Not-for-Profit Organizations (other than Healthcare and Education)

Summary

This rating methodology explains Moody’s approach to assessing the credit risk of not-for-profit organizations other than those providing healthcare and education. It provides a reference tool that can be used when evaluating credit profiles for not-for-profits, helping investors, borrowers and other interested market participants understand how key quantitative and qualitative characteristics affect rating outcomes. The report provides a detailed guide to the six main analytical factors and related ratios that drive ratings in this sector. It is not an exhaustive discussion of every ratio or sub-factor that might be considered relevant in determining an individual not-for-profit’s unique credit attributes. Related sectors not covered in this report include not-for-profit higher education, independent schools, and not-for-profit healthcare organizations, for which separate methodologies exist.

Not-for-profit ratings are based on our analysis of six credit factors:

» Market Position
» Operating Performance
» Balance Sheet and Capital Investment
» Governance and Management
» Legal Security and Debt Structure
» Other Credit Specific Considerations

This methodology updates and replaces Moody’s Rating Approach for Not-for-Profit Cultural Institutions (November 2004). It also serves as the initial published methodology for philanthropic, research and service/advocacy organizations.

1 U.S. Not-for-Profit Private and Public Higher Education, August 2011
2 US Independent Schools Methodology, February 2012
3 Not-for-Profit Healthcare Rating Methodology, March 2012
4 This rating methodology also does not apply to some other issuers that are not-for-profit and are addressed under other rating methodologies. This includes Government-Related Issuers and their subsidiaries, as well as organizations in the electric power sector, and cooperatives in the food and packaged goods sectors for which industry-specific methodologies are applied.
The methodology introduces a scorecard with weights assigned to 11 quantitative sub-factors. The quantitative portion of the scorecard is a tool designed to provide clarity around the rating process, but is not intended to provide an exhaustive treatment of all factors. In addition to the quantitative factors, the scorecard incorporates several qualitative factors.

**About the Rated Portfolio**

Moody’s currently rates 97 not-for-profit obligors based on their fundamental credit characteristics. On an aggregate basis, $13.6 billion of rated debt in this sector was outstanding as of fiscal year-end 2012. Not-for-profit organizations that seek ratings are a somewhat self-selective group and it is unsurprising that they tend to have very strong credit profiles, with 92% rated A3 or higher (Exhibit 1). The not-for-profits rated by Moody’s also tend to have greater asset and revenue size than those of the not-for-profit sector broadly.

The high average rating assigned to the rated not-for-profits is consistent with historical and expected rating performance and the very low rate of default in the sector, with only one Moody’s-rated not-for-profit default. In 2011, the New York-based Charitable Leadership Foundation defaulted on its Series 2002 Civic Facility Revenue Bonds issued through the City of Albany. The organization is no longer rated. The foundation’s credit decline included revenue pressure with the failure of the largest tenant in its debt-financed research facility to pay rent, and liquidity pressure from an atypical investment allocation with high exposure to illiquid investments tied to Albany’s regional economic development. In addition, the foundation’s governance was concentrated in a few individuals with limited diversity of opinion.

**EXHIBIT 1**

Not-for-Profits Median Rating of A1 Primarily Reflects Wealth

![Chart showing distribution of ratings among not-for-profit obligors]

Source: Moody’s; Ratings as of November 2013

**Sub-Sectors and Diversity of Rated Not-for-Profits**

Moody’s rated not-for-profits prove remarkably diverse. We categorize these organizations into one of four functional sub-sectors reflecting similarities in mission and purpose, revenue sources, and other financial and market characteristics. These sub-sectors are:

- Cultural
- Philanthropic

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Our annual medians report for not-for-profits has and will continue to provide sector-wide medians as well as medians by sub-sector. Exhibit 2 provides an overview of these sub-sectors.

These sub-sector groupings can be illuminating when comparing individual not-for-profits. Relative positioning in terms of market strength, for example, can be different when considering function. For a cultural organization, the number of annual visitors, membership revenue, and per capita auxiliary sales provide valuable insights into market strength. Philanthropic organizations can be divided between those that attract new gifts and those that are making distributions based exclusively on prior gifts. External grant funding is a distinguishing feature of research organizations, and market measures such as trends in sponsored research awards, diversity of funding sources, and research productivity per principal investigator can provide keen insight. Service/advocacy organizations present a diversity of business models and market strength from those with considerable pricing power and limited competition to those with stiff competition and limited ability to raise revenue.

### Exhibit 2

**Overview of Not-for-Profit Organization Sub-Sectors**

<table>
<thead>
<tr>
<th>Description</th>
<th>Cultural</th>
<th>Philanthropic</th>
<th>Research</th>
<th>Service / Advocacy</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Description</strong></td>
<td>Organizations committed to cultural enrichment, including museums, aquariums, zoos, performing arts, and public radio</td>
<td>Entities with a charitable mission and primary purpose of distributing funds to other entities for various uses</td>
<td>Non-degree granting organizations whose primary purpose is research</td>
<td>Diverse group of issue-oriented organizations, often with a mission to provide services to a body of constituents; includes membership organizations, religious organizations, social service agencies, professional associations among others</td>
</tr>
<tr>
<td><strong>Examples</strong></td>
<td>Carnegie Hall, Wildlife Conservation Society, Smithsonian Institution, California Academy of Sciences, New York Public Library</td>
<td>Andrew W. Mellon Foundation, UJA-Federation of New York, American Legacy Foundation</td>
<td>Cold Spring Harbor Laboratory, Carnegie Institution of Washington, Howard Hughes Medical Institute, National Academy of Sciences</td>
<td>YMCAs, World Wildlife Fund, Salvation Army, Nature Conservancy, AARP, Archdiocese of Indianapolis</td>
</tr>
<tr>
<td><strong>Credit Strengths</strong></td>
<td>Typically well-diversified revenues; Instances of strong state and/or local government support; Strongest fundraising of all sub-sectors</td>
<td>Tend not to be capital intensive (often only borrowing for administrative headquarters); Significant financial resources to cushion debt and operations</td>
<td>On average, financial resources provide good support for debt and operations; Considerable flexibility to contain operating expenses in response to declining revenue</td>
<td>Well-diversified revenue; Generally balanced to positive operating performance; Often broad pool of members and donors</td>
</tr>
<tr>
<td><strong>Credit Challenges</strong></td>
<td>Usually capital intensive; Fixed costs can limit response to revenue declines; Competition from other not-for-profits as well as for-profit venues; Visitor-driven revenue can fluctuate in response to external forces</td>
<td>Need for strong investment management and oversight in light of heavy dependence on endowment; May face difficult choices to contain operating expenses and grant commitments in response to investment losses</td>
<td>Grant-dependent research organizations susceptible to pressure on federal funding and shifting research priorities; Some institutions are highly capital intensive</td>
<td>Typically thinner levels of financial resources as a result of modest fundraising for endowment; Varying levels of market competition</td>
</tr>
<tr>
<td><strong>Median Rating (by Number of Ratings)</strong></td>
<td>A1</td>
<td>Aa1</td>
<td>Aa3</td>
<td>A1</td>
</tr>
<tr>
<td><strong>Underlying Rating Range</strong></td>
<td>Aaa to Baa1</td>
<td>Aaa to A3</td>
<td>Aaa to Baa2</td>
<td>Aa2 to Baa3</td>
</tr>
<tr>
<td><strong>Debt Outstanding</strong></td>
<td>$5.0 billion</td>
<td>$1.0 billion</td>
<td>$4.7 billion</td>
<td>$2.9 billion</td>
</tr>
</tbody>
</table>
Rating Scorecard

Our ratings result from an assessment of both quantitative and qualitative credit factors. No quantitative scorecard alone can fully capture the complex set of factors that determine the future performance of a not-for-profit. Therefore, we also incorporate a qualitative evaluation of each obligor. While the scorecard cites some of the more common non-quantitative aspects of our credit approach, it is not exhaustive and a rating committee may view other aspects as important in the analysis of an individual not-for-profit.

