To: The Cooper Union - Board of Trustees

From: Michael Borkowsky

Subject: Free Education Committee Report – January 15, 2018

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For five years Cooper Union has been roiled by the issue of charging tuition—the traumatic break with a tradition and an ethos of being "free" for more than 150 years.

The controversy and the debates have raged throughout the community. The decision led to a lawsuit and to the intervention of the New York Attorney General. It damaged careers and fractured friendships. And now, we have for the first time in these past five years, a recommendation from a committee of the Board of Trustees on how to get back to Cooper Union's historical benefit of full-scholarships for all admitted students.

The Free Education Committee report does have an end to tuition in sight, but it is ten years away. The report has been driven by the FEC, the Finance Committee of the board and the Financial Monitor. It applies a very complicated series of financial "metrics" used by financial consultants to assess the financial health of an institution. There is very little discussion of the risk and the damage being done to the reputation of Cooper Union every day that goes by and separates it from its heritage and its history. It is essential to have Cooper Union operating in a financially sustainable way. It is equally essential that it is doing so under its banner of full scholarships for all students qualified to attend. That is what made Cooper Union unique. That is what made Cooper Union special.

In order to overcome that loss and restore Cooper Union's unique position and reputation, it was clear that the financial structure, mismanaged for more than twenty years, had to be put in order. And the effort to do that was triggered by the directive from the Attorney General's office. The possibility for remedying the long-standing crisis on a relatively short timetable was greatly encouraged by a major increase in revenues and a conscientious effort on the part of the school's new leadership to reduce administrative costs. The annual rental revenue from the Chrysler Building land lease increased by almost $25 million beginning this year. And 9 million dollars of cost reductions have been identified—for a total of $34 million in additional annual cash flow. After twenty-five years of operating deficits that drained the school's endowment, Cooper Union will be operating at a surplus. Next year, the projected surplus is $14 million after paying down the MetLife and bridge loan debt and covering a significant amount of neglected operating needs.. For the next ten years, the projected average annual surplus is $12 million.

There are certainly risks in the projections. The plan's metrics view the risks on annual revenues of about $85 to $108 million and annual expenses of $72 to $92 million. I am not certain whether they take into account that, unlike most other comparable institutions, a very large portion of Cooper Union income and expense is fixed. The Chrysler Building lease and the debt service have no variability barring default. If reserves are being required to hedge those revenues and expenses, they may well be over-stated. The Chrysler Building asset which will about return 9% in revenue for the next ten years is excluded from certain reserve calculations because it is not a liquid asset. While I understand the rationale, I believe it inflates the reserve requirement unfairly.

The dramatic changes in the school's financial structure through the increased Chrysler Building revenue and reduced expenses fueled great optimism. In fact, it evoked a thought process that it might be sufficient to offset the income from tuition. The FEC plan says this cannot be done until 2029. That is a long period of time when the school's reputation is at stake and declining every year.

That concern triggered the question, "How important is tuition to creating a more financially sustainable Cooper Union?" The FEC plan projects revenues of $940 million over the next ten years. Of that total, 5.6% comes from net undergraduate tuition. Only 5.6% over the ten-year period. And that small proportion becomes progressively even smaller as tuition is gradually phased out. Over the same ten-year period, the plan generates $124 million in surpluses after meeting operating expenses, paying down the debt and funding deferred expenses. Without undergraduate tuition, that surplus would be $72 million. In effect, the plan contends that we must live with tuition and the damage it will continue to do to our reputation for ten more years. That is because, the 5.6% of revenues that tuition provides is essential and cannot be generated in any other way. And because we need to have $124 million in surpluses over the next ten years not $72 million so that we can cover risks to our projections, and, very importantly, meet a 4.0 CFI metric target.

