

## CREDIT OPINION

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## Howard University, DC

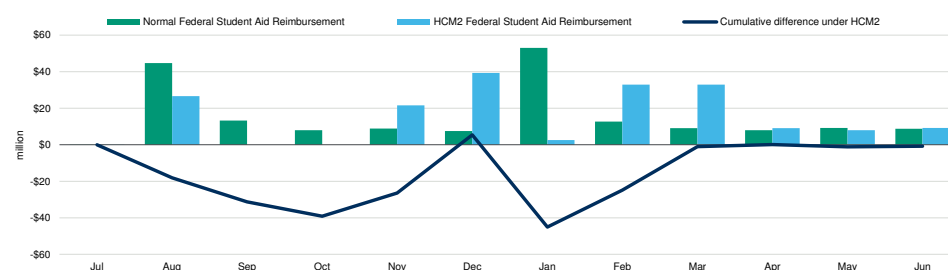
### Update to credit analysis

#### Summary

[Howard University's](#) fair credit profile (senior secured Ba1 negative) favorably incorporates Howard's federal funding, District of Columbia location, real estate value, and market reputation as a large Historically Black College and University. The rating is tempered by weak operating performance and revenue pressures from a patient care enterprise with high Medicaid exposure and a price sensitive student market. The university also has thin working capital and substantial deferred maintenance. The move to less favorable reimbursement status with the Department of Education for federal financial aid when combined with thin working capital means the university will be increasingly reliant on its operating line of credit as long as it remains on Heightened Cash Monitoring 2 status. Additionally, the university has significant fixed costs including debt service, pension and healthcare benefits.

Exhibit 1

**The pace of federal financial aid reimbursement under Heightened Cash Monitoring 2 status prompts Howard to make substantial draws on its \$100 million operating line of credit during several months of fiscal 2019**



Source: Howard University projections

#### Credit strengths

- » Ongoing federal support, accounting for 29% of fiscal 2018 revenue
- » Significant scale and program diversity with near \$775 million Moody's adjusted operating revenue base
- » Recent gains in student retention and graduation rates reflect strategy to recruit students who are academically and financially better suited to the university's programs
- » Demonstrated commitment by newer management team to move to operating equilibrium
- » Substantial real estate holdings with market value well above book value

## Credit challenges

- » Weak operating performance with 1.4% operating deficit in fiscal 2018
- » Thin operating liquidity compounded by move to Heightened Cash Monitoring 2 status and \$35 million increase in accounts payable and accrued expenses in fiscal 2018
- » Reduced but still substantial deferred maintenance which impacts student experience and academic programs as in the 2018 steam system failure
- » Material patient care exposure comprising 30% of operating revenue in 2018 with challenging payor mix
- » Considerable financial leverage combined with off balance sheet debt related to core student housing project debt
- » Debt structure includes demand debt and seasonal reliance on operating line of credit

## Rating outlook

The negative outlook reflects the sustained market challenges impacting Howard's student and patient care markets. Weak operating performance when combined with debt service coverage covenants continues to translate into limited bandwidth for revenue underperformance. While management continues to make strides in restructuring the university and invest in new programs, its progress will be tempered by the need to invest in many functions as well as facilities, given the very high age of plant. Given those funding needs, the ability to meaningfully improve operating liquidity, especially in light of the university's Department of Education Heightened Cash Monitoring 2 (HCM2) status, under which it administers financial aid on a reimbursement as opposed to advance basis.

