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, 2013. The current year deficit of approximately $34 million is slightly less than 1% of the University's revenue – and in that context the deficit, while still meaningful, is manageable. However, the ability to stay in financial balance going forward depends in large part on an institutional commitment to cost management and an embrace of innovative revenue opportunities.

Colleges and universities around the country continue to face substantial pressure, and Harvard is no exception. The federal government's ongoing commitment to research funding is more uncertain than it was last year, and we have already begun to feel the chilling effects of the budget sequester on research grants. Net tuition, particularly at the undergraduate level, is likely to continue growing slowly due to Harvard's unwavering investment in grant aid for our students. And while the endowment had a strong year, with an investment return of 11.3%, we are ever mindful of the volatility of global financial markets and the resulting caution we must use in planning for future endowment distributions.

The combination of these pressures, which impacts substantially more than half of the University's total revenue, means we must continue to be aggressive and innovative in our financial management strategies. Harvard's position is strong both academically and financially, but remaining strong requires constant attention and vigilance, and a willingness to make changes in the near term that will position us competitively in the longer term.

Decisive actions taken over the past five years leave Harvard better positioned to weather the persistent uncertainty of our times. The global financial crisis created an opportunity to broadly reevaluate our approaches in many different realms, including:

- New, foundational policies for liquidity management and short-term investments that more closely integrate activities at Harvard Management Company (HMC) with activities in the University's Treasury function. This has resulted in an accumulation of cash held outside HMC that totaled approximately $1.5 billion at June 30, 2013, and a substantially improved ability to understand, identify and evaluate both risks and opportunities in our treasury and investment activities.

- A reduction in the University's outstanding debt. While we believe debt is an important enabler of growth, it currently constitutes an outsized proportion of the University's capital structure. From a high of $6.3 billion at June 30, 2011, Harvard's outstanding debt still stands at $5.7 billion. We are de-levering in a deliberate yet gradual manner in order to maintain flexibility.

- Deeper analytic insights regarding our budgets and the interaction between our budgets and capital plans. The University's governance reform efforts gave rise, beginning two years ago, to a new Finance Committee of the Corporation. The Finance Committee has engaged in close, in-depth collaboration with the University's management team on budgets and longer-term financial plans. The result of this highly productive engagement has been a more sophisticated understanding of the University's financial pressures, a closer tie between budgets and cash needs, and a clearer perspective on the degree to which our operating budgets should provide financing for our capital plans – particularly as those plans relate to the maintenance and renewal of existing facilities.

The progress we have achieved to date positions us well to face the challenges and opportunities ahead. It also gives us the confidence to move forward on critical strategic priorities for the University, including the renewal of Harvard's undergraduate Houses and resumed development of the University's Allston properties. Continuing to pursue our strategic imperatives notwithstanding the highly uncertain context in which we operate reflects Harvard's strength, as well as our success in taking an increasingly proactive rather than reactive approach toward managing our finances. And yet like most colleges and universities, we already have exhausted the easiest opportunities for budget improvement. As a result, we will face increasingly complicated yet unavoidable choices as we seek to cover more ground in cost management.

One area of opportunity relates to activities currently replicated in many parts of the University that might be done more efficiently in aggregation. For example, in the past two years we have pursued efficiencies by reconfiguring our library administration, integrating many aspects of IT operations, and initiating a project to unify the University's many student information systems. Strategic procurement is another promising realm where the sum of the University's parts can be leveraged far more effectively than each unit acting independently – with the result of cost savings, higher quality services, and an improved ability to manage vendor-related risks.

Culture change of this sort is hard for any large and decentralized organization. Changing Harvard's culture will require time, transparency, a willingness to make mistakes along the way, and the capacity to learn from them. Other changes, such as reducing the growth rate of our benefits costs, can be more difficult since they often are experienced at a more personal level. Yet these changes are inevitable and will allow us to protect the integrity of the high-quality teaching and research that has allowed Harvard to lead throughout the centuries. If we do not adapt to overcome the constraints of our circumstances, the future may well find Harvard at a disadvantage, less able to produce for the world the discoveries and graduates that have created such substantial value over time. But if we have the courage to make prudent decisions with our resources and operations, the current moment presents us with the possibility of reshaping that future.

Of course, Harvard's faculty, students and staff are not alone in this endeavor. The Harvard Campaign is a critical vehicle for maintaining and enhancing the University's strength. The Campaign was launched in September, and the impact of our pre-launch engagement can be seen in this year's financial report – most notably in the $792 million in cash receipts during fiscal 2013 (including an increase of nearly $50 million in current use giving), and the 36% increase (to $1.2 billion) in pledges receivable at June 30. We always appreciate the extraordinary generosity of those who care so deeply about the University, but at this particular time we are especially grateful for their ongoing support.

