



New Issue: MOODY'S ASSIGNS Aa3 RATING TO UNIVERSITY OF ROCHESTER'S (NY) \$163 MILLION OF SERIES 2011A AND B BONDS; OUTLOOK IS STABLE

Global Credit Research - 11 Aug 2011

RATINGS AFFIRMED ON \$781 MILLION OF PRO-FORMA RATED DEBT BACKED BY THE UNIVERSITY, INCLUDING THE CURRENT OFFERING

Monroe County Industrial Dev. Corp., NY
Higher Education
NY

Moody's Rating

ISSUE	RATING
Series 2011A Tax-Exempt Revenue Bonds	Aa3
Sale Amount \$124,000,000	
Expected Sale Date 08/15/11	
Rating Description Private University Revenue Bonds	
Series 2011B Tax-Exempt Revenue Bonds	Aa3
Sale Amount \$39,000,000	
Expected Sale Date 08/15/11	
Rating Description Private University Revenue Bonds	

Moody's Outlook Stable

Opinion

NEW YORK, Aug 11, 2011 -- Moody's Investors Service has assigned a Aa3 rating to the University of Rochester's \$163 million combined tax-exempt, fixed-rate Series 2011A and B Revenue Bonds to be issued through the Monroe County Industrial Development Corporation. The rating on the University's previously issued debt backed by the University's general obligation has also been affirmed. The outlook is stable.

Moody's also maintains an A2 rating on Highland Hospital's bonds. Highland Hospital is a wholly owned subsidiary of the University.

SUMMARY RATING RATIONALE

The Aa3 rating reflects the University's role as a large private research university in upstate New York with an improving student market position and prominent health care system providing unique clinical services to the region. Strong management is highlighted by the University's consistently positive operating performance and healthy cash flow. These credit strengths are counterbalanced by longer-term capital needs which will require borrowing as well as expendable resources providing a moderate cushion for a large expense base.

STRENGTHS

- Large and diversified enrollment base (9,050 full-time equivalent students in fall 2010) with steady growth in applications allowing the University to become increasingly selective (36% freshmen selectivity for fall 2011 entering class);
- Consistently positive operating performance and healthy operating cash flow generation by the University as a whole (three year average operating margin of 2.3%), including operating surpluses at the health system;
- Fundraising and positive endowment returns in FY 2010 and 2011 contributing to balance sheet strengthening with \$1.6 billion of total financial resources in FY 2010;

CHALLENGES

- Significant healthcare exposure, including hospital ownership and large faculty practice plan with patient-care related revenue of \$1.7 billion in FY 2010 (June 30, 2010) comprising 65% of operating revenue (Moody's adjusted);
- Highly competitive environment for students as highlighted by 24.1% average freshmen matriculation ratio during fall 2006-2010 (percentage of admitted students who chose to enroll);
- Expendable financial resources of \$1.3 billion providing a moderate cushion for a large expense base (\$2.5 billion of expenses in FY 2010); unrestricted monthly liquidity would provide 142.6 days cash on hand for the entire University (compared to a median of 293 days for Aa-rated large private universities in FY 2010).

DETAILED CREDIT DISCUSSION

USE OF PROCEEDS: Approximately \$149 million (par amount) of bond proceeds will be new money and used for a variety of capital projects,

including but not limited to a new undergraduate residence hall (150 beds), an addition to the cancer center, dining center renovations, and various other campus renovations. Bond proceeds will also current refund the Series 2001A bonds and pay for costs of issuance and capitalized interest (approximately \$3.2 million).

LEGAL SECURITY: Payments under the Loan Agreement are an unsecured general obligation of the University.

DEBT-RELATED INTEREST RATE DERIVATIVES: The University has several swaps outstanding related to its variable rate bonds, with a combined notional amount of \$234.2 million. The swap counterparties are diversified among three counterparties, Wells Fargo (\$60 million notional amount), Citibank (\$63 million), and Merrill Lynch (\$111 million). The total fair value for the swap portfolio as of July 21, 2011 was negative \$26.9 million to the University, with no collateral posted at that valuation date. The University could be required to post collateral if the fair value of individual swaps exceeds threshold levels, although the University has never had to post collateral to its swap counterparties to-date. Based on a stress test of low interest rates provided by management, including rates dropping to 0%, the University is unlikely to be required to post a material amount of collateral.

