Moody’s
INVESTORS SERVICE

New Issue: Moody's assigns Aaa to University of Washington's $209.4M Series 2015 Bds.; outlook stable

Global Credit Research - 16 Jan 2015

$2.2B rated debt including full CP

UNIVERSITY OF WASHINGTON, WA
Public Colleges & Universities
WA

Moody's Rating

<table>
<thead>
<tr>
<th>ISSUE</th>
<th>RATING</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Revenue and Refunding Bonds, Series 2015A (Taxable)</td>
<td>Aaa</td>
</tr>
<tr>
<td>Sale Amount</td>
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</tr>
<tr>
<td>Rating Description</td>
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<tr>
<td>General Revenue Refunding Bonds, Series 2015B</td>
<td>Aaa</td>
</tr>
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</tr>
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<td>Revenue: Public University Broad Pledge</td>
</tr>
</tbody>
</table>

Moody’s Outlook STA

NEW YORK, January 16, 2015 --Moody’s Investors Service assigns a Aaa rating to University of Washington's (UW) $209 million of General Revenue and Refunding Bonds, Series 2015 A&B. We also affirm the university's issuer level and debt ratings. The outlook is stable.

The University of Washington's (UW) Aaa rating reflects the synergies and strengths of its large-scale research, healthcare and educational operations and revenues. UW is one of the nation's largest research enterprises and one of the two largest healthcare providers in the Seattle region (and the only academic medical center in a five-state region) with generally balanced operating performance and well-diversified revenue streams. Offsetting challenges are growing healthcare operations with narrower margins, high reliance on federal research funding and rising debt levels.

The Aa1 rating on the Lease Revenue Bonds, one level below the General Revenue Bonds, reflects the lease structure for the transaction, including a ground lease for privately-owned property and a facilities lease with a sole purpose corporation as well as limited abatement risk.

The Aa1 rating on the Student Facilities Fee Revenue Bonds, one level below the General Revenue Bond rating, reflects the narrower source of revenue dedicated to repayment.

The Aa2 rating for the Series 2006 TSB Properties Lease Revenue Bonds reflects non-renewal risk of the lease in 2021 and abatement risk.

The P-1 short-term rating reflects ample university self-liquidity for maturing commercial paper.

STRENGTHS

*UW enjoys a strong market position with a large national research profile, solid student demand, and as a major clinical care provider for the Pacific Northwest.
*The board and senior leadership evidence best practices of governance for integrated planning, active debt and project management, and very good disclosure.

*Financial resources provide above average financial flexibility. For FY 2014, $1.7 billion of the total $4.9 billion of financial resources was unrestricted.

*Operations and cash flow are consistently favorable with a 10.5% operating cash flow margin for FY 2014.

CHALLENGES

*The university has moderately high leverage of debt-to-revenues of nearly 0.6 times, with total pro-forma direct debt of $2.4 billion including the fully authorized $250 million of commercial paper and debt of Northwest Hospital and Valley Medical Center.

*With its large research enterprise, UW faces significant revenue and operating pressure from reductions in federal research funding resulting in greater grant competition.

*UW has significant healthcare exposure, with patient care representing 27% of FY 2014 total operating revenue (38% if Northwest Hospital and Valley Medical Center’s revenues were included).

*Pressure is expected on net tuition revenue growth as UW manages its tuition increases and faces frozen undergraduate resident tuition from the proposed biennial state budget.

DETAILED CREDIT DISCUSSION

USE OF PROCEEDS: Proceeds from the General Revenue and Refunding Bonds, Series 2015 A&B will be used to refund outstanding commercial paper, refund all or portions of the outstanding Series 2005 Student Facilities Fee Bonds, the Series 2006 TSB Properties Lease Bonds, and the Series 2007 General Revenue Bonds, and pay issuance costs.

LEGAL SECURITY

Security of the General Revenue Bonds and the General Revenue Notes are General Revenues, including all non-appropriated and non-restricted revenues and fund balances, with $2.64 billion of pledged general revenues and $1.6 billion of general revenue balances. There is no debt service coverage covenant, no debt service reserve fund, and no additional bonds test.

The Aa1-rated Lease Revenue Bonds are secured by UW lease payments from General Revenues to WBRP-3.1. Lease payments are not subject to appropriation or abatement. The lease structure for the transaction includes a ground lease between City Investors XII, a non-affiliated land owner and WBRF3; and a facilities lease between WBRF3 and University of Washington. There is no debt service reserve fund.

The Aa1-rated Student Facilities Fee Revenue Bonds (to be refunded by the current issue) are secured by a superior claim on a mandatory student fee charged to all full- and part-time students for student services.

