New Issue: Moody’s assigns A1 long-term rating to Case Western Reserve University’s (OH) $28.1 million Series 2012A revenue refunding bonds; outlook is stable

Global Credit Research - 26 Oct 2012

University has $547 million of rated debt, including full authorization of the tax-exempt commercial paper program

OHIO HIGHER EDUCATIONAL FACILITY COMMISSION
Private Colleges & Universities
OH

Moody’s Rating

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<td>Revenue Refunding Bonds, Series 2012A</td>
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<td>$28,100,000</td>
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Moody’s Outlook

Opinion

NEW YORK, October 26, 2012 --

Moody’s Investors Service has assigned an A1 rating to Case Western Reserve University’s (CWRU or Case Western Reserve) $28.1 million of fixed rate Series 2012A revenue refunding bonds expected to be issued by the Ohio Higher Educational Facility Commission. The rating outlook is stable.

SUMMARY RATING RATIONALE

The A1 rating is based on Case Western Reserve University's solid financial resources, national reputation as a research institution with prominent graduate and professional degree programs, revenue diversity, and healthy gift revenue. Offsetting credit factors include satisfactory liquidity to support demands related to variable rate debt and swaps and a fiercely competitive undergraduate student market.

The short-term P-1 rating on CWRU’s commercial paper program reflects the university’s access to adequate daily liquidity, including a backup bank facility provided by JPMorgan Chase as well as adequate amount of available funds with weekly liquidity which could be shifted to investments with same-day liquidity should the bank liquidity facility be terminated prior to the expiration date.

The short-term VMIG 1 rating on the Series 2001 and Series 2002A bonds reflects a standby bond purchase agreement structured to provide adequate liquidity to support the tender feature of the bonds.

STRENGTHS

*Healthy philanthropic support with gift revenue averaging over $65 million annually over the last three years with $62 million of gifts in FY 2012.

*Sizeable balance sheet cushion with total financial resources of $1.45 billion and expendable financial resources of $748 million at end of fiscal year 2012, cushioning pro-forma debt (includes full $90 CP authorization) adequately at 1.3 times.
*National student market and research position with a wide array of undergraduate, graduate and professional programs, including a medical school, law school, and school of engineering.

*Large revenue base of $768 million in FY 2012 with relatively healthy revenue diversity provided by grants and contracts including Cleveland Clinic Lerner College of Medicine (45%), student charges (34%), investment income (9%), other revenue (7%), and gifts (5%). The sponsored research enterprise adds to the diversity as indicated by research expenses of $270 million in FY 2012.

CHALLENGES

*Highly competitive undergraduate student market, evidenced by a relatively low matriculation rate that has risen to 17% in fall 2012 from a very weak 13% in fall 2011.

*Risks associated with variable rate demand debt, carrying potential acceleration of repayment and rollover risk associated with remarketing or extending liquidity facility expiration dates. The university also has an extensive swap portfolio and is currently posting collateral. However, the university's unrestricted monthly liquidity provides 130% coverage of demand debt, while thin, is sufficient.

*Decline in monthly liquidity of 10% to $384 million in FY 2012 from $429 million in FY 2011. Monthly liquidity provides a satisfactory 201 monthly days coverage of the university's large expense base of $761 million. Excluding expenses associated with CCLCM research activity, unrestricted liquidity covers cash operating expenses for 234 days.

*High reliance on grants and contracts, as research activity represents a large portion of CWRU's expense base (including certain CCLCM research activity which flows through CWRU's audit), CWRU may face challenges in growing its research endeavors given the increasingly competitive environment for federal research funding, as well as impact from potential sequestration, though potential impact is minimal.

DETAILED CREDIT DISCUSSION

USE OF BOND PROCEEDS: Proceeds from the 2012A bonds will refinance a portion of the fixed rate Series 2004A bonds and the tax-exempt portion of a capital lease for campus technology systems, as well as pay costs of issuance.

LEGAL SECURITY: General obligation of the university; the bonds and CP are also secured by a guaranty agreement under which the university unconditionally guarantees full and prompt payment of principal and interest on the bonds and CP.

