INDUSTRY OUTLOOK

US Higher Education 2012 Mid-Year Outlook Remains Mixed
Weak Economic Recovery, Government Budget Stress, Regulatory Risk and Rising Student Debt Pose Growing Challenges for Majority of Sector

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Summary

We maintain a mixed outlook for the US not-for-profit private and public higher education sector—stable for market leading diversified universities and negative for the remainder of the sector. Our mid-year outlook focuses on established and developing trends that have become more prominent since our annual outlook was published in January 2012. Many of the credit challenges outlined in our January outlook have intensified as the economic recovery continues to stumble, equity markets have produced stagnant-to-negative investment returns, federal and state budgets remain stressed, and household net worth remains well below prior levels. These factors, combined with rising political and regulatory scrutiny of the industry and tougher accreditation standards, are making it difficult for colleges and universities to grow revenue and are intensifying the focus on governance, operating efficiency and revenue diversity.

Market leading universities with strong balance sheets and diversified revenue sources face new challenges, but remain resilient enough to maintain a stable credit outlook. These market leaders tend to be rated in the Aaa and Aa categories due to their excellent brands, powerful market positions, healthy balance sheets and multiple revenue-generating business lines.

We maintain a negative outlook for the remainder of the sector, which represents the majority of our rated portfolio. This segment is much more dependent on student revenues and/or government funding. Public colleges and universities in this category are largely dependent upon a combination of state appropriations and tuition, while their private peers depend on student tuition for the majority of operating revenue. Universities in this majority segment tend to attract students more regionally, retain less pricing power and have weaker balance sheets.1

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1 Sharp Drop in Net Worth Is Credit Negative for Higher Education, State & Local Governments, June 2012
2 U.S. Higher Education Outlook Mixed In 2012, January 2012

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Diversified Market Leaders:
» National/global brand name; excellent student demand
» Diverse revenue sources, often including large research operations and strong philanthropy
» Low dependence on state operating funds or student tuition revenue
» Strong balance sheets and liquidity providing healthy support of debt and operations

### Key Strengths and Challenges of the Higher Education Sector

<table>
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<th>Strengths</th>
<th>Challenges</th>
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<tr>
<td>Family willingness to save and spend for college still underpins core demand for US higher education</td>
<td>Weakened family incomes/household net worth causing increased tuition revenue pressure</td>
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<td>Strong market acceptance of postsecondary education as an essential long-term investment; still no obvious substitute for undergraduate college degree</td>
<td>Demand for graduate, professional and adult learner education softening due to lingering weak economy; increased student price discrimination and competition even for undergraduate degrees</td>
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<td>Broad government support for the industry in the form of subsidies/grants/loan guarantees/tax exemptions for operations, research and student aid</td>
<td>Weak US economic conditions causing government budgetary stress at national, state and local levels leading to stagnant public funding. Rising scrutiny of sector’s funding and tax exemptions</td>
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<td>Private gifts for endowment and operations, although weak for many smaller or regional colleges, provide material financial support for many, distinguishing US higher education from other industries and sectors</td>
<td>Large donations highly correlated with equity appreciation, indicating vulnerability to stagnant or weak stock market returns. We expect growing dependence on private gifts to support student aid and research</td>
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<td>Universities seen as regional economic engines providing education, workforce training, employment, research activity, business spinoffs and cultural enrichment</td>
<td>More intense public and community engagement, combined with new limits on public funding, opens door for heightened regulatory intervention in university operations, cost structure and accreditation</td>
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<td>Traditional faculty-driven, decentralized governance model for US higher education tends to promote operating stability, long-run planning capacity and consistency in quality of programs, but often serves as an obstacle to responding to change</td>
<td>New economic constraints and emerging technology platforms for delivering academic content threaten to disrupt traditional educational models, causing the need for more centralized board and management control and greater need to adopt new technologies to lower costs for students</td>
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Despite its growing challenges, the higher education sector overall retains many unique credit strengths, as highlighted by low rating volatility and comparatively high median ratings of A2 for private colleges and universities, and A1 for public universities. Key credit strengths of the sector are largely based on the nation’s still strong consensus that postsecondary education is a valuable long-term investment as college graduates tend to have higher income levels and lower unemployment rates. While critics have emerged to challenge this assumption, there remains no broadly viable substitute for the traditional undergraduate college degree and, for those that can afford it, the unparalleled personal growth experience of the residential college model. Furthermore, the nation’s research universities are growing in importance as regional economic development engines and drivers of scientific discoveries, technological development and business start-ups.\(^3\) Many smaller colleges continue to be the economic and cultural centers of their communities. Finally, the sector’s uniquely strong support from private philanthropies shows few signs of waning.

