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Credit Rating Enhancement Committee
C/O Julie Ellsworth, Treasurer
State Treasurer's Office, 700 W Jefferson St
Boise, Idaho 83702

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Dear Committee Members:

We want to thank you for your time and the opportunity to share details of the affiliation with the University of Phoenix and the related relevant protections afforded the state and its credit rating. This communication is a follow up to the public meeting held on October 16 and questions raised there. Our understanding was that the meeting was to evaluate the impact of the affiliation with the University of Phoenix (UOPX) on the state's credit rating, so we made available our financial advisors and employees relevant to that question. We did not have our outside counsel there to discuss extraneous issues but will endeavor to answer those questions here as well. We reiterate that, although requested, the questions were not provided in advance, so we did not bring experts to answer questions on other topics beyond whether the proposed transaction with the University of Phoenix would impact the State's credit rating.

Summary of the Impact on the State's Credit Rating

As you are aware, PFM is the leading advisor nationally for issuers of municipal debt and their work is relied on by many issuers. At the meeting, Ryan Conway of PFM answered the question put forth by the committee whether the transaction will impact the state's credit rating. The clear answer is no, the transaction will not impact the state's credit rating. And we previously forwarded that analysis to the committee. Moody's, S&P and Fitch all have their own published rating methodologies for evaluating the credit strength of states. All of them focus on tax-supported debt, and none of the rating agencies include obligations that are non-recourse to the state. Individual opinions offered at the meeting that this transaction might impact the State of Idaho's credit rating are speculative, at best, and not based on the published rating criteria of any of the rating agencies. For this reason, the debt of U of I and other colleges and universities in the state, while included in the State's audited financial report, is not included in the Credit Rating Enhancement Committee's Annual Report. Given this fact, a 501(c)3 for which the University of Idaho Board of Regents is the sole member would not be treated any differently. While the debt of an independent 501(c)3 can be included in the credit calculation of the university, it is not included in the calculation for the State's credit rating. In the Oct. 16 meeting, we note that Committee advisor, Eric Heringer of Piper-Sandler, agreed with the opinion of PFM that the 43E debt would not be counted saying, "I agree with you (meaning Ryan Conway) that rating agencies won't include the debt we are talking about here in the leverage metrics."

Constitutionality

Under the Idaho Constitution, the University of Idaho Board of Regents is the constitutional authority for the university and "shall have the general supervision of the university, and the control and direction of all the funds of, and appropriations to, the university, under such regulations as may be prescribed by law."

Questions have been raised about the constitutionality of Four Three Educations' structure. While our outside counsel was not present, we did provide a summary of the opinion of outside counsel we retained to evaluate this question. Some committee members were critical of the wording used in the summary and lack of references. In fact, the law firm's analysis cited several Idaho Supreme Court cases:

- *Moscow Hardware Co. v. Regents of Univ. of Idaho*, 19 Idaho 420, 113 P. 731 (1911).
- *State v. State Bd. of Educ.*, 33 Idaho 415, 196 P. 201 (1921).
- *State ex rel. Miller v. State Bd. of Educ.*, 56 Idaho 210, 52 P.2d 141 (1935).
- *Dreps v. Bd. of Regents of Univ. of Idaho*, 65 Idaho 88, 139 P.2d 467 (1943).
- *Davis v. Moon*, 77 Idaho 146, 289 P.2d 614 (1955).
- *Engelking v. Inv. Bd.*, 93 Idaho 217, 458 P.2d 213 (1969).

Also cited is the Idaho Nonprofit Corporation Act which, among other things, specifically provides that a member of a non-profit can be a governmental institution. Again, it was a summary, but it may be useful to understand how we retain counsel and view their opinions. We use four criteria to select counsel:

- An attorney that has a law degree from an accredited and reputable law school;
- An attorney that has deep experience and specializes in and makes a living from the subject matter area;
- The attorney or firm has had success in closing transactions or ably defends their opinions in the courts; and
- With respect to finance matters, the firm is listed in the Bond Buyer's "Redbook" of Municipal Finance Counsel. U of I's bond firm has been listed in the Redbook continuously since 1985.