## Factors that could lead to an upgrade

- » Significant and sustained improvement in operating performance
- » Material improvement in the hospital's competitive profile and operating performance or successful spin off of hospital
- » Ongoing gains in unrestricted liquidity including removal from HCM2 status and reduced reliance on operating line of credit
- » Ability to increase pace of addressing deferred maintenance while limiting increases in financial leverage

## Factors that could lead to a downgrade

- » Inability to meet or reduction in already thin headroom related to debt service coverage covenant requirement of 1.1x
- » Material decline in unrestricted liquidity or increase use of operating line of credit
- » Marked increase in financial leverage
- » Disruption in health care operations and/or cut in federal appropriations

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## Key indicators

Exhibit 2

Howard University, DC

	2014	2015	2016	2017	2018	Median: SG Rated Private Universities
Total FTE Enrollment	9,530	9,352	8,428	8,893	8,713	3,137
Operating Revenue (\$000)	799,596	796,598	793,934	762,962	781,165	82,044
Annual Change in Operating Revenue (%)	-4.4	-0.4	-0.3	-3.9	2.4	0.8
Total Cash & Investments (\$000)	549,529	559,885	565,838	616,538	658,861	136,521
Total Debt (\$000)	413,537	430,822	481,437	449,407	472,701	61,947
Spendable Cash & Investments to Total Debt (x)	1.0	1.0	0.9	1.1	1.1	1.5
Spendable Cash & Investments to Operating Expenses (x)	0.5	0.5	0.6	0.6	0.7	1.0
Monthly Days Cash on Hand (x)	163	172	193	208	216	248
Operating Cash Flow Margin (%)	3.7	3.9	11.7	5.2	6.7	12.6
Total Debt to Cash Flow (x)	13.9	14.0	5.2	11.3	9.1	5.0
Annual Debt Service Coverage (x)	0.9	0.8	2.3	0.9	1.3	2.3

Source: Moody's Investors Service

## Profile

Howard University is a private not-for-profit historically black college and university in Washington, D.C. with approximately 9,100 full-time equivalent students and approximately \$775 million in operating revenue. Comprised of 13 schools and colleges, it is known for its undergraduate health sciences, business, marketing, and communication programs as well as its graduate programs in business, law, and medicine. The university owns the Howard University Hospital where medical students do their internships, residencies, and/or fellowships and where members of its faculty practice provide clinical services. The university produces more on-campus African-American Ph.D. recipients than any other university in the United States and has several subsidiaries engaged in international initiatives.

## Detailed credit considerations

### Market profile: fundamental challenges for academic and health care enterprises

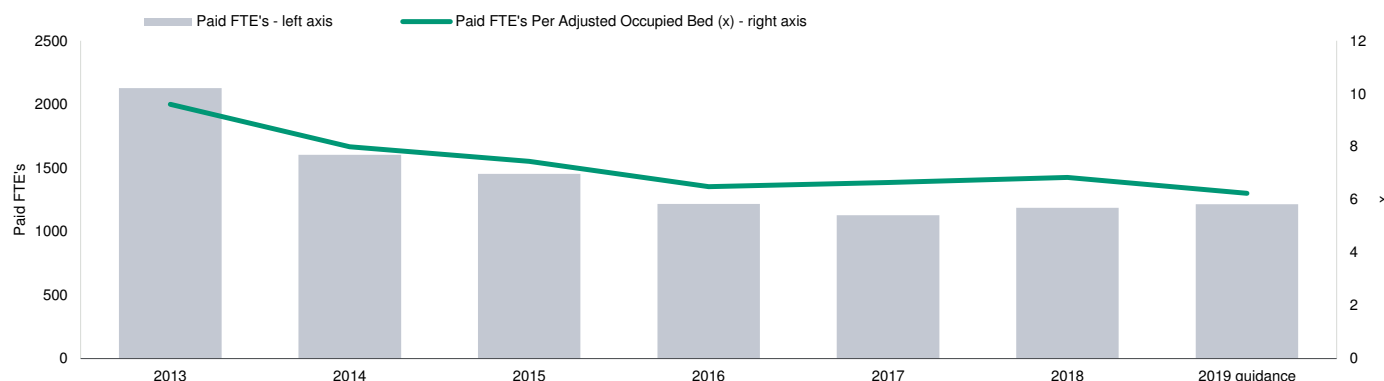
Howard will continue to confront fundamental challenges in both its core academic programs and its hospital that will make it difficult to maintain fiscal balance without effective budgetary controls. Although Howard is federally chartered and is one of the largest of the Historically Black Colleges and Universities, the university has struggled to maintain fiscal balance while providing a high quality education and medical care for price-sensitive student and patients.

