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# 2012 Annual Sector Outlook for U.S. Higher Education

Higher Education & Other Not-For-Profit Teleconference

JANUARY 24, 2012

# 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

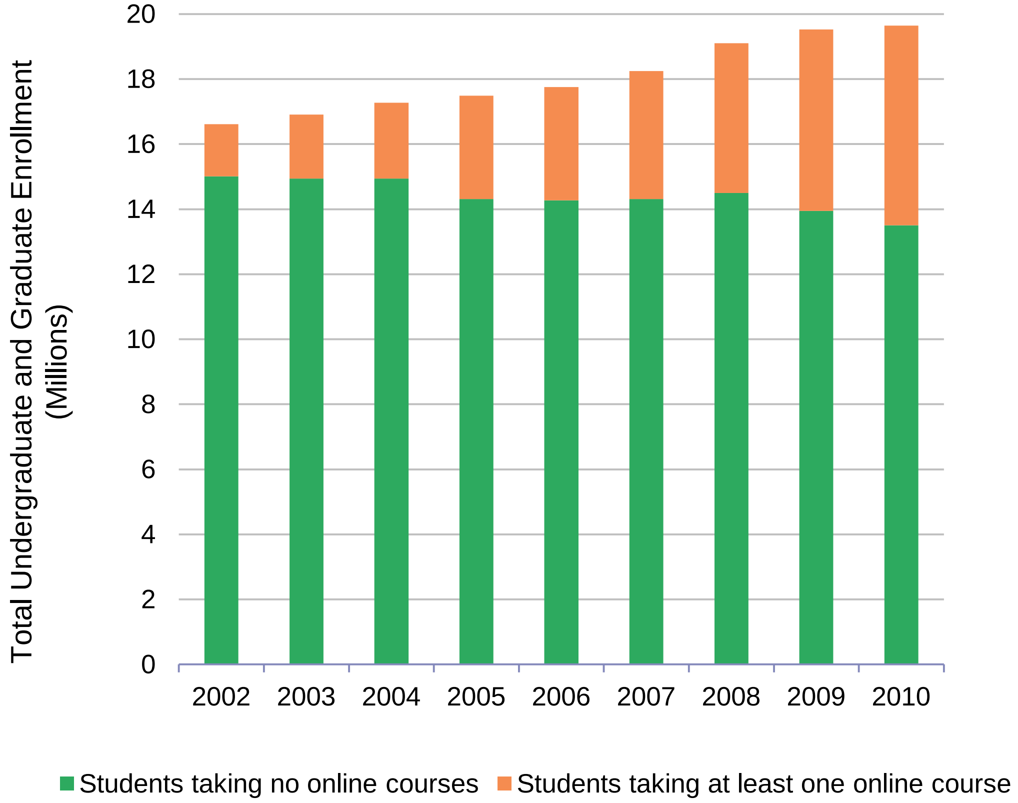
# Critical Credit Factor #1: Evolving Undergraduate and Graduate Student Demand Trends

- 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

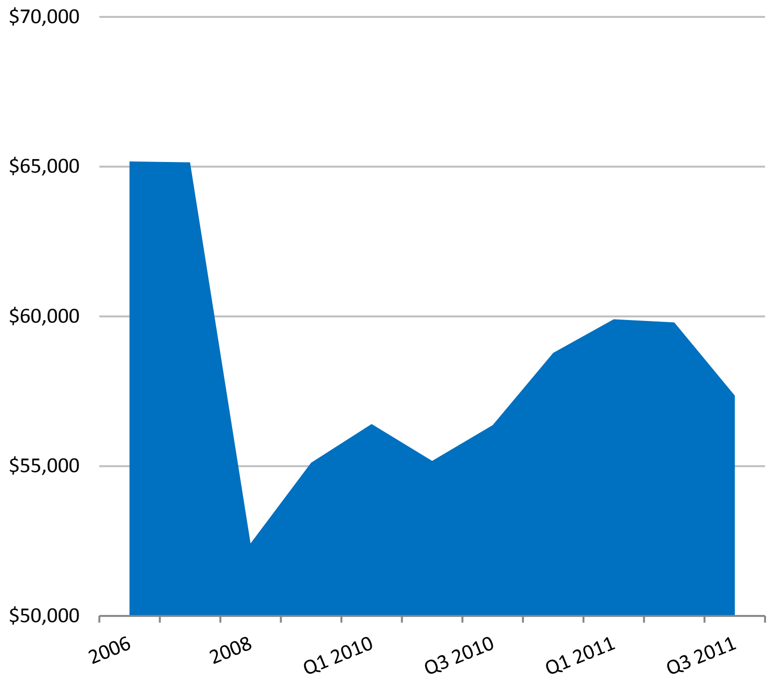
## Online Education Blossoms




Source: Going the Distance: Online Education in the US, 2011; Babson Survey Research Group; Sloan Consortium

