

The Whole May Be Less than the Sum of the Parts: A Personal Perspective on the Rice-BCM Merger

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Why this talk?

- ◆ 1912: Rice Institute opened
- ◆ 1960: Rice Institute -> Rice University
- ◆ 2010: Rice University to merge with Baylor College of Medicine?
- ◆ A critical point in Rice's history, but, until recently:
 - Essentially no public discussion
 - External publicity: mostly Rice Administration's view
 - Muffled internal discussions (veil of confidentiality)
- ◆ Sep. 25, 09: Rice report on academic aspects of merger released to public, Rice President interviewed by Houston Chronicle

Why here?

- ◆ Universities are “temples” of free inquiry.
- ◆ We cherish our academic freedom, which is the freedom of inquiry and instruction.
- ◆ We direct our inquiring gaze into nature, society, and culture.

We should not shy of directing that inquiry at ourselves!

We should not hide under “confidentiality”!

Why me?

- ◆ I am senior faculty member at Rice
 - Perspectives: industrial research manager, faculty member, department chair, institute director, member of Rice President's Faculty Advisory Committee and Faculty Merger-Review Committee
- ◆ I was member and chair of national advisory boards
- ◆ I have tenure, which is a privilege accompanied by the obligation to:
 - Tell the unvarnished truth
 - Speak truth to power

This talk: based on publicly available information - my personal perspective

A Brief History of Rice-BCM Merger

- ◆ June 2008: Rumors of merger at BCM
- ◆ Aug. 2008: Negotiations start
- ◆ Sep. 2008: President Leebron meets with department chairs at Rice
- ◆ Oct. 2008: First report in Houston Chronicle
- ◆ Nov. 2008: Leebron interviews with Chronicle, expects matter "to be settled by end of academic year"
- ◆ Mar. 2009: MOU signed
- ◆ June 2009: MOU extended
- ◆ Sep. 2009: MOU extended until a "final" deadline of January 31, 2010

Houston Chronicle: Enthusiastic Reception

- ◆ Chron. Editorial, Nov. 11, 08: Promising Pairing!
 - "has the potential to create a national powerhouse!"
 - "Whatever the financial challenges, a pairing with Baylor would certainly provide an academic boost."
- ◆ Chron. Editorial, Nov. 17, 08: Eyes on the Prize, ... a Union with Rice should be a high priority!
 - "The pairing of Rice and Baylor is so logical and promising ... a once-in-lifetime academic opportunity."

Enthusiastic Rice Administration

President Leebron, Nov. 11, 08: "I think this would be pretty great for Rice. The opportunities that exist in terms of synergies between these two institutions are pretty remarkable."

The “Party Poopers”: Rice Faculty

- ◆ Chronicle, Nov. 11, 08: “possibility has created a wave of excitement among alumni and professors. Many of the school’s faculty members see the possible union as a boost for its prestige and research funding.”
- ◆ LeBron, Nov. 11, 08: “Reaction to the proposed merger has been positive ... among faculty across the curriculum.”
- ◆ April 26, 09: Survey of Rice faculty opinion: 38% consider merger to be a bad idea (20% neutral)
- ◆ Sep. 11, 09: Survey of Rice faculty opinion: 57% consider merger to be a bad idea (14% neutral)

The “Prestige Argument” for the Merger

- ◆ A merger between two prestigious institutions would create a super-prestigious institution.
- ◆ Rice would gain a larger “footprint” and international visibility.
- ◆ Rice might see its ranking increased.
- ◆ Rice would expand its educational mission.
- ◆ Rice would gain strength in the biosciences, which would dominate the sciences in the 21st century.

Prestige is Not Enough!

Leebron, Nov. 11, 08:

- ◆ Rice is not "in the market for a medical school".
- ◆ Rice needs to "continue to see possibilities ... to build on the synergies that exist between the institutions."
- ◆ Bottom line: no synergy, no merger!

Why?

