The outlook expresses Moody’s expectations for the fundamental credit conditions in the industry over the next 12 to 18 months and does not speak to the expected balance of rating changes during this timeframe.

Summary Opinion

For 2011, we have revised our outlook to stable from negative for diversified market-leading colleges and universities in the public and private sectors in the United States. These market leaders operate multiple revenue-generating business lines, insulating them against declines in any one revenue source. They have global reputations and attract strong student demand, philanthropic support, and research funding even during weak economic periods. This segment of the sector is comprised of a minority of rated colleges and universities that are generally rated in the Aaa and Aa categories. For the large majority of rated universities, we maintain a negative outlook. This larger segment is comprised of less diversified private and public universities that are most directly challenged by tuition pricing and state funding threats. This group typically has a more regional student draw, weaker pricing power, and less diversified revenues that are largely derived from a combination of student charges and state appropriations.

The most critical credit factors driving our outlook for U.S. higher education in 2011 are:

1. Weakened prospect for net tuition revenue growth causing market shifts favoring both lowest cost and highest reputation competitors

2. Differing degrees of pressure on non-tuition revenues placing a premium on business line diversity

3. Need for stronger management of operating costs, balance sheet risks and capital plans
We expect that aggregate demand for higher education will remain strong over the long-term and continue to grow globally, with colleges and universities providing positive economic benefits for their communities and states. The large majority of our rated higher education institutions have weathered the economic crisis quite well, demonstrating agility under stressful circumstances. However, many colleges and universities are facing significant tuition resistance and weak fundraising results for the first time in recent decades. Longer-term fundamental economic questions remain about the viability of many colleges, especially smaller ones. The reduced prospect for long-term net tuition revenue growth for both private and public universities, funding pressure on donors and state governments, and the need for careful management of debt structure and liquidity are critical credit factors driving our 2011 outlook. We expect that colleges and universities that benefit from diversified business lines, distinct brand name recognition, and strong management and governance practices will maintain the strongest credit profiles in coming years.

Mixed Outlook for U.S. Higher Education in 2011

For 2011, we have revised the outlook to stable from negative for a small portion of the U.S. higher education sector. This segment of diversified market leaders tends to be rated in the Aaa and Aa categories and is less reliant on student charges and state appropriations, with research, fundraising, endowment spending, and patient care often representing important components of core operations. Examples include large public university systems, flagship and land grant universities, leading private research universities, and wealthy highly selective liberal arts colleges. For some of these universities, patient-care is a significant component of operating revenue, with revenue generated by hospital ownership or affiliations and faculty practice plans. Although the not-for-profit health care sector has a negative credit outlook, most of the universities with sizeable health care exposure have relationships with large and thriving academic medical centers which are themselves far more diversified than community hospitals. These hospitals typically have a diverse payer mix, national reputations with multiple clinical specialties, healthy philanthropic support, and significant research activity.

Characteristics Associated with a Stable Outlook

» Market leaders with top-ranked academic programs and global reputations supporting pricing power

» Multiple business lines, typically with no one source accounting for more than 50% of revenue

» Consistently strong demand from top quality students and faculty

» Generous philanthropic support, low dependence on state funding, and diversified research funding

» Strong balance sheet providing good support for debt and operations as well as ample liquidity

We maintain a negative outlook for both public and private universities which have less diverse operations and more revenue concentration. The less selective private colleges and universities that are highly dependent on student charges will be challenged in this economic environment to grow net tuition per student as they face heightened competition from lower cost higher education alternatives.
Public universities that are still highly dependent on state funding also face negative credit conditions. They tend to have a local or regional student draw, very limited financial reserves, and must focus heavily on more efficient operations as state funding declines across much of the nation due to the conclusion of federal stimulus funding in 2011. Collectively, these colleges and universities are typically rated in the A category and below and include smaller regional, less selective standalone colleges and universities, with student charges and/or state appropriations comprising the bulk of operating revenue.

