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Moody's Rating Approach for Independent Elementary and Secondary Schools

Executive Summary

This article provides an overview of Moody's rating approach for private K-12 schools. It reviews the factors analyzed in assigning a rating, and the appendices include additional information about our independent school ratio calculations, rating definitions, and the credit rating process.

Moody's rating methodology for independent schools is based on five broad credit factors assessed together to arrive at a bond rating. However, there is not a set formula for generating a rating, and each of the factors listed below may be weighted differently for each institution depending on particular circumstances. The factors are:

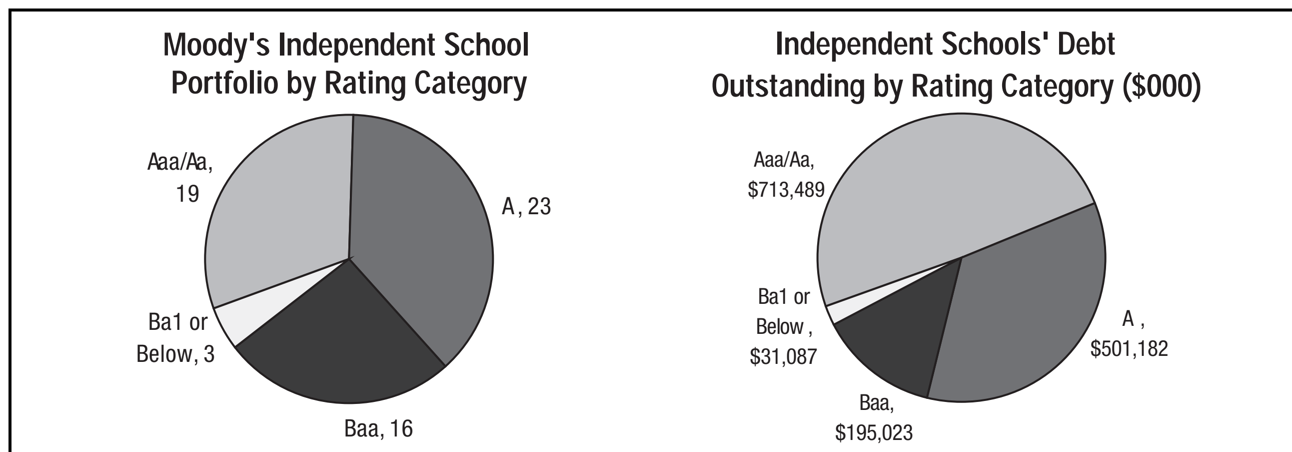
- Student market position
- Financial resources
- Operating performance
- Debt position and legal structure of borrowing
- Strategy and management

Moody's credit analysis of the independent school sector focuses heavily on understanding a school's fundamental student market position because we believe it is a key driver of longer-term financial health. We focus on student demand and a school's ability to reach enrollment targets, particularly during periods of economic downturn. In assessing a school's financial health, we look at a school's financial resource base relative to debt and operating expenses, as well as the relative liquidity of these resources. We measure a school's ability to grow this financial resource cushion over time through investment returns, fundraising, and retained operating surpluses. In addition to monitoring multi-year trends in operating results, we focus on a school's cash flow and ability to cover actual debt service responsibilities as well projected maximum annual debt service. Moody's analysis of an independent school's debt position focuses on current leverage levels, debt structure, legal covenants, and the potential for additional borrowing. Finally, we assess management's ability to ensure the future financial health of the school, and we examine the governing board's role in such areas as setting strategic direction, fundraising, and investment management.

Moody's Investors Service
Global Credit Research

Overview of Credit Quality of Moody's Independent School Portfolio

Moody's currently rates 61 independent schools based on their own credit quality, which had $1.4 billion of direct debt outstanding at the end of fiscal year 2003. Our average rating on these schools is A2 based on the number of institutions, with the average rating increasing to A1 when weighted by the amount of debt outstanding. Appendix 4 includes a list of these schools and their ratings as of January 2005. In addition to these ratings, Moody's has over 150 ratings on independent schools based upon credit support from a bank letter of credit or bond insurance. On all of the insured transactions, Moody's Public Finance Group's higher education and not-for-profit team analyzes each of the organizations and assigns an unpublished underlying rating as part of our assessment of the insurance companies. The statistics in this publication include only our published ratings based on the institution's own credit quality, and do not include those ratings based solely on bond insurance or a bank letter of credit.



Once a year, usually in the third quarter, Moody's publishes our independent school sector outlook and medians. Our current outlook for the independent school sector is cautiously stable, based on our median calculations using FY 2003 financial data and fall 2003 enrollment and student demand data. Although private K-12 schools' investment portfolios and financial resource bases have benefited from recent improved market conditions, operating performance for the sector as a whole tightened further in FY 2003. Also, many independent schools have reported recent pressure on fall 2003 and 2004 application volume and less predictable matriculation numbers, which management has attributed to the weaker economy, stock market decline from its peak in early 2000, and families' heightened concerns over the affordability of private education. For a full discussion of Moody's outlook on independent schools, and for our medians of key financial ratios, please refer to our publication "Independent School Outlook and Medians" published this year in August 2004 and updated annually.

Key Factors

I. MARKET POSITION

Moody's rating analysis of an independent school focuses heavily on understanding a school's fundamental student market position, which Moody's believes is a key driver of long-run financial health. Strong student demand generally translates into net tuition revenue growth, enrollment stability, and over the longer term, into stronger fundraising. We begin our analysis by learning about a school's mission, educational philosophy and program offerings, which will heavily influence student demand. Since many schools are engaged in multiple lines of business--serving boarding students, day students, and students at different grade levels--Moody's seeks to understand the competitive dynamics of each sub-market, including the degree of competition from other schools, as well as marketing strategies employed by the school we are rating.

