MOODY'S INVESTORS SERVICE

INDUSTRY OUTLOOK

US Higher Education Outlook Negative in 2013

Revenue Pressure on All Fronts Intensifies Need to Grapple with Traditional Cost Structure

Table of Contents:

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This outlook expresses our expectations for the fundamental credit conditions in the sector over the next 12 to 18 months. It does not speak to expectations for individual rating changes and is not a prediction of the expected balance of rating changes during this time frame.

Summary

For 2013, Moody's revises its outlook for the entire US higher education sector to negative, marking a shift to negative from stable for even the sector's market leading diversified colleges and universities. The outlook for the remaining majority of the sector remains negative, as it has been since 2009. The new sector-wide negative outlook reflects mounting pressure on all key university revenue sources, requiring bolder actions by university leaders to reduce costs and increase operating efficiency. As the economic growth languishes below previous benchmarks and the federal government seeks to reduce spending in key areas, even market leading universities with diversified revenues are facing diminished prospects for revenue growth. Universities have been restraining costs in response to the weak economic conditions since the 2008-09 financial crisis, but they have only recently begun examining the cost structure of their traditional business model.

Macroeconomic conditions and anticipated federal budget reductions have weakened or created considerable uncertainty around the prospect for growth of household income and wealth, philanthropic support, investment returns, state appropriations, and federal funding. In addition to recent tax code changes, the resolution of the federal fiscal deficit will likely involve flat to diminished research funding, cuts to Medicare and Medicaid as well as possible changes to federal student aid programs such as Pell Grants – all of which would impact important revenue streams for higher education.

The underlying value proposition of higher education persists, lending inherent credit strength and support for ongoing demand for the sector's services. However, the sector will need to adjust to the prospect of prolonged muted revenue growth. Strong governance and management leadership will be needed by most universities as they navigate through this period of intensified change and challenge.

We continue to watch the impact of several emerging trends in higher education which have already shown some destabilizing effects on colleges and universities, including the growth of on-line learning technology initiatives such as Massive Online Open Courses (MOOC); rising student debt burdens and defaults; greater government focus on cost and value of college education degrees and increased activity by accrediting agencies.

Critical factors contributing to the negative outlook:

1. Price sensitivity continues to suppress net tuition revenue growth
2. All non-tuition revenue sources are also strained; diversity no longer offers a safe haven
3. Rising student loan burden and defaults taint perception of value of a college degree
4. Increased public scrutiny drives escalated risk of more regulation and accreditation sanctions
5. Prospects for long-term sustainability depend upon strong leadership through better governance and management

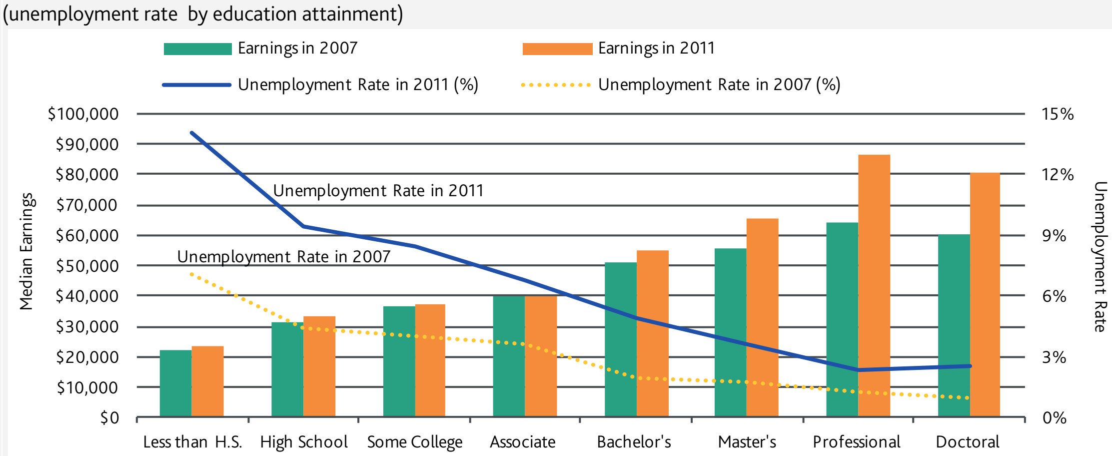
Demand for higher education remains strong, but pricing power nearly exhausted

Overall, postsecondary education remains a valuable long-term investment. College graduates still have much higher income and lower unemployment rates than those without college degrees as highlighted in Exhibit 1. While there is still no substitute for a higher education degree on the immediate horizon, education providers are experimenting with alternative forms of recognition/certifications for online courses. Families remain willing to pay for college, but their capacity to pay higher prices has been largely tapped and has dramatically dampened the sector's capacity to grow tuition revenue. The culmination of persistent economic pressure, heightened political focus, and major technological shifts in course delivery are forcing a reevaluation of the traditional higher education cost structure, mainly high cost of instruction due to guaranteed employment through tenure and continual investments in student services and capital facilities.

EXHIBIT 1

The value of higher education persists

(unemployment rate by education attainment)



Source: Bureau of Labor Statistics, Current Population Survey

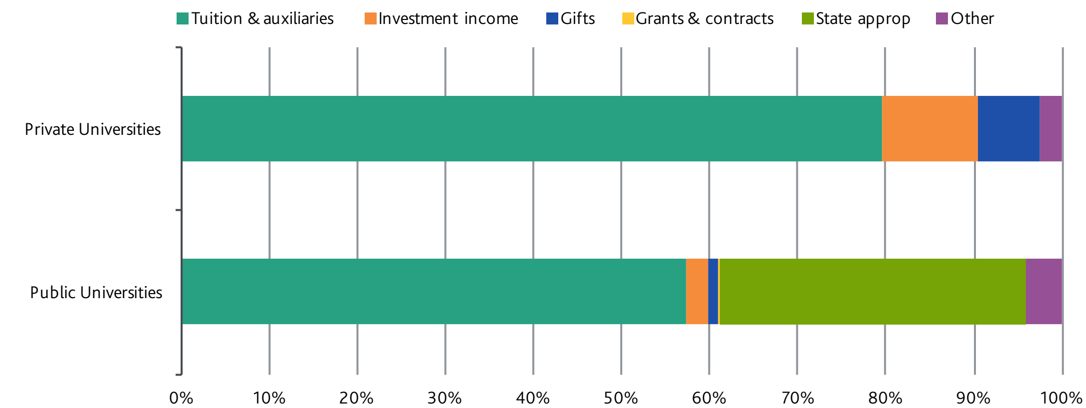
Factor #1: Price sensitivity continues to suppress net tuition revenue growth

Years of depressed family incomes and net worth, as well as uncertain job prospects for many recent graduates and a slight decline in the number of high school graduates, are creating enrollment pressure and weakened pricing power for colleges and universities. In addition to these economic and demographic pressures, elevated governmental scrutiny of higher education costs is causing many universities to slow the rate of tuition growth. Continued federal budget negotiations may result in further pressure on colleges because a rising share of students are dependent on federal grant and loan programs, both of which may be curtailed to some degree. According to The College Board, the number of Stafford loan recipients has grown by 95% over the last 10 years to 10.4 million students in 2011-2012.[1] In addition to the rapid growth in loans, the number of low-income students receiving Pell Grants has more than doubled over the last decade to 9.4 million in academic year 2011-2012.

EXHIBIT 2

Tuition is the largest share of operating revenue for private and public universities

Median revenue contribution ratios for FY 2011



Source: Moody's MFRA

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

All but the most elite universities face diminished student demand and increased price sensitivity due to a prolonged period of depressed family income, household net worth, and a dip in the number of domestic high school graduates since the peak of 3.34 million for school year 2007-2008[2].

According to a study released in June 2012 by the US Federal Reserve, the average American family experienced a 39% decline in net worth during the three years ending 2010, bringing median net worth to its lowest level since 1992.[3] In addition, the median value of real family income (adjusted for inflation) before taxes fell 7.7% during this time period.[4] Moody's Analytics reports that household income growth in 2011 was below average, and 2012 is estimated to be just about at the Federal Reserve Bank's 2% target rate for inflation.

