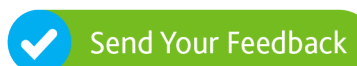


## CREDIT OPINION

18 May 2023



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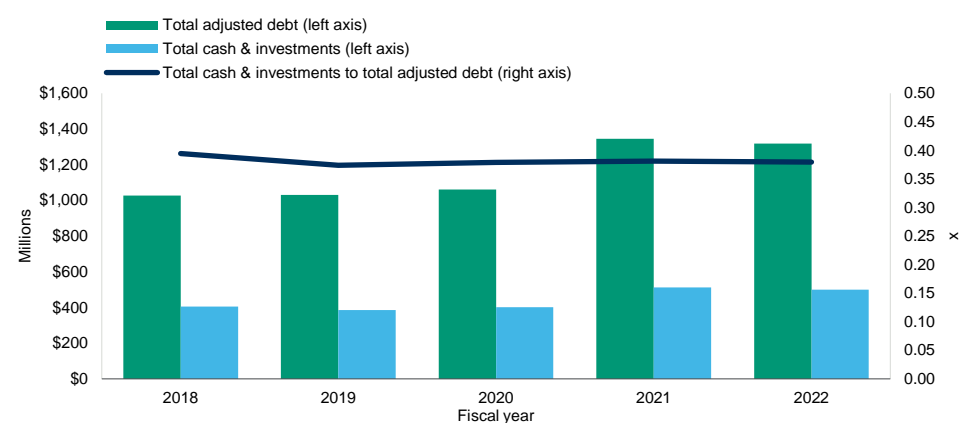
# Northern Arizona University, AZ

## Update to credit analysis

### Summary

Northern Arizona University's (NAU, A1 stable) very good credit quality reflects its established brand and strategic position as a large comprehensive university in northern Arizona, sizable \$597 million scope of operations, strong total cash and investments of \$500 million, good annual fundraising and continued support from the [State of Arizona](#) (Aa1 stable) for operations and 16% of annual debt obligations. NAU continues to face strained net tuition revenue because of a highly competitive market for students in Arizona and the southwest region. Limits to the university's pricing power and continued investments in strategic initiatives to attract and retain students in a competitive environment will pressure the university's generally good operating performance in future fiscal years. Other key credit challenges include NAU's high financial leverage, which includes a high pension liability and agreements with third parties for on-campus housing projects.

Exhibit 1



Source: Moody's Investors Service

### Credit strengths

- » Established presence as a large, comprehensive university in northern Arizona's city of Flagstaff, with \$597 million scope of operations
- » Strong fundraising with three-year average gift revenue of \$19 million in fiscal 2019
- » Support from the Aa1-rated State of Arizona for 16% of outstanding debt, with growing appropriations for operating and capital expenses

## Credit challenges

- » Highly leveraged with total cash and investments to total adjusted debt of 0.4x, in part due to a substantial pension liability
- » Highly competitive market for students has contributed to declining net tuition revenue over the last three fiscal years
- » Enrollment goals and strained revenue environment will require careful management of expenses

## Rating outlook

The stable outlook reflects our expectations that EBIDA margins will remain in the mid double digits and annual debt service coverage will continue to provide sufficient coverage of debt service obligations. The outlook also incorporates expectations that total cash and investments and liquidity will remain steady.

## Factors that could lead to an upgrade

- » Substantial increase in total cash and investments that outpaces peers and provides for greater coverage of debt and expenses
- » Strengthening of student demand that leads to material net tuition revenue growth and improvement in operating performance
- » Increase in fundraising that leads to growth in unrestricted financial reserves

## Factors that could lead to a downgrade

- » Sustained deterioration of operating performance that leads to less than sufficient annual debt service coverage
- » Additional sizable debt issuance without meaningful accompanying growth of wealth
- » Failure of the State of Arizona to support state-funded debt service

## Key indicators

Exhibit 2

NORTHERN ARIZONA UNIVERSITY, AZ

	2018	2019	2020	2021	2022	Median: A Rated Public Universities
Total FTE Enrollment	29,383	29,175	28,078	27,123	26,918	9,275
Operating Revenue (\$000)	550,822	565,497	563,176	557,992	597,049	232,885
Annual Change in Operating Revenue (%)	2.0	2.7	-0.4	-0.9	7.0	3.2
Total Cash & Investments (\$000)	405,392	385,637	401,695	513,019	500,247	240,898
Total Debt (\$000)	602,668	594,632	599,735	789,746	757,966	132,722
Total Cash & Investments to Total Adjusted Debt (x)	0.4	0.4	0.4	0.4	0.4	0.6
Total Cash & Investments to Operating Expenses (x)	0.7	0.7	0.7	1.0	0.9	1.1
Monthly Days Cash on Hand (x)	154	155	144	173	172	191
EBIDA Margin (%)	13.3	13.2	10.9	18.2	15.9	15.4
Total Debt to EBIDA (x)	8.2	8.0	9.7	7.8	8.0	3.9
Annual Debt Service Coverage (x)	1.6	1.4	1.3	2.2	1.9	3.2

Source: Moody's Investors Service

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## Profile

Northern Arizona University is a comprehensive, public four-year university with its main campus located in Flagstaff, Arizona and with over 20 satellite locations around the state as well as an established online program. In fiscal 2022, the university had operating revenue of \$623 million and enrolled 26,918 full-time equivalent (FTE) students in fall 2022.

