HIRTLE CALLAGHAN & CO
Chief Investment Officers

BUILDING FINANCIAL FLEXIBILITY

Strategies for Boosting Unrestricted Endowment

Many schools lack the level of unrestricted net assets they need to have an appropriate level of financial flexibility. As opposed to assets that are restricted by donors for a specific purpose, unrestricted net assets can be allocated where an organization needs them the most, whether it is operations, capital improvements or strategic initiatives. Unfortunately, many times a school's net assets are tied up in capital and restricted funds. Independent schools have focused their resources on enhancing the academic experience and making capital improvements, with the unintended consequence of depleting unrestricted assets. We recommend that schools create a plan to boost unrestricted net assets and build financial flexibility for the future.

WHY BOOST UNRESTRICTED NET ASSETS?

* FINANCING CAPABILITY

Unrestricted net assets are critical to a school's ability to issue debt. Lenders look at unrestricted net assets as a measure of fiscal strength because they can be pledged to secure debt. One of the primary ratios calculated by lenders is the level of unrestricted net assets to debt. Even if you have never issued debt before, the time to start planning for debt is well in advance of when you need the funding.

* OPERATING CUSHION

Unrestricted net assets serve as a reserve that can be drawn upon in times of stress. Schools often budget to break even, but that does not give them a cushion in the event of a crisis. While working capital reserves (which tend to be cash) can offer short-term relief, unrestricted net assets help protect a nonprofit's core mission.

* CAPITAL FUNDS

Schools can use unrestricted net assets to fund the upkeep of buildings. Most schools assume that funds for major renovation/replacement will be donated. However, a more prudent strategy is to accumulate unrestricted net assets and spread the cost of replacement more equitably across generations of students.

STRATEGIES FOR BUILDING UNRESTRICTED ENDOWMENT

Since the endowment is often the largest component of unrestricted net assets, this paper will explore strategies schools can employ to increase unrestricted endowment.

The easiest way that a school can increase unrestricted endowment is to differentiate the spending rate for restricted endowment from unrestricted endowment. **The amount of total spending does not change, rather the source of the spending changes.** By spending more from your restricted endowment and less from the unrestricted endowment, you can build your inancial lexibility.

CASE STUDY 1

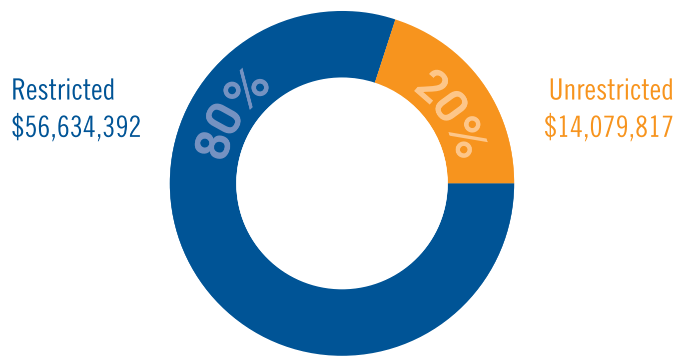
The below example is for a school with a $70 million endowment, of which only $1.7 million, or 2%, is unrestricted. The organization has a spending rate of 4% annually from the endowment, using the same spending rate for both restricted and unrestricted endowment funds. There are several options to grow the unrestricted endowment.

SCENARIO 1 — One path is to stop spending from the unrestricted endowment and spend a little more (4.4%) from the restricted endowment. By doing this year-after-year, the organization will be able to grow its unrestricted endowment incrementally over the 10-year period. In this scenario, net assets increase by $780,519 (the difference between the first and second column in the chart below).

