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June 2013 COGR Meeting Guest Speaker Presentation - Moody's

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2013 US Higher Education Outlook

Council on Governmental Relations

Agenda

- Moody's in Capital Markets
 - Ratings, research, ratios

- Negative Outlook for Entire US Higher Education Sector
 - Affordability: Weak revenue outlook here to stay?
 - Research Funding: Cuts to grants and contracts outpacing expense reductions?
 - Bubble-Talk: Will technology, student loans and other risks disrupt or even destroy higher education "business model?"
 - Sustainability and Leadership: What's ahead for higher education governance, management and strategy?

- Questions and Answers

Moody's: Ratings, Research, Ratios

Independent Risk Opinions for Investors & Lenders: 21 point scale ranging from Aaa to C to evaluate credit risk of loss in lending to or investing in colleges and universities

Largest Team Evaluating Colleges/Universities: 20 full-time analytical professionals and support staff globally

Rate Most Colleges and Universities: In US, ratings cover 90% of public higher education sector and 70% of private, independent sector measured by enrollment in four-year degree institutions

Most Research on Colleges & Universities: 500 reports yearly on individual colleges/universities & 30 topical sector research reports

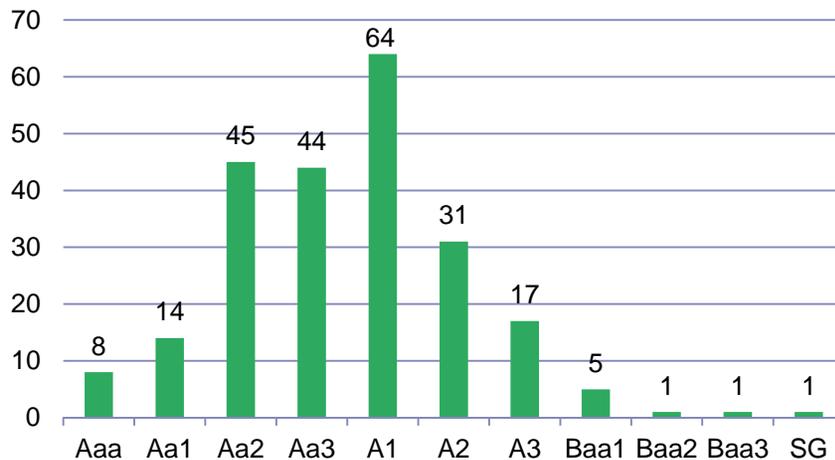
Robust Ratios & Data on Higher Ed: Historical and current data on financial and student demand trends in the 500+ colleges, universities and systems; all adjusted for comparability

US Public Universities Rated Higher, but More Aaa-Rated Private Universities

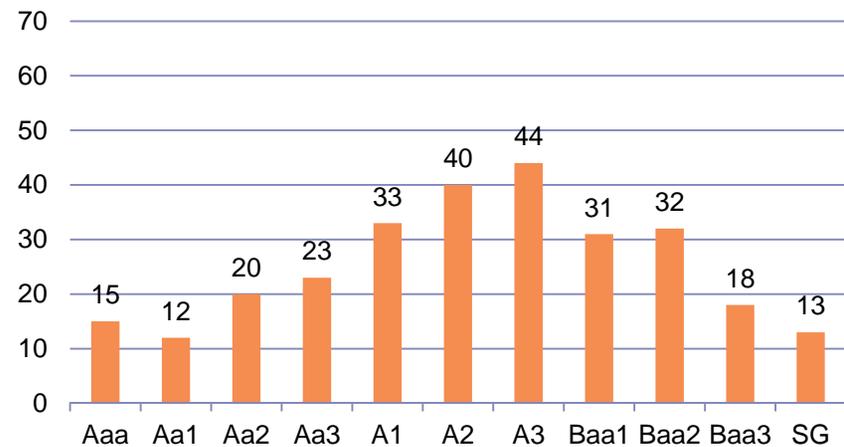
- » 228 four-year public universities
- » \$124.3 billion total rated debt outstanding
- » Median rating of Aa3/A1 by # of institutions
- » Median rating of Aa2 weighted by rated debt

- » 282 private colleges and universities
- » \$85.3 billion of rated debt outstanding
- » Median rating of A2/A3 by # of institutions
- » Median rating of Aa2 weighted by rated debt

US Public University Ratings



US Private University Ratings



Source: Moody's MFRA, ratings as of May 24, 2013

Negative Outlook for US Higher Education Sector in 2013

Outlook Horizon: 12-18 months

Critical Factors:

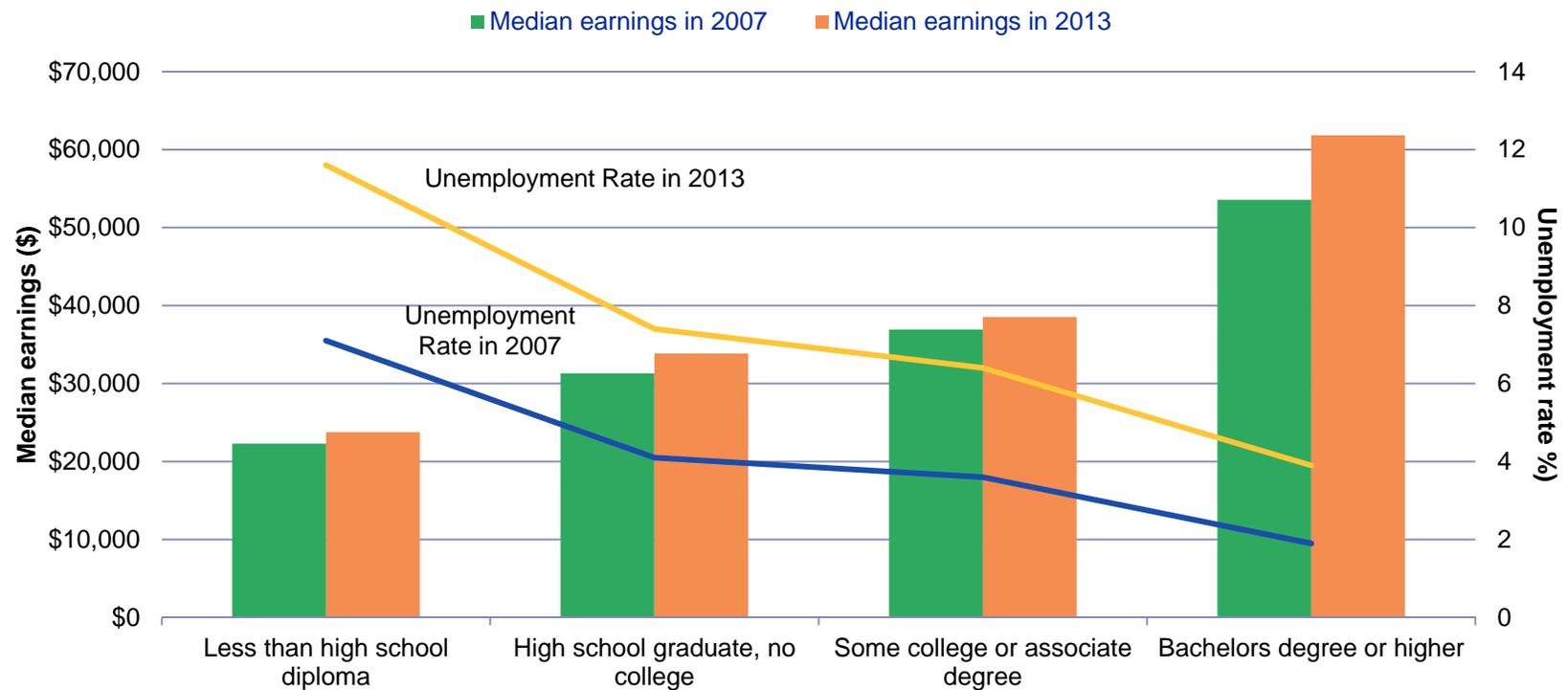
1. Limited prospects for tuition revenue growth
2. Rising student loan burden and defaults taint public perception
3. Escalated regulatory and accreditation risk
4. Focus on governance and management to provide long-term sustainability

Baseline Assumptions:

1. Fundamental demand for the product is still high
2. Stronger earnings by educational attainment
3. Global economy creates need for educated workers

Underlying Credit Strength: Value of a College Degree

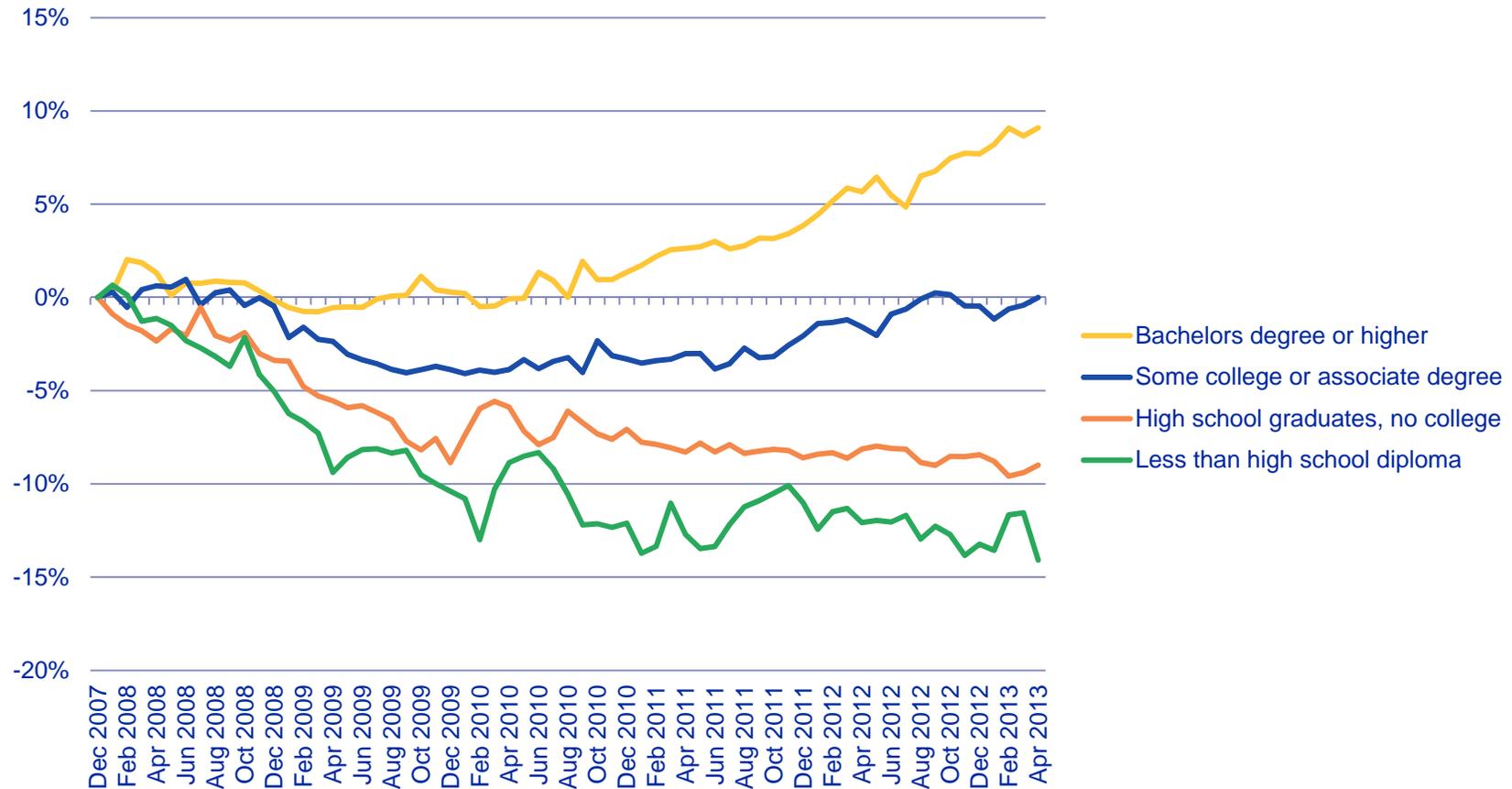
- » Demand Remains Solid
- » No Viable Substitute for a College Degree
- » But Recent Grads Face Tougher Time Getting Jobs