MARKET POSITION/COMPETITIVE STRATEGY: GROWTH OF ENROLLMENT AND NET TUITION PER STUDENT HIGHLIGHT HEALTHY STUDENT MARKET POSITION; HEALTHCARE SYSTEM MAINTAINS MARKET LEADERSHIP

Moody's believes that the University of Rochester's student market position has strengthened over time, as highlighted by enrollment growth, improved selectivity, ongoing geographic diversification of student body, and growth of net tuition per student. However, as a large private research university located in upstate New York, the University faces strong competition, particularly from the multitude of other private as well as public universities in the northeast. In fall 2010, the University enrolled 9,050 full-time equivalent (FTE) students, an increase of nearly 13% since fall 2006 with notable growth in the undergraduate program. The University offers a diverse array of undergraduate, graduate and professional degrees, including schools of engineering, medicine, nursing, dentistry and business as well as the Eastman School of Music. In fall 2010, approximately 60% of FTE students were undergraduates.

Although the University faces strong competition from other educational institutions, management has continued to improve and expand the University's reputation, with improvements in freshmen selectivity (36% for fall 2011 compared to 53% in fall 2002). Freshmen matriculation (percent of admitted students who enroll) has averaged close to 24% over the past five years, which is an improvement over earlier years but highlights the strong competitive environment for students. Moody's believes the improvement in yield rate, coupled with ongoing growth in net tuition per student (\$21,085 in FY 2010), positions the University more favorably for a more challenging student recruitment and financial aid environment. The University has also successfully attracted a more geographically diverse student body, with approximately 60% of the fall 2011 entering freshmen class drawn from outside New York state (compared to 49% in fall 2004). Further, management reports that close to 15% of the entering class is drawn from outside the U.S.

The largest portion of the University's consolidated operations is comprised of its academic medical center, University of Rochester Medical Center, which includes Strong Memorial Hospital (SMH, 749 beds), the schools of medicine, dentistry and nursing, and a large faculty practice plan (over 1,000 physicians and over 875,000 physician visits in 2010). Further, the University is the sole corporate member of Strong Partners Health System, which is the sole corporate member of Highland Hospital (HH), a 261 bed hospital. Highland's debt is separately secured and not a legal obligation of the University. Moody's maintains a separate rating on Highland Hospital's rated debt of A2 with a stable outlook.

SMH continues to maintain its role as a regional referral center providing high-end exclusive services, ensuring its status as an essential provider in the area. SMH maintains close to 40,000 annual discharges including newborns (plus another 9,000 to 10,000 observation stays). Management reports that SMH and HH maintain a combined 53.8% market share of the four county primary service area, well ahead of Rochester General Hospital's 30% and Park Ridge Hospital's 16.2% market share. We expect that SMH's patient volumes will continue to increase as a result of its strong reputation and planned expansion of clinical facilities, with management reporting occupancy at SMH already exceeding 90%.

OPERATING PERFORMANCE: TRACK RECORD OF CONSISTENTLY POSITIVE OPERATING PERFORMANCE BY THE UNIVERSITY AS A WHOLE IS A KEY CREDIT STRENGTH

Moody's expects the University of Rochester to maintain at least balanced operating performance, although heavy reliance on healthcare operations and research grants indicates some potential for volatility in performance over the long term especially in light of uncertainty over the ultimate impact of federal healthcare reform and planned federal budget cuts. Our affirmation of the Aa3 rating and stable outlook heavily incorporates confidence in the University's management and governance, and its track record of budgeting conservatively, containing expenses, improving operating efficiencies, and achieving positive margins on a consolidated university-wide basis. In response to the economic downturn in 2008-2009, management took a variety of steps, including a reduced endowment draw (lower than spending policy would allow), implementation of a salary freeze, extensive cost reductions, as well as slowed capital spending.

On a consolidated basis, the University generated an average annual operating margin of 2.3% during FY 2008-2010. Operating cash flow margins have historically ranged from 8% to 10% annually with average debt service coverage of 3.1 times in FY 2010 (June 30 fiscal year end). Including a large principal payment related to a New Markets Tax Credit financing scheduled for FY 2018, the University's cash flow in FY 2010 would cover maximum annual debt service (\$123.9 million) a healthy 2.2 times. Based on management's unaudited financial projections, we expect another operating surplus in FY 2011.

