Higher Education

College And University Credit Ratings

The evaluation of private colleges and universities focuses on four core areas—demand, finances, management, and debt. Demand is particularly significant because student enrollment often drives financial operations, especially at tuition-dependent colleges and universities. Enrollment declines can result in shortfalls in tuition revenues, directly affecting budget operations. Since most private universities rely heavily on tuition revenues, enrollment and admissions trends are therefore critical. These trends are perhaps even more significant than for public institutions, where state support can sometimes cushion the impact of enrollment declines. A school that experiences weakened demand may be forced to cease operating, while a school that suffers from deteriorating finances can recover if demand is favorable, and management is astute.

When asked to evaluate the credit or debt rating of a new private institution, Standard & Poor's Ratings Services will often make a site visit to the institution. At a minimum there should be a conference call with management for any newly rated credits. Seeing the institution provides an opportunity to see facilities from an outside perspective—an especially important consideration for a product that is discretionary and highly consumer driven. The process involves evaluating a full range of information ranging from enrollment and demand information, to 5 years of audited financial results, budget information, and other information about the institution.

Demand

Standard & Poor's evaluates an institution's demand in the context of the school's niche and the current higher education environment. Demographic trends, the popularity of particular types of programs, and the existence of competing institutions also are incorporated into the rating process. Standard & Poor's measures demand in terms of enrollments, applications, acceptances, student quality, yield, and retention.

Enrollment

Standard & Poor's first examines enrollment size and trends. While size is not by itself a primary rating factor, it can indirectly affect the rating. Smaller institutions tend to have more limited program offerings, making them more vulnerable to shifts in program popularity. Furthermore, for smaller institutions, the loss of a few students can have a proportionately greater impact on revenues. A small college that has little or no financial cushion and limited budget flexibility can find itself particularly vulnerable. However, many students prefer a small college setting for the personal attention and level of involvement it may provide, and there are, indeed many highly rated small colleges. Whatever a school's size, enrollment trends are analyzed, and the reasons for upward or downward cycles are determined. Specialized schools tend to be smaller than more comprehensive institutions.

To isolate particular trends, enrollment is broken down into headcount and full-time equivalents, graduate and undergraduate students, and full and part-time students. Often, enrollment in particular programs is examined. Application, acceptance, and matriculation information provides an ongoing measure of demand for an institution and reveals the school's admissions flexibility or ability to cope with changes in student demand. While all three figures often fluctuate from year to year, Standard & Poor's focuses on general trends and their consequences. Standard & Poor's also evaluates information about the number of transfer students, and selectivity information related to transfers. For some institutions, transfer students can supplement a weak retention rate.

Enrollment in nontraditional programs—such as adult learners, noncredit or nondegree programs—tends to be more volatile than enrollment in traditional four-year college degree programs.

Standard & Poor's requests at least five years of demand information for new ratings.

Flexibility

An institution's admissions and program flexibility is an essential part of demand analysis. The more flexible an institution, the better able it is to deal with the vagaries of demographic declines, economic downturns, increased competition, and changing program preferences. Standard & Poor's assesses an institution's flexibility in seven areas:

Selectivity. Selectivity is measured by an institution's competitive position and the degree of difficulty in gaining admission to an institution. Standard & Poor's evaluates the absolute number of

applicants to an institution's programs—for undergraduates, graduate, and professional students. Standard & Poor's measures completed applications only, and evaluates the acceptance rate. For the most competitive institutions, acceptance rates of below 20% are increasingly common. Among the investment-grade rated universe, acceptance rates vary from a low of 5% to as many as 95% of students being admitted from completed applications. Matriculation rates, measured by the percentage of admitted students who enroll, range from as low as 15% to as high as 80%. Generally, the lower the acceptance rate and the higher the matriculation rate, the more competitive the institution. Sometimes, more specialized schools such as engineering-based universities, or art and music schools exhibit a high degree of self-selection. Acceptance rates may be slightly higher than for other comprehensive institutions, but at the same time, matriculation rates may be higher as well. Standard & Poor's considers whether a particular niche changes the degree of selectivity for an institution.

Geographic diversity. As a rule, the wider an institution's student draw or geographic diversity, the less likely it is that a regional demographic downturn will affect enrollment. Hence, a wide geographic draw is a rating strength. However, in attempting to widen its draw, an institution may lose ground on its matriculation rate, since applicants from farther away are often less likely to matriculate than those closer to the college. Sometimes institutions attempt to widen their geographic draw, but they may do so at the expense of their historic demand base. States like California, Texas, and Florida (high growth states) create special circumstances in the assessment of demand. Rapid population growth and the vast population in these states makes it difficult for an institution to expand geographic diversity. Location in a high growth state is generally viewed as a positive credit factor for private institutions as the potential demand for an institution grows naturally.

Student quality. Strong student quality, as measured by class rank or average high school GPA, standardized test scores (SATs and ACTs), and other factors, enhances a school's ability to withstand a decline in demand. Schools with high-quality standards often can maintain enrollment by lowering admissions requirements. Since student quality measures differ substantially from one college to another, care is taken to understand the method used at the institution being rated. While student quality measures are one indicator of flexibility, Standard & Poor's never views these scores and ratios in isolation.

Faculty. High levels of tenured faculty generally mean higher levels of fixed expenses for items such as salary and benefits. In addition, fixed faculty levels may not allow a school to easily change program offerings to reflect current demand, therefore limiting an institution's flexibility. Applications, in turn, may drop off if program offerings do not match current preferences. A high tenure rate can create problems if the number of faculty needs to be adjusted. Standard & Poor's considers a tenure ratio of over 70% to be somewhat constraining. Nonetheless, most highly rated institutions also have a high rate of tenure for full-time faculty.

Documentation Requirements

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.

Program offerings. Schools with highly specialized programs can fall out of favor quickly. On the other hand, schools with specialized programs are often successful because of a lack of significant competition, or a niche program. Conversely, comprehensive institutions with a wide variety of undergraduate offerings plus many strong graduate programs generally experience less volatile enrollment, even if demand falls off in a particular area. Standard & Poor's examines the popularity of various curriculum offerings and notes program closures and openings.

Competition. In analyzing competition, a key question is, which colleges does this institution win or lose students from or to? Although exact win/loss statistics can be hard to obtain, such information gives Standard & Poor's insight into the institution's competitive position. Analysis of competition enables Standard & Poor's to determine whether the school has its own niche, or whether it must constantly change its programs to adjust to external competition. Obviously, first-choice schools are less vulnerable than students' second or third selections.

Retention and graduation. A trend of increasing attrition is a sign of rising student dissatisfaction and is often a precursor to declining demand. The reasons for such a trend, and actions taken to correct it, are examined. The nation's most selective institutions generally demonstrate freshmen reten-

Selected College/University Financial (FASB) Ratios

Ratio	Definition
Revenue diversity (all numerators divided by total unrestricted operating revenues)	
Tuition dependence (%)	Numerator = gross tuition and fees
Gifts and pledges (%)	Numerator = annual fund gifts and pledges
Endowment income (%)	Numerator = endowment spending policy income
Health care operations (%)	Numerator = health care operating revenues
Auxiliary operations (%)	Numerator = auxiliary system operating revenues
Expense and financial aid ratios	
Instruction (%)	Instructional costs/total operating expenses
Tuition discount (%)	Total financial aid costs/gross tuition and fees
Financial aid burden (%)	Total financial aid costs/total operating expenses
Bottom line results	
Net operating income (NOI) (%)	Change in UNA/total unrestricted operating revenues
Net income (IN) (%)	Change in UNA/total unrestricted revenues
Return on net assets (%)	Change in total nett assets/total net assets (BOY)
Balance sheet ratios Liquid ratios	
Cash and investment/operations (%)	Total cash and investments/total operating expenses
Unrestricted resources/operations (%)	Unrestricted resources/total operating expenses
Expendable resources/operations (%)	Expendable resources/total operating expenses
Debt ratios	
Unrestricted resources to debt (%)	Unrestricted resources/total debt
Expendable resources to debt (%)	Expendable resources/total debt
MADS burden (%)	MADS/total operating expenses
Full-time equivalent measures	
Net tuition per FTE (%)	Tuition revenue less financial aid/FTE students
Revenue per FTE ($)	Total operating revenue/FTE students
Expenses per FTE ($)	Total operating expenses/FTE students
Pro forma debt per FTE ($)	Total pro forma debt/FTE students
Unrestricted resources per FTE ($)	Unrestricted resources/FTE students
Expendable resources per FTE ($)	Expendable resources/FTE students

UNA—Unrestricted net assets. MADS—Maximum annual debt service. Unrestricted resources—(UNA - (net PPE - long-term debt). Expendable resources—(UNA + TRNA - (net PPE - long-term debt). PPE—Property, plant and equipment. TRNA—Temporarily restricted net assets.

tion rates of 90% or more. A retention rate of 65% or below, or conversely, an attrition rate of 35% from year-to-year can be cause for concern. Graduation rates nationwide are dropping over time, and a failure of students to continue their educational progress represents a significant concern for institutions, both in terms of maintaining institutional demand and demonstrating favorable outcomes. Graduation rates tend to correlate with selectivity—the more selective an institution, the higher the four-and five-year graduation rates. Institutions with a large number of engineering programs tend to have slightly lower four-year graduation rates, but five-year graduation rates should be closer to the norm for its competitive peers.

Finances

Standard & Poor's analysis of a private university's financial strength focuses on revenue and expenditure composition, financial operating performance, financial resources, balance sheet liquidity, and debt burden. Standard & Poor's evaluates at least five years of historical audited information, as well as current year's budgets to actuals, and any forecasts or multi-year financial plans that are being used by management.

Revenues. Standard & Poor's evaluates historical and projected trends in revenue composition. A diversified revenue base is viewed positively, since multiple revenue sources tend to mitigate fluctuations or shortfalls in an individual revenue stream. Larger institutions with graduate programs and research activities tend to have greater revenue diversity. Many smaller colleges and universities also demonstrate less dependence on tuition and fees because of gift income and endowment levels, which provide annual operating income. However, at many private institutions, tuition and fee income usually accounts for at least 20% of total revenues. Standard & Poor's considers financial aid to be a discretionary expense item, and therefore we gross-up tuition and fee revenues. Unlike the health care sector, where discounts are contractually determined, financial aid is not a contractual obligation. Research grants, endowment income, private gifts, public grants, and auxiliary income from dormitories, dining, and parking facilities can reduce reliance on tuition.

Standard & Poor's assesses an institution's ability to raise revenues through tuition adjustments, intensified research activities, or auxiliary operations. Tuition rates are compared with competitors' charges to determine rate flexibility. Research grants are reviewed for diversity in source, purpose, and recipient. For most institutions, research revenues tend to be nearly equal to research expenses, although a thorough accounting of all costs may show otherwise—that the costs of research actually exceed revenues. A new area of revenue for many colleges and universities is patent income and royalties, especially from the development of new drugs. Generally this revenue is a small source for most universities, however, major discoveries can lead to hundreds of millions of dollars over the life of a patented drug. Generally, these revenues are viewed favorably and can provide additional revenue to an institution. Conversely, the revenues tend to be accruing to already highly rated, and usually revenue-diverse, institutions.

An institution's endowment spending policy also is reviewed to determine income-raising capability and to ensure that the endowment corpus is being preserved. Many colleges and universities are experimenting with new spending models and moving away from an historical industry standard that allows spending 5% of a three-year moving market value average. Concerns that might cause an institution to adjust its endowment spending model include smoothing spending levels in volatile markets and guaranteeing a minimum or maximum level of spending. Ultimately, institutions that adjust their endowment spending models are hoping to improve the predictability of spending rates. Whatever the model, Standard and Poor's examines deviation from prior spending practices, especially when the rate of spending exceeds or is substantially lower than comparable peers.

Finally, Standard & Poor's examines past fundraising experiences, as well as planned fundraising efforts, and proposed purpose of gifts. Alumni participation rates usually are highest for colleges and universities, which have produced mostly undergraduates. Alumni of graduate and professional schools tend to donate at lower rates than alumni with undergraduate degrees. Alumni participation rates tend to be highest at small to medium, liberal arts colleges, where rates of 40%-60% are not uncommon. Alumni participation rates are lower at public colleges and universities, but some flagship public universities, which have produced hundreds of thousands of alumni, have strong fundraising records and development potential.

Expenses. Standard & Poor's evaluates expenses and assesses an institution's ability to reduce costs if revenues decline. A high ratio of fixed to variable costs limits this flexibility. Faculty commitments, financial aid budgets, utility costs, plant maintenance needs, health care costs, pension payments, and debt service payments constrain financial flexibility. Standard & Poor's looks at historical expenditure trends and will investigate large percentage increases.

Risk management

Standard & Poor's evaluates institutions for their ability to plan in the event that operations become disrupted for any reason. Many institutions are now developing an office of risk management, or appointing chief risk officers, who oversee the development of contingency and emergency plans for the institution. Standard & Poor's asks about insurance coverage in three areas: property and casualty, business interruption, and liability.

