

New Issue: MOODY'S ASSIGNS A3 RATING TO \$285 MILLION HOWARD UNIVERSITY SERIES 2011 BONDS TO BE ISSUED BY THE DISTRICT OF COLUMBIA; OUTLOOK REVISED TO NEGATIVE

Global Credit Research - 18 Mar 2011

HOWARD'S PRO-FORMA RATED DEBT OF \$252 MILLION

District of Columbia
Higher Education
DC

Moody's Rating

ISSUE	RATING
Revenue Bonds (The Howard University Issue), Series 2011B (Taxable)	A3
Sale Amount	\$58,185,000
Expected Sale Date	04/05/11
Rating Description	Private Higher Education Revenue
Revenue Bonds (The Howard University Issue), Series 2011A	A3
Sale Amount	\$226,900,000
Expected Sale Date	04/05/11
Rating Description	Private Higher Education Revenue

Moody's Outlook Negative

Opinion

NEW YORK, Mar 18, 2011 -- Moody's Investors Service has assigned an A3 rating to \$226.9 million District of Columbia Revenue Bonds (The Howard University Issue) Series 2011A and \$58.185 million District of Columbia Revenue Bonds (The Howard University Issue) Series 2011B (Taxable). At the same time, we have revised the outlook to negative reflecting uncertainty about a federal government shut-down, pressures related to the Howard University Hospital, and an ambitious programmatic and facilities plan that may lead to even more debt for this already heavily leveraged institution.

SUMMARY RATING RATIONALE

Howard University benefits from a reputation as the best among Historically Black Colleges and Universities in the country. While the university's new management implemented a cost reduction initiative that resulted in positive operating results for fiscal year 2010, fiscal 2011 will likely show similar results, but only after the proposed financing reduces the amount of debt service that the university has to pay in fiscal 2011. Major revenue streams are fairly evenly split among tuition and grants; federal government support; and patient care each of which has its own pressures. As the university has endeavored to modernize its campus and provide the equipment required for a top-notch research institution, debt has increased and will increase again by about two-thirds with the issuance of the proposed bond issue and additional planned operating lines of credit. The proposed new debt, while providing funds for capital improvements, will relieve the university of pay-as-you-go capital which can then be utilized to meet increasing pension and post-retirement health care payments.

STRENGTHS

- Reputation as the best among Historically Black Colleges and Universities in the country attracting students with higher average SAT scores than the national average.
- New management that has developed a plan to reduce expenses by streamlining the university's educational offerings; expand the university's relevance in Science, Technology, Engineering and Mathematics; and update facilities and technology to attract funding, faculty, and students.
- Consistent support from the federal government which has averaged approximately \$230 million annually for the last five years.

CHALLENGES

- Narrow operating margin with increased pressure from pension and debt obligations expected in coming years
- Significant leverage that will equate to almost \$37,000 per student after the proposed issuance and increased operating lines of credit, together with an ambitious facilities plan
- Dependence on the federal government for funding for 27% of operating revenue with related exposure to budget delays and potential for reduction in support given fiscal pressures
- Exposure to the financial pressures of providing health care through operation of the Howard University Hospital

DETAILED CREDIT DISCUSSION

LEGAL SECURITY: Unconditional general obligations of the university. The debt service reserve fund for the Series 2011A bonds is expected to be funded with cash at closing in the amount of one-half maximum annual debt service or approximately \$11.845 million. The indenture does allow use of a credit facility to satisfy the debt service reserve fund requirement, but only if the rating will not be affected. Covenants include a rate covenant that the university will charge and collect fees such that, when combined with all other revenues and receipts, will be sufficient to cover debt service on the bonds by 1.10 times and a negative pledge of real estate. The additional bonds test requires a certificate stating that, after issuance of additional bonds, revenues will cover debt service by 1.10 times. Non financial covenants include release of audited financial statements issued within 180 days after the close of the fiscal year.

USE OF PROCEEDS: Proceeds from the fixed rate bonds to be issued under a new indenture are expected to provide \$100 million in new money for various capital projects including building upgrades and new construction and to refund the District's outstanding Revenue Refunding Bonds (The Howard University Issue), Series 1998, the District's outstanding Revenue Bonds (The Howard University Issue), Series 2006A, and the District's outstanding Multimodal Revenue Refunding Bonds (The Howard University Issue), Series 2006B as well as pay for certain capital improvements, fund a debt service reserve fund for the Series 2011A Bonds, pay two and one-half years of capitalized interest on the Series 2011A Bonds, and pay certain costs related to the issuance of the Series 2011A and 2011B Bonds. Approximately \$3.5 million of the bond proceeds will be used to terminate a swap (see Debt-Related Derivatives, below).

