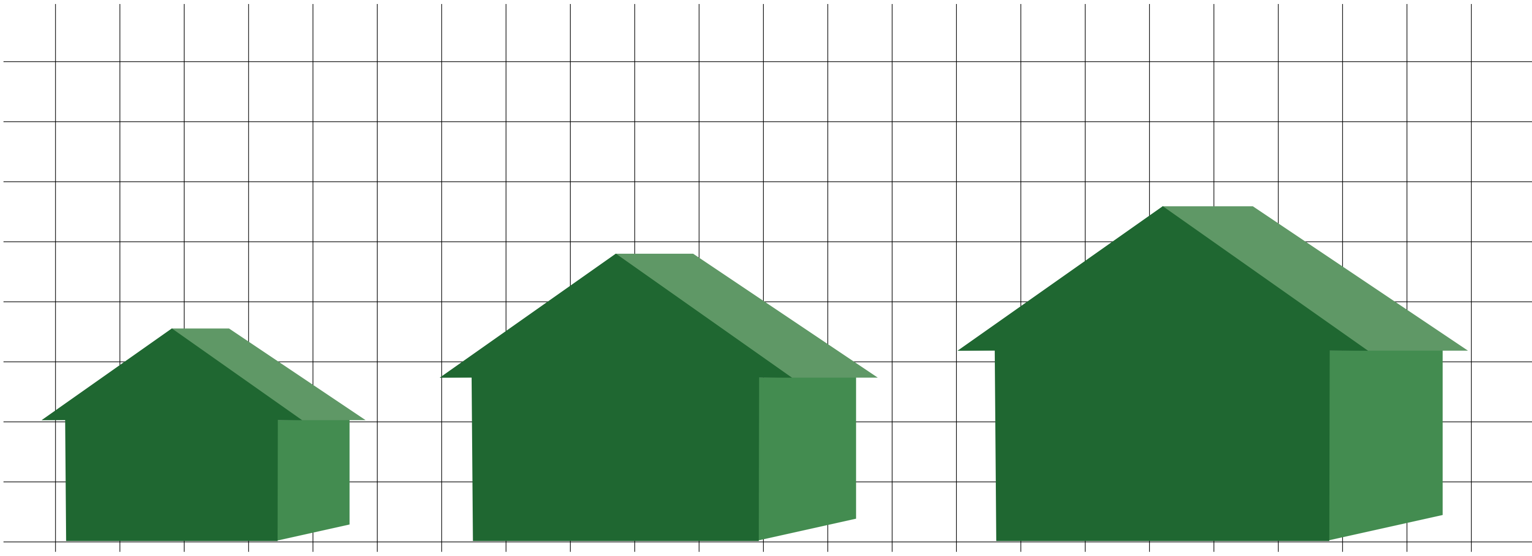

Student Housing 2006

What Happens When the President's Vision & Financial Realities Collide?

by

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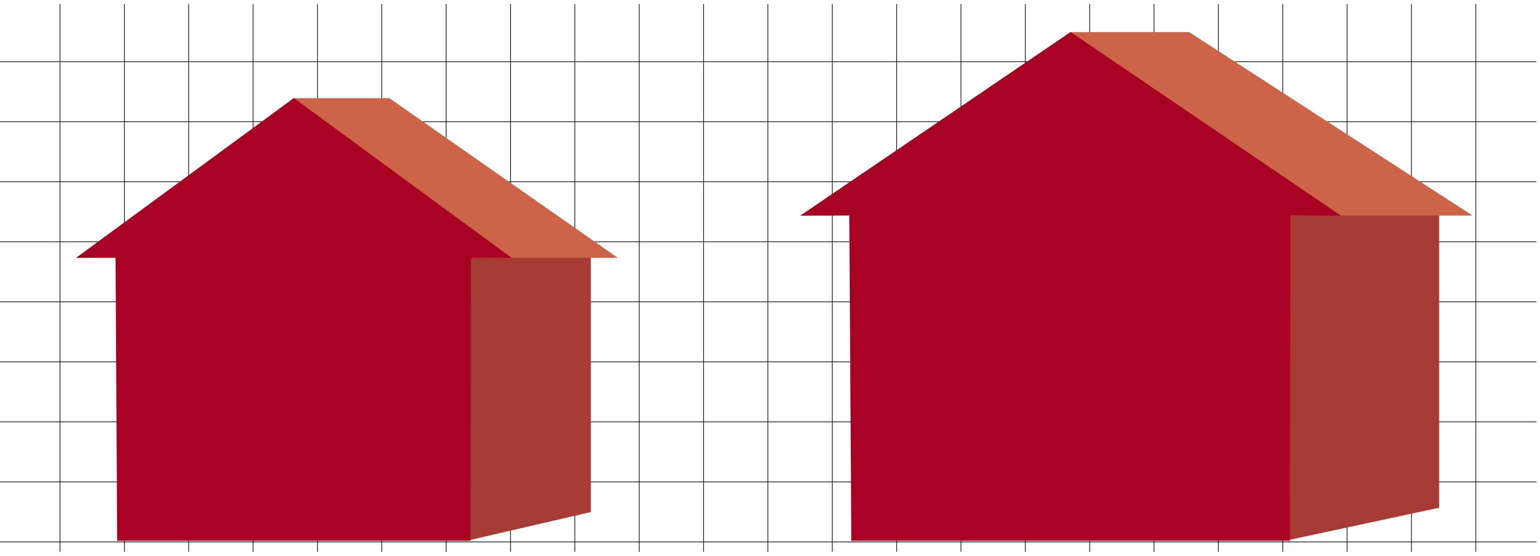
Usually under the direction of the institution's senior leadership, many colleges and universities are developing long-range master plans that are attempting to promote a sense of on-campus community. They have found that building community – such as making the campus more pedestrian-oriented, more residential, and enabling 24-hour access to facilities – is an important step toward helping students feel more connected to their school. Through these enhanced connections, the belief is that students will have a more positive college experience, which will help schools with retention, recruitment, alumni support, and numerous other goals.

