University of New Mexico, NM
Update following downgrade to Aa3

Summary
University of New Mexico’s (UNM, Aa3 stable) benefits from its essential role as the state’s flagship public university and major healthcare service provider, with a large $2.4 billion scope of operations. Favorably, UNM also has a modest debt burden and good debt service coverage due to historically healthy capital support from New Mexico. However, UNM faces limited prospects to significantly improve modest operating performance and thin reserves across both the academic and healthcare enterprises. Growth in state operating support from the State of New Mexico, whose general obligation bond rating was downgraded to Aa2 stable on June 18, 2018, will be muted due to spending pressures from rising Medicaid needs, an economy that lags national averages, and high reliance on volatile oil and gas revenue. UNM is additionally challenged by a sizeable 51% revenue exposure to a competitive healthcare market, lagging enrollment influenced by a price sensitive student population, modest reserves relative to expenses, and an elevated underfunded pension liability.

On November 14, 2018, Moody’s downgraded UNM’s rating to Aa3 and revised the outlook to stable.

Exhibit 1
Modest cash flow margins limit significant growth of flexible reserves

Source: Moody’s Investors Service
Credit strengths

» New Mexico’s flagship university and academic medical center, with sizeable $2.4 billion scope of operations

» Essential role as one of the largest employers in New Mexico, including major research and economic development activity in Albuquerque and Bernalillo County

» Critical role, both as a safety net provider and the state’s only Level 1 Trauma Center, with a county mill levy supporting hospital fiscal stability

» Manageable direct debt burden with limited additional debt plans and regular principal amortizations resulting in a low 0.3x debt to revenue

Credit challenges

» High 51% exposure to more volatile health care revenue, with only modest cash flow margins across both university and healthcare enterprises

» New Mexico generally lagging economy will pressure UNM’s state support and Medicaid reimbursements, heightening student and patient affordability concerns

» Thin unrestricted liquidity, with only 68 days monthly cash on hand relative to Aa3-median of 163 days

» Large unfunded pension liability adds considerable debt-like liabilities and inflexible costs

Rating outlook

The stable outlook reflects our expectations that the university will maintain steady, though modest, operating performance with good debt service coverage. The stable outlook additionally incorporates UNM’s expected adeptness in rebalancing operations across both university and healthcare enterprises given healthcare funding and enrollment challenges.

Factors that could lead to an upgrade

» Substantial increase in financial reserves and liquidity

» Sustained increase in operating performance and cash flow generation

» Sustained growth of net tuition revenue and research activity

Factors that could lead to a downgrade

» Sustained deterioration of operating performance at the university or healthcare enterprises

» Discontinuation of the mill levy supporting the hospitals

» Material weakening of state’s credit quality

» Continued erosion of liquidity

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Key indicators

Exhibit 2

<table>
<thead>
<tr>
<th>UNIVERSITY OF NEW MEXICO, NM</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>Median: Aa3 Rated Public Universities</th>
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<tbody>
<tr>
<td>Total Fall FTE Enrollment</td>
<td>23,617</td>
<td>23,154</td>
<td>25,068</td>
<td>22,865</td>
<td>21,978</td>
<td>30,065</td>
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<tr>
<td>Operating Revenue ($000)</td>
<td>1,800,670</td>
<td>1,856,295</td>
<td>2,021,499</td>
<td>2,125,938</td>
<td>2,357,485</td>
<td>1,136,474</td>
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<tr>
<td>Annual Change in Operating Revenue (%)</td>
<td>5.2</td>
<td>3.1</td>
<td>8.9</td>
<td>5.2</td>
<td>10.9</td>
<td>3.3</td>
</tr>
<tr>
<td>Total Cash &amp; Investments ($000)</td>
<td>1,099,839</td>
<td>1,063,670</td>
<td>1,172,139</td>
<td>1,214,256</td>
<td>1,301,127</td>
<td>1,206,900</td>
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<tr>
<td>Total Debt ($000)</td>
<td>719,104</td>
<td>700,000</td>
<td>814,472</td>
<td>636,247</td>
<td>651,889</td>
<td>663,840</td>
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<td>Spendable Cash &amp; Investments to Total Debt (%)</td>
<td>1.0</td>
<td>1.1</td>
<td>1.4</td>
<td>1.5</td>
<td>1.5</td>
<td>1.4</td>
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<tr>
<td>Spendable Cash &amp; Investments to Operating Expenses (%)</td>
<td>0.4</td>
<td>0.4</td>
<td>0.4</td>
<td>0.4</td>
<td>0.4</td>
<td>0.7</td>
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<tr>
<td>Monthly Days Cash on Hand (x)</td>
<td>67</td>
<td>94</td>
<td>75</td>
<td>67</td>
<td>68</td>
<td>168</td>
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<td>Operating Cash Flow Margin (%)</td>
<td>5.7</td>
<td>6.0</td>
<td>7.2</td>
<td>7.3</td>
<td>7.5</td>
<td>11.4</td>
</tr>
<tr>
<td>Total Debt to Cash Flow (x)</td>
<td>7.0</td>
<td>6.3</td>
<td>4.2</td>
<td>4.1</td>
<td>3.7</td>
<td>4.7</td>
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<tr>
<td>Annual Debt Service Coverage (x)</td>
<td>2.8</td>
<td>3.0</td>
<td>3.7</td>
<td>4.0</td>
<td>3.6</td>
<td>2.9</td>
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</tbody>
</table>

