Kennedy & Company

ACHE National Conference

The Future of Outsourced Online Education: Negotiating Revenue Sharing and Program Management Agreements with OPMs

October 15, 2019

What's On the Agenda

Agenda:

- A quick introduction
- The Rise of NFP Online Education
- Changes to OPMs
- The So-What for Institutions
- What Matters in Contracts?

What I Wish I Knew Then…

Where Do We See Online Education Going?

Are we moving to Phase 3?

Phase I:

For Profit Era

- *Modern Marketing for Higher Ed*

Phase II:

For-Profits & Innovator Not-for-Profits

- *Culture, Leadership, Need*

Phase III:

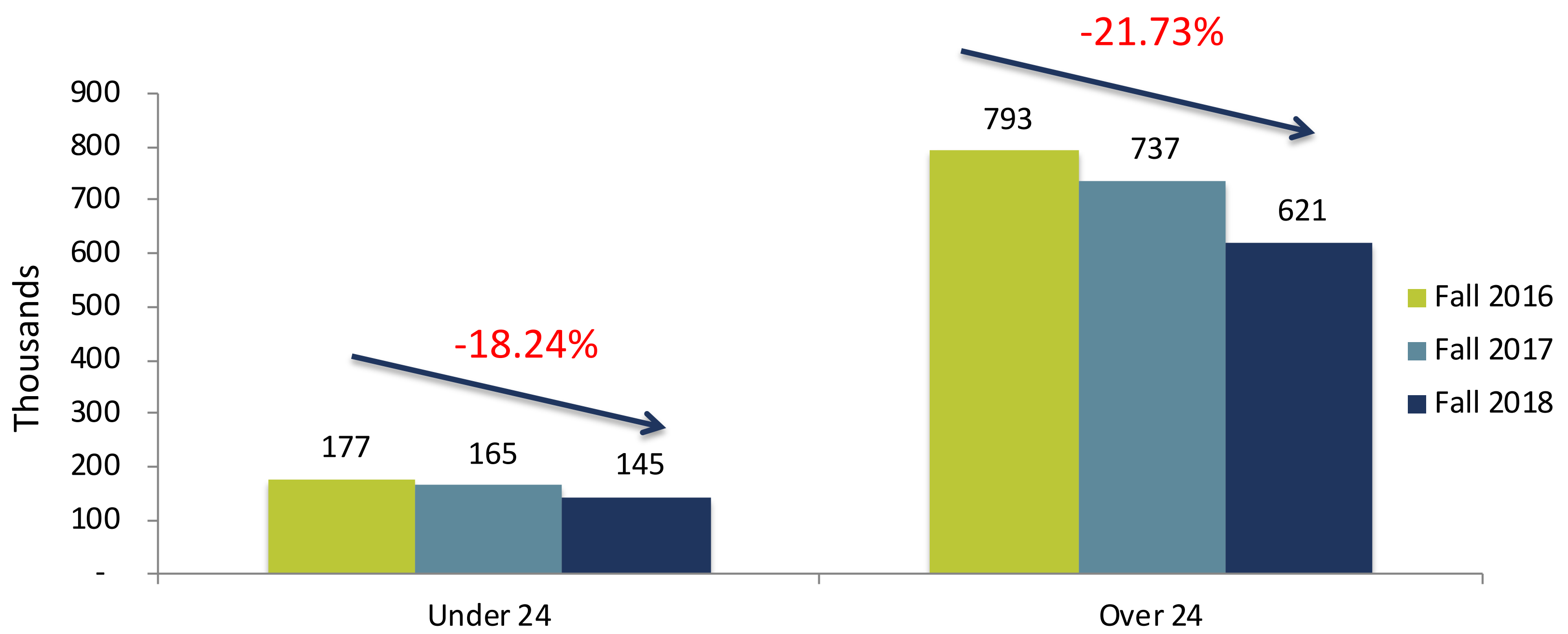
Regional/State Players

- *Born from Necessity*

Fall of the For-Profits

Enrollments in the for-profit sector have been steadily declining for the past several years. High dropout rates, modest job placement, and dubious recruiting tactics have led for-profit institutions to come under increased scrutiny by online learners (both traditional and non-traditional), the higher education community, and the federal government.