We analyze enrollment and student demand patterns during periods of economic downturn to assess how the school might perform during similar conditions in the future. Moody's examines enrollment trends and analyzes reasons for increases and decreases over time. We attempt to understand a school's longer-term enrollment profile and target size, and discuss the rationale behind planned growth in detail, especially in situations in which a school may have plans to expand to additional grade levels.

INDEPENDENT SCHOOLS CAN BE VULNERABLE TO EVENT RISK

Relative to private colleges and universities, independent schools are more vulnerable to event risk due to their smaller size (often under 500 students), which magnifies the impact of a single event, and the younger ages of their students. When rating an independent school, Moody's carefully weighs the risk of adverse publicity, investigations, and lawsuits arising from accusations of hazing practices, abuse of students by other students or faculty members, negligence in the injury or death of a student, or other similar events. Publicity and investigations related to executive compensation, investment management, and other financial matters can also be a concern. In particular, we focus on the potential negative impact that these types of events could have on a school's reputation, student demand, financial resources, and philanthropic support by alumni and parents. We discuss matters pertaining to lawsuits and high-profile media reports with the school's management in detail. We look for indications that management takes these matters seriously and has an effective mechanism for communicating with its constituents and dealing with problems when they do arise.

In order to assess student demand, Moody's focuses on several ratios including **selectivity** rate (number of acceptances divided by number of applications) and the **yield** or **matriculation** ratio (number of admissions divided by number of acceptances). A low selectivity rate and high yield rate are ideal, but Moody's recognizes that some schools with specialized missions or a more limited geographic draw may have largely self-selecting applicant pools. In such cases, Moody's would be less concerned with a higher selectivity rate, but would also expect to see a strong yield on accepted students to indicate that the school is indeed an applicant's top choice. In some cases, schools' admission departments may counsel interested students not to apply if they will not likely be accepted or may only accept students who indicate that the school is a top choice for them. This tactic will also increase (worsen) a school's selectivity ratio, but should also result in an improved yield. In light of recent pressure on applications to independent schools, largely attributed to the recent weaker economic environment, we have increased our discussions with management on strategic steps being taken to counter volatility in student demand. We will be carefully monitoring schools' abilities to reach future application and matriculation targets, as two years of application declines could put stress on ratings that are heavily based on demonstrated strength of demand.

In contrast to colleges and universities, independent schools generally offer financial aid to a small proportion of their students, and do not engage heavily in tuition discounting to attract students. However, some lower-rated schools may be discounting tuition in order to fill their class and reach enrollment targets, which is a concern. In analyzing tuition pricing trends, Moody's focuses on **net tuition per student**, which measures average tuition and fees actually received per student. A sustained period of flat or declining net tuition per student could indicate competitive pressure and credit stress. We discuss with management plans for future tuition increases and how the school's tuition pricing strategy compares to that of its main competition.

Geographic diversity of the student body is usually viewed as a credit positive since it reduces vulnerability to enrollment declines due to regional economic or demographic conditions. Even for day schools, a student draw from a broader geographic region, as opposed to a single town, can enhance credit quality. We also focus on measures of **student quality**, including SAT/ACT scores of graduating students and college placement information. Student quality is often tied to a school's ability to garner net tuition revenue because schools that have stronger academic reputations can generally charge a higher price. Also, if demand weakens due to external factors, schools which already attract highly qualified applicants are able to lower their admissions standards slightly and still maintain a strong entering class. Student quality measures are also often linked to retention, which correlates with stronger student satisfaction and future fundraising potential.

Moody's Analysis of Student Demand Focuses on:

- Mission and educational philosophy
- Historical enrollment trends and target size
- Selectivity and yield (matriculation) rates
- Geographic diversity
- SAT/ACT scores of graduating students
- Secondary school and college placement of graduating students
- Retention rates
- Trend of net tuition per student, and future pricing plans
- Cross-admission (win/loss) data versus primary competitors

Finally, Moody's requests **cross-admission statistics** (for example, win/loss rates), if readily available. This information provides additional insight into a school's market position compared to its major competitors.

II. FINANCIAL RESOURCES

Moody's believes that the size of an institution's financial resource base is key to credit quality, as this is the cushion that allows institutions to weather potential periods of economic or enrollment stagnation or deterioration. It also provides an important stream of income earnings that supports operating and capital needs. In analyzing an institution's financial position, we look at both the resources currently available as well as the potential for additional growth through retained earnings, gift support, and prudent endowment management practices.

Moody's uses ratio analysis to compare an institution's financial resources to its expense base and amount of debt. Three main types of ratios underpin our analysis: **financial resources to operations**, **financial resources to debt**, and **financial resources per student**. There are no target levels necessary to achieve a given rating level, and sometimes a school's ratios can differ from the medians for its rating level if it has other offsetting credit strengths or weaknesses.

Various Levels of Financial Liquidity Examined

Moody's calculates three levels of available liquidity: financial resources which are immediately available to be expended (unrestricted financial resources), those that are spendable over the long run (expendable financial resources), and those which include the school's permanently restricted endowment funds (total financial resources).

