MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns A1 to Northern Arizona University, AZ's $35M Series 2015 SRBs and A2 to $19M Series 2015 COPS; outlook stable

Global Credit Research - 23 Mar 2015

$626M rated pro-forma debt

ARIZONA BOARD OF REGENTS
Public Colleges & Universities
AZ

Moody's Rating

ISSUE	RATING
System Revenue Refunding Bonds, Tax-Exempt Series 2015	A1
Sale Amount $34,800,000	
Expected Sale Date 04/15/15	
Rating Description Revenue: Public University Broad Pledge	
Tax-Exempt Refunding Certificates of Participation, Series 2015	A2
Sale Amount $18,715,000	
Expected Sale Date 04/16/15	
Rating Description Revenue: Public University Broad Pledge	

Moody's Outlook STA

NEW YORK, March 23, 2015 --Moody's Investors Service assigns an A1 rating to the Northern Arizona University (NAU) $34.8 million of fixed rate System Revenue Bonds (SRBs), Series 2015 (maturing in 2035). We are also assigning an A2 rating to $18.7 million of fixed rate Certificates of Participation (COPs), Series 2015 (maturing in 2030). At the same time, we are affirming the ratings on the university's outstanding SRBs, COPs, and SPEED (Stimulus Plan for Economic and Educational Development) and lease revenue bonds. The outlook is stable.

SUMMARY RATING RATIONALE

The university's A1 system revenue bond rating reflects NAU's established presence as a large supra-regional university in northern Arizona, with steady enrollment growth, rising net tuition revenue, and sufficient cash flow to meet debt service requirements.

Favorably, the A1 rating also incorporates historic, uninterrupted state support for nearly 30% of debt obligations.

Challenges facing NAU include recent weak operating performance to be further pressured by a sizeable state cut in fiscal year 2016 appropriations, high leverage and debt burden, and a competitive student market. Our analysis also incorporates NAU's agreements with third parties for strategic housing projects.

The A2 rating on the COPs, one notch below the university's senior most rating, reflects the nature of the leases which are subject to non-appropriation (for more information on the COPS pledge, see Legal Security).

OUTLOOK

The stable outlook reflects our expectation that NAU will generate continued solid cash flow and near balanced operations for FY 2015 and make FY 2016 budgetary adjustments necessary to meet debt service, while holding available reserves steady. The outlook also incorporates the expectation that the privatized housing projects will meet performance objectives, with no adverse impact on the university's operations.

WHAT COULD MAKE THE RATING GO UP

- Substantial increase of financial resources and liquidity with limited increase in debt

- Meaningful improvement in operating margins, with surplus contributions to build flexible reserves

WHAT COULD MAKE THE RATING GO DOWN

- Sustained deterioration of operating performance leading to further declines in liquidity

- Additional debt issuance without meaningful offset in financial resources

- Failure of the state to support State-funded debt service

STRENGTHS

- Robust growth of net tuition revenue (up 19% for fiscal years (FY) 2012-14) and net tuition per student (up 10% for FY 2012-14) offset flat state appropriations

- Growing enrollment of nearly 26,000 full-time equivalent (FTE) students in fall 2014 and strong non-resident draw (30%)

- State support for roughly 30% of its $626 million in outstanding debt, with a demonstrated record of state payment despite operating appropriation cuts

CHALLENGES

- State operating appropriation volatility, with current flat funding, recently announced FY 2016 $17 million cut and ongoing deferral of $30.5 million annually

- Narrowing operating performance (FY 2012-14 operating margin of 1.3% versus 5.1% for FY 2011-13)

- Weakened flexible reserves (liquidity) to 132 days in FY 2014 from 211 days in FY 2010

- Thin financial resources relative to debt (pro forma of 0.4 times at is weaker than the 0.8 times A1-rated median)

- Board of Regents political pressure to limit tuition increases and maintain affordable tuition rates

RECENT DEVELOPMENTS

On March 12, 2015, the State of Arizona's (Aa3 positive) Governor signed the FY 2016 budget, which included a $99 million reduction in funding for the state's higher education institutions. This translates to a $17 million cut to NAU for FY 2016 (15% decrease in appropriations and roughly 3.5% of the FY 2015 operating revenues). The university is working to offset the cut through a combination of budgetary reductions, additional facility fees, and a higher tuition increase than originally planned.