National Enrollment in 4-Year For-Profits, by Age Group

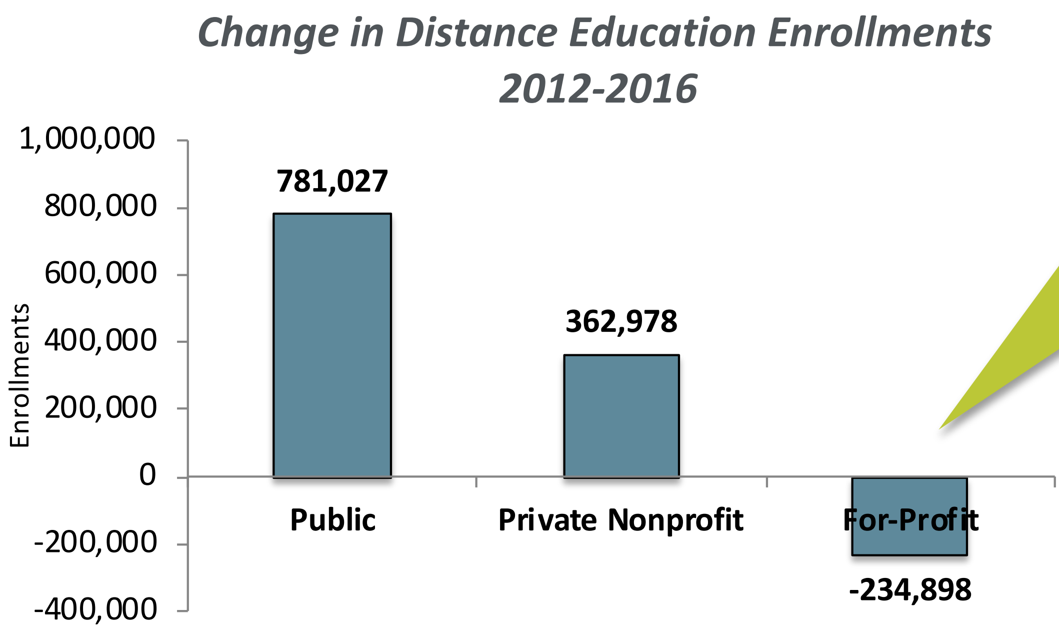


Several prominent for-profit institutions have been subject to federal inquiry. Among them, the institutions which have spearheaded enrollment declines have been Ashford University (Bridgepoint Education; operating loss $34.5M) and the University of Phoenix (Apollo Education Group; operating loss $54.5M).

Sources: National Student Clearinghouse Research Center, "Term Enrollment Estimates, Fall 2018"
https://nscresearchcenter.org/wp-content/uploads/CurrentTermEnrollmentReport-Fall-2018-3.pdf

Expansion of the Nonprofit Online Landscape

Distance education delivered by non-profit institutions has become the gold standard. While for-profits continue to lose revenue and students, enrollments at public and private non-profit institutions have steadily grown.



In 2016, fully online programs were offered by

72% **of public colleges**

&

50% **of private non-profits colleges**

Between 2012 and 2016 alone, distance enrollments at public and private non-profit institutions increased by 22% and 48%, respectively, while for-profit enrollments decreased by 22%.

Increased scrutiny of the for-profit sector, combined with the increasing attractiveness of a fully-online non-profit degree, has led students to reevaluate the online marketplace.

Sources: https://wcetfrontiers.org/2018/03/01/distance-education-enrollment-growth-major-differences-persist-among-sectors/; Clinefelter, D. L., et. al. (2019) *Online college students 2019: Comprehensive data on demands and preferences*. Louisville, KY: Wiley edu, LLC

Driven by Home Field Advantage?

Distance education delivered by non-profit is being driven by awareness that even more students look for the online institution that's close by.

5. Distance From Home to Campus Continues to Shrink

When this study was first conducted in 2012, 44% of online college students chose a school within 50 miles of their residence. However, in 2019, 67% of online college students are enrolling at schools within 50 miles of their residence, and 44% of those students live within 25 miles of their school.

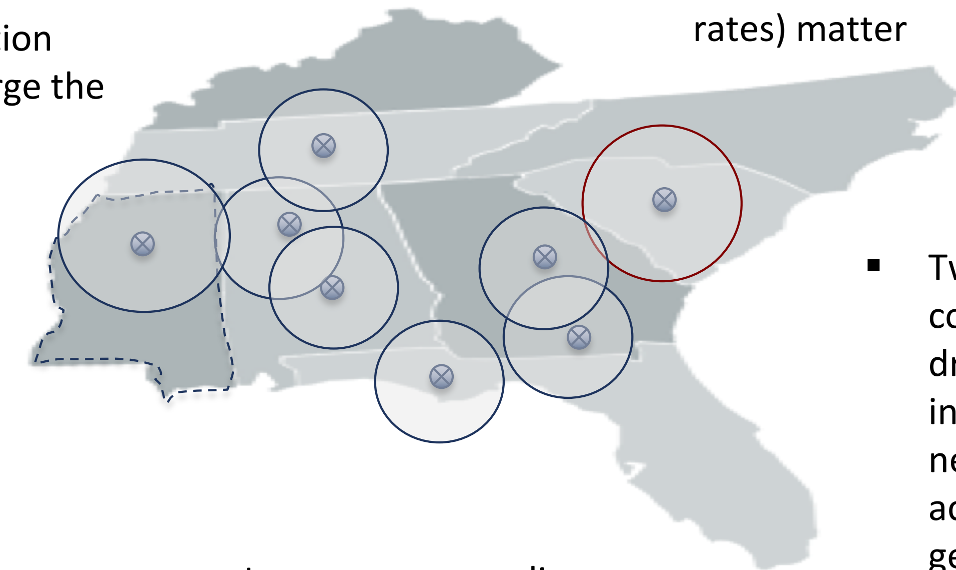
Sources: "Online College Students: Comprehensive Data on Demands and Preferences by Aslanian/Learning House/Wiley

Online Marketing Efficacy Follows Reputation, Brand

Despite the presence of national offerings, (many) inquiries and enrollments still correlate highly with proximity and brand awareness.