Our concerns about financial pressures in higher education and at Harvard are rooted in a deep underlying passion for what universities are and can be. By naming and addressing these pressures rather than ignoring them, Harvard can more quickly adapt to the very different context in which we find ourselves in order to preserve and even enhance our investment in our most important endeavors. And in doing so, we might bequeath to future generations an even more transformative and inspiring institution than the Harvard of today. Pursuing this aspiration has never been more important.

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 8, 2013

FINANCIAL OVERVIEW

The University ended fiscal 2013 with an operating deficit of $34 million compared to an operating deficit of $7.9 million in fiscal 2012. Despite the operating deficit, the University's net assets increased by $3.0 billion to $38.6 billion at June 30, 2013, driven mainly by positive endowment returns and an increase in giving.

OPERATING REVENUE

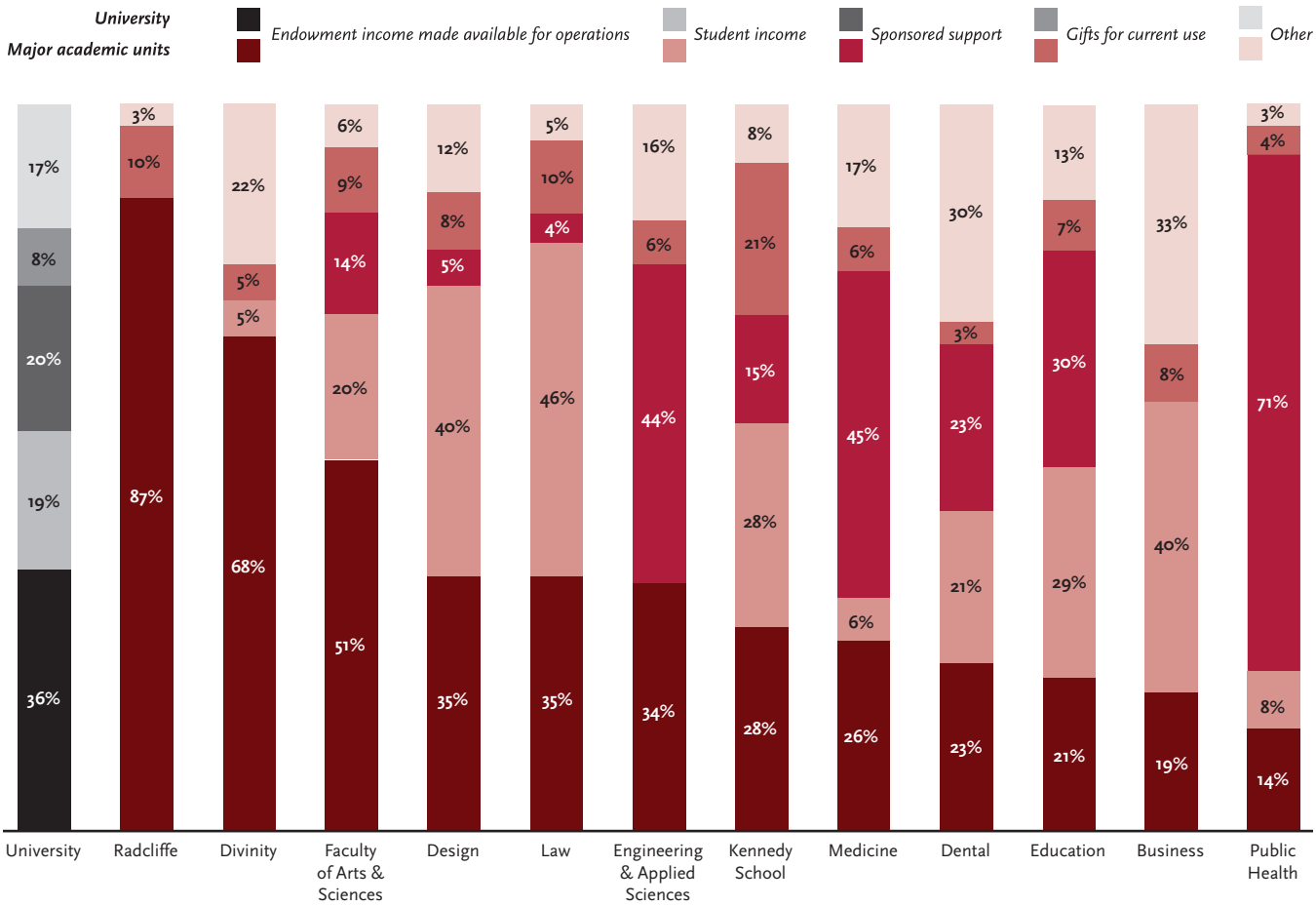
Total operating revenue increased 5% to $4.2 billion, due largely to the increased annual distribution from the endowment and a substantial increase in gifts for current use.