The University's revenue sources are varied, but concentrated in healthcare activities, including patient care revenue generated at the hospitals as well as the faculty practice plan (65% on a Moody's adjusted basis). In addition, grant and contract revenue, primarily reflecting the research activity of the University, represents close to 16% of operating revenues, with student derived tuition and auxiliary service revenue representing just 10.8% of Moody's adjusted operating revenue in FY 2010. As such, the University's ability to sustain balanced or positive operating performance is highly reliant on the continued strong performance of the healthcare enterprises, primarily Strong Memorial Hospital and Highland Hospital, which we expect will continue.

Operating performance at the hospitals continues to be strong, with SMH generating a 5.6% operating surplus during the 12 months ending December 31, 2010 excluding transfers to the school of medicine. Incorporating a \$29.7 million internal transfer to the school during calendar year 2010, SMH had a 2.8% operating margin and 7.9% operating cash flow margin in 2010, on a \$1.066 billion operating revenue base. As of December 31, 2010, SMH had 103 days cash on hand, and as of June 30, 2011, SMH maintained close to \$266 million in unrestricted cash and investments. SMH's payer mix (net revenue by payer) includes: 30% Medicare, 16% Medicaid, 28% Blue Cross, 8% MVP Healthcare, and 18% to others including other private insurers and self-pay patients. We believe that the Medical Center's management team budgets conservatively and is building contingencies into the budget to help cushion against future anticipated pressure on revenue, particularly Medicare and Medicaid

exposure. We expect that patient volume and clinical revenue will grow as a result of planned capital expansion, including a vertical expansion of the cancer center, the construction of a separate children's hospital (currently housed within the SMH facility), and a total net increase of 73 beds across the projects.

University of Rochester is a member of the Association of American Universities (AAU), and as such maintains a sizeable research program, with over \$300 million of research expenses in FY 2010, per the audited financial statements. The University's volume of competitively awarded grants from the National Institutes of Health (NIH) has steadily increased over time. The University was awarded \$62.8 million in federal stimulus funding (ARRA) for research which was largely expended in FY 2010 and 2011. Patent and royalty income also represents an important source of revenue with close to \$39 million of royalty income in FY 2010. We expect that this royalty revenue stream may decline as a result of the expiration of one large patent.

BALANCE SHEET POSITION: GROWTH OF FINANCIAL RESOURCES IN FY 2010 AND 2011 AS A RESULT OF POSITIVE OPERATIONS AND ENDOWMENT PERFORMANCE AND ENHANCED FUNDRAISING

Moody's believes that the University's consolidated financial resource base (\$1.6 billion of total financial resources in FY 2010) provides adequate support for debt and operations. However, FY 2010 expendable financial resource coverage of pro-forma debt and operations (1.45 times and 0.5 times) is weaker than the medians for the Aa-rating category. We expect that ongoing positive operations, strong endowment management, and enhanced fundraising will continue to strengthen these balance sheet ratios. Close to 80% of the University's financial resources is expendable (unrestricted and temporarily restricted) providing additional financial flexibility. With the implementation of UPMIFA in New York State, we anticipate that approximately \$220 million of unrestricted net assets will be reclassified to temporarily restricted in the FY 2011 audited financial statements.

The University's liquidity remains healthy, with management reporting over \$928 million of unrestricted cash and investments which could be liquidated within a month as of June 30, 2010. This unrestricted monthly liquidity would cover 142.6 days of cash expenses. Further, the University has three committed operating lines of credit from three separate banks with a combined \$175 million authorized and only \$1 million drawn as of June 30, 2011.

The University's endowment management is overseen by an internal investment office as well as the investment committee of the Board of Trustees. The long-term investment pool has a sizeable allocation to alternative investments, and as of May 31, 2011 management reports endowment asset allocation of 32.5% to public equities (16.4% domestic equity and 16.1% international equity), 21.8% to hedge funds, 15.1% to real assets, 22% to private equity, and 8.6% to fixed income instruments. The University's largest manager allocation is to a single, traditional, long-only domestic equity and fixed income manager and totals 6.3% invested with one manager. After experiencing endowment losses in FY 2008 and 2009 (-0.1% and -19.8%, respectively), endowment performance was positive in FY 2010 (12.1%) and FY 2011 (18.2% for the first 11 months of FY 2011). Strong endowment performance in FY 2010 and 2011 has contributed to growth of financial resources, with management estimating approximately \$2.6 billion of total net assets as of March 31, 2011 (unaudited), up from \$2.38 billion in FY 2010. The University's endowment spending has been high in the past (as high as 6.7% of the five year moving average of the endowment in FY 2006), and management is targeting a reduced draw with an ultimate goal closer to a 5.5% draw.

