University of Washington

New Issue: Moody’s Assigns Aaa to University of Washington's Series 2016 General Revenue Bonds; Outlook Stable

Summary Rating Rationale

Moody’s Investors Service has assigned a Aaa to University of Washington’s (UW) proposed $188.1 million of General Revenue and Refunding Bonds, 2016A (maturing 2046) and $10.2 million of General Revenue Refunding Bonds, 2016B (Taxable) (maturing 2036). We have also affirmed the university’s Aaa issuer rating, the Aaa on $1.6 billion of rated General Revenue Bonds, the Aa1 on $396 million of Lease Revenue Bonds, and the P-1 on the university’s commercial paper program ($250 million authorization) supported by its own liquidity. The outlook is stable.

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 pressuring consolidated performance, high reliance on federal research funding and rising leverage.

The Aa1 rating on the Lease Revenue bonds is one level below the General Revenue Bonds’ Aaa 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 P-1 short-term rating reflects ample university self-liquidity for maturing commercial paper.
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Exhibit 1
University of Washington Maintains a Dominant Research Position Among Aaa Peers
Grants and Contracts as % of Total Operating Revenues

Credit 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 $3.9 billion of spendable cash and investments
- Ample and growing pledged revenues
- Strong self-liquidity supporting the P-1 short-term rating

Credit Challenges

- Pressured operations from healthcare enterprise, with the university projecting a modest deficit for the recently completed FY 2016
- Balance sheet leverage higher than peers as debt issuance outpaced growth of reserves and revenues
- Unrestricted liquidity lower than peers
- Slowing net tuition revenue growth, with the state requiring a tuition reduction for undergraduate residents in exchange for receiving higher appropriations
- Increasingly competitive research funding environment

Rating 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. We also anticipate no significant debt plans in the near term beyond those outlined and operational flexibility to cope with constrained federal research funding. It also incorporates an expectation of stable unrestricted liquidity and slowly growing balance sheet resources that will provide a growing cushion for debt and operations.

Factors that Could Lead to an Upgrade

- Not applicable

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Factors that Could Lead to a Downgrade

» Weakened balance sheet metrics from growth of cash and investments lower than Aaa-rated peers
» Continued trend of declining unrestricted liquidity
» Material debt plans beyond those outlined
» Sustained deterioration in consolidated operations and cash flow
» Significant reduction in research funding and revenue

Key Indicators

Exhibit 2

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<td>Total FTE Enrollment</td>
<td>50,579</td>
<td>51,400</td>
<td>53,380</td>
<td>54,858</td>
<td>55,963</td>
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<td>Operating Revenue ($000)</td>
<td>3,876,400</td>
<td>3,926,641</td>
<td>4,190,984</td>
<td>4,401,513</td>
<td>4,702,687</td>
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<td>Annual Change in Operating Revenue (%)</td>
<td>6.4</td>
<td>1.3</td>
<td>6.7</td>
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<td>6.8</td>
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<td>Total Cash &amp; Investments ($000)</td>
<td>4,027,627</td>
<td>4,008,783</td>
<td>4,379,590</td>
<td>4,947,767</td>
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<td>Total Debt ($000)</td>
<td>1,546,531</td>
<td>1,736,056</td>
<td>2,047,276</td>
<td>2,228,901</td>
<td>2,078,546</td>
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<td>Spendable Cash &amp; Investments to Total Debt (%)</td>
<td>1.9</td>
<td>1.7</td>
<td>1.6</td>
<td>1.7</td>
<td>1.9</td>
<td>1.8</td>
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<td>Spendable Cash &amp; Investments to Operating Expenses (%)</td>
<td>0.8</td>
<td>0.8</td>
<td>0.8</td>
<td>0.9</td>
<td>0.8</td>
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<tr>
<td>Monthly Days Cash on Hand (x)</td>
<td>184</td>
<td>145</td>
<td>157</td>
<td>150</td>
<td>129</td>
<td>129</td>
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<tr>
<td>Operating Cash Flow Margin (%)</td>
<td>11.7</td>
<td>9.3</td>
<td>11.7</td>
<td>10.5</td>
<td>9.9</td>
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<tr>
<td>Total Debt to Cash Flow (%)</td>
<td>3.4</td>
<td>4.7</td>
<td>4.2</td>
<td>4.8</td>
<td>4.5</td>
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<td>Annual Debt Service Coverage (%)</td>
<td>5.6</td>
<td>4.5</td>
<td>5.0</td>
<td>3.1</td>
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*Total FTE Enrollment is fall enrollment
*2015 Sensitivity includes Series 2016 bonds and assumed $125M CP
Source: Moody's Investors Service

