Moody's assigns A1 to American University's, DC $128.5M Series 2015; outlook stable

Global Credit Research - 02 Mar 2015

$326M pro forma rated debt

AMERICAN UNIVERSITY, DC
Private Colleges & Universities
DC

Moody's Rating

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<td>Taxable Bonds, Series 2015</td>
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<td>Sale Amount</td>
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Moody's Outlook STA

NEW YORK, March 02, 2015 --Moody's Investors Service assigns an A1 rating to American University's ("American") $128.5 million in proposed revenue bonds. The bonds, which American will issue, are expected to be fixed rate taxable with a 30-year maturity. We also affirm the A1 rating for the Series 2003, 2006 A&B, and Series 2008 revenue bonds. The outlook is stable.

SUMMARY RATINGS RATIONALE

The A1 rating is based on the university's continued robust market position as an established research university in an urban area, strong fiscal oversight, and healthy operating performance.

The rating is supported by management's demonstrated ability to plan for and achieve very strong cash flow from operations, which has allowed the university to build flexible reserves over time.

These strengths balance the impact of the university's large capital program, currently in its final phase, its relatively aggressive debt structure, and high reliance on student charges.

OUTLOOK

The stable outlook reflects expectations of continued solid student demand, maintenance of flexible reserves, exemplary operating performance, and careful management of capital and borrowing plans as debt increases.

WHAT COULD MAKE THE RATING GO UP

- Exceptional growth in financial resources
- Increased philanthropic support
- Greater revenue diversification

WHAT COULD MAKE THE RATING GO DOWN

- Softening of student demand
- Decline in operating performance leading to material reduction in flexible reserves
- Significant additional borrowing beyond current plan

STRENGTHS

- Strong cash flow and flexible reserves, with monthly liquidity of $764 million
- Solid financial flexibility, with FY 2014 expendable financial resources of $723 million cushioning debt by 1.73 times and operations by 1.52 times.
- Competitive market position as an established research institution with diverse programmatic offering that leverage the District of Columbia location
- Sound planning and careful monitoring of strategic, operational and capital initiatives

CHALLENGES

- Relatively aggressive debt structure with $321 million of demand debt for FY 2014
- Limited revenue diversity, with an 81% reliance on student charges in FY 2014, and weak donor support compared to similarly rated institutions
- Lower budgeted tuition increases than in past years demand expense containment in order to maintain strong cash flow performance
- Long-dated swaps with a total notional amount of $195 million include collateral posting requirements and contractual costs

RECENT DEVELOPMENTS

American's market strength continues to build, as demonstrated by a larger than budgeted fall 2014 entering class of 1,789 students, up from 1,641 in fall 2013, and improved yield despite lower applications resulting from a more targeted application process. The university is also entering the final phase of its 2011 capital plan. A new Washington College of Law campus is expected to open in December 2015, and the mixed-use East Campus is targeted for occupancy in summer 2016.

DETAILED RATING RATIONALE

MARKET POSITION: CONTINUED POSITIVE MOMENTUM IN STUDENT DEMAND AND DESIRABLE URBAN LOCATION

The university's market position has steadily strengthened due, in part, to its desirable urban location and brand enhancement strategy. American has demonstrated strong pricing power, with a high net tuition per student of $31,053, due in part to a large percentage of graduate students (37%). The large entering first-year class contributed to overall enrollment growth of 1.9% in fall 2014, despite softening law school and business school enrollment. Future undergraduate classes are budgeted at a smaller size than 2014's entering class. Should enrollment continue to exceed projections, American's student housing will be pressured due to the District of Columbia's requirement that American house 67% of all undergraduates.

In recognition of family price sensitivity and increasing competition from wealthier universities, American's forward projections call for lower increases in costs of attendance than in the past. Lower budgeted tuition increases will depress net tuition revenue growth relative to recent years and will continue to demand expense containment and careful oversight of enrollment numbers in order to maintain strong cash flow performance.

OPERATING PERFORMANCE, BALANCE SHEET, AND CAPITAL PLANS: EXCEPTIONAL CASH FLOW MARGIN, LIQUIDITY CONTINUES TO GROW

American has a strong track record of sound planning and careful monitoring of strategic, operational and capital initiatives. The operating cash flow margin of 20.4% in FY 2014 improved from an already strong 18.8% in FY 2013, with Moody's adjusted debt service coverage of 7.7 times, well above the 3 times average for A-rated peers. Strong cash flow and flexible reserve growth are a pattern we expect to continue, even as pro forma debt increases to $482 million with the anticipated debt issuance.

The university's continual reinvestment in capital facilities has resulted lower growth of resources than peers and in moderately high leverage, which currently anchors it at the A1 rating. Expendable financial resources cover pro
forma debt by 1.5 times, and debt to operations was a high .77%. Capital investment should slow in coming years as the university is entering the final phase of a multi-year capital plan designed to bring facilities in line with the evolving aspirations of its programs and students. Major projects nearing completion include a new Washington College of Law facility as well as development of the multi-purpose East Campus that will include 590 additional student housing beds.

