

## CREDIT OPINION

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# University of Washington, WA

Update to credit analysis following outlook revision to negative

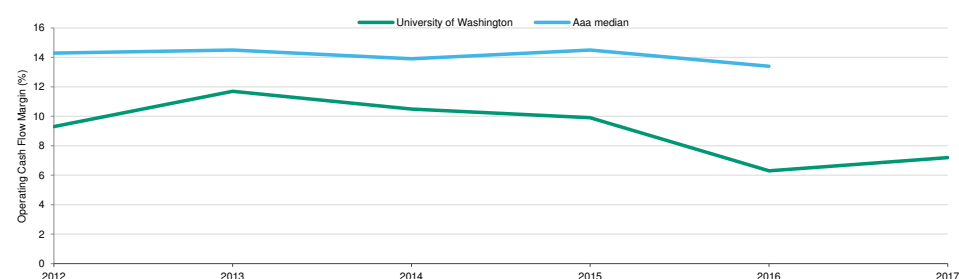
## Summary

[University of Washington's](#) (UW) exceptional credit quality is supported by the strength of its large-scale research platform and its strong student demand as the state's flagship university with a comprehensive array of programs. UW's large and diversified operations add stability to its operating model, even as its healthcare operations confront financial challenges which are depressing consolidated operating performance. Total cash and investment of nearly \$5.5 billion and very strong fundraising also enhance credit strength. Favorably incorporated in the university's credit profile is strong governance and management including integrated planning and very active oversight. In addition to deficits at UW Medicine, other offsetting considerations include declining liquidity, high reliance on federal research funding and moderately high leverage inclusive of a large and growing pension liability.

The outlook revision on January 9 to negative from stable incorporated potential challenges to the execution of a financial stability plan, adopted in November, due to a highly competitive health care environment.

Exhibit 1

### Operating performance, already below Aaa peers, weakens due to health care challenges



Aaa medians from "Medians - Public university sector mostly stable, but with pockets of stress" (July 2017)

Source: Moody's Investors Service

## Credit strengths

- » Sizeable scale with a national research profile, strong student demand and serving as a major clinical care provider for the Pacific Northwest
- » Very strong overall wealth levels, with nearly \$4 billion of spendable cash and investments enhancing financial flexibility
- » Consistently robust fundraising, with 3 year average gift revenue of \$245 million, provides funds for academic and capital investment, bolstering excellent strategic position
- » Integrated planning and strong fiscal oversight enhance prospects for strengthened operations
- » Strong self-liquidity supports the P-1 short-term rating

## Credit challenges

- » Multi-year weak performance of health care operations, with a deeper deficit in fiscal 2017, drives overall low operating cash flow margins
- » Very low and declining liquidity for the rating category; 105 monthly days cash on hand is half the median for Aaa peers
- » Slowing net tuition revenue growth following two years of state mandated tuition reductions for undergraduate residents in exchange for receiving higher appropriations
- » Increasingly competitive and uncertain research funding environment
- » Moderately high leverage with a large and growing unfunded pension liability

## Rating outlook

The rating outlook is negative. Inability to successfully execute on a board-approved strategic five-year financial stabilization plan passed in November to bring UW Medicine to positive operating performance and to rebuild liquidity could result in rating pressure. The stabilization plan focuses on service growth, revenue cycle improvement and staffing measures that may prove difficult to achieve given the competitive landscape and uncertain regulatory and reimbursement environment.

## Factors that could lead to an upgrade

- » Not applicable

## Factors that could lead to a downgrade

- » Failure to improve consolidated and health system operations in fiscal 2018 and beyond
- » Further declines in unrestricted liquidity
- » Material debt plans beyond those outlined given already moderately high leverage
- » Significant reduction in research funding and revenue

