

## CREDIT OPINION

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# University of Washington, WA

Update following revision to stable

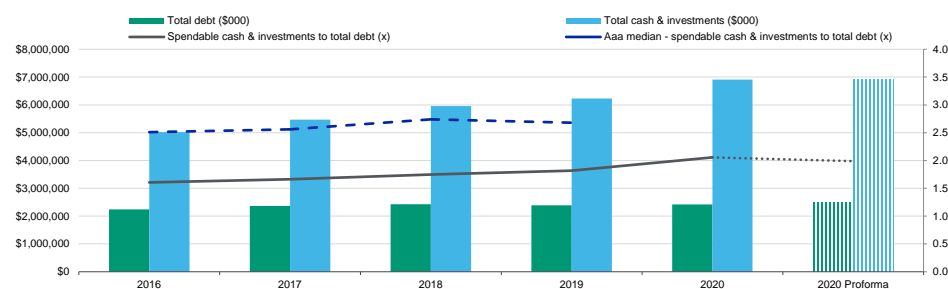
## Summary

[The University of Washington's](#) exceptional credit quality (Aaa stable) reflects the synergies and strengths of its large-scale research, healthcare, and educational operations that support its excellent strategic positioning. As the state's flagship university with a comprehensive array of programs, the university benefits from strong student demand. Its market position is bolstered by a prominent research profile enhanced by its sizable academic medical center. Overall wealth levels are considerable and growing supported by strong fundraising. UW governance and management are strong, including integrated planning and very active oversight. However, the university's operating performance remains exposed to the volatility of its healthcare enterprises compounded by the ongoing challenges related to the coronavirus pandemic. A large and growing pension liability, and comparatively modest liquidity are other offsetting credit considerations.

On January 29, 2021, the rating was revised to stable from negative.

Exhibit 1

### Substantial wealth and conservative debt strategy leads to stable buffer for leverage



Source: Moody's Investors Service

## Credit strengths

- » Sizable scale with a national research profile, strong student demand and major clinical care operations contribute to significant credit strength
- » Very strong overall wealth levels, with \$5.0 billion of spendable cash and investments enhancing financial flexibility
- » Consistently robust fundraising, with \$464 million of gift revenue for fiscal 2020, 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 along with excellent debt and treasury management support the P-1 short-term rating

### Credit challenges

- » Consolidated operating cash flow remains moderate, highly exposed to performance of the healthcare enterprise
- » Large and growing unfunded pension liability adds to leverage
- » Limited tuition pricing flexibility due to state caps on resident undergraduate tuition increases

### Rating outlook

The rating outlook is stable incorporating our expectations that the operating cash flow margin will return to above 8% post-covid, incorporating UW Medicine's improving results, particularly given the consolidation of Northwest Hospital and program to unify and streamline administrative and operating systems. The outlook is also underpinned by our expectations that continued growth in reserves will remain in line with peers and additional borrowing will remain moderate.

### Factors that could lead to an upgrade

- » Not applicable

### Factors that could lead to a downgrade

- » Sustained weakening of operating performance, or revenue pressures on major revenue streams such as patient care, state funding, or research funding
- » Material debt plans beyond those outlined
- » For the short term rating, reduction in same day liquidity, increased calls on liquidity, or weakening of debt and treasury management

### Key indicators

Exhibit 2

	2016	2017	2018	2019	2020	2020 Proforma	Median: Aaa Rated Public Universities
Total FTE Enrollment	56,972	58,155	59,505	59,660	60,829	60,829	59,834
Operating Revenue (\$Billion)	4.9	5.6	5.9	6.2	6.4	6.4	4.2
Annual Change in Operating Revenue (%)	4.1	13.5	5.4	5.8	3.5	3.5	5.4
Total Cash & Investments (\$Billion)	5.0	5.5	6.0	6.2	6.9	6.9	8.1
Total Debt (\$Billion)	2.2	2.4	2.4	2.4	2.4	2.5	2.4
Spendable Cash & Investments to Total Debt (x)	1.6	1.7	1.7	1.8	2.1	2.0	2.7
Spendable Cash & Investments to Operating Expenses (x)	0.7	0.7	0.7	0.7	0.8	0.8	1.4
Monthly Days Cash on Hand (x)	175	150	156	155	167	167	186
Operating Cash Flow Margin (%)	6.3	6.9	10.0	9.9	8.9	8.9	10.3
Total Debt to Cash Flow (x)	7.3	6.2	4.1	3.9	4.2	4.4	4.0
Annual Debt Service Coverage (x)	2.1	2.5	3.3	3.6	3.0	3.0	3.5

