April 6, 2020

To: The Honorable Julia G. Brncic, Chair, Board of Curators
Members of the Finance Committee
   The Honorable David L. Steelman, Chair
   The Honorable Darryl M. Chatman
   The Honorable Greg E. Hoberock
   The Honorable Michael A. Williams

From: Ryan Rapp, Vice President for Finance and CFO, UM

Re: Financial Status Report – April 2020

Our universities and healthcare system are addressing several challenges due to COVID-19, including negative headwinds on our three primary operating revenue sources (tuition, patient revenue, and state support). The severity of the economic challenge and duration of the public health crisis is not fully known at this time but will be significant. These challenges will require us to remain out in front in terms of cost cutting measures and revenue opportunities. This is necessary to maintain our mission and position us to emerge from the crisis in a position of strength. How we lead through this will either elevate or depress our universities and healthcare system; a neutral outcome is highly unlikely.

We will not make the budget plans we set for fiscal year 2020. We have taken several immediate actions to cut cost and protect revenue. We will continue to proactively implement significant measures to address the financial uncertainties to ensure proper fiscal stewardship of our universities and healthcare system. To that end, our decision-making is focused on the next 60 to 90 days. We want to take careful but decisive actions in the short run that allow for future flexibility and optionality. This will best prepare us to deal with resetting our long-term financial plans as the lasting impacts become clear.

The focus remains on the priorities below and the resources necessary to achieve them:

- Ensuring our students receive a high-quality education
- Supporting retention and recruitment of our students
- Continuing research and scholarship, especially related to the public health crisis and precision health
- Supporting the University’s response to the public health crisis and other engagement activities
- Supporting activities that sustain and/or grow revenues for the University
Our success in both the short-term and long-term will be driven by our ability to proactively reduce our overhead through administrative consolidations, reducing our space footprint, improving our contribution margins from academic programs and reevaluating existing program offerings, and aggressively expanding our online education capabilities. We need to ensure we are evaluating mission-focused plans against the financial return they provide instead of the dollars they spend.

We plan to bring forward the fiscal year 2021 budget at the June Board meeting for approval, with the understanding the budget will need to be updated at least quarterly until we have clarity on the long-term impact. The attached financial status report provides an industry outlook, balance sheet positioning, key income statement financial drivers and sensitivities, our framework to ensure the financial health and viability of our universities and health system, and a summary of near-term actions.

We remain committed to our long-term approved investment strategy and remain in daily contact our investment advisors. When the crisis passes and the long-term impact becomes clearer we will review the results of our investment performance, status of the university pension plan, and the need for any potential strategic actions that need to be considered with the Board.

Enclosures

c: Members of the Board of Curators
   Mun Y. Choi, President, UM and Interim Chancellor, MU
Financial Status Update

Industry Outlook
In March, the Moody’s financial outlook for higher education sector was listed again as negative. "For fiscal 2021, universities face unprecedented enrollment uncertainty, risks to multiple revenue streams and potential material erosion in their balance sheets," the report from Moody's said. The report noted the following risks.

Ability to respond to rapidly increasing downside risk varies widely across the sector. About 30% of universities currently have weak operating performances and will have an even harder time adapting to the disruption caused by the coronavirus and recession. Universities with positive operating cash flow and strong liquidity will be better able to navigate these challenges.

Coronavirus response will immediately hit revenues and drive expenses higher. Many universities have responded to the coronavirus by offering digital education platforms and sending students home, which will immediately impact revenue streams, according to Moody's.

Universities face multiple risks to revenue in 2021. The sector will face not only disruption in enrollment but also state support, endowment income and philanthropy, and research grants and contracts.

Financial market disruption presents several immediate and longer-term challenges. These significant investment losses will have an immediate impact on university’s reserves. Growing net pension liabilities have and will continue to be a credit risk for universities. The financial disruption will only increase the unfunded pension liability, if market losses continue.

