2012 Annual Sector Outlook for U.S. Higher Education

Higher Education & Other Not-For-Profit Teleconference
Agenda

1. Mixed Higher Education Outlook for Different Segments of the U.S. Higher Education Market
2. Negative Outlook for Private K-12 Schools and Other Not-for-Profits
3. Baseline Assumptions
4. Critical, Near-Term Issues Facing Colleges and Universities
5. Review of Recent Higher Education Rating Activity
6. Questions and Answers
Mixed Outlook for U.S. Higher Education in 2012
Trends Still Favor Larger Diversified Organizations

Characteristics Associated with Stable Outlook

» Market leaders with top-ranked academic programs and global reputations supporting pricing power

» Many, but not all, are among the 1/3 of private or public colleges and universities rated Aaa or Aa

» Highly selective and/or high net tuition per student reflecting strong national/international demand from top quality students and faculty

» Multiple business lines generating revenue from diverse sources

» Generous philanthropic support, low dependence on state funding, and diversified research funding

» Strong balance sheet providing good support for debt and operations as well as ample liquidity

Characteristics Associated with Negative Outlook

» Typically small or medium-sized enrollments and lack of economies of scale

» Mainly represented among the large majority of private or public colleges and universities rated A-Baa-Ba

» Non-selective to moderately selective colleges and universities with average to low net tuition per student and a more regional student draw

» Undiversified business lines with heavy reliance on student charges and/or state appropriations

» Small scale fundraising lacking regular major gifts and similarly small scale to non-existent funded research

» Modest endowments or limited liquidity providing little support for operating budget and debt
Negative Outlook: Independent K-12 and Other Not-for-Profits

Independent K-12 Schools

» Slowed growth of net tuition per student, increased tuition discounting

» Focus on expense containment, decline in educational expenses per student

Other Not-for-Profits

» Downward pressure on revenue, including grants and endowment spending

» More pressure on philanthropy than higher education

» Slowdown in pace of capital spending
Baseline Assumptions Underlying Credit Strengths & Challenges

» Core student demand for undergraduate higher education remains strong– graduate and professional programs less secure

» There is no real threat from substitutes for “the college experience” for 18-23 year old students even given on-line growth

» The student body is becoming ever more diverse--influencing recruitment, retention, pricing and discounting strategies

» Technology will play an increasingly important role in reaching more students at lower cost—and competing with for-profits

» Colleges and universities face growing regulatory risk even as they become important regional economic engines for their communities

» Philanthropy remains a core credit strength of US higher education

» Federal funding for research will slow, and private research funding sources will be increasingly important
Critical Credit Factors Driving 2012 Outlook:

1. Evolving Demand Trends Highlighting Flight to Quality and Affordability

2. Rattled Consumer Confidence and Intense Spotlight on Affordability

3. Pressure on Non-Tuition Revenue Streams Underscoring Importance of Revenue Diversification and Operating Efficiency

4. Liquidity and Debt Structure Risks Mitigated but not Eliminated; Slowed Capital Spending and Borrowing
Critical Credit Factor #1: Evolving Undergraduate and Graduate Student Demand Trends

» Student demand and net tuition growth remain strongest for those that are most affordable, reputable, and programmatically diversified.

» Surging undergraduate application volume masks underlying challenges for some.

» Demand for some graduate and professional programs softening, reflecting concerns about student loans and job prospects.

» *Demonstrated product value and market position are very important in a highly competitive market.*
Online and Distance Learning: Avenues for Enrollment and Revenue Diversification

» Rapid growth of on-line participation

» More actively used by for-profit providers in the past

» Expected to continue to grow, making education more accessible across geographies and demographics

» Outcomes data closely scrutinized; becoming a more accepted and marketable tool even by traditional colleges

Online Education Blossoms

Source: Going the Distance: Online Education in the US, 2011; Babson Survey Research Group; Sloan Consortium
Critical Credit Factor #2: College Affordability in the Spotlight; Fragile Consumer Confidence

Household Net Worth Still Well Below 2007

Persistently High Unemployment Rate (%)

Source: Federal Reserve Statistical Release, Flow of Funds Accounts of the U.S.

