Article Title: Criteria | Governments | U.S. Public Finance: Non-Traditional Not-For-Profits Data: (EDITOR'S NOTE: —On Aug. 11, 2021, we republished this criteria article to make nonmaterial changes. See the "Revisions And Updates" section for details.) The substantial number of rated not-for-profit corporations generally falls into four broad areas that are separate from the traditional sectors of health care and higher education. They are: Cultural institutions and attractions; Voluntary membership organizations; Endowed and charitable foundations and corporations; and Research institutions. In many respects, the only similarity between these four entities is their tax-exempt status. Yet, despite this diversity, S&P; Global Ratings has developed a common rating methodology to assess their creditworthiness. This methodology builds on our criteria for hospitals and universities, yet incorporates the unique characteristics of each new nonprofit entity. In general, S&P; Global Ratings public finance does not rate political parties and churches. Rating Methodology The four main credit factors generally considered for each organization are: Demand for the organization's products and services; Management and governance; Financial performance and resources; and Debt and capital structure. While these factors are the same as those used for assessing many types of credits in public finance, the focus of the evaluation is quite different, depending on the type of organization. For cultural institutions, demand is often the focal point. Most of the cultural institutions rated by S&P; Global Ratings are admissions-driven, and earned income is a function of the number of people who attend or visit a facility. For membership organizations, the primary focus is the tie between the organization and its members, and an analysis of the service or services provided. Membership revenue may not be the largest source of operating income for the organization, but the relative importance of the corporation to a particular industry is often a key factor. Analysis of endowed foundations focuses less on demand and more on financial resources and balance sheet strengths, and the likelihood of growth or stability, or the possibility of reduction in the pool of assets. The driving factors behind the analysis of research organizations are the nature and level of the research, whether the costs of research are fully reimbursed, and an entity's ability to withstand funding changes. Most of the research institutions rated by S&P; Global Ratings, in addition to a sizable research base, also benefit from the presence of long-term investments or endowment. Demand S&P; Global Ratings' assessment of demand includes a thorough understanding of each entity, its mission, market, and niche. An important component shaping the character of these organizations is often an issuer's tax-exempt status. Such status entitles nonprofits to an exemption from taxes on related business income and to issue tax-exempt debt—two significant advantages not available to for-profit counterparts. Conversely, not-for-profits often run breakeven financial operations; but because these organizations retain earnings without shareholder distribution, they tend to build reserves over time. S&P; Global Ratings might review an organization's charter to assess its mission and changes in this role over time. Depending on the primary activity of the organization, S&P; Global Ratings might also examine various measures of industry effectiveness and performance. For example, when assessing a museum, S&P; Global Ratings might review net revenues per visitor, a common industry statistic. When assessing an endowed or charitable foundation, assessment of fundraising efficiency (what portion of dollars raised is spent on programs and what portion on administrative costs), could also be important. This point is especially true for organizations that engage in direct mail fund drives and which raise a substantial portion of their annual budgets from external donors. An assessment of competition or competitive position can also be important. Unlike a municipality, which provides essential services and therefore is likely to survive despite fiscal stress, nonprofits often have a role unique enough to ensure ongoing viability, even though they might not be essential. Closing a local service nonprofit organization might not cause significant long-term distress or dislocation to the local community or users. But closing an important federally sponsored research institution that provides essential research for the federal government might be more disruptive to the government of the entities in this sector. However, very few of these institutions go out of business. Some organizations have voluntarily rescinded their exempt status and converted to taxable, or proprietary corporations. Typically, any tax-exempt debt would be refunded at that point. Management and governance Management is an important credit factor, particularly for nonprofits wrestling with industry competition and often limited financial flexibility. S&P; Global Ratings assesses management and governance typically by reviewing: The composition of the board of trustees, its expertise, its independence, its committee structure, and its role in setting financial guidelines and goals; The quality of management information readily available in the rating process; Operational policies, investment and debt policies, and strategic plans; The ability to anticipate and react to new developments in the marketplace; and Current tenure of existing administrative officers of the organization and their relevant experience in the industry. While nonprofit corporations are not required to fully adopt the provisions of Sarbanes Oxley at this time, in practice many of them voluntarily adopt most of these as practices, with the exception of certification of financial statements. Most of the