Outlook

U.S. Higher Education Outlook

Outlook is Negative for Higher Education Sector; Pressure likely to be Greater for Private Universities than Publics

Moody's outlook for the U.S. Higher Education sector is negative. This outlook expresses Moody's expectations for the fundamental credit conditions in the industry over the next 12 to 18 months and does not speak to the expected balance of rating changes during this timeframe.

Summary Opinion

The credit and liquidity crisis combined with a deepening recession will drive negative credit trends in the Higher Education sector through at least 2009. Higher Education, compared with many other sectors of the municipal market, has been more insulated from economic impact in prior recessions. However, in 2009, at least four critical risks facing U.S. higher education are likely to be especially intense:

1. increased pressure on tuition and financial aid;
2. the broad impact of investment losses on operations and philanthropy;
3. illiquidity of balance sheets, amplified by alternative investments; and
4. volatility in debt markets as well as debt structures.

Sound management skills and governance oversight will be even more significant in determining the credit impact on higher education institutions during this period of financial challenge. Fundamentally, 2009 will be a year of re-evaluation of underlying assumptions for endowment management, tuition pricing strategies, and risk management.

In this report, we focus on the most significant issues driving our outlook for the sector, the core issues that will most directly affect the credit outlook for 2009. We note that other broader, longer-term fundamental issues not discussed in detail in this report will affect colleges and universities--referred to generally as baseline issues. These issues, such as long term demographic trends, have been addressed in depth in our previous research but are unlikely to alter the fundamental direction of our outlook during 2009, especially if the issues described below persist.
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While our outlook is negative for the sector, we do believe that public institutions (both four-year institutions and community colleges) are likely to be somewhat less pressured than private institutions. First, as discussed below, we believe some families may choose lower-cost alternatives for college in a weak economic period and therefore, the potential for declines or weak growth in tuition revenue is less for public institutions than for privates. Second, private colleges are generally more reliant on endowment income and philanthropy which will be a significant challenge in the coming year. Lastly, while public institutions are likely to see appropriation cuts from the sponsoring states or local governments, these universities are more accustomed to periodic reductions and have proven adept at planning for cuts and managing through these periods. In this cycle, however, political pressure to keep tuition rates and increases low may limit one of the tools used to deal with prior appropriation reductions.

Outlooks for Independent K-12 Schools and Other Not-For-Profits Also Negative

Moody’s has not generally published separate outlook reports for the independent K-12 sector or the highly diversified not-for-profit organization sector. We recently published medians reports for each sector highlighting the coming challenges given the weak economic environment. (See reports entitled “Not-for-Profit Organization Medians for Fiscal Year 2007” from December 2008 (#113276) and “Independent School Outlook & 2007 Medians” from October 2008 (#112099).

We generally believe both sectors face largely the same pressures as higher education, especially deriving from investment returns, philanthropy, and variable rate debt. However, both have the additional significant disadvantage that their services may be viewed as somewhat more “discretionary” expenses than higher education. For example, private K-12 schools compete directly with free public education, meaning families facing declining household wealth may choose to give up private education for their children. Likewise, boarding schools may face the challenge of competing with day schools because many families can save costs through commuting to school, while continuing to provide private education to children. Similarly, many not-for-profit organizations provide services that compete directly with other entertainment choices (for example, museums) which may be scaled back in weak economic environments. Others, however, provide services that are unlikely to be significantly impacted by economic conditions, such as research contracts or certain social services. Perhaps most vulnerable are philanthropic organizations that rely solely on investment income.

For these reasons, we believe the outlooks for these sectors are also negative.