Operating results

Standard & Poor's analyzes a college's income statement over the most recent five-year period, focusing on activity within unrestricted net assets. 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. Standard & Poor's notes whether the school includes depreciation as a budgeted expense. Often, year-end GAAP results are negative, because depreciation was not a budgeted item for the year.

Endowment and long-term investment pools

Depending on its size and restrictions, endowment (or a long-term investment pool) gives an institution significant financial strength and liquidity. Growth trends in endowment are examined, and investment and spending policies are analyzed. Endowment levels are compared with an institution's debt level and budget, and a per student endowment level is calculated and compared with those of other colleges and universities. Generally, the larger the portion of unrestricted endowment, the better, but even a largely restricted endowment can provide significant strength, as it also produces spendable endowment income. Restricted endowment funds also may be somewhat fungible, freeing up other operating funds that can be used for other purposes. In addition, endowments restricted for scholarships or faculty chairs may lend programmatic strengths and help a college attract students and faculty.

Investment performance is compared to broader benchmarks such as the National Association of College and University Business Officers (NACUBO) mean, which is published every year based on a national survey, and to particular benchmarks selected by the institutions themselves. These measures provide a yardstick—how well did the institution's investments perform relative to its choices. Standard & Poor's generally asks for a copy of the investment report reviewed by the board on a quarterly basis. This report typically provides important information on asset classes, recent investment performance, and highlights any anomalies related to investment performance. Liquidity of the endowment is a growing concern as colleges and universities diversify their investment portfolios in an effort to enhance return and reduce volatility. Standard & Poor's asks how frequently the portfolio is valued; management should be aware of what portion of the invested assets are highly liquid—could be valued on a daily basis as marketable securities. If large portions of the endowment are "locked-up" in private equity arrangements, that would need to be disclosed during the rating process. Most schools spend a prespecified portion of their endowment on annual operations. The most common spending policy has been that 5% of a three-year market value average of the endowment will be utilized for operations. Because of recent fluctuations in equity markets, however, more schools are adopting spending policy caps or collars—to spend no more or less than a certain percentage of the endowment. Standard & Poor's considers an endowment spending rate above 6% to be high, and above 8% to be excessive.

Liquidity

In general, liquidity measures how long a school could function without taking in additional revenue. Three different measures are used to assess both operating and debt liquidity: cash and investments, unrestricted resources, and expendable resources. Each of these figures is drawn from the balance sheet and then compared to operating expenses, total debt (long-term and short-term) outstanding, and pro forma debt. Because endowment is included in the balance sheets of private colleges and universities, available liquidity can include sources derived from all funds of the institution—endowment, operating funds, and internal plant funds. Standard & Poor's does not exclude endowment from its assessment of liquidity, unless the endowment is restricted for a specific purpose. Therefore the calculation of available liquidity rests on the type of equity and generally includes only unrestricted or temporarily restricted net assets. However, unrestricted equity and temporarily restricted equity should be supported by sufficient liquid assets such as cash and marketable securities. If unrestricted resources to operating expenses exceed 100%, or a year of annual operating expenses, the school exhibits good liquidity. Conversely, institutions with unrestricted resources to operating expenses below 30% have more limited cushion and operating constraints. Unrestricted resources at less than 25% of pro forma debt are a concern.

Debt

A college or university's total debt burden or total amount of debt outstanding relative to its operating budget also is part of Standard & Poor's financial analysis. 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. However, schools with particularly high levels of endowment and liquidity, and good operating performance, often can support a greater debt load. Unrestricted resources are particularly important when evaluating unenhanced short-term or demand feature debt. Standard & Poor's compares the variable-rate debt burden in a "worst-case scenario" with unrestricted and expendable resources and with operating expenses. There are no guidelines as to what the ideal debt structure should be for a college or university. In general, the higher the level of endowment, the greater the amount of variable rate debt issued by these institution. When a university has a very high level of floating-rate debt (above 50%), Standard & Poor's expects the institution to budget for a higher cost of capital to cover any unexpected rises in interest rates. Most interest rate swaps for highly rated colleges and universities are used to hedge interest rate exposure—to convert variable rate payments to a fixed rate of interest and therefore ensure some predictability in future payments. Standard & Poor's expects that issuers who enter into swaps or other derivative instruments understand their use and can quantify the relative risks of these transactions and provide a swap management plan, whether the swap is used to hedge interest rate risk on debt instruments or to enhance investment return.

Management And Governance

Decisions in admissions, finances, and debt strategy can be critical to an institution's future and reveal a great deal about management's philosophy. The choices made by different schools in very similar circumstances can mean the difference between ongoing viability and financial distress, or even closure. Standard & Poor's analysis evaluates management's:

Ability to foresee and plan for potential challenge

Management's ability to anticipate the impact of events such as changes in the general education market, demographic trends, or deferred maintenance needs is assessed.

Strategies and policies

Whether proactive or defensive, the policies adopted by an institution must be evaluated in light of how realistic or attainable they are. While Standard & Poor's does not try to determine whether one strategy is better than another, it does evaluate whether a strategy seems realistic. For example, a college budget that assumes an incoming class of 500 freshmen when recent new enrollments have consistently been below 450 would not be convincing.

Track record

An institution's track record indicates how management will deal with new situations and problems. Standard & Poor's examines the effectiveness of past operations and plans and evaluates management's ability to lead an institution through industry and environmental shifts.

Tenure

Sudden or frequent management turnover can be a sign of stress or weakness. While less quantifiable in and of themselves, management decisions directly affect the variables involved in Standard & Poor's demand and financial analysis.

Board composition and structure

Standard & Poor's evaluates boards and governance by looking at a number of areas. These include board composition, committee structure, strategic planning, board financial contributions, and board elections. A board should be an independent body that is able to replace a president or other senior leadership. A recent trend is a reduction in the number of board members. Certainly a board needs to be large enough to have an appropriate committee structure: generally including audit, finance, academic affairs, and an executive committee. Most boards meet on a full basis four times a year. Less frequent board activity could be a concern unless there is an active executive committee. A board should be financially independent from the college and conflicts of interest should always be disclosed.

Debt

Legal provisions

Security pledges. Standard & Poor's debt ratings refer to a specific bond issue; they are not a general statement about the issuer. In contrast, an issuer credit rating is a current opinion of an obligor (such as a college or university) to meet its financial obligations. An issuer credit rating focuses on the Obligor's capacity and willingness to meet its financial commitments as they come due. The opinion is not specific to any particular financial obligations, as it does not take into account the specific nature or provisions of any particular obligations.

The demand and financial analysis described above allows Standard & Poor's to assign ratings to

a general obligation pledge of a private university. Most private universities that sell debt issue unsecured general obligations, supported by a full faith and credit pledge. Sometimes particular issuing authorities (since most private universities who issue tax-exempt debt must issue debt through a tax-exempt conduit issuer) require a lien against certain revenues of the institution and the maintenance of legal covenants such as asset to liability ratios. However, these legal requirements would not raise a private college debt rating above its GO rating.

Public universities, in contrast, may issue a variety of debt types and very few have the ability to issue full faith and credit debt. However, a school's flexibility to raise tuition and fees charged against all students, for example, allows Standard & Poor's to rate unlimited student fee or tuition fee pledges for public colleges and universities on par with an institution's GO rating. This policy is important in analyzing public institutions because many public schools are restricted in their use of GO and state appropriation pledges. Other types of security pledges may be applied to a university's bonded debt, such as pledges of revenues from a specific enterprise, including dormitories and parking systems, or a limited pledge of tuition or student fees (see section on privatized dormitories and enterprise financings for more information on auxiliary revenue bonds).

Standard & Poor's views debt secured by enterprise funds to be generally weaker than GO or tuition pledges. For example, a dormitory bond's revenue source may be limited to room rentals, while a GO or tuition pledge implies a much broader revenue-raising capability. A bond secured by tuition or a school's GO pledge is likely to experience problems only if the entire school experiences difficulty. An individual dormitory, on the other hand, could close without necessarily affecting university operations. However, if the revenues pledged are from a large dormitory system, and most students live on campus, dormitory revenues could perhaps be as important to the college's overall health as tuition and student fees. The dormitory's value to the school largely determines the distance between the dormitory rating and the school's GO rating.

Covenants

Rate covenants and additional bonds tests also are examined. However, with the exception of enterprise debt, these provisions generally carry less weight in university analysis than in other types of bond issues for other municipal enterprises. This de-emphasis is because the payment of debt service depends less on the maintenance of specific rates and charges than on demand for the institution's services and its financial health. Additional bonds tests for virtually all GO pledges do not enhance bondholder protection because the requirements, which are usually based on assets and liabilities, impose no real constraint on the college. However, enterprise operations must set rates to provide sufficient coverage; therefore, for enterprise-backed debt, Standard & Poor's prefers rate covenants and additional bonds tests with substance. Rate covenants usually require institutions or their governing boards to set rates and charges which would enable debt service coverage to meet greater than sufficient coverage. Minimum rate covenants of 1.15x-1.2x are acceptable, if debt service coverage is historically good and stable. The strongest additional bonds tests require historical revenues to be at least 1.25x future maximum annual debt service, including the proposed bonds. Many other additional bonds tests in this sector are proposed, rather than historical, and allow certification of future revenues by a business officer of the college.

Debt service reserve policies. Cash flow considerations in colleges and universities usually are less of a problem than in other municipal enterprises; therefore, reserve funds are not always necessary. While it is true that tuition revenue inflows are seasonal, the presence of unrestricted resources and endowment often compensates for the absence of a reserve, or rainy day, fund. Nevertheless, bonds secured strictly by enterprise revenues generally require a fully funded debt service reserve fund, even if the college has a large endowment.

Other liabilities and debt-like instruments

Standard & Poor's also incorporates other liabilities in its analysis of financial resources. These can include short-term debt outstanding at year-end, unfunded pension liabilities and postretirement benefits, contingent liabilities, debt obligations of affiliates and wholly owned subsidiaries, and operating leases. Because our analysis focuses on retained equity, versus strictly cash and investments, all liabilities reduce the amount of equity. Therefore, all liabilities are indirectly captured in Standard & Poor's calculation of unrestricted and expendable resources. A large unfunded liability relating to postretirement benefits such as health care and pensions could be of concern if management has no plan for how to fund these liabilities or benefits over time. Many colleges and universities are frequent users of commercial paper and variable rate debt obligations. Often commercial paper has been authorized, but not issued. If a commercial paper program is dormant, or the institution has never issued up to the authorized amount of the program, only the actual amount issued by the college will be incorporated in the financial ratios based on audited financial statements. However, our rating takes into account the possibility that additional may be issued.

Rating Public Colleges And Universities

Standard & Poor's rating approach for public universities is similar to that used for private institutions in terms of demand, management, finances, and legal provisions. However, since fiscal 1996, financial accounting for private institutions has differed from the accounting standards that public institutions follow. As a result, Standard & Poor's maintains two different sets of financial ratios for use in evaluating colleges and universities. In addition, since a major portion of a public university's annual budget comes from state sources, analysis of state support is also a rating factor. State mandates and policies also can greatly influence the demand and financial characteristics of a public university.

State support

On average, public colleges and universities derive much less than half of their unrestricted operating budgets from state appropriations and the amount provided for operating support continues to decline over time. On the other hand, many states provide considerable capital support for construction and maintenance of academic facilities along with general operating support. Standard & Poor's evaluates state support by focusing on the following factors:

- The state's GO rating, which provides a snapshot of a state's economic, debt and financial condition and offers a basis for evaluating the strength of higher financial education support.
- The track record of appropriation support for higher education within a given state. Particular attention is paid to how higher education fares in times of financial stress at the state level. Standard & Poor's is interested not only in how successful individual institutions are in obtaining appropriations, but also in the strength of a state's overall support for higher education.
- The history of allocations to the specific institution being rated. In addition, Standard & Poor's compares the institution's historical percentage share of total higher education appropriation with that of other state institutions.
- Nominal amount of state support and changes in the funding formula which might benefit higher-growth, stable, or slow-growth institutions; and
- The history of state appropriations per full-time equivalent enrollment. Some of the highest levels of support on an FTE basis, such as at the University of California and University of North Carolina, are virtually double other flagship peers.

While not the sole rating feature, a state's general creditworthiness (often measured by a GO rating) may provide a helpful starting point for a public university rating. An analysis of an individual public institution's demand and finances, combined with similar information about the state's other public universities, allows Standard & Poor's to develop a range of possible ratings. The highest ratings for public colleges and universities are usually assigned to flagship institutions characterized by high funding levels, nationally recognized academic programs, and unusually strong admissions or financial position. Other state schools generally receive lower ratings, depending on the strength of state support to specific institutions, financial and admissions characteristics, and the security pledge. However, ratings tend to be higher than for private colleges and universities because of the presence of state support.

While a state has unlimited taxing power, a state university may have less flexibility because a major portion of its annual budget is at the discretion of the state legislature. Thus, without overwhelming demand or financial strength, a state university's creditworthiness usually does not exceed or even equal that of its sponsor state. Public institutions have broken through this barrier on the basis of highly selective demand, large endowment holdings, and/or comprehensive research programs, and broad revenue diversity. Most public universities are not affected by a positive or negative change in a state's financial condition, except that a funding environment can become more favorable if a state's financial condition improves. The degree of change, if any, in a rating will reflect institutional demand and financial characteristics, as well as the university's role in the state system of higher education and its funding history.

