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Southwest Higher Education Authority Inc., Texas Southern Methodist University; Private Coll/Univ - General Obligation

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Credit Profile

Southwest Hgr Ed Auth, Inc., Texas

Southern Methodist Univ, Texas

Southwest Hgr Ed Auth Inc (Southern Methodist University) ser 2007, ser 2009 and ser 2010

<i>Long Term Rating</i>	AA-/Stable	Affirmed
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Southwest Hgr Ed Auth, Inc. (Southern Methodist Univ Proj) ser 2007, 2002

<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
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Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings affirmed its 'AA-' long-term rating and underlying rating (SPUR) on Southern Methodist University (SMU), Texas' debt outstanding, issued by Southwest Higher Education Authority Inc. The outlook is stable.

The rating reflects our view of SMU's very strong enterprise profile and strong financial profile. We base the very strong enterprise profile on the university's market position, and demand and fundraising ability. The financial profile incorporates SMU's solid operating performance and high maximum annual debt service burden. Combined, these credit factors lead to an indicative stand-alone credit profile of 'a+'. As our criteria indicate, the final rating can be within one notch of the indicative credit level. In our opinion, the 'AA-' rating better reflects SMU's significant endowment of \$1.5 billion, or \$150,605 per full-time equivalent (FTE) student. We believe that the university is at its debt capacity for the 'AA-' rating level, although it has no formal plans to issue debt during the two-year outlook period.

General credit strengths, in our view, include SMU's:

- Solid demand and enrollment with a headcount of about 11,739 for fall 2016 and 11,789 for fall 2017, and a comprehensive selection of undergraduate and graduate programs, including law, business, and engineering;
- Strong operating performance with a history of full-accrual operating surpluses for the past three years, coupled with a long trend of net tuition revenue growth; and
- Demonstrated fundraising ability, with a recently completed comprehensive campaign and a large endowment of about \$1.54 billion as of May 31, 2017.

Offsetting factors, in our view, include the university's:

- Low financial resource ratios for the rating category, with fiscal 2017 expendable resources of \$836.9 million equal to 120.8% of operating expenses and 135% of total debt; and
- Somewhat less flexibility regarding tuition compared with that of peer Texas private universities.

The bonds are a general obligation (GO) of SMU. The university has \$520 million of debt outstanding excluding bond proceeds held in escrow to retire \$103 million in debt in 2019. In 2016, it issued \$118.5 million in tax-exempt series 2016A bonds and \$25.5 million in taxable series 2016B bonds. The proceeds for the bonds were placed in escrow; they will purchase securities being held in escrow and refund \$103 million of the series 2009 bonds at par in 2019. About \$50 million of the proceeds funded projects including various parking structures and surface parking, as well as athletic and recreational facilities, a child care facility, an aquatic center, and other building infrastructure improvements. In addition, management drew on a bank loan to refund a portion of the series 2007 bonds at a par value of \$49 million on their 2017 call date. For fiscal 2018, management intends to enter a \$100 million private placement agreement; we have factored this into our analysis.

Outlook

The stable outlook reflects our expectation that, during the next two years, SMU will maintain a stable enrollment and student demand profile, continue to generate operating surpluses, and improve financial resource ratios relative to both debt and operating expenses consistent with the rating category.

Downside scenario

A negative rating action is possible if the university issues additional debt, or if financial resources ratios fail to improve relative to the 'AA' category. Additional pressure on the rating could result from softer demand metrics.

Upside scenario

We do not believe a positive rating action during the outlook period is possible, given the leveraged balance sheet.

Enterprise Profile

Industry risk

Industry risk addresses the higher education sector's overall cyclical and competitive risk and growth by applying various stress scenarios and evaluating barriers to entry, levels and trends of profitability, substitution risk, and growth trends observed in the industry. We believe the higher education sector represents a low credit risk when compared with other industries and sectors.

Economic fundamentals

In our view, SMU has modest geographic diversity; however, it is mostly regional. About 58% of students are from within the state, and the remaining come from other states or countries. Therefore, the local GDP per capita anchors our assessment of the university's economic fundamentals.

