

Public Finance Authority, Wisconsin Carolina Friends School, North Carolina; Independent Schools

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Credit Profile

Rationale

S&P Global Ratings assigned its 'BBB+' rating on Public Finance Authority, Wis.' \$5.85 million series 2016 educational facilities revenue bonds, issued for Carolina Friends School (CFS) of Durham, N.C. The outlook is stable.

The rating reflects our opinion of the school's stable student enrollment, strong demand profile, low debt burden, and solid financial resources ratios, especially relative to debt. In our view, these strengths balance the school's somewhat small size, and below-average, albeit growing, endowment relative to peers in the rating category.

The rating reflects our opinion of CFS':

- Stable student enrollment, with strong selectivity and matriculation rates;
- Low pro forma maximum annual debt service (MADS) burden, with no plans for additional debt;
- Solid financial resources ratios, especially relative to debt;
- Historically healthy operations on a full accrual basis, mostly driven by enrollment growth, with moderate surpluses in fiscal 2016 and going forward given the school is at its physical capacity; and
- Conservative and experienced management team, which supports the school's operational stability.

Partially offsetting the aforementioned strengths is our view of the school's:

- Below-average endowment relative to its rating category peers, although the school board has set a goal to preserve and gradually grow endowment over the next few years;
- Somewhat small enrollment base; and
- Strong competition for students in the geographical area from both private and public schools.

The \$5.85 million series 2016 bonds is the first ever debt issuance in the school's history. The proceeds of the series 2016 bonds will be used to construct and equip a 12,600 square foot performance auditorium on the CFS's main campus, fund a debt service reserve fund in the amount of MADS and pay for issuance costs. The bonds are structured as tax-exempt, fixed-rate debt with 31-year amortization with final maturity date at Aug. 1, 2047, and relatively level debt service through the life of the bonds. The debt service reserve fund will pay the debt service of the last year. The bonds are a general obligation of the school. MADS is anticipated to be approximately \$299,000 in 2027. We consider the pro forma MADS burden low at about 2.7% of fiscal 2015 operating expenses. The school has no additional debt plans in the near term.

Founded in 1962 by Durham and Chapel Hill Friends Meeting members as a deliberately racially integrated school, Carolina Friends School began as a small class of five-year olds and has expanded to include early and lower, middle

and upper school, with current enrollment of 513 students as of fall 2016. CFS is a Quaker, co-educational pre-K-12 day school with its main campus located just west of Durham, N.C. As reflected in its mission statement, the School is "Inspired by Quaker values—the pursuit of truth, respect for all, peaceful resolution of conflict, simplicity, and a call to service."

Outlook

The stable outlook reflects our expectation that, during the two-year outlook period, CFS will maintain its stable enrollment and demand profile, achieve balanced-to-surplus operations on a full-accrual basis, sustain solid financial resources ratios, while continuing to grow its endowment.

Upside scenario

We could consider a positive rating action if CFS grows endowment; improves its expendable resources ratios, especially relative to operations, to be commensurate with a higher rating level; and maintains its current enrollment and demand profile.

Downside scenario

Although unlikely during the two-year outlook period, credit factors that could lead to a lower rating beyond the outlook period include a significant weakening of the school's demand profile, a notable decline in financial resources, a significant amount of debt issuance without commensurate level of financial resources, or if there are sizable operating deficits.

Enterprise Profile

Organization

CFS is a Quaker, co-educational, pre-K-12 day school that was founded in 1962 by Durham and Chapel Hill Friends Meeting members as a deliberately racially integrated school. As reflected in its mission statement, CFS is "Inspired by Quaker values--pursuit of truth, respect for all, peaceful resolution of conflict, simplicity, the call to service." The school has a vision to build a sustainable educational community for a responsible, global future by enhancing the School's capacity to equip and inspire students to learn, lead, and serve.

CFS began as a small class of five-year olds and has expanded to include early, lower, middle and upper school, all while remaining committed to its Quaker roots. For the 2016-2017 academic year, the school enrolled 513 students. CFS enrolls students on three campuses: the main campus, including campuses for the early school, lower school, middle school, and upper school, the Chapel Hill early school campus, and the Durham early school campus. The main campus is situated on 126 wooded acres, with a stream and nature trails, bordering the Duke Forest and across Friends School Road from the Duke Campus Farm.

