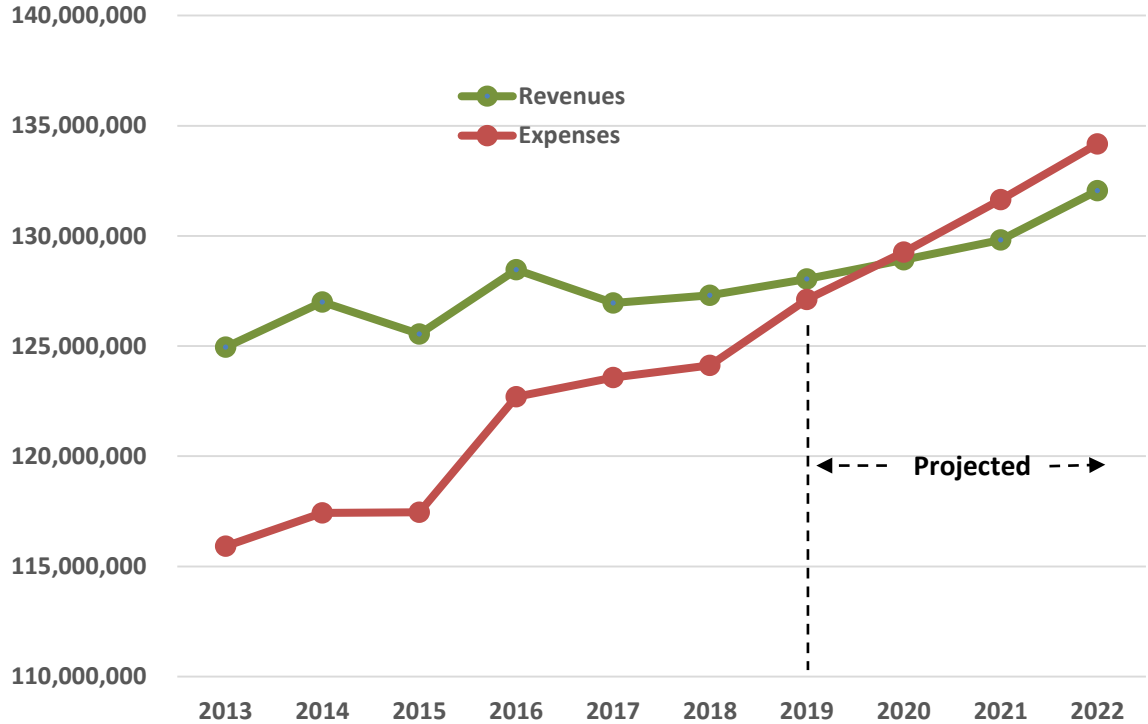


SRAP FAQs

The Strategic Resource Allocation Project is intended to promote the long-term financial sustainability of the college. We want the extraordinary education St. Olaf provides to remain affordable to our students, and we want the experience of providing it to remain attractive to our faculty and staff. Here is some information about the challenges we are facing, why we are facing them, and how our situation compares to that of other colleges like ours.

What is the problem we are trying to solve?

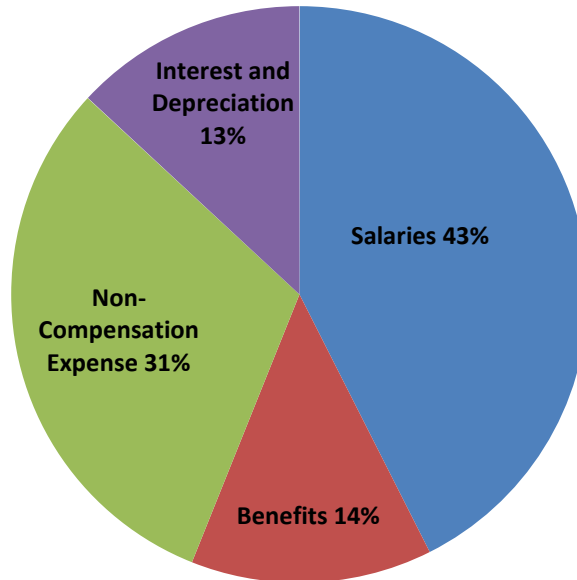
For the past five years, our operating expenses – the day-to-day bills we have to pay in order to provide our programs and services – have been growing faster than the revenues available to pay for them. Unless we take action, we will be facing a deficit beginning in FY2018-19 that will only increase going forward, depriving us of the opportunity to make thoughtful and strategically-focused decisions to right the balance.