Source: Moody's Investors Service

Profile

The University of New Mexico is the flagship public higher education institution for the State of New Mexico, and includes the University of New Mexico Hospital and consolidated operations of the UNM Health Sciences Center. Associated with UNM are four Branch Community College campuses - Gallup, Los Alamos, Taos and Valencia. In fiscal 2017, the university recorded operating revenue (Moody's adjusted) of $2.4 billion and for fall 2018, enrolled 20,245 full-time equivalent (FTE) students.

Detailed credit considerations

Market position: dominant higher education provider and sole academic medical center in New Mexico; demographic and scholarship challenges disrupted fall 2018 enrollment

UNM will continue to play an integral economic role in New Mexico as the state's flagship university and sole academic medical center, located in the state's largest city, Albuquerque.

A rebounding economy and changes to the state's lottery-funded scholarships adversely impacted UNM's fall 2018 enrollment, highlighting the university's vulnerable demographic profile. Fall 2018 headcount enrollment totaled 20,245 full-time equivalent (FTE) students. Enrollment declined a precipitous 7.9% in fall 2018 from 2017 as a result of a multiple factors: improved employment opportunities, reduced lottery scholarship funding, and affordability and programmatic options at the adjacent Central New Mexico College. The university has partnered with an enrollment consultant to rebuild its first time freshman class to a target 2,850 in fall 2019 from the actual 2,653 in fall 2018.

Changes to the state's Lottery Tuition Fund were a cause of UNM's enrollment disruption in fall 2018, though with additional legislative directed funding for fiscal 2020, fall 2019 has better prospects for some enrollment rebound. The Lottery Tuition Fund provides scholarship funding for New Mexico high school graduates attending a state public college or university, for seven semesters. A sizeable 12,000 UNM students received a Lottery Tuition Fund scholarship for fiscal 2019.

The University of New Mexico Hospital (UNMH), a 527-bed facility in Albuquerque 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. 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. While this contributes to some market share stability it also adds operating risk and vulnerability to Medicaid reimbursement changes. Following the state's expansion of Medicaid eligibility, UNMH's role as an
essential provider to Medicaid patients has grown. Medicaid payer mix was a high 35% in fiscal years 2017 and 2018. The potential expansion in this program may rise when the state’s comprehensive delivery program Centennial Care 2.0 is rolled out January 1, 2019.

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 60-bed hospital located in Rio Rancho, an area with a more favorable payer mix than the one UNM Hospitals serves. The UNMMG is a faculty practice plan that practices at UNM Hospitals and to a lesser extent at SRMC.

UNM has a moderate research enterprise for a university of its size, particularly with such a large healthcare component. In fiscal 2017, research expenses totaled $185 million or 8% of operating expenses. Federal agencies account for the largest funding sources, with awards largely from the National Science Foundation (NSF) and the National Institutes of Health (NIH).

Operating performance: modest operating performance to continue

UNM’s combined operating performance will remain modest relative to peer comprehensive universities and academic medical centers, limiting meaningful growth in financial reserves, though still providing very good debt service coverage. Favorably, UNM’s cash flow margins have been improving, to 7.5% in fiscal 2017 and an estimated 8% for fiscal 2018, from 5.7% in fiscal 2013, due to renewed fiscal discipline across the academic and healthcare enterprises. Overall debt service coverage across both enterprises was 3.6x for fiscal 2017 and an estimated 3.5x for fiscal 2018, exceeding the Aa3-median of 2.7x.

