

New Issue: Moody's assigns Aa1 to University of Washington's Series 2015 Lease Rev. Bds; outlook stable

Global Credit Research - 15 Sep 2015

\$2.3B rated debt

UNIVERSITY OF WASHINGTON, WA
Public Colleges & Universities
WA

Moody's Rating

ISSUE	RATING
Lease Revenue Bonds, Series 2015A	Aa1
Sale Amount	\$104,565,000
Expected Sale Date	09/24/15
Rating Description	Lease Rental: Other

Lease Revenue Bonds, Series 2015B (Taxable) Aa1

Sale Amount	\$24,455,000
Expected Sale Date	09/24/15
Rating Description	Lease Rental: Other

Moody's Outlook STA

NEW YORK, September 15, 2015 --Moody's Investors Service assigns a Aa1 rating to University of Washington's (UW) \$104.6 million of Lease Revenue Bonds, Series 2015A (maturing 2048) and \$24.5 million of Lease Revenue Bonds, Series 2015B (Taxable) (maturing as a bullet maturity in 2018). The bonds are issued by Washington Biomedical Research Properties (WBRP 3.2). The outlook is stable.

SUMMARY RATING RATIONALE

The Aa1 rating on the Lease Revenue bonds is one level below the Aaa rating on the University of Washington's (UW) Aaa General Revenue Bond rating, reflecting a lease structure for the transaction with no abatement risk, including a ground lease for privately-owned property and a facilities lease with a sole purpose corporation.

The University of Washington's highest 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.

OUTLOOK

UW's stable outlook reflects expectations of a strong market position supported by its large national research profile, strong student demand and regional health care presence as well as good gift revenue, manageable near-term borrowing plans and operational flexibility to cope with constrained federal research funding. It also incorporates expectations of growing balance sheet resources that will provide a growing cushion for debt and operations.

WHAT COULD MAKE THE RATING GO UP

Not applicable

WHAT COULD MAKE THE RATING GO DOWN

- Growth in balance sheet resources lower than Aaa-rated peers, resulting in relatively weaker balance sheet metrics
- Material debt plans beyond those outlined
- Significant reduction in research funding and revenue
- Sustained deterioration in university or medical center operations and cash flow

STRENGTHS

- Significant national research profile, good student demand, major clinical care provider for the Pacific Northwest
- Integrated planning, active debt and project management, and very good disclosure
- Good financial flexibility, with \$1.6 billion of unrestricted financial resources
- Consistently favorable operations, with a 10.5% operating cash flow margin for FY 2014

CHALLENGES

- Increasing leverage, debt issuance outpacing growth of financial resources and revenues
- Slowing growth in net tuition revenues, with the state re-assuming full tuition-setting authority for in-state undergraduate tuition
- Increasingly competitive research funding environment
- Significant healthcare exposure with lower margins and liquidity

RECENT DEVELOPMENTS

Recent developments are included in DETAILED RATING RATIONALE.

DETAILED RATING RATIONALE

MARKET POSITION: LEADING NATIONAL RESEARCH PROFILE AND STATE'S FLAGSHIP PUBLIC UNIVERSITY

University of Washington (UW) will maintain its strong market position, anchored by its large, national research enterprise and good student demand as the state's flagship university. UW is a leading research enterprise, with a substantial \$1.3 billion in research awards in FY 2015. While the research environment is increasingly competitive, UW is well positioned given the scale, diversity, and reputation of its research program. Further, UW has contingency plans to cope with grant reductions and has operating flexibility from its largely variable expense structure.

Student demand will remain healthy, based on the university's academic reputation and diversified undergraduate and graduate programs. Total enrollment has grown by over 9.5% in the last five years. While growth in net tuition revenue has been favorable in recent years due to this enrollment growth and tuition increases, we expect net tuition revenue to moderate over the next several years. The state has re-assumed in-state undergraduate tuition setting authority, and is requiring a 15% decrease in resident undergraduate tuition over the next two years. Increases in state funding will offset this move in the short term, but loss of tuition setting flexibility is a credit negative in the longer term. A partial mitigant is UW's diverse enrollment, with about 30% of incoming freshmen are non-resident and one-third of total enrollment at the graduate and professional level.

