Financial Overview

From the Vice President for Finance and the Treasurer

We write to report on the University's financial position and results for the fiscal year ended June 30, 2012. Since Harvard thinks and acts in long-term timeframes, we believe it is important not only to understand this year's approximately breakeven operating result, but also to consider that result in the broader context of Harvard's changed financial circumstances and prospects.

The University's financial profile has changed considerably over the last decade in ways that have mirrored changes in the broader economy. We accumulated and deployed significant resources through the middle of 2008 when the global recession caused us to retrench and then reconsider our financial strategies in very fundamental ways. The University has become increasingly sophisticated in managing our finances, which should serve us well as we consider the more challenging environment that lies ahead – a landscape that almost certainly will be widely shared across higher education.

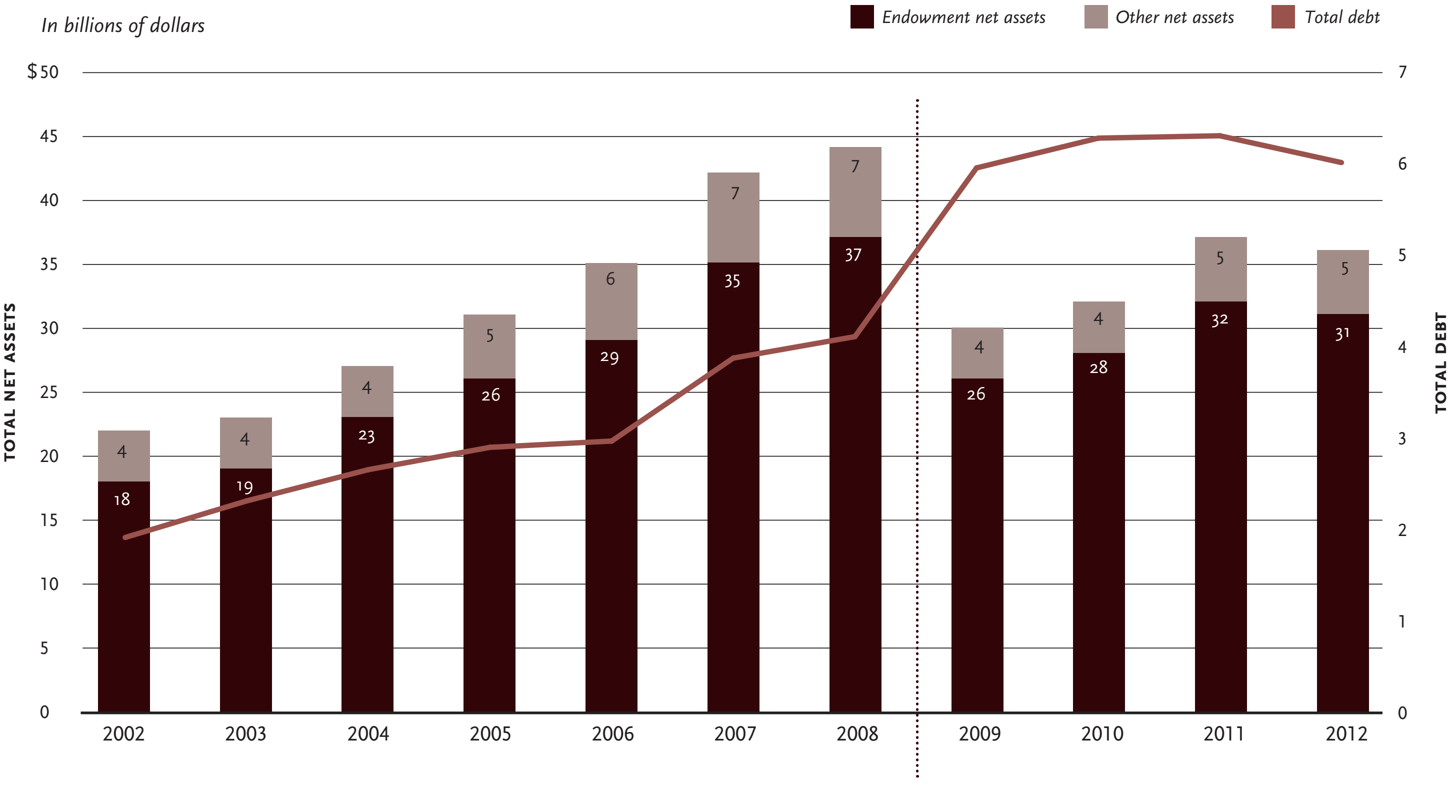
LOOKING BACK

The last decade is a story with two distinct chapters. In the first chapter, the University enjoyed substantial growth through fiscal 2008 driven by large increases in both endowment wealth and debt. Harvard was able to make important investments in the academic enterprise, adding approximately 200 faculty (a 10% increase) between fiscal 2002 and fiscal 2008. In the realm of science, the University enhanced its leadership position, bringing faculty from across the University and the affiliated hospitals together to support the first cross-University department in Stem Cell and Regenerative Biology and launching the Wyss Institute for Biologically Inspired Engineering. Investments made during this period required campus expansion with the addition of over four million gross square feet to the University's physical plant (a 20% increase).

Perhaps most noteworthy during this first chapter were the University's investments in better ensuring that a Harvard education would be accessible to students of extraordinary talent and promise regardless of financial means and sufficiently affordable to give those students the flexibility to pursue careers of their choosing without significant incremental debt. The Middle Income Initiative, announced by Harvard College in fiscal 2008, redefined the financial compact with undergraduates and their families by limiting the percentage of family household

UNIVERSITY NET ASSETS AND DEBT SINCE FY02

In billions of dollars



income that would be contributed toward an undergraduate education. This approach altered financial aid policy broadly across higher education, and from a financial perspective had a very meaningful impact. University-wide net tuition income actually declined by 1% in nominal terms between fiscal 2008 and fiscal 2009 – a noteworthy event that nonetheless was trumped by preceding growth of 80% in grant aid between fiscal 2002 and fiscal 2008.