Source: Bureau of Labor Statistics, Current Population Survey

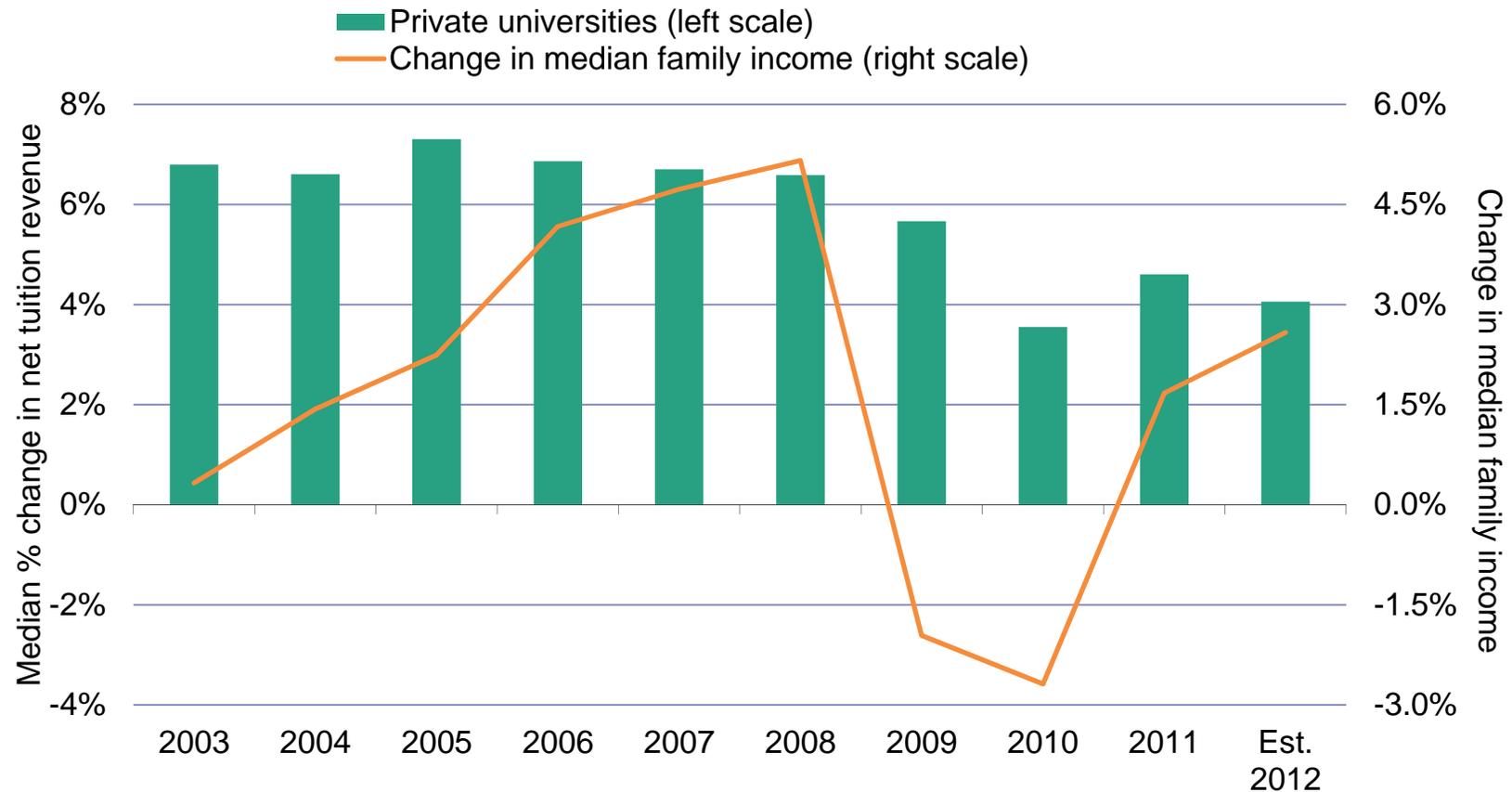
Educational Attainment Tightly Linked to Employment

Change in employment since the start of the recession



Source: Bureau of Labor Statistics, Current Population Survey

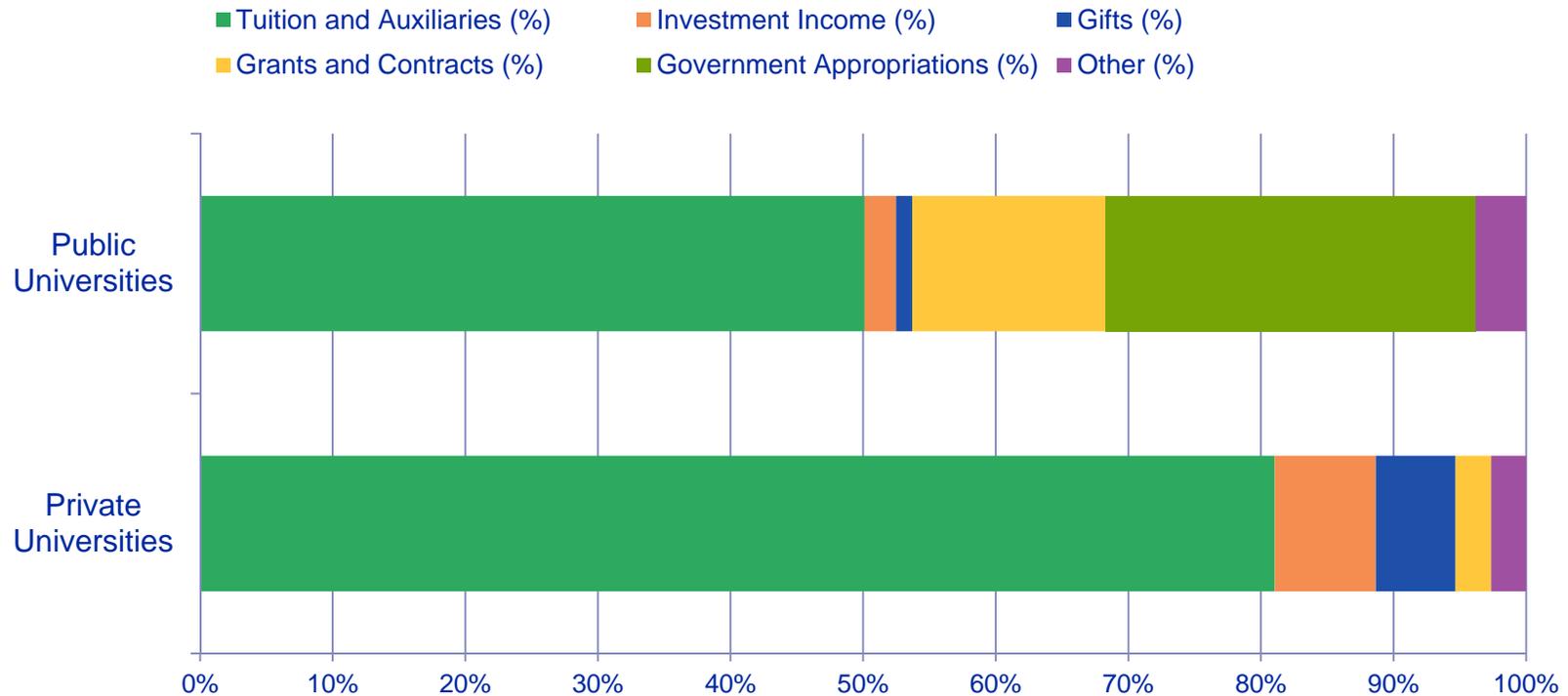
Factor #1: Price Sensitivity Continues to Suppress Net Tuition Revenue Growth