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\(^3\) U.S. Research Universities Face Loaning Federal Funding Cuts, But Remain Well Positioned To Withstand Credit Challenges: December 2011; Cornell University and The Techton Partner to Expand in New York City: December 2011; Stanford University Drops In Bid to Expand in New York City, a Credit Positive: December 2011
Credit Risks Facing the US Higher Education Sector

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<th>Developing Risks</th>
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<td>1. <strong>Macroeconomic headwinds intensify flight to quality and value.</strong> As</td>
<td>1. **Regulatory and accreditation risk intensifies as government focuses more</td>
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<td>unemployment remains high, and household net worth and incomes remain depressed,</td>
<td>on affordability, transparency &amp; outcomes. The challenging job</td>
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<td>the sector faces weaker purchasing power in its core markets, forcing heightened</td>
<td>market for college graduates and headlines on student loan defaults have heightened</td>
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<td>competition that favors the most reputable and the lower priced options.</td>
<td>public and political pressure on the sector to justify the cost of a college</td>
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<td>degree. Increased scrutiny manifests in a higher level of regulatory and</td>
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<td></td>
<td>accreditation risk.</td>
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<td>2. **Revenue growth remains a challenge for most, underscoring need for</td>
<td>2. **Growth of online education and new technology platforms will create new</td>
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<td>operational efficiency.** Tuition, investments, donor support, state</td>
<td>winners and losers.</td>
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<td>appropriations, and federal research funding continue to face considerable</td>
<td>Online technology platforms are evolving at a rapid pace, presenting new</td>
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<td>headwinds.</td>
<td>disruptive risks to universities, but also new opportunities for the delivery</td>
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<td>of educational content and new revenue streams.</td>
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<td>3. **Backlogged capital spending threatens higher future capital maintenance</td>
<td>3. <strong>Growing need for bolder leadership creating new conflicts.</strong> With the</td>
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<td>costs, but universities slowly begin to restart capital projects. The slowed</td>
<td>stagnation of key revenue sources, rising public scrutiny and growing need for</td>
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<td>investment in capital since 2008 cannot continue indefinitely if universities are</td>
<td>operating efficiency, universities are facing a critical need for more decisive</td>
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<td>to remain competitive. The favorable interest rates in the first half of 2012</td>
<td>leadership that will create more conflicts between governing boards, management</td>
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<td>have brought an uptick in debt issuance.</td>
<td>and faculties.</td>
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Established Risk #1: Macroeconomic headwinds intensify flight to quality and value

The largest single challenge facing all private and public universities remains weakened capacity for tuition revenue growth due to sustained economic stress and increased public scrutiny of higher education pricing. The US Federal Reserve recently announced that the median net worth of American families fell to its lowest level since 1992 as of the end of 2010, driven by a 23% decline in home prices and a 14% decline in stock values. US jobs growth has also been lackluster since the end of the recession: the current unemployment rate has been above 8% for several years running, a trend not seen since the 1980s; and the 2012 projected US per capita income of $36,820 remains lower than that of 2008 ($37,558). At the same time, families’ education-related debt burdens have increased. The confluence of these factors has created the stiffest tuition price resistance that colleges have faced in decades, forcing many to reduce the pace of tuition increases and expand financial aid budgets. Exhibit 1 illustrates how a greater portion of our rated portfolio is struggling to attain revenue growth beyond the rate of inflation. For FY 2011, 35% of private colleges and universities and 21% of public universities did not achieve more than 2% operating revenue growth.

