U.S. Higher Education: Key Credit Challenges and the Need for Adaptation

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New England Board of Higher Education
Agenda

- Overview of Moody’s Higher Education Portfolio
- U.S. Higher Education Rating Methodology
- Mixed Higher Education Outlook for 2011 and Key Credit Challenges
- New Realities and the Need for Adaptation
- Reasons for Optimism
- Questions and Answers
Higher Ed Ratings: Public Universities Rated Higher, but More Aaa-Rated Privates

» Moody’s currently rates 226 public colleges and universities in the U.S.
» Median rating of A1 by number of institutions
» Median rating of Aa2 when weighted by debt

» Moody’s currently rates 288 private colleges and universities in the U.S.
» Median rating of A3 by number of institutions
» Median rating of Aa3 when weighted by debt
Higher Education in New England

Snapshot of Moody’s Ratings in New England

- 50 rated private colleges and universities (Aaa to B1); enrollment ranging from <1,000 students to >25,000 students
- Several large public universities, including flagships and systems

A Challenging Landscape: Supply and Demand

- Strong Supply: Northeast is a highly competitive region for higher education
- Pressure on Demand: Challenging demographic forecasts for the number of high school graduates
  - Out of state recruitment is highly competitive (FL, CA, AZ)
  - You can recruit out of state, but can you retain?
Moody’s U.S. Not-for-Profit Private and Public Rating Methodology

- Updated rating methodology published in August 2011

- 5 broad rating factors in rating assessment:
  - Market position
  - Operating performance
  - Balance sheet and capital investment
  - Governance and management
  - Legal security and debt structure

- Introduction of a scorecard with a weighted quantitative grid and notching for qualitative factors
Governance & Management: Key Underpinning for a Rating

- Governance
  - Diversified boards with sector expertise and philanthropic capacity
  - Strong accountability and oversight of management
  - Use of self-assessment, benchmarking, term limits and strong conflict of interest policies

- Management
  - Mix of veterans and newcomers
  - Detailed, multi-year financial planning
  - Realistic benchmarking—peers vs. aspirants
  - Commitment to disclosure to all constituencies
Higher Education Outlook – A Look Back over Past Few Years

*Moody's Sector Outlook*: our expectation for fundamental credit conditions over the next 12-18 months; not a prediction of expected rating changes during this period

2009 & 2010: **Negative Outlook for All Sectors** (private/public universities, K-12, and other not-for-profits)

- Increased pressure on tuition and financial aid
- Broad impact of investment losses on operations and philanthropy
- Illiquidity of balance sheets, amplified by alternative investments
- Volatility in debt markets as well as debt structures
- More credit pressure for private universities than public universities

January 2011: **Mixed Outlook for U.S. Higher Education**

- Outlook revised to stable for diversified market leading universities
- Maintenance of negative outlook for majority of tuition and state-dependent universities
Mixed Outlook for U.S. Higher Education in 2011: Business Diversity is a Key Stabilizing Factor

<table>
<thead>
<tr>
<th>Factors Associated with Stable Outlook</th>
<th>Factors Associated with Negative Outlook</th>
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<tr>
<td>• Market leaders with top-ranked academic programs and global reputations supporting pricing power</td>
<td>• Moderately selective to non-selective institutions with a regional student draw</td>
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<tr>
<td>• Multiple business lines, typically with no one source accounting for more than 50% of revenue</td>
<td>• Moderate to weak pricing power and more limited ability to grow net tuition</td>
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<tr>
<td>• Consistently strong demand from top quality students and faculty</td>
<td>• Less diversified business lines with heavy reliance on student charges and/or state appropriations</td>
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<td>• Generous philanthropic support, low dependence on state funding, and diversified research funding</td>
<td>• Small, if any, fundraising or research enterprises</td>
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<td>• Strong balance sheet providing good support for debt and operations as well as ample liquidity</td>
<td>• Modest endowments or limited liquidity providing little support for operating budget and debt</td>
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<td>• Management and governance teams focused on long-term sustainability</td>
<td>• Typically small or medium-sized enrollments and lack of economies of scale</td>
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Critical Credit Factors Facing Higher Education Today