The school provides a variety of curriculum options, co-curricular activities including arts, athletic, and clubs as well as extended learning programs. Approximately 52% of the faculty hold a Master's or other advanced degree, and 54% of full-time faculty have more than 20 years' teaching experience. Management reports that CFS mainly competes with local private and public schools, including Duke School, Durham Academy, Ravenscroft School etc.

Enrollment and demand

In our view, CFS' enrollment and demand profile is stable and strong. We expect CFS to maintain this profile despite the competitive landscape due to its solid selectivity and matriculation, strong student retention, and good student quality. Enrollment has been moderately growing in recent years to about 513 students as of fall 2016 and management indicates enrollment is essentially at facility capacity, with future enrollment expected to hover near current levels. Applications have fluctuated between 250 and 300 in recent years, and the school received 292 applications for fall 2016, representing an increase of 9% compared with fall 2015. CFS generally maintains a wait list for most of its grades, which also reflects the school's stable demand.

In our opinion, the school is quite selective, with good student quality and a diverse student body. The school has become increasingly selective in recent years, with a 36% acceptance rate in fall 2016, improved from 45% in fall 2015 and 49% in fall 2012. There was some softening in the school's matriculation rate in the past five years. According to management, this was mainly driven by increasing competition as well as the fact that the school became more selective in middle/high school which resulted in accepting more students that are also appealing to other competing schools. The matriculation rate was 70% and 74% in the falls of 2016 and 2015, respectively, compared with 77% in fall 2012, but still remains very strong compared with rating category median and similarly rated schools. The school's retention rate, which we consider strong at 90%, also supports the solid demand profile. Student quality, as measured by the average graduating class SAT score, is a strong 1660 (on the 2400 scale) for the class of 2016 (well above the national average of 1497).

Management

The administration of CFS is the ultimate responsibility of the school head. Assisting the head are the assistant principal for teaching and learning, assistant principal for facilities, director of advancement, director of finance and human resources, director of admissions, director of technology, and respective heads of the early, lower, middle and upper schools.

The senior management team has been relatively stable except for the recent transition of the school head. In September 2015, the longtime school head announced his departure to assume the headship of another independent school. CFS quickly named Renee Prillaman, the long-tenured teacher and administrator, serving at the time as the assistant principal for teaching and learning, as interim principal. Renee Prillaman began serving as interim head in July 2016 and will serve through the end of the 2016-2017 academic year. In January 2016, a search committee was formed to administer the search for a replacement. The school brought in finalist candidates for interview in September 2016, and plans to select a new school head to begin in July 2017. The director of finance and human resources, Katie Collini, CPA, joined CFS in 2012 and has held various positions with government as well as public accounting firms previously. The other management team members all have extensive experience in their related areas and have been long-tenured with the school.

The school's governing board is composed of 22 members, drawn from each of the Friends Meetings in Durham and Chapel Hill as well as co-opted members, with various business, finance, law and physician background, appointed by the board. The board has been stable aside from normal term-limit rotations. Board debt policy reflects the current board's intent to use debt for capital investment purposes only rather than to cover operational and/or routine expenses. In our view, the conservative debt policies also support the school's operational stability.

In December 2008, CFS created their fourth long-range strategic plan, "Meeting the Challenge", which is still in place today. On top of plans for general advancement of the School's programs and culture, the plan also includes developmental plans for campus facilities. The School is launching its next strategic planning process in January 2017. Strategic planning committee has been formed, and a consulting firm has been engaged to facilitate the process with its knowledge of the local market as well as data analysis skills.

Financial Profile

Operations

Overall operating performance has been balanced-to-positive on a generally accepted accounting principles basis, and consistently positive on a cash basis in the past six years. For fiscal 2015, CFS posted a healthy \$1.4 million operating surplus (12.6% operating margin), fairly consistent with the \$1.1 million and \$1.8 million operating surplus in fiscal 2014 and fiscal 2013 (11.5% and 18.7% operating margin respectively). The operating results were balanced in fiscal 2011 and 2012. We adjust operating results for unrealized investment gains and losses. The healthy operating results during fiscal 2013 through 2015 were attributable to larger than budgeted enrollment according to management. For fiscal 2016, the school expects similar operating surplus as fiscal 2015. For fiscal 2017, school has adopted balanced operations. We expect the operating results of CFS to be softer compared with prior years given limited potential of enrollment growth in near term without physical expansion.