Source: Moody's MFRA; US Census Bureau, Current Population Survey

Majority of Sector is Tuition Dependent

Median Revenue Contributions, FY 2012

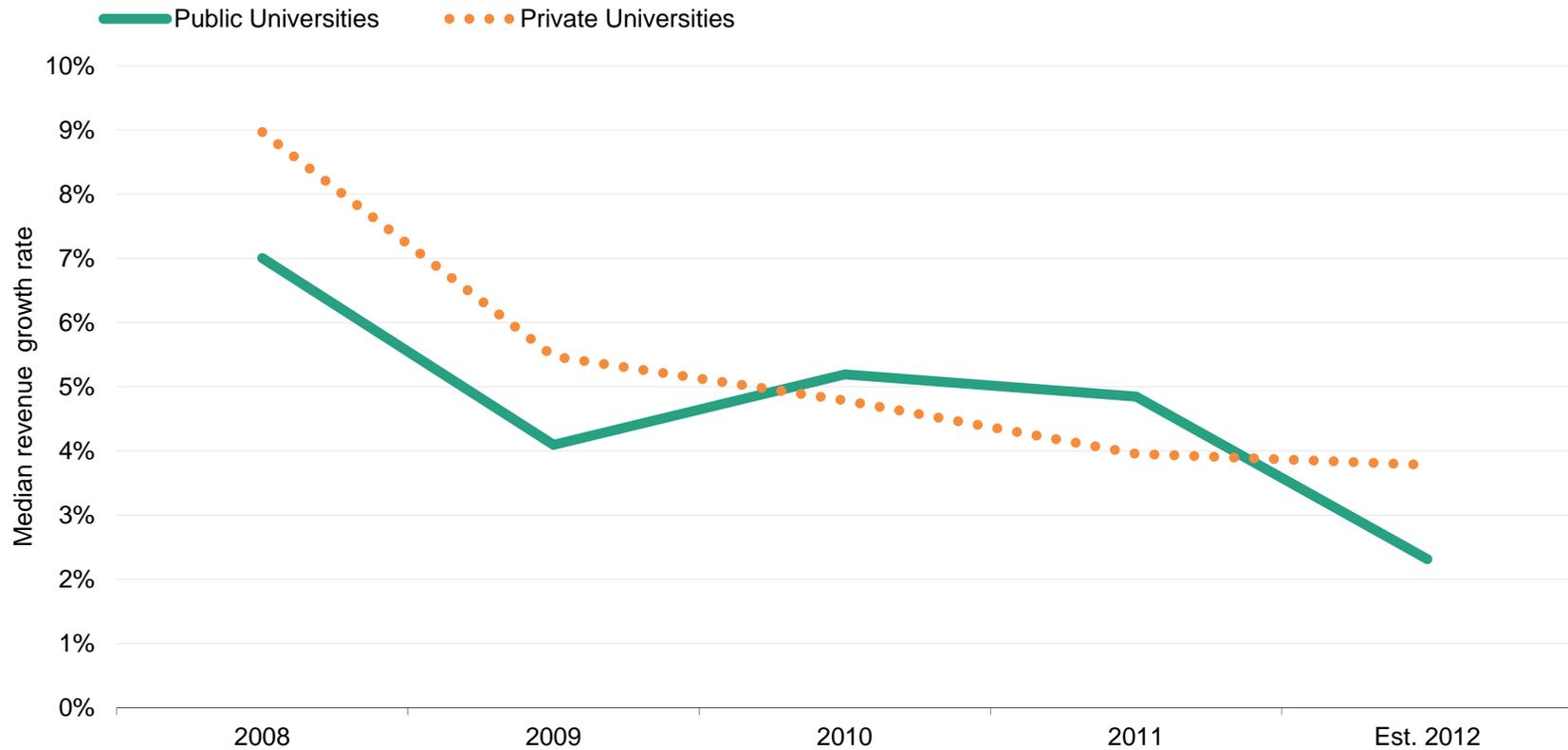


Note: The majority of the rated portfolio does not receive meaningful revenue from patient care or from tax revenue, therefore the median contribution ratios for those two revenue sources is zero.

Source: Moody's MFRA

Factor #2: All Non-Tuition Revenue Sources are Strained

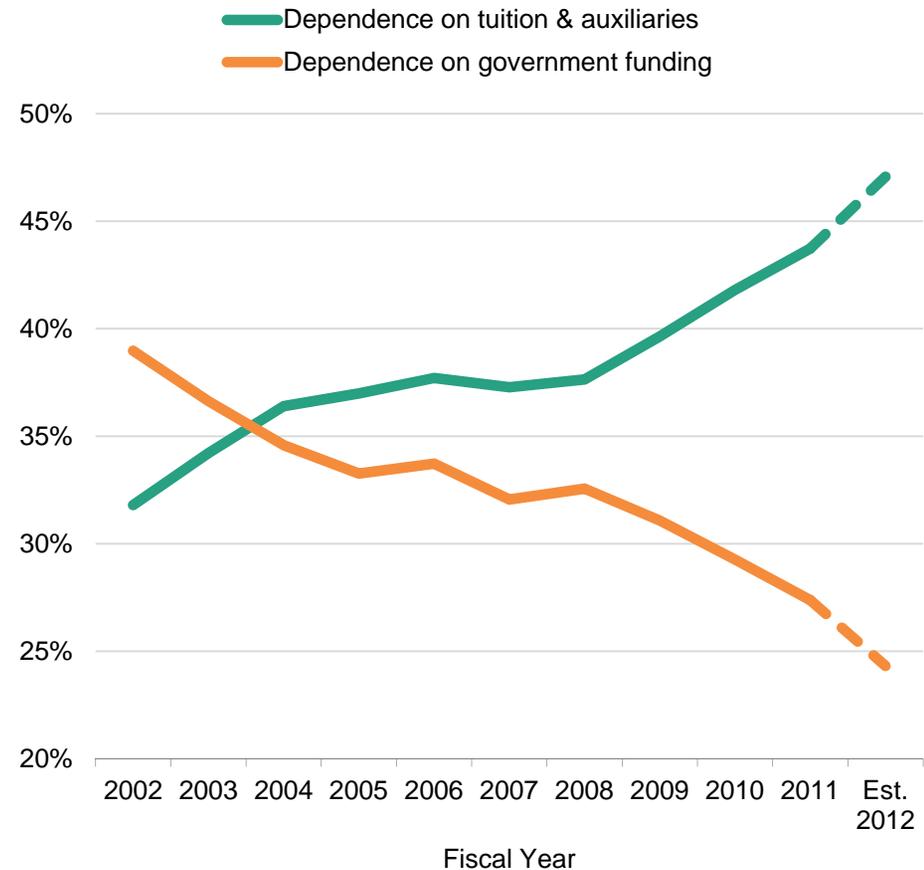
Growth of operating revenue continues to slow for the entire sector



Source: Moody's MFRA

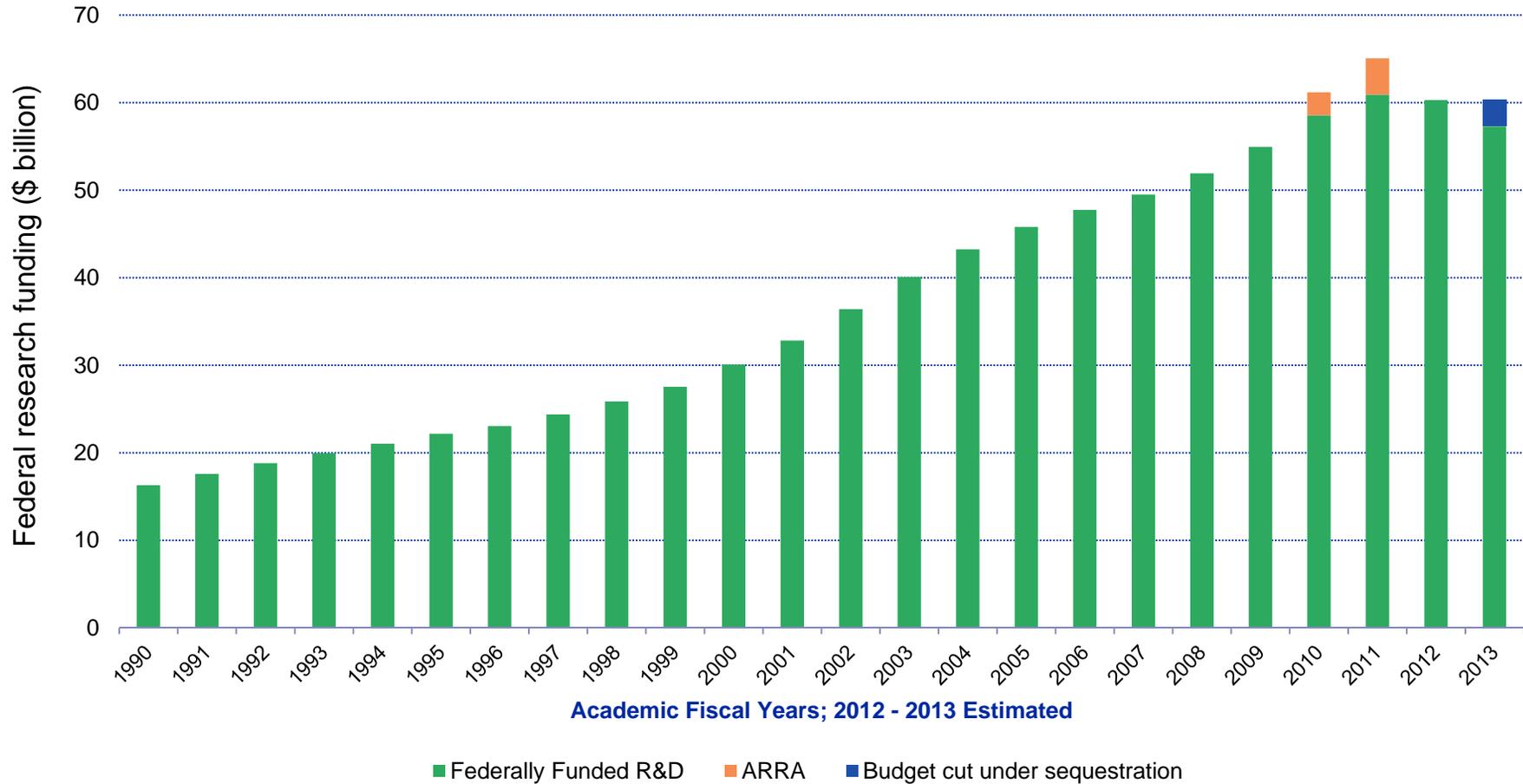
Public Universities Cope with Declining State Support

- » Stagnant to declining state operating and capital support for most
- » State operating results mixed as macro economy lags
- » Declining state appropriations per student offset by growth of student charges



