

UNIVERSITIES AND THE CONGLOMERATE CHALLENGE

Complex business combinations have been unwinding for years. Will the bell toll for universities?



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Business leaders in the United States and across the world spend countless hours in the boardrooms of major research universities. For many institutions and trustees, those meetings have become more challenging due to some well-documented threats. Rapidly rising tuition, shifting demographics, the growing popularity of online learning, pressure on research funding, volatile endowment earnings, and parental and graduate dissatisfaction with employment opportunities: all are trends that pose significant risks for university departments, colleges, and central administrations.

Lurking beneath the surface, and making those trends more ominous, is an issue that corporate executives have been wrestling with for years. It's what we call the "conglomerate challenge" of today's research universities. In short, today's research universities mirror corporate conglomerates in structure, but without the degrees of freedom enjoyed by their corporate counterparts. We believe that by better understanding the realities and the limits of their corporate conglomerate-like structures, university leaders can increase their odds of successfully addressing the many threats they face.



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The theory of the case is straightforward: from a strategic-management and corporate-finance perspective, a university can be viewed as a diversified conglomerate of independent strategic business units (SBUs): colleges, divisions, and schools. Each of these SBUs has a business-level strategy that is driven by its intellectual traditions, educational objectives, and professional disciplinary norms. The corporate strategy of a university supports these strategic intents by serving as a platform for attracting and allocating resources across its academic units.

In business, much of the economic value created by a conglomerate lies in the coinsurance of risks across its SBUs. Conglomerates

can attract a lower cost of debt because lenders expect that downturns suffered by one SBU will be offset (or coinsured) by other revenue-generating units.

Against this advantage, conglomerates also suffer from the well-known conglomerate or diversification discount. The discount exists because of the costs of coordination across SBUs, the inefficiencies that arise because SBU operations aren't transparent to the external capital markets, and the tendency for conglomerates either to overinvest relative to comparable stand-alone firms in segments with limited opportunities or to slow walk the divestment of formerly good opportunities that have soured.¹

In the higher-education conglomerate, there are analogous disadvantages. These include the “carrying” of economically inefficient academic units (defined as those chronically unable to earn their cost of capital in tuition, endowment, or research funding); the nonfungibility of specialized real-estate assets and scientific equipment; and the immovability of the tenured faculty.

In business, when conglomerates face the combination of declining demand, insufficient returns on capital employed, and less patient capital markets, they restructure by selling fringe or unprofitable businesses, or by breaking up and spinning out stand-alone businesses to unlock free cash flows from underutilized assets. Those that choose not to do so rather quickly add themselves to the ranks of failed conglomerates.

Most universities struggle to take either step. That's partly due to institutional rigidity and partly to the fact that not all strategic options available to a business are accessible to a higher-education conglomerate. Barriers to restructuring include regulation (the closing and launching of programs requires governmental approval in some states) and the stickiness of faculty contracts. Also, there are the many and varied interests, expectations, and demands of past and present donors, students, and alumni to consider.


Neither these barriers nor the fundamentals of the university's conglomerate challenge are anything new. Making them more significant today are shifts such as the growth of online learning, whose economies of scale are creating new competitive dynamics, and the growing skepticism among employers and parents (the actual “customers” of the university) over the value of a university credential.

There has never been a better time, therefore, for business-minded trustees to bring their strategic-thinking skills to bear on the conglomerate challenge—and most are well prepared to do so. Many corporate executives have been well schooled in the trade-offs associated with diversification and focus. They may also have scars from keeping disparate businesses

together for too long or from unwinding overly complex combinations. All of that positions them extremely well to encourage university leaders and other trustees to start thinking of the university not as a collection of individual SBUs but as a portfolio of revenue-producing or cost-incurring assets, each with different risk profiles and possibilities for navigating disruptive change in the sector.

To ensure their asset portfolios can deliver, at acceptable cost, high-quality outcomes for students, funding agencies, employers, and other consumers of intellectual capital, trustees and administrators must ask themselves some difficult questions: What mix of academic programs is best able to generate sustainable growth, stable cash flows (in portfolio parlance, businesses with countercyclical demand patterns), and brand equity? What programs are truly critical, and which are “nice to have?” What current academic programs and areas of research do not contribute to sustainability, stability, and reputation of the whole? What new innovations (academic programs and emerging domains of research) deserve further investment to create new sources of revenue and new opportunities for mission and brand building?

We do not want to imply that the decision making for academic initiatives be centralized, or that economic criteria must hold sway. Conglomerates sometimes choose to carry unprofitable SBUs if these units serve specific operational and marketing purposes, and universities may choose to do the same. What’s critical, for both conglomerates and universities, is do so consciously, with an eye toward understanding the value they create for other units and the options they create for the future. The trade-offs made plain by dispassionate, comparative analysis of SBUs against a common set of shared economic metrics such as contribution margins (in addition to academic criteria) are likely to be eye-opening for universities, which generally find it easier to launch programs than to close them down.

Making choices about structure, resource allocation, and shift of focus and mind-set are challenging for the leaders of any enterprise—which is precisely why we encourage business leaders serving on university boards to tackle the conglomerate challenge head-on and university administrators to seek their advice. By wrestling with questions such as the ones we have posed, trustees and administrators can better address the external vulnerabilities of our research universities, while preserving the health, influence, and growth potential of these important institutions for many more years to come. 

¹ Recent research has attempted to explain the diversification discount by pointing to sample selection, measurement, and model-estimation biases. Still, none of the explanations has been able to fully account for the size of the implied gap between the coinsurance advantage and the conglomerate discount. For a good summary of these issues, see Linda Gorman, “The diversification discount and inefficient investment,” National Bureau of Economic Research, nber.org.