So, I have gone ahead with the review and analysis of the reserve levels, the CFI, the risks and the priorities in the FEC plan. But I am left thinking, "Will the Cooper Union Board of Trustees in good conscience be willing to subject the leadership of the school and the entire Cooper Union community to ten more years of distraction from the educational mission, erosion of the goodwill toward what has been an educational treasure for a century and a half and prolong the debate and dissension over the need for tuition?" Or will it go back and reconsider the plan's level of reserves or find other ways to replace the sliver of tuition that is contributing in a minor way to the financing of the institution and in a major way to its potential decline.

I. OBJECTIVE

The objective of this document is to propose a discussion of alternative approaches to the Free Education Committee's plan to return Cooper Union to its long-time practice of awarding full-tuition scholarships to all admitted students. That a plan has been proposed is a major step forward. It contradicts the view of prior board leadership and many board members that the financial issues confronting the school were too daunting even to consider the elimination of tuition. But while the FEC report presents a plan to return to free in 2029, it is the opinion of many in the community that the urgency to accomplish that goal is not adequately addressed. When tuition was imposed four years ago it was to help offset chronic operating deficits. It is now contributing to annual operating surpluses. The perception is that the report has focused primarily on producing a plan which meets certain guidelines of financial stability and sustainability but is severely under-estimating the significant and cumulative risk to the school's reputation and quality.

I believe the time for getting back to free must be shortened. It can be done by:
-reevaluating the level of reserves essential to the plan,
-eliminating programs not critical to the return to free, and
-accelerating the implementation of additional revenue sources or cost reduction programs that have already been identified by the Free Education Committee.

I believe it is the fundamental responsibility of the board to focus all of the financial resources on an urgent return to free while maintaining a responsible level of financial reserves in order to insure that the goal is achieved.

II. CONSENT DECREE

The Consent Decree demanded that the board make a good faith effort to return to free while retaining enrollment levels of the three schools and the reputation and quality of the institution. The priority of the lawsuit which ultimately prompted the Consent Decree was to remedy the imposition of tuition and to restore the school's unique and long-standing heritage of awarding full-tuition scholarships to all admitted students. Therefore, a responsible financial plan and the use of resources must be built around that objective.

The Financial Monitor is required to offer experience and expertise in financial matters and oversee the board's actions to be certain that they are made in the best interest of Cooper Union and are consistent with the requirements of the Consent Decree. It is the board that is required to establish priorities and set the optimum balance between prudent financial management and protection of the reputation and quality of the school by an urgent, "time is of the essence" return to free.

III. RISKS

A. Reputation

While there are financial risks to the plan going forward, there are also significant risks to the reputation, quality and culture of the school that have already begun. Applications have declined in spite of the use of the common application form and increased international recruiting efforts. This has resulted in a lower level of selectivity, considered a prime measure of "reputation". Through most of its history, Cooper Union was rated as a highly selective school, often in the very top tier with the military academies and the best of the Ivy League. Between 2009-13 and 2014-17, the average percentage of applicants admitted across all three schools rose from 8% to 14%, a major decline in selectivity.

Yield, overall, has also declined significantly over the same time period, from 76% to 61%.

Those are dramatic declines in only four years. They are likely to accelerate over time. Decreased selectivity is particularly critical because it tends to discourage the best students from applying.

A ten-year delay also brings with it potentially major changes in the competitive environment. There is a growing level of concern about student debt as it has grown to more than one trillion dollars. There is a growing belief in the concept of free higher education and a growing number of "honors colleges" such as Macauley, part of CUNY, which promotes itself as a college "where students can graduate debt-free".

All of this points to the need to restore the full-scholarship at Cooper on an urgent basis. There are members of the Cooper Union community that have had extensive experience with branding that support the concern for the decline in reputation. There are, if necessary, research methodologies available to quantify the magnitude of that risk. But it is an accepted fact that high quality brand images if allowed to decline are extremely unlikely to be revived.

