Moody's INVESTORS SERVICE

Rating Update: MOODY'S DOWNGRADES HOWARD UNIVERSITY'S (DC) DEBT RATING TO A3 FROM A2; OUTLOOK REVISED TO STABLE FROM NEGATIVE

Global Credit Research - 01 Jul 2010

RATING ACTION AFFECTS $152 MILLION OF RATED DEBT

District of Columbia
Higher Education
DC

Opinion

NEW YORK, Jul 1, 2010 -- Moody's Investors Service has downgraded the debt rating on Howard University (Howard or the University) to A3 from A2. The outlook has been revised to stable from negative. The rating action reflects a weakened financial resource base, relatively thin liquidity, and pressure on operating revenue. The outlook revision incorporates stable funding from the federal government as well as projected balance sheet deterioration through fiscal year (FY) 2010. The University has a total of $203.5 million of direct debt outstanding, of which 19% is in a variable rate mode with a put feature. The rating change affects $152 million of rated debt (see RATED DEBT below).

LEGAL SECURITY: Unsecured general obligation of the University. Cash-funded debt service reserve fund for the Series 1998 bonds. The University is subject to several financial covenants associated with its Series 1998 bonds, the letter of credit and reimbursement agreement for its Series 2006 bonds, and its revolving credit agreement with Bank of America (rated Aa3/P-1). These covenants include: a Liquidity Ratio measured semi-annually of at least 0.30 times as of June 30, 2010 that increases to 0.50 times at December 31, 2011 and a Debt Service Coverage Ratio of 1.0 times measured each June 30. Additional bonds test also requires Howard to meet a Leverage Ratio measured each June 30 of either 0.50 times (1998 bonds) or 0.75 times (letter of credit and reimbursement agreement for the Series 2006 bonds). The University must also comply with non-financial covenants, including the provision of audit financial statements with an unqualified opinion within a specified time period.

DEBT-RELATED DERIVATIVES: The University has entered into two swap transactions with a total notional amount of $43.7 million. Under one agreement with Bank of America, N.A. (rated Aa3/P-1), the University pays a fixed rate of 6.685% in exchange for a variable rate payment based on 1-month LIBOR. The notional amount and termination date are based on the amount and amortization of a bank note (swap notional amount is currently $3.2 million). In addition, the University is party to a swap agreement that hedges the interest rate on its Series 2006B bonds (current notional amount is $40.6 million). Under the agreement, the University pays Goldman Sachs Mitsu Marine Derivative Products, L.P. (rated Aa1) a fixed rate of 3.549% in exchange for a variable rate payment based on 1-month LIBOR. The notional amount and amortization schedule match that of the Series 2006B bonds. Under each swap, Howard is required to post collateral based on the University's rating and the market value of the swap. To date, the University has not been required to post collateral. At March 31, 2009, the combined market value of the swaps was negative $3.7 million to the University. Moody's has incorporated the risks of these transactions into our rating.

CHALLENGES

*Weakened balance sheet as a result of investment losses, operating deficits, and pension liability. After peaking at $460 million in FY 2007, Howard's total financial resources declined to $83 million in FY 2009 as a result of investment losses of negative 3.7% and negative 17.0% in FY 2008 and 2009, respectively, as well as operating deficits averaging negative 4.0% in those years and a shift from an overfunded defined benefit pension plan of $86 million in FY 2007 to a liability of $74 million in FY 2009. Net assets are depressed by a post-retirement medical and life insurance benefit liability that totaled $166 million in FY 2009 following an increase of $46 million from the previous year due to an adjustment in prior service benefits. Expendable financial resources were negative $12 million at June 30, 2009 (this figure includes the pension liability of $74 million). Adjusted for the post-retirement benefit liability, total financial resources at June 30, 2009 were $249 million. Adjusted expendable financial resources of $153 million cushioned direct debt by 0.7 times and operations by 0.2 times, which were decreases from adjusted figures of 1.9 times and 0.4 times coverage in FY 2008.

For fiscal year 2010 through May 31, 2010, Howard reported an investment return of 13.0%. As of December 31, 2009, the University's investments are allocated across equities (30%, including 19% domestic and 20% global excluding US and emerging markets), fixed income (20%, including 14% US and 6% global), hedge funds (15%), private equity/venture capital (12%), inflation hedging assets (7%), cash and equivalents (6%), and private real estate (2%). Moody's notes some concentration of asset management, with one fixed income fund representing 9.9% of investments and one U.S. equity manager holding 9.2% of investments. The University successfully completed a $250 million capital campaign at December 31, 2007, having raised $276.5 million. Gift receipts have been higher in recent years, with the three-year average of $152 million cushioned direct debt by 0.7 times and operations by 0.2 times, which were decreases from adjusted figures of 1.9 times and 0.4 times coverage in FY 2008.

