Consolidation Or Closure: The Future Of U.S. Higher Education?

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Key Takeaways

- Consolidations and closures will continue in U.S. higher education
- Closures will outpace M&A, though largely outside of our rated universe
- The Northeast and Midwest may see more consolidations and closures due to unfavorable demographic trends as well as competition
- Small private colleges may be prime candidates for M&A as well as closures

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Their long tenure demonstrates that many U.S. universities and colleges have evolved within changing economic and sector dynamics. However, S&P Global Ratings believes that the higher education industry has reached a critical juncture with decreasing financial support (as evidenced by declining state appropriations as a percentage of public university operating budgets), increasing student debt, and rising skepticism about the value of a four-year college degree.

With many colleges and universities facing financial stress and enrollment pressure, there is increasing discussion around mergers and partnerships, as well as closures, in the sector. In our opinion, successful partnerships allow for scale, revenue or geographic diversity (or both), and at times capital avoidance, but effecting these relationships seems to bring its own challenges. While other industries, such as health care, might regularly merge or make acquisitions, higher education's distinctions, including long-standing brand identity and loyal alumni, have made these types of transactions less common. However, there have still been many successful consolidations over time. Examples include Case Institute of Technology and Western Reserve University forming Case Western Reserve University, and the Carnegie Institute of Technology and Mellon Institute of Industrial Research forming Carnegie Mellon University. Both of these mergers occurred in 1967, resulting in prestigious institutions.

In our opinion, consolidations and closures in higher education will continue, and at a higher rate than in recent years. Small and private colleges, and regions with projected high school graduate declines and significant competition, such as the Northeast and the Midwest, may see more of this activity. Also, we anticipate that closures could be more prevalent than mergers in the sector and that these will occur largely outside of our rated universe.

Challenges For The Higher Education Sector

The higher education landscape is swiftly evolving. The sector is facing unprecedented challenges from demographic trends, mounting enrollment and financial pressures, a growing disparity between student expectations and willingness to pay, and increasing questions about the value of its offerings. We believe some of these issues stem from the revolution of technology and the raised expectation for higher education, which have intensified competition among institutions to invest in human capital as well as in facilities to transform the way they provide their services. Other pressures arise from unfavorable demographic trends that are projected to continue in various regions across the country.

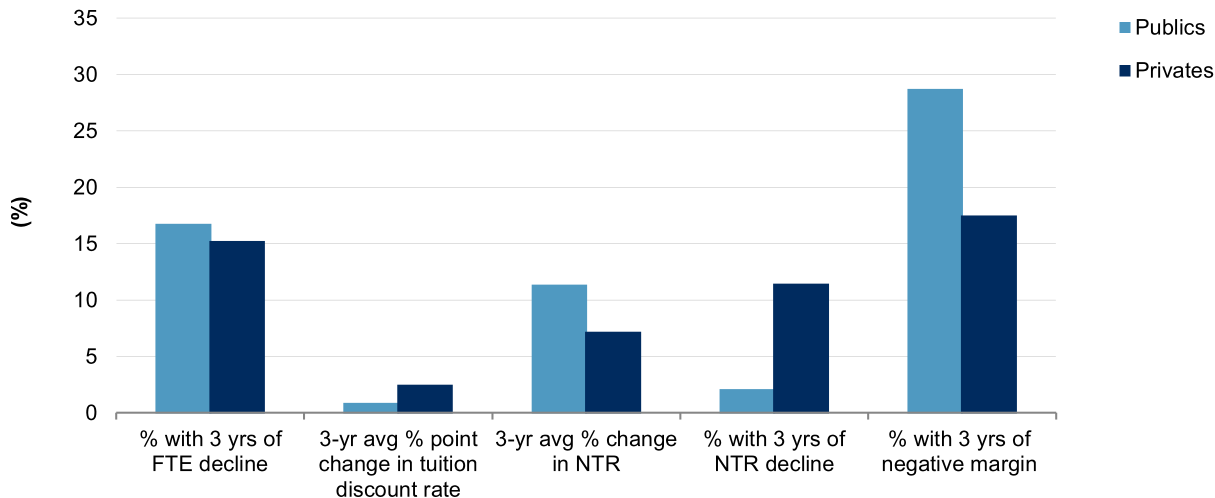
As noted in our "Global Not-For-Profit Higher Education 2019 Sector Outlook: Credit Pressures Proliferate," published Jan. 24, 2019, on RatingsDirect, our rating actions on U.S. institutions have skewed generally more negative than positive since 2012. In 2018, the downgrade-to-upgrade ratio reached a five-year record high of 6.7 to 1, which is a general reflection of the rising pressure facing the sector. For the purpose of this study, we analyzed the recent performance of 414 public and private colleges and universities that we rate (150 public and 264 private), which represent the vast majority of our rated universe. We noticed the following trends:

Public institutions demonstrate more flexibility

Seventeen percent of the public institutions and 15% of the private institutions in our sample experienced three consecutive years of full-time-equivalent (FTE) decline during fiscal 2015 to 2017 (see chart 1). We believe the decline was due to unfavorable demographic trends in certain regions, a strong economy attracting potential students to enter the job market, and the increased online and distance learning options (many of which are for-profit). In contrast, only 2% of the public universities, as compared with 11% of the private institutions, saw three years of net tuition revenue (NTR) decline during the same period. On average, the public schools saw NTR growth of 11%, compared with only 7% growth for the private schools, from fiscal 2014 to 2017, and the public schools managed a more modest increase (0.8%) in tuition discount rate compared with the private schools (2.4%). More recently, in fiscal 2017, only 6% of the public institutions saw more than a 5% FTE decline, while 11% of the private institutions experienced the same change.

We believe these varying trends in enrollment and NTR reflect the pricing differential between public and private schools. Public institutions generally have more revenue diversity and less reliance on tuition revenue, which affords them more flexibility in tweaking their tuition strategy. In our opinion, the trends also implicate the reality that the traditional model of raising gross tuition every year might not be sustainable, especially for the higher-priced private institutions without a strong brand.

Chart 1



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Consistent with our 2019 sector outlook, we expect demand pressure to continue in the near term, given the declines in high school graduating classes in certain states. We've already seen significant declines in the Northeast and Midwest, which are projected to stabilize a bit over time, but not increase. Compounding the issue, a decline in new international students emerged in fall 2016, followed by another decline averaging 7% in fall 2017; early indications show that international enrollment was down again in fall 2018. Looking forward, we expect many colleges and universities will carefully manage their recruitment process and tuition strategies to expand geographic outreach and attract students from shrinking prospective pools. We also believe many schools will continue to explore innovative ways to diversify revenue sources and reduce reliance on student-generated revenues.

Trends diverging across regions

The Midwest experienced the most enrollment pressure, which is in line with the negative demographic and outmigration trends in the region. During fiscal 2015 to fiscal 2017, 29% of the public institutions and 28% of the private institutions in the region experienced three consecutive years of FTE decline (see chart 2). These decreases averaged a cumulative 9% for the public schools and 12% for the private schools. In comparison, only 10% of the public institutions and 13% of the private institutions in the other regions experienced three consecutive years of FTE decline during the same period.

Despite the demand pressure, the private colleges and universities in the Midwest seem to demonstrate operational resilience during enrollment fluctuations, as only 9% of the institutions in this region experienced three years of negative operating margin (the lowest of all regions). On the other end of the spectrum, significantly higher percentages of private institutions in the Northeast and Southeast regions exhibited three years of negative operating margin (19% in the Northeast and 22% in the Southeast, respectively), as reflected in chart 3.