organizations in this sector that achieve investment grade ratings also engage in multi-year financial planning and can easily produce budget models that forecast future operations. Since many exempt organizations rely on large endowments, balance sheet management (both asset and liability) can be important. S&P; Global Ratings generally reviews investment policies, investment performance relative to market benchmarks, current asset allocation, and spending policies. As far as liabilities, S&P; Global Ratings usually reviews debt policies, existing debt structure (including any off balance sheet or subsidiary liabilities), plans for reducing any postretirement liabilities, and employment cost structure. Financial performance and resources Financial analysis generally begins with an historical overview of the institution's operations. The not-for-profit corporations rated by S&P; Global Ratings almost universally report their operations under FASB reporting guidelines. Financial analysis typically incorporates five years of historical performance, current year's preliminary results, and the next year's operating budget. If five-year, or multi-year forecasts are available, these documents might be able to provide a good indication of management's assumptions about future business activities. Within the financial context, S&P; Global Ratings often examines: Growth in the operating budget and budgeting practices; Revenue diversity and cyclicality and the opportunity for future revenue growth; Expense flexibility, or the ability to make programmatic changes without negatively affecting demand; and Rate flexibility, particularly in those cases where there is significant industry competition; Financial performance on an aggregate basis, measured by the existence of operating surpluses or deficits; And financial resources, measured by cash and investments and unrestricted and expendable resources. Affiliated organizations are generally consolidated in financial statements of the entity being rated, and S&P; Global Ratings' analysis generally incorporates the assets and operations of subsidiary corporations of not-for-profits. Projections beyond the current budget year might also be reviewed, for they often reveal new program directions and can be a gauge of management's realism. Important financial ratios can include the assessment of debt burden and operating cushion. For debt burden, S&P; Global Ratings usually examines maximum annual debt service as a percentage of expenses and total debt relative to cash and investments and to total unrestricted resources. Unless there is an ability to adjust rates on an ongoing basis, S&P; Global Ratings generally expects current operating surpluses to cover total debt service, including principal and interest associated with new debt. While many nonprofits operate on a breakeven basis, S&P; Global Ratings finds that these organizations often have an operating cushion to shield them from inevitable economic cycles. Operating margin varies by type of organization. Some membership organizations demonstrate a high level of profitability, while some charitable organizations only break-even from year-to-year. The most important cushion ratio generally compares unrestricted resources to expenses and provides a measure of an entity's ability to fund operations if operating revenues decrease. Different organizations might display different cushion levels. For the most part, the level of working capital needed by an organization is a function of the organization's cash flow. An entity that receives a steady stream of income throughout the year can sometimes operate on thinner reserves than one that receives most of its revenue once or twice a year. An exempt organization that can quickly and easily reduce expenditures at midyear can operate with thinner reserves than one that must commit funds well in advance. Most not-for-profit corporations rated by S&P; Global Ratings tend to have a good sense of their cost structure—what portion of their operating expenses are fixed and what portion, or components, are variable. Some organizations indicate that a substantial portion of their salaries and benefits could be considered to be variable in nature, while facilities costs, insurance, and legal fees are not. Generally, institutions with unrestricted resources (measured in cash and liquid investments) below 25% of their annual operating budget tend to have a limited financial cushion. In addition to operating revenues, many nonprofits rely on annual voluntary contributions. A long history of successful fundraising managed by a professional staff can sometimes offset concerns about the cyclicality of this revenue source. However, these strengths might not be enough to offset the risks associated with an organization totally dependent on contributed revenues. Debt and capital structure In addition to reviewing specific debt ratios as noted above, S&P; Global Ratings generally considers security, the project being financed, and future capital plans in its assessment of debt. Organizations that are capital, or facilities-intensive, should have debt policies in place. Debt policies often include the types of allowable debt, directions about when derivatives can be used, and how an appropriate level of debt is determined. Other long-term liabilities, such as postretirement obligations, might be considered in addition to any long-term bonded indebtedness. The level of debt that is manageable is very much specific to the type of institution being rated. Cultural facilities, which are more place-intensive, tend to have higher debt burdens than other types of nonprofit corporations. Security.Most not-for-profit corporations' bond issues are secured by an unsecured corporate, GO pledge of the obligor institution. While S&P; Global Ratings considers all types of security, such as membership fees at a museum or indirect cost recoveries of a research laboratory, a