Creating Strategic Margin in Higher Education Through Innovative Financing Solutions

by

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INTRODUCTION

Is higher education heading toward a financial crisis? Nearly two-thirds of college and university chief business officers (CBO) think so.[1] While the situation is not all doom and gloom, there are significant challenges facing higher education that will require proactive and definitive action now to lay the foundation for a financially secure future. Leaders in higher education institutions, both public and private, will need to engage in innovative approaches and solutions that will drive business model transformation and create the "strategic margin" opportunities to fund and implement the necessary changes to ensure institutional survival and success.

A Bain & Company report discussing "the financially sustainable university" made this observation, "If you are the president of a college or university that is not among the elites and does not have an endowment in the billions, chances are cash is becoming increasingly scarce—unless you're among the most innovative. The reason is simple: Approximately one-third of all colleges and universities have financial statements that are significantly weaker than they were several years ago."[2]

On average, colleges and universities are carrying $217.5 million of long-term debt, according to the 2014 NACUBO – Commonfund Study of Endowments.[3] However, not all debt is bad and carrying long-term debt is often a normal part of the financial plan for institutions.

NACUBO published a report in 2015 entitled College and University Business Administration Strategic Debt Management and states that "The debt obligations incurred today, for example, are likely to last through several generations of institutional leaders. Because debt affects intergenerational equity, it becomes incumbent on finance officers to not leave an undue burden on future generations of students and campus leaders."[4]

In addition to the diminishing cash reserves, large amounts of long-term debt, increasing discount rates and the ongoing changes to the higher education landscape (e.g., online vs. on-campus programs), there is a projected long-term plateau in the number of high school graduates. Not only that, but the demographics for high school graduates are shifting which will require institutions to adapt to the changes in their prospective students and to shift their marketing approach in order to reach a more culturally diverse student population. [5]

The president of WICHE (Western Interstate Commission for Higher Education), Joe Garcia, had this to say regarding WICHE's latest projections, "We're simply going to have fewer students in our K-12 system, and we'll be producing fewer graduates, that has significant implications to our institutions -- our colleges and universities -- as well as to our employers and our work force."[5]

The challenges facing higher education right now and for the foreseeable future, apply to both public and private institutions. Institutional leaders need to think creatively and strategically to ensure the long-term financial health of their colleges and universities.

The purpose of this paper is to broaden the awareness of CBOs, Provosts, Presidents and other institutional leaders regarding the availability of several financing solutions that will allow them to strategically plan for the future, stay financially secure, and position their institution for success in the highly competitive higher education market. These funding mechanisms (described below) will enable the college or university to address a wide range of institutional strategic objectives, including the opportunity to invest in new academic programs; enhance campus information systems; address deferred maintenance and facility needs; fund new faculty appointments; and drive student services initiatives. According to Richard Welkowitz, the founder of Blackford Ventures, "These innovative financing mechanisms have had remarkable success for a variety of businesses and we believe that with our extensive experience and deep understanding of how to structure these transactions, Blackford Ventures is well positioned to introduce these instruments into the higher education market."

The lease-leaseback model (LLB). In the 1970s, Richard Welkowitz, a well-known entrepreneur and philanthropist, and a group of bankers developed the LLB business model to help public and private entities monetize their trapped equity without having to go to a bank for a loan, borrow against an endowment, relinquish ownership, or endure the costly, laborious, bureaucratic, and stringent bond issue process.

The sale-leaseback model (SLB). In a sale-leaseback arrangement, the specifics of the arrangement are made concurrently with the sale of the asset, with the amount of the payments and the time period specified. The leases are always triple net. Essentially, the seller of the asset becomes the lessee and the purchaser becomes the lessor in this arrangement.

Higher Education Loan Program (HELP). Through Blackford and their financial partners, the institution is the beneficiary of a total funding solution. The proceeds of the agreement will be available to the institution to use as they see fit. The institution's primary source of repayment will be to pledge a portion of their Federal Loan Proceeds - only equal to one year's principal and interest payments based on the principal amount of the loan.

Blackford Ventures (Blackford) has partnered with Emerge Education to bring these financing solutions to higher education institutions across the country. Given the complexities and the urgency of the transforming business environment, CFOs need to identify and assess all available financing mechanisms, now more than ever. This paper describes just some of the ways that institutions can take advantage of these solutions, gain access to their assets, and position their institution for success for many years to come.

Blackford is familiar with the new GASB Rules, (issued by the Governmental Accounting Standards Board in June 2012, effective for fiscal years beginning after June 15, 2014). Blackford and/or our professional/certified accounting partners can advise institutions on how best to leverage various financial vehicles as they consider the best path forward to financial security and stability.