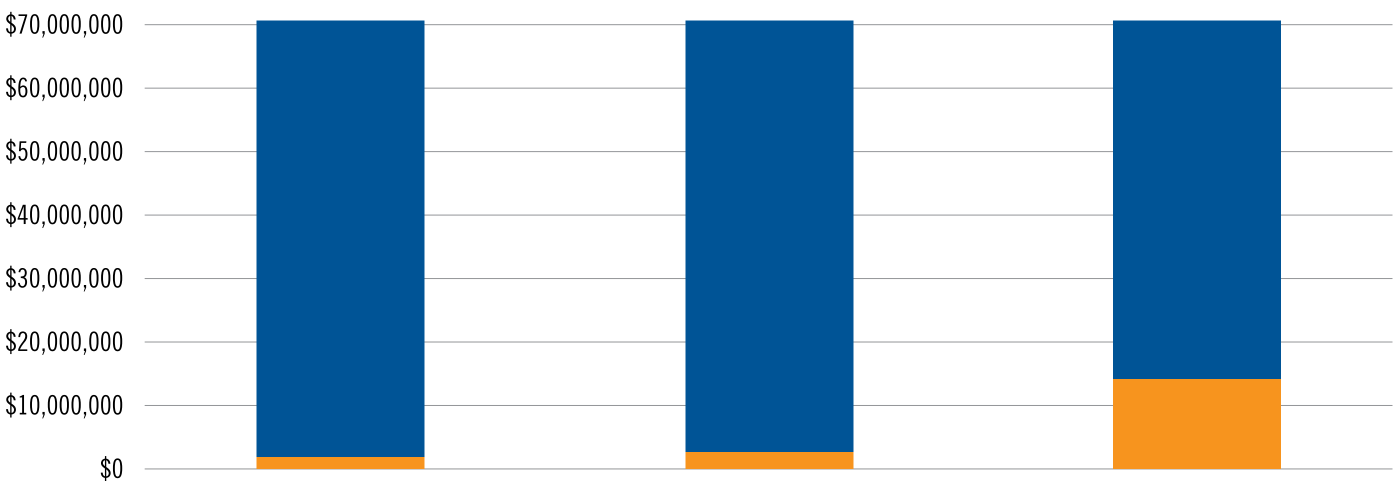
SCENARIO 2 — An alternative, more impactful plan is to raise spending from the restricted endowment to 6%. This will generate more endowment payout, but rather than putting the additional money into the operating budget, the school will continue to budget for a 4% endowment distribution and use the operating surplus to create an unrestricted endowment.

In this second scenario, the unrestricted endowment assets increase from $1.7 million to $14.1 million over 10 years. The unrestricted endowment grows to 20% of the total endowment value. This increase vastly improves the ability of the school to dedicate resources where they are needed the most.

AFTER 10 YEARS OF 6% SPENDING FROM RESTRICTED



ENDOWMENT VALUE 10 YEARS



	Base Case 4% Spending	No Spending from Unrestricted Endowment	6% Spending from Restricted Endowment
Restricted	$68,837,220	$68,240,972	$56,634,392
Unrestricted	$ 1,692,719	$ 2,473,238	$14,079,817

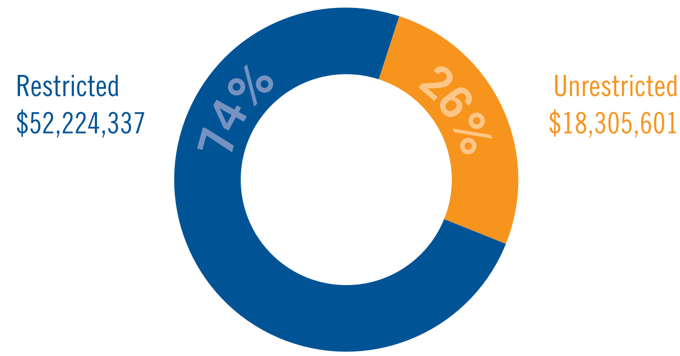
Source: Hirtle Callaghan

CASE STUDY 2

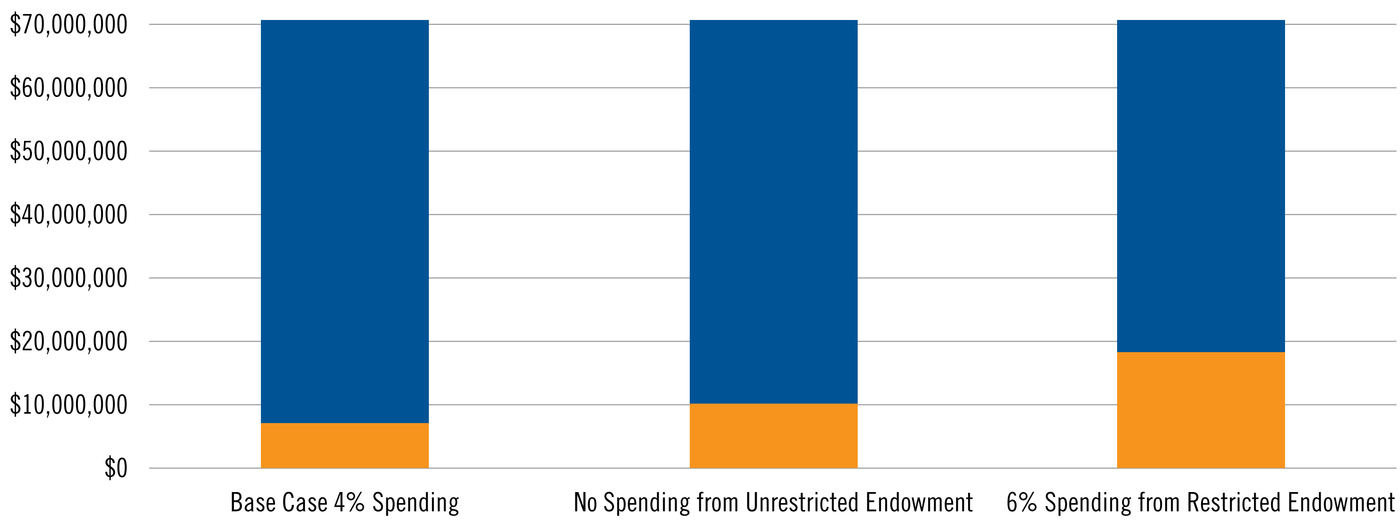
Let us look at a different school with a higher level of unrestricted assets—$7 million, or 10%—of its $70 million endowment.