*Relatively moderate liquidity compared to similarly rated peers. Based on Moody's methodology for analyzing monthly liquidity, the University held over $207 million in monthly liquidity as of FY 2009, translating into 9.1 monthly days cash on hand (days cash on hand from investments liquid within one month). Our preliminary median figure for A-rated private colleges and universities for FY 2009 is 249 days. During the first half of FY 2010, Howard utilized $45 million of new operating lines of credit to fund payments under the voluntary separation and retirement program and delayed federal appropriation payments. To date, $25 million has been repaid. Howard's debt structure places further potential pressure on liquidity. Bank lines with outstanding balances of $29.2 million are due beginning August 1, 2010 through March 2011, and $39.5 million of Series 2006B bonds could require accelerated repayment under a letter of credit and reimbursement agreement. If Howard had to draw on the LOC supporting the Series 2006B bonds as the result of a failed remarketing, bondholders would be paid, but the University would be required to repay the bank within three years. In addition, should certain events of default occur under the LOC, such as violation of financial covenants...
described above under LEGAL SECURITY), the bank could require the University to prepay the full amount of the LOC commitment and instruct the trustee to accelerate the bonds. As of June 30, 2009, monthly liquidity represented 301% of variable rate debt.

*Despite projected improvements in operating performance in FY 2010, lower-than-budgeted revenues may slow plan to create structural operating balance. Through FY 2007, Howard had a history of positive operating margins and satisfactory debt service coverage (2.1% and 3.8 times three-year averages, respectively, in FY 2007), despite hospital deficits that pressured overall performance in recent years. While hospital operations are improving, a structural imbalance in core University operations began producing operating deficits of negative 4.2% in FY 2008 and negative 3.8% in FY 2009 for Howard as a whole due to faster growth in expenses than revenues (4.7% average annual growth in expenses versus 2.7% average annual growth in revenues as measured by Moody’s from FY 2005 through 2009). Adjusting for the non-cash portion of post-retirement liability expense, operating cash flow margin of 3.3% in FY 2009 produced debt service coverage of 1.4 times.

Under the leadership of a new President who assumed office in August 2008 and a new management team, the University aims to reach financial equilibrium by FY 2013. The plan includes a review of academic offerings that is expected to redirect 25% to 30% of expenses, primarily to support research and health care enterprises. The plan incorporates significant tuition increases accompanied by additional financial aid, which was anticipated to result in lower net tuition and fee revenue for FY 2010. In FY 2009, the University implemented a voluntary separation and retirement program that resulted in the reduction of 350 staff positions. University projections for FY 2010 show breakeven results based on a nearly 6% decrease in expenses compared to FY 2009, particularly in the cost of supplies and external services. However, no revenue growth is anticipated for FY 2010. Revenues were budgeted to grow 5% in the year, but significant sources are projected to fall short of their targets. Patient care revenue (36% of operating revenues as calculated by Moody’s) is expected to be lower than budgeted by 9%, or basically even with FY 2009. Net tuition and fees (23% of operating revenues) will be 3% under budget as softening enrollment yielded less gross tuition. Howard’s plan for FY 2011 is ambitious and forecasts a nearly 6% operating margin based on increases in patient care revenue, net tuition and fees, and grants and contracts revenue as well as further reductions in the purchase of external services and reduction of an additional 300 positions. While new financial managers have significantly improved the information available to University leadership for decision making, we believe assumptions about revenue growth may be aggressive.

*Vulnerability to changes in federal support for the University, although dramatic changes would be unprecedented and have largely failed when proposed in previous years.

STRENGTHS

*Consistent support from federal government, including approximately $235 million in annual appropriations. While federal appropriations (including appropriations for academic programs, hospital operations, and endowment matching) have been essentially flat at between $230 million to $235 million between FY 2002 and 2010, they have provided approximately one-third of the University’s annual revenues as measured by Moody’s. The University expects flat funding levels going forward. Moody’s views this ongoing support as a key factor underpinning the current rating, but is concerned that delays in receipt of federal funds could pressure Howard’s liquidity.

*Traditionally strong market position, with a unique role in the education of African-American students. Total full-time equivalent enrollment (FTE) declined in fall 2009 to 9,830, the low end of a recent range that peaked at 10,019 in fall 2005. Following a sharp 28% rise in first-year undergraduate applications for fall 2008, freshman applications have declined, falling 5.5% for fall 2009. Through mid-May 2010, applications were more than 4% below the same time in the prior year. Both graduate and professional enrollments (representing about one-third of total FTE enrollment) were steady through fall 2009, but first-time graduate applications have been trending downward. Net tuition per student of $13,411 in FY 2009 remains considerably below Moody’s preliminary medians for A-rated private colleges and universities of $20,354, but 33% higher than in FY 2005. Howard’s selectivity rate averaged 51% between fall 2006 and 2009, and early results for the fall 2010 freshman class indicate the figure will be slightly worse. Matriculation decreased to 32% for fall 2009 from 37% for fall 2003, reflecting the competitive market for students faced by Howard.

