2014 Outlook – US Higher Education, Not-for-Profits and Independent Schools

Expense growth expected to outpace revenue growth for all sectors; Independent K-12 schools show resilience

Moody’s outlooks for the US Higher Education and Not-for-Profit sectors are negative. The outlook for Independent K-12 Schools is stable. The outlooks express our expectations for the fundamental credit conditions in the sectors over the next 12 to 18 months. A negative sector outlook indicates our view that fundamental credit conditions will worsen. A stable sector outlook indicates that conditions are not expected to change significantly. Since sector outlooks represent our forward-looking view on conditions that factor into ratings, a negative outlook indicates that negative rating actions are more likely on average.

Summary

Fundamental business conditions in the US higher education and not-for-profit1 sectors will remain stressed in 2014, with continued price resistance and a challenged federal budget leading to weak revenue growth. Heightened competition for students, donors and government funds combined with pressure to increase compensation and invest in programs and facilities will result in continued deterioration of financial performance. Quickly evolving delivery models are also intensifying competition. Evolving federal and state higher education policies and erratic public funding exacerbate uncertainty.

Colleges, universities and not-for-profits have exhibited willingness and ability to adapt to weak economic conditions. However, the uncertainty in the funding and regulatory environment overshadows the strengths of these sectors in the near term and the need for strong governance remains paramount. Historically reliable revenues streams for the diverse not-for-profit sector are now strained by a variety of factors. Because of the economic resilience and population served, our outlook for independent K-12 schools is revised to stable.

Key drivers of our negative outlook are:

- Slowly growing revenue eclipsed by pressure to increase expenses
- Heightened competition, including changing delivery and business models
- Flat to declining governmental funding and apportionment may not be predictable
- Heightened political scrutiny and increased regulatory oversight add uncertainty

1 Rated not-for-profits covered in this comment include non-healthcare not-for-profits, such as Independent Research Institutes, Philanthropic Organizations, Cultural Institutions and Service and Advocacy Organizations.
Slowly growing revenue eclipsed by pressure to increase expenses

Revenue growth for 2014 is expected to remain much lower than historical standards while expenses rise due to pent up institutional needs.

Weak general economic conditions continue to affect families’ willingness and ability to pay for higher education. The lagging recovery is also reducing discretionary spending capacity for higher education and for not-for-profit institutions. Affordability remains a key issue as unemployment remains relatively high, incomes stagnate and labor force participation rates lag. These macroeconomic pressures are undercutting universities' ability to grow net tuition revenue and not-for-profits’ ability to raise prices and bolster other revenue.

Rising student loan default rates combined with weak employment, especially among recent college graduates, have led many to question the value of higher education. However, US Census Bureau data continue to demonstrate that educational attainment correlates with higher income, with median earnings for individuals with a bachelor’s degree exceeding those of a high school graduate by 60%. While these data support the value proposition of higher education, they do not eliminate the scrutiny of affordability and outcomes.

Operating margins are expected to fall for many colleges and universities in the coming year. After multiple years of stagnant capital investment and tightened control of operating spending, pressure is building to invest in capital, information systems, faculty compensation and program renewal.

New money borrowing is expected to remain sluggish. Many institutions remain debt averse in this uncertain environment. We expect new capital investment will be made largely from other sources, such as reserves, gifts and cash flow. The use of these funds combined with declining weaker cash flow will limit improvement in balance sheets.

EXHIBIT 1
Expense Growth Exceeding Revenue Growth for All Sectors

Source: Moody’s Municipal Financial Ratio Analysis

2 “Rising Student Loan Default Rates Present Growing Risk to Universities”, October 2013 (159324)
3 US Census Income Data
Some revenue relief is expected for universities and not-for-profit institutions with large endowments and robust philanthropic support. Strong investment returns in 2013 – preliminary median reported June 30, 2013 endowment return for Moody’s rated entities is 12.2% – will help boost endowment income over the next several years due to multi-year endowment spending formulas. Fundraising is also highly correlated to stock market returns and should strengthen if current market performance is sustained.

