MEMORANDUM

TO: The Finance Subcommittee:

John A. Griffin, Chair
Frank B. Atkinson
Kevin J. Fay
Victoria D. Harker
John G. Macfarlane III
George Keith Martin, Ex Officio

and

The Remaining Members of the Board and Senior Advisor:

L.D. Britt, M.D.  Bobbie G. Kilberg
Frank M. Conner III  Stephen P Long, M.D.
Allison Cryor DiNardo  Edward D. Miller, M.D.
Helen E. Dragas  John L. Nau III
Barbara J. Fried  Margaret N. Gould
Frank E. Genovese  Leonard W. Sandridge Jr.
William H. Goodwin Jr.

FROM: Susan G. Harris

SUBJECT: Minutes of the Finance Subcommittee Meeting on July 25, 2014

The Finance Subcommittee of the Board of Visitors of the University of Virginia met, in Open Session, at 9:00 a.m. on Friday, July 25, 2014, in Cirrus B conference room at the Hyatt Dulles Airport in Herndon, Virginia; John A. Griffin, Chair, presided.

Present were Frank B. Atkinson, Kevin J. Fay, Victoria D. Harker, and John G. Macfarlane III.

Present as well were Patrick D. Hogan, John D. Simon, Ian B. Baucom, Melody S. Bianchetto, Megan K. Lowe, David W. Martel, James S. Matteo, Nancy A. Rivers, Kristina Alimard, Sarah Collie, S. Pace Lochte, Susan G. Harris, and Debra Rinker.
Lawrence Kochard, CEO of the University of Virginia Investment Management Company (UVIMCO), participated by telephone in the endowment portion of the meeting.

Mr. Griffin reviewed the agenda and noted that committee members have engaged in significant outreach efforts to the Board, former rectors, nationally known educators, the Council of Foundations current chair and incoming chair, and others, including Brit Kirwan, former chancellor of the University of Maryland as well as Ohio State. Members of the committee also looked at specific issues within the committee’s charge and will report on those.

Mr. Griffin said the discussion with regard to tuition and financial aid should focus on net price. The University’s in-state model is low tuition and very high financial aid. He compared it with Maryland, which was listed in Kiplinger as the number seven bargain in higher education, whereas the University is listed as number two. The University’s net price for in-state students is significantly lower than Maryland’s. The University of North Carolina was number one; North Carolina provides substantial state support per student, twice that of Virginia.

Follow-up from June 27 Meeting

Mr. Hogan said the subcommittee should focus on net price in the materials, and introduced Associate Vice President for Finance Melody Bianchetto to provide information that had been requested at the June 27 meeting of the Finance Subcommittee. Ms. Bianchetto reviewed the total price versus net price of attending the University for Virginian using several assumptions. The first set of assumptions was a family of four with one in college and a $40,000 annual income and no significant assets. The University’s net price is the third lowest in the state after VMI and William & Mary; it is only slightly higher than William & Mary. For a family with an $80,000 annual income, the University is the fourth from the lowest: William & Mary, Virginia State University, and VMI are slightly lower.

The model for out-of-state students is a high tuition, high aid model, with the University covering 100% of financial need; however, out-of-state students are offered larger loans. For a family income of $40,000, the University has the highest out-of-state tuition in the state, and the lowest estimated cost to students after grants, as well as the lowest total cost to students when all financial aid (grants, loans, and work study) is taken into account.

Ms. Bianchetto provided a comparison with William & Mary’s program. The sticker price at William & Mary is significantly higher for in-state students, however, William & Mary provides all grant aid for the lowest income in-state students; they do not provide full need for out-of-state students. She said one thing that could be changed to address middle income students at the University is the expected family contribution part of financial aid packages.
When asked if students who decline admission, or don’t apply, do so because of affordability, Ms. Bianchetto said they track the reasons through surveys. Mr. Fay said it is important to look at the impact on middle income students. Ms. Harker suggested that the Director of Admission present the information to the subcommittee at a future meeting. Mr. Simon said we need to look at ways of getting prospective students to apply — many do not have an understanding of the extent of financial aid available at the University. Professor Sarah Turner has done extensive research in this area.

Ms. Bianchetto said William & Mary has a high tuition, high aid model for in-state, and a high tuition, low aid model for out-of-state, undergraduate students.

Leveraging the University’s Triple A Balance Sheet

Ms. Harker introduced the topic. Mr. Hogan then asked James Matteo, University Treasurer, to provide details about the University’s balance sheet. Mr. Matteo first reviewed the areas of focus of the Treasurer’s office, which include debt management, cash and liquidity management, short-term investment management, serving as a bank for internal departments, and handling foundation administration.

