Article Title: Criteria | Governments | U.S. Public Finance: Privatized Student Housing For Higher Education Data: (EDITOR'S NOTE: —On April 24, 2023, we republished this criteria article to make nonmaterial changes. We deleted sections that have been superseded by "Global Not-For-Profit Education Providers," published April 24, 2023. See the "Revisions And Updates" section for details.) Privatized Dormitories Rating approach for on-campus privatized housing The issuance of dormitory revenue bonds is not a new development in higher education finance. Their use, like bonds used to finance parking, dining, and athletic facilities, was almost universally limited to public universities because debt constraints or other statutory limitations were not experienced by private colleges and universities. Private colleges have not been prohibited from issuing debt for any reasons other than the former cap on tax-exempt bonds. Private colleges and universities always pledged their general obligation because they could do so. However, beginning in the 1990s the environment began to change. Colleges experienced a surge in demand for modern, updated apartment style housing, and needed to respond more quickly to market demands. The concept of using developers' expertise and separately created 501(c)3 issuers to help issue the debt for these projects rose in popularity. The motivation for most institutions was obvious. For public institutions, the ability to circumvent traditional financing guidelines can cut years off a construction project and significantly reduce construction costs. Private colleges and universities, meanwhile, face their own growing capital needs and are looking for ways to preserve their debt capacity and yet remain competitive. Colleges and universities pursuing the option of privatized housing often want to know two things: (1) whether using off-balance sheet debt for residential facilities will affect their existing credit profile and debt capacity; and (2) the degree to which they need to support a project to ensure a lower cost of capital for their students' housing. S&P; Global Ratings' criteria for off-balance sheet housing addresses these concerns and largely rests on the below "credit-risk" relationship model. The credit-risk relationship model If a college transfers credit strength to an affiliated entity or project, then the corresponding risks of that enterprise will almost always transfer back to the college. The greater the linkage between the sponsor institution and the project, the more likely the debt financing will affect an institution's credit profile, whether the financing is "off-balance sheet" or not. However, a closer link to an institution's credit strengths and the possibility of subsidization of debt service will usually mean a higher stand-alone rating and a lower cost of capital. A new housing project with very little link to a sponsoring institution will probably not benefit from the institution's creditworthiness. On the other hand, the institution can probably safely assume that the issuance of the related debt will not affect its rating at or after the time of the transaction. Nonetheless, debt related to an entity's business is generally of concern, especially when the primary customers are the institution's students. Even a project that does not require immediate subsidization may require management effort or time. Future accounting rules could also change, requiring debt that was off balance sheet to be consolidated in subsequent financial statements. A project related to an institution can also represent competition; if future housing occupancy drops on campus, an important question is whether students will occupy newer facilities related to the campus, but not the university's own housing facilities. Issuing additional debt, even if off-credit, could represent credit dilution for existing bondholders of dormitory revenue bonds. Because of these issues, S&P; Global Ratings generally uses two standards in evaluating the "credit-risk" relationship: economic interest and control. Does the university or school have an economic interest in the project; and does it control who uses the facilities being financed, project budgets and rate setting, and who manages the property (control). Comparing traditional dorm revenue bonds and privatized housing When rating on-campus privatized housing facilities, S&P; Global Ratings might focus on the differences between these projects (often called privatized student housing debt) and traditional university dormitory revenue bonds. The chief distinction between privatized student housing debt and traditional auxiliary bonds is the absence of university oversight and ownership. Traditional dormitory revenue bonds are, in many instances, sold directly under the university's name, controlled by the university, and revenues and expenses of the project and related debt are consolidated in the university's financial statements. Because of the absence of ownership, S&P; Global Ratings usually does not rely on its historic method of shading ratings on dormitory revenue bonds using the institution's GO equivalent rating as a starting point. Instead, for project-based, privatized housing, S&P; Global Ratings might use a university's long-term rating as a proxy for long-term viability and potential demand for housing. If demand for on-campus housing is weak or non-existent, and the university's long-term rating is low investment-grade, it is unlikely that any proposed financing might achieve an investment-grade rating without a very substantial link to a sponsoring institution. Conversely, if housing demand is strong, and the proposed project is being used to replace existing