During periods of fiscal stress, many public universities are able to increase tuition and fees considerably, without any reductions in demonstrated demand. Universities with significant insulating characteristics could experience some fiscal strain, if their respective states make cuts to higher education, but it may not be demonstrated in the university's financial results. Standard & Poor's evaluates each institution on a case by case basis, in the event of state rating changes, to determine whether the outlook has changed, or the financial circumstances are unchanged, better, or weaker.

State policies

In addition to actual appropriations, underlying state mandates and policies also impact public university finances and must be considered in the rating process. Mandated tuition caps, budgetary reversions back to the state, required remission of excess or unspent dollars back to the state, and limits on bonding for specific projects can all affect an institution's financial operations. These policies make analysis of a public university's finances quite

Selected Public College/University Financial Ratios (GASB)

Income statement ratios Revenue diversity (all numerators divided by adjusted operating revenues)	
Net tuition dependence	Numerator = net tuition
Student dependence (net tuition + auxiliary rev)	Numerator = net tuition + auxiliary revenue
State operating appropriations	Numerator = state operating appropriations
Grants and contracts	Numerator = state, private, and federal grants
Gifts	Numerator = gifts
Auxiliary income	Numerator = auxiliary income
Health care income	Numerator = total health care income
Total adjusted operating expenses	Audited operating expenses plus appropriate nonoperating expenses considered to be operating expenses, such as interest expense
Total Adjusted Operating Revenues	Audited operating revenues plus appropriate nonoperating revenues considered to be operating revenues such as state appropriations, investment income, and private gifts
Operating results (all ratios computed relative to adjusted operating expenses	
Change in adjusted operating income	Change in estimated operating income/adjusted operating expenses
Change in unrestricted net assets	Change in UNA/adjusted operating expenses
Change in total net assets	Change in total net assets/adjusted operating expenses
Balance sheet ratios Liquidity and debt ratios	
Cash and investments/expenses	Univ. C&I/adjusted operating expenses
Cash and investments/pro forma debt	Univ. C&I/pro forma debt principal
Cash and investments/outstanding debt	Univ. C&I/outstanding debt principal
UNA/expenses	UNA/adjusted operating expenses
UNA/pro forma debt	UNA/pro forma debt principal
UNA/ outstanding debt	UNA/pro forma debt principal
Adjusted UNA/expenses	Adjusted UNA/adjusted operating expenses
Adjusted UNA/pro forma debt	Adjusted UNA/pro forma debt principal
Adjusted UNA/outstanding debt	Adjusted UNA/pro forma debt principal
Adjusted UNA	UNA, adjusted at analytical discretion to include: foundation quasi endowment or foundation UNA; debt service reserves; debt service balances; board-designated reserves or endowment; university-held quasi endowment not included in UNA
Debt burden	
Current debt service burden	Current debt service/adjusted operating expenses
MADS burden	Current MADS/adjusted operating expenses
Pro forma MADS burden	Projected MADS/adjusted operating expenses
Average age of plant (years)	Accumulated deprecation/annual depreciation expense
Full-time equivalent measures	
Net tuition per FTE ($)	Net tuition/total full-time equivalent students
State operating appropriations per FTE ($)	Total state operating appropriations/total full-time equivalent students
Outstanding Debt per FTE ($)	Outstanding debt/total full-time equivalent students
Pro forma debt per FTE ($)	Proforma debt/total full-time equivalent students
Net capital assets per FTE	Net capital assets/total full-time equivalent students
Endowment per FTE	Endowment (market value)/total full-time equivalent students

different from that of a private institution. For example, while a large financial cushion allows a university more flexibility and independence from the state, some public institutions are limited as to the amount of unrestricted reserves they can retain. Standard & Poor's considers public colleges and universities with unrestricted resources below 5% of total annual operating expenses to be vulnerable to severe operating constraints. Capital campaigns to increase unrestricted resources or endowment are looked upon favorably.

Mission

Although analysis of demand is similar for private and public universities, ratings of public schools are sometimes skewed by the institutions' role in providing education and the importance of state support. Standard & Poor's generally regards acceptance and matriculation rates as key factors in determining an institution's overall demand position. However, public institutions generally have more liberal or open admissions requirements, and acceptance rates for public schools (ranging from 30%-80%) are generally not as competitive as those for comparably rated private institutions. In addition, while some premier public institutions have very high student quality indicators, and acceptance rates may equal those of more selective private institutions, many public institutions exhibit lower quality measures because of open admissions policies. However, a public university may be a primary provider of higher education, or the state's flagship institution and matriculation rates may be very high. Thus, public universities are often highly rated, despite having less admissions flexibility than their private counterparts.

Legal provisions

Since public universities enjoy state funding support, they have less need to guard against revenue volatility. Where the debt being rated is a GO, or equivalent, of a public institution, a debt service reserve is not needed if a college has met two ratios for each of the past three years. First, unrestricted resources divided by operating expenses and interest, should exceed 5%. Second, maximum annual debt service divided by unrestricted resources should be less than 50%. In Standard & Poor's view, meeting these two ratios demonstrates enough liquidity to mitigate the absence of a debt service reserve.

Rating Community College Debt

As the role of community colleges has expanded over the past decade, enrollment growth and improved state support have resulted in increased creditworthiness for these institutions.

Community colleges have developed along the same lines as public four-year institutions. However, while public colleges and universities look much the same from state to state, community colleges exist in many different forms.

In some states, community colleges fall under the responsibility of large flagship universities. Other states have less centralized systems, whereby individual community college districts have been formed that resemble independent school districts. Other structures include a state board of education that oversees activities of community colleges, in much the same way as a state board of regents governs four-year institutions. Finally, some states do not even have community colleges, but, rather, elect to offer technical and vocational classes through their four-year institutions.

The wide array of structures has led to debt being issued under a variety of security pledges. It is this variety of security pledges, rather than any real differences in debt-repayment ability, that has resulted in the ratings on community college debt being spread across the spectrum, from potentially a 'AAA' where debt is secured general obligations or ad valorem tax revenues to the 'BBB' category.

Most community colleges are supported by three main revenue sources:

- Local ad valorem property taxes;
- State appropriations; and
- Tuition and fees.

These income streams can be pledged individually or in combination to create numerous security pledges. The most common pledges, in descending order from broadest and most creditworthy to narrowest, include:

- A GO pledge of all of the school or district's resources, including ad valorem property taxes;
- A pledge of tuition or tuition and fees, excluding property tax support;
- A pledge of one or more unlimited student fees, excluding tuition and property tax support; and
- A pledge of auxiliary (dormitory, dining hall, parking) revenues.

Depending on the underlying security, ratings assigned to the debt of a single community college, or district, could vary from one issue of bonds to another. Community college revenue bonds are typically rated below GO bonds, depending on the breadth of the pledged revenues. Issues secured by tuition and fees, and other enterprise revenues might be rated higher than revenue bonds secured solely by enterprise revenues of the community college. All ratings still take into account the community college's financial performance and other credit characteristics.

The revenue pledge

The GO analysis also forms the starting point for the analysis of a community college or district revenue bond. Because the bondholder no longer can rely directly on tax-raising capability and the usually predictable nature of property taxes for repayment of bonds, an assessment of the demand. financial, management, and legal characteristics behind the pledged revenue stream becomes more important.

For this purpose, the analysis can be broken down into four main areas:

- Demand or enrollment and admissions trends;
- Financial operations;
- Management; and
- Debt type and structure.

The last three factors are assessed according to the criteria that Standard & Poor's has established for public four-year colleges and universities. Demand is evaluated from a slightly different perspective than it is for traditional four-year public colleges and universities.

Demand analysis

Unlike most public colleges and universities, community colleges generally do not apply strict admissions criteria. Instead, they employ open-enrollment policies that guarantee full access to students who meet minimum entrance requirements. Thus, the most telling demand statistics are not related to selectivity, but to enrollment trends.

To measure enrollment trends, Standard & Poor's looks at several factors, including:

- The absolute number of enrollees from year to year;
- Total credit hours annually for five years;
- The breakdown between full-and part-time students;
- Reasons for any cyclical increases or declines in enrollment;
- The presence of other two-year educational options in the immediate area;
- The breadth of the college's course offerings and any overlap with other local educational institutions;
- The college's role in local economic development efforts and reliance on agreements with private industry for retraining of workers;
- The strength of the underlying economy and demographics as a generator of students; and
- The number and type of articulation agreements with nearby colleges and universities.

Typical demand characteristics of an investment-grade revenue bond rating for a community college would be increasing enrollment trends, a balanced mix of full-and part-time students, and a management team that is actively seeking articulation, or transfer, agreements with four-year institutions and/or tie-ins with local private industry. Declining enrollments can be an indicator of competition from neighboring districts or colleges, negative underlying demographic trends, or poor management.

Auxiliary Revenue Bonds And Privatized Dormitories

Traditional auxiliary revenue bonds

Standard & Poor's has been rating university auxiliary revenue bonds for decades. Traditionally, proceeds from these bonds financed parking, dining, residence and athletic, and research facilities. In most cases, auxiliary bond issuance is driven by public universities who often have limited GO or tuition-backed bonding capability. Auxiliary, or enterprise, revenue bonds are generally supported by revenues from the related project being financed such as room and board charges, parking fees, indirect cost recoveries, and other limited student fees.

The starting point for Standard & Poor's assessment of all auxiliary revenue bonds is the full faith and credit, or GO, rating for the university issuing the bonds. This rating assesses the university's demand and financial strengths and weaknesses and provides a measure of institutional long-term viability and potential demand for the auxiliary project under consideration. This approach also reflects the university's role as project manager responsible for project maintenance, rate-setting, and control over policies governing facility use (for example, a policy that all freshmen must live on campus). Standard & Poor's perceives this high level of university oversight and ownership to be equivalent to a pledge of the university's moral obligation to repay auxiliary system debt.

Because auxiliary revenue bonds are secured by a narrower revenue stream than the GO or tuition debt of the university, ratings on such debt are usually not as high as the university's general obligation rating. In most cases, auxiliary revenue bond ratings are placed one-to-three notches below the university's GO bond rating, but the ultimate rating depends on the size and strength of the particular facility or system, financial performance, historical and projected debt service coverage, and legal provisions. The GO bond rating typically acts as a ceiling for these ratings and it is unlikely for auxiliary debt that is not secured by unlimited student fees, or a very broad pledge of revenues, to be rated on par with a university's GO debt.

After establishing the GO rating for the university, Standard & Poor's analyzes the specific characteristics of the auxiliary project including:

- Demand for the facility;
- Essentiality of the service being provided;

- History of financial operations including coverage of pro-forma maximum annual debt service;
- Scope of the pledged revenue stream; and
- Legal provisions, including rate covenants and additional bonds tests.

Analysis of these factors, in combination with institutional demand, long-term viability, and underlying creditworthiness, helps to determine the rating.

Modified rating approach for on-campus privatized housing

The issuance of dormitory revenue bonds is not a new development in higher education finance. Many of the dormitory revenue bonds rated by Standard & Poor's date back to the 1960s. Their use, like bonds used to finance parking, dining, and athletic facilities, was almost universally limited to public universities because debt constraints or other statutory limitations were not experienced by private colleges and universities. Private colleges have not been prohibited from issuing debt for any reasons other than the former cap on tax-exempt bonds. Private colleges and universities always pledged their general obligation because they could do so.

However, beginning in the 1990s the environment began to change. Colleges experienced a surge in demand for modern, updated apartment style housing, and needed to respond more quickly to market demands. The concept of using developers' expertise and separately created 501©3 issuers to help issue the debt for these projects rose in popularity. The motivation for most institutions was obvious. For public institutions, the ability to circumvent traditional financing guidelines can cut years off a construction project and significantly reduce construction costs.

Private colleges and universities, meanwhile, face their own growing capital needs and are looking for ways to preserve their debt capacity and yet remain competitive. Colleges and universities pursuing the option of privatized housing often want to know two things: (1) whether using off-balance sheet debt for residential facilities will affect their existing credit profile and debt capacity; and (2) the degree to which they need to support a project to ensure a lower cost of capital for their students' housing. Standard & Poor's criteria for off-balance sheet housing addresses these concerns and largely rests on the "credit-risk" relationship model.

The credit-risk relationship model

If a college transfers credit strength to an affiliated entity or project, then the corresponding risks of that enterprise will almost always transfer back to the college. The greater the linkage between the sponsor institution and the project, the more likely the debt financing will affect an institution's credit profile, whether the financing is "off-balance sheet" or not. However, a closer link to an institution's credit strengths and the possibility of subsidization of debt service will usually mean a higher stand-alone rating and a lower cost of capital. A new housing project with very little link to a sponsoring institution will probably not benefit from the institution's creditworthiness. On the other hand, the institution can probably safely assume that the issuance of the related debt will not affect its rating at or after the time of the transaction.