narrow pledge might not receive as high a rating as a GO pledge. As additional security, a fully funded debt service reserve can be prudent unless the issuer has substantial liquidity. Most issuers also include legal covenants, such as rate covenants, asset-to-liability tests, and restrictions on the issuance of additional debt. The rating impact of such covenants depends on the nature of the entity and each covenant's relative strength or degree of restriction. Some covenants are so loosely written that they do not usually provide any real protection for bondholders. Stronger legal covenants generally do not result in a higher general obligation rating. Endowed foundations present a special case for bondholders. While they look for some indication that a pool of assets will not be spent down, nonprofit corporations issuing tax-exempt debt are subject to arbitrage restrictions, which could be a strong disincentive to pledging any kind of "reserves". However, restrictive covenants and policies remain a protection that bondholders wouldn't otherwise have, and a gauge of willingness to meet the needs of investors. Project.An analysis of the project to be financed generally incorporates several factors. S&P; Global Ratings initially might examine the need for and scope of the project, and how it fits into the organization's overall activities. Many of the nonprofit project financings rated by S&P; Global Ratings involve the construction of new headquarters buildings and the consolidation of operations in one location, and are considered fairly essential. S&P; Global Ratings also might analyze the degree of self support assumed for the project, compares debt maturity with project life, and evaluate other sources of funding. Undertaking a project that does not help meet an organization's mission, that takes it in new untested directions, or that is likely to require considerable financial resources in the future even when an organization has debt capacity, could be considered a negative rating factor. Most of the project financings rated investment grade are projects being undertaken by existing exempt organizations. Start-up projects by new organizations without a track record, or by entities without any financial resources, may find it difficult to achieve investment-grade ratings. Capital improvement program.A review of the size, sources of funding, and timing of future capital plans provide important insight into an organization's needs and goals for expansion. S&P; Global Ratings also is interested in determining whether these plans will significantly change an organization's scope or mission. Some organizations, such as aquariums or other attendance-driven cultural institutions, must constantly plan for new attraction and updates of their facilities. A failure to consider new exhibits or changing exhibits could be of concern to the organization. Cultural Institutions While the rated universe of cultural organizations largely consists of museums, the rating approach is similar for all types, including zoological parks, public radio and television stations, aquariums, and historical sites. Rated issuers are highly diverse, ranging from fine arts to natural history institutions. They also vary widely in their constituencies (adults, children, tourists, or local residents), admission and membership levels, revenue sources, and financial flexibility. To assess demand for a cultural institution, S&P; Global Ratings generally examines: The national and/or international prominence of the collection; Admissions and membership levels and trends; Competition from and location near other local museums, similar organizations, and tourist attractions; and Fee structure and rate flexibility. Service area economic conditions can also play an important role, particularly when the institution has a more limited, local draw. In addition, admission and membership trends often are affected by the use of blockbuster or special exhibits, a phenomenon somewhat unique to museums. These super shows usually run for a limited time and, despite huge crowds and swelling revenues, often are money-losing propositions. Nonetheless, blockbusters can have a longer-term positive effect by attracting new members and repeat visitors. Because blockbusters dramatically inflate revenues and expenditures in show years, it is often difficult to make accurate financial plans. As a cultural institution assumes long-term debt, it is important that it budget for these variations and maintain an adequate financial cushion to offset fluctuations. In fact, the highest-rated museums enjoy significant financial flexibility, with endowment and unrestricted monies well in excess of the annual operating budget, even though they do not always produce consistently good operating margins. The visible civic role played by many cultural institutions often results in high levels of municipal government and/or private donor support. Attendance-based cultural facilities with cyclical revenue streams, limited outside support from governmental or private donors, and no endowment, might not achieve investment-grade ratings. Start-up cultural organizations could receive lower ratings, since they do not have a record of attendance or membership, and might not have an endowment. Museums that undergo significant expansions can often demonstrate that there is some predictability to their current revenue source, such that projections seem attainable. In fact, most forecasts are far more positive for first year attendance after a major project completion than what actually occurs when the project is completed. An important part of S&P; Global Ratings' analysis of a cultural institution can be a review of the proposed project, particularly its potential impact on attendance or membership and the organization's mission and focus. Exempt organizations often receive substantial governmental support, which might offset the risks