B. Financial

1. Operating Revenue

Cooper Union is in a unique position of having a large portion of its total revenue contractually fixed by real estate leases. I will discuss the risk of default on those leases, but absent default, there is little or no immediate risk to about $60 million or 70% of the $85 million in revenue. In assessing the necessary reserves required to cover potential risks in operating revenues then, it is at most $25 million in revenues that are subject to fluctuation, not $85 million. Reserves are needed to hedge primarily against shortfalls in fund-raising. If the fund-raising projections in the plan were missed by as much as 20%, for example, about $1 million annually in reserves would be needed to cover it in the initial years of the plan and as much as $3.5 million annually in FY2029.

2. <u>Real Estate Revenue</u>
Because the Chrysler Building is such a dominant part of Cooper Union's assets, a decline in the quality and desirability of the building or a significant general decline in the New York City real estate market would have major consequences. It could reduce the assessed value which would reduce the tax equivalency payments. It could also lead to a request for renegotiation of the lease terms or even a possible default on the lease. In that case the building would revert back to the school which could renegotiate the terms, find a new lessee or, possibly, try to sell the building. As has been often noted, the value of the land lease to another owner would be significantly lower than it is to Cooper because they would not get the tax equivalency revenue--currently $21 million per year. In the extreme, a loss of a major portion of the current $54 million in revenue would produce a catastrophic result for Cooper Union—one that could not be covered by the plan's reserves except for a short period of time during which a decision would have to be made on a major restructuring of the school if it could even survive.

*It should be noted that Tishman, Speyer is no longer the majority lessor. It has spun off 90% of the ownership of the lease to the Abu Dhabi Investment Council.

3. <u>Operating Expenses</u>
On the cost side, again Cooper is in the unique position of having a significant portion of its expenses fixed. Debt service requirements are fixed and represent about 25% of total expenses in the early years and almost 20% in the last years of the plan. So, it is operating expenses of $55 to $70 million that need to be "hedged" throughout the period until 2029. For example, the projections include annual increases of roughly 2% or 3%. Inflation could increase, unusual health insurance expenses could arise, many other potential one-time or short-term problems could occur. Higher inflation costs could be at least partially offset by higher tax equivalency payments and other increases in revenue. If operating expense increases doubled—to 5% or 6% per year, for example, it would add about $2 million to the annual operating budget in the early years and as much as $3-4 million per year, compounded, in later years.

III. RESERVES

In effect, then, the clear challenge is to provide an adequate level of financial reserves while insuring the urgency of returning to free. A reserve fund, i.e., a build-up in the endowment of $152 million has been reported as the minimum required level of reserves before the school can afford to eliminate tuition. This is based on a series of "metrics"--financial measurements used to produce an index called the "CFI". I have several issues with the application of the CFI to Cooper Union which are discussed in the Appendix. I believe it does not frame the real issue in the most cogent way. The creation of this $152 million reserve occurs by the accumulation of annual surpluses between FY2019 and FY2029 at an average of about $12 million per year.

The fundamental question is whether the need to generate that level of surplus every year is more critical than the need to restore free tuition at the earliest possible time. If so, it is essential to fill most or all of the gap in that surplus now being provided by tuition with alternative cost reduction or revenue-increasing programs. There is also the "last resort" of continuing to defer certain expenses if a short-term financial crisis does develop. The current plan calls for funding of post-retirement health care benefits and deferred maintenance. In the ideal world and with prudent financial management those expenses should be funded. But deferred expenses have the advantage of being deferrable, at least for a limited period of time. That makes them available to help get through short-term problems if doing so serves a more critical need.

Based on the risk analysis, it could be argued that a $12 million annual surplus is substantially more than necessary to cover operating risks in variable revenues and expenses. It would be adequate to cover a relatively modest downturn in the real estate revenues, if, for example, the Chrysler Building lease was renegotiated or reassigned. As noted, a drastic decrease in the Chrysler Building revenue could not begin to be covered other than for a short period of time by even the reserve levels in the plan.