**Changing delivery and business models increase competition**

*Changing delivery and business models have become part of the competitive landscape, but also offer new sources of revenue and expense control.*

Education delivery is changing in multiple ways, with increased cross-registration in online courses, growing focus on competency based models, and moves to unbundling of educational services potentially increasing mobility across institutions. The rapid rise of Massive Open Online Courses (MOOCs) has accelerated the pace of change in online delivery models over the last two years.\(^4\) Over the next several years, navigating this landscape will have economic impacts (both positive and negative). It will also force institutions to become more nimble in their strategic positioning. Over the long term, this evolution can be credit positive if it provides greater access and flexibility to students, combined with reduced cost through greater collaboration across institutions.

Many not-for-profits’ business models are also evolving due to changing technology, including online accessibility, unbundling of their own services and increased competition for customers and donors. For cultural institutions, audiences are more interested in single ticket purchases than season passes or memberships, increasing revenue uncertainty. This shift requires deft management of short- and long-range planning and a reevaluation of traditional revenue flow.

As organizations assess long-term financial sustainability in light of forecasts for lower revenue growth, cost efficiencies continue to be explored through a variety of sources including: partnerships, mergers, virtual mergers, consortia, affiliations and shared services. However, traditional employment structures, such as tenure and unionization, are obstacles for some to achieve required expense reductions in a timely manner.

**Flat to declining governmental funding and apportionment may not be predictable**

*Governmental funding (federal and state) for higher education and not-for-profits will remain constrained in 2014.*

Federal budget pressures will continue for the foreseeable future, potentially affecting Pell Grants and other federal financial aid, graduate medical education (GME) funding, Medicare and research funding and support for the arts and other not-for-profits. State funding for higher education and not-for-profits is mixed. Some states continue to reduce funds for higher education while others are maintaining or slightly increasing funds for higher education, in part driven by recognition of universities’ role in economic development.

Reauthorization of the Higher Education Act, which governs the $150 billion of federal financial aid programs (also known as Title IV funds), is scheduled for 2014. Based on past reauthorization years, we expect the process to be delayed but for there to be significant governmental focus and discourse during the renewal process. Discussions to date include streamlining and updating both the accreditation process and financial aid program to recognize changing modes of educational delivery,

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\(^4\) *Continued Growth in Online Learning Is Credit Positive for the Higher Education Sector, but Challenges Emerge*, January 2013 (149213)
including allowing financial aid to be used for online coursework. Tying financial aid to various performance based metrics, such as graduation rates, will also be a focus of discussion.

With limited federal funding available, it is likely that the budget for financial aid will remain flat or decline slightly, with some reallocation among programs (see Exhibit 2). Federal financial aid may also be reduced if potential sequestration cuts go into effect on January 15, 2014. While the Pell Grant program is exempt from sequester cuts, it may be subject to budgetary cuts after fiscal year 2014 and beyond. These cuts could result in a reduction of the maximum annual Pell Grant, currently $5,645 for the 2013–14 award year, or changes to eligibility. The maximum Pell Grant covered just 63% of average public four-year tuition and fees in 2013-14 compared to 87% 10 years ago. Lower-rated public and private universities and community colleges would feel the greatest impact of a reduction in Pell Grant funding or changes to eligibility due to their higher reliance on this program. Four-year universities would face the need to increase financial aid budgets to match the declining Pell Grant funding or possibly lose enrollment. Community colleges would be the most impacted by changes to eligibility – as evidenced by declining enrollments corresponding to the removal of summer Pell awards in 2012.

Federal research funding, which represents approximately 70% of research grants and contract revenue for our rated research universities and institutes, will contract further in 2014 following a 5% cut through sequestration in 2013. Under sequestration, research funds are expected to be cut annually for the next 10 years. Even if a federal budget agreement is reached, we expect funding to at best remain flat. Universities that built facilities expecting growth in research funding that is now not materializing will be have to absorb those debt service and operating costs in their budget. For those where research remains a strategic priority, internal reallocations or redeployment of philanthropic priorities will also result in operating pressures, even as new sources for funding are being explored.