If the committee has an opinion from an attorney or firm that both meets our criteria and that counters the opinion we have, we would be interested in receiving it and having legal experts evaluate it. Otherwise, we are comfortable with our advisors and their work product. Case law and statutes support their position.

It was also asked if the university asked the State's Attorney General for an opinion on the constitutionality of the transaction. The answer is no, as the AG has historically not represented the University of Idaho. It may be noteworthy that in 2014 the Legislature, with the agreement of the Attorney General's office, removed from the Higher Education Bond Act the provision for the Attorney General to approve University bond issues. The Statement of Purpose of HB 562 stated: "Current law provides for Attorney General approval for bonds issued by state universities and city and county housing authorities. The approval creates an administrative burden and is unnecessary for the acceptance of bonds into the marketplace. The approval also raises a concern that the State is impliedly responsible for the bonds, which could make bonds subject to legal challenge under Article VIII Section 1 and 4 of the Constitution."

We did hear comments from the chair regarding the age of some of the laws under which we operate. There was concern that relying on the Territorial Charter and the State Constitution could be problematic given how old those are, essentially expressing concern that they "predate the SEC (Securities and Exchange Commission)." We are a nation of laws and we operate under the U.S. Constitution and Idaho Constitution. Neither the Constitution of the United States nor the Idaho Constitution are time barred,

rather they are timeless. We strongly disagree with the comment that it is “not a good governance look,” or “that we think it will be frowned upon,” to comply with the Constitution of the U.S. or the State of Idaho, which are, respectively, the founding documents of our nation and state. The University's adherence to these founding documents ensures good governance, in keeping with Legislative and Executive Branch expectations.

Structure

One of the first questions raised was whether the structure used to create Four Three Education Inc. is unique? As reported by PFM, both universities and municipal entities commonly utilize Special Purpose Entities (SPE) as a tool to manage risk. The use of SPE and their ability to shield liability is well tested through the courts. What is unique about Four Three Education is the additional protections it provides beyond comparable transactions where a public university affiliated with or acquired a for-profit higher education institution. Four Three Education will have a majority independent board and will also have what is called a “clean break” where the seller will have no ongoing participation in the University of Phoenix or its operations. These additional safeguards align with guidance coming from the U.S. Department of Education and strengthen the commonly used 501(c)3 structure. So, while unique, to say that the structure has never been used or tested would not be accurate. It has been tested many times, and if anything, the additions we have made make the structure even stronger.

A committee member inquired if there were other universities that created 501(c)3s other than for foundations and if so, did the related entity issue debt? The answer is yes. Universities commonly use SPEs that have the ability to issue debt against their revenue as a risk mitigation tool. Examples can include academic medical centers, real estate transactions, student housing, parking, hotels, monetization of royalties, etc. Examples include University of California across several campuses, University of Massachusetts, Arizona State University, Texas A&M University, among many others and, in no instance, has the State's credit rating been impacted.

The State has created several bond issuers to place bonds on behalf of nonprofits. These issuers include the Idaho Housing Finance Association which issues bonds for housing projects and nonprofit education such as College of Idaho; and the Idaho Health Facilities Authority which issues bonds for nonprofit healthcare providers. The total amount issued by the Health Authority since 1975 is in excess of \$4 billion, of which \$1,599,694,049 is outstanding across 23 borrowers. Neither the bonds of the issuers, nor the obligation of the nonprofit borrowers to repay their loans from the issuers obligate the State. The State's ACFR itself notes that such debt that is secured solely by the revenues of the project (which is the contemplated structure for Four Three Education) and “do not constitute a debt or obligation of the State or any political subdivision, agency thereof... Accordingly, these bonds are not reported in the accompanying financial statements”.