Measurement of the Key Rating Factors

The following sections describing the quantitative factors along with Appendix B explain how we calculate or estimate the sub-factors for use in the scorecard. We generally draw the information used in our initial assessment of the sub-factors from the not-for-profit’s audited financial statements. Some sub-factors, as well as projections used to inform our assessment, require more detail than that contained in the financial statements. These we calculate using data provided by the not-for-profits themselves. In cases where data is not available from the issuer, we will adjust our measures as needed in order to form an opinion based on publicly available information including audited financial results.

The quantitative grid assigns weights to each of the various factors (Exhibit 3). The weights shown for each factor in the grid represent an approximation of the importance for rating decisions but the actual importance may vary substantially across organizations. Given the lack of homogeneity of the rated not-for-profits, we limited each weighting to a multiple of 5% in keeping with a view that the quantitative portion of the scorecard should provide an approximation and is not intended to be exact. The factor weightings for the sector incorporate an assessment of relative merit of each factor that matter most of the time.

We place the greatest weight on balance sheet and capital investment. This reflects our view that not-for-profits with substantial financial reserves are better positioned to weather prolonged periods of economic and market volatility, increasing probability of debt repayment even in periods of stressed operations. Under the standard weighting market position accounts for 35% of the grid score as it is a key driver of long-term financial stability and revenue generation. Operating performance, meanwhile, accounts for 20% and while lower weighted, still informs the scorecard of the importance of healthy cash flow from operations for long-term sustainability. These weights were developed with an eye toward the subset of not-for-profit organizations rated by Moody’s that tend to be among the larger and wealthier organizations within the sector.

Introduction of alternative weightings for not-for-profits where wealth dominates credit strengths

The quantitative portion of the rating scorecard for not-for-profits introduces two different sets of weights for the three factors (Exhibit 3). A standard weighting will be used for the majority of credits, but an alternative “balance sheet heavy” weighting will be used in limited cases. The “balance sheet heavy” weighting will be used when rating committee decides it will more appropriately measure risk for a given issuer. This will typically be the case for issuers who have less market and operational risk and are instead more reliant on the presence of large levels of cash and investments to maintain operations and financial health. The decision to use the balance-sheet heavy weightings will be made by rating committee.
EXHIBIT 3

<table>
<thead>
<tr>
<th>Not-For-Profit Quantitative Grid Weights</th>
<th>Standard Weighting</th>
<th>Balance Sheet Heavy Weighting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Factor 1: Market Position</td>
<td>35%</td>
<td>10%</td>
</tr>
<tr>
<td>Factor 2: Operating Performance</td>
<td>20%</td>
<td>15%</td>
</tr>
<tr>
<td>Factor 3: Balance Sheet and Capital Investment</td>
<td>45%</td>
<td>75%</td>
</tr>
</tbody>
</table>

One test that will be applied to determine suitability for the balance-sheet heavy weightings will be a comparison of total cash and investments to annual operating expenses. Those not-for-profits with total cash and investments that cover operations by over five times will generally be considered for use of the balance-sheet heavy weightings (Exhibit 4). This indicator provides insight into the degree to which an organization’s cash and investment strength could provide a buffer when its market position or operating performance may be stressed. In general, the threshold of five times reflects a point where the wealth of an organization tends to become a more dominant determinant of future credit strength. The variability of this measure within the sector is notable. Of the sub-sectors listed in Exhibit 2, philanthropic organizations are most likely to have total cash and investments to operations above five times. In fact, the recent median for this sub-sector is well above the threshold at 15 times. On the other hand, service/advocacy organizations rarely exhibit this strength as demonstrated by recent median cash and investments to operations of 1.1 times. Currently, approximately one-third of rated not-for-profits have total cash and investments-to-operations of over five times. The decision to use the balance-sheet heavy alternative weightings is not automatic, and other factors such as expense flexibility, and demonstrated ability and willingness to cut costs when necessary, may be considered as well.

EXHIBIT 4

<table>
<thead>
<tr>
<th>Not-For-Profit Quantitative Grid Weights</th>
<th>Standard Weighting</th>
<th>Balance Sheet Heavy Weighting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Factor 1: Market Position</td>
<td>35%</td>
<td>10%</td>
</tr>
<tr>
<td>Operating Revenue ($000)</td>
<td>25%</td>
<td>5%</td>
</tr>
<tr>
<td>Average Gift Revenue ($)</td>
<td>10%</td>
<td>5%</td>
</tr>
<tr>
<td>Factor 2: Operating Performance</td>
<td>20%</td>
<td>15%</td>
</tr>
<tr>
<td>Operating Cash Flow Margin (%)</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Average Debt Service Coverage (x)</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Revenue Diversity (Max Single Contribution) (%)</td>
<td>10%</td>
<td>5%</td>
</tr>
<tr>
<td>Factor 3: Balance Sheet and Capital Investment</td>
<td>45%</td>
<td>75%</td>
</tr>
<tr>
<td>Total Cash and Investments ($000)</td>
<td>10%</td>
<td>15%</td>
</tr>
<tr>
<td>Expendable Financial Resources to Direct Debt (x)</td>
<td>10%</td>
<td>20%</td>
</tr>
<tr>
<td>Expendable Financial Resources to Operations (x)</td>
<td>10%</td>
<td>20%</td>
</tr>
<tr>
<td>Debt to Operating Revenues (x)</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Monthly Days Cash on Hand (x)</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Monthly Liquidity to Demand Debt (%)</td>
<td>5%</td>
<td>10%</td>
</tr>
</tbody>
</table>

There are several reasons a committee may determine it would be inappropriate to use the balance sheet heavy weighting, even with a not-for-profit with a resoundingly strong balance sheet and total cash and investments-to-operations well over five times. Examples of reasons a committee may decide to use standard weighting for those organizations include:

» Expectations that operating results could materially erode the balance sheet over time
» Comparatively less ability or willingness to reduce expenses in the face of revenue declines
» Expectations of greater than typical total cash and investments volatility
» Small expense base and limited total cash and investments

Factor 1: Market Position (Standard Weighting 35%/Balance Sheet Heavy Weighting 10%)

<table>
<thead>
<tr>
<th>Sub-factors and Weights</th>
<th>Aaa</th>
<th>Aa</th>
<th>A</th>
<th>Baa</th>
<th>SG</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Revenue</td>
<td>≥ 600,000</td>
<td>&lt; 600,000</td>
<td>≥ 140,000</td>
<td>&lt; 60,000</td>
<td>&lt; 30,000</td>
</tr>
<tr>
<td>($000) (25%/5%)</td>
<td></td>
<td>140,000</td>
<td>60,000</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Average Gift Revenue</td>
<td>≥ 80,000</td>
<td>&lt; 80,000</td>
<td>≥ 20,000</td>
<td>&lt; 20,000</td>
<td>-</td>
</tr>
<tr>
<td>($000) (10%/5%)</td>
<td></td>
<td>20,000</td>
<td>0</td>
<td>-</td>
<td></td>
</tr>
</tbody>
</table>

Why it matters
For most not-for-profits, market position is a key driver of long-term financial stability since it leads to the ability to successfully generate revenue, either earned or donated, in support of mission. Our analysis of market position takes into account quantitative factors such as scope of operations and average gift revenue, as well as intangible factors like reputation, brand, competition, essentiality of services provided, and role within the community.

A strong market reputation and brand drive a not-for-profit’s ability to attract board members, garner donor support and generate earned revenue. A not-for-profit’s ability to shape, protect, and enhance how others perceive the value of its mission, programs and services, provides the foundation for its credit rating. Protecting the brand translates into the identification and assessment of potential risks followed by coordinated efforts to minimize, monitor and control the probability and/or impact of those risks.

How we measure it
Because of the diversity of the not-for-profit sector, common measures of market position are necessarily limited. Unlike a common measure of pricing power, such as net tuition per student for higher education or payer mix for healthcare, there is no similar measure to provide quantitative insight across these various types of not-for-profits. Within the sub-sectors, however, there are some quantitative measures such as number of paid visitors for museums, average ticket price or subscription renewal rates for performing arts organizations, membership revenue for service/advocacy groups, or magnitude of sponsored research awards for research institutes.

