

SPECIAL COMMENT

The Sequester Series: Limited Impact on US Universities and Related Not-for-Profit Organizations

Research Institutes and Universities Most Heavily Affected by Sequestration, But Are Equipped to Manage Cuts

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This report is one of a series of articles to focus on the impact of federal sequestration on US public finance sectors. In this article, we discuss the impact on not-for-profit universities and related not-for-profit organizations. In other articles, we examine the challenges the sequester poses for states, local governments, not-for-profit healthcare institutions, and the housing sector.

Summary

Federal budget sequestration mandates approximately \$1.2 trillion in spending cuts to be phased in over the next 10 years, \$85 billion of which will occur over the next six months. Though there have been discussions and proposals, and even official budgets approved in both the House and the Senate, both political parties and the White House are not yet close to agreeing on budget terms that might alter deficit reduction measures prescribed in sequestration.

The vast majority of rated US universities and not-for-profit organizations (NFPs)¹ face only minimal effects from the sequester in fiscal year (FFY) 2013. A small one percent of rated issuers, predominantly standalone research institutes², face a potential revenue loss of greater than 3% in the first year of sequestration (see Exhibit 2). While some of these cuts will be restored through growth in funding in subsequent fiscal years, the restoration will be slow, and although federal sequestration is not a major disruptor for US higher education, it will contribute to existing revenue pressures. Weakening revenue growth is a primary driver for Moody's negative industry outlook for 2013³ and is forcing universities and not-for-profit organizations to identify alternative funding sources and to intensify cost containment.

¹ In this report, NFPs refers to not-for-profit organizations. This group excludes hospitals and other health care organizations which are discussed in a separate section

² In this report, standalone research institutes refers to the sub-sector of not-for-profit organizations which are non-degree granting and whose primary purpose is research

³ Moody's: "[US Higher Education Outlook Negative in 2013](#)", January 16, 2013 (148880)

Despite these challenging business conditions, the long term demand for higher education and research discoveries remains strong and we anticipate the large majority of rated organizations will continue to have a stable outlook⁴ for their individual ratings, for the following reasons:

- » Long-term demand for higher education and research services remains high
- » Balance sheets remain comparatively strong in this sector, allowing borrowers to absorb modest revenue disruptions
- » Universities affected by sequestration cuts have high revenue diversity and expense flexibility
- » Most research universities⁵ have improving leadership and management teams able to contain costs and seek revenue opportunities to offset federal funding cuts

EXHIBIT 1

Sequestration's Impact on US Universities and Not-for-Profit Organizations and Mitigating Factors

Federal Program	Sequestration Cut	Sub-Sector Affected	Risk Mitigant
Federal Research Funding (largely from NIH and NSF)	5%	<ul style="list-style-type: none"> » Research universities » Research institutes 	<ul style="list-style-type: none"> » Expense flexibility through ability to reduce or delay purchasing decisions, reduce staff, and slow down spending of federal grants » Ability to replace federal funding with gift revenues and corporate grants
Medicare	2%	<ul style="list-style-type: none"> » Academic Medical Centers* » Universities with patient care revenues 	<ul style="list-style-type: none"> » Large and diversified revenue sources » Proportion of revenue at risk is small (estimated revenue losses of less than 0.5%)
Pell Grant	0%	<ul style="list-style-type: none"> » Lower rated universities » Historically Black Colleges and Universities (HBCUs) 	<ul style="list-style-type: none"> » Pell Grants are expected to remain fully funded into FFY 2014 with less than expected (\$2 billion) reductions in FFY 2015**
Student Loans	0%	<ul style="list-style-type: none"> » HBCUs and professional schools 	<ul style="list-style-type: none"> » Impact through increase in loan origination fees is minimal

*Academic Medical Centers derive revenues from patient care from affiliated or owned hospitals, not all universities with patient care revenues are classified as Academic Medical Centers⁶