Nonetheless, debt related to an entity's business is always of concern, especially when the primary customers are the institution's students. Even a project that does not require immediate subsidization may require management effort or time. Future accounting rules could also change, requiring debt that was off balance sheet to be consolidated in subsequent financial statements. A project related to an institution can also represent competition; if future housing occupancy drops on campus, an important question is whether students will occupy newer facilities related to the campus, but not the university's own housing facilities. Issuing additional debt, even if off-credit, could represent credit dilution for existing bondholders of dormitory revenue bonds. Because of these issues, Standard & Poor's uses two standards in evaluating the "credit-risk" relationship: economic interest and control. Does the university or school have an economic interest in the project; and does it control who uses the facilities being financed, project budgets and rate setting, and who manages the property (control).

Comparing traditional dorm revenue bonds and privatized housing

When rating on-campus privatized housing facilities, Standard & Poor's first focuses on the differences between these projects (often called off-balance sheet debt) and traditional university dormitory revenue bonds. The chief distinction between off-balance sheet debt and traditional auxiliary bonds is the absence of university oversight and ownership. Traditional dormitory revenue bonds are, in nearly every instance, sold directly under the university's name, controlled by the university, and revenues and expenses of the project and related debt are consolidated in the university's financial statements. Because of the absence of ownership, Standard & Poor's does not rely on its historic method of shading ratings on dormitory revenue bonds using the institution's GO equivalent rating as a starting point.

Instead, for project-based, privatized housing, Standard & Poor's will use a university's long-term rating as a proxy for long-term viability and poten-

tial demand for housing. If demand for on-campus housing is weak or non-existent, and the university's long-term rating is low investment grade, it is unlikely that any proposed financing will achieve an investment grade rating without a very substantial link to a sponsoring institution. Conversely, if housing demand is strong, and the proposed project is being used to replace existing housing, the project would be viewed favorably. A substantial link might be a college guaranty of debt service or an unconditional lease vacancy agreement.

The chief similarity between traditional dormitory revenue bonds and project dormitory bonds is that even traditional dormitory revenue bonds are technically non-recourse obligations. Bondholders are often entitled only to pledge revenues derived from the project or system of projects. So, for both, the revenue streams are narrowly defined as being produced by a particular project or set of projects. Another corollary is that both are occupied by customers—students of the college or university. As such, it is probably incumbent on the college to ensure that any project to which they are related provides students with decent, livable, and economical space. If students in the privatized facilities also receive financial aid from the institution for living expenses, the school is indirectly paying for the facility. If the college is a residential college, it may not make financial sense to use financial aid for a project in which the college builds no ownership equity.

Rating methodology

In assessing this type of debt—without ownership (and usually without management) by the university—Standard & Poor's examines many of the same characteristics that are evaluated for traditional auxiliary bonds. Generally the following factors are necessary to achieve an investment-grade rating. While the following section speaks largely to housing, any other enterprise financing could apply the criteria for relevancy.

Evidence of long-term institutional viability

A school with a long-term GO rating of 'BBB+' or higher and a strong residential mission is likely to have the capacity to consider this new type of financing option. Below this rating threshold, achieving an investment-grade project-based rating might be difficult, unless the school provides direct financial support.

Relationship between project owner and related institution

The relationship between the two will be evaluated based on board composition, ground lease structure, management agreement, and the factors leading to the decision to pursue the particular financing. A university that will ultimately own housing in the middle of its campus seems to have a vested interest in making that project successful. However, the degree to which a university, particularly a public university that does not currently own a project, can legally, or is willing, to cover a shortfall in debt service for that project is untested. It may be easier for private universities to step up to a financially unsuccessful project, but only if it is on their campus and they already exercise some control and oversight.

Project demand

Student demand for a new housing facility might be demonstrated by demand for existing on-campus housing. High occupancy rates, replacement housing, the presence of waiting lists, university leasing of off-campus housing accommodations, and recent enrollment growth will all be viewed favorably. Standard & Poor's will evaluate external feasibility studies that show sufficient demand for on-campus housing, but these usually provide only partial comfort.

Project location

Most projects rated in this way will be on or near the core college or university campus. If the proposed housing is off-campus, the college does not the land, and there is no significant financial or managerial link to the school, Standard & Poor's would most likely use its affordable housing criteria to rate the project debt.

Project management

The highest rated projects will often by managed by an institution itself (which connotes a higher degree of responsibility and oversight). At the behest of the university, other projects will be handled by outside managers, usually a for-profit company. The length of management contract is generally not as important as other credit factors. A stronger institutional link will include university rate setting, budget setting, and housing policies that are virtually indistinguishable from other university housing.

Rate covenant

Rate covenants will typically cover debt service and operating expenses. A typical rate covenant will set rates at a minimum level of 1.20x the next year's debt service and operating expenses. In Standard & Poor's experience, many standalone privatized housing projects, that have been completed, have experienced either pricing pressure or higher than expected costs, such that it has been difficult to meet the standard 1.2x rate covenant.

Additional bonds tests

Additional bonds tests should protect bondholders against the possibility of future debt weakening or diluting the specific project's revenue base.

Historical additional bonds tests are viewed more favorably than projected tests. The absence of an additional bonds test will be viewed negatively.

Reserves and insurance

A full debt service reserve should either be funded from bond proceeds or through an approved reserve substitute. A portion of net cash flow should also be retained to build up maintenance and repair reserves. Projects should include a capital (per bed) reserve funded from cash flow, sufficient to handle annual maintenance. Housing maintenance is important to keep the facility attractive during the life of the bond issue and provide for unanticipated major maintenance. Standard & Poor's evaluates business interruption insurance and the provision for coverage (generally 18-24 months) in the event of damage or destruction. The single site nature of many of these projects creates additional risk and full insurance and reserves are crucial.

Coverage

Most projects rated by Standard & Poor's provide adequate or better cash flow protection, with a multiplier of at least 1.2x coverage of maximum annual debt service in every year.

Other considerations

Projections should include a reasonable allowance for vacancies and expense growth. Historically many projections provided for these projects have used a very high occupancy rate of 95%-97%. Standard & Poor's looks for break-even occupancy that is much lower than this level; generally if break-even occupancy is less than 75%, cash flows are viewed more favorably.

Because of the untested history of these projects and the concurrent risks of an aging facility, a shorter debt maturity is viewed more favorably than a longer maturity, even if coverage drops slightly with the shorter maturity.

Many investment-grade projects do not include construction risk. However, construction risk will be evaluated based on Standard & Poor's criteria, and a project with construction risk can be rated investment grade. There are mechanisms available to mitigate construction risks so that a project can be rated prior to actual completion. Sometimes the formation of a new "privatized housing system" can offset concerns about single site project or construction risk. Significant university involvement in the construction process is also viewed favorably.

Credit links

As seen from the above section, the closer the link between a project and its sponsoring institution, often the higher the rating. However, the closer the relationship, the more likely it is that the housing debt will be considered a direct or indirect obligation of the institution. Good reasons to consider off-balance sheet, or indirect debt, as institutional debt are:

- The institution receives a direct economic benefit;
- The institution manages the project as if it were any other on-campus activity;

Accounting Issues

Currently public and private universities follow very different accounting standards-in general public universities follow standards proposed by the Governmental Accounting Standards Board (GASB) and private universities follow standards set by FASB. These differences in accounting rules for similar institutions make comparisons between private and public colleges and universities difficult and require the use of separate analytical ratios for the two groups. However, beginning in fiscal 2002, and for early adopters, fiscal 2001, public universities produced financial statements in accordance with Governmental Accounting Standards Board Statement No. 35 (GASB 35). While these financial statements resulted in different-looking statements for public colleges and universities than under fund accounting, they are similar to the current format followed by private colleges and universities. Perhaps the most striking effect of the change is the appearance of a large operating loss on a university's statements, because any state operating appropriations are considered to be a nonoperating revenue, or subsidy, item under the new statements. Not unlike our approach to endowment spending, we add back in state appropriations as an operating revenue item. Public colleges and universities are also required to expense depreciation. Operations should be balanced including depreciation, as failure to account for depreciation expense will lead to reduced equity over time. Since Standard & Poor's ratios for higher education institutions measure liquidity largely based on equity, this accounting issue can ultimate reduce a college or university's unrestricted equity.

Measuring Operating Performance

Recent investment losses highlight an analytical problem in the credit analysis of higher education: the absence of a standard industry measure of operating performance for colleges and universities. Not only do accounting applications vary among private and public colleges, but private colleges and universities also record their financial results in very different ways. Some colleges record all investment income and gains as operating revenue. When investment performance is positive, their operating results appear favorable. On the other hand, for those who record only endowment spending as operating revenue, even a year with significant investment losses can appear uneventful. Investment losses of millions or more simply tend to fall below the line. Performance appears to vary dramatically from year to year without endowment spending as a smoothing device. Thus, in order to place institutions on an equal footing and eliminate dramatic ups and downs in investment markets, Standard & Poor's adjusts for differential accounting by moving all investment income and gains (or losses) below the line for those institutions who do not record some component of endowment spending as operating revenue. Standard & Poor's then adds back actual endowment spending allocation to get a measure of operating performance. If an institution does not have an endowment spending policy (a rare occurrence), realized income in the form of interest and dividends are often a proxy for endowment spending. A major concern surrounding this exercise is the necessary adjustment of audited financial information. When GAAP statements are difficult to reconcile, Standard & Poor's higher education analysts often ask management for internal operating statements. In these cases, internal statements do not replace the need for audited statements, they merely provide a supplement.

- The project is highly essential for the institution and loss of control could be harmful to the institution's overall performance and reputation;
- The institution benefits from immediate or eventual ownership of the project being financed.

Ultimately, ratings encompass a variety of factors, of which debt is just one. The inclusion of additional indirect debt in an analysis of an institution's overall credit picture does not necessarily mean that a rating will change. Most often the revenue-producing nature of projects will be taken into

Auxiliary Revenue Bond Rating Factors

	Scope of Pledge	Demand	Essentiality	Financial Operations	Legal Structure
Housing					
	% of students housed on campus	Historical occupancy	Commuter or residential school	Adequate coverage	Additional bonds test
	Revenues derived from standalone facility or system	Evidence of waitlist	Part-time or full-time student body	Rate flexibility	Rate covenant
		Competition—on or off campus		Budgeted capital expenditures	Closed or open flow of funds
		Location of facility			Debt service reserve
					Renewal and replacement reserve
Dining					
	% of students participating in meal plan	Competition—on or off campus	Commuter or residential school	Adequate coverage	Additional bonds test
	Revenues derived from standalone facility or system		Part-time or full-time student body	Rate flexibility	Rate covenant
				Budgeted capital expenditures	Closed or open flow of funds
					Debt service reserve
					Renewal and replacement reserve
Parking					
	Number of spaces in system	Historical occupancy	Commuter or residential school	Adequate coverage	Additional bonds test
	Revenues derived from standalone facility or system	Defined users—students	Faculty and/or visitors student body	Part-time or full-time	Rate convenant
		Evidence of waitlist		Budgeted capital expenditures	Closed or open flow of funds
		Competition—on or off campus			Debt service reserve
		Location of institution—urban or rural			Renewal and replacement reserve
		Location of facility(ies) relative to main campus building			

account when considering institutional ratings. Self-supporting projects are generally viewed more favorably than projects, which produce no additional revenues, all other factors being equal.

Rating Stand-Alone Medical Schools

From a rating perspective, since most U.S. medical schools are affiliated with a university or hospital or both, it is impossible to evaluate the medical college without considering the associated university/hospital operation. Partnerships and affiliations with other health care entities is still an important part of the rating analysis, but only one of many factors.

Most ratings associated with medical colleges are refined by their relationship with a related university and/or hospital. In the case of publicly supported medical colleges, the rating also incorporates an evaluation of state support. However, Standard & Poor's does rate free-standing medical schools not affiliated with a university or a hospital.

The rating process begins with evaluation of demand and a financial analysis similar to that used when assessing other higher education institutions. The analysis is tailored to incorporate special characteristics of medical schools, such as limited class size, high tuition levels, state reimbursement programs, research programs, affiliation agreements, and revenues from faculty practice plans.

State-Supported Medical Schools

State support adds another twist to the evaluation of medical schools. Standard & Poor's rates a few combined hospital/medical school entities that receive significant state appropriations. While student demand, hospital utilization rates, and service area characteristics are important rating factors for schools of medicine that also run teaching hospitals, strength of state support can be a key credit factor.

Independent Medical Schools

Free-standing medical schools—those without hospital facilities, offer an opportunity to assess a medical college unaffected by the credit characteristics of affiliated institutions or hospital revenues. These colleges depend more on student demand and tuition, than other medical schools, and must support themselves without the benefit of state money or a larger university or hospital. However, they may benefit from affiliated income from partnerships with adjacent or associated hospitals, and the amount of reimbursement for residents and faculty can be significant. In addition, because their faculty practice in associated clinics and hospitals, they are still subject to health care industry risk. Because of their limited wherewithal and sometimes their weak financial performance, historical ratings on free-standing medical schools generally have not been rated higher than the 'A' category.

