

US Higher Education Industry Analysis

*In support of
Creating the ability to thrive...
A workshop and conversation of Philadelphia Higher Education
Leaders
June 16, 2014*

Intent of the workshop

1. Engage key Philadelphia Higher Education leaders in dialogue about the competitive arena for Higher Education
2. Set the stage to think in competitive and proactive terms about the current situation
3. Explore whether there are actions that the group might take collaboratively that could improve the group's and individual competitive situations
4. If there are next steps, agree to how we will take them...

A brief analysis of the Higher Education Industry

- Economic and Operational Trends
- Industry structure analysis
 - Changing power structure
- Synthesis
- Comparison to “history”
- A consideration....

Primary data sources:



United States Census Bureau

U.S. Department of Commerce | Blogs | Index A-Z | Glossary | FAQs

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The 2012 Statistical Abstract

to the National Data Bank

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DIGEST of EDUCATION STATISTICS

LIST OF TABLES AND FIGURES 2012

- 2012 full version of the Digest
- Digest from 1990-2012 (PDF)

LIST OF 2012 DIGEST TABLES

Tables Figures

Chapter 1: All Levels of Education [Show All]

Industry Analysis- Five Forces Summary

The Industry analysis and possible impacts focuses mostly on supplier power, buyer power and the existing competitive landscape, as there were sufficient challenge in these categories to consider for the purpose of the workshop.

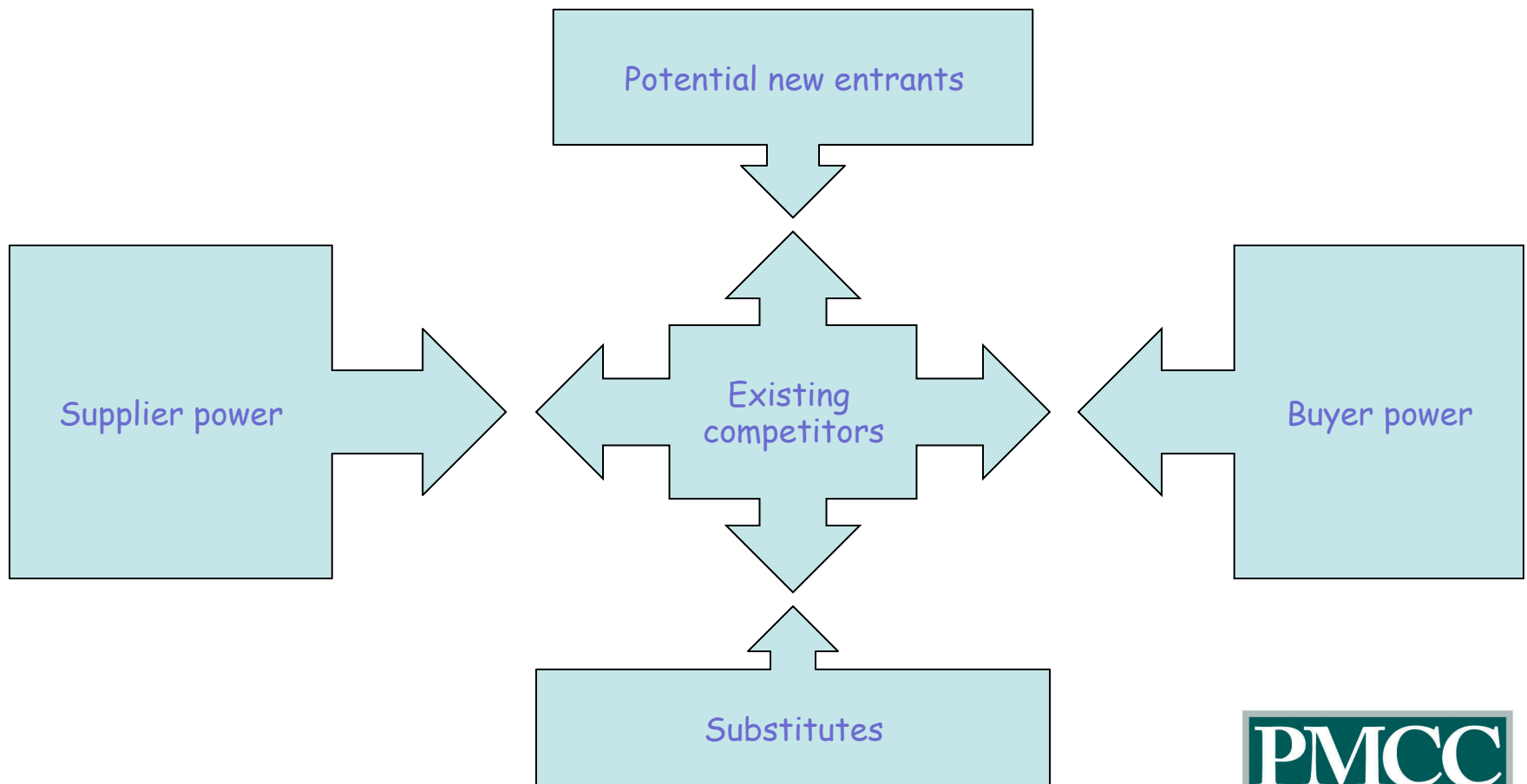
That is not to say that new entrants or substitutes don't pose significant challenges, but the focus of our conversation was what can be done now.

Therefore, this section is not intended to be a comprehensive analysis of the Higher Education sector.