The global financial crisis changed the University's financial profile in a sudden and consequential way, beginning a more turbulent second chapter. (See chart on page 3.) The endowment's negative return of 27% in fiscal 2009 caused an $11 billion decline in its value and an even greater decline of approximately $14 billion in the University's net assets. At the same time, the University issued $1.5 billion in incremental debt to enhance liquidity. The University's ratio of expendable resources to debt – a key metric used by credit rating agencies to evaluate balance sheet strength – fell in that one year from 9.2 to 3.9. The endowment's decline caused the University to implement a substantial reduction of $96 million and $129 million in the endowment payout for operations in fiscal 2010 and fiscal 2011, respectively. The University's interest expense, meanwhile, more than doubled to almost $300 million in fiscal 2011 compared to approximately $146 million in fiscal 2008.

As a further complication, over the past 10 years the University experienced only minimal inflation-adjusted growth in key non-endowment sources of revenue. As an example, our cumulative investments in financial aid have meant that net tuition has not been a source of meaningful support for new initiatives within Harvard. In fact, undergraduate net tuition actually has declined on an inflation-adjusted basis during the past decade at an average rate of 5%. Excluding the counter-cyclical benefits of federal government American Recovery and Reinvestment Act (ARRA) awards, federal sponsored research revenue has had an inflation-adjusted compound annual growth rate of only 2% since 2002, and non-federal sponsored research has fared worse. Meanwhile, on the expense side of the ledger, benefits expense has more than doubled in the past decade to $476 million in fiscal 2012.

The financial crisis has acted like a tidal wave that, as it receded, exposed certain vulnerabilities with a new clarity: endowment dependence and volatility, federal government dependence, non-endowment revenue stagnation, and a highly fixed cost structure. We have spent the past several years pursuing opportunities to be more efficient and effective without compromising our ability to fulfill our teaching and research mission. Among other things, exercising more discipline over staffing decisions, implementing organizational restructurings, constraining wage growth while nonetheless remaining competitive in attracting and retaining our talented individuals, and managing space for maximum efficiency have been important steps. While we have successfully achieved operating results of breakeven or better throughout this challenging period, we know additional financial headwinds may lie ahead. Flat investment returns in fiscal 2012 are just one good example. We know that our work is far from complete – and indeed, that we likely will need to undertake an even more fundamental examination of our activities with the goal of more crisply prioritizing what we do and what we are willing to forgo.