The committee also raised the issue of the spread between the state rating and the U of I's rating. We are not sure why that is relevant to the State's credit rating and note that of the sixteen states with Aaa credit ratings, only two respective land grant universities have matching ratings (Texas A&M and Purdue University). This reflects the different methodologies that the rating agencies rely upon to assess state and higher education credits, and comparison of data across states show no correlation between states with higher or lower ratings and the associated ratings of their institutions of higher education.

Looking at comparisons of the historical ratings of the State and the U of I also demonstrates this lack of correlation. When the State's rating was upgraded in 2010, the U of I's rating was not affected, when U of I's rating improved in 2013 and then later lowered in 2020 the State's rating remained stable through each. Changes in the U of I's credit rating in 2020 not only did not impact the State's rating, in fact, the State's rating increased to Aaa two years later.

The limiting factor for U of I's rating is generally related to scale, and this affiliation is intended to address some of those limitations (diversification of revenue, access to adult learner market segment, increased EBITDA). Our rating is also impacted by our operating margin, which is relatively lower than some other land grant institutions. As evidenced by our #1 Best Value Public University in the West ranking by U.S. News & World Report, the U of I has prioritized student affordability over managing to a rating, and this affiliation will improve U of I's operating margin while not increasing student costs.

Another question was asked why we could not affiliate through a 501(c)3 set up in a different state? An affiliation between the University of Idaho and University of Phoenix has many benefits for both institutions and their students including, potentially, the sharing of best practices, intellectual property, support and career services, and the expansion of educational opportunities, in particular for Idaho students who are time and place bound. The two institutions are also committed to working together to solve challenges currently, and soon to be, facing the state of Idaho, including a steep enrollment cliff of traditional college students put in motion by the 2008 recession, and the fast-advancing needs of Idaho's employers driven by the rapid evolution of technology.

Practically, establishing the 501(c)3 in Idaho will ensure the two institutions affiliation is regulatorily sound and, advantageously, that the benefits of the affiliation remain in Idaho and are influenced by Idaho. For example, with the 501(c)3 being in Idaho, Four Three Education, Inc., of which the Regents of the University of Idaho are the sole member, is governed by the non-profit laws of Idaho. This would mean the regulatory agencies and other arms of the State of Idaho regarding non-profits will ensure compliance, rather than some other agencies of another state. We want Idaho law to guide decisions about an Idaho non-profit. This also allows more flexibility for the University of Idaho in its affiliation with University of Phoenix and the structuring of the non-profit's board. Importantly, licensing and affiliation agreements will be determined by that locally based Board of Trustees, including the reinvestment of excess revenue from University of Phoenix into the University of Idaho to address the university's— and the state's —needs.

Overall, the two institutions seek deep affiliation with one another, and intentionally requested that the Board of Regents establish the 501(c)3 in Idaho so that the sole member of the non-profit would be the University of Idaho Board of Regents demonstrating that this affiliation is designed to support the University of Idaho, the State of Idaho, and the citizens of Idaho for many, many years to come.

In response to another structure question, we want it to be clear that just because the U of I Board of Regents created the 501(c)3, and obtained IRS recognition as a not for profit, it does not mean that the state now has recourse for the debt of Four Three Education Inc. The debt is non-recourse to the State of Idaho and risk of default, which is remote given the enormous profitability of the UOPX, will be borne by the bondholders.

The Transaction

While we do not see any nexus to the State's credit rating, there were comments from the committee about the expenses of the transaction. The first was if payment to our advisors was contingent on a successful transaction. Our due diligence advisors have been, and continue to be, paid for their hourly work advising the University of Idaho. They have conducted deep due diligence to ensure that we have identified known and contingent risks. Our municipal advisor is compensated based on a combination of a fixed monthly fee and a transaction fee that is subject to the project reaching financial close. It is common for a municipal advisor to be paid on a contingent basis. They are also regulated and held to the standard of a fiduciary. Finally, compensation for our investment bankers is contingent on a successful placement of the debt. Successful debt placement is aligned with our interests and in keeping with industry standards.

