

# BONDS & CREDIT RATINGS

# What are Bonds?

- A bond is a loan in which the lender and the borrower enter into an agreement under which the lender will receive periodic interest payments and ultimately will get back the principal at maturity.
- Bonds can be bought and sold and have values that fluctuate accordingly.
- Public sector bonds (referred to as municipal bonds or “muni bonds”) that are issued by institutions such as universities are generally tax exempt, i.e. the interest paid to the investor is typically not subject either to federal income tax or to state and local taxation

# Issuing Bonds Requires Management to Disclose Information

- Official Statement which includes material information about the institution, including the most recent Comprehensive Annual Financial Review (CAFR) or audit
- Continuing Disclosure Requirements
- These Documents should be available online: for no cost at the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA) site <http://emma.msrb.org/> or for a fee at a



# Who Purchases Bonds?

- Institutional investors, such as mutual funds, pension funds, and banks.
- Importantly, institutional investors may use credit ratings to establish thresholds for credit risk and investment guidelines.

# What are Credit Ratings?

- Credit ratings are opinions about credit risk that are used by investors when making decisions to buy, hold and sell bonds.
- Credit rating agencies assign credit ratings based on their analysis of an issuer's ability to make interest payments and repay principal in a timely manner.
- Credit rating agencies such as Moody's and Standard & Poor's apply their own methodology in measuring creditworthiness and each use a specific rating scale. Ratings are typically letter grades that range, for example, from 'AAA' to 'D' to communicate the agency's opinion of relative level of credit risk.

# Standard & Poor's Ratings Scale

General Summary Of The Opinions Reflected By Standard & Poor's Ratings		
<b>Investment Grade</b> 	'AAA'	Extremely strong capacity to meet financial commitments Highest rating
	'AA'	Very strong capacity to meet financial commitments
	'A'	Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances
	'BBB'	Adequate capacity to meet financial commitments, but more subject to adverse economic conditions
	'BBB-'	<i>Considered lowest investment grade by market participants</i>
<b>Speculative Grade</b> 	'BB+'	<i>Considered highest speculative grade by market participants</i>
	'BB'	Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions
	'B'	More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments
	'CCC'	Currently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments
	'CC'	Currently highly vulnerable
	'C'	A bankruptcy petition has been filed or similar action taken, but payments of financial commitments are continued
	'D'	Payment default on financial commitments

# Credit Ratings are Based on Four General Factors

- Economic Strength
- Financial Strength
- Management and Governance
- Debt Profile

# Factors Shaping Credit Ratings In Higher Education

- “The ability of a university to balance revenue with expenses and meet debt service obligations is of central importance.” –  
**Moody’s Methodology for Rating Public Universities, 2007**
- Factors listed in “Moody’s Approach For Evaluating Community Colleges” (1999)
  - Debt Position
  - Student Demand and Market Position
  - Strength, Size, and Diversity of the Local Economy
  - State Operating and Capital Support
  - Operating Performance
  - Financial Reserve Base
  - Management and Strategy

# Information Used to Evaluate a University by Standard & Poor's

## **Bond documents**

- Bond resolution or indenture.
- Lease or mortgage.
- Official statement.
- Demand information
- Five years of headcount enrollment information broken down by undergraduates and graduates and reflecting full- or part-time status.
- Five years of first-time freshman application information, including acceptances, matriculants, and student quality indicators and average test scores.
- Top 10 competitor institutions and win/loss statistics, if available.
- Program offerings indicating additions and deletions of programs over the past five years.
- Five years of student fee tuition and room and board charges.
- Five years of faculty information broken down by full - and part-time faculty, percentage tenured, and percentage holding doctorates

## **Financial information**

- Five years of audited financial statements and current year budget summary.
- History of state appropriations and formula used to determine appropriation, if applicable.
- History of annual giving, capital campaign, and fund drives, including participation rates and goal success.
- Endowment investments, investment reports, and spending policy.
- Capital improvement and future debt plans, and comprehensive debt service schedule.

