2015 Outlook - US Higher Education

Slow Tuition Revenue Growth Supports Negative Outlook

Summary

Our outlook for the four-year US Higher Education sector is negative. This outlook reflects our expectations for the fundamental business, financial and economic conditions in the sector over the next 12-18 months.

The annual change in aggregate operating revenue for four-year colleges and universities will decline and remain below 3% (modest real growth in a low-inflation environment) over the next 12-18 months, supporting our negative sector outlook. Slowed revenue growth coupled with mounting expenses will contribute to weaker operating performance in fiscal year 2015. Amidst the backdrop of challenging business conditions, there are signs of stability, including overall strong student demand and balance sheet strengthening. The outlook for the entire sector has been negative since January 2013.

» Price sensitivity, as evidenced by the ongoing national discourse on college affordability, will constrain net tuition revenue growth. Net tuition revenue growth will be the weakest in more than a decade in 2015, with a growing number of universities experiencing acute pressure.

» State funding for public universities will grow, but remain lower than historic levels and may come with strings attached. State appropriations per student remain below fiscal year 2009 levels and increases, for some, will be coupled with state-imposed limitations on tuition increases.

» Research and patient care revenue will be challenged and increasingly competitive to secure. Positively, academic medical centers generally maintain strong credit characteristics and benefit from good research and clinical reputations.

» Strong investment performance and fundraising are an offsetting positive, helping fortify balance sheets. Double-digit average endowment returns in fiscal years 2013 and 2014 have aided the majority of universities in growing total cash and investments above pre-recession peaks.

» What could change the outlook. An annual change in aggregate operating revenue in our rated sample of at least 3%, representing real growth in a low-inflation environment, coupled with ongoing solid student demand and balance sheet strength would support a return to a stable outlook. Revenue growth well in excess of inflation expectations for the sector would drive a positive outlook.
**Revenue growth will decline, pressuring operating performance**

We maintain a negative outlook for the US higher education sector due to lingering stagnation of operating revenue, coupled with mounting expense pressures and anticipated weakening of overall operating performance in 2015. We forecast the annual change in aggregate revenue growth to hover below 3% for not-for-profit private and four-year public universities over the next 12-18 months (see Exhibit 1). Constrained net tuition revenue growth is a key driver of our negative outlook, but most revenue streams are growing at a slower pace and are more competitive to secure, including state funding, sponsored research and patient care revenue for those universities that own hospitals or faculty practice plans.

Aggregate operating performance for the sector will weaken moderately as expense pressures increase following multiple years of restraint. In response to lower top-line revenue growth, management teams are focused on operating more efficiently and containing expenses. In reaction to the weak economy, many universities have been able to hold expenses down, taking steps that have included freezing salaries, voluntary retirement programs, and deferral of non-essential capital investments. Colleges and universities now face mounting pressure to increase operating and capital investments, or risk some loss of competitive position. Operating budgets must incorporate expanded financial aid, increasing energy and healthcare costs, fixed costs including tenured faculty, and growth of debt service and depreciation as a result of increased leverage. Public universities, in particular, will have to absorb growth of post-retirement service costs.

**Exhibit 1**

*Aggregate Revenue Growth Remains Depressed*

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*Source: Moody’s Investors Service*
**Slowed growth of student charges is a key challenge**

Slowed growth of net tuition revenue is a key contributor to overall intensifying revenue pressures, with US public and private universities expecting the weakest net tuition revenue growth in a decade in FY 2015. The ongoing national discourse around the cost of attending college coupled with increasing demands for financial aid will continue to depress net tuition growth. Because most colleges rely heavily on student charges (75% median contribution ratio for private universities; 47% median contribution ratio for four-year public universities), net tuition growth at least at the pace of industry inflation would be necessary for a return to a stable industry sector outlook.

Multiple factors hinder revenue growth including declining enrollment for some, lower gross tuition increases than in the past, and expanded tuition discounting. Colleges and universities with regional draws in areas expecting a declining number of high school graduates will be particularly challenged to maintain stable enrollment and grow tuition. For instance, colleges and universities drawing students largely from the Midwest and Northeast will face intensifying competition and limited future enrollment growth. Conversely, institutions in the South will benefit from favorable trends in high school graduates.

Results of this year’s [Moody’s tuition survey](#) indicate a growing proportion of universities projecting annual growth of net tuition revenue below 2% for FY 2015. Public universities project 1.9% overall net tuition revenue growth, and private universities expect 2.7% growth in FY 2015. While the majority of private university survey respondents have forecasted 2015 tuition growth at or above 2%, public universities will be more challenged to do so as a result of political pressure and in some cases state-imposed requirements to hold down tuition increases. The impending reauthorization of the Higher Education Act, which governs federal financial aid programs (Title IV) adds an additional layer of uncertainty, particularly for those institutions serving students heavily dependent on financial aid including Pell grants.