DEBT STRUCTURE: In FY 2012, total debt outstanding was approximately $577.2 million, including the full CP program authorized at $90 million ($63 million is currently outstanding), of which 51% is in the variable rate mode. Approximately $294.6 million of this total is a combination of variable rate demand bonds and the fully authorized CP amount. In FY 2012 monthly liquidity to pro-forma demand debt, inclusive of fully authorized CP) provided sufficient coverage of 130.4%, but remains modest.

DEBT-RELATED DERIVATIVES: CWRU has entered into five floating-to-fixed interest rate swap agreements for a total notional amount of approximately $177.2 million. All but one are non-amortizing and Morgan Stanley (rated Baa1/P-2) is the counterparty. Under the agreements, CWRU may be and has been required to post collateral at its current rating level if the liability to the university exceeds $20 million with a minimum transfer of $1 million. The swaps had a market valuation of $36.5 million against CWRU as of October 12, 2012. As of that date, the university was posting approximately $16.5 million of collateral. If the rating were to deteriorate, the collateral posting thresholds would also decline.


The Series 2008A bonds are supported by a letter of credit (LOC) agreement with PNC Bank (rated A2/P-1 positive outlook). The Series 2008B bonds are supported by an LOC with US Bank, NA (Aa2/P-1 rating under review for possible downgrade). For more information on the LOC terms for the Series 2008A and 2008B bonds, please refer to Moody's reports dated January 3, 2011 and April 27, 2011, respectively for each series.

MARKET POSITION/COMPETITIVE STRATEGY: LEADING PRIVATE RESEARCH UNIVERSITY WITH STRONG
CWRU, a relatively large private university enrolling 9,259 FTE students, is located in the University Circle section of Cleveland, Ohio (A2 revenue-back rating), an urban district comprising education, arts, and medical institutions. The university offers a wide array of undergraduate as well as graduate and professional programs including a law school and medical school. The university’s medical school is principally affiliated with University Hospitals of Cleveland, but also has collaborative relationships with a number of Cleveland health care providers, such as the Cleveland Clinic and county hospitals. The university continues to expand its masters programs, particularly in the health science areas. As part of its strategy to diversify its programs, CWRU continues to add programs made available to a wider body of students at off-site locations and on line. For example, the university offers a master of science in anesthesia at an off-site campus located in Houston, Texas and upcoming new programs include an online masters in social work starting in spring 2013. The university is also adding international cohorts to its business and law schools. In fall 2012, graduate students comprised 53.5% of total FTE enrollment.

The main strategy for undergraduate enrollment remains bolstering the university's prominence and market presence through improving the academic quality of incoming students. Favorably, the university enrolled its largest first-year class of 1,372 students this fall 2012, above its goal and beating the prior three-year average (fall 2009-fall 2011) of 963 students. Management indicates that the university has capacity for undergraduate growth, but that incoming class sizes in the near term will likely remain below 1,300 students. CWRU operates in a highly competitive market, evidenced by a low matriculation rate hovering below 20% since fall 2008 and the yield of 17.1% in fall 2012 is well below the 23.4% median for Moody’s A-rated private universities. Substantially more students have applied to the university each year since fall 2008 when the university received 7,351 applications. In fall 2012, the university received 14,778 applications. Management attributes the application growth to more aggressive marketing and growing national recognition of CWRU’s brand.

CWRU has a healthy research profile common to universities operating medical schools or other scientific or engineering programs, with a relatively significant amount of federally sponsored research. Research expenses peaked in FY 2012 with $269.9 million in research expenditures, representing 35.4% of operating expenses (including CCLCM). CWRU receives the majority of its grants from federal agencies with the largest share from the National Institutes of Health (approximately 90%) followed by the National Science Foundation and then the Department of Education. This high concentration of revenue received from the NIH makes the university more vulnerable to cuts in this area, and it would benefit from diversification of its grantors both inside and outside of the federal government.

