American University, DC

Update to credit analysis

Summary

American University’s (A1 stable) credit quality reflects the university's market position as an established research university in an attractive urban location with ongoing robust student demand. Revenue growth is healthy, and operating performance remains solid despite some recent softening. Liquidity is strong, providing an excellent 592 monthly days cash on hand for the fiscal year ending April 30, 2018. While absolute wealth is good, at over $1.1 billion of total cash and investments, spendable cash and investment coverage of operating expenses and debt is weak relative to peers given the university’s large operating scale. Thoughtful strategic and financial planning help to offset the impact of elevated financial leverage and the university’s high reliance on student charges. American’s pro forma debt profile is expected to consist of all taxable fixed rate debt and no outstanding swaps. Although the new issuance will increase debt, it significantly reduces complexity and risk associated with American’s existing debt portfolio, which includes approximately 40% variable rate debt, privately placed debt and notes, and swaps, collateral postings and covenants.

Exhibit 1

Healthy cash and investment growth and solid operating performance support A1 rating

Source: Moody’s Investors Service
Credit strengths

» Stronger market profile and robust student demand, evidenced by increased competitiveness in selectivity and matriculation
» Consistently strong operating results and excellent cash flow despite some recent softening
» Solid financial flexibility enhanced by high proportion of flexible reserves, with excellent liquidity for the rating category
» Careful planning and monitoring of strategic, operational and capital initiatives, including planned significant reduction of debt profile's complexity

Credit challenges

» Weaker financial reserve coverage of operations relative to peers
» Moderately high debt relative to scope of operations and spendable cash and investments
» Limited revenue diversity and lower philanthropic support relative to reputational peers

Rating outlook
The stable outlook reflects expectations of continued strong student demand, maintenance of flexible reserves and ongoing healthy operating performance.

Factors that could lead to an upgrade

» Exceptional growth in financial resources
» Increased philanthropic support leading to enhanced revenue diversification

Factors that could lead to a downgrade

» Softening of student demand
» Decline in operating performance leading to material reduction in flexible reserves
» Significant additional borrowing beyond current plans, which include eliminating swaps

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Key indicators

Exhibit 2
AMERICAN UNIVERSITY, DC

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<tbody>
<tr>
<td>Total FTE Enrollment</td>
<td>12,035</td>
<td>12,112</td>
<td>12,260</td>
<td>12,625</td>
<td>13,090</td>
<td>4,604</td>
</tr>
<tr>
<td>Operating Revenue ($000)</td>
<td>540,598</td>
<td>557,352</td>
<td>576,474</td>
<td>595,097</td>
<td>625,137</td>
<td>185,094</td>
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<tr>
<td>Annual Change in Operating Revenue (%)</td>
<td>3.8%</td>
<td>3.1%</td>
<td>3.4%</td>
<td>3.2%</td>
<td>5.0%</td>
<td>2.6%</td>
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<tr>
<td>Total Cash &amp; Investments ($000)</td>
<td>886,463</td>
<td>952,937</td>
<td>889,493</td>
<td>951,586</td>
<td>1,107,386</td>
<td>382,221</td>
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<tr>
<td>Total Debt ($000)</td>
<td>418,676</td>
<td>481,905</td>
<td>481,620</td>
<td>481,311</td>
<td>561,375</td>
<td>144,757</td>
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<tr>
<td>Spendable Cash &amp; Investments to Total Debt (x)</td>
<td>1.9</td>
<td>1.8</td>
<td>1.7</td>
<td>1.8</td>
<td>1.8</td>
<td>1.8</td>
</tr>
<tr>
<td>Spendable Cash &amp; Investments to Operating Expenses (x)</td>
<td>1.7</td>
<td>1.8</td>
<td>1.6</td>
<td>1.6</td>
<td>1.7</td>
<td>1.4</td>
</tr>
<tr>
<td>Monthly Days Cash on Hand (x)</td>
<td>627</td>
<td>651</td>
<td>547</td>
<td>552</td>
<td>592</td>
<td>365</td>
</tr>
<tr>
<td>Operating Cash Flow Margin (%)</td>
<td>20.4</td>
<td>20.4</td>
<td>21.7</td>
<td>20.3</td>
<td>16.5</td>
<td>14.1</td>
</tr>
<tr>
<td>Total Debt to Cash Flow (x)</td>
<td>3.8</td>
<td>4.2</td>
<td>3.8</td>
<td>4.0</td>
<td>5.4</td>
<td>4.9</td>
</tr>
<tr>
<td>Annual Debt Service Coverage (x)</td>
<td>7.7</td>
<td>7.3</td>
<td>6.2</td>
<td>6.0</td>
<td>2.3</td>
<td>2.7</td>
</tr>
</tbody>
</table>

Fiscal year ending April 30
Source: Moody’s Investors Service

Profile
American University is a private non-sectarian research institution situated in a residential area of northwest Washington, DC. The university enrolled over 13,000 students in fall 2018 across a comprehensive array of undergraduate, graduate, and professional programs including law, business, public affairs and international service.

Detailed credit considerations
Market profile: robust student demand and increased competitiveness
American’s market position will remain strong, bolstered by its desirable urban location in a residential area of Washington, DC, capital investment and brand enhancement. Improvements in selectively and matriculation are strong. Though there was some year-to-year fluctuation, selectivity strengthened to 32% for fall 2018 from 46% in fall 2014, and matriculation grew to 29% from 26% over the same period. Favorably, American achieved these gains while maintaining a low tuition discount rate under 30% compared to a 36% median for A-rated peers.