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## Key indicators

Exhibit 2

UNIVERSITY OF WASHINGTON, WA

	2012	2013	2014	2015	2016	2017 w/ Series 2018	Median: Aaa Rated Public Universities
Total FTE Enrollment	51,400	53,380	54,858	55,963	56,972	58,155	56,725
Operating Revenue (\$000)	3,926,641	4,190,984	4,401,513	4,702,687	4,896,339	5,556,845	3,712,137
Annual Change in Operating Revenue (%)	1.3	6.7	5.0	6.8	4.1	13.5	4.5
Total Cash & Investments (\$000)	4,006,103	4,379,590	4,947,757	5,180,099	5,018,792	5,472,940	6,517,203
Total Debt (\$000)	1,736,056	2,047,276	2,228,901	2,078,545	2,220,242	2,592,476	1,820,133
Spendable Cash & Investments to Total Debt (x)	1.7	1.6	1.7	1.9	1.6	1.6	2.5
Spendable Cash & Investments to Operating Expenses (x)	0.8	0.8	0.9	0.8	0.7	0.7	1.3
Monthly Days Cash on Hand (x)	145	157	150	129	122	105	211
Operating Cash Flow Margin (%)	9.3	11.7	10.5	9.9	6.3	7.2	13.4
Total Debt to Cash Flow (x)	4.7	4.2	4.8	4.5	7.2	6.3	3.5
Annual Debt Service Coverage (x)	4.5	5.0	3.1	3.4	2.2	2.6	3.7

Total FTE Enrollment is for fall of indicated year.

Source: Moody's Investors Service

## Profile

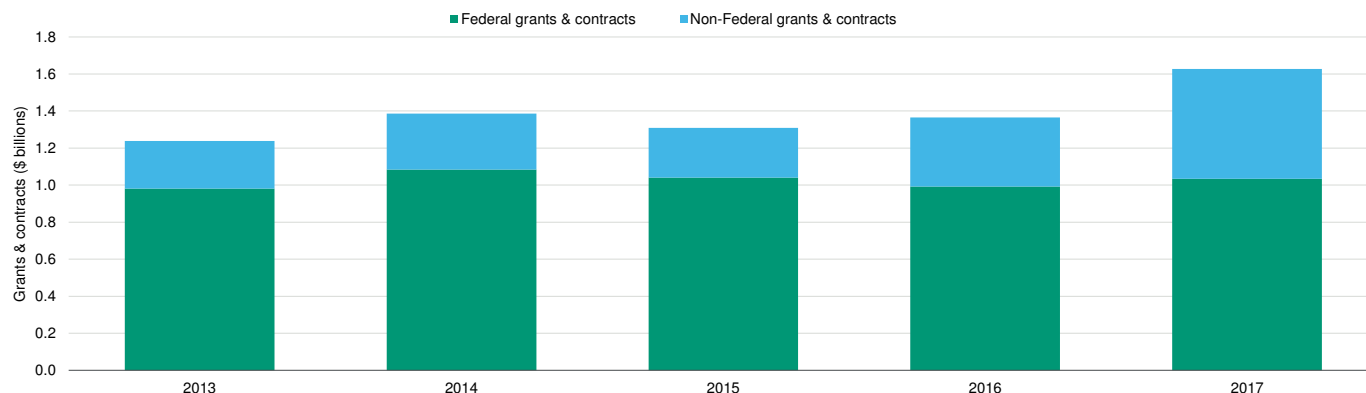
Founded in 1861, University of Washington is the [State of Washington](#)'s flagship university with over 58,000 FTE students on its campuses in Seattle, Tacoma and Bothell. UW's operations are sizable with \$5.6 billion of operating revenues. UW is also one of the nation's largest research universities with nearly \$1.6 billion of research awards for fiscal year 2017. The university operates UW Medicine, with \$2.1 billion of revenues (including University of Washington Medical Center (UWMC), Valley Medical Center and Northwest Hospital). The 529-bed UWMC is the flagship facility and an operating division of the university. UW Medicine's service area is broad as the only academic health system and Level 1 trauma care provider for Washington, Wyoming, Alaska, Montana and Idaho (WWAMI).

## Detailed credit considerations

### Market profile: leading national research profile and state's flagship public university anchor excellent strategic position; challenging health care operations

University of Washington will maintain its strong market and excellent strategic position anchored by its large, national research enterprises and strong student demand as the state's flagship university. UW has one of the nation's largest research enterprise with annual research awards averaging over \$1.3 billion. Given the scale, diversity, and reputation of its research program, UW should continue to succeed in an increasingly competitive research environment. The university has well-developed contingency plans to address any federal funding reduction.