The school has some revenue diversity, with tuition and student-generated fees accounting for 69% of adjusted fiscal 2015 revenues, followed by gifts accounting for 8% of revenues. Continued increases in enrollment have supported good revenue growth, with net tuition revenue increasing in the range of 5%-7% during fiscal 2012 through 2015. CFS' tuition rates vary by grade level, and on average it is competitive with those of its peers. Historical tuition increases have been in the range of 3%-5%. For the 2016-2017 school year, tuition was increased by approximately 4.4% to \$17,737, which remains competitive relative to peers in our view, to balance the increased expenses relating to bond issuance. The school's tuition discount rate has been steady in recent years and remains low for the current rating category in our opinion, at 10% of fiscal 2015 adjusted operating expenses. The school board has decided to increase tuition discount moderately to provide financial aid to more students in the next couple of years. At the current stage, the school seeks not to grow beyond its approximate current enrollment, but rather to make deliberate enhancements to programs and facilities. Also, the school is developing its extended learning program, including after-school, summer, and off school days, which could potentially produce non-tuition revenue. In our view, these concerted efforts will continue to support overall operational stability.

Financial resources

The school's financial resources have strengthened considerably in recent years, and we consider its overall levels solid for the rating category, with respect to both operations and pro forma debt. As of June 30, 2015, the school has expendable resources of \$9.6 million, representing a slight decrease from \$10.3 million as of fiscal 2014 but a significant improvement from \$4.2 million as of fiscal 2011. Similarly, the school's cash & investments was \$19.8 million at fiscal year-end 2015, reflecting a material increase from \$13 million in fiscal 2011. As of June 30, 2015, expendable resources to operations is at 85% and to pro forma debt is at 164%, and cash and investments to operations is at 176% and to pro forma debt is at 338%. CFS' expendable resources calculation (unrestricted net assets

plus temporarily restricted net assets less [net plant, property, and equipment, or PPE, plus debt]) is deflated due to the school's low debt relative to net PPE. In addition, the current expendable resources figure excludes the benefit (as debt is added to calculate expendable resources) of new debt, but is being compared with pro forma debt, which understates the ratio. As such, we view cash and investments as a better relative measure. We expect the school's financial resources to remain solid, with expectations of no additional debt plans.

CFS has a small endowment valued at \$9.3 million as of June 30, 2015. Though CFS' endowment is modest relative to its peers and the rating category medians, the endowment has steadily increased from \$8 million in fiscal 2011, and management is focused on increasing it further through on-going fundraising efforts as well as lowering endowment spending policy rate from 5% to 4.5% over the next couple of years. The investments asset allocation consists of approximately 25% in domestic large cap, 45% in domestic mid/small cap and 35% in international equity. While investments are largely restricted with about \$1.2 million unrestricted as of fiscal 2016, management indicates that all of the investments have daily liquidity. The school also retains healthy cash balances for operating flexibility, at about \$9.2 million as of fiscal year-end 2015.

Fundraising

In November 2011, CFS began the "Building Friends Capital Campaign", a comprehensive capital campaign designed to raise funds to expand and enhance the spaces for teaching and learning at the school. This was the school's largest campaign to date, with the goal to raise \$7.75 million. While this campaign is still underway, the School has received gifts of \$7.3 million to date toward this goal, with about \$1 million in pledges.

The campaign ties closely with the school's current strategic plan, which focuses on addressing pressing needs for existing facilities upgrade and additional expansion initiatives. Campaign proceeds have successfully funded many of the school's recent capital needs, including expanding the middle school space for science, computer labs, and art, expanding lower school space for library, art, and music, converting the Quaker Dome –an open-air covered recreation space–to an enclosed multi-purpose athletic facility, and increasing storage space at Chapel Hill early school. The only capital plan on horizon in the next three years is the construction of the performing arts center, which will be funded by the debt offering. The school expects to have another campaign in three to five years (pending on board approval) and aims to enhance its human infrastructure.

The School receives annual fund support from trustees, alumni, current parents, and parents of alumni. For fiscal 2016, annual fund giving totaled \$372,000, with an alumni participation rate of 3.3%. The historical annual fund has been stable at similar levels.

Debt

The \$5.85 million series 2016 bonds is the first ever bond issuance over the school's history. The proceeds of the series 2016 bonds will be used to construct and equip a 12,600 square foot performance auditorium on the CFS's main campus, fund a debt service reserve fund in the amount of MADS and pay for issuance costs. The bonds are structured as tax-exempt, fixed-rate debt with 31-year amortization and relatively level debt service through the life of the bonds. The debt service reserve fund will pay the debt service of the last year. The bonds are a general obligation of the school.