housing, the project would generally be viewed favorably. A substantial link might be a college guaranty of debt service or an unconditional lease vacancy agreement. The chief similarity between traditional dormitory revenue bonds and project dormitory bonds is that even traditional dormitory revenue bonds are technically non-recourse obligations. Bondholders are often entitled only to pledge revenues derived from the project or system of projects. So, for both, the revenue streams are narrowly defined as being produced by a particular project or set of projects. Another corollary is that both are occupied by customers--students of the college or university. As such, it is probably incumbent on the college to ensure that any project to which they are related provides students with decent, livable, and economical space. If students in the privatized facilities also receive financial aid from the institution for living expenses, the school is indirectly paying for the facility. If the college is a residential college, it may not make financial sense to use financial aid for a project in which the college builds no ownership equity. Rating methodology In assessing this type of debt--without ownership (and usually without management) by the university--S&P; Global Ratings generally examines many of the same characteristics that are evaluated for traditional auxiliary bonds. Generally the following factors are necessary to achieve an investment-grade rating. While the following section speaks largely to housing, any other enterprise financing could apply the criteria for relevancy. Evidence of long-term institutional viability A school with a long-term GO rating of 'BBB+' or higher and a strong residential mission is likely to have the capacity to consider this new type of financing option. Below this rating threshold, achieving an investment-grade project-based rating might be difficult, unless the school provides direct financial support. Relationship between project owner and related institution The relationship between the two is generally evaluated based on board composition, ground lease structure, management agreement, and the factors leading to the decision to pursue the particular financing. A university that will ultimately own housing in the middle of its campus seems to have a vested interest in making that project successful. However, the degree to which a university, particularly a public university that does not currently own a project, can legally, or is willing, to cover a shortfall in debt service for that project is variable. It may be easier for private universities to step up to a financially unsuccessful project, but only if it is on their campus and they already exercise some control and oversight. Project demand Student demand for a new housing facility might be demonstrated by demand for existing on-campus housing. High occupancy rates, replacement housing, the presence of waiting lists, university leasing of off-campus housing accommodations, and recent enrollment growth will all be viewed favorably. S&P; Global Ratings will sometimes evaluate external feasibility studies that show sufficient demand for on-campus housing, but these usually provide only partial comfort. Project location Most projects rated in this way are usually on or near the core college or university campus. If the proposed housing is off-campus, the college does not own the land, and there is no significant financial or managerial link to the school, S&P; Global Ratings would not rate the project debt under these criteria. Project management The highest rated projects are often by managed by an institution itself (which connotes a higher degree of responsibility and oversight). At the behest of the university, other projects will be handled by outside managers, usually a for-profit company. The length of management contract is generally not as important as other credit factors. A stronger institutional link will include university rate setting, budget setting, and housing policies that are virtually indistinguishable from other university housing. Rate covenant Rate covenants typically cover debt service and operating expenses. A typical rate covenant might set rates at a minimum level of 1.20x the next year's debt service and operating expenses. In S&P; Global Ratings' experience, many standalone privatized housing projects, that have been completed, have experienced either pricing pressure or higher than expected costs, such that it has been difficult to meet the standard 1.2x rate covenant. Additional bonds tests Additional bonds tests generally protect bondholders against the possibility of future debt weakening or diluting the specific project's revenue base. Historical additional bonds tests are viewed more favorably than projected tests. The absence of an additional bonds test might be viewed negatively. Reserves and insurance A full debt service reserve is usually funded from bond proceeds or through an approved reserve substitute. A portion of net cash flow is often retained to build up maintenance and repair reserves. Projects generally include a capital (per bed) reserve funded from cash flow, sufficient to handle annual maintenance. Housing maintenance is important to keep the facility attractive during the life of the bond issue and provide for unanticipated major maintenance. S&P; Global Ratings will often evaluate business interruption insurance and the provision for coverage (generally 18-24 months) in the event of damage or destruction. The single site nature of many of these projects can create additional risk and full insurance and reserves are sometimes crucial. Coverage Most projects rated by S&P; Global Ratings provide adequate