

The Not-For-Profit Higher Education Sector Faces Mixed Prospects In 2012

Primary Credit Analyst:

Mary Peloquin-Dodd, New York (1) 212-438-2079; mary_peloquin-dodd@standardandpoors.com

Secondary Credit Analysts:

Bobbi B Gajwani, New York (1) 212-438-1084; bobbi_gajwani@standardandpoors.com

Jessica Matsumori, San Francisco (1) 415-371-5083; jessica_matsumori@standardandpoors.com

Table Of Contents

Rating Activity In 2011

Schools Aim To Have A Sustainable Business Model

Competition Is Likely To Intensify

The Affordability Factor Could Dampen Ratings

State Funding Cuts Will Continue Through Fiscal 2013

A Rise In Expenses And Liabilities

Debt Reduction Continues

Investment Markets Are Changing

The Long-Term Credit Profile

The Not-For-Profit Higher Education Sector Faces Mixed Prospects In 2012

The outlook remains mixed for the U.S. not-for-profit higher education sector in fiscal 2012. We believe that operating results and demand will likely be uneven for fiscal 2012 and 2013, and that many institutions will report some weakening in income performance. Despite public concern about the rising costs of going to college, the affordability crisis has not yet affected actual credit quality for most rated institutions.

The rating results for calendar 2011 supported our view of a mixed outlook, with an almost equal number of upgrades and downgrades. During the year, we also assigned an equal number of positive and negative outlooks, making for an absolutely mixed picture.

Overview

- The number of upgrades and downgrades in 2011 was almost equal, as was the number of positive and negative outlook revisions. We believe these trends will continue for 2012.
- Most states will likely further reduce support to their public colleges and universities in fiscal 2013, despite an improved economy.
- Competition for students and major revenue sources will increase, while debt issuance will be light through the year.

In Standard & Poor's Ratings Services' view, the sector's trends do not portend a bubble that's about to burst. The vast majority of rated colleges and universities, both public and private, maintain investment-grade ratings and stable outlooks. One element that both characterizes and distinguishes U.S. higher education from other sectors is its diversity. Performance during a more challenging economic period is typically based on resources, management, and demand, which means it is difficult to make generalizations about credit quality for the sector. Some institutions will continue to do better than others, and some will struggle to survive.

How institutions respond to their challenges will partly influence their ratings performance. The affordability issue will persist given that tuition and fees are effectively capped at a low rate of growth and have been for many institutions since the recession began in fiscal 2008. State support for public colleges and universities remains under pressure in fiscal 2012 (which generally ends on June 30) with a prospect of additional cuts for fiscal 2013. Sponsored research, largely provided by the federal government, is likely to remain flat at best for the foreseeable future. Consequently, universities with a heavy reliance on medical research could face stronger competition than before to maintain the same level of research dollars.

Fundraising results for fiscal 2012 continue to be more positive than for fiscal 2009-2011, but we believe that the results continue to disproportionately benefit the wealthiest institutions. Academic medical centers, we believe, are in a holding pattern with favorable financial performance bolstering a university's overall performance, although future results following health care reform in 2014 will not be as robust.

As a whole, we do not expect public universities to underperform private universities despite weathering one of the most drastic reductions in state support in 50 years. The 7.6% reduction in state support from fiscal 2011 to fiscal

2012 was the steepest drop for public universities in many decades, according to the Grapevine Survey from the Center for the Study of Education Policy at Illinois State University. Despite reduced state support, the number of negative outlooks in the sector is very low, and the percentage of outlooks other than stable is down to 7% from a peak of 10%-12% during the recession, reflecting credit stability.

