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Maryland Industrial Development Finance Authority McDonogh School, Inc.; Independent Schools

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Table Of Contents

Maryland Industrial Development Finance Authority
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Credit Profile		
US$15.29 mil econ dev rev bnds (McDonogh School, Inc.) ser 2019 due 09/01/2049		
Long Term Rating	A+/Stable	New
Maryland Indl Dev Fin Auth, Maryland		
McDonogh School, Inc., Maryland		
Maryland Indl Dev Fin Auth (McDonogh School, Inc.) 2011 A,B,D,C		
Long Term Rating	A+/Stable	Affirmed

Rationale

S&P Global Ratings assigned its 'A+' long-term rating on Maryland Industrial Development Finance Authority's series 2019 bonds issued for the McDonogh School, Inc. At the same time, S&P Global Ratings affirmed its 'A+' rating on McDonogh's series 2011 bonds. The outlook is stable.

McDonogh plans to use $7.65 million of the series 2019 bond proceeds to reimburse the school for construction costs related to a faculty housing project and certain other campus projects. The remaining $8.65 million par amount will be used to refund the series 2013 variable rate direct bank placement. School does not have any current plans for additional debt, but may consider a moderate future financing, to supplement fundraising underway for a middle school project.

The rating reflects our view of McDonogh's solid demand profile, history of stable operating performance, and successful fundraising history, including long-standing support from the Rollins-Leutkemeyer Foundation (RLF; not rated). While financial resources are light for the rating category, we believe this is primarily attributed to the school's usage of cash to finance its recent faculty housing project , which deflates its expendable resource ratios. Cash and investments are more in-line with peer medians and we expect financial resources to normalize, given the school's positive operations and strong track record of fundraising. We view the additional debt as manageable at the current rating level. We understand that McDonogh is in the planning stages of its next capital campaign, which will support the school's growth in financial resources and upcoming capital projects.

The rating reflects our view of McDonogh's:

- Stable enrollment and solid demand profile, characterized by good selectivity and strong matriculation rates;
- Long-standing relationship and support from Rollins-Leutkemeyer Foundation (RLF; not rated), which has pledged $48 million to McDonogh payable in 30 equal annual installments of $1.6 million beginning in 2010, and good track record of fundraising;

- Historically stable management team, although there have been some recent transitions, and 32-member board of trustees that provides additional oversight;
- Historically positive financial performance on a full-accrual basis with a significant increase in operations in fiscal 2018 primarily due to capital contributions and net assets released from restrictions; and
- Conservative pro forma debt profile consisting solely of fixed rate debt.

In our opinion, constraining credit factors include the school's:

- Highly competitive area for private schools, although applications increased in 2018-2019 after two years of declines;
- Light financial resources, although expected to strengthen as proceeds of the 2019 bonds will reimburse certain prior capital expenditures and pledged gifts are received; and
- Requirements to meet and maintain certain operational and fundraising criteria to sustain RLF funding.

The bonds are a general obligation of the school. As of June 30, 2018, McDonogh had $28.7 million in long-term debt outstanding, including $20.0 million in series 2011A bonds and $8.8 million in series 2013 bonds (direct placement with SunTrust Bank). After issuance, pro forma debt is expected to be about $35.4 million, consisting solely of fixed rate debt (the series 2011A and series 2019 bonds).

The McDonogh School is located in Owings Mills, Md., on an approximately 800-acre campus. It is a co-educational, nondenominational, private kindergarten through 12th-grade (K-12) college preparatory school founded in 1873. The school is named after John McDonogh, a merchant and philanthropist who died in 1850 and bequeathed a portion of his estate to the city of Baltimore for the formation of the school. A small portion of students are five-day boarders; the remaining are day students. The school has small class sizes with a 7 to 1 student-faculty ratio and employs 253 full-time faculty members, 23% of whom live on campus.

Outlook

The stable outlook reflects our expectation that, over the two-year outlook period, McDonogh will maintain stable demand and enrollment, continue to collect pledged gifts, and produce break-even to positive operations on a full-accrual basis. We expect financial resources to normalize and remain consistent with the rating category, inclusive of any potential additional debt plans, due to the school's fundraising capabilities, which help support the school's capital needs.

