Moody's Investors Service

Global Credit Research
New Issue
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New Issue: UC San Diego Medical Center, CA

MOODY'S UPGRADES UNIVERSITY OF CALIFORNIA'S SENIOR MOST RATING TO Aa1 FROM Aa2; OUT REMAINS POSITIVE AT HIGHER LEVEL

Aa2 RATING ASSIGNED TO LIMITED PROJECT REVENUE BONDS, SERIES 2007; APPROXIMATELY $9 BILLION IN RATED DEBT AFFECTED

University of California, CA
Higher Education
CA

Moody's Rating

ISSUE	RATING
Limited Project Revenue Bonds, 2007 Series D	Aa2

Sale Amount	$418,185,000
Expected Sale Date	10/10/07
Rating Description	Public University Revenue

Moody's Outlook Positive

Opinion

NEW YORK, Oct 8, 2007 -- Moody's Investors Service has upgraded the University of California's (UC's) senior most rating to Aa1 from Aa2. The rating outlook remains positive. Various other bonds issued by the University under other indentures have also been upgraded. Moody's has assigned a Aa2 rating with a positive outlook to the University's Limited Project Revenue Bonds, 2007 Series D.

The upgrade of the University reflects the System's status as one of the premier academic institutions in the world with a very large presence in research (largest university recipient of federal R&D funding), medical care (over 140,000 discharges) and teaching (approx. 200,000 full-time equivalent students).

SUMMARY OF RATING ACTIONS:

General Revenue Bonds: Upgraded to Aa1/Positive from Aa2/Positive

Limited Project Revenue Bonds: Upgraded to Aa2/Positive from Aa3/Positive

Certificates of Participation: Upgraded to Aa1/Positive from Aa2/Positive

Research Facilities: Upgraded to Aa1/Positive from Aa2/Positive

Medical Center Pooled Bonds: Upgraded to Aa2/Positive from Aa3/Positive

Multiple Purpose Project Bonds: Affirmed Aa2/Positive

State Public Works Board Bonds: Affirmed Aa2/Positive

UC San Diego Medical Center Series 2000: Upgraded to Aa3/Positive from A1/Positive

Commercial Paper: Affirmed P-1

USE OF PROCEEDS: Fund housing projects at multiple campuses within system.

LEGAL SECURITY: For Limited Project Revenue Bonds: Lien on gross revenues of projects issued under indenture; subordinate lien to General Revenue Bonds; wide powers of borrower to add or remove projects and revenues

INTEREST RATE DERIVATIVES: The University is an active user of various derivative instruments to manage both its debt and its assets. Given the University's substantial liquidity, $5.9 billion of unrestricted financial resources, strong operating cash flow in excess of $2 billion, and active treasury management, we do not believe these derivative instruments pose a credit risk to the University inconsistent with the current rating.

STRENGTHS:

*The University of California is one of the premier higher education systems in the world, serving over 200,000 students, conducting over $3 billion of research annually (excluding its role in managing several national laboratories), and generating in excess of $4 billion of net patient revenue at its five academic medical centers;

*Healthy and highly consistent operating performance, with operating cash flow in excess of $2 billion driven by a highly diversified revenue stream with no single revenue source exceeding 26% of total revenues;

*Sizeable balance sheet that remains highly liquid, with $5.9 billion of unrestricted financial resources and active treasury management monitoring a short-term investment pool approaching $8 billion in recent years;

*Management and board focus on long-term strategic planning, accountability, transparency, and improved balance of central administrative controls versus individual campus autonomy, should enhance relationship with State and continue growth in philanthropic and other external support;

CHALLENGES:

*The University as a whole faces significant capital needs that are likely to result in rising borrowing levels; the Board of Regents has approved an additional $1 billion in various capital projects with associated debt expected to be issued over the next few years; despite expectations for rising capital investment and debt, we believe management and the board will remain prudent and focus on utilizing debt strategically while reserving some future debt capacity as an important asset;

*Substantial exposure to healthcare sector (26% of operating revenues) and associated credit challenges, including generally more volatile operating performance, high susceptibility to regulatory and government payor changes, and unique stresses on California healthcare, including rapidly rising construction costs, unionized labor, and seismic requirements;

*Retirement benefits are likely to be significant and require additional funding over time; the System is expected to report a significant postretirement liability associated with GASB 45, and it is uncertain how the System will manage this liability, although upfront funding or financing for the liability is not expected.

