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# The Not-For-Profit Higher Education Sector's Outlook Remains Mixed Despite A Gradual Recovery

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# The Not-For-Profit Higher Education Sector's Outlook Remains Mixed Despite A Gradual Recovery

**Overview**

- While the short-term rating outlook is mixed, the sector's long-term credit profile is stable.
- Operating results for 2011 will likely be uneven despite the economy's recovery.
- We expect an equal number of upgrades and downgrades in 2011.
- Key challenges include growing competition, state funding cuts, higher expenses and liabilities and continued tuition and scholarship pressures.

The outlook remains mixed for the not-for-profit U.S. higher education sector in fiscal 2011, according to Standard & Poor's Ratings Services. We believe that operating results and demand will likely be uneven, and institutions with high debt and limited liquidity could experience severe stress. Still, we believe that the long-term credit profile of many rated institutions remains stable, and that many institutions will perform favorably over the next year.

As a whole, Standard & Poor's does not expect public universities to underperform private universities despite likely cuts in state funding. However, we may see some public colleges and universities consider consolidation or consider mergers with their peers.

We believe that the credit performance of not-for-profit colleges and universities generally remains tied to an institution's financial resources, demand, and management, rather than industry risk. Therefore, we expect overall credit trends to be mixed for the balance of 2011, with small pockets of distress and larger pockets of strength.

In 2010, we raised 33 debt or credit ratings on higher education institutions, and lowered five. We began 2011 with outlooks other than stable for 51 institutions, indicating a possibility that more ratings could change in 2011. In our view, significant long-term credit risks remain, and some institutions that struggled through the recent recession may find that they have fewer resources left to position themselves in an improving market.

The picture for the fiscal year ending from May to August 2011 is slightly more stable compared with that of fiscal years 2009 and 2010. We have observed that many rated not-for-profit colleges and universities lost financial ground in the recent recession because of investment losses and general economic weakness, and the recovery that followed has been a slow one. Fixed-income and equity markets did bounce back by the end of fiscal 2010, with the National Association of College and University Business Officers (NACUBO) reporting an average return of 11.9% (net of fees and expenses) for the year ended June 30, 2010, compared with a negative 18.7% return a year earlier. In response to reduced economic circumstances, we saw most institutions cut expenses, decreased and restructured their debt, and shored up liquidity to achieve a more-stable credit profile this fiscal year. Notwithstanding these actions, we believe that many colleges and universities will continue to face difficulties in the current and next fiscal year.

## Competition Is Likely To Intensify

One of the sector's key issues, in our view, is coping with greater competition. Not only do not-for-profit institutions compete with for-profit providers, but we expect the competition between public and private universities to accelerate as public universities respond to funding cuts for fiscal 2011 and 2012. We have also seen students choose lower-cost community colleges instead of four-year institutions. We expect many public universities to step up their recruiting efforts both in and out of their states. However, with continued and sometimes substantial increases in out-of-state tuition, we expect that the competitive advantage that public universities have with respect to cost, especially for these students, will likely continue to diminish over the next two or three years. It is our view that competitive pressures will intensify.

## State Funding Cuts Continue Through Fiscal 2012

As states struggle with budget deficits, we believe that funding cuts to public universities are likely to continue at least through fiscal 2012. In past economic cycles, we found that funding for public universities lagged behind a state's financial recovery, and we expect history to repeat itself. We anticipate delays or even cuts in already-committed state funding for the remainder of fiscal 2011.

Most public universities made significant budget cuts for fiscal 2009 and 2010. They reduced administrative expenses, cut the number of courses, eliminated noncore programs, lowered future enrollment levels, cut merit increases and cost-of-living adjustments, and even furloughed faculty and staff. Sometimes they laid off tenured academic staff and hired adjunct teachers to fill new positions. Some public institutions began to prepare multiyear forecasts of their results for fiscal 2011, 2012, and beyond.

Many public colleges and universities were able to raise tuition and fees to close their budget gaps for fiscal 2010 and 2011 despite some resistance from policymakers in their states. We believe that funding pressures could lead to new financial arrangements between states and public universities. Some public universities are offering these new arrangements, including reduced funding, in exchange for greater flexibility. In our view, larger flagship institutions with greater revenue diversity, stable enrollment, and strong fundraising cultures would benefit the most from these arrangements. Overall, the percentage of state support in public university budgets continues to drop, and we believe that trend is likely to continue into fiscal 2012.