Growing healthcare enterprise

UW's significant healthcare enterprise is a key strategic focus tied to research and medical education. With a breadth of services, active management, and university board attention to enterprise risk, we anticipate that healthcare activities will continue to generate positive cash flow and remain a credit additive.

Patient care is substantial with \$1.2 billion or 27% of FY 2014 UW's revenues (up to \$2.0 billion or 38% when including Northwest Hospital and Valley Medical Center, both components units). The 450-bed University of Washington Medical Center (UWMC) is the flagship facility and 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 stable) and Seattle Children's Healthcare System (Aa2 stable). It is one of two preferred partners for The Boeing Company, one of two Accountable Care Programs for state employees in a five county area beginning January 2016 and the preferred complex tertiary/quaternary health system for PeaceHealth hospitals (not rated).

OPERATING PERFORMANCE, BALANCE SHEET, AND CAPITAL PLANS: GOOD CASH FLOW FROM DIVERSIFIED REVENUE STREAMS; RESOURCES PROVIDE GOOD FINANCIAL FLEXIBILITY; LEVERAGE INCREASING

UW will continue to produce good operating cash flow, in the 10-12% range, from its diverse revenues, reflecting strong fiscal oversight offsetting thin-margined research and healthcare operations and low tuition increases. Expense pressures come from higher pension costs and non-capitalized capital expenses.

UW projects FY 2015 to be at least comparable to FY 2014 with improved margins at UW Medicine. UW Medicine exceeded budgeted performance in FY 2015 with strong performance at UWMC, with good demand expected to continue following the opening of significant components of UWMC's tower expansion this year (final completion of the project is expected in October 2017).

The State of Washington (rated Aa1, stable) provides only 6% of Moody's-calculated operating revenue. State funding increased nearly 20% to \$292 million for the current FY 2016-2017 biennium, with the increase largely offsetting the tuition reduction. The increase also provided for general wage increases and for STEM and healthcare education funds. However, pressure on the state budget may arise as the state looks to fully fund K-12 education costs as compelled under the Supreme Court of Washington's "McCleary" ruling.

The University of Washington's financial assets provide excellent flexibility, with \$4.9 billion of total financial resources at the end of FY 2014, \$1.6 billion of which was unrestricted. Total financial resources have grown by nearly 50% over the past five years, and are expected to increase further based on cash flow and fundraising.

Although currently not in an active comprehensive campaign, UW continues to generate strong gift flow, averaging \$180 million annually over the three years ended June 30, 2014. The university reports another strong year for FY 2015. UW is in the early stages of a comprehensive campaign, with a tentative \$4.0 billion goal.

Capital spending has been high as the university has invested in student housing among other initiatives, with over \$2.4 billion invested in plant from FY 2010-2014. While the university has benefitted from a mix of funding sources, outstanding debt has increased substantially over this same time frame, from a comparatively low \$1.2 billion in FY 2010 to over \$2.5 billion on a pro-forma basis. Pro-forma debt includes the Series 2015 Lease Revenue Bonds, the recently issued Series 2015 C/D GRBs, and assumes full issuance of \$250 million of Commercial Paper.

While this debt level currently remains manageable, with maximum debt service consuming less than 5% of operations, UW's leverage metrics are now at the lower end of the Aaa-rating category. Debt issuance is expected to moderate, with management projecting to issue about \$70 million in new debt through FY 2018 for campus projects. This would more than be offset by principal repayments. However, material issuance above the current plans given the increase in leverage over the past five years could result in rating or outlook pressure.

Liquidity

UW 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 reimbursable research grants and expanding healthcare operations normally with lower liquidity. Liquidity is projected to be higher for June 30, 2015.

At June 30, 2015, UW's Consolidated Endowment Fund (CEF) increased to \$3.1 billion from \$2.8 billion at June 30, 2014 and reported a 6.8% twelve-month investment return, well above peer institutions. The portfolio allocations are generally consistent with other large endowment portfolios. UW Investments Office is appropriately

staffed for the complexity of the endowment, with over 20 investment and operational professionals, and additional oversight and expertise provided by investment advisory committee members and external investment professionals. On September 10, 2015, UW's board announced the formation of University of Washington Investment Management Company (UWIMCO), which will oversee the CEF.

