Impact of the Credit Crisis and A Weaker Economy on U.S. Higher Education

Summary Opinion

Since our last outlook comment on U.S. Higher Education in July, the credit and liquidity crisis has worsened and the prospects of a significant recession are greater. Higher Education, compared with many other sectors of the municipal market, is normally more insulated from near-term budget shortfalls caused by recessions. However, the potential impacts of the combined credit freeze and recession on some colleges and universities will be significant if current trends persist. In this report, we categorize the short and long-term risks facing the sector and assess the degree of credit impact. We conclude that sound management skills and governance oversight will become even more significant in determining the credit impact on Higher Education institutions during the coming period of financial adjustment.
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Short-Term Risks of the Credit Crisis for Higher Education

Moodys has previously noted a weakening trend in some fundamental credit factors affecting U.S. Higher Education, including weak investment returns, pressures on family ability and willingness to pay tuition, potential reductions in philanthropy and weaker demographics in some areas of the U.S. Despite these trends, we have maintained a stable outlook for the sector due to its fundamental strengths reflected in high student demand for higher education, generally strong balance sheets and a resilient business model supported by philanthropy and government subsidies. However the short-term risks to some colleges and universities are increasing. Most of these risks emanate from the variable rate debt structure adopted by some colleges:

- Rates on variable rate bonds have spiked, in some cases to 10%, but are now generally somewhat lower
- Exposure from mismatch of swap rates (based on % of LIBOR) and bond rates
- Failed remarketings of demand obligations and commercial paper can lead to rapid repayment terms on “bank bonds”¹ and put new liquidity pressure on some universities
- Draws on “self-liquidity”² programs have occurred, often for the first time since the programs were initiated
- General access to capital markets is more limited for low-rated and small colleges as many insurers are weaker and bank capital for LOC’s is constrained

We believe most colleges can absorb short-term disruptions to the debt markets given their ability to reduce the rate of operating and capital spending, as well as their relatively high levels of unrestricted liquidity. Furthermore, interest rate spikes can frequently be absorbed because many universities employ conservative budgeting assumptions for the cost of servicing variable rate debt.

Failed remarketings present the largest risk to universities in the near term (see prior report entitled “Bank Liquidity Support and Variable Rate Financings Can Impact Underlying Long-Term Credit Ratings” #107262), 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 when variable rate markets will begin to return to normal, but we expect that eventually remarketing success will increase and short-term repayment may not be necessary. With fairly large quasi-endowments in many cases, colleges can often meet even rapid repayment of these bank bonds should this prove necessary. Likewise, many could choose to refinance with fixed rate debt, although possibly at higher rates. Although most colleges are likely to weather the freezing up of variable rate markets, we remain concerned that some low rated organizations may face challenges restructuring debt and could face difficulty meeting obligations for accelerated repayment.

Short-Term Investment Risks

In addition to the short-term risks presented by variable rate debt, universities also face challenges as investors in the debt and equity markets. In the near-term, investment risk for colleges is largely based on sudden and unexpected changes in liquidity of investments (as occurred with the Commonfund Short-Term Fund), and dramatic loss of individual investments given exposure to leveraged private investments and hedge funds. These risks include:

- Investments in private funds, such as hedge funds, private equity and other alternatives, may experience less liquidity than expected as distributions from private investments have been rare recently and hedge funds may face difficulty liquidating even portions of investment holdings in the face of withdrawals

¹ “Bank bonds” are variable rate demand bonds held by a liquidity bank that have failed to be remarkedeted to new investors following a tender of the bonds; universities may be obligated to pay off these bonds on accelerated terms under the provisions of the bank liquidity agreement.
² “Self-liquidity” debt is variable rate demand bonds or commercial paper that is backed by the university’s own liquidity; there is no bank liquidity agreement to support the bonds.
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- The freezing of the Commonfund Short-Term Fund has placed some colleges in a liquidity-constrained position, although release of funds has run ahead of expectations (exceeding 40%), providing significant immediate relief.
- Nevertheless, some colleges have increased operating lines of credit in the short-term or liquidated quasi-endowment funds.
- Lack of diversification among endowment managers or investments could mean that some schools face outsized investment losses.

Colleges typically hold significant amounts of securities in quasi-endowment that could be sold to build liquidity and working capital balances. Somewhat surprisingly, even in light of the freezing of the Commonfund Short-Term Fund (see our previous publications on the fund listed at the end of this report), most colleges have not chosen to sell long-term holdings to build liquidity and have relied instead on drawing on operating lines of credit or allowing liquidity to fall substantially, thereby ramping up risk profiles. While we have not taken any rating actions on colleges due to exposure to the Commonfund Short-Term Fund, we note many face reduced liquidity that will become tighter as colleges wait for spring tuition payments. The lowest liquidity levels for universities are typically recorded in late November and December, as well as late June and July.