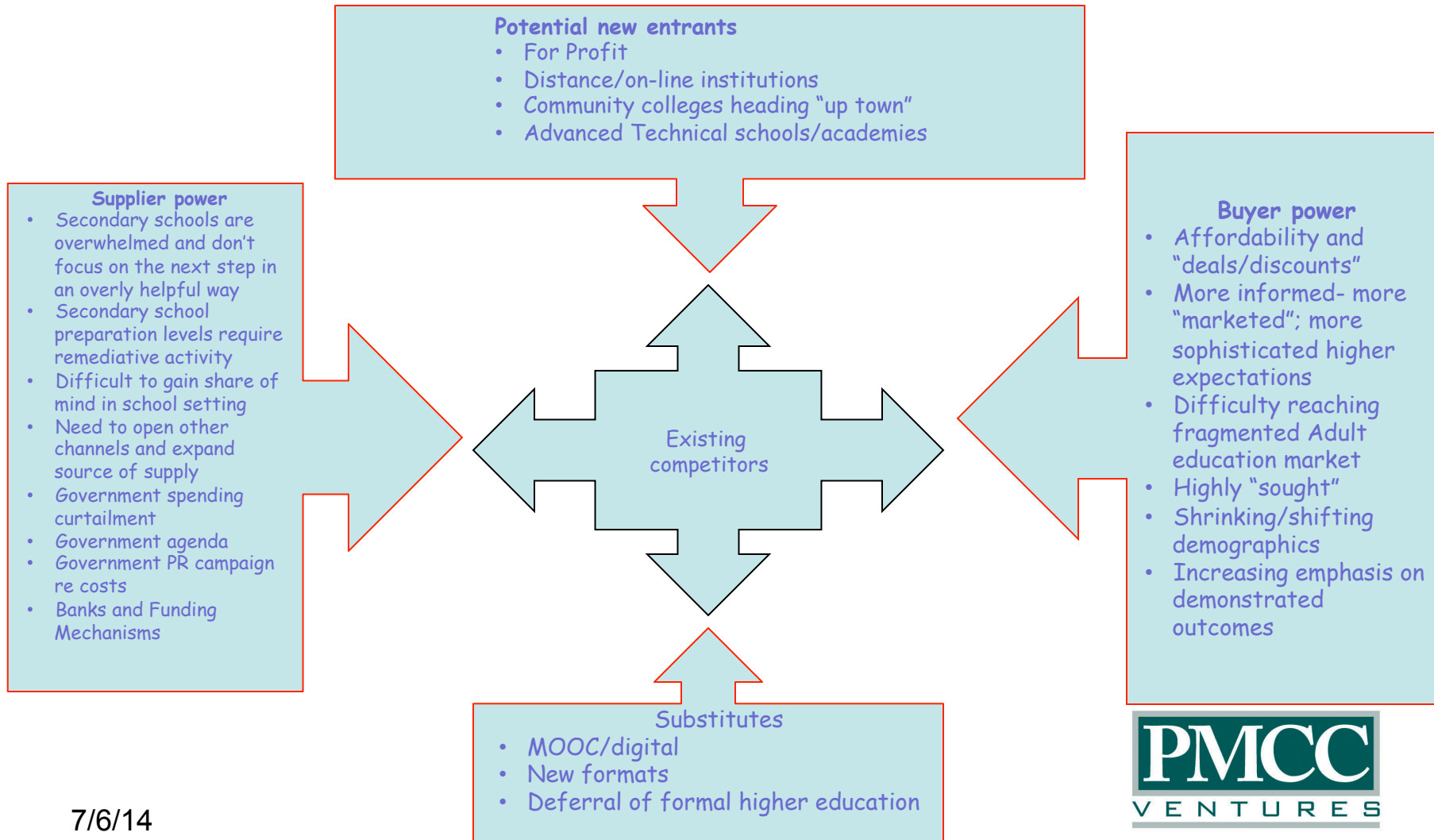
In Summary...some of the key business challenges for higher education...

- Increasingly intensifying competitive environment
 - Lack of growth
 - Inability to access adult learners
 - More informed/discriminating market
- Traditional channels are more difficult to access
- Burden for expected outcomes with respect to employability placed at feet of Universities despite general economic challenges
- Public competitors hold scale and cost structure advantage
- Natural pressure on cost structure because of high % of people related costs
- Competitive pressure to innovate and renew.... drive costs and stretch capabilities
- Pricing challenges
 - Government
 - Secular/Affordability
- A bit of “change adversity” in the industry

Beyond individual institution's competitive situation there are significant challenging structural forces at play



Beyond individual institution's competitive situation there are significant challenging forces at play



Supplier Power *Notes*

- Three major suppliers were identified and discussed:
 - Secondary schools and community colleges
 - Government support
 - Lenders
- Secondary schools and community colleges are increasingly focused on issues in their own domains. In the Philadelphia area, the Philadelphia Public Schools and the Catholic School systems are in a state of disarray and have redirected resources away from the “college guidance” process. Increasingly, students are left to navigate those channels by themselves, which significantly impacts and fragments the go-to-market efforts of Universities. Further, it is believed that in many instances, the secondary schools and community colleges are not doing an adequate job of preparing students for success in post secondary education; therefore, increasingly, the remediative burden falls to colleges and universities.
- Relative to community colleges, they are suffering many of the same challenges as four year institutions, and as they begin the process of “coping more”, they could “move their programs up town” and not be as robust of a source of students as they have been in the past.

Supplier Power *Notes continued*

- Government policy, attitude and attendant funding strategies are shifting dramatically. Easy government money, similar to that which led to the housing boom and bust in the early 2000's, was made available to universities through students and their families by increasing net affordability and driving new revenues to the universities. During this timeframe, universities used these funds and expanded in terms of programs as well as physical and technical assets.
- The Government is now saying that higher education is too expensive and not providing sufficient value to students for the investments they are required to make. Student debt levels are slowing economic advances as the debt laden cohorts are not credit worthy and do not have cash flow to invest in household formation, purchase of homes, cars etc. Paradoxically, the imperative for higher education is clear because of lifetime earning differences for participating students. The government is now taking steps to restructure and extend student loans, but more action is likely to follow.

Supplier Power *Notes continued*

- There are several examples of how shifting government approaches moved other industries to “market prices” and away from a cost sharing model that is essentially represented by today’s student aid practices and formula. These same methods could likely be deployed in higher ed by establishing more common funding models that are not so heavily gauged by individual university tuition/costs.
- Lenders, including both banks and fiduciaries for public debt and rating agencies, have been “ringing the bell” about the economic challenges in higher education. Yet, not many have taken steps to intervene and reset the table- but their messages are quite clear.

