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Contact

David Levett 312-706-9990
Analyst
david.levett@moodys.com

Mark G. Lazarus 312-706-9976
AVP - Analyst
mark.lazarus@moodys.com

Rachel Cortez 312-706-9956
VP-Senior Credit Officer
rachel.cortez@moodys.com

Naomi Richman 212-553-0014
MD-Public Finance
naomi.richman@moodys.com

Diane F. Viacava 212-553-4734
VP-Sr Credit Officer
diane.viacava@moodys.com

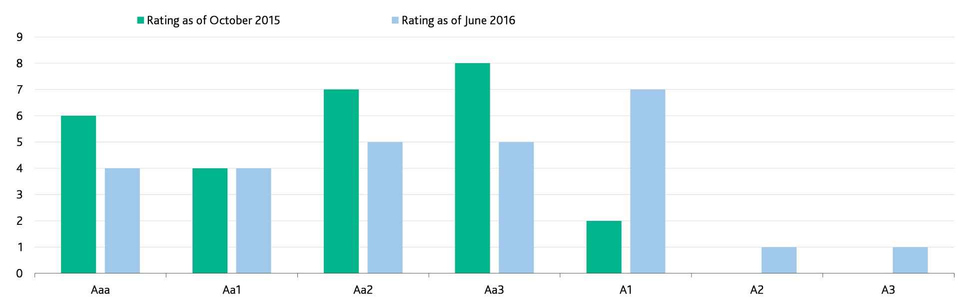
Susan I Fitzgerald 212-553-6832
Associate Managing Director
susan.fitzgerald@moodys.com

Local Government - US

FAQs: Illinois Community Colleges Tested by State's Financial Uncertainty

Despite the State of Illinois' (Baa2 negative) unprecedented year-long delay in approving a full higher eduction budget, the credit quality of rated Illinois community colleges remains strong due to their sound reserves and diverse revenue streams. However, the state's fiscal challenges have taken a toll, weakening colleges' financial positions and leaving them vulnerable to further state aid delays and potential increases in pension costs. Due to these credit pressures, we recently downgraded 15 of the 27 community colleges we rate (see Exhibit 1) and 23 now carry a negative outlook.

Exhibit 1
More than Half of Illinois Community Colleges Downgraded, but Ratings Remain High



Source: Moody's Investors Service

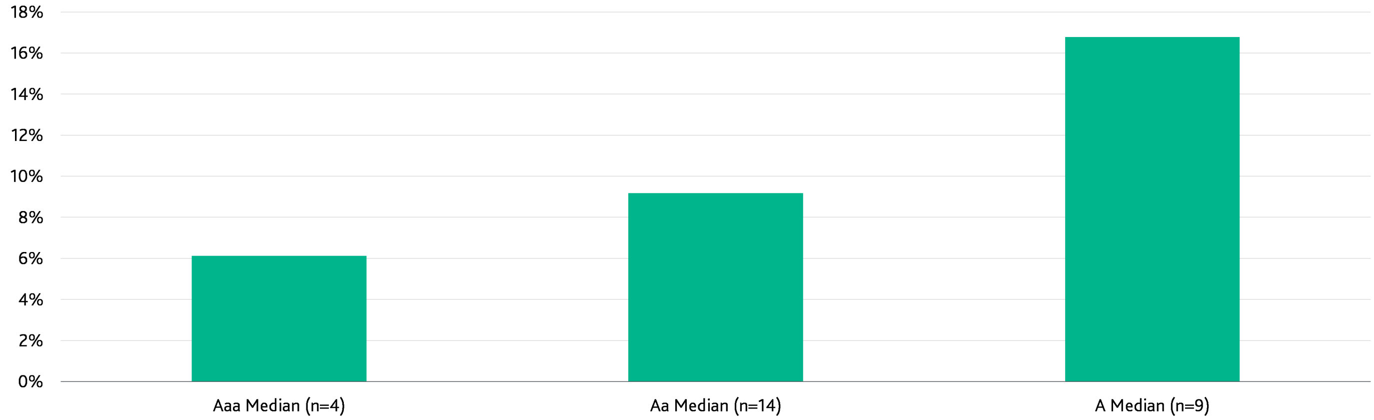
Do you expect your recent rating actions to be reversed when the state passes a budget?