Follow the Money

- ◆ Chronicle, Nov. 11, 08: "Whatever the financial challenges ..."
- ◆ LeBron, Nov. 11, 08: "*A general prerequisite is that we're sure the medical school would be on stable and secure financial footing.*"

BCM's Finances

Year	Investments (\$M)	Bonds (\$M)	Net (\$M)	Operational Loss (\$M)
2004	1093	122	971	(17)
2005	1116	119	997	(48)
2006	1162	292	870	(63)
2007	1329	289	1040	(54)
2008	1101	852	249	(68)
2009	749	897	(148)	(73)

Cumulative Loss (2004-9): \$323M

Outstanding liabilities: \$505M

Unrestricted assets: \$378M

A Brief History of BCM

- ◆ 1900: founded in Dallas
- ◆ 1903: merged with Baylor University
- ◆ 1943: moved to TMC
- ◆ 1948: DeBakey joined
- ◆ 1949: started graduate school
- ◆ 1954: partnered with Methodist Hospital
- ◆ 1969: separated from Baylor University; agreement with TX to increase class size, and keep tuition low in return of a substantial state subsidy
- ◆ Mid 1990s: a top-tier medical school!

Recent History of BCM

- ◆ 2004: "BCM and Methodist sever ties after 50 years"
- ◆ 2005: 50-year affiliation agreement with St. Luke signed
 - "promise of joint efforts in program development and funding initiatives"
- ◆ 2006: "The ballyhooed partnership between BCM and St. Luke has foundered."
- ◆ 2006: "BCM to build hospital without partner, cites St. Luke's new direction as reason to split."

The BCM-Methodist Split

- ◆ *Texas Monthly*, March 2005: "For half a century, in sickness and in health, the marriage of Baylor Medical School and Methodist Hospital produced first-class medicine for Houston and the world. But money, egos, and backstabbing came between them, and now both institutions—and all of us—are the poorer for it."
- ◆ Irreconcilable differences: control and money!
- ◆ Some BCM faculty members warned of "financial implosion".

The BCM Clinic and Hospital (BCH)

- ◆ 600-bed not-for-profit hospital on the McNair Campus - focused on personalized medicine
- ◆ Rationale: will give Baylor control over its clinical mission and streamline the clinical use of research advances
- ◆ **Bottom line:** BCH necessary for BCM's status as a top-tier medical school, after the splits from Methodist and St. Luke!
 - "from a Top-10 ranked medical school to a Top-5"

BCH Status

- ◆ Construction started in early 2007.
- ◆ Early signs of trouble: "It's not like there's lack of capacity in the TMC, and there's the question of whether people will want to keep coming to the TMC, as care becomes more sophisticated in the suburbs."
- ◆ Project frozen in March 2009, only exterior to be completed
- ◆ Wikipedia: "This venture is now considered a toxic asset."
- ◆ Key observation: Without income from BCM, debt cannot be repaid.

The Unraveling

- ◆ Nov. 20, 08: "Baylor medical school axes chief"
- ◆ June 30, 09: Covenant defaults by BCM - "breach of agreement to maintain a Historical/Pro Forma Debt Service Coverage Ratio of at least 1.0 in each fiscal year, and breach of agreement to prevent the Capitalization Ratio from exceeding 0.70 as of the end of each fiscal year."
- ◆ Sep.-Oct, 09: BCM's bonds downgraded by Moody and S&P, bond insurance cancelled.
- ◆ 08-09: faculty leaving, BCM drops in ranking.
- ◆ Bottom line: Whither BCM without Rice?

What would it cost to bail BCM out?

- ◆ Public figures are not available.
- ◆ Given BCM's debt level, cost has to be over \$0.5B. Completing the hospital would probably costs hundreds of millions of dollars.
- ◆ Rice will probably not bear the cost alone, but said it "will make a substantial one-time investment to support the merger."

But Rice is rich. Right? Surely, it can afford this.