## **Management**

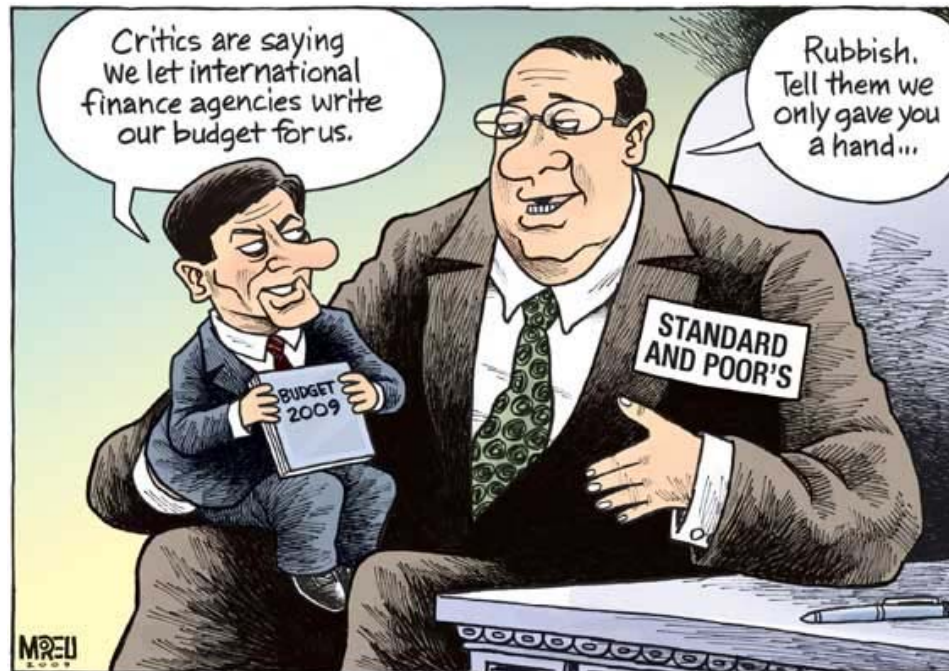
- Brief management biographies.
- Description of governing board or body and relationship with institution.
- Strategic plan.

