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From: Ammerman, Paula [REDACTED]
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Subject: Published Issuer Comment
Attachments: July 2012 Penn State Issuer Comment.pdf; ATT00001.txt

To: Members of the Board of Trustees

President Erickson asked that distribute the attached to you and advise that, as part of Moody's ongoing credit monitoring process and in response to the release of the Freeh report, the rating agency released the attached "issuer comment" report Friday morning. The statement indicates that Moody's is continuing to review the Freeh report including proposed recommendations and that Moody's expects the following:

- 1) The University will likely be able to absorb the financial impact of the civil suits and settlement of known claims in the near term given continued strong demand, positive cash flow and financial resources.
- 2) The University faces greater long term uncertainty regarding reputational risks and the emergence of additional claims.
- 3) The Board will implement most if not all of the recommendations.
- 4) Moody's will continue to monitor developments in following up the November revision of the University's outlook to negative.

As a reminder, Moody's affirmed the University's Aa1 credit rating in February of this year, but described our outlook as "negative" in light of the uncertainty surrounding costs of litigation and potential reputational risk. Joe Doncsecz and David Gray are scheduled to confer by phone with Moody's representatives on August 7, and should be in a position to share how Penn State intends to respond proactively to the Freeh Report's recommendations.

Thank you.



ISSUER COMMENT

Penn State faces ongoing financial and reputational risks in wake of Freeh report

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Summary

With today's release of a special investigative report (Freeh Report)¹ and its harsh criticism of both the Board of Trustees and senior leadership of Pennsylvania State University (Penn State), rated Aa1, negative outlook, the university faces greater uncertainty regarding the emergence of both future legal actions and financial claims against the university.

Led by former FBI Director Louis Freeh, the report was commissioned by the Penn State board following events surrounding the arrest and ultimate conviction of former university coach Jerry Sandusky. The report found that senior university administrators failed to report allegations of child sexual abuse by Sandusky to external parties or to the Penn State board. It also criticized the board for failing to exercise proper oversight of senior university management. A detailed set of recommendations was also set forth in the report.

Moody's is reviewing the Freeh Report, including proposed recommendations, as well as the board's response, to assess any impact on Penn State's credit profile. We expect that the university will likely be able to absorb the impact of the civil suits and settlement of the known claims in the near-term, given its still strong market demand, positive cash flow and financial resources exceeding \$5 billion. However, with the release of the Freeh report and its harsh criticism of both the Board of Trustees and senior leadership, Penn State faces greater uncertainty regarding the emergence of both future legal actions and financial claims against the university. We will continue to monitor these related events as they unfold and will make changes to the rating or outlook when and if warranted.

¹ "Report of the Special Investigative Counsel Regarding the Actions of The Pennsylvania State University Related to the Child Sexual Abuse Committed by Gerald A. Sandusky". The report was provided by Freeh Sporkin & Sullivan LLP, the Special Investigative Counsel retained by Penn State's Board of Trustees' Special Investigative Task Force to conduct a full and independent investigation of the alleged failure of the Penn State personnel to respond to and report the child sexual abuse by Jerry Sandusky, a former assistant football coach at Penn State convicted of child sexual abuse charges. The Special Investigative Counsel was also asked for recommendations regarding the university oversight, governance and policies and procedures that will help prevent and better respond to future incidents.

Report highly critical of Penn State's board and senior leadership

The Freeh Report's conclusions and recommendations were released concurrently to both Penn State and to the public, a step that reinforces the independent nature of the investigation. The report found that the university's most senior leadership both disregarded the safety and welfare of Sandusky's victims and concealed his actions from the Board of Trustees, the university and the broader community. It is highly critical of the board for not performing its oversight duties appropriately and, instead, relying on the senior leadership to deal with these matters as it became aware of the grand jury investigation. As a result, the report states Penn State and its board was unprepared to effectively and immediately respond to the filing of the criminal charges against Sandusky and against two senior university officials.