DEBT-RELATED DERIVATIVES: The university currently has two swaps outstanding; one with Goldman Sachs Mitsui Marine Derivative Products, L.P. and one with Bank of America, N.A. (rated Aa3/P-1). The Goldman Sachs swap will be terminated with the issuance of the Series 2011 bonds. The Bank of America, N.A. swap in the notional amount of approximately \$3 million, will remain outstanding. The terms of this swap require the university to pay a fixed rate of 6.685% in exchange for a variable rate payment based on 1-month LIBOR. The swap is scheduled to terminate on March 31, 2013. The small swap is hedging a Bank of America N.A. loan.

UNIQUE MARKET POSITION AS PREEMINENT HISTORICALLY BLACK COLLEGE

Howard University maintains a unique position as the preeminent university among Historically Black Colleges and Universities. Located in Washington, D.C., Howard is one of only 27 private not-for-profit universities in the U.S. to be designated a Research University (High Research Activity) by the Carnegie Foundation. Applications dipped 4.5% for the fall of 2010, but the university was able to maintain the quality of its incoming undergraduate class by admitting those with an average SAT score of 1,067 (math and verbal portions), comfortably above the average SAT score among all U.S. universities (1017 for fiscal 2009) and well above the average among other Historically Black Colleges and Universities (856 for fiscal 2009). Total full-time equivalent enrollment (FTE) improved slightly to 9,931 (close to 3,500 graduate students) in 2010 compared to 9,868 in 2009 possibly due to an increase in the total tuition discount to 30.5%. Selectivity of undergraduates has stabilized at a little above 50% and about one-third of those accepted actually enroll. Favorably, the freshman to sophomore retention rate exceeds 80%.

The comprehensive facilities plan is important to maintaining the university's competitive position. Despite investment in the plant from operations, the age of plant has hovered around 15 years for the past five years. The 10-year master plan for the campus calls for construction of four new research facilities, the construction of two new schools and colleges, the redevelopment of Howard University Hospital and its expansion to include new research and ambulatory care facilities, the modernization and/or new construction of student housing and student activity centers, the development of new athletic, recreation, and performing arts complexes; the adaptive reuse of two large buildings of historic significance, major upgrades in existing academic buildings, the construction of workforce-affordable housing, the construction of the new charter middle school, and the redevelopment of the Georgia Avenue corridor with a new university façade, a mix of commercial and neighborhood-serving retail, housing and parking facilities. It does not directly address expressed interest on behalf of the university to take over use of two buildings on the Walter Reed campus that have been awarded to the university, but it is conceivable that this property could be used to satisfy portions of the facilities plan. This ambitious plan will likely require the issuance of significant additional debt even if the university is successful in attracting private funding and contributions.

IMPROVED OPERATING RESULTS FOR FISCAL YEAR 2010; FUTURE PRESSURE

The university's operating margin improved to a slim, but positive 1.9% in fiscal 2010 from negative 3.8% for fiscal 2009 and negative 3.6% in fiscal 2008 (all based on Moody's pro forma analysis that assumes an endowment spend rate equal to 5% of the average three-year fair value) primarily due to expenditure reductions and a small increase in revenues. Major revenue streams supporting the university come from three sources; tuition and auxiliary services (22.5% of Moody's adjusted operating revenues in fiscal 2010), patient care (35.5%); and federal government support (27.1%). For fiscal 2010, the \$5.2 million increase in net auxiliary revenues more than compensated for the 3% decline in net tuition revenue. Patient care revenue increased by \$4.2 million, and federal government appropriation was basically flat at \$231.4 million. Operating revenues were also bolstered by a \$5 million increase in net assets released from restrictions. Total operating expenses were reduced by 4% to \$838.3 million for fiscal 2010 from \$872.9 million for fiscal 2009, largely reflecting a successful early retirement incentive.

According to the university's unaudited December 31, 2010 treasurer's report, the university is on course for positive operating results for fiscal 2011 of approximately \$30 million. These positive results will be aided by the current debt restructuring which will reduce projected 2011 long-term debt service to approximately \$22 million from approximately \$25 million. In addition, the university plans to make no contribution to its defined contribution pension plan in fiscal 2011. However, beginning in fiscal 2012, due to the requirement to make up one-seventh of the deficiency and fund current costs, the university anticipates having to infuse \$35 million into the pension fund. The debt restructuring which includes 2.5 years of capitalized interest will help the university shoulder the pension payment over the next few years, but the university will have to improve operating margins to accommodate both the pension payment and the increased debt service in the mid-term.

Howard has benefited from stable support from the federal government since 1928. Appropriations have been remarkably steady at about \$235 million annually over the past decade. In fiscal 2010, this federal support accounted for approximately 27% of Howard's operating revenue. While the appropriations have been stable, funding is subjected to the ebb and flow of the federal budget process whereby continuing resolutions routinely utilized by the federal government to provide funding during its protracted budgeting process interrupt the steady flow of cash to the university. The university has handled this cash-flow interruption by relying on its somewhat steadier patient service revenue and draws on lines of credit that currently amount to \$65 million. At this time, as the federal government approaches its debt ceiling, federal budget deliberations are more contentious than they have been in at least 15 years. While Howard's funding has been stable over many years, pressure on the federal budget may result in some contraction of this revenue stream.

