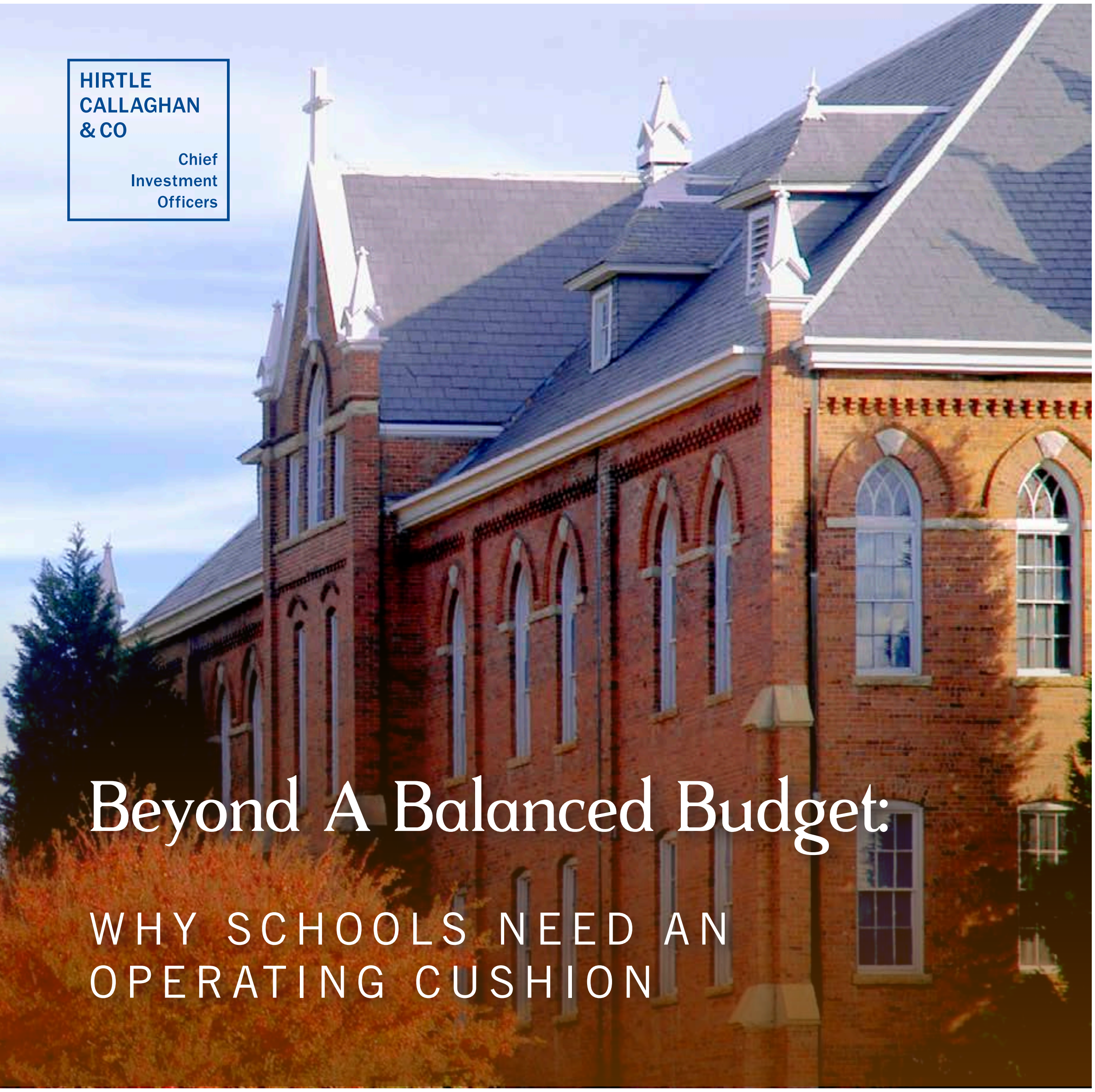

Beyond A Balanced Budget:

WHY SCHOOLS NEED AN OPERATING CUSHION

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I have long believed that the term "nonprofit" is a misnomer, and it is in fact critical for mission-oriented organizations to have an operating surplus. A surplus will serve as a cushion in the event of a decline in revenue or unexpected cost increases, such as the recent disruptive increase in inflation. An operating surplus can also help you maintain your bond rating and your capacity to borrow, allowing you to make strategic investments in programs or facilities that are essential to further your mission.