Chart 2

% of Populations Experiencing Three Years of FTE Decline
(Comparison across regions)

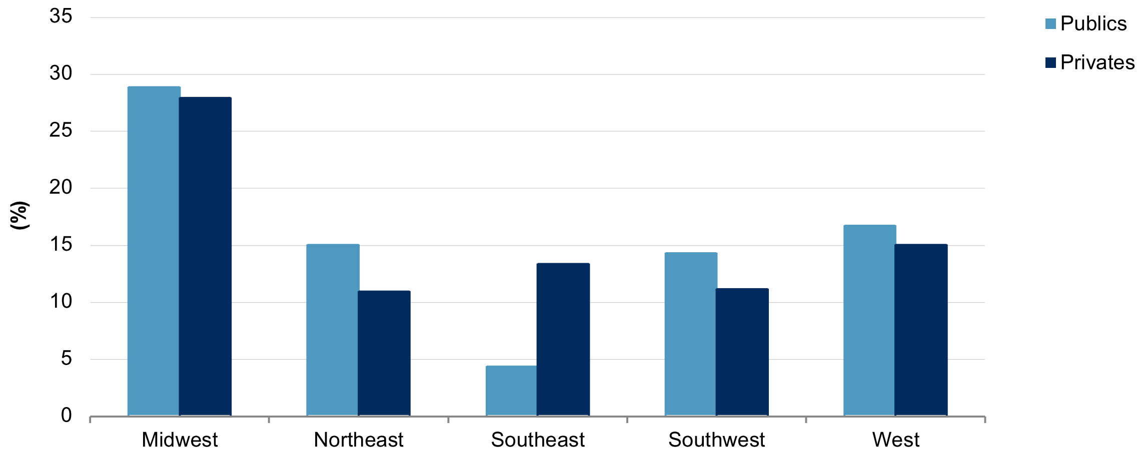

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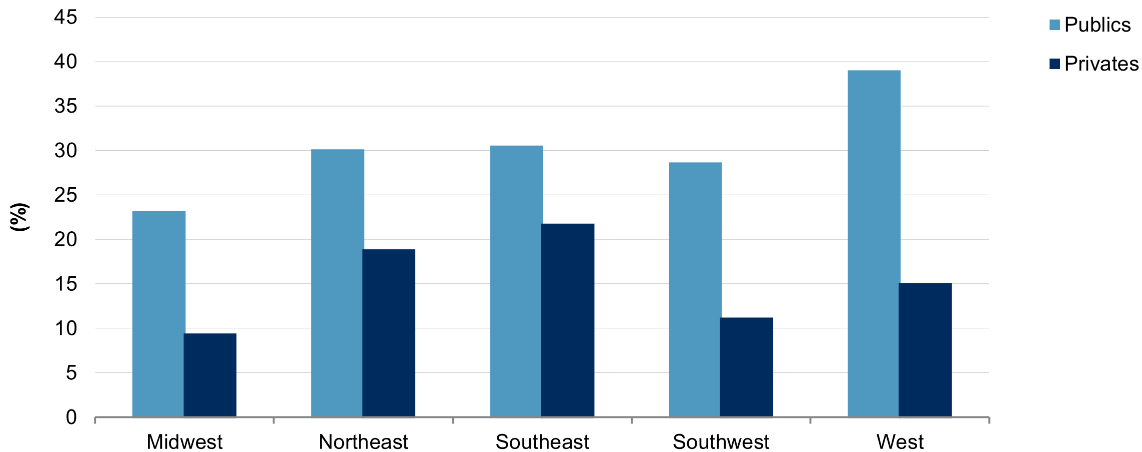
Chart 3

% of Populations Experiencing Three Years of Negative Margin
(Comparison across regions)



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We believe these trends reflect the intense competition in the saturated Northeast market, where schools had to boost financial aid and operational spending to attract students. They also reflect the somewhat-limited operational flexibility of the institutions in this region, which might be partially attributable to the higher living and labor costs. With regard to the Southeast, we recognize that a broad array of states exhibiting differing trends are located in this region. In general, though, we believe the operational pressure seen in the Southeast, which includes many of the nation's lowest-income-level states, could be partially due to the higher tuition discounts and slower growth in tuition levels, as students in these areas may have a higher need for financial support. However, we want to note that although the Northeast and Southeast had the highest percentage of private institutions posting three years of negative margins, these regions' average operating margins in fiscal 2017 were stronger than the Midwest's. In our opinion, these stronger average margins reflect that while a larger portion of the schools in these two regions have been operationally pressured for multiple years, the presence in these regions of many prestigious and highly selective institutions, which continue to enjoy healthy demand and operational trends, offset the weaker performance of the remaining schools.

