TAX-EXEMPT CREDIT PERSPECTIVES: HIGHER EDUCATION

MAY 27, 2020

How Is the Higher Education Sector Being Impacted?

The Higher Education sector, which was facing challenges of affordability, demographics, shifts in international student demand, and enrollment pressures before the Coronavirus outbreak, is now facing even greater stresses. Campuses have gone quiet since mid-March leaving a sizeable gap in budgets. While most schools are preparing return to campus plans, the conditions and details remain uncertain, thereby introducing a need for careful credit scrutiny.

Appleton's Approach to Higher Education Security Selection

Our holdings include some of the largest and most highly regarded colleges and universities. We focus on formidable educational institutions buttressed by strong consumer demand, solid financial operations and conservative balance sheets. These bond issuers were far better positioned pre-Coronavirus and we expect all our holdings to remain creditworthy as this cycle plays out. Lower rated schools, those with multi-year declines in demand, and weak balance sheets present much greater credit risk.

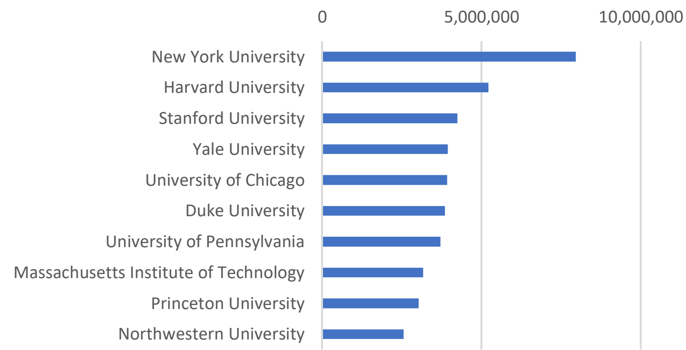
Our Higher Education Holdings

Appleton currently holds bonds of 34 private higher education issuers with an average credit rating of AA. Within the public subsector, we are invested in 43 issuers with an average AA credit rating.

Stress Testing Offers Credit Comfort

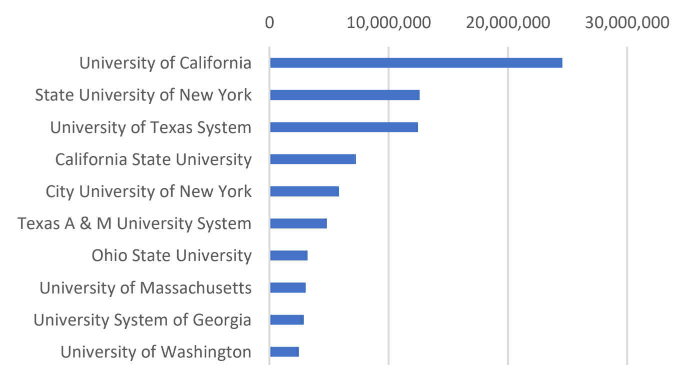
We recently evaluated and ranked all Appleton approved higher education issuers based on demand profile and financial strength. Doing so helps us project how well they are likely to stand up to prolonged adverse conditions. Our stress-testing modeled 10%, 20%, 30%, 40% and 50% declines in net revenue available for debt service while assuming no expense adjustments. Even with what we feel is an unlikely 50% revenue decline, all our private higher education bond holdings would be able to maintain debt service, while most of our public holdings would as well. This is a conservative model, as many expense reductions are being made. State aid could also present a potential resource for public issuers, as many of our bond holdings are state flagship universities and systems that help drive economic growth.

Top 10 Private Higher Education Issuers:
Total Outstanding Debt ($000 as of FYE 2019)



Source: Investortools

Top 10 Public Higher Education Issuers:
Total Outstanding Debt ($000 as of FYE 2019)



Source: Investortools

What Credit Factors Are Most Important?

Our analysis evaluates private and public schools somewhat differently given their unique characteristics. Certain data points are not available or as relevant in both sub-sectors, although in each we identified and stress-tested key credit drivers to derive an overall risk score for each institution. Sizable rating variations among the names we evaluated suggest relative value distinctions, thereby offering a valuable security selection and trading input.

Market position	This metric reflects demand characteristics and size of operations. We assessed each school's 5-year enrollment change, 3-year average selectivity ratio, 3-year average matriculation ratio, and the size of their operating base.
Operations	Operational factors include tuition revenue as a percent of total operating revenue, degree of reliance on healthcare revenues as a percent of operating revenue (if applicable), the school's dependence on state appropriations as a percent of operating revenue (public schools), 3-year average operating margin (private schools), and 3-year average debt service coverage (public schools).
Balance sheet	Balance sheet weighting looks at cash and financial leverage by measuring unrestricted net assets per full-time equivalent student (FTE), endowment size per FTE (private schools), expendable resources to operations (public schools), and total debt to operating revenue.

Although we are cautious on the sector and could see credit downgrades among some of our holdings, we feel comfortable with the bonds we own. We are looking to selectively add to our higher education exposure when market values present favorable opportunities to do so.

Accessibility and communication are important in any environment, although these attributes are especially valuable during uncertain and volatile times. Appleton Partners is committed to sharing our market and portfolio management perspectives as developments unfold. We hope these briefs are helpful and also invite you to reach out to us directly and/or visit www.appletonpartners.com/Insights for additional commentary and insights.

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