Demand Analysis

Demand analysis of medical schools mirrors that used in evaluating colleges and universities. Standard & Poor's focuses on enrollment trends, application, acceptance and matriculation results, student quality, and competition from other programs. Medical schools often offer more than just medical degrees, and some medical schools offer both allopathic and osteopathic programs in medicine. Larger, more comprehensive programs provide diversity, particularly since health science academic programs are known for their cyclicality. However, historical demand for medical school admission has far exceeded the available supply. This relationship holds, despite several years of a national decline in applications to medical schools. In general, allopathic schools of medicine tend to be more competitive in admissions than osteopathic schools of medicine, however, there are more standalone osteopathic schools of medicine rated by Standard & Poor's than allopathic. More of the nation's allopathic medical schools are associated with large, research universities. Osteopathic medicine schools, with a few exceptions tied to public, research universities, tend to be standalone institutions.

Since there are so few medical school spaces, students' choices are limited, and matriculation rates are often higher than for other unrelated professional programs such as law and business. The flexibility afforded by such selective admissions is particularly significant for medical schools that cannot rely on enrollment in other programs to offset periods of falling demand. While medical colleges remain vulnerable to industry changes and changing attitudes regarding the medical profession, Standard & Poor's expects demand for medical education to remain strong, and in fact, recent trends indicate a positive movement upward in medical school applications.

Financial Analysis

Standard & Poor's financial analysis of medical colleges also parallels the approach used for other higher education institutions, centering on:

- Revenue and expense composition;
- Annual financial operating results;
- Liquidity and endowment; and
- Debt load.

Standard & Poor's uses the same financial ratios and indicators used in the assessment of colleges and universities. The chief focus on the balance sheet is liquidity represented by various degrees of restrictions on equity. Many medical schools built their financial reserves more through decades of

strong operating performance, until the 1990s and 2000s, when performance was more strained. Thus, most medical schools have a higher degree of unrestricted equity than most colleges and universities. The chief focus of the income statement is operating performance and revenue diversity, as well as an underlying Profit and Loss analysis of the various components of the income statement.

While the analytical approach is similar, some of the financial characteristics of medical schools are very different from other colleges and universities. For example, revenues from faculty practice plans, research grants, and state capitalization programs can result in much greater revenue diversity for small medical schools than for similarly-sized colleges and universities. Medical schools affiliated with hospitals, or those classified as state institutions, often derive an especially small portion of their revenues from students and tuition. Tuition discounting is usually not a concern for medical schools.

While these other revenue sources help to insulate medical colleges from fluctuations in student enrollment, they may be vulnerable to change themselves. For example, financially strapped state governments can reduce state support, forcing potentially large increases in tuition rates.

Faculty practice revenues, mirroring reimbursement pressures on other health care providers and institutions, are often strained, with costs exceeding revenues. Payments for graduate medical education or residency programs can also come under pressure if the affiliated hospitals, with which the medical schools partner, face weak operating results. When payments under affiliation agreements decrease, often it is reimbursement for graduate medical education that suffers the most. Most payments under affiliated contracts are multi-year in nature, providing some revenue stability, but renegotiations can prove difficult in a weak environment. Most standalone medical schools are not heavily leveraged, but few also have the large endowments seen at other colleges and universities. ■

Private Elementary And Secondary Schools

The universe of rated private primary and secondary schools, although still relatively small, encompasses a diverse group of educational institutions whose operations and characteristics resemble colleges and universities more closely than traditional elementary and high schools. As a result, in rating private primary and secondary schools, Standard & Poor's Ratings Services assesses operational indicators similar to those used in rating colleges and universities.

A key element in the rating is demand, measured by such factors as enrollment, the number of applicants, the percentage accepted, matriculation rate (percentage of students offered admission who attend the school), and student quality. Institutional characteristics, such as the curriculum offered and whether a particular institution is a boarding or day school, also are important considerations. Financial factors, management, and legal provisions generally, but not always, modify the rating. A high endowment can considerably offset weaker demand. Most debt sold by private schools is secured by a GO pledge, so legal provisions bear less weight for debt ratings in this area.

Independent schools, while facing many of the same challenges as colleges and universities, operate in an environment vastly different from that of higher education institutions. For example, independent primary and secondary schools generally draw from a smaller, more regional market—particularly if they only offer day school programs—than do colleges, which may receive enrollment applications from across the country. In addition, independent schools typically are smaller than their public school counterparts, which receive local support and property tax revenues. Given the high tuition levels, a significant number of students attending such schools are affluent, which further limits the potential applicant pool.

Tuition is an important element in the financial profile of independent schools, and in general, private primary and secondary schools have considerably less revenue diversity than colleges and universities. However, with student charges already rivaling those of colleges and universities, the potential for additional increases may be limited. More and more tuition increases are being matched by rising financial aid costs. Although most of the schools make significant amounts of financial aid available to help offset the high tuition cost, Standard & Poor's believes that local economic fluctuations may be more likely to affect parents' decisions to send their children to private primary

and secondary schools. Parents may be forced to choose between a private primary/secondary education or a private college education for their children. While many parents are motivated to finance a private primary or secondary education, it still represents a discretionary choice. Typically, independent schools are very small and their revenue base is very concentrated. This concentration provides limited flexibility, and the loss of just a few students can have a big impact on a school's financial performance. Too, because of their small size, independent schools may find it difficult to achieve economies of scale.

Demand

In analyzing demand factors, Standard & Poor's first considers the school's mission (day versus boarding school, level and number of grades offered, single-sex versus coeducational, parochial versus nonsectarian, and program type). Standard & Poor's also reviews the size of the territory from which students are drawn and the number of schools in competition for this select pool of applicants. Boarding schools, with a wider geographic draw, are potentially more creditworthy than day schools, which draw students only from their local areas. However, the creditworthiness of boarding schools is often affected by the additional financial stress of having to maintain housing and a larger overall plant. A day school with local draw would be able to achieve a high rating if, for instance, it had a very large endowment and considerable unrestricted monies. This, in addition to solid demand, would more than compensate for its position as a day school.

Student demand factors are reviewed to determine a school's popularity and selectivity. Standard & Poor's examines enrollment and application trends, acceptance rates, matriculation, and student quality, as measured by standardized test scores (secondary SAT scores of applicants and SAT scores of graduates), and retention. Independent schools generally display stable demand trends, i.e. the number of applications tends to be very stable, along with enrollment levels. Management should explain changes or disruption in the number of applications or wide swings in enrollment. The highest rated independent schools often lose less than 5% of their students each year to attrition. In addition to these factors, Standard & Poor's looks at colleges attended by students upon graduation from the independent school.

Despite smaller enrollment levels and applicant pools, which often result in acceptance rates that are generally weaker than comparable measures for colleges and universities, most private primary and secondary institutions have had a relatively strong record of growth.

As a means of increasing enrollment, some independent schools use marketing efforts similar to those employed by higher education institutions. Such strategies include broadening geographic draw by targeting specific areas, increasing student aid, and expanding programs. An example might include an expansion from solely day programs to a mix of day and five-day boarding.

Admissions flexibility is a key factor in evaluating an independent school. Strong student quality enhances a school's ability to withstand a reduction in its applicant pool, allowing it to accept less qualified students. Other measures of student quality include the percentage of graduates attending college, analysis of the colleges attended, and graduates' success in college. Indicators for elementary and middle schools tend to be less standardized, requiring case-by-case determination of appropriate criteria, such as students' performance on statewide tests compared with norms. For all schools, Standard & Poor's assessment of competing institutions also is important. The attrition rate, or the percentage of students who do not return each year, is helpful in measuring student and parent satisfaction with the school and also provides insight into financial performance.

Documentation Requirements

- Five years of audited financial statements.
- Current year's budget summary.
- Comprehensive debt service schedule.
- Major strategic, capital, operating, or academic plans.
- Official statement providing descriptive information.
- Most recent investment report.
- Bond resolution or indenture.
- Lease or mortgage (if applicable).
- Loan agreement (if applicable).

Operational And Financial Factors

Standard & Poor's review of operations and finances starts with an examination of revenue sources and diversity of funding. The private schools rated by Standard & Poor's are evaluated using the same ratios and financial indicators used to assess the creditworthiness of private colleges and universities. These ratios are developed for institutions that follow FASB standards of accounting and display. Important areas of inquiry are relative restrictions on equity, total change in net assets, and change in unrestricted net assets from operations. Similar to many private colleges and universities, many independent institutions rely on

tuition as their main source of revenues, although endowment income and auxiliary revenues from sources such as boarding fees, summer programs, and rental facilities provide significant support for some schools. However, for more highly rated schools, endowment income and private contributions are increasingly important. Most independent schools run annual fundraising campaigns, and major comprehensive fundraising or capital campaigns. The largest of these campaigns is generally much smaller than the largest of capital campaigns for colleges and universities, but the alumni base for most independent schools is quite limited. Parental participation rates for many of the schools rated by Standard & Poor's are quite high—as high as 90% or more. Alumni participation rates vary, but can be much higher than a comparable level at a private liberal arts college.

Standard & Poor's also examines expenses and fixed costs, such as tenured faculty, operation and maintenance of plant facilities, and debt service. In general, primary and secondary schools do not have tenured faculties, giving these schools greater ability to react to fiscal pressures than educational institutions that award tenure to faculty. On the other hand, these schools are often so small that it may be difficult to achieve economies of scale seen in larger institutions. It is not uncommon for a school with fewer than 400 students to receive an investment grade rating. However, it is likely that it is not strong operating margins, but a good balance sheet, balanced operations, and good demand that drive an independent school rating.

The debt service burden is assessed by looking at maximum annual debt service as a percent of operating expenses. Because of their small size, and small operating budgets, independent schools debt service burden is often a high percentage of operating expenses. A debt load above 10% could be significant and may be a rating factor, however, it depends on whether the school has the existing operational capacity to take on the debt. A troubling indicator is the need to raise the endowment draw to support the increased costs of debt service, particularly if the increase in endowment spending results in a rate well above 5%. Day schools without large auxiliary operations present a special case. For example, in the context of a small budget and lack of tenured employees, even a high maximum annual debt service could be considered manageable if operating performance is good and an endowment provides additional support. Many independent schools issue variable rate debt secured by letters of credit or other credit enhancement. More of these schools are using interest rate swaps to hedge the interest risk exposure on the transactions. Standard & Poor's evaluates swaps to calculate a Debt Derivative Profile (DDP) score.

Standard & Poor's reviews a school's annual operating results to determine long-term financial stability and strength. Liquidity analysis principally compares cash and investments, unrestricted resources, and expendable resources with operating expenses and debt. Unrestricted resources exceeding 100% of expenses indicate strong liquidity position. Schools with unrestricted resources to operating expenses below 50% have more limited cushion and operating constraints. Often, again because of their small operating budgets, most independent schools have higher relative resources to expenses and debt than a comparably rated college or university.

Finally, Standard & Poor's reviews facility needs, capital plans, and deferred maintenance to determine their potential impact on future financial strength. Strong operating results may be significantly offset by substantial deferred maintenance, which can cause future financial strain. Little or no deferred maintenance would be an added financial strength to a school. Some independent schools fail to account for depreciation in their operating budgets, which subsequently results in a year-end decline in unrestricted net assets. Because Standard & Poor's evaluates liquidity using net equity ratios, the drop in unrestricted net assets directly leads to a drop in liquidity. If a school does not budget for depreciation, Standard & Poor's will evaluate the quality of the physical plant for signs of neglect and will ask about annual allocations to plant renewal and replacement.

Relevant Admissions Statistics*

- Headcount enrollment and projections.
- Total full-time equivalent enrollment.
- Total number of boarding and/or day students.
- New student information—including applicants, acceptances, and matriculants for each class, if available, and average SSAT scores or SAT scores of graduating seniors.
- Top 10 competitor institutions and win/loss statistics.
- Attrition and/or retention rates.
- Colleges and universities attended by graduating seniors.
- Day and boarding tuition and fee charges.
- Average room and board charge.
- Number of part-time and full-time faculty.

*Five-year historical data required.

Private primary and secondary schools that show a combination of strong results when evaluated against the criteria discussed above will be positioned to achieve investment-grade ratings. Standard & Poor's is unlikely to assign ratings much higher than the 'A' category without significant endowment and financial strength. Furthermore, Standard & Poor's expects that most institutions with ratings at the higher end of the spectrum will continue to be very selective boarding schools with a diverse student draw. ■

Charter Schools

A charter school is an independent public school, receiving public funds, that operates under a charter or contract for a specified period of time to educate children according to the school's own design, outside of the existing public education bureaucracy. It may be a new school, a start-up school, or an existing one that separates from an existing school district. It is held accountable in terms of its charter and continues to exist only if it fulfills those terms. The statutory framework under which charter schools operate varies significantly by state and often requires the reauthorization of the charter by the sponsoring entity after a specified period of time, typically three to five years. After renewal, some charter authorizations may run as long as 10-30 years. The first charter school opened in Minnesota in 1991.

Charter schools pose unusual analytical challenges. Public school districts and charter schools differ in critical ways. Public school districts must remain "going concerns", regardless of management performance or economic environment. Financial stress does not cause a public school district to go out of business, and may even generate positive counter-measures due to state oversight and support. In addition, public schools do not need to get their charter renewed periodically to stay in business. In contrast, charter schools may permanently go out of business. Most charter school closures to date have occurred largely because of issues relating to financial mismanagement.