Upside scenario

We could consider a positive rating action during the outlook period if McDonogh were to significantly strengthen financial resources such that they are consistent with a higher rating category.

Downside scenario

We could consider a negative rating action during the outlook period if the school fails to receive expected pledge commitments, issues significant additional debt without a commensurate increase in revenue or financial resources, or produces deficit operations on a full-accrual basis.

Enterprise Profile

Enrollment and demand

We consider McDonogh's demand profile solid, with consistently selective admissions and strong matriculation rates. Total enrollment at the school has grown modestly over the years with 1,399 students enrolled for fall 2018. Management is not expecting additional growth as 1,400 students is the school's current limit. For fall 2018, applications increased by 10% to 930, after previous declines in fall 2016 and fall 2017.

Management attributed the rebound primarily to the school's life ready program, which is an experiential learning program focused on research, communication, and presentation skills. They believe the program played a big part of the admissions process and helped to improve demand. The school's innovation center was also a huge draw, although going forward management expects applications to remain around the high 800 level. Selectivity and matriculation continue to remain strong, with a selectivity rate of 29% and a matriculation of 76% for fall 2018.

Student quality, as measured by the average graduating class SAT score, is well above the national average. The major points of entry for new students are kindergarten, and the sixth and ninth grades. Average tuition from the McDonogh School day program was $30,720 for the 2018-2019 academic year, a nearly 3% increase from the previous year, which management expects will continue going forward. McDonogh's tuition remains competitive compared with peers for the day program. McDonogh competes with Severn School, Friends School of Baltimore, The Bryn Mawr School, Garrison Forest School, St. Paul's School, The Boys Latin School of Maryland, Roland Park Country School, and Gilman School. The tuition discount rate for fiscal 2018 was 22.5%. The school expects this to increase at a slower rate as the school balances affordability and financial sustainability.

Management

Historically, the senior management team has been relatively long-tenured and stable, which we believe supports the school's consistent enrollment, fundraising, and financial operations. The school has recently had some transitions within the management team, although we believe the school has managed through the transition phase smoothly and we expect no additional changes going forward. The new head of school as of July 1, 2018 is Dave Farace. Mr. Farace replaced the previous longstanding head of school, who helped lead the school for the past 11 years before announcing his retirement. Mr. Farace has served in various capacities with the school in the past and served as the head of school for Bolles School for the past three years. After a comprehensive national search Kate Mueller, currently Associate Head at Western Reserve Academy (OH) will become McDonogh's next Associate Head of School on July 1, 2019, replacing Brad Shelley, who will become Head of School at The Pembroke Hill School (MO).

McDonogh is governed by a 32-member board of trustees predominately from the metropolitan region, including parents and alumni, although there has been a recent focus on expanding national outreach to elevate the school's presence and expand fundraising. Board members are limited to two consecutive terms and membership has been stable aside from normal term-limit rotations.

Financial Profile

Operations

McDonogh School has had a history of generating balanced to positive operating surpluses on a full-accrual basis, though the school has shown stronger operating performance in recent years.

We believe the performance is attributed to management's conservative budgeting, stable enrollment, and solid gift support. In fiscal 2018, the school generated a surplus of $10.7 million, or a 19% margin, which was an increase from the $6.2 million in fiscal 2017. The improved performance is primarily due to the large net assets released from restriction (NARR), as the school has undergone a number of capital projects over the past few years. Additionally, net tuition revenue continues to improve, in addition to gifts received. We believe NARR will be recurrent but variable, as the school fundraises for capital and other needs, although we expect McDonogh to maintain performance consistent with the rating level. The school is budgeting for a surplus in fiscal 2019 based on conservative enrollment and expense contingencies, which we believe is achievable given the school's historical performance. Management does not budget for depreciation, which we do not view as best practice, however, they do include an allocation to plant and maintenance on an annual basis, which we view as a close proxy. Revenue diversity is good, in our opinion, with roughly 67% of adjusted revenue from tuition and fees and auxiliary income in fiscal 2018 and the remainder primarily comes from endowment spending and gift contributions.