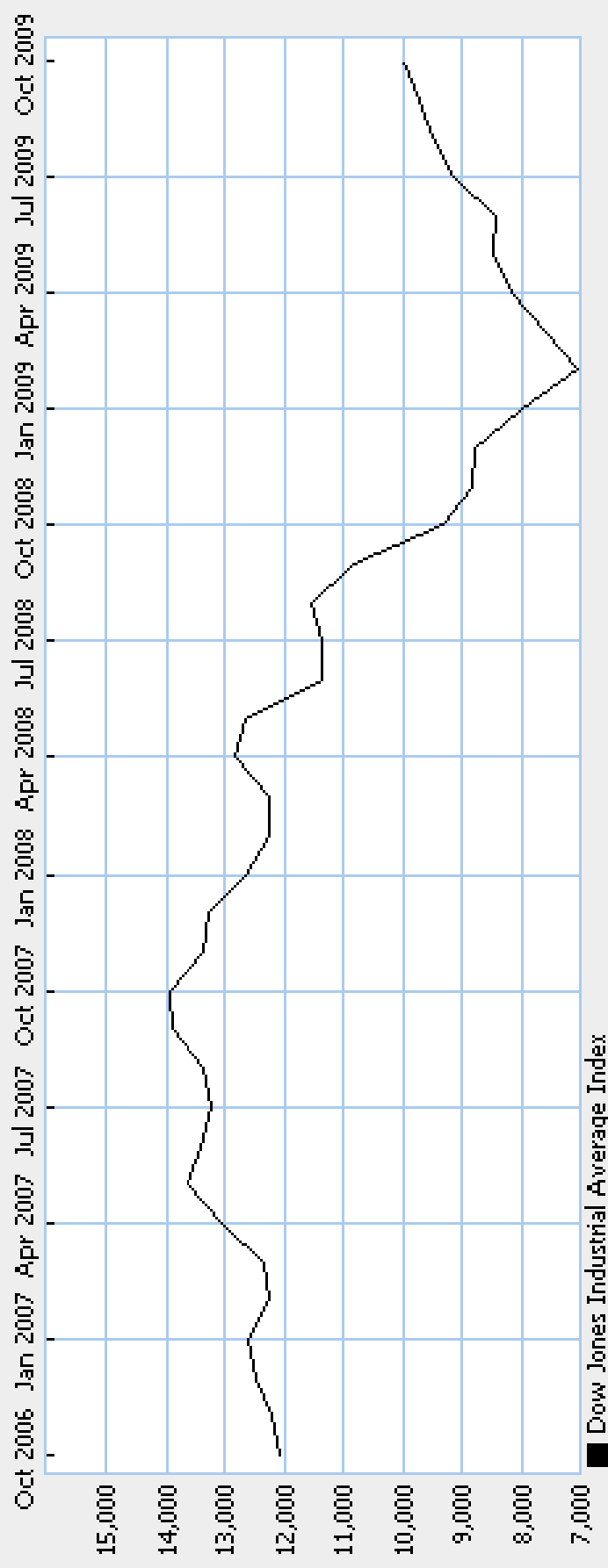
Not quite! Moody put Rice on a watch list after the March 09 MOU was signed.

Rice's Finances

Year	Invest.	Bonds	Net	Inv. Ret.	Expenses
2000	3,534	145	3,389	124	240
2001	3,345	164	3,181	139	259
2002	3,003	189	2,814	145	288
2003	3,171	203	2,968	153	316
2004	3,574	210	3,362	161	334
2005	3,898	205	3,675	167	350
2006	4,283	223	4,060	176	371
2007	5,213	492	4,721	183	396
2008	5,197	618	4,516	202	424
2009(est.)	4,000	725	3,275	225	467

It's the Economy, Stupid!

Price history - \$INDU (10/19/2006 - 10/16/2009)



Impact on Budgets

- ◆ Rice draw about 5% (payout rate) from its investments for operations.
- ◆ Investments are averaged over 12 quarters to reduce volatility.
- ◆ The Board can adjust the payout rate to reduce volatility.
- ◆ Bottom line: In the long term, a drop of \$1.2B in investments, translates to a budget loss of \$60M.
- ◆ 2010 cut: \$12M (5% of base budget)
- ◆ 2011 cut: ???, cut programs?
- ◆ 2012 cut: ????