The weakened financial condition of American families has contributed to slowed growth of net tuition revenue for private universities, as shown in Exhibit 3. Reduced financial prospects are factoring into college decisions. In academic year 2011-2012, US families spent, on average, 5% less on higher education than the prior year and price was of increasing importance in deciding where to

1 The College Board, "Trends in Student Aid 2012"

2 Western Interstate Commission for Higher Education, "Knocking at the College Door: Projections of High School Graduates," December 2012

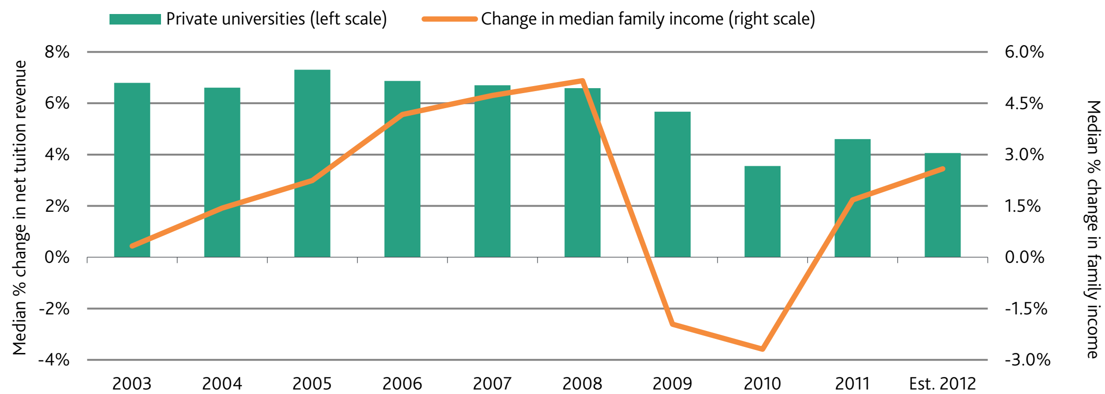
3 Moody's: "Sharp Drop in Net Worth is Credit Negative for Higher Education," June 20, 2012 (143299)

4 Changes in US Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances, Federal Reserve Bulletin, June 2012

attend college, according to Sallie Mae's annual study "How America Pays for College 2012". The study highlighted that since the economic downturn in 2008, higher education consumers have been more receptive to lower cost alternatives such as community colleges or colleges closer to home in order to avoid the cost of living on campus. The greatest impact of price sensitivity is felt by small-to-mid-sized less selective private colleges that are highly dependent on annual increases in tuition.[5]

EXHIBIT 3

Private university revenue growth has slowed due to families' weakened ability to pay



Source: Moody's MFRA; Moody's; Federal Reserve

An increasing proportion of our rated portfolio is unable to grow tuition revenue at the average rate of inflation. In fiscal 2011, 35% of Moody's rated private colleges and universities and 21% of public universities did not achieve tuition revenue growth at even the Federal Reserve's target rate of inflation of 2%. In FY 2008, the last year before the global financial crisis and the recent peak in the number of domestic high school graduates, only 11% of privates and 9% of publics failed to grow their tuition revenue by at least 2%.[6] According to our fourth annual tuition survey, this faltering revenue trend continued in fiscal year 2012 and 2013. Such weak revenue growth means a college cannot afford meaningful salary increases or new program investments unless it cuts spending on staff and existing programs, or creates cost efficiencies.

Consistent with previous post recessionary periods, enrollment growth has begun to decelerate across the sector, especially for graduate, professional, and adult education programs. According to our fourth annual tuition survey, nearly half of all universities are reporting lower enrollment for fall 2012, which for many universities means FY 2013 net tuition revenue will be flat or lower than the previous year. Enrollment declines are concentrated in colleges with smaller enrollment size, high tuition dependence, weak selectivity/yield rates, and soft regional demographics.[7] This trend will increase competition for students, lead to the exploration of new markets for applicants, and further hamper net tuition revenue growth. Business and law professional degree enrollments, which have long been strong cash generators for universities, have seen persistent declines over the last few years, as have masters programs in education. Soft demand for graduate and professional programs over the last two years has contributed to weak net tuition revenue growth for many universities, but especially for standalone graduate schools and for universities that rely on undiscounted graduate tuition to boost net tuition revenue. Approximately 85% of Moody's rated colleges and universities have graduate

5 Moody's: "Students Are Growing More Cost Conscious, a Credit Negative for US Colleges and Universities," July 27, 2012 (144383)

6 Moody's: "More US Colleges Face Stagnating Enrollment and Tuition Revenue, According to Moody's Survey," January 10, 2013 (148363)

7 Moody's: "More US Colleges Face Stagnating Enrollment and Tuition Revenue, According to Moody's Survey," January 10, 2013 (148363)

programs and will therefore experience some pressure on net tuition revenue if enrollments continue to contract.[8]

Private institutions with greatest endowments have flexibility to subsidize tuition

A small number of top-tier private universities with large endowments have chosen not to fully exercise their pricing power, despite the depth of their student demand and willingness of families to pay much higher prices for admission. Instead, this small group of private universities uses their large endowments and donor support to fund their tuition discounts and expand financial aid initiatives so that socioeconomic diversity of the student body is promoted regardless of students' ability to pay. Truly "need-blind" admissions policies, which usually pledge to meet full need of accepted students, are limited to the wealthiest colleges, typically in the Aaa-Aa categories.

Lower rated colleges are far more dependent on tuition revenue and have much less financial resources per student – these colleges lack large endowments and sufficient donor support to fund student aid and typically engage in pure price discounting to be competitive in the student market (Exhibit 4). This means they generate less revenue per student, spend less per student, and struggle more to attract students than wealthier and higher rated competitors. Even with a median tuition discount of 29.5% in fiscal 2011, Baa-rated institutions were only able to yield 24.2% of admitted students (matriculation rate in Exhibit 4), while Aaa-rated private universities were able to yield a median 50.2% of their admitted students at a 42.8% discount rate.[9]

EXHIBIT 4

Fiscal 2011 private university medians

	Aaa	Baa
Selectivity	13.1%	67.0%
Matriculation	50.2%	24.2%
Net tuition per student	$21,505	$18,216
Educational expenses per student	$75,435	$21,531
Tuition discount	42.8%	29.5%
Total financial resources per student	$1,028,416	$23,252

Public universities retain pricing power, but face slowed revenue growth and high Pell Grant dependence

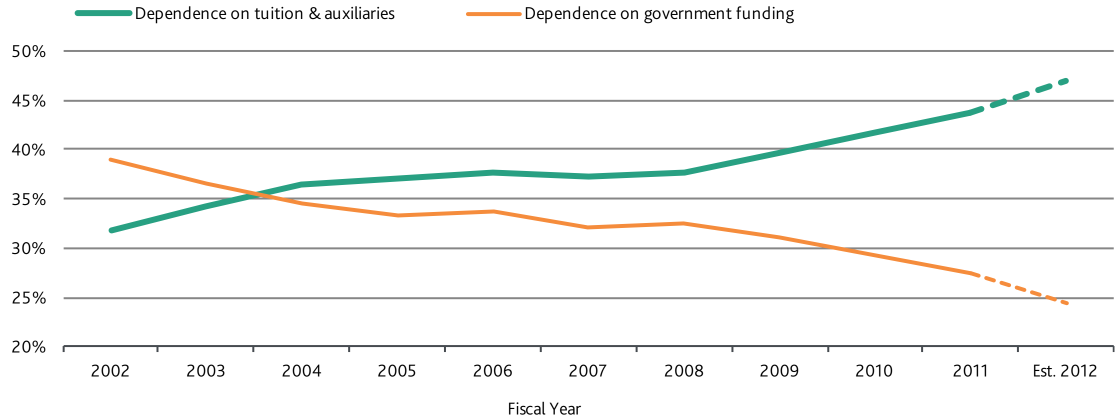
Public universities are now as market driven as private universities, but remain a lower cost option with stronger pricing power. In response to long-term declines of state funding, these universities have responded by raising tuition and increasing out-of-state enrollment year over year. Net tuition revenue has therefore grown in direct response to diminished government support (Exhibit 5). We expect this trend to continue, but the juxtaposition of public focus on affordability combined with public universities' access mission and the need to generate tuition revenue presents a unique challenge to this sector. The tuition survey shows that public universities are projecting a lower rate of growth for net tuition per student of 2.7% for FY 2013, down from a median of 6.7% over the past five years (2007-2012).