or better cash flow protection, with a multiplier of at least 1.2x coverage of maximum annual debt service in every year. Other considerations Projections often include a reasonable allowance for vacancies and expense growth. Historically many projections provided for these projects have used a very high occupancy rate of 95%-97%. S&P; Global Ratings generally looks for break-even occupancy that is much lower than this level; generally if break-even occupancy is less than 75%, cash flows are viewed more favorably. Because of the untested history of these projects and the concurrent risks of an aging facility, a shorter debt maturity is often viewed more favorably than a longer maturity, even if coverage drops slightly with the shorter maturity. Many investment-grade projects do not include construction risk. However, construction risk is generally evaluated based on S&P; Global Ratings' criteria "Assessing Construction Risk," and a project with construction risk can be rated investment-grade. There are mechanisms available to mitigate construction risks so that a project can be rated prior to actual completion. Sometimes the formation of a new "privatized housing system" can offset concerns about single site project or construction risk. Significant university involvement in the construction process is usually viewed favorably. Credit links As seen from the above section, the closer the link between a project and its sponsoring institution, often the higher the rating. However, the closer the relationship, the more likely it is that the housing debt will be considered a direct or indirect obligation of the institution. Good reasons to consider privatized student housing debt, or indirect debt, as institutional debt are: The institution receives a direct economic benefit; The institution manages the project as if it were any other on-campus activity; The project is highly essential for the institution and loss of control could be harmful to the institution's overall performance and reputation; The institution benefits from immediate or eventual ownership of the project being financed. Ultimately, ratings encompass a variety of factors, of which debt is just one. The inclusion of additional indirect debt in an analysis of an institution's overall credit picture does not necessarily mean that a rating will change. Most often the revenue-producing nature of projects will be taken into account when considering institutional ratings. Self-supporting projects are generally viewed more favorably than projects, which produce no additional revenues, all other factors being equal. Privatized Student Housing Bond Rating Factors SCOPE OF PLEDGE DEMAND ESSENTIALITY FINANCIAL OPERATIONS LEGAL STRUCTURE % of students housed on campus Historical occupancy Commuter or residential school Adequate coverage Additional bonds test Revenues derived from stand-alone facility or system Evidence of waitlist Part-time or full-time student body Rate flexibility Rate covenant Competition on or off campus Budgeted capital expenditures Closed or open fow of funds Location of facility Debt service reserve Renewal and replacement reserve Revisions And Updates This article was originally published on June 19, 2007. Changes introduced after original publication: Following our periodic reviews completed in 2016 and 2017, we deleted the sections "Private College And University Credit Ratings," "Rating Public Colleges And Universities," "Rating Stand-Alone Medical Schools," "State-Supported Medical Schools," and "Independent Medical Schools," which were superseded by "Methodology: Not-For-Profit Public And Private Colleges And Universities," published on Jan. 6, 2016. We also removed certain references to evaluating pledged revenue streams of community colleges, which were superseded by "Assigning Issue Credit Ratings Of Operating Entities," published May 20, 2015. Following our periodic review completed on April 4, 2018, we added the "Revision And Updates" section and updated the contact information. On May 28, 2019, we republished this criteria article to make nonmaterial changes to update the contact information. On May 25, 2021, we republished this criteria article to make nonmaterial changes. We removed noncriteria language and clarified terminology in various sections. Additionally, we updated criteria references and contact information. On April 24, 2023, we republished this criteria article to make nonmaterial changes following the publication of "Global Not-For-Profit Education Providers." We deleted the section of this criteria that applies to community college debt and auxiliary systems because they are now in the scope of "Global Not-For-Profit Education Providers." Specifically, we renamed this criteria article "Privatized Student Housing For Higher Education" to better clarify the revised scope and content. We also deleted the section "Rating Community College Debt" and renamed the section previously titled "Auxiliary Revenue Bonds And Privatized Dormitories" to "Privatized Dormitories" to better clarify the scope of this criteria. Within this section, we also deleted the subsection titled "Traditional auxiliary revenue bonds" because this content is now in the scope of the not-for-profit education providers criteria. In addition, we updated the table summarizing rating factors to reflect the revised scope of this article, which focuses on privatized housing. Finally, we updated criteria references and contact information. Related Publications Related criteria Global Not-For-Profit Education Providers, April 24, 2023 Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015 Principles Of Credit Ratings, Feb. 16, 2011 Assessing Construction Risk, June 22, 2007