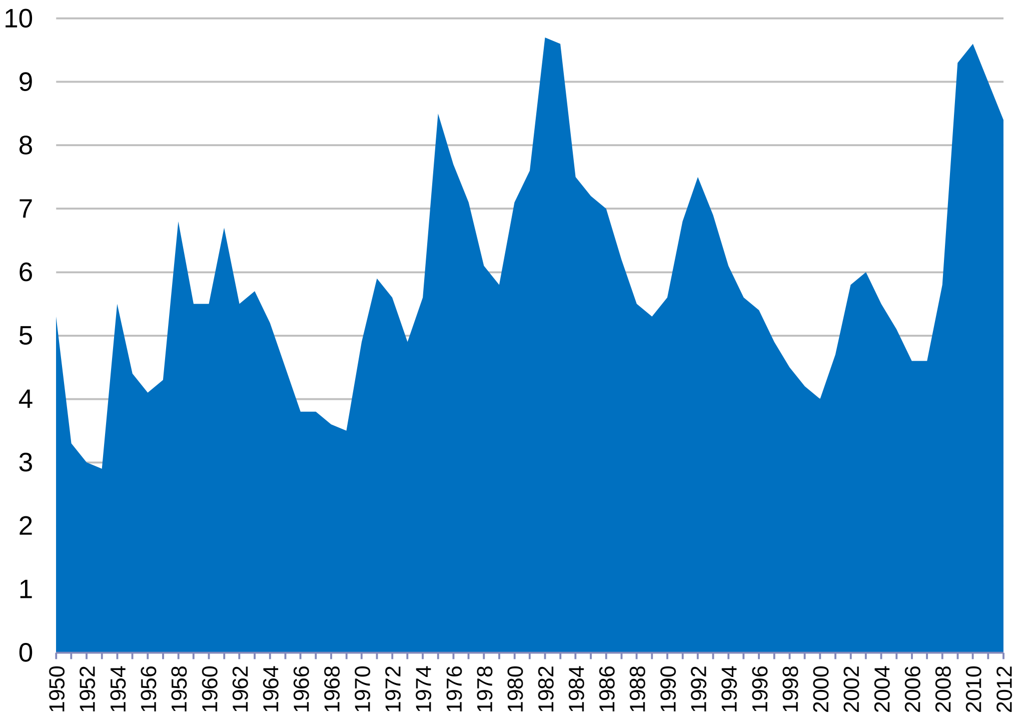
# Critical Credit Factor #2: College Affordability in the Spotlight; Fragile Consumer Confidence

