

# Strategic Allocation of Capital, Planning & Budgeting in Volatile Times

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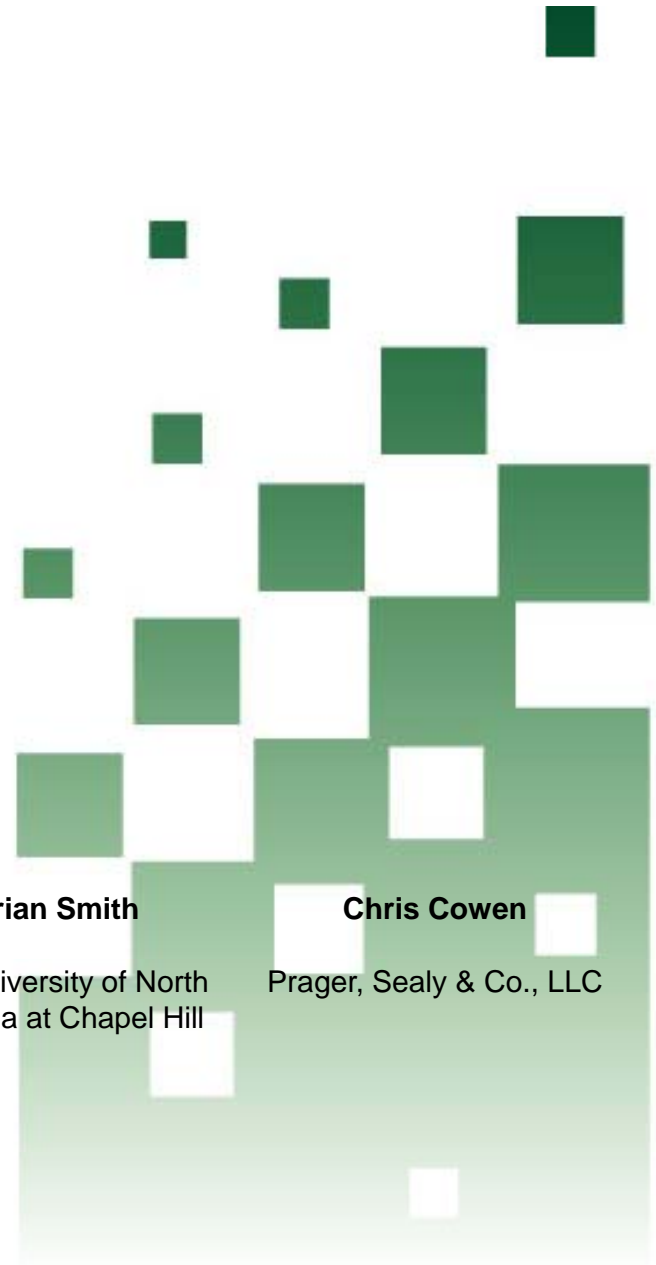
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# Things We Still Know Are True

- ◆ The sun rises in the east and sets in the west
- ◆ The only constant is change
- ◆ My Aunt Helen will be playing Bingo Monday and Thursday nights
- ◆ Nothing is “certain” anymore

# Things We Thought Were True (circa Jan 2008)

- ◆ There is a liquid market for auction rate securities
- ◆ Municipal bond insurers are rated “AAA”
- ◆ There is a relationship between SIFMA and Libor (or pick any other market relationship)
- ◆ Our investment bank is always there for us
- ◆ The bond documents worked exactly as we expected them to (maybe we didn't really believe that one)
- ◆ Certain short term investments we thought were cash weren't
- ◆ Our financial advisor accurately predicted the market last year
- ◆ Our risk models work

# Things That May Be True

- ◆ We will have continued access to attractive tax exempt 30 year debt, and markets return to “normal”
- ◆ Liquidity becomes available attractively priced
- ◆ The downturn is at its worst and over by the time we meet next year
- ◆ Financial pressures on student aid, research funding, philanthropy, state aid, medical care, [fill in the blank] improve
- ◆ This is another business cycle (albeit at a much more severe level)
- ◆ Will higher education become more “corporate-like” and take advantage of the current opportunity to restructure?