Financial Exigency

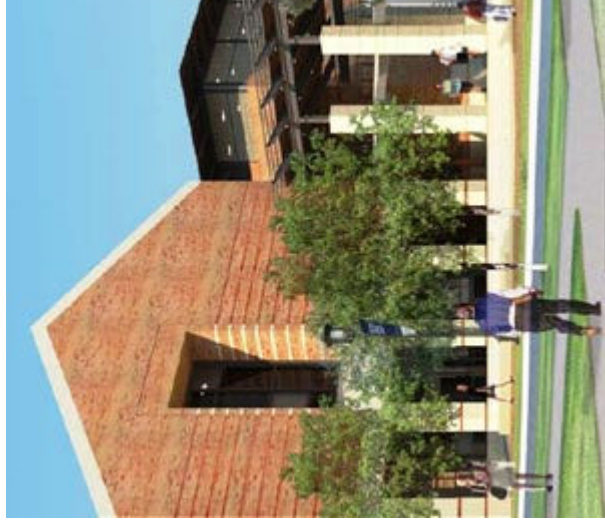
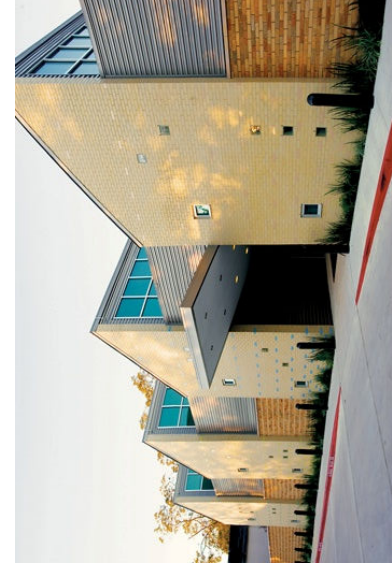
Policy No. 201-01: FACULTY APPOINTMENTS, PROMOTIONS, AND TENURE

- ◆ "The University may terminate an appointment with tenure under extraordinary circumstances because of a demonstrably bona fide financial exigency, i.e., an imminent financial crisis which threatens the survival of the University as a whole and cannot be alleviated by any less dramatic means."

On Leverage

- ◆ Debt increases leverage - Rice's investments now have leverage of over 120%.
 - Both ups and downs are amplified!
- ◆ Because Rice draws distributions from gross investments, its debt expenses are amplified.
 - For example: $4.75\% + 6.5\% = 11.25\%$.
- ◆ **Bottom line:** continued financial stress at Rice for years!

Rice's \$900M Construction Boom



BioScience Research Collaborative

A Brief History:

- ◆ May 2003: University & Main Faculty Committee Report
- ◆ Dec. 2006: Construction starts of the Collaborative Research Center (CRC)
- ◆ April 2009: Building renamed (BRC)
- ◆ July 2009: Researchers start moving into building

May 2003: The University & Main Report

Wild enthusiasm for the idea of a building shared by Rice and TMC bioscience researchers!

- ◆ Current Collaborations: IBB, CBEN, NSBRI, GCC, ...
- ◆ New collaborations: long list!
- ◆ Crux: *Bioscience collaborations w/o ownership of medical school - Best of All Possible Worlds*

Recommendation: get going with project!

Dec. 2006: Construction starts

- ◆ TMC “partners”: BCM, MDACC, MHRI, TCH, UTHSC
- ◆ Other potential partners: Monterrey Tech
- ◆ Leebron: “This combination of the TMC research institutions and Rice has the capacity to be one of the most powerful biomedical research efforts in the world.”
- ◆ Early problems: no intellectual program, no budget for Informatics floor.

June 2009: Signs of Big Trouble!

Nature: "Texas-sized challenge" - TMC hits by souring economy

- ◆ MDACC: Major budget cuts
- ◆ BMC: Cannot complete hospital
- ◆ Rice: Cannot find partners for BRC due to souring economy and glut of research space in TMC.