- Natural boundaries and pricing boundaries (in-state vs. out-of-state rates) matter

- Brand and reputation can improve/enlarge the circle size



- Two well-financed competitors can dramatically increase the cost of new student acquisition if geographies and offerings intersect

- Natural boundaries and pricing boundaries (in-state vs. out-of-state rates) matter

- In some cases, online offerings do not overlap, or admissions barriers lessen competition

As data improves, we can start to better quantify competitive intensity in online offerings, though costs and cost increases for particular Google search terms serve as a good proxy now.

A Change in the OPM Landscape?

2U's recent stock slide—and the reasoning behind it—signals a sea change in the competitive environment for OPMs.

Stock Price Plummeting

2U Stock Plummets After Company Slashes Launch Plans

Steve Symington, The Motley Fool
Motley Fool July 31, 2019

...dnesday's 60%-plus plunge, you'd think **2U**'s (NASDAQ: TWOU) second-...esults were an absolute disaster. To the contrary, the online education ...r technically enjoyed a solid end to the first half, delivering healthy revenue ...g an enormous strategic acquisition, and striking a number of encouraging ...ips.

But 2U also tempered full-year guidance for its core business for the second time in as many quarters. And this time, rising competition and a steep moderation in 2U's new program launch cadence is to blame.

Let's look closer, then, for a better idea of what 2U accomplished in the second quarter, and what investors can expect in the quarters ahead.

2U results: The raw numbers

Metric	Q2 2019	Q2 2018	Change
Revenue	$135.5 million	$97.4 million	39.1%
GAAP net income (loss)	($28.0 million)	($18.3 million)	N/A
GAAP earnings (loss) per share	($0.46)	($0.33)	N/A

DATA SOURCE: 2U. GAAP = generally accepted accounting principles.

New Transparency

We believe greater transparency into the role online program management (OPM) companies play in helping universities offer degree and non-degree programs to students is important and will help to foster a more constructive and well-informed dialogue about our industry.

With that goal in mind, 2U is announcing and embracing a framework for transparency, grounded in six core pillars: University Oversight & Accountability; Marketplace Openness; Access; Affordability; Quality; and Outcomes.

We believe this Framework for Transparency will allow universities, students, and policymakers to better understand and assess the role 2U plays in helping our non-profit university partners build high-quality educational offerings and deliver great student outcomes.

With leadership comes responsibility, and we look forward to releasing our inaugural 2U Transparency Report in 2020. We hope that other OPMs will join us in embracing the need for greater transparency in our industry by publicly releasing their own metrics.

2U, Inc. Framework for OPM Transparency

1 University Oversight & Accountability

We value and respect the institutional independence of our non-profit university partners. In the Title IV eligible degree programs we power, our partners set the admission criteria and tuition pricing, and they manage faculty and curriculum governance. For the non-degree offerings we power, our partners exercise final approvals over instructors and curriculum. This oversight and accountability is core to our model and written into our contracts. As such, we commit to release:

- our standard contractual terms related to academic oversight and decision making control of our non-profit partners, including our responsibility to comply with all laws and regulations applicable to our services

2 Marketplace Openness

2U has always been transparent about our university partnerships and publicly listed the degree and non-degree offerings we power. Today, that is not standard practice in our industry. We believe any OPM company—whether its business is based on a tuition revenue share or fee-for-service model—should publicly disclose the existence and nature of all of its university relationships. 2U commits to disclose:

- a comprehensive list of partners and offerings we power
- a complete list of the services we contractually provide to partners
- our aggregate annual investment in partner programs
- the aggregate number of students enrolled in 2U-powered programs
- our total advertising and digital marketing spend as a percentage of tuition generated by launched programs

3 Access

2U's degree and non-degree offerings create greater flexibility and access by allowing adult learners to return to school without needing to quit their jobs or uproot their lives and families. 2U commits to disclose aggregate:

- percentages of enrolled students by gender, race, age, and geographic location, as well as data on enrollment by active-duty military and veterans

4 Affordability

The rising cost of higher education is a serious and important societal issue. All stakeholders in the higher education community, including 2U, have a responsibility to be part of the solution to this complex and growing challenge. 2U commits to disclose:

- the percentage of degree programs in our portfolio priced at or below their comparable campus-based program
- the average price, by discipline, of degree programs in our portfolio
- the average price of our non-degree offerings
- our total investment in student scholarships

5 Quality

As a brand steward to many of the world's most respected and highly ranked universities, quality is core to 2U's value proposition. 2U commits to disclose average:

- hour requirements for synchronous, asynchronous, and in-person clinical or immersive work in degree programs
- attendance rates
- student satisfaction ratings (e.g., Likert or Net Promoter Scores)

6 Outcomes

Although defining appropriate qualitative and quantitative outcome measures is complex, since people's motivations and goals for furthering their education are personal, we believe there are some consensus benchmarks. 2U commits to disclose average:

- retention, graduation and, where applicable, employment outcomes and licensure passage rates
- time to completion by offering

2U

2U announces lower than expected revenues and a longer path to profitability on one day and then released a new model for OPM transparency and a new *unbundled* partnership with the UNC system on the very next day.

Our take: this is a emblematic of the new market for OPM services.