DETAILED RATING RATIONALE

MARKET POSITION: HEALTHY GROWTH IN NET TUITION PER STUDENT BOLSTERED BY STEADY RISE IN ENROLLMENT

The university has an established presence as a large regional public university based in Flagstaff, with multiple satellite (rural and urban) locations, a growing on-line presence, and a mission to be a lower cost alternative in Arizona. Fall 2014 FTE enrollment of 25,934 is up 7.1% over fall 2012 (24,209). Roughly 70% of students are at the main campus, with the remaining split between satellite campus and NAU's online programs. Enrollment trends are mixed, with a healthy rise in first time freshman (5,025 in fall 2014, up from 4,254 in fall 2012), followed by a management reported 74% sophomore retention rate (fall 2014). Junior and senior years are bolstered by strong and rising transfer student market (2,746 in fall 2014). Graduate enrollment is declining in line with national trends; NAU recorded a 3.3% loss over the last three years (2,993 FTE in fall 2014).

NAU retains some pricing power as its net tuition per student is nearly one-third less than the other Arizona four-year

institutions. Net tuition per student rose a healthy 10% from FY 2012-14, owing to enrollment improvements and a 5.0% tuition increase. The FY 2015 tuition rate was a more limited 2.6%. In light of FY 2106 appropriation cuts, NAU is considering a higher tuition increase for fall 2015. NAU's commitment to provide its freshman with a fixed four year tuition is a challenge as it potentially limits future net tuition revenue growth, but is mitigated in part by a high non-resident (higher tuition) draw (39% in fall 2014). Roughly 75% of its student body presently participates in the NAU Pledge.

Research activity is a small, but meaningful component of academic draw and revenue diversity. Grants and contracts (largely federal) were 9% of revenues, with associated research activity comprising 5% of expenses. Large recent grants are sponsored by the Department of Defense, National Institutes of Health, and National Science Foundation.

OPERATING PERFORMANCE, BALANCE SHEET, AND CAPITAL PLANS: PRESSURE TO MINIMIZE TUITION INCREASES HAS PRESSURED MARGINS AND LIQUIDITY; LIMITED DEBT PLAN IS FAVORABLE

Enhanced conservative budgeting practices and expense control will be critical to maintaining the necessary cash flow to meet rising debt service, especially in light of very moderate tuition increases and the expected FY 2016 cut in state appropriations. Fiscal year 2014 marked a third year of weakening operating performance (FY 2012-14 average operating margin of 1.3%) relative to past credit positive double-digit margins, due to a significant reduction in state support, the drop off of federal stimulus funding, and modest tuition increases. Weakening operating performance has also been driven by public pressure to spend down flexible reserves; the university used those funds for one-time instructional costs. Management reports that it will maintain this level of reserves moving forward, and that FY 2015 results are expected to be similar to FY 2014. Significant deviation from expectations, in addition to FY 2016 use of reserves for balanced budgeting, would cause negative rating pressure.

State appropriations continue to be a meaningful, but mixed, component of revenues (24% in FY 2014). The university is striving to be less reliant on state funds over the longer term in light of the FY 2016 cut and limited state capital support (other than debt service reimbursement for certain obligations). FY 2015 operating appropriations of $116 million are up 4.4% over FY 2014, due the $6.6 million in performance funding for disparity funding payments that NAU is receiving to bring appropriations into a more equitable balance among the Arizona higher education institutions. NAU also continues to experience delays in cash funding from the state. Beginning in FY 2010, the state has held back $30.5 million of operating support, which it pays out to the university on October 1st of the following fiscal year. Although the state has made the university whole each following fiscal year, there is no certainty that this would continue should economic conditions at the state level weaken.