Supplier Power *Notes continued*

- We discussed that bank lenders are likely to be the first to react to eroding economic well-being as regulatory forces on them cause them to focus on risk and related lending categories. Because of the high profile nature of higher education institutions, at this juncture, banks are not willing to take advantage of their normal tools to limit exposure and compel borrowers to perform at improved levels of operation.
- Public debt fiduciaries will follow suit once moves are made in the banking community. These abrupt changes will be very disruptive to Higher Education institutions as there are not many places to turn for alternative financing, and industry leaders don't have a deep history of successfully dealing with these types of challenges.

New Entrants and Substitutes *Notes*

- The conversations did not focus too heavily on these matters, yet their disruptive power is significant. Their approach to the market needs to be closely monitored and in some cases, cloned.

Buyer Power *Notes*

- Buyer power is increasing in numerous ways.
- Primarily, as the industry copes with excess capacity in many different ways, competitors will always resort to price competition as they seek to cover variable costs and add to the pot to cover fixed costs. This phenomenon yields significant benefit to the buyers in terms of pricing and diminishes economic performance for institutions opting for the least bad of two not so favorable options. Further, this places the institution in the “hunt” for volume which both causes the university to invest more in terms of marketing and “selling”, while at that same time reducing net tuitions. This is a negatively reinforcing cycle.
- As buyers begin to feel “highly sought”, they will begin to ask more of institutions, bidding up costs as the tendency to respond positively with new services and capabilities for small market groups will be hard to resist because of the capacity issue mind set discussed above. \

Buyer Power *Notes continued*

- As noted in the supplier discussion, the government seems to be succeeding in projecting the issue of the cost of higher education solely on the institutions and ignoring their role in the challenge- i.e. more regulation, more reporting, more diverse services etc. And, as the government begins to curtail educational support spending, the issue will become even more prominent for institutions as the government continues to deflect.
- Much seems to be written about the impact of the birth dearth on undergraduates. But, when you consider individual market share of the small to medium size institutions, this places pressure on single digit numbers of students, when these institutions crave and need hundreds of new students. Yet, it is a subtle power shift for the buyers, particularly if some institutions take the bait and focus on single digit issues vs. the larger issue in play of benefitting from attracting hundreds of more students.

Buyer Power *Notes continued*

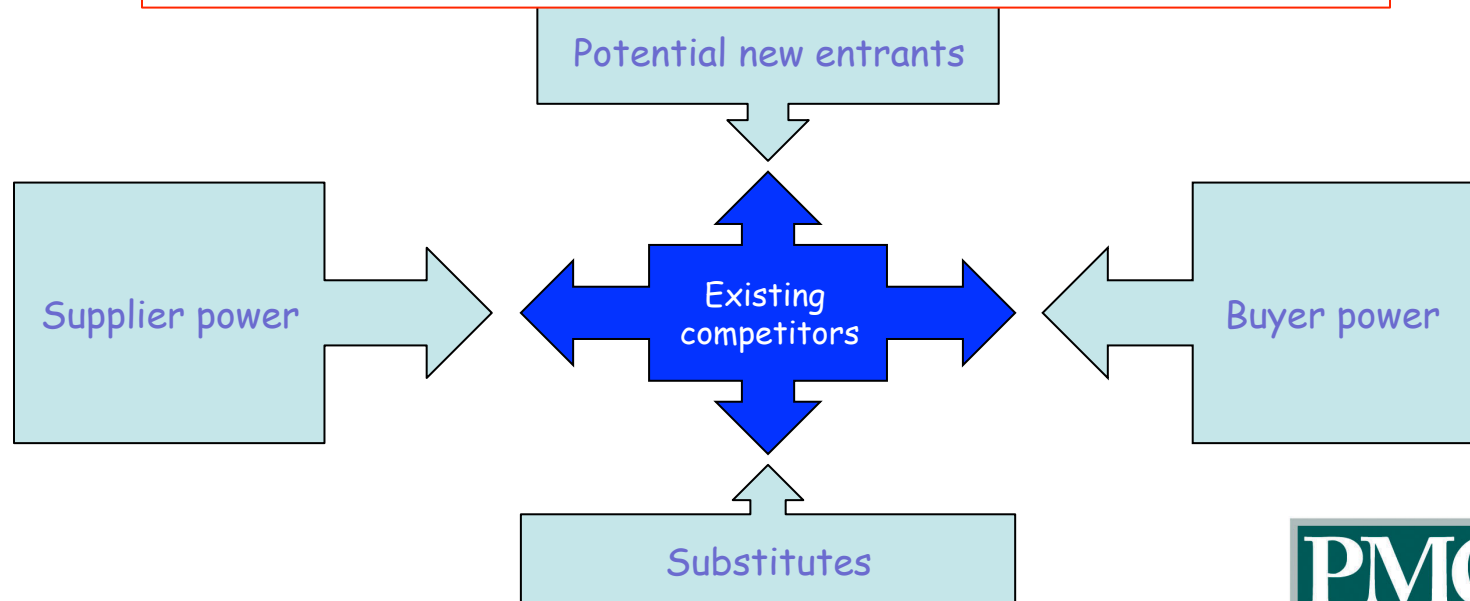
- The issue of affordability and value is real. In our meeting and in subsequent articles that were circulated, it appears that at least in terms of wages earned post graduation, compared to the cost of the education, that the buyer is in a negative spiral. Yet, it is widely known that the necessity of having a “college degree” is critical to long term work place success and participation. So, the buyer is looking to colleges and universities to provide the magic sauce for the value equation. In the realm of excess capacity, many institutions will strive to at least appear to fill in the difference and create value, often with little insight as to what prospective students or employers may need or want.