Operating Revenue
The size and programmatic diversification of a not-for-profit, or its scope of operations, is an indicator of demand for its mission and services. So long as relevance to mission and competitor differentiation are maintained, a larger scope of operations generally provides for greater market and credit stability, potentially insulating the not-for-profit from local economic and demographic changes as well as shifts in societal preferences. Greater scale often implies higher brand recognition, increased revenue diversification, ability to alter focus and programs in response to market conditions and consumer preferences, and flexibility to consolidate during economically challenging times.
Positive indicators of operating revenue include:

» Large and diverse scope of activities with solid prospects for continued ability to generate revenue

» A high profile brand with wide recognition

» Diversity of revenue sources

In our review of a not-for-profit’s breadth of programmatic offerings, we discuss with management areas of distinction, any new programs, and the elimination or reduction of offerings with limited demand. We also consider the dependability of revenue streams and alternative sources of revenue generation as well as partnerships with other organizations.

**Average Gift Revenue**

Philanthropic support both affirms and enhances a not-for-profit’s market position. Donor support indicates that stakeholders support the not-for-profit’s mission and have confidence in management and the overall strategic direction of the not-for-profit and its programs. Gifts that fund key strategic operating or capital projects help the not-for-profit advance its mission. Since the act of philanthropic support can be viewed as a public endorsement, large gifts or gifts from particularly high-profile donors enhance the not-for-profit’s brand by association. Thus, high levels of philanthropic support can itself create a trend of increasing giving, further improving a not-for-profit’s market position and reputation relative to its peers.

Positive indicators of philanthropic support include:

» Track record of meeting or exceeding campaign goals

» History of maintenance or growth of donor support through economic cycles, including successful collection of pledge payments

» Broad and diverse pool of donors

» Effective cultivation of donors to support future fundraising capacity

**Factor 2: Operating Performance (Standard Weighting 20%/Balance Sheet Heavy Weighting 15%)**

<table>
<thead>
<tr>
<th>Sub-factors and Weights</th>
<th>Aaa</th>
<th>Aa</th>
<th>A</th>
<th>Baa</th>
<th>SG</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Cash Flow Margin (%) (5%/5%)</td>
<td>≥ 35%</td>
<td>&lt; 35% ≥ 15%</td>
<td>&lt; 15% ≥ 7%</td>
<td>&lt; 7% ≥ 4%</td>
<td>&lt; 4%</td>
</tr>
<tr>
<td>Average Debt Service Coverage (x) (5%/5%)</td>
<td>≥ 15.0</td>
<td>&lt; 15.0 ≥ 5.0</td>
<td>&lt; 5.0 ≥ 2.5</td>
<td>&lt; 2.5 ≥ 1.0</td>
<td>&lt; 1.0</td>
</tr>
<tr>
<td>Revenue Diversity (Max Single Contribution) (%) (10%/5%)</td>
<td>≤ 35%</td>
<td>&gt; 35% ≤ 55%</td>
<td>&gt; 55% ≤ 95%</td>
<td>&gt; 95% &lt; 100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

**Why it matters**

Strong operating performance enables a not-for-profit to repay debt from financial operations while providing funds for strategic investment in programs and facilities. All not-for-profits face the challenge of balancing spending to achieve their strategic missions with the realities of financial constraints for the long-term.
The ability to achieve balanced to surplus operating performance is important for the long-run financial health of all not-for-profits, but is especially critical for those that do not have significant financial reserves. We evaluate a not-for-profit’s operating performance relative to its own historical trends, performance of peers, and external economic factors. Steady, consistent, and predictable operating results are viewed as credit positives. Our scorecard uses operating cash flow margin as a measure of the relative strength of operations.

Expense flexibility varies across the sector and provides a means for a not-for-profit to maintain or even improve future operating performance despite revenue declines. While individual management teams may be adept at describing their fixed versus variable costs, expense flexibility is difficult to quantify across a broad range of credits and is discussed below as a sub-factor in the qualitative portion of the scorecard.

How we measure it

Operating Cash Flow Margin

The operating cash flow margin indicates the amount of cash flow a not-for-profit is able to generate on an annual basis from its core operating activity. It is a measure of the institution’s long-term financial viability. We exclude non-operating gifts and certain other non-operating items such as gains or loss on real estate sales. Our measure adjusts for volatility in investment performance, as discussed below under Moody’s Operating Ratios Use a Standard Endowment Spending Rate. Operating performance is analyzed in relation to a not-for-profit’s operating complexity and expense flexibility.

While a slight operating deficit in a single year may not reflect an elevated credit risk, multiple years of weak financial performance signal more fundamental challenges related to the not-for-profit institution’s business model or weak governance and management.

Positive indicators for this ratio include:

» Consistently favorable annual cash flow which enables strategic investments in programs and facilities
» Cash flow sufficient to provide ample, steady debt service coverage
» Growth in revenue that is equivalent to or greater than growth in expenses
» Clearly articulated organizational commitment to achieving positive cash flow from operations, and willingness to alter program expenses in line with revenue changes

We review a not-for-profit’s source of and trends in revenue and expenses to determine the sustainability of operating performance. We evaluate budget-to-actual operating performance, endowment spending policies, and expense management in times of revenue pressure. We also assess the use of bank lines to meet cash flow requirements throughout the year.

We review a not-for-profit’s multi-year budget plan, including key assumptions to gain a forward view and to assess management’s planning capabilities. We examine contingency plans as well as past performance following unexpected events. Particularly when revenue or expenses are pressured, our analysis focuses on management’s actions to contain or cut costs as well as protect against revenue volatility. We discuss any market or stakeholder pressures that could affect the budget.
Average Debt Service Coverage
Average debt service coverage measures the level of cash flow from operations that is available to cover principal and interest payments on debt, and thus measures the affordability of debt. A higher ratio is a credit positive and indicates a not-for-profit’s ability to not only service its debt from operations, but also to potentially establish flexible reserves and fund capital needs over time. Since some not-for-profit organizations rely on revenue sources such as gifts that can be volatile on an annual basis, our scorecard looks at debt service coverage averaged over three years. Even as we look at the average debt service coverage, we analyze the underlying volatility in operations that could cause actual annual debt service coverage to vary from the average.

Positive indicators of debt service coverage include:

- Strong historical coverage combined with declining debt service commitments over time
- Demonstrated ability of operations to fund debt service commitments without relying on reserves or non-recurring revenue sources

In addition to average debt service coverage, we review maximum annual debt service (MADS) to determine whether future peak debt service can be covered with the current year’s cash flow. For not-for-profits with variable rate debt, we focus on interest rate budgeting assumptions and the not-for-profit’s ability to adjust to rising interest rates and changes in the relationship of indexes used in swap agreements, if any. If the not-for-profit budgets conservatively for interest rates higher than current levels, we inquire as to how management currently uses those budgetary savings.

Moody's Operating Ratios Use a Standard Endowment Spending Rate
For some not-for-profits, endowment income provides an important revenue stream to support operations, capital, and other special initiatives. The endowment spending policy aims to balance the need for consistent operating support with maintaining the purchasing power of the endowment. Typical spending policies seek to prevent weak investment returns from forcing commensurate decreases in spending and ensure that any increased spending can be sustained into the future when investment returns are healthier. While endowment spending policies are based on the principal of inter-generational equity, which attempts to ensure that future generations will benefit from the endowment to the same degree as the current generation, individual policies vary widely. To ensure comparability of operating performance, we apply a 5% spending formula to all not-for-profits. This formula is based on a trailing three-year average of cash and investments measured as of the close of each fiscal year. This calculation is in line with common industry practices. Those not-for-profits with an elevated endowment draw, whether to fund debt service or special projects, will therefore have a depressed Moody’s calculated operating margin.

Revenue Diversity
Diversity of revenue sources and diversity within a given source of revenue provide greater revenue stability for a not-for-profit. We analyze the consistency, potential growth, self-sustainability, and correlation of all revenue streams. The benefits of diversity are most pronounced in cases where revenue sources have a negative or low correlation. Some prominent not-for-profit revenue sources prove highly correlated, as exemplified by the direct relationship between economic prosperity, gift revenue, and investment returns.

Positive indicators of revenue diversity include:

- Multiple sources of revenue, with diversity within each revenue stream
- Negative or limited correlation between revenue sources
Self-sufficiency of major lines of business, with limited cross-subsidization required

Revenue diversity is measured as the highest percent reliance on a single revenue type such as ticket sales, grant revenue or investment income. A lower ratio is credit positive.

