Kalamazoo College, MI

Update following outlook revision to negative

Summary
Kalamazoo College's (A1 negative) credit quality is supported by its strong levels of total cash and investments and liquid reserves, which provides it with significant flexibility to navigate through a challenged revenue growth environment. The college favorably has been able to manage expenses, sustaining better than balanced operating performance. A regionally favorably brand and investment in areas of market distinctiveness provide a reasonable likelihood of sustained enrollment. Good fundraising also provides the college with some resources for strategic investment. However, a highly competitive environment and declining numbers of high school graduates in the college's core market have contributed to rising tuition discounting. This has constrained overall revenue growth and it is uncertain if the college can continue to limit expense growth without impairing its competitive position. The college will likely need to make some additional capital investments, which could result in rising leverage, albeit from comparatively low and manageable current levels.

Moody's affirmed the college's A1 rating and revised the outlook to negative from stable on February 12, 2018.

Credit strength
» Good levels of reserves relative both to modest amount of outstanding debt and to small operating base
» Strong liquidity, with over 530 monthly days cash on hand, provides significant flexibility
» Favorable financial management, demonstrated by ability to sustain balanced operating performance to date despite weak revenue growth
» Clear identification of distinctive programs and sound brand recognition provides prospects for steady enrollment

Credit challenges
» Weak net tuition revenue growth, resulting in stagnant operating revenue
» Competitive operating environment pressuring net tuition revenues, evident in tuition discounting above 50%
» Small revenue base of $57 million limits operating flexibility
Rating outlook
The negative outlook reflects prospects for credit deterioration should the college not be able to sustainably grow revenue resulting in lack of funds for academic and facilities investments and deterioration of operating performance.

Factors that could lead to an upgrade
» Significant and sustained net tuition revenue growth, bolstering operations
» Significant increase in total wealth
» Sustained strengthening in student demand

Factors that could lead to a downgrade
» Continued weak revenue growth
» Further thinning of operating cash flow
» Material decrease in available liquidity
» Significant additional borrowing absent identified new debt repayment streams

Key indicators
Exhibit 1

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</thead>
<tbody>
<tr>
<td>Total FTE Enrollment</td>
<td>1,453</td>
<td>1,459</td>
<td>1,435</td>
<td>1,441</td>
<td>1,435</td>
<td>1,441</td>
<td>1,435</td>
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<tr>
<td>Operating Revenue ($000)</td>
<td>55,761</td>
<td>57,649</td>
<td>58,686</td>
<td>59,846</td>
<td>53,038</td>
<td>55,892</td>
<td>56,993</td>
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<tr>
<td>Annual Change in Operating Revenue (%)</td>
<td>9.4</td>
<td>3.4</td>
<td>1.8</td>
<td>2.0</td>
<td>-11.4</td>
<td>-4.8</td>
<td>2.0</td>
</tr>
<tr>
<td>Total Cash &amp; Investments ($000)</td>
<td>199,832</td>
<td>231,583</td>
<td>233,612</td>
<td>220,841</td>
<td>241,159</td>
<td>220,841</td>
<td>241,159</td>
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<tr>
<td>Total Debt ($000)</td>
<td>34,500</td>
<td>33,455</td>
<td>32,375</td>
<td>32,265</td>
<td>31,125</td>
<td>32,265</td>
<td>31,125</td>
</tr>
<tr>
<td>Spendable Cash &amp; Investments to Total Debt (x)</td>
<td>3.4</td>
<td>4.1</td>
<td>4.1</td>
<td>3.5</td>
<td>4.2</td>
<td>3.5</td>
<td>4.2</td>
</tr>
<tr>
<td>Spendable Cash &amp; Investments to Operating Expenses (x)</td>
<td>2.4</td>
<td>2.6</td>
<td>2.5</td>
<td>2.1</td>
<td>2.4</td>
<td>2.1</td>
<td>2.4</td>
</tr>
<tr>
<td>Monthly Days Cash on Hand (x)</td>
<td>581</td>
<td>640</td>
<td>569</td>
<td>498</td>
<td>534</td>
<td>498</td>
<td>534</td>
</tr>
<tr>
<td>Operating Cash Flow Margin (%)</td>
<td>17.7</td>
<td>17.0</td>
<td>17.3</td>
<td>15.0</td>
<td>5.4</td>
<td>9.0</td>
<td>11.9</td>
</tr>
<tr>
<td>Total Debt to Cash Flow (x)</td>
<td>3.5</td>
<td>3.4</td>
<td>3.2</td>
<td>3.6</td>
<td>10.9</td>
<td>6.4</td>
<td>4.6</td>
</tr>
<tr>
<td>Annual Debt Service Coverage (x)</td>
<td>5.2</td>
<td>4.2</td>
<td>4.3</td>
<td>3.8</td>
<td>1.2</td>
<td>2.1</td>
<td>2.9</td>
</tr>
</tbody>
</table>

Note: Adjusted columns reflect an accounting adjustment made to operating revenue in fiscal 2017 and fiscal 2016 to better estimate actual net assets released by the college.
Source: Moody’s Investors Service

Profile
Kalamazoo College, founded in 1833 and located in Kalamazoo, MI, is a small liberal arts college enrolling just over 1,400 in fall 2017. The college’s K-Plan offers students an integrated approach to education through academics, experience based learning, study abroad opportunities and independent scholarship.
Detailed credit consideration

Market position: stable enrollment with a strong fall 2017 class, but competitive environment for students pressures net tuition revenue growth

Kalamazoo College's good strategic position will continue as it manages through a highly competitive environment for students. The college recruits heavily from Michigan and surrounding states that are witnessing demographic pressures. Favorably, unlike many peers, the college's enrollment is fairly stable, with 1,435 students enrolled in fall 2017. The college reported a strong fall 2017 class, with 448 matriculating students, a level not achieved since 2013, and expectations are for another strong class size in fall 2018.

