

## Fitch Rates University of California's General Rev Bonds 'AA+'; Outlook Stable

Written by Australian Business

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NEW YORK--( [BUSINESS WIRE](#) )--Fitch Ratings assigns an 'AA+' rating to the following series of general revenue bonds (GRBs) in the approximate aggregate amount of \$2.6 billion to be issued by the Regents of the University of California (UC, or the university):

--GRBs 2013 series AI;

--GRBs 2013 series AJ (taxable);

--GRBs 2013 series AK (put structure);

--GRBs 2013 series AL (variable-rate demand bonds).

Fitch also assigns a short-term 'F1+' rating to the 2013 series AL variable-rate demand bonds based on UC's internal liquidity. The bonds are expected to sell via negotiation the week of September 23. Bond proceeds will be used to refund and restructure approximately \$2.4 billion of presently outstanding California State Public Works Board (SPWB) lease revenue bonds (currently rated 'AA' by Fitch) issued by the state on UC's behalf into GRBs, and to pay costs of issuance.

At the same time, Fitch affirms UC's long and short-term ratings as detailed at the end of this release.

The Rating Outlook is Stable.

SECURITY

GRBs are secured primarily by a broad pledge of UC's unencumbered revenues, namely gross tuition and fees, indirect cost recovery revenues, and auxiliary receipts. Presently, the state separately appropriates funds to pay UC's SPWB bond-related debt service directly to bondholders on the university's behalf. While state appropriations are specifically excluded from UC's general revenue pledge, recently enacted legislation allows UC to pledge as general revenues its annual general fund support appropriation, less amounts that are (1) required to fund GO debt service for the portion of state GO bonds funded for university projects, and (2) required to fund rental payments for SPWB lease revenue bonds issued on UC's behalf (to the extent any SPWB bonds remain outstanding).

### KEY RATING DRIVERS

**EXCEPTIONAL REPUTATION:** The 'AA+' rating is primarily supported by UC's strong reputation for academics, research and medical care that continues to promote consistently strong student demand and selective admissions, despite considerable increases in student charges over the past several years.

**SOUND, BUT PRESSURED, FINANCIAL POSITION:** Substantial balance sheet resources; diverse revenues; and a manageable debt burden, despite an increase in financial leverage over the past few years, partially mitigate concern over UC's negative and fluctuating operating results and sizable capital needs. Strategic initiatives undertaken by management as well as the state's stabilizing fiscal position and additional appropriation funding to UC are expected to yield positive results going forward, though slow progress is anticipated.

**STABILIZING STATE FUNDING:** Following years of cuts, implemented and proposed appropriation increases in fiscal years 2013 and 2014 should provide a level of stability to UC's operating budget over the near-term. Partially offsetting the steep decline in funding over the past few years is the university's limited reliance on the state for operating support and the timely measures consistently taken by UC's board of regents and seasoned management team during times of state fiscal stress.

**RESOURCE SUFFICIENCY:** The 'F1+' rating is based on UC's ability to cover the maximum potential liquidity demands presented by its variable-rate debt programs by at least 1.25x from internal resources, including cash and highly liquid, highly rated

investments.

## RATING SENSITIVITIES

**FURTHER MARGIN DETERIORATION:** An inability to stem operating losses and return to a near-breakeven level of performance over the near-term may result in negative rating pressure. The rating and outlook assume that management's ability to improve operations began to be evidenced in fiscal 2013 (audited results are not yet available and interim financial information is not prepared on a university-wide basis).

## CREDIT PROFILE

Chartered in 1868, UC is a comprehensive graduate research university with 10 campuses located in Berkeley, Davis, Irvine, Los Angeles, Merced, Riverside, San Diego, Santa Barbara, and Santa Cruz, with a graduate and research institute in San Francisco for health sciences. It also operates five academic medical centers, three law schools, and a 135,000-acre statewide agricultural and natural resources division. UC's exceptional reputation is the basis for its exceedingly strong demand and selective admissions. Fiscal 2013 enrollment totaled 238,156 students. Applications continue to grow, with nearly 175,000 applicants applying to UC campuses for the fall 2013 term, and an overall acceptance rate of approximately 59% - fairly selective for a public institution.

