Financing Public Colleges and Universities in an Era of State Fiscal Constraints

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Agenda

Ratings as Window into Public University Financial Risk
- Mixed sector credit outlook vs. stable ratings?
- Quantitative data vs. analyst judgment

Public University Business Model Fundamentally Changed
- Market-driven with a public mission, not government-driven
- Greater financial stability under student pay-market driven model
- Means-tested tuition pricing is consistent with public mission
- Bond market/donors replace state as main capital source

Where are we headed?
- Governance, management, market strategy key drivers
- Greater professionalism and efficiency
- Better disclosure to investors, students, donors, regulators

Questions and Discussion
Ratings as Window into Public University Financial Risk
Moody’s Sector Outlook – No Longer Negative for All

2009 & 2010: Negative Outlook for All Sub-Sectors of Higher Education (all private/public universities)

- Increased pressure on tuition and financial aid
- Broad impact of investment losses on operations and philanthropy
- Illiquidity of balance sheets, amplified by alternative investments
- Volatility in debt markets as well as debt structures
- More credit pressure for private universities than public universities

2011: Mixed Outlook for U.S. Higher Education; Stable for Some

- Outlook revised to stable for diversified market leading universities, many of which are public flagships, land grants and systems
- Maintenance of negative outlook for majority of tuition-dependent private colleges & regional public universities
### But Negative Outlook Remains for Most…

**Reflects “New Realities” and Need for Adaptation**

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<thead>
<tr>
<th>Factor</th>
<th>Impact</th>
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<tr>
<td>Heightened price sensitivity</td>
<td>Reduced tuition increases; growth of financial aid budgets; need to demonstrate product value</td>
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<td>Pressure on top-line revenue growth</td>
<td>Expense containment, operating efficiency, cut backs in capital</td>
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<td>Long-term pressure on government funding</td>
<td>Business diversification; growth of alternative private revenue sources (research, gifts, tuition)</td>
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<td>Increasing diversity of the student market</td>
<td>On-line, weekends, counseling vocational, 3 year B.A.)</td>
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<td>Uncertainty about long-term endowment returns</td>
<td>More stress testing of long-range assumptions and management planning</td>
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<td>More financial accountability placed on boards of trustees and management teams</td>
<td>Increased transparency to all constituencies</td>
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Public Universities Are Rated Higher Than Privates

Moody’s currently rates 220 U.S. public colleges and universities, with over $100.9 billion of debt outstanding.

More than 3/4, or 77%, of public universities are rated A1 or higher

Moody’s rates approx 300 private colleges/universities in the US, with over $75.4 billion of debt outstanding

Only about 1/3, or 36%, of private colleges and universities are rated A1 or higher

U.S. Public University Rating Distribution

U.S. Private University Rating Distribution
Public University Rating Stability, Despite Funding Stress

Public University Activity 2005 - 2011 YTD

Private University Activity 2005 - 2011 YTD

Financing Public Colleges and Universities in an Era of State Fiscal Constraints November 30, 2011
Public University Business Model Fundamentally Changed
State Government Funding On Long-Term Decline…

Federal ARRA funds ended in FY 2011

State budget gaps persist necessitating cuts to sacred cows
- Operating funds
- Capital support

Research funding is tighter

Cash flow squeeze at a few public universities for first time
As State Funding Has Declined, Student Based Revenue Has Filled the Gap

Students are paying more: like progressive income taxing

Publics acting just like privates:

- Higher tuition and higher aid
- National/international student recruitment
Public Universities Exercise Their Market Pricing Power…

Public sector net pricing rising 3x faster than private sector tuition

Reaction from state government varies from attempts at WWII-era price controls to laissez faire, hands off realism

Reaction from students is generally accepting despite events in California

California sudden sharp tuition spikes reveal unstable model used by government in that state vs Big Ten pricing model

Unsustainable political compacts vs Market Gradualism
... And Lowest Cost Competitors

Public Net Tuition Per Student Remains Competitive
Source: Moodys Median MFRA Data ($)

- Public sector remains far more affordable than private competitors
- Publics are actually more affordable than privates five years ago
- Advantage in 2011 $13,000 compared to $12,000 in 2006

Graph showing tuition costs for public and private institutions from 2004 to 2011.
Will Public Universities Use Up Their Pricing Power?

Demand is function of net worth, income & demographics

Political and public pressure to improve affordability

Moderation of tuition increases

Expanded financial aid budgets

Need to become more efficient

Slowed Net Tuition Growth Lags Steep Decline in U.S. Net Worth

Demand is function of net worth, income & demographics

Political and public pressure to improve affordability

Moderation of tuition increases

Expanded financial aid budgets

Need to become more efficient

Source: Change in Net Worth 1980-2010, Federal Reserve; 2011 Forecast from Moody’s Analytics; Median Net Tuition per Student: Moody’s
Dependence on Pell and other aid for low income students is increasing, but it is covering a smaller portion of net tuition per student.

