

Private Schools  
Criteria Report

**Private School Credit Analysis  
Guidelines**

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*This report updates Fitch Ratings' private kindergarten through grade 12 credit analysis guidelines prepared in November 2003 and describes Fitch's approach to analyzing the credit of private elementary and secondary schools issuing bonds through authorized public entities in the U.S. tax-exempt and taxable bond markets.*

■ **Overview**

**Industry Assessment**

Based on a March 2006 study prepared by the U.S. Department of Education, there were more than 5.1 million students enrolled in private elementary and secondary (K-12) schools in the U.S. as of fall 2003. About 53% of the students were enrolled in private elementary schools (kindergarten through sixth grade), 17% in secondary schools (grades seven through 12), and 31% in combined K-12 schools. Enrollment in private schools declined 4.1% between fall 2001 and 2003 but is projected to grow by about 7% through 2015. Projections indicate that there will be regional variations, with greater growth in states in the South and the West offset by flat or negative enrollment changes in states in the Northeast and Midwest. Projections for this age cohort conform to regional projections in the number of high school graduates. Moreover, because public school enrollment is projected to grow at a faster pace, the relative proportion of students enrolled in private schools may continue to decline from the current 10% penetration.

Students are enrolled in about 28,400 schools. The market penetration of private K-12 schools is significantly below the 25% market penetration of private higher education institutions. According to data compiled by the National Association of Independent Schools (NAIS), private K-12 schools are generally small; the average enrollment for 1,000 schools that are members of the NAIS was 472. The average size for the broader private school universe is even smaller, according to a National Center for Education Statistics private school survey from March 2006. Given the limited size and market penetration of private elementary schools, Fitch Ratings believes that it is important to link the analysis of enrollment trends with a school's competitive position.

Critical attributes for bolstering a K-12 school's competitive position are its mission, the demographic and socioeconomic attributes of its service area, its market niche or unique programs offered, its reputation for high-quality and safe educational services, and/or the presence of strong community or religious ties that provide a well-established feeder for enrollment.

**Capital Market Assessment**

The vast majority of private K-12 schools have little or no bond market experience. These institutions have relied instead on traditional fundraising and tuition-driven approaches to finance capital improvements. Fitch estimates that about 70 private schools have been assigned underlying bond ratings based solely on institutional credit characteristics. Fitch believes that the majority of K-12 schools have

**Definitions**

Private elementary and secondary schools include not-for-profit, nonsectarian, Catholic, and other religious schools serving prekindergarten through 12th grade. Private schools include boarding and day schools. Unlike public schools, private schools receive little or no tax revenue. Catholic schools include parochial, diocesan, or private order schools that may or may not receive church funding. Other religious schools include conservative Christian schools and other schools that may or may not be affiliated formally with an organized religious institution. Nonsectarian schools include regular elementary and secondary schools and schools with a special program emphasis or offering special education.

issued bonds based solely on the credit support of a bank (typically via a direct-pay letter of credit) or a bond insurance company.

**■ Rating Considerations**

The primary rating factors are:

- Enrollment trends.
- Competitive position.
- Financial resources for operations and debt repayment.
- Management practices and internal controls.
- Debt structure and security.

Due to the relatively small size of most private K-12 schools, it is important to focus on enrollment trends and tuition pricing flexibility, the school's competitive position or market niche, and the adequacy of cash flow and liquidity to cover operating needs and debt. The qualitative analysis focuses on management's ability to fulfill a school's mission, deliver high-quality education in a safe environment, attain financial equilibrium, safeguard financial assets, and meet payment and performance requirements of its debt obligations.

Generally, the key question for Fitch analysts is what distinguishes an investment-grade from a non-investment-grade school. Sound credit analysis does not overemphasize any single credit feature but examines the interrelationship of all of an institution's credit characteristics. Ultimately, evidence of solid student demand, a sound operating track record, and balance sheet strengths should result in an investment-grade rating.

