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OUTLOOK
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Higher Education - US

2017 Outlook - Stable with Clouds Forming on Horizon

Our outlook for US higher education is stable. This outlook reflects our expectations for the fundamental business conditions in the sector over the next 12 to 18 months.

The stable outlook reflects our expectation of aggregate annual revenue growth at or above 3% for public and not-for-profit private four-year colleges and universities. Higher education demand will remain sound, contributing to overall steady enrollment. However, the continued focus on affordability and accountability will continue to limit net tuition revenue growth to inflationary increases. State funding will continue to vary significantly from state to state and will likely moderate over the outlook period. The sector remains highly exposed to investment market performance and federal policy and funding changes.

» **Aggregate revenue growth will remain above 3% for both public and private universities.** Modest net tuition revenue growth, incremental increases in state appropriations, stable research funding and favorable academic medical center performance support our stable revenue growth projections.

» **However, clouds are beginning to form on the horizon.** Rising pension liabilities, increasing labor costs and uncertainty around future federal policies and funding could weigh on the sector during the later portion of the outlook period.

» **Changing business conditions will affect elements of the diverse sector differently.** Universities, both public and private, with the strongest brands and value propositions for students will continue to outperform. Smaller, more regionally oriented public and private universities will face the greatest challenges.

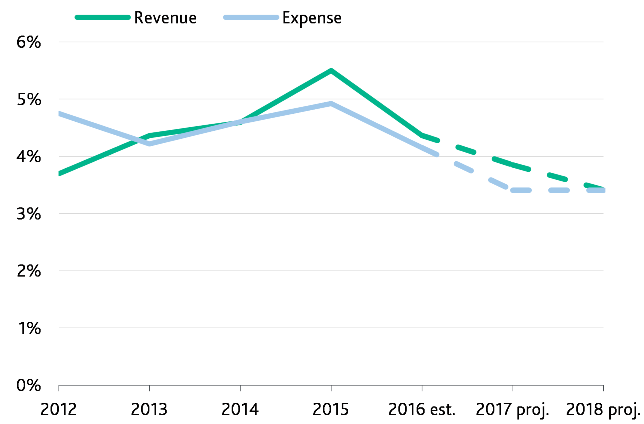
» **What could change our outlook.** A third year of weak financial market performance or material negative changes to federal policy or funding related to higher education or healthcare are the primary downside risks for the sector.

Aggregate revenue growth will remain above 3%

Both public and private universities in aggregate will sustain stable revenue growth through the middle of calendar year 2017. For FY 2017, we expect aggregate revenue growth will be moderately above 3%, which will meet or exceed our projected expense growth (see Exhibits 1 and 2). These revenue levels will lead to steady operating cash flow margins of 10%-12% for most public universities and 12%-14% for private universities. Diverse revenue streams, not all of which are correlated, benefit the sector and contribute to sector stability.

Exhibit 1

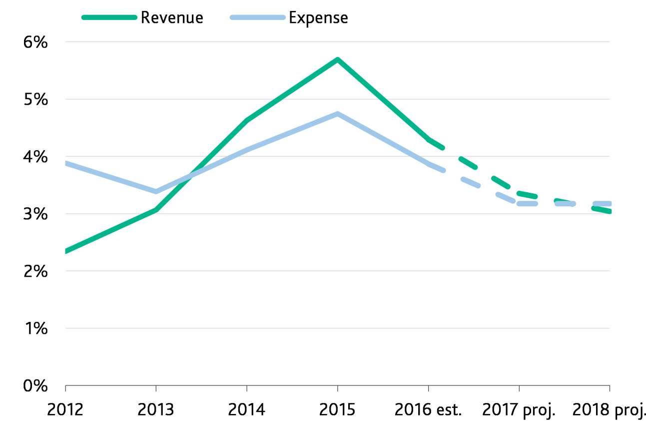
Private University Revenue Growth Will Continue to Exceed Expense Growth Over Outlook Period
Aggregate % Change in Private University Revenues and Expenses



Source: Moody's Investors Service; Moody's Projections

Exhibit 2

Revenue Growth Likely to Slow for Public Universities
Aggregate % Change in Public University Revenues and Expenses



Source: Moody's Investors Service; Moody's Projections

Net tuition revenue will grow 2%-3%

Our expectations of modest enrollment growth combined with an improving ability to pay for the cost of education will support 2%-3% net tuition revenue growth for both public and private universities. However, a highly competitive environment, continued focus on affordability and state constraints on tuition increases limit prospects for stronger net tuition revenue growth.