# Has Fear Taken Over?

“Right now there are incredible opportunities to do something differently. Yes, they are risky and some will fail. But while others wait for the storm to pass, I’m busy expanding into new areas. If I wait for money to start flowing again, the opportunities will be passed”

*Gregory Berns, M.D., Ph.D.  
Center for Neuropolicy  
Emory University*

# Implications

- ◆ Are we assigning too high a probability to negative “fear-based” scenarios?
- ◆ What are the implications for strategic planning, budgeting and investment?
- ◆ What are the consequences of being too conservative or too aggressive?
- ◆ Stresses between short-term needs/realities and long-term vision – how to strike a balance
  - Greater pressure on prioritization and tensions among various constituents
- ◆ Greater involvement of senior management and board in treasury and debt management
  - How are issues communicated
- ◆ Flexibility is paramount
  - Nothing is “certain” anymore
- ◆ Long-term planning must continue; the importance is even greater now



# Liquidity Challenges

A confluence of events has affected most institutions resulting in an overall reduced liquidity position for most. Ensuring access to liquidity if the other shoe drops should be critical.

- Swap collateral postings
- Prior strategy of investing working capital in less liquid assets (and virtually non-existing earnings on traditional working capital investments)
- Use of self liquidity to support variable rate bonds/disappearance of auction rate market
- Capital calls for private equity/lack of distributions
- Potential slowing in collections from patients and students experiencing economic difficulties
- Potential slowing of cash receipts on pledges; reduced annual fund dollars
- Reduced or slowed State support

A severe reduction in liquidity can cause the most significant credit and operating exposure to the institution.

# Strategic Allocation of Capital

- ◆ Prioritization
  - Mission/financial
- ◆ Pacing of capital investment
  - Slowed at virtually all campuses
- ◆ Need for flexible debt structure
  - Appropriate “cost” of capital
  - Role of variable rate debt and derivatives in the future
  - Performance of tax-exempt fixed rate market
  - Inclusion of taxable debt

# Strategic Planning

- ◆ Role of scenarios – what is “likely”
- ◆ Communication
  - Campus involvement
  - Statements to the community
- ◆ Role of ratios/rating agency relationships



# Budgeting

- ◆ What is the relevance of a capital budgets? How is flexibility incorporated/communicated/managed?
- ◆ Are there lessons to be learned from the Fiscal Year 2010 budgeting process?
  - Did we make the strategic re-allocations, or
  - Business as usual?

# Duke University Allocation of Capital

- ◆ Liquidity Issues:
  - Paying spending distributions, funding collateral and capital calls
  - Preserving franchise investments – close coordination with Investment Management Company (DUMAC, LLC)
  - Fixed rate tax-exempt and taxable financing for capital plans and working capital bridge – limit variable rate exposure and liquidity requirements
  - How to allocate smaller cash “bucket” between University and Health System
  - Change in future investment? (Less working capital invested LT?)
  
- ◆ Adjustments to capital plan:
  - Continue with projects “core” to the mission and strategic plan through prioritization
  - Key Infrastructure improvements
  - Delay Central Campus, possible scale back of Hospital Addition

# Duke University Planning

- ◆ Look to scale-back but continue long-term view
- ◆ Planning for revenue shortfalls - gifts, investment income, grants, etc. (possible increase in financial aid expense)
- ◆ Detailed Financial Projections:
  - Cash flow considerations – Best, most likely, worst case scenario (dynamic modeling) – 5-year outlook, liquidity impacts?
  - Implications to Strategic Initiatives?
  - Includes detailed assumptions related to decreases in gifts, capital spending, grant revenue, etc., and possible increases in financial aid
- ◆ Cost cutting initiatives – look to cut less priority operating expenses by a third
- ◆ Greater communication between constituents:
  - Board of Trustees
  - University and Health System
  - Central Administration and Schools
  - Detailed Budget Coordination

