

CREDIT OPINION

12 November 2016

Update

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Reed College (OR)

Update - Moody's Affirms Reed College's (OR) Aa2; Outlook Stable

Summary Rating Rationale

Moody's Investors Service has affirmed Reed College's Aa2 long term debt rating with a stable outlook. We have also affirmed the Aa2/VMIG 1 ratings on the Series 2008A bonds, with the short term rating supported by a standby bond purchase agreement with [Wells Fargo Bank N.A.](#) Total rated debt, all issued through the Oregon Facilities Authority, is \$79.2 million.

The Aa2 rating favorably incorporates Reed's steady student demand as a liberal arts college with an increasingly national brand, contributing to excellent strategic positioning. The college has generated consistently strong operating cash flow and has sizeable financial reserves and very good liquidity. Leverage is comparatively low and manageable. Offsetting considerations include an ever more competitive environment as Reed increasingly competes against a broader pool of well-resourced colleges. Reed's relatively small scale with moderate prospects for net tuition revenue growth will likely require enhanced philanthropy and growth in endowment to support a comparatively high cost business model.

Credit Strengths

- » Total cash and investment in excess of \$540 million support Reed's excellent strategic positioning
- » Sound student market position is supported by stable enrollment prospects as a nationally recognized liberal arts college accepting under 35% of applicants
- » Operating performance is consistently strong, albeit somewhat variable due to gift flow
- » Modest amount of outstanding debt relative to financial reserves provides some capacity for additional borrowing

Credit Challenges

- » Reed is increasingly competing against a broader pool of universities, some of which are better resourced
- » A high cost business model and relatively small scale provide little flexibility to quickly adjust operations if necessary
- » Philanthropy is low relative to peer institutions

- » High allocation to hedge funds and private equity investments limits investment portfolio liquidity and requires significant oversight

Rating Outlook

The stable outlook reflects our expectations that student demand will remain sound with consistent growth in net tuition per student in the 3-4% range, that the college will gain some traction in its prospective fundraising campaign, and that additional borrowing will remain modest in the \$20-\$30 million range.

Factors that Could Lead to an Upgrade

- » Substantial increase in cash and investments, outpacing peer growth
- » Material strengthening of student demand and philanthropy

Factors that Could Lead to a Downgrade

- » Below peer growth in cash and investments over a multi-year period leading to relative credit weakening
- » Inability to sustain strong operating cash flows
- » Borrowing materially above projected levels

Key Indicators

Exhibit 1

REED COLLEGE, OR

	2012	2013	2014	2015	2016
Total FTE Enrollment	1,358	1,378	1,359	1,416	1,397
Operating Revenue (\$000)	87,160	83,698	93,040	93,266	112,992
Annual Change in Operating Revenue (%)	6.6	-4.0	11.2	0.2	21.1
Total Cash & Investments (\$000)	482,224	533,448	583,370	582,522	545,945
Total Debt (\$000)	84,523	84,397	81,873	80,644	79,165
Spendable Cash & Investments to Total Debt (x)	4.0	4.5	5.2	5.3	4.9
Spendable Cash & Investments to Operating Expenses (x)	4.2	4.7	5.0	4.9	4.1
Monthly Days Cash on Hand (x)	630	550	544	455	405
Operating Cash Flow Margin (%)	22.2	11.7	17.6	15.3	26.1
Total Debt to Cash Flow (x)	4.4	8.6	5.0	5.6	2.7
Annual Debt Service Coverage (x)	15.6	4.2	3.6	4.2	8.5

FY 2016 operating revenue includes unusually large gift flow bolstering the annual change in operating revenue as well as operating cash flow margin, annual debt service coverage, and improving debt to cash flow.

Source: Moody's Investors Service

Detailed Rating Considerations

Market Profile: Wealthy Liberal Arts College Increasingly Competing Nationally

Reed's increasingly national brand recognition as a prestigious West Coast liberal arts college should sustain steady enrollment. Continued investment in the campus and programs made possible by accumulated reserves and philanthropy support the college's excellent strategic position.

The college is near target enrollment of approximately 1,400 students. Reed is increasingly competing with a broader array of institutions as its geographic reach has expanded beyond the coasts and into the middle part of the country. This is reflected in a

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declining yield rate on accepted students, dropping to around 20% in fall 2016, and some moderate year to year volatility in the entering class.

The college has increased outreach strategies, invested in higher demand programs such as computer science, math, and environmental studies, and made renovations to its residence halls, sports center, and science facilities to sustain its competitive position. It has also restructured its financial aid packages to be more competitive, meeting full need inclusive of student loans. Tuition discounting is reasonably forecast to stabilize in the mid 30% range, with projected 3-4% growth in net tuition per student incorporated in the college's five year financial plan.

Reed's philanthropy, while very good within the broader context of the higher education landscape, is below many of its competitors. Three-year average gift revenue of under \$18 million compares to a median of nearly \$30 million for all Aa-rated small colleges. This is a potential longer term competitive disadvantage. Favorably, the college is in the early planning stages for a new campaign, with goals yet to be determined, that provides prospects for improved levels of gift giving.