Unlock Your Assets

Quickly increase cash flow

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Create an internal line of credit

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Refinance existing loans for better rates

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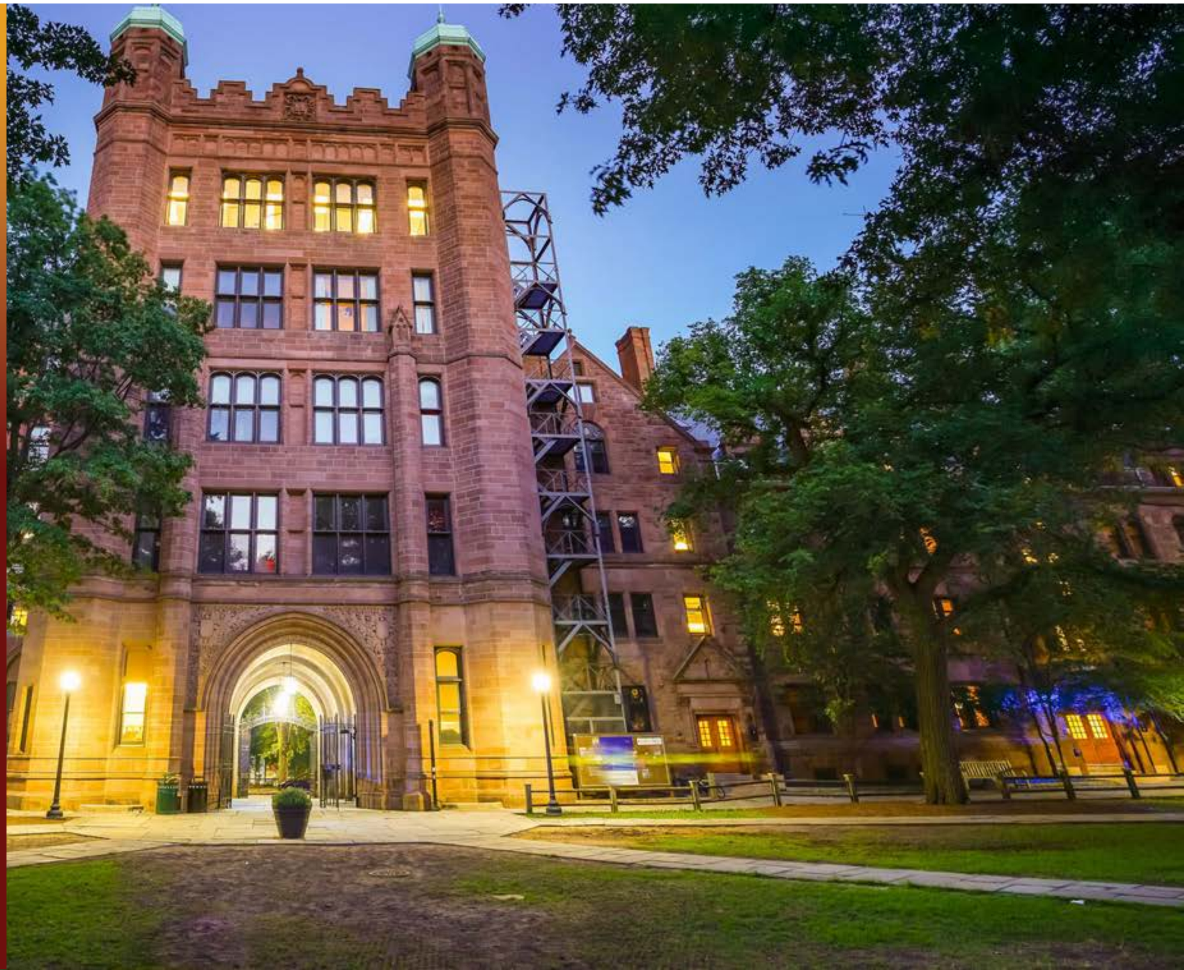
Build new facilities

—

Hire more staff

—

Launch new programs



LEASE-LEASEBACK (LLB)

The LLB is an ideal mechanism to allow institutions to monetize funds that are tied up in holdings, while at the same time, retaining ownership of their facilities and continuing operations in the same manner as before the transaction was completed. In the LLB transaction, two parties enter into two (2) simultaneous leases for the same lease term, with the entire lease term under the first lease being paid in full in advance (based on fair market value of the property). Lease payments under the second lease are paid monthly.

At the time of closing, the institution leases the asset to Blackford Ventures, and in turn, Blackford immediately leases the asset back to the institution providing cash for up to the fair market value of the asset.