In order to encourage such campus community, many college master plans are calling for a significant increase in the number of on-campus beds. As housing directors and auxiliary service personnel try to implement these plans, the cost associated with these developments continues to rise at a significant rate. As a result, some colleges are discovering that their stand-alone housing projects they easily penciled a few years ago are simply financially unfeasible.

Why Are These Initiatives Important?

An increasing number of universities recognize the inherent value of a true living/learning environment, where students can study, play, work, eat, and sleep. This model promotes a sense of community on campus, which is particularly valuable for freshmen and sophomores who desire to build strong connections in their new environs. As students mature, they often become more independent, and therefore seek environments that promote greater autonomy. But even some of these older students will continue to desire an on-campus experience,



particularly if the new housing meets their demands. And campuses eager to attract older students to fill their larger inventory of bed spaces are providing the appropriate amenities that will capture them. Today's new residence halls are replete with modern-day amenities such as single bedrooms, private/semi-private bathrooms, private living rooms, kitchens, study areas, recreation facilities, and retail options. When properly planned, a campus with attractive housing options can be an incredible asset in recruiting students. A recent study performed by David Cain and Gary Reynolds, sponsored by APPA's Center for Facilities Research, showed that 42.2 percent of students surveyed felt that residence halls were extremely important or very important in their college selection process, and over half of the students indicated that residence halls were important to see during their initial visit.

In addition, schools frequently design new residence halls, which foster community, such as first-year halls where 20-30 people live on one floor and have numerous opportunities to bond throughout the year. These initial experiences can help shape students' attitudes about school for the rest of their college careers. Conversely, a freshman who arrives on campus and is placed in an isolated off-campus apartment will have fewer opportunities to connect with his/her peers and may not feel as connected to the school. In our years of performing focus groups with students on their housing preferences, many choose on-campus housing for its convenience. What better way to enjoy all of the benefits of campus living than to roll out of bed and walk 100 yards to class or the recreation center, or to use the 10 minutes between classes to go home and grab that homework you left on your desk?

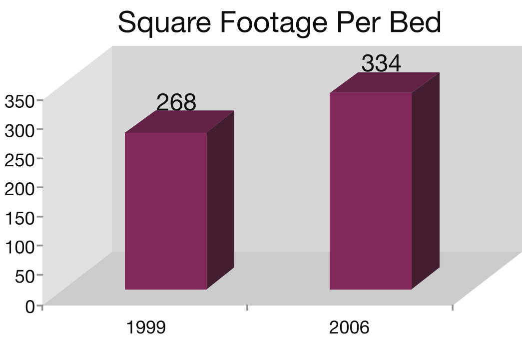
In addition, through our quantitative research of surveying over 100,000 students in the last ten years, the results indicate that many students value the comfort and security of living on campus. In the "university-as-landlord" environment, students' one semester payment covers everything, and they can simply pick up the phone if they have any significant problems. But for those living off campus, one must deal with the not-so-free free market system, equating to more financial unpredictability for the frequently cost-conscious student.