associated with increased debt issuance. Therefore, the outlook for future governmental and private support is often a crucial part of S&P; Global Ratings' analysis. Membership Organizations One subset of not-for-profits that has garnered significant market interest is voluntary membership organizations. Such entities range from professional membership organizations to trade associations, religious organizations, and scientific societies. The rating analysis depends, in large part, on the primary activity of the organization and the benefits derived from membership. As with other not-for-profits, S&P; Global Ratings' analysis of a membership organization might begin with a comprehensive evaluation of the operating history of the institution and its current activities and management. While actual membership growth is important as a proxy for demand, the main focus is generally on understanding an institution's particular industry and role within that industry. To that end, S&P; Global Ratings might examine offered services, membership trends, and measures of industry effectiveness and performance. Some organizations have a role so unique that they have no competition in their particular industry. For example, the Association of American Medical Colleges is the accrediting body for the majority of the nation's medical schools and the only sponsor of the Medical College Admissions Test (MCAT). Regardless of an organization's competitive position, S&P; Global Ratings generally expects to see a consistent or stable membership base. Wide fluctuations in membership can make planning and budgeting difficult and are sometimes viewed negatively. S&P; Global Ratings rates both large and small membership organizations and size can be an important characteristic. Generally, the larger the organization, the more revenue diversity and greater level of financial resources it possesses relative to operating expenses and debt. However, a small membership organization could be highly rated with a substantial endowment and good operating performance. Other areas of inquiry for membership organizations can include: Historical membership data by type of member for at least ten years; Breadth of focus. Organizations with a narrow focus are sometimes the most vulnerable to periods of economic stress; Degree of professionalism in the administrative staff. For any investment-grade credit, S&P; Global Ratings generally sees an experienced, permanent staff with functions distinct from the governing body, or membership directorate of the organization; Benefits derived from membership. Exceptionally strong credits provide services that are highly desired and cannot be obtained elsewhere; and Competing membership organizations who provide the same type of services and may overlap with members Percentage of members who count the organization as their primary professional society. Financial performance The financial history of a membership organization is analyzed for a multi-year (usually five-years) period. S&P; Global Ratings evaluates historical financial performance to determine how well the organization performed given its available revenues (income statement) and resources (balance sheet). Most of the membership organizations rated by S&P; Global Ratings have limited capital needs and an operating cushion equal to six months of operating expenses, however, there are entities with a considerably higher cushion and those with a much lower cushion who pursue a rating. While many organizations have sufficient liquidity to pay for the project being considered, partially paying the project costs with accumulated equity to reduce debt burden also reduces operating cushion. Unless debt burden is a concern, using equity for long-term projects is unlikely to result in a higher rating for the organization. S&P; Global Ratings tends to examine the major sources of revenues and patterns of expense growth. As for most rated organizations, revenue diversity is generally important and shields membership organizations from potential cycles. A critical issue is budgetary flexibility and the ability to cut expenditures midyear without jeopardizing operations. Management is usually able to quantify areas of variable costs that can be eliminated, or scaled back, in the event of financial stress. Ancillary services, provided at no cost to the membership, account for a major portion of operating expenses at many membership organizations, and are often the first place that management will look to scale back. However, organizations often recognize that major cuts in public service activity could call into question their tax-exempt status. Membership fee history is usually examined and compared with that of any competing organizations. Rate flexibility can be particularly important, and rate setting capacity is usually centralized within the financial management function rather than with a voluntary board. Endowed And Charitable Foundations The common characteristic of all tax-exempt endowed foundations is a pool of money used to support a specific cause, such as health care or medical research, educational endeavors, or programs for low- and moderate-income people. United States tax laws, in fact, require that certain philanthropic organizations give away at least 5% of their assets every year. This required drawdown in resources is an important consideration, since most foundations will secure their bonds with an unsecured GO pledge, which in effect, encompasses the corpus of their unrestricted endowment and related income. Many of the not-for-profits currently rated by S&P; Global Ratings have no source of income other than investment earnings. The size and quality of a foundation's endowment relative to both debt and operating expenses is thus of paramount importance. S&P; Global Ratings generally requests at least five years of historical financial data and usually asks for portfolio and endowment