

Higher Education
Special Report

Higher Education Outlook for 2007: Stable

Analysts

Douglas J. Kilcommons
+1 212 908-0740
douglas.kilcommons@fitchratings.com

Elissa Granick
+1 212 908-0658
elissa.granick@fitchratings.com

Sandy Matthews
+1 212 908-0738
sandra.matthews@fitchratings.com

■ Summary

Bond ratings of colleges and universities generally are expected to be stable in 2007. Favorable long-term prospects for the sector include successful completions of major fundraising campaigns, more sophisticated management practices, the ability to issue relatively low cost debt without stringent bond covenants, and state and national efforts to promote higher education attainment. However, certain factors for the sector will be advantageous for some colleges and universities, while these same factors will be challenges for others. These factors include demographics, increased competition, tuition increases, debt management, and research funding. The sector may also be challenged with increased scrutiny of the not-for-profit sector in general and more specifically with the reauthorization of the Higher Education Act (HEA). The majority of colleges and universities rated by Fitch Ratings are expected to weather these challenges. However, certain colleges with already weak enrollment and demand trends and limited financial flexibility could be vulnerable to downward rating pressure.

■ Enrollment and Competition

Fitch considers student demand to be a critical factor in assessing the relative creditworthiness for sector and a key determinant of an individual school's credit profile.

Enrollment trends for individual schools are assessed within the context of national and state-specific industry and demographic trends. Between 1994 and 2004, national enrollment increased 21%. The pace of growth accelerated over the prior decade, and enrollment is projected to increase by an additional 12% to nearly 19.9 million by 2015 based on projections prepared by the U.S. Department Education's National Center for Education Statistics (NCES). Increased enrollment will come from traditional 18–24 year olds and from more students 25 years and older. Growth in attendance by women and non-white racial and ethnic populations is expected to drive overall growth. As of fall 2004, four-year public colleges and universities enrolled 39% of students, two-year public institutions enrolled 36% of the students, and private institutions enrolled 23% of college students. Fitch expects growth in public institutions to outpace growth in private institutions

Future demographic trends and the projected growth in the number of high school graduates are key determinants of future demand. According to the Western Interstate Commission on Higher Education (WICHE), the number of students projected to graduate from high school is to peak at 3.2 million in 2008–2009. The number of high school graduates is projected to moderate or decline in subsequent years until 2017–2018. The WICHE and NCES data show that growth will vary significantly by region — the South and the West are

February 5, 2007

projected to experience significant gains and offset declines in the Midwest and the Northeast. The number of high school graduates are projected to increase in about 20 states and decline in 30 states. The highest projected increase in high school graduates will occur in Arizona, Nevada, Florida, Georgia, North Carolina, New Jersey, Texas, Colorado, Utah, and California. States projected to experience the greatest decline in high school graduates include Wisconsin, Louisiana, Iowa, Minnesota, West Virginia, Maine, South Dakota, Vermont, Wyoming, and North Dakota.

According to the College Board, about 81% of resident students attend college in their state of residence. States with higher retention include Florida, California, Michigan, Alaska, Alabama, South Carolina, Utah, and North Carolina. States with more students attending college outside of their home state include Maryland, Maine, Connecticut, New Jersey, Vermont, and the District of Columbia. Competition for students is intensifying among colleges within and across state lines, between flagship public universities and top tier private institutions, and among second and third tier institutions. The growth of for-profit privates is another variable changing the higher education landscape.

Outlook

More than 17.3 million students are enrolled in 4,200 colleges and universities. Fitch believes that the projected growth in overall enrollment over the next decade is a stabilizing force for the sector. However, Fitch also believes that greater credit differentiation may result from varying regional and state-specific enrollment growth prospects, increasing competition within the sector, and the occurrence of event risks, such as the downturn in Michigan's automobile sector and Hurricane Katrina, which adds an element of uncertainty to projections.

While many institutions rated by Fitch have reported increases in student applications over the past few years, the most selective schools continue to maintain a relatively low acceptance rate while non-top tier institutions are accepting a higher percentage of applicants to maintain enrollment. Fitch believes that this trend is evidence of increased competition particularly for more well-qualified students. Over the long term, Fitch believes that this may contribute to a wider gap between successful institutions and those institutions that are not the most sought after or do not have important student funneling

relationships. Factors related to price, location, and student life will have a direct bearing on competition.