No. Our recent rating actions reflect colleges' exposure to the fiscally challenged State of Illinois for operating support, program and scholarship grants and pension funding. This exposure will continue beyond passage of a state budget. We would consider reviewing the credits in a positive direction if the state's credit quality were to improve. We downgraded the State of Illinois' rating to Baa2 from Baa1 on June 8.

Why are community colleges rated higher than the State of Illinois?

Illinois community colleges have diverse revenue streams. For rated colleges, revenue derived from property taxes and tuition exceed state aid. Excluding on-behalf pension payments, state support comprises a median of only 11% of revenue for rated colleges (see Exhibit 2). Most colleges in the state can increase tuition and many have shown a willingness to do so. Providing further cushion, most rated colleges maintain sound liquidity or can issue Working Cash bonds for liquidity if needed. Other credit fundamentals that support high ratings for community colleges include low debt levels and large tax bases.

Exhibit 2
Highly Rated Community Colleges Characterized by Low Dependence on State Aid



Source: audited financial statements, Moody's Investors Service

While we believe the strengths of community colleges support generally high ratings, the GO ratings of most Illinois community colleges carry negative outlooks, reflecting their vulnerability to potential state-imposed revenue reductions or pension cost increases.

What are the primary revenue source for IL Community Colleges?

There are three main sources of revenue for Illinois community colleges.

1. **Property taxes:** The largest single revenue source for most community colleges is property taxes, which comprised a median of 33% of revenues for rated colleges in fiscal 2015. All colleges in the state are subject to property rate limits for certain operating funds. Chicago area colleges (those in Cook County and the "collar counties" of suburban Chicago) typically operate well below rate limits. However, they are also subject to the Property Tax Extension Limitation Law (PTELL), which limits annual growth in the operating property tax levy to the lesser of 5% or growth in the consumer price index (CPI), plus new construction. Colleges that are not subject to PTELL (generally those outside of the Chicago metropolitan area) are not subject to limits on overall annual levy growth but typically do not have significant headroom under rate limits for operating funds.

2. **Tuition:** Tuition is a growing share of community college revenues and comprised a median of 15% of revenues in fiscal 2015. State statute outlines tuition and fee limits for community colleges, which are based on per capita costs in certain operating funds. However, most colleges operate well below the limits. The state does not have an enforcement mechanism to prevent colleges from exceeding tuition and fee limits.

3. **State appropriations:** State appropriations are a declining share of community college revenues, comprising a median of 11% of revenues in fiscal 2015, not including on-behalf payments. The Illinois Community College Board distributes funding according to prescribed formulas that take into account factors such as credit hours and local property tax wealth. Community colleges receive a variety of state assistance including state base operating grants, equalization grants, and monetary assistance program (MAP) grants to provide financial assistance to students.

How do the credit profiles of Illinois four-year public colleges universities and community colleges differ?

Unlike regional four-year public universities, which primarily rely on state appropriations and tuition, community colleges also use property tax revenue to support operations, providing for a diverse funding framework. Also, the state's four-year universities cannot legally borrow to support cash flow or augment liquidity, while community colleges can issue both short-term cash flow notes and longer-term Working Cash Bonds. This distinction is particularly important because the regional four-year universities, with their heavy reliance on state operating appropriations, are experiencing a higher degree of liquidity stress than their community college counterparts.