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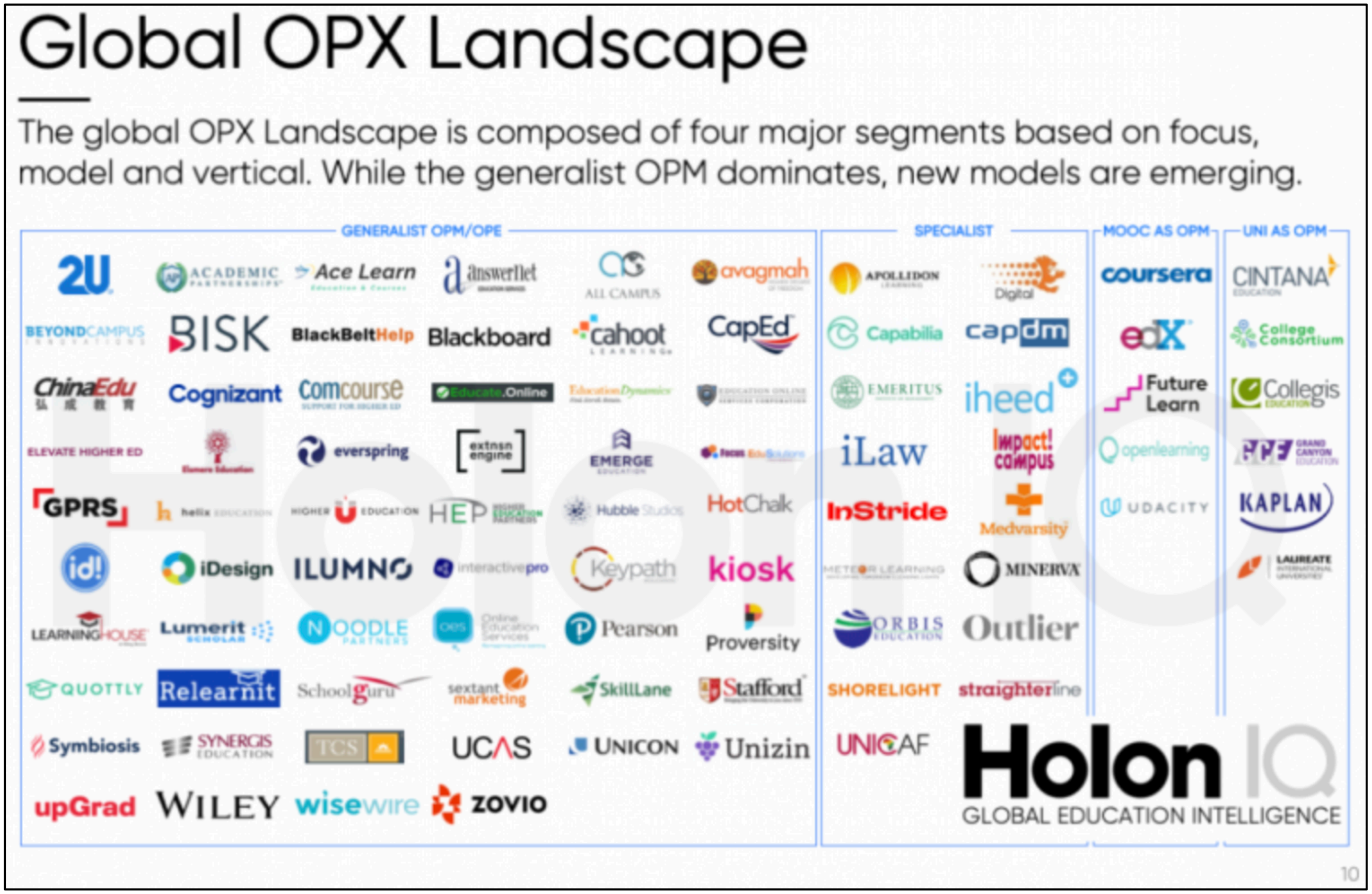
A Larger Landscape

The number—and type—of OPM vendors has increased quite a bit in the last 3 to 5 years.



Generalists

Specialists

MOOCs as OPMs

University as OPM

Sources: Inside Higher Ed *The Global Landscape of Online Program Management Companies featuring HOLON IQ and* Kennedy & Company analysis of over 100 OPM contracts.

What does this all mean for institutions looking at OPMs?

- OPM Rhetorical war remains over alignment with clients
- Unbundled services and non-revenue share for all OPMs?
- Mix of revenue share and a la carte contracts
- Push towards technology-enabled subscriptions (a pivot)
- More players, but fewer high-end revenue share plays?
- OPMs still looking for longer-term deals
- OPM Divorces

Sources: Kennedy & Company analysis of over 100 OPM contracts; Inside Higher Ed *The Global Landscape of Online Program Management Companies*

Three Potential Online Program Management Paths

Institutions with growing online program portfolios seeking improved coordination and efficiency typically choose one of three paths, based on what in-house competencies they have.