Source: Moody's MFRA

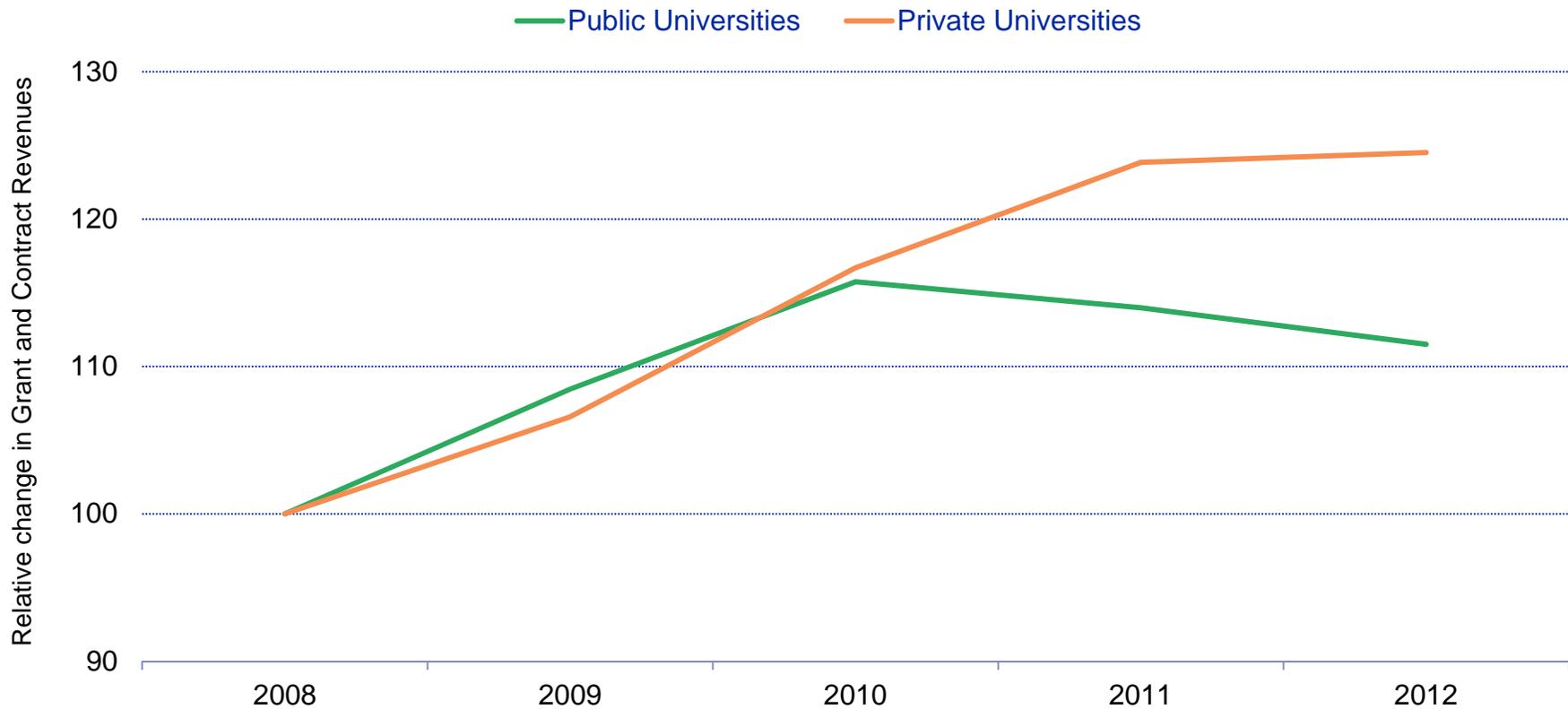
Research Funding Slows, with Sequestration Cuts



Source: National Science Foundation/Division of Science Resources Statistics; Survey of Research and Development Expenditures at Universities and Colleges, FY 2009; National Science Foundation/National Center for Science and Engineering Statistics; Higher Education Research and Development Survey, FY 2011; Moody's Estimates

Private Research Universities have had More Success Growing Grant Revenue in the Last Two Years

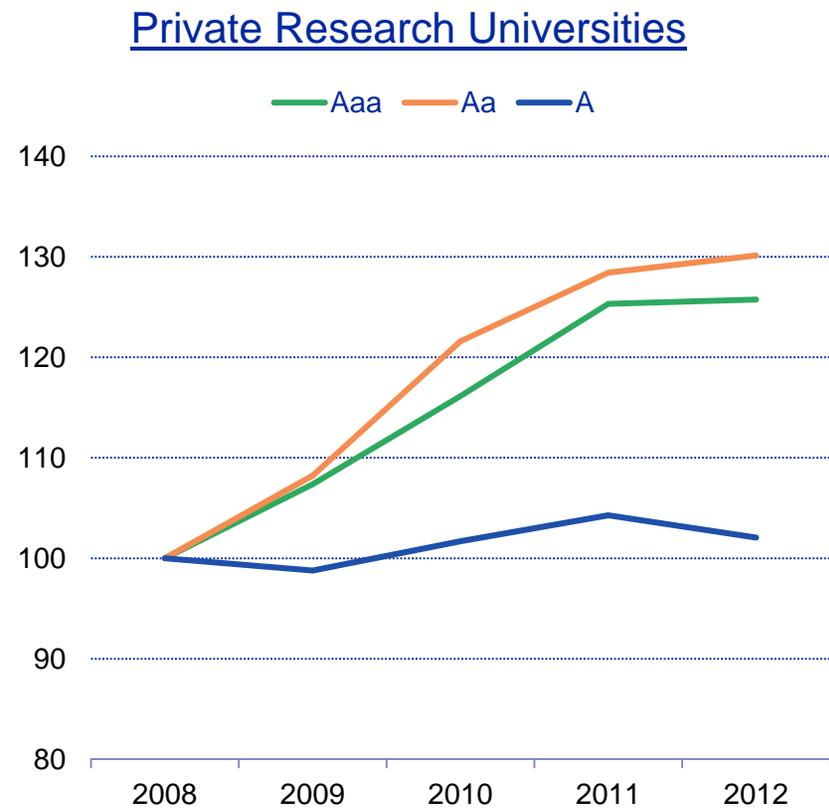
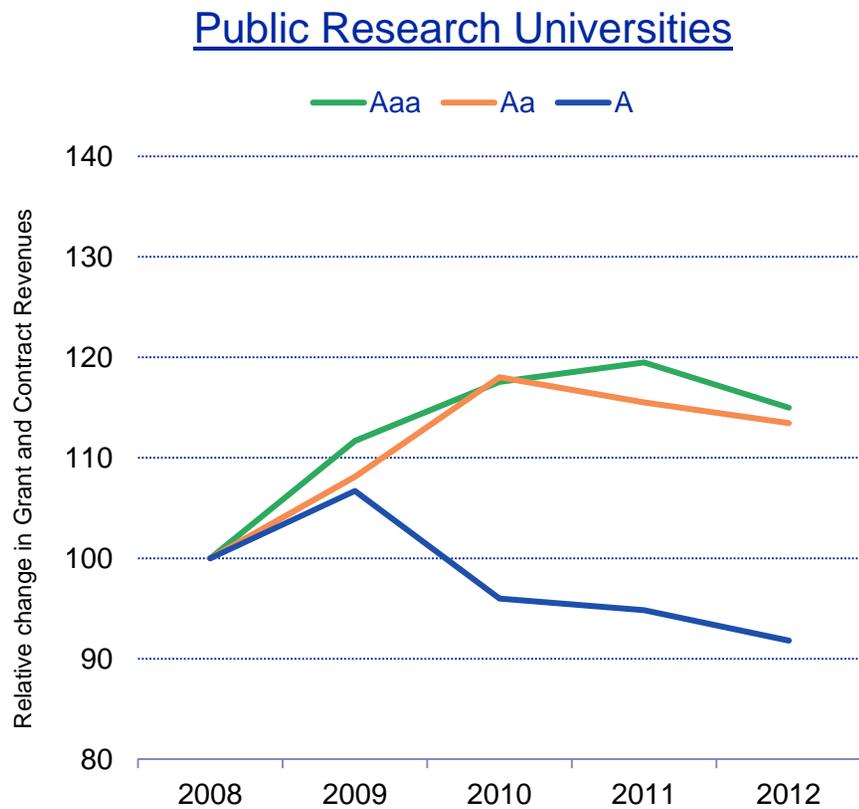
Total Grants & Contracts (Indexed; 2008 = 100)



Source: Moody's Municipal Financial Ratio Analysis
Research Universities are defined universities with over \$500 million in operating revenue and either:
\$150 million in grants & contracts or more than 15% of revenue from grants & contracts

Funding for Higher Rated Research Universities has Grown, While Grant Revenue for A-Rated has Stagnated or Declined

Total Grants & Contracts (Indexed; 2008 = 100)

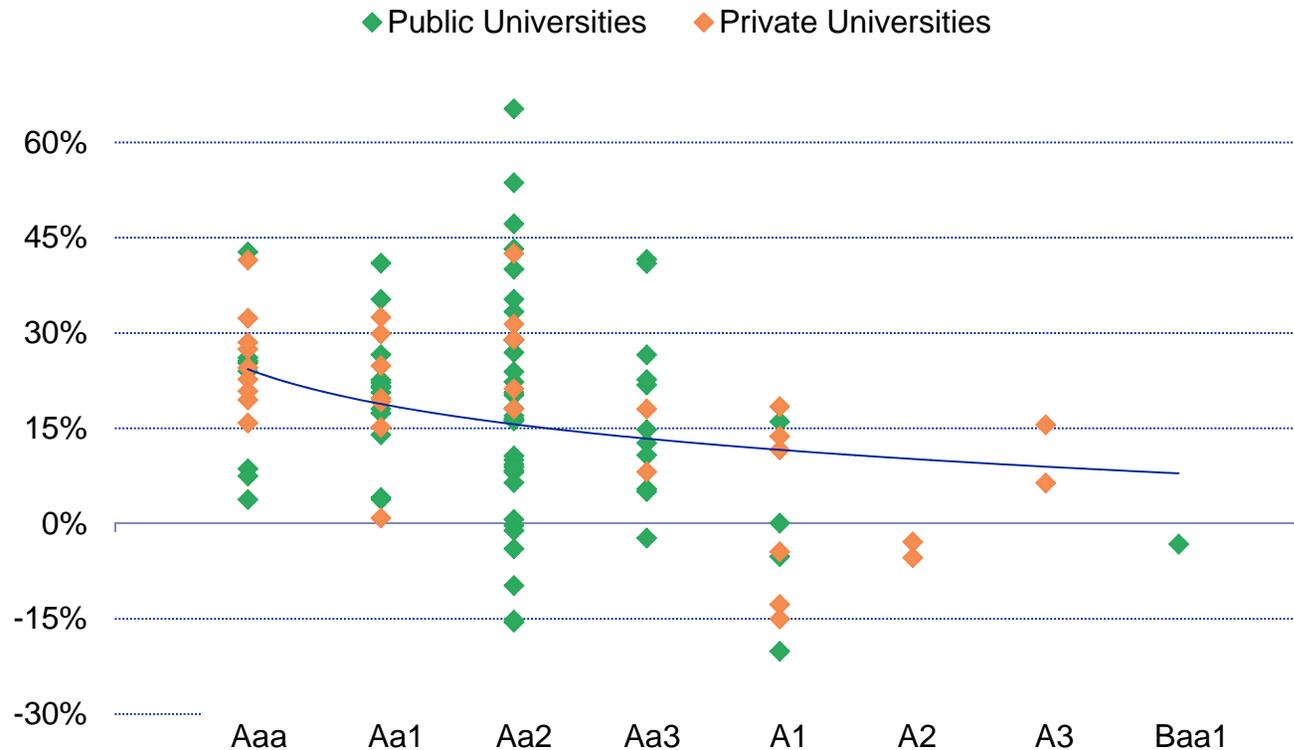


Source: Moody's Municipal Financial Ratio Analysis

Research Universities are defined as universities with over \$500 million in operating revenue and either: \$150 million in grants & contracts or more than 15% of revenue from grants & contracts