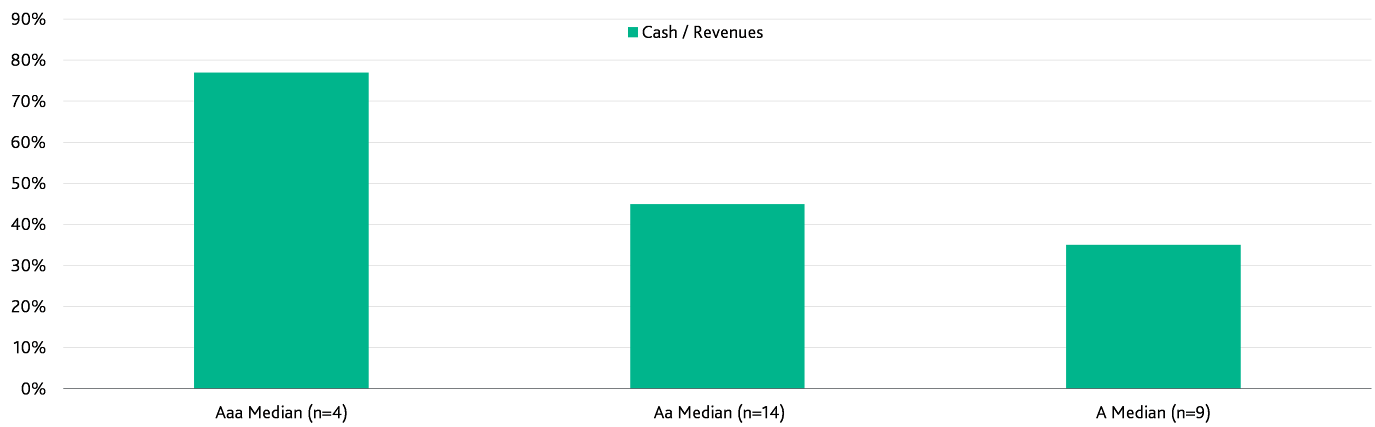
Community college debt is secured by a GO tax pledge, frequently with the pledge to levy a property tax unlimited as to rate or amount for debt service. In contrast, four-year university revenue bonds are secured by auxillary revenues, while certificates of participation are payable from state appropriations and legally available non-appropriated revenues.

How has the budgeted impasse affected community college financial operations and liquidity?

The state has gone nearly a year without adopting a full budget, leaving community colleges with only a fraction of the state support they were expecting. Most entered the fiscal year with healthy reserves (see Exhibit 3) providing some cushion against the revenue shortfalls. Based on our conversations with community college officials, we expect most will close fiscal 2016 with reduced, though still sound, cash levels. The weakest colleges will likely have narrow reserves but still retain sufficient liquidity.

Exhibit 3

Community Colleges Entered the Budget Impasse with Healthy Reserves



Source: Moody's Investors Service, audited financial statements

While a few community colleges have issued Working Cash Bonds to boost liquidity, most colleges have managed through the impasse with operating cash and interfund borrowing, given a high level of reserves in comparison with state aid. Community colleges with narrow liquidity have generally been proactive in developing contingency plans to boost liquidity if the state budget impasse continues. For instance, Prairie State (A1 negative) is exploring the issuance of Tax Anticipation Warrants, and Kaskaskia (A3 negative), is establishing a line of credit with a local bank.

How have community colleges responded to the budget impasse?

Community college officials have implemented various strategies to respond to the lack of state funding, including:

Expenditure reductions: Many colleges have made material expenditure reductions such as reducing staffing, deferring capital outlays, eliminating programs and freezing discretionary spending. We typically view expenditure cuts as a credit positive given they mitigate draws on reserves and make possible structurally-balanced operations. However, cost cutting that materially affects the quality of programmatic offerings or campus facilities can be credit negative if it affects a college's competitive position and enrollment trends.

Revenue increases: Many colleges have turned to tuition increases to offset all or a portion of state aid loss. Like expenditure reductions, such measures are generally credit positive, but extreme tuition hikes could hurt a college's competitiveness. Some community colleges can increase property taxes, but most are restrained by legal tax caps.

Reserve use: Many community colleges have tapped reserves to cover state aid and budgetary shortfalls. The extent to which a drawdown affects credit quality depends on the underlying financial health of the district. The negative implications may be minor for a district with very ample reserves. For example, College of DuPage (Aa1 stable) closed fiscal 2015 with $265 million in cash compared with state appropriations of $14 million. The college can operate without state aid for years and still maintain healthy cash levels. In contrast, a prolonged budget impasse could cause John Logan (A2 negative) to burn through a large portion of the $13.6 million in cash (26.7% of revenues) it had at the close of fiscal 2015 absent operational changes, given its annual state appropriations of more than $5 million.

Issuance of short and long-term debt: Illinois law allows local governments to issue Working Cash Bonds to establish or increase a Working Cash Fund for liquidity, subject to limitations. Many community colleges entered the current fiscal year with margin to issue Working Cash Bonds. We typically view the practice of issuing long-term debt to finance operations as a credit negative. However, this negative impact can be mitigated if the bonds amortize rapidly, if the bonds have a dedicated revenue source for repayment, and if the college maintains a low debt burden even with the issuance. Community colleges with narrow liquidity also have options for short-term borrowing including TAWs and line of credits.