Source: Moody’s, NCES & The College Board
Publics Are Biggest …

- 20% All Campuses > 5,000 FTE
- 60% All Publics > 5,000 FTE
- 8% All Private NFPs > 5,000
- 6% 4Yr Publics <1,000 FTE
- 46% 4Yr Private NFP <1,000 FTE

<table>
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<tr>
<th>Average US FTE Enrollment</th>
<th>By Degree Granting Type</th>
<th>Priv/NFP</th>
<th>Prop</th>
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<td>Associate's Degree</td>
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<td>568</td>
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<td>986</td>
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<td>Bachelor's thru Professional Only</td>
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<td>2,105</td>
<td>1,649</td>
<td>9,860</td>
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Publics Have Size/Price Advantages; Privates Have Leadership Edge

PUBLIC UNIVERSITIES
- Economies of Scale
- Low Price Competitor
- Public Subsidy/Ultimate Support
- More Diversified Revenues
- Management Slow but Improving
- Governance Lagging
- Some Exposed to Pensions/OPEB
- Political Limits of Tuition

PRIVATE COLLEGES
- Much Smaller on Average
- Moderate to High Price Competitor
- Philanthropic Subsidy
- Most Highly Tuition Dependent
- Management More Nimble
- Governance Mostly Better
- Investments/ Liquidity Challenges
- Economic Limits on Tuition
Where are we headed?
Arguably, Public Universities Are More Stable with Less State Funding

Reduced public operating funding of public universities is irreversible

Higher tuition dependence makes revenue less volatile – better for planning

Challenges

- Access at affordable tuition rates for low income, first generation students
- With less state capital funding, borrowing will keep rising
Strategies to Cope with Pressing Issues

Community colleges as cost-effective capacity relief; also partnerships with for-profits and traditional private colleges

Enable graduation in shorter periods of time

Public universities have large economies of scale and can reap many more operating efficiencies—much more capacity can be freed

Private fundraising will follow same pattern as private universities, most especially for financial aid
Improved Governance in the Public Sector will be Necessary Outcome

- Commitment to market disclosure
- Strong accountability and oversight of management without government dominance
- Diversification of board members to include those with sector expertise as well as strong philanthropic capacity
- Competitive strategies and culture driven to succeed financially as well as meet public mandate for more affordable education
- Use of detailed, multi-year financial plans linking budget and capital plans with key assumptions to guide annual budgets
- Use of self-assessment, benchmarking
- Openness to new organizational partnerships, campus closure, and even mergers in some cases
Government Relations to Combat Cut-Backs is Especially Important

Pressure to restrict access to capital, reduce tax subsidies, and increase regulatory oversight

University leaders can promote:

- New political partnership with state fostering operating independence and ultimately allowing universities the flexibility to promote an entrepreneurial climate and promote economic development
- Continuance of state financial support for operations and capital projects
- Special programs which provide additional support for public higher education such as debt service reimbursement, intercept programs, and funds established to support one or more universities
Additional Areas of State/Public University Intersection

Tuition

Procurement

Zoning and construction regulations

Personnel Benefits

  ➢ Health Care

  ➢ Pensions

  ➢ Compensated Absences

Investment of public funds
So… A New Business Model for Publics and Privates?

“Moody’s rates large majority of higher education measured by enrollment and not one rated college or university has ever defaulted on its debt” – Moody’s Higher Ed team, November 2011

“The American system of higher education is going to change dramatically in the 21st century,” said Aoun. “Our existing college campuses are based on a model that we imported from England in the 17th century. This model cannot meet the full demands of contemporary society” – Joseph Aoun, President of Northeastern University, November 2011

“The institutions to which the country would turn to help tackle this (competitive) challenge—its colleges and universities—are facing a crisis of their own…(this) presents an opportunity to rethink many of the age-old assumptions about higher education—its processes, where it happens, and what its goals are—and to use the disruptive start-up organizations to create institutions that operate very differently and more appropriately to address the country’s challenges.” – Clay Christianson, Harvard Business School, from Center for American Progress “Disrupting College”, February, 2011
Why the Business Model Still Works…for now

States need public universities even more now despite funding cuts
- Labor force training, job growth, research/tech transfer, health care

No real substitute for face-to-face

But, cost structure is too high

Public universities offer an expensive bundled product
- Content delivery not valuable part, easily replicated more cheaply by for-profits
- Customers pay for transformation of the late adolescent into a young-adult with judgment, thinking skills, communication ability and career connections

But can the wealth and income levels of the country support the model?