Financial resources

In our view, financial resources are somewhat light for the rating category. As of fiscal year-end 2018, the school's expendable resources totaled $70 million, equal to 123% of fiscal 2018 operating expenses and 199% of pro forma debt outstanding. Cash and investments were stronger at $115 million, or 200% of operations and 324% of pro forma debt outstanding. In our view, expendable resources are somewhat deflated given net property plant and equipment is above 3.0x total debt. Cash and investments are also slightly understated relative to peer credits given that the school recently used cash reserves to fund a faculty housing project. We expect these ratios to normalize, given the school's positive operations and strong fundraising track record.

Endowment

As of June 2018, the endowment had a market value of about $98 million. The investment asset allocation remained steady at 35% domestic equities, 20% alternative investments, 15% international equities, 10% real assets, and 20% bonds. The school's current allocation remains close to the target allocation. The endowment draw was $4.4 million in fiscal 2018.

This is equal to an effective rate (the draw divided by the market value of the endowment) of about 4.9% based on trailing 12-quarter average. Management has indicated its goal is to keep the draw under 5.0%, and would like to lower this rate going forward, in order to meet its goal of larger endowment growth. Additionally, the RLF pledge is not captured in the financial statements beyond the sizable annual $1.6 million distribution; we believe that the pledge provides McDonogh with a reliable source of funds that is equivalent to a school with a larger endowment.

Fundraising

The RLF came into its current form in 1973. Prior to 1973, Beale Rollins, a 1915 McDonogh graduate, had already donated a significant amount to the school. RLF has pledged $48 million to McDonogh payable in 30 equal annual installments of $1.6 million beginning in 2010, subject to certain conditions. Pledges totaling $11.2 million have been paid to date in accordance with RLF's commitment to pledge $1.6 million each year. McDonogh uses such RLF funds to make full debt service payments on the series 2011A bonds.

At the end of December 31, 2018, the school had received matching funds equal to $23 million toward a $40 million match, an additional $16.1 million in pledges and still has about $900,000 in fundraising remaining. The agreement contains limits on the level of match that will be permitted for particular uses and from specific individuals. The RLF pledge requires that the total outstanding indebtedness of the school cannot exceed 60% of the value of the endowment and other investments, and that the school may not operate in cash deficit for more than two consecutive years. The school is in compliance with these conditions.

The agreement with the RLF was recently supplemented to incorporate an additional gift from the RLF foundation to provide additional support, including the faculty housing project as aforementioned as well as future 2019 bond debt service. Inspired by a donor's $5.5 million gift, the RLF has agreed to pledge an additional gift of $500,000 and three subsequent gifts of $1.6 million each from 2040 through 2042, as long as the original donor's gift is received and the school operates the faculty housing on a positive cash flow basis starting from June 30, 2020. The gift proceeds can be used for construction costs and repayment of the series 2019 bonds.

McDonogh has had good success with its fundraising efforts. The school completed a $75 million campaign in 2014 to fund major improvements across campus, having secured $81 million in pledges. Total giving increased in fiscal 2018 to $13.6 million. This was primarily due to gifts received related to capital projects ($8.17 million including pledges). Annual giving has increased slightly to $2.5 million from historical $2.3 million levels. Management has indicated the school is making a concerted effort to grow the annual fund to approximately 8% to 10% of annual operating expenses. Parent and alumni annual fund participation remains solid at about 75% for parents and 22% for alumni.

The school's two largest capital projects included a faculty housing project, which increased housing for faculty and staff from 22 to 38 families, and a 7,500 square foot engineering and robotics center. The faculty housing renovation was completed in the summer of 2018. The engineering building was 88% gifted and the school fundraised a little under $1.2 million. We expect that McDonogh will continue to pursue solid fundraising results and will achieve the targets set forth in the RLF agreement.

Debt

Post-issuance, McDonogh will have approximately $35.4 million in long-term debt outstanding consisting solely of fixed rate debt (the series 2011A and series 2019 bonds). The series 2019 issuance will simplify the school's debt structure and eliminate its outstanding direct bank placement contingent liabilities, which we view positively, resulting in a 100% fixed-rate debt structure. With the repayment of the 2013 variable-rate debt, the prior interest rate swap agreement with SunTrust Bank will also be terminated. Pro forma maximum annual debt service is expected to occur in 2020 at $2.98 million or 5.2% of 2018 adjusted operating expenses and will step down gradually as pledged gifts are received.