8 Moody's: "Continued Graduate Enrollment Declines Are Credit Negative for Higher Education Institutions," October 4, 2012 (145966)

9 Moody's: "US Private College and University Medians Underscore Revenue Challenge and Mixed Outlook for Sector," July 27, 2012 (143631)

EXHIBIT 5

Tuition revenue grows at public universities in response to diminishing government support

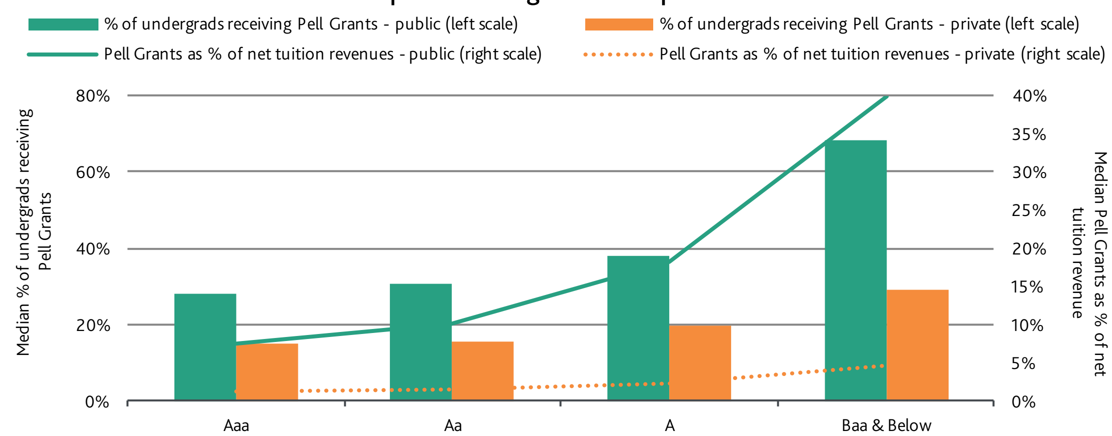


Source: Moody's MFRA

Pell Grant funding for low income students is a major contributor to tuition revenue growth for public universities – these need-based federal grants provided a total of $36.5 billion to all of higher education in FY 2011.[10] Pell Grants represented a median 10.3% of net tuition revenue for the public flagship universities and university systems in FY 2011 (up from 7% in FY 2010), and a substantial median 20.9% of net tuition revenue for regional public universities (up from 14.5% in FY 2010).[11] Resolution of the federal budget debate could involve changes in eligibility or reductions to federal student aid, including Pell Grants, hurting primarily lower rated and regional public universities as well as community colleges and other universities that serve a higher proportion of low-income students and lack institutional wealth to offset the loss of this revenue (Exhibit 6).

EXHIBIT 6

Public universities and lower-rated private colleges more dependent on Pell



Source: Moody's MFRA; Department of Education, Integrated Post Secondary Education Data System

10 US Department of Education

11 Moody's: "US Public University Medians Show Greater Reliance on Student Funding As States Cut Back," September 14, 2012

Online education offers opportunities for enrollment expansion and revenue growth

We expect the higher education sector to continue to invest in online education and distance learning programs, especially as the Massive Open Online Course (MOOC) structure evolves. These programs allow universities to both grow enrollment and tuition revenue, as well as increase the flexibility and productivity of faculty. The 2012 Survey of Online Learning by the Sloan Consortium shows that approximately 32% of all post-secondary students took at least one online for-credit course in fall 2011. The survey further shows that although leaders in higher education remain skeptical about the value of MOOCs and the overall legitimacy of online learning platforms, 69% of them acknowledge that online learning is a key long-term strategy.[12]

Trend Watch: Will MOOCs and online education change the landscape of higher education in the long-term?

The rapid evolution and adoption of Massive Open Online Courses (MOOCs) signals a fundamental shift in strategy by industry leaders to embrace technological changes that have threatened to destabilize the residential college and university's business model over the long run. Below is a summary of the six major credit effects likely to emerge from the MOOC and online course movement[13]:

1 New revenue opportunities through fees for certificates, courses, degrees, licensing or advertisement

2 Improved operating efficiencies due to the lower cost of course delivery on a per student basis

3 Heightened global brand recognition, removing geographic campus-based barriers to attracting students and faculty

4 Enhanced and protected core residential campus experience for students at traditional not-for-profit and public universities

5 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

6 New competitive pressure on for-profit, and some not-for-profit, universities that fail to align with emerging high-reputation networks to find a viable independent niche

Factor 2: All non-tuition revenue sources are also strained; diversity no longer offers a safe haven

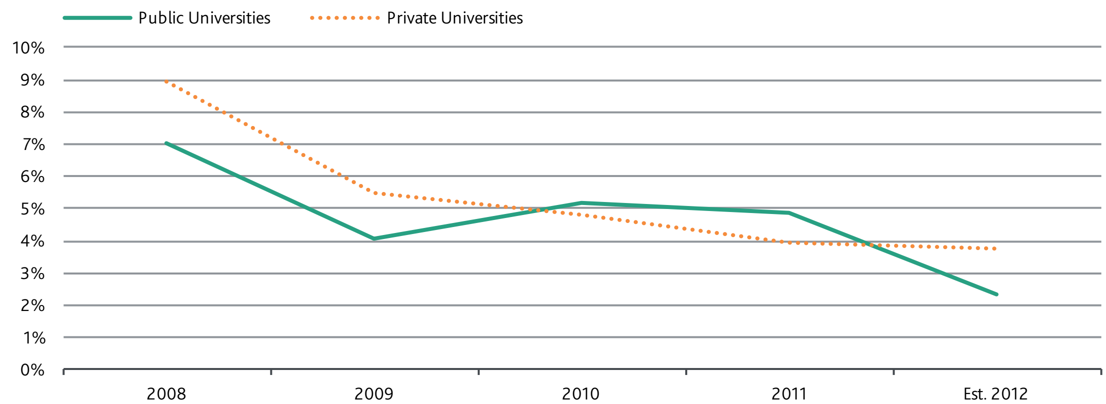
The weakening capacity to grow revenue on all fronts is the thrust behind our negative outlook for the entire higher education sector. Exhibit 7 highlights how growth of total operating revenue has slowed dramatically since fiscal 2008 for both public and private universities. The slow economic recovery and the potential economic stress from federal deficit reduction measures have created an environment where all key non-tuition revenue sources are also under pressure or facing considerable uncertainty. These revenue sources include state government appropriations, investment earnings, gifts, research grants and patient care reimbursements.

12 "Changing Course: Ten Years of Tracking Online Education in the United States;" Babson Survey Research Group; Sloan Consortium

13 Moody's: "Shifting Ground: Technology Begins to Alter Centuries-Old Business Model for Universities," September 12, 2012 (144483)

EXHIBIT 7

Growth of operating revenue continues to slow for the entire sector



Source: Moody's MFRA

State appropriations: an ever shrinking piece of the pie

Continued declines of state appropriations, as a share of public university operating revenue, will remain a key credit challenge for public colleges and universities for the foreseeable future. US states had mixed revenue results in 2012 with many still pressured by the weak economic recovery, so state contributions to operations are not likely to rise meaningfully in the near term. The impact of this reduced funding is most pronounced among regional public universities that have historically been more dependent on state support and have less ability to substitute other revenues. Flagship and land grant public universities are less affected since they can recruit students nationally and also benefit from diverse revenues including private gifts, research grants, and patient service.[14]

In this era of public funding cutbacks, several states are seeking to consolidate campuses within the public university systems (Georgia, Louisiana, West Virginia, and New Jersey). While these mergers present managerial and cultural challenges, they are largely viewed as credit positive because they foster operating efficiencies and reduce overhead costs amid declining state support.[15]

Research funding, already flat, likely to be cut after federal budget resolution

US budget negotiations will likely result in cuts to federal research funding. As such, we expect that even the top programs at the largest, research-intensive universities and independent research institutes will have to compete more rigorously to maintain their current sponsored funding. Federal government funding, which accounted for approximately 56% of research grants awarded to US universities in fiscal 2011, has been stagnant over the last few years, with few prospects for improvement given the growing federal budget deficit (Exhibit 8). The success rate of university grant proposals approved by NIH has already reportedly fallen significantly from a high of 30% in 2003 to just 18% in fiscal years 2011 and 2012. [16]

[14] Moody's: "US Public University Medians Show Greater Reliance on Student Funding As States Cut Back," September 14, 2012 (145278)

[15] Moody's: "Georgia Public Universities' Campus Consolidation Plan Is Credit Positive," January 16, 2012 (139195)

[16] National Institutes of Health Data Book

President Obama has made it clear that the White House values the key role of research universities as drivers of job growth, economic development, innovation, and discovery.[17] However, the current fiscal environment offers limited possibility for stable or increased funding by the federal government.