We analyze the diversity of revenue within each broad revenue component. A single category of revenue such as museum admission can contain underlying diversity through geographic diversity of visitors, diversity of programs, diversity of sites, diversity of age groups, etc. For not-for-profits reliant on investment income, we focus on investment management and oversight, as well as the target endowment return relative to the endowment draw. For not-for-profits heavily dependent on gift revenue, we focus our assessment on the diversity of donors, donor cultivation and stewardship.

**Factor 3: Balance Sheet and Capital Investment (Standard Weighting 45% / Balance Sheet Heavy Weighting 75%)**

<table>
<thead>
<tr>
<th>Sub-factors and Weights</th>
<th>Aaa</th>
<th>Aa</th>
<th>A</th>
<th>Baa</th>
<th>SG</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sub-factors and Weights</strong></td>
<td><strong>Aaa</strong></td>
<td><strong>Aa</strong></td>
<td><strong>A</strong></td>
<td><strong>Baa</strong></td>
<td><strong>SG</strong></td>
</tr>
<tr>
<td>Total Cash and Investments ($000) (10%/15%)</td>
<td>≥ 1,500,000</td>
<td>&lt; 1,500,000</td>
<td>≥ 250,000</td>
<td>&lt; 80,000</td>
<td>&lt; 30,000</td>
</tr>
<tr>
<td>Expendable Financial Resources to Direct Debt (x) (10%/20%)</td>
<td>≥ 8.0</td>
<td>&lt; 8.0 ≥ 2.0</td>
<td>&lt; 2.0 ≥ 0.50</td>
<td>&lt; 0.50 ≥ 0.30</td>
<td>&lt; 0.30</td>
</tr>
<tr>
<td>Expendable Financial Resources to Operations (x) (10%/20%)</td>
<td>≥ 8.0</td>
<td>&lt; 8.0 ≥ 2.0</td>
<td>&lt; 2.0 ≥ 0.50</td>
<td>&lt; 0.50 ≥ 0</td>
<td>&lt; 0</td>
</tr>
<tr>
<td>Debt to Operating Revenues (x) (5%/5%)</td>
<td>≤ 0.10</td>
<td>&gt; 0.1 0.40</td>
<td>&gt; 0.40 0.85</td>
<td>&gt; 0.85 2.0</td>
<td>&gt; 2.0</td>
</tr>
<tr>
<td>Monthly Days Cash on Hand (x) (5%/5%)</td>
<td>≥ 2,500</td>
<td>&lt; 2,500 ≥ 600</td>
<td>&lt; 600 ≥ 150</td>
<td>&lt; 150 40</td>
<td>&lt; 40</td>
</tr>
<tr>
<td>Monthly Liquidity to Demand Debt (%) (5%/10%)</td>
<td>≥ 2,000% or No Demand Debt</td>
<td>&lt; 2,000% ≥ 350%</td>
<td>&lt; 350% ≥ 100%</td>
<td>&lt; 100% ≥ 50%</td>
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**Why it matters**

A not-for-profit’s balance sheet is often a distinguishing credit characteristic when compared to governments, corporations, and other public entities. Financial reserves are particularly important for not-for-profits since they typically have smaller operations and usually lack taxing authority. Many not-for-profits benefit from financial reserves intended to provide mission-related support in perpetuity and these reserves support long-term capital and financial planning horizons. Management of the balance sheet has become increasingly important given the complexity of investment strategies and debt structures utilized throughout the sector. Our analysis of balance sheet and capital investment centers on wealth, liquidity and capital needs.

Not-for-profits with substantial financial reserves are better positioned to weather prolonged periods of economic and market volatility, providing heightened security that bondholders will be repaid despite potentially stressed operations. Reserves are assessed relative to the size of operating expenses, as well as to debt and other liabilities.

We review both the resources currently available as well as the potential for additional growth through retained earnings, gift support, and prudent investment management practices. We also evaluate potential uses of financial resources, including funding of capital or other strategic initiatives, or financing of deficits for not-for-profits with weak operating performance. For not-for-profits with
defined benefit pension plans or other post-employment benefits, we review the size of the unfunded actuarial accrued liability relative to the not-for-profit’s other assets and liabilities, annual contribution relative to its expenses, actuarial assumptions used to determine the size of the liability, benefits that are currently and projected to be provided to employees, and the flexibility to modify those benefits.

The strength of a not-for-profit’s liquidity position is measured in relation to its unique business structure and potential demands on liquidity, including investment strategies, complexity of operations, and debt structure. Through a “sources and uses” approach, we seek to understand the correlation and likelihood of liquidity demands and the not-for-profit’s broad ability to meet those demands. Therefore, management expertise (including external advisors and board members) is also an important component of our liquidity evaluation.

We review a not-for-profit’s sources of liquidity by examining its investment allocation, operating cash flow, dependence on investment income to support the annual budget, availability of bank lines, near-term fundraising capacity, and market access. We evaluate potential calls on a not-for-profit’s liquidity by examining endowment spending policies and trends, unfunded capital commitments, collateral posting requirements related to interest rate swap agreements, the potential for debt to be accelerated, headroom under covenants, as well as planned use of liquidity to fund strategic initiatives.

We assess how management monitors liquidity risks associated with its business model, investment strategies, and debt structure, including reviewing the not-for-profit’s sensitivity models and presentations made to senior leadership and board members. We view liquidity management that is well integrated across treasury, finance and investment functions as a credit positive. We also assess management’s willingness to take actions to preserve or improve the liquidity position.

Not-for-profits vary widely in capital needs with some philanthropic and service organizations requiring only limited office space for administrative headquarters. Others, such as museums, are more capital intensive, with ambitious campuses designed to serve a high volume of visitors and display collections in expensive facilities built to high standards. Proper development and maintenance of facilities are necessary in order for a not-for-profit to remain competitive. Determining the appropriate balance between capital investment and financial sustainability is a significant challenge, since too little investment can result in a gradual decline in earned revenue, as well as philanthropy if donors feel the not-for-profit is deteriorating. On the other hand, too much capital investment can burden a not-for-profit financially with unsustainable increases in maintenance and debt service costs. We therefore seek to understand the strategic drivers behind capital plans, including potential outcomes such as expected costs and revenue generation related to the plans. The strongest not-for-profits typically have multiple means of funding capital, including annually budgeted renewal and replacement funds, retained surpluses, debt, and philanthropy. We also view integrated strategic, capital and financial planning as a credit positive.

We analyze a not-for-profit’s identified capital plan in the context of the strategic plan, fundraising projections and operating revenue available to cover any additional debt service and increased maintenance costs. We also seek to understand how projects are prioritized and review internal policies related to when construction may proceed. We examine the magnitude of the capital program and type of investment relative to peers, the current state of the facilities (deferred maintenance and new needs), as well as identified sources of funding for capital investment, including debt. If a not-for-profit uses public-private partnerships, capital leases, operating leases, or alternative funding strategies, we explore the rationale for each as well as any financial burden, either explicit or implied.
How we measure it

Total Cash and Investments
Total Cash and Investments provides a direct measure of absolute wealth and measures the base of assets that generate investment return. A higher amount indicates greater financial resources available to be harnessed to meet demands and fulfill strategic objectives and is considered a credit positive.

Positive indicators related to total cash and investments include:
» Ongoing presence of cash and investments that are free from external restrictions and maintained as a buffer against uncertainty
» Clear organizational articulation of goals to maintain or build cash and investments over time
» History of increasing total cash and investments through operating surpluses, philanthropic support or investment returns over time

Expendable Financial Resources to Direct Debt
Expendable Financial Resources to Direct Debt measures coverage of debt by financial reserves or funds a not-for-profit can access in the intermediate term. This proxy provides a measure of balance sheet leverage. Higher coverage of debt by expendable financial resources is a credit positive.

Positive indicators related to this measure include:
» Ample spendable financial reserves relative to debt
» Prospects for ongoing growth of spendable financial reserves
» Manageable capital needs with diverse sources of funding

Expendable Financial Resources to Operations
Expendable Financial Resources to Operations measures coverage of operating expenses by financial reserves or funds a not-for-profit can access in the intermediate term.

