University of New Mexico, NM

New Issue - Moody's Assigns Aa2 to University of New Mexico's Series 2016A&B; outlook stable

Summary Rating Rationale
Moody's Investors Service has assigned Aa2 ratings to UNM’s proposed $180 million of Subordinate Lien System Refunding and Improvement Revenue Bonds, Tax-Exempt Series 2016A and Taxable Series 2016B to be issued by the Board of Regents of the University of New Mexico. We have also affirmed the ratings on outstanding rated debt.

The Aa2 rating reflects the University of New Mexico’s essential role as the State’s flagship public university and major healthcare service provider, its history of strong state support for operations and capital, as well as good debt service coverage. The rating also incorporates UNM’s relatively weaker cash flow and liquidity than peers. Significant exposure to health care operations and a very large pension liability are key credit challenges. The Aa2/VMIG 1 ratings on the variable rate bonds are based on the structure of the standby bond purchase agreements, short-term rating of the liquidity facility bank, and UNM’s long-term rating.

Credit Strengths
» UNM is a key driver of economic, research and business development through provision of education, and serves one of the largest employers in the State of New Mexico (Aaa stable) and Bernalillo County (Aaa stable)
UNM hospital also serves a critical role, both as a safety net provider and the state’s only Level 1 Trauma Center, with mill levy support from the county supporting fiscal stability

As the dominant provider of higher education within the state, UNM has a strong matriculation rate of over 40%

Consistent operating and capital support from the state contribute to fiscal stability and state lottery revenues dedicated for scholarships support high in-state demand

Manageable direct debt burden with limited additional debt plans and regular principal amortizations resulting in a low 30% proforma debt to revenue

Credit Challenges

Health care operations have generated inconsistent results over the last several years, and represent a substantial and growing portion of the university’s revenues (47% in FY 2015)

Thin liquidity relative to operations and growing expenses intensifies need to maintain cash flow, with monthly liquidity of $388 million providing under 70 days cash on hand

High reliance on in-state students (over 80% of incoming first-year students) and relatively flat projections for high school graduates will make enrollment growth challenging

Very large pension liability and growing contributions to the Public Employees’ Retirement System present operating and long-term leverage risk

Rating Outlook

The stable outlook reflects our expectation that the university will maintain generally steady enrollment and good debt service coverage with operating cash flow in the 7-9% range.

Factors that Could Lead to an Upgrade

Substantial growth of financial resources, particularly monthly liquidity

Greater diversification of the student population to lessen reliance on in-state demographics

An expanded an elevated research profile

Factors that Could Lead to a Downgrade

Trend of deteriorating cash flow outside of the 7-9% range

Substantial new debt issuance absent growth of liquidity and resources
Key Indicators

Exhibit 2

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<tr>
<td>Total FTE Enrollment</td>
<td>23,370</td>
<td>23,480</td>
<td>23,617</td>
<td>23,154</td>
<td>23,068</td>
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<td>Operating Revenue ($000)</td>
<td>1,746,456</td>
<td>1,711,538</td>
<td>1,800,670</td>
<td>1,856,295</td>
<td>2,149,499</td>
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<td>Annual Change in Operating Revenue (%)</td>
<td>4.4</td>
<td>-2.0</td>
<td>5.2</td>
<td>3.1</td>
<td>15.8</td>
<td>15.8</td>
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<tr>
<td>Total Cash &amp; Investments ($000)</td>
<td>1,147,537</td>
<td>1,019,410</td>
<td>1,009,639</td>
<td>1,093,670</td>
<td>1,172,139</td>
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<td>Total Debt ($000)</td>
<td>763,940</td>
<td>737,378</td>
<td>719,104</td>
<td>700,060</td>
<td>614,472</td>
<td>669,472</td>
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<tr>
<td>Spendable Cash &amp; Investments to Total Debt (x)</td>
<td>1.2</td>
<td>1.1</td>
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<td>1.1</td>
<td>1.4</td>
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<tr>
<td>Spendable Cash &amp; Investments to Operating Expenses (x)</td>
<td>0.5</td>
<td>0.5</td>
<td>0.4</td>
<td>0.4</td>
<td>0.4</td>
<td>0.4</td>
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<tr>
<td>Monthly Days Cash on Hand (x)</td>
<td>90.68</td>
<td>67.67</td>
<td>94.72</td>
<td>72.72</td>
<td>9.8</td>
<td>9.8</td>
</tr>
<tr>
<td>Operating Cash Flow Margin (%)</td>
<td>12.1</td>
<td>7.8</td>
<td>5.7</td>
<td>6.0</td>
<td>9.8</td>
<td>9.8</td>
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<tr>
<td>Total Debt to Cash Flow (x)</td>
<td>3.6</td>
<td>5.6</td>
<td>7.0</td>
<td>6.3</td>
<td>2.9</td>
<td>3.2</td>
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Fiscal Year End June 30; Fall Enrollment Numbers
Source: Moody's Investors Service