Regional Breakdown

Region	States
Midwest	Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, South Dakota, Ohio, and Wisconsin
Northeast	Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, and Vermont
Southeast	Alabama, Arkansas, Delaware, District of Columbia, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, and West Virginia
Southwest	Arizona, New Mexico, Oklahoma, and Texas
West	Alaska, California, Colorado, Hawaii, Idaho, Montana, Nevada, Oregon, Utah, Washington, and Wyoming

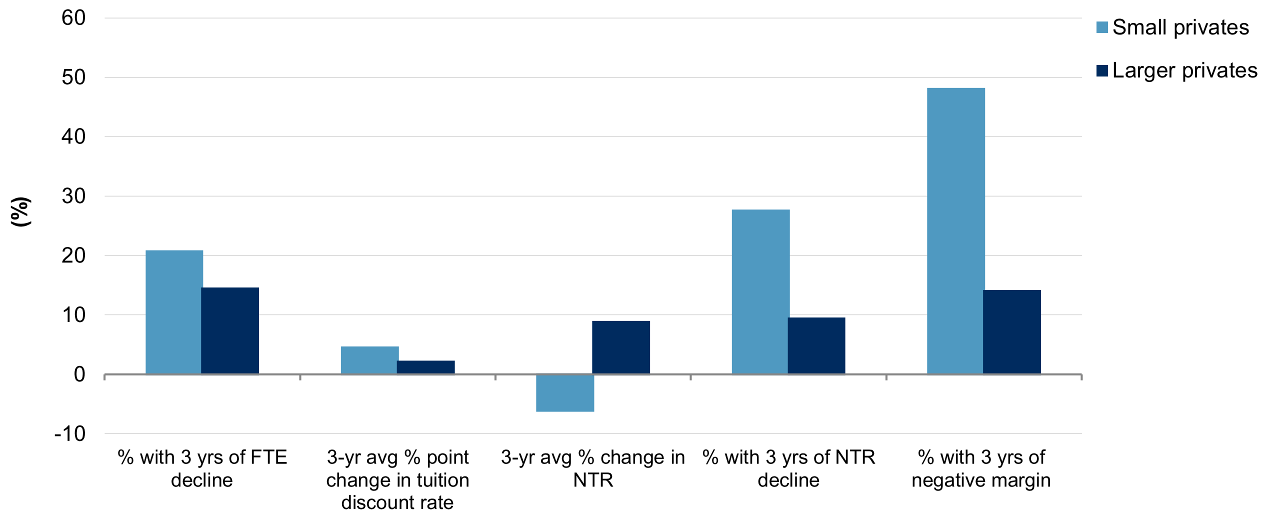
For the purpose of our analysis.

Small private institutions face significant pressure on various fronts

As stated in our 2019 sector outlook, smaller schools (fewer than 1,400 FTEs) are facing more significant enrollment declines and are having more difficulty managing their tuition discount strategy than are larger schools. Twenty-one percent of the small private schools experienced three consecutive years of FTE decline during fiscals 2015 to 2017, well exceeding the 14% of larger schools experiencing the same change (see chart 4).

During the same period, 28% of the small schools experienced three consecutive years of NTR decline, more than triple the percentage (9%) of the larger schools. Along those lines, small schools had an average tuition discount rate of 49% in fiscal 2017, compared with 36% for the larger schools, and the nominal increase in the tuition discount rate of the small schools (4.5%) more than doubled that of the larger schools (2.1%) from fiscal 2014 to fiscal 2017. From fiscal 2014 to fiscal 2017, the NTR of the small schools declined by 6% on average, in contrast with an average 9% increase for the larger schools. Moreover, 72% of the small schools posted a negative margin in fiscal 2017, and almost half of the small schools had three consecutive years of negative margin from fiscal 2015 to fiscal 2017.