Operating performance at UNM Health Sciences, which represents 51% of consolidated university revenue, will remain a key driver. Consolidated health system operations (unaudited) cash flow margins averaged a weak 5% in the fiscal 2016-18 period. UNMHS is in the midst of a system-wide revenue enhancement and cost reduction initiative, facilitated by an external consultant, that is expected to improve operating efficiencies.

UNMHS benefits from tax support through a mill levy from Bernalillo County, and Sandoval County will provide renewed tax support owing to voter approval in the recent November 6, 2018 election. Though proceeds are dedicated to specific uses, the incremental revenue provides for critical community healthcare support enhancing the UNMHS mission. Bernalillo County support was $110 million in fiscal 2017, with its voter renewal passed in November 2016 to last through fiscal 2025. Expected Sandoval County tax revenue in fiscal 2020 will be roughly $6 million and is in place until fiscal 2027.

Diversity among remaining revenue sources - student charges, state operating appropriations, and grants and contracts - enhances UNM’s operating profile. However, limited improvement in these revenues, of roughly 8%-11% over the fiscal 2013-17 period contributed to modest operating performance. This trend is expected to continue for fiscal 2018 and in the near term constraining UNM’s ability to budget for meaningful net income growth.

Improved state revenues owing to the oil and gas sector and employment-related activity are favorable and may benefit UNM operations. However, state funding uncertainty will continue as New Mexico grapples with its outsized pension liabilities.

Wealth and liquidity: lagging wealth and liquidity relative to operations; capital campaign aids investment growth

UNM’s wealth position relative to expenses lags similar comprehensive public universities, with limited prospects for outpacing peers. Cash and investments at fiscal year end June 30, 2017 totaled $1.3 billion, with fiscal 2018 estimated to increase to roughly $1.4 billion. Spendable cash and investments of $983 million covered expenses by 0.4x, well below the Aa3-median of 0.7x.

Donor gifts and favorable investment returns will remain essential to grow cash and investments in the absence of strong retained surpluses. UNM has been in the midst of a $1.0 billion capital campaign, which is scheduled to end in 2020. To date, the goal has been met, with nearly 60% of gifts already collected and the remaining 40% a mix of pledges, in-kind or bequests.

University and UNM Foundation endowment assets are managed by the foundation, with assistance from a third-party advisor. The combined endowment of $452 million at June 30, 2018 was up 8.2% for the one year period.

Liquidity

UNM’s thin liquidity is a key credit challenge given the university’s modest cash flow, exposure to healthcare volatility, and limited prospects for sizeable increases in state operating support. In fiscal 2017, UNM’s combined university and healthcare operations had just 68 monthly days cash, well below the Aa3-median of 163 days. Continued solid state support and the ability to request monthly
appropriations in advance of regularly scheduled disbursements to support cash flow are important mitigants to the university’s weak liquidity. Fiscal 2018 liquidity is expected to be comparatively similar.

Leverage: state capital support underlies manageable leverage offset by a sizeable unfunded pension liability

Historic state capital support, totaling $221 million over the fiscal 2008-18 period, has allowed the university to maintain a relatively low debt burden. Outstanding debt for fiscal 2017 was $652 million, and with principal amortizations, declined to $625 million for fiscal 2018. Roughly 65% of the debt is university supported, with the remaining 35% supported by health system revenues.

Exhibit 3
Consolidated UNM debt is separately secured by the university or hospital
Audited fiscal 2017 data

Source: Moody’s Investors Service

Relative to spendable cash and investments and operating revenue, UNM’s leverage measures were 1.5x and 0.3x, respectively, for fiscal 2017, with continued improvement in fiscal 2018. With more moderate wealth levels relative to peers, spendable cash and investments to debt was weaker than the 1.3x Aa3-median, while the large scope of operations provided a stronger debt to operating revenue relative to the Aa3-median of 0.6x.

Near-term capital funding needs for university-only projects are expected to be provided largely by roughly $49 million in state sources. On November 6, 2018, New Mexico voters approved a state general obligation bond issue, of which UNM will receive $27 million to be used for a chemistry building renovation, ROTC facility, and Career Center in Taos. The university will be requesting $20.5 million in the upcoming legislative session, with proceeds and $3.5 million of capital reserves, to be applied to multiple campus projects. An additional $5.0 million request and $1.5 million in capital reserves, respectively, will relate to projects at the Branch campuses.