Characteristics Associated with a Negative Outlook

» Moderately selective to non-selective institutions with a more regional student draw
» Moderate to very weak pricing power and more limited ability to grow net tuition
» Less diversified business lines with heavy reliance on student charges and/or state appropriations often accounting for upwards of 60% of revenues
» Small, if any, fundraising or research enterprises
» Modest endowments or limited liquidity providing little support for operating budget and debt
» Typically small or medium-sized enrollments and lack of economies of scale
» Weakest colleges prone to consolidation, merger, acquisition, and even closing over the longer term if macroeconomic conditions do not improve

Strong Overall Demand for U.S. Higher Education Offset by Near- and Long-Term Key Credit Challenges

We expect that demand for higher education will remain robust over the long-term and continue to expand globally, but the boom period that characterized demand in the sector since the mid-1990s has ended. In light of ongoing economic uncertainty and related anxiety, universities are questioning the sustainability of their near- and long-range financial forecasts. Since the beginning of the Great Recession, the large majority of rated higher education institutions have made difficult decisions to improve operational efficiency—often disrupting capital plans and reducing staffing levels that had been built up over many years. This unheralded ability of colleges and universities to adjust to tough economic conditions is highlighted by the relative rating stability during 2008 through 2010, with rating affirmations comprising the large majority of rating activity during the past three years.

Looking ahead, it is also clear that the easiest efficiency measures have already been taken, and further adjustments will be more difficult to implement. While almost all institutions are affected by these challenges to a certain extent, we believe that some are far better positioned than others to respond, which is why we have a mixed outlook for 2011.
Negative Outlook for Independent K-12 School and Other Not-for-Profit Sectors

Both the independent K-12 school and the diversified not-for-profit organization sectors share some credit characteristics with higher education. To varying degrees, many of these debt issuers rely on philanthropy, endowment earnings, government funding, student tuition, or research grants. During fall 2010, we published updated median reports for the independent K-12 sector and the diverse Not-for-Profit sector (excluding health care and higher education borrowers), comprised of cultural institutions, research organizations, service/advocacy entities, philanthropic foundations, and others.

For 2011, we maintain a negative outlook for these two sectors. We expect that the private K-12 schools will face many of the same challenges as the higher education sector, most notably tuition pricing risk, competition from lower cost options, and pressure on philanthropy. Although the unique risks of the diverse not-for-profits will vary by sub-sector, most will be challenged to continue to grow admission, membership, and/or gift and grant revenue. Those that are heavily endowment-dependent will be challenged to adjust their budgets to incorporate reduced endowment draws. For the most recent medians data, refer to “Independent K-12 School Medians for Fiscal Year 2009” (November 2010) and “U.S. Not-for-Profit Organization Medians Present Mixed Picture” (December 2010).

Critical Credit Factor #1: Weakened Prospect for Net Tuition Revenue Growth Causing Market Shifts Favoring both Lowest-Cost and Highest Reputation Competitors

We expect that long-term demand for higher education will remain strong despite weakened household wealth, higher unemployment and more discerning student demand favoring both low-cost as well as high-reputation universities. Our long-term view is supported by the demonstrated economic value of a postsecondary education degree, demographic forecasts for the projected number of high school graduates growing over the next decade, and strong international demand for U.S. universities. With the unemployment rate not projected to decline substantially in the near-term, data showing the unemployment rate by educational attainment supports the argument that post-secondary education remains a worthwhile investment. Figure 1 highlights not only the consistently higher unemployment rate in the U.S. for those without a college degree, but also the steeper increase in the unemployment rate for that segment of the population over the past three years.

FIGURE 1
Return on Investment: Slower growth of unemployment rate for college graduates

<Graph showing unemployment rate trends for different educational attainment levels from 1992 to 2010.>

Source: U.S. Bureau of Labor Statistics
Furthermore, the Obama administration is focused on significantly increasing the U.S. higher education participation and graduation rates by 2020, including growth of non-traditional age and part-time student populations. Although we expect that overall demand for higher education will remain strong, we are already beginning to see clear trends of shifting demand across the sector, driven largely by price sensitivity, a more diverse student population, a changing workforce with evolving educational prerequisites, and the development of new educational delivery formats, including rapid growth of online education and distance learning models.

Despite strong application volume and enrollment stability across the sector through fall 2010, pressure on net tuition revenue growth is a key credit challenge, particularly for those facing significant competition from lower cost alternatives or political and public pressure to limit tuition increases and growth of student debt. Families, increasingly sensitive to their own financial pressures, are carefully evaluating available financial aid packages, student loan options, and the predictability of future tuition increases in making decisions as educated consumers. We believe that institutions which can clearly demonstrate the value of their product in the market and have the operational flexibility and motivation to adjust, including revenue enhancement and expense containment, will be best positioned to succeed.

Lagged Impact of Declines in Family Home Equity and Net Worth on Tuition Growth

The sharp decline in household net worth, including home equity, over the past three years is a key driver for increased price sensitivity in making higher education selection decisions. As demonstrated in the chart below, home equity values remain depressed, and Moody’s Analytics projects prolonged weakness in the housing market, with home equity levels not projected to begin growing until 2012, but likely remaining well below peak levels for a decade or more. This sustained decline of home values will continue to impact the higher education sector for years to come by preventing some families from using their homes as collateral to borrow to cover the rising cost of attending college. In addition to relying on scholarships, accumulated savings, and annual personal income, many families utilize home equity loans and lines of credit in order to pay for college tuition.