Pro forma includes new money borrowing of \$82 million.

Source: Moody's Investors Service

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## Profile

Founded in 1861, the University of Washington is the State of Washington's flagship university with fall 2020 full time equivalent students (FTEs) of 60,829 students on its campuses in Seattle, Tacoma and Bothell. UW's operations are sizable with \$6.4 billion of operating revenue in fiscal 2020. UW is also one of the nation's largest research universities with \$1.6 billion of research awards for fiscal 2020.

UW operates UW Medicine whose service area is broad as the only academic health system and Level 1 trauma care provider for Washington, Wyoming, Alaska, Montana and Idaho (WWAMI). The university's consolidated operations include the now merged University of Washington Medical Center (UWMC) and Northwest Hospital (NWH) with 810 beds. UW Medicine's Harborview Medical Center, owned by King County and managed by the university is not included in university results and Valley Medical Center, a public district hospital managed by UW Medicine under a strategic alliance is reported as a component unit outside the consolidated results.

## Detailed credit considerations

### Market profile: leading national research profile and state's flagship public university anchor excellent strategic position; healthcare enterprise has good market position but challenged performance

The University of Washington will maintain its 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 operations with annual research awards averaging over \$1.5 billion over the five years through fiscal 2020 and growth of 3% in fiscal 2020 reflecting strength in both federal and nonfederal grants. Grants are projected to rise by 5% in fiscal 2021 in part supported by the university's important role in researching the coronavirus. 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.

Student demand remains favorable, based on UW's academic reputation and diversified programs, although with only moderate tuition revenue growth. Enrollment of over 60,000 FTEs is up nearly 7% since fall 2016. Despite conducting most programs online in Fall 2020, enrollment rose by 2.0% reflecting a moderate 1.4% rise in undergraduate and a 3.1% rise in graduate and professional students. In addition, greater in-resident attendance offset some declines in international and out of state graduate students.

The state retains tuition setting authority over resident undergraduate tuition and has limited increases to just over 2% in recent years. A credit negative in the longer term, this is partially mitigated by both nonresident undergraduate enrollment that is about one-third of total undergraduate enrollment and graduate and professional enrollment representing about one-third of total university enrollment. The university draws students internationally that comprise around 12% of the student body.

### Healthcare enterprise adds to scope and reputation, but with some operating challenges

UW's significant healthcare enterprise including the Clinical Enterprise and School of Medicine that are part of the broader UW Medicine operation are key credit drivers due to their scale and importance to UW's strategic position. Medical activities are substantial with \$2.1 billion or 33% of the university's fiscal 2020 consolidated revenue, rising to 39% if Valley Medical center is included. Favorably the healthcare enterprise draws significant research dollars and philanthropy, and, along with its strategic partners, including the Seattle Cancer Care Alliance (SCCA which is jointly owned by Seattle Children's Hospital and Fred Hutchinson Cancer Research Center), and Children's University Medical Group, adds substantially to the prominence of the healthcare sector to the regional economy.

However, UW Medicine continues to experience market and operating challenges from utilization, competition and reimbursement models. These challenges have been exacerbated by the impact of the coronavirus pandemic on their operations. As a result, the hospitals<sup>1</sup> financial performance has been weak and a drag on the university's overall financial performance in recent years. We expect margins to improve in fiscal 2021 as year-to-date figures indicate that elective procedures will be above budget and fiscal 2020 levels. In fiscal 2020, a two-month suspension of elective procedures imposed by the state government because of the coronavirus pandemic severely dampened patient revenue, in part offset by significant federal and state funding, while expenses climbed leading to further erosion of margins.