Exhibit 3

**One of US' largest research universities**

Source: University of Washington

Student demand remains solid, based on UW's academic reputation and diversified programs, although with only moderate tuition revenue growth. Enrollment of over 58,000 FTEs is up a notable 13% since fall 2012, with modest future growth expected. Net tuition per student decreased in both fiscal 2016 and 2017 when the state required a 15% decrease in resident undergraduate tuition, largely offset by higher state funding. Although UW approved tuition increase of over 2% for fall 2017, the state retains tuition setting authority over resident undergraduate tuition, a credit negative in the longer term. However it is partially mitigated by the generally 30% of incoming freshmen who are non-resident and about one-third of enrollment at the graduate and professional level.

**GROWING HEALTH CARE ENTERPRISE WITH WEAK OPERATIONS AND LIQUIDITY**

UW's significant health care enterprise (UW Medicine) is a key credit factor in the university's profile and the current negative outlook. An important university strategic focus, the health care system is experiencing market and operating challenges from utilization, competition and reimbursement models. Patient care, including University of Washington Medical Center (UWMC) and Northwest Hospital (NWH), is substantial with \$1.9 billion or 35% of fiscal 2017 consolidated revenues. This rises to 41% when including Valley Medical Center (VMC) reported as a component unit.

The university's expansion of its health care enterprise occurred through acquisitions, affiliations and strategic partnerships. UW Medicine continues the integration of the components into the system. The expansion of UW Medicine is occurring in a highly competitive region seeing reimbursement and revenue pressures impacting revenues, and labor pressures driving expense growth. These trends are consistent with the national health care sector.

The university's board approved in November 2017 a multi-year plan (Financial Improvement and Transformation - "Project FIT") to bring stability to the health system. The university projects the most significant factors for improvement are clinical service growth with labor mix and productivity improvements. Results to date for the current fiscal year are better than budgeted, although sustainability of improvement is untested.

**Operating performance: weaker operating cash flow with pressure from health care operations**

UW's operations will remain pressured from UW Medicine's own weak performance until the FIT plan results in sustained improvement. Fiscal 2017 consolidated operations resulted in a weak 7% operating cash flow margin, only slightly improved from the previous year. This is well below the generally 10% margins produced in previous years which were adequate given the scale of its thin-margined research and healthcare operations and low tuition increases. The university has also experienced enterprise-wide operating pressures from rising compensation costs, higher pension costs and non-capitalized capital expenses.

State funding, only 6% of operating revenues, was up nearly 20% in the fiscal 2016 and 2017 biennium to \$302 million and \$342 million, respectively, to offset the tuition reduction and provide for other expenses. The state budgeted another increase to \$352 million for fiscal 2018. The state has not yet passed a capital budget for the 2017-2019 biennium, which includes payment for compensation for some staff that UW is directly paying until passage. There are future state budget pressure from the Supreme Court

of Washington's "McCleary" ruling, including the November ruling that the legislature is not on track to meet its deadline to fully fund K-12 education. The state may provide additional funds in fiscal 2019 which could constrain its funding for higher education.

#### **Wealth and liquidity: growing available funds but thin liquidity; excellent fundraising**

The University of Washington's growing total wealth provides good financial flexibility, with \$5.5 billion of total cash and investments, nearly \$4 billion of which is spendable. The 37% increase in total cash and investments since fiscal 2012 reflects largely fundraising and investment performance. UW has shown real fundraising success, announcing over \$4.3 billion in gift commitments through November toward a \$5 billion campaign goal. The university projects fiscal 2018 fundraising results to outpace fiscal 2017, already a record year. Three-year average gift revenues, based on audited financial results and excluding private grants, were \$245 million for fiscals 2015-2017, with \$304 million for fiscal 2017 alone.

At June 30, 2017, UW's Consolidated Endowment Fund (CEF) totaled over \$3 billion and reported a 13.6% investment return comparable or better than peers. The portfolio allocations are generally consistent with other large endowment portfolios. The university also has \$2.4 billion in operating fund investments (including investments in the CEF). University of Washington Investment Management Company (UWINCO) oversees the CEF and operating funds.