Moody’s notes this outlook could change back to stable if the economy returns to normal after the outbreak is contained and enrollment stays steady in the fall.
**Balance Sheet Positioning**

The University continues to maintain healthy liquidity and a manageable debt portfolio. Investment strategies for the University and the pension plan remain focused on the long-term and unchanged from our pre-crisis strategies. The University is currently taking actions to fortify its balance sheet further by restructuring debt and protecting liquidity. This is offset by what will most likely be a growing net pension liability increasing the University’s liabilities in the coming years.

The University’s balance sheet is conservatively positioned to allow the University to manage through the crisis but will require forward action. It provides the time needed to make the hard but necessary decisions strategically. It does not provide optionality in making those decisions.

**Key Income Statement Financial Drivers and Sensitivities**

Figure 1 illustrates the University’s sources of operating revenue. The projection for FY20 shows the University’s expectation based on a normal ending to the year. Healthcare continues to be largest single source of revenues for the University enterprise, and after years of growth, faces a significant risk due to COVID-19 and the related impacts on volumes, especially of elective procedures. Net tuition and fees and auxiliary enterprises are approximately 35% of the total operating revenues. Half of the auxiliaries’ revenues are generated from student service operations. Every revenue stream will most likely be challenged in FY21, with potential declines across many sources.

**Figure 1: Operating Revenue by Source**

*Net Tuition and Fees includes Pell Grant State Funded Aid Revenue*
Tuition and fees are the primary source of revenue for the academic enterprise. Coupled with the auxiliary enterprises that primarily support student activities, student driven revenues account for over $1 billion in revenue for the University. Enrollments are the primary drivers of tuition and fees as well as the student auxiliary enterprises. Transitioning from on-campus to online for our traditional students, while positive for the University in terms of preserving tuition and fee revenue, will have significant ramifications for the University in terms of student auxiliary enterprises (i.e., residence halls, dining halls, athletics, bookstore, etc) if that transition persists into the fall. After FY2020, enrollment growth at MU was projected to increase as the incoming freshman classes become larger than graduating senior classes. Missouri S&T and UMSL experienced enrollment declines from FY2019 to FY2020 of 8% and 3%, respectively with UMKC being flat. Across the University first-time college admissions and acceptance are up 4.8% and 7.8%, respectively due primarily to strong demand at MU. Maintaining enrollments will be key to the University’s financial sustainability throughout the current crisis.

**Figure 2:** 10 Year Change in Enrollment

State appropriations are also a key operating revenue stream. Current budget planning is based on the Governor’s recommendations, in which core appropriations remain flat for FY21. However, the current crisis is putting significant pressures on state budgets as spending on healthcare and unemployment increases while revenues from taxes driven by economic activity fall.

Missouri like other states is faced with difficult choices when it comes to funding higher education as mandatory spending programs like Medicaid and employee pension contributions as well as other high priorities like public safety and elementary and secondary education continue to absorb a significant portion of the state’s available resources. 82% of the total general revenue budget is funding the mandatory programs referenced, and that amount is expected to increase as the economic downturn exacerbates
mandatory program spending. The remaining 18% is discretionary general revenue as illustrated in Figure 3 on the following page of which Higher Education makes up 51%.

Four-year institutions account for 71% of the Higher Education funding in the Governor’s recommended budget and the University of Missouri System receives 54% of the 71% allocated to 4-year institutions. If the State had to withhold $100 million in funding, the University would experience a $20 million reduction in state appropriations on a prorated basis. For every discretionary dollar cut, the University is likely to experience 20 cents on that dollar on a pro-rata allocation. This general rule held true for the $180M in spending restrictions announced by the governor, with UM receiving $36 million (20%) in reductions. The impact of the Federal stimulus could help offset declines in state appropriations in FY20 and FY21.