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5. The College Board, *Trends in Student Aid 2013*
7. "Research Universities Lose Funding With Sequestration, Increasing Competitive Environment", November 2013 (160455)
Net state funding will remain flat in 2014 for higher education and not-for-profits, but state operating support as a percent of total operating revenue continues to decline (see Exhibit 3).

EXHIBIT 3
Approximately 60% of states cut state funding since 2008
Shading reflects five-year change in gross state funding

In states where higher education funding is increasing, it is increasingly tied to limits on increases of resident undergraduate tuition, restricting overall revenue growth (see Exhibit 4). Most universities are experiencing increases in pension expense. In those limited number of states where the state makes pension payments on behalf of public universities, rising pension expenses represent a growing share of state operating support, so that the amount left to support the educational enterprise continues to diminish.

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8 Connecticut, Hawaii, Illinois, Louisiana, New Jersey and Texas. However, in Texas and New Jersey, certain universities are required to reimburse a portion of pension contribution.
EXHIBIT 4

Public Universities Rely Less on State Funding Since Recession

<table>
<thead>
<tr>
<th>Year</th>
<th>% of Public Universities Whose Largest Revenue Source is State Funding</th>
</tr>
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<tbody>
<tr>
<td>2003</td>
<td>40%</td>
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<tr>
<td>2004</td>
<td>39%</td>
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<td>2005</td>
<td>38%</td>
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<td>2011</td>
<td>32%</td>
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<tr>
<td>2012</td>
<td>31%</td>
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<td>Est. 2013</td>
<td>30%</td>
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</table>

Source: Moody’s Municipal Financial Ratio Analysis

Heighted political scrutiny and increased regulatory oversight add uncertainty

The political and regulatory environment for higher education continues to present a number of unique challenges and risks, with many outcomes unknown for 2014.

Policy changes are evolving on both the state and federal levels. At the federal level, the focus is on affordability for higher education and accreditation, which has already led to greater regulatory oversight including heightened accreditation sanctions. In the next year, the White House plans to launch a federal college rating system that would allocate Title IV (financial aid) funding based on a university’s ratings for access, affordability and student outcomes. Title IV federal financial aid currently represents a median one-third of operating revenue for Moody’s rated public and private universities. These efforts will pressure net tuition revenue growth, the major source of revenue for the majority of public and private universities.

A significant number of unknowns surround the implementation of the Affordable Care Act, making it difficult for Academic Medical Centers (AMCs) to budget and perform necessary strategic planning. Similar to other not-for-profit hospitals, we expect AMC hospitals to increase collaborations or merge with hospitals to gain market share and revenue, which can result in growing exposure to patient care revenue for the university. Throughout the last several years, many university-owned AMC hospitals have contributed positively to the operating margins, research, and donor support for the parent universities. Going forward, AMC hospitals will be challenged by changing reimbursement models and the rise of narrow networks, lower reimbursement rates, a shift to outpatient care and slowed growth of inpatient admissions, the challenge of relatively high Medicaid exposure, and likely tightening of margins. As universities face their own revenue pressures, many AMC hospitals, in particular highly profitable hospitals, as well as faculty practice plans, are facing requests for increased financial transfers to their associated medical schools.

9 "Tighter Regulations Proposed by President Obama Pose Near Term Risks for US Colleges and Universities but Have Long Term Benefits”, February 2013 (150146)
10 “US Academic Medical Centers: Complex, Successful Organizations Driven by Integrated University-Hospital Strategies”, November 2012 (146668)
Other political and regulatory factors:

» **Performance Based Funding**: State funding models are evolving and the transition to performance based funding will benefit some, but not all public universities and community colleges. With performance funding focused heavily on graduation and retention rates as well as course completion, universities and with strong academics or targeted programs will fare best.