# Where's the Risk?

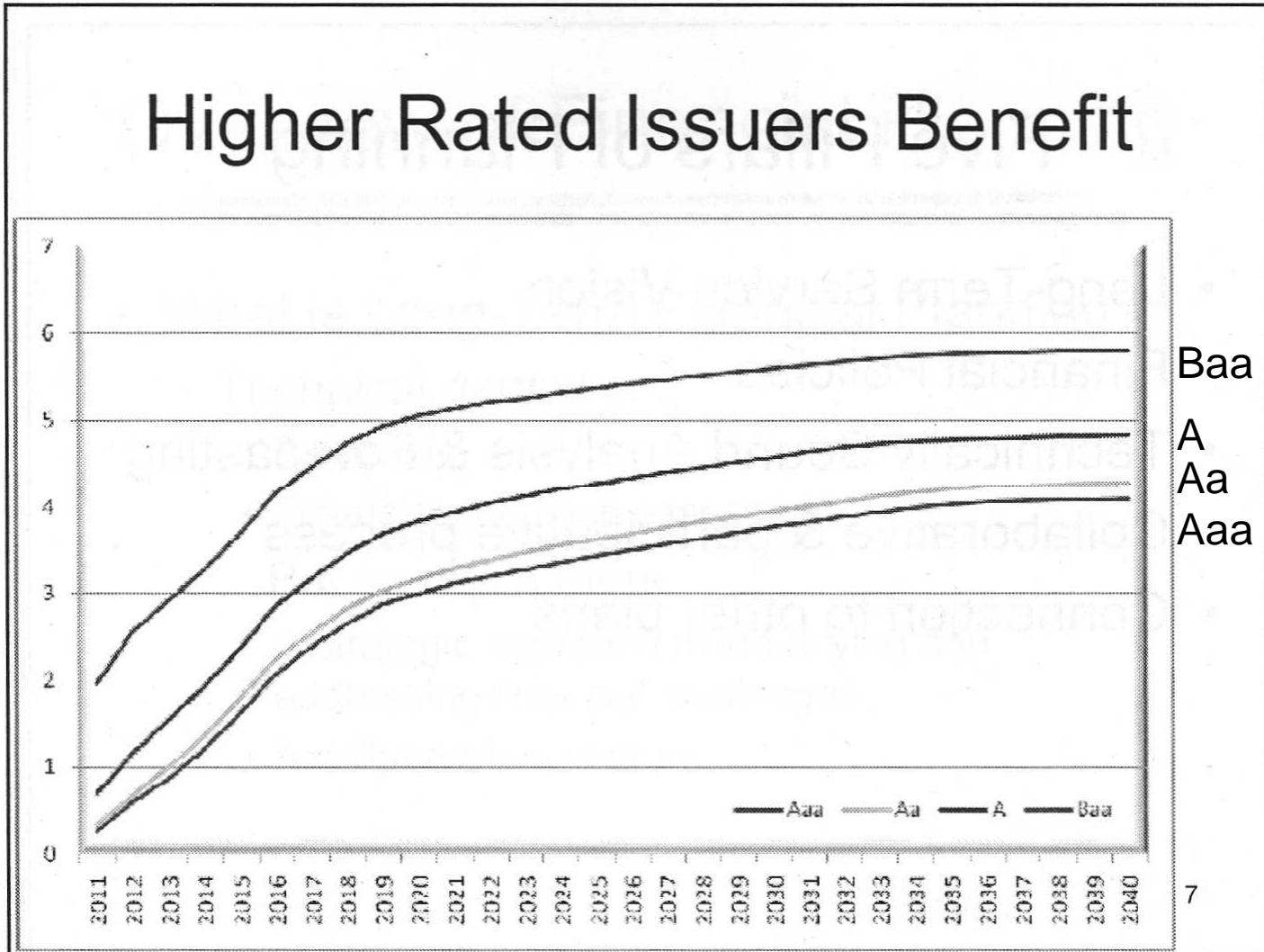
- Moody's employs a weighted average approach to analyzing these factors to arrive at a rating range. The precise rating is based on a comparison with peers...
- “There has never been a default by a Moody's-rated public university in the US, and we believe that the possibility of a default is extremely low due the likelihood of state support of a public university in financial distress. In the few cases of a public university encountering financial problems, such as financial mismanagement, declining enrollment, or other crises, state governments have intervened to correct the problems.” – *Moody's Methodology for Rating Public Universities, 2007*

# Why are Credit Ratings important to us?

First, management cares deeply about them: an institution's credit rating helps to determine the cost of borrowing. As a result management decisions are often made with an eye towards improving or maintaining a high credit rating.



# Higher Rating = Lower Interest Rates



# Why are Credit Ratings Important to Us? (Slide 2)

- The credit rating reports that accompany a rating offer an independent 3<sup>rd</sup>-party analysis of our employer.
- These reports may be at odds with what management is telling us:



# Credit Agencies Offer Working Definitions of Financial Distress

5 warning signs of financial distress:

- 1) Declining Enrollment
- 2) Declining Net Tuition Per Student or Declining Net Tuition Revenue
- 3) Two consecutive years of operating deficits greater than 5% of revenue,
- 4) One year of a “serious” operating deficit, even when adding back depreciation; and
- 5) Declining Liquidity due to Investment Losses or Operating Deficits

Source: Moody's Higher Education Sector 2003 Industry Outlook

# Credit Rating Agencies also offer other useful benchmarks

- **OPERATING DEFICITS:** Generally, Standard & Poor's expects at least modest operating surpluses over the long run, signifying that revenues are sufficient to meet all operating needs, including depreciation and plant renewal expense. However, a one- or two-year operating deficit is not considered a problem, if the school has a large, liquid financial cushion.
- **ENDOWMENT SPENDING:** Standard & Poor's usually considers an endowment spending rate above 6% to be high, and above 8% to be excessive.
- **DEBT BURDEN:** One way to measure a university's debt burden is to compare maximum annual debt service to annual operating expenses. A ratio greater than 10% generally indicates an excessive debt burden, and over 7% is considered to be moderately high