The committee also questioned the expenses that were to be paid from the bond issuance. Again, the nexus between the state's credit rating and what we pay our advisors is questionable. But the answer is that there was a place holder in our budget of \$40 million for all expenses, not only for the cost of issuance, but also for interest rate hedging costs and reimbursement to the University of Idaho for our due diligence costs associated with the transaction. The placeholder was very conservative, as is our practice, and actual expenses will be much lower. We will adjust the amount of debt placed based on actual fees and expenses. An example of a cost of issuance for a recent offering of tax anticipation notes was cited by a member of the committee and was not of the same type, size, duration and complexity of the bond offering to be made by Four Three Education Inc. The placement fees negotiated for the Four Three Education Inc. transaction are market for complex placements. The underwriter's discount is 1.5% of par (estimated at \$680M) or \$10.2M, which is similar to the fee charged by the State's advisor. Piper Sandler, who is serving as the Treasurer's financial advisor, also serves as underwriter on other transactions. As one example, in March 2023 they earned a comparable spread to what is proposed for Citi on a financing where they served as underwriter for the Atlantic Park Community Development Authority in Virginia.

A question was raised about the sellers purchase price for the entity. The point made was that the private equity firm paid more than what they are selling the entity for. Again, we do not see a nexus with the credit rating, but the short answer is that we believe there were a number of affiliated entities acquired in the initial purchase that were sold with net proceeds returned to investors. Investors also received distributions from the cash flows generated by the entity for years, therefore, to simply compare what an entity is bought for and what it is sold for fails to account for material cash flows made available to private equity investors. We understand from the sellers that they have received a fair return on their investment even before accounting for this transaction.

There was a question regarding the calculation for the EBITDA multiple. The EBITDA multiple is calculated using the purchase price, less cash left on the balance sheet, divided by EBITDA. In this case, the purchase price is \$550 million, and cash left on the balance sheet is \$200 million, leaving a net of \$350 million. Divide the \$350 million by \$150 million EBITDA and you get a multiple of 2.3x.

Remote Risks

A point was made that the legislature had to bail out LCSC when they defaulted on housing revenue bonds in the 1950s. The legislature was neither legally obligated nor directed by a court to bail out LCSC,

they chose to do so. The Court specifically stated "It is true that under said act the owners of the dormitory revenue bonds had no claim against the general fund of the state of Idaho but only against dormitory funds." *Davis v. Moon*, 77 Idaho 146, 150, 289 P.2d 614, 616 (1955). The case shows it was clearly optional for the legislature to act and we would note that the default on those bonds occurred after, and caused by, the 1951 legislature not providing an appropriation to LCSC (then the North Idaho College of Education), resulting in the school ceasing to operate and generating no revenues from the new dormitory or any other dorms for several years. In the case of Four Three Education Inc., while the chances of a default are remote given the enormous profitability of the operations to be held there, if they did default, neither the legislature nor the University of Idaho would be responsible for the debts of Four Three Education Inc. The bondholders would take the loss. The U of I may choose to guarantee a portion of the debt payments (\$10 million) for a limited period if it would help placing the bonds but would only be liable to the limit of what is agreed to.

The ruling in this case clearly supports the analysis of our counsel; it upholds that the University of Idaho Board of Regents (acting as the State Board of Education in the *Davis v Moon* case) may issue bonds and that those bonds are not an obligation of the state. Further, it upheld the legislature's authority to enact *Idaho Sess. Laws 1955, c. 277* to appropriate funds to be held by the Treasurer to repay those bonds. Even the lone dissenting opinion of the court supports our analysis: that the Regents have the authority to issue bonds to be paid from revenues and that those bonds are no recourse to the state. The dissent asserted the belief that the legislature does not possess the authority to make an appropriation to repay the bonds. As the Treasurer said of the legislature in the Oct. 16 meeting, "...it's their constitution. It's their statute," it is unclear to us whether she supports the majority or dissenting opinion, though each supports the authority of the University of Idaho Board of Regents in this matter and holds that the debt is no recourse to the State of Idaho. Regardless, as Four Three Education does not rely on, nor will it receive, an appropriation from the Idaho legislature we do not see a comparison in risk to the State.