What are the major components of our operating expenses?

As is the case across all of higher education, more than half of our operating expenses involves spending on our people:

2017/18 Budgeted Expenses: \$124,123,000



Salaries (~\$53m) – This includes salaries not only for faculty and staff, but also for our student employees and temporary employees, and for overtime as well.

Benefits (~\$17m) – Health insurance, dental insurance, life insurance, retirement, etc.

Non-compensation (~\$38m) – Office, classroom, and lab supplies; travel; professional development; guest speaker honoraria; consulting fees; catering for meetings and events; legal fees; utility bills; routine building repairs and maintenance; etc.

Interest and depreciation (~\$16m) – Interest on loans for long-term capital projects like building renovations, and the annual loss in the value of our long-term capital assets (they are worth less each year as a result of aging and wear and tear, and we account for that as an expense line in our operating budget)

Why do our operating expenses keep going up?

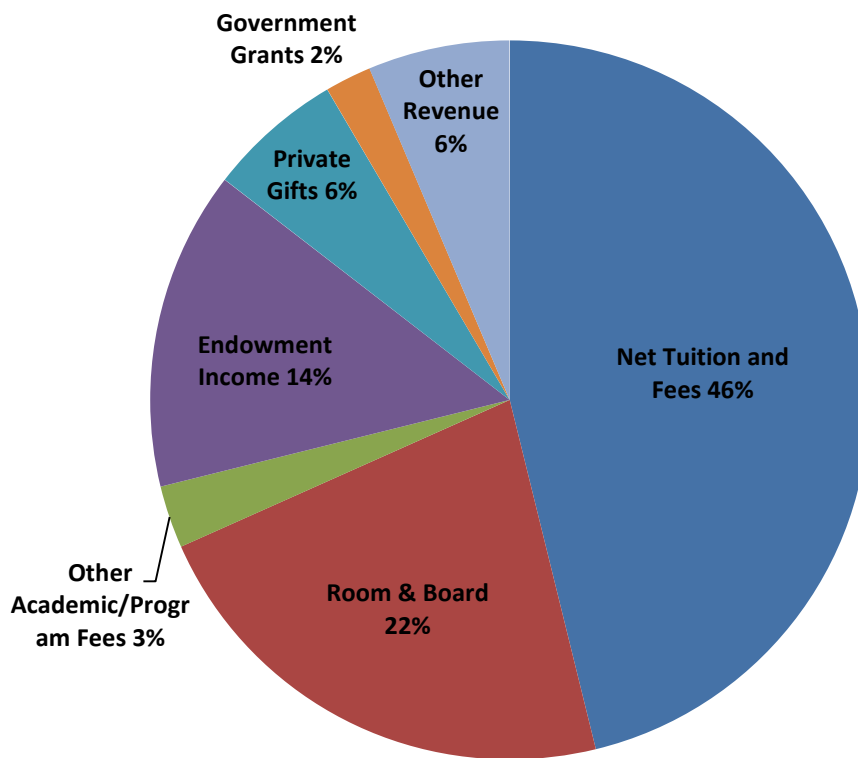
The college has worked hard, and successfully, to hold down many of its day-to-day non-compensation expenses, such as general supplies and travel. But we are seeing steady growth in our compensation and benefit expenses, particularly for health care, as well as in meal plan expenses and contracts and professional services. In addition, like other colleges, St. Olaf has experienced increased expenditures resulting from emerging federal Title IX, Affordable Care Act,

and Fair Labor Standards Act regulations. These upward trends are likely to continue, because many of these costs are necessary, but not necessarily negotiable.

What are the major sources of the money we use to pay for our operating expenses?

St. Olaf, like most liberal arts colleges, is often described as a “tuition-dependent” institution. That’s because the biggest source of the revenues we use to fund our day-to-day expenses – almost half – consists of student tuition payments.

2017/18 Budgeted Operating Revenue: \$127,228,000



Net tuition revenue (~\$59m) – This amount is what we *actually collect* from students and families, which is different from the tuition we advertise. Most students pay less than the full amount of tuition, either because of “funded discounts” – scholarships and other forms of aid paid for by private gifts, external grants, or designated endowments (and those sources are “counted” in the other categories of revenue), or because of “unfunded discounts” – aid provided directly by the college without support from any alternative revenue source.

Room and board (~\$28m) – This is the amount we collect from students for their housing and meal plans.