» **Tax Reform**: Possible tax reform including restrictions on tax deductions could impact the cost of capital and philanthropy.

» **Tax-Exemption**: Increased scrutiny of tax-exempt activities and property from both municipalities and the federal government could lead to increased operating expenses.

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**What Could Change the Higher Education and Not-for-Profit Sector Outlooks to Stable?**

» Indications that revenue growth will stabilize to a level that matches or exceeds expense growth.

» Demonstrated ability to generate cash flow sufficient to invest in strategic initiatives including facilities expansion and renovation, as evidenced by a growing percent of rated entities obtaining operating cash flow of greater than 10% and a capital spending ratio of greater than 1.

To date, higher education and not-for-profits have been able to adapt to accelerated changes in the general business environment, even when combined with several years of depressed revenue growth. We expect ongoing volatility in the business environment of these institutions, so a change to a stable outlook would focus on the sectors’ ability to stabilize operations at a level that will continue to allow them to strategically position themselves going forward. At this point, we do not see these signs of stability, but rather the prospects of further margin contraction.
A Closer Look at the Sectors

Higher Education

Negative Outlook

The negative outlook for higher education reflects tepid revenue growth combined with growing expenses, resulting in operating margin contraction.

Net tuition revenue for public and private universities and community colleges will continue to be stressed by:

- continued price sensitivity
- increasing public and political focus on affordability
- limitations on tuition increases in some states
- increasing competition for students due to a contraction in the domestic pool of graduating high school students

We expect increases in net tuition revenue to remain weak in 2014, with a growing number of universities, both public (44%) and private (42%), unable to grow this critical revenue stream even at the rate of inflation. After several years of cost containment, universities have begun to increase expenses, often at a much higher rate than revenue growth, resulting in declining cash flow. The current margin contraction is not sustainable over the long term. The greatest stress is on lower rated colleges and universities that are highly tuition or state funding dependent. These universities also tend to lack a clearly defined student market and do not have strong resources or philanthropic support to provide operating flexibility.

Strategic prioritization and creative management will be critical to long-term sustainability. The opportunity for the strategic development of new programs and delivery models, as well as non-tuition revenue sources, will become an increasingly important insulating factor.

Some budgetary relief is expected with improved investment returns and greater philanthropic support, for higher rated institutions with large endowments and strong fundraising infrastructure as well as public universities that continue to successfully invest in improving their philanthropic support. We view these revenue sources as sensitive to changes in general economic conditions, tax policy and federal budget negotiations, which could result in market instability. Graduate medical education (GME) and federally sponsored research funding is expected to decline, or at best remain flat, due to federal budget challenges. Changes to healthcare funding will challenge institutions with academic medical centers.

Counterpoint: Demand for higher education remains sound. Universities have historically been adept at adjusting expenses incrementally to adapt to economic conditions. However, the confluence of sustained price sensitivity, public and political scrutiny and a dramatic acceleration of technological disruption have created an intensely competitive near-term environment that requires more rapid adjustment and potential investment at a time when revenue growth is at an historic low.

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Evolving trends that could impact the competitive landscape for higher education include:

» The continuing evolution of online education, including MOOCs for credit, cross registration across institutions and a recent push toward competency-based credit

» The globalization of higher education with increasing competition for students and growing risks, as well as opportunities, associated with global expansion

» Demographic shifts:
  - In 2014, the number of graduating high school students in the United States is projected to hit its lowest point. Growth is projected to remain depressed until 2016, resulting in increased competition for domestic students, and potentially lower enrollment for the next several years.12
  - Nearly half of Moody’s rated public and private universities are anticipating total enrollment declines in 2014.13
  - The Northeast and Midwest will have the steepest declines. Regional and local public and private universities in these regions will feel the greatest impact in the near term.