Despite depressed home values and the low probability that peak levels will be recovered even over the next decade, overall family net worth has resumed growth from its most depressed levels of 2009. This is largely a result of recent positive performance of the stock market. Signs of growth in personal
investment portfolios have relieved some near-term anxiety. After sharp stock market declines in 2001 and 2002, resumed growth of family net worth in 2003-2007 supported robust growth of net tuition per student. Figure 3 displays private university median growth of net tuition per student in 2005-2008, over 5% annually. There is a logical relationship between household net worth, student demand, and tuition pricing for private colleges, in particular, although the effects are lagged. Private higher education for many families is a preferred investment, but also one subject to changes in financial net worth. The sharp decline in family net worth in 2008 has continued to trigger decelerated growth of net tuition revenue.

Increased price sensitivity has required both private and public universities to re-evaluate multi-year tuition increase assumptions and evaluate the potential price “ceiling” for different types of institutions and degrees. Ongoing federal scrutiny, public debate, and household resistance to an increasing cost of higher education are not expected to subside near-term.

As highlighted in our recently released tuition and enrollment survey of rated colleges and universities, the large majority of survey respondents reported growth of net tuition revenue in FY 2010 as well as a projection for further growth in FY 2011. However, 15% of private university survey respondents in this year’s survey reported declining net tuition revenue in FY 2010, much higher than the roughly 3% to 5% that annually experienced declines prior to 2009. For public university respondents, net tuition growth was strong in FY 2010 (median increase of 11%), but this pace of growth is not expected to be maintained due to political pressures to limit both tuition increases and out-of-state student enrollment.

Premier Private Institutions Benefit from Robust Demand and Pricing Power
We believe that the most selective, highest-rated private institutions (broadly, but not exclusively, Aaa and Aa-rated) will maintain the student demand and pricing power to be able to grow tuition at the fastest rates, should they choose to do so. Generally, these institutions include the Ivy League and other globally reputable research institutions, top-tier liberal arts colleges, and other highly selective institutions which draw students nationally and internationally. Although some have seen marginal shifts in application volume, their student demand remains remarkably strong and is likely understated.

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1 “Tuition Challenges Continue for Many U.S. Universities, but Majority Forecast Growth,” (December 2010)
since many academically strong students may not apply due to the low probability of being admitted. In fact, some have chosen to expand their student enrollment modestly in order to generate additional net tuition revenue without jeopardizing student quality, selectivity metrics, or the on-campus student experience.

Despite their inherent market strength, many colleges and universities in this segment are choosing not to maximize their pricing power by admitting more qualified full-pay students. Rather, some are choosing to lessen the growth of, or even accept an absolute decrease in, net tuition per student due to their commitment to admit top students regardless of income. These universities have the largest endowments within the sector and many are choosing to expand financial aid budgets and attract a more diverse student body, creating an increased need for financial aid. This willingness to shape a more socioeconomically diverse enrollment by using more financial aid reflects their not-for-profit mission and is more voluntary than driven by economic market forces per se. Our 2010 tuition survey highlights this trend, with private college and university respondents rated A1 and above projecting a median 2.7% increase in net tuition revenue in FY 2011. In contrast, private university survey respondents rated below A1 project a stronger median 4.8% net tuition increase in FY 2011.

Although we expect a slower pace of net tuition revenue growth across the sector compared to earlier years, our 2010 enrollment and tuition survey revealed more optimism for this year’s respondents compared to last year. Figure 4 highlights the higher share of private universities that are estimating a decline in net tuition revenue in FY 2010 and 2011 compared to actual results for prior years.

**FIGURE 4**

*Increased Pressure on Net Tuition Revenue Growth*

![Graph showing increased pressure on net tuition revenue growth.]