Recent Development

The university is embarking on the first phase of the Innovate ABQ, a joint economic development initiative between the university, city, state and county, this spring. A separate non-profit board is now governing the project with representatives from all related parties, and it is possible that Central New Mexico Community College will also join. Phase one involves public private partnership (P3) construction of a $31.5 million six-story mixed use facility; with a combination of retail and university programming on the first floor, and apartment style housing on the remaining floors. The Innovate ABQ board has selected Signet Development as the developer.

UNM will ground lease the building to Signet for approximately $100,000 to $150,000 per year, and will pay up to $3.5 million of annual operating leases for the student housing and programming.

Detailed Rating Rationale

Market Profile: Essential Role to the State as Dominant Higher Education Provider and Sole Academic Medical Center

University of New Mexico will continue to demonstrate solid student demand for its undergraduate and graduate programs as the State’s flagship university. UNM’s integral role as dominant higher education provider, research and economic hub, and sole academic medical center in the Aaa-rated State of New Mexico and County of Bernalillo provide the backbone for its very good strategic positioning and stable long-term demand. Overall enrollment is stable at over 23,000 full-time equivalents, comprised of undergraduate, graduate and professional students. Enrollment will remain stable with projections for flat demographics for graduating high school students, and a very high reliance on in-state students (over 80% of incoming freshmen). Further strengthening resident enrollment is the State’s Lottery Tuition Fund providing scholarships to New Mexico high school graduates attending a state public college or university, including University of New Mexico, for seven semesters. For fall 2015, the university had approximately 7,800 scholarship recipients, representing a material segment of its student population.

The University of New Mexico Hospital (UNMH) 527-bed facility plays an essential role in providing health care within the state. It is the state’s only Level 1 trauma center for children and adults and a key provider of indigent care as Bernalillo County’s public hospital, and a faculty practice plan. Albuquerque is a highly competitive healthcare market, with flagship facilities for three systems within two miles of each other in the downtown section. UNMH’s primary service area includes Bernalillo and Valencia counties, as well as portions of Sandoval, Torrance, and Santa Fe counties.

While UNMH only holds about a quarter of the total Albuquerque market share, it is the primary Medicaid and indigent care provider and only partially competes for commercial patients. Following implementation of the Affordable Care Act and the state’s expansion of Medicaid eligibility, UNMH’s role as an essential provider to Medicaid patients has grown. Over the last two years, the hospital’s payor mix has changed significantly with Medicaid exposure reaching a very high 37.5% in FY 2015, up from approximately 30% in recent
years; there has been a corresponding decrease in self-pay, which was a low 4% of gross revenue in FY 2015. The initial impact of the payor mix shift has been positive as UNMH is now receiving payments for patients that were previously uninsured and unable to pay.

In addition to the UNM Hospitals, there are two other clinical healthcare entities that are consolidated in the UNM audit, the UNM Medical Group (UNMMG) and the Sandoval Regional Medical Center (SRMC). SRMC is a new hospital in Rio Rancho, an area with a more favorable payer mix than the one UNM Hospitals currently serves. FY 2014 was the first full year of clinical operations at SRMC, and operating performance has improved significantly in FY 2015. The UNMMG is a faculty practice plan that practices at UNM Hospitals and to a lesser extent at SRMC.

The university’s research enterprise is relatively smaller than other flagship universities’, but has experienced slow funding growth due to diversified funding sources and niche programming. Primary cluster areas for research include quantum physics and new manufacturing initiatives. Federal funding represents approximately half of overall funding, with the remainder coming through state, local and private sources.