**Figure 3:** Discretionary versus non-Discretionary General Revenue Budget

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**Patient Medical Services:** historically accounted for the majority of revenue growth across the University. For the FY2020 projection, revenue growth in healthcare was already beginning to slow, prior to the coronavirus outbreak, relative to the growth rate seen in the past few years. It is still unknown the full impact the coronavirus outbreak will create for the University’s medical center, but the impact could be significant depending on the duration of the outbreak. Currently, elective or optional procedures are being deferred which is significant from a revenue standpoint as these procedures typically produce favorable operating margins on a per case basis.
Grants and Contracts research growth is a strategic initiative for all of the universities. Both the four universities and System office have made strategic commitments to fund research and creative works. The University has halted most lab experiments due to the coronavirus outbreak. The revenue disruption will depend on the duration of the outbreak. Federal agencies are allowing the University to fund payroll on projects that have been stopped due to the outbreak. Longer term, with the stimulus package and related downturn, it is not clear at this time how this revenue stream will be impacted as the federal government responds to the public health crisis and related economic impacts. It is important to understand that research is part of our mission and requires investment and cost sharing on the part of the University for every external dollar received. On average, that ratio of University funding to Federal funding for research is 1.2.

Salaries & Wages encompasses approximately 60% of the University’s operating expense. The University has fixed compensation structure in the form of tenured faculty. Tenured/tenure track faculty account for approximately 11% or 1,750 of total full-time University employees, this group of faculty members declined by 150 or 8% in Fall 2019 due to the Voluntary Separation Program, (VSP) which provided tenured faculty with a one-time lump sum payment to relinquish tenure.

While tenured/tenure track faculty represent 11% of full-time University employees, their base salary accounts for on average 18% of the University’s total base salary. Benefit eligible staff excluding healthcare account for on average 35% of the University’s total base salary, however these employees represent 73% or 10,920 of full-time University employees.

Benefits remain an area that will apply upward pressure on the institution’s cost over the long-term. The pension plan remains a significant risk, with the unfunded liability likely to grow above $1 billion in the current return environment, even though the plan remains closed to new entrants. Contributions into the plan will be forced to increase significantly, and will likely need to include contributions from current participants. Contributions into defined contribution plans also may face pressure on a forward basis, as many companies in private industry defer contributions into 401k plans in times of financial stringency. The University’s medical cost growth remains below market averages, but long-term trends in medical cost still exceed inflation and average wage increases, placing pressures on other cost items. The current pandemic could result in increased or decreased costs in medical, as elective procedures are deferred to save cost while the costs of hospitalizations from COVID could increase the medical plan costs.
**Supplies Services and Other Expenditures** are approximately 30% of the University’s operating expense. Figure 6 illustrates supplies services and other by source, the healthcare operations account for nearly half of these expenditures, with pharmaceuticals and medical supplies driving the majority of healthcare spend.

**Figure 6:** Supplies Services and Other Expenditures by Source

![Supplies Services and Other Expenditures by Source](image)

**Sensitivities**

With the pandemic, there is a high degree of uncertainty and a wide range of financial outcomes. Only the passage of time will give better information on the various impacts. The following outlines the relative risk and impact of those various factors:

**State Appropriations:** The University represents 20% of the state’s discretionary budget. Any state revenue disruption will impact the University. State revenue represents 15% of the University’s budget. Disruption in state revenue is likely, but the timing will largely be determined by the federal stimulus package and the severity of the economic downturn.

**Tuition and Auxiliaries:** Tuition and auxiliary revenues are primarily driven by student enrollment. Collectively, these operations generate approximately $1 billion in revenue for the institution:

- A 1% change in enrollment therefore changes revenue by $10 million including auxiliaries.
- Non-resident students generate roughly double the net revenue of resident students and make up approximately 20% of total undergraduate enrollments.
- Undergraduate enrollments remain the primary driver of tuition income.
Patient Revenues: Patient revenues encompass over 40% of the University’s total revenues. In the short run, revenues remain at risk as about a fifth of the enterprise’s revenues relate to elective procedures that are currently canceled. Current estimates show a substantial loss in contribution margin per week that elective procedures are deferred. In the longer term, the healthcare enterprise will likely provide a stabilizing base to the University’s revenues, without unforeseen decreases in consumption.

Grants and Contracts: federal and state projects represent 75% of research funding and are likely to remain stable through the crisis, however, future outcomes after the crisis are less certain. Grants and contracts represent 9% of total incomes.

