University of San Diego, CA

Update to credit analysis

Summary
The University of San Diego’s CA (USD) credit profile (A1 stable), reflects its very good strategic position as a Catholic university with diverse undergraduate, graduate and professional programming and an attractive campus in San Diego. These are critical given USD’s high operating reliance on student charges and the highly competitive student market driving rising tuition discounting that will pressure future growth in net tuition revenue. The university’s well integrated long-term financial and strategic planning, strong cash flow, and strengthened fundraising have contributed to a solid cash and investment cushion with ample liquidity. USD’s significant self-funding of important capital projects has resulted in low leverage and a high degree of debt affordability compared to its peers.

Exhibit 1
Strong operating cash flow contributing to growth in spendable financial reserves

Fiscal year ending June 30
Source: Moody’s Investors Service
Credit strengths
» Long-term trend of growing reserves with no debt issuance results in a very low leverage, with spendable cash to debt of 3.9x
» Prudent fiscal management with careful expense management leads to robust 19% cash flow
» Liquid reserves provide strong cushion with 451 monthly days cash on hand
» Attractive location and campus with healthy reinvestment and diverse programming contribute to solid net tuition per student growth

Credit challenges
» High revenue dependence on student charges in an extremely competitive student market
» Commitment to affordability will slow tuition growth constraining ability to implement new initiatives
» Exposure to 58% variable rate debt and counterparty risk through direct placement and swap require careful debt and liquidity management

Rating outlook
The stable outlook reflects our expectation the university will maintain favorable operating cash flow in the 15-20% range despite slower growth in net tuition revenue expected in fiscal 2019 and 2020.

Factors that could lead to an upgrade
» Substantial growth of cash and investments outpacing that of peers and providing stronger cushion of operations
» Consistently stronger philanthropy to support growing financial aid and capital projects

Factors that could lead to a downgrade
» Trend of declining operating cash flow coupled with deteriorating liquidity
» Weaker operations from stagnating enrollment or net tuition revenue pressure
# Key indicators

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<td>Total FTE Enrollment</td>
<td>7,721</td>
<td>7,612</td>
<td>7,746</td>
<td>8,107</td>
<td>8,212</td>
<td>8,212</td>
<td>4,604</td>
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<td>Operating Revenue ($000)</td>
<td>320,432</td>
<td>331,109</td>
<td>345,066</td>
<td>362,720</td>
<td>372,659</td>
<td>372,659</td>
<td>185,094</td>
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<td>Annual Change in Operating Revenue (%)</td>
<td>2.7</td>
<td>3.3</td>
<td>4.2</td>
<td>5.1</td>
<td>2.7</td>
<td>2.7</td>
<td>2.6</td>
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<tr>
<td>Total Cash &amp; Investments ($000)</td>
<td>622,139</td>
<td>634,271</td>
<td>625,143</td>
<td>707,277</td>
<td>787,375</td>
<td>787,375</td>
<td>382,221</td>
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<td>Total Debt ($000)</td>
<td>171,858</td>
<td>167,661</td>
<td>162,465</td>
<td>159,467</td>
<td>155,693</td>
<td>205,693</td>
<td>144,757</td>
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<td>Spendable Cash &amp; Investments to Total Debt (x)</td>
<td>2.7</td>
<td>2.8</td>
<td>2.8</td>
<td>3.3</td>
<td>3.9</td>
<td>2.9</td>
<td>1.8</td>
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<td>Spendable Cash &amp; Investments to Operating Expenses (x)</td>
<td>1.6</td>
<td>1.6</td>
<td>1.5</td>
<td>1.6</td>
<td>1.8</td>
<td>1.8</td>
<td>1.4</td>
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<td>Monthly Days Cash on Hand (x)</td>
<td>399</td>
<td>383</td>
<td>359</td>
<td>390</td>
<td>451</td>
<td>451</td>
<td>355</td>
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<td>Operating Cash Flow Margin (%)</td>
<td>19.2</td>
<td>18.3</td>
<td>16.7</td>
<td>18.2</td>
<td>18.7</td>
<td>18.7</td>
<td>14.1</td>
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<tr>
<td>Total Debt to Cash Flow (x)</td>
<td>2.8</td>
<td>2.8</td>
<td>2.8</td>
<td>2.4</td>
<td>2.2</td>
<td>3.0</td>
<td>4.9</td>
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<tr>
<td>Annual Debt Service Coverage (x)</td>
<td>5.4</td>
<td>5.4</td>
<td>5.3</td>
<td>6.2</td>
<td>6.6</td>
<td>6.6</td>
<td>2.7</td>
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Pro forma column includes planned borrowing of $50 million in fiscal 2020.
Source: Moody’s Investors Service

# Profile

University of San Diego is a mid-sized private Catholic comprehensive university located in San Diego, California. It reported over 8,200 students in fall 2018 and $373 million in operating revenue in fiscal 2018.

## Detailed credit considerations

### Market profile: excellent location and diversified programming support solid demand
USD’s diverse programming and urban location in economically vibrant San Diego (county rated Aaa stable and city rated Aa2 stable) and its Catholic mission will contribute to stable undergraduate demand and enrollment growth in sought after graduate programs. Growth of net tuition revenue will grow at slower rates due to fierce competition with growing financial aid, including tuition discounting.