Source: Bureau of Labor Statistics
Most Face Downward Pressure on Net Tuition for Different Reasons and to Varying Degrees

» Robust pricing power at premier private universities rarely translates into strong tuition growth due to their ability to use endowment and funded discounts to shape classes.

» Lower rated private colleges (weaker market positions) increase unfunded tuition discounting and increasingly compete with public universities.

» Public universities retain greater pricing power, especially for in-state students.
  - Some constrained by state-imposed limitations and political control
  - Greater Pell grant exposure
“New Normal” for Tuition Pricing and Financial Aid Strategies

Tuition Tipping Point? More Private Colleges Struggle to Grow Tuition Revenue

Percent of Private Colleges Rated A1 and Below with an Annual Decline in Net Tuition Per Student

Source: FY01-10 Moody’s MFRA; FY11 & 12 estimates based on Moody’s 3rd Annual Tuition Survey
Critical Credit Factor #3: Pressure on Non-Tuition Revenues

Is the Higher Education Model Broken? Efficiency improvements and new avenues for revenue growth are key:

» A more collaborative market, with increased partnerships and affiliations
» More centralized control of basic shared services, especially purchasing, IT, personnel, as well as outsourcing more functions
» Expanded, more efficient use of facilities (summer, winter, weekends)
» Enrollment growth and outreach to non-traditional students, through distance learning, multi-site operations
» Increased faculty productivity through tenure restraint, more adjunct faculty and on-line part timers
» Growth of research-related revenue streams, including technology commercialization
» Increased cost-sharing with employees for existing benefits
Public Universities Cope with Declining State Support and the End of ARRA

- Stagnant to declining state operating and capital support for most
- End of ARRA funding in 2011
- State budgets pressured by reduced tax collections, weak housing sector, increased public service demands
- Declining state appropriations per student offset by growth of net tuition per student
- Larger public universities have more diverse revenue bases, lower reliance on state support
- **Net result:** most public universities are far more market-oriented and better managed than 10 years ago
Heightened Competition for Gifts and Grants

Fundraising

» Fundraising gains momentum, typically cyclical with stock market performance

» Higher rated universities dominate fundraising

» Examples of substantial “mega gifts”

» Philanthropy a unique credit trait of the not-for-profit sector

Research

» Federally sponsored research funding will slow

» Increased focus on private sources

» Slowed capital investment in new research facilities

» Top research universities will maintain research market share and attract top talent
Endowment-Dependent Universities Still Absorbing Past Investment Losses and Seeking New Efficiencies

» FY11 endowment draw formulas still picking up “bad” years

» Aaa and Aa-rated universities most reliant on endowment draw as part of budget

» Many proactive in cutting expense in anticipation of future depressed endowment draws

» Many modeling lower assumptions for future returns

Source: Moody's MFRA
Health Care Exposure: Declining Revenue Growth and Patient Volumes Challenge All Hospitals

**Near-term credit challenges:**

» Declining top-line revenue growth and patient volumes

» Reimbursement pressures from all payers

» Uncertain future of Graduate Medical Education (GME) funding

**Counterbalanced by credit strengths:**

» Increased expense containment and operating efficiency

» Academic medical centers often offer high-end services, and may benefit from diverse revenue, including gifts and grants
Critical Credit Factor #4: Liquidity & Debt Structure
Oversight; Slowed Pace of Capital Investment

» Liquidity
– University-wide assessment of sources/uses of liquidity; improved communication between endowment office and treasury offices and academic units of university
– Largest endowments remain active investors in alternative asset classes, but still maintain strongest liquidity across the rating spectrum

» Debt Structure
– Successful navigation of wave of bank agreements that expired in 2011
– Reduced issuance of variable-rate debt; increased use of direct bank loans
– Swaps increasingly negative during FY 2012
– Examples of use of taxable bond market; long-dated maturities

» Capital Planning
– Careful re-evaluation of capital plans and prioritization of resource use
– Slower pace of debt issuance anticipated during 2012
RATINGS IN PRACTICE: Relative Stability, But Some Negative Trend

Public University Activity 2005 - 2011

Private University Activity 2005 - 2011

But Post Housing Bubble Rating Changes…
Far Fewer Upgrades than After Tech Bubble Burst

Higher Education Rating Activity 2000 - 2011

- Upgrade
- Downgrade
Questions & Answers

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