■ Tuition and Fees

According to the 2006 study on college pricing prepared by The College Board, fall 2006 average tuition and fees charged by four-year private colleges was \$22,218, the average price for four-year public colleges was \$5,836, and public two-year colleges charged an average \$2,272. Students attending public institutions located outside of their resident states pay a nonresident surcharge, which adds on average about \$4,000 to the published price for a four-year institution and approximately \$2,000 for two-year institutions.

While significant pricing differentials exist between public and private colleges and universities, the gap is closing. Over the past five years, four-year private institutions increased their tuition and fees by 28%, while four-year and two-year public institutions increased their prices by 55% and 41%, respectively. Steep increases at public universities were the direct result of cuts in or static state appropriations during fiscal years 2001–2004 and increased demand and cost pressures. Following two years of modest growth in state appropriations, early indications point to static or declining appropriations for the next one to two years.

The total price of attending college for full-time students includes tuition and fees, room and board, and other auxiliary expenditures. When factoring in these auxiliary charges, the average total cost of attendance for four-year private institutions rises to \$30,367, or about two and one-half times the average cost of attending a four-year public institution. Over the past decade, the annual rate of growth at four-year public institutions was 6.3% compared with 5.6% at four-year private institutions.

Average costs also vary by region. The majority of students attending four-year public schools are enrolled in institutions charging less than \$6,000 per year. According to The College Board's 2006 study on trends in college pricing, there is a wider range of tuition and fees for private schools. Private four-year institutions in New England, the middle states, and the West are on average more expensive than schools in the Midwest, the South, and the Southwest (which had the lowest tuition and fees). Four-year public institutions in New England, the middle states, the West, and the Midwest are 20%–30% more expensive than four-year public institutions in the South and the Southwest. The average charges for

two-year public colleges are highest in the middle states, New England, and the West. The regional variation is lowest for this type of institution.

Significant levels of financial aid from federal and state grants, private and institution sources (including endowments and restricted funds), tax benefits, and competitive discounting practices have contained the net price trend to date. According to The College Board's study on tuition discounting, the average discount rate for four-year private institutions has increased from 23.8% in fall 1994 to 33.5% in fall 2005, the most recent date for which data is available. For four-year public colleges and universities, the discount rate increased from 11.7% in fall 1994 to 15.4% for fall 2002. The discount rate moderated to 14.7% in fall 2004 as the average price increase declined. Available data for two-year public colleges reflect a discount rate of 12.5% for the 2003–2004 academic year, almost double the 1994 discount rate. Accordingly, discount rates vary significantly by institution and by type of institution.

The higher education sector has moved away from strictly need-based financial aid in an effort to shape its student body, and in many cases, grow enrollment. For four-year private institutions, gross price of attendance is reduced by about 30% on average. For four-year and two-year public colleges and universities, the average discount rate is 16% and 7%, respectively.

From a rating perspective, the discount ratio can be more complicated to interpret. A high ratio does not necessarily reveal reduced pricing flexibility if the discount is primarily for financial need and almost totally funded through external sources. In this scenario, it may be a source of financial strength.

Outlook

Approximately 75% of all students are enrolled in public colleges and universities. These institutions represent 40% of the number of institutions. While the majority of public institutions tend to be large, Fitch believes that the relative affordability of public institutions plays an important role in attracting students. Fitch expects tuition and fees to trend higher. However, due to the use of financial aid to limit net price, increases should be sustainable. Institutions with large endowments that are earmarked for scholarships should be able to effectively balance pricing and discounting decisions. However, institutions that are not top-tier or flagships in state university systems and private institutions that face increased competition are expected to have reduced pricing flexibility.

■ Debt Issuance

Fitch believes that most colleges and universities will continue to use debt to fund a portion of their ongoing capital needs. Colleges today report that they must offer better amenities and modern facilities to attract students. Such facilities include dining halls, health and wellness centers, academic buildings, student life centers, and residence halls. Providing facilities to meet student demands is crucial to remaining competitive.

Colleges and universities have often opted to issue debt to finance all or a portion of improvements to their facilities. As the capital markets have become increasingly accessible to institutions across the credit spectrum, the size and volume of college and university debt transactions has increased sharply over the past five years. According to *The Bond Buyer*, annual bond sales among colleges and universities (including refundings) grew from \$7.1 billion in 2002 to \$9.8 billion in 2006. Moreover, Fitch notes that many colleges in the 'BBB' category, which had historically relied upon traditional bank financings, are now securing their own bond rating for issued debt.