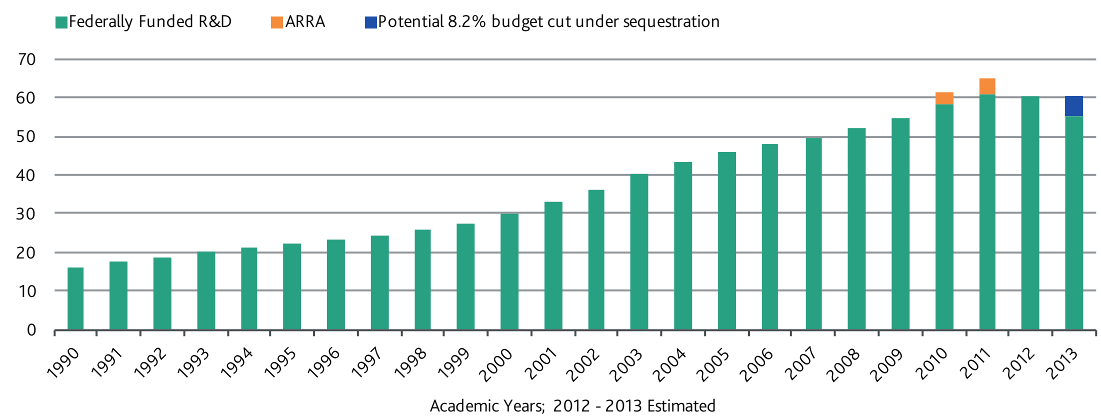
In addition to potential funding cuts, the uncertain federal funding environment has caused delays in federal contract renewals or execution.[18] Although such delays are not likely to impact research universities' credit ratings, they cause stress on organizational cash flow and liquidity and underscore the importance of tight cash flow management for these complex organizations.

Most top US research universities are rated Aaa-Aa and have withstood cuts to federal and state research funding due to their superior reputation and ability to garner a higher share of awards. They also can use their own substantial financial resources to fund research as well as attract more private grants and pursue commercialization of intellectual property. However, the lack of growth in federal funding, combined with a weakened outlook for future funding, will cause indirect cost recoveries to stagnate, forcing some research universities to scale back investment in research infrastructure and personnel, or have plans in place to do so in the future if funding recedes.

EXHIBIT 8

Federal research funding declines after years of strong growth

($ current billion)



Sources: 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

Patient care revenues continue to face downward pressure

Universities that own or operate hospitals or faculty practice plans are subject to all of the challenges inherent to the healthcare sector: reduced graduate medical education funding, limited rate increases and potential funding cuts for Medicare and Medicaid, lower patient volumes, uncertainty over healthcare reform implementation and payer reimbursement pressure. Despite these challenges, most US not-for-profit hospitals have found operating stability through improved competitive strategies, better commercial contracts, expense reduction, and mergers with feeder community hospitals.[19] These mounting challenges are reflected in Moody's negative outlook on the not-for-profit healthcare sector.

17 Moody's: "White House Report Supports Funding for Research Universities, a Credit Positive," (148312) December 14, 2012 and "US Research Universities Face Looming Federal Funding Cuts, but Remain Well Positioned to Withstand Credit Challenges," December 15, 2011 (144819)

18 Moody's: "Johns Hopkins University's Aa2 Rating Unlikely to be Affected by Delayed Contract Renewal for Major Research Lab," October10, 2012 (146074)

19 Moody's: "Not-for-Profit Healthcare Mid-Year 2012 Outlook: Strong Headwinds Continue," August 15, 2012 (144819)

Academic medical centers are better positioned to weather the pressures of healthcare funding because of the specialized services they provide, as well as relatively good revenue diversity (through gifts and research grants), and stronger balance sheets. For more information on the particular strengths and challenges of Academic Medical Centers, please see our November 2012 special comment, "US Academic Medical Centers: Complex, Successful Organizations Driven by Integrated University-Hospital Strategies".

Endowment-dependent universities dealing with weak fiscal 2012 returns; investment volatility likely for 2013

Fiscal year 2012 brought the first negative endowment returns since 2009 for many universities. Fiscal 2012's flat to negative endowment returns will result in stagnant or modestly lower endowment draws, impacting primarily the wealthiest universities that tend to rely heavily on investment income for operations. When taking into account an average 4-6% annual endowment spend, most universities saw a 1-5% decline in endowment value, net of new gifts. Although this decline is not nearly as sharp as losses seen in fiscal 2009, it will suppress endowment support of university budgets over the next several years, just as spend rates had been cycling off of earlier losses (endowment spend rates typically incorporate a component that is based on multi-year lagged endowment valuations).

The revenue impact will be felt most by endowment-dependent universities, particularly those rated Aaa and Aa, that tend to use their endowment to fund 30-60% of their operating expenses. We expect these universities to absorb lower endowment draws into future budgets through cost containment and to continue making more conservative spending decisions for future fiscal years.

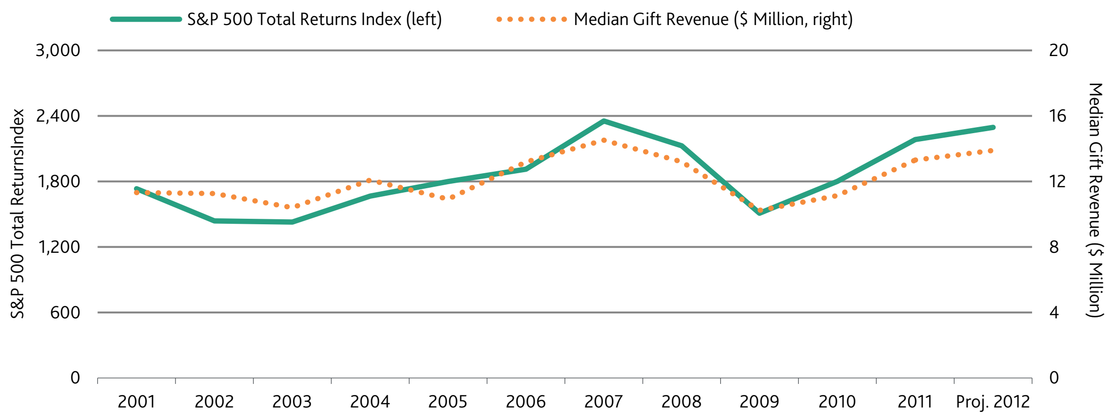
The outlook for capital market returns is partly linked to the potential resolution of the federal budget deficit and any economic fallout from action or inaction taken in Washington. However, some degree of volatility is likely over the next several months as the US government struggles to settle key tax and budget issues and Eurozone problems persist. Moody's Analytics predicts that the US economy will pick up by the second half of 2013 should Congress and President Obama swiftly settle on a federal budget and deficit reduction plan.

Gift revenue: near-term uncertainty, but is an overall credit strength

We expect gift support to show little to no growth in the near-term due to continued volatility in the stock market, which is the best indicator of private philanthropy (Exhibit 9). Colleges and universities with the strongest brand names, culture of giving, and best development staff will continue to fare best. Although investment returns turned positive in the first half of FY 2013 (July 1 to December 31 2012), continued volatility in the global equity markets and, to a lesser extent, possible tax reform restrictions on deductions for charitable giving for the wealthiest Americans are likely to constrain philanthropic giving in the near-term. A recent report from Giving USA showed that charitable giving to educational organizations rose just 0.9%, on an inflation-adjusted basis from 2010 to 2011, despite the very strong investment returns in 2010 and 2011.[20] Gift support is likely to remain stagnant until equity markets turn strongly positive and tax implications are clearer.