Higher Rated Universities Typically have Stronger Growth in Grant Revenues

5-Year Change in Grant & Contract Revenue, FY 2008 - 2012

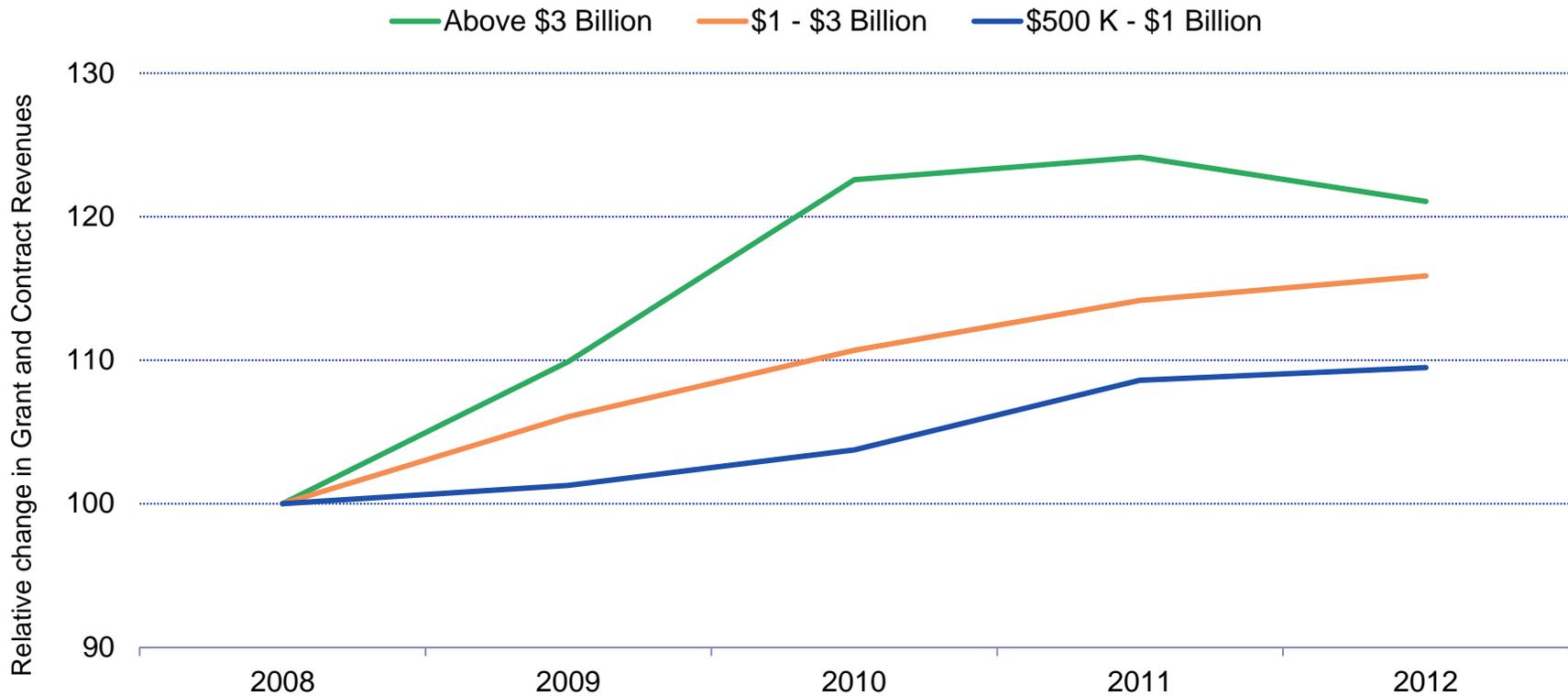


Source: Moody's Municipal Financial Ratio Analysis

Research Universities are defined as universities with over \$500 million in operating revenue and either: \$150 million in grants & contracts or more than 15% of revenue from grants & contracts

Larger Research Universities have had More Success Growing Grant Revenues

Total Grants & Contracts, By Amount of Operating Revenue (Indexed; 2008 = 100)

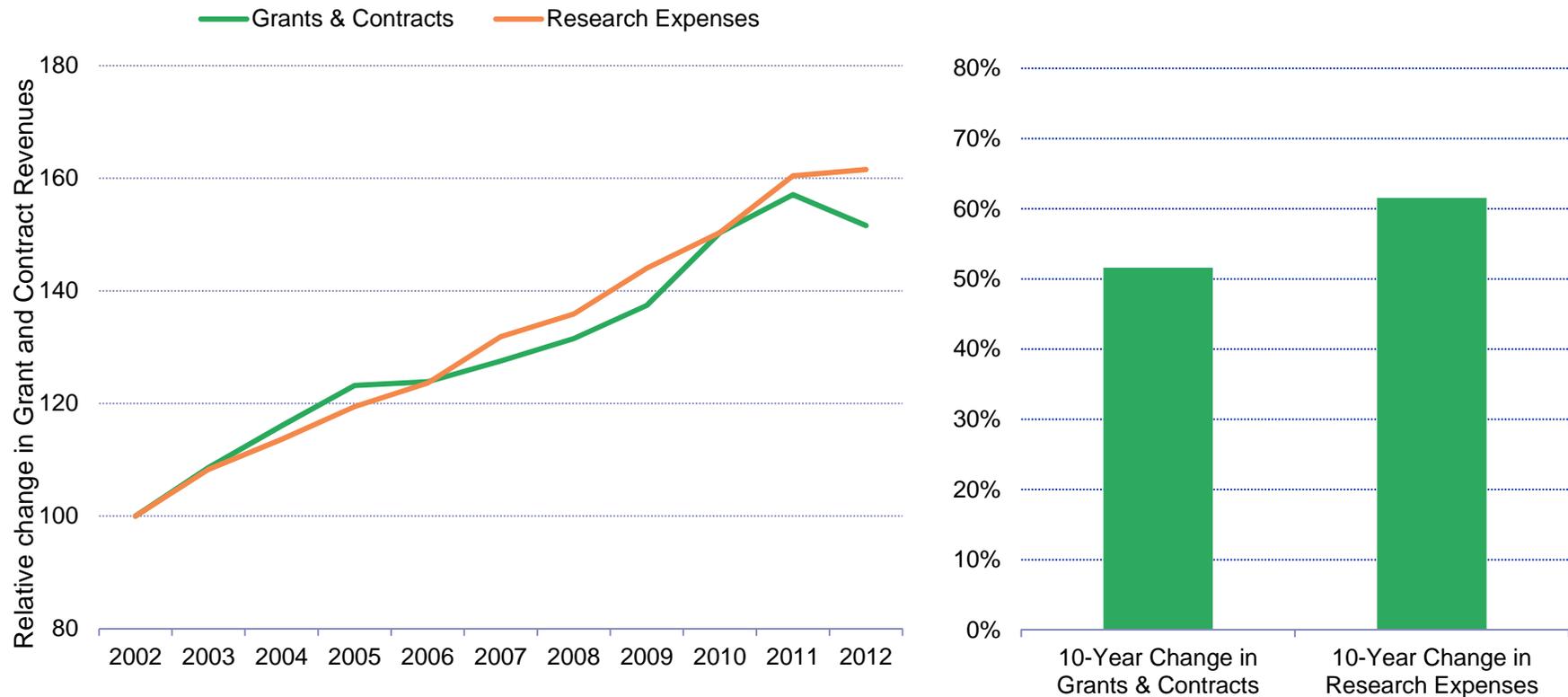


Source: Moody's Municipal Financial Ratio Analysis

Research Universities are defined as universities with over \$500 million in operating revenue and either: \$150 million in grants & contracts or more than 15% of revenue from grants & contracts

Research Expense Reductions Lag Cuts to Grant Revenue Growth

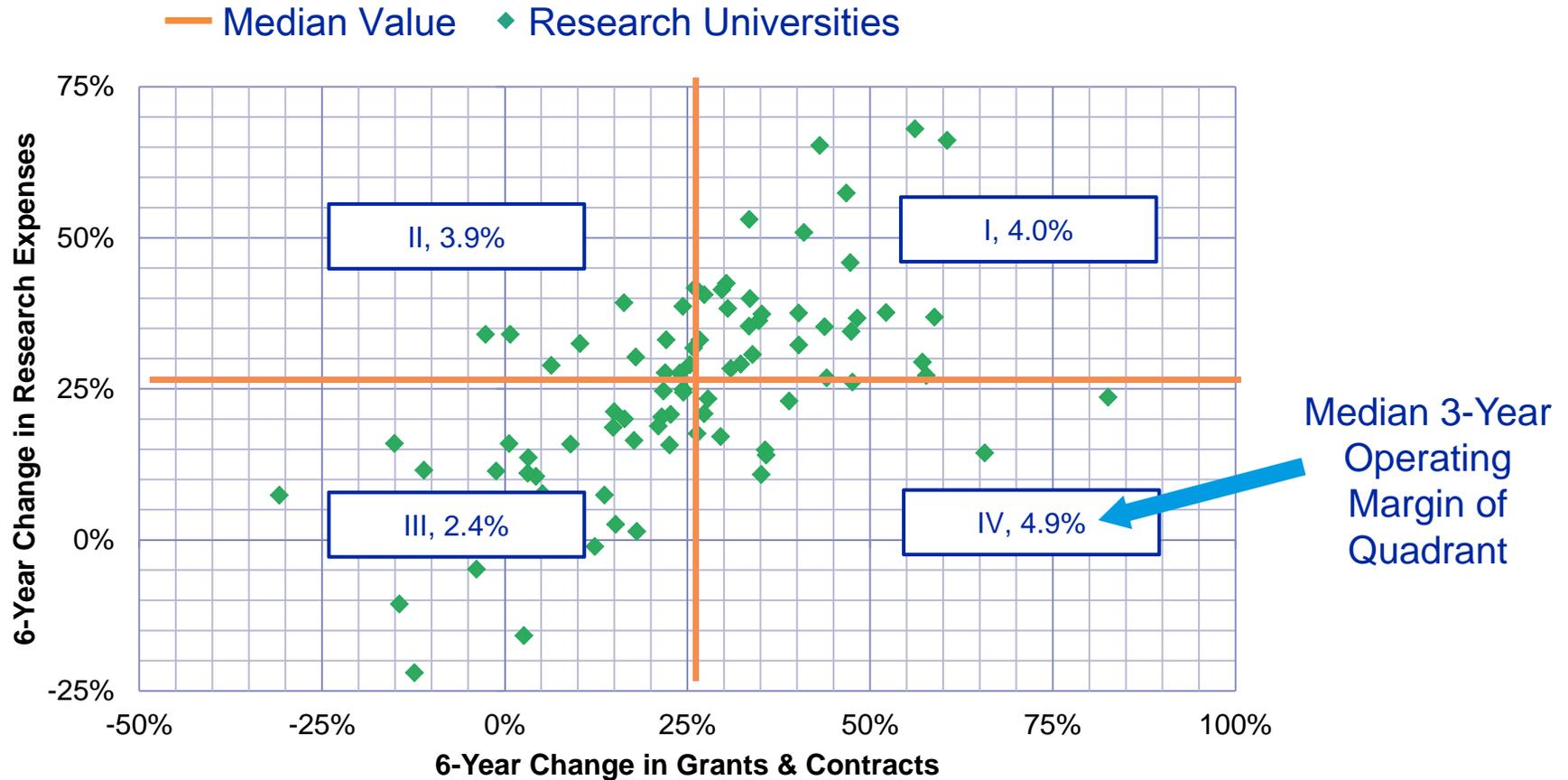
Total Grants & Contracts, Expenditures (Indexed; 2002 = 100)