Rating Activity In 2011

In 2011, we raised 31 debt or credit ratings on higher education institutions and lowered the ratings on 27. We assigned a slightly higher number of positive (31) than negative outlooks (25). Most of the outlook and rating changes occurred in the 'A' category or below, indicating a greater degree of rating variability (both up and down) for those institutions. For many, the long-term outlook is stable, but this largely depends on their ability to expand revenue sources, restructure financial operations, or reduce operating costs. Tuition-dependent institutions that are more nimble, or whose existing cost structure allows them to charge lower tuition will have a competitive advantage over their peers. Indeed, demand has grown for both lower-price institutions and for wealthy schools with the ability to provide financial aid.

Other institutions with greater revenue diversity who manage to maintain financial equilibrium, or expand their financial resources through fundraising, operating results, or greater market share will also perform favorably in 2012. We will likely continue to raise ratings on institutions with strong income performance and balance sheet growth, and lower the ratings on those with increasing leverage or weak income performance.

Schools Aim To Have A Sustainable Business Model

There is increasing focus on how the industry can adjust its operating model to one that is sustainable during a long period of slow economic growth. As painful as the recession was for many colleges and universities, the level of substantial restructuring was negligible while the focus to date has been largely on cost reductions and modest revenue enhancement, such as online courses. We believe this represents just the first phase of potential industry restructuring. Phase two, which is already underway at some public universities, represents more fundamental change in organizational structure, such as establishing new business lines, eliminating nonperforming programs, forming new schools or colleges (perhaps in different locations), and opening or closing campuses. We found that some campuses, like Bethany College, W. Va., have begun to consider nontraditional sources of revenue, such as leasing land to for-profit companies engaged in natural gas exploration. Others, like Emerson College, are opening satellite campuses in disparate geographic locations. Phase three-type restructuring, which has rarely occurred in U.S. higher education, includes even bolder actions such as mergers and acquisitions.

Competition Is Likely To Intensify

One of the sector's key issues in 2012, in our view, is coping with greater competition amid heightened cost sensitivity. Not only do not-for-profit institutions compete with for-profit providers, but we expect the competition between all universities, public and private, to heat up as public universities continue to respond to funding cuts for fiscal 2012 and 2013. Students are choosing lower-cost community colleges over private four-year institutions, and historically regional public universities are continuing to ramp up their out-of-state recruiting efforts. Out-of-state students represent a higher-income pool of students, as do international students who come in sizable numbers from

China, India, and South Korea.

However, with continued and sometimes substantial increases in out-of-state tuition, we expect public universities' competitive advantage on cost for these students will continue to diminish over the next year or two.

The Affordability Factor Could Dampen Ratings

We believe that rising college costs, along with a decrease in state support at public institutions and more volatile revenue at private schools, could begin to weigh on some ratings, especially if economic growth remains slow or stalls. We saw a decline in net tuition revenue at some private nonprofit colleges for the first time in fiscal 2010 and 2011, and are beginning to see a slowdown in net tuition revenue growth at public colleges and universities, which are increasing their financial aid budgets to offset tuition increases. Most state university systems already receive more revenue from tuition rather than from their respective states.

While schools are struggling with lower revenues, so are students. Faced with stagnating family incomes, many are finding it harder to pay for college without borrowing. That has resulted in increased demand for less-expensive institutions. We also note that student debt continued to grow during the recession. While consumers are generally borrowing less, college students are borrowing more in what could be an unsustainable trend. In 2012, we expect to see an increased focus on Pell Grant funding and other student grant programs to help fund the cost of tuition.

State Funding Cuts Will Continue Through Fiscal 2013

As states struggle with budget deficits, we believe that funding cuts to public universities are likely to continue through fiscal 2013. In past economic cycles, we found that funding for public universities lagged behind a state's financial recovery, a trend we expect to be repeated. We anticipate potential cuts in already committed state funding for the remainder of fiscal 2012. We also expect funding reductions for fiscal 2013, although the size, or percentage decline, of cuts could moderate if the economy continues to recover.

For fiscal 2013, we expect funding to be flat or decrease between 3%-7%, the exception being resource-rich states such as Nebraska and Montana that have continued to boost funding. However, some states, including Pennsylvania, North Carolina, Washington, and California, that were hardest hit during the recession are still considering cuts of more than 7%. Many public colleges and universities were able to raise tuition and fees to close their budget gaps for fiscal 2011 and 2012, encountering less resistance than in preceding years from some state policymakers.