DIY

Modify existing support functions in order to fully serve online students in-house

- Typically the most ***high-risk, high-reward*** proposition due to the time and investment needed to develop all of the competencies in-house
- Runs the risk of creating an internal OPM model, where individual school and programs are pushed to the most efficient approach

Preferred Hybrid/ Fee-for-Service

In-source the functions most prepared to function on Day 1, while outsourcing functions not currently ready to substitute for OPM services on a fee-for-service basis (i.e. Noodle, iDesign).

- Typically the ***most favorable option*** because it allows the university to focus on cultivating core competencies in house while leveraging external expertise
- May require more up front capital from the institution but also has a notable upside due to limited or no revenue shares
- Leverages the purchasing power of the institution across schools to negotiate rates

Preferred Full-Service Provider

Negotiate improved revenue share and potentially some unbundling of services with a preferred full-service provider (e.g. 2U, AP, Pearson)

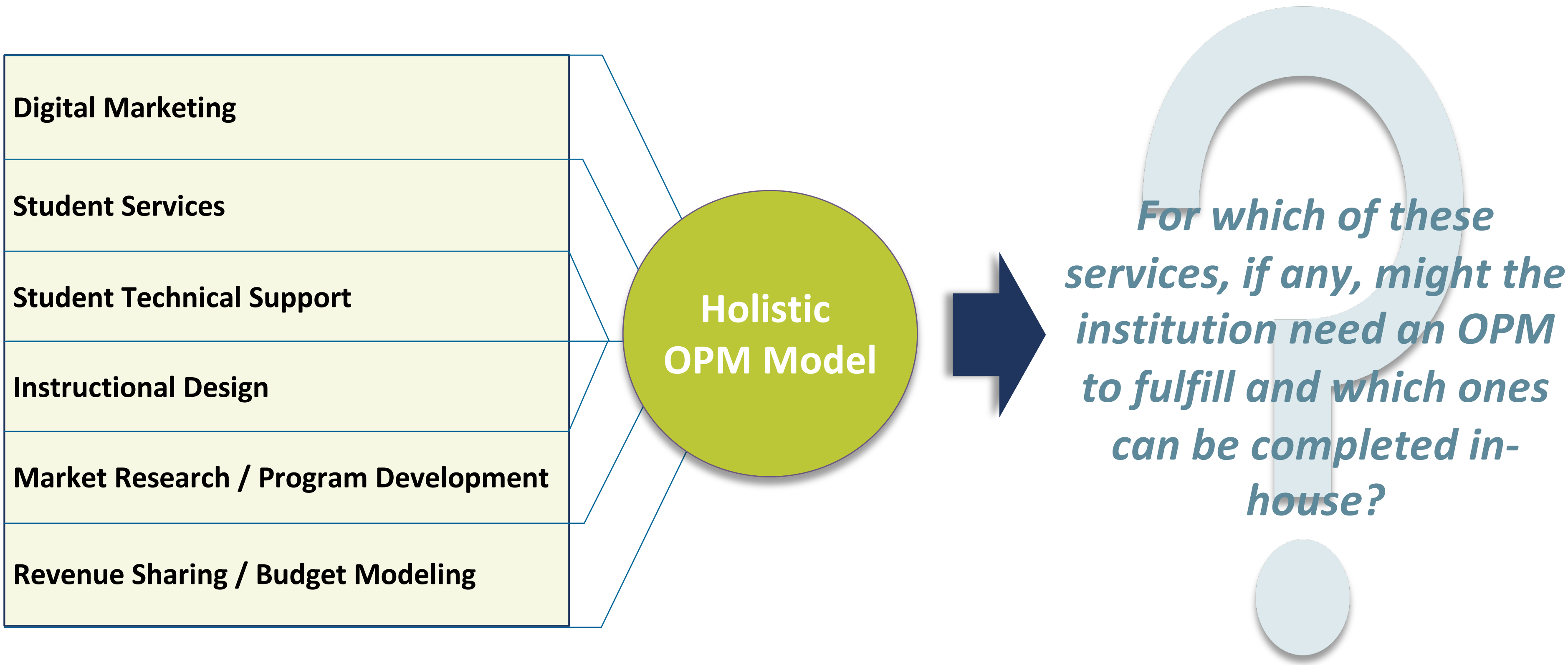
- Typically the most ***low risk, low reward*** option due to the continued sharing of online education revenues and limited investment required by the institution
- Administrative costs, particularly in shared services, and other institutional costs of launching and running programs are often under-estimated, further impacting program profits

What to Outsource?

Institutions considering hybrid or full-service OPM models should consider all elements of the online enterprise value chain.

