Rating Update: Moody's upgrades American University, DC to A1; outlook stable

Global Credit Research - 07 Feb 2014

University has $198M rated debt

DISTRICT OF COLUMBIA
Private Colleges & Universities
DC

Opinion

NEW YORK, February 07, 2014 --Moody's Investors Service has upgraded its underlying rating on American University's revenue bonds to A1 from A2. The outlook is stable. The Series 2003, 2006 A&B and 2008 revenue bonds were issued through the District of Columbia. The upgrade reflects the ongoing positive momentum in the university's market strength, flexible reserve growth and financial stewardship that help counterbalance large capital plans over the next several years.

SUMMARY RATING RATIONALE

The upgrade is driven by strengthening of the university's student market position as well as management's demonstrated ability to plan for and achieve exceptional cash flow from operations. This exceptional performance has allowed the university to build flexible reserves over time. Our upgrade also incorporates the expected impact of the university's large capital program. The program calls for expected capital expenses of $235 million in FY 2014 through FY 2017. This plan will involve both additional debt (68% of total), use of reserves (25%), and gifts (7%).

In spite of the university's strong market position with growing enrollment, conservative budgeting, consistently healthy operating performance, and flexible reserves, it does have some challenges. Credit challenges include the risks associated with its relatively aggressive debt structure, increasing leverage, high reliance on student charges and limited philanthropic support.

STRENGTHS

*American University’s market strength continues to gain momentum. The private university with a desirable Washington D.C. location has strong pricing power with net tuition per student of $30,312 and $521 million in operating revenues.

*American has a long track record of achieving exceptionally strong cash flow performance, a pattern we expect to continue. The operating cash flow margin of 18.8% in FY 2013 supported Moody's adjusted debt service coverage of 3.0 times.

*The university has a record of sound planning and careful monitoring of strategic, operational and capital initiatives.

*The university's strong cash flow has allowed it to consistently build flexible reserves. Monthly liquidity of $691 million as of FY 2013 more than doubled compared to $300 million in FY 2009.

*The university maintains solid financial flexibility with FY 2013 expendable financial resources of $639 million cushioning debt by 1.66 times and operations by 1.38 times.

CHALLENGES

*The university has a relatively aggressive debt structure with $286 million of demand debt at FY 2013 including $30 million under a commercial paper program that has a maximum size of $125 million.

*American has limited revenue diversity with an 81% reliance on student charges in FY 2013, underscoring the importance of effective enrollment management to financial stability.
*Escalating price sensitivity of students and their families could challenge the university’s ability to increase net tuition revenue at a pace it has enjoyed over recent decades. In light of the need to keep tuition increases to a minimum, expense containment will be necessary to maintain strong cash flow performance.

*Ongoing capital needs, including near term plans will increase debt and draw on flexible reserves. With pro forma debt of $479 million reflecting a planned $125 million fixed-rate issue, operating leverage will increase.

*While the university’s gift revenue averaged $22 million per year (in fiscal years 2011 through 2013), donor support per student remains weak at $1,837 and well below the median for A-rated private universities of $3,559.

*Long-dated swaps with a total notional amount of $195 million include collateral posting requirements and contractual costs.

**DETAILED CREDIT DISCUSSION**

**RECENT DEVELOPMENTS**

The university’s market position has steadily strengthened due, in part, to its desirable urban location, brand enhancement strategy, and increased selectivity at other private universities located in D.C. In addition to enhancing the university’s brand, senior management also attributes a stronger market position to improved efforts to identify those students more likely to attend the university, more aggressive recruiting of students outside the DC/Maryland/Virginia region, and investments in programs. While freshman to sophomore retention rates have been in the 90% to 91% range for fall 2009 to fall 2013, we note a 2% decline to 88% for the fall of 2013.

Counter to trends impacting many private universities, net tuition per student at American has continued to increase over the last few years. Net tuition per student of $30,312 for FY 2013 remains bolstered by the 39% of enrollment in graduate and professional programs including a law school. The law school has seen steady enrollment advantaged by strength in international law and part-time programs in high demand. In recognition of the price sensitivity and increasing competition from wealthier universities, American’s forward projections call for lower increases in costs of attendance than in the past. The budgeted increase for FY 2014 and FY 2015 is 2.9%.

The university has ongoing capital needs as its facilities catch up to the evolving aspirations of its programs and students. Over the last five years (FY 2009 through FY 2013) the university purchased $224 million of property, plant and equipment. Major projects over the next few years include a new College of Law facility ($125 million) as well as development of the multi-purpose East Campus that will include 590 additional student housing beds. The plan will be partially financed with $125 million of fixed rate debt issued in 2014 or 2015. Our upgrade reflects the university’s statement that this additional debt will be fixed rate.

Of the university’s $808.6 million total cash and investments for FY 2013, 86% is both free from donor restriction and liquid within one month. This is in keeping the longstanding practice of slowly building flexible reserves and limiting the allocation to illiquid investments within the pooled endowment. As of October 31, 2013, the university’s pooled endowment was valued at $520.7 million and does not include $2.5 million of non-pooled endowment and $17.1 million held as interest in perpetual trust. Investment return on the pooled endowment was 14.1% in FY 2013. The pooled investments have an equity bias, with assets allocated as of October 31, 2013 among global equities (60%), hedge funds (18%), fixed income (11%), real assets (1%), real estate (5%), cash (2%), and private equity (3%).

**LEGAL SECURITY AND DEBT STRUCTURE:** Under the loan agreements the university's repayment is an unsecured general obligation.