Detailed Rating Considerations

Market Profile: Leading National Research Profile and State’s Flagship Public University Anchor Excellent Strategic Position
University of Washington (UW) will maintain its strong market and excellent strategic positions anchored by its large, national research enterprises and good student demand as the state’s flagship university. UW has one of the nation’s largest research enterprises, with a substantial almost $1.4 billion in research awards in FY 2016. UW is well positioned given the scale, diversity, and reputation of its research program to continue its research success in an increasingly competitive research environment. In the event of grant reductions, UW has contingency plans to cope, with operating flexibility from its largely variable expense structure.

Student demand will remain solid, based on UW’s academic reputation and diversified undergraduate and graduate programs. Total enrollment has grown by 11% from fall 2011 to fall 2015, with additional growth expected for the current fall 2016 quarter. Following favorable growth in net tuition revenue in recent years from rising enrollment and tuition increases, we expect net tuition revenue to moderate over the next several years. The state re-assumed in-state undergraduate tuition setting authority and required a 15% decrease in resident undergraduate tuition in FY 2016 and 2017. Increased state funding largely offsets the tuition reduction, but loss of tuition setting flexibility is a credit negative in the longer term. A partial mitigant is UW’s diverse enrollment, with about 32% of incoming freshmen non-resident and 28% of total enrollment at the graduate and professional level.
Growing healthcare enterprise

UW's significant healthcare enterprise (UW Medicine) 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 generate positive cash flow and remain a credit additive to UW's profile.

Patient care is substantial with $1.36 billion or 29% of FY 2015 UW's revenues (up to $2.2 billion or 38% when including Northwest Hospital and Valley Medical Center, both component units) that will increase with rising patient utilization. The 529-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. Effective this FY 2017, Northwest Hospital, currently a component unit of the university, will be consolidated in the university's financial results due to the governance structure under the GASB 80 guidance. Valley Medical Center will remain a discrete component unit.

UW's board invested in the healthcare operations through capital investment and strategic alliances. UW shares ownership of the Seattle Cancer Care Alliance with Fred Hutchinson Cancer Research Center and Seattle Children's Healthcare System. It is one of two preferred partners for The Boeing Company, and one of two Accountable Care Programs for state employees in a five county area. UW Medicine is also affiliating with regional hospitals for tertiary/quaternary referrals and expanding its network of primary care clinics throughout the greater Seattle area. Patient utilization rose at UWMC, Valley and Northwest over the past four years, with the trend expected to bolstered by the affiliations.

Operating Performance: Adequate Cash Flow From Diversified Revenue, With Some Pressure From Weaker Healthcare Operations

UW will continue to produce adequate 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. Operations will continue to be pressured from the weaker healthcare enterprise, higher pension costs and non-capitalized capital expenses.

UW projects FY 2016 to be slightly lower compared to FY 2015 due to an expected operating deficit at UW Medicine from the late FY 2016 opening of significant components of UWMC's tower expansion. The university expects patient demand and healthcare revenues to continue to grow with the expansion (final completion of the project is expected in FY 2018).

The State of Washington provides only 5% of Moody's-calculated operating revenue. State funding increased in the current FY 2016 - FY 2017 biennium nearly 20% to $341 million for FY 2016 and is budgeted for $332 million for FY 2017, 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.

Wealth and Liquidity: Good Financial Flexibility; Leverage Increasing

The University of Washington's total wealth provides good financial flexibility, with $5.2 billion of total cash and investments, of which $3.9 billion spendable cash and investments are not considered restricted and non expendable. Total cash and investments grew about 30% over the past five years, and, although FY 2016 is likely to be flat with weak investment returns, future growth is expected based on cash flow and fundraising.

UW expects to formally announce a comprehensive campaign on October 21, 2016. With an intended June 30, 2020 end, the campaign will have a goal of at least $4 billion. The university reports it received $249 million in private gifts in FY 2016. Three-year average gift revenues, based on audited financial results, were nearly $197 million for FY 2013-2015.