Over the outlook period, total enrollment will grow modestly, averaging 1.5% annually for FY 2017 and FY 2018.[1] Slowly improving retention rates will also help stabilize enrollment; retention rates improved by two percentage points for the entering classes between fall 2009-14, due in part to increased investment in retention initiatives, including more intensive student counseling.[2] Universities will be able to raise tuition moderately if income and wages continue to rise and unemployment stays low as we expect it will according to Moody's Global Macro Outlook 2017-18 .

Because our outlooks represent our forward-looking view on credit conditions that factor into our ratings, a negative (positive) outlook suggests that negative (positive) rating actions are more likely on average. However, the outlook does not represent a sum of upgrades, downgrades or ratings under review, or an average of the rating outlooks of issuers in the country or sector, but rather our assessment of the main direction of credit fundamentals within the country, region or sector.

Higher education's enduring value proposition – meaning the value of a four-year degree to the student – further supports steady demand and pricing power over the outlook period. The mean annual earnings of those with a bachelor's degree or higher was over $75,000 in 2015, compared to $35,615 for those with just a high school degree.[3] College graduates also have much more job stability, reflected in lower unemployment rates through economic cycles. For example, in 2015, the unemployment rate of 20-24 year olds who had a bachelor's degree or higher was 5%, compared to 16% for those with only a high school degree.[4]

Our annual tuition survey indicates that net tuition revenue will grow by a median 2.5% for private universities and 2.0% for public universities for FY 2017. We expect similar growth for FY 2018.

State funding may moderate in 2018

Aggregate state funding will grow approximately 3%-4% for the current fiscal year 2017, but early projections indicate that increases will taper to 1.5%-2.5% in FY 2018, the later portion of our outlook period. This is consistent with our stable outlook for state revenue growth, published in June.

Changes in state funding will continue to vary widely from state to state, depending on individual state economic conditions and policy priorities. The states where we see continued pressure include, among others:

» States with concentrations in energy sectors, such as Alaska (Aa2 negative), Louisiana (Aa3 negative), West Virginia (Aa1 negative) and Wyoming (not rated).

» States that have a vulnerability to outsized retiree benefit liabilities, such as Illinois (Baa2 negative) and New Jersey (A2 negative).

» States such as Kansas (Aa2 negative) where policy choices, including tax reductions, have curbed revenue growth.

Increases in state operating support for public universities will likely be modestly lower than overall state revenue growth given competing state budget priorities and mandates. There also will be a continued move by state governments to tie funding to various accountability measures. These measures, which include metrics such as graduation rates and degrees awarded in specified fields of study, will vary from state to state. Performance-based funding will continue to cause some funding variability as states shift funding between institutions depending on various performance goals.

Patient care will remain the most rapidly growing revenue stream

Patient care revenue for academic medical centers will grow 4%-5% over the outlook period, according to our projections, through a combination of intrinsic growth and ongoing industry consolidation. Academic medical center hospitals will continue to outperform other not-for-profit and public hospitals due to a greater volume of higher acuity and more profitable cases.

We expect patient volume growth to level out at around 1% as the uninsured population stabilizes. However, academic medical centers with developed and successful outpatient growth strategies will still have robust revenue growth.

Similar to the rest of the healthcare industry, we expect the rapid pace of consolidation – including mergers, acquisitions and strategic partnerships – to continue. Consolidation drives opportunities for market share and profitability growth, but may include risks associated with capital commitments, transitional operating expenses, and governance and cultural challenges.

Research grants and contracts projected to grow 2%-3%

In light of uncertainty around future federal funding priorities, we have incorporated grant and contract revenue growth of 2%-3% into our forecast, which we based on the 2017 requested budget for the National Science Foundation (NSF) and the National Institutes of Health (NIH). Given the strategic importance of research to the most research intensive universities, we anticipate that they will continue to fund additional research growth from gift support and other internal resources. Universities will also continue to search for corporate and foundation research funding, although this tends to come with lower reimbursement for the indirect cost of research, such as general research administration, than federal funding.