Net tuition revenue and auxiliary revenue has declined as management refocused its recruitment efforts, instituted new policies on collections, outsourced some auxiliary functions and rightsized operating expenses. Net tuition revenue came in at \$144 million in fiscal 2018, down from \$155 million in 2015. Enrollment edged upward in fall 2018, aided by improved retention rates from recently admitted classes.

Despite its important role in the district, the hospital is financially challenged by a myriad of issues including a high Medicaid population, tightening reimbursement, aging facilities, increasing market consolidation and intensifying competition, and past disruptions resulting from changes in hospital leadership.

Exhibit 3

### Labor utilization at Howard University Hospital continues favorable trend in fiscal 2019 aided by position control and increase in patient volume in rapidly shifting market



Fiscal year data with 2019 guidance on based on FYTD results through October 2018

Source: Howard University

The university engaged Paladin Healthcare Management in fall 2014 to implement an operational improvement program. Revenue cycle and information technology issues in fiscal 2018 led to a revenue miss for the year. These issues contributed to a \$10 million year over year decline in operating results and weighed on university-wide operating performance. Based on management reports the net patient service revenue should increase in fiscal 2019, aided in part by the imminent closure of Providence Hospital which had approximately 9% market share of DC acute inpatient admissions in fiscal 2017.

Howard has a long-standing history of federal support, which enables it to offer a higher cost and quality academic program than would be supported by its own independent pricing ability. The federal appropriation is \$236 million for fiscal 2019, up from \$232 million in the prior year.

#### Operating performance: weak operating performance with critical focus on expense management

With soft prospects for revenue growth, Howard will be challenged to manage through a sustained period of careful expense management without harming its reputation and programmatic strategies. Fiscal 2018 results produced a deficit 1.4% operating margin. The operating cash flow margin 6.7% covered debt service by a limited 1.3x as hospital results weighed on broader university gains. Projections for fiscal 2019 show close to break-even results. Importantly, management has stated that to fulfill its mission as an academic medical center, it does not need to own a hospital and will seek various approaches to spinning off the hospital operations. The potential credit impact of any form of hospital restructuring will be dependent on the specific form and terms of the new relationship.

Weak operating performance has translated into limited capital renewal at the university and university continues to see alternative to enhance its ability to renew facilities. In a credit positive move, management has committed to not use any of those one time gains to plug operations. Instead, the gains will primarily be used to make capital investments or debt reduction. Asset monetization is one potential source of capital renewal funding being explored by the university.

#### Wealth and liquidity: substantial wealth although operating liquidity remains thin with periodic reliance on line of credit

With total cash and investments of \$659 million as of June 30, 2018, Howard has substantial wealth relative to its size, but 32% of the total is subject to donor or grantor restrictions and is not, therefore, readily available to support operations. Moody's adjusted total cash and investments does not include the Federal term endowment. The university saw a \$35 million increase in accounts payable and accrued expenses on June 30, 2018 versus the prior year. Thin operating liquidity increases the university's reliance on its operating line of credit.

#### LIQUIDITY

The university's liquidity is weak especially given its negative operating performance history and exposure to the more volatile patient care revenue. While the fiscal 2018 monthly days cash on hand of 218 days seems substantial for the rating category, this amount was higher due to a \$35 million increase in accounts payable and accrued expenses during the year.

The university maintains a \$100 million line of credit to manage seasonal working capital needs and any potential timing delays or reductions in federal funding. The line of credit is secured by the same tuition revenue and mortgage pledge supporting the Series 2016 reimbursement agreement discussed below.

### **Leverage: substantial leverage not including P3 student housing debt combined with substantial deferred maintenance burden**

The university's leverage is already relatively elevated, which will remain a key credit challenge as the university seeks to tackle material deferred maintenance that is negatively impacting its strategic position. The university had total debt of \$473 million as of June 30, 2018, when it had no amounts outstanding on its line of credit. The primary components are the taxable Series 2016 bonds (\$160 million), the Series 2011 A and 2011 B bonds (\$252 million) and \$55 million of capital leases.