At June 30, 2016, UW's Consolidated Endowment Fund (CEF) stood at nearly $3.0 billion, down slightly from the prior year, with an investment return comparable or better than peers. The portfolio allocations are generally consistent with other large endowment portfolios. The university also has $2.35 billion in operating fund investments (including $731 million invested in the CEF). UW Investments Office is appropriately staffed for the complexity of the endowment, with additional oversight and expertise provided by...
investment advisory board members and external investment professionals. In September 2015, UW’s Board of Regents announced the formation of University of Washington Investment Management Company (UWINCO), which will oversee the CEF.

LIQUIDITY
UW holds $2.35 billion in operating fund investments, largely cash and treasuries/agencies but including funds invested in the CEF. FY 2015 unrestricted monthly liquidity of $1.5 billion translated to 129 days, lower than peer 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 show a small decrease for June 30, 2016. 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 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 June 30, 2016, UW reported $1.02 billion of discounted daily liquidity, including Aaa-mf rated money market funds and US treasuries and agencies. The internal daily liquidity (excluding the largest money market fund) provides a strong 9.5 times assuming $125 million outstanding commercial paper over the next six to twelve months.

Leverage: Growing Leverage, With Significant Near-Term Future Debt Issuance
UW’s capital spending is high as it has invested in student housing and other capital initiatives, with $2.5 billion invested in plant from FY 2011-2015. While the university has benefitted from a mix of funding sources, outstanding debt has increased substantially over this same time frame from $1.5 billion in FY 2011 to over $2.4 billion pro forma (assuming $125 million CP issuance over the next 12 months).

Currently 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. Management now projects about $2.7 billion of capital projects from 2017 to 2023 and anticipates issuing about $225 million of debt in FY 2018 for campus projects. Principal repayments will offset some of the debt increase. However, material issuance above the current plans given the growing leverage could result in rating or outlook 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 in the FY 2015 audit under GASB 68 was $623 million. Moody’s adjusted net pension liability (ANPL) at June 30, 2015 was $3.2 billion, bringing total adjusted pro forma debt to $5.6 billion. Total adjusted debt to operating revenues of 1.2 times is comparable to the median for all rated public universities, but above the 0.7 times median for Aaa-rated public universities.

The university contributed a total of $386 million for pension and healthcare benefits, about $134 million and $248 million respectively, for FY 2015. 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 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, the PERS contribution is 11.18% of payroll.

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 six-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.

The university installed a new president, its former provost and executive vice president serving as interim president, in October 2015. In June 2016 UW named its provost, a long-standing faculty member serving as interim provost.

**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 $3.0 billion of pledged general revenues and $864 million 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 University of Washington solely from its General Revenues under a facilities lease between UW and the borrower for the bonds. General Revenues include all non-appropriated and non-restricted revenues and fund balances. Lease payments are not subject to appropriation or abatement. There is no debt service reserve fund for any bond series.

All borrowers are single purpose not-for-profit corporations 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 each bond series, the borrowers enter into a ground lease with City Investors XII LLC, a non-affiliated land owner. WBRP assigns its interest in the leases 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.

**Use of Proceeds**
Proceeds from the 2016A and 2016B General Revenue Bonds will be used to provide funds for capital projects and refund outstanding commercial paper previously issued to partially finance those projects; to advance refund a portion of the outstanding General Revenue Refunding Bonds, 2008; and to pay issuance costs.

**Obligor Profile**
Founded in 1861, University of Washington is the state’s flagship university with nearly 56,000 FTE students on its campuses in Seattle, Tacoma and Bothell. UW’s operations are sizable with $4.7 billion of operating revenues. UW is also one of the nation’s largest research universities with nearly $1.4 billion of research awards for fiscal year 2016. The university operates UW Medicine, with $2.2 billion of revenues (including University of Washington Medical Center, Valley Medical Center and Northwest Hospital).
Methodology
The principal methodology used in this rating was Global Higher Education published in November 2015. The additional methodology used in the lease rating was Lease, Appropriation, Moral Obligation and Comparable Debt of US State and Local Governments published in July 2016. The additional methodology used in the commercial paper rating was Rating Methodology for Municipal Bonds and Commercial Paper Supported by a Borrower’s Self-Liquidity published in January 2012. Please see the Rating Methodologies page on www.moodys.com for a copy of these methodologies.

Ratings

Exhibit 3

University of Washington, WA

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<td>General Revenue &amp; Refunding Bonds, 2016A</td>
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Source: Moody’s Investors Service
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