Cracking the EGG

Preserving the College While Protecting the Core

BY MICHAEL B. GOLDSTEIN

TAKEAWAYS

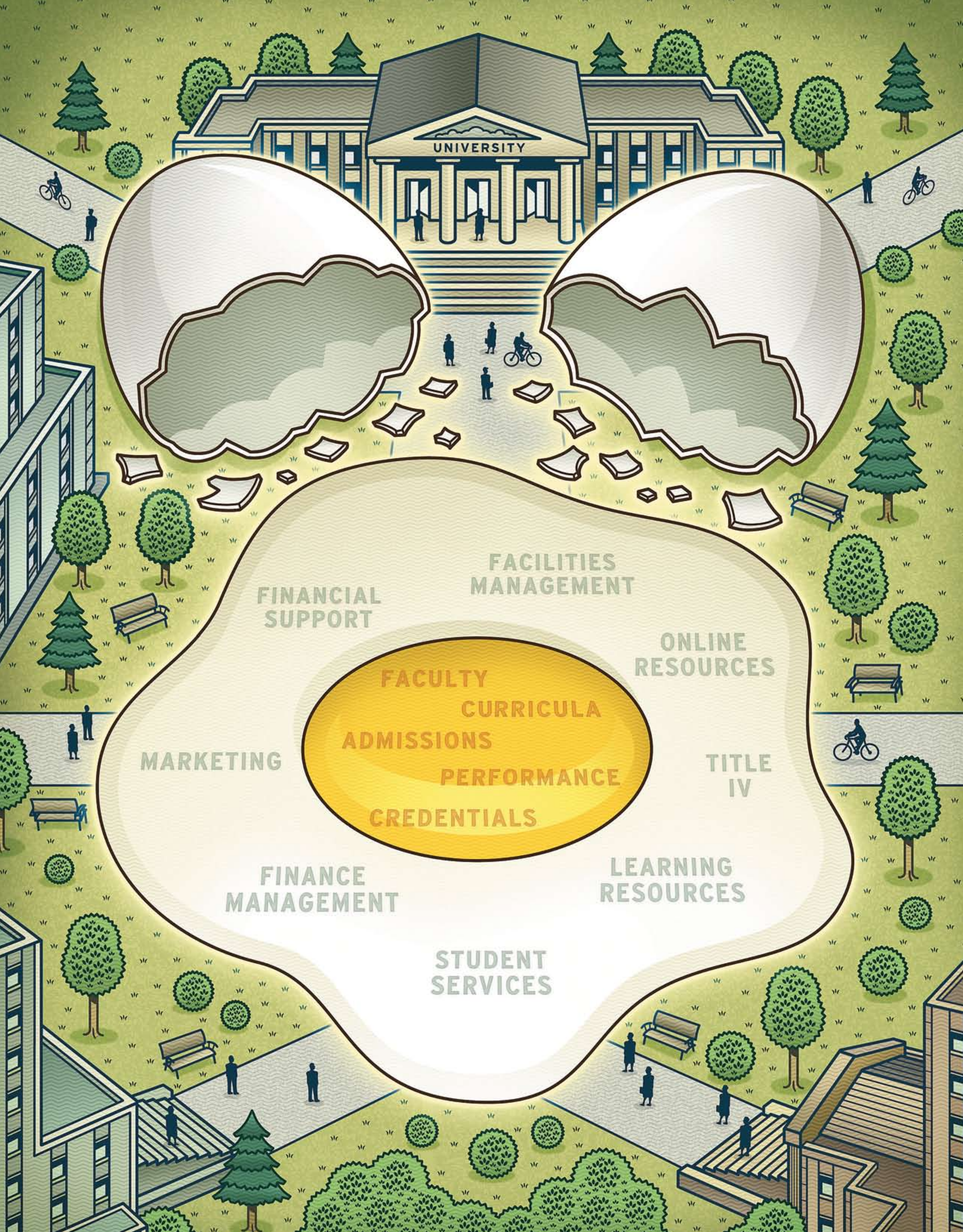
1 One reaction to the strong growth of many for-profit universities has been a tremendous increase in the interest of financial investors in the higher-education market.

2 Some "hybrid" institutions are being created that preserve the key attributes of non-profit private or public colleges while organizing to allow use of investors' funds to deliver functions that support the core activities.

3 The key to the hybrid model is the ability of the institution to retain the core academic functions and still maintain control of the non-core functions.

THERE ARE CURRENTLY THREE CATEGORIES OF independent colleges and universities: Those that are flush with resources, those that are stable but suffering from the effects of the recession, and those whose financial stress has been exacerbated to the breaking point.