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1. Moody’s Analytics; Bureau of Labor Statistics; Bureau of Economic Analysis
Increased price sensitivity since the financial crisis continues to impede all but the best known and least expensive US colleges’ ability to attract students without increasing financial aid. Exhibit 2 examines the effects of increased price sensitivity through the lens of matriculation (a college’s ability to enroll students who have been accepted) and tuition discounting (the percentage of financial aid offered to students). While the median matriculation rate for a large majority of our rated portfolio had been declining since 2003, the pace increases dramatically in 2008, in juxtaposition to the rapid increase of the median tuition discount rate. In contrast, the market leading private universities continue to see strong matriculation, highlighting their strong brands and ability to draw students. To be sure, FY 2011 median matriculation rates for Aaa- and Aa-rated private universities were 50.2% and 34.9%, respectively. We expect this trend to continue as families seek the best value in education, either through quality or cost.
The trend of increased financial aid to attract students in a more competitive market has already eroded net tuition revenue growth for the majority of our rated portfolio which is highly dependent upon tuition as a primary source of operating revenue. A large portion of private (36%) and public (22%) universities have experienced diminished revenue growth since 2009, largely because student aid has grown at a faster pace than tuition revenue (Exhibit 1). We expect that universities with diversified revenue bases will continue to fare best as they are buffered from declines in any one source of revenue, but that the majority of the tuition dependent portfolio will face slower growth of their primary revenue source in the near term.

Established Risk #2: Revenue growth remains a challenge for most, underscoring need for revenue diversification and cost containment

The US economy has continued its slow and fragile recovery from the recession, but there are major stumbling blocks ahead as we face a global economic slowdown of indefinite duration. Additionally, the US has significant federal spending cuts scheduled to take effect at the end of 2012 through the federal deficit reduction plan. Either occurrence could potentially stall or reverse what little economic growth has occurred. These factors herald sustained revenue pressure on all business lines in the higher education sector, especially for philanthropic giving, investment returns, federal research funding, federal and state financial assistance for students and state appropriations. Revenue diversity will help cushion the diversified market leaders against volatility from any given quarter, but the entire sector will need to focus even more upon cost containment in order to maximize revenue growth in this environment.

Almost all colleges and universities depend upon philanthropy and investment returns to support operations and capital expenditures at some level. Through June 2012, the 12-month S&P 500 return was 3.14% and Global Equities were down 16.67% as measured by the Morgan Stanley Capital International’s EAFE Global Investable Market Index. Given these results, after endowment spending is accounted for, we expect university endowment portfolios to decline in FY 2012. FY 2012 will likely bring the first negative returns since 2009 for most. Some large and sophisticated university endowments that have effective hedges in “absolute return” hedge funds may have stronger performance, but these will be few and far between.

Philanthropic giving is highly correlated to the success of the stock market and we expect modest gift support to universities in the near term, with the strongest fundraisers and market leaders garnering bigger gifts and wider donor support. On June 19, 2012, Giving USA reported that charitable giving to educational organizations rose 4% from 2010 to 2011, yet the inflation-adjusted increase was a narrow 0.9%; and this for a year that produced better investment returns than the market had seen over the first six months of 2012. The lackluster returns for the first half of 2012 will likely translate to reduced or stagnant donor support in fiscal year 2013 for the majority of the higher education sector. The market-leading universities will continue to enjoy strong donor loyalty and gift support, but overall this key source of revenue diversity will be under pressure in the future for the entire sector until the equity markets stabilize.

Federal research funding is expected to remain flat or contract due to pressure on the federal budget, especially in light of the automatic US federal budget cuts that are scheduled to take place in December 2012. Federal government funding accounts for approximately 60% of research grants

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5 Moody’s Analytics
6 Standard & Poor’s
7 Giving USA 2012 Annual Report on Philanthropy for 2011
8 Moody’s Expects Private Gifts to U.S. Private Universities to Rise Significantly in Fiscal Year 2011, July 2011

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awarded to US research universities\textsuperscript{15}, with the lion’s share garnered through the National Institutes of Health (NIH). Except for the temporary boost provided by the 2009 stimulus bill (ARRA), NIH funding has been generally stagnant from FY 2009 to 2012.\textsuperscript{16} The President’s federal FY 2013 budget (October 1, 2012 – September 30, 2013) proposes flat funding to the NIH.\textsuperscript{17} The top research universities are global reputation leaders with considerable economic impact and are often among the wealthiest, most reputable universities. However, some smaller research universities that lack the diversified strengths of their larger, more established peers will face more credit risk in coming years as federal funding is more likely to flow to the top, well-established programs.