Source: Moody's Municipal Financial Ratio Analysis

Research Universities are defined as universities with over \$500 million in operating revenue and either: \$150 million in grants & contracts or more than 15% of revenue from grants & contracts

Universities That Have Grown Grants and Contracts While Containing Expenses Show the Highest Operating Margins



Source: Moody's Municipal Financial Ratio Analysis

Research Universities are defined as universities with over \$500 million in operating revenue and either: \$150 million in grants & contracts or more than 15% of revenue from grants & contracts

Volatility for Investment Returns and Uncertainty around Gift Revenue

Endowments

- » Outlook for capital markets clouded by federal budget negotiations
- » Fiscal 2013 endowment draw formulas will pick up weak FY 2012 (flat to negative returns)
- » Aaa- and Aa-rated universities most reliant on endowment draw as part of budget
- » Liquidity remains focus of management teams

Fundraising

- » General correlation with stock market performance
- » Higher rated universities dominate fundraising
- » Tax risk around charitable donations
- » *However: philanthropy is a unique credit attribute for US higher education and related not-for-profits*

Health Care Exposure: Declining Revenue Growth & Patient Volumes

Near-term Credit Challenges

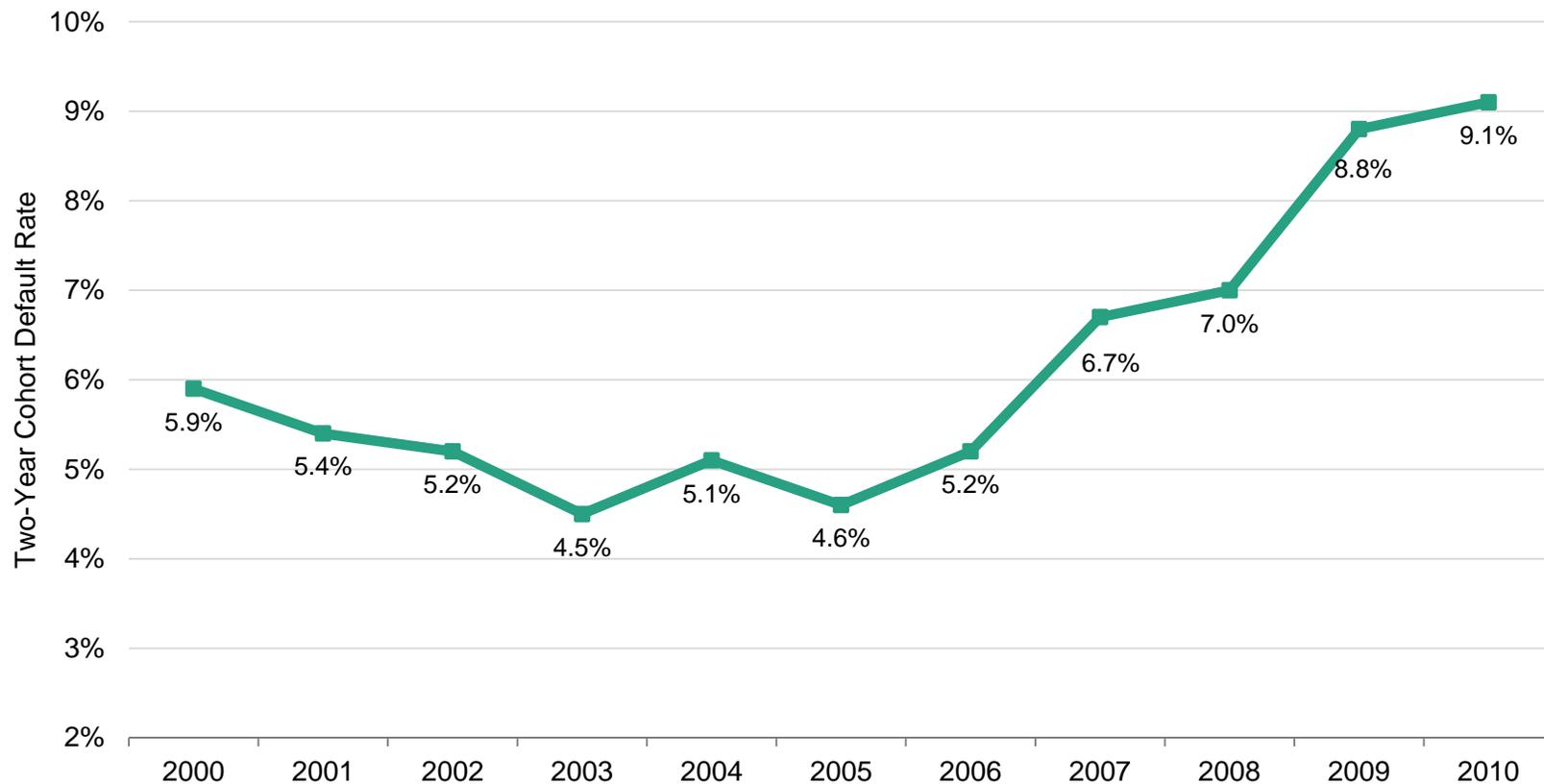
- » Declining top-line revenue growth and patient volumes
- » Reimbursement pressure from all payers
- » Limited rate increases and potential funding cuts for Medicare and Medicaid
- » Reduced graduate medical education (GME) funding
- » Uncertainty over implementation of healthcare reform

Counterbalanced by Credit Strengths

- » Still favorable operating margins driven by increased expense containment and operating efficiency
- » Sector consolidation through Mergers & Acquisitions
- » Academic medical centers often offer high-end services and may benefit from diverse revenue, including gifts and grants

Factor #3: Rising Student Loan Burden and Defaults Taint the Perception of the Value of a College Degree

Student Loan Defaults Have Doubled Since 2003

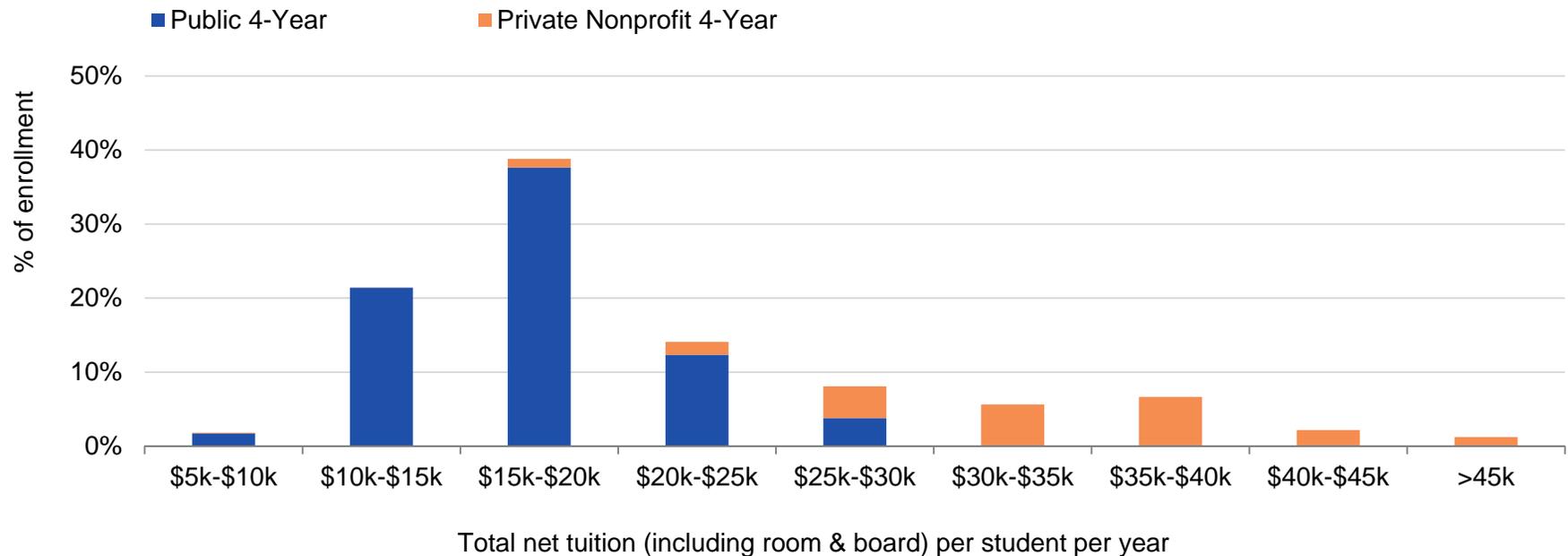


Source: Department of Education

Getting College Degree Costs Far Less than Perceived

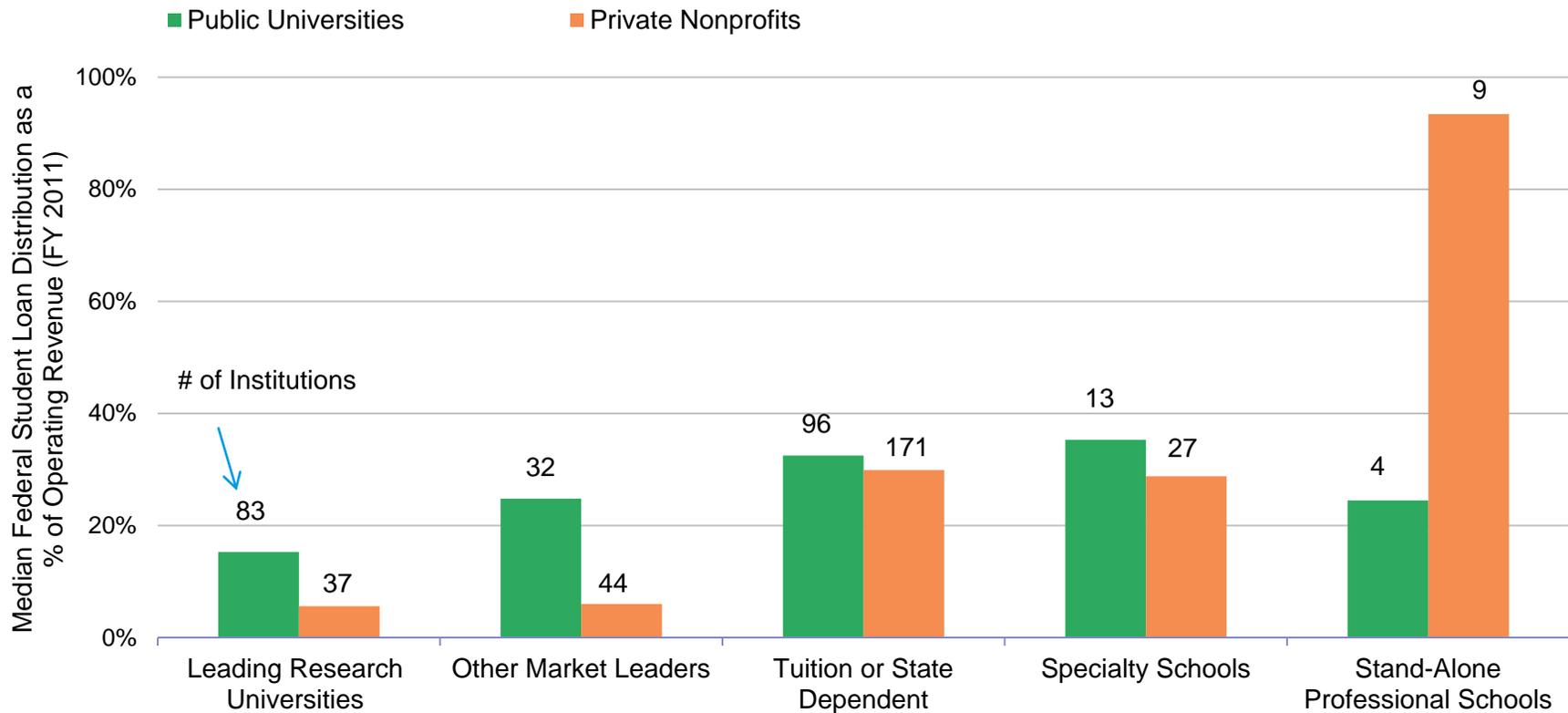
Most Private Colleges Heavily Discount Sticker Price: Publics Enroll Large Majority

