

**Primary Credit Analysts:**

Jonathan Jacobson  
New York  
(1) 212-438-2027  
jonathan\_jacobson@  
standardandpoors.com

**Secondary Credit Analysts:**

Lori Torrey  
New York  
(1) 212-438-2876  
lori\_torrey@  
standardandpoors.com

**Publication Date**

March 23, 2006

## Public-Private Partnerships Advance U.S. Higher Education Student Housing Projects

Colleges and universities in the U.S. continuously face the challenge of providing safe and attractive housing for their students. As enrollments grow and student preferences change, institutions must identify ways to update existing facilities or create new alternatives to remain competitive.

Historically, institutions issued auxiliary revenue bonds, secured by dormitory system revenues, to address student-housing needs. In recent years, however, more institutions — particularly public universities — have turned to public-private partnerships to finance construction of new or replacement housing stock.

A major appeal of such partnerships is the ability to circumvent traditional financing conditions, offering the benefit of significantly reducing the length of time to complete the project and the project cost. Such partnerships differ from traditional auxiliary revenue bond financings in that they are often not issued under the institution's name. More importantly, the institution does not directly own the housing facilities. Rather, the private entity or public entity owns them with private-partner involvement. As a result, from a credit analysis perspective, ratings are based primarily on student demand for the project and secondarily on the university's general credit characteristics.

### Evolution Of University Housing Transactions

For decades, colleges and universities issued auxiliary revenue bonds to finance residential projects and parking, dining, athletic, and research facilities. Auxiliary, or enterprise, revenue bonds generally are supported by revenues from the project being financed, such as room and board charges, parking fees, indirect cost recoveries, and other limited student fees.

Given restrictions on their ability to issue general obligation (GO) or tuition-backed debt, public institutions traditionally led the issuance of auxiliary bonds, which were used for housing project financing for many years. Historically, the issuance of dormitory revenue

bonds was almost universally the domain of public universities, because private institutions were not subject to debt constraints or other statutory limitations and were able to pledge their GO as security for debt financing.

Beginning in the 1990s, however, the higher education housing environment began to change. Institutions experienced a surge in demand for modern, apartment-style housing and needed to respond more quickly to market demands. The concept of using developers' expertise and separately created 501(c)3 entities to help issue debt to finance these projects rose in popularity. In the past decade, Standard & Poor's Ratings Services has seen three different models that universities have used to provide housing through public-private partnerships.

***Model 1***

In the initial years of public-private partnerships for housing projects, the institution and the private developer typically pursued even splits of cash flow and issued taxable debt to finance the projects. Taxable financings meant housing could be open to non-students, if desired or necessary. These financings were very much developer driven and were usually located off-campus with loose ties to an institution. Standard & Poor's does not have any public ratings on these transactions because most of these deals were either low investment grade or speculative grade and sold with bond insurance or LOCs.

***Model 2***

In time, as equity investors found that their internal rates of return for student housing projects were not sufficiently high, a tax-exempt market developed which reduced interest costs. Such financings were still pursued primarily by public institutions with many projects ultimately being gifted to an institution or its foundation, which in turn issued debt to refinance the projects. These financings typically received low-investment-grade ratings with many rating outlooks changed to negative at some point in time and eventually some ratings lowered. Typically, an outside management company oversaw some of the related projects from the financings with little ties to the university, such as an agreement to provide marketing materials or the withholding of student transcripts until students paid their rents. Most of these projects were directly on campus or adjacent to campus on university-owned land.

An example of this model is Capital Project Finance Authority, Fla.'s bonds, which were issued to fund the acquisition and subsequent ownership of two apartment complexes that were housing University of Central Florida (UCF) students. The bonds were first rated 'BBB' with a stable outlook in December 2000. That rating reflected a demonstrated need for housing at the university; UCF and its related foundation's level of involvement with the project, and project management and marketing; the financial viability of the proposed transaction; and an absence of construction risk and adequate legal provisions. The stable outlook reflected the anticipation of sufficient occupancy levels to allow both projects to generate cash flows in excess of debt service requirements and the expectation that the UCF's eventual ownership of the project would have positive implications for successful ongoing operation.

In January 2002, however, Standard & Poor's placed Capital Project Finance Authority's credit on CreditWatch with negative implications for very low debt service coverage of less than 1x, draws against the operating reserve fund to meet required sinking-fund payments, lack of funding for the

reserve and replacement funds, lower than expected demand for the housing projects' with occupancy levels well below the break-even level, and an increasingly competitive operating environment for the project. In October 2002, the rating was lowered to 'BBB-' with a negative outlook, reflecting low estimated coverage of senior debt, the project's higher than anticipated operating expenses, and a narrow band of occupancy between break-even financial results and full capacity. In 2005, the rating outlook was changed to stable, reflecting the university's support of the project and good and stabilized occupancy levels.