Endowment income (~\$18m) – The endowment consists of funds donated to the college that are to be invested rather than spent outright. A portion of the interest earned by the endowment (the

“income” produced by the endowment principal) is used as a source of revenue to pay for our operating expenses. The larger our endowment, the more interest income it generates, and the less tuition we have to collect from our students.

Private gifts and grants (~\$8m) – This category includes contributions to the college’s Annual Fund, other gifts given for designated purposes, and grants obtained from private foundations to support teaching and research.

Other academic/program fees (~\$4m) – This category includes fees charged for programs or academic expenses not covered by tuition, such as off-campus study and lab fees.

Government grants (~\$3m) – This includes need-based federal grants that reduce the cost of tuition for individual students, and grants for teaching and research provided by state and federal agencies.

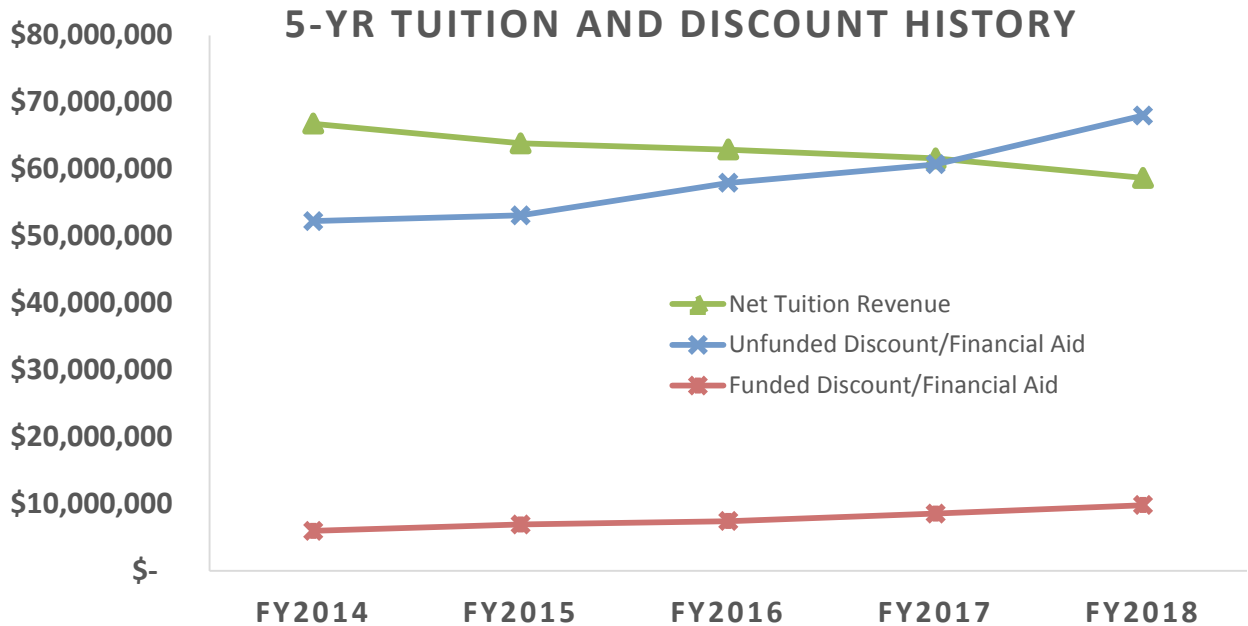
Other revenues (~\$8m) – This category includes items such as fees for study travel programs for alumni and friends of the college; bookstore revenues; fees for St. Olaf conferences, camps, and clinics; and other miscellaneous revenues.

Why aren’t our operating revenues keeping pace with our operating expenses?

The main reason that our operating revenues haven’t been growing fast enough is because our principal revenue source – *net tuition revenue* – has been declining over time, without enough of an increase in our other sources of revenue to make up for this decline. *Net tuition revenue* is the amount of money St. Olaf actually receives in tuition payments from students and families, which is always lower than our total “list price” because of financial aid awards (also referred to as “tuition discounts”). The amount of net tuition revenue received by the college has steadily decreased over the past five years. In 2014, our net tuition revenue peaked at \$66.8 million; in 2018 we’re projecting net tuition revenue of \$58.7 million, a reduction of more than \$10 million (12%) in four years.