Buyer Power *Notes continued*

- The cost of education vis-a-vis family incomes, and in light of curtailment of government support, is simply too high. Tuition increases will not be the significant source of future funding. As the large part of the market becomes increasingly “strapped” because of high and unaffordable costs and diminishing financing sources, institutions trying to contribute to fixed costs, will likely have to further cut costs, hence conveying more power to the buyer.
- The adult market is increasingly fragmented and hard to approach in meaningful and compelling ways. Yet this can be the most profitable segment to serve. As institutions strive to figure this out, power will continue to shift to this buyer segment.

Beyond individual institution's competitive situation there are significant challenging forces at play

- Excess capacity at all levels
- Plan to "break even" stresses financial resources- each year
- Emotional barriers to exit/change
- Structural barriers to change
- Varying degree of financial performance and capability/resource
- Public institutions shifting in focus and competitive stance
- Rational competitors becoming irrational
- Pace, intensity and interrelatedness of change elements increasing



Industry Competition *Notes*

- For purposes of our conversation we segmented this group into private and public institutions. From an industry structure point of view, it looks like the health care and banking industry of the 80's. As barriers to competition were removed or regulations put in place that promoted competition, these two industries began a process of consolidation, and in neither industry has this process been neat and encouraging. The consolidation was done to increase service capability, reduce costs and to take advantage of skill sets and specialists that were not affordable on a stand-alone basis nor provided robust career tracks for people in smaller institutions.
- Public competitors are larger and enjoy significant cost per student advantage. Taking advantage of relatively inexpensive credit and government backstop guarantees, they expanded dramatically and have built out wider capabilities. Because of this scale, private capital was attracted to build out student housing, thereby allowing the universities to focus on truly differentiating investments for their academic programs and student services. For private institutions, this has “bid up the costs of keeping up with the Joneses”.

Industry Competition *Notes continued*

- Some public institutions, in one form or another, are renegotiating their relationships with states. The higher performing institutions will start to compete more like [larger] private institutions. The scale of the public institutions both causes and allows them to offer a diverse range of offerings and services.
- While the public institutions possess significant cost advantage, they give that up in tuition costs to the market. However, in an era of affordability challenges, their lower costs can be extremely attractive to the market, particularly if these institutions come alive and are able to identify and communicate the unique value they provide. They are positioned to gain significant market share.
- Meanwhile, there are four times more private institutions. Each of them operate with significantly less scale opportunity than the public institutions, consuming larger components of their resources just to fund day-to-day activities, leaving little room for investment, or buffer from unforeseen financial challenges. Regrettably, because of the excess capacity issue, some of the costs are incurred to fund non-value producing activities.

Industry Competition *Notes continued*

- In summary, the challenges for the smaller and non-selective institutions are significant. There does not appear to be any industry-wide watershed events or factors on the horizon for this group. So, like many others they are forced to compete with less, or change and innovate and figure out how to reduce their cost of operations to stay in business.
- The negative economic impact in the industry will manifest slower than many believe. Institutions can limp on for many years, but eventually, the operating challenges will show up in terms of further reduced perceived value and enrollment. But it will be felt.
- The challenge is to decide what you can do smartly now in order to buy the time to devise and implement fundamental and important change.