Bonds covenants include a debt service reserve fund, funded at closing to at least equal MADS debt service coverage

ratio of at least 1.25x for existing and additional debt and negative pledge on the primary campus of the school. MADS is approximately \$299,000. We consider the MADS burden low at about 2.7% of fiscal 2015 operating expenses. The school has no additional debt plans in the near term.

Carolina Friends School, N.C. Financial Statistics						
	--Fiscal year ended June 30--					Medians for 'BBB' rated independent schools
	2017	2016	2015	2014	2013	2015
Enrollment and demand						
Headcount	513	510	504	499	498	MNR
New student selectivity (%)	35.6	45.0	43.2	41.8	48.8	56.0
New student matriculation (%)	70.2	73.6	72.1	74.0	77.3	60.0
Tuition increase year over year (%)	4.4	3.3	3.8	5.4	3.7	MNR
Income statement						
Adjusted operating revenue (\$000s)	N.A.	N.A.	12,661	11,233	11,405	MNR
Adjusted operating expense (\$000s)	N.A.	N.A.	11,245	10,079	9,611	MNR
Net operating income (\$000s)	N.A.	N.A.	1,416	1,154	1,794	MNR
Net operating margin (%)	N.A.	N.A.	12.59	11.45	18.67	MNR
Tuition dependence (%)	N.A.	N.A.	69.1	74.1	68.3	79.6
Tuition discount (%)	N.A.	N.A.	10.3	10.4	10.8	18.3
Student dependence (%)	N.A.	N.A.	76.8	82.1	77.1	MNR
Change in unrestricted net assets (\$000s)	N.A.	N.A.	1,845	1,484	2,105	MNR
Debt						
Outstanding debt (\$000s)	N.A.	N.A.	0	0	0	24,789
Proposed debt (\$000s)	N.A.	N.A.	5,845	N.A.	N.A.	MNR
Total pro forma debt (\$000s)	N.A.	N.A.	5,845	N.A.	N.A.	MNR
Pro forma MADS	N.A.	N.A.	299	N.A.	N.A.	MNR
Current debt service burden (%)	N.A.	N.A.	0.00	0.00	0.00	4.30
Pro forma MADS burden (%)	N.A.	N.A.	2.66	N.A.	N.A.	MNR
Financial resource ratios						
Endowment market value (\$000s)	N.A.	N.A.	9,271	8,524	8,306	27,098
Cash and investments (\$000s)	N.A.	N.A.	19,759	19,351	16,960	MNR
Unrestricted net assets (\$000s)	N.A.	N.A.	13,250	11,405	9,921	MNR
Expendable resources (\$000s)	N.A.	N.A.	9,571	10,295	8,096	MNR
Cash and investments to operations (%)	N.A.	N.A.	175.7	192.0	176.5	143.9
Cash and investments to debt (%)	N.A.	N.A.	N.A.	N.A.	N.A.	172.5
Cash and investments to pro forma debt (%)	N.A.	N.A.	338.0	N.A.	N.A.	MNR
Expendable resources to operations (%)	N.A.	N.A.	85.1	102.1	84.2	86.6
Expendable resources to debt (%)	N.A.	N.A.	N.A.	N.A.	N.A.	92.3
Expendable resources to pro forma debt (%)	N.A.	N.A.	163.7	N.A.	N.A.	MNR

Carolina Friends School, N.C. Financial Statistics (cont.)

	--Fiscal year ended June 30--					Medians for 'BBB' rated independent schools
	2017	2016	2015	2014	2013	2015
Average age of plant (years)	N.A.	N.A.	12.0	15.6	14.9	14.7

N.A.--Not available. MNR--median not reported. Total adjusted operating revenue = unrestricted revenue less realized and unrealized gains/losses and financial aid. Total adjusted operating expense = unrestricted expense plus financial aid expense. Net operating margin = 100 times (net adjusted operating income/adjusted operating expense). Tuition dependence = 100 times (gross tuition revenue/adjusted operating revenue). Current debt service burden = 100 times (current debt service expense/adjusted operating expenses). Current MADS burden = 100 times (maximum annual debt service expense/adjusted operating expenses). Cash and investments = cash + short-term and long-term investments. Adjusted UNA = Unrestricted net assets + unrestricted net assets of the foundation. Average age of plant = accumulated depreciation/depreciation and amortization expense.

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