

Fitch Ratings

Fitch Rates Southern Methodist Univ, TX Series 2017 Rev Refunding Bonds 'AA-'; Outlook Stable

Fitch Ratings-Chicago-21 November 2017: Fitch Ratings has assigned a 'AA-' rating to the approximately \$97.52 million series 2017 higher education revenue refunding bonds issued by Southwest Higher Education Authority, Inc. on behalf of Southern Methodist University (SMU).

The bonds are expected to sell via negotiated sale the week of Nov. 27. Bond proceeds will advance refund all or portions of the 2010 bonds for savings and pay issuance expenses.

In addition, Fitch has affirmed the 'AA-' rating on SMU's series 2016A and 2016B revenue bonds, issued by the authority on behalf of SMU.

The Rating Outlook is Stable.

SECURITY

The bonds are issued on parity with outstanding SMU debt, and are an unsecured general obligation of the university.

KEY RATING DRIVERS

SOLID BALANCE SHEET: Fiscal 2017 balance sheet ratios adjusted for MV are consistent with the 'AA' rating category. SMU's balance sheet ratios are based on investments valued at carrying value instead of market-value (MV), and Fitch views them as understated.

SOLID DEMAND: SMU's solid demand metrics drive stable enrollment and very high student-quality, and support the 'AA-' rating.

IMPROVED OPERATING MARGINS: SMU's operating margin, as adjusted by Fitch, improved in fiscals 2016 and 2017, reflecting the university's expense management focus, strong enrollment and strong net tuition revenue growth.

MODERATE REVENUE DIVERSITY: Revenues are more diverse than that of many comparable private universities, with student fees providing about 66% of operating revenue. The next largest revenue components are endowment draw and gifts. Fitch considers SMU's endowment draw to be sustainable.

ABOVE-AVERAGE DEBT BURDEN: Pro forma maximum annual debt service (MADS) burden remains moderately high-to-high at 8% of fiscal 2017 operating revenues. Fitch considers this manageable given positive margins and coverage. SMU's debt structure is conservative with serial fixed-rate maturities and is intentionally somewhat front-loaded.

RATING SENSITIVITIES

MARGIN EROSION: A marked decline in Southern Methodist University's debt service coverage or consistently negative operating margins (as adjusted by Fitch) could trigger a negative rating action. Fitch expects SMU to continue generating solid operating margins on a GAAP basis.

HIGH DEBT BURDEN: Growth in SMU's pro forma MADS burden could negatively affect the rating. Fitch expects SMU's debt burden to moderate over time.

MAINTAIN BALANCE SHEET: Solid balance sheet ratios and a substantial \$1.54 billion endowment help off-set SMU's above-average MADS burden. Declines in balance sheet ratios relative to the rating category could pressure the rating.

CREDIT PROFILE

SMU is a private, non-profit university which opened in 1915 and is affiliated with the United Methodist Church. The main campus is located in a residential area of University Park, TX, on 234-acres. The University Park campus is essentially surrounded by Dallas, TX. SMU's accreditation is in good standing and was renewed in 2011 by SACS for the standard 10 years.

SMU offers 106 undergraduate degrees, 114 masters' degrees, 31 doctoral degrees and two professional degrees (law and theology). Of 11,789 students enrolled for fall 2017 (10,294 full-time equivalent), a substantial 45% were graduate students.

Prominent graduate programs include education, law, business, engineering, and theology.

SMU has a 42-member board of trustees, all of whom are nominated by the South Central Jurisdiction of the United Methodist Church. Dr. R. Gerald Turner has been SMU's president since 1995.

SUCCESSFUL FUNDRAISING

SMU has a strong fundraising record, and has completed two comprehensive campaigns in the last 18 years. The most recent, 'SMU Unbridled', raised \$1.15 billion in gifts and pledges between 2008 and 2015. Management is currently focusing on increasing the annual fund (the "Pony Power" initiative) and targeting strategic capital projects. It is not in an active comprehensive campaign at this time.

SOLID ENROLLMENT AND DEMAND

Headcount at SMU has grown about 6% over the past five years, to 11,789 in fall 2017. Some of that growth was for undergraduate students, but most is on the graduate side. Management reports that education, business and engineering enrollment increased during that time, and several new programs and certifications were started.

SMU's undergraduate strategy focuses on attracting high quality students from a broad geographic area rather than enrollment growth. For fall 2017, about 55% of undergraduate students were from out of state. Student quality, as measured by standardized tests, remains quite high and well above national averages. The average freshman ACT score for fall 2017 was 30, well above the national average of 21.