## Financial Cushion Augments Weakened Operating Performance

While UC's operating deficit narrowed in fiscal years 2010 and 2011, its operating margin fell to negative 8.4% in fiscal 2012 (the most recent audited data available), partly attributed to continued state cuts and rising employee health care related costs. After discussions with management, Fitch expects marginal operating improvement for fiscal 2013, based on a roughly 4.7% increase in state general funds, primarily to augment the state's share of retirement contributions; modest enrollment growth, coupled with past tuition increases; and positive fiscal impact being realized through various cost-saving initiatives. While Fitch anticipates fiscal 2013 and 2014 operating performance to demonstrate gradual improvement, reversion to the fiscal 2012 level will put downward pressure on the rating and/or outlook.

Fitch believes UC's financial cushion continues to support the 'AA+' rating. Available funds, defined as cash and investments less nonexpendable restricted net assets, grew to an impressive \$17.32 billion as of June 30, 2012. Available funds covered fiscal 2012 operating expenses (\$26.05 billion) and pro forma debt (about \$17.12 billion) by a solid 66.5% and 101.2%, respectively. Pro forma debt includes revenue bonds, commercial paper (CP), various bank loans and capital leases, and non-cancellable operating leases. Also included are the \$2.4 billion of presently outstanding SPWB lease revenue bonds issued by the state on UC's behalf, and which are being refunded and restructured under the university's GRB indenture.

The available funds balance is expected to have improved in fiscal 2013, with UC's short-term investment pool and total return investment pool having grown to \$10.6 billion and \$4.5 billion, respectively as of June 30, 2013 (from \$9.8 billion and \$4.3 billion, respectively as of June 30, 2012). UC's general endowment pool improved to \$7 billion from \$6.4 billion over the same period.

UC benefits from a very diverse revenue base, a credit factor Fitch views favorably. Its largest funding sources include revenues derived from the operation of its medical centers (28.4% of fiscal 2012 operating revenues), grants and contracts generated by its substantial sponsored research activities (23.3%), and student-generated revenues, including tuition, fees, and auxiliary receipts (18.6%). State appropriations still represent a notable sum (\$2.27 billion in fiscal 2012), though as a percent of revenues continued to decline, to 9% in fiscal 2012 from 16% in fiscal 2008.

Federal monies received for research and interest subsidies associated with Build America Bonds related debt service could be or already have been affected by federal sequestration. Fitch anticipates that management will be able to make necessary budgetary adjustments, with any impact expected to be minimal relative to UC's total resource base. Its significant pension and retiree health benefits liabilities present additional operating pressures, although UC is expected to apply any cash flow savings realized through the SPWB restructuring to its pension costs.

Complex, Yet Manageable Capital Structure

Total pro forma maximum annual debt service (MADS) occurs in fiscal 2019 at roughly \$1.2 billion, including UC's \$286.5 million of outstanding 2013 series AH put bonds that the university intends to remarket come fiscal 2019. While this figure has grown in recent years, UC's pro forma debt burden remains manageable, with MADS consuming a moderate 5% of fiscal 2012 operating revenues of \$24 billion. MADS includes debt service on UC's GRBs, limited project revenue bonds (LPRBs), medical center pooled revenue bonds (MCPRBs), hospital revenue bonds, as well as debt service associated with the SPWB bonds now being refunded into GRBs. Going forward, SPWB-related debt service will no longer be a line item appropriation; instead, UC expects to receive a like amount as part of its overall state appropriation.. However, the additional appropriations will not materially alter the pro forma debt burden as it will have minimal effect on the UC's large operating budget.