The integration of UWMC and NWH into one hospital with one license on two campuses, was completed on January 1, 2020 with the aim of improving operating performance, particularly at Northwest Hospital. Further improvements stemming from efficiencies achieved through other reforms such as – the clinical transformation program, "Destination: One", that includes installation of EPIC as the electronic health record platform to be completed in March 2021 and the university's multiyear Project FIT (Financial Improvement and Transformation) to financially stabilize the health system. The FIT project was granted a year extension from its initial completion date of 6/30/2020 and the new completion date has not yet been set.

### **Operating performance: still sound operating cash flow despite pressures from healthcare operations and coronavirus pandemic**

Over the next several years UW's operating cash flow margins will be supported by some improvements in healthcare operations, that will emerge in fiscal 2021 with increased elective procedures, and as auxiliary revenue recovers from the impact of the coronavirus pandemic along with improved cost controls in fiscal 2022.

Fiscal 2020 consolidated operations of a nearly 9% operating cash flow margin were only slightly below the 10% result in fiscal 2019 despite significant challenges related to the impact of coronavirus. Revenue growth of 3.5% was bolstered by healthy increases in government appropriations, grants and contracts, gifts, and sales related to COVID testing, offset by declines in patient revenue and housing and dining fees. The higher rate of growth in expenses, up by 4.6%, because of a rise in salaries and benefits, in part reflected some delays in implementing cost adjustments.

State funding is relatively low at \$415 million or only 6.5% of consolidated operating revenue for fiscal 2020. But it has improved in recent years rising by 63% since fiscal 2015 and is projected to increase by 9.5% in fiscal 2021 in part reflecting emergency funds for COVID. The Governor's proposed 2021-2023 biennial budget includes increases of 6.3% over the two-year period and is slated to be approved in late April following the legislative process. The proposed budget is also supportive through capital grants that would fully fund University requests – double recent years levels – including important healthcare related projects such as the Behavioral Health Teaching Facility.

### **Wealth and liquidity: growing available funds supported by excellent fundraising; liquidity remains relatively thin**

The University of Washington's growing total wealth provides excellent financial flexibility, with \$6.9 billion of total cash and investments of which \$5.0 billion is spendable at year end fiscal 2020. Growth will continue albeit at a slower pace than in recent years with completion of the fundraising campaign. A gradual reduction in the endowment draw to 4.5% by fiscal 2022 will support growth in reserves.

UW has exceptional fundraising success, reaching its goal with \$6.3 billion raised as of fiscal 2020 with the completion of a capital campaign with an initial goal of \$5 billion. Gift revenue has averaged annually over \$404 million over the past three years and reached a high \$464 million in fiscal 2020 including a \$125 million gift from the Bill & Melinda Gates Foundation for the Population Health Initiative.

At June 30, 2020, UW's Consolidated Endowment Fund (CEF) totaled \$3.6 billion, with a 1.1% investment return somewhat below peers in part reflecting its private equity strategy. The portfolio allocations are generally consistent with other large endowment portfolios. The university also has \$2.1 billion in its Invested Funds (IF) for its operating fund investments, which had a return of 3.7%. University of Washington Investment Management Company (UWINCO) including a CIO oversee the CEF and IF.

#### **Liquidity**

UW's liquidity is modestly lower than peers but still sufficient relative to business risks. Unrestricted monthly liquidity at year end fiscal 2020 of \$2.7 billion equates to 167 days (155 days when Medicare Advance and FICA deferrals are excluded) compared to the fiscal 2020 Aaa-rated public universities median of 173 days. This in part reflects its large research base funded by reimbursable, largely "just in time" research grants and the health system operating with thin days cash.