July 2009: Finally, a partner!

- ◆ July 2009: TCH signs a lease, only partner so far, half a floor!
- ◆ Restated target for Rice occupancy: 50%.
- ◆ Rice to bear cost of building (\$300M)
 - Series 2007 A&B bonds: \$315M at avg. 4.75% interest
 - Annual interest payments: \$15M!

Financial Impact of Merger

- ◆ Impact 1: Merger costs at expense of Rice programs
- ◆ Impact 2: Increased financial volatility
 - BCM depends on two volatile income sources: NIH funding and clinical-care business
 - BCM's budget is 2.5X that of Rice
 - Instability of TMC relationships
 - \$50M from TX in ongoing risk
- ◆ Reality: Institutions cannot build internal financial "Chinese walls".

Pessimism, Optimism, and Realism

- ◆ Question: Are you not too pessimistic? The economy seems to be recovering, and the endowment will surely recover, eventually!
- ◆ Answer: A university is not a hedge fund!
 - The purpose of the endowment is to add stability, not volatility.
 - Rice should not make bets that depend on the stock market.
 - BMC made such a bet, and lost!
- ◆ Andy Grove: "Only the paranoid survive!"

Prestige vs. Synergy

- ◆ The “prestige argument” may suffice if BCM and Rice were financially healthy, but it cannot overcome the challenges of BCM’s near insolvency and Rice’s budget stress.
- ◆ To justify a financially risky merger, the “synergy argument” has to be employed, promising “numerous academic benefits” for Rice, beyond merely having a medical school.

Where is the synergy?

- ◆ Starting in Jan. 09, the faculty challenged the Rice Administration to substantiate the synergy argument.
- ◆ V., March 09: "Big claims require big proofs!"
- ◆ Sep. 7, 09: Subcommittee on Academic Matter issues Final Report ("SAM Report")
- ◆ Sep. 25, 09: SAM Report released

Sep. 25, 09 Press Release

- ◆ "A joint academic committee explored opportunities for potential synergies and the process that would be needed to capture them."
- ◆ "The committees concluded that a merger could lead to a wide array of academic benefits."
- ◆ "We will work hard to bring our discussions to a successful conclusion over the next four months."

Finally, a detailed argument! Let's subject it to peer review.

The SAM Report: Provenance

- ◆ Authors: Jim Coleman, Rice's Vice Provost for Research, and Adam Kuspa, BCM's Associate Dean of Research
- ◆ Committee: Joint to Rice and BCM
- ◆ Charge: "to produce specific recommendations as to how a potential merger should be implemented"
- ◆ Date launched: April 24, 09
 - One day after the Rice faculty voted to establish an independent Faculty Merger Review Committee (FMRC).

SAM Report: Substance

- ◆ Conclusion: "numerous *potential* academic benefits" (emphasis in original!)
 - New collaborations
 - New collaborative programs
- ◆ But: the fact that there are *potential* benefits has never been in contention!
- ◆ Missing: a sober analysis of what it'd take to turn *potential* benefits into *actual* benefits.

Sober Analysis - I

- ◆ Q1: Why more collaborations has not developed?
 - Rice and BCM have been neighbors for over 60 years.
 - Numerous collaborations exist.
 - How would the merger enable new collaborations that did not exist so far?
 - Collaborations occur because of intellectual affinity, not because of organizational affinity.

Example: Informatics

- ◆ Biology is becoming an information science- numerous potential collaborations between biomedical and informatics researchers.
- ◆ Culture gap: informatics researchers discover *methods* for solving computational problems; biomedical researchers need their *concrete* problems solved.
- ◆ Fact: The real barrier to more collaboration is cultural, not organizational.

Sober Analysis - II

- ◆ Q2: What are the current barriers to collaboration? Would the merger lower them? Can they be lowered without a merger?
 - Many people and units at Rice are dedicated to developing collaborations between Rice and the TMC.
 - SAM did no analysis of current collaborations and collaboration barriers
 - It is the job of administrators to lower administrative barriers, not to raise them!
 - E.g, negotiate an umbrella IP agreement.