The faltering macroeconomic conditions will continue to filter down to public universities who have already felt the impact of a major divestiture of state funds over the last decade. Public universities have had to become much more market driven over the last several years as state appropriations, once a primary source of revenue, have declined and federal stimulus funding ended for most in FY 2011. Although the rate of cuts to state appropriations has slowed, very few public universities have seen state appropriations return to pre-recession levels, and we expect future growth for this revenue source to remain limited. The most likely revenue replacement for state appropriations is tuition revenue—through enrollment growth and/or tuition increases or new revenues generated by online offerings. Market strength, reputation and capacity will determine which public colleges and universities are able to grow enrollment while also instituting tuition increases, thereby maximizing tuition revenue growth.

Established Risk #3: Backlogged capital spending threatens higher future capital maintenance costs, but universities slowly begin to restart capital projects

The extremely low interest rates in the first half of 2012 have begun to reawaken the higher education and not-for profit sectors’ appetite for borrowing (Exhibit 3), which had been suppressed since the economic crisis in 2008 with the exception of a spate of borrowing by public universities issuing Build America Bonds in 2010. Over the last few years, universities scaled back capital spending and put large capital projects on the back burner. Investment in plant is critical to maintaining a university’s market position as facilities remain an important factor in attracting students, faculty, and research awards. Although we expect colleges and universities to remain cautious due to volatile investment returns and pressure on net tuition revenue, we have seen a small lift in the moratorium on capital spending over the last six months. We expect this trend to continue for higher-rated universities and those undertaking revenue generating projects.\textsuperscript{18} Additionally, a handful of universities will continue to borrow to renovate or build new facilities in the hopes that the investment in their campuses will enhance their competitive position.

\textsuperscript{15} www.nih.gov/News\%20and\%20Media/News\%20Releases/2012/12/30/NIH\%202012\%20Budget.pdf
\textsuperscript{16} http://www.whitehouse.gov/treasbudget
\textsuperscript{17} Taxable Debt Issuance by U.S. Universities Continues For New Reasons, February 2012
Taxable bond issuance by US universities has remained elevated in 2012, driven by historically low spreads between tax-exempt to taxable long-term interest rates, combined with the reduced IRS compliance requirements of taxable debt (Exhibit 4). Taxable bonds do not carry the same restrictions on use, investment restrictions, and required record-keeping as tax-exempt bonds, which makes them especially appealing for research universities or large universities with varying programmatic needs. Century bonds, with 100-year maturities, remain very attractive at the current interest rates, but to date have only been feasible for highly-rated colleges and universities whose ample balance sheets and strong brands create public buy-in for long-term staying power. The ability to borrow for very long horizons in the taxable market is credit positive for highly rated universities because it gives them long-term capital at an affordable cost that is largely unavailable in the tax-exempt market. It is yet another advantage that these market leaders have over their lower-rated and lesser known peers.15

Developing Risk #1: Regulatory and accreditation risk intensifies as government focuses more on affordability & outcomes

The macroeconomic pressures on the sector have been underscored by heightened public scrutiny and political focus on the issue of affordability, especially as the nation’s student debt burden has been on the rise. Since we released our 2012 outlook in January, the affordability of higher education has received an elevated level of political attention and we expect that trend to intensify through the presidential election. In late January, President Obama announced a college affordability plan with a

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15 Taxable Debt Issuance By U.S. Universities Continues For New Reasons, February 2012

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bid to expand federal student financial aid and reward public institutions that moderate tuition increases. Affordability of higher education has become one of the president’s campaign platforms, and he has since announced plans for improved disclosure from colleges and universities on net price and financial aid. While Congress passed legislation that settled the federal student loan interest rate debate for one more year in June 2012, the national concern over the student loan burden will likely continue to gather steam during this election year. For the legislation, student loan interest rates will not immediately increase, but graduate students with federal loans will have to pay interest while in school and undergraduates will have to begin paying interest immediately upon graduation, rather than after a six month grace period. Colleges and universities will continue to carefully test pricing power and elasticity in the current political environment, which means they must seek financial sustainability through revenue diversification, expense containment and operational efficiency.