### **Model 3**

In more recent years, shrinking debt capacity, anemic endowment growth, and rising capital needs resulted in the further evolution of the off-balance-sheet market. Both public and private institutions opted to pursue this strategy to finance housing projects. In some instances, institutions built entire housing systems with off-balance-sheet financing to replace existing systems or create entirely new facilities. With a more mature off-balance-sheet market for housing projects in place, universities started to apply similar financing strategies to other ancillary markets, such as athletics and research facilities. Standard & Poor's is now seeing more and more universities creating their own foundation with the sole function to finance additional student housing on the university's campus. Many universities in the University of North Carolina System have opted for this approach. We view this as a stronger, more stable approach to financing student housing as evidenced by some institutions achieving medium-investment grade, 'A' category ratings. These projects tend to have a stronger security pledge of the net project revenues along with the net revenues of the existing housing system after paying all debt service. The university manages these new projects, which fit seamlessly with the current housing stock, but ownership tends to reside with related foundations.

An example of this type of financing model is University of North Carolina at Charlotte Facility Development Corp. Inc.'s debt (A/Stable), issued for housing at University of North Carolina at Charlotte. The 'A' rating reflects the university's stable position as the fourth-largest higher education institution in North Carolina (AAA) and strong overall state support; strong operating performance; solid pledge of revenue generated by the new facilities, coupled with a subordinate pledge of net housing revenues after all existing housing and dining system debt service has been paid; enrollment growth and increasing demand; and strong demand for on-campus housing.

(See the table for selected public ratings for Models 1, 2, and 3)

### **Rating Privatized University Housing Using The Credit-Risk Relationship Model**

Colleges and universities pursuing the option of privatized housing often want to know whether using off-balance-sheet debt for residential facilities will affect their existing credit profile and debt capacity, and the degree to which they need to support a project to ensure a lower cost of capital for student housing. Standard & Poor's criteria for off-balance-sheet housing addresses these concerns and largely rests on the "credit-risk relationship" model.

The model works as follows: If a university transfers its own credit strength to an affiliated entity or project, the corresponding risks of that enterprise almost always transfer back to the university. The stronger the link between the sponsor institution and the project, the more likely the debt financing will affect the institution's credit profile whether or not the financing is off balance sheet. A close link

to the institution and the possibility of subsidization of debt service, however, will usually mean a higher stand-alone rating and a resultant lower cost of capital. A new housing project with little link to the sponsoring institution will probably not benefit from the institution's creditworthiness. By the same token, the institution can probably safely assume that the issuance of the related debt will not affect its own credit position.

Nonetheless, debt related to an institution's enterprise is always of concern, especially when the primary customers of the enterprise are the institution's students. Even a project that does not require immediate subsidization could require management effort or time. Accounting and reporting rules could change, requiring debt that was once off balance sheet to be consolidated in subsequent financial statements. Privatized projects related to an institution could also represent competition because students may opt to reside in the newer related facilities rather than the university's housing facilities. Issuing additional debt, even if separate from the institution, could represent credit dilution for bondholders of existing dormitory revenue bonds. Because of these issues, Standard & Poor's gauges two key factors, economic interest and control, in evaluating the "credit-risk" relationship. This analysis determines the extent to which (a) the institution has an economic interest in the project and (b) the institution controls project budgets and rate setting, who uses the facilities being financed, and who manages the property.

### **Traditional Dormitory Revenue Bonds Versus Privatized Housing Project Financing**

When rating campus privatized housing facilities, Standard & Poor's focuses on the differences between these projects and traditional dormitory revenue bonds. The primary difference between these financing alternatives is the absence of university oversight and ownership. Traditional dormitory revenue bonds are typically sold directly under the university's name, the facility is controlled by the university, and revenues and expenses of the project and related debt are consolidated in the university's financial statements.

For privatized housing projects, Standard & Poor's will use a university's long-term rating as a proxy for long-term viability and demand. 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 will achieve an investment-grade rating without a very substantial link to a sponsoring institution. A substantial link might take the form of a college guaranty of debt service or an unconditional lease vacancy agreement.