## Exposure To Banking-Sector Risk Remains

One of the risks we see for fiscal 2011 is the industry's increasing exposure to banking-sector risk because more and more institutions are choosing bank bonds to replace their expiring letters of credit. Although this type of debt does not generally allow frequent investor puts or require external liquidity facilities to be in place, we have seen many bank bond documents include the possibility of a very short repayment period should the bank accelerate the debt due to an event of default. Our view is that these events of default, which include a wide range of covenant violations, could ultimately also affect the ratings on all debt issued by an institution.

## Expenses And Liabilities Are Rising

Another risk we see is the rising cost of doing business partly because of higher prices for services such as insurance and possible increases in commodity and energy prices. Many institutions did not raise wages in fiscal 2010 and 2011, and some deferred contributions to retirement plans. Many institutions began to restore these costs in their fiscal 2011 budgets, but others are deferring reinstatement until fiscal 2012. We believe that the combination of rising prices and reinstatement of employee compensation could lead to additional pressure on fiscal 2012's operating income statement.

In the long term, however, we believe the failure to keep up faculty salaries and benefits could make some institutions less competitive in attracting strong staff as well as research funds. Also, the sector faces rising other postemployment benefit liabilities. Many institutions were able to defer their contributions to defined benefit pension plans for many years, but recent investment losses mean that some institutions are again facing significant unfunded liabilities. Colleges and universities, especially private ones, which only have defined contribution plans, do not face significant liabilities or annually required contributions.

We saw the cost of capital rise sharply in the past two years, and institutions that benefited from low interest rates for many years will need to incorporate higher interest rates in their budgets for fiscal 2012. We think that variable-rate debt and interest-rate swaps could become more attractive, depending on bank pricing and availability.

## Investment Losses Still Sting

An ongoing problem for colleges and universities is the real loss of wealth between 2008 and 2010, notwithstanding the recent upturn in fixed-income and equity markets. We saw investment returns begin to weaken in fiscal 2008, but the greatest impact on endowed institutions came in fiscal 2009 (especially for those with a June 30 fiscal year-end) when endowment market values dropped by as much as 25%-30%. NACUBO's recent survey of the sector's investment performance for the 12 months ended June 30, 2010, showed a rebound to an average return of 11.9% (net of all fees and expenses), from fiscal 2009's average of negative 18.7%. The largest endowments, which tend to be those with a greater percentage of assets allocated to private equity, achieved an average cumulative return of negative 3.5% in the three years ended June 30, 2010. As a result, despite the rebound in fiscal 2010, many endowments still lost ground.

## Enrollment, Demand, And Affordability Are Key

Demand for rated colleges and universities was favorable in fiscal 2010 and we expect the same trend in 2011. This is because, in general, more students seek admission than the typical rated college or university can admit. However, some institutions are still struggling to attain their enrollment targets, and some are scaling back their numbers. Some private colleges are reducing targeted class sizes, while others are expanding class size to achieve economic and financial equilibrium. We see transfer strategies as becoming more important and even crucial for many public universities, which are enrolling transfer classes in greater numbers than before, or in some cases in greater numbers than traditional first-year students.

Public universities still have a price advantage over their private counterparts. The College Board reported that the average four-year public college tuition was $7,605 for the 2010-2011 academic year, compared with $27,293 at



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private colleges and universities. We believe that demand for the most selective institutions will likely remain stable, if not improve, for 2011 and 2012, while less-selective institutions may struggle amid intensifying competition.

## The Long-Term Credit Profile Is Stable

While we view the short-term rating outlook for the U.S. higher education sector as mixed, the long-term credit profile remains stable in our view. Despite many challenges, many of which we expect will continue into fiscal 2012 in the form of reduced balanced sheets and financial resources, we believe that the long-term credit profile of many rated institutions remains stable. Credit quality and rating changes for the remainder of calendar 2011 will likely be mixed. We believe there could be an equal number of upgrades and downgrades. We will continue to evaluate underperformance and overperformance as a possible indicator of economic resilience. Those institutions that outperform their peers in terms of operating results and growth of financial resources could be candidates for positive rating changes. As a result, we expect the number of outlook changes will increase in the next several years.

The recession also created greater demand for certain academic programs and degrees. For instance, we've seen a drop in workforce development programs as both financially strapped employers and employees stopped on-the-job training requirements. Elsewhere, we have seen an increase in health-related programs such as pharmacy schools, and a jump in graduate school attendance. Distance learning is also becoming more popular.