## Household Net Worth Still Well Below 2007




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

## Persistently High Unemployment Rate (%)



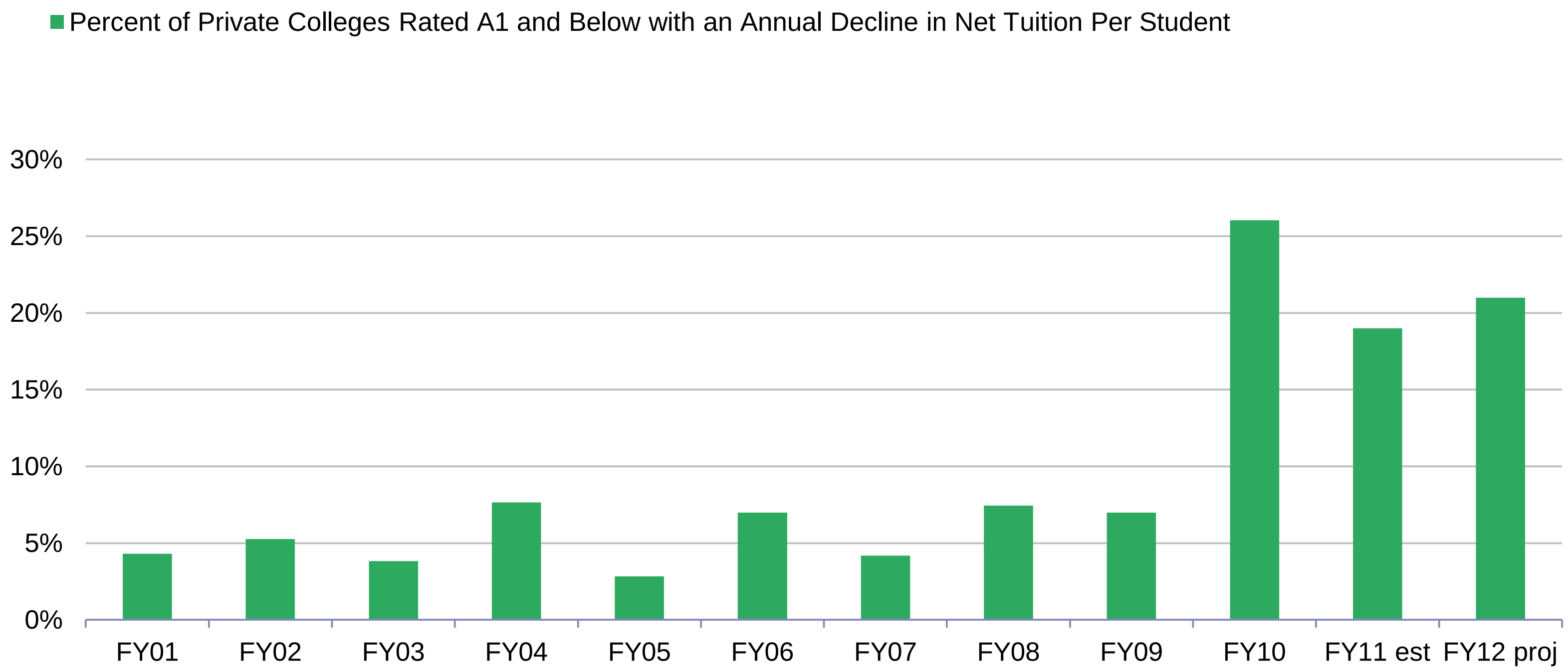

Source: Bureau of Labor Statistics

# 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




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

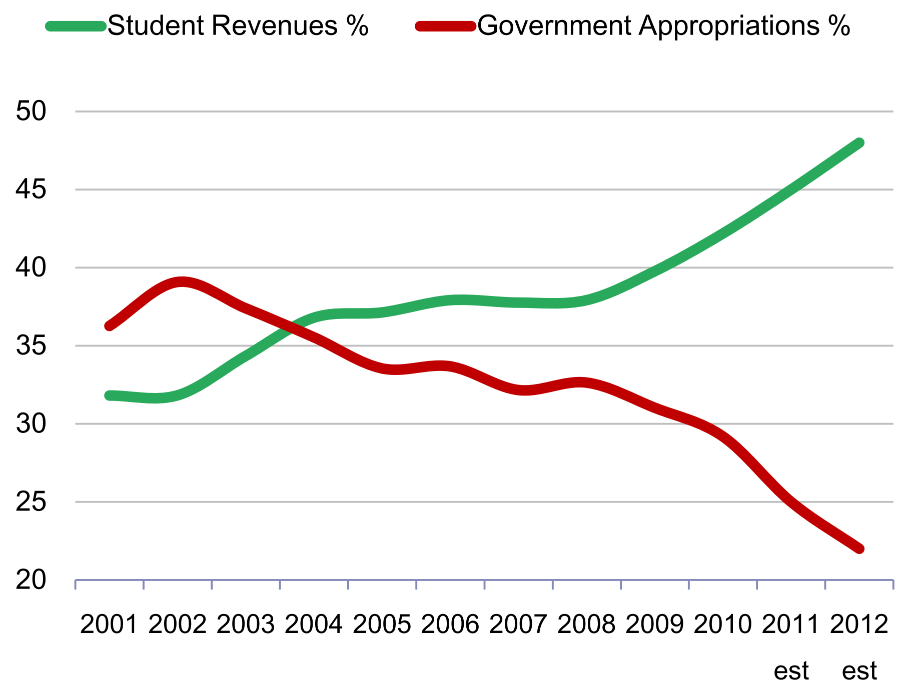
**Is the Higher Education Model Broken? Efficiency improvements and new avenues for revenue growth are key:**