Operating Performance: Continued Strong Debt Service Coverage with Some Cash Flow Variability

We expect the university to return to generally balanced operations with cash flow of 7-9% sufficient to produce good debt service coverage. Operating performance and cash flow were very strong in FY 2015 due largely to an extraordinary year at the hospital. Average debt service coverage is a very strong 3.7 times for FYs 2013-2015. Net tuition revenue (19%), state appropriations (14%) and research revenue (13%) are all projected to rise modestly, and, barring any unforeseen expenses, we expect at least break even operations for FY 2016. Although the state has been hit by declines in oil and gas prices, those declines have been offset by growth in other taxes so far this fiscal year.

At 47% of total operating revenue, health care operations are the primary driver of the recently improved operations at UNM. Operating performance at all healthcare divisions, including the hospitals, UNMH and SRMC was particularly strong in FY 2015. UNMH’s improved performance was driven by increased insurance coverage under Medicaid expansion, and a corresponding reduction in patients with little or no ability to pay. Although UNMH recognized $38 million in revenue related to activities in FY 2014 (revenue recognition was delayed due to the overwhelming number of Medicaid applications), operating performance was very strong, with an operating cash flow margin of nearly 15% (excluding the $38 million related to FY 2014). Performance at SRMC is also strong with an operating cash flow margin of over 20%, although its base of operations is under $100 million, compared to nearly $1 billion at UNMH. SRMC operates in an area with significantly more commercially insured patients than UNMH. The faculty practice plan, UNMMG had a larger gain from operations than is typical in FY 2015, consistent with the strong performance from the other healthcare entities; UNMMG generates approximately $200 million of operating revenue.

Through the first six months of FY 2016, healthcare operations are ahead of budget, but remain significantly below FY 2015. Although patient demand is strong and the hospital is full, the state has cut Medicaid disproportionate share payments (DSH) and rates to Medicaid managed care companies, which is offsetting some of the benefit of expanded coverage. Medicaid enrollment exceeded projections, which has strained the state’s budget, and we expect further supplemental funding cuts to pressure the healthcare operations over the coming years. UNMH (including UNMMG and SMRC) benefits from tax support through a mill levy from the County that represented almost $90 million in FY 2015. The levy is up for renewal by voters in 2016, but is unaffected by the Medicaid changes.

Wealth and Liquidity: Adequate Coverage of Debt, but Thin Liquidity

Healthy operating and capital support from the State of New Mexico help mitigate the university’s low liquidity position relative to peers. Total cash and investments of almost $1.2 billion as of FYE 2015 (including foundation investments), covers proforma debt by a solid 1.7 times. Further growth is anticipated as the university pursues a $1 billion comprehensive capital campaign, with expected conclusion in FY 2020.

Capital and debt plans are currently manageable, with just $50 million of additional bonds planned in FY 2017. Given relatively weaker cash flow and thinner liquidity than peers, future debt capacity beyond what is currently anticipated will depend on the university’s ability to generate additional revenue and resources to absorb additional debt service.
The university has entered into two public-private partnerships for housing facilities with American Campus Communities (ACC), a private developer. Together, these two housing projects total 1,892 beds and represent a meaningful 43% of UNM’s overall student housing. The housing is located on university-owned land that is ground leased to ACC, and construction was fully funded by ACC without any project-related debt. The university is not legally responsible for any associated ACC residential facility capital expense. We view these projects as part of the university’s broader credit profile, especially as management explores the possibility of additional privatized student housing and these facilities become an increasingly large portion of the university’s overall housing stock.

LIQUIDITY
UNM’s thin liquidity is a key credit challenge given the university’s recent weak cash flow. In FY 2015, the university had just 72 monthly days cash compared. Continued strong state support and the ability to request monthly appropriations in advance to support cash flow are important mitigants to the university’s weak liquidity.

Leverage
Historic state capital support has also allowed the university to maintain a relatively low debt burden. Proforma debt to operating revenue is just 0.3 times, and we expect it to remain low with regular principal amortizations and revenue growth keeping pace with additional debt issuances.

DEBT STRUCTURE
UNM’s debt structure is comprised of 88% fixed rate bonds, including debt of the hospital and a component unit of UNM. The variable rate debt, specifically the Series 2001, 2002B and 2002C, are backed by standby bond purchase agreements (SBPAs) provided by US Bank, N.A. that all expire on December 29, 2017. This debt structure carries additional risks as, under certain circumstances, the bank could require an acceleration of the bonds and terminate the agreements. However, UNM’s FY 2015 monthly liquidity of $388 million provides a healthy 4.7 times coverage of demand debt.