What was the impact of recent funding released to community colleges and what are officials budgeting for fiscal 2017?

On April 25, Governor Bruce Rauner signed Senate Bill 2059, which provided $600 million in emergency funding for all Illinois higher education institutions. The bill included $74 million in base operating and equalization grants to community colleges. While the funding was credit positive, the impact is modest as the amount was less than one-third of previous year's state appropriation.

College officials have varying assumptions for state aid in the upcoming year. The most common approach reported by officials is to budget for a portion of state aid while continuing to develop contingency plans for larger shortfalls. In general, we believe that budgets built on conservative assumptions of reduced and/or delayed state aid will better insulate colleges from the risk of further credit challenges than budgets that are built on optimistic assumptions of full and/or timely state aid. An example of a college with conservative budget assumptions is Richland Community College (A1 negative); officials plan to completely offset state appropriations with revenue and expenditure adjustments for fiscal 2017.

How significant are community college pension liabilities?

Under current law, the State of Illinois is responsible for contributions to the Illinois State University Retirement System (SURS) on behalf of all community college employees other than those whose positions are grant-funded. Therefore, under our methodology for assessing pension liabilities, we assign all SURS liabilities to the state, resulting in a Moody's Adjusted Net Pension Liability (ANPL) of $0 for most community colleges. State on-behalf support for pensions is significant comprising 13% to 20% of college revenues.

To address the state's budget pressures, members of the Illinois General Assembly have in the past introduced proposals to “shift” a portion of these pension costs to community colleges. Some proposals have suggested shifting just the normal costs to districts with the state remaining responsible for accrued liabilities. Under these proposals, the normal cost would be shifted to community colleges in phases, with colleges charged up to 1% of payroll increasing each year for several years to cover the system's normal costs. To date, no such proposal has been enacted, but as the state's budget impasse continues, the risk of a cost-shift will increase. We believe that most colleges would be able to absorb a phased-in approach without a significant impact on financial operations. However, a cost-shift, coupled with reductions to state aid, could pressure some colleges more than just cost-shift alone.

Appendix: Rated Illinois Community Colleges

College	Rating	State Appropriations / Revenues
Elgin	Aaa	5%
Oakton	Aaa	7%
Lake County	Aaa	7%
William Rainey Harper	Aaa	4%
College of DuPage	Aa1	5%
McHenry County	Aa1	6%
Moraine Valley	Aa1	10%
Waubonsee	Aa1	8%
Joliet	Aa2	7%
Danville	Aa2	19%
Heartland	Aa2	8%
Illinois Central	Aa2	5%
Lincoln Land	Aa2	8%
Parkland	Aa3	12%
Southwestern Illinois	Aa3	17%
Carl Sandburg	Aa3	11%
Triton	Aa3	12%
Morton	Aa3	21%
John Wood	A1	9%
Rock Valley	A1	11%
Lake Land	A1	19%
Richland	A1	12%
Rend Lake	A1	27%
Black Hawk	A1	17%
Prairie State	A1	11%
John A Logan	A2	26%
Kaskaskia	A3	25%

State appropriations in most audits include state grants such as the Monetary Assistance Program (MAP); on-behalf pension payments are not included. MAP grants are awarded by the state to individual students. Federal grants may be included for some colleges that do not separate state and federal grants in audited financial statements. Some colleges also receive personal property tax replacement taxes (PPRT) from the state, which have not been impacted by the budget impasse. PPRT may be included in state appropriations for some colleges depending on reporting.
Source: Moody's Investors Service, audited financial statements

Moody's Related Research

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Sector Comments

» Illinois' Stopgap Higher Education Funding Bill Is Credit Positive, but Funding Challenges Persist, May 2016 (189575)

» Pressure Builds on Illinois Public Universities and Community Colleges, February 2016 (1016199)

» Illinois' Release of Revenues Is Credit Positive for Chicago and Other Local Governments, December 2015 (186637)

Credit Opinions

» Moody's downgrades Illinois GOs to Baa2 from Baa1; related ratings also downgraded, June 2016

» Moody's Places Seven Illinois Public Universities on Review for Downgrade, June 2016

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