In fiscal 2013, the endowment distribution increased 5% to $1.5 billion. Growth in the endowment distribution was a result of the annual Corporation-approved increase, as well as the impact of new gifts. In the aggregate, Harvard's endowment payout rate (i.e., the dollars withdrawn annually for operations and for one-time or time-limited strategic purposes, as a percentage of the endowment's prior year-end market value) was 5.5%. This is in line with the University's targeted payout rate range of 5.0-5.5% and is consistent with the 5.5% payout rate in fiscal 2012.

Current use gifts increased by 17% from $289 million in fiscal 2012 to $339 million in fiscal 2013, and total cash receipts from giving, including gifts designated as endowment, increased 22% to $792 million (see Note 16 of the audited financial statements). As the University launches its first capital Campaign in more than a decade, it has seen a significant increase in giving. We are extremely grateful to our alumni and supporters for their extraordinary generosity.

The University's sponsored funding, including both federal and non-federal funds, increased by 1% to $845 million in fiscal 2013. Federal funding, which accounted for 77% of the total sponsored funding during fiscal 2013, declined 2% to $653 million in fiscal 2013 while non-federal funding increased 17% to $191 million in fiscal 2013.

FISCAL 2013 SOURCES OF OPERATING REVENUE



The decline in federal sponsored funding was anticipated due to the winding down of ARRA funding, as well as the initial impact of the federal budget sequester. The 17% increase in non-federal funding mitigated the effect of the decline in federal funding and was the result of an increase in support from foundations, state, local and foreign governments, and industry sponsors.

Total student revenue increased approximately 5% to $815 million in fiscal 2013. Net revenue from undergraduate students (i.e., undergraduate tuition, fees, board and lodging, less scholarships applied to student income) increased 4%, which reflects a 3% increase in tuition and fees combined with a modest increase in financial aid. The University's commitment to financial aid, which ensures that the cost of attendance is not a barrier to qualified students, resulted in approximately 60% of undergraduate students from the class of 2016 receiving grant aid awards. Graduate net student revenue increased by approximately 7% due to increases in tuition as well as enrollment increases at several of the University's graduate and professional programs.

OPERATING EXPENSES

Total operating expenses increased by 6% to $4.2 billion. Compensation expense (i.e. salaries, wages and benefits), which represents approximately half of the University's total operating expense, increased 4% from $2.0 billion in fiscal 2012 to $2.1 billion in fiscal 2013.

Salaries and wages increased by 4%, or $55 million, to $1.6 billion in fiscal 2013 mainly due to the University's merit increase programs.

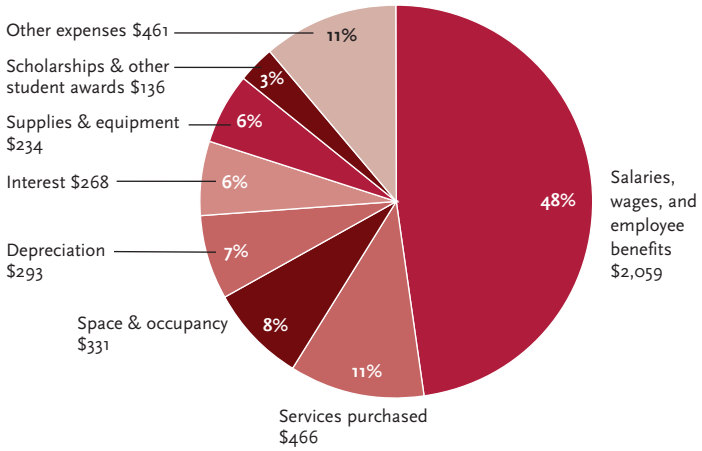
Employee benefits expense increased 6%, or $30 million, to $507 million. The increase was driven mainly by:

- Higher costs associated with active employee health plans, due to health care cost inflation and an increase in family enrollments;
- Employer contributions to defined contribution retirement plans as a result of increases in salary and wages on which the contribution is based, and;
- Higher annual expenses related to the University's defined benefit plans, due primarily to changes in actuarial assumptions.

The University's non-compensation expense increased 7% to $2.2 billion in fiscal 2013. The University increased expenditures on a number of strategic initiatives in fiscal 2013, including its edX collaboration with MIT, further development of its Allston properties, and the Harvard Campaign. These increases in non-compensation expense were offset in part by a $19 million decrease in interest expense, reflecting the reduction in debt outstanding during fiscal years 2012 and 2013.