PETER HOEY


UNIVERSITY
FACILITIES MANAGEMENT
FINANCIAL SUPPORT
ONLINE RESOURCES
FACULTY
CURRICULA
ADMISSIONS
PERFORMANCE
CREDENTIALS
MARKETING
TITLE IV
FINANCE MANAGEMENT
LEARNING RESOURCES
STUDENT SERVICES

For the fortunate few in the first category, the solutions posed here may represent useful options for continued growth; for the latter two groups, they may offer an alternative to decline or radical transformation.

Before exploring solutions, let's take a moment to explore the economic environment surrounding independent colleges and universities. Higher education has long been said to be counter-cyclical: In the face of a declining economy, and especially with rising unemployment, people return to school. The current recession has validated this theory. Demand for admission at public colleges is up sharply, particularly at community colleges, although in many states admissions have been curtailed as a result of increasingly draconian cuts in public support. Similarly, the proprietary sector, uninhibited by state budgetary constraints, has benefited from double-digit growth, most particularly in online programs.

Meanwhile, independent institutions have faced increased cost-consciousness among potential students; at some institutions that has affected demand and increased competition and raised the self-destructive lure of steep tuition discounting. At the same time, endowments, and the revenues they represent, have fallen steeply and have yet to come near a full recovery. For an increasing number of institutions, the future does not look promising.

One reaction to the very attractive growth of many of the for-profit universities has been a tremendous increase in the interest of financial investors in this higher-education market. As a prime example, a recent annual conference for higher-education investors and financial analysts, held by one of the major investment banking firms, saw a *doubling* of attendance from last year. Interest in acquiring existing for-profit institutions is running extremely high, at the same time that the number of such institutions that are on the market—and that offer certain key attributes, notably regional accreditation—diminishes with each transaction.

As a result, there has been a flurry of activity in converting independent colleges into for-profit institutions. Several of the most successful proprietary institutions, such as Kaplan, Walden and Capella Universities, all started with the acquisition of small independent colleges, which then were reorganized as for-profit entities. This provided the base for vastly expanded academic enterprises whose growth has been driven by the availability of substantial amounts of private capital. More recently, Grand Canyon, Ashford and Webster Universities, among others, have followed the same pattern.

The chief advantage of this approach is the ability of the acquiring entity to build upon an institution's existing authorization and accreditation, rather than starting a process that can take years to complete. The disadvantage, of course, is that the character of the institution changes. An independent institution is just that: It is *independent*, not *owned*.

While there is no inherent reason why the type of ownership (for-profit versus non-profit) should alter the nature of a college, for most governing boards the thought of "selling" the institution represents an extraordinary challenge, if not an admission of defeat. Tossing the keys across the table to new owners is a last-resort option, often seen as worse than simply shutting the doors. Alumni are not customers who can patronize another store, and "mission" is more than a brand name.

There is, however, another path that can preserve the mission, character, form, and function of an institution—what we can call the "core"—while enabling the institution to benefit from the financial markets' current high level of interest in American higher education. This path is the creation of a "hybrid" institution that preserves the key attributes of an independent (or a public) college, while tapping into an entirely new source of financial support.

Investors' interest in collaborating with existing independent and public institutions is a function of the extremely high cost of entry into American higher education. Anyone who has had any serious contact with the field understands that higher education in this country is a very highly regulated industry, with entry zealously controlled by overlapping gatekeepers. Starting a new for-profit institution from the ground up is nearly impossible from an economic perspective, primarily because of the interrelationships among state authorization requirements, accreditation, and the all-important access to federal Title IV student financial aid.

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Federal law that applies only to for-profit institutions requires them to have been providing their program of studies for at least two years before they can become eligible to provide their students with access to Title IV programs. Another provision of law requires that before an institution may even apply for Title IV eligibility, the institution must be authorized by the state in which it operates and must be accredited by an accreditation body recognized by the U.S. Secretary of Education. Finally, another provision, which only applies to for-profit schools, requires that they be *fully* accredited to gain eligibility to offer their students Title