Mr. Matteo focused on debt management. As of June 30, 2014, the University carries $1.34 billion in debt, with the Medical Center holding 32% of the total debt. Mr. Hogan added that the Medical Center is important for debt coverage because of their operating margin. Mr. Matteo explained the key ratios for the triple A bond rating currently enjoyed by the University using Moody’s scorecard as an example. The ratio of expendable resources to debt is a strength of the University, as is debt service as a percentage of operating expense. He said the University would be at risk for downgrading if we added more than $600-700 million of debt.

The committee engaged in a discussion of monetization of assets, and Mr. Hogan said he would support a review of assets across all state institutions. Mr. Hogan said that some universities, for instance Ohio State, have sold their parking facilities; however, the initial review at the University indicated that parking is utilized primarily by faculty, staff, students, and patients, and in order to make it attractive to potential investors the parking rates would have to double initially and rise fairly steeply from there. Some concern was expressed by committee members about losing control of pricing. Investors are attracted by the guaranteed income stream, but they will want to raise rates. Mr. Macfarlane said we would have another master.

Mr. Matteo returned to his presentation and reviewed the University’s cash management policies. He said the University maintains 236 monthly days cash on hand, which is comparable to others with a triple A bond rating except Purdue, which counts all operating
funds as cash on hand and so they are high at 352. Mr. Matteo reminded the committee that under state restructuring, operating funds were returned to the University to manage; previously the state held these funds. He said it was possible to leverage some operating funds by investing in longer term investments.

Mr. Matteo then turned to a more detailed discussion of asset monetization. He said they have evaluated monetizing parking, the radio station, and residence halls, as examples. There are significant disadvantages; for instance, the residence halls are a key component to the undergraduate student experience and some control over this would be lost as would assuring certain levels of maintenance and cleanliness. Also, housing rate increases would be controlled by the lessor. The debt on residence halls is 40% of the replacement cost, so this would affect the net cash received in a monetization deal.

Mr. Hogan said areas that may be more conducive to monetization include some properties held by the UVA Foundation that are not contiguous to Grounds. For instance, Currie Farm in Haymarket was sold. There is the issue of leasing versus owning. The University is currently creating an inventory of all noncontiguous property.

Mr. Macfarlane mentioned that there is no Class A office space available in downtown Charlottesville and the west side of town, and the University should look at property they hold that is underutilized such as the Cavalier Inn.

The discussion turned to debt capacity utilization. Mr. Matteo explained that the University’s current debt capacity is $600-700 million. The debt in the capital plan is $250-$350 million in the next three to five years, and the Emergency Department expansion is most of that number. Mr. Hogan said he would be comfortable borrowing $100 million to put toward financial aid if there is a plan in place to raise the funds to cover debt service. It is not possible to arbitrage tax-exempt debt, but it would be possible to put taxable debt funds into UVIMCO. A century bond was mentioned as a possibility; also, funding start-up packages through debt. Mr. Simon said the University would never get repaid on start-up packages - research costs exceed indirect cost payments and the size of start-up costs have escalated. The question was raised as to why we would not debt finance start-up costs when we debt finance academic buildings? Ms. Bianchetto replied that the University does not finance purely academic buildings with debt.

Mr. Matteo discussed the mix of fixed and variable rate debt, and said traditionally there has been a bias toward fixing rates. He said $5 million could be saved by converting (current) commercial paper to floating rate debt rather than all fixed rate debt. The length of a fixed rate is matched to the project life with most capital projects.
Mr. Macfarlane suggested using debt capacity to fund innovation if there is high confidence that over time the debt service can be covered by philanthropy. Mr. Hogan said there will be a presentation by Mr. Sweeney in September on philanthropy. Mr. Griffin added that we do not want to lose great professors because we are waiting for donations. Mr. Simon said the biggest need is endowed chair positions.

Role of the Endowment

Ms. Bianchetto introduced the discussion of the role of the endowment. The University's unrestricted endowment generates about $18 million per year; this does not include the foundation funds. The University itself has about $4 billion in endowment funds. She compared the University's endowment size to some of its peers. For instance, the University's endowment is approximately $5.2 billion (with foundation money) whereas Princeton has an $18.2 billion endowment, which is a value of almost $2.5 million per student. The University's value per student is about $250,000.