**Congressional Budget Office estimates

- » **Standalone Research Institutes Most Impacted by Sequestration.** Independent research institutes and research universities will face reductions in grants primarily from the National Institutes of Health (NIH) and the National Science Foundation (NSF). Beginning in FFY 2014 and continuing through FFY 2021, increases in federal support for universities and not-for-profit organizations will thereafter be capped at 2% along with other non-exempt domestic spending.
- » **Pell Grant Funding Safe in FFY 2013 and 2014, Minimal Cost Increases Associated with Student Loans.** More severe sector-wide credit effects were averted because the \$35.6 billion⁷ federal aid program for low income students, known as Pell Grants, was held harmless in FFY 2013 and is expected to remain fully funded in FFY 2014. Furthermore, federal student loan programs that are a critical source for students to pay university tuition and fees, will remain largely intact except for increases in interest rates and fees.
- » **Negligible Immediate Impact from Medicare Cuts.** Within the portfolio, only 10% of universities receive any revenues from patient care, and of this subset, the largest estimated revenue loss due to Medicare cuts is a minor 0.5%.

⁴ In calendar year 2012, 76%, or 307 out of 406 rating actions affecting universities and not-for-profits were affirmations with a stable outlook.

⁵ In this report, research universities are defined as rated US colleges, universities and university systems that report more than 15% of operating revenues from grants and contracts, and generate more than \$500 million in total operating revenues, as calculated by Moody's.

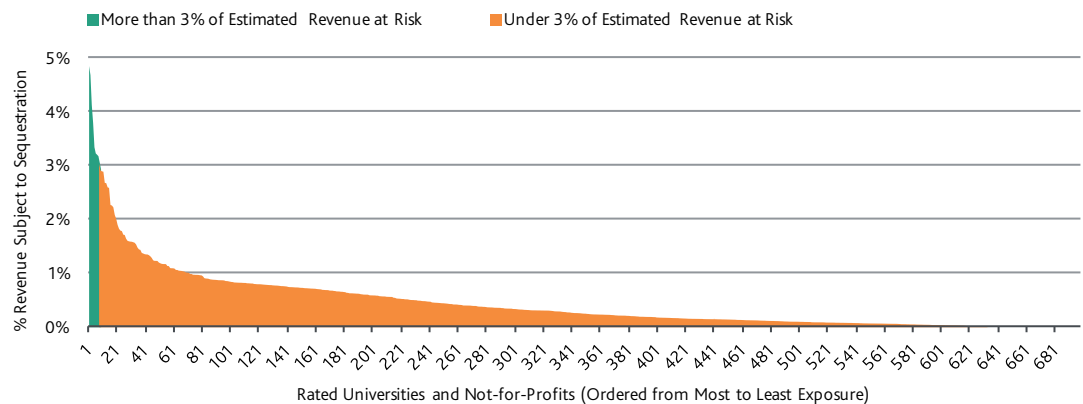
⁶ Moody's: "[US Academic Medical Centers: Complex, Successful Organizations Driven by Integrated University-Hospital Strategies](#)", November 7, 2012 (146668)

⁷ [US Department of Education](#)

- » **Build America Bond Subsidies Also Subject to Sequestration.** A number of public universities could face cuts in interest rate subsidies paid by the federal government under the Build America Bond (BABs) program, although the Internal Revenue Service fully paid direct subsidy requests made before March 1, 2013. In any case, loss of the BABs interest subsidy is not expected to significantly impact the financial health of those who participated in the BAB program as the volume of direct subsidy losses is relatively small.

EXHIBIT 2

Majority of Universities and Not-for-Profit Organizations Have Little Revenue at Risk under Federal Sequestration