- Negative revenue pressures on all fronts:
  - Growing resistance to tuition increases
  - Lower gift revenue
  - Declining federally sponsored research
  - Cuts in state funding to public universities

- Balance sheet risks:
  - Investment volatility, more limited liquidity
  - Heightened debt structure risks
  - Capital needs
All Universities Face Increased Tuition Pressure

- Political and public pressure to improve affordability
- Moderation of tuition increases
- Expanded financial aid budgets
- Strong competition from lower-priced alternatives
- Need to become more efficient including use of online delivery of classes and degrees

**Slowed Net Tuition Growth Lags Steep Decline in U.S. Net Worth**

![Chart showing Change in Net Worth of Households & Not for Profit Organizations (\$, trillion) and Median Private College Change in Net Tuition per Student (%) from 2005 to 2011. Source: Change in Net Worth 1980-2010 from Federal Reserve; 2011 Forecast from Moody's Analytics; Median Net Tuition per Student from Moody's.]

Source: Change in Net Worth 1980-2010 from Federal Reserve; 2011 Forecast from Moody’s Analytics; Median Net Tuition per Student from Moody’s.
State Budget Gaps Result in Higher Education Funding Cuts

- End of ARRA funding in 2011
- State budget gaps persist; lower tax receipts due to recession; depletion of state reserves
- Longer term increases in state funding have not kept pace with growth of operating budgets
- Larger public universities and systems better poised to take advantage of economies of scale and operational efficiencies
- Smaller regional publics are more reliant on state funding and compete more heavily with community colleges
- Instances of delays in cash funding from the state or late in the year appropriation cuts (Illinois and Arizona): adequacy of liquidity?
Heightened Competition for Research Funding and Philanthropic Support

Research Funding:
- ARRA funding for research provided temporary boost
- Flattening of federal research funding; increased competition
- Largest, nationally prominent research institutions best positioned for stable funding
- Increased focus on grant funding diversification including private funding sources, commercialization of research

Philanthropic Support:
- Gifts are down, but still a unique credit factor for the sector
- Likely to be stabilizing at lower base level
- Shifting donor priorities?
Balance Sheet Management: Liquidity and Debt Structure
Still Carry Risk and Require Ongoing Attention

- **Liquidity**
  - Renewed focus on liquidity
  - Organization-wide assessment of sources/uses of liquidity
  - Past investment losses impact future endowment draws

- **Debt Structure**
  - Wave of bank agreements expiring in 2011
  - Swaps still negative, although reduced collateral posting requirements
  - Increased use of fixed-rate debt

- **Capital Planning**
  - Strong debt issuance in 2010, including BABs; slowdown so far in 2011
  - Careful re-evaluation of capital plans and prioritization of resource use
"New Realities" and the Need for Adaptation

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<th>Heightened price sensitivity</th>
<th>Reduced tuition increases; growth of financial aid budgets; need to demonstrate product value</th>
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<td>Pressure on top-line revenue growth</td>
<td>Expense containment, operating efficiency</td>
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<td>Long-term pressure on government funding</td>
<td>Business diversification; growth of alternative private revenue sources (research, gifts, tuition)</td>
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<td>Increasing diversity of the student body</td>
<td>More flexible schedules (weekends, hybrid, 3 year B.A.)</td>
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<td>Uncertainty about long-term endowment returns</td>
<td>More stress testing of long-range assumptions and enterprise risk management planning</td>
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<td>More financial accountability placed on boards of trustees and management teams</td>
<td>Increased transparency to all constituencies</td>
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Reasons for Optimism

- Strong and resilient demand overall
- Long-term family planning and saving for college
- Good business model
- Few defined benefit pensions
- Philanthropy
- In most cases, room for expense containment and slowed capital investment
Questions & Answers

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