Positive indicators related to expendable financial resources to operations include:
» Ample spendable financial reserves relative to expenses
» Ability to grow reserves at the same or greater pace than growth in expenses

Debt to Operating Revenue
Debt to Operating Revenue provides a measure of operating leverage by comparing the debt burden to the not-for-profit’s revenue. A lower ratio means lower operating leverage and is a credit positive. Debt relative to revenue provides a measure of affordability.

Positive indicators related to debt to operating revenue include:
» Realistic prospects for revenue growth to outpace increases in debt
» Likely ability of operations to provide ample cash flow to service debt without relying on financial reserves for repayment
Monthly Days Cash on Hand

Monthly Days Cash on Hand provides a measure of liquidity relative to operations. It measures the number of days a not-for-profit could continue paying its operating expenses from existing unrestricted cash and investments in the absence of future cash inflow, assuming equal daily expenditures. Monthly liquidity is limited to cash and investments that are free from restriction and liquid within 30 days. A higher ratio indicates greater financial flexibility and is a credit positive.

Positive indicators related to monthly days cash on hand include:

» Clear strategy to maintain healthy monthly liquidity relative to expenses, incorporating known as well as uncertain and potential demands on monthly liquidity
» Predictable expense structure and revenue cycles that do not create seasonal valleys in liquid funds
» Absence of reliance on operating lines of credit to maintain working capital

Monthly Liquidity to Demand Debt

Monthly Liquidity to Demand Debt is measured as monthly liquidity divided by demand, or “put” debt. This ratio compares the amount of liquid financial resources to the amount of debt that a not-for-profit could be forced to repay immediately. A higher ratio indicates a greater cushion of monthly liquidity to this potential demand on liquidity and is credit positive.

Positive indicators related to monthly liquidity to demand debt include:

» Careful monitoring of potential demand debt risks and mitigation of risks through counterparty diversity, maintenance of headroom over covenants, and other contingency planning
» Proactive stance related to renewal or replacement of credit facilities with executed agreements well in advance of stated expiration dates
» Demand debt that is subject to infrequent put events

We also assess the repayment terms in bank agreements following a liquidity draw. Positive indicators within this assessment include longer time to repay following liquidity draws, a repayment period that could extend beyond the stated expiration date of the agreement, reasonable interest rate during the bank bond period, and limited events of default that could allow the bank to accelerate in advance of or during a repayment period.

Factor 4: Governance and Management

Why it matters

Effective governance and strong management enable an organization to efficiently manage operations. Strategy, financial health, and credit position are all fundamentally driven by decisions made by a not-for-profit’s board members and leadership team. Over the longer term, non-quantitative indicators of governance and management are likely to provide equal, if not greater, predictive insights into credit quality than quantitative ratios.

Governance and management assessments may result in a rating which is one or more notches different from the rating outcome that would be indicated by purely quantitative ratio analysis. The weight of this assessment in our analysis is particularly important when a not-for-profit is facing strategic changes. These might include self-initiated changes such as embarking on a major expansion of programs, a significant new borrowing or fundraising campaign, or a capital expansion. They can
also include externally driven changes: unexpected financial stress, a market position weakened by a new competitor, or high turnover in senior management.

### Board and Senior Management Composition

Board members and senior leadership both share the responsibility to balance a not-for-profit’s long-term charitable mission with the practical need to manage financial resources in a way that ensures the institution’s continued viability. It is the board members, however, who retain the ultimate authority in setting a not-for-profit’s strategic direction. The composition of a not-for-profit’s leadership is the foundation for organizational effectiveness and we assess the diversity of skills and experiences of board members as well as those of senior management.

Positive indicators of board and senior management composition include:

- Mix of tenured and new members who can ensure institutional history as well as access to external best practices and strategic ideas, thereby ensuring continuity as well as new perspectives
- Board members who provide expertise in the different areas of risk management, financial reporting, financial and capital planning, marketing, and investment strategies, as well as material philanthropic support
- A president who demonstrates clear understanding and leadership on financial and capital matters as well as the not-for-profit’s mission
- Strong officers in the key financial roles who demonstrate independent expertise and mastery in planning, budgeting, and reporting
- Broadly skilled leadership, experienced both inside and outside the not-for-profit, reflecting business and government sectors in addition to other not-for-profit organizations

We review the professional and community service backgrounds and tenure of board members and senior management, the composition and structure of the board and its committees, the procedures for selection of new board members as well as the president, and division of responsibilities.

### Oversight and Disclosure Practices

Clearly articulated policies and division of responsibilities provide transparency, accountability, and oversight. While internal controls cannot eliminate problems, they can alert management to potential issues and minimize the impact of such issues when problems arise. Effective internal controls are necessary for maintaining standards, eligibility for grants and contracts, as well as donor confidence. Additionally, external public disclosure of policies, budgeting practices, projections, and long-term plans help ensure accountability to key stakeholders.

Positive indicators of oversight and disclosure practices include:

- Established board-approved policies and practices including those related to investments, debt, liquidity, and conflicts of interest
- Appropriate disclosure and transparency for internal decision makers and external stakeholders
- Appropriate staffing for effective implementation of policies
- Regular board oversight of the president, including annual performance assessments by multiple board members who rotate over time
» Use of internal audits to inform the board
» Detailed external disclosure regarding program outcomes, financial statements, research activity, budgets, compliance with bond covenants, or other material issues
» Filing of financial statements in a timely manner, including detailed management discussion and analysis
» Availability of quarterly financial statements or interim information especially for larger and more operationally complex not-for-profits
» Clearly defined board committee structure and responsibilities
» Term limits for board members

We review a not-for-profit’s written policies, assess presentations made by management to the board, and discuss staffing and processes for risk management with members of senior leadership. We look for the board to develop and routinely review key policies overseeing the not-for-profit’s investments, debt, operations, and compliance-related issues. We also examine information made available to external stakeholders through websites, financial statements, official statements associated with debt issuances, and regulatory disclosures.

**Short- and Long-Term Planning**

Effective utilization of a not-for-profit’s resources requires a long-term strategic plan, a long-term financial plan, and prudent short-term budgeting, along with the regular re-alignment of all three. Planning is critical given the institutional imperative to fulfill a stated mission in an environment of changing financial constraints, coupled with increasing external stakeholder scrutiny (tax-exempt status, regulatory compliance, and community relations). The plans of higher rated not-for-profits typically incorporate detailed and conservative, but realistic, assumptions.

Positive indicators of short- and long-term planning include:

» Integrated strategic, capital, and financial plans
» Use of detailed multi-year financial plans and budgets that tie to audited financial statements
» Conservative budgeting, producing consistent operating surpluses
» Financial and capital scenario evaluation and stress testing
» Development of well considered contingency plans
» Prudent endowment management and sustainable endowment spending policies that are regularly reviewed in context of overall not-for-profit risk assessment and multi-year financial plan
» History of meeting or exceeding internal forecasts for budget performance, earned revenue, and fundraising
» Recognition of key risks in multi-year plans and development of contingencies for addressing them

We review a not-for-profit’s written strategic plan, master facilities or capital plan, as well as mid-range and long-range budget projections. We analyze budget-to-actual results for earned revenue, fundraising, investment returns, and operational performance. We examine management’s assumptions used in projections as well as use of stress testing scenarios.
Self-Assessment and Benchmarking

Self-assessment provides governing boards and management teams with the tools to identify challenges early and to develop strategies to address those challenges in the interest of maximizing efficiency. External benchmarking is of particular importance in light of increasing competition for earned revenue, grants, and philanthropic support. The most successful organizations follow best practices in self-assessment, including use of key metrics that are closely monitored on a regular basis to identify adverse trends quickly and develop contingency plans to make mid-course adjustments when necessary.

Positive indicators of self-assessment and benchmarking include:

» Benchmarking relative to best practices and strategies across relevant peer organizations
» Establishment of key performance indicators that are regularly monitored
» Regular performance reviews and assessment of the president and senior leadership
» In-depth institutional research and evaluation of competitive landscape

We review the metrics and set of peer organizations by which a not-for-profit chooses to measure itself. We discuss with management the frequency and depth with which the information is reviewed by senior leadership and board members. We also inquire about examples of leadership actions based on a not-for-profit’s performance relative to key indicators to understand its willingness and ability to react to developing situations.