Other Revenue Sources:

- **Investment Income:**
  - General Pool: returns on the general pool (the University’s cash balances) are expected to be depressed during the crisis placing further pressure on the University’s operating budget. A 1% change in return equates to approximately $20 million in income. To the extent the University spends working capital, the general pool balance will also drop for future income. The general pool impact will largely be shorter term.
  - Endowment Pool: the endowment pool is likely to experience a higher investment loss due to the strategy, but the flow through to operating budgets will take a longer amount of time. The endowment distribution policy utilizes a 28 quarter average, so the losses will feather in over the long-term rather than the short term like the general pool.

- **Gifts:** gifts represent a small proportion of the University’s revenue, with approximately $60M per year in current giving for 2% of total budgets. The slowdown will likely significantly impact giving, but this will remain a smaller driver than the other items noted above.

The University will be required to balance revenue disruptions above within the following areas:

- **Salaries and Wages:** represent the largest area of expenditure for the University, with any 1% change representing $15 million in related savings. Revenue disruptions will undoubtedly impact staffing levels in the related operation experiencing the revenue impact. One fifth of the University’s salary spend relates to tenured faculty. With the recent voluntary separation program, many will likely remain through any downturn as those who were likely to retire already have.

- **Benefits:**
  - **Medical** costs approximately $10,500 per benefit eligible employee. To the extent the university reduces headcount, it will save $10,500 per employee. This represents the fixed cost within benefits that can be managed. It is possible there will be some lift on medical from reduced consumption of elective procedures.
- **Retirement** will present a significant challenge over the longer-term. The magnitude of the issues with retirement will depend on the portfolio’s performance through the downturn. A market event similar to 2007-2008 would roughly double the University’s retirement costs over 5 years, increasing required contributions by an estimated $150 million. An increase of this magnitude would undoubtedly impact other pension plans and the range of available options for the University to address the shortfall would likely be wider than in the past.

- **Supplies, Services, and Other**
  - MU HealthCare drives 50% of the spend on supplies, services, and other expense, and these expenses should trend in line with utilization and revenues for MUHC.
  - For the remaining supplies, services, and other related to academic operations:
    - 30% relates to buildings, utilities, and equipment and will trend with space use and footprint
    - 20% relates to contracted services and will trend with staffing and other needs. It might make sense for this number increase in some areas and fall in others.
    - 14% relates to meetings and travel and should drop significantly in the short run. In the longer term, these expenses will flex based on the size of the workforce.
    - 13% relates to the cost of goods sold for auxiliary enterprises and should trend appropriately with auxiliary volumes and revenues.
    - 13% relates to departmental supplies and should trend with both enrollment and research.
    - 10% relates to technology and should trend with enrollment, employee headcount, and research.

- **Capital Expenses** average 250 million per year with the majority dedicated towards significant building projects. The University can slow capital expense temporarily to improve cash flow, but over the long-term investing in the right capital projects will be key to the University’s rise from the current crisis. The current crisis has accelerated the need to significantly reduce and consolidate space.
Financial Health and Viability Goals and Critical Areas of Focus

Currently, we are in a crisis, we need more information before making long-term decisions. We will use the framework outlined below to be decisive and in front of the decisions that need to be made.

The financial health and viability goals and critical areas of focus (CAF) is intended to provide the financial framework through which we will lead through the crisis. This effort by design must be proactive, across all our Universities and MU Health and exhibit a laser focus on the challenges presented and the corresponding governance required to navigate the unknown crisis that lie ahead. This effort will allow for: deployment of a cohesive financial management strategy, complimentary and robust decision-making, and the strengthening of a unified leadership team. The Board of Curators will similarly benefit from the coordinated effort and enhanced communications. By responding with a sense of purpose, the University will be better positioned to maintain its mission and financial strength when faced with divergent exogenous challenges. Our response to the crisis will elevate or depress our universities and healthcare system; a neutral outcome is highly unlikely.