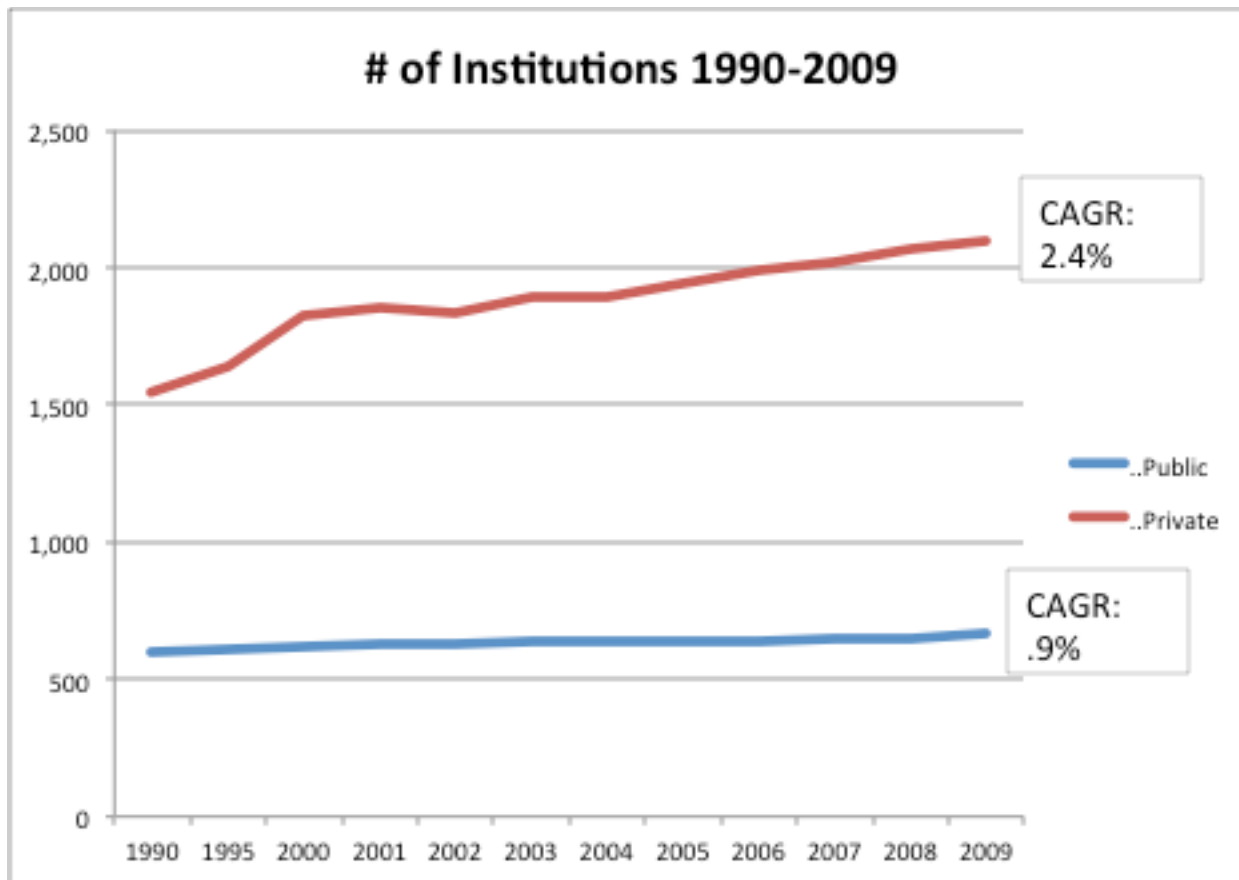
Industry Competition *Notes continued*

- All of the above converge to create significant challenge for incumbent institutions. Excess capacity, lack of scale vis-a-vis large private and public institutions are just one set of factors combining to diminish the competitiveness of small and mid size institutions. The pricing strategies, coupling with ever increasing costs, leave most institutions with sparse funds to re-invest in transformation or improving their market position. These conditions, along with the fact that the net cost of higher education is placing stress on households (mainly for undergraduates) and businesses are no longer as generously funding advanced education, will place further pricing pressure on incumbents and limit their options for growth and development. Over the medium term, this will create a quality chasm, further disadvantaging many of the small and medium institutions.
- History provides more than adequate example of other industries that have successfully navigated these challenges. The typical approach and life cycle includes steps to improve cost structure or match it to revenue realities, outsource or combine services to take advantage of scale and skill economy, and eventually, consolidation of an industry. Those that successfully navigated this process did so by getting out in front and managing the process.

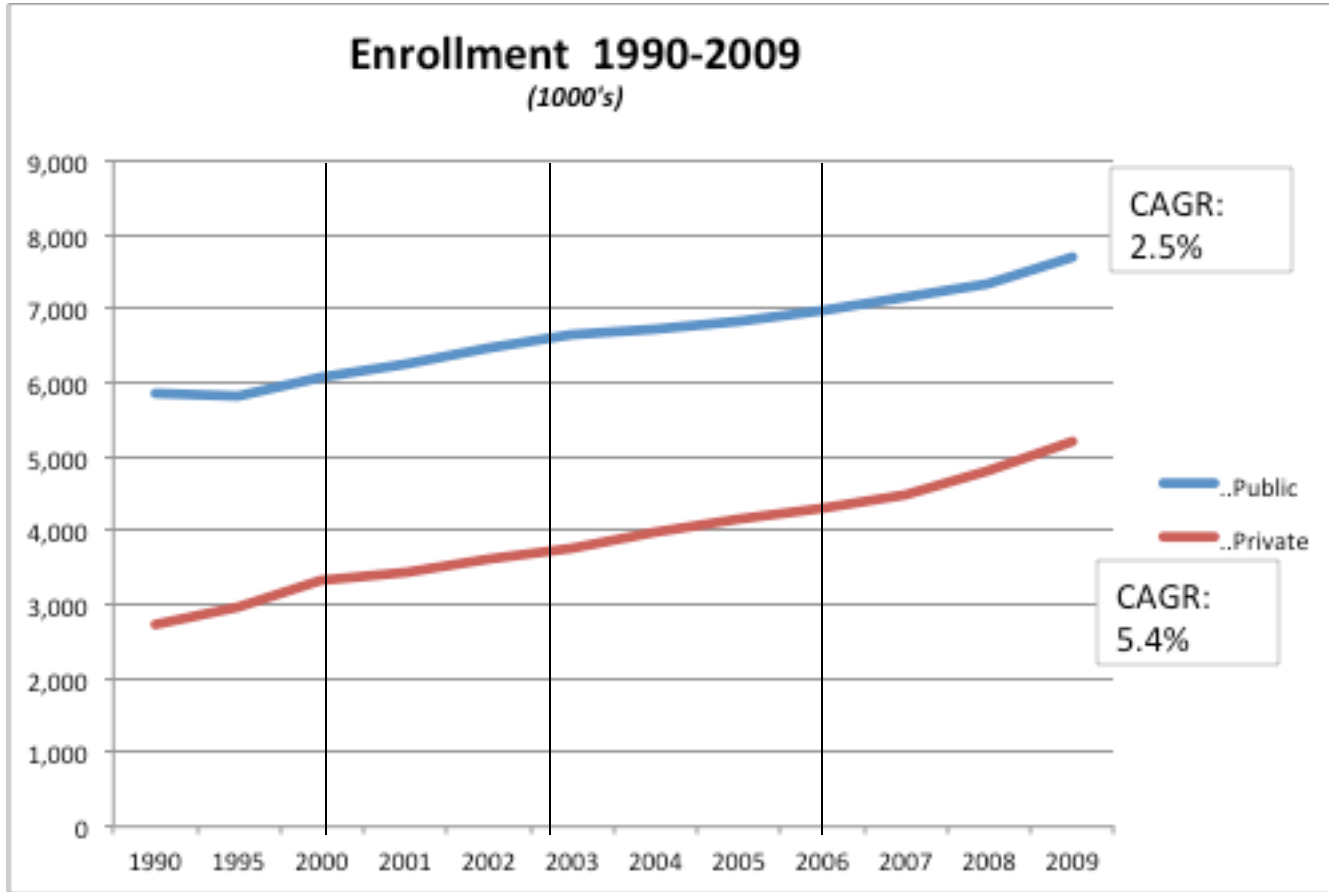
From a revenue and cost point of view, the margin pressure issue for Private Institutions is straight forward:

- Tuition and fee revenues grew at a CAGR of 4.6% (in CD\$) while costs have grown at a CAGR of 6.1%
- Approximately 70-80% of University costs are people related; without productivity gains, there will always be upward pressure on costs
- Technology and related costs have increased as schools struggle to stay current
 - Rapid technology innovation (and need to stay relevant to students) drives needs to upgrade before costs are “fully amortized”
- Growth in Physical plants generate additional maintenance and depreciation costs (Public institution depreciation costs have grown 58% since 2005)

of Private institutions grew at more than twice the Public institution rate and there are approximately 4x more Private institutions