DEBT STRUCTURE AND LEGAL COVENANTS

Debt Structure

All of UW's long term debt is fixed rate. The university does use 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 significant pension and benefit costs which represent a credit challenge. The university expensed a total of \$467 million for pension and healthcare benefits, \$179 million and \$288 million respectively, for FY 2014. This amounts to a very substantial 11% 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 on 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, UW's contribution is 11.18% of payroll.

For June 30, 2014 PERS Plan 1 has a participating employers' net pension liability of \$5.04 billion, representing 61% funding. PERS Plan 2 and Plan 3, with a defined contribution plan, have a participating employers' net pension liability of \$2.02 billion with over 90% funding. UW projects it will report a \$830 million decrease in its Fiscal Year 2015 Beginning Unrestricted Net Position due to the implementation of GASB 68, which includes approximately \$250 million for Harborview, a related party owned by King County and excluded from UW's financial results. However, as all of the Harborview employees are university employees, UW is required to include the Harborview employees in the related pension liability in its financial results.

UW employees are provided OPEB retirement benefits through the Washington State Health Care Authority. Premiums are calculated on a pay-as-you-go basis. UW is only required to pay a \$150 subsidy for each retiree.

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

University of Washington's governance and management are excellent, 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 thoroughly reviews all capital projects and planned borrowings to finance the projects, both through debt issuance or borrowing from UW'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.

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.

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 Pro-Forma Direct Debt: \$2.5 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: 3.6 times
- State of Washington Rating: Aa1, stable outlook

OBLIGOR PROFILE

Founded in 1861, University of Washington is the state's flagship university with more than 50,000 FTE students on its campuses in Seattle, Tacoma and Bothell. UW's operations are sizable with \$4.4 billion of operating revenues. UW is also one of the nation's largest research universities with \$1.3 billion of research awards for fiscal year 2015. The university operates UW Medicine, with nearly \$2 billion of revenues and includes University of Washington Medical Center.

LEGAL SECURITY

The Series 2015A and B Lease Revenue Bonds (for WBRP 3.2) are secured by lease payments made by University of Washington solely from its General Revenues, under a facilities lease between UW and WBRP 3.2. UW's obligation to pay the lease payments is on parity with the other Aa1-rated lease revenue bonds - the Series 2005E, 2006J and Series 2014 bonds (for WBRP II), the Series 2013 bonds (for WBRP I) and the Series 2010B (for WBRP 3.1). General Revenues include 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 for FY 2014. The General Revenues are also pledged for UW's General Revenue Bonds (rated Aaa), General Revenue Notes (rated P-1) and for the lease payments for the TSB Lease Property Revenue Bonds (rated Aa2). Lease payments are not subject to appropriation or abatement. There is no debt service reserve fund for any bond series.

The borrower, WBRP 3.2, is a single purpose not-for-profit corporation related by management to the National Development Council. The Council creates sole purpose subsidiaries that enter into financing leases with UW for individual projects. Given that each subsidiary is a sole-purpose entity with no operating risk, the lessor is deemed to be bankruptcy remote.

For the Series 2015 bonds, WBRP 3.2 entered into a ground lease with City Investors XII LLC, the property owner on July 30, 2010 that was extended as of September 30, 2015 and terminates May 31, 2063. The Ground Lessor has the right to terminate the ground lease if construction has not commenced by early- to mid-2019. WBRP entered into a facility lease with UW for the new biomedical research building also terminating May 31, 2063 subject to a 5-year extension. The university is obligated under the facilities lease to begin paying base rent and a lump sum payment on March 1, 2018. WBRP assigned its interest in the lease to the Trustee, including UW's lease payments. At the end of the lease term, the property reverts to City Investors XII, the property owner. There is no debt service reserve fund.

For information on the legal security for UW's other rated debt, see Moody's report dated September 2, 2015.

USE OF PROCEEDS

Proceeds of the Series 2015 Lease Revenue Bonds will fund the costs of construction and furnishing a biomedical research facility in South Lake Union, pay capitalized interest, and pay issuance costs. The project is the second part of the third phase of a multi-phase development of a campus of biomedical research facilities leased by UW's School of Medicine.

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 this rating 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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