Endowment income and gift revenue strong in FY 2017, potentially slowing in FY 2018

For the remainder of FY 2017, we project a 4%-5% increase in endowment income that is available to support operations (see Exhibit 3).[5] However, for FY 2018, we are currently incorporating relatively flat endowment income levels due to weak investment returns in FY 2015 and FY 2016.

We expect gift revenue to remain healthy in FY 2017, growing 4%-5% with potential modest slowing in FY 2018. However, gift revenue is largely dependent on investment market performance and overall consumer confidence.

Exhibit 3
Different Revenue Streams have Varied Expected Growth Rates

Source of Revenue	FY 2017 Forecast Growth Assumptions (%)	FY 2018 Forecast Growth Assumptions (%)	% of Aggregate Private University Revenue	Median Private University Revenue (%)	% of Aggregate Public University Revenue	Median Public University Revenue (%)
Net Tuition & Auxiliaries	2-3	2-3	38	75	34	49
State Appropriations	3-4	1.5-2.5	-	0	20	24
Patient Care	4-5	4-5	25	0	17	0
Grants & Contracts	2-3	1-2	14	2	17	11
Endowment Income	4-5	0-1	12	8	3	2
Gifts for Operations	4-5	3-4	3	6	3	2
Other Revenue	4-5	4-5	8	2	6	4

Median data is the median for each revenue stream and will not add up to 100%. Aggregate data is driven by the largest universities in the portfolio, whereas median data adjusts for the diversity across the sector.
Source: Moody's Investors Service

Higher education's business model will continue shifting gradually

Over the outlook period, we expect ongoing gradual, but not disruptive, shifts in the higher education business model.

» **Technology will continue to allow universities to reach new markets and deliver content in new ways.** Over time, technology will provide a platform to begin to bend the higher education cost curve. However, over the outlook period, it is more likely to be an additional budgetary pressure for institutions as they invest in administrative, marketing and content-delivery (online learning) technology.

» **Expanded academic, research and capital investment partnerships can enhance efficiencies.** In addition to universities exploring additional means of cost-sharing, more formal affiliations and mergers are possible. Particularly for public universities in states with declining state operating support for universities, we expect ongoing discussion and execution of various types of consolidations and collaborations.

» **Institutions will increasingly commercialize and monetize activities to drive modest revenue growth.** For example, research universities will continue to focus on translating their research into potential commercial activities, either through patents and licensures, fostering of research parks and other types of commercial partnerships. Some universities will explore monetization of revenue producing activities, such as housing and parking, with varying potential credit impacts.

Clouds forming on the horizon

Toward the middle to later end of the outlook period, we see potential pressures building for the sector. Expense pressures will increase as key revenue streams likely soften, resulting in potentially weaker FY 2018 cash flows. Furthermore, the direction of federal higher education policy, including funding of key programs, is highly uncertain.

Among the potential clouds are:

Softening revenues

Starting in 2018, less endowment income will likely be available to support operations, absent unexpectedly robust FY 2017 investment returns. State funding growth will also likely moderate in FY 2018, based on current state revenue growth projections. Finally, a continued focus on affordability will limit tuition revenue growth to 2%-3%.

Rising inflation and labor costs

Moody's Global Macro Outlook highlights prospects for rising inflation, which is in part driven by wage pressures due to strengthening labor markets. With a high proportion – typically in the 60% range – of universities' budgets associated with personnel, prospective wage growth of over 3% may drive higher overall expense growth absent additional efficiencies. Growing unionization of adjunct faculty and graduate students will further contribute to prospective wage increases.

Increasing pension liabilities

For public universities, adjusted net pension liabilities may increase as much as 40% between FY 2015 and FY 2017, driven by several years of investment returns below actuarial assumptions. While pension expense is currently a relatively low approximately 3% of public universities' budgets, this will increase as liabilities grow. Potential financial market volatility could result in additional pension liability growth in FY 2018 and beyond should investment returns continue to fail to meet actuarial assumptions. For those universities where the state pays all or a portion of pension expense, the potential for shifting pension costs to universities rises as liabilities increase.

Growing borrowing costs

Those universities that access the capital markets in 2017 and 2018 are likely to face moderately higher borrowing costs, which will also contribute modestly to budgetary pressures. If financial market volatility remains subdued, we expect that the Federal Reserve will raise the federal funds rate by 25 basis points in December.[6] Should the economy continue to grow at a healthy pace, we expect two to three more rate increases in 2017. Although rates will likely rise, they are expected to remain relatively low. Further, many universities have already taken advantage of a multi-year low interest rate environment to refinance debt and to borrow for capital needs over the next several years at a locked-in lower rate.