The additional debt issuance is reflected by an increase in the annual debt burden for schools. Fitch measures a school's debt burden by determining what level of annual unrestricted revenues that would be needed to cover maximum annual debt service (MADS). In 2001, for private universities rated in the 'BBB' category, approximately 4.9% of annual unrestricted revenues would be needed to service MADS. In 2006, the percentage had increased to 6.9%. Similar increases also were reflected in the 'A' and 'AA' categories.

Outlook

Fitch expects the debt issuance to continue to climb given the relatively low interest rate environment, ongoing capital needs, and an increasing desire to stay competitive in the student selection process. Although debt issuance is expected to increase, Fitch expects the debt burden for most rated colleges and universities to remain manageable due to an increase in revenues attributed to increasing tuition and fees, higher investment returns, and greater fundraising efforts.

■ Research Funding — National Institutes of Health

The majority of grant and contract funding colleges and universities receive is from the federal government. In particular, the National Institutes of Health (NIH) and

the National Science Foundation (NSF) are the two largest sources of federal funding for academic research. Funding from NIH far exceeds the level of funding from the NSF. In fiscal 2006, NSF funding was slightly less than \$6 billion, while NIH funding was slightly less than \$29 billion.

When the level of federal funding is a significant portion (greater than 10%) of the school's revenues, Fitch views the funding as a positive since the level of federal funding is not related to other revenues of the school. In addition, a significant level of research funding can have a positive impact on the school's reputation.

The NIH, which today represents 27 institutes and centers, was founded in 1938. Most colleges and universities receive grants from at least one of the five institutes with the largest budgets. For fiscal 2007, the total NIH budget is \$28.5 billion, the same amount as in the prior fiscal year. Approximately 52% of this amount is allocated to research project grants. The National Cancer Institute's budget represents 17% of the total. The next largest institute is the National Institute of Allergy and Infectious Disease, with 15% of the total. The next three largest institutes with regard to funding are the National Heart, Lung and Blood Institute, the National Institute of General Medicine Sciences, and the National Institute of Diabetes and Digestive and Kidney Disease, with funding representing 10.0%, 7.0%, and 6.5%, respectively, of the total NIH budget.

From fiscal years 1998–2003, the NIH budget doubled. In fiscal 1998, total NIH funding was \$13.6 billion. By fiscal 2003, total funding had reached \$27.1 billion. During this period, many colleges and universities expanded their research efforts by adding researchers and buildings to accommodate the growth in funding. Schools were very interested in expanding their request for funding since research contracts include a component that allows schools to recover a portion of the overhead cost in conducting research. This reimbursement component is known as indirect cost recovery and provides a funding source for financing research buildings. Specifically, the federal Office of Management and Budget (OMB) Circular A-21 allows depreciation and interest expense on debt for research facilities to be included in the computation of the indirect cost recovery rate.

While many schools have increased their efforts into soliciting federal funding, it appears that the premier research colleges and universities have remained at

the top in receiving the funding. For several years, the schools with the most in research expenditures have included Johns Hopkins University, University of Texas, University of Washington, University of Michigan, Stanford University, University of Pennsylvania, University of California, University of Illinois, Columbia University, University of Wisconsin, University of Colorado, Harvard University, Massachusetts Institute of Technology, University of Pittsburgh, Washington University, and the State University of New York System.

Fitch believes that schools that already have a significant level of federal funding are likely to maintain their funding due to existing grants and ongoing research; additionally, if the school already supports research, the ability to attract researchers and new research facilities is greater. In addition, the NIH has implemented a road map for biomedical research, which provides for more efficient and productive research through collaboration and interdisciplinary research. Several schools are now working with other schools to meet NIH's goals.

Outlook

Fitch believes that the outlook for research funding is positive for schools that already are established as premier research institutions. Schools that are not consistently in the top percentile of research rankings, but have the desire to increase their level of federal research funding will face challenges. After five years of double-digit increases in the NIH annual budgets, annual funding increases since 2003 have ranged from approximately 0% to 3%. Fitch expects the NIH budgets to remain flat in the future. Fitch also notes that federal funds that are earmarked for special projects, rather than funding that is included in the budgets of NIH or NSF, are more vulnerable to reductions. The slight growth of federal funds over the past several years provides limited opportunities for schools wishing to expand their research efforts. Fitch believes that the challenge for most schools will be to retain their researchers. Researchers that are able to secure large grants are a commodity since the grant is usually to the researcher; as a result, if the researcher leaves the school, the grant follows the researcher to the next school. Compensation, benefits, and facilities are all factors that can enhance a school's ability to retain faculty, and these factors can be expensive.