[20] Giving USA 2012 Annual Report on Philanthropy for 2011

EXHIBIT 9
Private university gift revenue tracks fluctuations in equity market



Sources: Standard & Poor's Daily Indices; Moody's MFRA

Factor 3: Rising student loan burden and defaults taint the perception of value of a college degree

Public and political scrutiny have escalated due largely to growing student debt burdens and the rise in student loan defaults, further questioning the value of higher education and the seemingly endless cost escalation for a degree. While employment and earnings data continue to support the underlying value of a college degree (Exhibit 1), alarm over a potential student loan bubble and diminishing affordability of higher education has reached a fevered pitch over the last two years.

Growing default rates and debt burden hit for-profits hardest, but all feel the backlash

Federal student loan volume doubled since 2003 with both an increase in the number of recipients as well as increased debt per student. As the amount of debt outstanding has risen sharply, so has the percent of students defaulting on their loans. In fall 2012, the US Department of Education released data that showed that the national two-year fiscal 2010 federal student loan cohort default rate (CDR) more than doubled to 9.1% from 4.5% in 2003. This trend is, however, subject to reversal as default rates are highly correlated with employment rates and improved job prospects would help stem the tide of rising defaults.[21]

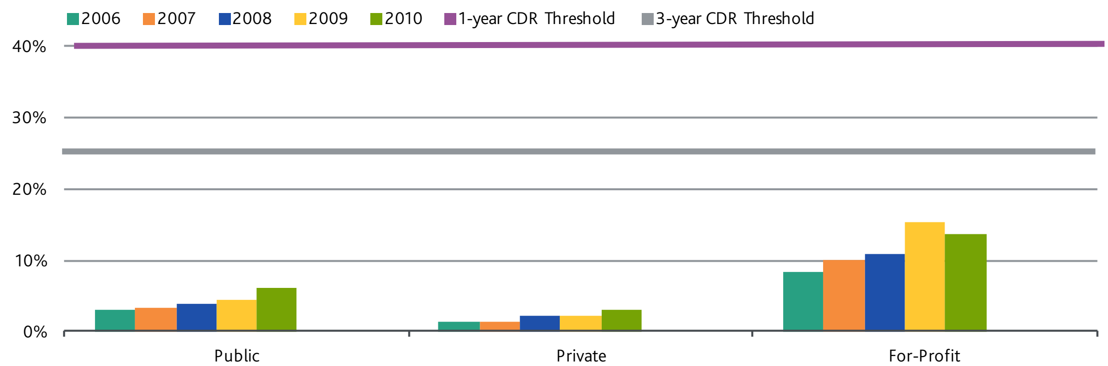
For-profit colleges and traditional colleges that rely heavily on federal financial aid as a share of revenue and lack strong brand reputation face the greatest credit risk related to student loan defaults. The default rate for most of Moody's rated universities remains well below the Department of Education thresholds that would render the university ineligible for federal financial aid (40% in a single year or more than 25% for three consecutive years based on the two-year cohort default rate) (Exhibit 10). However, many for-profit universities have very high default rates.

[21] US Department of Education

EXHIBIT 10

Public and not-for-profit private universities are well below regulatory trigger

Aggregate Two-Year Cohort Default Rates for 4-year Degree-Seeking Institutions



The current 3-year CDR threshold represents three consecutive years of two-year CDRs in excess of 25%. The 1-year CRD threshold represents any year the CDR is in excess of 40%. Both sanctions can lead to ineligibility for Direct Loans and/or Pell Grant Programs

Source: US Department of Education, The National Student Loan Data System (NSLDS)

For most traditional non-profit private and public universities, the credit risk emanating from rising student loan default rates and student debt burden relates to the threat of increased regulation and political pressure to moderate the cost of tuition rather than the potential loss of federal student funding by tripping default rate limits. However, there are subsectors that tend to enroll large shares of low income students that borrow heavily – some regional public universities, historically black colleges and universities (HBCUs), Hispanic serving institution (HSIs), and other small private colleges that serve a similar demographic as their for-profit peers. The relatively open access mission of these universities means they enroll students with lower levels of college preparedness and experience high attrition and low graduation rates – all driving high default rates as students fail to complete their education and have to repay loans without the benefit of a degree to help them secure employment and boost income.

Average debt per student on the rise, but still manageable

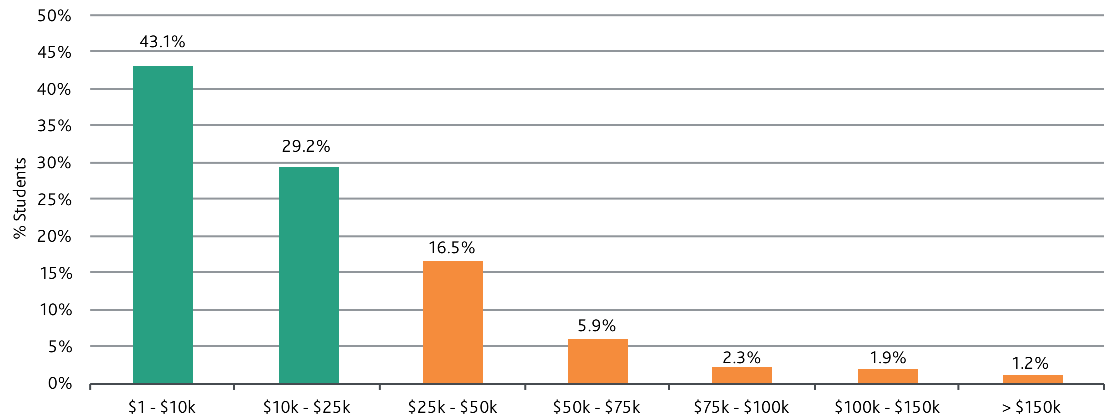
Increasing media attention focused on student loan burdens notwithstanding, the average debt per student graduating with a bachelor's degree is still relatively manageable, despite the dramatic rise in debt burden over time. As the relatively moderate per student debt burden suggests, the cost of getting a college degree is far lower than generally perceived because the majority of students attend lower-cost public universities (71% of the full-time equivalent students in our rated portfolio) or community colleges (9.7%); while most private colleges and universities heavily discount their tuition with financial aid.

From 2001-02 to 2011-12, average total borrowing per full-time equivalent student for undergraduate and graduate students increased by 55% in inflation-adjusted dollars. Despite the rise in student debt burden, 72% of student loans (including private borrowing) are held by borrowers with less than $25,000 in debt and nearly 90% of loans are held by borrowers with less than $50,000 in debt. Forty percent of students at public universities and nearly one-third of students at four-year private not-for-profit universities have no student loan debt.

EXHIBIT 11

Large Majority of students have less than $25,000 of student loan debt

Percentage of Student Loans Outstanding



Source: FRBNY Consumer Credit Panel/Equifax (Q3 2011). Represents all student loans reported to Equifax (including private loans)

Factor 4: Increased public scrutiny drives escalated risk of more regulation and accreditation sanctions

Rising student debt burdens and long-term concerns about the affordability of a degree are already generating greater political pressure and greater regulation of the higher education industry. Over the last year, President Obama placed considerable focus on the subject of affordability and educational outcomes, in effect extending a focus brought to bear on the sector by the previous Bush administration. In his 2012 State of the Union Address, the President threatened to reduce funding from taxpayers if college presidents do not slow the rate of tuition increases.[22] The President discussed plans to build on the now required net price calculator to improve disclosure of the cost of a college education and financial aid. He has also launched a small college affordability plan which would link certain federal financial aid eligibility to the rate of tuition growth and to reward public universities that moderate tuition increases. These regulations effectively limit a college or university's ability to increase tuition – furthering pressure on growth of this major revenue source.

State governments are also focused on affordability. Several statewide proposals and initiatives seek to address both the cost and the value of higher education. The attention reignited the movement toward measuring and funding outcomes, rather than just enrollment, particularly for state appropriations. Virginia recently published a pioneering database with starting salary information for new college graduates across the state by university, degree, and program. The database allows students to compare which Virginia university (public and private) yields the highest starting salary within each type of program or course of study. The database will serve as one input into a student's decision to attend a particular university or enroll in a certain program. If the availability of this information were to alter student preferences, it could serve as a tool for colleges to make strategic programmatic and resource decisions.[23]

22 2012 State of the Union Address

23 Moody's: "Virginia Database is Value Added for Students, Colleges and Universities," October 12, 2012, (146229)

Performance based funding, such as that which has been used by the Pennsylvania State System of Higher Education since 2000, uses several performance metrics measuring degree completion, retention, and faculty productivity. Colleges in the system that meet the metrics receive a share of the education and general budget. This type of funding has experienced periods of popularity over the last 20 years and is employed by many states already. But the idea has been gaining traction again with the Obama administration's focus on higher education. The State of Georgia recently implemented a new funding model that includes performance metrics and the governors of Ohio and Texas currently have proposals to implement similar programs.