Operating Performance: Consistently Healthy Operating Cash Flow with Moderate Prospects for Revenue Growth

With reasonable expectations for tuition revenue growth and gift flow as the college begins planning for a campaign, operating performance should remain sound. The college relies on tuition revenue for approximately 55% of its budget, investment income for a quarter, and gifts and other sources for the remainder. Reed's steady state operating cash flow margin has been in the 15% range in recent years, bolstered to over 25% in FY 2016 due to unusually strong gift flow. We expect some continued variability in performance based on the timing and nature of gift receipts.

Reed operates under a high cost business model based on small classes and intensive faculty interaction. A 1999 board approved resolution has a stated goal of a 10:1 faculty student ratio. Combined with comparatively small scale, with an operating budget of under \$100 million, this business model provides Reed limited flexibility to adjust quickly to any adverse changes in its market and business conditions. The college's longer term flexibility is more substantial given its wealth levels and liquidity.

Over the outlook period, more limited growth in investment income to support operations will be a budget pressure. Reed continues to make progress on reducing its own budgeted endowment spending rate down to 5.2% in FY 2017, ultimately to reach 5% by FY 2021. However, investment returns were below many peers in FY 2016, at -5.4%. This weak performance will negatively impact the budget over the next several years absent stronger investment performance in the current fiscal year.

Wealth and Liquidity: Strong Financial Resources and Excellent Liquidity Relative to Commitments

The college's strong relative wealth remains the primary factor supporting the Aa2 rating. Total cash and investments are in excess of \$545 million, a substantial 70% spendable over a medium term time frame. Spendable cash and investments would cover over four years of operating expenses.

The potential for relative weakening of its credit profile compared to Aa2-rated peers due to weaker investment performance and lower gift revenue is a longer term credit risk. In addition to lowering its spending rate and beginning to plan for its next campaign, the college is examining various aspects of its endowment management, including asset and manager allocations. The college has comparatively high allocations to alternative investments which limits its monthly liquidity as a percent of total cash and investments to just 17% relative to the Aa-median of 29.6%. The college has identified an additional over \$20 million of non-publicly traded funds that could potentially be released monthly, which would improve this ratio to 22%. As of September 30, Reed's had a 24% allocation to absolute return and 30% to private equities and illiquids including real assets. Reed also has a comparatively large number of partnerships, 70 private equity and 15 hedge funds, adding complexity to the college's endowment management and manager oversight. Endowment management is provided by investment committee, an external consultant, and a senior investment officer reporting to the Vice President and Treasurer of the College.

LIQUIDITY

Liquidity remains healthy relative to commitments, with approximately \$95 million of unrestricted cash and investments that could be liquidated within a month. This provides over 400 days cash on hand. However, liquidity has declined in recent years, from over 630 monthly days cash on hand in 2012, and material further deterioration could also begin to negatively pressure credit quality.

The college's investment strategies, rather than externally imposed use restrictions, are the key limiting factor to liquidity. As a result, improvement in liquidity is in part under the control of management and the board.

Unfunded commitments total over \$86 million and are a potential call on liquidity, depending on timing of calls as well as cash flow from existing investment strategies.

Leverage: Historically Low Leverage with Manageable Future Debt Plans

Reed's \$79 million of outstanding debt is modest compared to its balance sheet reserves, and manageable from an operating perspective, with debt service consuming less than 4% of the budget.

Management has identified the potential for a \$20-\$30 million borrowing within the next two years for a new residence hall. This would expand residential capacity on campus and is expected to be partially self supporting.

DEBT STRUCTURE

Reed has two series of bonds outstanding: \$40 million of fixed rate Series 2011 bonds and \$39 million of variable rate Series 2008 bonds supported by a stand-by bond purchase agreement (SBPA) with [Wells Fargo Bank N.A.](#) Debt is amortizing through 2041, and modestly escalating, with principal payments on the Series 2011 bonds commencing in 2026. There are various financial covenants associated with the bonds and SBPA, including an unrestricted liquid asset covenant and a debt service coverage covenant. The college has significant headroom under both covenants.

DEBT-RELATED DERIVATIVES

Reed has one \$16.65 million interest rate swap to partially hedge the interest on the Series 2008 bonds. As of fiscal year end 2016, the college recorded a \$2 million swap liability.

PENSIONS AND OPEB

Reed has a nearly \$30 million unfunded postretirement benefit liability for a plan that was closed as of 2006. This liability is manageable in the broader context of Reed's credit profile. The college operates a defined contribution pension plan, with an annual expense of \$3.5 million as of FY 2016, also manageable relative to cash flow.

Governance and Management: Excellent Strategic Position Benefits from Good Planning and Investments

Management has demonstrated an ability to adjust its programs, facilities, and outreach to sustain its competitive position. Financial planning is sound, supported by five year financial modeling with realistic assumptions. The college has strong external disclosure practices.

Legal Security

Loan repayments are unsecured general obligations of the college.

Obligor Profile

Reed College, also known as The Reed Institute, is a liberal arts college enrolling approximately 1,400 students. It is located in Portland, Oregon, and was founded in 1908.

Methodology

The principal methodology used in this rating was Global Higher Education published in November 2015. The additional methodology used in the short term rating was Variable Rate Instruments Supported by Conditional Liquidity Facilities published in March 2015. Please see the Rating Methodologies page on www.moody.com for a copy of these methodologies.

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REPORT NUMBER

1047766