In FY 2010, the University had 33.5% of its total debt issued in a variable rate mode, although the variable rate demand debt is largely hedged with interest rate swap agreements. The University has two series of variable rate bonds backed by letters of credit (Series 2003A, B and C and 2006A-1 and B-1). The letters of credit are provided by several banks (see RATED DEBT section below) with letter of credit expirations extended through 2013. Unrestricted monthly liquidity in FY 2010 covered demand debt nearly 3.2 times.

The University is likely to continue significant capital investment and renewal spending over time, with a planned pattern of borrowing roughly every two years. However, management has chosen to phase certain projects to build in flexibility and demonstrated a willingness to scale back capital or postpone projects in the past in response to the challenging economic environment. With the issuance of the Series 2011 bonds, the University's pro-forma direct debt increases to \$920 million. Although this amount of pro-forma debt represents a material increase over the past five years (approximately \$541 million of debt in FY 2006), pro-forma debt to revenue is manageable at 0.36 times, and maximum annual debt service (including the spike in debt service in FY 2018) is not excessive at 4.9%. Further, the University pays down a sizeable amount of principal annually. We expect that the Series 2011 will cover the University's borrowing needs through at least FY 2012. Future debt is anticipated for a variety of capital projects in 2013, most notably for the construction of the Golisano Children's Hospital.

The University has successfully secured several large gifts in recent years, including large private gifts as well as awards from New York State and the NIH. Total gift revenue (per the audited financial statements) averaged \$70.6 million annually during FY 2008-2010, a notable increase over average gift revenue closer to \$50 million in FY 2004-2006.

Outlook

The stable outlook is based on Moody's expectation of maintenance of positive operating performance and enhanced fundraising contributing to balance sheet growth, strong student demand, and manageable future borrowing plans.

WHAT COULD MAKE THE RATING GO UP

Ability to expand fundraising leading to significant growth in liquid financial resources relative to debt and operations, coupled with ongoing positive operating performance and further strengthening of student market position

WHAT COULD MAKE THE RATING GO DOWN

Operating deficits and sustained deterioration of operating cash flow, including weakened performance at the Medical Center; rapid expansion of debt without offsetting financial resource growth

KEY DATA AND RATIOS (Fiscal year 2010 financial data; fall 2010 enrollment data):

Total Enrollment: 9,050 full-time equivalent students

Pro-Forma Direct Debt: \$920 million

Pro-Forma Comprehensive Debt (including unfunded defined benefit pension liability at Highland Hospital as well as operating leases) \$1.14

billion

Expendable Resources to Pro-forma Direct Debt: 1.45 times

Expendable Financial Resources to Operations: 0.5 times

Three-Year Average Operating Margin: 2.3%

Operating Cash Flow Margin: 10.6%

Annual Debt Service Coverage: 3.2 times

Reliance on Patient Care Revenue: 65%

Reliance on Endowment Draw: 4.1%

Reliance on Student Charges (Tuition and Auxiliary Revenue): 10.1%

Reliance on Grants and Contracts: 16.0%

RATED DEBT:

University Backed Bonds:

Series 1999A and B, 2004A, 2007A and B, 2009A-E, 2011 A and B: Aa3 rating

Series 1997A, 1998A, 2000A, and 2003 Direct Note Obligation: Aa3 Rating; Insured by National Public Finance Guarantee Corp

Series 2001A: Aa3 rating; Insured by Ambac

Series 2003A, B and C: Aa3 underlying rating; Aa1/VMIG1 enhanced rating based on letters of credit from JPMorgan Chase, HSBC Bank USA, and JPMorgan Chase respectively and based on Moody's two-party pay methodology; HSBC LOC expires 9/3/13 and JPMorgan Chase LOC expires 3/13/13

Series 2006A-1 and B-1: Aa3 underlying rating; Aa1/VMIG1 enhanced rating based on letters of credit from Bank of America (rated Aa3/P-1), using two party pay methodology ; Bank of America LOC expires 9/10/13

Highland Hospital Bonds: Series 2005, Series 2010: A2 rating

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PRINCIPAL METHODOLOGY:

The principal methodology used in this rating was Moody's Rating Approach for Private Colleges and Universities published in September 2002. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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