Market position and demand

SMU's campus is in University Park, a residential area five miles north of the Dallas business district. The university offers undergraduate and graduate programs to over 11,000 students, approximately 10,000 of whom are FTE students. Approximately 56% of the student body is undergraduate, and nearly all are full-time. SMU has a variety of graduate and professional programs, including law, business, theology, and engineering. Among the more popular undergraduate programs are the performing and fine arts and communications programs in the Meadows School, as

well as undergraduate business programs.

Enrollment continues to increase modestly, and SMU is a large institution for the rating category, which we view positively. For fall 2016, it had a total headcount of 11,739 (less than a 1% increase from fall 2015) and FTE enrollment of 10,231 (a 1.6% increase from fall 2015). Enrollment for fall 2017 indicates another increase to 11,789 (10,294 FTEs), which we view positively. The university is fairly selective, admitting 49% of its first-year applicants. However, the matriculation rate is weak at 22%, in part reflecting the highly competitive area in which the university competes.

First-year retention rates are below average for the rating category at 91% for fall 2017. Student quality continues to improve and remains well above national averages, with a 1348 average SAT score for first-year students in fall 2017, compared with 1274 in fall 2012. SMU's geographic draw is mostly from the Texas area, with approximately 57% of total students and 38% of the entering fall 2017 first-year students coming from Texas. The university, in our opinion, has somewhat limited tuition-price flexibility because its rate is well above that of Texas' large public university systems. Total charges (tuition, fees, room, and board) for the 2017-2018 academic year increased approximately 3.8% from the previous year to \$69,008.

Most undergraduate students live in SMU-owned housing. For fall 2017, this included 94% of the first-year students and 57% of undergraduates. The university has a freshman and sophomore residency requirement program that was instituted upon the completion of its residential commons in August 2014.

Fundraising

SMU is a strong fundraiser and recently completed its "Second Century Campaign," which coincided with its centennial. The campaign focused on raising funds for student scholarships, endowed faculty positions, and academic programs and enhancements. The initial goal was \$750 million, which has increased to \$1 billion through December 2015. The university raised \$1.1 billion through calendar year 2015. For fiscal 2016, the university raised \$111 million in gifts and pledges. For fiscal 2017, fundraising declined to \$78 million, although SMU is not currently in a campaign phase.

Management and governance

The board of trustees governs and establishes all policies and guidelines for the operation of the university. There are 42 trustees, including representatives from The United Methodist Church. The president and representatives of the faculty senate, student body, and alumni association serve as ex-officio members. In 2017, SMU had some changes to its senior leadership with a new vice-president of student affairs, and a new chief investment officer. However, we believe the overall management team is stable, with the president having been in the current role since 1995. The university continues to focus on its strategic plan, which emphasizes improvements in student quality, increased academic research, and effective financial stewardship.

Financial Profile

Financial management policies

SMU has formal policies for its endowment, debt and reserves and liquidity. It monitors liquidity closely relative to operating, endowment, capital and debt needs. The university prepares quarterly, full-accrual-based financial reports,

which we view as a best practice. As with other institutions with large endowments, management places significant importance on oversight and operations of its endowment. The financial policies assessment reflects our opinion that, while there might be some areas of risk, the organization's overall financial policies are not likely to negatively affect its ability to pay debt service. Our analysis of financial policies includes a review of the organization's financial reporting and disclosure, investment allocation and liquidity, debt profile, contingent liabilities, and legal structure, as well as a comparison of these policies to similar providers. Overall, we view the financial policies as appropriate for the institution.