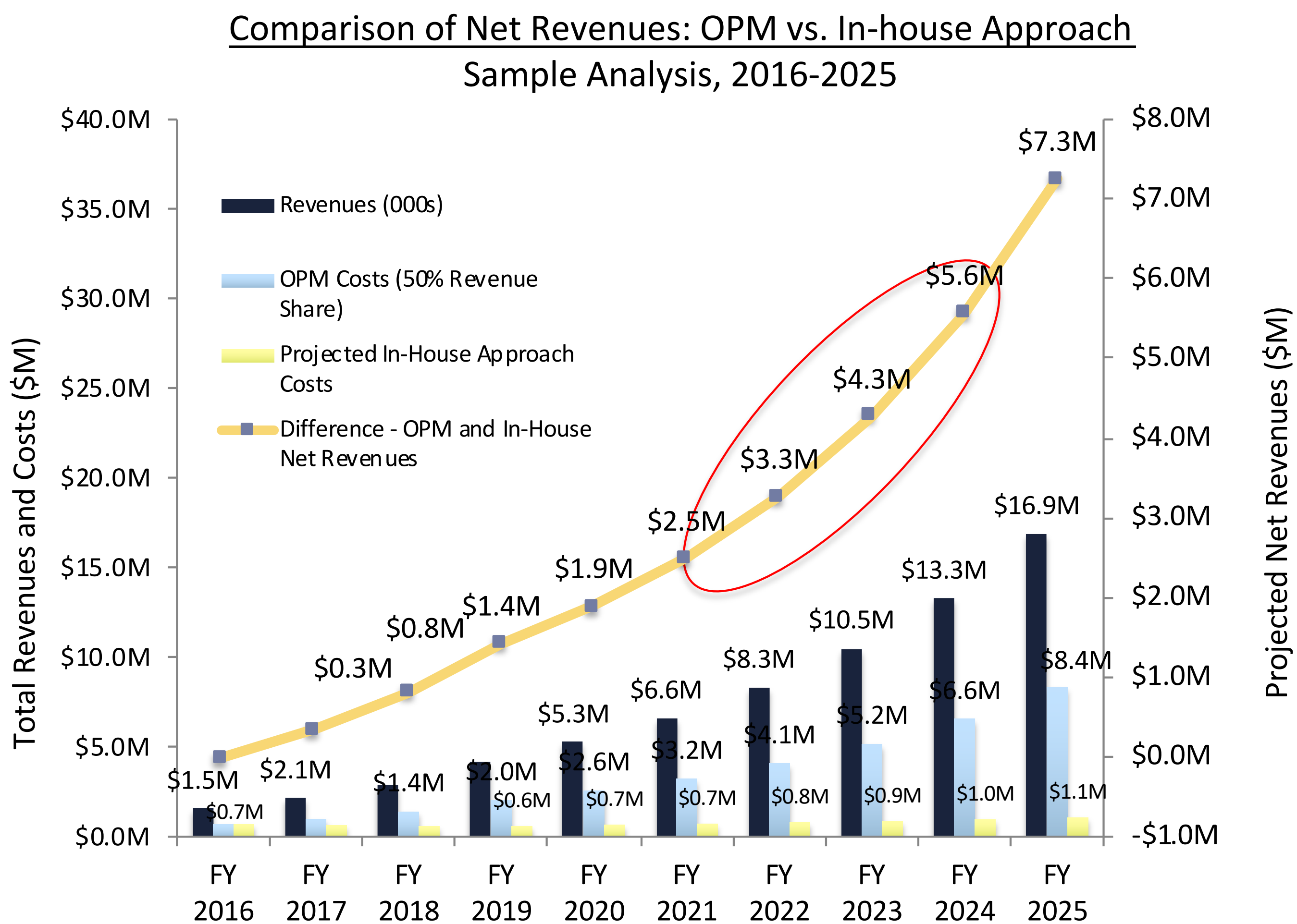
OPM Assessment Begins With Understanding of In-House Capabilities

When considering the development of new online programs, institutions will need to consider which elements of the online service model that they are able support in-house and which will need to be outsourced to an OPM.



When Does Outsourcing Make Financial Sense?

Outsourcing to an Online Program Management (OPM) company can be a good way to get off the ground quickly using experienced recruiters, website developers, and course developers. But it comes with a potentially hefty long-term cost. The right contract terms are critical.