Standard & Poor's Ratings Services' approach to rating charter schools depends on factors affecting each local school, as well as the state legal framework for authorizing and funding charter schools from statewide revenue sources. Rating analysis will vary from state-to-state and continue to evolve, because each school and state charter structure is very different.

Standard & Poor's rating methodology for both school districts and charter schools includes an overview of the following:

- Charter framework
- Demand for a school
- Finances
- Management and administration
- Debt, capital planning, and expansion risk
- Demographics
- Legal structure of the debt

State Statutory Framework

An important ingredient of a creditworthy charter school includes a clearly established state statutory framework for establishing, maintaining, and financing charter schools.

Charter authority

Standard & Poor's examines who, under statute, has the authority to grant charters. Powers are usually vested with a state-appointed board, a state university, or most commonly, a local school district. When a local school district is granting the charter, Standard & Poor's needs to feel comfortable that the school district supports the charter school, since the two may compete for the same students. Local school districts may support the charter school for varying reasons, such as relieving new building needs in growing districts, or providing a unique educational curriculum not currently provided. The number of charter schools and competing new entrants that are allowed by statute or may be established in the future is an important demand consideration. In some cases, a local school district official may serve on a charter school board, enhancing support and integration of the charter school with the local school district. In some states, charters can be granted by a city, state, or a university that do not actually compete directly with a local school district, thus eliminating some of the competitive aspects.

State legal framework

State charter statutes set the legal foundation—as well as the payment mechanism—for charters in a state. A very important component of the statutes is

an impartial legal framework for charter renewal or revocation, including a right to appeal a charter non-renewal; such oversight contributes to more uniform results. A clear renewal and appeal process should diminish the political elements involved in establishing or maintaining such schools, while ensuring adequate community input.

Some states also provide start-up or other additional capital funding for charter schools, enhancing the ability of a charter school to fund its debt.

Charter term

The charter term is an important credit factor. The state statute will either limit the term or establish the entity that is charged with granting the charter term. Charter schools are often granted charters of limited terms—typically up to five years—and therefore are subject to periodic renewal evaluations. Some states do grant charter renewals for longer periods, some as long as 20 years. Charters can usually be revoked even prior to the end of the charter term, usually for cause. While charters may only extend for five years, longer-term capital financings are generally amortized over a 20-30 year term. A good match between the charter term and bond amortization may contribute to a better rating, although Standard & Poor's does not require long charter authorization periods for an investment-grade rating. A school with good financial operations and stable enrollment is likely to remain a going concern, and thus a shorter charter term relative to debt maturity can be acceptable. Schools that have been through a charter renewal or similar review process at least once support the assumption of future successful renewals, and are most likely to be rated investment grade.

In general, Standard & Poor's believes that the periodic need to renew a charter does not necessarily pose a major risk to receiving an investment-grade rating. A successful charter school with high demand for its product will have its charter renewed, much as successful hospitals will have their operating licenses renewed if they meet a community need. Closures of charter schools generally follow from management or financial disorder, not from the arbitrary charter revocation or closure decision of the authorizing body.

The role of the charter school authorizer

The charter school authorizer plays an important role in determining credit quality. Nearly all of the investment-grade charter schools rated by Standard & Poor's have been through a successful charter renewal process, although schools that have not been through the renewal process may still merit an investment-grade rating. A long-term charter could be a positive rating consideration. In addition, a school that has received interim charter approvals as new grades are added or programs changed will be considered to have gone through a process similar to a charter renewal. In some cases, where the initial charter term is long, Standard & Poor's has accepted a letter from the charter authorizer affirming current school compliance with the terms of its charter.

Standard & Poor's focuses on the following questions when evaluating the authorizer as part of a credit review:

- What are the guidelines for charter renewal? If this is a detailed and specific process, there is less room for arbitrary revocation.
- What is the history of charter revocation in the state and for the specific authorizer? Have a sponsor's charter decisions been appealed? Who handles the appeals?
- What is the level of oversight from a financial reporting and facilities planning standpoint? Is there a formalized financial reporting and oversight process during the fiscal year that allows for corrective action to be taken in advance of the charter review time frame?
- Is there a role for the authorizer in providing liquidity or credit enhancement relating to short-or long-term debt issuance? This could be a positive credit factor.
- Is there an interim charter renewal period when grades are added or triggered to some other event?
- What is the relationship between the sponsor and its charter(s) over time? What level of academic, planning, or administrative support is available?
- How many charters have been granted and/or are overseen by the charter authorizer? How many schools has the charter authorizer closed?

The strongest sponsor/charter relationships will have formalized coordination and reporting in place, and good communication that allows quick resolution of any academic, policy, facilities or financial issues that arise. As part of the rating process, Standard & Poor's will typically meet with officials from both the sponsoring entity and the charter school.

Charter School Financing

A key part of the analysis deals with the funding mechanism for charter school operation, that is, whether a combination of state or local funds will be predictable and adequate. Many states simply finance students in their charter schools at or near the same per-pupil funding level of traditional public schools, while others leave the funding formula to negotiation with the sponsor. In some states, charter schools get less funding per pupil than public schools and receive no public funds for capital

facilities financing. Others provide special per-pupil facilities funding. While each state's formula for distributing funds to its charter schools differs, the strongest systems occur when the state standard per-pupil funding of public schools follows the students to the charter schools. Additionally, per-pupil funding may flow-through a sponsoring district, or come directly from the state.

Standard & Poor's will evaluate the funding mechanism and payment requirements to determine if cash-flow difficulties of a sponsor, such as a sponsoring school district, could create cash-flow difficulties at the charter school. A stand-alone charter school typically has less flexibility to withstand funding reductions or timing delays than a traditional multi-facility and multi-grade public school district.

The statutory authorization for issuing charter school debt needs to be clear. If specific funding under statute for facilities is available, it is also evaluated and considered a credit strength. Some states provide direct funding for facilities, while others provide statutory authorization for local school districts to provide facilities funding. Other states provide no capital funding provisions for charters.

Student Demand

Student demand for the charter school is one of the key elements of a rating evaluation. State funding generally follows pupil attendance for most charter schools. Charter schools need to demonstrate a record of demand for their educational services, as measured by stable-to-increasing enrollment, in order to retain funding.

Standard & Poor's does not have a minimum enrollment size threshold for any given rating category. However, a small school may sometimes become dependent on only one or two key administrators, or be less able to be withstand minor random fluctuations in enrollment. There may also be economies of scale involved with some larger schools, although every example must be examined on its own merits.

Specifically we look at the following:

- A well-documented waiting list that is regularly updated and maintained. A positive trend is particularly important if the charter school is issuing debt to significantly expand its facilities. The quality of waiting lists will vary dramatically depending on its requirements, such as, the age of the list, the level of detail required per applicant, parent volunteer time agreed to serve upon enrollment acceptance, and other requirements.
- An overview of competition in the area that affects the long-term viability of the school. This would include an analysis of other charter schools currently operating in the area and whether competing new charters could be authorized in the future or whether competing charter schools have authorization in their charters to expand enrollment. In addition, the local public school district is examined as a potential competitor in terms of quality of school offerings and its degree of overcrowding. Analysis of other private school alternatives in the area is also done. Forecast assumptions should be based on reasonable well laid out assumptions as regards public and private competition and anticipated future competition.
- A charter school enrollment trend that is stable or growing is also preferable, with good retention rates and manageable student turnover. Enrollment forecasts should be based on reasonable, well laid out assumptions.

Unlike private independent schools rated by Standard & Poor's, charter schools are required to maintain open admissions policies. If demand exceeds supply, most charters use a lottery system to fill available spaces.

Unusual curricula present a challenge in the rating process. Standard & Poor's has to determine whether a unique academic focus is relevant to the community and will continue to attract students. Another challenge associated with charter schools is a frequent absence of recreational and student facilities typically found in large suburban high schools or private independent schools. Limited athletic facilities and related programs can significantly hamper recruitment efforts for older students, particularly those in high school and junior high, although they may reduce charter school operating costs. Some charter schools have the ability to charge a facilities fee to offset activities' costs; others cannot. Some charter schools may be able to coordinate with their local public school districts to provide recreation programs.

Financial Factors

The charter school's own management of its resources is a key determinant of its creditworthiness. Since most charter schools are likely to be small, there will be fewer opportunities to realize economies of scale; therefore, careful financial management is critical. Of particular importance is the formula by which revenues are derived, often net a management fee to the sponsor. Revenues in some

states are not always determined on a per-pupil basis. Other financial factors include:

Operating history

Investment-grade rated charter schools will likely have a stable financial operating history, preferably for at least three years.

Fund balance

Fund balance reserves are critical due to charter school reliance on enrollment for funding. Enrollment can, and does, fluctuate, while fixed costs may not. Standard & Poor's examines whether there is a formal fund balance policy based on cash flow requirements, and if the school successfully adheres to such policies.

Financial flexibility

The ability to reduce budgets, if necessary, also contributes to financial flexibility in the event of an unexpected downturn in enrollment, as do conservative budgetary policies. Standard & Poor's routinely asks charter schools how they would maintain a balanced operating budget if enrollment dipped or state funding were delayed or reduced. In this respect, low class sizes provide some flexibility to increase student-to-teacher ratios and cut costs.

General financial policies

Adequate casualty insurance is advisable since charter schools often use a single site facility. Existence of long-range financial and facilities planning, and formalized policies relating to fund balance and cash flow reserves are also positive management and financial factors.

Audits and financial reporting

While Standard & Poor's strongly prefers independent audits, we have rated schools that are presented as a component unit of a school district that is also the authorizer. Availability of independent audits—at the charter school level—may be a critical rating factor. Uniform financial reporting is important for fiscal accountability and also factors into charter renewal decisions.

Cash management

Cash management policies and procedures are important. The frequency and timing of payments to charter schools throughout the year varies by state, which may affect daily cash flow. Banking relations may also be reviewed when access to liquidity becomes important due to modest cash reserves, since cash flow requirements can be uneven. While some states have provisions to accelerate funding to charter schools that can alleviate cash flow issues, other states have no such provisions.

Renewal and replacement reserves

Existence of a formal reserve for future renewal and capital expenses that is funded within the operating budget each year is considered a positive credit factor. The establishment of such a reserve with funding up-front or through required payments over time may strengthen credit security.

Endowment/fundraising

Is there an established endowment or fundraising program? The existence of such a program may contribute to financial flexibility. Conversely, is there a dependence on fundraising to support programs crucial to attracting students to the school?

Management And Administration

Management factors are a critical part of charter school review and will be a pivotal factor in determining if a school is investment grade. Standard & Poor's considers the history of charter school establishment. Biographies of key staff members may indicate the depth of the management team. Key staff should have solid experience in financial management in addition to the expected academic/educational credentials, or an experienced management company or public school district staff should provide such expertise. Charter school management is expected to have, or obtain, construction management expertise, as needed. In situations where the success of the charter school is closely tied to the charisma and personality of a founder, succession planning is necessary to ensure ongoing viability of the school.

Private management contracts are not uncommon. This is generally credit-neutral as long as the management company is experienced and the terms of the management contract do not adversely affect bondholder repayment. There should be policies in place to maintain operations in case a management company resigns or is fired.

Details about the budgeting process are important financial management issues, and Standard & Poor's checks to see if management has been generally accurate in its enrollment and cost projections. Information regarding teacher recruitment is also important, as well as teacher certification, salary scale comparisons with the local school district and competing charter schools, how teachers are recruited, certification requirements, comparative salary scale, and turnover.

Debt And Capital Planning

Many state statutes specifically authorize charter schools to issue debt. Public capital financing for charter schools, however, is in its infancy compared to other municipal rating sectors. Many states have

not yet developed an active public debt market for charter schools. Although charter school facilities financing varies substantially from state to state, many schools are left to their own resourcefulness and the diligence of interested community members to secure and finance adequate facilities. Many new schools initially finance space using short-term leases, then later purchase their leased facilities or relocate to new facilities purchased with long-term debt once they have established a financial track record. If a substantial portion of classroom space will still remain under short-term lease after a debt-financed expansion, a contingency plan needs to be in place in case the leased space cannot be renewed.