- 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**

**Median % Revenues by Source for US Public Universities**




Source: Moody's

# 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

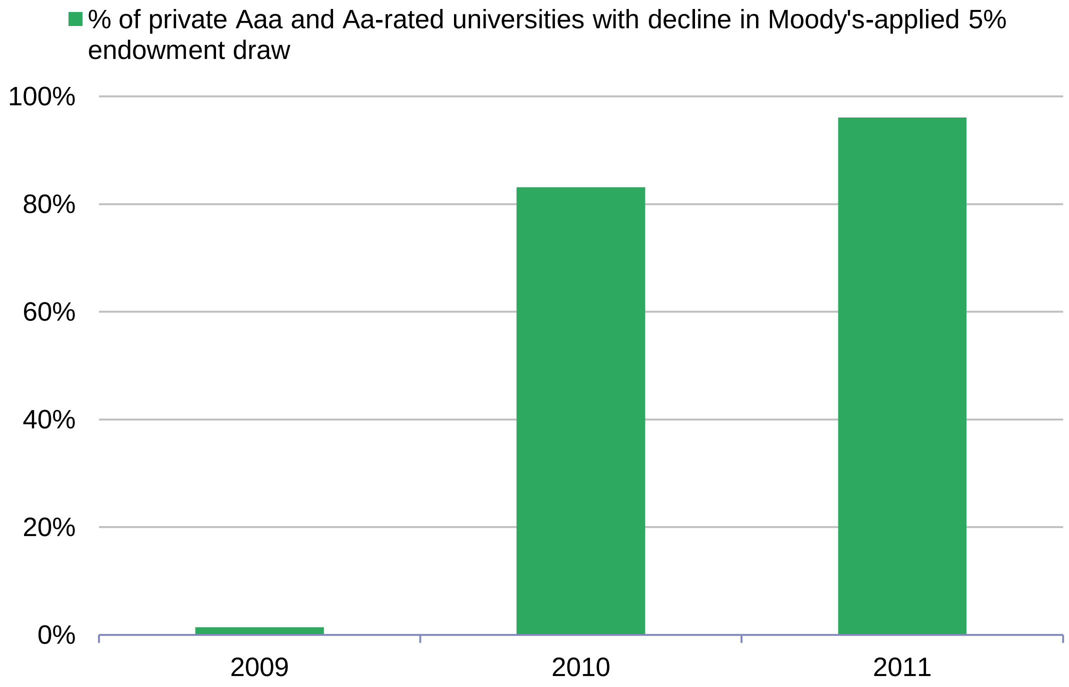
» Increased focus on private sources

» 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:

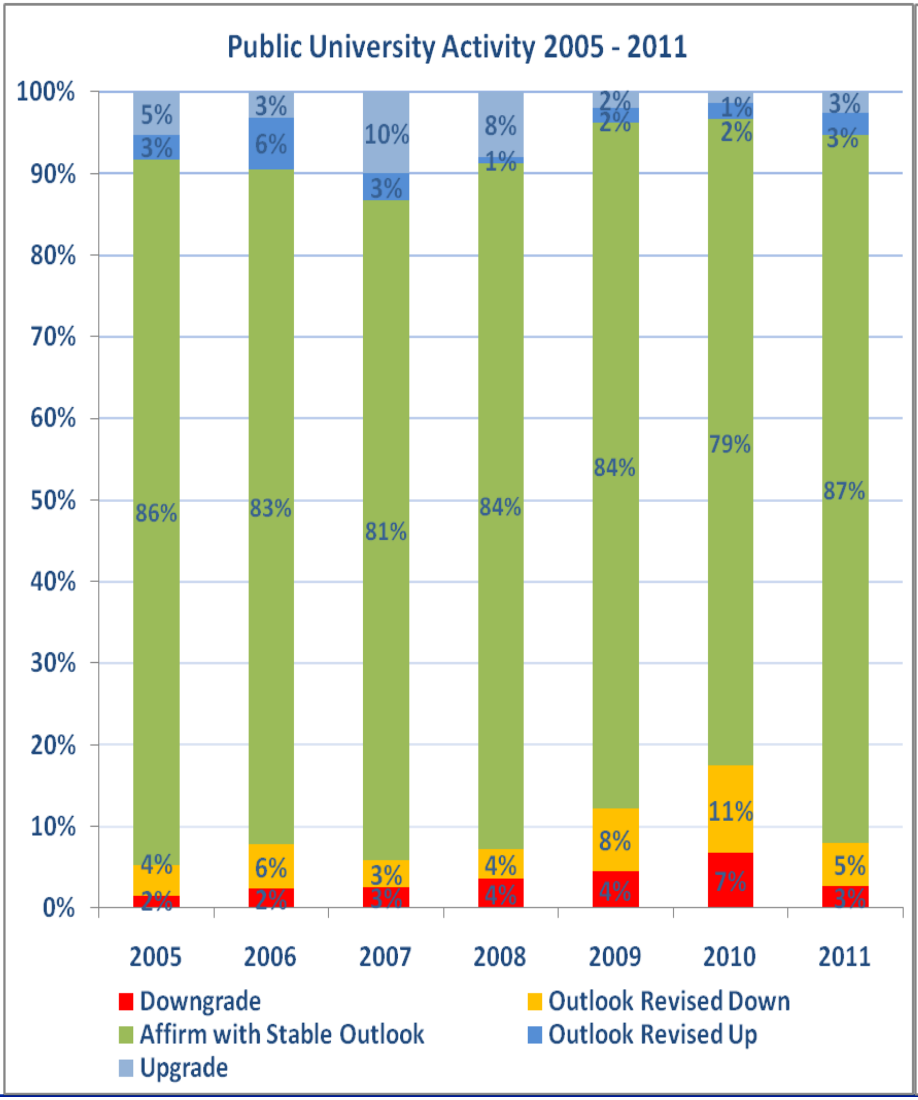
» Increased expense containment and operating efficiency

