U.S. Not-For-Profit Higher Education 2017 Sector Outlook: Credit Quality Should Stay Stable Despite Headwinds

Primary Credit Analyst:
Jessica A Matsumori, San Francisco (1) 415-371-5083; jessica.matsumori@spglobal.com

Secondary Credit Analyst:
Laura A Kuffler-Macdonald, New York (1) 212-438-2519; laura.kuffler.macdonald@spglobal.com

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S&P Global Ratings' outlook for the U.S. not-for-profit higher education sector in 2017 is stable. While we expect the sector will continue to face significant headwinds in the near to medium term, we believe most institutions have adapted to these challenges and the future cumulative effects of these competitive pressures will manifest themselves over several years. Consequently, we believe credit quality for the majority of institutions will remain stable through the year, with the majority of rating changes likely to affect outlying institutions.

For additional information on our view of the international higher education sector, see the article "2017 Outlook For Not-For-Profit Public Universities In Australia, Canada, Mexico, And The U.K.: A Stable Trend For All, Despite Funding Concerns", published Jan. 17, 2017.

Risks And Opportunities

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<th>Opportunities</th>
<th>Risks</th>
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<td>• More schools have shown a willingness to make difficult decisions to refine operations through focused, rather than general, expansion strategies.</td>
<td>• Limited revenue-raising flexibility as smaller schools struggle to predict enrollment and all institutions face pressure to limit tuition increases.</td>
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<td>• Increased regulation and lawsuits against for-profit colleges and universities could lead to enrollment and programmatic opportunities for not-for-profit schools.</td>
<td>• Growing acceptance among some states to reduce or limit funding for higher education while exerting more control over the management and governance of public universities.</td>
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<td>• Aging workforce and upcoming retirements could lead to lower tenure rates and salary expenses.</td>
<td>• Decline in actuarial rates could lead to further pressure on pension and other postemployment benefit (OPEB) obligations.</td>
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<td>• Highly endowed institutions face lower return assumptions and the federal threat of losing their not-for-profit status.</td>
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Overview Of Sector Ratings

As of Dec. 13, 2016, S&P Global Ratings maintained public ratings on 440 U.S. not-for-profit colleges and universities, ranging from 'AAA' to 'CC'. Both the number of speculative-grade ratings and the number of 'AAA' ratings increased during 2016, reflecting the bifurcated performance of schools at either end of the spectrum. The average rating remains 'A' for private universities and 'A+' for public universities.

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Chart 1

U.S. Higher Education Rating Distribution*


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Chart 2

U.S. Public College/University Rating Distribution*


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Despite significant rating movement in selected pockets of ratings in 2016, most notably Illinois public universities, ratings remain relatively steady, with nearly 87% of outlooks stable, nearly 10% negative, nearly 3% positive, and 1% on CreditWatch with negative implications.
Opportunities And Risks In 2017

Demand and enrollment: Unlimited potential, elusive results

Demand for higher education in the U.S. remains strong and continues to grow despite some headlines to the contrary. According to the National Center for Education Statistics, as of 2012-2013 (the most recent year reported), there were 4,253 degree-granting higher education institutions in the country, an all-time high. More than 3,000 of these were four-year colleges and universities. Though total college enrollment has declined in recent years to 20.2 million in 2014, from a peak of 21 million in 2010, the decline is almost entirely at for-profit institutions, with four-year public and private nonprofit institutions experiencing year-over-year growth in enrollment. Additionally, we note that college enrollment tends to run countercyclically to the economy. During economic downturns when job layoffs are more widespread, many individuals tend return to school and then resume full-time employment as the economy improves.

One could argue the potential number of students is limitless between high-school graduates, degree-completion, international students, workforce training and development, graduate and professional students, or a variety of other subsets of the population who might be interested in additional learning. However, students' price sensitivity, competition between schools, and physical capacity constraints can often limit the rate of enrollment growth for many
institutions. Recently, many for-profit institutions have struggled amid decreasing enrollment, unfavorable press, and increasing regulation or enforcement from the government, resulting in the closure of a large number of for-profit schools. These schools do not often directly compete with not-for-profit colleges and universities in programming or students, but nonetheless, we are interested to see if not-for-profit institutions can take advantage of the reduction in for-profit enrollment, particularly those in close geographic vicinity with similar programs, or schools with online offerings that are able to find and appeal to these displaced or potential students.