DEBT-RELATED DERIVATIVES
The university has floating to fixed rate swap agreements related to its Series 2002B, 2002C, and a portion of its 2001 variable rate bonds. The swaps are with RBC Capital Markets and JPMorgan and are are conterminous with the maturity of the debt, with swap payments on parity with debt service payments. At the current rating level, the university must post collateral at a $20 million threshold but has not been required to do so. At December 31, 2015, the swap portfolio's market valuation, including the swap overlays, was a $9.7 million liability for university.

PENSIONS AND OPEB
The university has significant debt-like obligations through a very large pension liability and other post-retirement health benefit (OPEB) liability. Although contributions for the multiple employer state-run pension and UNM OPEB plans are rising for the university, pension contributions are paid by the state (through state appropriations), and therefore do not represent significant operating risk at this time. The over $2 billion three-year average Moody’s adjusted net pension liability (ANPL) is substantial, but due to UNM's relatively low debt burden, increases adjusted debt to operating revenue of just 1.3 times, below many peers. The state is expected to continue to fund contributions in the near term. In 2014, UNM established a voluntary trust for its OPEB plan, with UNM matching employee contributions toward funding a trust for retirement health benefits. Contributions will hit 1% in FY 2017 and are expected to remain there. After 10 years, the university anticipates that it will be able to use the earnings from the trust to pay annual benefits.

Governance and Management: Thoughtful Planning and Careful Implementation of New Initiatives Bolster Strategic Positioning
UNM’s board and senior management’s careful budgetary oversight and integrated strategic planning help to offset some of the challenges of the growing exposure to more volatile health care revenue. The hospital and university are well integrated through its Health Sciences Center and that center’s separate board of directors. The university’s key strategic initiatives, including a new branding initiative and Innovate ABQ, capitalize on UNM’s unique and essential role within the state.

Legal Security
University of New Mexico’s rated bonds are payable from a subordinate lien on Pledged Revenues which include tuition and fees; auxiliary revenues derived from the bookstore, parking, housing; indirect cost recovery; and income from the permanent and land funds. Pledged Revenues exclude state appropriations, restricted funds, and hospital revenue. The senior lien is associated with $12.5
million of outstanding Series 1992A bonds and is closed. The subordinate bonds are further secured by a debt service reserve fund, sum sufficient rate covenant, and additional bonds test of at least 1.75 times coverage of pro-forma peak debt service coverage. For FY 2015, the university had approximately $200 million of net revenues available for debt service of $31.4 million, or 6.4 times coverage. Proforma coverage is expected to remain at or above 3.4 times for the next several years, including the Series 2016A&B bonds.

The university’s hospital revenues bonds are secured solely by hospital revenue and the mortgage insurance from the Federal Housing Administration’s Section 242 mortgage insurance program, with no recourse to the revenue streams supporting debt service on the System Revenue Bonds. The hospital provides good debt service coverage of its outstanding $247 million in FY 2015 (including SRMC bonds).

Use of Proceeds
Proceeds from the Series 2016A&B bonds will be used to: 1) refund certain maturities of the outstanding Series 2007A bonds; 2) purchase, construct, renovate and equip improvements and facilities for the Anderson School of Management, the Johnson Center, and the Smith Plaza projects; 3) fund capitalized interest for the 2016A bonds; 4) acquire a reserve fund insurance policy to fund or otherwise fund a debt service reserve fund; and 5) pay costs of issuance.

Obligor Profile
University of New Mexico is a large, comprehensive public research university located in Albuquerque with over 23,000 students and $2.1 billion in operating revenue. UNM provides a broad array of undergraduate, graduate and profession programs, including New Mexico’s only public schools of law, architecture and planning, and pharmacy. The university operates several health care facilities, include the state’s only academic medical center.

Methodology
The principal methodology used in this rating was Global Higher Education published in November 2015. An additional methodology used in the short term rating was Variable Rate Instruments Supported by Conditional Liquidity Facilities published in March 2015. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

Ratings

Exhibit 3

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Source: Moody’s Investors Service
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