Overall, we expect total enrollment, currently at 8,212 FTEs, will rise slowly, largely as graduate enrollment continues the growth trend, while undergraduate attendance eases following record class sizes in recent years, and before the completion of a new business school. Enrollment challenges at some of the graduate schools in earlier years overall were reversed, with a 17% rise in graduate FTE’s over the three years through fall 2018, due to growth in programs such as the School of Leadership and Educational Sciences and the School of Nursing, as well as a stabilization in law school enrollment (see Exhibit 2).
Operating performance: continued strong margins through conservative budgeting and careful expense management
USD will maintain excellent operating performance with surplus operations generating cash flow above 15% margins through conservative budgeting and careful expense management. Fiscal 2019 results are being pressured due to increased financial aid, however, margins are expected to remain strong through expense controls.

Operating margins averaged a high 11% over the three years through fiscal 2018 while operating cash flow margins were above 18% in the last several years, which is well above the A1-rated private university median of 13.8%. These strong margins provide three year average debt service coverage of a high 6.0x for fiscal 2016 through fiscal 2018, double that of its peers at 3.0x.

With student charges representing a high 81% of operating revenue and expectations for lower net tuition revenue growth, USD's demonstrated expense discipline and contingency budgeting are important credit strengths.

Wealth and liquidity: growing cash and investments support capital program and operations
Cash flow, investment returns and philanthropy will continue to build USD's financial reserves cushioning debt and operations. However, growth will likely slow compared to recent years given plans to devote more resources derived from operations to capital expenditures. Spendable cash and investments rose steadily by 27% over the past five years to $602 million, providing 1.8x cushion of operations which is on par with A1-rated peers. Fundraising has strengthened with USD successfully completing its comprehensive campaign in the summer of 2018, raising $317 million against the $300 million goal. However, relative to the university's size, gifts per student are lower than key competitors, measuring $3,934 on average compared to the $7,571 median of A1-rated institutions.

A concentrated effort to grow and retain a quasi-endowment through prescribed annual contributions since 2003 supported USD's growing unrestricted reserves. Over the next five years, these contributions will fund capital expenditures, which will slow growth in unrestricted reserves over the medium term.

Liquidity
Monthly liquidity will continue to provide a solid cushion for operations but is likely to grow more slowly. As of June 30, 2018, USD had $384 million of monthly liquidity or 451 days cash which is more than sufficient to cover any capital calls or other liquidity needs. USD also has an $8 million line of credit with Wells Fargo for working capital, though the university has not drawn on this line in many years.

Leverage: favorable leverage underpinned by conservative bias and strong self-funding
The university's policy of investing extensively in its capital plant, largely self-funded through operations and gifts, will continue to support its low leverage position, even with new borrowing planned this year. The multi-pronged funding approach to capital and low debt issuance along with growth in reserves results in strong 3.9x cushion of debt. While a planned bond issuance of $50 million in fiscal 2020 will reduce the cushion, it will remain strong at 2.9x, slightly better than the 2.5x of A1-rated private university peers. Debt affordability is very strong, with fiscal 2018 debt to cash flow of 2.2x, and 3.0x on a pro forma basis compared to the much higher 5.4x median of A1-rated private universities.
USD’s multi-year capital plan, the Renaissance Plan, includes $190 million of major projects through fiscal 2023 and will be funded through current operating revenues, gifts, and a $50 million bond issue targeted this calendar year. The plan includes a $67 million business school, a $20 million Learning Commons, and major upgrades to 4 existing buildings including a library and academic/residence halls. Construction of the business school was advanced by two years due to receipt of a $20 million gift. An additional $60 million for ongoing deferred maintenance will be funded through the annual operating budget over ten years.

**Debt structure**

The university’s regularly amortizing and relatively level debt service provide operating and budgeting predictability. USD’s approximately $90 million outstanding of variable rate 2015 direct placement bonds with US Bank present very modest remarketing and acceleration risk, given excellent headroom to covenants and strong monthly liquidity. The bonds mature in October 2045, while the direct placement expires in July 2022.

Events of default that could lead to immediate acceleration include failure to maintain at least a Baa3 rating on rated debt or failure to meet a debt service coverage covenant of at least 1.25x, amply met by 4.2x at June 30, 2018. There is also an additional bonds test that requires unrestricted and temporarily restricted net assets to equal at least 200% of pro forma debt to issue, which the university well exceeded at fiscal 2018 with 767% coverage.

**Debt-related derivatives**

The university’s swap exposure is manageable. USD has a LIBOR-based swap agreement with Société Générale in conjunction with its 2015 Direct Placement bonds for a current notional amount of $89 million. As of January 2, 2019, the mark-to-market was negative by $22 million. There are no collateral posting requirements at the current rating. The swap terminates on October 1, 2045, when the bonds mature.

**Pensions and OPEB**

The university’s retirement plans present minimal credit risk, and are manageable within the scope of its operations. The annual expense for the defined contribution retirement plan of $16.9 million is a moderate 5.2% of operating expenses.

**Governance and management: strong fiscal stewardship; excellent planning**

The university’s strategic positioning is very good, with in-depth and integrated strategic, capital and financial planning. Continual reinvestment in facilities and programming through a wide variety of funding sources bolsters its competitive position. USD’s forward-looking and fiscally disciplined management team enhance its long term financial stability and bolsters operating performance. Prudent fiscal management practices include integrated strategic, financial and capital planning, annually budgeted capital and operating allocations, regular benchmarking and self-assessment, and conservative endowment spending and budgeting assumptions.

The president, who joined USD in August 2015, and senior management and the board have finalized thorough strategic planning and master planning initiatives. New members of the leadership team bring a mixture of deep internal and external experience to their roles and include a VP of Institutional Effectiveness and Strategic Initiatives with long-term experience at USD and a new Provost, both hired in 2017, and a new VP of University Advancement, hired in summer 2018.
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