Despite stabilizing enrollment, the college has witnessed stagnant net tuition revenue growth, driven by increasing tuition discounting. In fiscal 2017, net tuition revenue grew by just 1.8%, after declining slightly in fiscal 2016. Total tuition discounting has increased yearly since fiscal 2009 and is now over 50%. Though the college seeks to bring down its tuition discount rate, this will be difficult to achieve in its current operating environment.

To distinguish itself in a crowded higher education market, the college continues to invest in its experiential education programs along with its study abroad opportunities. Kalamazoo has also expanded its recruiting efforts, hiring a number of regional recruiters, and is working with an enrollment consultant on targeted strategies.

The college's overall size is modest compared to other A-rated peers, with revenues of $57 million in fiscal 2017, limiting future operating flexibility.

Operating performance: historically solid operating performance pressured by lack of revenue growth

Kalamazoo's operating performance will remain weaker as it struggles to grow revenue. The college reported operating cash flows of approximately 12% in fiscal 2017 and 9% in fiscal 2016, well below performance in fiscal year 2013 through 2015 (approximately 17% each year) and below A-rated peers recent performance (14.4% median in fiscal 2016). We expect similar operating results in fiscal 2018 as witnessed in fiscal years 2017 and 2016.

The college has struggled in recent years to grow revenue, driven by a lack of net tuition revenue growth. The college reported just 1.0% of revenue growth in fiscal 2017 and a decline of 4.8% in fiscal 2016. Fiscal 2018 revenue is expected to decline modestly, as the college continues rolling off smaller graduating classes.

Favorably, the college has demonstrated excellent expense containment. In fiscal 2017, reported expenses declined slightly, by 0.9%, and have increased by an average of just 2% annually since fiscal 2013. We expect the college to continue managing its expenses conservatively, including seeking out collaborative cost-sharing initiatives with regional peers as well as continuing to implement a voluntary separation program.

Wealth and liquidity: solid wealth for operating size and strong liquidity support the college's operations

The college will continue to build its total wealth through fundraising efforts. The college's total wealth is solid for its size, at over $240 million in fiscal 2017. The college completed a successful campaign in 2015, raising $129 million against a goal of $125 million, with nearly $60 million dedicated to its endowment. Expectations are the college will embark on a campaign in the near future. Investment returns in fiscal 2017 were 13.5%.

LIQUIDITY

The college will continue to have strong liquidity for the rating category. The college has $75 million of available liquidity, providing 500 days of monthly cash on hand, significantly higher than the A-rated median of 293 days reported in fiscal 2016.

Leverage: low and manageable debt levels with potential of additional borrowing

Kalamazoo's debt levels are expected to remain manageable as it uses a mix of gift support and debt to invest in its facilities. For fiscal 2017, spendable cash and investments covered debt by 4.2x, significantly stronger than A-rated peers. Although operating cash flows have weakened, total debt to cash flow is still a manageable 4.6x in fiscal 2017.

The college has completed a number of campus investments in recent years, spending an average of over 2 times the level of depreciation over the past five years. Nonetheless, the college has additional capital investment needs as evidenced by an over 20 year
age of plant (calculated by Moody's). The college is contemplating a moderate amount of additional borrowing, under $20 million, later in the year.

**DEBT STRUCTURE**

The college's Series 2011A bonds are privately placed with PNC Bank, N.A. with a mandatory tender date on December 1, 2021 ($26.1 million) and final maturity date of December 1, 2040. The bonds do have annual principal payments. Under the Guaranty Agreement between the college and PNC Bank, N.A., Kalamazoo must maintain no less than 100% of minimum unrestricted and temporarily restricted cash and investments to long term debt greater than or equal to 100 percent. Coverage as of June 30, 2017 is ample, at 414%. The bonds are unsecured.

The college also has a $1 million bank loan with PNC Bank, N.A. with interest due monthly calculated at the Daily Libor plus 1.35%, with principal due in full on December 1, 2021. The note is secured by general assets of the college. The note agreement also requires the college to maintain a liquidity ratio of equal or greater than 100%.

**DEBT-RELATED DERIVATIVES**

None

**PENSIONS AND OPEB**

The college provides eligible employees with access to a defined contribution plan. The expense associated with the defined contribution plan was $2.1 million, a reasonable 3.8% of total expenses.

The college provides a defined benefit postretirement healthcare benefit plan for eligible employees. Recent changes to the plan structure have dropped the overall liability of the program to $15.8 million in fiscal 2017 from $25.5 million in fiscal 2016. The college contributed a modest $121,547 to the plan in fiscal 2017.

**Management and governance: stable management promotes expense flexibility**

The college's management team has continued to thoughtfully manage expenses in a difficult operating environment. The college budgets for contingencies and has held down expenses through strategic spending plans.

In July 2016, Dr. Jorge Gonzalez began his tenure as president of the college. Prior to becoming president, President Gonzalez worked at Occidental College as Vice President of Academic Affairs and Dean of the College from 2010 until 2016.

**Endnotes**

1 Accounting adjustments were made to fiscal 2017 and fiscal 2016 operating revenue to better estimate actual net assets released by the college.
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