Using a 6% spending rate from the restricted endowment, the school can significantly grow the unrestricted endowment, but not at the same level as in Case Study 1. Over 10 years, the unrestricted endowment would grow from $7 million to $18.3 million, comprising 26% of the total endowment.

AFTER 10 YEARS OF 6% SPENDING FROM RESTRICTED



ENDOWMENT VALUE 10 YEARS



	Base Case 4% Spending	No Spending from Unrestricted Endowment	6% Spending from Restricted Endowment
Restricted	$63,476,944	$60,224,780	$52,224,337
Unrestricted	$ 7,052,994	$10,305,158	$18,305,601

Source: Hirtle Callaghan

In both cases above, the school would benefit significantly from differentiating the restricted endowment spending rate from the unrestricted endowment spending rate. In addition to providing more financial flexibility, using a higher spend rate for restricted endowment will significantly improve your school's ability to secure financing. Having a greater unrestricted endowment and a surplus will make your operations appear stronger and strengthen the operating ratios that are critical to lenders.

CONSIDERATIONS FOR SCHOOLS USING THIS APPROACH

Before a school goes down this path, there are some very important operational issues to be aware of:

1) DONOR RESTRICTIONS MUST BE SATISFIED.

You need to have an operating expense that satisfies the donor restriction. If you are not able to satisfy the donor restriction, you cannot create an unrestricted endowment with this additional payout. Nothing in this scenario eliminates the need to legally satisfy the donor restriction.

2) DONOR RELATIONS MUST BE MAINTAINED.

The optics of altering your spending need to be managed. A donor could believe you are overspending from their endowment. To manage this, some organizations create an unrestricted endowment and attach it to the restricted endowment fund. For reporting, the donor will have an endowment statement with two components, a restricted and unrestricted component. While this is not necessary, it may be the best path to maintain strong donor relationships.

3) UPMIFA[1] HAS IMPORTANT IMPLICATIONS.
Each state has laws that outline spending from endowments where the current market value has fallen below the book value. By increasing the spending rate on restricted funds, you are also increasing the possibility of having underwater endowments. To guard against this outcome, you may choose to only spend at a higher rate from the older established endowments that have significant market appreciation.

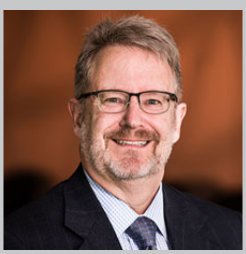
As a result of these concerns, you need a customized plan that is well understood by all related parties. Most importantly, your total spending rate should remain unchanged. The Board and school leadership need to be budget hawks to ensure that you are not spending more, as it will defeat the purpose of this exercise.

[1] *UPMIFA is the Uniform Prudent of Institutional Funds Act which governs investments in nearly all 50 states in some format.*

CONCLUSION

The amount of unrestricted net assets needed by an organization varies depending on factors such as its size, mission, revenue volatility/predictability, condition of the capital plant, fixed vs. variable operating expenses, and future plans. Generally, having a sufficient reserve of unrestricted net assets ensures financial stability during unexpected events or economic downturns and provides flexibility to pursue strategic opportunities or address emerging needs without relying solely on external funding sources.

It is wise to start building your school's unrestricted endowment today. While you may not need it now, the process of building unrestricted endowment takes time and will pay off when the need arises for financial flexibility in the future.



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John is a Director and Endowment Specialist with Hirtle Callaghan. He has over 35 years of nonprofit experience. John works closely with nonprofits to design customized investment programs that are fully aligned with their goals and risk tolerance. He also helps them tackle key strategic issues, including spending policy, liquidity policy, debt ratios and covenants, capital campaigns, operating reserves and governance. Prior to joining Hirtle Callaghan, he was the Chief Financial Officer and Treasurer of Bryn Mawr College.

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Chief Investment Officers

Since 1988, Hirtle Callaghan has been serving as the Chief Investment Officer for families and nonprofits who rely on the growth of their assets to support the causes and people they care for. With each client in mind, we design and manage a customized investment program that is diversified across global opportunities, including public and private markets. We use our $20 billion in assets to facilitate access to highly skilled specialist managers and keep down costs. We always place our clients first, avoiding conflicts so every decision is in your best interest.