Potential federal policy and funding changes

The higher education sector is highly exposed to any potential changes in federal policies or funding. Universities derive a significant share of revenues from the federal government, for student financial aid programs (both grants and loans), research funding and Medicare/Medicaid revenues at academic medical centers. Additionally, there are various federal programs that benefit specific market segments, such as capital financing programs that provide low cost borrowing options to rural universities and historically black colleges and universities, and a discretionary/competitive grant program for hispanic-serving institutions.

The Department of Education is responsible for many funding and regulatory programs, including a process for formally recognizing accrediting groups that verify colleges and universities' viability. Any material changes to the Department of Education and its scope of operations could alter the competitive higher education structure, for example by cutting some funding programs or altering regulatory compliance. As the sector is structured today, any potential regulatory changes contributing to a resurgence of for-profit universities would not likely have a large effect on not-for-profit universities because for-profit universities typically enroll mostly older and part-time students.

President-elect Donald Trump's proposal to discourage companies from employing H-1B workers would likely reduce international student enrollment because it would make it harder for companies to hire foreigners, diminishing the post-study job prospects of international students in the US. This type of policy change would most negatively affect universities with less well-known global brands and those that more recently entered the international student market. Even the possibility of, and the uncertainty around, possible immigration policy changes may be enough to discourage some international students. Universities have in recent years benefitted from a significant increase in non-US students, who typically receive less discounting and pay higher net tuition. Reductions in international enrollment would place further pressure on net tuition revenue.

Relatively strong reserves enhance sector stability

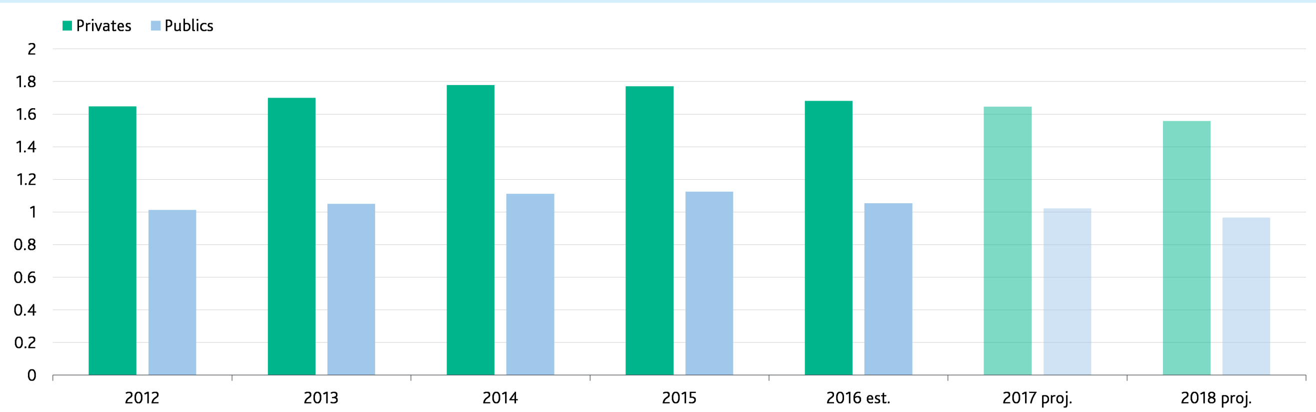
Moody's-rated universities tend to have stronger reserves and wealth levels than the overall higher education sector, helping to stabilize universities' credit during potential periods of economic volatility.

On the median, spendable cash and investments cover more than 16 months of annual operating expenses for private universities and 7.5 months for public universities. Sector wide, liquidity remains sound with a median of more than 300 days cash on hand for private universities and a median of more than 135 days cash on hand for public universities. These levels have remained relatively stable over the last several years, although levels may weaken modestly over the outlook period given potential for ongoing investment market volatility and budgetary growth (see Exhibit 4).