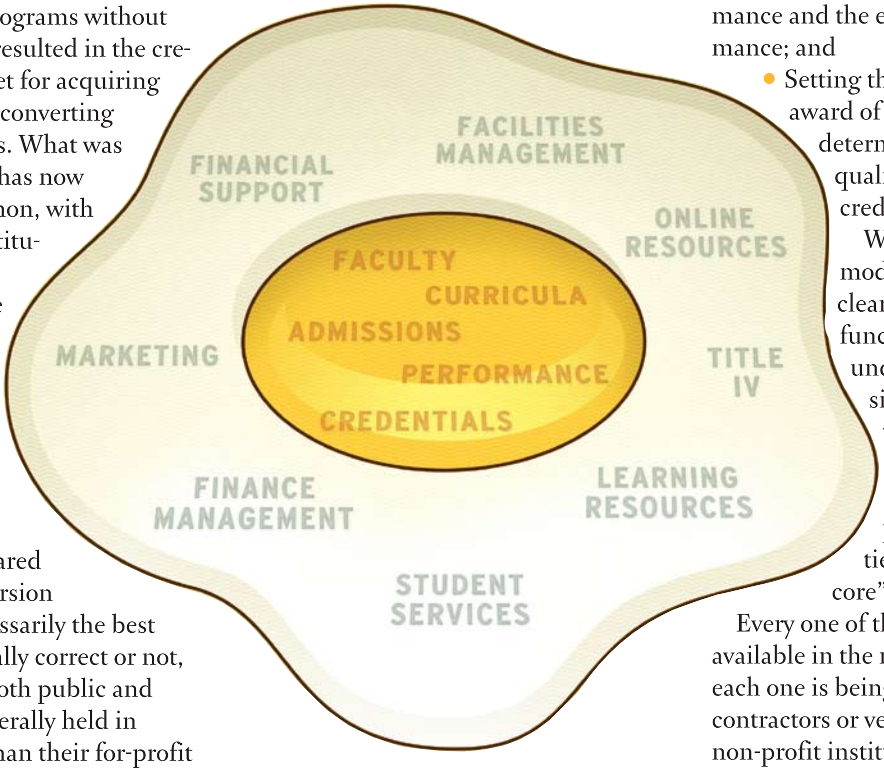
IV grants and loans, unlike public and independent institutions for which candidacy for accreditation is sufficient.

As a result, few investors are prepared to commit substantial sums to build, equip, and staff an institution whose students would not be able to receive federal grants and loans for generally well in excess of three years. On the other hand, an *existing* college can be *converted* to for-profit form and, as long as it has been operating for at least two years and meets the other criteria, it can continue its participation in Title IV programs without interruption. This has resulted in the creation of an active market for acquiring "frail" institutions and converting them to for-profit status. What was once a rare occurrence has now become far more common, with about a dozen or so institutions having been converted or beginning the process of conversion in 2009 alone.

But the presence of eager buyers does not mean that there are a commensurate number of institutions whose leaders are prepared to "sell." Nor is a conversion to for-profit status necessarily the best answer. Whether factually correct or not, non-profit colleges—both public and independent—are generally held in higher public esteem than their for-profit competitors, and they have other advantages, such as more favorable regulatory treatment and the continuing ability to receive charitable gifts. For example, the Higher Education Act limits for-profit institutions to offering programs "to prepare students for gainful employment in a recognized occupation," effectively excluding such institutions from offering, say, general liberal-arts programs. The holy grail is to retain the regulatory status and public prestige of an independent or public institution, while being able to access the private equity funds whose leaders seek a stake in the higher-education marketplace.

These factors have resulted in the development of a "hybrid" model, which preserves the institution in both form and function, but at the same time allows the institution to access a portion of the enormous financial resources available in the private equity market. Thus, instead of *selling* the institution, the college leaders enter into a partnership that can strengthen the core of the institution and preserve its mission, while allowing both the investor *and* the institution to reap a material profit.

The hybrid model is based on a different view of the nature of colleges and universities than we usually have. Visualize an egg. This is how we generally perceive our institutions, that is, as unitary entities that carry out the multifaceted work of a "college."



But that perception is incomplete. Crack open the egg, and you find a sharply defined yolk surrounded by an amorphous gel of white. The yolk—the essential "core" of the egg—symbolizes the functions that are inextricably a part of the institution *as an educational entity*. The white, spreading out from the yolk in all directions, represents the functions that are necessary to *support* the core, as the egg white does the yolk, but that are clearly separate from it.

In the most concise terms, the "core academic functions" of an institution of higher education can be described as consisting of five elements, each flowing from the other:

- Setting the qualifications for, and appointing and supervising, qualified faculty members;
- Selecting and adopting the curricula;
- Setting admissions standards and admitting students who meet those standards;
- Setting standards for student performance and the evaluation of that performance; and
- Setting the requirements for the award of academic credentials and determining those students qualified to receive such credentials.