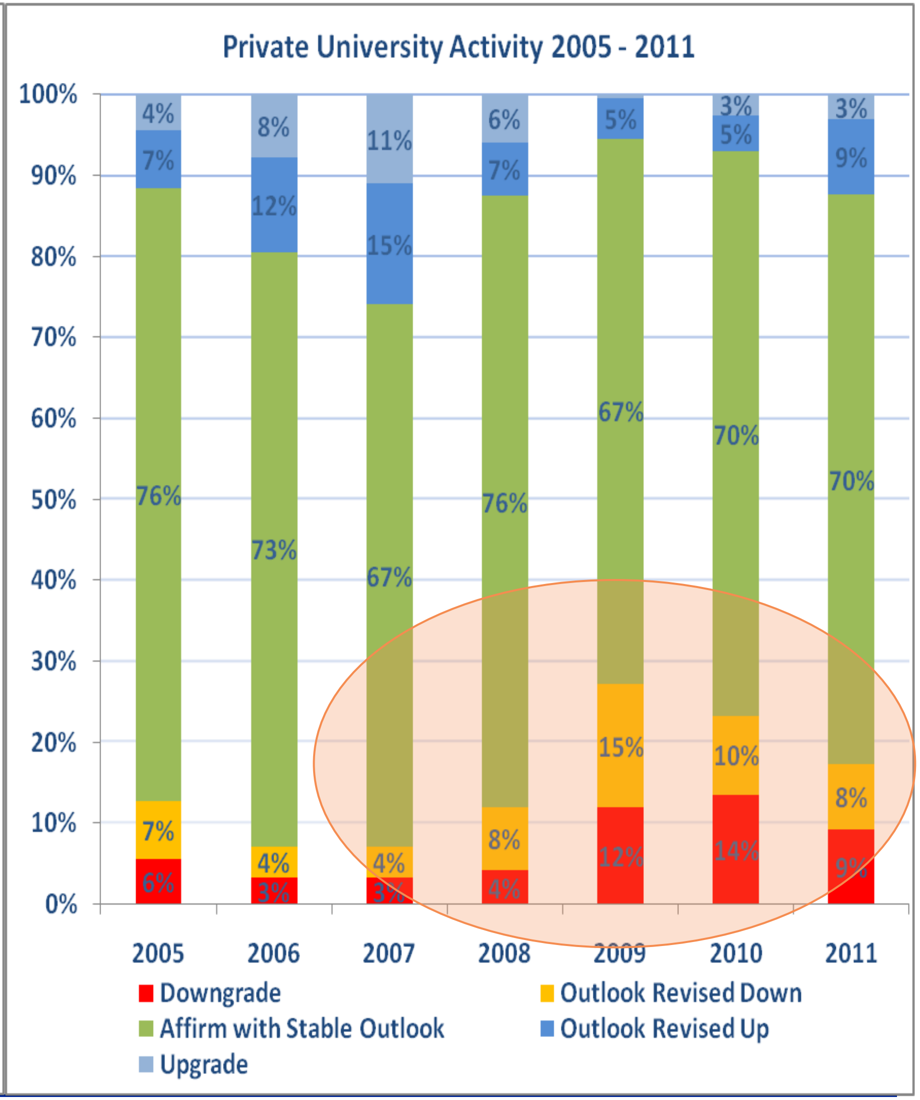
» Academic medical centers often offer high-end services, and may benefit from diverse revenue, including gifts and grants