Pressure on Core Revenue Stream: Tuition

With a steep economic recession, rising unemployment, and significantly reduced savings in many cases, family choices on college attendance are likely to be extremely difficult in the current enrollment cycle (admission and enrollment for fall 2009). While tuition trends have been fairly favorable in recent recessions, with few institutions actually facing declines in net tuition revenue, we believe there are two core issues that may place more pressure in this cycle. First, declines in household net worth are likely to be the largest in decades as both investment holdings and home equity fall simultaneously, placing significant pressure on ability and willingness to pay high tuition rates. Second, access to student loans and other financing that has been utilized in prior years has become scarcer, potentially limiting choices for some families.

Although higher education has developed a highly complex pricing model that allows for individually based discounting driven by ability to pay and academic merit, we expect to see significant pressure on financial aid budgets in FY2009 and FY2010 and risk of missed enrollment targets and net tuition revenue budgets for some universities. Generally, we expect higher education to prove to be a non-discretionary expense, meaning families with college age children will rarely completely postpone enrollment in higher education. Therefore, we do not expect dramatic enrollment declines across universities.
Some families will gravitate toward a lower cost option during weaker economic times. For example, private universities that are not highly selective and already compete directly with regional public universities may see a greater number of students choose to enroll in local four-year public institutions. For public universities, students may choose to enroll in community colleges for two years before transferring to a four-year university or perhaps commute from home rather than absorbing the cost of residence halls and meal plans. While this migration toward public institutions is favorable in some ways for public universities and community colleges, the swell of enrollment also creates pressure. Most are likely to face significant pressure from government to limit tuition increases and to absorb higher enrollments while sustaining cuts in appropriations. Given that tuition recoups only a portion of the full cost of enrollment, larger enrollments without additional funding brings net revenue increases but also budgetary pressure on services and expenses.

In some niches of higher education, enrollment may continue to follow its historical counter-cyclical trend, and may actually improve substantially. Community college enrollment frequently rises with unemployment rates. Likewise, students frequently view master’s degree programs as a way to retool and prepare for re-entering the workforce when individuals are laid off. Anecdotally, we are already hearing that applications to graduate business programs are up substantially compared to the prior year. Universities that are well diversified programmatically and diversified between graduate and undergraduate enrollments may benefit from this counter-cyclical nature of enrollment.

### Table 1: Although Outlook Negative for All Higher Education, Relative Pressures Vary

<table>
<thead>
<tr>
<th>Private Universities</th>
<th>Public 4-Yr Universities</th>
<th>Public 2-Yr Colleges</th>
</tr>
</thead>
<tbody>
<tr>
<td>Endowment losses generally more significant to credit quality and operating budgets</td>
<td>Endowment losses likely, but many have investment limitations as public institutions and hold larger “operating” funds that are conservatively invested</td>
<td>Often small balance sheets with liquidity held in less volatile securities</td>
</tr>
<tr>
<td>Higher cost, premium provider may lead to vulnerability to shifting to lower cost options</td>
<td>Lower cost than Private, but may lose some students initially to community colleges</td>
<td>Lowest cost provider, but large enrollment increases can create budgetary pressure</td>
</tr>
<tr>
<td>Political and mission driven limits to tuition increases</td>
<td>Subject to state oversight; may lead to legislative limits on tuition increases in some cases</td>
<td>Subject to state and local oversight; may face legislative limits on tuition increases in some cases</td>
</tr>
<tr>
<td>Greatest users of variable rate debt and swaps, could lead to operating and liquidity pressure</td>
<td>Somewhat lesser use of variable rate debt and swaps as a sector, although there are notable exceptions</td>
<td>Rarely use variable rate debt</td>
</tr>
<tr>
<td></td>
<td>Face state appropriation cuts; cuts likely to be significantly larger than prior periods</td>
<td>Face state and local appropriation cuts; cuts likely to be significantly larger than prior periods</td>
</tr>
</tbody>
</table>

### Endowment Losses Mount, Pressuring Credit Metrics and Revenues Available for Operations

We have noted in numerous reports this year that colleges will likely report some of the largest losses on endowments seen in recent decades, barring an unlikely and dramatic rebound in equity markets by the end of the next fiscal year. We believe most endowments through mid-December are likely down between 25%-35% since June 2008, with some exceptions both positive and negative from this range. We broadly expect portfolios with greater embedded leverage and portfolios with very high allocations to publicly traded equity to see the largest declines. These losses will clearly reduce balance sheet ratios for the sector as a whole. However, as universities typically have produced very large gains in recent years, we believe in most cases
investment losses in this range will not automatically result in rating changes\(^1\). On average, we expect balance sheet ratios (such as expendable financial resources to debt) to fall to pre-2000 levels given the significant increase in debt outstanding in the last decade.