A sizeable component of the university's finances relate to the Howard University Hospital as the hospital accounts for approximately 32% of the university's operating revenues. The hospital is an acute inpatient care facility that serves as a tertiary care, teaching and research facility

primarily serving the faculty and students of the university and the community of the District of Columbia. The hospital operates 290 beds (licensed for 482). Admissions reached a 5-year high in fiscal 2010 at 13,285, following several years of declines. Clinic visits and emergency visits are also up over the 5-year period although there was a slight decline in clinic visits in 2010. The payor mix is heavily weighted to government payors with 45% Medicaid and 23% Medicare in fiscal 2010 (based on gross revenue). The hospital achieved breakeven operations, after consideration of an annual allocation of the university's federal appropriation, in fiscal 2009 and 2010 (operating margin of 0.2 and 0.1, respectively) after several years of material losses and negative operating cash flow. This improvement is positive for the university as it reduces the need to support the hospital financially. However, the hospital age of plant was 15.5 years in fiscal 2006 (the latest date for which this metric is available) suggesting that capital improvements are necessary to maintain service levels. Any additional expenses for the hospital or any change in government reimbursement levels could put a strain on the financial condition of the university.

Liquidity for Howard, which is normally seasonal has been stretched by late payments from the federal government. Based on Moody's methodology for analyzing monthly liquidity, monthly days cash on hand as of June 30, 2010 equaled 95 days or a little over three months. This is weaker than the 240 days median for private colleges and universities rated by Moody's reported for fiscal 2009. Howard's cash position is supported by three lines of credit totaling \$65 million. Two of the lines are collateralized by \$45 million from the university's endowment. Another \$30 million has been authorized by the Board of Trustees to support liquidity.

If there were an extended disruption in revenues from the federal government or if liquidity were to narrow for any other reason, the university has \$125 million of unrestricted funds in its endowment and management reports an additional \$47 million in operating investments on the balance sheet as of December 31, 2010 that is invested with the endowment, but is not a part of the endowment. The university's low net assets in fiscal year 2009 triggered a covenant violation and new lender-imposed restrictions on new borrowings. In order to relieve itself of these conditions, the university plans to replace its existing \$65 million (\$45 million secured and \$20 million unsecured) operating lines with at least \$100 million in new operating lines over the next few months. It is not known at this time whether the university will be able to secure these lines and the terms of any future lines of credit are not known at this time.

BALANCE SHEET HIT HARD BY MARKET DOWNTURN AND RECALCULATION OF POST-RETIREMENT BENEFITS

Howard University is highly leveraged with negative \$37 million in expendable financial resources as of June 30, 2010 supporting \$364 million of pro-forma direct debt (coverage of negative 0.10 times). However, these expendable financial resources include several non-cash liabilities including those for pension (\$133.6 million), post-retirement health care (\$183.2 million), and swaps (\$5.6 million). Adjusted expendable financial resources netting out these noncash liabilities is \$285.4 million and coverage of pro-forma direct debt is a stronger 0.78 times. Similarly, expendable financial resources of negative \$37 million covered operations by negative 0.04 times. When adjusted for noncash liabilities, this ratio increases to a stronger 0.34 times.

In fiscal 2010, the university's total financial resource base declined to negative \$215 million from a recent high of \$245 million in fiscal 2007 as a result of two major factors; investment losses for the endowment totaling \$125 million as well as a significant increase in retiree obligations from 2008 to 2010.

The university's endowment consisted of total net assets of \$407 million as of fiscal 2010, up 9.9% when compared to fiscal 2009. Through December 31, 2010, net assets had increased by 10.5% over a six-month period.

Investments in the university's endowment are diversified with 20% each in hedge funds and fixed income. As of fiscal year-end 2010, 17% was in private equity and venture capital and 15% was in equity funds. As of fiscal year-end 2010, approximately one-half of the university's operating funds were invested in cash and cash equivalents and another 50% were invested in publicly traded equities.

The endowment is overseen by an Investment Committee with advice from a contracted professional and an independent investment consultant. Investments have been awarded to approximately 80 investment managers with no single manager responsible for more than 10% of the fund. The spend rate policy is 5% of the three-year average market value and only applies to the donor restricted (permanent endowment) and Board-restricted (unrestricted endowment) as a large portion of the temporarily restricted funds come from the federal government and are restricted for 20 years. For fiscal years 2009 and 2010, the university drew down \$15 million from the endowment. The draw in fiscal 2011 is expected to be \$14 million.