Institutions with strong credit ratings receive the best lease terms and Blackford ensures the institution receives the most favorable terms by making the credit agencies compete for the business. Since there is no change in ownership, the LLB is tax-free and the institution garners asset appreciation over the life of the lease.

The Lease-Leaseback Model: A Case Study

Assume an institution owns a fieldhouse, gym, library, student center, or other operating venture (the "Facility") and wishes to enter into a lease-leaseback transaction with Blackford Ventures (BV). The Facility is determined to have a fair market value of $10 million. The institution leases the Facility to BV for a term of 20, 25, or 30 years.

The parties agree that the rent for the entire term of the lease will be the fair market value of the asset, which in this case is $10 million and is then paid by BV to the institution on the first day of the lease. For the purposes of this illustration, this lease is referred to as the "First Lease." On the same day that the First Lease commences, the institution leases back the Facility from BV for a term of 20, 25, or 30 years with annual rental payments based on an agreed upon interest rate. This is referred to as the "Second Lease."

The First Lease and the Second Lease both begin on the same day and both terminate on the same day 20, 25, or 30 years later. The institution continues to operate the Facility as it always has, being the sole beneficiary of all profits and appreciation generated from the Facility and being responsible for the maintenance to the same standards as before the transaction is completed.

The institution is free to raise rates or make operational changes regarding the Facility without any interference or approval from BV. The institution always retains ownership of the Facility as fee title never passes to BV under the LLB transaction.

Additional institutional benefits of the LLB

1. *The provisions of the lease cannot be altered unless both parties to the lease agree to the changes in writing.*
2. *Most third-party reports, such as appraisals and environmental reports may be required, and if so, such reports will be paid for by Blackford.*
3. *Closing typically occurs within 75 days.*
4. *No restrictions or specificity on the use of the funds by the institution in any manner. A capital markets bond issue will require additional legal documentation and carry more restrictions on the use of funds.*
5. *The only paperwork relating to a LLB transaction are the lease agreements.*

At lease termination, the institution has received the following benefits based on the above case study.

1. *An immediate $10 million payment to the institution with no conditions on the use of the funds.*
2. *Increase in value of the asset which could be $30-$40 million, depending on the terms of the lease.*
3. *Any increase in the rates charged by the institution for the asset are solely retained by the institution, not Blackford.*
4. *Any increase in value of the Facility is retained by the institution.*
5. *Due to both leases beginning and ending at the same time, nothing further needs to be done as the title never changed ownership. The institution always retains ownership and control of the property.*

SALE-LEASEBACK (SLB)

In contrast to the LLB model, a sale-leaseback resembles a hybrid debt product. The institution does not increase its debt load but gains access to capital through the sale of assets. This transaction allows for the institution to concentrate on their primary business functions and invest/grow their organization in those areas that are central to their strategic plan. Most of the fortune 1000 companies do not own their own real estate for this reason.

A sale-leaseback arrangement is particularly useful when the college or university desires to use the cash invested in an asset for other investments, but the asset is still needed in order to operate. Sale-leaseback deals can also provide the institution with additional tax deductions, as all rental payments are treated as fully deductible expenses. Should the asset be fully depreciated this would create a renewed tax benefit through write-offs. The lessor benefits in that it receives a guaranteed lease with stable payments for a specified period of time, typically 20 to 25 years. This also serves as an advantage, in that the tenant controls the real estate for a long period of time.

One of the great advantages (other than the tax benefits) is that the asset in this case, real estate, may only be appreciating at a rate of less than 1% a year. The monetization of the asset, the cash received for the sale, can be used internally to return 8% to 10% or greater. Additionally, some of the sale proceeds can also be used for capital expenditures to create greater efficiencies in operating costs.

Finally, a sale-leaseback approach may result in increased profitability and serve to provide the college or university increased financial flexibility.

HIGHER EDUCATION LOAN PROGRAM (HELP)