How Much is Too Much: When will Investment Losses Lead to Broad Based Rating Changes in Higher Education?

With investment portfolios down in excess of 25% in many cases, we are frequently asked if broad based rating downgrades are expected in the sector. As described in this report, at these levels we do not expect broad based rating downgrades due solely to investment losses. Most institutions have reaped substantial gains in recent years and will react to losses through budget and capital restraint. We also have not had broad based rating upgrades in the last several years due solely to the high levels of investment returns. Our rating methodology recognizes the exposure to equity markets in the balance sheets of colleges and universities and incorporates room for volatility without substantial credit impact.

However, we acknowledge that there is likely to be a high enough level of investment loss that would lead us to conclude that many, if not most, endowed private colleges faced substantial enough investment losses to lead to rating downgrades. While each rating decision will always be made individually, we expect that investment losses exceeding an additional 20%-30% would lead to a more substantial level of rating changes in the coming year. As always, even in this hypothetical circumstance, we would expect some institutions to fare better than others, and that there would continue to be significant credit differentiation across the industry.

In the last significant equity market downturn (2000-2002), colleges and universities saw losses in balance sheet strength and declines in revenue available for operations based on endowment spending formulas. In 2002 and 2003, the number of rating changes spiked up to nearly 14% of the portfolio. However, these rating changes were concentrated among colleges and universities that had undertaken large new borrowing programs or held less diversified investment portfolios and experienced outsized losses in their endowments. In addition, some institutions did not adjust budgets to account for lower endowment spending flows, subsequently running deficits while increasing leverage.

Figure 1: TUCS Median Total Return (%) for Non-Profits

<table>
<thead>
<tr>
<th>Returns</th>
<th>FY99</th>
<th>FY00</th>
<th>FY01</th>
<th>FY02</th>
<th>FY03</th>
<th>FY04</th>
<th>FY05</th>
<th>FY06</th>
<th>FY07</th>
<th>FY08</th>
<th>FYTD</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY99</td>
<td>10.7</td>
<td>9.0</td>
<td>-2.3</td>
<td>-5.2</td>
<td>3.9</td>
<td>15.5</td>
<td>8.8</td>
<td>10.2</td>
<td>16.9</td>
<td>-4.5</td>
<td>-30.0</td>
</tr>
<tr>
<td>FY08</td>
<td>3.0</td>
<td>2.5</td>
<td>5.0</td>
<td>10.0</td>
<td>15.0</td>
<td>20.0</td>
<td>25.0</td>
<td>30.0</td>
<td>35.0</td>
<td>40.0</td>
<td></td>
</tr>
</tbody>
</table>

Source FY99-FY08: Wilshire Trust Universe Comparison Service with fiscal years ending June 30; FYTD: Moody’s estimate through mid-December

\(^1\) Please see our report from November 2008, “Recent Steep Investment Losses Highlight Risks and Resilience of U.S. Higher Education and Not-for-Profit Ratings.” (#112915)
These typical circumstances that drove rating downgrades in the last downturn will likely recur in the current cycle. Namely, organizations that have weaker balance sheets, but adjust capital and operating plans to reflect losses are less likely to see rating downgrades. Moody’s rating methodology for colleges includes the expectations of significant variability in balance sheet strength given their appetite for equity exposure. In light of the large increase in net assets achieved by most rated institutions over the last six years, we expect that many universities are well positioned to withstand moderate declines (25%-35% losses) without leading to large rating changes, assuming management responds to adjust future capital plans and operating budgets accordingly.