Other investments under management by the university include the university's defined benefit pension plan and approximately three-quarters of a billion dollars of 403(b) assets.

Pension Plan Restructuring Will Reduce University's Obligation

The university's defined pension plan ceased to accrue benefits as of July 1, 2010. The plan was 75% funded as of June 30, 2010 and the unfunded liability on an actuarial basis, had grown to \$133.6 million due to the valuation discount rate being lowered to 5.75% from 7.10% in June 2009 and from 7.13% in June 2008 reflecting deterioration in the capital markets. This decline in the plan's assets requires the university to fund the deficit over a seven-year period while reinstating annual contributions. For fiscal 2012, the university expects to have to contribute approximately \$35 million compared to no contributions for each of the prior five years. Since benefits have ceased to accrue, once the university absorbs pension payments into its operating budget, the liability and, therefore, the annual payments, should start to decline. Pension plan assets yielded 11% returns during fiscal 2010.

University's Obligation for Post-Retirement Health Care Benefits Is Capped

Another liability for the university is post-retirement health benefits. This liability, on an actuarial basis, totaled \$183 million as of June 30, 2010 after certain assumptions were revised resulting in an increase in the accumulated plan benefit obligation of approximately \$46 million in fiscal 2009. Not unlike other institutions, Howard pays for post-retirement health care benefits on a pay-as-you-go basis. The university's obligation is capped for most recipients and currently totals approximately \$9 million per year. It is expected to grow to approximately \$11 million per year over the next 10 years and then to decline.

NEW MANAGEMENT HAS INTRODUCED FISCAL DISCIPLINE

The university welcomed a new president in October 2008 and, shortly thereafter, an almost entirely new management team. Fiscal responsibilities have been contracted out to a private firm that has introduced fiscal reports including monthly reports comparing operating revenues with budget and quarterly reports that provide financial highlights for operations, investments, and cash-flow on both a past and projected basis. A newly-constituted Operations Committee made up of senior members of the management group meets weekly to review

spending related to a streamlined group of accountable units.

In January, the Board of Directors approved the elimination or consolidation of 71 out of the currently offered 171 programs. There will be a renewed emphasis on Science, Technology, Engineering, and Mathematics (STEM), health sciences disciplines and research, Africana and Diaspora Studies beginning in fall 2011. In addition to helping to recruit faculty and students, this program focus is expected to leverage the university's educational strengths and should help to attract funding and to reduce costs. Successful implementation of this restructuring is critical to Howard's ability to remain competitive and to build student-related fees and grants to absorb increasing debt service and lessen dependence on patient service revenues and the federal government.

Outlook

The negative outlook reflects current uncertainty related to the federal budget appropriation for the university, pressures related to the Howard University Hospital, and ambitious programmatic changes and capital plans that will likely result in significant additional debt.

WHAT COULD CHANGE THE RATING UP

Sustained improvement in balance sheet metrics and operating balance over multiple years

Lower dependence on patient service revenue and federal government support

WHAT COULD CHANGE THE RATING DOWN

Failure to restore financial resources or produce ongoing operating balance; substantial loss of federal support or market position

Issuance of significant additional debt further leveraging the university's balance sheet

KEY DATA AND RATIOS (Fiscal year 2010 financial data; fall 2010 enrollment data):

Total Enrollment: 9,931 full-time equivalent students

Freshman Acceptance Rate: 54.5%

Freshman Matriculation Rate: 31.1%

Total Direct Debt: \$221.891 million

Adjusted Expendable Financial Resources (adjusted for \$133.6 million pension liability, \$183.2 million post-retirement liability, and \$5.6 million swap liability): \$285.4 million

Adjusted Expendable Financial Resources to Pro-Forma Direct Debt: 0.78 times

Adjusted Expendable Financial Resources to Operations: 0.34 times

Monthly Unrestricted Liquidity: \$205.5 million

Monthly Days Cash (unrestricted funds available within 1 month divided by operating expenses excluding depreciation, divided by 365 days): 95.1 days

Three-Year Average Operating Margin: -1.9%

% of Operating Revenues from Patient Care: 35.5%

% of Operating Revenues from Federal Appropriations: 27.1%

OUTSTANDING RATED DEBT (ALL TO BE REFUNDED WITH THE CURRENT ISSUE)

Series 2006B: A3 underlying rating; Aa3/VMIG 1 enhanced rating based on letter of credit provided by Bank of America, N.A. (expires 6/16/2011)

Series 2006A: A3; insured by Ambac (current financial strength rating is Caa2 with a developing outlook)

Series 1998: A3; insured by National Public Finance Guarantee Corp, formerly MBIA (current financial strength rating is Baa1 with a developing outlook)

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PRINCIPAL METHODOLOGY USED

The principal methodology used in this rating was Moody's Rating Approach for Private Colleges and Universities published in September 2002.

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