Exhibit 3
Enrollment has grown while selectivity has improved

Source: Moody’s Investors Service
While higher than budgeted financial aid and some softening in residential hall occupancy contributed to weaker operating performance in fiscal 2018, management expects improvements in both areas for fiscal 2019. American will continue to demonstrate the ability to adjust operations and expenses to enrollment shifts.

**Operating performance: strong operating performance and exceptional cash flow will continue despite some softening**

American will continue to demonstrate sound planning and careful monitoring of strategic, operational and capital initiatives, resulting in ongoing strong operating performance. While operating cash flow margin of a very good 16.5% for fiscal 2018 was softer than historic high levels of over 20%, it remains strong relative to a peer median of 14%. Although American will change its fiscal year end from April 30 to June 30 effective fiscal 2019, twelve month internal estimates comparing April 30, 2019, to fiscal 2018 show improved operating cash flow of approximately 19% for fiscal 2019, in line with historical performance. The university uses a two-year budgeting model and best practices, including budgeting for various contingencies, contributions to the quasi-endowment and investment in staff, facilities and technology.

Limited revenue diversity, with 79% of revenue derived from student charges, underscores the need for continued effective enrollment management. Increased revenue diversity, particularly from fundraising, would be credit positive.

**Wealth and liquidity: ongoing surpluses contribute to very favorable unrestricted financial reserves and liquidity**

American will continue to benefit from a high proportion of flexible financial resources built largely through years of consistent operating surpluses. Spendable cash and investments comprise a very strong 90% of American’s $1.1 billion in total cash and investments for fiscal 2018. Five-year growth in cash and investments was a very strong 25%, considerable higher than the peer median of 16%. This is particularly strong and notable considering the university’s $380 million investment in its physical plant over the same period.

American recently undertook a thorough review of its investment management program, resulting in changes to its advisors and target asset allocations. While funds previously had an equity bias, the university targets increased investment in alternatives over the next few years.

While three-year average gift revenue is in line with peers at $35 million, gifts per student lag peers. American raised a three-year average of $2,659 per student compared to a median of approximately $7,600 for A1-rated peers. The university will benefit from an upcoming campaign, with the goal and timeline not yet finalized.
Liquidity
Liquidity remains extremely strong for the rating category, with $883 million of monthly liquidity providing 592 monthly days cash on hand. After American’s planned debt refunding, calls on liquidity will be limited with the elimination of variable rate debt and swaps requiring collateral posting. In line with strategic shifts in asset allocation, unfunded commitments have more than doubled over the past two years, to $131 million in fiscal 2018, still very manageable given American’s strong liquidity.

Exhibit 6
Liquidity very strong relative to A-rated peers

Fiscal year ending April 30
Source: Moody’s Investors Service

Leverage: planned significant reduction to complexity of debt structure, moderately high debt relative to scope and financial resources
Investment in a large 10-year capital improvement plan, which will culminate with construction of a science center expected to open in 2020, has resulted in moderately high financial leverage, which anchors the university at the A1 rating. Spendable cash and investment covers pro forma debt, which includes estimated $70 million of new debt associated with swap termination fees, by 1.5x, lower than a 2.6x A1 peer median. High leverage is mitigated by strong operating cash flow; pro forma debt to cash flow with estimated April 30, 2019, results is in line with peers at 5.1x. With excellent cash flow expected to continue, American is able to absorb this incremental debt at the current rating level.

Debt structure
Favorably, American plans to refund outstanding variable rate and privately placed debt with fixed rate, taxable debt. This significantly reduces the complexity of the university’s debt structure, eliminating variable rate debt, swaps, and privately placed debt with covenants. American’s pro forma debt portfolio with consist of all fixed rate debt. Pro forma debt service is generally level at approximately $25 million of interest only payments through 2044, when principal payments are scheduled and debt service increases to a high $135-$155 million. In 2028, a principal bullet payment will increase debt service to $47 million.

American’s existing debt structure is relatively aggressive, with demand debt comprising 46% of the $561 million total debt portfolio, which is almost entirely structured as bullet maturities. Tender features on $219 million of variable rate debt is in bank purchase mode with three banks with expiration dates in 2020, 2021 and 2023. Management continues to demonstrate the ability to manage the portfolio’s complexities effectively.

Bank agreements are subject to leverage ratio and debt service coverage ratio covenants. The university has ample headroom under both ratio covenants for fiscal 2018 (leverage ratio of 1.65x compared to a 0.85x requirement; debt service coverage ratio of 5.35x compared to a 1.6x requirement). As of April 30, 2019, ratios were estimated at 2.14x and 5.35x, respectively.

Legal Security
Bonds are a general obligation of the university.
**Debt-related derivatives**
American has five swaps with two counterparties for a total notional amount of $195 million. As of April 30, 2019, the swaps were a $70 million liability to the university and required $24 million of collateral to be posted. While the swaps add risk to the university’s debt structure, American’s significant liquidity mitigates the risk of collateral posting or termination payments. The swaps are expected to be terminated with the proposed refunding transaction.

**Pensions and OPEB**
The university has a $19 million OPEB liability that is funded on a pay-as-you-go basis. Total OPEB costs and contributions to American’s two defined contribution plans were a manageable 3% of expenses for fiscal 2018.

**Governance and Management:** Strong management exhibits careful planning and management
With a strong management team in place, continued healthy operating performance in a highly competitive higher education environment will continue. The university’s board of trustees and senior leadership emphasize transparency and close fiscal oversight, yielding consistently positive results and a heightened market profile.
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