With on-campus housing affecting student attitudes toward their college experience, it's understandable why many colleges also care deeply about on-campus housing opportunities. Happy students are more likely to become happy alumni, who become integral components of colleges' marketing and fund-raising efforts for years to come. And when planned appropriately, on-campus housing can generate significant income for a school, which can be re-invested into housing improvements or re-directed toward other development efforts.

Rising Costs

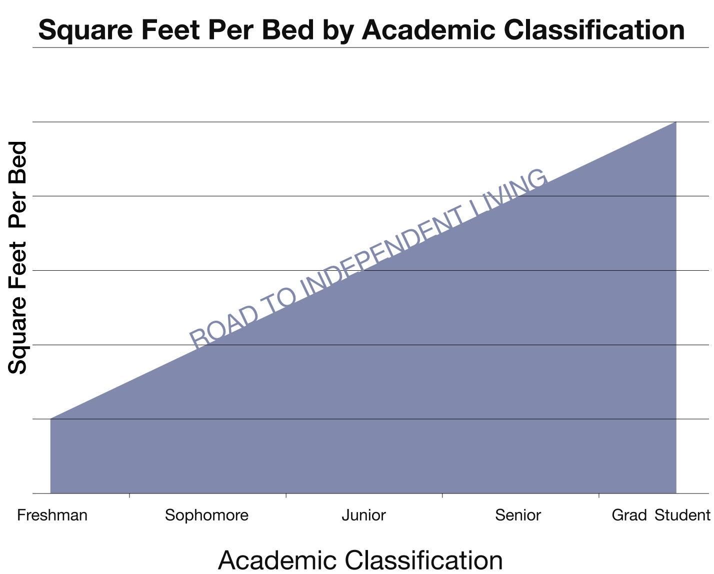
In recent years, however, rising construction costs and interest rates have made it difficult for many schools to invest in new on-campus housing. Factors such as steel and labor shortages as well as rising oil prices have increased construction costs beyond what some schools can afford. According to *American School & University* magazine, between 1996 and 1999, the median cost to construct a new residence hall (without any "soft costs" such as architecture fees) was $114 per square foot. Between 2000 and 2004, the median number rose to $132. And in 2005, the cost jumped to $169. *College Planning & Man-*

agement magazine recently reported that the average cost per bed has increased from $31,000 in 1999 to $55,000 in 2006.



What is often overlooked today is that the increased cost per bed often due to other factors besides the escalating cost of construction. For a long time, housing planners would use a rule of thumb of 250 to 300 square feet per bed to plan for their new residence halls. As more halls are being built for older students, those numbers are simply not accurate today. The amenities and features described earlier that colleges are using as carrots to keep upperclassman on campus are part of the reason for pushing up the overall square footage per bed, which ultimately increases the cost of the project. *College Planning & Management's* College Housing 2006 Special Report showed that the average square footage per bed has increased 20 percent in the last seven years.

Another factor driving up the cost pertains to how many new residence halls are being built in the heart of the campus. While campus edge projects can feature more "developer quality" construction, campus core projects can typically cost 20-30 percent more because of their strategic location in the center of the campus. Meanwhile, the Federal Reserve raised the federal funds rate for 17 consecutive meetings from June 2004 through June 2006, significantly increasing the cost to borrow money. These economical shifts translate into millions of dollars in additional costs that need to be borne by the new residence hall.



Equally important, universities are facing an "erosion of affordability" shared by many communities around the country. Many schools are facing the squeeze of needing to increase room and board rates to keep up with the operating and debt service payments on their buildings, while at the same time attempting to minimize the increases to keep housing accessible for all students. Nowhere is this more evident than at community colleges that have recently been developing student housing at a fast pace. As a result, education institutions that desire a more residential campus are increasingly confronting harsh economic realities that are making renovation and expansion projects financially unfeasible.

Recently, a few projects have had to be pulled due to the lack of feasibility. For example, a growing comprehensive regional university in California was shelved because the financials just couldn't work. The University's master plan calls for new residence halls, several new academic buildings, and new athletic facilities to address a growing student population. In developing the financial model, the following challenges became apparent:

- Soaring construction costs are estimated at $200 per square foot, based on current housing construction taking place in the area and confirmed by examining other projects currently under development in California.
- As replacement housing, the project either must be a break-even operation or make some gains in its first year of operation without monetary subsidies from existing housing.
- The off-campus market is able to offer rents significantly below current projections as well as offer more amenities.
- The President issued a clear dictate that the project must be self-sustaining.