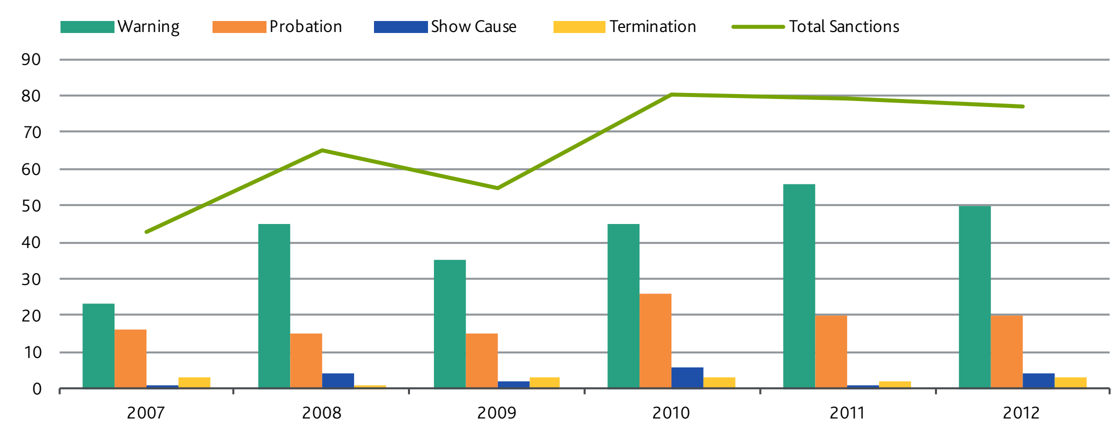
State legislators and governors have put forth more extreme proposals to modify the price of a college degree. Florida, Texas, and California have vowed to create a $10,000 four-year degree. Another proposal in Florida that was subsequently voted down would have varied the cost of degrees by earning potential of the program. While these proposals are innovative and generate important discussions around the price of a degree, they do not address the actual cost structure behind offering the degree, which will be the major challenge for universities as they adjust to long-term muted tuition revenue growth. Until universities demonstrate better ability to lower their cost of operations, perhaps through more intensive use of on-line classes and elimination or reduction of tenure, we expect government officials to produce bolder solutions in response to the public outcry against the cost of higher education.

Accreditation risk has accelerated, affecting even high profile universities

Increased public and political scrutiny of the industry is fueling a substantial increase in sanctions by the nation's accrediting bodies. Negative accreditation actions taken against US colleges and universities increased by almost 50% from 2009 through 2011 and remained at a similarly high level in 2012 in response to growing government criticism of poor disclosure about quality, pricing, and outcomes, as well as inefficient cost management (Exhibit 12).[24]

EXHIBIT 12

Sanctions increase over last three years: warnings and probations dominate



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

24 Moody's: "Accreditation Risks on the Rise for US Higher Education," December 18, 2012 (148140)

Accreditors are citing colleges and universities for a broad range of issues that include deficiencies in governance, integrity, and assessment of student learning outcomes. Failure to comply with accrediting standards can lead to various levels of sanctions and reputational damage, but the most severe risk is withdrawal of accreditation. Loss of accreditation will usually lead to the closure of a college, although not necessarily to a default on its debt.

A college lacking accreditation is barred from receiving federal Title IV funding, commonly known as federal financial aid, which in Fiscal Year 2011 comprised approximately one-third of the median operating revenue of Moody's rated universities.

Not long ago, accreditation sanctions were rare and actions against highly rated universities were rarer still. This past year saw some very high profile universities receiving warnings from accrediting bodies with both the University of Virginia and Pennsylvania State University being sanctioned for noncompliance with governance standards.[25] We expect heightened accreditation activity to increasingly impact not just smaller, weaker colleges that have traditionally been cited for various insufficiencies, but also larger universities with sound financial health and solid market demand.

Factor 5: Prospects for long-term sustainability depend upon strong leadership through better governance and management

Facing a weak outlook for operating revenues, universities will need to continue to diligently manage their debt structures and liquidity to ensure ample cash flow in times of economic volatility. We also expect to see more aggressive approaches to increasing operating efficiency over the next several years, as well as continual focus on new revenue strategies as the online learning environment continues to evolve.

Existing cost structure of higher education will change as revenue growth remains constricted

The US higher education sector has hit a critical juncture in the evolution of its business model. Most universities will have to lower their cost structures to achieve long-term financial sustainability and to fund future initiatives. Better strategic leadership, predicated on improved governance and management, will be the backbone to transforming university operations and taking on the entrenched cost drivers of the business model: shared governance, classroom instruction, tenure, and student life services.

Nearly two decades of extraordinary annual revenue growth allowed universities to grow without focusing on productivity and efficiency.[26] The negative economic and political pressure built up during the post 2009 financial crisis period is finally proving to be the catalyst for universities to focus more aggressively on operating efficiency and cost containment. However, deeper and more structural changes will be necessary to adjust to the long-term muted prospect for revenue growth.

As revenue growth stagnates, we expect universities to see more faculty and administrations clash over program prioritizations and resource allocations. As illustrated in Exhibit 13, management teams have generally reacted to revenue declines in a particular year and adjusted expenses accordingly. It is notable that even at the height of the financial crisis in FY 2010, less than 30% of universities reduced

[25] Moody's: "University of Virginia's Accreditation Placed on Warning," December 17, 2012 (148371); "Pennsylvania State University's Accreditation Warning is Credit Negative," August 20, 2012 (144923)

[26] According to data from Moody's MFRA and the Integrated Post Secondary Education Data System, public universities experienced 6.3% average annual revenue growth from FYs 1993-2006 while private universities had average annual revenue growth of 6.7% over that time period.

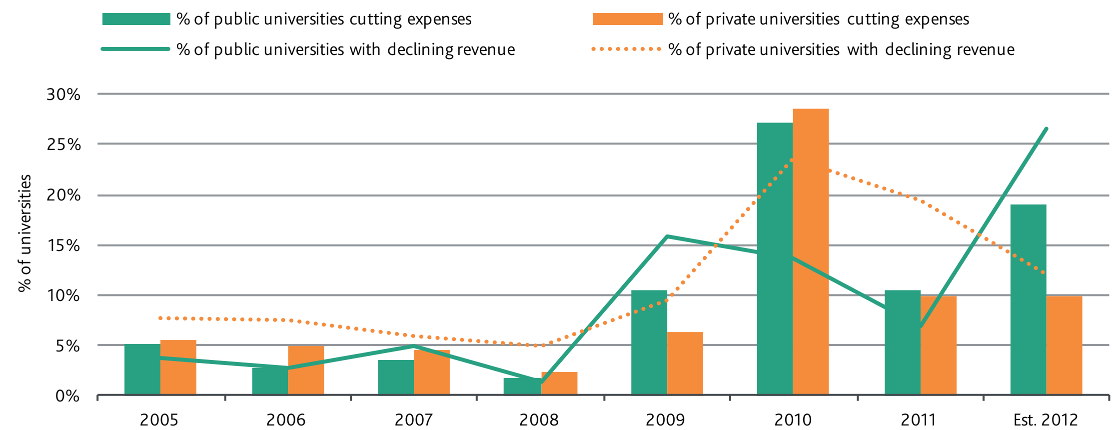
expenses in the face of tremendous uncertainty and volatility. Expense controls were mainly achieved through nonrecurring savings or reductions – leaving positions unfilled, furloughs, early retirement plans, stalled capital plans, and flat or modest increases in compensation – rather than through long-term modifications to the core cost of instruction.

Many public university systems and large private research universities are moving to a shared services model, but even the efficiencies generated by reducing duplicative administrative functions will not be enough to withstand the need for growth in other expenses and slow revenue growth. Only comparatively few colleges and universities have made the difficult decision to cut faculty and existing programs. Even fewer are explicitly reducing tenure rates or backing away from shared governance with faculty.