In depth: Private Colleges and Universities

Colleges that are modestly gaining market share include either those with strong reputations or low cost, leaving the majority of colleges and universities struggling to maintain enrollment and with limited pricing power. Demand remains for the traditional on-campus experience with low faculty-to-student ratio for those who can afford it.14 Private colleges and universities with large endowments have a competitive advantage by providing a higher value option, with stronger ability to provide financial aid for prospective students.

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12 Knocking at the College Door, Western Interstate Commission for Higher Education
13 “Weakened Tuition Revenue Plagues US Higher Education”, November 22, 2013 (160487)
14 “Private College and University Medians Highlight Challenges in Post-Recession Era”, August 2013 (156736); “Weakened Tuition Revenue Plagues US Higher Education”, November 22, 2013 (160487)
In depth: Public Colleges and Universities

More public universities are expecting declines in tuition revenue for fiscal 2014. Combined with inconsistent state support and growing expense pressures after multiple years of constraint, our outlook for the financial performance of public universities has become increasingly negative though demand remains strong.

For several years, lower sticker prices allowed public universities to increase tuition at extraordinary rates in order to compensate for declining state appropriations. While some universities retain pricing power, it can be constrained by either mission-based or political limitations on tuition increases.

As a result, public universities are increasingly competing for out-of-state students, including those from outside of the US, for which the universities can often raise tuition at a greater rate.

The state funding environment is improving, and we do not expect the widespread cuts of recent years to continue. While there is some stabilization, we do not expect significant reinvestment. In many cases funding increases will remain below inflation or in exchange for holding tuition for resident undergraduates stable, resulting in no net revenue increase.

EXHIBIT 6
Public Universities have Become Less Affordable

<table>
<thead>
<tr>
<th>Year</th>
<th>Median Family Income</th>
<th>Public Net Tuition</th>
<th>Median Family Income</th>
<th>Private Net Tuition</th>
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<tbody>
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Source: US Census Bureau, Moody’s Municipal Financial Ratio Analysis

In depth: Community Colleges

Community colleges have greater operating flexibility and an adaptable business model that enables them to quickly respond to changing enrollment and local programmatic needs. Demand is often driven by local demographics and the economy surrounding a particular community college, although more community colleges are seeking to geographically expand their enrollment as they focus increasingly on serving a transfer student population. Concerns remain about federal financial aid funding and heightened accreditation focus; especially with significantly higher student loan default rates among the community college student population (see Exhibit 7).

15 “Heightened Pressure on Revenue Growth for US Public Universities in FY 2012”, August 2013 (156607)
16 Moody’s Municipal Financial Ratio Analysis
Negative Outlook on For-Profit Higher Education Providers

Moody’s US for-profit post-secondary education sector outlook remains negative due to continued top-line revenue strain, earnings stress and regulatory pressure. Sustained enrollment contraction reflects the negative effects of prolonged high unemployment, public and political scrutiny of rising student loan burdens and more selective admissions standards implemented by some companies to identify students more likely to succeed. Federal initiatives to link financial aid funding to performance metrics, reconsideration of the gainful employment rule, and potential reductions or changes to federal financial aid through federal budgetary decisions or the reauthorization of the Higher Education Act will constrain near-term revenue growth.

An additional area of pressure is the federal government’s focus on community colleges as a low-cost option to expand access to higher education. Since community colleges have historically served a similar demographic as for-profit providers, non-traditional age or first-generation students, potential investment in this sector would free up physical or virtual capacity for online courses and erode for-profit education’s market share. Similar to not-for-profit colleges and universities, the changing delivery model of higher education, including technological advancements, online education and competency-based learning could negatively impact for-profit companies.
Non-Healthcare Not-for-Profit Overview

Negative Outlook

The negative outlook for not-for-profits reflects revenue volatility, evolving business models which require changes to financial management and investment and growing expense pressures.