An important similarity between traditional dormitory revenue bonds and privatized housing bonds is that traditional dormitory revenue bonds are technically non-recourse obligations. Moreover, bondholders typically are entitled just to pledged revenues, derived from the project or system. As a result, for both debt types, the revenue streams are narrowly defined as being those produced by a particular project or set of projects, and the facilities are occupied by customers, such as university students. Consequently, it is probably incumbent on the university to ensure that any project with which it is affiliated provides students with decent, inhabitable, and economical space. If the institution provides the students in the privatized facilities with financial aid for living expenses, the school is indirectly paying for the facility. If the university is residential in nature, 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 privatized housing debt without university ownership (and usually without management), Standard & Poor's examines many of the same characteristics that are evaluated for traditional auxiliary bonds. The following factors are generally necessary to achieve an investment-grade rating and are specific to housing projects, but are also relevant criteria to other enterprise financings:

### ***Evidence of long-term institutional viability***

An institution with a long-term GO rating of 'BBB+' or higher and a strong residential mission is likely to have the credit capacity to consider this type of financing option. Below this rating threshold, achieving an investment-grade, project-based rating may be difficult unless the institution provides direct financial support.

### ***Relationship between project owner and related institution***

The relationship between these two parties will be evaluated based on board composition, ground lease structure, management agreement, and the factors leading to the decision to pursue the financing. A university that will ultimately own housing in the middle of its campus likely has a vested interest in the success of such a project. However, the degree to which an institution, particularly a public university that does not currently own a project, is willing and legally able to cover a shortfall in debt service for the project is untested. It may be easier for private universities to rescue a financially unsuccessful project, but just if it is on campus and the institution already exercises some control and oversight.

### ***Project demand***

Student demand for a new housing facility may be reflected in demand for existing on-campus housing. High occupancy rates, use of replacement housing, the presence of wait lists, university leasing of off-campus accommodations, and recent enrollment growth all reflect favorable demand. Standard & Poor's evaluates external feasibility studies that show sufficient demand for on-campus housing, but these usually provide just partial comfort.

### ***Project location***

Privatized housing projects should be on or adjacent to the core campus. If the proposed housing is off-campus, the land is not owned by the institution, and there is no significant financial or managerial link to the school, Standard & Poor's will most likely apply its affordable housing criteria to rate the project debt.

### ***Project management***

Generally, the highest-rated projects are those that the institution manages, which implies a higher degree of responsibility and oversight. An outside, usually for-profit management company can also manage projects at the behest of the university. The length of the management contract is generally not as important as other credit factors. A stronger institutional link will include university rate setting, budget control, and housing policies that are virtually indistinguishable from traditional university housing projects.

***Legal provisions***

Rate covenants should ensure coverage of debt service and operating expenses by pledged revenue. A typical rate covenant will set rates at a minimum level of 1.2x the next year's debt service and operating expenses. In Standard & Poor's experience, many completed stand-alone privatized housing projects have experienced either pricing pressure or higher-than-expected costs, making it difficult to meet a standard 1.2x rate covenant.

Thresholds that must be met before incurring additional debt should protect bondholders against the possibility of future debt weakening or diluting the specific project's revenue base. Additional bonds tests based on historic revenues are viewed more favorably than projected revenue tests. Standard & Poor's views the absence of an additional bonds test negatively.

***Reserves and insurance***

The single-site nature of many of these projects creates additional risk, making insurance and reserve provisions important credit factors. A debt service reserve should be funded either with bond proceeds or through an approved reserve substitute. A portion of net cash flow also should be retained to build up a reserve fund for maintenance and repairs. Housing maintenance needs to be sufficient to keep the facility attractive during the life of the bond issue and provide for unanticipated major maintenance. Business interruption insurance should provide 18-24 months of coverage in the event of facility damage or destruction.

***Debt service coverage***

Most projects rated investment grade by Standard & Poor's provide adequate or better cash flow protection, with a multiplier of at least 1.2x coverage of maximum annual debt service by pledged revenues.

***Construction risk***

Although construction risk is present in virtually every transaction involving new facilities, it typically introduces credit risk only transactions where debt service payment is contingent on project completion or acceptance. Standard & Poor's analysis of construction risk includes assessment of the following factors:

- Project essentiality,
- Experience with similar projects,
- Contractor experience with the issuer or obligor,
- Project schedule and cost structure,
- Construction contingencies in the project budget,
- Duration of capitalized interest,
- Insurance coverage during the construction period, and
- Full permitting and site approvals.

In many instances, construction risk does not adversely affect investment-grade projects. There are mechanisms available to mitigate construction risk so that a project can be rated prior to actual completion. Sometimes the formation of a new privatized housing system can offset credit concerns about single-site project or construction risk. Significant university involvement in the construction process is also viewed favorably.