Charter School Information Requirements

Relevant demand information

- Description of school's history and founding
- Total student enrollment (for last 5 years)
- Current year and future enrollment targets
- Number of students on waiting lists (for last 5 years), preferably broken out by grade-level
- Measures of educational outcomes (test scores, performance on standardized tests)
- Number of faculty and staff
- Description of current facilities (if more than one location, indicate number of students
- Number and description of close competitors

Relevant financial information

- Sponsor (names and addresses of key contacts)
- Charter School management biographies
- Current charter provisions (term and funding levels)
- Charter renewal history and description of charter renewal process
- Audited financial statements (or independent financial reports for last 3 years)
- Current year operating budget
- Description of funding mechanism and cash flow
- Description of any fundraising activities, public or private gifts or grants
- Revenue projections (including estimated enrollment, revenues, expenses, and debt service coverage)

Other documentation requirements

- Sources and uses and debt service schedule
- Description of bondholder security
- Offering statement/disclosure information
- Independent property appraisal (market value assessment of completed project and land may be required)
- Independent site assessment (may be required)
- Lease agreement
- Trust indenture

A key charter school debt ratio is the debt service burden relative to the operating budget. An annual debt service burden of more than 20% of expenses would be considered onerous in most cases. This is probably one of the more critical measures, because a high fixed cost for debt service can significantly limit fiscal flexibility. Any charter school expecting to raise its debt levels needs to demonstrate an ability to pay for the increased debt service, especially if the revenues are expected to come from enrollment growth. The need to grow enrollment rapidly to meet approaching debt service obligations is considered a weakness. The strongest charter schools can demonstrate ability to meet future debt service with existing enrollment levels or very limited reliance on enrollment growth. An example of limited reliance on future growth might be the addition of an extra grade level, which currently enrolled charter school students may graduate into.

Using a lease structure to repay debt rated at the lower end of the credit spectrum may not be considered a material credit weakness, although it is preferable to have a general obligation pledge of the charter school in addition to a mortgage on a school building.

Charter school lease structures must meet Standard & Poor's lease criteria. Basic security features such as appropriate debt service reserve funds, additional bonds tests, use of a trustee to hold bond funds, and similar security features should be incorporated into the financing structure. Legal covenants such as a rate covenant are not relevant to a charter school; charter schools do not charge tuition, but receive state revenues. A charter school usually can only increase net revenues by increasing enrollment or reducing expenses.

Standard & Poor's also considers what future capital requirements and other projects will be necessary to keep schools viable and competitive:

- How will annual maintenance requirements be handled as part of the operating budget?
- If capital facilities are to be expanded, how will the increased operating costs be handled?
- How thoroughly have expansion plans been considered?

Charter schools are at a disadvantage compared with public schools, because their state operating revenues might also be needed for paying debt service, in contrast, public schools enjoy a separate property tax levy for debt service. A formal comprehensive business or capital plan can be a credit strength.

Also of concern are the debt issuing provisions of the entity providing the charter authorization. Is it actively involved and does it have an approval role on projects under consideration? Does the

authorizer have guidelines regarding facilities or debt structure?

Projected future debt service coverage margins are evaluated but may be of limited value compared to a demonstrated ability to manage budgets and generate revenues. Projected budgets should adequately provide for future debt service payments plus a margin for unexpected financial fluctuations. Identifying areas of the budget that could be cut would be an advantage and may serve the purpose of providing a hedge against potential drops in enrollment.

Standard & Poor's prefers projections indicating a coverage margin on new debt. However, the unique nature of charter schools, which receive the bulk of their revenues from government, as opposed to tuition receipts, makes the level of coverage of debt service less important, since the credit quality of the state providing the funding provides a certain level of revenue stability, assuming enrollment stability. Revenues will be stable due to stable state funding and stable enrollment, not from tuition-setting power. Given this, flexibility that can be found in the budget on the expenditure side of the budget to accommodate fixed debt service costs will demonstrate credit strength.

Charter schools that finance facilities to accommodate significant additional student enrollment growth will usually have greater difficulty achieving an investment-grade rating. Facilities construction/expansion risk is present if debt service is onerous and the ability to repay the increased debt is limited if the facility does not open on schedule, is over budget, or can not attract enough additional students to pay for itself. Demonstrating demand for an expanded facility becomes increasingly difficult as the anticipated percentage increase in enrollment grows. It may be even harder to demonstrate the ability to attract enough new students to pay for the increased debt if the school plans to open a new satellite campus in a far away location.

Even a move to new facilities in a nearby location can create the risk that not all students will follow to the new location. In some cases, the attraction of a school may be the ability to walk to school, or a desirable central drop-off location, a feature that may be lost in a move.

Sometimes an additional bonds test can help mitigate concerns about potentially aggressive expansion plans, although additional bonds tests don't necessarily provide full protection, since subordinate debt could also create financial hardship. A senior lien on debt does not help if a school closes due to the difficulties of repaying its other obligations.

Socioeconomic Factors

Traditional economic indicators for general obligation public school districts, such as income, employment base, and unemployment rates, are less of a credit issue for charter schools than for public schools because charter schools are not directly tax supported by the local economic base, but by statewide school funding appropriations. Demographics of an area serviced by a charter school are nonetheless analyzed, particularly population growth. Historic and projected student enrollments are an indicator of overall education demand. A rapidly growing area is generally more capable of supporting education alternatives in order to meet demand for facilities. However, a charter school can be successful in a slow or declining enrollment environment if public school options are substandard, the charter school represents a more attractive alternative curriculum, and there is not major political friction with a charter authorizer from the competition for a declining student pool. Documentation of higher test scores than in competing public schools can help demonstrate the appeal of a school. In some cases, the attraction of a charter school over a public school may be simply the amount of greater discipline being offered, or maybe a less structured environment. Some public school districts view charter schools with specialized curriculum options as almost another kind of magnet school within the overall public school system, and worthy of their support. ■

Non-Traditional Not-For-Profits

The substantial number of rated not-for-profit corporations generally falls into four broad areas that are separate from the traditional sectors of health care and higher education. They are:

- Cultural institutions and attractions;
- Voluntary membership organizations;
- Endowed and charitable foundations and corporations; and
- Research institutions.

In many respects, the only similarity between these four entities is their tax-exempt status. Yet, despite this diversity, Standard & Poor's Ratings Services has developed a common rating methodology to assess their creditworthiness. This methodology builds on our criteria for hospitals and universities, yet incorporates the unique characteristics of each new nonprofit entity. In general, Standard & Poor's public finance does not rate political parties and churches.

Rating Methodology

The four main credit factors considered for each organization are:

- Demand for the organization's products and services;
- Management and governance;
- Financial performance and resources; and
- Debt and capital structure.

While these factors are the same as those used for assessing many types of credits in public finance, the focus of the evaluation is quite different, depending on the type. For cultural institutions, demand is often the focal point. Most of the cultural institutions rated by Standard & Poor's are admissions-driven, and earned income is a function of the number of people who attend or visit a facility. For membership organizations, the primary focus is the tie between the organization and its members, and an analysis of the service or services provided. Membership revenue may not be the largest source of operating income for the organization, but the relative importance of the corporation to a particular industry is often a key factor. Analysis of endowed foundations focuses less on demand and more on financial resources and balance sheet strengths, and the likelihood of growth or stability, or the possibility of reduction in the pool of assets. The driving factors behind the analysis of research organizations are the nature and level of the research, whether the costs of research are fully reimbursed, and an entity's ability to withstand funding changes. Most of the research institutions rated by Standard & Poor's, in addition to a sizable research base, also benefit from the presence of long-term investments or endowment.

Demand

Standard & Poor's assessment of demand requires a thorough understanding of each entity, its mission, market, and niche. An important component shaping the character of these organizations is an issuer's tax-exempt status. Such status entitles nonprofits to an exemption from taxes on related business income and to issue tax-exempt debt—two significant advantages not available to for-profit counterparts. Conversely, not-for-profits often run breakeven financial operations; but because these organizations retain earnings without shareholder distribution, they tend to build reserves over time.

Standard & Poor's reviews an organization's charter to assess its mission and changes in this role over time. Depending on the primary activity of the organization, we examine various measures of industry effectiveness and performance. For example, when assessing a museum, Standard & Poor's might review net revenues per visitor, a common industry statistic. When assessing an endowed or charitable foundation, assessment of fundraising efficiency (what portion of dollars raised is spent on programs and what portion on administrative costs), is also important. This point is especially true for organizations that engage in direct mail fund drives and which raise a substantial portion of their annual budgets from external donors.

An assessment of competition or competitive position is also important. Unlike a municipality, which provides essential services and therefore is likely to survive despite fiscal stress, nonprofits must have a role unique enough to ensure ongoing viability. Closing a local service nonprofit organization might not cause significant long-term distress or dislocation to the local community or users. But closing an important federally sponsored research institution that provides essential research for the federal government might be more disruptive to the government of the entities in this sector rated by Standard & Poor's. However, very few of these institutions go out of business. Some organizations have voluntarily rescinded their exempt status and

converted to taxable, or proprietary corporations. Typically, any tax-exempt debt would be refunded at that point.

Management and governance

Management is an important credit factor, particularly for nonprofits wrestling with industry competition and often limited financial flexibility. Standard & Poor's assesses management and governance by reviewing:

- The composition of the board of trustees, its expertise, its independence, its committee structure, and its role in setting financial guidelines and goals;
- The quality of management information readily available in the rating process;
- Operational policies, investment and debt policies, and strategic plans;
- The ability to anticipate and react to new developments in the marketplace; and
- Current tenure of existing administrative officers of the organization and their relevant experience in the industry.

While nonprofit corporations are not required to fully adopt the provisions of Sarbanes Oxley at this time, in practice many of them voluntarily adopt most of these as practices, with the exception of certification of financial statements. Most of the organizations in this sector that achieve investment grade ratings also engage in multi-year financial planning and can easily produce budget models that forecast future operations.

Since many exempt organizations rely on large endowments, balance sheet management (both asset and liability) also is important. Standard & Poor's reviews investment policies, investment performance relative to market benchmarks, current asset allocation, and spending policies. As far as liabilities, Standard & Poor's reviews debt policies, existing debt structure (including any off balance sheet or subsidiary liabilities), plans for reducing any postretirement liabilities, and employment cost structure.

What is a Nonprofit?

A nonprofit organization is an entity organized so that no part of its income benefits a private shareholder or individual. A nonprofit corporation usually applies for a tax-exemption under Subchapter F of the Internal Revenue Code. The majority of tax-exempt organizations rated by Standard & Poor's derive their tax-exempt status from Section 501(c)(3) of the Internal Revenue Service Code.

Financial performance and resources

Financial analysis begins with an historical overview of the institution's operations. The not-for-profit corporations rated by Standard & Poor's almost universally report their operations under FASB reporting guidelines. Financial analysis typically incorporates five years of historical performance, current year's preliminary results, and the next year's operating budget. If 5-year, or multi-year forecasts are available, these documents provide a good indication of management's assumptions about future business activities. Within the financial context, Standard & Poor's examines:

- Growth in the operating budget and budgeting practices;
- Revenue diversity and cyclicality and the opportunity for future revenue growth;
- Expense flexibility, or the ability to make programmatic changes without negatively affecting demand; and
- Rate flexibility, particularly in those cases where there is significant industry competition;
- Financial performance on an aggregate basis, measured by the existence of operating surpluses or deficits;
- And financial resources, measured by cash and investments and unrestricted and expendable resources.

Affiliated organizations are generally consolidated in financial statements of the entity being rated, and Standard & Poor's analysis incorporates the assets and operations of subsidiary corporations of not-for-profits. Projections beyond the current budget year also are reviewed, for they often reveal new program directions and can be a gauge of management's realism. Important financial ratios involve the assessment of debt burden and operating cushion.

For debt burden, Standard & Poor's examines maximum annual debt service as a percentage of expenses and total debt relative to cash and investments and to total unrestricted resources. Unless there is an ability to adjust rates on an ongoing basis, Standard & Poor's expects current operating surpluses to cover total debt service, including principal and interest associated with new debt. While many nonprofits operate on a breakeven basis, Standard & Poor's believes that these organizations should have an operating cushion to shield them from inevitable economic cycles. Operating margin varies by type of organization. Some membership organizations demonstrate a high level of profitability, while some charitable organizations only breakeven from year-to-year. The most important cushion ratio compares unrestricted resources to expenses

and provides a measure of an entity's ability to fund operations if operating revenues decrease.

Different organizations require different cushion levels. For the most part, the level of working capital required is a function of the organization's cash flow. An entity that receives a steady stream of income throughout the year can operate on thinner reserves than one that receives most of its revenue once or twice a year. An exempt organization that can quickly and easily reduce expenditures at midyear can operate with thinner reserves than one that must commit funds well in advance. Most not-for-profit corporations rated by Standard & Poor's have a good sense of their cost structure—what portion of their operating expenses are fixed and what portion, or components, are variable. Some organizations indicate that a substantial portion of their salaries and benefits could be considered to be variable in nature, while facilities costs, insurance, and legal fees are not. Generally, institutions with unrestricted resources (measured in cash and liquid investments) below 25% of their annual operating budget have a limited financial cushion.

In addition to operating revenues, many nonprofits rely on annual voluntary contributions. A long history of successful fundraising managed by a professional staff can offset concerns about the cyclicality of this revenue source. However, these strengths would not be enough to offset the risks associated with an organization totally dependent on contributed revenues.

Debt and capital structure

In addition to reviewing specific debt ratios as noted above, Standard & Poor's considers security, the project being financed, and future capital plans in its assessment of debt. Organizations that are capital, or facilities-intensive, should have debt policies in place. Debt policies should include the types of allowable debt, directions about when derivatives can be used, and how an appropriate level of debt is determined. Other long-term liabilities, such as postretirement obligations, may need to be considered in addition to any long-term bonded indebtedness. The level of debt that is manageable is very much specific to the type of institution being rated. Cultural facilities, which are more place-intensive, tend to have higher debt burdens than other types of nonprofit corporations.