Sober Analysis – III

- ◆ Q3: Can collaboration occur without merger?
- ◆ Coleman, Rice VPR, Oct. 2, 09: "smaller projects are certainly possible in the present state, but any large-scale initiative would require the coordination of a single administrative entity."
- ◆ Really?
 - Broad Institute: 231,000 sf genomic lab, with over 100 faculty members, in Cambridge, MA, joint to Harvard and MIT
 - Georgia Tech/Emory Department of Biomedical Engineering
- ◆ FMRC: "We believe that many of the benefits could be realized without a merger."

Sober Analysis – IV

- ◆ Q4: How have other institutions leveraged their medical schools to create synergies? What can we learn from their experience?
 - Report contains *no* examination of other institutions!
- ◆ Faculty Advisory Committee, after several phone calls to colleagues across the country:
 - There is a large gap between glossy brochures and fancy websites, on one hand, and the reality on the ground, on the other hand.
 - Medical schools tend to be “academic islands”, separated from their campus by cultural barriers.

Sober Analysis – V

- ◆ Q5: How much would it cost? Will new programs have new positions?
 - Remember, this report was supposed to be an implementation plan!
 - Surely, “large-scale initiatives” would not happen without a major investment!
 - Without realistic costs estimates, the SAM Report is just a wish list!
- ◆ FMRC: a careful cost estimate of \$250M for academic investment.
- ◆ Cost estimation cost is such a basic element of an implementation plan that this omission *cannot* be accidental.

Example I: IT Infrastructure

- ◆ SAM Report: "The best example of possibilities for sharing infrastructure are in the area of computational hardware and the associated faculty to manage and exploit its use."
- ◆ Reality: Both BCM and Rice are short of space to house computational hardware. Building such space is exceedingly expensive.
 - Rice is trying to raise \$6.5M to do site preparation for 4,000 sf of already built data-center space.

Ex. II: Perpetuating Collaborative Success

SAM Report:

1. "Provide funded faculty sabbaticals for Rice faculty at BCM and BCM faculty at Rice."
2. "Develop a competitive, prestigious, interdisciplinary postdoctoral research program."

◆ No cost estimate!

Sober Analysis - VI

- ◆ Q6: What is the opportunity cost?
- ◆ Wikipedia: "Opportunity cost is the value of the next best alternative foregone as the result of making a decision. Opportunity cost analysis is an important part of a company's decision-making process."
- ◆ What are Rice's alternatives to the merger? Is the substantial investment in the merger Rice's best investment opportunity? Can Rice afford to make a substantial investment, given its budgetary constraints?

Sober Analysis - VII

- ◆ Q7: What would be the budgetary impact of the merger on academics at Rice?
 - Direct investment from the endowment reduces the distribution from the endowment.
 - Financing such investment by debt simply shift costs to the future.
- ◆ Reminder: Rice is cutting budgets and will continue to cut budgets in the coming years!

Sober Analysis - VIII

- ◆ Q8: What'd be the academic consequences of having one of the most unbalanced universities in the country?
 - BCM is about 3X Rice in number of faculty.
 - Natural comps: Johns Hopkins, Wash. U., Univ. Rochester
 - Already, about 1/3 of Rice students are pre-meds.
- ◆ Will non-medical Rice have to grow to address the imbalance? How much would that cost?

A Positive Element in SAM Report

The Committee recommended that "an Integration Coordination Office be created."

- ◆ Excellent recommendation!
- ◆ In fact, such a recommendation was made to the Rice Administration about five years ago, and rejected "for lack of funds".

SAM Report: My Conclusions

- ◆ The SAM Report was likely never meant to be an analytical report
 - IMHO: Its conclusions were decided before it was written.
 - Not "Academic due diligence"! No cost/benefit analysis.
- ◆ The "synergy argument" has been overhyped!
 - There are potential benefits, but they will not be realized without a substantial investment, and many are attainable without a merger.

If the "prestige argument" is too weak, and the "synergy argument" is overhyped, what's left as an argument for the merger?