As of April 30, 2013, direct debt totaled $384 million, of which $286 million, or 68%, was demand debt. This portion included $30 million of outstanding commercial paper as well as the $198 million of Series 2003, Series 2006A and B, and Series 2008 bonds, all of which have bullet maturities. The university also has a $75 million taxable fixed-rate 10-year term loan with JPMorgan Chase Bank, N.A. to partially finance its current capital plan.

The university’s commercial paper (CP) program was instituted to temporarily finance the capital plan at an authorized level of $125 million which will be supported by its own internal liquidity. We do not rate this program. Preliminary plans are to permanently finance any CP outstanding in 2014 or 2015 with fixed rate bonds. Daily maturities of CP are limited to $20 million, and no more than $50 million of CP can mature in any week under the university’s policies.

The university relies on external liquidity support in the form of letters of credit (LOCs) to support the tender feature of $198 million of its debt. There is some renewal risk concentration in that all three of the LOCs expire within two...
months of each other. Two letters of credit are with JPMorgan Chase Bank, N.A. (rated Aa3/P-1) that support $161 million of outstanding Series 2006A and B bonds and Series 2008 bonds. The stated expiration date is June 16, 2015. Two support agreements with Wells Fargo Bank, NA support the Series 1999 and 2003 bonds. The stated expiration date is June 28, 2015 for the Series 2003 agreement and August 15, 2015 for the Series 1999 agreement. The term out provisions are generally favorable and in some scenarios would allow for a three-year repayment period commencing one year after following a liquidity advance.

The bank agreements are subject to Leverage Ratio and Debt Service Coverage Ratio covenants. The university must maintain a Leverage Ratio (unrestricted and temporarily net assets less net investment in plant divided by long-term indebtedness) of at least 0.85 at the end of each fiscal year and the end of the second quarter of each fiscal year. Failure to comply with the Leverage Ratio would trigger an event of default notice. The ratio at the end of the university’s 2013 fiscal year was 1.68 times; as of October 31, 2013, it was 1.85 times. Any CP outstanding is included in the Leverage Ratio. The Debt Service Coverage Ratio (change in unrestricted net assets from operations plus depreciation and interest expense compared to principal and interest payments) must be at least 1.60 times as calculated at the end of each fiscal year. At FYE 2013, the debt service coverage ratio was 6.70 times, providing ample headroom and in line with university’s strong cash flow performance. We note, however, that the headroom under this covenant will likely diminish as debt service increases in the coming years.

INTEREST RATE DERIVATIVES: American University has five floating-to-fixed interest rate swaps with two counterparties. The total notional amount is $194.7 million. The swaps serve to hedge the interest rates on outstanding variable rate debt. Four of the swaps are with Morgan Stanley Capital Services (Morgan Stanley rated Baa2/P-2) for a combined notional amount of $133.8 million. The remaining swap is with Bank of America, N.A. (A2/P1) for a notional amount of $60.9 million. American can terminate the swaps at any time at market value. The counterparty could terminate the swap if American’s rating fell below Baa3. The university is required to post collateral depending on the current market value of the swaps and its rating level. As of December 31, 2013, the market value of the existing five swaps was negative $37.2 million. The collateral posting threshold is $25 million for each counterparty and the university has $4.7 million posted with Morgan Stanley and none with Bank of America. While the swaps add risk to the university’s debt structure, American’s significant liquidity mitigates the risks of collateral posting or termination payments.

Outlook

The university’s stable outlook reflects expectations of continued solid student demand, maintenance of healthy flexible reserves, exemplary operating performance and careful management of capital and borrowing plans. The stable outlook also incorporates the expectation that the university will recast its debt structure, issuing fixed rate bonds.

WHAT COULD MAKE THE LONG-TERM RATING GO UP

Upward pressure could result from continued growth in financial resources and increased philanthropic support, greater revenue diversity combined with solid operating performance and strengthening of student market position.

WHAT COULD MAKE THE LONG-TERM RATING GO DOWN

The long-term rating could move down through sustained tightening of operating performance, significant additional borrowing beyond current plan, material reduction in flexible reserves, deterioration of student market position or inability to increase net tuition revenue.

KEY INDICATORS (FY 2013 financial data, fall 2013 enrollment data)

Full-Time Equivalent Enrollment: 11,783 students

Primary Selectivity: 43.1%

Primary Matriculation: 21.5%

Net Tuition per Student: $30,312

Educational Expenses per Student: $30,080

Average Gifts per Student $1,837

Total Cash and Investments: $808.6 million
Total Direct Debt: $383.9 million ($478.9 pro forma)

Expendable Financial Resources to Direct Debt: 1.66 times (1.33 times pro forma)

Debt to Operating Revenues: 0.74 times (0.92 times pro forma)

Expendable Financial Resources to Operations: 1.38 times

Monthly Days Cash on Hand: 576 days

Monthly Liquidity to Demand Debt: 242%

Operating Revenue: $521 million

Operating Cash Flow Margin: 18.8%

Three-Year Average Debt Service Coverage: 7.1 times

Reliance on Tuition & Auxiliaries Revenue (% of Moody’s Adjusted Operating Revenue): 81.3%

RATED DEBT

Series 2006 A&B and 2008: A1 underlying; Aa3/VMIG based on LOC with JPMorgan Chase

Series 2003: A1 underlying; Aa3/VMIG1 based LOC provided by Wells Fargo Bank

METHODOLOGY

The principal methodology used in this rating was U.S. Not-for-Profit Private and Public Higher Education published in August 2011. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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