MARKET POSITION/COMPETITIVE STRATEGY: PREMIER ACADEMIC INSTITUTION, WITH LEADING MARKET POSITIONS IN TEACHING, RESEARCH AND CLINICAL CARE

Moody's believes that the University of California's premier position in teaching, research and clinical care, along with a clear role in the State's higher education system as the research intensive institution are vital components of its credit strength. The University's enrollment exceeds 200,000 students, the largest such single system in the country, with continued growth expected. UC maintains ten campuses with each campus (other than the new Merced campus and the San Francisco specialized health sciences campus) enrolling between 15,000 and 33,000 students. Through a strong emphasis on research, the University has achieved unique success in rapidly developing multiple campuses ranked near the top in the country. Five of its campuses are ranked in the top twenty universities in research funding according to the National Science Foundation. While differences in selectivity rates and academic rankings remain between the campuses, overall student demand is extraordinarily strong. Undergraduate selectivity ranges from just 24% to a high of 87% at the established campuses (excluding Merced). In-state demand is so strong, that UC does little recruiting of freshman from out-of-state. Moodys views this as an untapped strategic asset because UC could easily increase its student demand further if it followed national recruiting practices similar to most peer universities.

Although the University has benefited from favorable demographic trends in the State over the last decade, projections for the number of high school graduates call for a declining trend beginning this year through 2017. Overall, a 7% decline is expected from 2007 to 2017. However, we believe the University will comfortably address this downturn as it is frequently the top choice of students and has historically done very limited out-of-state recruitment for undergraduates. The University expects the rate of growth in undergraduate enrollment to slow and will focus more heavily on increasing graduate enrollment as the proportion of graduate students to total enrollment has fallen dramatically over the last several decades.

The UC system collectively represents a vital part of the nation's research infrastructure, as evidenced by its status as the largest university recipient of federal R&D spending in the country. Total grants and contract revenue in FY2006 exceeded $4 billion, with research expenditures exceeding $3 billion. In FY2006, approximately $1.6 billion of research funding was received from the National Institutes of Health. Three of the campuses of the University are in the top ten recipients of total federal research and development expenditures, and five are in the top twenty. Despite a significant slowdown in federal research funding and rapidly increasing competitiveness for grants, UC has sustained positive trends in research expenditures and revenues. The rate of growth in research expenditures has slowed over the last few years, but we believe the University's premier reputation, ability to attract top faculty, and diversified campuses and research programs will help the University sustain research trends.

Moody's has historically excluded the revenues and expenses associated with the University's operation of several large federal government research labs. Beginning with FY2007, one of these lab's activities will no longer be presented in the audited financial statements, reducing reported revenues and expenses by over $2 billion. The financial impact on the System is limited as the revenues and expenses were largely pass-throughs and the University will retain its management fee despite the change in reporting and organizational structure.

The five academic medical centers collectively represent the third largest system of publicly-owned hospitals in the nation, after the federal Veterans Administration system and New York City's Health and Hospital Corporation. Each medical center faces unique challenges related to its specific markets, as well as general challenges of operating in a highly regulated health care market in California. We believe the diversification of credit risk across different markets is a credit strength, despite the remaining potential for volatility of the health care sector overall. The medical centers generally provide the highest acuity clinical care in their markets and provide a substantial amount of charity care, both factors which are likely to lead to ongoing support from the University and from the State. The medical centers combined include over 5,000 faculty physicians, 140,000 admissions and nearly 4 million outpatient visits. The Medical Centers largely borrow under a pooled revenue pledge established within the last year. For more information on the medical centers and the medical center pooled revenue bonds, please see our last report dated July 6, 2007.

OPERATING PERFORMANCE: GEOGRAPHIC AND REVENUE DIVERSITY SUPPORT HIGHLY CONSISTENT AND FAVORABLE OPERATING PERFORMANCE

We expect the University to sustain favorable operating performance across the System, driven by highly diversified revenues and a renewed focus on operational efficiencies. UC has generated an operating margin averaging more than 4% for the last six years (since current GASB reporting standards were adopted) and in FY2006 operating cash flow exceeded $2 billion. While the individual components of the University's revenues each face their own challenges and potential volatility, we believe the diversity of revenue sources and the geographic diversity within each revenue source should provide a large degree of stability for the organization overall.

Patient care, the largest single revenue stream, makes up 26% of total revenues. However, these revenues are spread across five academic medical centers in distinct markets within California, representing a diversified market and public service presence throughout the state. There are clearly high degrees of correlation for these medical centers, especially if an unfavorable downturn in performance was driven by changes in Medicare or Medicaid funding levels, but we believe the geographic diversity is a meaningful positive for the organization. The Medical Centers generally have very large ongoing capital projects, including replacement facilities. While operating performance has remained very high across the system, we believe performance is likely to moderate in the future.