- » 77% of students are enrolled at public universities
- » 62% of students enrolled at public/private universities facing average cost of less than \$20,000



Source: Moody's MFRA; data as of FY 2011 and excludes medical schools, law schools, and community colleges. Net tuition revenue includes scholarship discounts and allowances, as well as other types of financial aid not paid by students.

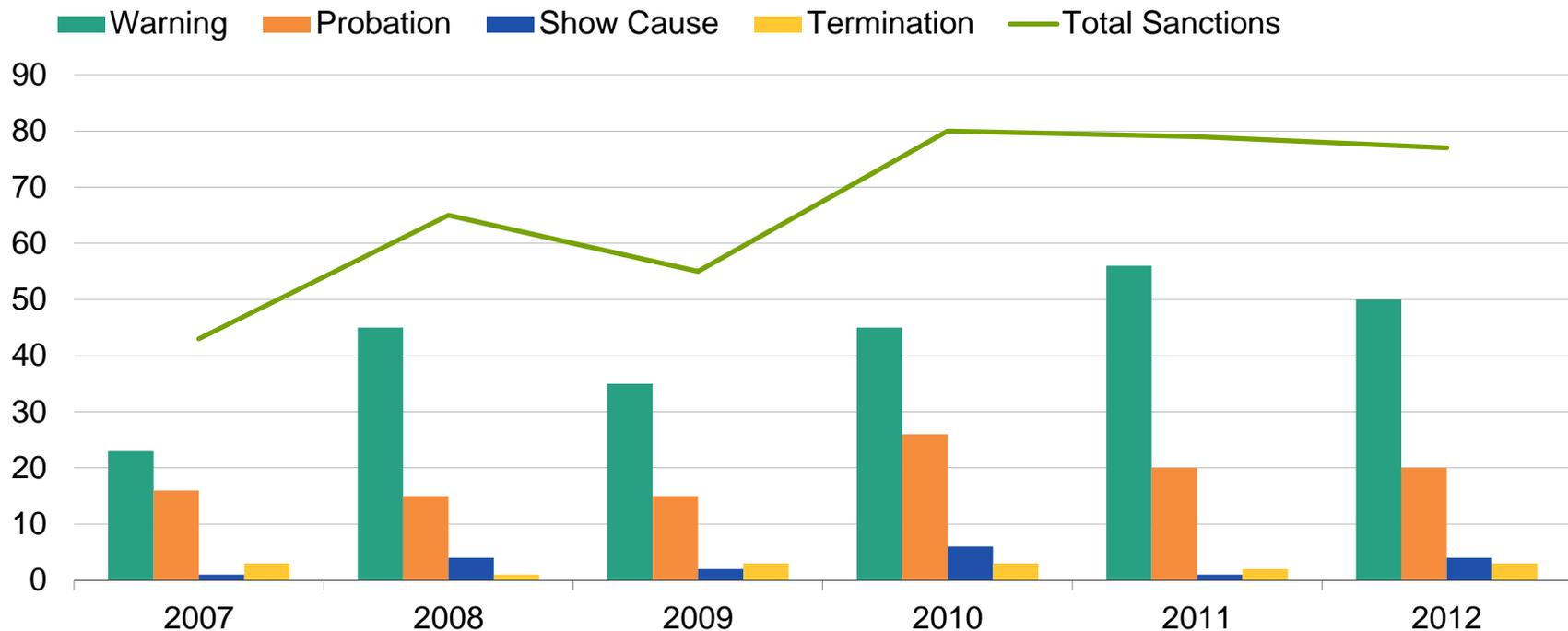
Professional Schools Highly Dependent on Student Loans



Source: Moody's MFRA, New America Foundation

Factor #4: Escalated Risk of Regulation & Accreditation Sanctions

Number of accreditation actions



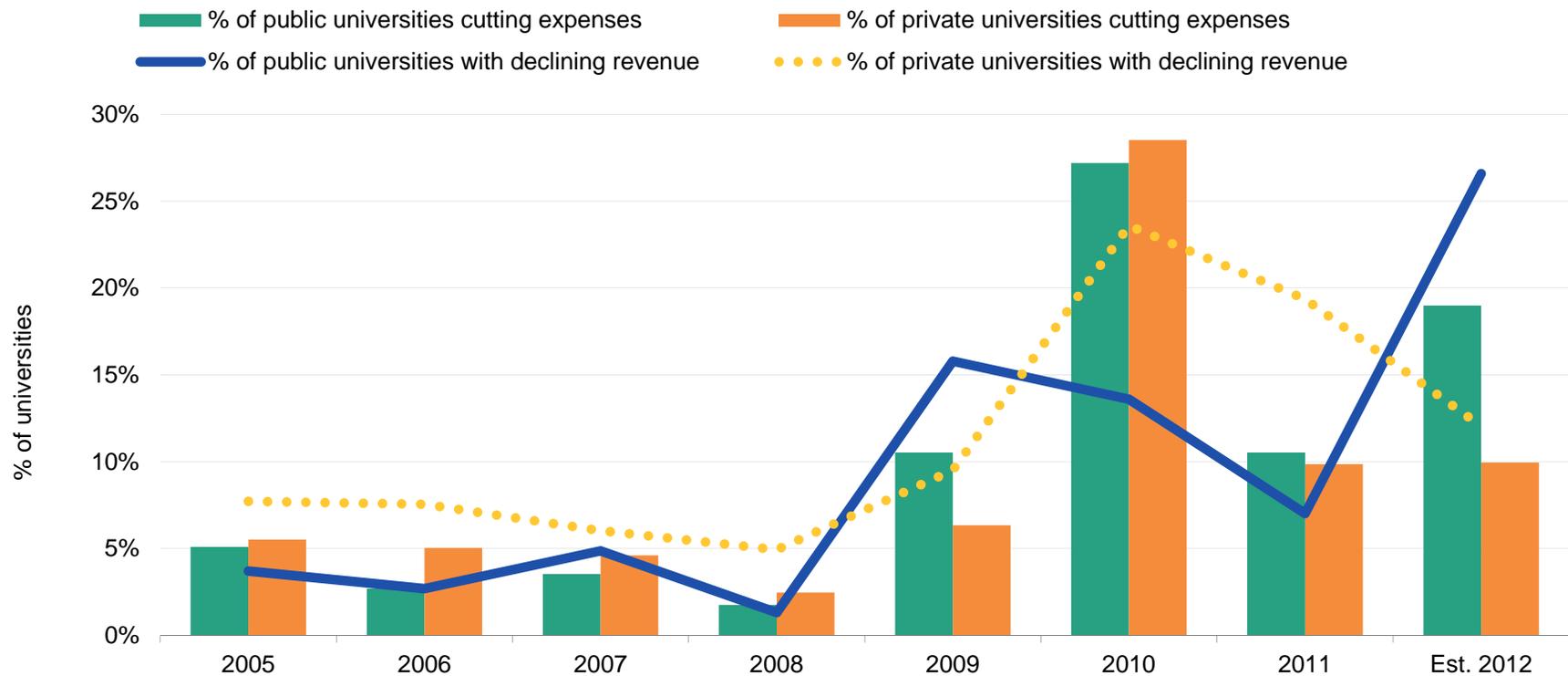
HLC/NCA uses a sanction called "on Notice" rather than "Warning" - "on Notice" has been counted as "Warning" in this graph. NEASC and SACS do not issue "Show Cause" sanctions. NEASC does not issue "Warning" sanctions.

WASC Sr. did not provide data for 2007-2010 and is not included in this figure; there were 3 sanctions issued in 2011 (1 warning, 1 probation, 1 show cause) and 2 sanctions in 2012 (1 warning, 1 probation)

Sources: Individual Accreditation Organizations, November 2012, US Department of Education

Factor #5: Focus on Governance & Management to Provide Long-Term Sustainability

Quest for Cost Efficiency in Light of Decelerating Revenues



Source: Moody's MFRA

Governance and Management : The Underpinning of University Credit Ratings

- » Effective governance and strong management enable an organization to reach its full potential while avoiding financial stress.
- » Strategy, financial health, and credit position are all fundamentally driven by decisions made by a university's board members and leadership team.