**Enrollment**

Fitch views a school's ability to attract and retain students as critical in the rating process. Five years of data on full-time student enrollment are evaluated in terms of the school's size, trends over time, its mission, and management's enrollment goals. Since these schools typically enroll less than 500 students, significant enrollment swings or declines could have a negative impact on a school's financial viability. A one-year decline should be explained by management but is not necessarily viewed as a negative. However, a significant and steady decline of 10% or more over three years would be viewed as a negative in the rating process.

Private K-12 schools enrolled approximately 10% of total enrollment in public and private schools as of fall 2003. Penetration varied by region. Private schools in the Northeast enrolled about 14% of the total enrollment. Private schools in the Midwest enrolled about 11%, and private schools in the South and West enrolled 9% and 8%, respectively. Key factors influencing student demand include the school's mission and location; the demographic and socioeconomic characteristics of the service area; competition, primarily with public schools and other private schools; and the school's reputation and/or market niche. For example, certain private schools in New England draw students from rural areas devoid of public school systems. Generally, private day schools draw students from their immediate service area, and favorable demographic and economic trends of the immediate service area are important attributes for success. When evaluating these schools, Fitch believes that it is important to focus on the community or service area's demographic and socioeconomic characteristics and trends and the prevalence of private schools and private school enrollment. States with more than 1,000 private K-12 schools include California, Florida, Illinois, New York, Pennsylvania, Texas, and Wisconsin. With the exception of Wisconsin, these states each enroll more than 200,000 students in private schools.

Boarding schools, schools with specialized programs, and schools catering to students with special needs may have a wider regional draw. Private schools that can draw students from a broader service area are generally viewed as less vulnerable to economic downturns. Fitch looks at student origin and referral sources to assess a school's feeder network. For example, when evaluating Catholic schools, Fitch believes that it is important to review trends in the service area's Catholic population and the total

student population under Catholic instruction. For secondary schools, Fitch is interested in the enrollment trends of feeder or referral schools.

**Competitive Position**

A school's competitive position is assessed by reviewing the number of students applying, the ratio of admitted to applying students, and the ratio of matriculating to admitted students. A school's ability to funnel or select students from a wider applicant pool and increase its net tuition and fees per student indicates whether it has a strong and sustainable competitive position. Other indicators include the percentage of potential market served, the relative market share among competing schools or win-loss statistics, and comparative tuition and fee information for competing institutions, if available.

Private K-12 schools can be expensive. According to the NAIS, the median tuition for private day schools in the U.S. is close to \$14,000 for grades one through three, \$16,000 for grades six through eight, and \$18,000 for grades nine through 12. The median tuition for seven-day boarding schools is about \$35,000 for grades nine through 12. Parochial schools generally charge somewhat less. In addition to tuition, certain schools may require mandatory donations from the families. Fitch's analysis of a school's tuition incorporates these donations, which are typically used to self-fund financial aid grants and/or merit scholarships.

In most cases, private school credit analysis must be sensitive to local trends in competition and enrollment preference. The consistency or volatility of student demand will hinge on the school's reputation for delivering academically sound education services in a safe environment. Evidence of a school's sound reputation will signal successful future enrollments. Conversely, high-profile lawsuits and/or persistent negative publicity regarding student safety and incidences of crime could have a deleterious impact on enrollment trends. These topics will be vetted with management to assess service quality and the appropriateness of management controls. Indicators of relative strength or weakness in this area include student and teacher attrition rates, a high incidence of absenteeism among students and teachers, student retention, and accreditation status. These indicators will be evaluated within the context of planned business changes and external factors influencing the school's business environment.

Fitch believes that it is also important to review a school's academic quality indicators, such as grade point average, Scholastic Assessment Test/ACT test or other advanced placement scores, and student-teacher ratios. Schools that successfully attract and retain high-quality students should ultimately benefit from net tuition pricing flexibility and successful annual giving or fund raising. These financial resources are crucial to a school's long-term financial viability and ability to repay debt.