Further, our calculation of total debt does not include debt associated with two student housing facilities financed through legally distinct entities under the terms of a ground lease or service concession agreement as part of the university's real estate strategy. Combined these two projects would increase total debt by approximately \$250 million. While the net revenue performance of the projects has been sound to date, project underperformance could impact the university's credit profile and degree of leverage depending on its strategic responses. Favorably, the partners are able to market potential vacant units to non-Howard affiliated tenants.

The university is also deploying long term partnerships to address historic underinvestment in central heating and information technology infrastructure. Howard is insured for the remediation of damage and losses sustained through its January 2018 winter weather emergency and steam system failure. Management estimates the total claim could be in the \$110 million range. Advance reimbursements for its insurer has led to more limited impact on liquidity from the emergency and its aftermath.

### **DEBT STRUCTURE**

Of total debt of \$473 million at fiscal year 2018, 74% was fixed rate. The \$160 million of variable rate demand debt exposes the university to interest rate and potential demand risk. Under some scenarios the reimbursement agreement would allow for a multi-year term out period. Affirmative covenants include the commitment to redeem \$8.6 million in calendar 2019. The agreement includes a rating trigger, under which a rating on any debt below BB by S&P or Ba3 by Moody's would be an event of default. The reimbursement agreement also includes a most favored nation clause that would incorporate potential future covenants.

### **LEGAL SECURITY**

Howard's obligation to repay [Barclays Bank PLC](#) under the Reimbursement Agreement supporting the Taxable Bonds, Series 2016 is secured by pledged revenues including student tuition and fees and a mortgage pledge on certain real estate with an executed mortgage equal to at least \$237.4 million. Events of default under the agreement include a move to an unenhanced debt rating below BB by S&P or Ba3 by Moody's. The secured Series 2016 debt is rated Ba1, stable, reflecting the additional security provided by the mortgage pledge relative to the Series 2011A and 2011B bonds, rated Ba2 stable.

The Series 2011A and 2011B Revenue Bonds are unsecured general obligations, additionally secured by a debt service reserve fund and other funds created under the indenture. The debt service reserve fund for the Series 2011A bonds only, holds approximately \$13 million and was established at 50% of maximum annual debt service. There is a rate covenant of 1.1 times and an additional bonds test that requires a certificate of the university's chief financial officer concluding that projected debt service coverage will be at least 1.1 times upon issuance and, on a pro forma basis for the following fiscal year. If the debt service coverage falls below 1.1 times, the university will not be in default as long as it hires a consultant and does not drop below 1 times coverage as defined in the Loan Agreement.

### **DEBT-RELATED DERIVATIVES**

None.

### **PENSIONS AND OPEB**

Howard's defined benefit pension plan and post retirement benefits add considerable debt-like liabilities to its credit profile. The substantial \$657 million projected benefit obligation for Howard University's noncontributory defined benefit pension plan was 82% funded at June 30, 2018. Fiscal 2018 contributions were \$11 million, or 1.4% of operating expenses.

Howard provides post-retirement medical benefits and life insurance to certain employees. As of June 30, 2018, the unfunded projected benefit obligation was \$48 million.

**Governance and management: focus on operating stability requires investments in institutional control**

Stabilization of senior management and demonstration of effective implementation of financial and operational strategies will be critical as the leadership remains focused on achieving operating stability in the face of potential revenue declines and constrained resources. The current president began his role in July 2014 and has recruited and replaced most senior officers. Fiscal 2016 was the first year when the new management team had substantial control of the budget. While operating performance has generally improved making gains on earlier periods of under investment in IT, facilities and institution controls will take time to meaningfully correct in an environment of constrained revenue and liquidity. These constrained resources combined with the need to invest in facilities and institution control support the university fair strategic positioning.

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