# 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

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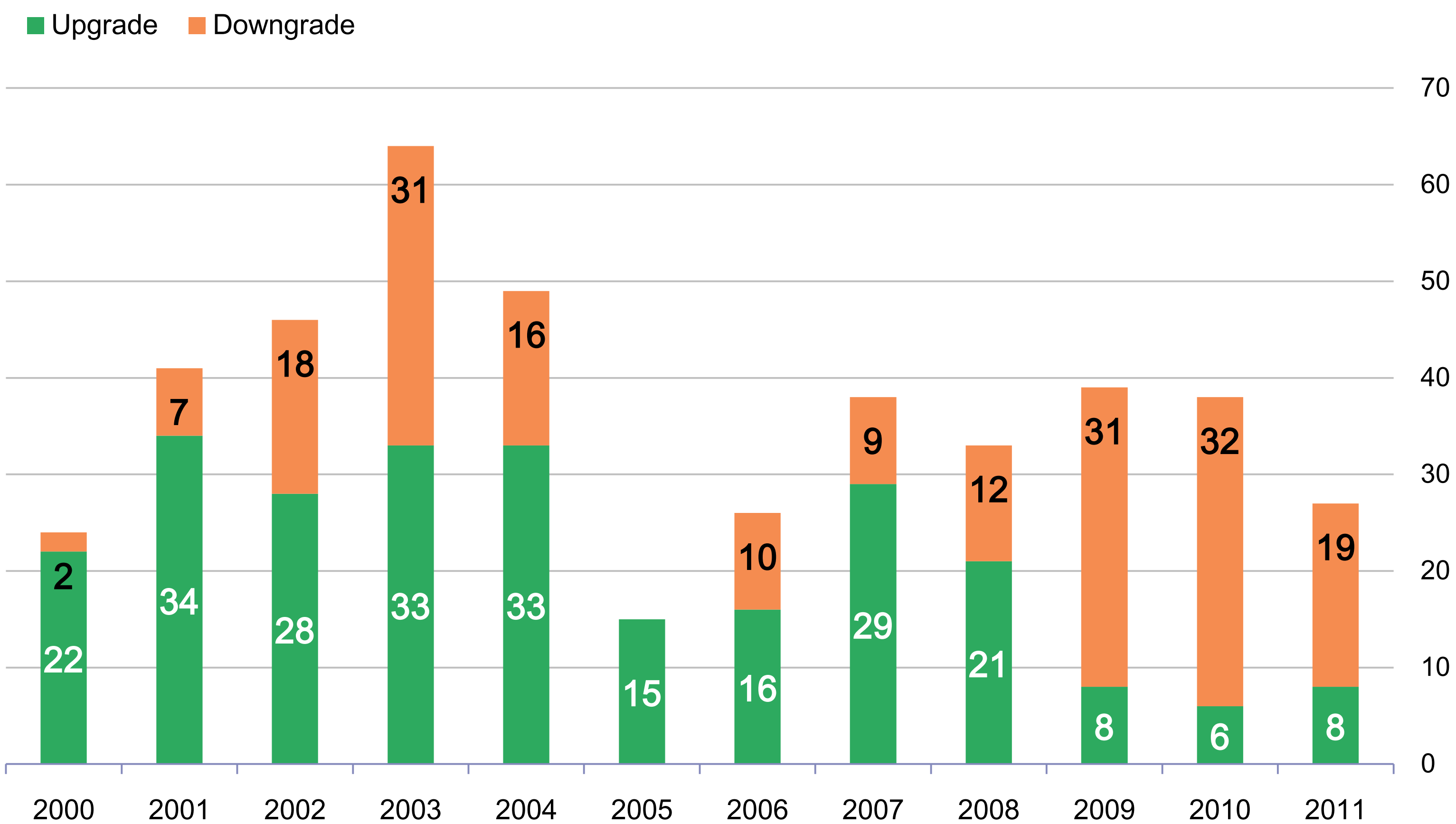
# But Post Housing Bubble Rating Changes…

## Far Fewer Upgrades than After Tech Bubble Burst

### Higher Education Rating Activity 2000 - 2011



# Questions & Answers

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