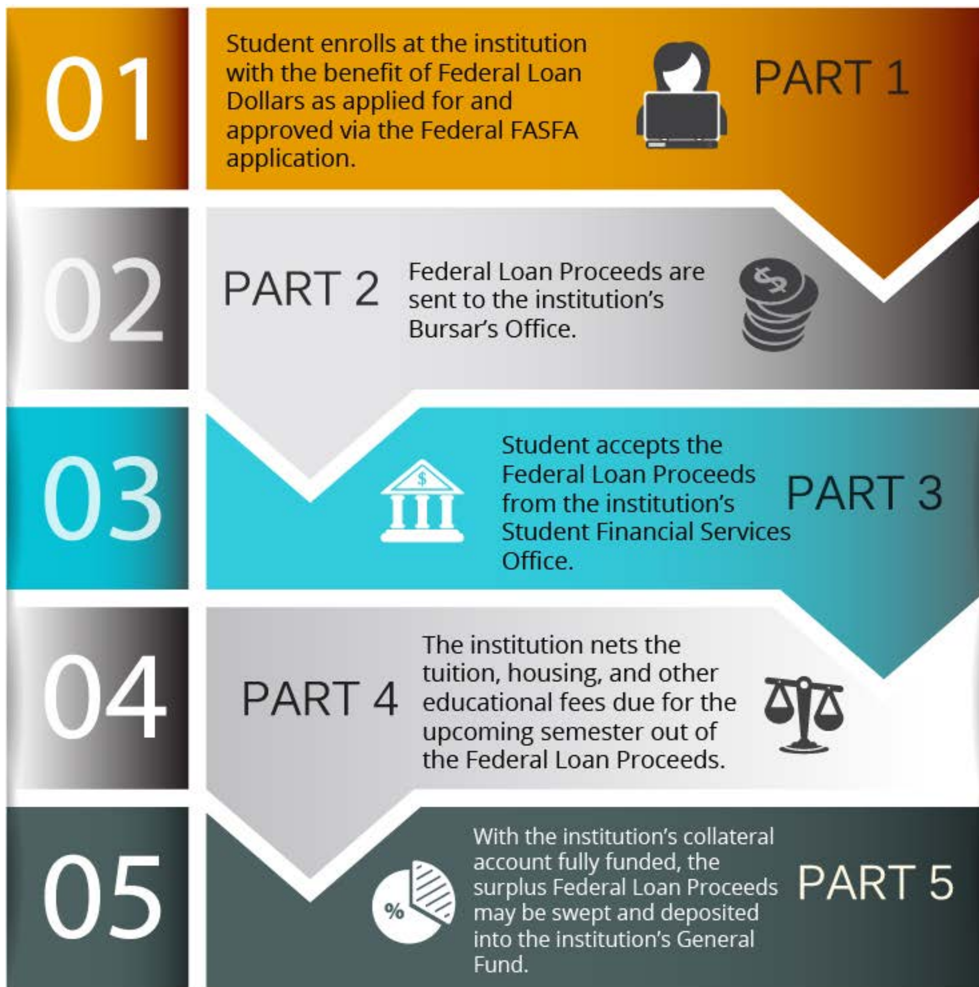
With this innovative loan program, the institution's primary source of repayment will be a pledge of their Federal Loan Proceeds - only equal to one year's principal and interest payments. This will provide greater security to the Lender and will result in greater flexibility and a lower rate, which will be directly passed on to the institution. The funding effectively emanates from the Federal Government, which drives the costs down since the government currently enjoys an AA+ S&P rating.

At closing, all transaction costs and loan fees will be netted out from loan proceeds to insure the Institution does not have to pay any out-of-pocket costs related to this transaction. Also funded out of loan proceeds and funded simultaneously at closing, an escrow fund will be established, representing 1-year of principal and interest payments. This fund will be held in an approved account and all interest accumulated will inure to the benefit of the institution. At closing, the remaining net proceeds will be distributed directly to the institution.

For the benefit of the institution and to provide the best loan rate, the primary collateral for this loan will be the Federal Educational Dollars. Specifically, the collateral will be equal to one year's principal and interest payments on an annual basis to include a full-faith and credit pledge by the borrower. This process can be a quick and easy method to increase the amount of available funds.