Moody's excludes a school's net investment in physical plant (plant equity), which is typically classified as unrestricted net assets, from any of our measures of financial health. We also exclude restricted gifts that can only be used to acquire plant assets. We exclude these assets from our measure of resources because campus property is highly illiquid, and also because its liquidation value is difficult to discern, due to the highly specialized nature of most campus facilities. Although none of Moody's ratios incorporate net investment in plant, Moody's does indirectly factor into our analysis the potential recovery available to bondholders from a school's fixed assets. Since sale of a school's plant assets would likely only be used to repay debt in the event of bankruptcy, Moody's places more weight on ultimate recovery when analyzing lower-rated credits.

The level of **unrestricted resources**, when compared to debt or annual operating expenses, indicates a school's most immediate financial flexibility. Unrestricted resources include all of a school's unrestricted net assets, with the exception of plant equity. The level of available unrestricted financial resources is particularly important for our analysis of lower-rated schools, which could be more vulnerable to enrollment volatility than larger schools given their weaker market positions, and some of which may also have a history of tighter annual operating performance.

For more financially secure schools, a Moody's rating more heavily incorporates relative levels of **expendable** and **total resources**. Expendable financial resources include all of a school's unrestricted and temporarily restricted net assets, again with the exception of net investment plant or funds temporarily restricted for construction of plant. Total financial resources include all expendable resources, plus a school's permanently restricted endowment corpus. While the corpus is generally unavailable to directly support debt service, endowment income from these funds, depending on restrictions, provides a source of operating income.

Fundraising is Integral to Financial Growth

Moody's believes that historical fundraising prowess can be a powerful indicator of future fundraising success. Some independent schools have been in the fundraising "business" for many decades, whereas others have only recently started to garner meaningful philanthropic support. However, many schools which are new to fundraising have wealthy and highly committed donor bases that can often yield dramatic success in a fairly short timeframe.

To determine the strength of a school's fundraising program, Moody's looks at the sources of support, such as parents, alumni, board members, and friends of the school. Diversity within the donor base is a positive credit factor, both in terms of the types of donors, and the degree of dependency on a few individuals for large gifts. We also examine the areas for which funds have been raised (operations, endowment, or capital), and the types of restrictions on gifts received. Many schools have historically focused on annual fund drives and capital campaigns for specific buildings, with others focusing more heavily on fundraising for endowment growth. Moody's assesses a school's stated fundraising goals against its proven track record, and if there is a discrepancy, seeks to understand why a school believes it can shift its historical pattern of philanthropic support.

Management of Financial Reserves Critical to Maintaining Credit Quality

Moody's believes management of financial reserves is a critical credit factor for all independent schools, regardless of endowment size. In addition to looking at a school's resource levels and means of accumulating resources, Moody's looks at four broad factors in this area: asset allocation, investment management oversight, investment performance, and endowment spending.

In our opinion, there is no ideal **asset allocation** strategy. We believe the asset allocation must reflect the size of the institution's investment pool, investment time-horizon, liquidity needs, and management expertise. We analyze the composition of a school's investment portfolio to determine if it appears to meet both medium-term needs as well as long-term growth objectives. We believe that diversification both in terms of asset classes and in fund managers is favorable for stability and growth.

More recently Moody's has seen a growing number of schools, even those with small financial resource bases, veer away from traditional investments in publicly traded fixed-income and equity securities. Some schools are amending their investment policies and allocating higher proportions of their portfolios to alternative investments, including hedge funds (both fund of funds and direct investments with hedge fund managers), private equity, venture capital, and other types of international, real estate, or distressed opportunity funds. The returns on these assets are typically not highly correlated with public debt and equity markets and offer the prospect of reduced investment volatility and improved performance. However, we are concerned that large investments in hedge funds and other alternative strategies can present challenges in the areas of manager selection, due diligence, and reduced liquidity. For schools that are investing heavily in alternatives, we have increased our analytical focus on how asset allocation decisions are made, how managers are selected, and how frequently board members and staff meet with managers. We are also concerned that many portfolios are not sufficiently diversified, with a single hedge fund accounting for more than 10% of the entire endowment. For further discussion, please read Moody's special comment, "Risks and Opportunities of Hedge Fund Investments by Higher Education and Other Nonprofits," published in August 2004.

Analysis of Financial Reserve Position

Moody's examines a variety of areas when determining an independent school's balance sheet strength, including:

Relative levels of financial liquidity compared to:
- Debt
- Annual operating expenses
- Enrollment

Methods of accumulating financial reserves:
- Fundraising
- Investment management
- Reinvested operating surpluses

Management of financial resources:
- Asset allocation
- Investment oversight
- Endowment spending

Means of financing capital improvements:
- Debt
- Cash flow/reserves
- Fundraising

In analyzing **investment management oversight**, Moody's examines both the expertise of the individuals involved in the day-to-day management of a school's investment portfolio, and the level of supervision provided by the school's board. Unlike some colleges, universities, and other not-for-profit organizations, with larger endowments to manage, most independent schools do not employ chief investment officers and often rely heavily on financial consultants and board members for investment expertise and guidance. Despite their critical role, Moody's is concerned that some investment committees may not meet frequently enough to react to changes in portfolio performance or market events, or may be heavily influenced by one or two members. Usually, Moody's requests a school's investment policy statement and compares these guidelines to actual asset allocation and spending rates.

When reviewing **investment performance**, Moody's analysts focus on short-term (current fiscal year) as well as longer-term (5 to 10 year) endowment returns. We benchmark an institution's investment track record against other institutions with portfolios of similar sizes. Over the long run, consistent over- or under-performance relative to peers can affect an institution's credit rating.

