

Higher Education Report

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Rating Agency Approach to UK University Credit Risk

Understanding differences in rating approach between different credit rating agencies is important because universities are increasingly expected to seek funding from capital markets for investments such as student accommodation or academic estate redevelopment. Long term bank lending may become less available at a time when the sector needs more borrowing to fund important infrastructure investments.

A credit rating is an opinion on the risk of default, in other words the risk of not being able to re-pay financial obligations when they become due.

Credit ratings can be given to individual institutions such as universities, or to specially structured financial instruments such as bonds secured on assets with income streams supported by, for example, rents underpinned by nominations agreements with universities.

Universities are independent entities with charitable status. An individual institution can be wound up if it becomes financially unviable, however UK universities benefit from a favourable system of regulation and support that to date has successfully prevented any notable defaults.

Because universities are not-for-profit organisations without shareholders requiring them to maximise financial returns, operating margins are typically low but gearing also tends to be low relative to the assets they own. Having said this, universities are increasingly operating in commercially driven areas such as competing for overseas students and private research. The introduction of domestic student fees and the potential for further increases to these fees, is likely to expose many institutions to greater commercial risk.

A university could be described as a hybrid organisation, a combination of a corporate entity facing commercial risks and a government-supported entity benefiting from regulatory and funding support, although not explicitly guaranteed by the UK Government.

Different assumptions and methodologies for assessing cash flow management and the degree of implied government support which would help prevent default in the first place and secure ultimate recovery of some or all of the investment if a default did occur, can therefore lead to different rating outcomes.

The three main rating agencies are; Standard & Poor's, Moody's, and Fitch.

Standard & Poor's, Moody's and Fitch have public ratings on several universities and specially structured off balance sheet financial instruments secured on student accommodation assets, which in turn are linked to the credit risk of the university associated with the accommodation.

There are some differences in the ratings outcomes between the agencies for certain university ratings, which in part reflects the differences in methodologies between the agencies.

Standard & Poor's

Standard & Poor's rating reflects the agency's opinion of the likelihood of a university not being able to meet an obligation on its due date. It does not, however, reflect directly the degree of loss suffered by a creditor in the event of default.

The likely amount of money an investor can expect to receive after a period of time can be assessed in a separate 'recovery' rating.

UK Government support is factored into Standard & Poor's rating, and this underpins the investment grade ratings that have typically been given to universities.

Having said that, measures of business performance such as operating margin, debt service requirements, future financial commitments and supporting liquidity arrangements are also given significant weight in the rating decision.

This results in a wider range of ratings for universities across the investment grade category.

Moody's

The Moody's rating reflects the likelihood of default and the probability of financial loss, and its rating approach tends to put more emphasis on the role of government support.

Moody's applies its joint default analysis (JDA) methodology for rating UK universities, which was first introduced a few years ago and resulted in rating upgrades for a number of government-related entities including UK universities.

This approach considers the university's own risk of default and the risk of default by the UK government.

Moody's then considers the default dependency between the two, and estimates the probability of government support.

With the strong likelihood of government support and the low probability of financial loss, Moody's ratings can be several rating notches higher than Standard & Poor's for certain institutions. This is particularly the case for financially weaker universities with concerns about underlying demand, which nevertheless are likely to have high credit ratings from Moody's because of its JDA approach.

There is less of a spread of ratings for UK universities given by Moody's, as the ratings tend to be clustered at the very high investment grade level. There is therefore less credit differentiation between institutions in terms of ratings as a consequence of Moody's analytical approach.

Fitch

Fitch's rating approach is similar to Standard & Poor's in that rating enhancement for regulation and Government support is provided to a "stand alone" rating for a particular university. This can lead to a greater spread of UK university ratings compared to Moody's.

Ratings between Fitch and Standard & Poor's can differ based on different interpretations of credit considerations relating to a particular institution.

Summary of differences

Potentially different rating outcomes given by different rating agencies will typically reflect the different methodologies between the agencies, which may become particularly pronounced in a somewhat unique sector such as the university sector.

In one sense the different approaches could be seen as complimentary, with the Standard & Poor's and Fitch ratings emphasising shorter term cash flow issues, while the Moody's rating emphasises the longer term recovery prospects and a greater consideration given in the rating to Government support.

The recent decision by Standard & Poor's to revise the rating outlook for the AAA rating for the UK from stable to negative, increases the prospect of a downgrade of the sovereign rating for the UK. Although both Moody's and Fitch have affirmed the stable outlook for the UK rating, if the sovereign rating was downgraded by Moody's this may have more of an impact on Moody's ratings for UK universities, as its ratings for UK universities are more explicitly linked to the UK sovereign rating.

Rating benefits

Having a good credit rating that sets out in a transparent way an institution's strong credit characteristics for investors should be an important element in a university's funding strategy.

Given the funding pressures faced by banks which have been the traditional lenders to the sector for many years, universities may also find it beneficial to take a more pro-active approach to developing relationships with other investors, such as pension funds and infrastructure funds, both in the UK and overseas.

A credit rating from one of the major credit rating agencies is not necessarily a prerequisite to secure funding from an institutional investor. Private placement funding can be agreed with an individual investor who will be typically looking to buy and hold the investment. A public bond issue is more likely to be traded between investors, and a public credit rating from one or more of the credit rating agencies typically is sought in order to facilitate this trading of bonds.

Having said that, obtaining a credit rating may help secure better costs of funding from investors that are less familiar lending to the sector, and may also help get better funding terms from banks as they are likely to become more discriminatory in terms of the different risk profiles associated with individual universities.

The pricing of university debt (both bank and bond) will, however, not just be a function of credit ratings but will reflect market conditions at the time, which takes into consideration other measures of risk.

Consideration of other types of risk

The credit rating is an opinion of the likelihood of default risk, and is supported by statistical data over a number of years. The likelihood of recovery of all or part of an investment following a default can also be assessed. Other types of risk, such as liquidity risk and market risk, are less straightforward to assess but are factored into the cost of debt at any particular point in time.

Liquidity risk relating to a specific issue can reflect a number of factors including size of issue, history of trading of that particular type of issue, the complexity of the issue structure, and the size of the investor community willing to acquire such issues. More generally liquidity risk can reflect a lender's cash needs to meet its future obligations, which can lead to a reduction in available credit and the cost of credit.

Market risk relates to volatility associated with the economic cycle including pricing and interest rate changes. It is typically of lesser consequence for investors that intend to buy and hold for longer periods of time, and for more stable securities where there is a strong degree of Government support.

Building Investor Relationships

Building and maintaining relationships with the investors both in the UK and overseas, will widen the potential sources of funding available to universities and may help secure better costs of funding. This could become increasingly important in the current funding climate, particularly if bank funding becomes more expensive and less readily available to meet the investment ambitions of certain universities.

A key feature on such a relationship will be the on-going communication of the credit strengths and weaknesses faced by a particular university through regular reporting and monitoring arrangements. Higher education institutions may wish to consider the increasingly competitive market for credit, and recognise that they may need to compete for funds from international investors not only with other universities in the UK and overseas, but also with other corporate sectors that already have developed relationships with a wide range of investors.

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