Exhibit 4

Sound Reserves Relative to Expenses with Modest Tightening Possible

Aggregate spendable cash and investments to total expenses (x)

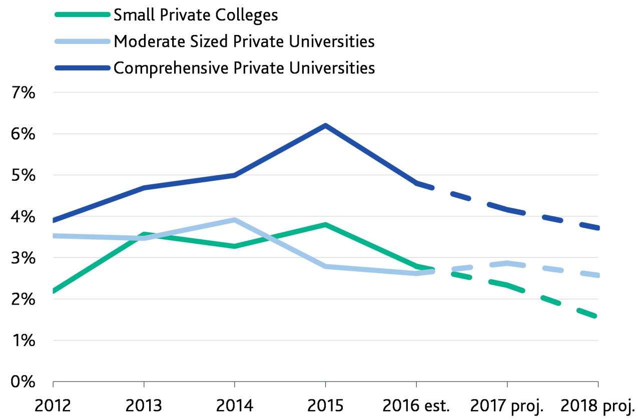


Source: Moody's Investors Service; Moody's Projections

Ongoing sector differentiation based on brand and revenue diversity

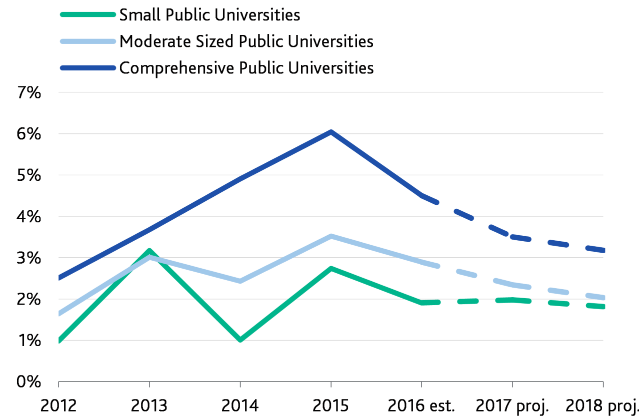
Against the backdrop of evolving business conditions and future uncertainty, universities with the strongest brands and greatest revenue diversity will continue to outperform those with more limited pools of prospective students and donors and more concentrated revenue streams (see Exhibits 5 and 6).

Exhibit 5
Comprehensive Private Universities Will Maintain Stronger Revenue Growth
Aggregate % Change in Revenue by University Type



Source: Moody's Investors Service; Moody's Projections

Exhibit 6
Comprehensive Public Universities Will Also Outperform
Aggregate % Change in Revenue by University Type



Source: Moody's Investors Service; Moody's Projections

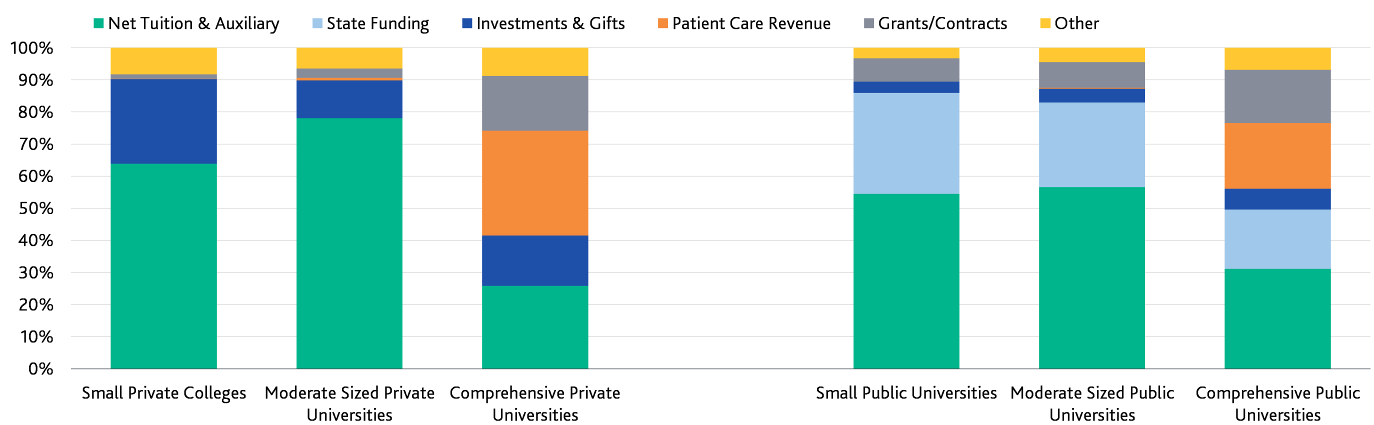
Private universities

» Comprehensive universities will continue to have the strongest revenue growth (see Exhibit 7). Not only do they have greater revenue diversity, but our 2017 tuition survey highlights that they have greater pricing power due to their brands and programmatic offerings.