But this raises another question: *How can our net tuition revenue be declining when we raise the comprehensive fee (tuition + room + board) every year?* The answer is that the tuition discounts funded by the college have been increasing at a faster rate than our “sticker price.” In other words, even though we are charging more, we are actually collecting less. Here’s why: St. Olaf has long been committed to meeting the full demonstrated need of all admitted students, and the vast majority of Oles – 94% – receive financial assistance (i.e., tuition discounts). Some tuition discounts are offset by other sources of revenue, such as external scholarships, federal grants, or designated endowment earnings. That’s our “funded discount,” and those amounts are included in the appropriate categories in our operating revenue reports. But our funded discount accounts for less than 12% of the total financial aid Oles receive. The remaining 88% is provided by St. Olaf, and constitutes our “unfunded discount.” In 2014, the total amount of unfunded (St. Olaf-provided) discount was \$52.3 million; this year it is estimated to be nearly \$70 million, an increase of 34% in just four years. These trends are being reinforced by our additional commitment to reducing

student indebtedness by decreasing the amount of need met through student loans. The average amount borrowed by the Classes of 2016 and 2017 was 9% lower than in previous years, a significant accomplishment. But decreasing student loans has meant increasing unfunded (St. Olaf-provided) tuition discounts.



We’ve been spending a lot of money on building renovations, like first-year residence halls and Holland Hall, with more to come, like the new ice arena. Why don’t we just slow down our spending on buildings and use the money to fund programs and people?

The money we spend on buildings, grounds, and infrastructure comes from a different funding source – our *capital budget*, which is separate from our operational budget. The capital budget is for long-term assets – buildings, grounds, and infrastructure – that require spending over longer timeframes, often with borrowed funds. All colleges and universities, as well as other entities like city and state governments, maintain a separate capital budget for such long-term expenditures. Some of the revenues in our capital budget comes from specially-designated gifts to the college; such “restricted” funds can’t be shifted over to the operational budget because of the terms of donor agreements. That is largely the case for the planned construction of the ice arena, which is the only “brick and mortar” component of the current “For the Hill and Beyond” comprehensive campaign, and which accounts for only \$6M (3%) of the \$200M goal.

The college seeks to time capital expenditures carefully, to ensure optimal use of capital resources and to avoid incurring unnecessarily large expenses in the future by failing to maintain or renovate our buildings and grounds in a timely way. Spending less on our buildings now could require the

college to take out large loans in the future to fix our long-term assets. This would ultimately have a negative impact on our operational budget, since interest payments on our capital loans are an operational expense. (This is also why the college has made a practice in recent years of shifting 2.5% of each year's unrestricted operating revenues into the capital budget; that makes more St. Olaf dollars available for capital projects, which means we have to borrow less and therefore pay less in interest.) The bottom line is that reducing our current capital expenditures would postpone, but not resolve, the challenges we are facing in our operational budget – and would ultimately compromise the quality of the living and learning environment for our students.

President Anderson has been saying that our endowment “yearns to start with a 5” and now it does; its current value is approximately \$508 million. Since we have achieved our endowment goal, why don’t we use more of our endowment to meet our operating expenses?

Endowment earnings come from interest earned on investments made with gifts to the college specifically designated as endowment principal. (Funds from the endowment principal can't be used for operational expenses; those funds are specifically designated as revenue-generators, not as revenues themselves.) Although an endowment of \$500 million is a great milestone and a cause for celebration, it is not a final goal. We want to keep growing the endowment because the bigger the endowment, the more it earns, and the more we have available as operating revenue, thereby reducing the percentage of our operating revenues that come from tuition payments.

The impact of a growing endowment on our operating budget is already being felt. At the end of FY2007-08, the market value of our endowment was nearly \$335 million, generating over \$10 million in earnings and accounting for 9.3% of our operating revenues. Despite the loss of nearly \$87 million the following year (a drop of more than 25%) as a result of the financial crisis, the endowment is once again growing, to the benefit of our current and future students. At the end of the most recent fiscal year (FY2016-17), the market value of our endowment was \$493 million, generating more than \$17 million in earnings (a 72% increase) and contributing 13% of our operating revenues.