#### **LIQUIDITY**

UW holds \$2.4 billion in operating fund investments, largely cash and treasuries/agencies but including funds invested in the CEF. However, calculated unrestricted monthly liquidity is much lower at \$1.5 billion without the CEF and non-marketable investments. This translates to only 105 days and is down from 122 days the prior year due to an expanded expense base from the blending of Northwest Hospital into its financial results. Liquidity is much lower than Aaa median of 211 days, in part reflecting its large research base funded by reimbursable, largely "just in time" research grants and the health system operating with thin days cash. Already the lowest of the Aaa rated public universities, a continued trend of declining unrestricted liquidity, particularly in the face of higher debt or weaker operating cash flow, could result in rating pressure.

UW's Commercial Paper program is authorized at \$250 million and is rated P-1 based on the university's self-liquidity. At September 30, 2017 UW reported \$776 million of discounted daily liquidity, including one Aaa-mf rated money market fund and US treasuries and agencies. The internal daily liquidity (excluding the largest money market fund) provides a very strong 7.8x of the maximum \$100 million of commercial paper that can mature in one business week.

#### **Leverage: high leverage with moderating near-term future debt issuance; substantial debt-like obligations**

UW's heavy capital investment and debt issuance results in debt metrics at the lower end of the Aaa-rating category. Spendable cash and investments cushion pro forma debt with the Series 2018 bonds only 1.6x, well below the Aaa median of 2.5x. Debt to cash flow is also high at 6.3x compared to the 3.5x median. The university spent over \$3 billion in capital expenditures from fiscal 2012 through fiscal 2017 paid from a number of funding sources, including debt, gifts, state funding and institutional funds.

University leadership revisited debt plans and is limiting debt issuance to about \$330 million through fiscal 2022. However with principal repayment the net increase is about \$121 million. Material issuance above the current plans could result in rating pressure.

#### **DEBT STRUCTURE**

All of UW's long term debt is fixed rate. The university utilizes its \$250 million commercial paper program as an interim financing vehicle, introducing some variable rate exposure but with de minimis risk given the good liquidity and only modest budget exposure.

#### **DEBT-RELATED DERIVATIVES**

None

#### **PENSIONS AND OPEB**

UW has substantial debt-like liabilities through pensions which represent a credit challenge. The pension liability reported for fiscal 2017 under GASB 68 was \$1.4 billion. Moody's adjusted net pension liability (ANPL) at June 30, 2016 was \$3.9 billion, bringing total adjusted pro forma debt to \$6.5 billion. Total adjusted debt to operating revenues of 1.2x is moderately above the 0.85x median for Aaa-rated public universities. However, spendable cash and investments cushion total adjusted debt only 0.6x, well below the Aaa median of 1.6x.

The university contributed a total of \$480 million for pension and healthcare benefits, about \$131 million and \$349 million respectively, for fiscal 2017. This amounts to a substantial 8% of operating expenses. However, most of the payment for healthcare benefits was for current employees, with UW paying only a \$150 subsidy per retiree.

UW offers two contributory pension plans - the Washington State Public Employees Retirement System ("PERS") plan, a defined-benefit retirement plan with three levels, and the University of Washington Retirement Plan ("UWRP"), a defined-contribution plan. The University of Washington Supplemental Retirement Plan, a defined-benefit plan, is closed to employees who were not active participants as of February 28, 2011. UW contributes to PERS, a cost-sharing, multiple-employer, defined-benefit pension plan administered by the State Department of Retirement Systems ("DRS"). For FY 2016, the PERS contribution is 11.18% of payroll.

UW has chosen to not adopt GASB 75 early for reporting its OPEB liability for fiscal 2017. It is reviewing the impact on its financial statements for the fiscal 2018 adoption. The university reports the actuary's allocation of the statewide liability related to UW and Harborview Medical Center, an unconsolidated related party, is \$1.2 billion for fiscal 2017.

**Governance and management: active central governance and management, with strong budgeting and financial oversight**

University of Washington's governance and management are excellent. The Board of Regents is comprised of 10 members, including one student, and includes leaders of major corporations located in the state. The board thoroughly reviews all capital projects and planned borrowings to finance the projects, including borrowing from UW's internal bank. These reviews include project revenue sources for debt service repayment and project staging, checkpoints and "off ramps". Capital projects are integrated into and centrally managed in UW's "One Capital Plan", its comprehensive six-year strategic plan.

UW provides excellent bondholder disclosure posted to both EMMA and its own website. The university has external audits done for its separate organizations.

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