- » Hallmarks of Governance & Management:
 - Board and Senior Management Composition
 - Oversight and Disclosure Practices
 - Short- and Long-Term Planning
 - Self-Assessment and Benchmarking
 - Government Relations

Appendix

Recent High-Profile Rating Actions

» **Boston University**

Upgraded to A1 from A2
\$1.5 billion debt affected

- Sustained improvements in overall market
- Large urban research university with diversified enrollment and positive operating performance
- Growth in philanthropy in the context of the University's first fundraising campaign
- Complex debt structure and high net tuition per student

» **Illinois Public Universities**

Combination of Downgrades (4) and Negative Outlook Revisions (4)
\$2.5 billion debt affected

- Tied to revision of state outlook to negative (high reliance on state appropriations)
- Continued appropriation payment delays negatively affecting cash flow and liquidity

» **University of California**

Outlook revised to Aa1/Negative from Aa1/Stable
\$17.7 billion debt affected

- Five years of operating deficits
- Reduction in cash flow and unrestricted financial resources
- Mounting pension and OPEB liabilities
- Significant borrowing expected due to large capital plans

» **University of Cambridge**

Aaa assigned to \$560 million debt

- Initial Rating; Moody's-only rating
- Global leader in education and research; ranked among top 10 universities globally
- Significant cash and investments with large share of unrestricted liquid assets
- Limited fundraising profile relative to reputation and international peers

MOOCs & Online Education Likely to Affect Demand, Business Model, and Teaching Approach

- » New revenue opportunities through fees for certificates, courses, degrees, licensing, or advertisement
- » Improved operating efficiencies due to the lower cost of course delivery on a per-student basis
- » Heightened global brand recognition, removing geographic campus-based barriers to attracting students and faculty
- » Enhanced and protected core residential campus experience for students at traditional not-for-profit and public universities
- » Longer term potential to create new networks of much greater scale across the sector, allowing more colleges and universities to specialize while also reducing operating costs
- » New competitive pressure on for-profit, and some not-for-profit, universities that fail to align with emerging high-reputation networks or find a viable independent niche

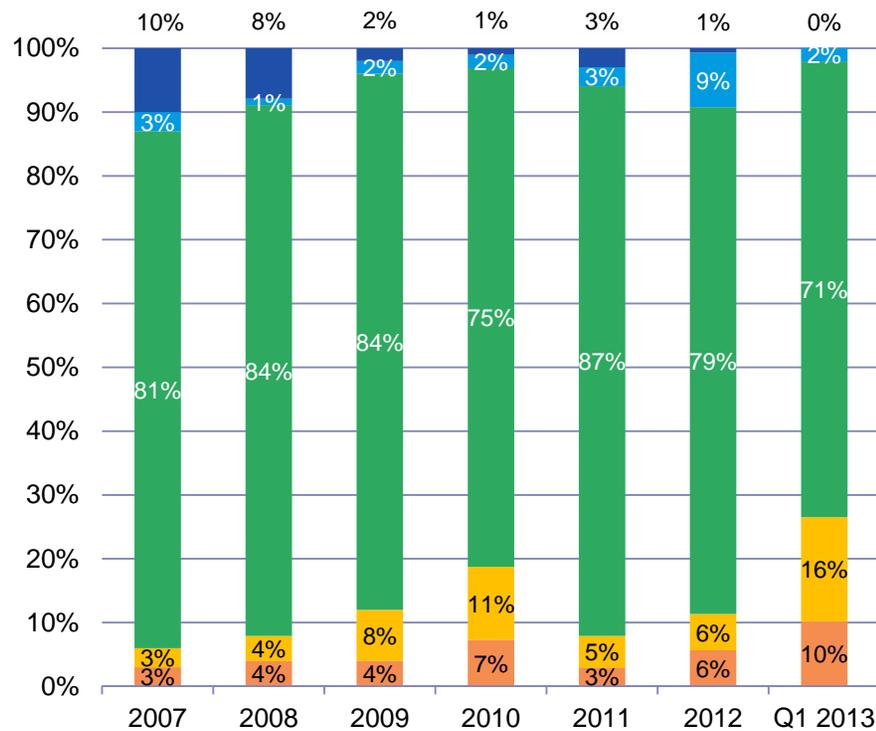
MOOCs Present Mixed Credit Implications

MARKET SEGMENT	BROAD CREDIT EFFECT	OPPORTUNITIES/RISKS
Global	Positive	<ul style="list-style-type: none"> » Superior brand reputation strengthens further » Free content offers opportunity for experimentation and supports tax-exempt mission; hedges regulatory risk » Greatest ability to monetize at later stage, but may require sharing of benefits with new technology partners
National	Highly Positive	<ul style="list-style-type: none"> » Align with global segment to build international presence/ join emerging networks » Leverage scale to keep up with industry trend and reduce operating costs
Regional / Specialized	Mixed	<ul style="list-style-type: none"> » Broaden brand recognition through the use of new technology » Operational efficiencies through lower cost of delivery and ability to specialize » Increased competition could weaken market share » Potential need to create partnerships with other less well-known universities/for-profit provider could be a costly new investment
Local/Commuter	Negative	<ul style="list-style-type: none"> » Technology dilutes value of physical proximity to student & increases reputation premium » Small size, weak market reputation renders many unattractive partners for emerging networks, may be left out as industry consolidation increases
For-Profit	Highly Negative	<ul style="list-style-type: none"> » Short-term benefit of legitimizing preferred form of delivery » Long-term threat as more reputable universities enter the market

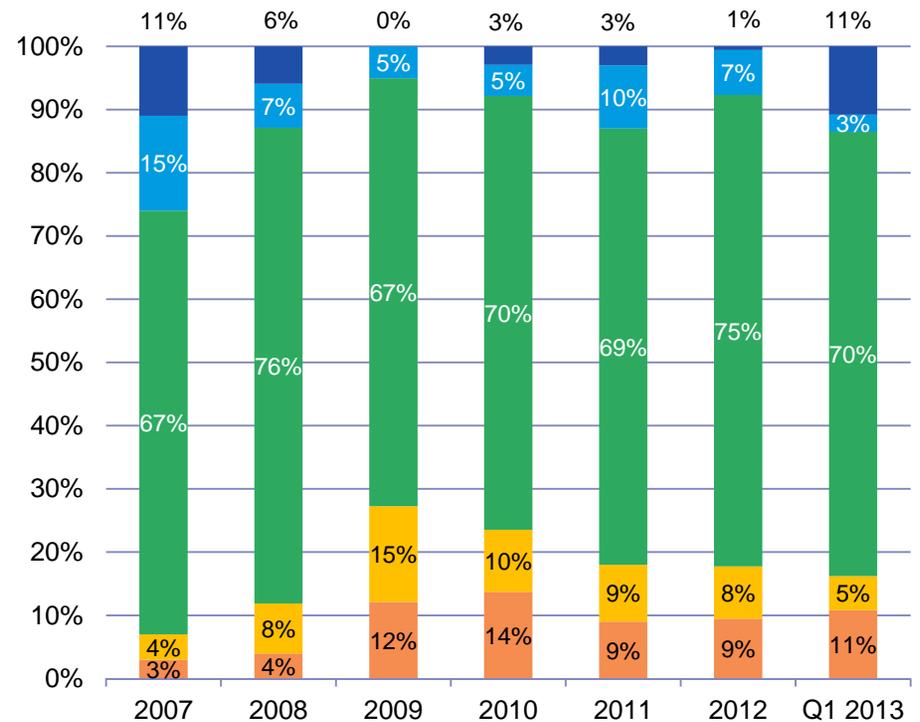
Ratings Show Relative Stability, More Pressure on Privates

■ Downgrade
 ■ Outlook Revised Down
 ■ Affirmation
 ■ Outlook Revised Up
 ■ Upgrade

Public University Activity 2007 – Q1 2013

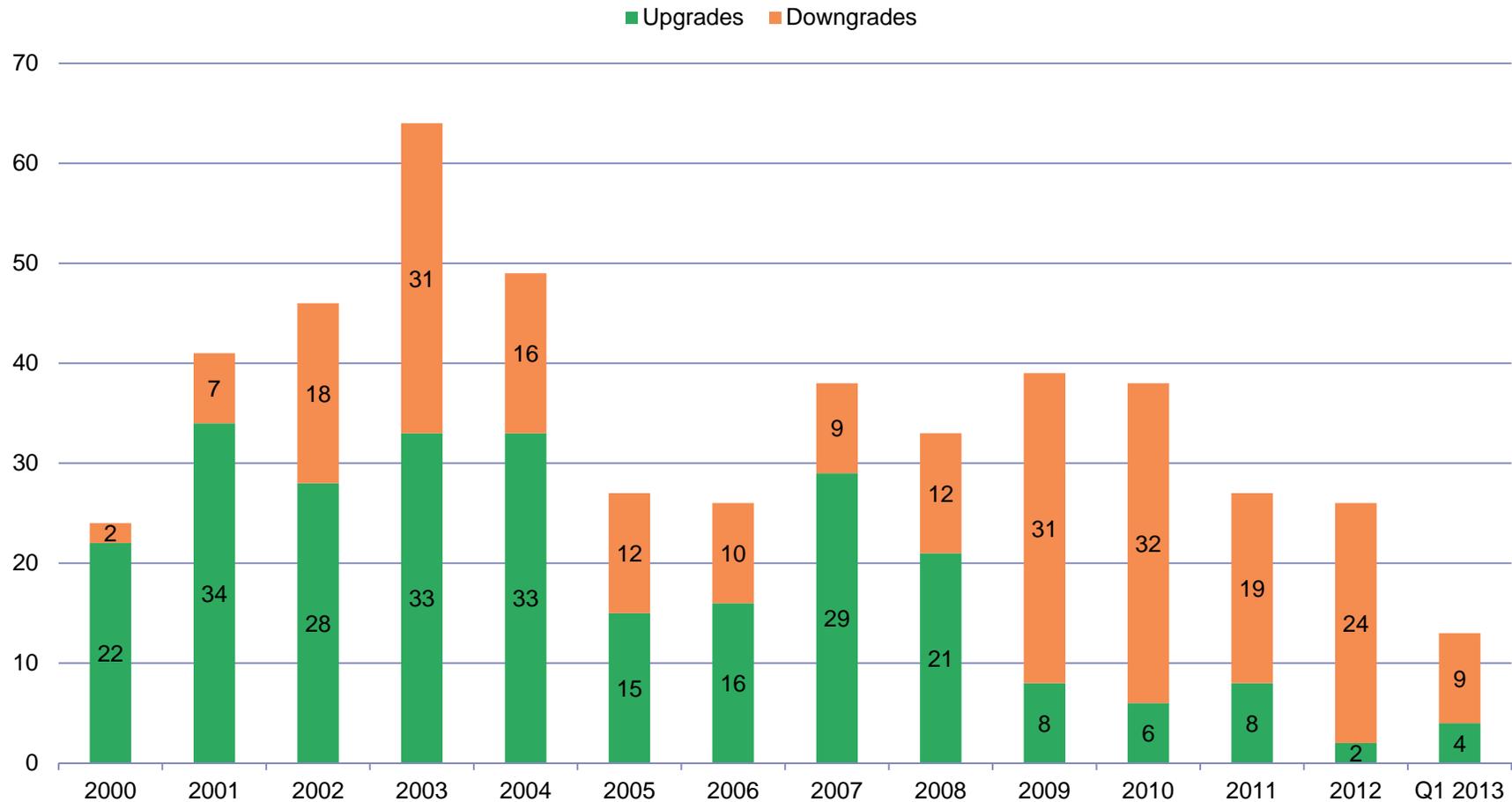


Private University Activity 2007 – Q1 2013



2013 Ratings as of Q1 2013
 Source: Moody's MFRA

Since 2008-09 Financial Crisis...Far Fewer Rating Upgrades



Source: Moody's MFRA, 2013 Ratings as of Q1 2013



Questions & Answers

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