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SPECIAL COMMENT

Market Position: Key Credit Factor of U.S. Higher Education Ratings

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Summary

U.S. public and private not-for-profit universities[1] are influenced by a combination of market competition, government funding, policy mandates, and non-profit missions. Market competition is, however, becoming a dominant business driver and is increasingly important in our ratings and assessments of universities' strategies and financial performance. A strong market position allows a university to compete effectively for tuition revenue, private gifts, research grants, and government support. As such, a university's market position provides the foundation for its long-term financial health and credit rating.

This report explains the general framework for our analysis of a university's market position, which is part of our broader methodology for rating higher education debt. The four broad factors we consider in our assessment of market position are:

1. **Strong Market Reputation**--Contributes to Long-Term Credit Stability and Favorable Financial Performance
2. **Large Scope of Operations**--Insulates Against External Volatility and Provides Economies of Scale
3. **Healthy Student Demand and Pricing Power**--Facilitate Management of Enrollment and Revenue Trends
4. **Robust Philanthropic Support**--Bolsters Market Position by Funding Strategic Initiatives

For 2011, Moody's maintains a negative outlook[2] for the majority of the U.S. higher education sector, largely due to widespread market position challenges. The negative outlook applies to universities that are heavily reliant on student-based revenues. Analysis of the development and execution of market segment strategies is especially critical for evaluating these universities. An effective market strategy provides for differentiation and enables a university to achieve a sustainable competitive advantage that furthers its mission given resource constraints.

The 2011 industry outlook is stable for diversified market segment leading universities, generally rated in the Aaa and Aa rating categories. These universities have global reputations and are able to attract strong student demand, healthy philanthropic support, and research funding even during weak economic periods.

1 In this report, the term "universities" covers all higher education institutions, including colleges, institutes, schools and universities.
2 2011 Outlook for U.S. Higher Education, January 2011

Effective Market Position Predicated on Successful Market Segment Strategies

The U.S. higher education industry is a highly segmented market with thousands of colleges and universities competing in many niches that signal varying quality, price, and specialization. The market is characterized by overlapping and increasingly competitive sector groupings of public, not-for-profit private, and for-profit providers. For example, a not-for-profit private university that targets non-traditional aged part-time students may find itself in direct competition not only with other not-for-profit private universities, but also with public and for-profit higher education providers. Therefore, it is important to understand how a university defines its target market segment, how it wants to be positioned within the segment, and how it allocates resources to achieve its goals.

A university may employ a variety of strategies to appeal to a particular market segment and differentiate itself from others in an increasingly competitive industry. Common strategic positions include being the low-cost provider, delivering the highest quality education, or creating a niche position in which products or services are delivered to a special segment of the market. Examples of niche market positions include a religious affiliation, single-sex, historically black colleges and universities, art schools, or standalone professional schools. It is important to note that universities can derive credit strength by excelling within their own market segment, whether that is as a comprehensive university, art and design school, or liberal arts college.

FIGURE 1

Credit Strength Derived from Leadership within a Market Segment

		Rating	Count of Institutions	Primary Selectivity (%)	Primary Matriculation (%)	Net Tuition Per Student ($)	Average Gifts Per Student ($)
Specialty School	Max	Aa2		7	81	42,129	147,952
(Standalone graduate or professional program, art school, single-sex, HBCU)	Median	A3	34	49	35	24,403	2,434
	Min	B3		81	6	8,623	302
Small Liberal Arts College	Max	Aaa		15	76	38,135	65,152
(< 3,000 FTE students and <15% of revenue from grants and contracts + patient care)	Median	A2	109	57	28	18,360	5,942
	Min	Caa2		94	11	3,016	629
Moderate Sized Liberal Arts College	Max	Aa1		21	66	28,612	16,088
(> 3,000 ≤ 10,000 FTE students and <15% of revenue from grants and contracts + patient care)	Median	A3	79	64	25	17,911	2,028
	Min	B3		100	14	7,181	117
Moderate Sized Comprehensive University	Max	Aaa		9	72	29,516	33,153
(> 3,000 ≤ 10,000 FTE students and >15% of revenue from grants and contracts)	Median	A2	13	38	27	18,968	5,868
	Min	Ba1		80	13	11,510	1,091
Large Comprehensive University	Max	Aaa		20	49	30,584	16,987
(>10,000 FTE students and >15% of revenue from grants and contracts + patient care)	Median	A2	24	56	24	21,942	1,979
	Min	Ba1		78	10	14,632	223
Research Intensive	Max	Aaa		7	76	34,636	47,376
(Grants and contracts >$400 million or >40% of revenue from grants and contracts + patient care)	Median	Aa2	26	22	33	21,851	13,671
	Min	A3		78	14	13,188	1,205