FISCAL 2013 OPERATING EXPENSES

In millions of dollars



TOTAL OPERATING EXPENSES $4,248

BALANCE SHEET

Investments

In fiscal 2013, the endowment earned an investment return of 11.3%, and its value (after the impact of distributions from the endowment for operations and the addition of new gifts to the endowment during the year) increased from $30.7 billion at the end of fiscal 2012 to $32.7 billion at the end of fiscal 2013. More information can be found in the Message from the CEO of Harvard Management Company (HMC), found on page 8 of this report.

The University's holdings of liquid investments (e.g., cash and treasuries) outside of the General Investment Account (GIA) increased from $1.3 billion at June 30, 2012 to $1.5 billion at June 30, 2013. The GIA is managed by HMC and includes the endowment as well as a portion

of the University's pooled operating funds. Over the past several years, the University has increased the amount of liquid, low risk investments held outside the GIA to ensure access to liquidity in situations of financial duress.

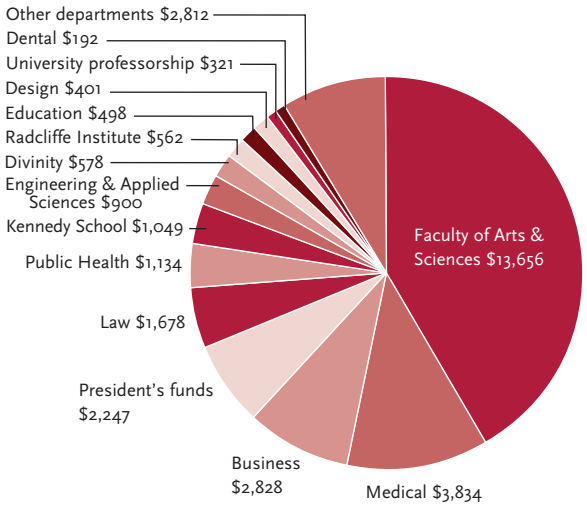
Debt

The University's outstanding debt decreased from $6.0 billion at June 30, 2012 to $5.7 billion at June 30, 2013. The weighted average interest rate of the portfolio was 4.7% at June 30, 2013, and the weighted average years to maturity was 17.1 years. In April 2013 the University refinanced its Series 2006A bonds with a total par amount of $402 million, lowering the interest rate from over 6% to below 4% and thereby reducing the University's projected long-term interest expense by over $10 million per year. The University is seeking to limit new debt over the next several years in order to avoid incremental interest expense and allow flexibility in the face of potential revenue and expense pressures on the University's budget.

The University's AAA/Aaa credit ratings with Standard & Poor's Ratings Services and Moody's Investors Service were re-affirmed in fiscal 2013. Additional detail regarding the University's debt portfolio can be found in Note 12 of the audited financial statements.

FAIR VALUE OF THE ENDOWMENT AS OF JUNE 30, 2013

In millions of dollars



TOTAL FAIR VALUE $32,690

Accrued Retirement Obligations

The University's accrued retirement obligations decreased by $302 million or 29% in fiscal 2013, and represented a $754 million liability at June 30, 2013. The valuation of these obligations is very sensitive to interest rates (i.e. higher interest rates result in a decrease in the liability). Rates increased meaningfully during fiscal 2013 after many years of decline and explain approximately half of the decrease. The remaining reduction is related both to changes in assumptions used in projecting the liability, and to our active management of the retiree medical plan. The University has made several plan changes in recent years, none of which meaningfully impacted the competitive positioning or breadth of the benefit offerings relative to peers but all of which, in the aggregate, have caused a reduction in our future obligation. We continue to dedicate attention to the management of this important area, and as of January 1, 2014 will be making further changes in the retiree medical plan. These changes are intended to better ensure a sustainable and competitive retiree medical benefit for the long term.

Capital Expenditures

The University invested $404.2 million in capital projects and acquisitions during fiscal 2013, an increase of 19% versus fiscal 2012. This enabled progress on several significant projects including:

- The Harvard Art Museums' renovation and expansion, which will result in greater accessibility to the University's world-renowned collections;
- Tata Hall, to support the Business School's portfolio of executive education programs;
- The completion of Stone Hall and commencement of construction for Leverett-McKinlock, the second test project in the broader renovation of Harvard undergraduate Houses; and,
- The Science Center Plaza, which supports the University's goal of creating new, engaging common spaces for the entire community.

This concludes the summary of the key financial highlights for fiscal 2013. We encourage you to read the audited financial statements and related notes for more information regarding the financial position and results of the University.