Security. Most not-for-profit corporations' bond issues are secured by an unsecured corporate, GO pledge of the obligor institution. While Standard & Poor's will consider a narrower pledge, such as membership fees at a museum or indirect cost recoveries of a research laboratory, it is unlikely that such a structure will receive as high a rating as a GO pledge. As additional security, a fully funded debt service reserve is prudent unless the issuer has substantial liquidity. Most issuers also include legal covenants, such as rate covenants, asset-to-liability tests, and restrictions on the issuance of additional debt. The rating impact of such covenants depends on the nature of the entity and each covenant's relative strength or degree of restriction. Some covenants are so loosely written that they do not provide any real protection for bondholders. Stronger legal covenants generally do not result in a higher general obligation rating. Endowed foundations present a special case for bondholders. While they look for some indication that a pool of assets will not be spent down, nonprofit corporations issuing tax-exempt debt are subject to arbitrage restrictions, which would be a strong disincentive to pledging any kind of "reserves". However, restrictive covenants and policies remain a protection that bondholders wouldn't otherwise have, and a gauge of willingness to meet the needs of investors.

Project. An analysis of the project to be financed incorporates several factors. Standard & Poor's initially will examine the need for and scope of the project, and how it fits into the organization's overall activities. Many of the nonprofit project financings rated by Standard & Poor's involve the construction of new headquarters buildings and the consolidation of operations in one location, and are considered fairly essential. Standard & Poor's also analyzes the degree of self support assumed for the project, compares debt maturity with project life, and evaluates other sources of funding. Undertaking a project that does not help meet an organization's mission, that takes it in new untested directions, or that is likely to require considerable financial resources in the future even when an organization has debt capacity, could be considered a negative rating factor. Most of the project financings rated investment grade are projects being undertaken by existing exempt organizations. Start-up projects by new organizations without a track record, or by entities without any financial resources, may find it difficult to achieve investment-grade ratings.

Capital improvement program. A review of the size, sources of funding, and timing of future capital plans provide important insight into an organization's needs and goals for expansion. Standard & Poor's also is interested in determining whether these plans will significantly change an organization's scope or mission. Some organizations, such as aquariums or other attendance-driven cultural institutions, must constantly plan for new attraction and updates of their facilities. A failure to consider new exhibits or changing exhibits could be of concern.

Cultural Institutions

While the rated universe of cultural organizations largely consists of museums, the rating approach is similar for all types, including zoological parks, public radio and television stations, aquariums, and historical sites. Rated issuers are highly diverse, ranging from fine arts to natural history institutions. They also vary widely in their constituencies (adults, children, tourists, or local residents), admission and membership levels, revenue sources, and financial flexibility.

To assess demand for a cultural institution, Standard & Poor's examines:

- The national and/or international prominence of the collection;
- Admissions and membership levels and trends;
- Competition from and location near other local museums, similar organizations, and tourist attractions; and
- Fee structure and rate flexibility.

Service area economic conditions also play an important role, particularly when the institution has a more limited, local draw. In addition, admission and membership trends often are affected by the use of blockbuster or special exhibits, a phenomenon somewhat unique to museums. These super shows usually run for a limited time and, despite huge crowds and swelling revenues, often are money-losing propositions. Nonetheless, blockbusters can have a longer-term positive effect by attracting new members and repeat visitors.

Because blockbusters dramatically inflate revenues and expenditures in show years, it is often difficult to make accurate financial plans. As a cultural institution assumes long-term debt, it is important that it budget for these variations and maintain an adequate financial cushion to offset fluctuations. In fact, the highest-rated museums enjoy significant financial flexibility, with endowment and unrestricted monies well in excess of the annual operating budget, even though they do not always produce consistently good operating margins.

The visible civic role played by many cultural institutions often results in high levels of municipal government and/or private donor support. Attendance-based cultural facilities with cyclical revenue streams, limited outside support from governmental or private donors, and no endowment, would be unlikely to achieve investment-grade ratings. Start-up cultural organizations are not likely to be rated investment grade, since they do not have a record of attendance or membership, and might not have an endowment. Museums that undergo significant expansions must demonstrate that there is some predictability to their current revenue source, such that projections seem attainable. In fact, most forecasts are far more positive for first year attendance after a major project completion than what actually occurs.

An important part of Standard & Poor's analysis of a cultural institution is a review of the proposed project, particularly its potential impact on attendance or membership and the organization's mission and focus. Exempt organizations often receive substantial governmental support, which might offset the risks associated with increased debt issuance. Therefore, the outlook for future governmental and private support is a crucial part of Standard & Poor's analysis.

Documentation Requirements

- Official statement or other disclosure
- Bond resolution or trust indenture
- Lease or mortgage
- Five years audited financial statements and current year's budget summary
- Entity descriptive information
- Legal opinions*

*In addition to tax and validity opinions, Standard & Poor's may require certain bankruptcy-related opinions, including the status of the issuer under section 303(a) of the Bankruptcy Code-the inability of a creditor to file an involuntary petition against the issuer-preference opinions, and, if applicable, nonconsolidation opinions. Most private universities issue tax-exempt debt through conduit issuers. Sometimes this requires additional documentation such as loan agreements and information on the intent to perfect security interests.

Membership Organizations

One subset of not-for-profits that has garnered significant market interest is voluntary membership organizations. Such entities range from professional membership organizations to trade associations, religious organizations, and scientific societies. The rating analysis depends, in large part, on the primary activity of the organization and the benefits derived from membership.

As with other not-for-profits, Standard & Poor's analysis of a membership organization begins with a comprehensive evaluation of the operating history of the institution and its current activities and management. While actual membership growth is important as a proxy for demand, the main focus is on understanding an institution's particular industry and role within that industry. To that end, Standard & Poor's examines offered services, membership trends, and measures of industry effectiveness and performance. Some organizations have a role so unique that they have no competition in their particular industry. For example, the

Association of American Medical Colleges is the accrediting body for the majority of the nation's medical schools and the only sponsor of the Medical College Admissions Test (MCAT). Regardless of an organization's competitive position, Standard & Poor's expects to see a consistent or stable membership base. Wide fluctuations in membership make planning and budgeting difficult and are viewed negatively. Standard & Poor's rates both large and small membership organizations and size is an important characteristic. Generally, the larger the organization, the more revenue diversity and greater level of financial resources it possesses relative to operating expenses and debt. However, a small membership organization could be highly rated with a substantial endowment and good operating performance.

Other areas of inquiry for membership organizations include:

- Historical membership data by type of member for at least ten years;
- Breadth of focus. Organizations with a narrow focus are felt to be most vulnerable to periods of economic stress;
- Degree of professionalism in the administrative staff. For any investment-grade credit, Standard & Poor's would expect to see an experienced, permanent staff with functions distinct from the governing body, or membership directorate of the organization;
- Benefits derived from membership. Exceptionally strong credits provide services that are highly desired and cannot be obtained elsewhere; and
- Competing membership organizations who provide the same type of services and may overlap with members
- Percentage of members who count the organization as their primary professional society.

Financial performance

The financial history of a membership organization is analyzed for at least a five-year period. Standard & Poor's evaluates historical financial performance to determine how well the organization performed given its available revenues (income statement) and resources (balance sheet). Most of the membership organizations rated by Standard & Poor's have limited capital needs and an operating cushion equal to six months of operating expenses, however, there are entities with a considerably higher cushion and those with a much lower cushion who pursue a rating. While many organizations have sufficient liquidity to pay for the project being considered, partially paying the project costs with accumulated equity to reduce debt burden also reduces operating cushion. Unless debt burden is a concern, using equity for long-term projects is unlikely to result in a higher rating for the organization.

Standard & Poor's examines the major sources of revenues and patterns of expense growth. As for most rated organizations, revenue diversity is important and shields membership organizations from potential cycles. A critical issue is budgetary flexibility and the ability to cut expenditures midyear without jeopardizing operations. Management should be able to quantify areas of variable costs that can be eliminated, or scaled back, in the event of financial stress. Ancillary services, provided at no cost to the membership, account for a major portion of operating expenses at many membership organizations, and are often the first place that management will look to scale back. However, organizations must recognize that major cuts in public service activity could call into question their tax-exempt status. Membership fee history also is examined and compared with that of any competing organizations. Rate flexibility is particularly important, and it is preferable that any rate-setting capacity be centralized within the financial management function rather than with a voluntary board.

Endowed And Charitable Foundations

The common characteristic of all tax-exempt endowed foundations is a pool of money used to support a specific cause, such as health care or medical research, educational endeavors, or programs for low-and moderate-income people. United States tax laws, in fact, require that certain philanthropic organizations give away at least 5% of their assets every year. This required drawdown in resources is an important consideration, since most foundations will secure their bonds with an unsecured GO pledge, which in effect, encompasses the corpus of their unrestricted endowment and related income. Many of the not-for-profits currently rated by Standard & Poor's have no source of income other than investment earnings. The size and quality of a foundation's endowment relative to both debt and operating expenses is thus of

Relevant Statistics for Cultural Institutions

- Historical admissions and membership trends.
- Competitor institutions (local tourist attractions and other museums).
- Fee structure and history of rate increases.
- Revenue diversity.
- Net revenue per visitor.
- Average annual membership fees.

paramount importance. Standard & Poor's requests at least five years of historical financial data and asks for portfolio and endowment data such as quarterly board reports.

In evaluating endowment, Standard & Poor's looks beyond size at a number of specific factors, including:

- Growth in endowment assets over time;
- Asset allocation policies and quality of the investment pool, and a comparison to targeted investment mix;
- Historical rates of return compared to broader market or customized benchmarks;
- Relative liquidity and availability of the portfolio;
- Endowment spending policies; and
- Restrictions on use of earnings and principal.

Since the endowment is the basis for any rating of an endowed organization, Standard & Poor's may require legal covenants restricting the foundation's use of its endowment. Generally, restrictions mandate liquidity and asset coverage tests, and limit additional debt issuance.

While the above analysis focuses primarily on the balance sheet, foundation mission, activities, and budgetary flexibility are also important. To date, rated foundations tend to fall into one of two categories—independent or grantmaking and operating. Although, one type is not necessarily more creditworthy than the other, grantmaking entities may have more budgetary flexibility than operating foundations that actually run their own charitable programs. Standard & Poor's is particularly interested in the type of activity supported by a foundation and the extent to which it can curtail this support and control operating costs. Once started, Standard & Poor's assumes that certain programs or foundation giving would be difficult to stop, particularly if the foundation is the sole sponsor.

Research Institutions

While nonprofit research institutions abound, those most capable of achieving investment-grade ratings generally have a long history of working with a governmental agency, or have a medium-to-high level of endowment. Despite their close ties to governments or sponsors, research organizations often face considerable credit risks, including contract nonrenewal and cyclical support for the type of research being sponsored. Because of these risks, small institutions in a single competitive field, or in a field with a low funding priority, are more likely to receive lower ratings.

As with most areas of credit analysis, Standard & Poor's reviews industry information to assess a nonprofit research organization. Specific governmental contracts are needed if the institution is operating under an especially large or long-term contract that provides the bulk of its operating income. Management meetings might include not only the institution's management, but also large sponsors to gauge ongoing support for the organization.

Standard & Poor's considers the following factors to be particularly applicable when rating research institutions:

- History of research programs and dollar amount of funding;
- Areas of research specialization and competition;
- Growth in the number of contracts and funding;
- Diversity of research—both classified and unclassified;
- Indirect cost recovery rates currently in place and timetable for renegotiation
- Funding stability—options for contract renewal if less than five years to termination dates; and
- Budgetary flexibility and the capacity to downsize.

Other lines of inquiry go beyond the research program and include an evaluation of management, financial operations and resources, and debt burden as previously discussed. Like membership organizations, Standard & Poor's expects rated institutions to include permanent staff whose functions include financial management and day-to-day operations. Most research institutions rated by Standard & Poor's are financially and operationally autonomous; however, any ties to a parent organization would involve an analysis of this relationship. Research institutions receiving federal funds for research have an incentive to issue tax-exempt debt for facilities. These organizations can include the costs of facilities capital in their requests for reimbursement. For many of them, being able to recoup the cost of capital makes debt a more favorable option than leasing research facilities.

Bondholder security for debt issued by these organizations is typically a GO of the institution, but for many research organizations, direct and indirect costs of research are the primary sources of

Relevant Statistics for Research Institutions

- History of research programs and funding
- Areas of research specialization and competition
- Growth in the number of contracts, funding levels, and rate of indirect cost recoveries
- Diversity of research-both classified and unclassified
- Funding stability-options for contract renewal if less than five years to termination dates
- Budgetary flexibility and the capacity to downsize

operating revenue. While research funding has become increasingly competitive, and there is potential for continued changes in reimbursement mechanisms, research funding in general is proving to be a stable source of reimbursement and revenue for research institutions. Rate covenants generally carry little weight in legal provisions, since these organizations do not have the ability to adjust their rates to federal or other sponsors on an annual basis. However, additional bonds tests carry more weight, and historical additional bonds tests add comfort that historical revenues have at least been sufficient to pay for the current and proposed debt. ■