**Financial Resources for Operations and Debt Repayment**

A Fitch debt rating assesses a school's ability to make full and timely payments of principal and interest. Fitch believes this capacity largely depends on the presence of sufficient financial resources to buffer potential revenue disruptions and limited dilution from ongoing operating performance. Adequate financial resources are essential to the recruitment and retention of quality faculty, to cushion business interruption or sporadic enrollment declines, and to fund deferred maintenance needs. Fitch's financial analysis of private K-12 schools places emphasis on liquidity relative to debt and operations. Important ratios include available funds to debt and available funds to operations. Available funds are defined as cash and investments that are not restricted. Fitch will analyze the level of total expendable liquidity and a school's ability to accumulate and preserve financial resources over time.

Fitch focuses on sources of revenue and the school's ability to achieve a balanced or positive operating margin, strengthen its net asset position, and generate residual cash flow for debt service coverage. Private K-12 institutions generally derive about 75% of their revenues from tuition. When analyzing this important funding source, Fitch focuses on tuition trends on a gross and net basis. For most private schools, the difference between gross and net tuition reflects the granting of need-based financial aid and/or tuition remission for teachers and other employees. A high ratio of financial aid to gross tuition may be a sign of the school's strength if it is planned for and used to diversify student enrollment and is supported by endowment resources or external scholarships. However, if a school uses tuition discounting as a strategy to improve its competitive position without regard to student financial need, it could negatively affect a school's future financial flexibility. Fitch focuses on management's motivation for tuition increases, financial aid and discounting practices, and the link between these practices and trends and the

school's mission and funding needs. Fitch is ultimately concerned with how these trends affect a school's future financial flexibility.

Due to a school's limited revenue diversity, financial equilibrium hinges on tuition pricing flexibility, the ability to augment tuition and fees with fund raising, investment income, and annual endowment spending, if available. Sound financial performance requires effective management of costs. Fitch reviews trends in fixed and variable costs and the ability of management to flex costs in response to declines in enrollment and revenues.

Fitch focuses on the historical operating trends and attempts to identify sources of excess cash flow that will be needed to cover added debt service costs. As a measure of a school's operating performance, Fitch calculates the operating margin based on changes in unrestricted net assets. Fitch's calculation excludes realized and unrealized gains and losses from the sale of investments as non-operating revenues, along with net assets released for capital purposes and unusual noncash adjustments. The statement of activities is also analyzed to identify the overall change in net assets from temporarily and permanently restricted contributions and other revenue sources.

Financial strength is also derived from the presence of an endowment as a source of operating income. In cases where schools have sizable endowments, Fitch computes the operating margin with interest and dividend income only and with the endowment distribution.

Additionally, Fitch analyzes the relationship of a school's total assets to liabilities. Fitch believes that a highly leveraged balance sheet will constrain future operating flexibility, while a strong net asset position is vital for a school's future capital access.

Fitch examines trends based on a minimum of three years of audited financial statements to assess the sustainability of current results and the relative strength of an institution's financial position. The analysis focuses on the balance sheet and the statement of activities. In cases where a proposed debt issuance is used for new programs or an auxiliary facility, Fitch assesses projections to determine if incremental revenues can cover debt service and ongoing higher operating expenses.

### **Management Practices and Internal Controls**

A school's financial strength is directly linked to its competitive position, as well as management's decisions, the successful execution of strategic plans, and sound budgeting practices with a multiyear outlook. Evaluation of the quality of management and the governance structure is a subjective but crucial component of Fitch's analysis. For this reason, Fitch prefers to conduct a site visit and a meeting with representatives of the board of trustees to get a better sense of the planning and decision-making processes. The success of a private school depends on management's experience and expertise and effective communications with key stakeholders, including students and faculty, alumni, the local community, government oversight agencies, and the Internal Revenue Service, if necessary.

Fitch also evaluates the presence of appropriate governing documents and policies, the use of financial and operating reports to track important operating indicators, and financial variances from budget.