Potential Solutions

So what can schools do to make their projects work financially? Consider the following example that looks at a university that desires to build 500 beds on its campus with the following assumptions:

- Interest rate = 6 percent
- Project cost = $175 per square foot
- Operating cost = $6 per square foot
- Per-student rental rate = $500 per month
- 350 square feet per bed
- 95 percent occupancy
- Targeted Debt Coverage Ratio: 1.1 to 1

In the first year of operation, the new housing project loses approximately $900,000 and has a debt coverage ratio of 0.6 to 1. Certainly no university official is going to give this project the green light.

The Possibilities

There are various ways that school administrators can roll up their sleeves to try to make the project financially solvent. So let's examine four approaches schools could use to make this project self-sustaining.

Option 1: Variable Rate Debt

Rather than use a fixed rate, a college might opt to proceed with a variable rate or interest-only option, yielding a lower rate in the short term until the project can stabilize financially. Over the last few years, many of our clients are utilizing a variable rate with a fixed rate structure that can reduce earlier payments. In this example, if the college is able to lock in a first-year variable interest rate of 4.5 percent, then it will increase its cash flow by more than $300,000 in the first year.

Option 2: Differentiated Pricing

Universities understand that new residence halls and apartments, when planned appropriately, can be the first choice for students, particularly because of all of the modern day amenities offered. Many schools have started to charge higher room rates to live in the newer housing facilities. Some institutions are resistant to this approach because they feel it could create a system of "haves and have-nots." In this example, by instituting a 15 percent premium on each of the new 500 beds, cash flow will increase an additional $70,000.

Option 3: Cross-Subsidization

Another big debate across campuses is the notion of project versus system-wide self-sufficiency. Many administrators insist that each project needs to be able to stand-alone. Others believe that the true measure is to look at the financial health of the entire housing program. Although not a preferred option by some, many colleges may attempt a cross-subsidization policy – for example, adding a 5 percent surcharge on all of the other rooms on campus. If the college has 3,000 rooms, cash flow would increase an additional $700,000.

Option 4: 12-Month Lease

While many students select housing with 9-month lease options that correspond with their academic schedule, a university might institute a 12-month lease policy, particularly if its academic, recreational, or job-related offerings would give students ample incentives to remain on campus during the summer. Any school looking at 12-month lease options needs to weigh all of the options carefully, because this will impact other auxiliary operations like food service that are often closed or minimized during the summer. Furthermore, a 95 percent year-round occupancy may simply be too aggressive in the first few years. Many schools continue to look into this option, which can certainly impact the overall financial success of your project. In our example, cash flow would increase an additional $800,000.

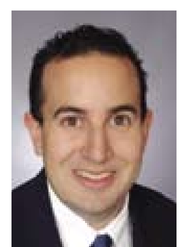
Which Option Should We Choose?

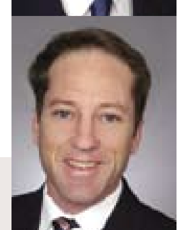
Interestingly, when applied separately, each of the above options would improve the financial picture, but none of them individually would give the University the desired 1.1 to 1 debt coverage. In this scenario, the University would have to use at least two (and most likely three) of the four options to make this project feasible. Other funding possibilities include fundraising opportunities, providing academic-related spaces in the residence halls that can help share some of the financial burden of the project, or attaching the project to a dining or retail component to help generate additional cash flow. Each option must be carefully explored to understand all of the tradeoffs.

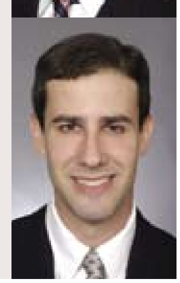
Where Do We Go From Here?

Campus Master Plans are wonderful tools that offer direction and guidance to institutions as they continue to evolve and support their overarching mission. Student housing continues to play a significant role in these plans and are helping to define the campus of the future. But just because the plan includes a pretty image of a new residence hall doesn't mean that the project has been adequately tested for financial feasibility. In all cases, these plans and their big ideas need to be carefully studied and examined for their overall impact on the health of the existing housing and auxiliary program. And unfortunately, some ideas simply may be too costly for the institution to take on despite the senior leadership's push to make it happen.

As B&D has witnessed first-hand throughout the country, the challenge to any project is to balance the institution's vision with the financial realities of today's construction and financial markets. With careful planning and creative thinking, institutions can rise above their economic obstacles and achieve their long-term goals. ◆







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