OPERATING PERFORMANCE: MANAGEMENT COMMITMENT TO IMPROVING OPERATING PERFORMANCE; HEALTHY REVENUE DIVERSITY

Through a combination of deliberate expense containment and net tuition revenue growth, the university achieved a 0.8% operating margin in FY 2012, returning to a positive Moody’s calculated operating margin for the first time since FY 2008. Operating cash flow margin of 13.6% produced 2.14 times debt service coverage in FY 2012. CWRU’s FY 2013 budget, approved in June 2012, shows a $5.2 million surplus (including $7 million retained surplus use) compared to the FY 2012 budgeted surplus of $2 million, which the university beat by $4.4 million. The negative variance between the university’s healthy budgeted surpluses and Moody’s slightly positive margin is that the university does not include debt service payments or depreciation in its budget and has a higher endowment draw than the Moody’s standard calculated draw. The university is tracking favorably to budget given higher enrollment, but it is early in the fiscal year. Improvement of operating performance to consistently produce at least breakeven results and healthier cash flow margin, as calculated by Moody’s, would be credit positive.

The university’s diversified revenue sources compared to other universities is a favorable credit factor, mitigating impact of declines in any one revenue source. CWRU’s largest two revenue streams are student charges and grants and contracts (includes CCLCM revenue), which compose 34% and 45%, respectively, of Moody’s calculated operating revenue, followed by 9% from investment income, 7% other, 5% gifts, and 0.4% state appropriations. This is of particular significance given the sector wide challenge of families’ price sensitivity and resulting challenge of continually growing net tuition revenue.

There is a risk, however, related to CWRU’s substantial federal research funding. Given pressure on the federal government, overall research grants are anticipated to decline. In addition, in the absence of federal legislation, sequestration of discretionary federal funding is scheduled to take effect January 2, 2013. CWRU has estimated that this sequestration would reduce non-security discretionary spending by 8.2%, translating to an annual indirect cost recovery loss of about $4.5 to $5 million for the school of medicine (SOM). In addition, federal direct revenue
that supports a portion of SOM research personnel salary/fringe and laboratory operations would also be reduced by about $8 million. In response to any reduction in federal revenue, the SOM plans to implement cost reductions, primarily in personnel and laboratory costs. As part of the university's long-term planning for a more challenging federal government funding environment, management reports that the SOM will continue to implement new revenue generating activities that will also help offset the impact of sequestration to the SOM.

The university's unrestricted monthly liquidity declined in FY 2012 to $384 million from $429 million in FY 2011, providing a sufficient 200.8 monthly days cash on hand of the university's large expense base (includes CCLCM research and training expenses). Monthly days cash on hand improves to 233.7 days when excluding CCLCM research and training expenses. In addition, the university has two lines of credit totaling $30 million each. One of the lines was drawn, for $15 million, in July 2011 and paid off in August 2011.

**BALANCE SHEET POSITION: SOLID BALANCE SHEET, BUT MORE THAN HALF OF TOTAL FINANCIAL RESOURCES ARE PERMANENTLY RESTRICTED**

Case Western Reserve maintains a solid balance sheet with total financial resources of $1.6 billion in FY 2012. However, approximately 54% of the university's financial resources are permanently restricted limiting financial flexibility. The university's sizable expendable financial resources of $748.3 million covers $577.2 million of pro-forma debt (including full authorization of the $90 million CP program) 1.30 times and operations 0.98 times. From FY 2011, the university's expendable financial resources declined nearly 17% from $898.1 million primarily from a $41 million increase in its accrued pension liability attributed to a decrease in the pension plan discount rate from 6.0% from 4.5%. Net assets are depressed by $158.4 million of liabilities associated with the university's defined benefit pension plan, deferred revenue, and swap liability. Total cash and investments declined 4% from $1.5 billion in FY 2011 and stood at $1.45 billion in FY 2012.

CWRU provides both a defined benefit and defined contribution pension plan for faculty and staff. Approximately 58% of employees, mainly support staff, are covered under the defined benefit plan. In FY 2012, the university's pension plan has a funded ratio per GAAP of 66%.

The university is in the midst of a $1 billion comprehensive campaign, "Forward Thinking" having raised more than $700 million through September 2012 to fund a broad range of initiatives in its 2008 strategic plan. Campaign priorities include enhancing scholarships, increasing endowed professorships, capital projects, and academic programs and centers. In FY 2011, the university received its largest single gift in history, a $50 million pledge. Case Western Reserve has proven a successful fundraiser evidenced by annual gift revenue averaging $64.9 million over FY 2010 through FY 2012. Increases in unrestricted giving would be credit positive, as much of the university's gifts have been for restricted purposes.