## Detailed credit considerations

### Market position: new strategic enrollment plan will come amid heightened competition for students

NAU's very good brand and strategic positioning continues to be supported by its size and diverse academic program offerings, which contribute to fairly stable enrollment despite a highly competitive student market. The university's ambitious strategic enrollment plan was heavily disrupted by the COVID-19 pandemic, which contributed to modest declines in full-time equivalent (FTE) enrollment in fall 2020 and fall 2021. The university's relatively new university president, who began his tenure in June 2021, released an updated strategic plan that aims to improve enrollment in part through improved recruitment and retention of first-generation, low-income and underrepresented student populations and by taking advantage of Arizona's favorable demographic trends. There are some prospects for enrollment growth over the short term, as management reports that the fall 2022 first-year class was the largest in the university's history. Management projects stable undergraduate enrollment and strong graduate student demand to contribute to modest enrollment growth in fall 2023.

While enrollment growth has remained fairly stable, net tuition revenue declined in each of the past three fiscal years because of greater financial aid and higher tuition discounting. The university plans to improve net tuition revenue by expanding its online and graduate program offerings and attracting a great international student population, but limits on NAU's pricing power will persist absent a sustained strengthening of student demand.

### Operating performance: solid operating performance will continue despite competitive market pressures

Operating performance will remain solid as the university manages through net tuition revenue challenges over the coming fiscal years. Fiscal 2023 operating performance is likely to be a slight improvement over fiscal 2022, because of strong auxiliary revenue growth, improved investment returns and growing support from the state for operations. Expenses will increase in fiscal 2023 because of moderate wage growth for university staff. To address rising expenses in fiscal 2024, the university is planning modest increases in tuition for the 2023-2024 academic year.

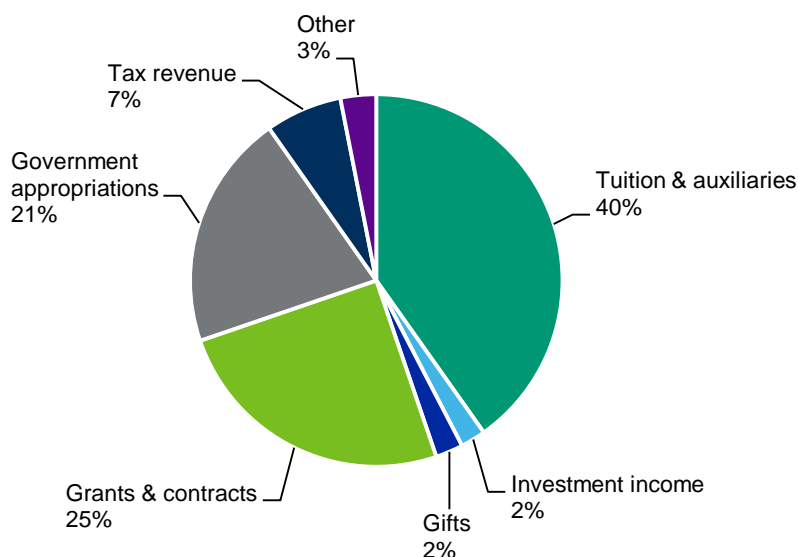
In addition to modest increases in state operating appropriations, NAU will benefit from the Arizona Promise scholarship program that began in 2022 and provides additional tuition assistance for low-income students and the Arizona Teachers Academy that covers tuition for students who agree to teach in Arizona schools after graduation. NAU also received substantial one-time support from the state for capital improvement projects, which will provide some relief for further capital needs over the next few years. Effective management of expenses will be key for the university as it executes on strategic initiatives to grow enrollment over the next two years.

NAU continues to benefit from strong revenue diversity, with 40% of fiscal 2022 operating revenue coming from student charges, 21% from appropriations and 25% from grants and contracts. The university's research footprint remains modest, but research expenses of \$52 million in fiscal 2022 represent a 28% increase over fiscal 2018.