A question being asked is whether the college could put more of the earnings from the endowment into the operating budget than it currently does. That \$17 million in our operating revenues that comes from endowment earnings is equal to approximately 3.5% of the overall market value of the endowment at the beginning of the year. Yes, many colleges, including most of our peers, use more than 4% of the market value of their endowment for operations. Part of the reason we don't use more endowment earnings as operating revenues is because we can't; there are stipulations in the gift agreements between the college and the donors of some endowment funds that restrict what the earnings can be used for. Even so, we are not using as much of our endowment earnings to pay for our operating expenses as we could. Instead, to ensure that the contribution of the endowment to our operating revenues keeps growing, the Board has designated the earnings from

approximately \$59 million of the endowment as funds for reinvestment rather than as funds to pay for current expenses. The Board’s goal is to “bake in” ongoing endowment growth, so that even if interest rates decline or gifts to the college slow down (both of which happened in the aftermath of the 2008 financial crisis), the college won’t have to turn to students and their families to make up any deficits. The decision to re-invest for the future rather than to spend now is complex, but guided by a consideration of both long-term and short-term benefits that resembles the college’s decisions concerning capital expenditures. Backing off of our commitment to re-investing a portion of endowment earnings would simply postpone and, eventually, aggravate our operational problem.

Do we need to be worried about the long-term financial viability of the college?

No – as long as we tend to our current projected revenue shortfall. The primary indicators of long-term financial health, as determined by the National Association of College and University Business Officers (NACUBO) and used throughout higher education, are all strong at St. Olaf:

| Indicator | Definition | What This Indicator Signifies | NACUBO Threshold for Financial Health* | Current St. Olaf Measure (FY2017) |
|--|---|--|--|-----------------------------------|
| Primary Reserve Ratio | <u>Expendable net assets</u> Total expenses | The length of time that a college could pay its bills using its existing reserves, expressed as a percentage of a year | >.40 | 2.37 |
| Viability Ratio | <u>Expendable net assets</u> Long-term debt | Whether a college would be able to settle its long-term debts if they all came due immediately, with money left over | >1.00 | 3.83 |
| Return on Net Assets Ratio | <u>Change in net assets</u> Total net assets at FY start | Endowment and investment performance, adjusted for inflation rate and market conditions (so threshold varies over time and relies on rolling averages) | .03-.04 | 0.08 |
| Net Operating Revenues Ratio | <u>Operating surplus/deficit</u> Operating revenues | Whether operating revenues exceed operating expenses, indicating whether a college lives within its means | .02 -.04 | 0.13 |
| Composite Financial Index (CFI) | Combination of all four ratios, with different weights assigned to each | Primary Reserve = 35% Viability = 35% Return on Net Assets = 20% Net Operating Rev = 10% | 2.00 | 8.50 |

*Tahey, P., et al., *Strategic Financial Analysis for Higher Education: Identifying, Measuring & Reporting Financial Risks* (7th ed.). Prager, Sealy & Co., LLC; KPMG LLP; & Attain LLC

How does the financial situation at St. Olaf compare to that of other liberal arts colleges?

Most liberal arts colleges are tuition-dependent, and most are facing the same challenges we are. The National Association of College and University Business Officers (NACUBO) tracks tuition revenues and tuition discounting practices every year, and reports that the national trend among private nonprofit colleges, like the trend at St. Olaf, is continually-climbing institutionally-funded tuition discount rates paired with little to no change in net tuition revenue. In a recent survey of Council for Independent Colleges (CIC) member institutions, all respondents reported pursuing either “cost containment and reduction” or “revenue enhancement and diversification” strategies, with about a third vigorously pursuing both strategies.

At the same time, the Council for Independent Colleges reports that, again as at St. Olaf, most small- to midsize private colleges and universities remain financially viable. A review of recent Composite Financial Index (CFI) scores from a subset of schools that are similar to St. Olaf in a variety of ways bears this out; on average, institutions are exceeding the NACUBO threshold of 2.00 for financial health, with St. Olaf’s score similar to or greater than the mean scores for other ELCA colleges and for other Minnesota private colleges:

| | 2017 | 2016 | 2015 | 2014 | 2013 |
|---------------------------------|------|------|------|------|------|
| St. Olaf 5-yr CFI Scores | 8.50 | 5.30 | 7.40 | 8.70 | 8.20 |

| Comparison CFI: MPCC and ELCA Schools | 2016 | 2015 | 2014 | 2013 |
|---|------|------|------|------|
| ELCA mean | 2.24 | 3.10 | 3.84 | 3.51 |
| ELCA mean for schools with > 2,350 student FTEs | 3.59 | 4.35 | 5.46 | 5.00 |
| MPCC mean | 3.95 | 4.82 | 5.48 | 5.11 |
| MPCC mean for schools with endowment > \$175 M | 5.40 | 7.08 | 8.13 | 8.05 |