Source: Moody's Municipal Financial Ratio Analysis

A well managed university will continually evaluate and adapt its market strategies in light of demographic changes, technological advances, and variations in societal preferences. A university's market segment strategies are particularly important during challenging economic periods when a polarizing effect causes a flight to the extremes of highest quality or lowest-cost education providers. Material shifts in the demographics of the university's target market, including the number of high school graduates as well as family income, can also influence a university. For example, a flagship public university facing constrained state funding and weak regional demographics may shift its focus to become a national or global institution of higher learning to attract a larger proportion of out-of-state enrollment and offset local challenges.

Upon evaluation of the effectiveness of its market strategies, a university may decide to maintain or improve its existing reputation within its current market segment or decide to change its strategy and pursue a different market segment. This choice, though perhaps appropriate, may result in the need for significant investment in order to develop this new market strategy. Furthermore, a change in strategy may result in deterioration of demand from the current market segment more quickly than can be offset by generating demand in the new market segment.

For example, as a single-sex college transitions to a coeducational institution, student demand and philanthropic support from its original market niche could deteriorate if the transition is not well evaluated and communicated to alumni and supporters. It will take time for the college to shift its brand identity away from being a single-sex education provider and establish a new reputation within the new market segment. The stronger the college's brand was as a single-sex education provider, the harder the transition would likely be. In light of these risks, a strategic market position change is often associated with increased short-term credit risk.

In order to understand a university's market position strategy, we hold discussions with board members and senior leadership as well as review the university's web site and marketing materials. We seek to understand the university's mission statement, strategic plan, facilities master plan, and fundraising case statement to evaluate its strategy and funding priorities. We discuss with management investments in programs and services, branding initiatives, and recruiting efforts. In addition, we review how management and the board monitor key indicators of the university's progress towards its goals. Particularly when a university is considering a shift in market strategy, we will discuss key assumptions and contingencies incorporated into the university's plans.

Framework for Assessing Market Position Credit Implications

Factor 1: Strong Market Reputation Contributes to Long-Term Credit Stability and Favorable Financial Performance

The perceived value of a university's programs and services determines its reputation and brand value. A strong market reputation and brand drive a university's ability to attract high quality students and faculty, board members, research grants, government support, and gifts. Therefore, a university's ability to shape, protect, and enhance how others perceive the value of its programs and services provides the foundation for its credit rating.

It is important to note that a university's actual market reputation may not be consistent with its strategic vision and goals. This misalignment may be the result of an inability to execute strategies due to limited resources, poor execution, external factors, or the transition from serving one market segment to another. For example, a university can aspire to be a top ranked research university, but may not have the financial strength to fund the construction or renovation of facilities, attract the best students and faculty, and secure grants and contracts to achieve this goal.

Reputational risk is one of the most significant threats posed to a university, but also one of the most difficult risks to manage given its amorphous nature. Risks to a university's reputation could occur slowly over time as the university is unable to maintain ground relative to peers in attracting students, research grants, or philanthropic donations. Or, the risks could be event driven, such as a major security and safety concern on campus or media coverage of a significant abuse of fiduciary responsibility. Since the most important asset for any organization is its good name, effective governance and management has policies and protocols in place to reduce the probability of certain risks as well as procedures for a coordinated response to potential events. [3]

We examine a number of critical factors when assessing a university's reputation, including:

- Brand identity consistent with the university's mission and market strategies
- Number of distinct or high quality academic programs or services to enhance the university's ability to attract students, faculty, and researchers
- Identification, assessment, and prioritization of risks followed by the coordinated application of resources to minimize, monitor, and control the probability and/or impact of the events

Moody's reviews student demand metrics, as described in Factor 3, as well as peer and aspirant groups reported by the university and by other rated entities. We also look at outcomes that indicate the opinion of other key stakeholders such as job placement, graduate/professional school acceptance rates (for an undergraduate degree program), research award success rate, published rankings, donor support, and media coverage. We discuss with management how the university identifies, evaluates and prioritizes risks. Particularly following a material event at a university, we evaluate management's application of resources to minimize, monitor, and control the impact of the event on the university's reputation.