As requested by the board, the report also provides 120 recommendations for its consideration regarding university governance, policies and procedures. The board has already implemented a number of changes since November 2011, including recommendations made by the Special Investigative Counsel in January 2012. As it is seeking to strengthen its oversight and governance of the university, Penn State's board is expected to act promptly to review and implement many, if not all, of the recommendations.

Penn State's rating carries negative outlook

On November 11, 2011, Moody's placed Pennsylvania State University's Aa1 long-term rating under review for downgrade to assess the reputational and financial risks that could result from the filing of criminal charges by the Pennsylvania Attorney General involving child sexual abuse against the former assistant football coach, as well as perjury and failure to report charges against two senior university officials, one no longer with the university and the other on administrative leave.

Moody's confirmed Penn State's Aa1 rating on February 17, 2012 and revised the medium term outlook to negative. The negative outlook reflects the high degree of uncertainty about direct litigation costs as well as emerging reputational risk that can result in weaker student demand or reduced philanthropic support from the university's alumni and other major donors.

Pennsylvania State University's strong Aa1 long-term rating reflects its position as a leading US public university with robust market strengths in student demand, research and fundraising. Pennsylvania's flagship and land grant university, Penn State is one of the largest universities in the US, with a strong national academic brand identity that results in high student demand including significant numbers of out-of-state students helping to mitigate a declining number of high school graduates in its home state. The university is also one of the nation's leading research enterprises, with \$805 million of research expenditures reported for fiscal year 2011. Penn State has proven to be a major fundraiser, with \$236 million of reported gift revenue for FY 2011, with continued strong support in FY 2012 to date.

To date, Penn State reports it has seen no negative impact on student demand, research or private fundraising. Undergraduate and graduate applications are higher for fall 2012 compared to the same time last year, as are freshmen deposits. The university reported its second highest gift flow in fiscal year (FY) 2012 although it reports commitments are down compared to last year, which included a large \$88 million commitment. More alumni contributed to the annual campaign than those who contributed in FY 2011 and the university has received record commitments from faculty, staff, and other supporters. Research remains strong, with awards about 13% higher than for fiscal year 2011 --

noteworthy as many research institutions are reporting lower awards in FY 2012 as the federal fiscal stimulus award program has ended.

For more information, please see Moody's last report on Pennsylvania State University dated February 17, 2012 and issuer comment dated June 27, 2012.

KEY INDICATORS (FY 2011 financial data, fall 2011 enrollment data)

Full-Time Equivalent Enrollment: 84,951 students

Primary Selectivity: 74.2%

Primary Matriculation: 32.3%

Net Tuition per Student: \$16,912

Educational Expenses per Student: \$23,073

Average Gifts per Student \$2,354

Total Cash and Investments: \$5.2 billion

Total Direct Debt: \$1.1 billion

Total Comprehensive Debt*: \$1.4 billion

Expendable Financial Resources to Direct Debt: 2.40 times

Expendable Financial Resources to Operations: 0.66 times

Monthly Days Cash on Hand: 358.5 days

Monthly Liquidity to Demand Debt: 2,146.5%

Operating Revenue: \$4.6 billion

Operating Cash Flow Margin: 17.5%

Three-Year Average Debt Service Coverage: 7.64 times

Reliance on Tuition and Auxiliaries Revenue (% of Moody's Adjusted Operating Revenue): 39.4%

Reliance on Patient Care Revenue (% of Moody's Adjusted Operating Revenue): 25.9%

Reliance on Grants and Contracts Revenue (% of Moody's Adjusted Operating Revenue): 19.3%

Commonwealth of Pennsylvania Rating: Aa1, negative outlook

* Comprehensive Debt includes direct debt, operating leases, and pension obligation, if applicable.

Moody's Related Research

High Profile Ratings Update:

- » [Moody's Confirms Pennsylvania State University's Aa1 Long-Term Rating; Outlook is Negative, February 2012 \(139902\)](#)

Issuer Comments:

- » [Sex Abuse Allegations Expose Penn State to Material Reputational Risks, November 2011 \(137537\)](#)
- » [Pennsylvania State University faces financial and reputational risks related to sex abuse conviction of Jerry Sandusky, June 2012 \(143489\)](#)

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.

www.pennstatesunshinefund.org

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