Government and Stakeholder Relations

Many external stakeholders can directly affect the financial position of not-for-profits through their potential to restrict access to capital, reduce tax subsidies, increase regulatory oversight or limit philanthropic support. External stakeholders include government entities, the neighboring community, regulatory entities, patrons, and donors. To enable a supportive relationship with stakeholders, not-for-profits must clearly articulate the quality of their programs and how program outcomes contribute to various communities.

Positive indicators of government and stakeholder relations include:

» Evidence of stable and supportive relationships including lack of contentious, destructive, or unnecessarily public disagreement
» Strong philanthropic support from board members and other stakeholders
» Positive local/regional economic impact of the not-for-profit

In some instances, not-for-profits receive material operating, capital or other support from the public sector, as in the case of a museum that receives ongoing revenue to cover a portion of its operations. Inasmuch as the public support has a well-established history and high likelihood of continuing without substantial disruption, governmental financial support can strengthen credit quality.

We evaluate the political and legal environment in which a not-for-profit operates and look for examples of limitations or flexibility in navigating challenging situations. We review statutory changes as well as the public discourse that could affect a particular not-for-profit or the sector as a whole. In addition, we seek to understand the major sources of philanthropic support, including board members, other individuals, foundations, corporations and other community member donors.
Factor 5: Legal Security and Debt Structure

Why it matters
External financings play an important role in supporting a not-for-profit’s capital investment and as a source of liquidity, supplementing internal financial reserves, cash flow, and philanthropy. Some not-for-profits have undertaken more complex debt structures, including a mix of variable rate and fixed rate debt, use of derivative instruments and escalating and/or bullet maturity debt structures. The terms and conditions of financings such as bonds, operating lines, leases, or private placements affect the amount and circumstances under which a not-for-profit is expected to make payments, regularly scheduled or accelerated. A not-for-profit’s debt structure, therefore, can have liquidity and cash flow implications. The legal security and covenants for these financings allocate these risks between the not-for-profit and the lenders/creditors.

Security provisions and covenants provide a source of protection to bondholders and can determine the priority of payments between creditors. Not-for-profits with strong and stable financial positions typically issue debt as an unsecured general obligation of the organization. For not-for-profits with more modest reserves, volatile operating history, or legal limitations on providing a broad pledge, specific security provisions may be granted to bondholders, including a security interest in specific revenue streams, such as indirect cost recovery on grants, or a mortgage pledge on a portion of or all of the not-for-profit’s facilities. The likelihood of payment or recovery, in case of default, is dependent upon the potential market value and liquidity of the underlying assets being pledged and the rights of bondholders under various scenarios.

Positive indicators of bondholder security provisions include:
» Pledge of revenues and/or assets that provides breadth and consistency relative to debt service
» Parity or senior position of bondholders relative to other lenders
» Appropriate additional security based on the risk of the project or borrower

We review the bond indenture, loan agreement, and any other legal documents that pertain to repayment of debt to evaluate the legal security for debt service, covenants, position of bondholders relative to other lenders, events of default, and remedies. We analyze the breadth of and stability in the pledged revenues, comparing historical and projected net revenues to maximum annual debt service requirements, not just annual requirements. We also examine the revenue and expense growth assumptions that govern projected debt service coverage ratios and, where the potential exists for construction delays, the adequacy of capitalized interest funding.

External Financing Terms and Conditions
A not-for-profit’s debt profile reflects its strategy of balancing the cost of capital with the potential balance sheet and operational risks of external financing. Our analysis of the debt structure for a not-for-profit depends on its unique credit characteristics and management’s risk tolerance. Some financing options, particularly structures that permit the sudden acceleration of debt repayment, carry more risks than others. We assess the ability of the not-for-profit to monitor, manage and mitigate risks associated with its debt structure.
Positive indicators of external financing terms and conditions include:

» Diversity of counterparties to insulate the not-for-profit from negative events associated with the counterparty’s credit profile

» Staggering of expiration dates on bank liquidity agreements and mandatory or optional tender dates

» Proactive renewal of bank facilities well in advance of expiration date

» Access to a variety of debt products and refinancing alternatives

Through discussions with senior management, we evaluate a not-for-profit’s understanding of and strategy for undertaking particular debt structures. We look for the not-for-profit, not a financial advisor, intermediary, or other third party, to explain these risks and specific mitigants. We evaluate the budgeting practices, staffing levels, wealth, and liquidity relative to the not-for-profit’s specific financing terms and characteristics.

We review the terms of bank liquidity agreements and interest rate swap agreements, including financial covenants, term-out provisions, events of default, termination events, acceleration provisions, and collateral posting requirements. If a not-for-profit plans to refinance a mandatory tender or bullet maturity, we assess the window of time to refinance, ability to access a variety of debt products or other alternatives, and management’s plans and procedures for ensuring a successfully executed refinancing.

Factor 6: Other Considerations

Why it matters

Other considerations regarding the unique characteristics of a particular sub-sector or expected changes in the credit or the environment are captured in this qualitative section. Individual credits often present particular aspects not captured in the first five factors. In addition, the historical quantitative factors, while valuable, might provide only limited insights as to future performance. These other considerations seek to adjust for those cases where the future may diverge from the recent past because of a change in trends, economic climate, the competitive landscape, unexpected expenses, or other factors. These other considerations also seek to consider the untapped strengths of some not-for-profits such as marketable real estate or uncommonly high ability to reduce expenses.

Multi-Year Trends

Moody’s ratings are forward-looking and incorporate our expectations for future financial and operating performance. Multi-year trends can capture a variety of scenarios in which the future performance may diverge from or the past or continue recent momentum. As a positive, negative, or neutral adjustment, multi-year trends can capture a variety of expected changes in key credit drivers.

Positive indicators of multi-year trends include:

» Recent credit-positive momentum in key drivers such as revenue growth, with reasonable expectations of continued momentum

» A substantial improvement in operating performance, following a period of weak performance, that resulted as intended from specific actions to control expenses or increase in revenue
» Clear evidence of market strength, including cases when a not-for-profit realizes material gains in earned revenue in a challenging climate

» Sustained growth in cash and investments, with material growth in both absolute terms and relative to peers

» Maturation of a recent initiative that may previously have represented start-up risk

Marketable Real Estate

While our financial resource calculations exclude real estate value of mission-related property, in limited cases we consider the potential value of excess real estate or unused land when making qualitative adjustments. Not-for-profits vary widely in their capital intensity and real estate needs and these needs can change over time. In some cases, a not-for-profit owns real estate it does not need which has a clear alternative use, could be separated from core real estate without impacting ongoing operations, and has a demonstrated market value. For instance, not-for-profits that own headquarters facilities in central business districts or other desirable commercial real estate environments have been able to lease a portion of their unused space to other tenants.

Positive indicators of marketable real estate include:

» Excess marketable real estate in a thriving market that could be sold or leased without damaging the operations or core mission of a not-for-profit

» A reliable demonstration of the market value of the real estate through an appraisal or other independent assessment

» Unsolicited offers from third parties to purchase or lease excess real estate

Event Risk

Event risk incorporates the credit exposure of a not-for-profit to natural disasters, legal judgments, or security incidents. This qualitative factor is not meant simply to acknowledge potential risk, but instead to focus on actual occurrence of a credit-negative event. Thus, location in a hurricane zone would not, by itself, be scored as negative for this sub-factor, but actual material disruption or damage from a hurricane would. In most cases, recovery from a material event is a long-term process, and we seek to incorporate the risks of that process in our ratings. Event risk analysis focuses on the nature of the disruption or damage, the costs of remediation, lost revenue, potential insurance coverage for property damage and business interruption, plan to pay for the costs of recovery and plan to respond to changes to operating model such as decline in earned revenue or increase in expenses.