data such as quarterly board reports. In evaluating endowment, S&P; Global Ratings can look beyond size at a number of specific factors, including: Growth in endowment assets over time; Asset allocation policies and quality of the investment pool, and a comparison to targeted investment mix; Historical rates of return compared to broader market or customized benchmarks; Relative liquidity and availability of the portfolio; Endowment spending policies; and Restrictions on use of earnings and principal. Since the endowment is the basis for any rating of an endowed organization, S&P; Global Ratings might review legal covenants restricting the foundation's use of its endowment. Generally, restrictions mandate liquidity and asset coverage tests, and limit additional debt issuance. While the above analysis focuses primarily on the balance sheet; foundation mission, activities, and budgetary flexibility are also important. To date, rated foundations tend to fall into one of two categories—independent or grantmaking and operating. Although, one type is not necessarily more creditworthy than the other, grantmaking entities may have more budgetary flexibility than operating foundations that actually run their own charitable programs. S&P; Global Ratings is often interested in the type of activity supported by a foundation and the extent to which an organization can curtail this support and control operating costs. Once started, S&P; Global Ratings usually assumes that certain programs or foundation giving would be difficult to stop, particularly if the foundation is the sole sponsor. Research Institutions While nonprofit research institutions abound, those most capable of achieving investment-grade ratings generally have a long history of working with a governmental agency, or have a medium-to-high level of endowment. Despite their close ties to governments or sponsors, research organizations often face considerable credit risks, including contract nonrenewal and cyclical support for the type of research being sponsored. Because of these risks, small institutions in a single competitive field, or in a field with a low funding priority, are sometimes more likely to receive lower ratings. As with most areas of credit analysis, S&P; Global Ratings generally reviews industry information to assess a nonprofit research organization. Specific governmental contracts might be reviewed if the institution is operating under an especially large or long-term contract that provides the bulk of its operating income. Management meetings might include not only the institution's management, but also large sponsors to gauge ongoing support for the organization. S&P; Global Ratings generally considers the following factors to be particularly applicable when rating research institutions: History of research programs and dollar amount of funding; Areas of research specialization and competition; Growth in the number of contracts and funding; Diversity of research—both classified and unclassified; Indirect cost recovery rates currently in place and timetable for renegotiation Funding stability—options for contract renewal if less than five years to termination dates; and Budgetary flexibility and the capacity to downsize. Other lines of inquiry go beyond the research program and could include an evaluation of management, financial operations and resources, and debt burden as previously discussed. Like membership organizations, S&P; Global Ratings generally rates institutions that include permanent staff whose functions include financial management and day-to-day operations. Most research institutions rated by S&P; Global Ratings are financially and operationally autonomous; however, any ties to a parent organization could involve an analysis of this relationship. Research institutions receiving federal funds for research have an incentive to issue tax-exempt debt for facilities. These organizations can include the costs of facilities capital in their requests for reimbursement. For many of them, being able to recoup the cost of capital makes debt a more favorable option than leasing research facilities. Bondholder security for debt issued by these organizations is typically a GO of the institution, but for many research organizations, direct and indirect costs of research are the primary sources of operating revenue. While research funding has become increasingly competitive, and there is potential for continued changes in reimbursement mechanisms, research funding in general is proving to be a stable source of reimbursement and revenue for research institutions. Rate covenants generally carry little weight in legal provisions, since these organizations do not have the ability to adjust their rates to federal or other sponsors on an annual basis. However, additional bonds tests carry more weight, and historical additional bonds tests add comfort that historical revenues have at least been sufficient to pay for the current and proposed debt. Revisions And Updates This article was originally published on June 14, 2007. Changes introduced after original publication: Following our review in 2016, we updated the contact information and added the "Related Criteria And Research" section. Following our periodic review completed on April 17, 2018, we updated the contact information. On June 10, 2019, we republished this criteria article to make nonmaterial changes to update the contact information. On Aug. 11, 2021, we republished this criteria article to make nonmaterial changes to update the contact information. Related Criteria And Research Related Criteria Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015 Ratings Above The Sovereign: Corporate and Government Ratings – Methodology and Assumptions, Nov. 19, 2013 Principles Of Credit Ratings, Feb. 16, 2011 These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as S&P; Global Ratings assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.