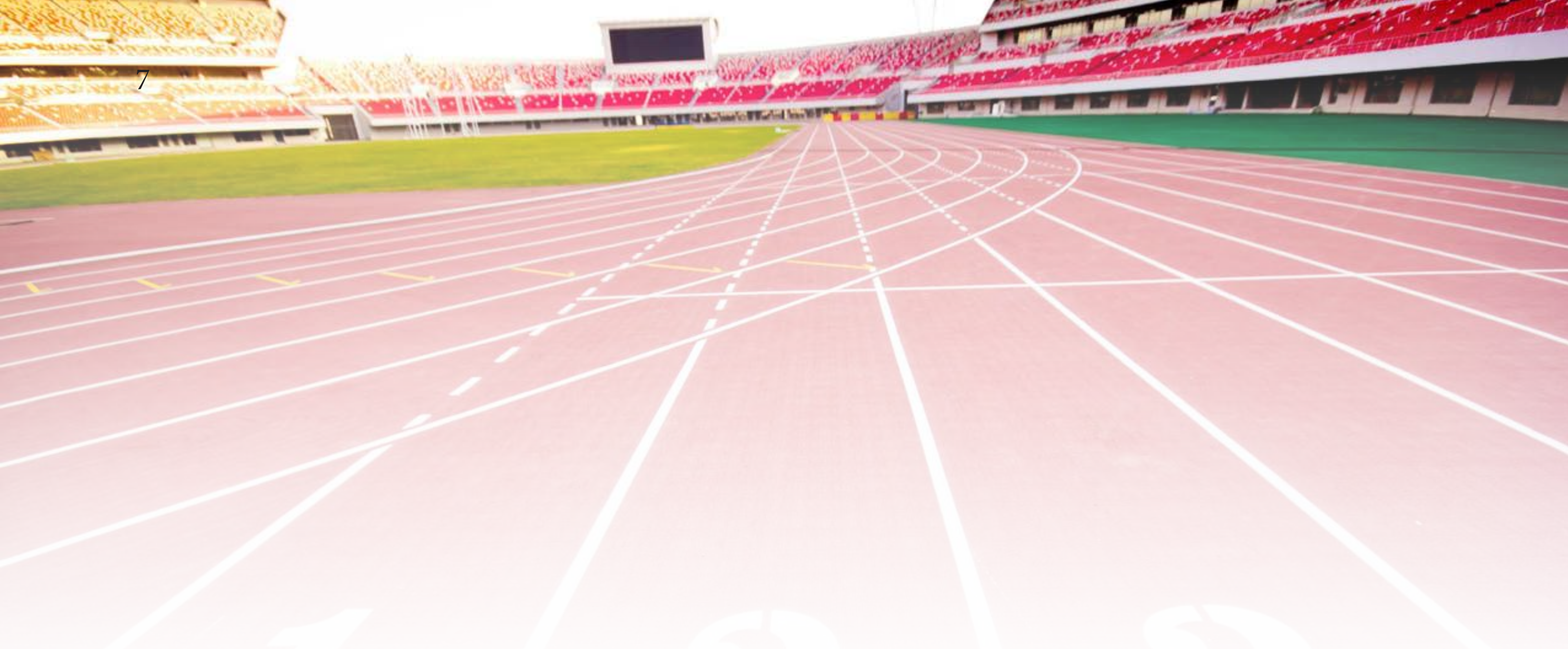
The funds provided to the institution will be for the benefit of their organization and its advancement to do as they see fit.

Figure 1 describes the HELP Collateral Pledge that allows Blackford to underwrite US Government Credit that yields one of the lowest competitive rates for this program.



The Federal Loan Proceeds are held in a separate account, to segregate from the General Fund. These funds will be further separated for a newly established collateral account and the account's balance will be kept equivalent to at least one year's principal and interest payments.

Figure 1. Higher Education Loan Program Collateral Pledge



The steps described in Figure 2 outline the process for an institution to take advantage of HELP quickly and easily to reach a successful conclusion with Blackford Ventures.

STEP 01

Blackford will determine which financial partner might be the best fit for the institution.

STEP 02

The institution provides the intitial financial packet to begin underwriting.

STEP 03

Both parties agree to all terms and conditions. Underwriting commences and due diligence begins (about 60 to 75 days).

STEP 04

The final step in the process involves closing, dispersal of funds, and creation of accounts.

Figure 2. Higher Education Loan Program Transaction Process

CONCLUSION

Higher Education stands at a particularly challenging juncture, facing demands for innovation and transformation in its core business, and this in an extremely difficult financial environment, with state support lessening and institutional costs increasing. We face a time in which innovation in academic programs and transformed delivery modes are demanded of all institutions.

Institutional leadership and Chief Financial Officers, in particular, will need to find new and innovative approaches to financing the transformation. Blackford Ventures and Emerge Education have combined their complementary expertise in the finance and higher education industries to develop the innovative financing mechanisms described here.

Collectively, these partners have designed and developed the innovative solutions that will enable institutions to create "strategic margin" to achieve institutional success and advancement.

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About Blackford Ventures

Blackford Ventures, LLC is a private, equity firm based in Lancaster County, Pennsylvania that invests in successful, growth-oriented businesses that desire to maximize market potential. Blackford also provides private and public entities with access to capital and has partnered with Emerge Education, LLC to provide the same level of business excellence and financial opportunity to higher education institutions.

About Emerge Education

Emerge Education supports colleges and universities interested in 21st century relevancy by providing a variety of educational, student, and institutional services to ensure institutions fulfill their mission and strategic objectives.

About edu Alliance Consulting

edu Alliance Consulting specializes in designing and implementing innovative alliance relationships across higher education, association, corporate, and government organizations. They forge alliances through joint programs, shared investments, co-sourcing agreements, and innovative business relationships.

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