A school's **endowment spending rate** also can have a significant long-term impact on its future financial health. Clearly, the more a school spends out of its endowment today, the slower the overall endowment will grow to support future operations. For the purposes of calculating an operating margin that is consistent from school to school, Moody's includes in operating income a smoothed calculation of endowment and investment income equal to 5% of a three-year rolling average of the market value of cash and investments. If a school employs a spending rate that is significantly higher than this industry average, Moody's seeks to understand if the higher spending rate is temporary, or if it reflects a permanent reliance on higher levels of investment income to fund annual operations. We have less concern if the high spending rate is planned for one-time capital or program investments. However, if high endowment spending is necessary to balance annual operations (including expenses such as development office activities and debt service), Moody's rating outcome could reflect a concern that the school might experience a gradual relative decline in financial and competitive position when compared to peer schools with lower spending rates and more rapidly growing endowments.

Key Ratios Used to Measure Balance Sheet Strength (see Appendix 1 for all ratio definitions)

- Unrestricted financial resources to debt
- Expendable financial resources to debt
- Total financial resources to debt
- Unrestricted resources to operations
- Expendable financial resources to operations
- Total resources per student

III. OPERATING PERFORMANCE

The ability to manage to at least a balanced bottom line is important for the long-run financial health of all independent schools, and critical for schools that do not have significant financial reserves. Recognizing that many schools experience variable operating performance from year to year due to the inherently unpredictable nature of gift support and certain unplanned expenditures, Moody's analysis focuses on multi-term trends in operating results. While a single operating deficit may not be a concern, two or more years of weak financial performance usually highlight factors that may affect fundamental financial equilibrium. Moody's seeks to understand drivers of operating performance from both the revenue and expense perspective.

Many independent schools place great internal emphasis on balancing the operating budget according to a set of internal budgetary accounting conventions. Because these conventions differ from school to school, for example in areas such as inclusion of certain gift and investment income, operating budgets are generally not comparable across schools. They also may exclude certain items (such as depreciation) which Moody's believes should be included as an operating expense. Therefore, our practice is to focus our analysis of operating results primarily on the Statement of Activities and Statement of Cash Flows as presented in the audited financial statements of the organization. We do, however, analyze budgeting practices and results as a tool to evaluate management's fiscal practices and use of financial controls.

Measures of Operating Performance

Moody's calculates a school's **annual operating margin** in order to assess the school's ability to balance operations in any given year. Due to potential variability in key revenue and expense areas, **average annual operating margin**, which measures operating results over a three-year time period, provides a better measure of a school's capacity to maintain financial balance. Moody's also calculates an **operating margin without gifts**, in order to measure a school's reliance on gifts to balance operations. This enables an analyst to see core trends in operating performance without gift flow variability.

Annual debt service coverage and 3-year **average annual debt service coverage** point to a school's capacity to successfully manage current leverage levels and successfully repay debt from fiscal operations. **Maximum annual debt service (MADS) coverage** and 3-year **average MADS coverage** indicate to what extent pro-forma future peak debt service can be covered from historical operating flow. If historical operating cash flow covers peak debt service by less than one time, Moody's seeks to understand how the school intends to repay bondholders, either by improved operating performance or by judicious use of financial reserves. In the case of scheduled balloon payments, Moody's assesses the institution's likely continued access to capital to refinance the debt. For schools which have issued variable-rate debt, Moody's focuses on what interest rates the school is currently budgeting for, and how the school will adjust if interest rates begin to rise. If the school conservatively budgets for interest rates higher than current levels, we ask about how management is using current savings.

To further measure the impact of leverage on operating performance, Moody's looks at the ratios of **annual and maximum annual debt service (MADS) to operations**. For the average school, debt service consumes between four and eight percent of operations. Typically, Moody's would view a school whose debt service was more than 10% of operations as highly leveraged and would have concerns about its ability to repay debt during less financially robust periods. A significant unrestricted financial resource base or a long record of consistently strong annual operating performance may mitigate some of these concerns.

Moody's broadest measures of operating performance highlight a school's ability to grow its financial resource base. Moody's calculates **return on net assets** and **return on financial resources** to help to quantify the magnitude of changes in financial resources over time and reflect management's strategy toward investing in the campus versus growing reserves. Return on net assets includes changes in all net assets, including net investment in plant, while return on financial resources excludes changes in plant equity, which is unlikely to be available for debt service of a school that is still a going concern.

Revenue Diversity Provides Stability

Moody's believes that institutions with greater **revenue diversity** are often financially stronger because of the stability that multiple revenue sources provide. Moody's analyzes each revenue stream (tuition and fees, auxiliary enterprise charges, private gifts, endowment income) individually to determine a school's reliance on any particular source of income and to note trends in income flow. Student charges, which include tuition, fees, and auxiliary revenue, usually compose the majority of an average school's revenue base.

When Moody's calculates operating revenue, we make a few adjustments to the change in unrestricted net assets as reported in the audited financial statements. First, as discussed above, we include 5% of a three-year rolling average of the market value of cash and investments as the amount of endowment spending (investment return) available to support operations, regardless of the school's actual spending of investment return for the year. We treat the balance of total investment return (which could be positive or negative) as non-operating income. Second, we adjust net assets released from restriction by excluding the portion of net assets released which is comprised of investment income. We do this in order to avoid double counting investment income which is already captured by our 5% endowment spending calculation. We also exclude any net assets released for the construction or acquisition of fixed assets, since these relate to plant rather than annual operations. We also place other extraordinary non-operating items below the line, such as a loss on early retirement of debt, loss upon disposition of physical assets, or one-time accounting adjustments.