The large earnings disparity between workers with an undergraduate degree versus a high school diploma has been a strong argument in favor of higher education. However, this theory has been undermined by the increasingly weak employment trends for graduates. As the public scrutiny of higher education intensifies, we expect to see more of a shift toward outcomes-driven state and federal funding, increased federal regulation of the industry, continued reevaluation of the not-for-profit higher education tax-exempt status and a demand for better disclosure from all colleges and universities.

Accreditation Risk Intensifies

The economic pressures and higher regulatory risk from Washington D.C. cited in our 2012 Outlook for US Higher Education have led to tougher accrediting standards, which have resulted in an increased number of accreditation actions – many brought on by economically-driven fiscal pressures. Accreditation issues have warranted several recent rating actions, such as:

» Kean State University—NJ, public; A2/ outlook revised to negative from stable on 6/10/2012
» Mountain State University—WV, private; downgraded to B1 from Baa3 on 7/11/2012, rating on review for potential downgrade
» Fort Valley State University—GA, public; A3 on review for possible downgrade from A3/ stable on 7/13/2012

As Congress and the general public continue to focus on affordability and measurable outcomes for higher education, we expect accrediting organizations, which are independent, non-governmental bodies, will enforce higher standards and issue a greater number of warnings and sanctions in order to avoid tighter regulations from Congress.
For-Profit Sector Gets Temporary Reprieve

Concerns related to high student loan default rates have tightened the regulatory environment for the for-profit higher education industry. In June, President Obama announced the Department of Education’s gainful-employment rule whereby career college programs (primarily at for-profit colleges) that could not demonstrate that their students were meeting one of three student loan repayment criteria would lose access to federal grants and loans for their students under Title IV of the Higher Education Act. The rule was subsequently overturned by the US District Court in late June, but we believe that marketplace and regulatory pressures on the for-profit higher education industry will continue and may spill over to affect not-for-profit institutions.16

Rising Student Loan Defaults Add Credit Risk

The student loan default issue has received heightened national attention with some arguing that default rates are vastly understated. In May 2012, the Federal Reserve Bank of New York announced that the amount of student loan debt reported on consumer credit reports hit $904 billion by March 31, 2012, up $663 billion since March 2003. The report also showed growth in 90+ day delinquency rates to 8.69% from the 6.13% reported in March 2003.17 This extreme increase in debt burden has heightened fears of a potential widespread default on student loans. Indeed, default rates are also on the rise. A 2011 report by the US Department of Education (DOE) indicated that the national student loan cohort default rate (CDR) was 8.8% in 2009, a 27% increase over the prior year. According to the report, students at for-profit institutions defaulted the most with a CDR of 15%, followed by public universities at 7.2%, and private colleges and universities had the lowest at 4.6%.18

The rise in student loan default rates is of particular concern for colleges and universities with student bodies that rely heavily on federal student aid programs. Both the realized increases in defaults and perceived risks of rising defaults could affect these institutions’ ability to recruit students at needed tuition levels. Prospective students’ willingness to pay tuition at a particular university will decline if it’s perceived that more graduates are securing jobs and consequently defaulting on their loans. An inability to access student loans will most likely affect non-rated colleges and for-profit institutions. Compared with the national average, our rated colleges and universities demonstrate significantly lower CDRs than for-profit education companies and other non-rated traditional colleges and universities, with CDRs well below the thresholds for federal financial aid eligibility. We do not expect widespread student loan defaults among Moody’s rated universities, however rising defaults outside of our rated universe will nonetheless precipitate added scrutiny on higher education by political and regulatory bodies and by the general public.