Exhibit 3

**Diverse revenue mix supports NAU's credit quality**

Fiscal 2022 sources of revenue



Source: Moody's Investors Service

**Wealth and liquidity: strong wealth continues to be a key credit strength**

NAU's strong wealth continues to be a key strength supporting its credit quality. Strong fundraising and investment market returns drove substantial growth in total cash and investments of over \$100 million in fiscal 2021, but future growth prospects are tempered somewhat because of volatile financial market conditions. The university's wealth provided healthy coverage of total adjusted debt and operating expenses by 0.4x and 0.9, respectively in fiscal 2022, both slightly below the A medians of 0.6x and 1.1x.

Fundraising will improve markedly in fiscal 2023 as the university is on track to set a record for the highest amount raised in one year. This will continue a strong run of improved annual fundraising, with three-year average gift revenue improving in each of the last fiscal years. The university recently onboarded new senior leadership in its advancement office and is in the process of exploring a new comprehensive campaign. NAU successfully completed its last \$100 million capital campaign in June 2016.

NAU continues to pursue a very conservative asset allocation approach for its foundation endowment. In fiscal 2022, most of the endowments assets were held almost entirely in equities (75%) and fixed income (23%).

**Liquidity**

NAU's monthly liquidity of \$248 million provided a solid 172 monthly days cash on hand in fiscal 2022, slightly under the A-rated median of 191 days. Liquidity has improved from 154 monthly days in fiscal 2018 because of wealth gains and strong investment returns. Given ongoing academic and capital investments, substantial growth in the university's liquidity is not expected moving forward.

**Leverage: high leverage and PPP exposure is a key credit challenge**

NAU remains highly leveraged, limiting its capacity for future debt financings at the current rating. NAU's total direct debt of \$758 million in fiscal 2022 was well above the A median of \$133 million. The university's elevated leverage is partially mitigated by ongoing state support for 16% of annual debt service, as well as the university's strong wealth and good operating performance that generally provides for sufficient coverage of debt. The university is in the process of updating its campus master plan and does not have any additional borrowing plans at this time. Ongoing capital projects across NAU's statewide campuses include technology infrastructure and routine facility improvements that will be funded from a combination of state capital appropriations, fundraising and existing reserves.

The university's leverage profile incorporates substantial lease obligations, the largest of which is a \$200 million sublease obligation related to the university's honors college resident building, which houses over 700 students and is operated by student housing developer [American Campus Communities](#) (ACC) on land that is ground leased from NAU.

In addition to the honors college lease obligation, NAU has residential PPP projects with ACC for four housing facilities. Like the honors college, the ACC facilities are located on land that is ground leased from NAU, owned and managed by ACC and directed primarily toward non-freshman students. 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. To date these privatized housing projects have met performance objectives, with no adverse impact on the university's operations.

#### **Legal security**

As of the end of fiscal year 2022, NAU's debt totaled \$758 million and was comprised of system revenue bonds, SPEED (Stimulus Plan for Economic and Educational Development) bonds, Certificates of Participation (COPs), lease revenue bonds and various capital leases.

The seniormost system revenue bonds (\$301 million) are payable from and secured by a pledge of and first lien on gross revenues, which include tuition, fees and other revenue-producing activities, including auxiliary enterprises and indirect cost recovery. In fiscal 2022, gross revenues totaled \$292 million, which comprised 47% of the university's \$623 million of operating revenue. The SRB's carry a rate covenant requiring the university to set fees such that gross revenues are at least 2.0x maximum annual debt service (MADS) of the SRBs. Gross revenues cover the SRB gross MADS of \$27.2 million by 11x.

The SPEED bonds (\$107 million) are payable from and secured by transfers of certain available state lottery funds and university funds to a "SPEED Fund" held by the state treasurer. The funds are further secured by a subordinate security interest in gross revenues of the university should lottery revenues and university funds be deficient. Lottery funds have been appropriated for debt service reimbursement funds since program inception.

The COPs (\$36 million) are secured by lease payments, as well as a security interest in the leased properties financed by each specific series of COPs. The leases are unconditional obligations, payable from NAU's operating budget but with no security interest in any revenue stream. The 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. The state legislature has consistently annually appropriated these debt service reimbursement funds since program inception.

Four series of lease revenue bonds (\$108 million) are secured by separate lease agreements between ABOR acting on behalf of NAU and a special purpose limited liability corporation established by Northern Arizona Capital Facilities Finance Corporation (NACFFC). NAU annually appropriates for lease payments from unrestricted revenues.

#### **Debt structure**

The university's debt structure is conservative, with a mix of revenue bonds, certificates of participation and leases that are fixed rate and generally amortizing over 30 years.

#### **Debt-related derivatives**

None.