**Revenues and expenses: Certainties becoming less certain**

While we believe U.S. colleges and universities will continue to face some of the financial pressures that besieged the sector in the past few years, we believe 2017 could present particular risks and opportunities as a few historical certainties become less certain.

Tuition revenue continues to be the major source of revenue for most colleges and universities. And while that is not expected to change, net tuition revenue growth is becoming less certain. Affordability remains a significant issue for students, parents, legislators, and university management alike. As a result, many institutions have chosen or are being required to limit the amount of annual tuition increases. Meanwhile, small or less-selective institutions are finding it more difficult to accurately predict fall enrollment for the year. Consequently, while institutions have historically been able to rely on growing net tuition, more institutions are finding it difficult to maintain this trend.

On the expense side, salaries and benefits tend to be the largest cost item. This expense has been reliably fixed to growing over time, particularly for institutions with high tenure rates. However, as institutions have moved away from tenure, coupled with a generally aging faculty, some schools may begin to see an opportunity to both decrease this expense and lower tenure rates. However, a continued decline in actuarial rates could lead to significant increases in pension and OPEB liabilities or funding requirements. Though the effect should be somewhat smoothed over time, this could have a particularly detrimental effect on public colleges and universities or private universities with legacy defined-benefit plans.

**State support: Less funding, more involvement**

Though state support for public universities has declined on a per student basis for many years, the general trend of operating appropriations for higher education has historically followed the strength of the state economy, increasing in good times and decreasing in bad on a nominal basis. This trend was relatively reliable as governors and legislators hesitated to deviate from the formula except to increase appropriations, reluctant to be pegged as anti-education. However, as the public conversation has shifted in recent years with some in the media starting to question the value of higher education given rising tuition costs, sentiment in some state governments has shifted as well. Legislators, faced with rising needs in multiple areas including health care, pensions and OPEBs, or infrastructure, have become more willing to cut higher education funding, institute additional requirements regarding student outcomes and access, or increase their involvement from a senior leadership or governance perspective. While the large, comprehensive research universities are best positioned to weather financial cuts, increased state requirements or involvement pose additional credit risks for all, as these actions generally limit an institution's ability to manage its own operations or the options available to it. As a result, while we continue to view the receipt of state operating appropriations favorably for public colleges and universities, we no longer consider this source of revenue to be as stable or predictable as it once was. Furthermore, an unfavorable political climate in individual states can have a negative and offsetting impact on
their related universities, particularly if the universities are highly reliant on state funding.

The most recent example of this shifting political climate is Kentucky, where Gov. Matt Bevin attempted to change how the state makes appropriations to public colleges, institute midyear appropriation cuts to higher education, and overhauled the president and board at the University of Louisville. In Wisconsin, Gov. Scott Walker has most famously cut funding to the public university system and frozen undergraduate tuition. The state of Washington required all public universities to cut tuition rates by 15%–20% over two years. While it backfilled the tuition rollback with an increase in state appropriations, which mitigated the financial effect to colleges, the cuts are expected to significantly limit overall growth in total revenue for those schools in 2015 to 2017. In Illinois, the protracted budgetary fight between the governor and legislature has resulted in tremendously delayed and reduced funding for its public colleges and universities, causing liquidity concerns for all but the most robust institutions.

Are institutions more nimble after the 2008 recession?

With so many different constituents, the higher education sector is notoriously slow to change. However, after multiple years of financial challenges and continuing pressures on the horizon, more and more institutions are becoming adaptable (and almost nimble) out of necessity.

Prior to 2008, U.S. colleges and universities only expanded—increasing the number of degrees or departments, student programs, enrollment, athletic offerings, and footprint. "Bigger is better" was the mantra, and schools added in any area they felt they were lacking competitively. However, with the 2008 recession and subsequent lengthy recovery and more limited resources, many colleges and universities (particularly smaller ones) were forced to make significant cuts or reductions. Their approach to growth is now much more strategic. These strategies range from specialization to diversification, a change in institutional direction or target student base, or new partnerships or ventures outside higher education. Though there is no single strategy that could be deemed one size fits all, we view university managements' ability to quickly adapt to changing circumstances favorably as it speaks to an organization's ability to survive over time. We will be interested to see if institutions will be able to successfully implement their strategic plans and how potential students will respond to such measures.

