Rating Update: MOODY'S ASSIGNS A1 ISSUER RATING TO KALAMAZOO COLLEGE (MI) IN CONJUNCTION WITH $36.4 MILLION SERIES 2011 PRIVATE PLACEMENT WITH PNC BANK TO REDEEM ALL OUTSTANDING BONDS; OUTLOOK IS STABLE

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AFFIRMS A1 RATING ON OUTSTANDING REVENUE BONDS TO BE REFUNDED; NO RATED DEBT OUTSTANDING POST-SALE

Michigan Finance Authority
Higher Education
MI

Opinion

NEW YORK, May 25, 2011 -- Moody's Investors Service has assigned an A1 issuer rating to Kalamazoo College (MI) in conjunction with the private placement of the $36.4 million Series 2011 A, B, and C Revenue Refunding Bonds with PNC Bank (rated A2/P-1). Concurrently, Moody's has affirmed the A1 rating on $22.1 million of outstanding Series 2000, 2003 and 2007 bonds that will be refunded with the current issue. The outlook is stable.

SUMMARY RATING RATIONALE

The A1 rating reflects the college's healthy operating performance, solid and increasingly leveraged balance sheet, and the refinancing risk in 10 years associated with the current private placement. The rating also incorporates that college's position as a small liberal arts with a unique curriculum, the competitive environment for highly qualified students in which it operates, declining high school graduates within the state, limited and concentrated donor base, and conservative fiscal and budgeting practices.

STRENGTHS

* Growing reputation with unique and academically challenging curriculum that focuses on study abroad experiences.
* Healthy liquidity compared to operations, with 421 monthly days cash on hand and satisfactory resources compared to debt and operations, with expendable financial resources of $87.7 million providing 3.0 times coverage of debt (1.9 times pro forma) and 1.5 times coverage of annual operating expenses in FY 2010.
* Strong governance and management practices that are highlighted by healthy operating performance and cash flow, and ability to generated surpluses and increase net tuition revenues despite recent declines in enrollment and economic downturn. Conservative budgeting practices, the development of five-year financial forecasts, and the implementation of self-evaluation processes for the board and senior management also reflect best practices.
* Positive results from strategic efforts to increase the percentage of the freshman class from outside Michigan given adverse economic conditions of the state, and projected decline of high school graduates within the state. In fall 2010, 64% of incoming freshman were from Michigan, compared to 69% in fall 2006. Recently implemented strategic efforts are underway to increase out-of-state students to 50% of the incoming class by fall 2017.

CHALLENGES

* Relatively small operating revenue base largely dependent on student-derived charges (including net tuition, fee, and auxiliary revenue streams), which accounted for two-thirds (66%) of the college's operating revenue in FY 2010. The college's relatively low net tuition per student ($18,041 in FY 2010 compared to the median for A-rated institutions of $21,035 for FY 2009) demonstrates the strong competition it faces from lower cost public universities and other small liberal arts colleges.
* Increased operating leverage with the current transaction, with limited capacity for additional debt at the current rating level as debt to operating revenue climbs to 0.75 from 0.48. Leverage profile compounded by potential need of the college to reduce the high age of plant (accumulated depreciation divided by annual depreciation expense) of 18.7 years in FY 2010, a signal for further investment in facilities.

DETAILED CREDIT DISCUSSION

USE OF PROCEEDS: The Series 2011 A (tax-exempt) and B (taxable) bonds will refund all outstanding bonds (Series 2000, 2003 and 2007 bonds). The Series 2011C bonds ($12 million), will finance a new athletic field house and athletic fields. The balance of the approximately $16 million project are expected to be financed with gifts, although any shortfalls may come from quasi-endowment.

LEGAL SECURITY: Bond payments are an unsecured obligation of the college. The Guaranty Agreement contains financial covenants that require a Minimum Unrestricted and Temporarily Unrestricted Cash and Investments to Long-Term Debt of 1.0 times and an additional bonds tests of 1.0. There are no debt service reserve funds.

The A1 issuer rating reflects the unsecured general obligation credit characteristics of the college and does not incorporate an analysis of the legal security of the organization's pro forma debt.

DEBT STRUCTURE: The Series 2011 bonds are structured as fixed rate bonds for a 10-year term. The fixed rate will equal to 70% of the bank’s cost of funds plus 1.0% to 1.6%. The rate will be set by PNC Bank at the day of funding or rate lock. After the initial 10-year term, the term could be further extend, or the bonds will be subject to remarketing or refinancing.

INTEREST RATE DERIVATIVES: None
RECENT DEVELOPMENTS/RESULTS

After a decline in enrollment and applications for the fall 2010 class, the college reports that applications have increased by 15% for fall 2011, including a 27% increase in applications from Michigan residents, and that deposits are significantly ahead of last year at 383 (as of 5/24/11) compared to 330 the same time last year. The improvement may be attributable to increased confidence in the economy of families, particularly those in Michigan, as well as recruiting efforts of the college. Conservatively, the college budgeted for flat enrollment overall for FY 2012 (fall 2011) compared to the prior year, although based on deposits to date, the college will comfortably exceed budgeted enrollment. The college’s five-year plan reflects a relatively aggressive (FTE) enrollment growth of approximately 9% to 1500 by fall 2017, with incoming classes growing to 405. The college's ability to leverage its solid reputation and achieve enrollment growth are important considerations in maintaining the current rating.