Source: Moody's MFRA

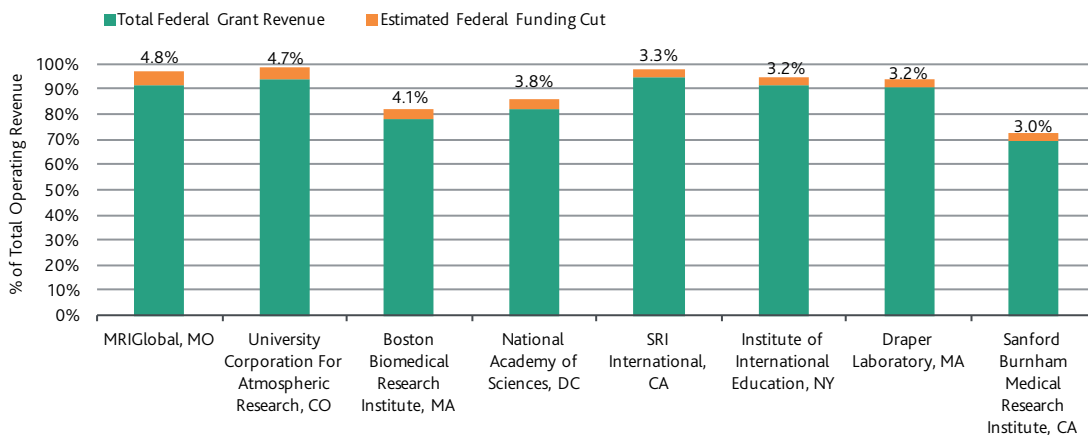
Standalone Research Institutes Lacking Revenue Diversity are Most Impacted by Sequestration

Reductions in federal research funding in FFY 2013 of roughly 5% pose the greatest challenge for the higher education and not-for-profit sectors. Federal research grants provided an average of 60% of all research revenues and 22% of total revenues for research intensive universities in fiscal year (FY) 2011. Facing the greatest risk are standalone research institutes, which rely far more heavily on federal research grants than diversified universities. However, for the combined sectors, we estimate that only 1% of rated universities and not-for-profits will experience more than a 3% loss in total revenue due to sequestration (see Exhibit 3).

Factors mitigating the risk for research universities and institutes include their ability to reduce or contain expenses or seek alternative funding sources. Expense containment measures include potential staff reductions due to lack of tenure among research staff, and delay or reduction of discretionary purchases. Grants spanning several years can also be drawn upon at a slower pace, delaying revenue and expense recognition or allowing institutions time to seek out alternative funding sources. Beginning in FFY 2014 and continuing through FFY 2021, we expect a modest 2% growth in research funding, slightly less than the average inflation rate for 2012. The smallest research institutes face the greatest potential impact from sequestration, although even they have significant cost flexibility and their lower ratings reflect their generally greater credit risk.

EXHIBIT 3

Not-for-Profit Research Institutes Face Total Revenue Loss of 3-5% in FFY 2013 Due to Sequestration

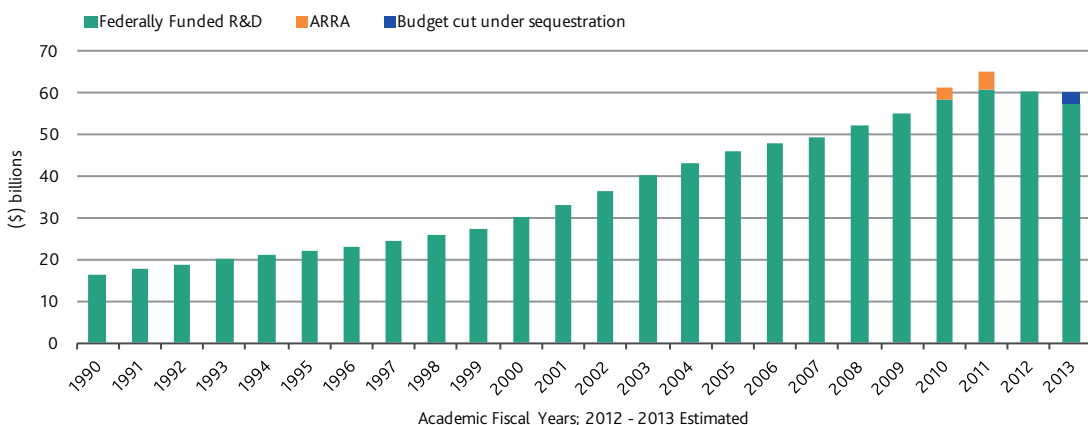


Source: Moody's MFRA (most recent available data)

Notably, no research intensive university has an estimated loss of 3% or more due to sequestration of federal research funding. These universities include some of the nation's most prominent public and private universities, all have higher revenue diversity than research institutes. These universities have already adapted to multiple years of constrained federal funding (see Exhibit 4), successfully diversifying funding sources.⁸ In the near term, organizations that did not budget for cuts due to sequestration, or do not typically budget for contingencies, will be faced with larger expense cuts or spending of financial reserves to bridge current year shortfalls. In the longer term, we expect research universities to identify alternate funding sources, contain costs, and/or form partnerships to continue to operate thriving research enterprises.