Moody's maintains a Aa3 issuer rating and positive outlook on the state of Arizona. For more information on the state's credit profile, please refer to the report published on May 13, 2014.

Further growth of resources through fundraising and surplus operations would be a credit positive for NAU. NAU is in the midst of a $100 million "Campaign for NAU", with gift priorities for scholarships, research, faculty support, and athletics. To date, roughly $83 million has been raised and the campaign end date is June 2016. As of June 30, 2014, the foundation's endowment totaled $122.5 million, with a fiscal year return of 20.3%. Assets are invested in multiple Vanguard funds and distributed among equities (79%) and fixed income (21%) per the policy allocation.

NAU is currently updating its capital master plan and has no stated capital plans for the near term, with the exception of one project that has been put on hold. The financing of a new wet lab building (approximately $8 million) has been delayed for at least one year in light of the state's announced FY 2016 appropriation cut and NAU's need to focus on balancing current operations.

The university has entered into a public-private partnership (P3) with student housing developer American Campus Communities (ACC) for two facilities and a total of 1,453 beds (16% of overall 8,942 housing stock). All facilities are operating with 99% occupancy as of fall 2014. The ACC facilities are located on land that is ground leased from NAU, owned and managed by ACC, and directed toward non-freshman students. NAU management has noted they are in preliminary discussions with ACC for a third housing facility of 500-600 beds due to the strong housing demand. While the university has limited its legal financial obligation to these projects, the strategic importance of the housing and reputational risk create strong incentives for involvement should the projects not perform as expected. We will monitor the ACC projects to determine if there are operating difficulties that may ultimately require direct support from the university.

Liquidity

We expect NAU to maintain its relatively lower level of liquidity due to political pressure to limit flexible reserves. Unrestricted liquidity totaled $154 million at FY-end 2014, which translated to 132 monthly days cash on hand. NAU's liquidity is below the A1-rated median of 140 days.

DEBT AND OTHER LIABILITIES

NAU is highly leveraged compared to other A1-rated public universities. This reflects historically weak state capital funding, rising capital investment, and recent use of reserves. State support for nearly one-third of debt service and the fixed rated debt structure are mitigants, but the slimming of liquidity is credit negative.

Moderate revenue growth going forward, constrained balance sheet resources, and rising debt service limit NAU's future debt capacity at the current rating. Expendable financial resources of $248 million in FY 2014 have not grown appreciably in the last four years, despite competitive investment returns and positive fundraising results. Expendable resources cover pro-forma debt (including the August 2014 Student Academic Services lease revenue bonds) of $626 million by 0.4 times, which is less than half of the A1-median of 0.8 times. This leverage measure improves to 0.6 times after removing the state supported debt service on the research infrastructure COPs and SPEED bonds.

Debt Structure

NAU's debt structure is conservative, with fixed rate debt generally amortizing over 30 years.

The state has historically and is expected to continue to cover debt service on $63 million of outstanding research infrastructure certificates of participation (COPs) and 80% of the debt service on the currently outstanding $140 million of SPEED bonds.

Debt-Related Derivatives

None

Pensions and OPEB

The university's pension obligations are manageable, with pension expense representing just 2.5% of FY 2014 expenses. The university participates in a cost-sharing, multi-employer defined benefit plan administered by the state (Arizona State Retirement System) and a defined contribution plan offered through three ABOR approved providers. At present, the university is fully funding its required contributions to all plans.

The university does not administer an OPEB plan. University employees, their spouses and survivors may be eligible for certain retiree health care benefit programs provided through the state.