Moody's Adjusted Unrestricted Revenue:

Gross Tuition and Fees
Minus unsponsored scholarships
Minus sponsored scholarships
=**Net Tuition and Fees**
Plus Auxiliary Revenue
Plus 5% 3-year average of cash and investments
Minus Investment Income
Minus Unrealized Gains and Losses
Plus Unrestricted Gift Revenue
Plus Grants and Contracts
Plus Net Assets Released from Restriction
Minus Investment Earnings Released
Minus Gifts Released and Used for Capital
=**Total Adjusted Unrestricted Revenue**

Moody's Analyzes Expense Drivers

In addition to looking at the composition and growth of a school's operating revenue base, Moody's seeks to understand the major drivers of growth in the expense base. Growth in expenses that exceeds growth in net tuition revenue can indicate that a school is approaching financial imbalance.

Faculty and staff compensation typically comprise the majority of a school's annual operating expenses. Therefore, Moody's pays particular attention to the degree of flexibility a school may have to reduce expenses in this area, if necessary. Moody's discusses management and faculty compensation relative to peer schools, as well as recent and projected trends in salary increases. Low compensation relative to peer schools may point to an upcoming need for larger than average annual salary increases in order to remain competitive in attracting desirable faculty and staff members. Similarly, recent and projected trends in salary increases can highlight to what extent this portion of a school's expense base is likely to increase in the future.

While recognizing that depreciation is a non-cash expense, Moody's nonetheless views depreciation as one indicator pointing to whether or not a school is appropriately reinvesting in its physical plant. Moody's believes that financially-sound schools should ultimately be able to balance their budget inclusive of a charge for capital reinvestment. While Moody's calculation of operating margin often reflects operating deficits for those schools unable to cover depreciation from operations, our debt service coverage measures are not affected since Moody's adds back this non-cash expense in analyzing a school's debt servicing capabilities.

IV. DEBT POSITION AND LEGAL STRUCTURE OF BORROWING

Debt Capacity is a Function of Both Total Resource Levels and Cash Flow

Moody's analysis of an independent school's debt position focuses on current leverage levels, debt structure, legal covenants, and the potential for additional borrowing. Moody's view of debt position includes both a balance sheet focus as well as an income statement analysis. Strong cash flow and good debt service coverage may be sufficient to garner an investment grade rating; however, higher rated schools typically have substantial reserves, which would cushion debt service payments through an extended period of operating stress.

Depending on a variety of factors, increased leverage may or may not have an impact on a school's credit quality. Debt-financed facilities that improve a school's ability to attract students are likely to result in an improved market position. If Moody's believes that a school's strategic position will be significantly enhanced by debt-financed projects, and if it is clear that the school will be able to service debt comfortably, then a rating downgrade becomes less likely. However, rating pressure can arise if the cushion provided by a school's financial resources to the amount of debt outstanding is no longer consistent with the risk profile of a particular rating. In addition, Moody's may be concerned about reduced long-term financial flexibility derived from the additional significant fixed costs added to a school's operating budget, including debt service and additional depreciation, which Moody's includes as an operating expense.

Debt Structure Can Potentially Have a Credit Impact

In addition to the overall leverage level, Moody's analysis focuses on the structure of a school's debt profile, including the mix of variable and fixed-rate debt and whether debt service is level, accelerated, or deferred. However, Moody's does not have specific benchmarks for variable versus fixed-rate debt, or for how debt should be amortized, with each situation being analyzed on a case-by-case basis.

For schools issuing variable-rate debt, Moody's focuses on how management plans to budget for interest rate payments and exposure to increasing debt service costs in a rising interest rate environment. Bullet maturity structures imply that at some point in the future the school may have to significantly reduce its asset base to repay debt, or potentially refinance during unfavorable market conditions, rather than gradually repaying debt from annual operations over a longer time frame.

Moody's also focuses its analysis on potential risks associated with transactions outside the traditional fixed-rate bond market, including letters of credit, swaps, lines of credit, and direct bank loans. The risks associated with these structural elements are more pronounced for borrowers rated Baa1 and below. Risks associated with these types of transactions include the possibility of an acceleration of demand debt and a call on the unrestricted financial resources, placing pressure on a school's available liquidity. In addition, credit arrangements with expirations prior to the full amortization of the underlying debt expose borrowers to renewal risk. Letters of credit and lines of credit from commercial banks are examples of financing arrangements that introduce this type of risk. When incorporating renewal risk into our ratings, Moody's assesses the difficulty a borrower could face in finding a replacement provider if the current lender decided not to renew its commitment. In addition, the borrower's ability to at least temporarily absorb repayment of the debt while finding a replacement lender is considered.

Moody's has also increased its analysis of interest rate swap agreements, particularly for lower-rated schools. In Moody's credit reports, increased disclosure is provided about swap agreements, including immediate termination events, cross-default provisions, and situations in which a school would be required to post collateral. For further discussion, please read Moody's special comment, "Hidden Risks of Variable Rate Debt," published in March 2004.

V. STRATEGY AND MANAGEMENT

In assessing a school's management team, we look to such indicators as a coherent long-range strategic plan, clearly articulated debt and investment management policies, budgeting practices, past record of successfully dealing with difficult situations, and the ability to achieve favorable results such as stable enrollment and balanced operations as indicators of management strength. Since Moody's analysts meet with over 200 independent schools, colleges and universities, and other not-for-profit organizations each year, we are also able to comparatively assess management's industry knowledge and practices. In addition to evaluating a school's senior administrative staff, Moody's pays a great deal of attention to the structure and role of the governing board. We often find it helpful to have direct discussions with key board members as part of the rating process, as board members are often heavily involved in strategic planning, fundraising, and investment management.