The “Bailout Argument”

- ◆ The “bailout argument”:
 - BCM is a key asset to Houston and to Rice.
 - BCM cannot survive on its own without a bailout.
 - Rice can afford to bail BCM out.
 - It'd be better for Rice to have BCM become Rice's medical school, then, say UH's medical school.
- ◆ Is this what the Rice Administration has in mind?
- ◆ Unknown, but that would, IMHO, be a more compelling and honest argument.

Response to the “Bailout Argument”

- ◆ BCM is indeed a key asset and requires help.
- ◆ It is not clear that Rice can afford to bail out BCM – the risk to Rice may be too large.
- ◆ There is no obvious scenario for a merger of BCM with UH.
 - Unlike current negotiations, such a deal would have to be negotiated in public.
- ◆ If BCM does merge with UH, launching UH towards Tier I status as research university, then Houston and Texas benefits, and Rice will have to compete harder.
- ◆ **Important Question:** BCM after a bailout?

BCM: Status after Survival?

- ◆ BCM is fighting for its life—its goal is to survive, not to stay a top-tier medical school.
- ◆ BCM may not maintain its top-tier status w.o. pre-O4-like partnership (control & money)
 - Seems unlikely that such a partnership with Methodist or St. Luke can be resurrected.
 - BCM may continue to decline inexorably, even as a Rice or UH medical school.
- ◆ UH may be content with a 2nd-tier medical school.
- ◆ For Rice, it'd be a tragedy to merge w. BCM, and end up with a 2nd-tier medical school.

Summary: Risks of Merger

- ◆ Academic decline due to budgetary stress and volatility
- ◆ Continued decline of BCM even after merger

Special Role of Faculty

- ◆ I. Rabi, 1948: "The faculty is the university"

Why?

- ◆ Mission of university: teaching, learning, research, scholarship
 - Faculty members decide what to teach and what to study.
 - Administration is overhead.
 - Universities are famous for their faculties, not for their administrations or boards.

The Faculty and the Merger

- ◆ SAM Report: "The success of any endeavors in research and education will require the passion and leadership of key faculty members whose commitment to the activity will be required for success."
 - (Who are these faculty members?)
- ◆ The Administration should have sought faculty involvement from the start.
- ◆ Instead, the Rice faculty has had to fight to have a formal role in the process.
- ◆ The Rice faculty lacks confidence in the Administration ability to execute the merger.

The Deciders: Rice Board of Trustees

The merger decision is a corporate decision and is appropriately in the province of the Board of Trustees of Rice University: James W. Crownover (Chair), J.D. Bucky Allshouse, Kent Anderson, Keith T. Anderson, Subha V. Barry, Suzanne Deal Booth, Alfredo Brener, Robert T. Brockman, Nancy P. Carlson, Robert L. Clarke, Bruce W. Dunlevie, Lynn Laverty Elsenhans, Douglas Lee Foshee, Susanne Morris Glasscock, David W. Leebron, Robert R. Maxfield, M. Kenneth Oshman, Jeffery O. Rose, Lee H. Rosenthal, Hector de J. Ruiz, Marc Shapiro, L.E. Simmons, Robert B. Tudor, III, James S. Turley

A Fateful Decision

- ◆ While the merger has the potential to lift Rice to the next level, it also has the potential to cause irreparable harm to Rice.
- ◆ The costs and the risks are high enough to place the burden of proof on those who advocate the merger.
- ◆ In my opinion, a compelling case for the merger has yet to be made.
- ◆ Great universities are built by years of hard work, not by making risky corporate moves.
- ◆ **Basic truth:** *human beings are fallible; great plans go awry* ("consider you may be wrong").

“Deals without Delusions”

HBR, Dec. 07 - Mergers' Errors:

- ◆ Confirmation bias
- ◆ Overconfidence
- ◆ Underestimating cultural differences
- ◆ Underestimating resources needed for integration
- ◆ Bidding above the target's true value
- ◆ Refusing to walk away from a deal

Keep in Touch

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