*Improved operating performance at Howard University Hospital, which comprises 36% of operating revenues as calculated by Moody’s. After incurring operating deficits and demonstrating great variability in operations over the last decade, the Hospital generated slightly better than break-even performance in FY 2009. A similar result is projected for FY 2010. The Hospital has experienced improved inpatient demand across most services, but volume has been below budgeted levels in FY 2010 and charity care expense is expected to have grown by over $5 million, or approximately 16%. Despite operational improvements, vulnerabilities remain for the hospital given the need for costly facilities investment, as much of the hospital facility is aged, and dependence on government payments for approximately two-thirds of gross revenue, with a disproportionate dependence on medicaid (32% of revenue in FY 2010).

RECENT DEVELOPMENTS:

The University in March 2010 submitted a proposal to develop the Howard University Academic Medical Center on part of the site of the current Walter Reed Army Medical Center in the District of Columbia, which is scheduled to be closed in September 2011 as part of the federal Base Realignment and Closure program. Under Howard’s proposal, the University would use all of the 62 acres to be assumed by the District for housing a new hospital as well as schools of medicine, pharmacy, and nursing. As currently outlined, the project would occur in several phases over 2011-2017. The University has estimated the total cost at $1.1 billion, of which it would fund $340 million from a variety of sources including $100 million in new debt, $100 million in financial contributions, $70 million of operating cash generated by additional health service, tuition, and grant revenues, and $70 million from leveraging non-core assets. Another $724 million would be derived from payments under public private partnerships and $80 million from developers. Moody’s recognizes that this plan is in preliminary stages, and that decisions about usage of the site may not be made until 2011. Nevertheless, we are concerned about the University’s financial and managerial ability to undertake such a significant project without detriment to its ongoing financial and academic initiatives and therefore to its credit rating. However, recently announced that its employee retirement plan would cease to accrue benefits as of July 1, 2010 and that the 403(b) savings plan would be restructured. According to the University, this change will result in annual savings of approximately $7 million, which represents a savings of $10 million in annual service costs net of $3 million in additional 403(b) contributions. Howard will remain obligated to fund the accumulated plan obligation over a seven-year period from June 30, 2010. At March 31, 2010, the obligation was $103 million.

At June 30, 2009, Howard was not in compliance with the Debt Service Coverage Ratio and Leverage Ratio covenants associated with its outstanding debt and had not published its audited financial statements within the required time period. These violations were waived by the lenders. The University projects that as of June 30, 2010, it will be in compliance with the required Liquidity Ratio and Debt Service Coverage Ratio covenants but not meet the Leverage Ratio. This failure would not create an event of default.

Outlook
The stable outlook is based on continued stable federal appropriations to support the University's operations and projected breakeven operating performance for FY 2010.

WHAT COULD CHANGE THE RATING - UP
Sustained improvement in balance sheet metrics and operating balance over multiple years

WHAT COULD CHANGE THE RATING - DOWN
Failure to reverse erosion of financial resource base or produce ongoing operating balance; substantial loss of federal support or market position

KEY DATA AND RATIOS (Fiscal year 2009 financial data; fall 2009 enrollment data):
Total Enrollment: 9,830 full-time equivalent students
Freshman Acceptance Rate: 54.0%
Freshman Matriculation Rate: 32.2%
Total Direct Debt: $209.3 million
Adjusted Expendable Financial Resources (adjusted for $165 million post-retirement liability): $153.4 million
Adjusted Expendable Financial Resources to Direct Debt (adjusted for post-retirement liability): 0.7 times
Adjusted Expendable Financial Resources to Operations (adjusted for post-retirement liability): 0.18 times
Monthly Unrestricted Liquidity: $207.1 million
Monthly Days Cash (unrestricted funds available within 1 month divided by operating expenses excluding depreciation, divided by 365 days): 91 days
Three-Year Average Operating Margin: -2.2%
% of Operating Revenues from Patient Care: 35.5%
% of Operating Revenues from Federal Appropriations: 27.5%

RATED DEBT
Series 2006B: A2 underlying rating; Aa3/VMIG1 enhanced rating based on letter of credit provided by Bank of America, N.A. (expires 6/16/2011)
Series 2006A: A2; insured by Ambac (current financial strength rating is Caa2 under review for possible upgrade)
Series 1998: A2; insured by National Public Finance Guarantee Corp, formerly MBIA (current financial strength rating is Baa1 with a developing outlook)

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METHODOLOGY
The principal methodology used in rating Howard University was the Private University Methodology, published in September 2002, and available on www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

The last rating action with respect to Howard University was on September 28, 2009, when a municipal finance scale rating of A2 was affirmed and a negative outlook maintained. That rating was subsequently recalibrated to A2 on May 7, 2010.

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