The Aa2-rated TSB Lease Property Revenue Series 2006 Bonds (to be refunded by the current issue) are secured by UW lease payments from General Revenues to TSB Properties. There is a debt service reserve fund equal to maximum annual debt service. The lease is subject to abatement in the event of damage or destruction of the facilities. There is risk of non-renewal of the lease in year 2021 and abatement risk.

MARKET/COMPETITIVE POSITION: LEADING NATIONAL RESEARCH PROFILE AND STATE’S FLAGSHIP PUBLIC UNIVERSITY

University of Washington will maintain its excellent market position, anchored by its large, national research enterprise and very strong student demand as the state’s flagship university. University of Washington is a leading research enterprise that has maintained its substantial research awards ($1.4 billion in FY 2014), in the face of increasing competition for funding. Recognizing the risks in the funding environment, UW has contingency plans in the event of grant reductions and has operating flexibility from a largely variable expense structure. With its strong reputation and programmatic and funding diversification, UW will remain well-positioned to attract increased research funding and maintain its national research prominence while readily coping with funding reductions.

Enrollment is expected to continue to rise, largely at the Tacoma and Bothell campuses. UW reports nearly 55,000 FTE total enrollment for fall 2014, up steadily since fall 2008 with a nearly 3% increase from fall 2013. Net tuition per student also grew over the same period to $13,987 for FY 2014. We expect UW to show minimal tuition
revenue growth if the governor’s 2015-2017 biennial budget proposal is enacted as, once again, undergraduate resident tuition would be held flat. Some net tuition revenue growth will come from the 31% of total enrollment comprised of non-resident and international students and the one-third of total enrollment who are graduate and professional students.

UNIVERSITY OF WASHINGTON REPORTING GROWING HEALTHCARE ENTERPRISE

UW’s significant healthcare enterprise is a key strategic focus tied to its research and medical education that, with the breadth of services, active management, and university board attention to enterprise risk, should provide continued favorable operating performance.

Patient care of $1.2 billion represents 27% of FY 2014 total revenues ($2.0 billion or 38% if Northwest Hospital and Valley Medical Center, both components units, were consolidated into UW’s results). The 450-bed University of Washington Medical Center (UWMC) is an operating division of the university. UW Medicine’s service area is substantial as the only academic health system and Level 1 trauma care provider for Washington, Wyoming, Alaska, Montana and Idaho (WWAMI). UW's School of Medicine is also the only public medical school for the region, with over 4,700 clinical faculty.

UW’s board invested in the healthcare operations through capital investment and strategic alliances. UW shares ownership of the Seattle Cancer Care Alliance (A2 positive) with Fred Hutchinson Cancer Research Center (A3 negative) and Seattle Children’s Healthcare System (Aa2 stable). It has become the preferred complex tertiary/quaternary health system for PeachHealth hospitals (not rated) and is a preferred partner for The Boeing Company.

OPERATING PERFORMANCE: ADEQUATE CASH FLOW GENERATION, WITH DIVERSIFIED REVENUE STREAMS

UW will continue to produce adequate operating cash flow from its diverse revenues, reflecting its strong fiscal oversight of operations with large research activities, thin healthcare margins and low tuition increases. The three-year average operating margin was 2.4% for FY 2012-2014, down from 4.0% for FY 2010-2012. The 10.5% operating cash flow for FY 2014 was down from 11.7% in FY 2013, but higher than in FY 2012. The thinner operations include higher pension expense, non-capitalized expenses from capital projects and weaker healthcare performance reflecting IT costs and changes in patient utilization from shifting of services across hospitals and the departure of some physicians at NW Hospital. The university projects FY 2015 to be comparable to FY 2014.

UW Medicine should continue to produce at least balanced performance. UW Medicine reported an overall decline in admissions and patient days for FY 2014 from the prior year, although UWMC saw an increase. The total case mix index is also up, driven by UWMC to over 2.1, indicating it is treating sicker patients. Washington’s Medicaid Expansion and Exchange enrollment surpassed expectations, and UW is currently seeing lower-than-budgeted self-pay patients, which should ultimately benefit them.

The State of Washington (rated Aa1, stable) provides only 6% of the university’s operating revenue. State funding increased 20% to $254 million for the current FY 2014-2015 biennium, with the increase partially offsetting the tuition freeze for FY 2014. The governor’s 2015-2017 biennial budget proposal includes additional state funding for UW and, in exchange, a freeze of undergraduate resident tuition. As in prior years, the state directed state agencies, including the university, to identify potential program reductions to meet a 15% cut of general fund costs in the event of state budget pressures. The budget is not expected to be enacted until March 2015 or later. For information about the state, please see Moody’s report of January 12, 2015.

