	563,326
Debt Management: Viability Ratio (expendable assets/debt)	**135%**	**71%**	**65%**	**117%**	**69%**	**22%**	**24%**	**14%**	**99%**	**397%**
Numerator: Expendable net assets (same as Primary Reserve Ratio)	1,891,809	463,197	99,383	181,400	39,304	16,418	38,376	13,833	71,374	331,130
Denominator: All amounts borrowed from 3rd parties - notes, bonds, capital leases. Includes both current and long-term	1,399,159	650,270	153,941	155,056	56,598	73,406	158,773	96,517	72,036	83,311
Asset Performance: Return on Net Assets Ratio (change in net assets/total net assets)	**3.9%**	**7.8%**	**0.1%**	**6.8%**	**-1.1%**	**-4.6%**	**5.9%**	**-8.0%**	**13.0%**	**6.2%**
Numerator: Change in GASB total net assets plus change in component unit total net assets regardless of whether restricted/not or expendable or not	141,548	68,615	164	27,705	(1,577)	(3,597)	11,110	(6,942)	10,036	38,774
Denominator: Beginning of the year total net assets	3,603,987	884,343	270,717	405,910	146,266	78,713	188,885	86,791	77,172	629,268
Operating Results: Net Operating Revenues Ratio (Net Income or loss/total revenues)	**3.2%**	**0.4%**	**2.2%**	**4.1%**	**-2.4%**	**-11.6%**	**7.9%**	**-17.5%**	**5.1%**	**5.1%**
Numerator: operating + non-operating net income/loss + component unit change in unrestricted assets	90,638	3,849	4,507	8,973	(1,572)	(5,271)	7,488	(7,039)	8,482	29,314
Denominator: operating +net non-operating revenue plus component unrestricted revenue	2,810,271	1,006,655	202,716	220,743	64,291	45,461	95,224	40,173	165,420	570,972