FINANCIAL OPERATIONS

Revenue Diversity

SMU has greater revenue diversity than many peer private universities due to substantial endowment income. Net student revenue, including auxiliary income, was a relatively modest 66% of fiscal 2017 operating revenue. The next largest revenue component was about 17.5%, the sum of Fitch-adjusted dividend and interest income and net assets released from restriction for operations (excluding capital). Positively, SMU has grown net student revenue since at least fiscal 2011, averaging over 5% annually.

The budgeted endowment draw uses a two-part formula: 30% is based on 4.5% of four quarters of investment market value, and 70% is a percentage of the prior year distribution. At this time Fitch considers SMU's endowment spend sustainable.

Operating Margins

SMU's operating margins, as adjusted by Fitch, have improved in the last four years. Margins were positive 6.3% in fiscal 2017, 4.9% in fiscal 2016, 0.2% in fiscal 2015 (a year with significant one-time expenses) and 3% in fiscal 2014. Management reports that factors contributing to the improvement include expense and discount controls and enrollment growth. Operations for the fiscal year ending May 31, 2018 are projected to be similar to fiscal 2017.

Adequate MADS Coverage

Coverage of pro forma MADS (about \$44.8 million) in fiscal 2017 was 2.3x, up from 1.9x in fiscal 2016. Fitch considers these coverage levels adequate, and supported by strong MV balance sheet ratios and a large endowment of about \$1.5 billion at May 31, 2017.

BALANCE SHEET

Balance Sheet Ratios

Available funds (AF; defined by Fitch as cash and investments less permanently restricted net assets) was \$892.7 million at fiscal 2017. This equaled a solid 170% of operating expenses (\$524 million) and 137.4% of pro forma debt (about \$649.8 million). Fitch views SMU's investments (and thus its balance sheet ratios) as understated, as the university records investments at carrying value on its balance sheet instead of the standard market value. Long-term investments at fiscal year-end May 31, 2017 were reported as \$1.45 million carrying value, and \$1.736 billion market (MV) value.

AF, adjusted for MV, increases to \$1.175 billion, resulting in stronger AF ratios relative to expenses (224%) and pro forma debt (181%). Fitch views the more conservative book value ratios as slim, but the higher MV ratios as solid for the 'AA' rating category.

Aggressive Endowment Portfolio

SMU's endowment portfolio is aggressive, but not inconsistent with peer private institutions with large endowments. As of May 31, 2017, investment carrying value was \$1.45 billion, and MV was \$1.73 billion. The percent of alternative investments (absolute

return, private equity, real assets, assets without liquidity and venture capital) was about 61% for carrying value and about 67% for MV. Investment liquidity relative to operating budget, including separate working cash reserves, remains solid. In addition, management reports that SMU has never used a \$25 million bank line of credit for working cash.

MANAGEABLE DEBT LEVERAGE

Fitch estimates SMU's pro forma debt at \$649 million, including \$100 million of taxable notes expected to close Dec. 15, 2017. To avoid double-counting, Fitch adjusted pro forma debt to exclude defeased series 2009 and 2007 maturities, which SMU's audit records as outstanding. After the pending \$100 million taxable note issue, which proceeds will be used for deferred maintenance projects, management reports no additional debt plans at this time. Debt structure is conservative: all debt is fixed-rate with serial maturities and no bullets.

Security

The bonds are issued on parity with outstanding debt and the 2017 forward bank placement under a master trust indenture (MTI). Under the loan agreement the 2017 forward bank bonds are a general obligation of SMU. SMU MTI debt has no debt service reserves, annual debt service coverage or annual liquidity covenants. SMU's balance sheet strengths largely mitigate concern over the lack of aforementioned covenants.

SMU actualized the fixed-rate 2017 forward bank placement to refund part of its outstanding series 2007 bonds. That \$48.8 million private placement took effect in fiscal 2017 and the loan extends to 2033. The bank placement is on parity with outstanding SMU debt, and related loan documents do not impose any material additional covenants. There is no 'put' or reset requirement.

Upon maturity or retirement of MTI debt outstanding at the time of the series 2016AB bond issuance, the current additional bonds test will be eliminated.

The pending \$100 million taxable notes are not issued under SMU's MTI, although they are considered parity GO debt. Disclosure indicates that a default under the notes could trigger note acceleration, but not trigger acceleration or default for bonds issued under the MTI. The taxable notes are fixed rate with serial maturities through 2047, and no re-set date or mandatory puts.

Above-Average Debt Burden:

Pro forma MADS is about \$44.8 million occurring in 2024, with a declining debt service structure thereafter. Management reports that it has intentionally front-loaded debt principal to reduce interest expense. However, pro forma MADS remains an above-average 8.0% of fiscal 2017 operating revenues. Fitch expects SMU's debt burden to moderate gradually over time.

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Applicable Criteria

Rating Criteria for Public Sector Revenue-Supported Debt (pub. 05 Jun 2017) (<https://www.fitchratings.com/site/re/898969>)

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