Source: Moody’s 2010 Survey of U.S. Higher Education

**Most Private Institutions Face Increased Tuition Pressure and Intense Competition from Publics, but Can Thrive with Strong Leadership**

We remain cautious about the long-term prospects for enrollment stability and net tuition revenue growth for the lower-rated private colleges (many rated in A and Baa categories) which often have smaller enrollments, more regional student draw, thinner endowments supporting financial aid initiatives, and significant competition from lower-priced public higher education alternatives. These institutions are the most heavily dependent on student charges, with tuition and auxiliary revenues representing a median 74% of operating revenue of A-rated privates and nearly 85% of operating revenue of Baa-rated privates in FY 2009. Median net tuition per student for this portion of the sector has grown at a rapid rate in recent years and is quite high, especially when compared to public options.
Our rated portfolio includes a small proportion of the weakest private colleges that face heightened risk in the coming years. Outside of our rated portfolio, there are hundreds of unrated small private colleges, with very thin financial reserves and enrollment under 1,000 students. In recent years, there has been a small increase in these challenged institutions going out of business or being acquired by larger organizations, including for-profit entities. Over the coming decade, it is likely that this trend will accelerate, barring a return to robust macroeconomic conditions.

Although total application volume in the sector remains healthy, allowing private colleges and universities to become increasingly selective, we believe the selectivity improvement is partly artificial, and masks the underlying challenges, because the improved selectivity principally reflects the trend of students applying to a larger number of colleges. Yield rates (matriculation) at private colleges and universities have declined over the past five years, highlighting increased competition. In fact, nearly 60% of private institutions rated below A1 have matriculation rates lower than 20%. This segment of the market is increasingly competing with lower-cost public colleges and universities and feeling the most pressure to limit tuition increases and expand financial aid budgets.

We expect the most credit pressure for those private colleges and universities which attract students largely from one state and are located in regions where the regional or state economy is particularly challenged, home values have declined steeply, and/or the number of high school graduates is projected to flatten or decline. As some public universities have invested in the development of honors colleges, more attractive academic and auxiliary facilities, and other amenities, these private colleges will be most challenged to demonstrate their market niche and the value of their product in order to attract high quality students.

Regardless of the macro threats to small private colleges, many will still thrive under more difficult market conditions because of strong management and governance. These organizations tend to be more nimble and entrepreneurial than is generally realized, and some are adapting new technology, entering new partnerships, expanding into new markets, and encouraging faculty to be more productive. Typically, successful private colleges are led by diversified and experienced management teams and effective boards that provide strong guidance and oversight. For more discussion of governance and management, see our recent comment, “Governance and Management: The Underpinning of University Credit Ratings” published in November 2010.

Ongoing Scrutiny of For-Profit Higher Education Could Foreshadow Greater Oversight for All

Increased federal scrutiny of for-profit universities is tightly aligned with very rapid enrollment and revenue growth in this sector and high reliance on federal financial aid as a revenue source. This increased political scrutiny and media coverage of the for-profit sector may spill over to the traditional not-for-profit colleges and universities. We anticipate longer-term growth of political and regulatory interest in higher education tuition rates, rising student debt, and tax-favored endowments. We expect policy debate to intensify on these topics and anticipate a growing demand for increased transparency and disclosure and measurement of educational outcomes, by a variety of stakeholders. For further discussion on this topic, please refer to “Scrutiny of For-Profit Universities May Signal Opportunity for Some Traditional Colleges, but Higher Regulatory Costs for All” (August 2010).
Public Universities: Mixed Results as Leeway in Tuition Setting and Out-of-State Recruitment Varies by State

While lower-priced public colleges and universities may have the student demand and competitive pricing to increase tuition, some states have tied the hands of public higher education institutions by imposing limitations on annual tuition increases and recruitment of higher paying students from outside of the state, particularly for the undergraduate student body. Most states allow more leeway in recruitment and tuition-setting for graduate and professional programs, compared to undergraduate programs. And, while public universities have benefited from strong student demand and robust enrollment growth in an era of increased price sensitivity, public universities are increasingly engaged in heavy competition. For example, community colleges have witnessed explosive enrollment growth, in some cases siphoning students away from the four-year public institutions for the first two years of college. Public universities also face growing competition from the for-profit sector, which tends to attract a more diverse student body and offers more flexible course schedules to accommodate adult and working students.

As described above, results of our recently released tuition survey highlight healthy net tuition revenue growth at most public universities in FY 2010. Public universities have especially benefited from a sharp increase in Pell awards, with the American Recovery and Reinvestment Act (ARRA) providing $17.1 billion in funding for Pell Grants (Federal grants of need-based aid for low-income students). In 2010, Pell Grant expenditures increased 58% over 2009 and the number of Pell Grant recipients spiked 26% in just one year. However, uncertainty remains about future financing for the Pell Grant program and the possibility of future pressure on the maximum award amount, given competing priorities within the federal budget and a new Congress likely more focused on spending cuts.

