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Contacts

Wesley Coggins +1.212.553.1927
Associate Lead Analyst
wesley.coggins@moodys.com

Christopher Collins +1.212.553.7124
AVP-Analyst
christopher.collins2@moodys.com

Susan I Fitzgerald +1.212.553.6832
Associate Managing Director
susan.fitzgerald@moodys.com

Florence Zeman +1.212.553.4836
Associate Managing Director
florence.zeman@moodys.com

Privatized student housing - US

University support, debt coverage mitigates coronavirus revenue impact in near term

University support and strong debt service coverage levels will mitigate both the decline in rental revenue as a result of the coronavirus outbreak and the need for most projects to tap their debt service reserves to make debt service within the next six months. Many universities have vacated their privatized projects of almost all student tenants for the remainder of the spring semester in response to the coronavirus outbreak, with students being offered prorated refunds for the remainder of their lease agreements. How the pandemic will affect pre-leasing and university enrollment for the fall semester remains uncertain.

» **Many privatized student housing projects that have closed benefit from strong university affiliation.** Eighty-six percent of Moody's-rated operating projects are offering either refunds or credits to student tenants. Many of these projects are a central part of universities' long-term strategic plans, and universities are consequently seeking to ensure that these projects meet their debt service obligations by covering their refund costs.

» **Projects that lack strong university affiliation will benefit from high debt service coverage ratios or sufficient short-term liquidity.** Of the 37 rated projects not currently under construction, 16 will benefit from strong university support/affiliation and nine have high debt service coverage ratios (DSCRs) of at least 1.5x. Of the projects that benefit from neither strong university support or high DSCRs, six have sufficient short-term liquidity to meet debt service payments in the short-term, four are not offering refund payments, and two have ratings below investment grade that reflect preexisting challenges.

» **Impact of pandemic on demand for student housing is uncertain for fall semester.** A continuation of online-only classes, a drop in university enrollment for the fall semester, and a shortening of the summer pre-leasing season will all be credit negative, should they occur. Additionally, financial performance and debt coverage levels will decline if projects' costs increase because of additional sanitizing of rental units or higher rental concessions caused by softer demand.

Many projects that have closed will benefit in the short term from strong university affiliation

Many privatized housing deals are a central part of the university's long-term strategic plan and consequently will benefit from strong university support and affiliation. This strong linkage has proven to be valuable during the coronavirus pandemic where many universities have made an effort to ensure that their associated privatized projects will meet their debt service requirements by covering the costs of refunds and credits offered to student tenants who were forced to vacate their units because of the outbreak.

Sixteen projects currently benefit either from an agreement established in the wake of the pandemic for the affiliated university to cover refund expenses or from an existing debt service guaranty or implied moral obligation on the part of the university that obligates close oversight and cooperation with the project. This strong university support prevents projects from having to tap their debt service reserves (DSRs) in order to make debt service.

Texas A&M University-Corpus Christi, for example, has stated that student tenants who have moved out of the Islander Housing Miramar project (Ba1 negative) and Momentum Village - Phase I and Momentum Village - Phase II (B2 negative) projects will have to fulfill the remaining terms of their spring semester lease. However, the university will offset the costs with a credit to the student's university account. The University of Toledo (A1 negative) has agreed to compensate Collegiate Housing Foundation (CHF) – Toledo, LLC, the owner of the privatized Honors Academic Village project (Baa3 stable) on its campus, for lost rental revenue. The University of California, Irvine (UCI) has entered into a similar financial agreement with regard to UCI's East Campus Apartments project (Baa1 stable).

Twenty of the 37 operating Moody's-rated privatized student housing projects mandated that almost all student tenants vacate their units for the remainder of the spring 2020 semester.[1] These closures were made in conjunction with a shift to remote and online classes for the affiliated universities. All of the closed projects are offering their student tenants either a prorated refund for the remaining term of each student's lease agreement or a credit to the student's account that will be applied next fall semester.

As shown in Exhibit 1, of the additional 17 projects have remained open and have not mandated students to vacate, 12 are offering refunds/credits for students who nonetheless move out, four are not offering refunds to those students, and one has not yet settled on a refund policy. In total, 32 of 37 operating projects will be offering refunds or credits to their student tenants.

