Gurtin Municipal Bond Management

Credit Research Flash

What Does Investment Grade Mean to Standard & Poor's?

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What does "investment grade" mean to Standard & Poor's (S&P)? On the heels of maintaining its investment grade ratings on Munster City School District, Indiana after the school district defaulted in January 2015 (detailed in a February 2015 credit report published by our credit team), S&P is faced with yet another black eye. On March 3rd, a week after the Board of Sweet Briar College in Virginia voted to close the college following summer classes in August 2015, and only four months after reviewing the obligor and assigning an investment grade BBB rating,[1] S&P downgraded the college an astounding seven notches to B-.[2] This severe downgrade makes it appear that S&P is either "asleep at the wheel," or the ratings agency is severely misevaluating future risk when they assign ratings. In our opinion, an investment grade rating is incongruent with obligors facing severe fiscal stress, which caused the missed debt payment in the case of Munster, or dire operating challenges, which caused Sweet Briar College to cease operating as a going concern. The variety of financial strains facing both obligors is indicative of a heightened probability of a credit event and we suggest that while S&P may not have been able

[1] All references to S&P's prior review of Sweet Briar College refer to their rating report dated November 4, 2014 in which S&P affirmed their BBB rating on the College's outstanding debt.

[2] S&P's rating action and report dated March 3, 2015 on Sweet Briar College (for debt issued through the Amherst Industrial Development Authority, Virginia).

to predict the outcomes, their ratings should have reflected the elevated risk facing bondholders.

While Sweet Briar College ("the College") does maintain good financial resources relative to its debt outstanding, there are multiple factors that are highly concerning regarding S&P's treatment of the College. Since S&P had reviewed the College's rating a mere four months ago, the ratings agency should have been aware of the mounting operational risks. In fact, during this review, S&P uncovered nearly all of the risk factors that ultimately led the College to decide to cease operations and the Board to cite "insurmountable financial challenges" in its closure announcement.[3] Even so, S&P did not find these factors sufficient to downgrade the College a single notch, let alone move it outside of investment grade territory.

Gurtin Municipal Bond Management, LLC has never had exposure to the College, and upon reviewing the College's financial and operating data, all of which was included in S&P's November 2014 rating report, we concluded that the College had far from investment grade credit characteristics. The extremely small, women-only private college was struggling to maintain a student headcount of even a miniscule 700. Despite repeated efforts over the past decade to boost enrollment, the College's matriculation levels (the number of accepted students that choose to attend) remained exceedingly low at 21%, and student headcount had decreased by 8% since 2011. The College's efforts to improve its market position were hampered by recurring and consistent turnover in management positions which created instability. On top of this, the College was burning through its endowment and reserve funds at an unsustainable rate in recent years – a challenge noted by S&P in its November report.[4] All of this was occurring in a niche higher education sub-sector which we believe remains deeply troubled and highly exposed to risk, as illustrated by the fact that the number of women's only colleges operating in the United States and Canada has declined by nearly 80% since 1960.[5]

This latest incident is yet another glaring example of the problem that has long plagued the rating agencies. Even when they recognize potential risk, they are slow to downgrade an obligor to a level that is commensurate with their mounting risk profile. As is the case with this most recent example, when the rating agencies do take rating actions, they are frequently just responding to credit events that have already occurred; they are not providing the market with the service for which we believe they are being charged – that is to provide letter grade ratings that accurately reflect the risk associated with an obligor. In the case of Sweet Briar College, while S&P appeared to focus nearly exclusively on the College's remaining cash levels relative to its debt outstanding, they missed the more holistic credit factors that led the Board to decide to close the university. While cash is certainly an important credit factor, we would argue that an obligor facing sufficiently massive

[3] Taken from Sweet Briar College's report on the Board's closure decision: http://sbc.edu/news/academics/board-directors-votes-close-college-2014-2015-academic-year/.

[4] In their November 2014 report, S&P stated, "The endowment spending rate remains very high and unsustainable, in our view."

[5] According to the Women's College Coalition, an association of women's colleges and universities, in 1960 there were 230 women's colleges and in 2014 only 47 remained.

challenges that ultimately led the Board to vote to close the College, does not deserve an investment grade rating.

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Share the report:

Analysts:

John Humphrey
Senior Vice President, Co-Head of Research
jhumphrey@gurtin.com

Michael Johnson
Managing Partner, Co-CIO
mjohnson@gurtin.com

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