Example

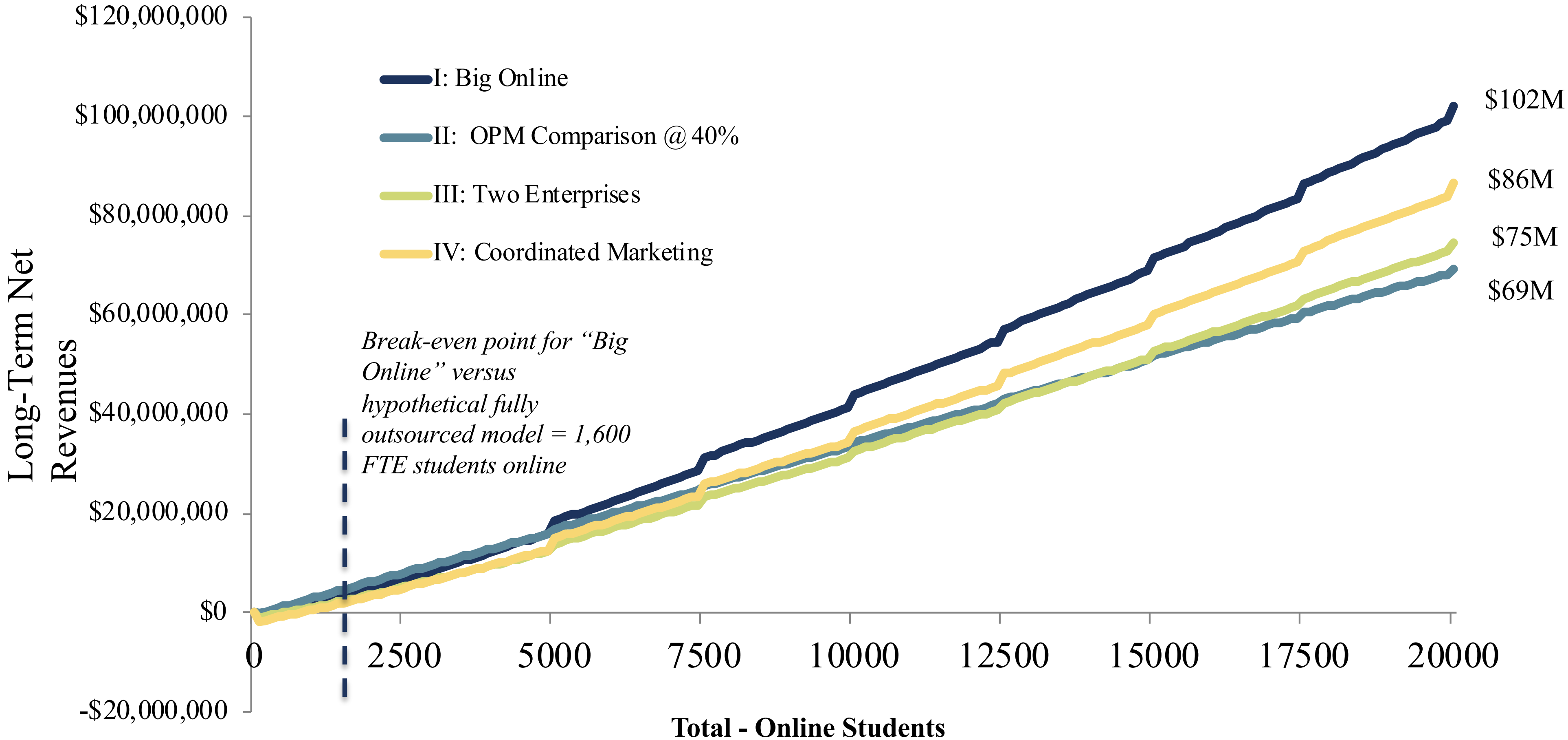
At 2,500 total students and $300/credit hour (projected 2025 levels), a "typical" OPM revenue sharing agreement would pin OPM-related costs at ~$8.4M/year, plus include the institution's internal expenses, cutting net revenues by roughly $8M per year by 2025

*In this example, an OPM would have to **outperform the in-house/DIY recruiting output by roughly 75%** to match the net revenue output for the sample institution under an in-house approach.*

**Model assumes that costs for admissions, financial aid, faculty, and course development are the same under both models and that these costs are borne by by the institution.*

Financial Implications – A Generic Model

Our "generic" online education models, **<u>predicated on a system's ability to execute efficiently on delivering like an online program management company</u>**, predict much greater financial success with increased cooperation, sharing of resources, and centralization.



Option	I. Big Online	II. OPM Comparison	III. Two Enterprises	IV. Coordinated Marketing
Direct Cost Ratio	25% to 30%	45% to 60%	35% to 40%	30% to 35%

*Includes costs for faculty, admin, and student services

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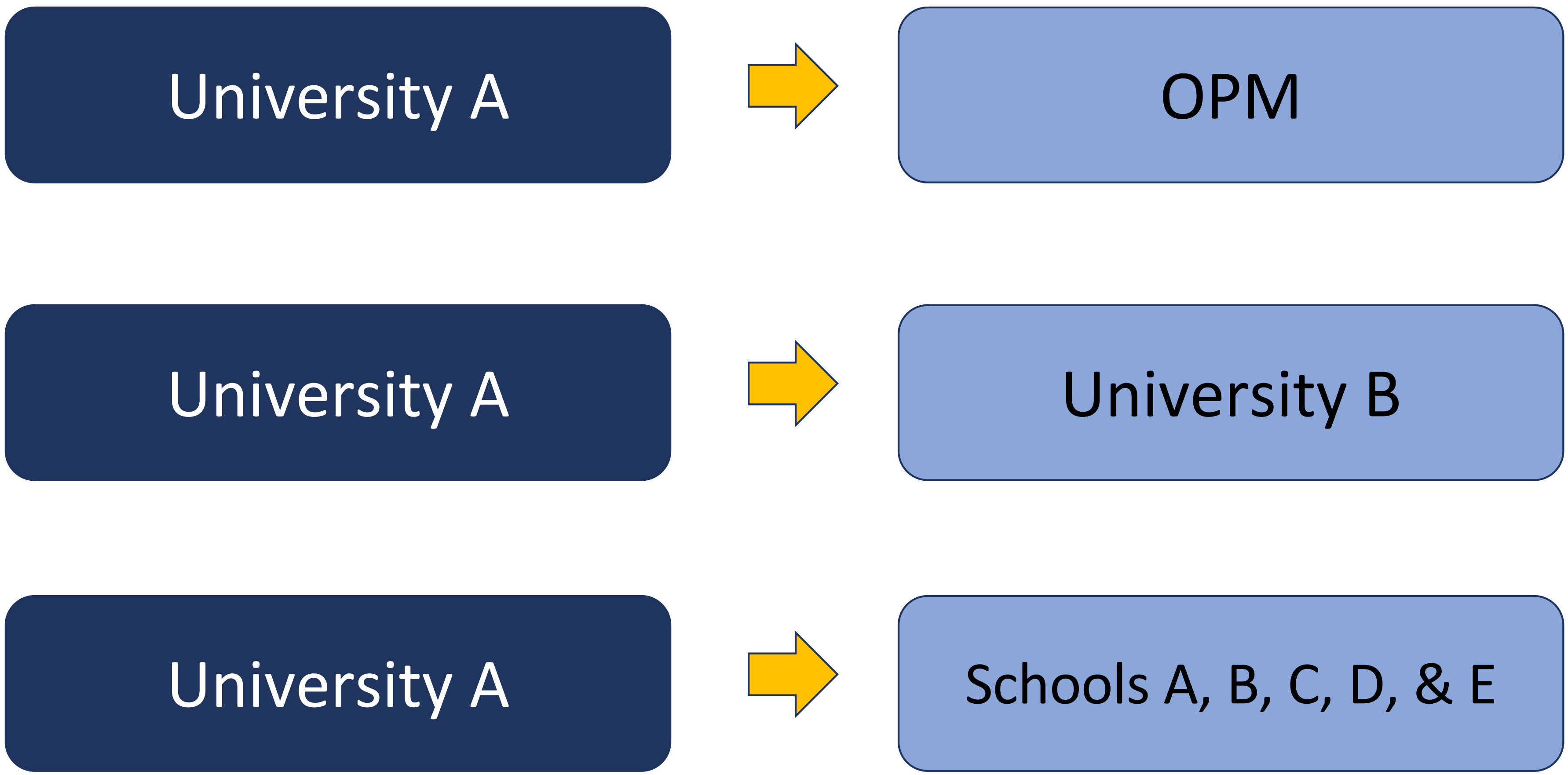
Forging Agreements with OPMs and Other Institutions