EXHIBIT 4

Federal Funding of University Research is Stagnating after Years of Strong Growth



Source: National Science Foundation/Division of Science Resources Statistics, Survey of Research and Development Expenditures at Universities and Colleges, FY 2009. National Science Foundation/National Center for Science and Engineering Statistics, Higher Education Research and Development Survey, FY 2011. Moody's Estimates

⁸ Moody's: "US Research Universities Face Looming Federal Funding Cuts, but Remain Well Positioned to Withstand Credit Challenges", December 15, 2011 (138109)

Student Aid Mostly Protected in the Short-Term; Pell Grant Funding Safe in FFY 2013 and 2014 and Only Minimal Increased Costs Associated with Student Loans

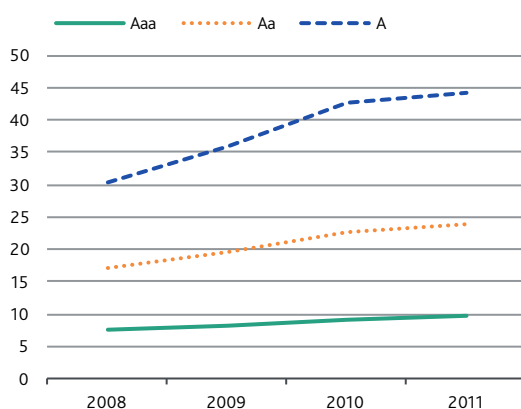
Federal student aid was held relatively harmless in the FFY 2013 sequestration. Pell Grant funding, the largest source of federal student aid, was held flat in FFY 2013 and is expected to remain fully funded in FFY 2014.⁹ Other, much smaller sources of federal student aid (such as federal work study and federal supplemental opportunity grants) will be sequestered in FFY 2013, affecting amounts disbursed in the award year beginning July 1, 2013 (FY 2014 for most universities).¹⁰ While interest rates and fees associated with student loans will increase, the short-term impact of these changes in student loan costs is expected to be negligible on rated universities.

Although revenue losses from sequestration are expected to be absorbed by most universities with little or no credit impact for now, there is a subset of universities with much higher dependence on federal student aid which may be disproportionately harmed by future funding cuts. Lower-rated universities, including historically black colleges and universities (HBCUs), have become more reliant on federal student aid as a proportion of operating revenue (see Exhibit 5) over the last few years. These universities often charge lower net tuition than other universities due to the low-income population they serve, maintain weaker balance sheets, and generate weaker philanthropic support.

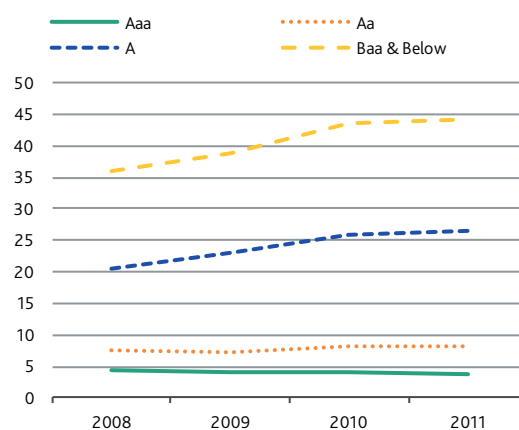
EXHIBIT 5

Profile of Universities with Highest Dependence on Federal Student Aid¹¹

Median federal aid as % of operating revenue - public universities



Median federal aid as % of operating revenue - private universities



Source: Moody's MFRA; Dept. of Education

Over the longer term, reductions to Pell Grant funding or reductions to other sources of federal student aid, are expected to exacerbate enrollment and revenue challenges for colleges and universities with higher dependence on student charges. In addition to lower-rated universities and HBCUs, this vulnerable group includes standalone professional law and business schools which tend to enroll students highly reliant on federal student loans (Exhibit 6).