Financial Statements

There was a question regarding the quality of the revenue stream and if it was primarily revenue from tuition and fees. The financial due diligence performed by one of the largest and best accounting firms in the world indicated that revenues were primarily derived from tuition and fees, but other income, such as sub-lease income does exist. The quality of those revenue streams were assessed as part of the due diligence process and factored into the net purchase price.

There was also a question pertaining to the accounts receivable discount rate. As reported in the FY22 audited financial statements for the University of Phoenix, gross student accounts receivable totaled \$81,326,000. The associated student bad debt A/R reserve was \$45,100,000 which is 55.5% of gross student A/R (the discount rate). Net student A/R is the difference between gross and the reserve, or \$36,226,000.

Inquiry was made regarding the intangible assets expected to be acquired in connection with the transaction. Like many educational and other service organizations, value is placed on marks, future revenue streams, investments in software and the entity's workforce. FY22 audited financial statements

show intangibles valued at \$388,000, primarily related to the value of capitalized course development. The financial statements are audited and received a clean opinion from the independent auditors.

Miscellaneous

A question was raised about the impact of the transactions on Idaho's community colleges. While we again do not understand the nexus with the State's credit rating, the transaction should be beneficial to the state's community colleges as the UOPX works with community colleges across the country to build pathways, including 2+2 programs for students. In fact, UOPX has an existing agreement with the College of Western Idaho.

A question was asked why we refused a public records request for BDR Due diligence. Again, there is no nexus to the states credit rating, however, the U of I general counsel responded to the public records request cited properly withholding privileged and protected competitive information.

A question was asked regarding why we did not take the opportunity to the legislature first. The constitutional authority for the evaluation and approval of the transaction lies with the University of Idaho Board of Regents. We simply followed the constitution and the reporting lines provided therein. There was no related appropriation being requested as the transaction is self-financing.

Credit Rating

The purpose of the public meeting was intended to determine the impact of the transaction on the State's credit rating. It is worth noting that this transaction is very public, the rating agencies are aware of the transaction and nevertheless reaffirmed the state's Aaa credit rating, a rating it has enjoyed from Fitch since 2021.

As presented by our independent financial advisor, PFM, while the debt of an independent 501(c)3 may be included in the calculation of the university's credit rating, it is not included in the calculation for the State's credit rating. As you are aware, PFM is the leading advisor nationally for issuers of municipal debt. It was mentioned in the last meeting that as treasurer, you sat down with the rating agencies. If you have feedback from those meetings that contradict PFM, we would be interested in reviewing that feedback with you.

There were also comments regarding AFR disclosures. While the debt of Four Three Education Inc. will be disclosed in our audited financial statements, and it is our intention to break out and provide supplemental information regarding the operations of Four Three Education, Inc., the State of Idaho's Credit Rating Enhancement Committee's Annual Report dated December 1, 2022 confirms that debt included in the AFR that is not supported by taxes does not impact the State's credit rating.

Conclusion

As to the question of whether the proposed affiliation will impact the State's credit rating, the answer is no, the debt of Four Three Education Inc, is non-recourse and not included in the State's bond rating calculation. We understand that your office will be presenting your opinion to JFAC on November 8. As such, we have also made this document available to the members of that committee so that they can have it available for reference. To date, we have not received any further questions, and assume that this

document addresses all of your questions precluding the need for a meeting on November 17. If there are further questions, please provide them and we can respond, either in writing or in person.

Sincerely,

A handwritten signature in blue ink, appearing to read "C. Scott Green", with a long horizontal flourish extending to the right.

C. Scott Green
President