Factor 2: Large Scope of Operations Insulates Against External Volatility and Provides Economies of Scale

The size and diversification of a university, or the scope of its operations, shape its target audience for its core lines of business including academic programs, research, and health care. So long as relevance to mission and differentiation are maintained, a larger scope of operations generally provides for greater market and credit stability, insulating the university from local economic and demographic changes as well as shifts in societal preferences for programs and services. Larger universities also benefit from economies of scale, although this advantage can be tempered by a highly diverse offering of programs and services. Greater scale implies higher brand recognition, broader geographic diversification, and ability to consolidate during economically challenging times. In addition, given the greater economic and political impact in their region, larger universities can better leverage their influence to help secure financial and regulatory support. Smaller and more homogeneous colleges may be challenged to react to changes in market preferences by adding or eliminating programs.

We examine a number of critical factors when assessing the scope of a university's operations, including:

[3] Governance and Management: The Underpinning of University Credit Ratings, November 2010

- Alignment of academic programs and services with the university's mission and strategies
- Diversity of programs and services
- Demonstrated ability and willingness to react to changing market preferences by adding, eliminating, expanding, or reducing programs based on student interest and profitability

Academic Programs: Moody's reviews a university's accreditation, curriculum, as well as student demand and enrollment in key programs (undergraduate, medicine, law, business, etc.). We discuss with management investments in programs of distinction, the addition of new programmatic offerings or partnerships, and the elimination or reduction of programs with limited demand.

Research: Moody's reviews trend data provided by universities on the type of research conducted, number of principal investigators, diversity of funding sources, indirect recovery rates, number of faculty awards, and percent of proposals funded. We review a university's Carnegie classification and rankings for receipt of federal funding (National Science Foundation or National Institutes of Health grants, for example). We discuss with management strategic hiring initiatives or capital investments to understand implications for the future of the university's research program.

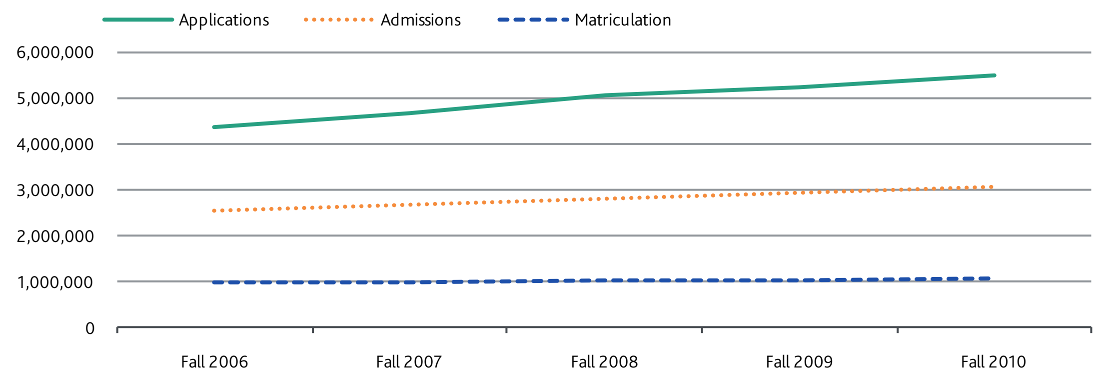
Health Care: Moody's reviews the relationship between a university and hospitals, clinical activities, and faculty practice plans by reviewing affiliation agreements, organizational charts, and through discussions with management. We review trend data provided by the university and/or health care organization on patient volume, acuity mix, payer mix, reimbursement rates, number of physicians, and market share. If the university owns or operates a hospital, Moody's reviews the separate financial statements of the health care entity, including interim financial information when available. We analyze the financial stability of the health care operations, flow of funds between the health care operations and the university, governance and management overlap, and history of the relationship between the two entities. In light of the substantial risk and complexity involved in significant health care operations, we work in close collaboration with Moody's not-for-profit health care ratings team. For more information about Moody's rating approach for not-for-profit health care institutions, please see Moody's rating methodology for Not-for-Profit Hospitals and Health Systems published in January 2008.

Factor 3: Healthy Student Demand and Pricing Power Facilitate Management of Enrollment and Revenue Trends

Student preference for one university over its peers is one of the most significant elements of market position. Deeper student interest in attending a particular university leads to increased flexibility for the university in shaping the characteristics of its enrollment. The depth of student demand directly influences a university's ability to charge a particular level of tuition and fees while maintaining its optimal enrollment in terms of quality and size. These factors combined reflect the perceived quality and value of a university's programs and services. State regulations, political pressure, or a university's mission may limit a university's pricing power. The strength of student demand and pricing power must be evaluated within the context of demographic trends, economic conditions, participation rates, societal preferences, peer performance, and a university's strategic goals.