The not-for-profit sector is heavily reliant on gift revenue, membership and admission fees, investment returns and, in some cases, research and other government funding. We expect all of these revenue sources to face some volatility in 2014 as federal deficit and debt ceiling debates continue. The top driver behind many of these revenue streams is family disposable income. General willingness to pay for non-essential items is diminished by general economic uncertainty and variable consumer confidence.

EXHIBIT 8
Not-for-Profits Rely on a Variety of Revenue Sources, with Varying Degrees of Pressure

Source: Moody’s Municipal Financial Ratio Analysis

All other sources of revenue include auxiliary, merchandise, tax revenue, and government appropriations

In depth: Independent Research Institutes

Research institutes, particularly standalone entities, face the greatest near-term pressure of all of our subsectors due to cuts in federal research funding and other often-limited revenue diversity. Those which have endowment support are better positioned than those with more limited reserves. We expect research institutes to seek greater collaboration amongst themselves with some possibility of merging or affiliating with universities.

In depth: Service and Advocacy Organizations

These organizations have a wide range of operating models and generally broad membership or donor bases. Operating relief from prudent budgeting and diverse revenue sources may not be sufficient to achieve financial sustainability over the next several years, especially in light of limited financial reserves. Some of these organizations are highly reliant on federal or state funding and will therefore see revenue growth flatten.

17 Moody’s Municipal Financial Ratio Analysis
In depth: Cultural Institutions

Cultural institutions without depth of philanthropic support and strong financial management may continue to struggle, as evidenced by the recent high profile closure of the New York City Opera and default of the Please Touch Museum in Philadelphia, both non-rated. Cultural institutions compete heavily both for visitors/members and donor support and changing societal preferences require rethinking ways of delivering services. The need to maintain attractive facilities and programs responsive to the consumer preferences, combined with the need to fund salary and other increases, will pressure expenses. Expense adjustments may be constrained by union or other contracts.

Evolution of consumer preferences includes:

» Individual events proving more appealing rather than season tickets will create the need to alter the traditional business model by unbundling services and tickets

» Introduction of the arts available through electronic media. For example, some museums are making their collections available online and performing arts organizations are filming performances and exhibiting at local movie theatres or online.

In depth: Philanthropic Organizations

Philanthropic institutions are more stable due to their low-cost structure, significant expense flexibility and a demonstrated willingness to reduce expenses when needed. These organizations rely on gift receipts and endowment returns and should expect to see stronger operating results in 2014. Due to their concentrated revenue streams, they are more vulnerable to performance of investment markets during a downturn.

Independent K-12 Schools

Stable Outlook

The outlook for Independent K-12 schools is revised to stable, reflecting continued strong student demand and proven resiliency to economic pressures.

Although this sector faces many of the same challenges as private colleges and universities, the schools we rate represent the strongest of the industry. Demand has remained remarkably resilient as families have prioritized education within their budgets. As a result, operating performance will remain sound and financial reserves will continue to be bolstered by often multi-generational philanthropic support.18

18 “Strength of Independent School Sector Evident in Fiscal 2012 Medians”, October 2013 (158928)
Moody's Related Research

Medians:
» Heightened Pressure on Revenue Growth for US Public Universities in FY 2012, August 2013 (156607)
» Private College and University Medians Highlight Challenges in Post-Recession Era, August 2013 (156736)
» Strength of Independent School Sector Evident in Fiscal 2012 Medians, October 2013 (158928)

Special Comments:
» Continued Growth in Online Learning Is Credit Positive for the Higher Education Sector, but Challenges Emerge, January 2013 (149213)
» The Sequester Series: Limited Impact on US Universities and Related Not-For-Profit Organizations, March 2013 (151835)
» Heightened Pressure on Revenue Growth for US Public Universities in FY 2012, August 2013 (156607)
» Performance Based Funding Introduces New Risk for US Universities, September 2013 (158048)
» Rising Student Loan Default Rates Present Growing Risk to Universities, October 2013 (159324)
» Research Universities Lose Funding With Sequestration, Increasing Competitive Environment, November 2013 (160455)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.
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