

## The Discontinuation of Indirect Debt



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As institutions of higher education and the student housing real estate community continue to examine the most recent special comment from Moody's Investor Services, *Privatized Student Housing and Debt Capacity of US Universities*, to understand its impact on future privatized student housing projects, there is concern that the discontinuation of the "indirect debt" category for privatized student housing will cause both current and future public-private student housing partnerships to receive less favorable credit treatment. Many in the community of student housing real estate participants are scrambling to understand how their preferred financing vehicles will be viewed by the rating agencies going forward. As an advisor to both the higher-education and commercial sides of the privatized student housing equation, our advice to our clients has been simple: nothing's changed.

Enrollment has surged on America's campuses over the past couple of decades, leading colleges and universities increasingly to seek public-private partnerships for their housing. In their infancy, the benefits of such privatized student housing relationships were viewed principally as a means to address surging demand for on-campus accommodations by outsourcing delivery to a partner who could build faster and at a lower cost than the institution. Of course, added benefits of these arrangements included not only an expedited procurement and delivery process, but also the potential to transfer construction and delivery risk to a third party. Moreover, by entering into a long-term ground lease and ceding some control of operations and financial return, colleges and universities could seemingly transfer the debt and obligation risk of the project to a third party as well. Indeed, the favorable balance sheet and credit treatment obtained by privatized student housing projects only increased their desirability to colleges and universities – many of which were nearing their debt ceiling as they attempted to expand campus classroom, laboratory and other facility capacity to meet record high enrollment.

Not surprisingly, as more campuses sought to transfer risk to third-party partners, more firms emerged with an appetite to enter into such partnerships – and the more sophisticated those partnerships became. What was once a developer taking a construction loan and selling the project back to the university upon completion became structured financings in which a non-profit special purpose entity was formed specifically to own a project that was 100 percent debt-financed and secured only by its own cash flow. The goal of these arrangements was to show that while the college or university may be affiliated with the project or own the ground upon which the project sits, it bears no responsibility for the repayment of debt. In turn, the institution was always asked, "If this project were to fail, would you rescue it?"

Almost without fail, the institution would respond "No."

And if the partnership were structured well enough, the project could fall under a classification known as "indirect debt." Indirect debt was a vaguely-defined term — and, no doubt, for the marketing opportunity it provided — those partnerships resulting in indirect debt were referred to as (wink, nod) "off-credit, off-balance sheet transactions."

What we already knew at the time, of course, was that there is no such thing as an "off-credit" student housing project if it includes a college or university's participation. Further, as more colleges and universities have learned through their own privatized student housing experiences that "indirect debt" is not "off-credit," the real estate community has responded by crafting and offering financing vehicles that minimize the project's impact to the school's credit. These include the more recent trend of

projects financed by the third-party partner's equity and corporate-level debt — or some combination of both. Simultaneously, colleges and universities have begun turning a more critical eye to the instances in which they seek public-private partnerships; they more actively recognize that there is a balance between the level of control they desire and the corresponding risk they wish to cede.

Our clients no longer speak in terms of “off-credit,” rather in terms of “credit friendly.” They recognize that a freshman residence hall on the campus core with required meal plans and an institution-run residence life program is not the same as a junior/senior student apartment complex located on the periphery of campus.

If we're being honest with ourselves, the elimination of the “indirect debt” classification for privatized student housing only cements the approach we already use to structure and evaluate partnership opportunities. Indeed, Moody's special comment goes out of its way to remind us that the analysis of credit impact hasn't changed. While many finance and ownership solutions have been created, credit impact will continue to vary based on specific project characteristics.

Going forward, the student housing public-private partnerships with the best outlook for success will continue to be those in which the college/university and developer/partner work together to create the structure which best balances the institution's appetite for risk and control. No two campuses are identical and no two projects are identical; those firms willing to be the most flexible will prosper the most. Or, in a nutshell – nothing's changed.

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