As the market evolves, new agreements are being forged between different types of institutions—the main contracting issues remain.



Major Terms & Conditions

Every contract or MOU needs to have these items included.

Online Enterprise

Strategic

Operational

1 **Governance**
Who decides on new programs and program ownership? On other major changes?

2 **Revenue Sharing**
How are tuition revenues shared? How are direct costs paid for?

3 **Accreditation & State Authorization**
How will various degree offerings be accredited? Who will seek authorization for serving students, as needed?

4 **Role in Brick-and-Mortar**
How can/should the online enterprise be involved?

5 **Types of Programs**
Should the online enterprise include continuing education, graduate programs, certificates, and any other online offerings?

6 **Retention & Student Services**

7 **Course Development**

8 **Marketing & Recruiting**
How does the brand stay consistent? Who runs call centers, online chats, etc.?

9 **Data & Decisions**
Who provides research and analysis on which new programs to build and how to recruit (and where)?

What to Watch For in Every Contract

- Term of Contract
- Renewal Terms and when Notice is Needed
- Termination Clause and Teach Out Provisions
- Ownership of Leads
- Transparency into Ad Spending – Who Pays
- Ownership/Governance of Images/Websites/Marketing Materials
- Designating affected students/programs and counting boomerangs
- Revenue Share
- Accounting for Institutional Costs
- Up-front payments from OPM
- Exclusivity for the institution
- Non-compete provision
- Governance of programs – new programs, sunsetting programs

Closing Thoughts

- Do Your Own Analysis
- Do Your Own Research
- Write Your Own Contracts (with help)
- Don't (Automatically) Make Working Capital the Issue
- Make Agreements *before* the Partnerships Begins
- Be Fast and Flexible (if you can)
- Seek Advice (especially free advice!)

What's Needed in Every Contract?

Term	Range/Detail
Time Period	3 years to 10 years
Revenue Share or A La Carte?	30% to 70% for a full bundle of services
Non-Compete or Competitor Notice	No In-State contracts; new contracts in other states only with notice (but not consent)
Marketing Control/Rights	University marketing has/does not have approval rights
Recruitment operations w/ CRM	Role of call center, recruiters
Advertising/Marketing/ Website	Who pays for ads? Transparency?
Enrollment Management	How are inquiries delivered?
Course Development and Faculty Training	Full support, training, QA, or less?
Coaching/Retention	Who delivers and how?
Market Research	Who does it? Impartial?
Helpdesk support	Who provides? Hours?
Enrollment Technology Usage	Which CRM system? Owned by whom?

Term	Range
Course Technology	OPM May have its own LMS or insist on using the university's provider
University Costs and Services	Always require University admissions, financial aid, registrar, and bursar services; plus incentive programs for faculty participation
Use with Other Partners	OPM can/cannot use courses with other partners for a different revenue share (and vice versa)
Project Management Services	OPM coordinates all new services and manages the implementation timeline
Personnel	The OPM may guarantee dedicated personnel solely for your account
Intellectual Property	Typical for University to maintain all rights?
Termination Clauses	Typical to have a teach-out where the OPM continues to get revenue share on the students it recruited. Also typical to have a termination for cause if the OPM makes a major mistake in operations. Some OPMs will put even more onerous buy-outs on the contract, which should be avoided.

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