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, 2020 UW reported \$1.8 billion 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 an extremely strong 17x coverage of the maximum \$100 million of commercial paper that can mature in one business week.

In August 2020, the university further bolstered external liquidity with two line of credit agreements of \$100 million each with [Washington Federal Bank, N.A.](#) which provides a revolving loan through August 1, 2023 and [US Bank National Association](#) through August 1, 2022 (a condition precedent to a loan includes a MAC clause and a rating trigger below A3 or equivalent from Moody's, Fitch, and S&P). The University also has a master financing agreement with [JPMorgan Chase Bank](#) to serve as a nonrevolving credit line (LOC) for the financing of short-term assets. The aggregate amount was revised to \$40 million from \$30 million and expires in June 30, 2023. Outstanding borrowings on the credit line as of June 30, 2020 were \$25 million.

#### **Leverage: moderately high leverage with annual issuance in line with amortization**

UW's leverage is manageable and expected to remain stable over the next several years with moderate annual issuance set to average, under \$100 million annually, in line with amortization. In prior years, heavy capital investment and debt issuance drove leverage to higher levels. Pro forma debt includes the proposed \$82 million of new money in series 2021 bonds. Spendable cash and investments buffer pro forma debt nearly 2.0x, just under the 2.3x 2020 Aaa-rated median. Pro forma debt to cash flow at 4.4x is in line with peers.

#### **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 \$3.8 billion of pledged general revenues and \$1.4 billion of general revenue balances. There is no debt service coverage covenant, no debt service reserve fund, and no additional bonds test.

The Lease Revenue Bonds are secured by lease payments made by the University of Washington solely from its General Revenues under a facilities lease between UW and the borrower for the bonds. Lease payments are not subject to appropriation or abatement. There is no debt service reserve fund for any bond series.

#### **Debt structure**

With the issuance of the proposed Series 2021 bonds, planned to be at fixed rates, the bulk of UW's pro forma debt is favorably at fixed rates and amortizing. The remaining exposure to variable rate or tender risk is considered extremely manageable given the sufficient liquidity and only modest budget exposure. Debt outstanding includes \$25 million of commercial paper issued under its \$250 million commercial paper program to be retired later this year.

#### **Debt-related derivatives**

None.

#### **Pensions and OPEB**

UW has substantial debt-like liabilities through pensions which represent a credit challenge. Moody's adjusted net pension liability (ANPL) at June 30, 2020 was an extremely large \$4.3 billion (average over last three years), bringing total adjusted pro forma debt to \$7.2 billion. Total adjusted pro forma debt to operating revenue of 1.1x is in line with the 1.0x median for Aaa-rated public universities. However, the spendable cash and investments buffer for total adjusted debt of only 0.7x is well below the 2019 Aaa median of 1.5x.

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").

In addition to the pension liability, UW reported a \$1.5 billion OPEB liability for fiscal 2020 following adoption of GASB 75. The plan is currently available to employees who elect to continue coverage and pay the premiums at the time of retirement. UW pays only a \$183 monthly subsidy per retiree at the beginning of calendar year 2020.

## **ESG considerations**

### **Environmental**

Environmental considerations are not a key credit driver at this time. However, the university's three campuses are located on geological faults exposing it to potential earthquakes as well as landslides. To mitigate this risk the university builds its facilities to

comply with seismic codes. Rising sea levels and increasingly severe rainfall are other potential risks. The University has implemented disaster preparedness plans.

### Social

Social risks are currently elevated for the broader university community because of the coronavirus pandemic. We regard the coronavirus as a social risk under our ESG framework, given the substantial impact for public health and safety. The university has operated on a largely remote basis, but was still able to grow enrollment in Fall 2020 as increases in resident students offset small declines in international students and students from out of state. In fiscal 2021, with only 40% of students residing on campus, housing and dining revenues and other auxiliary revenue are set to decline significantly. These revenue losses are projected, however, to be more than compensated by increases federal and state funding, patient revenues, and gifts. UW Medicine's financial performance has been significantly affected by reduced revenue, additional costs and operating impacts of the pandemic. In part these have been mitigated by substantial federal and state funding.