Financial performance

SMU consistently generates operating surpluses and its reported operating performance is affected by the investment returns. The audited operating performance was \$51.8 million in fiscal 2016 and \$54.2 million in fiscal 2017. For all universities, we exclude the realized and unrealized gains, and the resulting operating performance is \$26 million for fiscal 2016 and \$35 million for fiscal 2017. Fiscal 2016 and 2017 operating margins are 4% and 5%, respectively, which are improved from breakeven in 2015. The maintenance of operating margins around 2016 levels is supported by the university's continued focus on operational excellence. Overall revenues increased from both net tuition and auxiliary revenues while expenses also increased but at a slower rate and after being held flat in 2016. To date, the university has focused on cost-containment efforts through workforce reductions and administrative efficiencies. In fiscal 2017, SMU expects to achieve \$20 million-\$25 million in annual operational savings, and expects this to be part of the institution's ongoing culture. We expect the university to sustain its adjusted operating surpluses on a full-accrual basis in fiscal 2018 and beyond. Revenue diversity provides SMU with budget flexibility and some insulation from enrollment fluctuations. Based on the 2017 audit, 66% of the university's revenues came from gross tuition and fees, approximately 10% from endowment income, 8% from auxiliary and athletic revenues, and 3% from gifts.

Available resources

Financial resource ratios are low for the rating category, in our view. For fiscal 2017, expendable resources totaled \$836.9 million; they were 121% of operating expenses and 135% of total pro forma debt. We adjusted both the cash and investments and the pro forma debt for the planned retirements. Total cash and investments (including restricted endowment), were \$1.5 billion as of May 31, 2017, or 215% of operations and 239.2% of total pro forma debt. SMU's expendable resources calculation (unrestricted net assets plus temporarily restricted net assets less net plant, property, and equipment [PPE] plus debt) is slightly deflated due to rapid growth of net PPE relative to debt. Therefore, we view cash and investments as a better relative measure. We reduced cash and investments by the amounts 2016 bond funds held in escrow to refund the series 2009 bonds and we similarly reduced debt by this amount in our ratios. The pro forma debt includes the planned issue of \$100 million in fiscal 2018.

Endowment forms the core of SMU's financial resources and provides additional revenue diversification. As of May 31, 2016, the endowment's market value was \$1.5 billion, compared with \$1.4 billion a year ago. For fiscal 2017, the returns were a robust 11.99%. The endowment's asset mix has not changed materially since our most recent analysis and, in our opinion, is moderately aggressive but comparable with that of peer institutions with similar endowment sizes.

As of fiscal year-end May 31, 2017, approximately 33% of the university's investments were classified as level 1 or 2, which we use as a proxy for liquidity. We consider this to be adequate. As of May 31, the university had approximately

\$188 million of capital calls on an initial commitment of approximately \$717 million. We believe the institution has sufficient liquidity to cover the capital calls.

SMU's endowment spending policy is based 30% on a four-quarter average market value of the endowment pool and 70% based on the previous year's transfer increased by an inflation factor of 1%. While the policy also allows for a maximum 7% transfer, the spending formula results in an actual transfer much closer to 4.9%, which we consider average. Overall, the university does not overly rely on the transfer for operations; for fiscal 2017, the endowment transfer was \$71 million, or approximately 10% of the university's total revenues.

Debt and contingent liabilities

SMU has \$622 million of debt outstanding, including the series 2016A bonds. The university used \$116 million of bond proceeds to purchase securities, which are being held in escrow to refund the series 2009 bonds with a par value of \$103 million in 2019. In addition, management entered a bank agreement in October 2015 to refund the series 2007 bonds. Management drew on the bank loan to refund a portion of the 2007 bonds at a par value of \$49 million on their 2017 call date. In addition, management plans to enter a private placement with New York Life for \$100 million this fiscal year. Adjusting for these transactions, we consider pro forma debt to be \$619.8 million. Management reports that it does not have additional debt plans in the outlook period.

We have reviewed the loan agreement between SMU and UMB Bank N.A., which management used to refund the series 2007 bonds. We have determined that the risk from this debt is manageable given the university's liquidity position and significant fundraising abilities. There are cross-default provisions allowing for acceleration of the debt if SMU has defaulted on parity debt. The terms of the loan agreement include a material adverse effect clause but consider the likelihood of this happening to be remote. As management has not entered its private placement with New York Life, we do not have the associated documents. However, management intends for this private placement to be on par with the bonds and provisions to be comparable with those in the master trust indenture.