Significantly elevated application volume and sector-wide declining yield rates (% of accepted students who enroll) have also complicated budgeting and financial aid processes amidst the backdrop of a highly competitive and price-sensitive student market (see Exhibit 2). Heavily tuition-dependent colleges with weak market positions are most vulnerable, but even many diversified, well-endowed universities have chosen to expand financial aid initiatives in order to attract a socioeconomically diverse student body.

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**Exhibit 2**

*Pricing Power Continues to Erode for Public and Private Universities*

![Graph showing median annual change in net tuition revenue for public and private universities from 2004 to 2015. Source: Moody’s Investors Service](#)
While business conditions remain challenged, green shoots of stability persist

Amidst the backdrop of a challenging operating environment, green shoots continue to emerge pointing to future stabilization. Declining unemployment rates for college graduates and further data illuminating the lifetime earnings premium for those with a post-secondary education are credit positive for the higher education sector and support future growth of enrollment and tuition revenue. The US Department of Education recently projected 14% growth of enrollment in US colleges and universities between 2011 and 2022, with growth greatest at the graduate level. Strong enrollment demand from international students presents an opportunity for revenue growth and diversification, particularly for market-leading universities that attract the largest number of international students. A rebound in household net worth indicates an improved ability to pay for a college education. Colleges and universities with the strongest reputations, the broadest student demand and the greatest programmatic value proposition will be best positioned going forward.

With significant public and media attention on debt for graduating students, lower student loan default rates are also positive signs for the sector. Recent data released by the US Department of Education show modestly improved student loan default rates in the US for the first time in seven years, reflecting declining unemployment and expanded deferral and repayment options. Further, data analysis of the pace of increases in average educational debt shows a slowdown in recent years compared to the preceding decade.

State funding grows, often with strings attached

While combined state funding for US higher education grew in FY 2014, we expect the pace of increases over the next one to two years to slow based on initial state budget proposals. Higher education funding competes with multiple other state priorities, including rising pension expense, limiting likely future growth. Further, performance-based funding, which awards funding based on student outcomes measures, will likely expand and create some uncertainty in funding distribution.

We do not anticipate widespread cuts in state funding over the next few years because the finances of most state governments have improved since the recession. However, funding remains below pre-recession levels and has declined on a funding-per-student basis despite recent increases in state appropriations. Public universities’ median reliance on government operating support has dipped to new lows, representing less than 25% of operating revenue in FY 2013, compared to over 30% in FY 2009.

In some cases, increased state funding has been coupled with restrictions on tuition increases, particularly for in-state undergraduate students (see Exhibit 3). For example, increases in state funding for Ohio (Aa1 stable) public universities came with a requirement to limit fall 2014 tuition increases to no more than 2%. In Florida (Aa1 stable), a new law eliminates tuition increases pegged to inflation, with many of the state’s public universities keeping in-state undergraduate tuition frozen for fall 2014.
Competition for research and patient care funds intensifies, but academic medical centers are well positioned

Research funding will be increasingly competitive to secure. We expect fiscal 2015 research funding to universities by the National Institutes of Health and National Science Foundation to decline on an inflation-adjusted basis as a result of federal budget pressures, reductions to federal discretionary spending, and the impact of sequestration. Even top research universities are budgeting conservatively for grants and contracts. Gifts and grants from individuals, corporation and private foundations will increasingly fund research activity. However, these private funding sources tend to provide more limited indirect cost recovery (administration and facilities expenses), if any, further challenging top line revenue growth for research-intensive institutions. On a positive note, philanthropy, particularly for biomedical research, remains strong, and gift revenue at academic medical center (AMC) universities is much higher than the broader higher education universe.

Currently, most universities with AMCs are benefiting from their hospital relationships as a result of sustained improvement in AMC hospital performance. Improved cash flow and stronger hospital balance sheets have resulted in tighter working relationships between university and hospital partners. However, the implementation of US healthcare reform and changing reimbursement models will continue to slow the growth of clinical revenue. Negotiations around financial transfers from university-owned hospitals to their affiliated medical schools will become increasingly intense for some, and growth of this funding stream may slow for some universities. Future federal cuts in graduate medical education and disproportionate share funding will further challenge academic medical centers and narrow their contributions to university revenue.

Strong investment performance fosters endowment growth and philanthropy

Most universities have benefited from growth of total cash and investments in recent years, reflecting positive investment performance and continued strong gift flow to the sector. The majority of universities have grown cash and investments beyond pre-recession peak levels, providing stronger coverage of debt and expenses. Further, a slowed pace of new money borrowing and moderated capital spending have contributed to stronger balance sheet positions for both public and private universities.
Operating pressure will lessen for universities highly reliant on gifts and investment income, because positive investment performance in recent years has bolstered annual endowment spending in support of operations. With another strong year of endowment performance in FY 2014 (average close to 15%), endowment spending will increase for nearly all universities in FY 2015 since our calculation of endowment spending uses a trailing multi-year average of cash and investments. However, in light of ongoing volatility in global equity markets, endowment returns for FY 2015 could be lower than FY 2013 and 2014.