Another issue that has been raised to justify the size of the proposed reserve and the use of "objective criteria" to evaluate the school's financial health is that Cooper Union found itself in this very difficult financial position because it lacked those objective measures. But the clear and simple explanation of Cooper's financial crisis is that it arose because of a sustained period in which the endowment was permitted to be drained of $200 million or more to cover operating deficits. That drain is what led to the Met Life loan and then the bridge loan. A reserve of $152 million would be suitable for another long, sustained period of annual operating deficits. But I expect that it would be safe to assume that it would never be allowed to happen again.

IV. ALTERNATIVE APPROACH

I understand that there is a need for conservatism after having gone through the trauma of the past several years. But the current plan appears to accept the risk that fourteen years of abandonment of the fundamental essence of Cooper Union's heritage and strength will not accelerate the decline that evidence indicates has already taken place and make that reputation irretrievable.

The simplest way to consider an alternative approach is to remove undergraduate tuition revenue from the FEC plan. As has been pointed out, undergraduate tuition provides only 5.6% of total revenues and about 40% of the total surplus during the ten-year period. If it were eliminated and all of the other projections of revenue and expenses remained the same, the plan would continue to produce $4-$6 million in surpluses every year while covering all principal and interest payments on the Met Life and bridge loans, reserves for post-retirement health insurance and additional capital expenditures for deferred maintenance. There is an argument to be made that absent a major problem with the Chrysler Building in the next several years, this would be adequate reserves against operating revenue shortfalls or underestimated expense projections.

If it is judged that these more limited annual reserves do not give enough confidence that we will not begin to incur continual operating deficits, the board must find other ways to cover the relatively small portion of the reserves covered by tuition in order to shorten the time in which tuition is needed or eliminate its need completely. The FEC plan outlines several programs that have been considered but relegated to the "bullpen" because they did not engender unanimous support for their implementation. They include accelerating a complete move out of 30 Cooper Square, reconfiguring the library and converting a portion to retail space, selling the Stuyvesant Fish house, selling the dorm, etc. It is not my place to offer opinions on these individual ideas which have been thoroughly reviewed by the FEC, but it is my position that none of these ideas are more critical than a return to free for preserving the reputation of Cooper Union.

To take it a step further, the plan also continues to include programs that, while worthwhile, are not essential now because they require funding which further delays the return to free. There needs to be a more single-minded approach to fulfilling that objective. Once Cooper Union is back to free there should continue to be annual surpluses which would allow support for these programs. The challenge to the board is to reconsider the level of reserves that is absolutely required with recognition of the critical impact that delaying the return to free will have on Cooper Union's reputation. And to meet that required level, there needs to be a concerted effort to revisit all of the potential areas of cost reduction and revenue generation not included in the plan and build an implementation program that will shrink the timetable for the elimination of tuition to its shortest possible length.

In the longer term, as long as the Chrysler Building retains its level of contribution to Cooper Union revenues, the financial position of the school strengthens significantly. In 2028, the rental revenue will increase by another $8.5 million to $41 million. In 2038, it is contracted to increase by $14 million to $55 million. By 2039, both the Met Life loan and the bridge loan will have been repaid and the school would have very large annual surpluses. The singular, major long-term risk to the school is the continuing viability of the Chrysler Building. That issue should be part of immediate and on-going discussions by the board.

For Cooper Union to remain relevant and important as an academic institution that will warrant support from its alumni, from industry, from foundations and from the philanthropic community, it must not only achieve financial sustainability and maintain or improve its academic quality but restore its reputation. It is Cooper Union's unique reputation that has set it apart from all other colleges. The risk of its loss is likely to be the greatest risk of all.

APPENDIX

A. CFI

There are two issues that I see with the CFI as it has been applied to Cooper. One is whether it is reasonable to exclude the value of the Chrysler Building completely from certain measurements which go into computing the CFI. The other is using the total revenue budget and total expense budget for computation when significant portions of both are contractually fixed and therefore not subject realistically to conventional financial uncertainty.

