Middlebury College, VT

Update to credit analysis

Summary
Middlebury College's (Aa3 stable) credit profile incorporates expectations of continued weak though improving operating performance, which will continue to hinder growth of financial reserves relative to peers. Middlebury continues to take significant positive steps to achieve financial equilibrium, currently anticipated for fiscal 2020. Incremental improvements in operating performance in both fiscal 2017 and 2018 will continue in fiscal 2019 based on current management estimates. In addition, although monthly liquidity has improved over the past several years, unrestricted liquidity remains very low relative to Aa-rated peers, particularly in light of weak operating performance. Favorably, Middlebury's sizeable wealth, donor support and excellent reputation as a selective liberal arts college will continue to help offset weak financial performance over the near term. In addition, a planned refunding transaction will eliminate a large bullet payment, with improved operating performance enabling increased amortization.

Exhibit 1
Sizeable wealth underpins rating as college progresses toward balanced operating performance

Fiscal year ending June 30
Source: Moody's Investors Service
Credit strengths

» Very selective liberal arts college recognized for its broad strength across academic disciplines

» Significant total wealth, with cash and investments in excess of $1.1 billion

» Excellent medium-term financial cushion, with spendable cash and investments cushioning debt and operating expenses by 3.0x and 2.9x, respectively

Credit challenges

» Ongoing operating deficits hinder growth of wealth relative to peers, with flat cash and investments since 2015 compared to a 12.5% growth rate for peers

» Narrow unrestricted liquidity relative to peers, with monthly days cash on hand of just 177 days

» Relatively high financial leverage, with debt to cash flow of 14x and very thin debt service coverage, particularly in light of current largely non-amortizing debt service schedule

Rating outlook

The stable outlook is predicated on expectations of ongoing improved financial performance, with a cash flow margin of at least 10%, using a 5% endowment spending rate, in fiscal 2019 and thereafter, providing 1x debt service coverage minimum. Inability to achieve these targets could result in a rating downgrade or negative outlook. The outlook also incorporates expectations of at least stable unrestricted liquidity and continued strong student demand.

Factors that could lead to an upgrade

» Significant, sustained strengthening of operating performance

» Outsized growth of cash and investments and unrestricted liquidity

Factors that could lead to a downgrade

» Inability to reduce supplemental endowment draws and generate operating cash flow margins of at least 10%

» Deterioration of unrestricted liquidity

» Weakening of spendable cash and investments relative to debt and operations

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Key indicators

Exhibit 2
MIDDLEBURY COLLEGE, VT

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<tbody>
<tr>
<td>Operating Revenue ($000)</td>
<td>245,930</td>
<td>244,608</td>
<td>250,503</td>
<td>256,351</td>
<td>263,627</td>
<td>244,863</td>
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<tr>
<td>Annual Change in Operating Revenue (%)</td>
<td>4.2</td>
<td>-0.5</td>
<td>2.4</td>
<td>2.3</td>
<td>2.8</td>
<td>3.0</td>
</tr>
<tr>
<td>Total Cash &amp; Investments ($000)</td>
<td>1,154,199</td>
<td>1,147,760</td>
<td>1,034,944</td>
<td>1,111,339</td>
<td>1,158,884</td>
<td>1,426,382</td>
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<tr>
<td>Total Debt ($000)</td>
<td>269,750</td>
<td>269,340</td>
<td>268,650</td>
<td>267,480</td>
<td>263,745</td>
<td>278,625</td>
</tr>
<tr>
<td>Spendable Cash &amp; Investments to Total Debt (x)</td>
<td>3.2</td>
<td>3.1</td>
<td>2.6</td>
<td>2.9</td>
<td>3.0</td>
<td>3.5</td>
</tr>
<tr>
<td>Spendable Cash &amp; Investments to Operating Expenses (x)</td>
<td>3.3</td>
<td>3.1</td>
<td>2.5</td>
<td>2.8</td>
<td>2.9</td>
<td>3.0</td>
</tr>
<tr>
<td>Monthly Days Cash on Hand (x)</td>
<td>74</td>
<td>106</td>
<td>153</td>
<td>175</td>
<td>177</td>
<td>445</td>
</tr>
<tr>
<td>Operating Cash Flow Margin (%)</td>
<td>9.4</td>
<td>5.7</td>
<td>2.9</td>
<td>6.3</td>
<td>7.3</td>
<td>15.4</td>
</tr>
<tr>
<td>Total Debt to Cash Flow (x)</td>
<td>11.6</td>
<td>19.1</td>
<td>37.2</td>
<td>16.7</td>
<td>13.6</td>
<td>5.4</td>
</tr>
<tr>
<td>Annual Debt Service Coverage (x)</td>
<td>1.7</td>
<td>1.0</td>
<td>0.5</td>
<td>1.2</td>
<td>1.2</td>
<td>3.0</td>
</tr>
</tbody>
</table>

Source: Moody’s Investors Service

Profile

Middlebury is a highly selective liberal arts college recognized for its strengths across academic disciplines. The college has approximately 2,500 full-time equivalent students on its main campus in Vermont. An array of graduate and summer schools focusing on language, international studies, and literature contributes to annual operating revenue of $263 million.

Detailed credit considerations

Market profile: strong reputation, solid student demand and programmatic diversity support very good strategic positioning

Middlebury will continue to benefit from its strong reputation as a highly selective liberal arts college with broad academic strengths in languages, literature, international studies, economics, and the sciences, supporting its very good strategic positioning. Selectivity is a strong 17%, with a solid over 40% of students choosing to enroll in fall 2018.