The University has used a "snake in the tunnel" methodology since 2008 for determining the spending rate. The band is 4% to 6%. This provides reliable, predictable distributions and preserves purchasing power. The rate is determined by taking the prior year's payout and increasing it by the five-year rolling average of the Higher Education Price Index (HEPI). If the payout is within the band, no action is required of the Board. If the resulting payout amount is outside the band, the Board may re-set the payout within the band. The payout was 4.95% in FY 2014 and 4.68% in FY 2015. For FY 2016, it is expected to be about 4.3%, or just over $170 million.

Mr. Kochard said he is a big fan of the "snake in the tunnel" approach to spending policy. He said it is very good for modeling risk.

Ms. Alimard presented an endowment sensitivity analysis. The first scenario assumed a 30% decline in 2015, a 7.5% return in 2016-2021, 3% HEPI inflation each year, and 0.7% fees every year. The scenario would cause the distribution percentage to rise to 6.5% in 2017, triggering a review by the Board of Visitors to re-set the rate. The probability of this scenario for the long-term pool is 0.2%.

Ms. Alimard discussed two additional scenarios, the first with a 25% decline in investment return in 2015, and the second with a 15% decline in investment return. The latter is the more likely scenario, with an 8% probability. This would cause the spending rate to rise to 5.4%, however, it would remain within the band. She provided a fourth scenario of adjusting the spending rate in 2016 to reach the 6% limit of the band, which would increase spending from $170 million to $178 million.

Ms. Alimard drew some conclusions from the data:
The projected 4.3% FY 2016 distribution rate provides some headroom within the 4-6% band.

A drawdown of 24% or greater in FY 2015 would cause the spending rate to exceed the band in 2017. The probability of this is approximately 1%.

A drawdown of 15% allows spending to continue to increase within the band. Adding 19 basis points to the FY 2016 distribution would cause the spending rate to reach the 6% cap in FY 2021, assuming a 7.5% investment return in every year post-drawdown.

A slide was presented that shows the endowment spending distribution if a 25 basis points increase was instituted for FY 2015. Unrestricted funds would be $4.5 million, with total additional funds of $8.9 million. This includes the Medical Center and the College at Wise. Mr. Macfarlane said it is important to be cautious about increasing the endowment spending rate. He also pointed out that a one-time distribution does not allow fixing tuition for five years — it does not provide stability in revenues. Mr. Griffin said it could help fund one-time costs such as start-up packages. Foundations determine their own spending rate; some follow the lead of the University, but Ms. Alimard said some of the larger ones do not use the University’s spending rate.

Funding AccessUVA for the Long Term

Mr. Hogan began the presentation on funding AccessUVA for the long term. He reviewed the sources of need-based financial aid and said a $1 billion dedicated endowment would be required to fully fund the institutional investment in the program going forward. Currently, based on the assumption of meeting 100% of financial need for both in-state and out-of-state students, the level of unrestricted institutional investment is $45 million for FY 2014-15, and it is expected to increase 5-10% every year. The goal is to cap the budget impact of the unrestricted institutional investment and address amounts above the cap with new sources of funding.

Mr. Hogan introduced a proposal to "kick-start" the endowment objective by creating a fund using a combination of proceeds from asset monetization, contractual savings, the bridge campaign, loans, and residual cash. This would involve borrowing $100 million to $200 million through a bank loan at 3% interest. He said a bank is interested in working with the University on accomplishing this. Borrowings would be repaid with future gifts. Mr. Matteo said any "mission critical" borrowing would be considered by the rating agencies, so it would count against debt capacity. Mr. Fay said other Visitors have expressed a commitment to meeting 100% of student financial need, but also desire an institutional investment cap and building some dedicated funding source.
Mr. Griffin said an endowment campaign would be in addition to a robust annual giving program which connects donors to students. He said that raising endowment was harder to do. There was a discussion about how to interest donors in funding this program. The Jefferson Scholars Foundation model was mentioned. Mr. Griffin called it value-based philanthropy: donors can see how their money is used. He recommended talking in terms of scholarships rather than financial aid. He said this has worked at the K-12 level, and with the Blue Ridge Scholars program.

University Financial Model

Ms. Bianchetto provided a detailed explanation of the current budget model in contrast with the new University financial model. The current model collects funds centrally, pays central costs, and then distributes funds to the schools based primarily on historical funding. She reviewed the drawbacks of this model, which include not encouraging innovation at the school level, and not aligning budgets with strategic priorities. The new model, which distributes funds, including net tuition, to the schools, and also distributes indirect costs based on data-driven estimates of usage, delegates responsibility and accountability to the schools. It also increases budget transparency.