Tuition pricing flexibility has become a more recent challenge for many public universities. Public university tuition survey respondents foreshadow signs of pessimism about the pace of future tuition growth. In fact, approximately 19% of public university survey respondents project flat to declining net tuition revenue in FY 2011. Net tuition revenue growth is limited by both internal and external constraints, including a mission of accessibility and affordability, an increasingly diverse student body including more students who are the first in their families to attend college, and growing demand for financial aid support.

In recent years, some states have directly imposed caps on tuition increases, either through permanent statutory limitations on tuition increases or, in some cases, temporary compromises for low tuition increases at the public universities in exchange for replacement dollars from the state. However, some states are re-evaluating or lifting these limitations in certain circumstances, in light of declining state appropriations. Some notable examples include Florida and Louisiana, which had tight constraints on tuition setting in the past and recently have allowed increased tuition setting flexibility. A reform panel in New Jersey recently recommended that tuition caps on public universities, imposed last year, be lifted to allow more operating flexibility for the universities. In other cases, tuition-setting flexibility has been harder to win. In early 2010, New York’s governor proposed a change that would have increased tuition setting flexibility at the State University of New York and the City University of New York and would have removed tuition-setting from the state’s budget process. The act was not passed. Further, university systems are trying to better define the targeted markets across their campuses and price themselves accordingly. For instance, the University of Missouri System is considering decoupling base undergraduate tuition for the first time across its multiple campuses in fall 2011 in order to respond to different student markets served.

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2 “Trends in Student Aid 2010,” College Board
3 “New York Proposal Would Deregulate Tuition at One of Nation’s Largest Universities,” Moody’s, June 2010
Critical Credit Factor #2: Differing Degrees of Pressure on Non-Tuition Revenues Placing a Premium on Business Line Diversity

In addition to longer-term pressure on the ability to grow student charges, the economic recession has challenged other revenue streams, including state appropriations, fundraising, research funding, and patient-care related revenue. We believe the largest and wealthiest institutions remain the best poised to withstand these pressures, as they typically have research enterprises, strong balance sheets, long histories of robust fundraising weathering economic cycles, and good operational diversity. Higher education institutions which own large hospitals or faculty practice plans, particularly those which have more exposure to government payers or which could be more negatively impacted by the implementation of federal health care reform, will face additional challenges.

State Appropriations: Public Universities Must Absorb Further Cuts in State Funding and the End of ARRA Money

Pressure on state appropriations to higher education is a chief credit challenge faced by the large majority of public colleges and universities over the next five years, as states grapple with a reduction in tax receipts, an increase in service demand, and depletion of accumulated reserves due to the recession. In many states, this budgetary pressure has resulted in a reduction of higher education funding. The infusion of ARRA funding in FY 2009-2011 has moderated a potential period of sudden operational stress and eased public universities in many states toward the new reality of lower levels of government funding. The best managed universities used this additional time to reduce expenses, improve operational efficiencies, and focus on alternative revenue generation. With the results of the recent political elections, we expect state funding cuts to deepen across much of the U.S. as states work to balance their own budgets. For example, the large and highly rated university systems in California are likely to have their state operating support cut under budget proposals of newly elected Governor Brown. However, we expect the universities to be able to adapt to this loss of operating support largely by raising tuition, increasing out-of-state students, and achieving new spending efficiencies of their own. Further, some states are re-evaluating their funding frameworks for higher education, for example considering moving from an enrollment-based funding formula to a more performance-based model of institutional support incorporating college-completion rates and other measures of academic success. Future cuts in state funding and revamping of funding frameworks will need to be evaluated on a state-by-state and institution-by-institution basis.

Although state funding cuts have been steep starting in FY 2009, and the share of state funding for public universities has declined for decades, state funding to higher education actually increased in the last decade. State fiscal support for higher education, including only state tax appropriations for higher education, increased 15.3% between FY 2005 and FY 2010, as highlighted in Figure 5 below, with only nine states experiencing a decline in funding over this timeframe. Although median state appropriations per student of $7,363 in FY 2009 declined from FY 2008, this figure represents an increase compared to $6,641 of median state appropriations per student in FY 2005.
### FIGURE 5

