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Smaller Private Colleges Face Tougher Burden if Private Activity Bonds Go Away

The House Republican tax package would put some more pressure on the already pressured private higher education sector.

Eliminating the tax-exemption for private activity bonds would force private schools to issue more expensive taxable debt for capital projects.

The House bill, which advanced Thursday from the House Ways and Means Committee, would terminate PABs on Jan. 1, 2018.

A large number of the nation's private higher education institutions are located in the Northeast region and have historically borrowed for various campus improvement projects with tax-exempt bonds sold by conduit issuers.

"The loss of the tax exemption means the cost of capital across the board for private colleges is going up," said Bill Rhodes, who heads Philadelphia-based Ballard Spahr's higher education practice. "It's going to draw up their borrowing costs."

Rhodes said the loss of PABs could force some schools that have started long-range master plans to rethink the scope of their projects.

The loss of access to the tax-exempt market wouldn't be felt equally.

Moody's Investors Service Analyst Susan Fitzgerald said a growing amount of larger research institutions have been issuing taxable bonds in recent years due to favorable market conditions and more flexibility about how to use the proceeds, so their short-term capital projects may not be negatively impacted.

"Taxable and tax-exempt debt are very compressed with spreads now," said Fitzgerald. "This current market environment would not be a shock to the system, but in 20 to 30 years it could be."

Municipal Market Analytics managing director Lisa Washburn said many smaller private colleges are already facing negative headwinds and the loss of PABs would just add to their financial burden. It would be different, she said, for the most selective private schools with the largest endowments, which have the financial flexibility to withstand the rising borrowing costs and have already gained experience in the taxable bond arena.

"The Harvards, Princetons and Dartmouths are not likely to be meaningfully impacted, but smaller more tuition-dependent schools would definitely face some risk from the bill," said Washburn.

"The smaller, less selective schools would definitely be more impacted from the loss of private activity bonds because their resources are generally much thinner."

A report Thursday from S&P Global Ratings said higher education would be among the most impacted sectors from the House tax bill with both private and public schools impacted by an elimination of advanced refundings.

Jessica Matsumori, senior director for S&P's U.S. Public Finance Higher Education Group, said smaller schools could face serious fiscal challenges without the use of tax-exempt bonds.

"Smaller private colleges may face capital-raising challenges as the par amounts of their debt are small and their brand may not be as strong as the larger schools tapping the taxable market," said Matsumori. "While the difference in rates is not very meaningful at the moment for higher rated borrowers, this will certainly increase the institutions' cost of capital and could have significant implications over the longer term if the difference between taxable and tax-exempt rates widen or even return to a more historic relationship."

Fitzgerald said liberal arts colleges with small endowments would feel brunt of losing PABs since many are already feeling credit pressures from meeting targeted enrollment numbers with fewer high school graduates pursuing higher education than in past decades. She said with increased fiscal challenges in a competitive higher education landscape, increased borrowing costs hit the smaller schools much harder than universities with more revenue diversity.

"Many of these small schools already run on thin margins," said Fitzgerald. "It would squeeze their budgets."

Fitch Ratings analyst Emily Wadhwani said if the PAB option goes away for private colleges it would likely lead to more alternative capital financing structures with some schools delaying investments for non-critical maintenance expenses. Despite the rising cost of capital that would result, Wadhwani said the end of PABs would not likely have any direct impact on credit ratings.

"While it's probably too soon to tell whether the PAB exemption will remain in any final tax overhaul bill, there will be clear implications if it does," said Wadhwani. "It would increase borrowing costs incrementally and could pressure debt issuance overall for the sector."

While tuition-dependent schools may see the brunt of the damage from the tax bill, another provision in the legislation that taxes endowment investment earnings would negatively impact wealthier universities. The proposed bill includes 1.4% tax on endowment income of private not-for-profit colleges and universities with financial assets more than $100,000 per student.

Moody's noted in a Nov. 7 report that about 45% of private higher education issuers it rates surpass this threshold and some schools may also get additional pain from an excise tax of 20% on salaries of private higher education employees earning over $1 million.

Matsumori said the House's proposed 1.4% tax on endowment earnings would hit an estimated 20% of private and public colleges that S&P rates and may lead to high tuition rates at those institutions. She noted that while most small schools would not be subject to the endowment earnings tax, other parts of the bill that could lead to eliminating individual estate and charitable contribution deductions would add another barrier to fundraising efforts.

Washburn said the loss of PABs would mean some schools may need to reexamine their capital projects and prioritize more. She said the sea change could ultimately lead to fewer construction projects on college campuses.

"Projects will need to be evaluated in the context of costing more to finance and the impact of the higher debt service on the budget," said Washburn. "Arguably, all else equal, fewer dollars will be

available for higher education infrastructure.”

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