Fitch notes that GRBs, LPRBs and MCPRBs are each secured by separate, designated revenue streams. General revenues securing GRBs totaled a substantial \$9.67 billion in fiscal 2012 compared to GRB pro forma MADS of roughly \$878.3 million.. Adjusting for the 2013 series AH put bonds, GRB average annual debt service is a more manageable \$417.4 million.

Following issuance of the 2013 series AI-AL bonds, the expectation is that the state will continue to appropriate the necessary funds to adequately cover debt service on the refunded SPWB bonds. The funds will be added to UC's annual general appropriation rather than distributed as a separate line item. Fitch notes positively that despite an increasing debt load and years of significant state funding cuts, UC's debt burden remains manageable and partially mitigates concern over annual appropriation risk. However, further growth in UC's debt burden absent near-term financial performance improvement could negatively pressure the rating.

### State Environment Stabilizing but Pressures Remain

Following several years of significant cuts, state appropriations to UC are beginning to stabilize and slightly increase. Fitch rates California GOs 'A' with a Stable Outlook. Fitch viewed favorably voter passage of the governor's tax increase initiative (Proposition 30) in November 2012, which eliminated further cuts to higher education in fiscal 2013. The state's fiscal 2013 budget provided UC an \$89.1 million increase for its share of employer retirement contributions; a \$5.2 million increase for health benefits; and \$11.6 million for lease revenue bond debt service. In connection to passage of Proposition 30, UC will receive \$125 million in additional state funds in fiscal 2014 in return for having not

raised tuition for the 2012 - 2013 academic year.

In addition to the above, the state's adopted 2013-2014 budget includes a further base budget adjustment of \$125.1 million for UC, as well as increased funding for health benefits (\$6.4 million) and lease revenue bond debt service (\$10.2 million). UC's fiscal 2014 state general fund budget for operating purposes totals \$2.84 billion, up from \$2.38 billion in fiscal 2013 and \$2.27 billion in fiscal 2012. The fiscal 2014 figure also includes \$200.4 million of state GO bond debt service. While additional funding is positive, UC did not raise tuition for 2013-2014, which is the second year of flat student charges, and the first year of the governor's proposed four-year tuition freeze. This somewhat limits UC's tuition raising flexibility, which Fitch has historically noted as a credit positive.

Fitch affirms the following ratings:

--\$6.31 billion GRBs at 'AA+';

--\$3.3 million GRBs 2011 series W (taxable Clean Renewable Energy Bonds) at 'AA+';

--\$48.7 million California Statewide Communities Authority, Recovery Zone Economic Development Bonds (UC Merced Student Housing Phase 4) 2010 series A at 'AA+';

--\$500 million GRBs 2011 series Y (taxable floating-rate notes) at 'AA+/F1+';

--\$150 million GRBs 2011 series Z (taxable variable-rate demand bonds) at 'AA+/F1+';

--\$286.5 million GRBs 2013 series AH (taxable fixed-rate notes, six-year put structure) at 'AA+';

--\$1.99 billion LPRBs at 'AA';

--\$2.82 billion MCPRBs at 'AA';

--\$2 billion taxable and tax-exempt CP program at 'F1+'.

Additional information is available at '[www.fitchratings.com](http://www.fitchratings.com)'.

Applicable Criteria and Related Research:

--'U.S. College and University Rating Criteria' (May 10, 2013);

--'Criteria for Assigning Short-Term Ratings Based on Internal Liquidity' (June 13, 2013);

--'Fitch Affirms Ratings for California GOs at 'A'; Outlook Stable' (August 19, 2013).

--'Fitch Rates University of California's Medical Center Pooled Rev Bonds 'AA'; Outlook Stable' (July 23, 2013).

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U.S. College and University Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=708049](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=708049)

Criteria for Assigning Short-Term Ratings Based on Internal Liquidity

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=708640](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=708640)

Additional Disclosure

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