The Chrysler Building has been excluded because it is not an "expendable asset", i.e. it is illiquid--not immediately available as cash to cover some "emergency". The Chrysler Building is Cooper Union's dominant asset—its only truly significant one. Few colleges or institutions are in a similar situation. Right now, the Chrysler Building is an extraordinary asset because it is producing about $54 million in revenue between the lease ($32.5MM) and the tax equivalency payments ($21MM+). It is not an ideal situation to have so much of the school's income dependent upon a single asset, but its benefit to the school is extraordinary. At a value of roughly $600 million, the building is now generating a return of approximately 9%, well in excess of the 5% spending rate generally used for income from investment assets. In addition, this return is fixed for the next ten years, not subject to market fluctuations as more typical investment assets would be. This further confounds the premise that the building should be excluded from some CFI measurements. I am not in a position to debate how this unique situation should be accounted for in these metrics. I simply believe that the school should not be placed in a reserve requirement which is calculated in a way that ignores or diminishes the value and the stability of Cooper Union's dominant and critical asset.

B. BIO

While I have been "around" Cooper for many years, there are some new board members and others in the community who do not know me.

I was born and brought up in Brooklyn and graduated from Cooper in 1961 with a degree in Mechanical Engineering. I opted early on to try not to work in engineering. If there had been a faculty vote, they would have agreed. I went on to graduate school immediately and received an M.S. in Industrial Management from Purdue one year later.

It was a chance meeting the following year with a Marketing Professor from Purdue that enabled me to leave engineering. He was a Market Research consultant to a major Advertising Agency, BBDO, in New York and his recommendation got me a job in the Market Research Department. Five years later I was Account Supervisor on one of the agency's largest consumer products accounts.

I then went to work for Chesebrough-Pond's in brand management, and ultimately advanced to the level of Vice President-Marketing for their primary consumer products division. To broaden my experience I was moved to international development where I initiated sales of the company's products in China in 1980 and managed major projects in Japan and India. I also helped with the acquisition of Prince Manufacturing, the tennis products company, and a short time later was named its president.

I then moved on to Bristol-Myers Squibb Company where I held positions in Strategic Planning, International Development and Mergers & Acquisitions for their consumer products businesses. I was also president of the company's Clairol Personal Care Appliances Division and eventually managed the sale of that business to Remington Products. I retired in 2000.

My "career" at Cooper Union began not long after graduation when I became a member of the Alumni Association Board of Governors in, I believe, 1964. At that time, the Alumni Association was an independent organization, completely separate from the school. My career took me away from Cooper for several years, but I ultimately got back involved as a member of the CUAA Alumni Council and served as President of the Alumni Association from 1991 to 1993. I received the Presidential Citation from the school in 1993, was named Alumnus of the Year in 1996 and served on the Board of Trustees from 1996 to 2013. I was also the co-chair of The Working Group which identified cost savings that could help the return to free. When that effort did not produce the desired result, I decided to work with Adrian Jovanovic and the Committee to Save Cooper Union. I helped the committee in the negotiations with the New York Attorney General's office which produced the Consent Decree.

My experience with Cooper Union spans 60 years. I have worked with members of the classes of '05 to '18. That is 1905 (William Goldsmith) and 2018 (Anton Luz)—113 years of the school's 159 years of existence. I constantly have to deny having known Peter Cooper.

My post-retirement activities do go beyond Cooper. I have served on the Board of The United Way of Greenwich, on the Greenwich Planning & Zoning Commission, and on the boards of several private and non-profit organizations. I was just recently named to the Board of The United States Tennis Association Foundation.

I believe the combination of my extensive involvement with the school, my work with non-profit organizations and my work experience in marketing, branding and strategic planning have been great assets for me in trying to help Cooper Union get back to being free.