Similarly, grants and contracts revenues, primarily for research, may face some challenges given shifting federal funding for research and typically more volatile corporate and foundation funding. However, as discussed above, the research revenues are diversified by campus and by granting agency, with some concentration from NIH. The University has demonstrated a willingness and ability to work with corporate and other non-federal research funding sources, which should aid its ability to sustain growth in this area.

Net tuition and student related auxiliary revenues account for less than 15% of revenues. While trends in enrollment and net tuition rates remain positive, we believe constraints on future growth in this area will largely be mission-based and politically driven as market drivers would likely allow the University to grow tuition revenues at even higher rates than recent years, especially if the University was willing to seek out a greater proportion of out-of-state students.

Funding from the State of California (debt rated A1) has been healthy in recent years and in-line with a compact reached several years ago that outlined state levels of support for the University over a multi-year period. In FY2007, state appropriations increased by 8.6% over the prior year, including a variety of funding types. In FY2008, the University's state funding is budgeted to increase by 6.4%. However, the state economy is growing more slowly than it did in 2005 and 2006. Personal income is holding up, as is non-residential building. But the residential housing market is in a significant downturn, and shows no sign of improving in the near future. The housing market slump is affecting the rest of the economy, with certain employment sectors struggling (particularly housing and financial activities) and sales tax revenues dwindling. Since the May Revision to the State's revenue forecasts, actual tax revenue collections for the first month of fiscal 2008 have come in below forecast. Total tax revenues came in 16% below the May Revise for the month of July, with sales tax revenues showing the most significant decline. Personal income taxes were also below forecast.

The state's outyear forecast predicts a budget gap of more than $5 billion in 2009. If revenues continue to come in below forecasts, this could cause some concerns for future University funding. The University and State have made significant progress in building consensus around University funding levels and the importance of the University System to the State's economy. In addition, the State's support now accounts for less than 17% of operating revenues and were just 126% of operating cash flow in FY2006. Therefore, combined with additional tuition flexibility, we believe the University is very well positioned to deal with short-term fluctuations in state operating support.

BALANCE SHEET POSITION: BALANCE SHEET RESOURCES CONTINUE TO GROW AT RAPID RATE, SUPPORTING CAPITAL INVESTMENT AND ADDITIONAL LEVERAGE OVER TIME

Moody's believes that the University's demonstrated ability to grow financial resources through operating performance, investment returns and philanthropy should support planned strategic capital investments and additional leverage. UC's financial resources have grown from approximately $11 billion in FY2002 to over $15.5 billion in FY2006. Expendable financial resources have grown from less than $8 billion to over $13 billion over the same time period.

Resource growth has partially been driven by fundraising success across the campuses. The University reports total private giving in FY2006 approached $1.3 billion with over $10 billion raised in the last decade. Each campus maintains its own development effort and typically campuses are at varying stages of fundraising campaigns at any one time, which tends to reduce the volatility of giving for the System as a whole. The majority of gifts in FY2006 were restricted for various operating purposes and campaigns at many campuses are focused on building endowment for financial aid and for faculty support, including endowed chairs. The University generates a limited amount of giving for annual unrestricted funds, but this will become more of a focus in the future.

UC has also revamped its investment practices over the last several years, with a significant increase in diversity of asset classes and managers, as well as a repositioning of investment staff to focus on new alternative investments. The University's investment office is responsible for the short-term investment pool (STIP), the UC Retirement Plan Funds, the Defined Contribution plans and the Endowment Funds. In total the office manages in excess of $70 billion of assets, although the endowment and STIP are the primary drivers of the University's net asset growth. As recently as FY2000, the University's endowment was invested in just two primary asset classes (domestic equity and domestic fixed income). Over the last few years, the endowment asset allocation has been vastly diversified, which we believe reduced the overall risk of large fluctuations in the value of the pool. The long-term targets for the endowment pool would bring alternative assets (including hedge funds, real estate and private equity) to 35% of the total, with domestic and international equity accounting for another 45% of total assets. The University's overall exposure to private and leveraged investment strategies is still comparatively low and UC reports no material impact from the recent turbulence in credit markets.