### **Other considerations**

Projections should include reasonable allowances for vacancy and expense growth assumptions. Projections provided for these projects generally have used very high occupancy rates of 95%-97%. Standard & Poor's looks for break-even occupancy that is much lower than this level; generally, if the break-even occupancy rate is below 75%, cash flows are viewed more favorably.

A shorter debt maturity is viewed more favorably than a longer maturity — even if debt service coverage drops slightly as a result of achieving a shorter amortization schedule — because of the relatively short track record of these projects and the concurrent risks of an aging facility.

### **Business Risks And Credit Issues**

The greater the connection between the institution and the project, the more likely the financing will be factored in when analyzing the institution's own debt profile. Universities need to remain aware of the implementation of new accounting rules, such as GASB 39, and their impact on the reporting of off-balance-sheet obligations. From an operational standpoint, privatized housing projects may compete with other university auxiliary operations or businesses. This raises several questions and concerns: Does the university have similar experience in other business lines, and will the project affect contract relations with dining, bookstore, public safety, custodial, or other outside vendors? Privatized housing projects may also effectively result in an institution's loss of control over a core business product or service provided to a key customer. How will various university constituencies perceive the project?

When entering into such partnerships, universities must understand which partner is responsible for covering expenses in certain adverse circumstances. For example, who pays for unexpected repairs? Is insurance coverage adequate in the event of business interruption? A single-site project may mean that there are no economies of scale or risk-sharing opportunities. Another potential credit pitfall is insufficient coverage of debt service, even though rental rates actually may be high. This scenario may be exacerbated if student tenants are receiving financial aid. Privatized housing projects may also face new and different competition from other housing alternatives in the community, which begs the question: Is the project generating goodwill by providing additional affordable housing or is it competing directly with local developers?

### **The Project And The Institution**

Often times, the closer the link between a project and its sponsoring institution, the higher the rating. The closer the relationship, however, the more likely the housing debt will be considered a direct or indirect obligation of the university. Reasons to consider off balance sheet, or indirect debt, as debt of the sponsoring institution include the following:

- 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 or reputation.
- The institution benefits from immediate or eventual ownership of the project.

Ultimately, credit ratings encompass a variety of factors of which debt is just one. The inclusion of additional indirect debt in the analysis of an institution's overall credit picture does not necessarily mean that the institution's rating will change. The revenue-producing nature of projects is taken into

account when considering university ratings. Self-supporting projects are generally viewed more favorably than projects that produce no additional revenues, all other factors being equal.

While a university may find the concept of a public-private partnership and resultant off-balance-sheet financing appealing from an accounting perspective, it is not necessarily a risk-free means of constructing campus facilities from a credit perspective. Depending on the link between the project and the institution, the amount of off-balance-sheet debt issued can affect the university's debt capacity. At the same time, many institutions have few, if any, alternatives for funding new student housing construction.

Universities should also consider the following:

- Many private developers have a successful track record in constructing quality housing in an efficient and cost-effective manner.
- Off-balance-sheet debt usually is secured by only a pledge of project revenues with little or no bondholder recourse to the institution's overall resources.
- Management of the institution's newly constructed housing projects is possible and can be beneficial to the institution from a credit perspective.
- The reduction in debt capacity that can result from incurring indirect debt as part of an institution's total leverage profile might not result in a lowering of the institution's overall credit rating.

**Standard & Poor's Off-Balance-Sheet Student Housing Transactions (Selected Public Ratings)**

<i>Issuer</i>	<i>State</i>	<i>Obligor</i>	<i>Relationship to institution</i>	<i>Name of college/university</i>	<i>Private/public</i>	<i>Rating</i>	<i>Outlook</i>	<i>Gross debt (mil \$)</i>
Mesa Industrial Development Authority	Arizona	Mesa Student Housing LLC	Related to foundation/college	Arizona State University	Public	BBB-	Stable	265
Aztec Shops Ltd.	California	Aztec Shops Ltd.	Related to foundation/college	San Diego State University	Public	BBB	Stable	23,558
California Community College Financing Authority	California	Feather River College Foundation	Related to foundation/college	Feather River College	Public	BBB-	Stable	3,205
California Community College Financing Authority	California	Feather River College Foundation	Related to foundation/college	Feather River College	Public	BBB-	Stable	110
Capital Project Finance Authority	Florida	Capital Project Finance Authority	Related to foundation/college	University of Central Florida	Public	BBB-	Stable	147,970
Georgia Private College and University Authority	Georgia	Mercer Housing Corp.	Related to foundation/college	Mercer University	Private	BBB	Stable	16,990
Private College and University Authority	Georgia	Mercer Housing Corp.	Related to foundation/college	Mercer University	Private	BBB	Stable	18,255
University of North Carolina at Wilmington Corp Housing I LLC	North Carolina	University of North Carolina at Wilmington	Related to foundation/college	University of North Carolina at Wilmington	Public	A-	Stable	28,710
University of North Carolina at Charlotte Facility Development Corp. Inc.	North Carolina	University of North Carolina at Charlotte	Related to foundation/college	University of North Carolina at Charlotte	Public	A	Stable	16,745