UW Medicine is playing a central role in responding to COVID-19, including COVID-19 testing, research and clinical care protocols. UW Medicine is currently are conducting about 40% of all tests in the state. Clinical guidelines developed at UW medicine have been used by other hospitals countrywide and their database on infection, recovery and death projections "IHME" are used by all states. In December 2020, UW Medicine began distribution of the COVID-19 vaccines to its healthcare workers and community providers.

Given the research intensity, the university and its medical enterprises face ongoing cyber risks.

With slow growth projected for high school graduates in Washington state, the University of Washington will continue to face competition for students that is somewhat offset by its flagship status, and larger out of state attendance.

### Governance

Governance is bolstered by the institutional framework which includes strong state oversight, and while funding is comparatively low, it has increased in recent years following reductions in earlier periods. Governance is also enhanced by the importance of the university to the state given its role in economic development. The university's 10-member Board of Regents are appointed by the Governor and, hold their offices for six-year terms and include leaders of major corporations located in the state. The University retains authority to set tuition for graduate students and nonresident undergraduate students, but the Legislature limits increases in tuition for resident undergraduate students and it has risen at just over two percent in each of the 2019-2020 and 2020-2021 academic years.

Active central management, with strong budgeting and financial oversight underpin the university's excellent governance and management. The board thoroughly reviews all capital projects over \$15 million and planned borrowings to finance the projects, including borrowing from UW's internal lending program. 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 "Capital Budget," its comprehensive five-year strategic plan. The board regularly reviews performance and the covenant compliance of the internal borrowers. UW provides excellent bondholder disclosure posted to both EMMA and its own website. The university has external audits done for its separate organizations which enhances discipline in auxiliary operations.

## Rating methodology and scorecard factors

The [Higher Education rating methodology](#) includes a scorecard that summarizes the factors that are generally most important to higher education credit profiles. Because the scorecard is a summary and may not include every consideration in the credit analysis for a specific issuer, a scorecard-indicated outcome may or may not match an assigned rating. We assess strategic positioning on a qualitative basis, as described in the methodology.

Exhibit 3

### University of Washington, WA

Scorecard Factors and Sub-factors	Value	Score
<b>Factor 1: Market Profile (30%)</b>		
Scope of Operations (Operating Revenue) (\$000)	6,412,529	Aaa
Reputation and Pricing Power (Annual Change in Operating Revenue) (%)	3.5	Baa1
Strategic Positioning	Aa	Aa
<b>Factor 2: Operating Performance (25%)</b>		
Operating Results (Operating Cash Flow Margin) (%)	8.9	A1
Revenue Diversity (Maximum Single Contribution) (%)	32.6	Aaa
<b>Factor 3: Wealth &amp; Liquidity (25%)</b>		
Total Wealth (Total Cash & Investments) (\$000)	6,912,248	Aaa
Operating Reserve (Spendable Cash & Investments to Operating Expenses) (x)	0.8	Aa1
Liquidity (Monthly Days Cash on Hand)	167	Aa3
<b>Factor 4: Leverage (20%)</b>		
Financial Leverage (Spendable Cash & Investments to Total Debt) (x)	2.0	Aa2
Debt Affordability (Total Debt to Cash Flow) (x)	4.4	Aa1
Scorecard-Indicated Outcome		Aa1
Assigned Rating		Aaa

Data is based on most recent fiscal year available. Debt may include pro forma data for new debt issued or proposed to be issued after the close of the fiscal year.

For non-US issuers, nominal figures are in US dollars consistent with the Higher Education Methodology.

Reflects fiscal 2020 results and pro forma new borrowing of \$82 million

Source: Moody's Investors Service

## Endnotes

<sup>1</sup> Including primarily University of Washington Medical Center (UWMC) and Northwest Hospital (NWH) that are consolidated into the university's financial statements.

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