⁹ [US Department of Education](#)

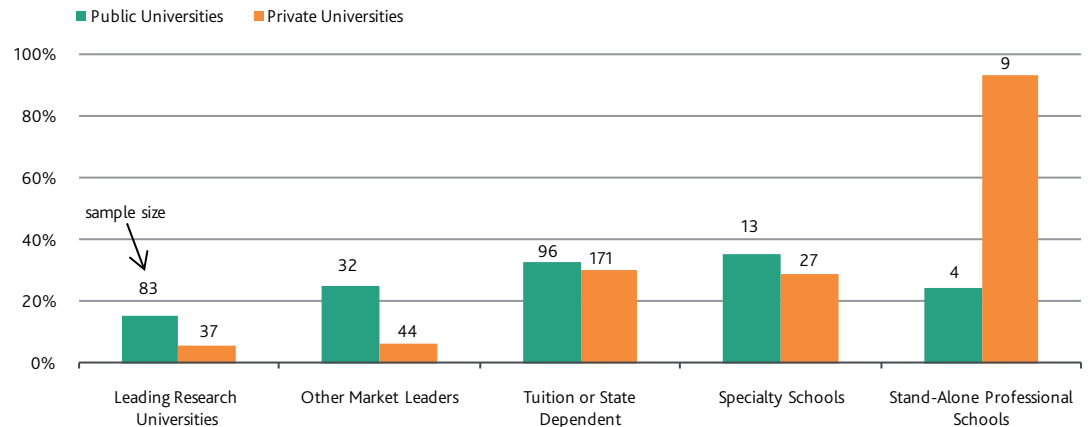
¹⁰ [US Department of Education](#)

¹¹ Federal Student Aid includes federal student loans and federal student aid grants

EXHIBIT 6

Most Rated Universities Have Moderate Reliance on Student Loans; Professional Schools Have High Exposure

Median federal student loan disbursements as a % of operating revenue (FY 2011)



Source: Moody's MFRA; Dept. of Education

Negligible Immediate Impact from Medicare Cuts

Under the current sequester, Medicare payments will be cut by 2% in FFY 2013 and further reductions will be capped at 2% in FFY 2014 and beyond.¹² These reductions will have only a minor effect on universities and not-for-profit organizations deriving revenue from health care services. Only 10% of rated universities and not-for-profit organizations receive revenue from patient care, and among this group, average patient care revenue derived from Medicare was 34% in FY 2011. No rated entity in the portfolio faces more than 0.5% in estimated revenue loss due directly to Medicare cuts. Universities that provide patient care services tend to be highly rated with more diverse revenue sources, so the reduction in Medicare reimbursement is negligible compared to total revenue.

Assumptions Used to Calculate Estimated Revenue Loss Resulting from Sequestration:

Federal Research Grants & Contracts: Assumed 5% cuts to that portion of Moody's adjusted operating revenue derived from federal grants and contracts. For institutions where the exact amount of grants and contracts from federal sources was unavailable, we assumed the sample average of 68% of grants and contracts derived from federal sources.

Medicare: We assumed 2% cuts to Medicare reimbursement. For institutions where the exact amount of patient care revenue from Medicare was not available, we assumed the sample average of 34% of patient service revenue attributable to Medicare reimbursements.

Federal Student Aid: We assumed 5% cuts to federal student aid (Federal Work Study, Federal Supplemental Educational Opportunity Grants and Teach Grants), we excluded Pell Grants and student loans.

¹² [OMB Report Pursuant to Sequestration](#)

Moody's Related Research

Special Comments:

- » [US Research Universities Face Looming Federal Funding Cuts, but Remain Well Positioned to Withstand Credit Challenges, December 2011 \(138109\)](#)
- » [US Academic Medical Centers: Complex, Successful Organizations Driven by Integrated University-Hospital Strategies, November 2012 \(146668\)](#)

Sector Comment:

- » [Pell Surplus Is Credit Positive for US Colleges and Universities, February 2013 \(147947\)](#)

Industry Outlook:

- » [US Higher Education Outlook Negative in 2013, January 2013 \(148880\)](#)

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.

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