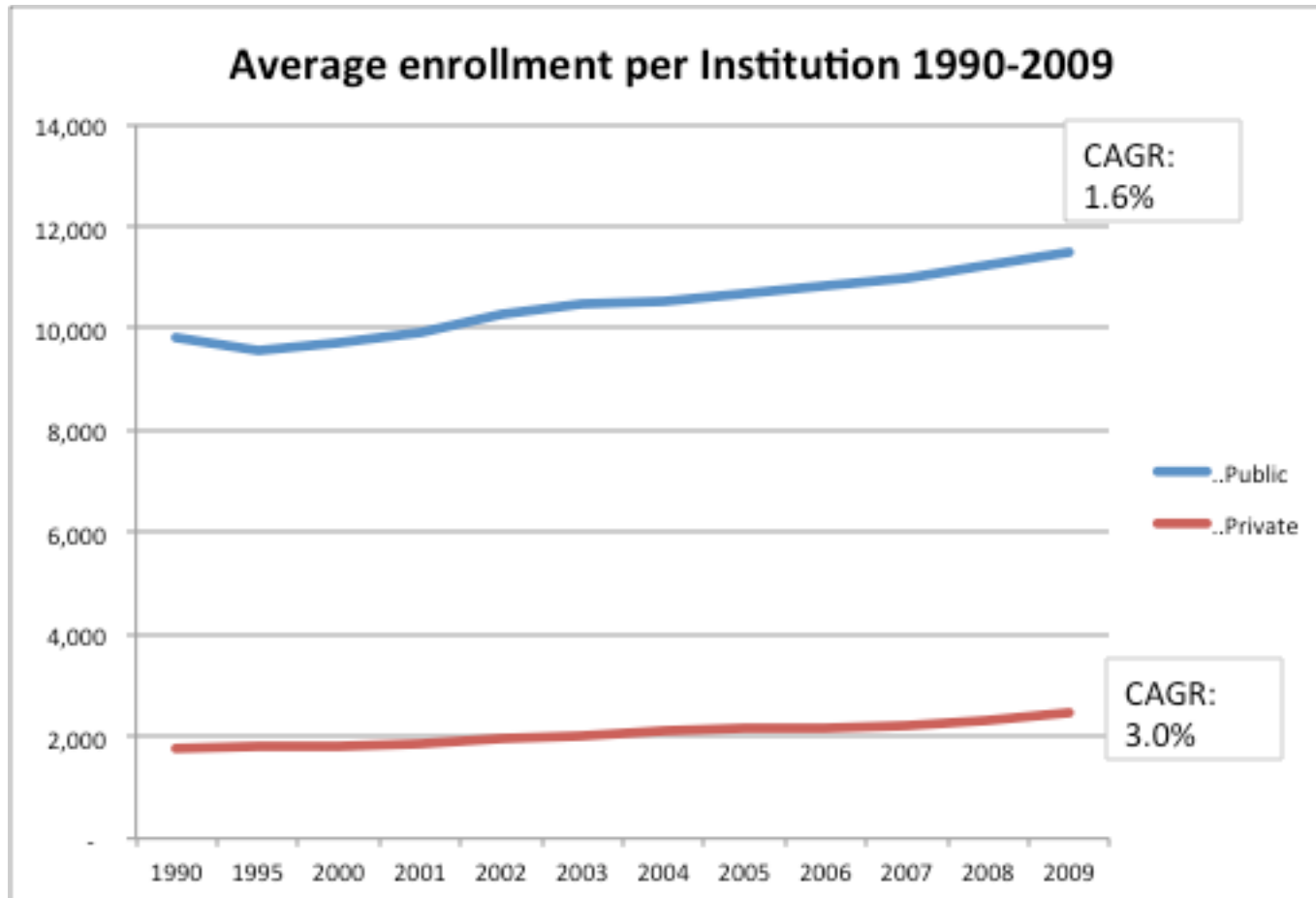


Private Institution Enrollment grew at 2x the rate of Public Institutions- “Four Year”

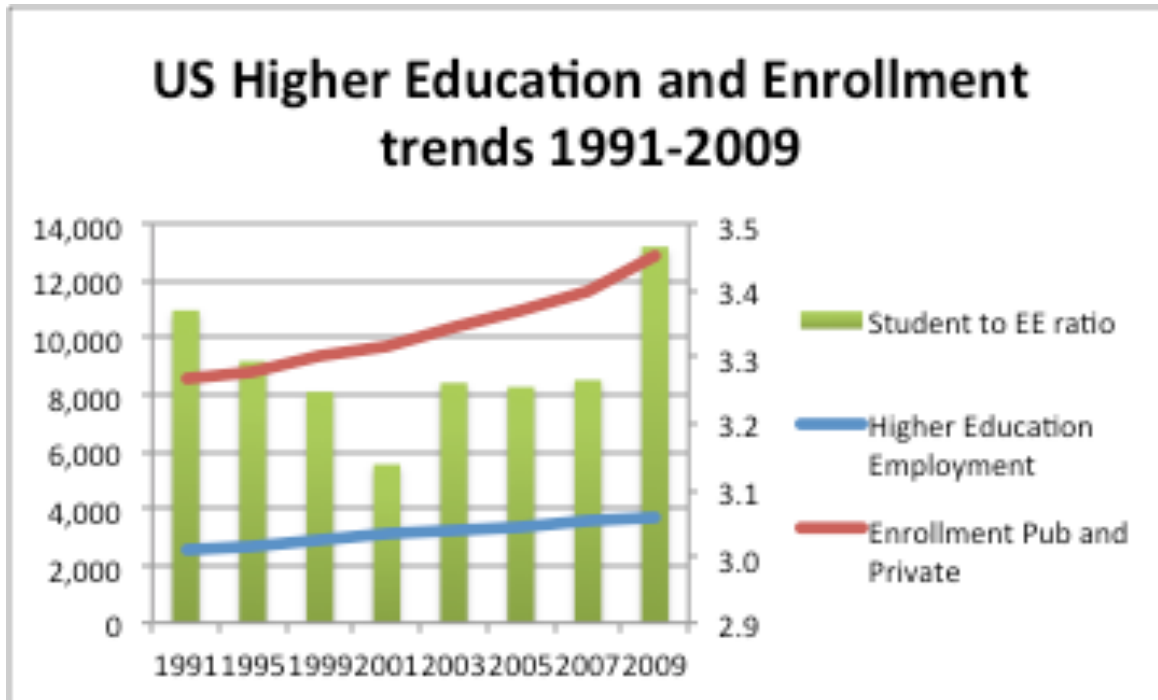


Private institutions represent 75% of # of institutions and 40% of enrolled students