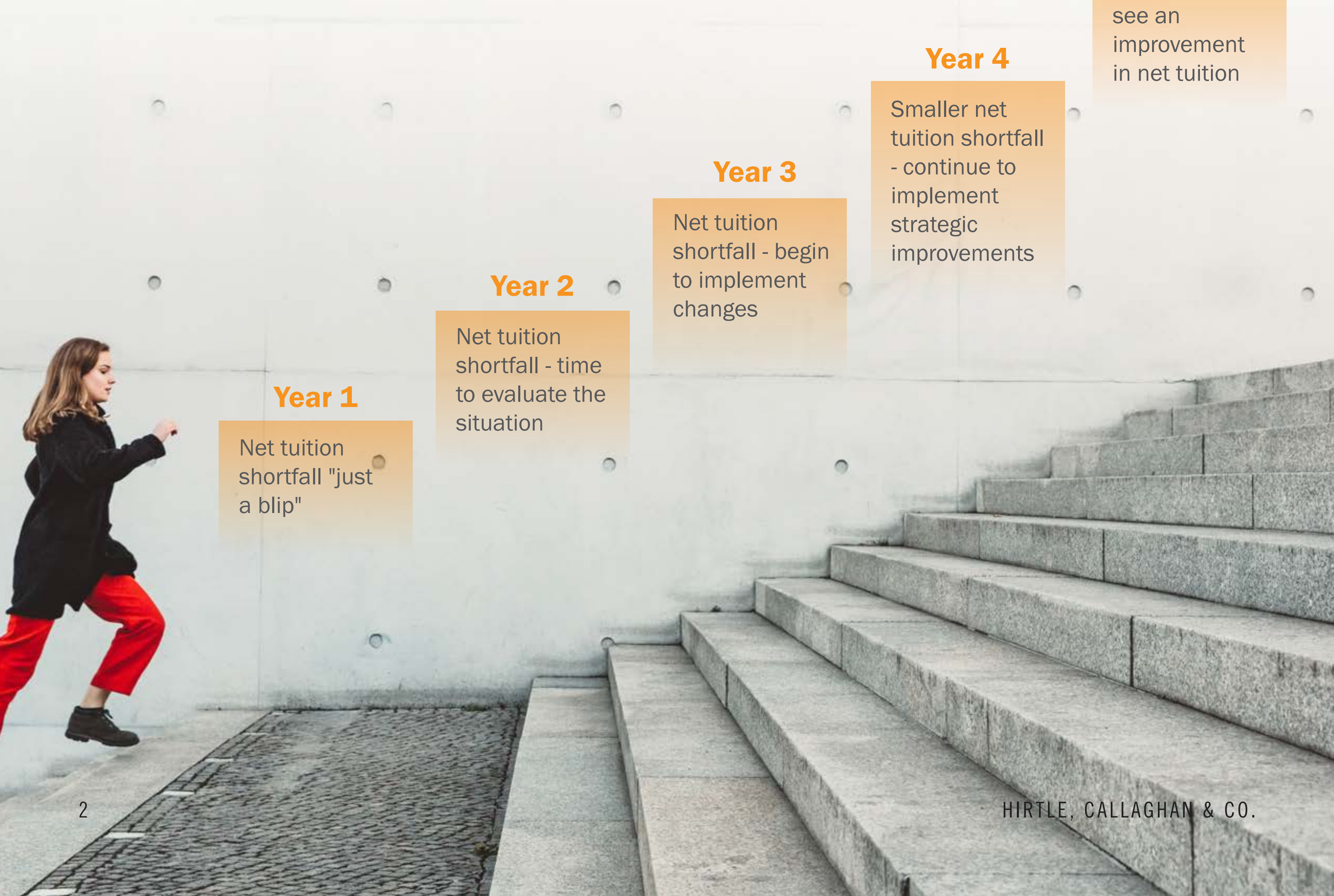
So why don't more nonprofits, and schools in particular, build an operating surplus into the budget? In general, organizations tend to budget with a short-term mindset, looking out a year or two, rather than taking a long-term, strategic approach. Annual budget issues often take priority over developing a stronger operating model and building the balance sheet. This mindset persists at the board level; when an operating surplus exists, many CFOs are admonished, "we could have had a larger salary increase" or "our budget is too conservative."