Exhibit 1
86% of Moody's-rated privatized student housing projects are offering refunds or credits
As of 4/20/20

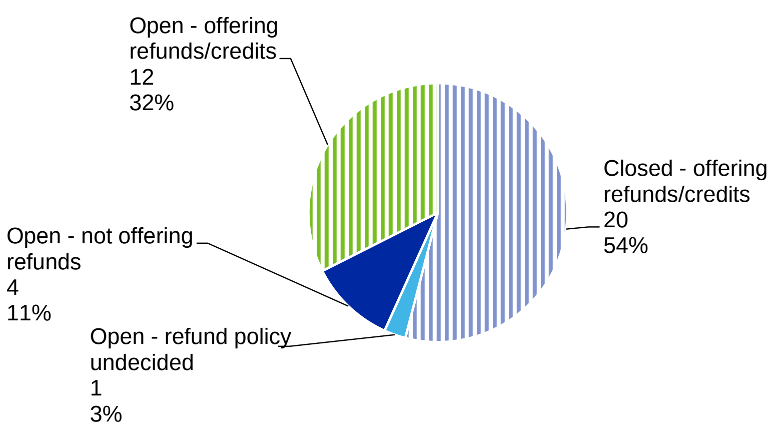

Chart does not include the 11 rated projects that are currently under construction
Sources: Moody's Investors Service, Electronic Municipal Market Access (EMMA)

Most student housing projects collect rental payments upfront at the beginning of each semester. The refund/credit total will therefore be approximately three to four months' worth of rent for semester lease terms and five months for calendar lease terms, depending on when the housing closed.[2]

Universities' financial support for privatized student housing underscores limitations of "risk transfer"

The willingness of some universities to provide financial support to privatized student housing projects underscores the limitations of risk transfer for these projects and reinforces our credit view that most should be included in a view of adjusted debt. For many universities, the opportunity to shift performance risk to the private partner is an attractive feature of a public-private partnership, including those for student housing. By embedding various contractual protections into long-term agreements, many universities believe that they are insulated against project underperformance regardless of cause.

However, universities are unlikely ever to be able to fully transfer project performance risks, even if they are not contractually obligated to provide financial support under any conditions. This is particularly true during the current period, when universities are stepping in to provide financial support to privatized housing projects. Student housing tends to be central to the residential experience and can materially enhance or detract from a student's satisfaction of a university. Because student housing is so closely tied to the customer experience, it carries significant reputational and financial risks in the event of underperformance. Ultimately, the university has an interest in ensuring project success regardless of its legal structure, particularly those that are built on university owned land and primarily serve university constituents.

Like many industries, the higher education sector is confronting an unprecedented period of business disruption tied to the coronavirus outbreak. To adhere to social distancing guidelines, universities were forced to pivot business models by moving all instruction and content delivery online. At this point, the timeline for restoring safe conditions to resume normal campus operations is unknown given uncertainty around the duration of the outbreak. All universities are grappling with varying degrees of negative financial impacts including revenue loss, wealth and liquidity declines, and operating performance weakening. While some universities are better positioned to absorb these negative financial impacts, none will be unscathed.

Projects that lack strong university affiliation will benefit from high debt service coverage ratios or sufficient short-term liquidity

Strong debt service coverage levels and sufficient short-term liquidity in lieu of close university affiliation will prevent many of the 37 rated operational projects from needing to tap their DSRs in order to make debt service within the next six months in response to lost revenue from the pandemic.

A DSCR at or above 1.5x will act as a cushion for many projects in dealing with the refunds/credits shortfalls that will approximately represent 25% of total annual rental revenue for academic year lease projects and 40% for calendar year lease projects. Nine rated deals that lack strong university affiliation have DSCRs of at least 1.5x. Even in the absence of strong university support, this debt service coverage level sufficiently buffers them in the short term from the significant losses in revenue and, consequently, from having to tap DSRs to meet debt service. A subset of projects have rate covenants which, if the annual DSCR dips below a specified level (typically 1.20x coverage), mandate that the project hire a financial consultant who will recommend operational changes to bring the DSCR back above 1.20x. Many of the projects that trip these covenants may not need to make large operational changes if the pandemic – and the associated financial challenges – are only temporary. However, if these challenges extend beyond one semester (as discussed below) then major operational changes may become necessary.

Additionally, if a project lacks both university support and a strong DSCR it could rely on operating reserve, operating contingency, repair and replacement (R&R) or surplus funds as a source of short-term liquidity for debt service. Six Moody's-rated projects possess adequate funds to meet debt service over a six-month window. In many cases, however, projects set aside these funds to pay specific operating expenses. Projects typically use R&R funds, for example, to address routine and emergency maintenance, while the surplus fund is often used to pay ground rent for a project. If a significant amount of R&R funds is diverted to pay debt service, a project will have to defer maintenance needs, potentially hindering its desirability to prospective student tenants – especially in the case of older projects. Also, if the surplus fund is used for debt service, the project might fall behind on its ground lease and have to eventually make up any delinquencies. However, ground rent payments are typically paid to the university and are seen as “soft” expenses, because lease terms are amenable to workouts between the project and the university. With many projects, the ground lease is only paid when a project can meet a certain DSCR threshold. In these cases, projects that are struggling will be able to retain surplus.