Southern Methodist University -- Enterprise And Financial Statistics

--Fiscal year ended May 31--

	2018	2017	2016	2015	2014	Medians for 'AA' rated private colleges and universities, 2016
Enrollment and demand						
Headcount	11,789	11,739	11,643	11,307	10,972	MNR
Full-time equivalent	10,294	10,231	10,072	9,853	9,447	6,253
Freshman acceptance rate (%)	48.8	48.9	49.0	52.4	50.7	25.7
Freshman matriculation rate (%)	22.2	23.5	21.6	23.6	23.4	MNR
Undergraduates as a % of total enrollment (%)	54.7	55.5	55.1	56.5	57.9	71.9
Freshman retention (%)	90.9	90.5	90.0	89.3	89.0	94.8
Graduation rates (six years) (%)	80.5	78.8	79.0	77.3	75.8	MNR
Income statement						
Adjusted operating revenue (\$000s)	N.A.	727,959	691,528	657,840	630,927	MNR
Adjusted operating expense (\$000s)	N.A.	692,791	665,254	656,538	616,384	MNR
Net operating income (\$000s)	N.A.	35,168	26,274	1,302	14,543	MNR

Southern Methodist University -- Enterprise And Financial Statistics (cont.)

--Fiscal year ended May 31--

	2018	2017	2016	2015	2014	Medians for 'AA' rated private colleges and universities, 2016
Net operating margin (%)	N.A.	5.08	3.95	0.20	2.36	1.59
Change in unrestricted net assets (\$000s)	N.A.	54,242	51,779	27,658	58,286	MNR
Tuition discount (%)	N.A.	35.2	34.3	34.8	35.5	37.1
Tuition dependence (%)	N.A.	65.7	65.5	65.3	63.8	MNR
Student dependence (%)	N.A.	73.8	73.7	73.4	70.5	60.0
Health care operations dependence (%)	N.A.	N.A.	N.A.	N.A.	N.A.	MNR
Research dependence (%)	N.A.	4.1	4.8	4.6	5.5	MNR
Endowment and investment income dependence (%)	N.A.	9.8	10.0	N.A.	10.5	MNR
Debt						
Outstanding debt (\$000s)	N.A.	622,480	640,880	532,813	548,565	305,339
Proposed debt (\$000s)	N.A.	100,000	N.A.	N.A.	N.A.	MNR
Total pro forma debt (\$000s)	N.A.	619,880	N.A.	N.A.	N.A.	MNR
Pro forma MADS	N.A.	N.A.	N.A.	N.A.	N.A.	MNR
Current debt service burden (%)	N.A.	6.58	5.81	5.42	4.46	MNR
Current MADS burden (%)	N.A.	5.88	6.13	6.12	6.52	5.53
Pro forma MADS burden (%)	N.A.	N.A.	N.A.	N.A.	N.A.	MNR
Financial resource ratios						
Endowment market value (\$000s)	N.A.	1,540,844	1,421,447	1,545,328	1,425,146	1,132,510
Cash and investments (\$000s)	N.A.	1,489,009	1,517,227	1,453,351	1,444,043	MNR
Unrestricted net assets (\$000s)	N.A.	663,262	609,020	557,241	529,583	MNR
Expendable resources (\$000s)	N.A.	836,878	867,510	718,809	752,223	MNR
Cash and investments to operations (%)	N.A.	214.9	228.1	221.4	234.3	331.4
Cash and investments to debt (%)	N.A.	239.2	236.7	272.8	263.2	446.5
Cash and investments to pro forma debt (%)	N.A.	240.2	N.A.	N.A.	N.A.	MNR
Expendable resources to operations (%)	N.A.	120.8	130.4	109.5	122.0	202.5
Expendable resources to debt (%)	N.A.	134.4	135.4	134.9	137.1	274.9
Expendable resources to pro forma debt (%)	N.A.	135.0	N.A.	N.A.	N.A.	MNR
Average age of plant (years)	N.A.	12.1	12.1	11.9	12.7	13.7

MADS--Maximum annual debt service. MNR--Median not reported. N.A.--Not available.

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