# Duke University Budgeting

- ◆ Budget Working Group (BWG) meets regularly – Central Administration, Provost and School of Medicine
- ◆ Preparing for sustained tight budgets
  - Salary increases limited
  - Operating budgets kept flat
- ◆ Bring most of the available resources to strategic priorities and protect core commitments
- ◆ Administrative and academic budgets are actively being reviewed for potential cuts – travel, publications, etc.
- ◆ Spending rate with cap has tempered the effect of decline of endowment assets (endowment spending 15% of budget)
- ◆ 5-year capital plan to be prioritized, reviewed, and projects postponed if there is no clear funding source (CPEC meets monthly)
- ◆ Blended interest rate for debt has provided certainty and flexibility in budgeting for debt service.

# Indiana Allocation of Capital

- ◆ Impact-to-date from economic crisis
- ◆ New President with significant capital plans
- ◆ 7 campuses – political implications
- ◆ Role of funding sources:
  - Fee replaced vs. non-fee replaced student fee debt
  - Auxiliary revenue
  - Gifts
- ◆ Role of internal liquidity
- ◆ Adjustments to plan based on current economic environment
  - Project prioritization
  - Project financing

# Indiana Planning

- ◆ Five year comprehensive financial modeling
  - Income statement, balance sheet, cash flows
  - Executive dashboard
  - Moody's & KPMG strategic financial ratio analyses
  - Detailed assumptions (including capital plan at the project level)
  - Cross functional involvement
- ◆ Communication
  - Internal cross-functional working committee ( incl. Treasury, Facilities, Budget, State Relations)
  - President's Cabinet
  - Board of Trustees
  - Underwriter Team ?

# Indiana Budgeting

- ◆ Operating budget adjustments to accommodate potential cuts in state operating appropriation
- ◆ Formal capital budgeting every two years through state submission of Capital Appropriation Request
  - Major focus is on state fee replaced debt
  - Includes short, medium and long term plans
- ◆ Proposed adjustments to current process
  - Articulate alignment with soon to be delivered Master Plan
  - Develop formal ranking system to enhance project prioritization process
  - Expand internal working group in development of plan to ensure consistency in expectations of outcome
  - Understand impact on debt capacity at all phases of plan
  - Educate and communicate relative to key drivers of debt capacity from both an income statement and balance sheet perspective

# UNC-Chapel Hill Allocation of Capital

- ◆ Still significant debt funding over the next three to four years as a \$2.1 billion capital improvement program tapers off.
- ◆ “Natural brakes” on the pace of the future funding needs.
  - Phase within the life cycle – Back side of program.
  - Decrease in State funding for capital projects in current economic environment.
  - Capital gifts.
- ◆ Structure of future bond transactions.
  - Variable rate in late 2009 (forward-starting swap).
  - Potentially shorter amortizations on future transactions.
- ◆ Higher future interest costs – allocate marginal increase to incremental project or allocate marginal increase to entire portfolio?
- ◆ Public-private partnerships (Carolina North).

# UNC-Chapel Hill Planning

- ◆ Maintain long-term perspective.
- ◆ Potential for another State Bond Bill when economy recovers.
- ◆ Diversify relationships with financial service providers.
- ◆ Planning scenarios for potential recurring State operating budget cuts in the amounts of 3%, 5% and 7% on State funding for FY 2009-2010 (In current fiscal year, recurring 2% cut and a one-time 4% cut on State operating funding).
- ◆ Develop comprehensive liquidity policy.
- ◆ Carolina North

# UNC-Chapel Hill Budgeting

- ◆ Facilities Planning Committee and Working Group meet twice per month and regularly review master plan updates and new projects.
- ◆ Capital Budgeting Committee meets on a monthly basis.
- ◆ Every two years update rolling 6-year capital plan for State (General Assembly must approve all University-issued debt).
- ◆ Every year review capital project needs for subsequent fiscal year.
- ◆ Review projected policy ratios for capital financing needs on a rolling 5-year basis and share with Board of Trustees on an annual basis.

# Questions