Positive indicators of event risk impact include:

» Reasonably predictable measures of impact from an event such as direct costs of repair of damaged facilities, financial judgments or settlements, emergency remediation, and business interruption

» Well-developed plans to fund the costs following the event with limited impact to flexible reserves

» Convincing evidence that the fundamental drivers of revenue will not be dislocated because of the event

» Competent execution of recovery plans in the recent past, as applicable
Competitive Landscape

Because of the diversity of market positions for the not-for-profit sector and limited comparability of measures across the various sub-sectors, the qualitative factors include a means to capture the position of a non-for-profit relative to its competitors. Demographic changes that affect the attendance at orchestral concerts will likely affect the demand for not-for-profits producing such concerts. Other factors affecting cultural not-for-profits include geographic diversity of its audiences and the ability and willingness of audiences to pay. We consider a broad array of competitors as some not-for-profits are competing for audience members’ leisure time and money.

The competitive landscape also affects donor support particularly as many not-for-profits achieve the best results with donors with some local or regional tie to the organization. The ability of a region to support its not-for-profits is limited and not-for-profits have to compete to garner a share.

Positive indicators of competitive landscape positioning include:

» Market leadership with demonstrated pricing power and ability to adapt to demographic changes
» Clear role as sole provider of goods or services within a well-established regulatory regime with high barriers to entry from new competitors
» Ownership of highly valuable non-financial assets such as art collections likely to generate longstanding interest and revenue

Expense Flexibility

Expense flexibility varies widely among not-for-profits, and it is an important factor that can determine how well or quickly an entity can respond to potential revenue declines. Not-for-profits with high expense flexibility are able to reduce expenses quickly and with minimal disruption in the face of revenue losses, thereby avoiding a disruption in operating performance or a balance sheet decline through deficit operations.

Our assessment of the cost structure of an organization focuses on fixed versus variable costs. Many not-for-profits—and particularly performing arts organizations—are labor intensive, and inflexible labor costs can spring from union contracts. In some cases programming decisions and commitments are made years in advance thereby reducing future flexibility. Capital intensive not-for-profits have higher costs and potential inflexibility through the simple costs of occupancy of their facilities. These fixed costs of occupancy include operation and maintenance of facilities, deferred maintenance, debt service on plant-related debt, as well as capital and operating lease payments.

Philanthropic, grant-making organizations typically exhibit high expense flexibility. We assess what portion of their grants extend for multiple years as well as the organization’s strategy toward longer-term commitments. We also assess how grant commitments have changed during prior eras of reduced revenue for a demonstration of support and flexibility.

Positive indicators of expense flexibility include:

» A demonstrated history of the ability and willingness to reduce expenses in line with revenues
» Negligible exposure to long-term contractual expenses for labor
» High proportion of variable costs that move with the size of operations
Other Factors

In addition to the factors listed above, we incorporate credit specific considerations into our analysis that may not be otherwise captured and that can add considerable strength or weakness to the organization. These factors include, but are not limited to, the following:

» Government funding trends and reliance
» Future capital needs and borrowing plans
» Potential for program change

Applying the Rating Methodology

The rating methodology consists of two steps. We begin with a grid indicated score generated from the weighted average of the quantitative metrics, which include the key factors of market position, operating performance, and balance sheet and capital investment. We then assess governance and management as well as legal security and debt structure. We also incorporate other credit specific considerations into our analysis that are not otherwise captured in the quantitative grid or common qualitative factors which can account for additional variation from the quantitative grid score. These factors provide equal, if not greater, insight into the long-term credit quality of a not-for-profit.

Quantitative Grid

The grid provides guidance for the quantitative factors that are generally most important in assigning ratings to not-for-profits. It is a summary that does not include every rating consideration. The weights shown for each factor in the grid represent an approximation of their typical importance for rating decisions, but actual importance may vary significantly. Accordingly, the grid-indicated rating is not expected to match the actual rating in many cases. This is particularly true for speculative grade borrowers, where qualitative factors weigh heavily in rating outcomes.

The weights assigned to various factors in the scorecard reflect our assessment of the key factors driving ratings in the sector for not-for-profits. Balance Sheet and Capital Investment factors have the highest weighting in the quantitative grid score, at 45% for the standard scenario. This weight reflects the importance of wealth in providing long-term stability given the small size of many not-for-profits and potential vulnerability to operating volatility. Market Position represents 35% of the quantitative grid score for the standard scenario and incorporates the absolute size of operations as well as donor support as a proxy for reputation, demand, and flexibility. Operating Performance for the standard scenario constitutes the remaining 20% of the grid score and is an indication of fiscal stewardship and the ability of a not-for-profit to repay debt.

The grid contains eleven metrics, detailed in Appendix A, with values mapped to a broad rating category based on the distribution of values in Moody’s current rated portfolio as well as an arithmetic extension for lower ratings. All of the quantitative metrics incorporate Moody’s standard adjustments to a not-for-profit’s balance sheet, income statement, and cash flow statement. The weighted average of the sub-factor scores produces a quantitative grid score. Each sub-factor receives a score based on the scale below.

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Scorecard Adjustments

We use both historical and projected financial results in the rating process. Moody’s ratings are forward-looking and incorporate our expectations for the future, including expectations for financial and operating performance. Accordingly, we make adjustments to the quantitative factors based on anticipated near-term results. In some cases, confidential information that we cannot publish may inform our expectations for future performance. In other cases, we estimate future results based upon past performance, industry trends, competitor actions, near-term borrowing plans, and other factors. Historical results and observations about credits with similar characteristics help us understand patterns and trends for a not-for-profit’s performance as well as for peer comparison.

The rating methodology grid incorporates a trade-off between simplicity that enhances transparency and greater complexity that would enable the grid to map more closely to actual ratings. Ratings may reflect circumstances in which the weighting of a particular factor will be different from the weighting suggested by the grid. Extraordinary strength or weakness in a key factor may dominate other factors and therefore alter the weight assigned to that one factor. Further, the three rating factors in the quantitative grid do not constitute an exhaustive treatment of all of the considerations that are important for ratings of not-for-profits.

Qualitative Factors

Moody’s assessment of a not-for-profit’s governance and management, legal security and structure of its debt instruments, and other credit specific considerations can account for a multiple notch differential from the output of the quantitative grid. We evaluate whether these factors have a positive, neutral, or negative impact on the not-for-profit’s credit profile and adjust the rating outcome accordingly.

The weight, or importance, of the qualitative sub-factors can vary based on the particular credit profile and circumstances under review. Extraordinary strength or weakness in a key sub-factor may dominate the others in light of the particular credit conditions. For example, our analysis of governance and management is particularly important when a not-for-profit is facing strategic change. This can include embarking on a major expansion of programs, initiating a significant new borrowing or fundraising campaign, undergoing financial stress, dealing with a weakening market position, or experiencing high turnover in senior management. In our published rating reports, we provide discussion of our assessment of these qualitative factors to explain our rating opinions. The depth of the discussion and points of emphasis will vary based on the particular credit issues facing the not-for-profit and the importance of those issues to the rating.
### Appendix A: Quantitative Grid with Ranges

#### Factor 1: Market Position: (35% / 10%)

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<tr>
<td><strong>Operating Revenue ($000)</strong></td>
<td>≥ 600,000 &lt; 600,000 ≥ 140,000 &lt; 140,000 ≥ 60,000 &lt; 60,000 ≥ 30,000 &lt; 30,000</td>
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<td><strong>Average Gift Revenue (3 year average) ($000)</strong></td>
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#### Factor 2: Operating Performance: (20% / 15%)

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<tr>
<td><strong>Average Debt Service Coverage (x)</strong></td>
<td>≥ 15.0 &lt; 15.0 ≥ 5.0 &lt; 5.0 ≥ 2.5 &lt; 2.5 ≥ 1.0 &lt; 1.0</td>
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<tr>
<td><strong>Revenue Diversity (Max Single Contribution) (%)</strong></td>
<td>≤ 35% &gt; 35% ≥ 55% &gt; 55% ≥ 95% &gt; 95% &gt; 100% 100%</td>
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#### Factor 3: Balance Sheet and Capital Investment: (45% / 75%)