What drives the hybrid model is the fact that while clearly the core academic functions must always remain under the direct and exclusive control of the institution, *everything else* can be (and sometimes has been) delegated to and performed by other parties. A listing of these "non-core" functions is revealing. Every one of them is, in fact, currently available in the marketplace—that is, each one is being performed by outside contractors or vendors on behalf of some non-profit institutions:

- Securing financial support necessary to support the institution;
- Securing, equipping, and managing facilities the institution agrees are appropriate to the academic program;
- Developing curricular materials, such as online courses and modules, subject to review and adoption by the institution's faculty;
- Marketing the institution, recruiting students, and presenting applicants who meet the institution's admissions standards for acceptance by the college;
- Providing instructional and learning resources, including learning-management systems, consistent with the requirements and standards of the institution;

- Providing student services determined by the institution to be appropriate to the academic program and the needs of enrolled students;
- Managing finances, including collection of tuition; and
- Administering the institution's participation in the Title IV programs. (Federal law permits an institution's participation in these programs to be administered in substantial part by a third-party provider.)

The key to the hybrid model is the ability of the institution to *retain* the core academic functions and still *maintain control* of the non-core functions. The academic program remains within the institution, the faculty remains a part of the institution within its existing academic structure, and academic decision-making remains with the faculty and the academic leadership. At the same time, costly services are separated so that they can be *independently financed* while remaining within the control of the institution (see figure 1).

While a number of models have been developed, one of the most attractive, for reasons I will discuss below, is the establishment of a joint venture (or "JV" in the parlance of finance) that is jointly owned by the college and by its partner. The partner may be a private equity investor, a strategic enterprise in the education field, or a combination of both.

This is possible because federal tax rules for tax-exempt non-profits such as colleges allow them to enter into joint ventures with for-profit investors, as long as the non-profit entity retains a majority of the voting control of the joint venture. This requirement of the tax code provides a powerful argument for affording the college majority control. However, the IRS does allow a partnership agreement to be crafted in a way that protects the rights and economic interests of the investor, usually by requiring a "supermajority" vote for certain decisions that could have a particularly severe impact on the investor, such as dissolution or taking on substantial debt.

It is the joint ownership of the venture that transforms this model from the simple outsourcing of services, which is common at colleges and universities—particularly in areas such as sports arenas, dormitories, and food services—to one in which the institution maintains an intimate *organizational* and *economic* interest in an enterprise specifically designed to support the institution's academic operations, using funds provided by the commercial partner (see figure 2). The JV becomes a vehicle of *both* the institution and the investor to assist the institution through the delivery of the non-core services. By transferring the non-core services into the JV, the institution can share in the value created by the enterprise, and both the institution and the investor can capitalize the JV sufficiently well to make it a more efficient provider of services, with the partner accessing the resources and services of the institution. Importantly, the faculty remain with the parent institution.

Figure 1

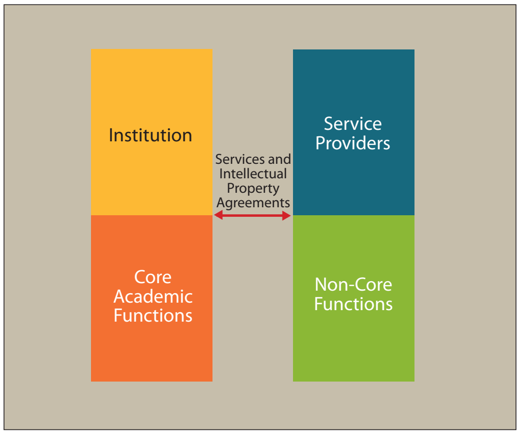


Figure 2

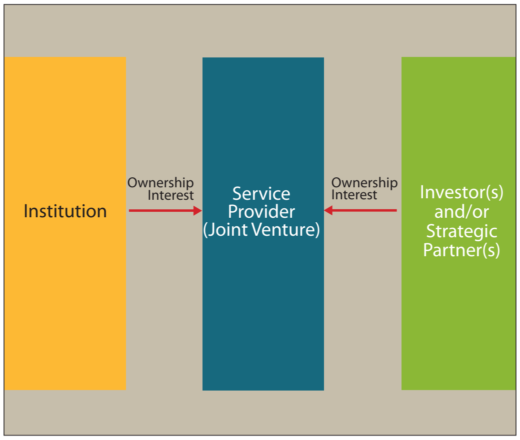
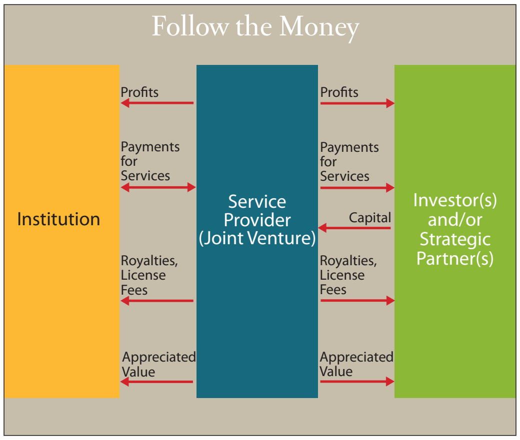