Developing Risk #2: Growth of online education and new technology platforms will create new winners and losers

The higher education sector is facing a critical point in its evolution as the digital revolution challenges our collective understanding of learning models and delivery of education. The number of premier universities offering massive open online courses (MOOCs) has grown this year – on July 17, 2012, a dozen new top-tier universities announced that they’ve become institutional partners with Coursera, a new company working on free online classes based on the Stanford University platform.19 This brings

18 If a college's CDR is more than 40% in a single year, or more than 25% for three consecutive years, it loses eligibility for federal student loan funding.
19 www.insidehighered.com

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the number of Coursera’s institutional partners up to sixteen worldwide. MOOCs will not be practical for most colleges and universities, but they highlight the potential opportunities for creative application of new technologies and could provide a tipping point for online education. While the traditional approach to higher education will retain its core value, colleges and universities that can harness the potential of online and other developing technology to create new learning models or operating efficiencies could, in the best case scenario, become new market leaders or gain significant market share and potentially generate new revenue streams in the future. The efficiencies offered through new technology have the potential to transform a university’s operations, academic and social programming, and teaching. On-line learning technologies will play an increasing role in creating new efficiencies and lowering costs per student. The way universities handle and utilize digital information, social media and mobile devices could make meaningful improvements to their bottom lines.

Developing Risk #3: Growing need for bolder leadership creating new conflicts

Recent headline news about governance and management issues at top universities such as Pennsylvania State University and University of Virginia highlight the changing dynamics between university presidents, boards and faculty. Against the backdrop of a faltering economy and public and political outcry for greater affordability and transparency in higher education, strong and savvy leadership along with clear and thoughtful strategic planning become ever more important. The underlying faculty-centric business model of higher education is evolving, and colleges and universities will have to adopt a shared governance model to meet the demands of a wider constituency in the future. In the past six months, we have seen emerging trends highlighting unique governance and management challenges for public universities, research universities and heavily tuition dependent small private colleges.

As discussed in our 2012 US Higher Education Outlook, with continued pressure from reduced state and federal funding, threats of an increased regulatory environment, and heightened political and public scrutiny, opportunities for revenue growth must now be found through operating efficiencies, particularly cost containment, and the discovery of feasible alternate business models. The sector as a whole will need to adapt its governance and management structures to this new normal of diluted growth potential. Boards and senior management will have to be vigilant in oversight and disclosure practices to combat the increased political and public focus on affordability. Integrated long-term strategic and capital planning with a focus on initiatives that enhance the strategic mission and core values of institutions is no longer a best practice, but a necessity in order to optimize and preserve capital. Leadership that can foster creative thinking, adaptability and change management will be required to break through the traditional faculty-centric model seen in almost all institutions of higher education.

Public university evolution to market-driven organizations accelerating

Public universities are facing conflicting pressures and expectations now that tuition revenue has begun to eclipse state appropriations as a percent of operating revenues.20 Public universities must shift their business models to adapt to a market-driven approach rather than running the institution as a government agency, which means accelerating the pace of tuition increases or enrolling a higher percentage of out-of-state students, and adjusting their operating models to allow for surpluses that can be carried over as cash reserves. And yet, they face the political and public pressure to continue to function as low cost institutions serving a public mission of accessibility to education, often with highly political governing boards who have been appointed by the state governor and have considerable power in running the university, selecting senior management and setting tuition. Both

20 Virginia Dispute Highlights Governance Stress And Economic Threats Facing Us Higher Education, July 2012
21 Low State Support Means More Public University Debt, March 2012
the public mission and the political nature of public university governance are in direct conflict with the increasing importance of net tuition revenue growth for public colleges and universities.