Organizational Excellence

Mr. Hogan introduced Ms. Sarah Collie, Assistant Vice President for Organizational Excellence, to present the Organizational Excellence (OE) program now underway. Mr. Hogan reminded the committee that this is an initiative in the Strategic Plan, Strategy 14 of Pillar 5. Pillar 5 is “Steward the University's Resources to Promote Academic Excellence and Affordable Access”.

Ms. Collie said the guiding principles of the program are academic and administrative collaboration; data-driven and results-oriented; a structure for ongoing impact rather than episodic; and a long-term, strategic focus. She gave the history and evolution of the program, and showed that administrative spending per full-time equivalent (FTE) student at the University is lower than all private (and some public) comparably-sized peers except Vanderbilt. Some larger public institutions that have economy of scale tend to have a lower spending per student. The University ranks 11th lowest in academic spending per FTE student among 26 peer institutions.

What is remarkable about the University is that in US News and World Report the reputational ranking differs so dramatically from the expenditure ranking — high reputational ranking compared with a low ranking with regard to resources.

Ms. Collie provided an overview of the OE program structure with the OE office in the middle coordinating initiatives overseen by
Executive Sponsors and a Leadership Council. She said developing a community network of individuals across the University who will disseminate the program within the schools and units is important. She outlined a number of initiatives and explained the results of a comprehensive benchmarking study on administrative services across the University. She said about one half of the administrative costs are central, and about one third of FTE personnel are central. Many employees are generalists with fragmented responsibilities spanning several functional areas; however, it varies greatly by functional area, for instance Information Technology (IT) is highly specialized whereas Procurement includes primarily generalists. Much of the work is transactional rather than analytical. There is also a mix of high enabling technology with manual activity.

Other initiatives include a thorough review of research administration; digital learning; and redesigning student internships, among others. There are internal project teams for each of the projects. Mr. Hogan said IT is a big challenge and will require significant investment, so at this time it is not included in the program. He suggested there might be an opportunity for a center of excellence in IT with all of higher education in the state participating.

Areas of focus in the coming year include realizing current initiatives, developing service delivery models, focusing on sourcing opportunities, enabling technology for efficiencies, and building capacity for change.

**Strategic Corporate Partner Program**

Mr. Hogan introduced Pace Lochte, Assistant Vice President for Strategic Initiatives, who presented the Strategic Corporate Partner Program. This program represents a shift from viewing corporations as purely opportunities for philanthropy to creating bilateral partnerships that benefit both parties. Working with the schools, the program focuses on cultivating corporate partnerships that will increase support for research, faculty, and students; will provide new educational and research experiences for our students; will provide a global platform for the University; and will leverage alumni networks. There are significant challenges as well, including potential disputes about ownership of intellectual property and potential conflicts of interest among other challenges.

Ms. Lochte said the ideal company is interested in collaborating and shares the University’s values and priorities. She looks for companies with the capacity for a long-term relationship. The Rolls-Royce partnership is a prime example of how a partnership can benefit the University and the company: Rolls-Royce has provided research funding, endowed chairs, and research assistantships, and the University has provided a talent pipeline, engineering and business expertise, novel technologies, access to equipment, and workforce training. Both benefit from the Commonwealth Center for Advanced
Manufacturing (CCAM), which is collaboration among a number of industries and universities that conducts applied research. Ms. Lochte mentioned a number of other companies that work with the University.

Mr. Griffin said Ms. Lochte should speak to the full Board, the McIntire Foundation Board, and the Council of Foundations, among others.

Meeting Conclusion

Mr. Atkinson said he has done some work on the research part of the equation. He said it is important that the research investment is tailored to what is available. It is very difficult to separate out research from a dollars and cents standpoint from other academic matters. It is not a direct lever, but important for recruiting both faculty and students. Ms. Harker said the committee may need to revisit funding for recruiting and retaining faculty and whether it is the right amount. Mr. Atkinson said there is a lack of information about the indirect cost recovery and how that impacts finances.

Mr. Griffin said the next meeting will be September 10, beginning most likely at 4:30 p.m. He said at that meeting members would provide summaries of each work section and they will discuss how to present the material and findings to the full Board in November.

Mr. Griffin adjourned the Finance Subcommittee meeting at 1:30 p.m.

SGH
These minutes have been posted to the University of Virginia’s Board of Visitors website: 
http://www.virginia.edu/bov/financesubcommiteminutes.html