Of the university’s $887.8 million total cash and investments for FY 2014, an exceptional 86% is both free from donor restriction and liquid within one month. This is in keeping with the longstanding practice of slowly building flexible reserves and limiting the allocation to illiquid investments within the pooled endowment. As of June 30, 2014, the university’s pooled endowment was valued at approximately $589 million and showed a strong one-year return of 18%. The pooled investments have an equity bias, with assets allocated as of June 30, 2014, among global equities (58%), hedge funds (18%), fixed income (10%), commodities (5%), real estate (5%), cash (<1%), and private equity (3%).

Limited revenue diversity, with an 81% reliance on student charges in FY 2014, underscores the importance of effective enrollment management to financial stability. While the university’s gift revenue averaged $22 million per year (in fiscal years 2011 through 2013), donor support per student remains weak at $2,065, well below the median for A-rated private universities of $4,062.

Liquidity

Monthly liquidity remains strong and continues to increase; at $764 million as of FY 2014, it has more than doubled compared to $300 million in FY 2009. American has 627 monthly days of cash on hand, compared to an average of 285 days for A-rated universities. The university should maintain a healthy level of unrestricted liquidity given solid cash flow and no plans for additional debt beyond the current issuance.

Recently diversified external bank facilities support the tender feature on the Series 2006A and 2006B bonds, totaling almost $100 million, which have a Letter of Credit from Royal Bank of Canada expiring in December 2017. The Series 1999 and Series 2003, totaling $58 million, have a direct purchase agreement with Wells Fargo, ending in February 2018, and the Series 2008 bonds ($60.9 million) have a direct purchase agreement with US Bank, ending February 2020.

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 as of October 31, 2014, was 1.92 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 1.6 times as calculated at the end of each fiscal year. As of October 31, 2014, the debt service coverage ratio was 6.77 times, providing ample headroom and in line with university’s strong cash flow performance. For the US Bank and Royal Bank of Canada agreements, American must also maintain investment-grade credit ratings with each of the major rating agencies; the university is currently in compliance with this requirement.

DEBT STRUCTURE AND OTHER LIABILITIES: MODERATELY COMPLEX DEBT PROFILE WITH MITIGATED RISK

Debt Structure

After the proposed transaction, approximately 53% of pro-forma direct debt of $482 million will be variable rate, before swaps. The fixed rate component of the portfolio is made up of approximately 57% 30-year and 43% 10-year or less bullet maturity debt. Over 90% of pro forma debt is non-amortizing, with bullet maturities in fiscal years 2018, 2022, 2028, 2034, 2037, 2039, and 2046.

Debt-Related Derivatives

American University has five floating-to-fixed interest rate swaps with two counterparties for a combined notional amount of $194.7 million. Four 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, 2014, the market
value of the five swaps was negative $76 million. The collateral posting threshold is $25 million for each counterparty; American has $32 million posted with Morgan Stanley and $1.5 million 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.

Pensions and OPEB

American has a relatively large $25 million OPEB liability that is depressing its net assets and financial resources. OPEB is funded on a pay-as-you-go basis, so the liability will likely continue to accrue. In addition to OPEB, American provides two contributory retirement plans for eligible faculty, administrative and staff employees. The university’s fiscal 2014 contributions to the retirement plans and postretirement healthcare plan totaled $15.5 million and $2.2 million, respectively, representing a manageable 4% of total expenses.

MANAGEMENT AND GOVERNANCE: DISCIPLINED BUDGET PLANNING AND HIGH TRANSPARENCY

American's strong operating performance is attributable to the board of trustees’ emphasis on governance transformation and transparency combined with management's strong budget oversight and planning. An Enterprise Risk Management Team provides additional oversight of institutional risk management. The board’s commitment to operating discipline should ensure continued healthy performance in a very competitive higher education environment.

KEY STATISTICS
- Full-Time Equivalent Enrollment: 12,087 students
- Total Financial Resources: $822.8 million
- Total Pro-forma Direct Debt: $482 million
- Total Operating Revenue: $541 million
- Reliance on Student Charges (% of Moody's-adjusted Operating Revenue): 81%
- Monthly Days Cash on Hand: 627 days
- Operating Cash Flow Margin: 20%

OBLIGOR PROFILE

American University is a private non-sectarian research institution situated in a residential area of northwest Washington, DC. The university enrolled over 12,000 FTE students in fall 2014 across a comprehensive array of undergraduate, graduate and professional programs, including law, business, public affairs, and international service.

LEGAL SECURITY

The bonds are an unsecured general obligation.

USE OF PROCEEDS

Bond proceeds are expected to be used to refund all outstanding Commercial Paper ($100 million), fund $28.5 million of various capital projects in the capital plan, and pay issuance costs.

PRINCIPAL 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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