Fundraising continues to be a distinctive credit strength of the higher education sector, with many universities in the midst of comprehensive fundraising campaigns supporting capital projects, financial aid, faculty and other initiatives. Charitable giving, which correlates closely with stock market performance, continues to steadily improve (see Exhibit 4). According to Giving USA, total charitable giving rose 4.4% (non-inflation adjusted) in the US in 2013, with gifts to educational organizations growing the fastest at 8.9% year-over-year. We expect higher education fundraising to remain strong in 2015 and 2016, helping to further bolster balance sheets and diversify revenue.

Exhibit 4
Strong Endowment Returns and Gifts Bolster Cash and Investments After Recession

Source: Moody’s Investors Service
Changing educational delivery models and online education intensify competition

The ongoing evolution of online education and other changes to educational delivery models will increase uncertainty in an already competitive landscape. At the same time, they present new prospects for revenue generation, expense containment and organizational partnerships. For example, recently a few universities have partnered with corporations to provide online education opportunities for employees, presenting new enrollment and revenue growth opportunities for the universities. These changes will present the most risk for colleges that lack distinctive brands and have weak student selectivity. Higher education management teams and boards will need to carefully evaluate short- and long-term strategic investments and opportunities in the context of their own institutions’ market niches, positioning, and financial capabilities.

In-depth: Private colleges and universities

We expect the divide between market-leading, diversified private universities and tuition-dependent colleges with weak market positions to continue to expand. Elite, wealthy national private colleges and universities will outperform the rest of the higher education sector over the next 12-18 months because their business models are most closely linked to investment returns and philanthropy, which have been robust in recent years. Further, these institutions benefit from global reputations, deep pools of applicants, revenue diversification and larger endowments supporting expanded financial aid. Their global brands will allow them to command high net tuition per student and will attract the largest gifts.

Alternatively, heavily tuition-dependent private colleges and universities with weaker market positions and regional draws will be increasingly challenged. Lack of clear market niche and demonstrated return on investment could be the downfall for many small heavily tuition-dependent private colleges that have limited pricing power. These lower-rated privates will face increased competition from cheaper public higher education as well as distance learning options.

In-depth: Four-year public colleges and universities

Public universities will be more challenged than privates to grow operating revenue, with both tuition and state funding revenue growth hindered. Public university operating margins have contracted in recent years, with median expense growth surpassing median revenue growth in both FY 2012 and FY 2013. We forecast this trend to continue over the next 12-18 months as publics absorb growing expense pressures including post-retirement benefits. In a few states, a growing proportion of state funding for higher education is designated for payment of pension and benefits, reducing availability of funds for general operating support.

Stand-alone regional public universities, with limited revenue diversification, will be more challenged than flagships and large systems which benefit from economies of scale and tuition diversification. Increasingly, regional publics will be competing with community colleges and other educational or employment options. Given their regional student draws, they are more vulnerable to local demographic trends. Further, these universities do not typically have the market advantage of flagships/systems that can attract significant numbers of higher-paying out-of-state and international students.

Please refer to our separate outlook for [US community colleges with revenue bonds](#).
For-profits face intense scrutiny
Most for-profit post-secondary education providers face increased risks including heightened state and federal scrutiny and enrollment declines. The Department of Education’s recent release of new gainful employment standards for federal student aid are credit negative for the for-profit providers who are not able to adjust their operations at affected locations to meet the new guidelines, although there is less of an impact for certificate, masters, or vocation programs of for-profit providers. The for-profit providers typically rely very heavily on federal funding, for up to 90% of operating revenue, so any disruptions or ineligibility for federal funding would have a significant negative impact. These new regulations will be modestly credit positive for community colleges and urban not-for-profit colleges and universities that can attract adult learners who avoid for-profits due to financial aid uncertainty and negative media attention.

What could change the outlook
We could change our US higher education outlook to stable if aggregate revenue growth in our rated sample improves to at least 3%, representing real growth in a low-inflation environment, coupled with ongoing healthy student demand for most, stabilization of operating cash flow and maintenance of strong balance sheet metrics.
In the future, the outlook could change to positive if projected growth in operating revenue exceeds 5%. This resumed robust revenue growth would need to be accompanied by sustained enrollment growth, improvement in operating cash flow, and strong endowment returns across the sector.
Moody's Related Research

» Tuition Revenue and Enrollment Pressure Remain Acute for Many US Universities, November 2014 (1001088)
» Growing Pressure Evident in Fiscal 2013 Public University Medians, July 2014 (172867)
» Stability of Fiscal 2013 US Private University Medians Masks Underlying Pressure, July 2014 (172855)
» Rising Student Applications Complicate College Enrollment Projections and Budgeting, October 2014 (176027)
Endnotes


2. Student Loan Update: A First Look at the 2013 Survey of Consumer Finances, Brown Center on Education Policy at the Brookings Institution

3. 5.7% aggregate one year change in state fiscal support for higher education in FY 2014; Grapevine, Fiscal Year 2013-2014, a joint project of the Center for the Study of Education Policy at Illinois State University and the State Higher Education Executive Officers (SHEEO)

4. Giving USA 2014
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