Of the six projects that have neither high DSCRs, strong university support nor sufficient short-term liquidity to meet debt service payments, four have remained open and are not offering refunds, and two have ratings below investment-grade that already reflect the impaired state of either the project or the affiliated university (see Exhibit 2). The 10 remaining projects below investment grade are included in other categories: three are not providing refunds, three benefit from strong university support but are impaired in other respects, three are currently under construction, and one has sufficient short-term liquidity. Lastly, since the rent for the majority of the academic year has already been collected, all 14 projects with an April debt service were able to make that payment without tapping DSRs.

Exhibit 2
Most rated projects will not need to tap DSRs to fund debt service in the short term
As of 4/20/20

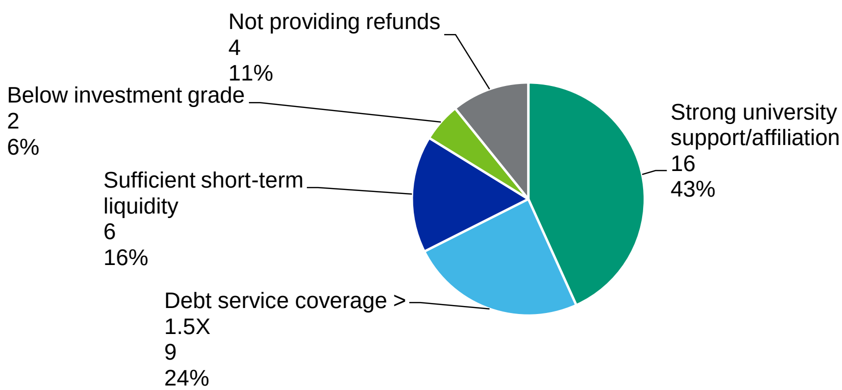

Chart does not include of the 11 rated projects that are currently under construction
Source: Moody's Investors Service, Electronic Municipal Market Access (EMMA)

If a project does find itself in a position of having to draw down its DSR below maximum annual debt service (MADs) level it would result in a substantially weaker credit profile. It is difficult for a project to replenish those reserves, especially when it is struggling to generate enough rental revenue to cover both debt service and operating expenses.

Impact of pandemic on demand for student housing is uncertain for fall semester

A number of factors will determine both how robust student demand will be for projects in the upcoming fall semester and whether median project financial performance will decline going forward.

If the affiliated universities announce that fall semester classes will be online, student demand for on-campus housing will plummet and occupancy levels will suffer as a result. Even if the university were to hold in-person courses in the fall, any lingering concerns about the pandemic would make some students reluctant to live on campus. Those concerns might also trigger some students to defer enrollment until the spring 2021 or fall 2021 semesters. In such a scenario, enrollment would decline in addition to the project's occupancy suffering. The reduced tuition revenue from enrollment losses would likely prevent many affiliated universities from continuing to cover lost rental revenue on behalf of projects beyond the spring semester, particularly since in most cases the universities are not contractually obliged to provide financial support. Lastly, continued uncertainty over the status of the fall semester will shorten and dampen the summer pre-leasing cycle, which serves as a leading indicator of project demand.

Aside from upcoming occupancy and enrollment challenges, many projects still face hurdles in restoring their DSCRs and liquidity metrics to pre-pandemic levels. Many projects are likely to face increased costs from the additional need for cleaning and sanitizing rental units. In response to potentially soft demand, many projects might offer rental concessions to boost occupancy levels. Additionally, if projects offered students credits in the fall rather than spring refunds, they have only delayed the inevitable revenue shortfall to the fall semester. However, those projects will have the advantage of having foreseen the upcoming difficulties and will be in a better position to budget and manage operating expenses accordingly.

All of these factors increase operating expenses and reduce DSCRs and liquidity, leaving projects in a weaker position to deal with other adverse events. The intensity of these challenges will determine whether the impact will last just one semester or instead persist over several, resulting in weaker credit profiles across the sector.

Lastly, projects coming online this fall also face the possibility of the demand and occupancy challenges described above. However, they will benefit from their capitalized interest accounts, which are typically funded to cover debt service throughout construction and for six months afterward. The state governments for all 11 Moody's-rated projects under construction have declared construction workers essential during the pandemic and contractors have taken measures to ensure workplace safety.

Moody's related publications

Sector Profile

» Medians - Number of stressed P3 projects increases, though sector is solid overall, May 2019

Sector Comment

» Federal aid provides modest support for universities coping with coronavirus, April 2020

Endnotes

1 In most cases the students who were allowed to stay were international or had no other housing alternative.

2 Calendar leases are typically 12 months and academic leases are typically eight to 10 months. Six of the 37 projects that are not currently under construction have calendar year leases while the remainder operate under academic leases.

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