■ **Greater Scrutiny of the Not-For-Profit Sector**

Over the past few years, several allegations of inappropriate spending of funds by senior level college and university administrators have been reported by the media. Such allegations include the spending of donations or endowments contrary to donor stipulations, using tax-exempt bond proceeds for activities considered to be private use, and elaborate spending by college leaders for travel, home furnishings, and entertainment. The allegations can have a negative impact on fundraising and employee moral. If the allegations are proven to be true, the inappropriate use of funds can result in a weakened financial position for the college.

At the same time, as more allegations are being reported, colleges are doing more to provide greater accountability. Fitch believes that many of the improved practices regarding accountability are a result of the Sarbanes-Oxley Act of 2002 (SOX), which was signed into law on July 30, 2003. Compliance with SOX is not required by colleges and universities, and many sections of the act would not be applicable to higher education. However, Fitch has observed the voluntary adoption by most colleges of the SOX principles, including those involving periodic reviews for compliance with the code of ethics, establishing conflict of interest policies, and assessing internal controls. Fitch views the adoption of these principles as an indication of the quality of management. While schools that utilize best management practices are not guaranteed financial success, Fitch believes that they generally are able to identify and address financial disruptions in a timely manner. Fitch published the criteria report, "Evaluating Internal Controls Related to Debt for Colleges and Universities," on Jan. 2, 2007, which emphasizes the importance that Fitch places on a college's ability to continually review its internal controls.

Outlook

With the increased reporting of allegations of fraud, abuses, and misuse of monies in the not-for-profit sector, Fitch expects more scrutiny of the sector. For higher education, Fitch believes that donors will be more specific in their documentation when conveying gifts, external audit companies will apply more rigorous testing and seek greater disclosure in the financial statements, the IRS will be more active in verifying the use of tax-exempt bond proceeds, and investors will request more disclosure. In general,

Fitch believes that most colleges are implementing policies and practices that increase the transparency and accountability of the school. However, Fitch believes that regardless of how adequate the policies and practices are, negative publicity regarding the misuse of funds is almost always a concern from a rating agency perspective.

■ **Reauthorization of the Higher Education Act**

The HEA was enacted in 1965 and currently requires reauthorization every six years. HEA was originally scheduled to expire Sept. 30, 2004, but has been extended several times. The last extension occurred in October 2006 and expires June 2007.

The extension gives the Department of Education the legal authority to maintain the various federal programs, including the Pell Grant. Since HEA's inception in 1965, it has been responsible for increases in federal money to colleges and universities and scholarships and low-interest loans for students. It also established the National Teachers Corps.

The importance of federal financial aid programs to both students and schools is critical. From a rating perspective, schools with a significant number of students that rely on federal financial aid could be negatively affected if federal funds are reduced. Over the past couple of years, proposals regarding reauthorization of HEA have included affordability and accountability, specifically capping tuition increases, retention rates, graduation rates, and successful employment after graduation.

Outlook

Fitch predicts that discussions regarding HEA's reauthorization or additional extensions will continue to focus on affordability and accountability. Regarding affordability, on Jan. 17, 2007, the U.S. House of Representatives passed a bill that would cut the interest rates on federal subsidized Stafford loans made to undergraduates from 6.8% to 3.4%. The U.S. Senate is expected to consider a similar bill in February. If the legislation were to become law, it will be phased in over a five-year period and would apply only to new loans taken by undergraduates at colleges and universities. According to the National Debt Project (www.projectonstudentdebt.org), a nonprofit organization that works to educate the public on the use and implications of student debt, the lower interest rate is expected to help an estimated 5.5 million students.

Fitch would view negatively any proposal that limits a college's financial flexibility to adjust to changing conditions. For example, any restrictions on tuition rate increases would reduce the alternative funding options to colleges when state funding is adjusted downward,

as was the case for most colleges in fiscal years 2002–2003. The elimination of a college's ability to increase one revenue source to offset the decline in another would likely impair the financial condition of the college and have a negative impact on the rating.

Copyright © 2007 by Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004.

Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. All of the information contained herein is based on information obtained from issuers, other obligors, underwriters, and other sources which Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of any such information. As a result, the information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed, suspended, or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from USD1,000 to USD750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from USD10,000 to USD1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.