Budgeting and Monitoring Practices Highlight Financial Controls

Moody's typically seeks to understand a school's method of budgeting and of monitoring the budget to determine whether sufficient flexibility and controls are in place to prevent operating surprises. Many well-run schools build some type of flexibility into the budget that can be used to cushion operations in the event of some sort of unexpected revenue shortfall or expense increase. Contingency measures may take the form of budgeting for fewer students than actually expected, limiting expected gift revenues to annual fund receipts, budgeting for a full complement of faculty or staff even when vacancies are expected, or building in an actual contingency reserve equal to some portion of revenues or expenses. Moody's also focuses on the extent to which schools' budget for renewal and replacement of capital facilities and how this compares to depreciation expense.

Controls on the budget over the course of the year can be another important sign of management's vigilance. While some schools appear to monitor expenses on a monthly and quarterly basis, interim controls are more lax at other schools. Equally important to monitoring interim results is the ability to take remedial action in the event departments are over budget. At some schools, senior financial management appropriately exerts administrative budgetary control; at others, overspending appears to be a routine occurrence.

Moody's paid particular attention to management's budgetary practices during the recent economic downturn, during which many independent school business officers were challenged to help navigate their schools through periods of financial stress and weakened student demand. We were impressed with schools that took active steps to counter budgetary pressure, for example by focusing on the containment of operating expenses or by possibly developing additional revenue sources.

Board Composition and Willingness to Support the Institution are Often Key to Credit Quality

Since an institution's board is ultimately responsible for ensuring the financial health of the organization, Moody's analysts work to understand the expertise represented on the board and the board's role in such areas as setting strategic direction, fundraising, and investment management. We will inquire as to how often the board meets, what level of decision making is delegated to management, and whether best practices are institutionalized through written policies, including conflict of interest policies. We focus on the length of term limits as well as any recent history of board turnover.

We believe the board's role in fundraising is very important to the success of an institution's ability to meet its development goals. We assess a school's ability to raise funds on behalf of the institution, either directly through individual board members' support or indirectly through contact with other funding sources. We focus on the concentration of the donor base (the number and size of gifts), and also review what portion of the gifts raised by the board are restricted and for what purpose. We believe a high level of unrestricted gifts not only increases the financial flexibility of the institution, but is indicative of confidence in management and the overall strategic mission of the institution. For further discussion, please see Moody's special comment, "Moody's Approach to Analyzing Governance of Private Higher Education and Not-for-Profit Organizations," published in December 2004.

Related Research

Outlook:

Independent School Outlook and Medians 2004-2005: Outlook for Private K-12 Schools Remains Cautiously Stable, as Some Schools Continue to Face Financial Challenges and Softening Market Demand, August 2004 (#88260)

Special Comments:

Hidden Risks of Variable Rate Debt, March 2004 (#81480)

Risks and Opportunities of Hedge Fund Investments by Higher Education and other Nonprofits, August 2004 (#88439)

Moody's Approach to Analyzing Governance of Private Higher Education and Not-for-Profit Organizations, December 2004 (#89757)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Appendix 1: Key to Moody's Independent School Ratios

Market Demand:

Ratio	Description	Calculation
Selectivity (%)	Measures student demand	Number of acceptances *divided by* number of applications
Matriculation (%)	Measures student demand	Number of admissions *divided by* number of acceptances
Net tuition per student ($)	Measures average tuition and fees actually received per student	Net tuition and fee revenue *divided by* total number of full-time equivalent students
Total tuition discount (%)	Measures the amount of tuition revenue funded by unrestricted institutional resources as well as restricted endowments and external sources	Total scholarships and fellowships *divided by* gross tuition and fee revenue

Capital Ratios:

Ratio	Description	Calculation
Unrestricted resources-to-direct debt (x)	Measures coverage of direct debt by the most liquid financial resources	Total unrestricted net assets less net investment in plant, *divided by* direct debt
Expendable resources-to-direct debt (x)	Measures coverage of direct debt by financial resources that are expendable in the long run	Total unrestricted and temporarily restricted net assets *less* net investment in plant, *divided by* direct debt
Total resources-to-direct debt (x)	Measures coverage of direct debt by total financial resources including permanent endowments	Total net assets *less* net investment in plant, *divided by* direct debt
Total cash & investments-to-direct debt (x)	Measures coverage of direct debt by assets that generate investment return	Total cash and investments *divided by* direct debt
Direct debt-per-student ($)	Compares direct debt to the size of the student body	Direct debt *divided by* full-time equivalent students
Actual debt service to operations (%)	Measures actual debt service burden on the annual operating budget	Actual annual debt service *divided by* total operating expenses
Peak debt service to operations (%)	Measures peak debt service burden on the annual operating budget	Peak annual debt service *divided by* total operating expenses
Age of plant (number of years)	Provides a crude indicator of institutional deferred maintenance as well as the operating efficiency of the existing plant facilities	Accumulated depreciation *divided by* depreciation expense

Balance Sheet Ratios:

Ratio	Description	Calculation
Unrestricted resources-to-operations (x)	Measures coverage of annual operating expenses by the most liquid financial resources	Total unrestricted net assets *less* net investment in plant, *divided by* total operating expenses
Expendable resources-to-operations (x)	Measures coverage of annual operating expenses by financial resources that are expendable in the long run	Total unrestricted and temporarily restricted net assets *less* net investment in plant, *divided by* total operating expenses
Total resources-per-student ($)	Compares financial resources to the size of the student body	Total net assets *less* net investment in plant, *divided by* full-time equivalent students

Operating Ratios:

Ratio	Description	Calculation
Annual operating margin (%)	Indicates the excess margin (or deficit) by which annual revenues cover operating expenses	Adjusted total unrestricted revenues (adjustments include limiting investment income to 5% of a three-year average of investments and subtracting net assets released for construction and acquisition of fixed assets), less total unrestricted operating expenses, divided by total unrestricted operating revenues
Average operating margin (%)	Averages operating margin over three years for a longer-term view	Three year average of the annual operating margin
Operating margin excluding gifts (%)	Measures the institution's dependence on gifts to finance annual operations	Adjusted total unrestricted revenues *less* gifts *less* total unrestricted operating expenses, divided by adjusted total unrestricted revenues *less* gifts
Actual debt service coverage (x)	Measures actual margin of protection for annual debt service payments from annual operations	Annual operating surplus (deficit) *plus* interest and depreciation expenses, divided by actual principal and interest payments
Average peak debt service coverage (x)	Measures margin of protection for peak debt service payments, averaged over three years	Three year average of annual operating surplus (deficit) *plus* interest and depreciation expenses, *divided by* peak principal and interest payments
Total gifts per student ($)	Compares gift revenues to the size of the student body	Total gift revenue (unrestricted, temporarily restricted, and permanently restricted) *divided by* total number of full-time equivalent students
Return on net assets (%)	Indicates direction and degree to which an institution has improved its total resource base	Increase (decrease) in total net assets, *divided by* beginning total net assets
Return on financial resources (%)	Indicates the direction and degree to which an institution has improved its financial resources (excluding plant)	Increase (decrease) in total financial resources (total net assets *less* net investment in plant), *divided by* beginning total financial resources

Appendix 2: Rating Definitions

US MUNICIPAL AND TAX-EXEMPT RATINGS

Municipal Ratings are opinions of the investment quality of issuers and issues in the US municipal and tax-exempt markets. As such, these ratings incorporate Moody's assessment of the default probability and loss severity of these issuers and issues. The default and loss content for Moody's municipal long-term rating scale differs from Moody's general long-term rating scale.

MUNICIPAL LONG-TERM RATING DEFINITIONS:

Aaa

Issuers or issues rated Aaa demonstrate the strongest creditworthiness relative to other US municipal or tax-exempt issuers or issues.

Aa

Issuers or issues rated Aa demonstrate very strong creditworthiness relative to other US municipal or tax-exempt issuers or issues.

A

Issuers or issues rated A present above-average creditworthiness relative to other US municipal or tax-exempt issuers or issues.

Baa

Issuers or issues rated Baa represent average creditworthiness relative to other US municipal or tax- exempt issuers or issues.

Ba

Issuers or issues rated Ba demonstrate below-average creditworthiness relative to other US municipal or tax-exempt issuers or issues.

B

Issuers or issues rated B demonstrate weak creditworthiness relative to other US municipal or tax- exempt issuers or issues.

Caa

Issuers or issues rated Caa demonstrate very weak creditworthiness relative to other US municipal or tax-exempt issuers or issues.

Ca

Issuers or issues rated Ca demonstrate extremely weak creditworthiness relative to other US municipal or tax-exempt issuers or issues.

C

Issuers or issues rated C demonstrate the weakest creditworthiness relative to other US municipal or tax-exempt issuers or issues.

Note: *Moody's appends numerical modifiers 1, 2, and 3 to each generic rating category from Aa through Caa. The modifier 1 indicates that the issuer or obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category.*

Appendix 3: The Credit Rating Process

The rating process typically begins with a request for a rating by the institution, its financial advisor, or its underwriter. For institutions that are contemplating issuing a credit rating for the first time, Moody's offers three basic levels of rating service: Estimated Ratings, Indicative Ratings, and Public Ratings. Moody's also has a Strategic Financial Assessment service that offers a more in-depth assessment of an institution's financial strength, on a confidential basis.

An **Estimated Rating** provides institutions with quick feedback regarding an expected rating range and potential factors of credit focus. Typically, the lead analyst assigned to the credit reviews one to three years of audited financial statements, three to five years of attendance and membership data, and any other readily available information regarding the organization's mission, market presence, strategic plan, etc. At this point in the rating process, the lead analyst typically does not have extensive contact with management, although some clarification of unusual factors may be helpful. Estimated ratings often assist the institution and its financial advisor in determining how to proceed with the financing. They can be used to make an informed decision between issuing the debt on an unenhanced basis relying only on the credit of the institution, or using credit support such as municipal bond insurance or a bank letter of credit.

An **Indicative Rating** provides a precise indication of a rating level based on a full review of financial and market demand information, conversations with management (either in face-to-face meetings or over the telephone), and a review of draft legal documents. Indicative ratings are confidential, and Moody's feedback is shared only with the institution and its investment banker or financial advisor.

A **Public Rating** reflects full dissemination of Moody's rating, including a report detailing key credit factors supporting the rating. It can be public on an unenhanced basis, without credit enhancement from municipal bond insurance or a bank letter of credit. Alternatively, it can be published as an underlying rating in conjunction with either form of credit support, reflecting to potential bondholders the institution's credit quality exclusive of the credit support.

The rating and accompanying credit report are usually delivered via electronic vendor services such as Bloomberg, and are also available on Moody's website, www.moodys.com and other subscription-based services. If there is significant market interest, Moody's may issue a press release on the assignment of the rating. We also respond to questions by potential investors who are subscribers to Moody's services, including most major participants in the public finance market.