As of June 30, 2012, the university's long-term investment pool totaled $1.26 billion with a fiscal year return of negative 2%, which was allocated: 20.4% hedge funds, 18.6% private equity, 14.2% domestic equity, 14.1% international equity, 10.8% commodities, 10.2% fixed income, 7.3% real estate, and 4.4% cash.

During FY 2013, management plans to draw the unused $27 million of tax-exempt CP to bridge finance construction of a new $50 million university center, in advance of expected gifts. Approximately $18.5 million has been received in cash as of September 30, 2012 and the remaining gifts are expected to be received over the next seven years. The expected project completion date is March 2014.

There are two other future major capital projects, including renovation and conversion of a building to a performing arts center and construction of a medical education building, which is expected to be located on the "West Campus" site the university is beginning to develop. The cost of these projects is anticipated to be similar in magnitude as that of the university center and fundraising is underway, but the university does not anticipate beginning construction of either in FY 2013 because the full amount has not yet been raised.

In addition, the university is considering issuing debt of between $50 and $75 million for undergraduate student housing. As discussions are in a very early stage and no decision has been made to proceed with a financing, Moody's has not incorporated this potential debt in the current rating. The university has modest additional debt capacity at the current rating level. We will evaluate the university's financial position, outstanding debt, and pledge payment schedule should the university issue additional debt or drawdown resources to finance the projects.

**MANAGEMENT AND GOVERNANCE: FINANCIAL MANAGEMENT TEAM FOCUSED ON IMPROVING OPERATING PERFORMANCE AND INCREASING LIQUIDITY**

The university benefits from a seasoned management team with various experiences within and outside the higher
education sector. CWRU is governed by a Board of Trustees consisting of 46 members, including Case Western Reserve’s president, who has served as president since July 1, 2007, and had been affiliated with the university as a law professor from 1983 to 1988, who is an ex officio member. The board members are geographically diverse, located across the county and internationally and have affiliations or professional careers in the private and public sectors. The board has several standing committees representing typical committees at comparable private universities, and also has a research and technology transfer committee given its level of research activity and plans to grow it.

The financial leadership team continues to focus on improving operating performance, increasing liquidity, and growing philanthropy. Management’s strategy for improved operations is to increase revenue through addition or enhancement of higher net revenue graduate programs, but the primary focus is on expense containment and more robust monitoring of expenses.

To manage the university's large investment portfolio, CWRU has an in-house investment office with an investment staff that has deep expertise to manage its diverse portfolio, including a chief investment officer, three directors, a manager of operations, and a new investment analyst. The university does not utilize a consultant and the board's investment committee remains active.

SELF LIQUIDITY SUPPORTING THE COMMERCIAL PAPER PROGRAM: ADEQUATE COVERAGE OF FULLY AUTHORIZED CP PROGRAM WITH HEALTHIER COVERAGE WHEN INCLUDING DEDICATED BANK LINE

The obligation to pay commercial paper at maturity is a general obligation of CWRU, and the university expects to pay for any CP which is not rolled over from self-liquidity that includes a $90 million Credit Agreement (liquidity facility) provided by JPMorgan. The commercial paper documents do not have any limitations on maturities and the full $90 million of CP could mature on one day. The liquidity facility commitment is for the bank to make loans up to $90 million as well as up to 90 days interest at a 10% maximum interest rate. The liquidity facility is dedicated to the purchase of CP and cannot be used for other operating purposes. The liquidity facility's expiration date is February 25, 2013. The university has had preliminary discussions about a possible renewal with JPMorgan and is also considering alternative providers of equivalent credit quality.

The bond trustee is responsible for making the request for funding and delivering the borrowing notice to the liquidity facility provider, per the Indenture. The facility provider is required to wire funds directly to the trustee. Moody's has reviewed the commercial paper documents and believes that the coordination of timing allows adequate time for the trustee to draw on the liquidity facility and have funds deposited with the trustee to pay make timely payments to CP holders.

The university has the right to permanently reduce the loan commitment amount in whole upon 20 business days' notice to the bank (or in part upon at least one day's prior notice to the bank), so long as the remaining bank commitment amount will not be less than the sum of principal of notes outstanding at that point in time and 90 days' interest on such notes. Per the Indenture, the CP must have a maturity date not later than 270 days after its date of delivery and not later than the fifth business day prior to the expiration of any liquidity facility then in effect. However, breach of certain events of default would allow the bank to immediately terminate the liquidity facility or terminate it with 30 days notice, in which case there could still be CP outstanding without a supporting liquidity facility.