The strength of student demand cannot be measured simply by the number of applications received, particularly in light of trends that show an increasing number of applications submitted per student (see Figure 2 below). Demand is measured by the number, quality, and composition of applicants and the students' preference for a particular university relative to its peers. Strong student demand helps to insulate a university from external factors that adversely affect overall national student demand including economic downturns or demographic changes by enabling it to maintain its target class size by slightly lowering admissions standards, selecting students with a greater ability to pay, or enrolling a larger class to help generate additional revenue.

FIGURE 2
Applications Continue to Grow at U.S. Universities While Enrollment Remains Flat



Source: Moody's (Moody's Rated U.S. Public and Not-for-Profit Private Universities)

Universities, albeit to varying degrees, offer an individually customized product to each of their potential customers by offering pricing discounts through financial aid, even to wealthy students who could afford to pay the tuition. Some universities charge high full tuition rates while practicing price discrimination on the margin with scholarship awards for preferred students. An important exception to this general pattern is that some of the most selective universities choose not to fully exercise their pricing power due to their commitment to admit some or all of their students regardless of ability to pay. These universities, typically rated in the Aaa- and Aa-rating categories, have the largest endowments within the sector and may channel financial aid to lower income students to attract a more diverse student body. This willingness to shape a more socioeconomically diverse student body through the use of financial aid reflects the not-for-profit mission of the university and is a voluntary action rather than a reaction to economic pressures.

We examine a number of critical factors when assessing a university's student demand and pricing power, including:

» Maintenance or growth of applicant pool to support a university's target enrollment size and student body composition

» Sufficient geographic diversity of students to reduce vulnerability to regional economic or demographic conditions

» Price differentiation strategy that enables the university to attract its target audience without hindering operating performance or financial reserves

» Statutory and political flexibility to increase tuition and fees, particularly in light of pressure on state financial support

Moody's reviews trends in the number of applications for primary academic areas (first-time freshmen undergraduate students, transfer students, and key graduate/professional programs), the geographic diversity of the applicants, win/loss data against primary competitors, and indicators of student quality such as standardized test scores and number of National Merit Finalists as provided by the university. We review demographic projections for the number of high school graduates, the industry's primary consumers, primarily for universities with geographically concentrated student enrollments. We evaluate the competitive landscape through discussions with universities about peer and aspirational organizations. Also, we discuss management's recruiting and admissions strategies.

When analyzing pricing power, we review absolute and comparative information including a university's "sticker price," planned tuition and fee increases, and tuition discount rates for its major programs. We discuss with management plans for future tuition increases and how the university's tuition pricing strategy compares to that of its main competition. For public universities, we review state regulations regarding in-state tuition and discuss political pressures that may limit pricing flexibility.

Factor 4: Robust Philanthropic Support Bolsters Market Position by Funding Strategic Initiatives

Philanthropic support both affirms and enhances the market position of a university. Donor support indicates belief in the university's mission and social significance, as well as confidence in its management and overall strategic direction. Gift revenue enables a university to fund marquee projects and programs that are at the core of a university's strategic plans. Beyond direct financial benefits, donor support strengthens a university's market position by providing opportunities for positive media exposure leading to greater awareness of the university. Since the act of philanthropic support can be viewed as a public endorsement, gifts from particularly high profile donors enhance the university's brand by association. Moody's believes that high levels of philanthropic support can create a positive feedback loop further improving a university's market position relative to its peers.

We examine a number of critical factors when assessing the level of philanthropic support of a university's programs, including:

» Track record of meeting or exceeding campaign goals

» History of maintenance or growth of donor support through economic cycles, including successful collection of pledge payments

» Broad and diverse pool of donors

» Continued cultivation of donors to support future fundraising capacity

Moody's reviews a university's track record of donor support relative to local, state, and national trends, recognizing that the relative share of support garnered is as important, if not more important, than the absolute amount pledged. We examine a university's fundraising pyramid and geographic diversity of donors. We review gifts raised relative to campaign goals as well as giving outside of major fundraising initiatives and the restrictions placed on gifts. Moody's discusses a university's fundraising strategy and staffing. We also analyze a university's capacity for philanthropic support by examining the composition of the board, board and alumni participation rates, number, age, and occupations of alumni. When a college's financial plans are predicated on an upcoming fundraising campaign, we assess the plan's potential for success based on management's track record and the strength of the target donor pool.

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