MEANING OF MOODY'S RATINGS

Moody's Municipal Ratings are opinions of the investment quality of issuers and issues in the United States tax-exempt markets. As such, these ratings incorporate Moody's assessment of the relative credit strength of these issuers and issues. The five factors outlined in this report are evaluated individually and in combination with the others in the context of the institution's ability and willingness to repay its debt. If an institution does not have any outstanding public debt, Moody's will assign an issuer rating, which reflects the institution's broad credit strength and is akin to an unsecured general obligation rating.

Moody's rating scale represents a consistent framework for ranking and comparing the relative risks of many debt issues. It typically includes a rating outlook of stable, positive, negative, or developing, indicating the likelihood of a change in the rating over the medium term of eighteen to thirty-six months.

Once a rating has become public, we generally maintain the currency and accuracy of the rating for the life of the bonds, as debt securities can be traded on the secondary market. We request financial statements and other supplemental information from the institution on an annual basis. The rating may be updated after review of this information or upon occurrence of a material event affecting the institution to reflect positive or negative changes in credit quality.

A **Strategic Financial Assessment** is a private report to senior management or board members that provides valuable feedback that can be used in formulating an institution's strategic or capital plan. It includes an analysis of our five rating factors, as well as a benchmarking report of financial and market ratios against peer and competitor institutions and an overview of broad industry and market factors potentially impacting the institution. A board or administration member of an institution typically contacts Moody's to initiate a Strategic Financial Assessment. The analytical process involved is similar to that of a private indicator, except that no specific rating level is assigned.

Moody's rating decisions are made by a committee comprised of the most experienced members of our not-for-profit team. When appropriate, the committee also includes representatives from other analytical areas at Moody's such as health care, housing, or government ratings. In preparation for committee, the lead analyst assigned to the institution prepares a thorough report that includes financial and market ratios, median and comparable ratios for like institutions, and a synopsis of the legal structure. This report forms the bedrock of the committee's rating decision, as we believe track record is an important measure by which to benchmark performance.

Moody's Rating Scale

	Long-term Debt	Variable Rate Demand Obligations	Notes	Commercial Paper
Investment Grade	Aaa	Long-term Rating/VMIG-1	MIG-1	Prime-1
	Aa1, Aa2, Aa3	Long-term Rating/VMIG-2	MIG-2	Prime-2
	A1, A2, A3	Long-term Rating/VMIG-3	MIG-3	Prime-3
	Baa1, Baa2, Baa3			
Speculative Grade	Ba1, Ba2, Ba3	SG	MIG-4	Not Prime
	B1, B2, B3			
	Caa1, Caa2, Caa3			
	Ca, C			

Note: 1) Variable rate demand obligations receive a dual rating combining the long-term debt (Aaa-C) rating and the VMIG 1-3 rating, which represents an evaluation of the risk associated with the demand feature of the bonds.

Beyond the historical quantitative analyses, committee also considers various qualitative issues, especially with regard to market position and fundraising. This discussion often focuses on institutional strategy and other aspects of the competitive landscape for private institutions that are more difficult to quantify, but remain vital to assessing credit quality.

Appendix 4: Moody's Private K-12 School Ratings By Rating Category (as of 1/1/05)

Institution	State	Rating
Hotchkiss School	CT	Aaa
Phillips Academy	MA	Aaa
Phillips Exeter Academy	NH	Aaa
St. Paul's School	NH	Aaa
Deerfield Academy	MA	Aa1
Groton School	MA	Aa1
St. Andrew's School	DE	Aa1
Woodberry Forest School	VA	Aa1
Peddie School	NJ	Aa2
Albuquerque Academy	NM	Aa3
Choate Rosemary Hall	CT	Aa3
Cranbrook Educational Community	MI	Aa3
Lawrenceville School	NJ	Aa3
Milton Academy	MA	Aa3
Park Tudor Foundation	IN	Aa3
Spence School	NY	Aa3
St. George's School	RI	Aa3
St. John's School	TX	Aa3
Taft School	CT	Aa3
Episcopal High School	VA	A1
Hill School	PA	A1
Middlesex School	MA	A1
Miss Porter's School	CT	A1
Blake School	MN	A2
Breck School	MN	A2
Brooks School	MA	A2
Ellis School	PA	A2
Loomis Chaffee School	CT	A2
Nightingale-Bamford School	NY	A2
Orchard School	IN	A2
St. Mark's School	MA	A2
Blair Academy	NJ	A3
California School of the Mechanical Arts	CA	A3
Church Schools in the Diocese of Virginia	VA	A3
Dexter-Southfield School	MA	A3
Greenwich Academy	CT	A3
Norwich Free Academy	CT	A3
Park School	MA	A3
Shady Hill School	MA	A3
St. Louis Priory School	MO	A3
St. Louis University High School	MO	A3
St. Paul Academy and Summit School	MN	A3
Concord Academy	MA	Baa1
St. John's High School	MA	Baa1
United Nations International School	NY	Baa1
Williston Northampton School	MA	Baa1
Gonzaga College High School	DC	Baa2
Latin School of Chicago	IL	Baa2
Oakwood School	CA	Baa2
Packer Collegiate Institute	NY	Baa2
Proctor Academy	NH	Baa2
Rippowam-Cisqua School	NY	Baa2
Rowland Hall - St. Mark's School	UT	Baa2
Xaverian Brothers High School	MA	Baa2
Berwick Academy	ME	Baa3
Lyndon Institute	VT	Baa3
Schools of the Sacred Heart	CA	Baa3
Waynflete School	ME	Baa3
Brewster Academy	NH	Ba1
Derryfield School	NH	Ba1
Marine Military Academy	TX	B3

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