Chart 4



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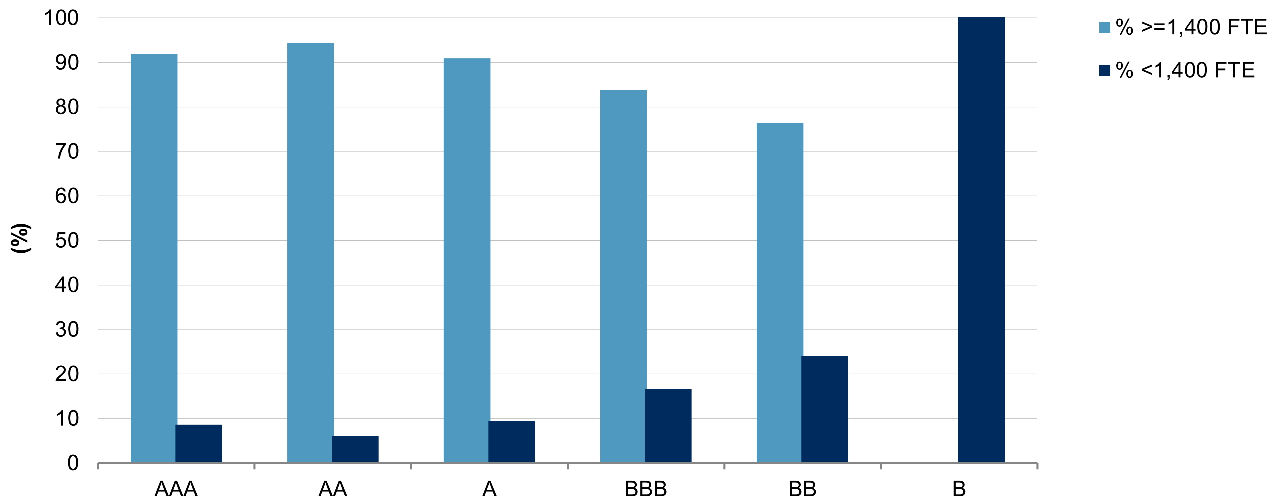
See chart 5 for the rating distribution of the private colleges and universities we rate. Of these, approximately 12.5% (35 institutions) have fewer than 1,400 FTEs. We note that the ratings on the small private institutions are concentrated in the lower categories of the rating spectrum, with 60% of them rated in the 'BBB', 'BB', or 'B' categories, which reflect their generally weaker credit quality (with a few stronger exceptions). Both of the institutions currently rated in the 'B' category--one of which is Sweet Briar College--have enrollments of fewer than 1,400 FTEs. We note that Sweet Briar announced its intent to close in 2015 after a precipitous decline in enrollment but, with the financial support of its alumni, remains open.

In our opinion, although many of the small private institutions may continue to capitalize on their niche programs to attract students, they are currently facing significant enrollment pressure because they typically lack a broad range of program offerings, a strong brand name recognition, or a national reach. Furthermore, small institutions tend to have less financial flexibility than do larger institutions, in our view, as many of them have limited room to further increase their tuition discount from an already elevated level. Also, they don't typically have a sizable endowment or other nonstudent-generated revenue sources for operating support during a downturn, and they may also lack the economies of scale for effective cost containment.

Chart 5



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Benefits And Limitations Of M&A

While we believe that the not-for-profit higher education industry is resilient and that many schools will continue to thrive and evolve, there is increasing potential for mergers, acquisitions, and closures among the weaker, or the less financially resilient, colleges. Given the aforementioned challenges, a merger, partnership, or acquisition between higher education institutions could appear appealing. In fact, the benefits and combinations of a potential merger are many: a larger enrollment base, better diversified programs (expanded and complementary offerings, online expansion, etc.), improved facilities, larger geographic reach, and improved efficiencies through economies of scale with administrative, operational, and IT-related functions.