LOOKING FORWARD

The primary financial risks facing Harvard also are present at other large private research universities. We are challenged by volatility in the capital markets due to our endowment dependence and disproportionately fixed cost structure. We depend considerably on the federal government's funding of biomedical research at a time when the government's projected deficits and accumulated debt create enormous pressure to reduce such discretionary dollars. The University's sizable campus requires significant annual funding to maintain and still more funding to address deferred maintenance. And our employee benefit expense, of which health care is the largest component, has been increasing at an unsupportable rate relative to actual and expected growth in the University's revenue.

At the same time, Harvard has critical objectives that require near-term expenditures. Those objectives are embodied in both bricks (e.g., enhancing our cross-University science and engineering collaborations on the University's Allston campus) and bytes (e.g., investing in the promise of online education through our edX collaboration with MIT). Harvard has neither the desire nor the luxury to postpone its pursuit of critical priorities despite the prospect of challenging economic circumstances. Indeed, competition and opportunity compel us to move forward in a disciplined way – in which fundraising, creative restructurings, and more rigorous evaluations of the University's activities will be important endeavors.

After many decades of growth and stability, higher education is likely to face rapid, disorienting change. The ability to adapt quickly and effectively will be increasingly important. In the years ahead, we are likely to focus our efforts in a number of areas:

- *Pursuing integration opportunities:* Most universities are decentralized, and that decentralization typically results in incremental costs through the duplication of various activities. Harvard's significantly decentralized governance has contributed to an unmatched breadth of excellence across its various programs. Yet it comes at a financial cost. Our challenge is to determine where we might reduce or eliminate redundancies in order to be more efficient without compromising our ability to understand and pursue the highest-priority "local" opportunities that promise to make the University stronger. Our library reorganization is an initial attempt to meet such a challenge. We also are making progress consolidating IT management, and seeking to leverage the University's purchasing power by enhancing our strategic vendor relationships. Other initiatives are underway or in the works.

- *Evaluating benefits offerings:* Universities tend to be generous with their employee benefit offerings, and Harvard is no exception. Yet with those costs continuing to increase at unsustainable rates, Harvard – like its peers and indeed like most other businesses – cannot simply continue with the status quo. The University is committed to offering fair and competitive compensation to all its employees, but ultimately must balance our responsibilities to the workforce with our need to pursue the University's broader objectives.

- *Exploring incremental revenue:* Managing through the next decade will require more than cost constraint; it also will require the University to consider new ways to generate incremental resources. One increasingly clear path is a fundraising Campaign—which would be Harvard's first in more than a decade. We also will need to adopt more creative strategies to leverage the University's space and its vast intellectual resources for additional monies that can be reinvested in our teaching and research aspirations. Creativity of this sort has not been a distinguishing feature of the higher education industry, but given expected pressures on the business model of practically all colleges and universities, it increasingly will be a competitive differentiator.

IN CONCLUSION

The need for change in higher education is clear given the emerging disconnect between ever-increasing aspirations and universities' ability to generate the new resources to finance them. Certain aspirations more closely resemble imperatives and will require universities to make decisive and inevitably difficult choices from among competing priorities. We can be successful if we equate change with the opportunity to improve and move forward.

The road ahead will present any number of challenges and opportunities including, without doubt, a few surprises. Success will require a tolerance for ambiguity, an openness to different ways of doing things, a commitment to experimentation, an underlying confidence in our ability to implement a sustainable economic model, and an abiding passion for the University and its impact in the world. These are the same success factors that have enabled Harvard to thrive throughout the centuries, and we expect to achieve similar results in the future.

We hope this introduction provides you with a helpful context for evaluating the University's financial report.

Daniel S. Shore
VICE PRESIDENT FOR FINANCE AND
CHIEF FINANCIAL OFFICER

James F. Rothenberg
TREASURER

November 2, 2012