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<th>Baa</th>
<th>Ba &amp; below</th>
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<tbody>
<tr>
<td><strong>Total Cash and Investments ($000)</strong></td>
<td>≥ 1,500,000 &lt; 1,500,000 ≥ 250,000 &lt; 250,000 ≥ 80,000 &lt; 80,000 ≥ 30,000 &lt; 30,000</td>
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<tr>
<td><strong>Expendable Financial Resources to Direct Debt (x)</strong></td>
<td>≥ 8.0 &lt; 8.0 ≥ 2.0 &lt; 2.0 ≥ 0.5 &lt; 0.5 ≥ 0.3 &lt; 0.3</td>
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<tr>
<td><strong>Expendable Financial Resources to Operations (x)</strong></td>
<td>≥ 8.0 &lt; 8.0 ≥ 2.0 &lt; 2.0 ≥ 0.5 &lt; 0.5 &lt; 0</td>
<td></td>
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<tr>
<td><strong>Debt to Operating Revenues (x)</strong></td>
<td>≥ 0.10 &gt; 0.10 ≥ 0.40 &gt; 0.40 ≥ 0.85 &lt; 0.85 ≥ 2.0 &lt; 2.0</td>
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<tr>
<td><strong>Monthly Days Cash on Hand (x)</strong></td>
<td>≥ 2,500 &lt; 2,500 ≥ 600 &lt; 600 ≥ 150 &lt; 150 ≥ 40 &lt; 40</td>
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<tr>
<td><strong>Monthly Liquidity to Demand Debt (%)</strong></td>
<td>No Demand Debt or ≥ 2,000% &lt; 2,000% ≥ 350% &lt; 350% ≥ 100% &lt; 100% ≥ 50% &lt; 50%</td>
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<table>
<thead>
<tr>
<th></th>
<th>Standard Weighting</th>
<th>Balance Sheet Weighting</th>
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<tbody>
<tr>
<td><strong>Operating Revenue ($000)</strong></td>
<td>25%</td>
<td>5%</td>
</tr>
<tr>
<td><strong>Average Gift Revenue (3 year average) ($000)</strong></td>
<td>10%</td>
<td>5%</td>
</tr>
<tr>
<td><strong>Operating Cash Flow Margin (%)</strong></td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td><strong>Average Debt Service Coverage (x)</strong></td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td><strong>Revenue Diversity (Max Single Contribution) (%)</strong></td>
<td>10%</td>
<td>5%</td>
</tr>
<tr>
<td><strong>Total Cash and Investments ($000)</strong></td>
<td>10%</td>
<td>15%</td>
</tr>
<tr>
<td><strong>Expendable Financial Resources to Direct Debt (x)</strong></td>
<td>10%</td>
<td>20%</td>
</tr>
<tr>
<td><strong>Expendable Financial Resources to Operations (x)</strong></td>
<td>10%</td>
<td>20%</td>
</tr>
<tr>
<td><strong>Debt to Operating Revenues (x)</strong></td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td><strong>Monthly Days Cash on Hand (x)</strong></td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td><strong>Monthly Liquidity to Demand Debt (%)</strong></td>
<td>5%</td>
<td>10%</td>
</tr>
</tbody>
</table>
Appendix B: Quantitative Grid Factors and Definitions

NFP Methodology Quantitative Grid Factors and Definitions (Standard Weight/Balance-Sheet Heavy Weight)

Market Position (35%/10% of Grid Rating)
Operating Revenue defines the scope of a not-for-profit’s operations and gives an indication of the magnitude of earned revenue, gifts supporting operations and investment income.

Total adjusted operating revenue as stated in the audit, including all unrestricted giving and excluding net assets released from restriction for capital or from long-term investment gains, less realized and unrealized gains or losses, plus 5% of the trailing three-year average of cash and investments.

Average Gift Revenue (3-year average) Measures philanthropic support of institution committed to annual operations, capital and endowment over three-year period.

Total gift revenue (unrestricted, temporarily restricted, and permanently restricted) for last three years, divided by three.

Operating Performance (20%/15% of Grid Rating)
Operating Cash Flow Margin measures the level of cash flow from operations that is available to cover principal and interest payments on debt, establish flexible reserves and fund capital needs.

Operating surplus (or deficit) plus depreciation expense plus interest expense plus additional non-cash expenses, divided by total adjusted operating revenues.

Average Direct Debt Service Coverage measures a not-for-profit’s ability to repay debt principal and interest from Moody’s adjusted net operating income. The calculation is a three-year average of income compared to actual principal and interest on capital debt.

Three years of annual operating surplus (deficit) plus interest and depreciation expenses, divided by three years of actual principal and interest payments.

Revenue Diversity measures the dependence of a not-for-profit on a single revenue stream.

Largest source of revenue divided by total adjusted operating revenues.

Balance Sheet and Capital Investment (45%/75% of Grid Rating)
Total Cash and Investments measures the base of assets that generate investment return.

Cash and investments plus bond trustee debt service reserve funds or debt service funds.

Expendable Financial Resources to Debt measures coverage of debt by financial reserves or funds a not-for-profit can access in the intermediate term due to temporary spending restrictions, largely donor or sponsor imposed. The amount includes unrestricted resources that are available for immediate expenditure, but excludes both unrestricted and temporarily restricted net investment in plant.

Total unrestricted and temporarily restricted net assets less unrestricted net investment in plant less temporarily restricted net investment in plant divided by debt.
Expendable Financial Resources to Operations measures coverage of operating expenses by financial reserves or funds a not-for-profit can access in the intermediate term due to temporary spending restrictions, largely donor or sponsor imposed. The amount includes unrestricted resources that are available for immediate expenditure, but excludes both unrestricted and temporarily restricted net investment in plant.

\[
\text{Total unrestricted and temporarily restricted net assets less unrestricted net investment in plant less temporarily restricted net investment in plant divided by total operating expenses.}
\]

Debt to Operating Revenue measures coverage of debt from annual operating revenue.

\[
\text{Debt divided by total revenues}
\]

Monthly Days Cash on Hand measures the number of days a not-for-profit is able to operate (cover its cash operating expenses) from unrestricted cash and investments from both operating and endowment/long-term accounts that can be liquidated and spent within 30 days.

\[
\text{Monthly liquidity (sum of a not-for-profit’s unrestricted investments in the operating funds with liquidity of one month or less plus the lesser of endowment funds available within one month or the sum of unrestricted board designated net assets plus unrestricted funds commingled with the endowment) multiplied by 365, divided by adjusted operating expenses minus depreciation expenses and other large non-cash expenses.}
\]

Monthly Liquidity to Demand Debt measures an institution’s ability to repay all putable debt from unrestricted cash and investments from both operating and endowment/long-term accounts that can be liquidated and spent within 30 days.

\[
\text{Monthly liquidity (sum of a not-for-profit’s unrestricted investments in the operating funds with liquidity of one month or less plus the lesser of endowment funds available within one month or the sum of unrestricted board designated net assets plus unrestricted funds commingled with the endowment) divided by demand debt.}
\]
Appendix C: Criteria for Sufficient Information to Assign or Maintain Ratings

If, in our opinion, sufficient information to effectively assess creditworthiness is not available and is unlikely to soon become available, we will decline to assign ratings, or we will withdraw outstanding ratings for a rated entity. If we do not have audited financial statements within 12 months after the end of the fiscal year and do not have sufficient, reliable information to support a credit analysis, we will withdraw the rating. To support ratings on entities with material pension liabilities, we expect regular updates to pension valuations or equivalent measures.
Moody’s Related Research

The credit ratings assigned in this sector are primarily determined by this credit rating methodology. Certain broad methodological considerations (described in one or more secondary or cross-sector credit rating methodologies) may also be relevant to the determination of credit ratings of issuers and instruments in this sector. Potentially related secondary and cross-sector credit rating methodologies can be found here.

For data summarizing the historical robustness and predictive power of credit ratings assigned using this credit rating methodology, see link.

Special Comments:

» US Municipal Bond Defaults and Recoveries, 1970-2012, May 2013 (151936)
» Governance and Management: The Underpinning of University Credit Ratings, November 2010 (128850)
» Campus Real Estate: A Financial Asset?, February 2007 (74086)
» Moody’s Views on Operating Leases for Higher Education and Not-for-Profit Organizations, August 2004 (88635)
» Risks of Variable Rate Debt No Longer Hidden, December 2008 (113702)

Rating Methodologies:

» U.S. Not-for-Profit Private and Public Higher Education, August 2011 (134044)
» US Independent Schools Methodology, February 2013 (149718)

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.
Report Number: 164670

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