The financial hit to educational institutions over the past five years has strongly reinforced the benefit of budgeting in an operating surplus. We have observed a noticeable difference between how schools with different operating models fared. Reflecting on those different outcomes, the biggest advantage of having a strong operating margin is not just the extra resources, but the time it gives you to react to a revenue shortfall or unexpected inflation.

What Happens Without an Operating Margin?

When a school experiences a downturn in revenue, often as a result of a decline in enrollment and net tuition, it is generally slow to react and adjust its budget. The first year of a net tuition shortfall is often mistakenly believed to be a one-year "blip." Then, when the school faces the second year of missing their net tuition budget, it has already started to enroll a third class without having made strategic program or capital investment to help enhance net tuition.

A school's reaction to a decline in revenue often takes years to resolve and get back on track. An operating margin gives you time to respond strategically to budget shortfalls.



How Does an Operating Margin Make a Difference?

Rather than getting stuck with an immediate multi-year budget deficit, a school with an ample operating margin is positioned to weather a revenue shortfall. The below scenario demonstrates the impact an operating cushion can have through a downturn. Let's assume revenue growth slows to 1% annually while expenses continue to grow at 3%. A school with a cushion – in this case a 5% operating margin – remains in a solid financial position with enough wiggle room to make necessary improvements. Before it ends up running a budget deficit, the Board and administration have time to address key issues, such as discount rate, enrollment, retention, staffing, etc.

Minor Revenue Shortfall Scenario

- Revenue Growth at 1% Annually
- Expense Growth at 3% Annually

	Base Year 5% Margin	Year 1	Year 2	Year 3	Year 4
Revenue	$10,000,000	$10,100,000	$10,201,000	$10,303,010	$10,406,040
Expense	-$9,500,000	-$9,785,000	-$10,078,550	-$10,380,907	-$10,692,334
Margin	$500,000	$315,000	$122,450	-$77,897	-$286,294
Operating Margin %	5.0%	3.1%	1.2%	-0.8%	-2.8%

5% Operating Surplus

In contrast, a school with no operating margin immediately goes into the red. It is left scrambling without time or resources to react strategically and thus ends up in a deeper hole four years into the crisis.

	Base Year Breakeven Budget	Year 1	Year 2	Year 3	Year 4
Revenue	$10,000,000	$10,100,000	$10,201,000	$10,303,010	$10,406,040
Expense	-$10,000,000	-$10,300,000	-$10,609,000	-$10,927,270	-$11,255,088
Margin	$0	-$200,000	-$408,000	-$624,260	-$849,048
Operating Margin %	0.0%	-2.0%	-4.0%	-6.1%	-8.2%