The STIP pool represented nearly $8 billion at June 30, 2007, invested 100% in a variety of fixed income instruments including over $3.5 billion of treasury and federal agency debt. Another $4 billion was invested in short-term corporate notes and commercial paper. The University does not have exposure to asset-backed commercial paper programs that underwent a significant loss of liquidity this summer. Management is currently studying investing a portion of the STIP pool in longer term assets, which may included various types of equity instruments. We believe the University is more conservatively invested and more liquid than many peer organizations and do not believe credit quality would be harmed by this potential change. In fact, over the long-term, if the University is successful in generating a higher level of return on the investment pool without sacrificing significant amounts of liquidity, the changes may be favorable for credit quality.

With expendable financial resources covering pro-forma debt by 1.4 times, and debt service consuming only 3.6% of operating expenses, we believe the University retains significant additional debt capacity. In addition, $1.8 billion of the $9.2 billion of direct debt included in our ratios, are issued as State Public Works Board Bonds secured by lease payments of the University but historically paid by the State of California, reducing their consumption of the University's debt capacity.

We believe the University and Board have taken a prudent approach to reviewing debt capacity, engaging external studies on debt capacity and treating debt capacity as an asset that should be deployed carefully. We view this deliberative process as a credit positive. While we do expect debt levels to grow, we believe the University can comfortably absorb its future debt and capital plans. The University expects to issue approximately $350 million of general revenue bonds later this year and the Board has approved an additional $770 million of projects that are expected to be partially financed by debt issued in FY2009 and beyond.

A summary of the University's debt structure is below:

General Revenue Bonds: The senior-most pledge of the University, including a broad pledge of gross revenues and used for the most "core" projects of the System. Approximately $3.7 billion of bonds outstanding with annual pledged revenues of $5.8 billion in FY2006. Rated Aa1/Positive

Limited Project Revenue Bonds: Primarily finances auxiliary services such as housing and parking. Approximately $1.4 billion outstanding, including the current issue. Pledged revenues are subordinate to the general revenue bonds and only include the gross revenues generated by projects financed by the indenture. Overtime, the revenue base is expected to grow, enhancing bondholder security. Revenues were nearly $260 million in FY2006, but should expand considerably when the currently financed projects are completed in FY2010. Rated Aa2/Positive

Medical Center Pooled Revenue Bonds: Secured by gross revenues of academic medical centers. Approximately $735 million of debt outstanding. Pledge is subordinate to limited amount of debt previously issued and secured by revenues of individual medical centers. These senior bonds are expected to be refinanced over time, with approximately $480 million remaining outstanding, primarily at the UC Davis Medical Center. Rated Aa2/Positive

State Public Works Board Bonds: Bonds are secured by the base rent payments of the University under a lease agreement. In practice, debt service has been appropriated and paid by the State. Approximately $1.8 billion of debt outstanding. Rated Aa2/Positive.

Commercial Paper: Rated P-1 and supported by the University's own liquidity, including the vast resources of its short-term investment pool. Holdings of US Treasury securities and federal agency debt far exceed the amount of commercial paper outstanding and the University's treasury function is highly active and positioned to respond to any necessary funding requirements.

Individual Medical Center Bonds: No additional bonds expected to be issued under these indentures, with approximately $480 million of bonds outstanding. Bonds are secured by the revenues of individual medical centers. UCSD bonds are rated Aa3/Positive with $54 million outstanding.

Multiple Purpose Projects Revenue Bonds: No additional bonds expected to be issued under this indenture, with approximately $306 million remaining outstanding. Secured by revenues of projects financed under the indenture ($690 million of revenue in FY2006) Rated Aa2/Positive

Certificates of Participation: No additional bonds expected to be issued under this indenture, with approximately $8 million outstanding. Secured by "lawfully available funds." Rated Aa1/Positive

Research Facility Bonds: No additional bonds expected to be issued under this indenture, with approximately $20 million outstanding. Secured by revenues from renting the facility, indirect cost recoveries. Rated Aa1/Positive.

Outlook

The positive outlook reflects the University's overall market, operational, and balance sheet strength

What Could Change the Rating - UP

Continuation of current trends of financial resource growth, favorable operating performance and further evidence that debt issuance will rise but remain manageable within the context of budget and balance sheet growth.

What Could Change the Rating - DOWN

Dramatic rise in borrowing well beyond current expectations; Sharp reductions in State operating and capital support that extends for multiple years and is not offset by other revenue growth

KEY INDICATORS (FY 2006 financial data, Fall 2006 enrollment)

FTE Enrollment: 191,697

Total Resources: $15.5 billion

Total Pro-forma Direct Debt: $8.9 billion

Expendable Resources to Pro-Forma Debt: 1.4 times

Expendable Resources to Operations: 0.86 times

Average Operating Margin: 4.6%

Reliance on the State: 17%

State of California Rating: A1, Stable

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