UNM’s health system is currently reviewing capital needs, which may include modernization of the UNM Hospital, although timing and size of the plan is currently in discussion.

UNM has two public-private partnership (PPP) projects, and has no plans for additional ventures within the next three years. Both PPPs are housing facilities with American Campus Communities (ACC), that represent a meaningful 41% of UNM’s overall student housing of 4,612 beds. We view these projects as part of the university’s broader credit profile, especially should management explore the possibility of additional privatized student housing in the future.

Debt structure
UNM’s debt structure is comprised of 89% fixed rate bonds, including debt of the hospitals, generally amortizing over 30 years that provides predictability in annual debt service payments.

The variable rate debt, specifically the Series 2001, 2002B and 2002C subordinate lien bonds, are backed by standby bond purchase agreements (SBPAs) provided by US Bank, N.A. that expire on December 29, 2020. This debt structure carries additional risks as, under certain circumstances, the bank could require an acceleration of the bonds and terminate the agreements. These circumstances include failing to meet certain financial and reporting requirements including a debt service coverage calculation (coverage is currently ample),
bank bond ratings upon request and maintaining a rating at or above A2 or A. Should the bonds become bank bonds, the repayment period commences 91 days following the purchase date and will end the earliest to occur of a) the third anniversary of the amortization commencement date, b) the conversion date and c) the substitution date. However, UNM’s fiscal 2017 monthly liquidity of $412 million provides a healthy 5.6x coverage of demand debt.

The university’s hospital revenue bonds are not rated, and are secured solely by hospital revenue and the mortgage insurance from the Federal Housing Administration’s (FHA) Section 242 mortgage insurance program, with no recourse to the revenue streams supporting debt service on the university’s senior and subordinate revenue bonds. The Series 2010A and 2010B Taxable FHA-Insured Mortgage Revenue Bonds, with $121 million outstanding at June 30, 2018, are payable by Sandoval Regional Medical Center (SRMC). The Series 2015 FHA-Insured Hospital Mortgage Revenue Bonds, with $98 million outstanding at June 30, 2018, are payable by UNM Hospital.

Legal security
UNM’s rated bonds are payable from a 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 the Series 1992A bonds, outstanding in the amount of $71 million, is closed. For fiscal 2017, the university had approximately $514 million of pledged revenues available for total debt service. Fiscal 2017 coverage for the senior lien bonds’ $2.9 million of annual debt service is a very strong 177x.

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 co-terminus 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. Requirement to post collateral would potentially further stress available UNM’s already thin liquidity. At November 9, 2018, the swap portfolio’s market valuation, including the swap overlays, was a $4.8 million liability for university.

Pensions and OPEB
UNM has a substantially underfunded pension liability, and significant underfunding of the pension fund presents the potential for escalating costs. Though the state does provide appropriations to be directed toward pension payments of the Educational Employees Retirement Plan (EERP), these are not considered to be on-behalf contributions. Further, though the state support currently alleviates significant operating risk, it will mean lower appropriations to cover general university operations if state appropriations growth is limited. The state is expected to continue to fund contributions in the near term.

The Moody's three-year adjusted net pension liability (ANPL) for UNM is sizeable $2.6 billion. Notably, due to UNM’s relatively low debt burden, when combined with outstanding debt and additional long-term obligations, relative to operating revenue at 1.4x is moderately higher than the 1.0x median for Aa3-rated public universities.

UNM's administers an Other Postemployment Benefit Plan, the UNM Retiree Welfare Benefit Plan (VEBA Plan), which adds some additional, but manageable leverage. OPEB contributions made by the university were a modest 0.5% of fiscal 2017 expenses.

Governance and management: leadership transitions and renewed strategic visions
UNM is in the midst of significant leadership transition that positions UNM to elevate it's dual academic and healthcare enterprises to a broader national level. A new university president and UNMHS CEO, who both began during fiscal 2018, are bringing new expertise and preparing updated strategic plans to enhance UNM’s state role and fiscal position. Additional senior leadership changes will be forthcoming during fiscal 2019 due to current vacancies and retirements. UNM’s very good strategic position reflects its important role to the state, more limited brand recognition outside of New Mexico, fundraising successes, and careful budgetary oversight.
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