Figure 2: Loss of Revenues from Investment Income Impacts Public Universities Far Less

Strong Management of Liquidity and Debt is Essential Given Exposure to Alternative Investments, Swaps, and Variable Rate Debt

Colleges and universities typically have strong balance sheets, with fairly large unrestricted or quasi-endowments providing cushions to support greater usage of variable rate debt and interest rate swaps. However, a confluence of pressures from swaps, variable rate debt, exposure to illiquid investment vehicles, and tight markets for liquidity facilities will place significant liquidity pressure on some organizations. We believe short-term liquidity issues, rather than fundamental pressure on enrollment pose the greatest risk of rapid credit deterioration for the sector.

Endowment Losses and Liquidity

Many colleges face greater challenges from the illiquidity of their endowment portfolios than from the aggregate declines in fair value of the portfolios. Investments in hedge funds, private equity, and other private investment vehicles are generally proving even more illiquid than originally thought. Many hedge funds have announced “gates” to slow the pace of redemptions or outright redemption freezes. As a result, investment vehicles that originally provided redemption with 30 or 90 day notice may not be available at all within that time window. This has made asset allocation rebalancing particularly challenging for endowment managers, as liquid asset classes have lost substantial value and liquidations from other allocations are less available to shift in response. In a few cases, we have seen institutions borrow in taxable debt markets to inject liquidity into their organizations rather than disrupt long-term investment strategies.
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We believe most organizations are placing a very high value on maintaining long-term investment strategies and not liquidating positions with large unrealized losses. Fundamentally, these organizations are valuing the potential return of these investments as greater than the certainty of liquidity that could be achieved by liquidation and reinvestment, even at lower prices. While it is impossible to predict the outcome of this choice, we believe it reflects a higher risk option for institutions with limited liquidity.

Swap Valuations and Collateral Posting

Higher education borrowers have frequently used variable rate debt and interest rate swaps to manage their cost of borrowing. In recent months, we’ve noted the substantial disruptions to these instruments and the potential for rapid repayment obligations under the bond and swap agreements. While some of the pressures from these variable rate bonds have somewhat lessened in recent weeks as short-term markets improved, they remain a risk and could return with little warning.

In addition, as long-term rates have fallen dramatically, the fair values of swap agreements in many cases have turned deeply negative for colleges. These negative fair values present two substantial risks. First, many swap agreements require collateral posting if the fair value falls below certain thresholds. In many cases, we have seen universities required to post collateral to counterparties in recent weeks, placing even greater liquidity pressure on these organizations. The second risk from low swap valuations stems from reporting requirements and covenant calculations. These swap values, if sustained until the end of the fiscal year, are reported as liabilities and directly reduce unrestricted net assets.

Many institutions also have covenants in letters of credit or other agreements that grant substantial rights to lenders should their “expendable net assets to debt” ratio fall below certain levels. In a year that combines significant investment losses and large liabilities for swap valuations, we expect a greater number of institutions to face technical defaults under these agreements.

Volatile Variable Rate Debt Markets

Failed remarketings of short-term debt present a large risk to universities in the near term (see prior report entitled “Risks of Variable Rate Debt No Longer Hidden” (#113702), as many liquidity facilities require fairly short-term repayment of bonds in the event unremarketed bonds (bank bonds) remain for any extended period of time. Unfortunately, we often find university management unaware of the risk that the expected repayment terms to banks could be unavailable to them if they have violated even minor covenants or representations and warranties in the agreements.

It is unclear whether recent improvement in variable rate markets will be sustained continuously, but we expect that eventually remarketing success will increase in consistency and short-term repayment may not be necessary. Recently, pressure has been on long-term fixed rate issues. For those schools planning to refinance variable rate debt as their “solution” to some of these swap and remarketing issues, periodic disruptions to fixed rate issuance may be an added concern.