As of September 30, 2012, the university had approximately $159.1 million in discounted daily liquid assets, with approximately $59.8 million across three 2a-7 compliant money market funds meeting Moody’s criteria for a Aaa-mf rating [State Street Global Advisors (SSgA), JPMorgan, and Federated Bank]. The remaining $100 million is in a checking account of a P-1 rated bank and US Treasuries. The coverage of the fully authorized amount of the CP program at $90 million is 3.95 times with the JPMorgan backup bank facility and 2.53 times without the facility. When excluding the largest SEC 2a-7 compliant money market fund that meets Moody’s criteria for a Aaa-mf rating, $50.7 million with SSgA, CWRU’s daily liquidity with the backup bank facility is 3.15 times coverage of debt. Without the backup bank facility coverage falls to 1.72 times.

OUTLOOK

The stable outlook reflects our expectation of at least balanced operating performance, continued growth in net tuition revenue and net tuition revenue per student, as well as continued growth of liquidity to support a large expense base and large amount of demand debt.

WHAT COULD CHANGE THE RATING UP
Material improvement of operating performance and growth in net tuition per student, stabilization and strengthening of undergraduate student market position, as well as growth of liquid unrestricted and expendable financial resources to provide a better cushion for outstanding debt and large expense base

WHAT COULD CHANGE THE RATING DOWN

Additional significant borrowing without commensurate growth of liquid resources and revenue to cover debt service; significant and sustained deterioration of operating performance, monthly liquidity, student market position, or research activity; reduction in available lines of credit

KEY INDICATORS (FY 2012 financial data, fall 2012 enrollment data)

Full-Time Equivalent Enrollment: 9,259 students

Primary Selectivity: 54.3%

Primary Matriculation: 17.1%

Net Tuition per Student: $22,658

Educational Expenses per Student: $49,079

Average Gifts per Student $7,008

Total Cash and Investments: $1.45 billion

Total Pro-forma Direct Debt: $577.2 million (includes full $90 million authorization of CP)

Total Pro-forma Comprehensive Debt*: $640.5 million (includes full $90 million authorization of CP)

Expendable Financial Resources to Pro-forma Direct Debt: 1.30 times (includes full authorization of CP)

Expendable Financial Resources to Operations: 0.98 times

Monthly Days Cash on Hand: 200.8 days; 233.7 days (excluding CCLCM expenses)

Monthly Liquidity to Pro-forma Demand Debt: 130.4%

Operating Revenue: $767.8 million; $669.5 million (excluding CCLCM revenue)

Operating Cash Flow Margin: 11.8%

Three-Year Average Debt Service Coverage: 2.46 times

Reliance on Tuition and Auxiliaries Revenue (% of Moody’s Adjusted Operating Revenue): 34.2%; 39.2% (excluding CCLCM revenue)

Reliance on Grants and Contracts Revenue (% of Moody’s Adjusted Operating Revenue): 45.0%; 36.9% (excluding CCLCM revenue)

* Comprehensive Debt includes direct debt and pension obligation.

RATED DEBT


Series 2004A: A1 rating, certain maturities of the Series 2004 bonds are insured by Ambac

Series 2006: A1 rating, insured by National Public Finance Guarantee Corp, formerly MBIA

Series 2008A: A1 underlying rating, Aa2/VMIG1 rating (based on letter of credit provided by PNC Bank, N.A. (rated A2/P-1) and Moody’s joint support analysis; LOC expires on
Series 2008 B-1 and B-2 bonds: A1 underlying rating, Aa1/VMIG1 rating (based on letter of credit provided by U.S. Bank (rated Aa2/P-1) and Moody's joint support analysis; LOC expires on 04/01/2014)

Commercial Paper Program: P-1 (supported by university's self-liquidity, including CWRU's ability to draw on a JPMorgan Chase Bank, N.A. (rated Aa3/P-1) credit agreement expires on 2/25/2013)

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RATING METHODOLOGY


REGULATORY DISCLOSURES

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