**Percent Changes in State Fiscal Support for Higher Education**

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<tr>
<th></th>
<th>1 Year % Change, FY 2009-2010</th>
<th>2 Year % Change, FY 2008-2010</th>
<th>5 Year % Change, FY 2005-2010</th>
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<tbody>
<tr>
<td>State Tax Appropriations Only</td>
<td>-3.4%</td>
<td>-6.7%</td>
<td>+15.3%</td>
</tr>
<tr>
<td>Sum of State Tax Appropriations, Other State Monies Devoted to Higher Education and Federal Stimulus Funds (in FY09 &amp; FY10)</td>
<td>-1.1%</td>
<td>-1.7%</td>
<td>+21.9%</td>
</tr>
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Source: *Grapevine FY 2009-2010, produced by Illinois State University’s Center for the Study of Education Policy in cooperation with the State Higher Education Executive Officers (SHEEO)*

Reliance on government appropriations has declined over the past five years as public universities have become increasingly market driven, and we expect this trend to continue. Based on our FY 2009 medians report, rated public universities (excluding community colleges) relied on government appropriations for a median 30% of operating revenue in FY 2009, compared to a higher 33% in FY 2005. The higher reliance on state support by the smaller regional publics is exemplified by the median data, with state support representing a median 20% of operating revenue for Aa1-rated publics in FY 2009, compared to nearly 32% for A1-rated public universities. We believe that the largest institutions, which generally benefit from more diverse operating bases and greater economies of scale, will fare the best. Smaller regional public colleges and universities will be more challenged because they are typically more heavily dependent on state operating support, less able to achieve operational efficiencies, and face the most competition from community colleges.

Delays in cash funding of appropriations to public universities in particular states, such as Illinois and Arizona, have placed credit pressure on their public universities. The implementation of late in the year surprise cuts in state funding has also created stress, as institutions do not typically have enough time to reduce expenses or implement an offsetting tuition increase in response. In these situations, we have focused on each individual university’s available liquidity (both internal reserves and available external bank liquidity) to provide a bridge during the delinquency in the state’s payment. We also evaluate longer-term liquidity projections and troughs in unrestricted cash and investments throughout the year relative to the size of the university’s expense base.

**Fundraising: Philanthropy Declines, but Still a Significant Credit Strength for the Sector**

Not surprisingly, declines in home equity and personal net worth have negatively impacted not-for-profit fundraising programs, with major donors more hesitant to commit to long-range, large-scale gifts. Total estimated charitable giving in the U.S. declined 3.6% in 2009 (3.2% decline when adjusted for inflation), according to Giving USA Foundation. Some universities have recently reported instances of extended capital campaign timelines, slowed growth of new gifts and pledges, and some very specific examples of donors requesting more time to pay on pledges or in some rare cases write-offs of large pledges.

Although fundraising is more challenging for most, we believe that philanthropy and donor loyalty remain key positive credit factors for the U.S. higher education sector, distinguishing it from the rest of the municipal market. Giving USA estimates total charitable giving in the U.S. at a very high $303 billion in 2009, with educational institutions receiving 13% of the total. Although fundraising has declined in recent years in response to the broader economy, we expect it to stabilize, perhaps at a new lower level, but to remain a strong revenue source for the higher education sector overall. Although donor priorities may shift (financial aid vs. capital, for example), the largest private and public colleges

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with well established fundraising programs are expected to maintain healthy gift flow, helping to support strategic priorities and serve as a revenue diversifier.

**Research Funding: Flattening of Federal Research Funding Creates Heightened Competition for Grants and Advantages for Market Leaders**

Although the infusion of ARRA funding for research created a temporary increase in available federal research funding, overall federal research funding has leveled off and become increasingly competitive to secure. We expect that the largest, nationally prominent research universities and independent research organizations will be best positioned to increase grant submission volume and win rates and secure multi-year funding. These organizations’ strong market positions attract top faculty and typically more diversity of research funding sources. Further, these top-tier research institutions may benefit from further revenue diversification, as they invest in research commercialization and growth of technology transfer revenue. We expect that smaller organizations hoping to expand their research enterprises will be much more challenged in this environment to attract and retain top researchers and grow their research enterprises.

**Endowment Spending: Wealthiest Institutions Most Affected by Reduced Endowment Draws, but Have Compensating Credit Strengths**

Past endowment losses are now more fully impacting endowment spending rates, with most endowment draws incorporating a component that is based on multi-year lagged endowment valuations. Pressure on endowment draws impacts the wealthiest private colleges and universities most significantly, with some of these institutions relying on investment spending for more than a third of their annual operating revenue. While these operating revenue losses are disruptive to budgets and have forced unprecedented layoffs at some premier universities, credit position has remained largely stable among this group due to their diversified credit strengths.