Long-Term Risks of Credit Crisis and Economic Aftermath to Higher Education

Beyond near-term disruptions to capital markets and liquidity, the recessionary economy and credit market shifts have the potential to disrupt longer term trends in the financial strength of higher education institutions.

Reaching the Tipping Point for Tuition and Financial Aid?

The long-term fundamental health of most colleges and universities is determined by the ability to attract students and families to pay relatively high tuition rates. In every economic down cycle, questions arise about whether colleges and universities will be able to continue to raise tuition rates at levels above inflation, as they have done for decades. The key question becomes whether or not the ability and willingness to pay tuition will reach a tipping point, driven by the absolute level of tuition and the change in the economic and wealth environment. Because the decision to send a child to college is rarely a "spur-of-the-moment" decision for parents, but one that is often based on years of planning, the decision to attend college is not easily disrupted by economic weakness. In previous cycles, college attendance rates did not decline, and there was only minor shifting from high cost to lower cost colleges observed.

The risk in the current cycle is that the absolute net worth of many families may decline far more than in previous cycles--it has likely already declined more than in the 2000-2002 period. In particular, equity market losses of similar magnitudes have occurred in the past. Troubling, however, is the fact that previous market declines have not been combined with significant declines in home equity values. It is impossible to predict with confidence the impact of this type of net worth decline, but it seems clear colleges will face different economic challenges in this cycle than previously.
While we do not expect large numbers of graduating high school students to decide not to attend college, we expect there may be a larger shift to lower cost alternatives. In particular, high priced private colleges may lose some students to lower cost four-year public colleges. Likewise, four-year public colleges may lose some students to community colleges at least for their first two years of education.

**Philanthropy Likely to Slow, but Impact Should be Moderate**

Philanthropy often reacts to economic and stock market fluctuations, but with relatively modest declines in recessionary times. As most ongoing capital campaigns have a strong focus on endowment growth, we don’t expect a moderate slow-down in gifts to cause significant stress for colleges. The risk remains a longer-term downturn in philanthropy than we have previously seen. While this is a possibility, especially as this crisis has hit the financial sector particularly hard and that sector often accounts for some of the largest gifts to universities, we expect declining philanthropy to only have a moderate affect on colleges.

**Fundraising Correlated to Investment Returns, But Giving Holds Up Relatively Well in Years of Poor Returns**

Source: Moody’s and National Association of College and University Business Officers
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**Long Term Investment Return Assumptions**

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.

These typical circumstances that drove rating downgrades in the last downturn will likely recur in the current cycle. The long-term model of endowment spending based on 7-10% expected long-term returns of endowments is unlikely to change. However, we are likely to see weakened balance sheets and reduced liquidity for the next year. Moody’s rating methodology for colleges includes the expectations of significant variability in balance sheet strength. 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 (10-25% losses) without leading to many rating changes.

The above chart demonstrates the degree to which balance sheet strength has improved in recent years. We expect, given approximately 5-7% median endowment losses in FY2008, combined with approximately 5% endowment spending rates, that total cash and investments will fall by approximately 10%. Given that between June 30 and September 30, the total return on the S&P 500 was nearly negative 20% and additional declines have continued since that time, we applied an additional 30% decline in cash and investments in FY2009 in the chart. While it is impossible to know whether this will prove to be overly pessimistic or overly optimistic, even this degree of decline leads balance sheets to be roughly in-line with FY2003 levels.

**Good Management and Governance Now Even More Important**

In any sector, challenging market conditions tend to differentiate those organizations with strong management teams and governance oversight from those with weak management and governance. Colleges are in a unique position to plan ahead for the challenges that are looming, but that does not automatically protect institutions from increased financial and economic risks. Student enrollments are largely a once-a-year cycle, allowing colleges time to adjust marketing strategies, increase financial aid programs and budgets, and temper
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growth projections. However, solid research on student markets and skilled execution of student recruitment strategies remain critical for most institutions.

There are also difficult balance sheet questions that boards and managements must answer. First priority will often be given to the endowment. 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 will have to be addressed as well, and 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.

Related Research

Special Comments:

- No Rating Actions Taken From Moody’s Review of Impact of Commonfund Short Term Fund Closure on Universities That Issue Self-Liquidity Debt, October 2008 (#111754)
- Bank Liquidity Support and Variable Rate Financings Can Impact Underlying Long-Term Credit Ratings, January 2008 (#107262)

Industry Outlook

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

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.
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Author(s)       Editor       Production Specialist
Roger Goodman   John Nelson   Cassina Brooks

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