Public-Private Partnerships Advance U.S. Higher Education Student Housing Projects

**Standard & Poor's Off-Balance-Sheet Student Housing Transactions (Selected Public Ratings) (cont. 'd)**

<i>Issuer</i>	<i>State</i>	<i>Obligor</i>	<i>Relationship to institution</i>	<i>Name of college/university</i>	<i>Private/public</i>	<i>Rating</i>	<i>Outlook</i>	<i>Gross debt (mil \$)</i>
Western Carolina University Research and Development Corp. LLC	North Carolina	Western Carolina University	Related to foundation/college	Western Carolina University	Public	A-	Stable	12,090
Western Carolina University Research and Development Corp. LLC	North Carolina	Western Carolina University	Related to foundation/college	Western Carolina University	Public	A-	Stable	11,050
Herkimer County Industrial Development Agency	New York	Herkimer County College Foundation Inc.	Related to foundation/college	Herkimer County Community College	Public	BBB-	Stable	4,710
Madison County Industrial Development Agency	New York	Morrisville State College Foundation Inc.	Related to foundation/college	Morrisville State College	Public	BBB-	Stable	12,160
Langston Economic Development Authority	Oklahoma	Langston University	Related to foundation/college	Langston University	Public	BBB-	Stable	24,720
Oregon Facility Authority	Oregon	Housing Northwest Inc.	Related to foundation/college	Portland State University	Public	BBB-	Negative	19,945
Texas Student Housing Corp.	Texas	Texas Student Housing Corp.	Related to foundation/college	University of North Texas	Public	BB	Stable	34,355

Published by Standard & Poor's, a Division of The McGraw-Hill Companies, Inc. Executive offices: 1221 Avenue of the Americas, New York, NY 10020. Editorial offices: 55 Water Street, New York, NY 10041. Subscriber services: (1) 212-438-7280. Copyright 2006 by The McGraw-Hill Companies, Inc. Reproduction in whole or in part prohibited except by permission. All rights reserved. Information has been obtained by Standard & Poor's from sources believed to be reliable. However, because of the possibility of human or mechanical error by our sources, Standard & Poor's or others, Standard & Poor's does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions or the result obtained from the use of such information. Ratings are statements of opinion, not statements of fact or recommendations to buy, hold, or sell any securities.

Standard & Poor's uses billing and contact data collected from subscribers for billing and order fulfillment purposes, and occasionally to inform subscribers about products or services from Standard & Poor's, our parent, The McGraw-Hill Companies, and reputable third parties that may be of interest to them. All subscriber billing and contact data collected is stored in a secure database in the U.S. and access is limited to authorized persons. If you would prefer not to have your information used as outlined in this notice, if you wish to review your information for accuracy, or for more information on our privacy practices, please call us at (1) 212-438-7280 or write us at: [privacy@standardandpoors.com](mailto:privacy@standardandpoors.com). For more information about The McGraw-Hill Companies Privacy Policy please visit [www.mcgraw-hill.com/privacy.html](http://www.mcgraw-hill.com/privacy.html).

Analytic services provided by Standard & Poor's Ratings Services ("Ratings Services") are the result of separate activities designed to preserve the independence and objectivity of ratings opinions. Credit ratings issued by Ratings Services are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions. Accordingly, any user of credit ratings issued by Ratings Services should not rely on any such ratings or other opinion issued by Ratings Services in making any investment decision. Ratings are based on information received by Ratings Services. Other divisions of Standard & Poor's may have information that is not available to Ratings Services. Standard & Poor's has established policies and procedures to maintain the confidentiality of non-public information received during the ratings process.

Ratings Services receives compensation for its ratings. Such compensation is normally paid either by the issuers of such securities or by the underwriters participating in the distribution thereof. The fees generally vary from US\$2,000 to over US\$1,500,000. While Standard & Poor's reserves the right to disseminate the rating, it receives no payment for doing so, except for subscriptions to its publications.

Permissions: To reprint, translate, or quote Standard & Poor's publications, contact: Client Services, 55 Water Street, New York, NY 10041; (1) 212-438-9823; or by e-mail to: [research\\_request@standardandpoors.com](mailto:research_request@standardandpoors.com).