» Highly tuition dependent small colleges will face the greatest challenges, given more limited prospects for tuition revenue growth and a typically more expensive business model focused on small class sizes and low student/faculty ratios.

» Colleges with a high dependence on endowment income may begin to feel additional budgetary pressures in FY 2018 if investment returns are low and volatile. These colleges typically have strong brands that would enable them to raise tuition as an offset. However, tuition increases will likely be limited by their focus on a diverse student body and likely ongoing public scrutiny around college costs and use of endowment funds for financial aid.

Exhibit 7
Comprehensive Universities Have More Diversified Revenue Streams
Aggregate revenue composition by subsector



Source: Moody's Investors Service

Public universities

- Consistent with recent years, comprehensive public universities, which are often their state's flagship and land-grant universities, will continue to have stronger overall net tuition revenue growth due to brand strength and a greater proportion of enrollment from non-resident and international students. Non-residents typically pay higher tuition and often receive less financial aid.
- Universities in states with fiscal pressures, notably energy-dependent states and states with high pension exposure, are the most vulnerable to potential state funding reductions.
- Smaller regional public universities, particularly those in regions of the country with weaker demographics such as the Midwest, will continue to be the most challenged amongst public universities given high reliance on student charges and more limited pricing power.

Diversified capital funding sources will enable judicious use of debt and moderate leverage

A highly competitive environment and capital intensive business models will lead to continued capital spending in excess of depreciation over the outlook period. However, the higher education sector's ability to tap a variety of funding sources to fulfill capital needs will contribute to moderate use of debt and stability in key leverage metrics.

Colleges and universities have increasingly been relying on gifts and cash flow to fund capital needs, resulting in a modest 7% increase in aggregate outstanding debt for publics and 6% increase in aggregate debt outstanding for privates from 2012-15. Some public universities, such as those in Texas (Aaa stable), will benefit from increasing state capital support, limiting growth in fixed capital costs.

We expect continued exploration of a variety of alternative capital investment strategies, including demand-risk public-private partnerships, concession agreements, and some availability-based payment structures over the outlook period. These arrangements carry various risks, as well as benefits, for the individual universities pursuing these arrangements.

What could change our outlook

We could revise our outlook to negative if there is a third consecutive year of weak investment returns, which results in lower endowment income to fund operations. Investment market volatility could also contribute to a negative outlook if donor support is dampened. There is significant uncertainty around the direction of multiple federal policies impacting higher education. Changes to immigration policy could slow the flow of international students, which now comprise an estimated 8%-10% of sector-wide tuition revenue. Similarly, alterations to the framework for federal financial aid or changes to accreditation processes could negatively change the competitive landscape. Repeal of, or changes to, the Affordable Care Act could have negative consequences for academic medical centers, particulary if they result in growth of uncompensated care. More material slowdowns than currently projected in state revenues could lead to reduced state funding for public universities.

Given the headwinds, a revision to a positive outlook seems less likely but could occur if federal stimulus results in robust investment market performance, enhanced philanthropy and a greater ability to raise tuition rates in excess of inflationary expense growth.

Moody's Related Research

Sector In Depths

- Alternative Capital Investment Strategies Offer Risks and Rewards for Universities, August 2016
- Tuition Survey Highlights Low but Steady Net Tuition Revenue Growth, November 2016

Medians

- US Public Universities Largely Stable, Considerable Sector Variability, July 2016
- US Private Universities Maintain Stability but Pockets of Stress Remain, July 2016

Methodology

- Global Higher Education, November 2015

Outlooks

- US Not-for-Profit and Public Healthcare - Sector Stable; Long-term Pressure Remains, December 2015
- US- States - Revenue Growth Supports State Fiscal Stability, June 2016

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Endnotes

1 National Center for Education Statistics, Projections of Education Statistics to 2023.

2 National Student Clearinghouse Research Center

3 United States Census Bureau Current Population Survey

4 National Center for Education Statistics, Digest of Education Statistics 2015

5 We arrived at this growth level by applying an industry standard 5% of the prior three-year average of cash and investments.

6 Moody's Global Macro Outlook 2017-18

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