Goals

- Enable University to ensure optimal actions are being taken to address the public health and economic crisis, maintain a healthy balance sheet, and underwrite the long-term mission of the University.
- Be proactive in identifying and planning for potential problems through active management and thorough analysis.
- Provide early warning input to academic and health care leadership.

Critical Areas of Focus

1. Manage liquidity, cash deployment, debt portfolio, bond covenants and counterparty risk
2. Actively manage investment portfolio risks (General Pool, Endowment, Pension)
3. Actively monitor state budget outlook
4. Continually monitor student enrollment outlooks and assess upside/downside opportunities
5. Actively monitor key auxiliary operations and assess upside/downside opportunities: residence halls, dining services, bookstores, athletics and recreation facilities
6. Fully deploy College level “RPK” P&L statements
7. Use financial planning framework to manage probable forecasted cash flow/revenue changes earlier and transition to building longer-term resizing strategy

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8. Actively monitor federal funding programs for opportunities and requirements

9. Proactively manage billing and receivables (student, patient, federal and state)

10. Aggressively manage staffing needs/capacity and restructuring opportunities

11. Utilize early warning approach to pension management and assess upside/downside opportunities

12. Be opportunistic in eLearning revenue stream and assess upside/downside opportunities

13. Actively engage with alumni and donors and assess upside/downside opportunities

14. Steward facilities utilization and capital capacity align with highest priorities and control cost

15. Aggressively manage procure to pay to manage spend and maximize float

16. Proactively manage ongoing capital projects to mitigate impacts to schedule and budget

17. Actively identify and develop a continuity strategy for potential counter party risk within existing academic and health care supply chain relationships. Review all major contract relationship for potential elimination or restructuring.

18. Optimize physician utilization and retention.

19. Actively manage athletic ticket and giving revenue and assess upside/downside opportunities

20. Proactively conduct stakeholder communications

Each CAF will be assigned to one core team member as its owner and each would become a sub-team within the overall effort. This organization structure will help assure inclusive coverage and cross-organizational information flow. Work will be undertaken with an extreme sense of urgency. Core team meetings will be held every Wednesday and Executive Stakeholder meetings will be conducted every Friday.

Measure
Each CAF will be evaluated to determine its relevance and baseline level of performance. Baseline measures will be established to allow robust monitoring of these CAFs to assure appropriate monitoring and steps taken.
**Analyze (Facts and Data Analysis)**
Each CAF will become an organizational structure for which critical metrics will be identified, which in many cases will represent operational levers. Initial baseline values will be established during Measure. During Analyze, the core team along with individual CAF sub-teams will conduct problem identification and root cause analysis to calibrate the original detailed metrics from Measure.

**Execute**
Each CAF will execute plans and report out weekly on accomplishments from the last week, plans for next week and decisions needed from executive leadership.

Every leader within a CAF must have the same mindset. CAF leaders will:

- Value action over inaction
- Look through the windshield instead of the rearview mirror
- Make the decisions that need to be made today
Summary of Near-Term Actions
As noted in the opening letter, we will not achieve our budget plans for fiscal year 2020. We have taken several immediate actions to cut cost and protect revenue. Our decision-making is focused on the next 60 to 90 days and we want to take careful but decisive actions in the short run that allow for future flexibility and optionality.

The University has taken the following actions:
- Restricted hiring and exceptions can only be granted by President/Chancellor
- Frozen all pay and positions reclassifications
- Placed limits on all non-personnel spend
- Purchasing requisitions and contracts require additional approvals including CFOs for those over $100,000
- Directed campus to support enrollment management and engagement with students help maintain enrollments as much as possible
- Moved all summer courses to on-line
- Vacated buildings except for essential staff
- Transitioning from administrative leave program to federal Families First Coronavirus Response Act (FFCRA) paid sick leave, FFCRA expanded FMLA leave and other paid leave by not later than April 12th.

Other near-term actions are being evaluated. We will remain decisive and in front of the challenging but necessary decisions. These decisions are not taken lightly, and demonstrate the challenging reality we’re confronting. Additional information will be provided as decisions are made.