For most public universities, the governance model has remained largely unchanged even as their underlying economics have shifted dramatically away from state funding (Exhibit 5). As the pace of that shift accelerates, public universities will have to find management that can strike the balance between providing an affordable education to its constituents, redefining the public understanding of affordability and access to allow for tuition revenue generation, establishing strong working relationships and clear communication with faculty and staff, and shifting the paradigm of the public education governance and operating model. In the coming years, we expect to see more clashes between public university boards and presidents such as what recently occurred at the University of Virginia.22

EXHIBIT 5
State Funding for Public Universities Continues to Fall
Median % share of public university revenues from state appropriations

Research universities' drive for more efficiency is just beginning. As noted above, US research universities are also being forced to adapt to tougher economic realities, as federal funding is projected to remain essentially flat over the next few years after a 20-year boom of generous increases. In the future, research universities are going to have to focus on operational efficiency and cost reduction in order to remain competitive. This will require them to hire management that can chip away at the highly decentralized, faculty-centric operating model that is common among the top US research universities. Scarcer funding encourages cost efficiencies gained through centralizing basic functions such as purchasing, information technology and human resources, while faculty resistance will mean that complete corporate-style centralization is unlikely to develop at most US colleges and universities. The "shared governance" model is deeply ingrained, especially at research universities due to their dependence on star "principal investigator" research faculty to attract grants and private gifts.23 Nevertheless, the ability of faculty to resist more aggressive cost containment strategies, even curriculum changes and increases in faculty workloads, is eroding by varying degrees across the sector.

23 U.S. Research Universities Face Looming Federal Funding Cuts, But Remain Well Positioned to Withstand Credit Challenges, December 2011

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Many research universities were amenable to expense reduction after the financial crisis hit in 2008, but we expect that the basic operating model of research universities will have to evolve further. Over time, some universities will shift toward administrative centralization in order to achieve the operating efficiencies necessary to optimize their funding during a prolonged period of moderated federal funding. The top US research universities are well positioned to handle growing competitiveness as they often have the strongest brands and greatest resources, and can afford to attract top management adept at extracting organizational efficiencies.

Small private, tuition-dependent colleges face special leadership challenges

Small private colleges lacking large endowments face the most credit pressure because they are heavily dependent on student revenue, have limited financial flexibility, weaker donor support, and operate with very few economies of scale. In order to attain financial sustainability in the coming years, they will require especially creative management who can foster a more entrepreneurial and market-oriented culture. Small private colleges are more reliant on student financial aid incentives in order to achieve enrollment targets. They also tend to be more receptive to innovative partnerships with other colleges and for-profit institutions in order to compete more effectively and achieve greater economies of scale.

One long established positive trend is increased recruiting of international students, most of whom can pay more than US students in net tuition revenue. While this trend is likely to continue, there are growing risks of overdependence on single countries, especially China, as well as programmatic and cultural concerns if too large a share of the student body is comprised of students with English as their second or sometimes, third language.

Many small private colleges are well governed by experienced managers fully versed in the sector’s challenges and opportunities. They have already cut costs considerably in response to the financial downturn and are pursuing innovative methods to create operating efficiencies. Successful colleges are boosting their market position with more focused admissions and financial aid strategies, often with the aid of consultants and market demand models. Many small colleges are addressing core productivity problems by evaluating and optimizing curriculum and facility utilization, and by exploring new revenue drivers, and some are increasing course loads for tenured faculty.
Moody’s Related Research

Industry Outlook:
» US Higher Education Outlook Mixed In 2012, January 2012 (139177)

Sector Comments:
» Virginia Dispute Highlights Governance Stress and Economic Threats Facing US Higher Education, July 2012 (143539)
» Stanford University Drops Its Bid to Expand in New York City, a Credit Positive, December 2011 (138357)
» Less State Support Means More Public University Debt, March 2012 (140391)
» For-Profit Education Industry: Court Decision to Strike Down Key Part of Gainful Employment Rule Is Credit Positive, July 2012 (145627)
» Cornell University and The Technion Partner to Expand in New York City, December 2011 (138388)
» Moody’sExpects Private Gifts to U.S. Private Universities to Rise Significantly in Fiscal Year 2011, July 2011 (134907)
» Sharp Drop in Net Worth is Credit Negative for Higher Education, State & Local Governments, June 2012 (142999)

Special Report:
» US Research Universities Face Looming Federal Funding Cuts, but Remain Well Positioned to Withstand Credit Challenges, December 2011 (138109)

Special Comments:
» US Expansion Offers Opportunities and Risks for Universities, November 2011 (137621)
» Taxable Debt Issuance by U.S. Universities Continues For New Reasons, February 2012 (139395)

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