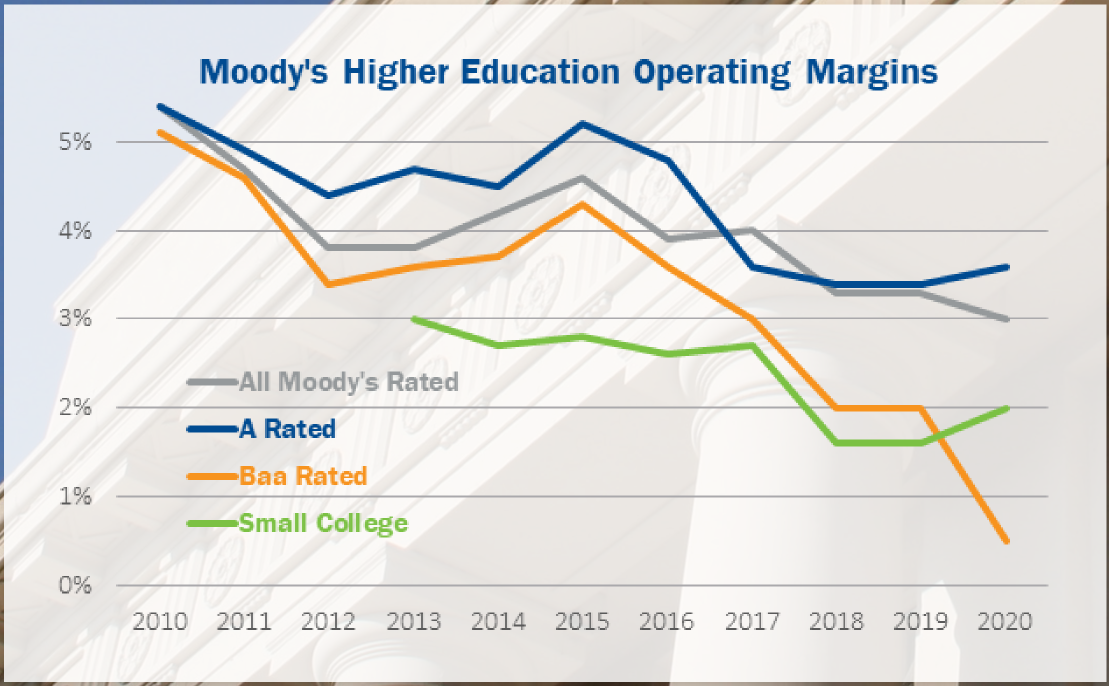
Breakeven Budget

The above example shows how even modest enrollment fluctuations can have a significant impact on a school's bottom-line. It does not take much for a short-term issue to turn into a long-term problem that threatens sustainability. As a school's deficit increases, it is forced to cut expenses, which further slows the implementation of strategic improvements. The damage in morale, internal politics and stalled momentum can impact every aspect of the organization's long-term plans. Most importantly, the student experience deteriorates, making it more difficult to attract and retain students. A short-term revenue problem can rapidly become a longer-term sustainability issue that is more difficult to turn around.

How Big of a Cushion Do I Need?

Historically colleges and universities had operating margins around 4% to 5%. This provided enough wiggle room to weather a downturn. As evidenced in the chart below, operating margins have declined on average from 5% to 3% over the past decade — the grey line shows all Moody's-rated higher education institutions. This trend corresponds with increased pressure on net tuition revenue in higher education. As competition has increased for student enrollment, schools have increased their tuition discounting, significantly impacting the ability to increase net tuition revenue. This trend was compounded if enrollment suffered despite the increase in tuition discounting. The chart shows how schools with a lower bond rating (and presumably lower enrollment) were disproportionately hurt.

It is worth noting that pressure on operating margins was relieved slightly during COVID because government relief funding covered the lost revenue and some schools reduced expenses; in 2020 operating margins were steady for A-rated schools and even improved slightly for small colleges.



Generally, we believe schools and colleges should maintain a minimum budgeted operating margin of 3% - 5%. However, determining the appropriate level of operating margin is a case-by-case exercise. Schools should evaluate the following factors to assess the size of their operating cushion:

Revenue Diversification:

The greater diversification of revenue both within tuition (e.g., summer, graduate, online, noncredit and international students), and among non-tuition revenue sources (endowment income, gifts, grants, corporate partnerships, and non-student auxiliary income), the less vulnerable your revenue sources. To the extent these sources of revenue are uncorrelated, a lower operating margin may be appropriate.