Although most colleges are likely to weather the freezing up of variable rate markets given their substantial quasi-endowment holdings and access to the fixed rate market, we remain concerned that some low rated organizations may face challenges restructuring debt and could face difficulty meeting obligations for accelerated repayment.

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2 Please see our reports from October and December 2008, “Risks of Variable Rate Debt No Longer Hidden” (#113702), “Impact of the Credit Crisis and A Weaker Economy on U.S. Higher Education” (#111958) and from January 2008, “Bank Liquidity Support and Variable Rate Financings Can Impact Underlying Long-Term Credit Ratings.” (#107262)
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The Baseline Issues
As noted in the introduction, this report focuses on critical, near-term issues facing the industry. Moody’s ratings will reflect not only these issues, but also the long-term trends that makeup the background for today’s stressed environment. A non-exhaustive list of background issues follows:

- Regional demographic trends for traditional age students, with significant declines in the northeast and upper midwest compared with large growth in the southeast and southwest.
- Weak outlook for research funding as federal budget pressure has never been greater, but with greater potential for stimulus and deficit spending under the new Obama administration.
- Cyclical downturn in state appropriations for public universities, with many states likely to institute very large cuts as part of long-term disinvestment from public higher education.
- Large capital investment over the last decade likely to slow, as economic pressures mount; many are in a good position to pause from large-scale investment and expansion.
- Underlying economic and workforce rationale for pursuing higher education; core demand likely to remain strong with education fundamentally viewed as a "non-discretionary" expense for families.
- Despite near-term expected slowdown in philanthropy, long-term competitive advantage for institutions able to fund capital and grow endowment from gifts will be sustained.

Operational Management and Governance to Play Key Role
As revenues are pressured and balance sheets weakened, we expect boards and management of universities to increasingly focus on operational management and improving their ability to respond to a rapidly changing environment. Management responsiveness to challenges and governance of organizations under stress are likely to play significant roles in how well a university weathers the challenges described above.

Fundamentally, organizations will face significant choices about capital investment, appropriate staffing levels, and prudent endowment spending policies in an environment where little about the future can be predicted with confidence.

We expect many organizations to begin to implement expense controls in the current year in anticipation of reduced endowment spending levels, projected declines in philanthropy and potential enrollment difficulties in the next year. Investment losses in FY2009 are unlikely to impact endowment spending significantly until FY2010 or FY2011 due to smoothed spending policies, but management must use this time to revisit budget assumptions and make reductions when and where appropriate.

Debt structures and debt policies will have to be addressed as well. The difficult choice of borrowing or spending reserves on capital becomes more complex when access to the market for fixed or floating rate bonds may remain strained for a period of time.

Lastly, after a long cycle of a capital spending boom, most institutions will have to carefully assess competitive pressures to attract students or research grants in deciding whether it may make strategic sense to proceed with capital plans. In some cases, it will be necessary to delay or slow capital spending plans to conserve balance sheet strength and limit additional leverage. The likely decline in large gifts from donors weakened by the broad equity market downturns will also be a major factor in reassessing of capital programs.

Many colleges are highly decentralized, consensus-driven organizations that are not accustomed to rapid implementation of expense reductions and budget changes in response to unexpected events. Those that are able to make quick decisions and plan for multiple possible enrollment and financial scenarios will fare best in this challenging environment.
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Moody’s Related Research

Outlook
- U.S. Higher Education Outlook: Six-Month Update, July 2008 (109911)

Special Comments
- Impact of the Credit Crisis and a Weaker Economy on Higher Education, October 2008 (111958)
- Recent Steep Investment Losses Highlight Risks and Resilience of U.S. Higher Education and Not-for-Profit Ratings, November 2008 (112915)
- Risks of Variable Rate Debt No Longer Hidden, December 2008 (113702)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.