



Credit Update on the Higher Education Sector

Colleges and universities operate in a highly competitive business environment and do not enjoy a sole franchise for students in a geographic region or academic field. They compete against one another for student enrollment. The successful ones are those that have established either a solid financial or academic advantage, or both.

For 2012, MTAM maintains a mixed credit outlook for the U.S. not-for-profit private and public higher education sector. MTAM has a stable outlook for the colleges and universities with strong market positions and balance sheets, and multiple revenue-generating business lines. Student demand, the driving force for the sector in general, remains strong for large, diversified, and highly rated colleges and universities. A negative outlook is assigned for the colleges and universities that are far more dependent on state appropriations, student tuition, or both. These institutions attract students more regionally, retain less pricing power, and maintain thinner balance sheets.

Despite the challenging environment, most colleges and universities have fared relatively well since the start of the 2008-09 financial crisis, demonstrating organizational nimbleness during a prolonged period of economic stress. However, MTAM expects slower revenue growth, greater student resistance to tuition increases, and heightened public scrutiny requiring universities to operate more efficiently.

Donors, research-granting organizations, and state governments currently have more limited resources to invest in higher education. Given a weaker revenue outlook for government support, private gifts, and research grants, public and private universities are especially focused on growing tuition revenue. For example, universities with less-expensive tuition, particularly public ones, have increased their rates to make up for lost government support. In this way, the gap in net tuition cost between more affordable and more expensive institutions may narrow in the future.

While some colleges and universities project net tuition revenue growth for fiscal 2012, more institutions anticipate decreases compared with the prior year. Prospective students and their families are increasingly price-sensitive, discerning consumers. Colleges and universities are under rising pressure to improve disclosure and limit tuition increases. There is a growing importance of perceived value and market reputation for colleges and universities as students and families struggle with flat incomes and stagnant net worth. With the market emphasis on value and affordability, tuition and aid strategies are becoming increasingly complex.

Public and private universities of all sizes and rating categories have experienced growth in applications. However, this reflects a long-established trend of increasing the number of colleges to which students apply, rather than a surge in demand. Total new student enrollment was relatively flat for fall 2011.



State Appropriations

State appropriations for higher education -- including a small amount from federal stimulus funding -- totaled \$72.5 billion in fiscal 2012, a decrease of 7.6% from \$78.5 billion in fiscal 2011. This marked the largest drop in a half century, according to a study released last week. Forty-one states reported budget declines for higher education, with funding decreases of as much as 41% in New Hampshire to 0.8% in Utah from a year earlier, according to the annual Grapevine survey. The decline represents both the drag on state tax revenue from the lingering effects of the recession, as well as the expiration of federal education aid from the 2009 American Recovery and Reinvestment Act.

The study also highlighted the fact that higher education budgets are lower than they were before the recession began. Only nine states increased funding for fiscal 2012 after they spent their stimulus funds. States with the largest percentage declines in state support are likely to see the greatest pressure to raise tuition, and to recruit out-of-state students who pay higher rates. More worrying is the potential loss of access for students with significant financial need as state support for financial aid also declines.

With states providing a dwindling share of money for higher education, many states and public universities are rethinking their ties. The public universities say that with less money from state coffers, they cannot afford the complicated web of state regulations governing areas like procurement and building, and that they need more flexibility to compete with private institutions.

As a result, the fundamental model for supporting higher education is being reconsidered, with many universities winning greater autonomy -- sometimes even in setting tuition. The University of Oregon's president is proposing a new model for state support: he wants the state to issue bonds raising money to build the university's endowment. In Ohio, Governor John Kasich talks of "charter universities" that would get less state financing, but be exempt from some state mandates, like those covering construction projects.

In Louisiana, the business-backed Flagship Coalition has the governor's support for a plan to free Louisiana State University from many state regulations. And in Wisconsin, Governor Scott Walker proposed to separate the main Madison campus from the rest of the state university system, and make it a public authority.

Many education experts say public universities deserve greater autonomy, now that the bulk of their support no longer comes from the state. But they worry that the shift could lead universities to stray from their mission of giving state residents access to affordable higher education. Critics are particularly wary of the trend toward splitting flagships like the University of Wisconsin-Madison, which generally have the biggest research grants, the most alumni support, the best faculty and students, and the most political clout, from the rest of the state's higher education system.