Level of Operating Reserves:

Having significant reserves may reduce how much operating margin you need. However, reserves are a one-time funding source and should not be viewed as a solution to a persistent revenue shortfall or expense increase.

Capital Structure and Level of Capitalization:

If you have a higher level of debt or are thinking about taking on additional debt, you should build a higher operating margin in anticipation that you will need to pay it down. A higher operating margin can also be used to build your reserves or unrestricted endowment, giving you greater financial flexibility in the future.

Planned Strategic Investment:

Institutions that have a strategic plan requiring investment should consider whether they have enough resources set aside to make the necessary investment over the life of the plan to achieve their goals. This is especially important where the investment will lead to future revenue growth and revenue diversification. Institutions need to seize on opportunities to grow revenue, now more than ever, to reduce their reliance on net tuition.

How Can You Protect and Grow Your Operating Margin?

Moving from a breakeven situation to a 3% to 5% operating margin will take time. Building a higher margin should be viewed as an incremental, long-term strategy. If your school can grow its margin by 0.5% a year, then it can build up to a 5% operating margin over the next 10 years. As a perpetual entity, schools are in a unique position to take full advantage of a longer time horizon. While a decade may seem like a long time, it is a more realistic goal and can be transformational over the long term. The key is to start working toward that goal today rather than waiting until the next crisis to focus on your operating margin.

It is helpful to have an opportunistic mindset as you think about building your margin. A few opportunistic strategies include:

1. With the recent strong market returns resulting in growth in endowment spending, build some of the additional revenue from the endowment into an operating margin.

2. In years when you have a net tuition surplus, build your operating margin instead of increasing your expense base. There will always be ways to spend it today, but you will be better off saving it for a future time when it is most needed.

3. Look to build extra margin into an expense reduction plan. To the extent you are going through a multi-year budget reduction process, budget in enough cuts each year that you can start to build an operating margin. However, it is not wise to cut funding for maintenance of buildings or IT infrastructure, as doing so will likely create a larger, institutional problem.

4. Develop a multi-year financial plan and work with your President, Cabinet, Budget Committees, Board of Trustees, etc. to educate your community about the strategic importance of building an operating margin. You can achieve buy in from key stakeholders if you help them understand the relationship between operating margin and long-term financial sustainability.

Conclusion

With so many current budgetary needs, prioritizing an operating margin is politically difficult. The concept is simple, but with competing priorities among constituents, budgeting an operating surplus is generally unpopular. There is pressure from parents to keep tuition low, from students to fund additional activities, from faculty to increase resources or salaries and from donors to make an immediate impact with their gift. For many organizations, this short-term thinking has stalled institutional progress. Having the same discussion each year about how to balance the budget in the face of competing needs results in reactive and sub-par decision-making. It reinforces a short-sighted mindset that can be extremely destructive to the long-term health of your organization. Instead, by building in a cushion, you can alleviate pressure and "buy" time to make better decisions, allowing you to take a more strategic approach so that your organization's mission can flourish uninterrupted by volatility in enrollment and other contributors to revenue.

With inflation threatening to increase expense growth, it has never been more important to focus on improving operating margins to provide a cushion. Investment Committees approach endowment management with inherent knowledge that financial market volatility is a risk. They design investment policies and spending policies that aim to mitigate the impact of market volatility, giving the organization time to react and the market to recover. We should take the same approach in managing operating budgets and enrollment volatility.

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John is a Director and Endowment Specialist with Hirtle Callaghan. He has over 28 years of higher education experience. From 2003 until 2014, he was the Chief Financial Officer and Treasurer of Bryn Mawr College. As the Treasurer at Bryn Mawr, he oversaw an $850 million endowment, managed cash, issued debt and was responsible for budgeting and strategy planning. At Bryn Mawr, he assisted in modernizing and diversifying the endowment. During the latest recession, Bryn Mawr was one of only a few colleges whose debt rating was upgraded. Prior to Bryn Mawr, John spent 15 years in various financial roles at the University of New Hampshire. He started his career at Coopers & Lybrand.

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