EXHIBIT 13

Universities cut expenses in reaction to revenue declines – but deep expense cuts are not widespread

% of universities cutting expenses vs. % with declining operating revenue



Source: Moody's MFRA

In the coming years, all universities will need to fund growing financial aid budgets, increasing healthcare costs, and capital improvements necessary to maintain or build market position. There is also a growing risk that public universities will be forced to assume payment responsibility for post-employment benefits that their respective states have historically paid. In order to do so, administrations will have to focus on traditional cost containment and operating efficiency, as well as take on the bigger issues of tenure and the student service intensive residential experience.

Higher Ed is exploring new ways to grow revenue and increase cost efficiency

- **Centralization and shared services:** human resources; fundraising; marketing; financial services; information technology
- **Consolidation:** within public systems (New York, Georgia, Louisiana); shared leadership and mergers
- **Expense flexibility:** increased use of adjuncts; reduced % of tenured faculty; leasing space for satellites/expansion
- **New market outreach**: continuing education and degree completion; non-traditional students
- **Online education**: distance learning programs; hybrid classes; fully online degrees; MOOCs for credit

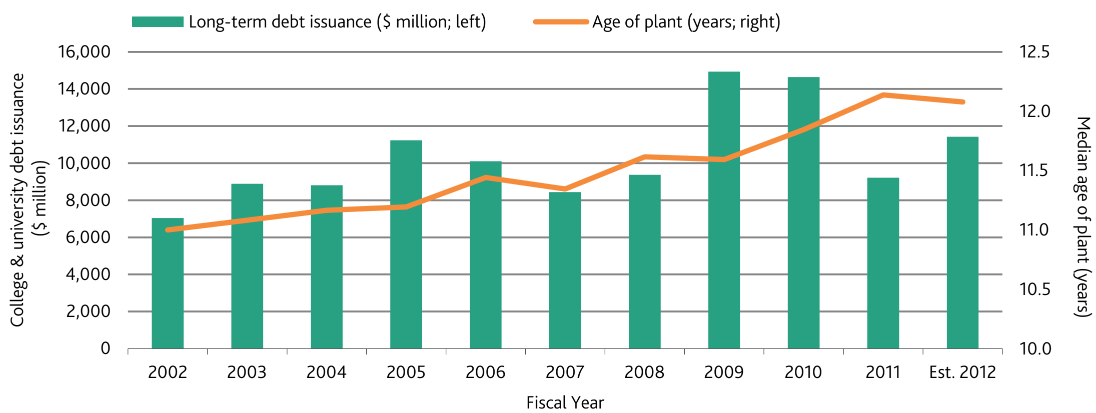
- **Partnerships/collaborations:** purchasing cooperatives; dual enrollment; joint BA/MA degree programs
- **Programmatic review**: elimination of small, underutilized programs
- **Space utilization:** weekend, evening, summer courses; moving administrative functions off core campus to lower cost space
- **Tuition pricing strategies:** recalibration of the number of credits covered by the standard full-time tuition with per-credit charges for additional coursework

Strong capital planning and careful debt management can lend stability

Many universities have delayed capital funding over the last several years to help shore up budget shortfalls and in light of continued economic volatility. Most management teams remain cautious on new borrowing since the economic downturn in 2008 despite record low interest rates. Capital spending and new money debt issuance remain well below fiscal 2008 levels for the entire sector, causing the average age of plant to rise (Exhibit 14). However, the wealthiest and highest rated public and private universities continue to spend and borrow at an elevated level relative to the rest of the rated portfolio. Eventually, universities will need to address the rising age of plant in order to maintain market share.

EXHIBIT 14

As universities continue to stall capital plans, age of plant is on the rise



Source: Barclay's; Moody's MFRA.

Note: Debt issuance includes new money with some amount of refunding where bundled in; all pure refundings are not included.

Another sign of more conservative debt management and planning is the shift to fixed rate from variable. Both the public and private 2011 medians show that the sector has continued to shift back to fixed rate debt, with median variable rate debt exposure (before swaps) declining as a percentage of total debt.[27] Many universities that want to take advantage of extremely low interest rates through variable rate debt instruments have opted to use direct bank placements, thereby reducing some market risk exposure. Although remarketing risk for these direct placements is often forestalled for several years, the debt usually carries risks similar to those found in variable rate demand bonds, including interest rate variability, repayment acceleration risks, and market access and renewal risks.

[27] Moody's: "US Private College and University Medians Underscore Revenue Challenge and Mixed Outlook for Sector," July 27, 2012 (143631) and "US Public University Medians Show Greater Reliance on Student Funding As States Cut Back," September 14, 2012 (145278)

Direct loans do not typically introduce any additional adverse credit risks to the borrower beyond what is found in VRDBs.[28]

Effective internal controls and disclosure practices can minimize impact of event risks

Universities are complex organizations playing an increasingly important public and economic role in their communities and regions. They depend on better quality leadership than in the past, and can no longer operate effectively under a passive governance model whereby most key decisions are effectively shared with faculty leaders. Universities now require board and senior management teams that can produce competitive strategies, transparent policies, and effective oversight as well as decisive action on important subjects or in times of crisis. In addition to the economic and political challenges driving this change, other risks—including sexual abuse, hazing, student violence-- are becoming elevated and point to the need to strengthen these core functions of governance and management.

Effective internal controls can alert management to potential problems and help to minimize any negative impact on the university's reputation and financial health. The audit function reporting to governing boards is increasing in importance as accrediting bodies focus on compliance especially after crises such as the recent events at Pennsylvania State University and University of Virginia. Universities must continue to develop processes to identify and evaluate risks on an ongoing basis, not simply in reaction to an event on campus or in the industry.

Public universities face unique governance and management challenges

We expect to see more governance stress at public universities because management teams, faculties and governing boards are often poorly aligned. University managers are driven increasingly by market strategy even as they face rising faculty opposition to change, while the boards often remain largely focused on political tactics to deal with state government criticism or promoting a corporate focus lacking communication styles suitable to universities. In 2012, we saw an extreme example of how these conflicting priorities can result in clashes among governing boards, management teams and faculties in the firing and subsequent rehiring of the University of Virginia's president.[29] Pennsylvania State University, on the other hand, was an example of concentration of power in a few dynamic senior managers with inadequate board oversight.

We would likely change the US higher education industry's outlook to stable if pricing power improves through strong economic growth with sustained improvements to the housing market, unemployment rate dropping below 6.5% and consecutive years of strongly positive stock market returns.

[28] Moody's: "Direct Bank Loans Carry Credit Risks Similar to Variable Rate Demand Bonds for Public Finance Issuers," September 15, 2011 (135849)

[29] Moody's: "Virginia Dispute Highlights Governance Stress and Economic Threats Facing US Higher Education," July 2, 2012

Outlook for Related Sectors

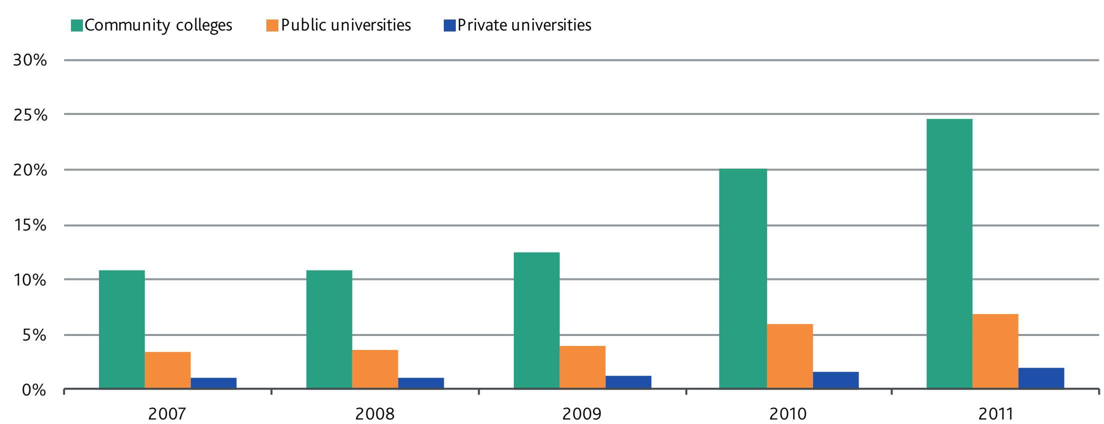
Community colleges challenged by enrollment declines and changes to federal student aid

The major challenges that two-year community colleges will face in 2013 are enrollment declines, price sensitivity, reduction in state funding, and potential Pell Grant reductions or changes to eligibility. After several years of burgeoning enrollments during the Great Recession, two-year community colleges experienced their second consecutive year of enrollment declines (a median of -3.1% in fall 2012 and -1.6% in fall 2011).[30] Enrollment at these colleges tend to move in counterpoint to unemployment rates, so fall 2013 enrollment will depend largely on any recessionary impact of the federal deficit resolution. The recent enrollment declines suggest that barring another recession, enrollment will continue to decline moderately. We expect the lower price point of community colleges to temper these declines as price sensitive students choose to take the first two years of their college degree at a community college at a lower cost. In FY 2011, tuition and fee revenue made up a median 41% of operating revenue for community colleges, while government appropriations, tax revenue, and grants and contracts made up the balance.