Kalamazoo College has shown early success with strategic initiatives to expand its geographic reach and increase the number of incoming students from outside Michigan and the U.S. This is important given the projected decline of high school graduates in Michigan and economic downturn that has impacted families financially within the state. In fall 2010, the percent of the freshman class from Michigan declined by five percent to 64% in fall 2010 compared to 69% in fall 2006. The college’s goal is have the incoming class evenly split between Michigan and non-Michigan residents by fall 2017.

Despite a decline in enrollment in FY 2010, college operations continued to reflect healthy performance and increase net tuition revenues. Cash flow margins averaged a strong 17% over the last three years, by Moody’s calculations, which provided a solid 4.0 times annual debt service coverage in FY 2010. We expect the college will continue to operate at similarly healthy cash flow and operating margins given its practice of contingency budgeting, careful expense management and stable enrollment. The ability to do so are key credit factors for the A1 assignment, particularly given the small size of college with less than one-half of the students (1,369 full-time equivalent students, or 38%) compared to A-rated private colleges and universities (based on 2009 median of 3,650 FTEs).

We expect the college’s balance sheet to grow over the medium-term driven by positive operations and healthy margins, contributions from the upcoming capital campaign, and conservative budgeting of investment returns against which the college is trending well-above. Given that in FY 2010, expendable and total financial resources were $67.7 million and $176.0 million, respectively. Moody’s calculations of total financial resources include approximately 90% of the market value of the Heyl Fund (approximately $29 million), an externally held trust. The fund distributes funds to the college for scholarships for qualifying students on a discretionary basis, with distributions equaling $1.1 million in FY 2010. The college maintains healthy liquidity with monthly liquidity of $47.1 million in FY 2010, exceeding operating expenditures by $2.25 million, and monthly days cash on hand of 421.

The balance sheet also reflects a 13% investment return after two consecutive years of declines of nearly 19% and 4.8% in FY 2009 and FY 2008, respectively. In fall 2010, the college lowered its fixed income target to 20% from 25%. As of March 31, 2011, the College’s investment asset allocation was primarily 56% in equities, 19% in fixed income, 17% in hedge funds, 7% in private equities, and the balance in cash, commodities, alternative investments, and real estate. We note some manager concentration as the college held nine positions that comprised more than 5% each of the total portfolio, with the largest position at 9.9%.

With the current debt issuance, we believe the college has limited debt additional capacity at the current rating level. Given the high age of plant of the college, Moody’s views Kalamazoo’s investment in its facilities as a factor in its ability to attract students, and we will continue to monitor capital spending. Although the college has a capital plan, its future debt plans are limited, with future capital projects expected to be financed with gifts. Kalamazoo has raised about $25 million towards a $125 million campaign target during the quiet phase of a major gifts campaign, with a portion of gift proceeds expected to be directed towards capital projects. Kalamazoo’s last capital campaign ended in 2004 and raised $78 million, surpassing the $65 million goal. While the college’s donor base has historically been concentrated, which leaves the college vulnerable to changes in individual donor’s circumstances, the college has hired consultants to assist with development and to increase donor diversification. Although $19 million of the $25 million raised to date are from nine donors, further diversification may be realized once the campaign is public and would be viewed positively.

Given the small enrollment size of the college and financial resources and operations that are below similarly rated private institutions, significant consideration has been placed on management’s continued ability to generate positive operations and increase net tuition revenues in light of a challenging economic, investment and student enrollment environments. Of note are the recently implemented five-year forecasting model, which includes conservative assumptions for investment returns (6%) and enrollment, as well as planned tuition increases (4% annually) along with a stabilization of the tuition discount at 40%. Moody’s views favorably management’s introduction of multi-year budgeting and sensitivity analysis which support five-year forecasts, which have so far demonstrated the ability to generate surpluses and positive margins even during periods of economic downturn and enrollment declines. An important consideration for the A1 rating is management’s ability to continue to generate positive operations, reflected by net tuition growth, operating surpluses, and growth in financial resources.

In August 2009, the Board of Trustees changed its charter to no longer require a specific number of board members who are members of good standing of the Baptist Church USA, a smaller component of the American Baptist Church. We view this positively, as it allows for greater autonomy in the selection of board members.

Outlook

The stable outlook reflects our expectation that operations and enrollment will continue with positive trends and that there are little to no future plans to issue additional debt.

WHAT COULD MAKE THE RATING GO UP

Significant growth in financial resources and enrollment

WHAT COULD MAKE THE RATING GO DOWN

Declines in enrollment; trend of flat to declining revenues; additional debt that would further increase leverage to 405.

KEY INDICATORS (Fiscal year 2010 financial data, fall 2010 enrollment)

Total enrollment: 1,356 full-time equivalent students
Freshman selectivity: 74.6%
Freshman matriculation: 23.6%
Total pro forma direct debt: $36.4 million
Expendable financial resources to pro forma direct debt: 1.9 times
Expendable financial resources to operations: 1.5 times
Monthly liquidity: $47.1 million
Monthly days cash on hand (unrestricted funds available within one month divided by operating expenses excluding depreciation, divided by 365 days): 421
Expendable Financial Resources: $67.7 million
Three-year average operating margin: 7.9%
Three-year average debt service coverage: 4.1 times
Reliance on tuition and auxiliary revenue (% of operating revenue): 66.3%

RATED DEBT
Series 2000, 2003, 2007: A1 (to be refunded by the current issue, which is not specifically rated)

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PRINCIPAL METHODOLOGY USED
The principal methodology used in this rating was Moody's Rating Approach for Private Colleges and Universities published in September 2002.

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