MANAGEMENT AND GOVERNANCE: FAVORABLE PROGRESS OF STATEGIC PLAN IMPLEMENTATION; RECENT NEW PRESIDENT AND PLANNED NEW PROVOST

The university, along with Arizona State University and Northern Arizona University, is governed by the twelve-member Arizona Board of Regents, of which two seats are held by the Governor and Superintendent of Public Instruction, and two by student regents. ABOR provides oversight of financial and policy activities of the three universities, including tuition, fees, capital development programs, and academic affairs.

A new president took office at NAU in August 2014. More recently, the provost is stepping down to return to the faculty. An interim is expected to be appointed while a search for her successor is underway. NAU is in the midst of implementing its FY 2013-17 Strategic Plan. To date, NAU has achieved several of the plan goals including: parity funding by the state (through FY 2015), investment in new learning models, and meeting milestones for state performance funding goals.

KEY STATISTICS (FY 2014 financial data; fall 2014 enrollment)

- Full-Time Equivalent Enrollment: 25,934 students

- Total Financial Resources: $329 million

- Total Pro-Forma Direct Debt: $626 million

- Total Operating Revenue: $458 million

- Reliance on Student Charges Revenue (% of Moody's-adjusted Operating Revenue): 55%

- Monthly Days Cash on Hand: 132 days

- Operating Cash Flow Margin: 12.1%

- State of Arizona Issuer Rating: Aa3 positive

OBLIGOR PROFILE

Northern Arizona University is a four-year university, with its main campus located in Flagstaff, over 30 satellite locations around the state, and established distance learning program. In FY 2014, the university recorded operating revenues of over $450 million and served a headcount enrollment of 27,715 students.

LEGAL SECURITY

The university's System Revenue Bonds ($327 million at FY-end 2014) are payable from and secured by a pledge of and first lien on Gross Revenues, which include tuition, fees, and other revenue-producing facilities, including auxiliary enterprises and indirect cost recovery. In FY 2014, Gross Revenues totaled $283 million, which comprised 62% of operating revenues (Moody's adjusted). The SRBs carry a rate covenant requiring the university to set fees such that Gross Revenues are at least 2.0 times maximum annual debt service (MADS) of the SRBs. Gross Revenues cover the estimated pro forma SRB MADS of $25.5 million over 11 times.

The COPS ($63 million at FY-end 2014) are secured by lease payments made by the board, as well as a security interest in the leased properties financed by each specific series of COPs. The leases are unconditional obligations of the board during any current fiscal year, payable from NAU's operating budget but with no security interest in any revenue stream. The board's obligation to pay lease payments is absolute and unconditional, but subject to non-appropriation or non-allocation for any succeeding fiscal year as a result of not having budgeted or allocated available funds. Given the importance of the COPS-financed projects, as well as the university's reliance on COPS as a financing vehicle, we believe that there is very little risk of non-payment under the leases.

In addition to the system revenue bonds, NAU's debt profile includes: SPEED bonds, $140 million; and three series of lease revenue bonds ($78 million) secured by separate lease agreements between ABOR acting on behalf of NAU and a special purpose limited liability corporation established by Northern Arizona Facilities Finance Corporation (NAFFC). For more detail on the legal security of the SPEED revenue bonds and the lease revenue bonds, please refer to our reports published on May 6, 2013 and July 1, 2014, respectively.

USE OF PROCEEDS:

Proceeds of the Series 2015 SRBs are expected to be used to refinance all or portions of the Series 2004, 2005, 2007 and 2008 bonds (dependent on market conditions) and pay costs of issuance. There is no debt service reserve fund for the Series 2015 SRBs.

Proceeds of the Series 2015 COPs are expected to be used to refinance all or portions of the Series 2005 COPs (dependent on market conditions) and pay costs of issuance. There is no debt service reserve fund for the Series 2015 COPs.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was U.S. Not-for-Profit Private and Public Higher Education published in August 2011. An additional methodology used in rating the lease bonds was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

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Analysts

Mary Kay Cooney
Lead Analyst
Public Finance Group
Moody's Investors Service

Eva Bogaty
Additional Contact
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
USA

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