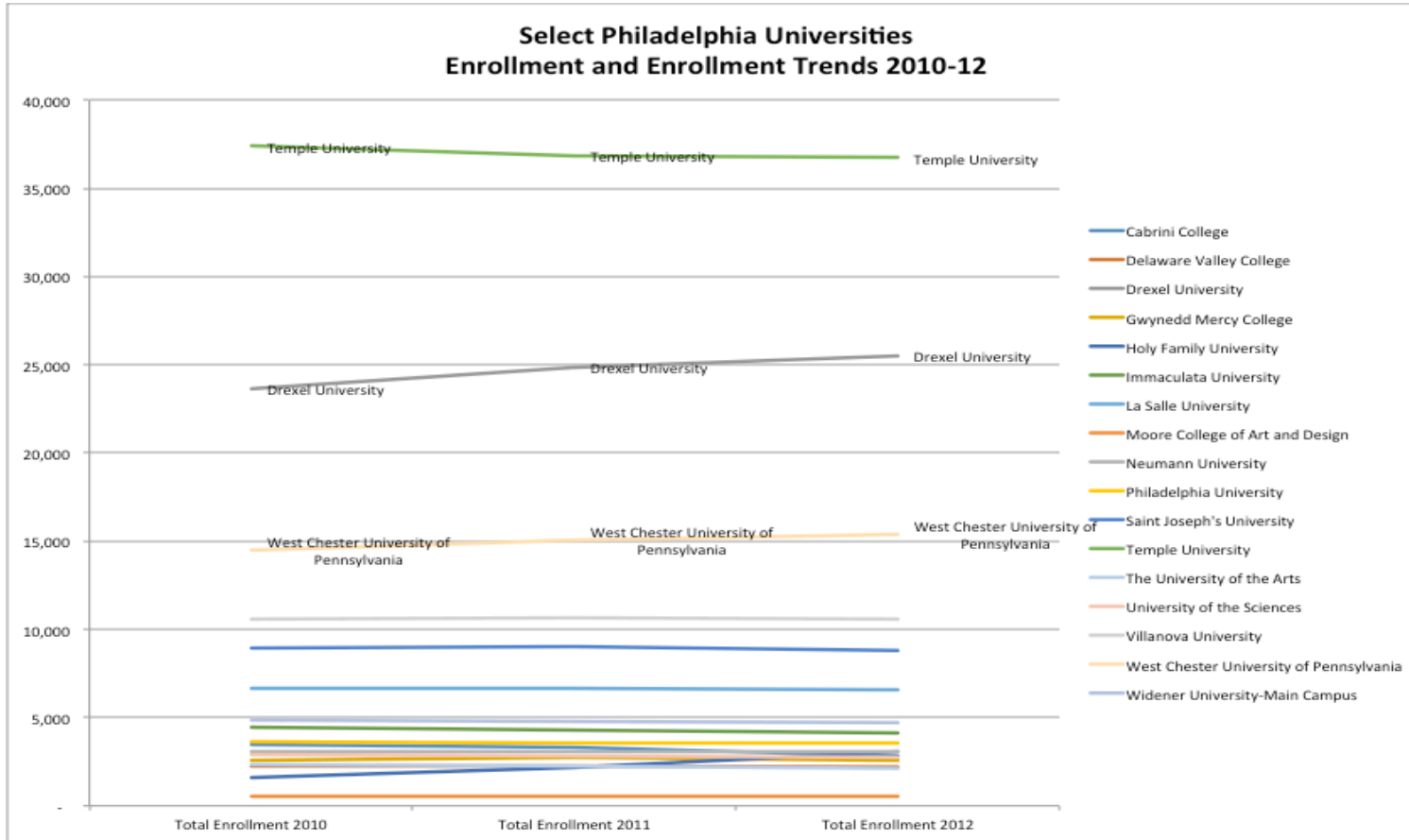
While average enrollment per institution is consistent with other growth rates, Public institutions enjoy approximately 4.5x scale opportunity



Paradoxically, Higher Education has not been able to take advantage of Learning/Experience curve phenomena enjoyed by other industries and create scale advantage



While the Philadelphia market has a high concentration of Universities, they are bigger than average, but growth is stagnant



Public and Private reveals different expenditure patterns, per student cost structure and expenditure growth

	Public Four Year Institutions Constant \$ in 000's		Private Four Year Institutions		Public Four Year Institutions Comon Size Analysis			
	2005-06	2011-12	2005-06	2011-12	2005-06	2011-12	2005-06	2011-12
Instruction	\$47,286,043	\$62,238,557	\$38,249,125	\$52,010,324	28%	28%	38%	39%
Research	\$23,031,885	\$29,635,707	\$13,241,769	\$17,429,483	14%	14%	13%	13%
Public service	\$9,054,397	\$11,184,077	\$1,931,804	\$2,332,440	5%	5%	2%	2%
Academic support	\$12,290,114	\$16,652,094	\$10,177,381	\$14,135,313	7%	8%	10%	10%
Student services	\$6,906,675	\$9,634,329	\$8,894,330	\$12,796,288	4%	4%	9%	10%
Institutional Support	\$50,913,575	\$70,235,933	\$15,524,004	\$21,003,182	30%	32%	16%	16%
Auxiliary Enterprises	\$18,120,806	\$19,819,696	\$11,696,510	\$14,924,473	11%	9%	12%	11%
Total	\$167,603,495	\$219,400,394	\$99,714,923	\$134,631,503	100%	100%	100%	100%