Smaller private institutions and public universities tend to rely on the endowment draw for a modest proportion of their annual revenues and have had their annual budgets impacted on a much smaller scale than larger private universities. In our opinion, heavily endowment-dependent not-for-profits have responded briskly to scale back expenses to compensate for current and future reduced endowment draws. For the most part, we do not expect to see dramatic pressure on operating performance for these endowment-dependent institutions, as they have focused on expense containment, including creating leaner administrative structures, increased centralization of processes, offering of voluntary retirement programs, and in some cases consolidation or elimination of academic programs.

**Patient-Care Revenue: Pressure on Patient Volumes and Reimbursement Rates Negatively Impacts Health Care Operations; Leading Academic Medical Centers Better Positioned**

For universities which own hospitals, clinics, or faculty practice plans, we expect ongoing pressure on health care operations and increased requirement of management oversight. Flat to declining patient volume trends, growing levels of uncompensated care, pressure on payer reimbursement rates (particularly government payers), and the uncertain impact of health care reform remain key credit challenges for the health care sector. Moody’s rated hospitals have experienced greater credit pressure and rating volatility since the beginning of the credit crisis than colleges and universities. While we expect that small single site hospitals in demographically weak regions will be the most challenged to improve operational efficiencies and negotiate with payers, larger academic medical centers are typically better positioned, because they offer unique, high-end services that community hospitals do not. They also have a more diversified revenue base, including philanthropy and research grants, as well as a working relationship with and potential longer term support from affiliated universities.
Critical Credit Factor #3: Need for Stronger Management of Operating Costs, Balance Sheet Risks, and Capital Plans

With endowments benefiting from positive investment returns in FY 2010, most endowments regained some of the value that was lost during FY 2008 and 2009. However, financial resources, for the most part, remain depressed, resulting in increased balance sheet leverage, reduced endowment spending available for operations, and a weaker cushion of financial resources to support operating expenses. Further, the adoption of UPMIFA (Uniform Prudent Management of Institutional Funds Act) and associated financial reporting requirements in most states resulted in the reclassification of unspent investment gains and a decline in unrestricted financial resources over the past two years. Further, post-retirement health benefits (OPEB) are quite large in certain states and a small number of public universities have large pension liabilities, further depressing net assets. As the size of these post-employment liabilities grow over time, we will continue to monitor development of long-range funding strategies and the institutional ability and willingness to curtail or revamp the benefit plans.

Private and public university medians for FY 2009 highlighted this sharp drop off in balance sheet strength. For FY 2010, we anticipate capital and balance sheet ratios will improve although not back to FY 2007 levels.

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Liquidity and Investment Management: Institution Wide Assessment of Sources and Uses of Liquidity is Key Challenge

For FY 2009, we launched a new set of liquidity ratios which mesh accounting restrictions with investment strategies and provides more transparency of available liquidity, beyond the data provided within the audited financial statements. Some of the key findings are highlighted in Figure 7, and a more elaborate review of the liquidity data will be included in an upcoming special comment. The credit crisis which began in the fall of 2008 was a “wake up call” for all and redirected attention to the importance of adequate liquidity management and the need to develop an integrated “sources and uses” approach to liquidity. However, for the largest endowments which tend to be avid investors in less liquid investment strategies, we have not seen a wholesale shift in asset management or investment allocations. We expect that large endowments will continue to use alternative investments, including hedge funds, private equity, real estate, and others, to diversify their portfolios and strengthen returns.
FIGURE 7

Key Higher Education Liquidity Findings:
For the large majority, accounting or donor restrictions on assets is the key factor limiting liquidity, not restrictions in investment manager agreements.

Aaa- and Aa-rated private and public colleges are the most active investors in longer-term illiquid asset classes.

Public universities tend to have a larger proportion of their assets in more liquid asset classes than private universities.

Public universities’ liquidity tends to provide stronger coverage for demand debt, partly due to limited use of variable rate debt.

Public universities’ liquidity tends to provide weaker coverage of expense base (lower days cash on hand), reflecting larger expense bases and typically thinner balance sheets (with affiliated foundation assets excluded from our monthly liquidity calculations).

Debt Structure: Variable Rate Debt and Swap Risks Illuminated by the Credit Crisis
The credit crisis clearly illuminated the risks associated with variable rate debt and interest rate swap agreements and the importance of carefully evaluating counterparty exposure, covenants and terms across bank, bond, and derivative agreements. Much of the new debt issuance in the higher education sector during 2010 was issued with fixed interest rates, with universities generally averse to increasing variable rate exposure or expanding their swap portfolios. We expect this trend to continue in the near term as issuers are able to lock in attractive fixed interest rates. Although some universities have refinanced variable rate bonds with fixed rate debt in order to mitigate liability risk, others are reluctant to do so often as a result of outstanding swaps with large negative valuations which would require termination payments.