A number of recent examples highlight the varied strategies being employed today. One widely publicized transaction was Purdue University's (a public nonprofit university) acquisition of Kaplan University (a private for-profit institution) as a means of expanding Purdue's online and adult student offerings. Just recently, National University (a private nonprofit university) followed a similar model and acquired Northcentral University (a private for-profit institution), which specializes in master's and doctoral-level online education. In the Northeast, after merger talks between Mount Ida College and Lasell College (both private colleges) failed, Mount Ida College closed, and the campus was subsequently acquired by the University of Massachusetts (UMass, a large public research university system). UMass intended to capitalize on the location of Mount Ida's campus to expand internship and career opportunities for UMass students and to boost university-industry partnership in research and development in the greater Boston area. Now a few years old, the 2015 merger of Berklee College of Music and Boston Conservatory seems to be a successful example of two smaller schools integrating to make use of their adjacent locations and complement each other in terms of program offerings. On the public side, the University System of Georgia (USG) has consolidated its campuses to 26 from 35 through a 2011 initiative with the goal

of "improving outcomes for students and better serving the education and workforce needs of their respective regions," according to a USG press release.

We believe small private liberal arts institutions, with little brand name recognition or reputation and, further, limited geographic reach, are most susceptible to being acquired (or even to closing). According to a 2018 survey by Inside Higher Ed, "24% of private baccalaureate college financial officers say leaders at their college have had 'serious' discussions about a merger, more than any other sector and almost five times more than answered that way a year ago (5%)." Since 2016, more than 30 private not-for-profit schools have closed, most of which were located in the Northeast and the Midwest, and enrolled fewer than 1,000 students. As we look at each situation, we are able to determine key stress indicators such as those outlined above--but we did not rate any of these schools.

In general, we believe institutions located in the Northeast or the Midwest are more inclined to consider some sort of partnership or acquisition, given a declining number of high school students, the large number of higher education institutions in these saturated markets, and the resulting strong competition to fill seats. Furthermore, this competition has led to rising tuition discount rates, which, coupled with rising operating costs, have pressured operating margins. As the institutions in the other regions expand their geographic penetration, especially when many of them try to recruit from Texas, Georgia, Florida, and California, we expect the competition to only intensify. Since these small institutions are typically highly dependent on tuition revenue, attracting and retaining students are key to remaining sustainable over the longer term. Considering the limited resources and modest endowments that many smaller institutions may have, a merger or acquisition may very well make sense.

While the benefits of a merger may seem obvious, we believe the challenges that accompany these transactions may overshadow the potential benefits, therefore restricting the number of mergers that actually take place. Because of this, we anticipate that M&A will continue, though at a limited rate on a nominal basis, when considering the overall higher education sector. While colleges and universities may engage in multiple rounds of discussions or varying levels of partnership, executing a successful merger or acquisition is difficult. Perhaps the biggest challenge in a potential merger is aligning the interests of boards, senior management, restricted funds, powerful faculty groups, vocal alumni, and students from each institution. Every school has a unique brand, culture, mission, and history--and can be reluctant to give these up.

Effect On Credit Ratings

To date, the merger and closure activity has not materially affected S&P Global Ratings' higher education credit ratings. None of our rated institutions have closed, and mergers to date within our rated universe have been credit neutral to positive. We believe that we will see more transactions involving the acquisition of smaller universities, which may not result in a meaningfully different enterprise or financial profile from that of the acquiring entity. In fact, many of these partnerships and closures, particularly those in the form of consolidations in larger systems, may allow for maintenance of ratings with more sustainable operating profiles rather than improvements to credit ratings.

A potential side effect of some of the closures could be improved demand, matriculation, and fundraising for the remaining schools in the short term, as they may absorb some of the transfer students or academic programs from a closed competitor. However, we believe the potential positive impact on demand is likely to be minimal over the long run if the remaining schools were only trying to tap the same student pool of their closed competitors without adapting to larger industry trends. This is particularly true for small schools with limited geographic and

programmatic diversity.

Looking Forward

As mentioned above, while there have been institutions that have recently been acquired or closed as a result of industry pressures, they have been less selective or well-known and have not been rated by S&P Global Ratings, as the institutions we rate tend to have better access to capital markets due to stronger credit quality. We expect to see this trend of consolidation and closures continue and to be widely publicized. However, we anticipate that the number of closures could increase at a higher rate than that of M&A, and will be largely outside of our rated universe.

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