Compound Annual Growth Rate (CAGR)

Instruction	4.6%	5.0%
Research	4.6%	5.2%
Public service	3.7%	2.6%
Academic support	4.9%	5.6%
Student services	5.5%	6.2%
Institutional Support	5.5%	4.9%
Auxiliary Enterprises	4.3%	3.9%
Total	4.9%	5.0%

Per Student	\$33,415	33,128	82,522	86,421
CAGR 2005-12		-0.3%		1.1%

Constant dollar costs increases are substantially above inflation

But- Public Institutions have sizeable cost advantage per student- because of scale economy

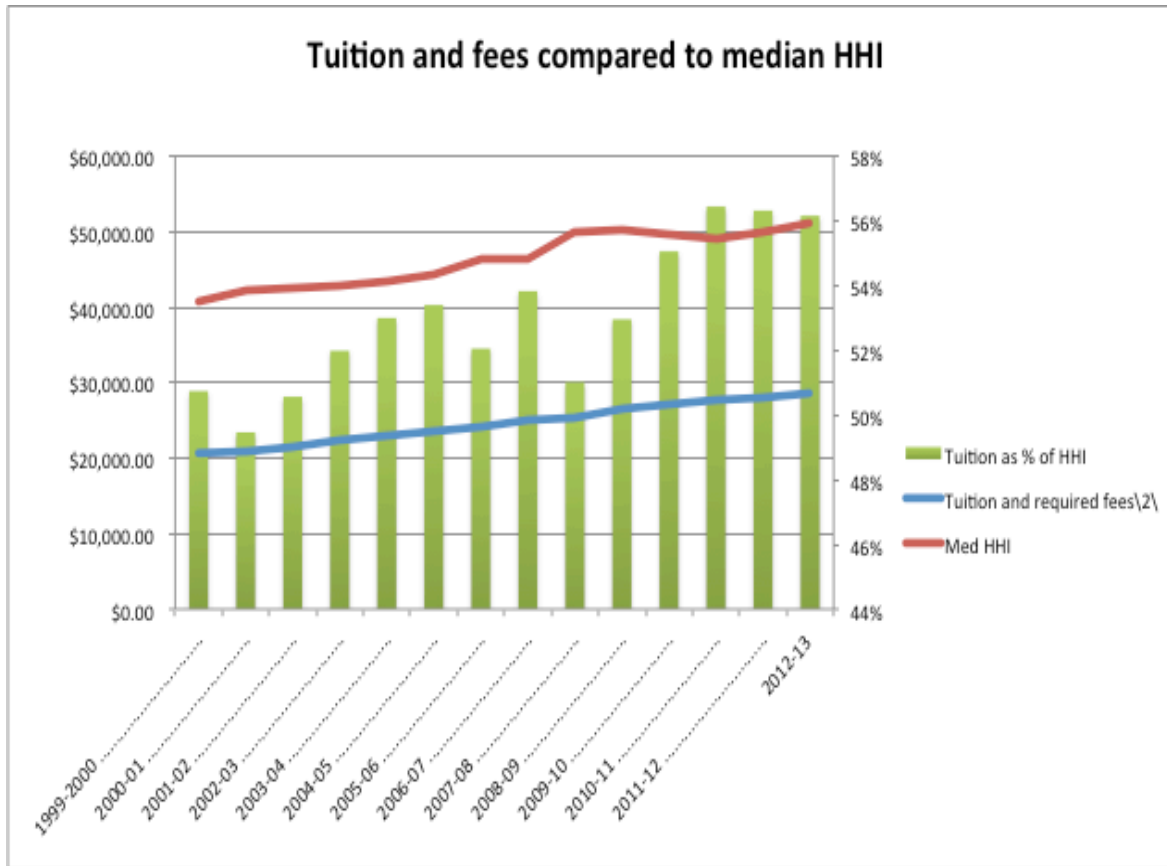


While public individual tuition and fees have grown at a faster pace than privates; the cost is still less than 1/3 of private education

Average Tuition and Required Fees - Constant Dollars			
	1999-2000	2012-13	CAGR
Private	20,678	28,746	2.7%
Public	4,576	8,070	4.6%
Public % of Private	22%	28%	

- As public entities endure additional pressure from government, will they sharpen their competitive edges? They have plenty of “negotiating room” on price
- Impact of Temple and West Chester in PHL market?
- Impact of PSU attempting to make their local campuses more competitive? In light of the other changes
- Note that tuition increases outpace inflation

Pressure on pricing extends beyond government interventions



Some other Industry observations

	Triggers	Other Contributing factors
Banking	<ul style="list-style-type: none"> • Interstate Banking allowed • Increased regulation and Prohibitions 	<ul style="list-style-type: none"> • Fewer “buying points” • Informed Customers • New forms of investment competition
Airlines	<ul style="list-style-type: none"> • Deregulation • New Competitors • Capital intensity 	<ul style="list-style-type: none"> • Cost structure makes service innovation difficult • Customer knowledge
Pharmaceuticals	<ul style="list-style-type: none"> • Gov focus on affordability • Government regulation • Bio Technology 	<ul style="list-style-type: none"> • Investment to bring drugs to market • Limited access to direct customers • Know how
Health Care	<ul style="list-style-type: none"> • Clinton era Health Care focus • Medicare/Medicaid pricing • Increased payor power 	<ul style="list-style-type: none"> • High labor intensity; slow to adopt changes • Lack of health system efficacy • Tort issues drive costs
Retail	<ul style="list-style-type: none"> • Internet 	<ul style="list-style-type: none"> • Customer time • General economic malaise
Wholesale Distribution	<ul style="list-style-type: none"> • Generational issues • Shift to “supply chain” mentality • Speed/velocity 	<ul style="list-style-type: none"> • Internet • Scale • Cost to “keep up”

I think we need to focus on practical and meaningful solutions— not problem solving...