Figure 3



In itself, this is an economically attractive model. By attracting new capital to fund the joint venture, the institution can greatly expand the quality and breadth of its services, notably in marketing and recruitment, as well as in student support and learning resources. The institution shares tuition revenue with the partner in a variety of ways: through payments for services performed by the institution and the joint venture; royalties for the use of the institution's name; and profits created by the joint venture.

Importantly, the college also shares in the value that is created by the venture; after all, the JV is a business, and at some future point a portion of the institution's interest in the JV can be purchased by another party (this is called "monetizing"). If structured properly, the institution still need not relinquish control, while at the same time converting value into usable funds. The movement of funds, while complex at first blush, is actually very straightforward and consistent with generally accepted practices in both business and higher-education circles (see figure 3).

While the hybrid model is valuable simply as a means to attract capital for the benefit of the institution, it also allows an investor to partner with an institution to create valuable new services. The investor avoids the high barriers that accompany starting a new institution, and the institution has capitalized a new educational enterprise without dipping into its own operating funds or reserves. The simplest example is expanding (or establishing) the ability of an institution to be competitive in online learning. The investor commits funds to the JV to provide capital for the development of the online service—the *academic* portion of which would be developed by the institution while the *marketing, curriculum design, learning-management system,* and the all-important *student support services* are either embedded in the joint venture or contracted out by the JV to other qualified parties. Because the institution has a significant ownership interest in the JV, the value created by the online service accrues to both the institution and the investor.

This process can be taken one step further. The hybrid model can be used as an incubator to allow for the creation of a new institution under circumstances that would substantially avoid the disadvantages of attempting to do so afresh. Through a series of carefully orchestrated steps, the institution can create and the partner can secure a fully licensed, accredited, and Title IV-eligible institution in almost certainly less time than it would take to accomplish the same outcome from scratch. Another advantage is having an economically viable enterprise during the entirety of that "developmental" period. This process is as follows:

- The online program (or other specialized program, say in the health professions) is established, with the approval of the institution's accreditor and state authorizing agency, as required, as a new *academic unit* of the institution. Although external approvals are required, this is far easier when undertaken by an already-accredited institution.
- The new academic unit uses the resources of the joint venture to develop, market, and implement its program. The institution and the partner, through their respective interests in the venture, benefit from the value created by the unit.
- The new academic unit is organized in such a way that it can be recognized as a "branch campus" by the institution's accreditor and, importantly, by the U.S. Department of Education. The requirements for designation of branch campuses are defined by regional accreditors and federal regulations.
- At a convenient time, the branch campus is transferred from a division of the institution into a wholly controlled non-profit subsidiary of that institution.

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- When two years have elapsed after the branch campus is recognized as such by the U.S. Department of Education, the non-profit within which it is embedded can be acquired by the partner either through a conversion to for-profit status or an asset purchase, for fair market value (generally a sum—or an agreed-upon method of calculating such a sum—previously negotiated among the parties when the original transaction was consummated).
- Most conveniently, the branch can be folded into the joint venture itself, with the partner then buying all or part of the institution's interest. If the institution retains an interest, it can continue to benefit from the profits and appreciated value of the former branch, including sharing in the value created by a public offering.
- If the venture has been providing services to the institution, such as student support or technical services, those could be continued under a separate agreement or folded back into the institution itself.

Such an approach accomplishes the multiple goals of providing significant capital to the institution to build its core programs in accordance with its existing mission, while allowing the partner to create a *new* institution in which the institution can continue to benefit.

This is not to say that all this can be accomplished either overnight or simply. There are considerable complexities, notably in dealing properly with the requirements of state authorizing agencies, accreditors, and the U.S. Department of Education. But it can be accomplished, and in the present economy there are investors and strategic partners eager to join in such efforts.

Most significant in the framework that I've outlined, the institution has not been sold. It has not been forced to change its mission, character, or legal status. Its financial situation has been stabilized and its services to its existing students and community have been enhanced by the availability of new capital. Finally, it has become a partner in a long-term, value-creating business that can evolve as the institution and the partner determine. ■

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T'SHIP LINKS: Robert C. Dickeson and David J. Figuli, "Slouching Toward Privatization." November/December 2007. John R. Shaddock, "When Competition Turns to Collaboration." May/June 2007.