BALANCE SHEET POSITION: BALANCE SHEET RESOURCES PROVIDE SIGNIFICANT FINANCIAL FLEXIBILITY AND CUSHION SUPPORTING HIGH DEBT BURDEN

University of Washington's financial assets will continue to provide a back-stop for its growing debt and operations. For FY 2014, expendable financial resources of $3.6 billion (including net assets of Northwest Hospital and Valley Medical Center) cushioned total $2.43 billion of pro-forma debt (including full CP) by 1.5 times, above prior years. Expendable resources cover operations 0.8 times, up since FY 2012. Although up, balance sheet metrics are below comparably rated institutions. We expect the balance sheet cushion to continue to grow slowly from fundraising, retained surpluses and investment returns.

UW expects to issue up to $200 million in new debt through FY 2018 for campus projects. Currently, assuming staged issuance and continued growth in cash flow and financial reserves, the current debt plans are manageable. However, further issuance above the current plans, particularly with constrained growth in balance sheet
resources or operating cash flow, could result in rating or outlook pressure.

UW's Commercial Paper program is currently authorized at $250 million and is rated P-1 based on the university's self-liquidity. At September 30, 2014, UW reported $1.08 billion of discounted daily liquidity, including Aaa-mf rated money market funds and US treasuries and agencies. The internal daily liquidity provides a strong 4.3 times assuming issuance of the full $250 million authorized amount of CP.

For the fiscal year ended June 30, 2014, UW's Consolidated Endowment Fund (CEF) increased to $2.8 billion ($2.9 billion at September 30, 2014) after a return of 15.8%. The portfolio allocations are generally consistent with other large endowment portfolios. UW Investment Committee (UWINCO), with board members and external investment professionals, advises and board. UW also utilizes Cambridge Associates as the general investment consultant. The investment office has a staff of 20 including investment professionals.

UW also holds $1.6 billion in operating funds, largely cash and treasuries/agencies. FY 2014 unrestricted monthly liquidity of $1.6 billion translated to 146 days, lower than other Aaa-rated institutions, in part reflecting the large research base funded by research grants and expanding healthcare operations that normally have lower days cash.

Although not in an active comprehensive campaign, UW continues to show fundraising strength, with an average of $180 million annually over the three years ended June 30, 2014. In FY 2014 alone there were $198 million in gifts. Average gifts per student are strong at $3,286 for FY 2014.

GOVERNANCE AND MANAGEMENT: ACTIVE CENTRAL GOVERNANCE AND MANAGEMENT, WITH STRONG BUDGETING AND FINANCIAL OVERSIGHT

University of Washington's governance and management demonstrates strengths contributing to its Aaa rating. The Board of Regents is comprised of 10 members, including one student, and includes leaders of major corporations located in the state. The board receives status updates about strategic initiatives and financed projects against projections. UW provides excellent bondholder disclosure that is posted to both EMMA and its own website. The university has external audits done for its separate organizations, including the healthcare organizations, the General Revenues fund and the internal lending bank.

The board thoroughly reviews all capital projects and planned borrowings to finance the projects, both through debt issuance or borrowing from the university's internal bank, including financial review of projects' 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 10-year strategic plan.

OUTLOOK

The stable outlook reflects our expectation that the market position will remain strong supported by a large national research profile, solid student demand and health care presence as well as good gift revenue, manageable near-term borrowing plans and operational flexibility to cope with constrained federal research funding.

WHAT COULD MAKE THE RATING GO UP

Not applicable

WHAT COULD MAKE THE RATING GO DOWN

A downgrade of UW's rating could be driven by substantial debt issuance without growth in balance sheet reserves and revenue; a significant reduction in research funding and revenue, particularly with failure to adjust operating expenses for revenue loss; sustained deterioration in university or medical center operating performance and cash flow.

KEY INDICATORS (FY 2014 financial data, fall 2014 enrollment data)

Full-Time Equivalent Enrollment: 54,857 students
Total Financial Resources: $4.9 billion
Total Cash & Investments: $4.8 billion
Total Direct Debt: $2.3 billion

Total Operating Revenue: $4.4 billion

Reliance on Grants and Contract Revenue (% of Moody's Adjusted Operating Revenue): 29%

Reliance on Patient Care Revenue (% of Moody's Adjusted Operating Revenue): 27%

Reliance on Tuition & Auxiliaries Revenue (% of Moody's Adjusted Operating Revenue): 23%

Monthly Days Cash on Hand: 146 days

Operating Cash Flow Margin: 10.5%

Three-Year Average Debt Service Coverage: 4.27 times

State of Washington Rating: Aa1, stable outlook

RATING METHODOLOGIES

The principal methodology used in this rating was U.S. Not-for-Profit Private and Public Higher Education published in August 2011. An additional methodology used in rating the commercial paper program was Rating Methodology for Municipal Bonds and Commercial Paper Supported by a Borrower's Self-Liquidity published in January 2012. An additional methodology used in rating the lease-revenue bonds was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

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