Private schools typically have a self-perpetuating board of trustees focused on planning for the future, establishing the school's operating and financial policies, financing the school through tuition setting and fund raising, authorizing contracts and budgets, and appointing and evaluating the head of the school. Representation frequently reflects the school's mission, any affiliations, if applicable, and community and parental representation.

Fitch acknowledges that board structures and the degree of diversification and parental representation vary among schools and does not prescribe to a one-size-fits all philosophy. Instead, Fitch's evaluation of the board's composition focuses on the qualifications of individuals capable of making sound business and fiduciary decisions. Regular board meetings and the participation of qualified individuals on key committees should facilitate the avoidance of mismanagement and appropriate board oversight. Although independent not-for-profit schools are not required to comply with the Sarbanes-Oxley Act of 2002, Fitch believes that the presence of an audit committee and assessment of internal controls bolster financial reporting and the audit process and contribute to the timely production and disclosure of audited financial statements. Appropriate internal controls should also enhance contract compliance.

Fitch believes a board should stand ready to contend with issues that could result in potential legal

problems or events that could have a deleterious effect on the school's reputation.

Fitch assesses management's strategic planning, knowledge of its internal and external environment, risk identification, and management practices and its ability to recognize areas that need improvement. Topics discussed with management include admissions policies, tuition and fees, fund raising/annual giving strategies, and plans to address deferred maintenance needs. While most independent schools do not budget for depreciation, some schools may set aside a provision for plant replacement, renewal, and special maintenance (PPRSM) needs. PPRSM funding and the use of budgets with a multiyear outlook demonstrate a higher degree of financial discipline and strategic thinking. Management needs to be forward thinking, adhere to prudent and appropriate financial practices, and be responsive to problems in a timely manner.

Management at investment-grade schools typically will have engaged in strategic planning for retention of market position, as well as contingency planning to react to potential changes in environmental and/or financial circumstances. Management should have clearly defined budgetary and financial controls. Long-term planning for an increased debt burden, including contingency planning in the event of enrollment, equity market, or interest rate volatility. Tuition and fee affordability among the school's student base must be considered part of planning. Investments generally should be managed professionally, pursuant to adopted board policies limiting the amount of the portfolio that can be budgeted annually for operating expenses to a sustainable level, typically 5% or less of rolling market value. Investment-grade schools generally focus on consistent maintenance of break-even or positive bottom-line financial margins annually.

### **Debt Structure and Security**

Fitch evaluates a school's pro forma debt burden using both balance sheet and income statement ratios.

Key ratios include available funds to debt, actual and maximum annual debt service coverage, and the percentage of revenues consumed by maximum annual debt service.

When assessing debt leverage, Fitch reviews the existing level of debt, debt structure, and future debt issuance plans. Fitch does not specify an optimal debt structure. Each school's debt profile is reviewed on an individual basis as part of its overall credit profile. Fitch considers the presence of all existing debt, including contingent obligations and short-term debt that requires immediate repayment or burdens issuers with additional covenants.

Fitch discusses with management processes for monitoring variable-rate debt exposure and plans to renew letters or credit or refinance variable-rate debt with fixed-rate debt. In evaluating a school's debt position, Fitch evaluates reimbursement obligations under letters of credit. In cases where schools use interest rate swaps, Fitch focuses on management's goals, the presence of a swap policy, and the understanding of the potential risks. Fitch also considers whether the debt-financed project will enhance revenues and cash flow.

Fitch evaluates security and covenant provisions to determine if appropriate credit protection and investor disclosure and intervention measures are in place at a given rating level. For example, credits rated 'A-' or lower should provide security in the form of a revenue pledge, a debt service reserve fund, limitations on permitted liens, and, at certain rating levels, a mortgage on certain assets. Examples of appropriate financial covenants may include a rate covenant, a liquidity covenant, and a relatively stringent additional bonds test. Covenants should be measured in a timely manner and linked with appropriate remedies in the event of a covenant violation.

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