We believe that funding pressures could continue to lead to new financial arrangements between states and public universities. Some public universities, for instance, have agreed to reduced funding and lower tuition increases in exchange for greater flexibility and autonomy.

We also anticipate that more states will shift more of their funding to a performance-based model. In our view, larger flagship institutions with greater revenue diversity, stable enrollment, and strong fundraising cultures stand to benefit the most from these arrangements. Overall, the percentage of state funding in public university budgets continues to drop and the trend is likely to continue into fiscal 2013. And the trend of increasing "privatization" of public universities is likely to accelerate.

A Rise In Expenses And Liabilities

Most universities will face higher costs for salaries and benefits this year and next. Many schools cut faculty (primarily adjuncts) and staff, postponed raises, and deferred pension fund contributions in fiscal 2010 to 2012. We believe that as some of these schools reinstate these costs, or begin to rehire faculty, budgetary pressures could increase. For now, low interest rates are providing debt-laden institutions with another form of budgetary relief. Low energy prices, especially for natural gas, also provide some budgetary flexibility for 2012. Finally, some institutions will need to address rising other postemployment benefit (primarily postretirement health care) costs and pension funding as well.

Debt Reduction Continues

We believe that debt issuance will be very light in fiscal 2012 and 2013 because many institutions are still focused on reducing borrowing and restructuring their debt portfolios. We believe that refinancing will increase this year as issuers take advantage of currently low interest rates to lower their financing costs. Some institutions, particularly those with the most financial resources and ratings in the 'AA' category or above, will borrow money because of favorable market conditions. We expect to see a continued focus on longer bond terms, fixed-rate debt, and taxable issuance. One leading indicator of future debt issuance is commercial paper, with many colleges and universities limiting their use of this form of borrowing this year. Many institutions still have some exposure to banking-sector risk in their debt instruments, and we see continued appetite for bank bonds, bank loans, and bank liquidity facilities in 2012.

Investment Markets Are Changing

While recent investment performance in marketable equities has improved, the investing world for most colleges and universities is very different from that of domestic exchange-traded securities. Most colleges and universities have endowments that are more diverse and generally less liquid than public equities markets. However, the investment picture for endowments for the two fiscal years ended June 30, 2010 and 2011 was favorable.

Based on the National Association of College and University Business Officers' survey of endowments, the average return was 11.9% (net of fees and expenses) for fiscal 2010 and 19.2% for fiscal 2011. We believe that endowment investment patterns will not significantly change in 2012, apart from some slight adjustments in how endowment spending models are designed. Some institutions are moving their spending models to five or even seven years from a three-year average of market value to reduce future payout volatility. For now, we see little change in the level of high-quality liquid instruments in the average portfolio.

The Long-Term Credit Profile

Despite a mixed outlook in the short term, we believe the sector's long-term credit profile remains stable although many economic and financial strains did not end with the recession. The long-term view will essentially reflect how colleges and universities address challenges.

Based on recent experience, we believe that there will continue to be positive and negative rating changes. We will

continue to evaluate performance as a possible indicator of economic resilience. Institutions that outperform their peers in operating results and increase their financial resources could be candidates for positive rating changes. We expect the number of outlook revisions will increase in the next several years.

Finally, the federal government's role in higher education is uncertain. For now, we believe that the big issues are federal-sponsored research funding and potential changes in student loans and grant programs. We will look for any changes in federal funding in the wake of President Barack Obama's January speech to make higher education more accessible and affordable. The other area is the impact of federal health care reform on academic medical centers as we head toward 2014. We believe that changes in health care delivery and financing could affect the financial performance of faculty practices, clinics, and university teaching hospitals, and levels of funding for graduate medical reimbursement.

Copyright © 2012 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.