#### **Pensions and OPEB**

NAU has material debtlike obligations that add to its already high leverage. The university's pension contributions could further limit the university's long term financial flexibility. The university participates in the Arizona State Retirement System, which is a cost-sharing multiple-employer retirement plan sponsored by the state. The university's defined benefit pension obligation is moderate, with a Moody's three-year adjusted net pension liability (ANPL) of \$560 million in fiscal 2022. Contributions to the defined benefit plan are set by the state but paid by NAU and totaled \$16 million in fiscal 2022, a manageable 2.7% of total operating expenses. The university also operates a defined contribution plan for some employees, with contributions to this plan totaling \$6.3 million, bringing the total cost of the two plans to 3.9% of operating expenses.

NAU also participates in an OPEB program that is provided through the Arizona Department of Administration. NAU's share of the net OPEB liability was reported at \$514 thousand for fiscal 2022.

## ESG considerations

### Northern Arizona University, AZ's ESG Credit Impact Score is Moderately Negative CIS-3

Exhibit 4

#### ESG Credit Impact Score

# CIS-3

## Moderately Negative

For an issuer scored CIS-3 (Moderately Negative), its ESG attributes are overall considered as having a limited impact on the current rating, with greater potential for future negative impact over time. The negative influence of the overall ESG attributes on the rating is more pronounced compared to an issuer scored CIS-2.



Source: Moody's Investors Service

Northern Arizona University's **CIS-3** indicates that ESG considerations have a limited impact on the current credit rating with potential for greater negative impact over time. The ESG considerations include physical climate risks, social risks around student market challenges, as well as a financial strategy that includes elevated financial leverage and external partnerships to fund capital investments.

Exhibit 5

#### ESG Issuer Profile Scores

ENVIRONMENTAL

# E-3

## Moderately Negative



SOCIAL

# S-3

## Moderately Negative



GOVERNANCE

# G-3

## Moderately Negative



Source: Moody's Investors Service

### Environmental

NAU's **E-3** score reflects exposure to physical climate risks related to the location of the main campus in a wildfire-prone region and vulnerability to weather-related damage. As part of its robust climate action plan, the university has taken a number of steps to improve energy efficiency in an effort to both reduce costs and carbon emissions. NAU has developed graduate and certificate programs in climate science and greenhouse gas accounting to meet emerging green economy workforce needs.

### Social

NAU's **S-3** incorporates its exposure to demographic and social trends, customer relations, and human capital risks. Favorably, it has a mission that is aligned with positive social impact through education and service. Risks around customer relations relate to relatively modest matriculation rates and state support per student, as well as elevated tuition pricing sensitivity, though relatively strong high school demographics aids higher in-state student reliance and moderate research activity is brand additive. Human capital risks stem from elevated exposure to a large unfunded pension liability.

### Governance

NAU's **G-3** score incorporates sound financial management practices tempering risks associated with financial strategies, organizational and board structures. Relatively high financial leverage and commitment for student housing public-private partnerships inform financial strategy and risk management considerations. Board structure risks are introduced by the selection process, with the majority of voting members appointed by the Arizona governor and confirmed by the state senate.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click [here](#) to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

## Rating methodology and scorecard factors

The principal methodology used in this rating was [Higher Education Methodology](#) published in August 2021. The Higher Education Methodology includes a scorecard that summarizes the factors that are generally most important to higher education credit profiles. Because the scorecard is a summary and may not include every consideration in the credit analysis for a specific issuer, a scorecard-indicated outcome may or may not match an assigned rating. We assess brand and strategic positioning, financial policy and strategy, and operating environment on a qualitative basis.

Exhibit 6

### Northern Arizona University, AZ

Scorecard Factors and Sub-factors	Value	Score
<b>Factor 1: Scale (15%)</b>		
Adjusted Operating Revenue (USD Million)	597	Aa
<b>Factor 2: Market Profile (20%)</b>		
Brand and Strategic Positioning	A	A
Operating Environment	A	A
<b>Factor 3: Operating Performance (10%)</b>		
EBIDA Margin	16%	Aa
<b>Factor 4: Financial Resources and Liquidity (25%)</b>		
Total Cash and Investments (USD Million)	500	Aa
Total Cash and Investments to Operating Expenses	0.9	Aa
<b>Factor 5: Leverage and coverage (20%)</b>		
Total Cash and Investments to Total Adjusted Debt	0.4	A
Annual Debt Service Coverage	1.9	A
<b>Factor 6: Financial Policy and Strategy (10%)</b>		
Financial Policy and Strategy	A	A
Scorecard-Indicated Outcome		A1
Assigned Rating		A1

Data is based on most recent fiscal year available. Debt may include pro forma data for new debt issued or proposed to be issued after the close of the fiscal year.

For non-US issuers, nominal figures are in US dollars consistent with the Higher Education Methodology.

Source: Moody's Investors Service

7



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