The unusually large wave of bank facility expirations scheduled during 2011 could be challenging for universities with variable rate debt. In particular, lower rated credits in our portfolio may encounter reduced availability of extensions and substitute liquidity facilities as well as more stringent terms and covenants in those new agreements. Strong demand for liquidity to support variable rate demand bonds in the public finance sector is met with a more limited supply of bank credit and liquidity support, as a result of bank consolidations and the potential implications of new financial legislation and Basel III banking regulations.

We expect that the highest rated issuers (Aaa and Aa) will have more extensive market access and more leverage to negotiate beneficial agreement terms. Organizations in the A rating category and below could have weaker access to bank facilities or refinancing options, depending on each borrower’s unique credit characteristics. Our assessment of this renewal risk will hinge on each university’s preemptive management of the situation, total variable rate and counterparty exposure, term out and payback provisions within expiring agreements, and organizational liquidity relative to amount of puttable debt. For more detail on this topic, please reference our special comment, “U.S. Public Finance Borrowers Face Increasing Renewal Risk of Bank Facilities,” published in September 2010.
Future Capital Spending: Slowed Building Plans Anticipated After Years of Significant Borrowing and Capital Investment

The past 15 years ushered in an era of significant capital investment on university campuses in the U.S., a capital “arms race” resulting in extensive spending on academic, auxiliary, research, and athletic facilities. In light of weakened balance sheets and pressure on philanthropy and state capital support, most universities are carefully evaluating long-range capital needs and the sources of funding for capital investment and renewal. Low interest rates and significant use of the Build America Bond program by public universities contributed to a strong pace of borrowing during 2010, and in some cases incentive to accelerate borrowing plans and lock in capital funding sources despite potential negative arbitrage implications.

However, many institutions are choosing to cancel, cutback, or delay capital plans, in some cases putting very large expansion plans on hold indefinitely, and we anticipate that the pace of higher education capital investment in the U.S. will slow substantially for several years. The scope and pace of future capital investment is weighed by boards and senior management teams against the strategic importance of the project, security of financing for the project, and competing priorities for resources. As universities face pressure on tuition growth, fundraising efforts may shift increasingly toward raising gifts to support scholarships and moderately away from new construction and building naming opportunities. In addition to a slowed pace of new construction, we will continue to monitor institutional deferred maintenance backlogs and the adequacy of investment in ongoing renewal and renovation of existing plant. Many universities have become increasingly creative with building plans in order to reduce costs while still producing useful results. For example, renovation of existing buildings or purchase of already leased facilities, rather than construction of new facilities from scratch, has resulted in capital budget cost savings. We anticipate that many universities will be increasingly conservative in their approaches to evaluating capital, strategic, and borrowing plans.
Management teams and boards have been forced to question the underlying assumptions in their long-range models and no longer accept the status quo as organizations adjust to “new normal” realities, including:

» More financial accountability placed on boards of trustees and management teams to demonstrate better control over tuition increases and improved long-range operational sustainability

» Increased focus on centralization of processes, economies of scale, and operational efficiency

» Growing demand for organizational transparency, outcomes data, and data-driven decision making

» Need to clearly demonstrate product value and quality and projected return on investment

» Ongoing resistance to tuition increases and growth of financial aid budgets

» Longer term pressure on state budgets and government funding for public universities; public universities’ increasing reliance on student charges

» Heightened political and public scrutiny of tax-exempt organizations

» Increasing diversity of the student body and resulting need for more educational flexibility

» Continued evolution of educational delivery formats and integration of technology

» Still strong philanthropy and research funding for higher education although at a new lower funding level

» Increased emphasis on balance sheet liquidity

» More stress testing of long-range assumptions and enterprise risk management planning
Moody's Related Research

Special Comments:
» Governance and Management: The Underpinning of University Credit Ratings, November 2010 (128850)
» State Funding Cuts Create Greater Stress for U.S. Public Universities, July 2010 (126080)
» Tuition Challenges Continue for Many U.S. Universities, but Majority Forecast Growth, December 2010 (129514)
» Liquidity and Credit Risks at Endowed U.S. Universities and Not-for-Profits, June 2010 (123460)

Median Reports:
» Moody’s Fiscal Year 2009 U.S. Private College and University Medians, July 2010 (126349)
» U.S. Public University Medians for Fiscal Year 2009 Show Tuition Pricing Power Amidst Rising Challenges, August 2010 (127197)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.
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