Endowments are bigger but not always better

While highly endowed institutions are often viewed as the most privileged and impenetrable institutions from a financial standpoint, 2017 could present particular challenges to these institutions. Average investment returns for fiscal 2016 were negative, spurring some institutions to reconsider their expected investment return assumptions. While we believe such adjustment to be prudent, actual lower rates of return would naturally lead to a decline in annual endowment contribution to the organization, and perhaps a lower endowment value over time if fundraising doesn't make up the difference. A lower endowment operating draw would be particularly difficult for highly endowed institutions, which tend to be more reliant on this source of revenue. Additionally, while no specific legislation has been proposed to date, these highly endowed institutions have increasingly come under the glare of federal authorities with regard to maintaining their not-for-profit status.
Other Current Issues

The Trump effect
For higher education, we believe the key policy focus of the new administration will be the federal student loan program, the funding environment for federal grants and contracts, and potential changes to the tax-exempt status of colleges and universities with large endowments. Because of the breadth of the higher education market, these federal policy issues would affect postsecondary institutions differently depending on their size and scope. For smaller colleges and regional universities, any changes to the federal student loan program, or political pressure, or legislation regarding student access, tuition levels, or postgraduation employment, could significantly affect operations and enrollment. Students at these institutions tend to be the most price-sensitive, in need of the most financial and academic assistance, and the institutions themselves highly reliant on student tuition and fees as their main source of revenue. Larger, comprehensive research and national/international colleges and universities will be more affected by the outlook for federal grants and contracts as well as any discussions surrounding tax-exemption for universities in general or for their debt or endowments.

The net effect of a Trump Administration on the not-for-profit higher education sector is uncertain. Given the settlement of a lawsuit against Trump University, presumably the incoming administration will be able to focus on other aspects of the sector. Neither President-elect Trump nor Betsy DeVos, his nominee for Secretary of Education, have outlined specific plans or intentions for education in general or for higher education in particular. While there is considerable speculation about potential actions on education, ranging from the dissolution of the Dept. of Education (which we consider unlikely) to decreased regulations for not-for-profit and for-profit colleges and universities (which we consider to be somewhat more likely), the only thing we believe to be certain is that even if Mr. Trump's actions do not directly target the financial health or competitive profile of colleges and universities, at a minimum, his actions will affect higher education as they influence the academic discussion by students, faculty, and administration alike.

Keeping an eye on public-private partnerships—off-balance sheet but on-credit debt
Continuing the trend of the past few years and given the recent remarks by Elaine Chao, the next Transportation Secretary, we expect to see additional public-private partnerships (P3s) in 2017. These agreements vary from developer-driven student housing projects to shared services or utility agreements and outsourcing of administrative functions or auxiliary departments. S&P Global Ratings is most directly interested in any arrangements that result in additional debt (see the article, "Living On Campus: Rating Factors For Privatized Student Housing Bonds", published Sept. 22, 2014) which are almost always considered on-credit or indirect debt of the university despite being issued by the partner organization, and thus could have significant negative credit implications for the school. These indirect debt arrangements could have other implications (both positive and negative), such as possible operating efficiencies, loss of control or ownership, additional financial investment, or other requirements as dictated by the arrangement. Although we don't presume that these partnerships are either positive or negative, they can have significant operating and credit implications for an institution, depending on the specifics of the agreement and partnering organizations. It is extremely rare for S&P Global Ratings to consider such arrangements to be completely off-credit for the related university.
Upcoming accounting changes
We anticipate the implementation of a change in both Financial Accounting Standards Board and Governmental Accounting Standards Board reporting standards in the upcoming year and are continuing to evaluate what, if any, modifications we will make to our calculations as a result of these changes. Our goal is always to accurately reflect the credit quality of institutions. To the extent these accounting changes provide additional insight into the credit of colleges or universities, we may make adjustments to the way we calculate certain ratios or numbers. However, we will not change ratings on a wholesale basis purely due to an accounting change.

Revised criteria and other considerations
S&P Global Ratings released revised criteria for analyzing not-for-profit colleges and universities on Jan. 6, 2016. While the majority of our rated universe has already been analyzed using the revised criteria, a small number of institutions will be reviewed based on the revised criteria for the first time in the first few months of 2017. At the time of our criteria release, we anticipated that approximately 15% of ratings could change under the application of the revised criteria, split between upgrades and downgrades. We do not believe the application of the revised criteria during 2017 will yield significantly different rating actions than what we anticipated last year.

Separately, we detected some model errors in our internal credit scoring tool in October 2016. We have corrected these errors and do not expect them to have any further impact on our ratings (see the article, "Credit Scoring Model Errors Have Minimal Impact On Higher Education Credits", Jan. 9, 2017).

Only a rating committee may determine a rating action and this report does not constitute a rating action.