The continuing role and support of the federal government is uncertain. Although funds from the American Recovery and Reinvestment Act of 2009 have been spent, the act also provided for an increase in the Pell Grant program (which provides need-based grants to low-income students to promote access to higher education), with the maximum award rising to $5,500 for the 2010-2011 academic year, and, unless it is changed by Congress, increasing in pace with inflation thereafter. Health care reform is likely to affect those institutions with academic medical centers. However, we do not expect to see changes in the health care delivery system until 2014, even though institutions are trying to prepare for the uncertainties associated with reimbursement and delivery.



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### How Colleges And Universities Coped With The Recession

Nearly all U.S. colleges and universities adjusted to the recent recession. For some, the economic downturn presented an opportunity to reduce excessive costs and reallocate strategic resources. At the same time, many responded with sharp increases in financial aid for fiscal 2009 and 2010, and stepped up tuition discounting. Private colleges and universities modestly increased their student charges. Some even kept charges unchanged or implemented increases that were the lowest in decades.

Many public colleges and universities substantially increased their student charges to offset cuts in state financial support -- when political pressure or state statutes didn't preclude it. We saw many changes in recruiting and marketing, beginning in fiscal 2009, for both public and private institutions. We saw more institutions hire consultants to help increase the size and quality of their applicant pools, as well as to help them restructure financial aid programs and policies. Across the sector, management focused on boosting net tuition income. Some schools pulled back on merit aid, and most increased financial aid for need-based reasons. For many, the absolute size of financial aid budgets rose in response to the recession. Many admitted more international students who pay full tuition rates, with South Korea and China continuing to be popular countries for recruiting.

As a result of endowment losses, we saw many institutions scramble to make expense cuts, beginning in fiscal 2009, and we also noted a significant correlation between the amount of reductions and the size of endowments. Expense cuts were greater at institutions with larger endowments. Many institutions reported reductions in force and layoffs--through attrition, positions held vacant, or furloughs--for the first time in many years. Others froze the salaries of faculty and staff, while some allowed only small increases in salaries of lower-paid employees. We believe many institutions did not realize the full budget impact of the expense cuts until fiscal 2010 and 2011, even though the cuts often began in fiscal 2009.

Although the expense reductions were often sizable, operating revenues did continue to grow for most private institutions in fiscal 2010, and as a result, the bottom-line operating performance improved. We see public colleges and universities, on the other hand, have a tougher time responding to cuts for fiscal 2011, even with the help of stimulus funds, because revenue didn't grow as rapidly. As a result, many institutions failed to produce positive results based on generally accepted accounting principles (which can include sizable depreciation and pension expenses) for fiscal 2010, and we expect similar results for 2011.

## A focus on increasing liquidity

We understand that many institutions, both public and private, have delayed capital projects, deferred the use of debt, and proceeded with debt only where projects were critical or had already begun. Others changed their stance by requiring new projects to be financed with gifts rather than debt. Finally, we have seen some institutions reconsider their approach to liquidity. They repositioned their investment portfolios, made slight changes in asset allocation, redeemed hedge funds, sold illiquid investments in secondary markets, and contracted for new bank lines or increased the size of existing bank lines.

We believe that the steps that many colleges and universities took to increase their cash holdings have somewhat mitigated liquidity risks and reflect the realization that adequate working capital is an important asset. Most colleges and universities did not significantly adjust their asset allocation strategies during this period, choosing to remain invested in private equity and staying with alternative market strategies. However, many stopped making new commitments to private equity managers, and a great number took active steps to reduce their unfunded commitments or future capital calls. Toward the end of the recession, we saw that distributions from less-liquid investment strategies began to equal the amount of capital call requirements. We also saw that as colleges' and universities' investment liquidity concerns began to ease, a number of institutions started to deploy their cash holdings into less-liquid and potentially higher-yielding investments.

## Planning for the future

We believe that the sector responded fairly quickly to the recession and general economic pressure. However, now that the economy is improving, in our view, it is uncertain whether institutions will continue to think about developing new business models that are not as dependent on gifts and investment income or how to plan for a future that could include a greater degree of inflation, investor aversion to risk, and banking-sector risk. The amount of debt and leverage in the sector is still high, in our view, given the increase in debt over the past 10 years. We believe that rising interest rates could present a budget challenge for institutions with variable-rate

debt. On the demand side, we think a change in demographics could become more of an issue in certain regions, and affordability remains a pressing concern for all institutions. Increasing enrollment does not necessarily plug any budget gaps for public universities. Some public universities respond to cuts in state funding with enrollment caps, and reduced funding often means reduced higher education enrollment capacity, as has been the case for California and Florida.

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