Financial Exigency

As many U.S. colleges and universities struggle with a weakened capacity to raise tuition and declining government funding, some could consider the controversial step of declaring a "financial exigency" that would allow them to lay off tenured faculty.

State support of public universities -- on the decline since the 1980s -- is likely to dwindle further as most states face the loss of federal stimulus funding, and the economy continues its slow recovery. The greatest area of potential savings is in the reduction of salary and benefits that is made possible through a declaration of financial exigency or crisis.

Because public universities are accustomed to disclosing their concerns over state funding cuts and are more likely to accept the risk of negative publicity than private colleges, they may take this step given the current conditions. Private colleges and universities are less likely to employ the rarely used procedure due to fears of reputational losses among investors, lenders, donors, students, and academics. Those willing to do so are likely to be low-rated already, and willing to incur the risk of further declines in reputation in the bond market.

On balance, financial exigency could be a positive step in terms of credit standing because it empowers management to take aggressive cost-cutting steps to preserve cash flow to pay debt service. Such a declaration could have little or no negative impact on a university's bond rating if the agencies expect the actions to improve the institution's future financial position.

If more universities follow the path of financial exigency, the competitive risks to reputation would likely lessen over time. However, if the practice does not become more prevalent, it could backfire on the few universities that take the step. Outside of higher education, school districts and other local governments in the U.S. occasionally declare a financial emergency or crisis in order to trigger supportive actions by the state government, or to break labor contracts with teachers.

Liquidity

Liquidity in the U.S. higher education sector is generally strong despite negative credit pressures affecting the large majority of colleges and universities. Liquidity risks have stabilized for most universities nearly three years after unexpected cash shortages caused 15 highly-rated private universities to borrow more than \$7 billion in taxable debt to bolster their liquidity. Nevertheless, significant uncertainty remains for some universities that face potential liquidity risks. Those risks could arise most from variable rate debt structures, weak tuition pricing power, investment volatility, and cuts in government funding.

Institutions reporting liquidity increases last year were aided by long-term investment returns, careful expense containment, and more active liquidity management. Coverage of demand debt broadly improved in 2011 due both to increases in monthly liquidity and reductions in use of demand debt.



Private universities usually maintain greater liquidity relative to their operating expenses. Monthly liquidity as a share of total investments is lower for wealthier universities as higher-rated universities have stronger balance sheets and can afford less-liquid investment strategies. Monthly liquidity for public universities provides an important buffer against state budget cuts.

Other Trends

Other trends MTAM has recognized in the higher education sector include:

- Demand for higher education by older, non-traditional students is increasing.
- Demographic trends point to an increased number of 18-22 year olds in many parts of the country, especially the south and the west (and especially minority students).
- Technology-driven economy raises demand for skilled, educated employees.
- Campuses that are conveniently located, with well-appointed living quarters located close to campus are attracting more students. Food services should be restaurant quality and athletic facilities should be similar to an advanced health club. Security has become increasingly important.
- In order to control both administrative and academic costs, some institutions have privatized student facilities and services on campus.
- To better consolidate and define their core businesses, some public academic medical centers have spun off their university hospitals with other area health care institutions.

Conclusion

Some higher education institutions are not adjusting as well to current market challenges, and debt issuance for new facilities continues to grow faster than debt capacity. While most colleges and universities continue to generate sufficient operating cash flow to cover their debt service, MTAM sees a tightening of operating margins, reflecting a combination of revenue constraints and expense pressures.

The credit outlook is stable for most large public institutions, primarily due to their pricing advantage and revenue subsidies from state appropriations; however, weakened state economies have reduced operating and capital funding for most public universities; tuition rate increases have been the result. The private institutions that are already strong credits are expected to remain healthy, while weaker ones are expected to remain stable, or, in some cases, worsen. The rising need for capital investment may threaten some of the smaller private universities. A weak economy would pose challenges in the areas of tuition revenue, fundraising, and investment performance. With investment income accounting for a rising share of many universities' operating revenues, endowment losses would likely stress operating performance as well.