The operation of summer language immersion programs, study abroad programs at 37 global locations, a West Coast campus, and three locations within Vermont add relatively more operating complexity than typically found at a liberal arts college of its size. Enrollment diversification is evidenced via a core of approximately 2,500 full-time undergraduate students, over 600 full-time graduate students, and over 2,200 summer participants at the Language Schools and non-degree programs, which are not included in FTE enrollment.

Operating performance: ongoing reduction of operating deficits during implementation of financial sustainability plan; near balanced performance expected in fiscal 2020

Middlebury has taken positive steps to improve operations, with continued improvements in operating performance expected that will further reduce deficits in fiscal 2019. Near balanced operating performance is expected in fiscal 2020 based on management estimates, which include a $3 million supplemental endowment draw. This is a significant improvement from an operating deficit of over 10% in fiscal 2016 with a supplemental endowment draw of $18 million. Operating cash flow remained thin in fiscal 2018 at 7%, providing just 1.2x coverage of debt service. Fiscal 2019 results are anticipated to be slightly better, exceeding budget targets and with operating cash flow near 10%.

Middlebury’s operating performance will benefit from recent board-approved initiatives, including a staff voluntary separation program and a faculty early retirement program. These significant steps will incur some initial costs but will generate annual savings beginning in fiscal 2020 and eliminate reserve endowment draws in fiscal 2021.
Wealth and liquidity: Strong wealth underpins rating, extremely thin liquidity
Middlebury’s sizeable cash and investments are notable credit strengths, particularly in light of weak operations. In fiscal 2018, spendable cash and investments of over $800 million provided solid coverage of operating expenses at 2.9x. However, growth of Middlebury’s financial reserves is slow relative to peers despite healthy investment performance. Between fiscal 2014 and 2018, Middlebury’s cash and investments remained flat compared to a median of 12% growth for Aa3-rated private colleges. With deficits expected to continue in fiscal 2019, Middlebury’s reserves will continue to lose strength relative to peers.

Strengthened fundraising may mitigate the impact of ongoing operating deficits over time. Average gifts per student of $11,567 over fiscal 2016 to 2018 is in line with Aa3 rated peers. A campaign is currently in the planning stages but timing and a goal are not yet finalized.

Liquidity
Middlebury’s unrestricted liquidity is very narrow relative to peers, particularly since the institution is operating at a deficit. Imbalanced operations have negatively impacted unrestricted liquidity over time and will continue to do so in the near term. At the end of fiscal 2018, Middlebury’s unrestricted cash and investments that could be liquidated within one month covered 177 days of operating expenses, well below the peer median of 445 days. In addition to its own liquidity, Middlebury has a $15 million operating line of credit available if needed for short-term working capital needs.

Despite the institution’s sizeable wealth, liquidity is limited by its external investment management strategy, a structure that the college thoroughly evaluates on a regular basis. Middlebury, along with other colleges and not-for-profit organizations, owns shares of various funds with a variety of redemption features. Although the underlying asset may be highly liquid, access to the assets may be limited by redemption restrictions. While this structure provides access to investment opportunities that the college may not normally access on its own, it also creates operational risk and more limited liquidity due to the heavy weighting to private equity and hedge funds. Middlebury’s investment of working capital alongside the endowment further narrows its cushion to absorb operating shocks or elevated capital calls. As of fiscal 2018, Middlebury had unfunded capital calls of $262 million, somewhat high given thin liquidity, though capital calls are funded from the endowment, which provides a broader pool of available financial resources.

All of Middlebury’s debt is issued in a fixed rate mode. With no covenants other than a rating trigger of A2 on a $21 million bank loan, the liquidity risks from debt structure are minimal.

Leverage: high debt burden, improved operating performance enables plans to amortize debt
Middlebury’s debt burden of $260 million is high relative to its thin cash flow and its small operating scale. In fiscal 2018, operating cash flow just covered Middlebury’s debt service at 1.2x coverage, with debt service comprised predominantly of interest due to the bullet maturity structure of over 70% of rated debt. Debt to cash flow was a very high 14x relative to an Aa3 peer median of 5x.
Debt structure
Currently, Middlebury’s bullet maturity structure enables the college to cover annual debt service requirements from operations but with minimal amortization and reduction of leverage, limiting future debt capacity. A planned refunding transaction will replace a $59 million bullet for the Series 2009 bonds due in fiscal 2038 with regularly amortizing debt, reducing the complexity of the debt portfolio, with only half of the debt with bullet maturities after the proposed transaction. Improved financial performance is expected to enable the college to cover increased debt service due to the higher principal amortization. The college is considering a similar transaction when $95 million in series 2010 debt becomes callable.

Legal security
Rated debt is an unsecured general obligation of the college.

Debt-related derivatives
Not applicable.

Pensions and OPEB
Middlebury has limited exposure to post-employment benefits, recording only a defined contribution plan and no retirement healthcare benefits.

Management and governance: focus on improved operating performance will continue to demonstrate results
Middlebury’s leadership continues to implement changes in personnel and processes, with a focus on improving operating performance. The leadership team has demonstrated success thus far, reducing the amount of elevated endowment spending as it right-sizes its faculty and staff, consolidates student services, and pursues other strategies for cost containment and revenue growth. Plans to reduce bullet maturities reflect increased budgetary discipline and financial flexibility resulting from anticipated operating performance improvements.
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