EXHIBIT 15

Community college students have become increasingly dependent on Pell Grants to pay tuition

Median Pell Grant disbursements-to-operating revenue



Source: Moody's MFRA, US Department of Education, Integrated Postsecondary Education Data System Database

Community college students tend to be highly dependent upon Pell Grants (Exhibit 15) and so enrollment may be further impacted by the new Pell eligibility requirements that went into effect on July 1, 2012 as well as any future cuts to Pell funding in federal fiscal year 2014. The new eligibility requirements include a lifetime cap on Pell funding equivalent to six years of education (600% times the maximum annual award, with no maximum time frame for usage), which could greatly limit the part-time and adult education population. According to the Department of Education, 40% of community college students received Pell Grant funding in 2011, and for the Moody's rated portfolio, Pell funding represented a median of 25% of total operating revenue in FY 2011, up from just 11% in FY 2007.

Positive factors for the community college sector include: strong mission alignment with the current political focus on affordability and workforce development and the increased focus of public universities on transfer articulation agreements, making the community college route an easier choice for traditional age students.

30 National Student Clearinghouse Research Center, http://research.studentclearinghouse.org/files/TermEnrollmentEstimate-Fall2012.pdf

Independent K-12 schools must also contend with uncertain economic outlook and tuition revenue pressure

Independent schools rely heavily on tuition revenue, gifts and endowment spending for their operations, all of which we expect to be under pressure in 2013. Although many of these schools tend to serve wealthy families who have long-standing traditions of sending their children to private school, tuition discounting rose by approximately 11% from fall 2007 to fall 2011, and if the economy reverts to recession, discounting will likely increase further. In addition, the upper middle class and wealthy demographic that these schools tend to serve will feel the pinch of recently increased federal taxes and removal of certain tax preferences.

Not-for-profits face continued tax risk and macroeconomic pressure

The not-for-profit sector, which includes cultural, philanthropic, research, and service/advocacy institutions as well as public university foundations, is heavily reliant on gift revenue, membership and admission fees, investment returns and, in some cases, research funding – all of which we expect will be under pressure in 2013. The top driver behind most of these revenue streams is the health of the economy and family disposable income. In times of economic downturn, institutions with recognizable brand names and premiere reputations will garner the most in admission and membership fees, gift revenue, and research funding, where applicable. The tax deduction on charitable contributions to not-for-profits has long been under scrutiny and may resurface as Congress grapples with the federal deficit.

Outlook for Global Higher Education: varying challenges and uncertainties, but long-term prospects remain strong

Universities outside of the United States are usually more directly funded by their national governments than are US universities, but they also rely less on student fees and benefit less from private philanthropic support. As macroeconomic growth varies widely across the world and many governments face difficult budgetary and policy tradeoffs, universities in some countries are facing stagnant or declining government funding. While certain Asian countries are rapidly expanding their higher education sector, other countries, especially in Europe, are restricting government funding. In this sense, universities around the world, including those in the US, share a common challenge in striving to keep higher education as affordable as possible to meet public policy goals - even as public sector funds may be dwindling. In some countries, such as Brazil, a growing for-profit, private sector is helping to meet the rapidly growing demand for university degrees.

To the extent that government funding becomes scarcer, universities will likely have to become more creative in finding means to meet increased public pressure to fulfill economic development and social goals while maintaining access-oriented missions. One proven way to supplement state funding is to compete for non-resident students, who nearly always pay higher fees than resident students. Universities in Australia, Canada, the UK, and the US are all well entrenched in this competition and are now being joined in this market by universities in many other countries. Another common strategy for navigating a constrained funding environment is to strive for greater operating efficiencies, driving down expenses and containing cost growth. In light of reduced operating and capital support from national governments, we would anticipate that non-U.S. universities would generally reduce capital expenditures in the short-term, but would need to seek alternate funding sources over the intermediate to longer-term- such as philanthropy or long-term debt.

Negative Outlook on For-Profit Higher Education Providers

Moody's outlook for the U.S. for-profit post-secondary education sector remains negative due to continued pressure on revenue and earnings and selected pressure on enrollment. Weak consumer spending, the negative effects of extended high unemployment, and pressure on student loan funding have tempered demand for education. For companies that are highly reliant on Title IV student loans, the sector has also faced significant challenges related to government concerns over default rates and marketing practices. Although a key part of the Department of Education's gainful employment rule (intended to regulate for-profit institutions educational outcomes) was overturned, we expect that marketplace and regulatory pressures on the industry will continue. Moreover, companies are still feeling the residual impact of actions taken to conform to these regulations and combat the underlying issue of high default rates within the for-profit sector. In our opinion, these issues may continue to negatively affect enrollment trends near-term. The U.S. based companies we follow in this space include The Washington Post Company (Baa1 negative) which operates Kaplan Higher Education ("KHE"), Education Management (B3 under review for downgrade), and Laureate Education (B2 stable).

Even if enrollment modestly recovers over coming periods, it might take some time before this translates into higher revenue and earnings. In addition, we expect increased competition for students that are more likely to succeed in the programs and after graduation will create pressure on tuition rates, marketing costs, and the level of services offered. Longer-term risks include the potential for increased competition from not-for-profit institutions as they expand online and non-traditional course offerings, and from funding pressures on student loans. The for-profit sector targets individuals that are not currently served well by more traditional non-profit universities.

Moody's Related Research

Special Comments:

» Accreditation Risks on the Rise for US Higher Education, December 2012 (148140)

» Continued Graduate Enrollment Declines Are Credit Negative for Higher Education Institutions, October 2012 (145966)

» Direct Bank Loans Carry Credit Risks Similar to Variable Rate Demand Bonds for Public Finance Issuers, September 2011 (135849)

» Georgia Public Universities' Campus Consolidation Plan Is Credit Positive, January 2012 (139195)

» Johns Hopkins University's Aa2 Rating Unlikely to be Affected by Delayed Contract Renewal for Major Research Lab, October 2012 (146074)

» More US Colleges Face Stagnating Enrollment and Tuition Revenue, According to Moody's Survey, January 2013 (148363)

» Not-for-Profit Healthcare Mid-Year 2012 Outlook: Strong Headwinds Continue, August 2012 (144819)

» Pennsylvania State University's Accreditation Warning is Credit Negative, August 2012 (144923)

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» Shifting Ground: Technology Begins to Alter Centuries-Old Business Model for Universities, September 2012 (144483)

» Students Are Growing More Cost Conscious, a Credit Negative for US Colleges and Universities, July 2012 (144383)

» University of Virginia's Accreditation Placed on Warning December 2012 (148371)

» US Private College and University Medians Underscore Revenue Challenge and Mixed Outlook for Sector, July 2012 (143631)

» US Public University Medians Show Greater Reliance on Student Funding As States Cut Back, September 2012 (145278)

» US Research Universities Face Looming Federal Funding Cuts, but Remain Well Positioned to Withstand Credit Challenges, December 2011 (144819)

» Virginia Database is Value Added for Students, Colleges and Universities, October 2012, (146229)

» Virginia Dispute Highlights Governance Stress and Economic Threats Facing US Higher Education, July 2012 (143539)

» White House Report Supports Funding for Research Universities, a Credit Positive, December 2012 (148312)

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