MOODY'S UPGRADES RATING ON UNIVERSITY OF ROCHESTER TO Aa3 FROM A1 IN CONJUNCTION WITH CONVERSION OF SEVERAL SERIES OF VARIABLE RATE DEBT; OUTLOOK IS STABLE

RATINGS AFFIRMED ON $618 MILLION OF DEBT BACKED BY THE UNIVERSITY

Dormitory Authority of the State of New York
Higher Education
NY

Opinion

NEW YORK, Aug 26, 2008 -- Moody's Investors Service has upgraded the rating on the University of Rochester to Aa3 from A1 in conjunction with the conversion and reoffering of several series of bonds. The outlook is stable. The upgrade is driven by continued strong trends in operating cash flow, balance sheet growth and a strengthening student market position. The University will convert the Series 2003A and B bonds from an auction rate mode to a daily VRDO mode backed by letters of credit from JP Morgan and HSBC respectively. The Series 2003C bonds will be converted from an auction rate mode to a weekly VRDO mode backed by a letter of credit from JP Morgan. MBIA insurance on the bonds will be terminated. The University will also terminate the MBIA insurance on the Series 2006A-1 and 2006B-1 bonds and replace the existing standby liquidity facility with a direct-pay letter of credit from Bank of America. Although these changes increase the amount of puttable variable rate debt for the University, the total of $254 million remains manageable given the University's $1.6 billion of unrestricted financial resources. The variable rate and swap exposure of the University will not change as the existing swaps will remain as hedges against the restructured bonds.

Moody's also maintains a Baa1 rating on Highland Hospital's bonds. Highland Hospital is a wholly owned subsidiary of the University.

LEGAL SECURITY: The bonds are a general, unsecured obligation of the University.

INTEREST RATE DERIVATIVES: The University has two swaps outstanding related to the Series 2003 bonds and the 2006A and 2006B bonds. Under the swap for the Series 2003 bonds, the University pays a fixed rate in exchange for variable payments based upon a percent of LIBOR. The swap term matches the maturity of the bonds, expiring in 2033. In connection with the 2006A and 2006B financing, the University entered into a swap for the full amount of the bonds, under which it pays a fixed rate in exchange for variable payments based on the BMA index.

STRENGTHS

- Large and diversified enrollment base (8,274 full-time equivalent students) with highly reputable graduate programs and continued healthy growth in net tuition per student ($17,979 in FY2007); continued strengthening of student demand most directly demonstrated by a ramp up in yield on admitted students to 23.4% in fall 2007 from 19% in fall 2005;

- Healthy and highly consistent cash flow generation by the University as a whole (average operating margin of 3.4%) stemming from strong performance of health system, growing research activities and a rising endowment;

- Large financial resource base ($2.2 billion of total financial resources) which has exhibited continuous growth over the last few years as fundraising and investment returns fueled growth;

- Potential for significant expansion in fundraising success as senior leadership team focuses on investing in
development infrastructure (gift revenue of $75 million in FY2007)

CHALLENGES

- Relatively heavy reliance on healthcare operations (64% of total revenue) which has historically been more volatile than other University operating units, although recent performance has been strong and hospitals are leaders in service area;

- Highly competitive environment for students (demonstrated by low matriculation rate of 23%) may place pressure on future tuition flexibility, although recent enrollment trends have been sustained as the University has lowered its discount rate;

- Capital spending requirements are likely to remain substantial, but operating cash flow and rapid retirement of debt should continue to sustain debt capacity.

MARKET POSITION/COMPETITIVE STRATEGY: STRENGTHENING OF STUDENT MARKET POSITION EXPECTED TO CONTINUE; HEALTHCARE SYSTEM MAINTAINS MARKET LEADERSHIP

Moody's believes the University of Rochester will continue to build strength in its undergraduate and graduate student markets, despite strong competition, leading to relatively stable enrollments and student related revenues. The University experienced greater than 3% growth in total FTE enrollment for the last two years, with total enrollment rising to 8,274 students. The University's graduate enrollment is relatively large, comprising approximately 40% of total enrollment. Although the University faces strong competition from other educational institutions, management has continued to improve the University's standing, with continual improvements in selectivity (40% in fall 2007 compared to 53% in fall 2002). The University achieved an increase in yield on admitted students for the last three years after reaching a low of 19.7% in fall 2004 (compared to 23.4% fall 2007). Management reports similar success in the fall 2008 class. Moody's believes the improvement in yield rate, coupled with ongoing growth in net tuition per student, may signal a notable strengthening trend in the University's market position. The University's diverse program array also provides some cushion to variances in demand for any particular program.

Strong Memorial Hospital (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 together with Highland Hospital (HH) a growing 53.1% market share in the greater Rochester metropolitan area (based on 2006 data), well ahead of Rochester General Hospital's 30.5% and Park Ridge Hospital's 16.4%. After the opening of eighteen new beds, inpatient admissions grew 2.1% in FY 2008 due to improved patient throughput and length of stay initiatives, although occupancy remains elevated at 93.5%.

OPERATING PERFORMANCE: OPERATING PERFORMANCE HAS REMAINED HEALTHY, CONTINUING LONG TREND OF BALANCED OPERATIONS FOR THE UNIVERSITY AS A WHOLE

Moody's expects the University of Rochester to maintain a long record of balanced operating performance, although heavy reliance on healthcare operations indicates some potential for volatility in performance over the long term. On a consolidated basis, the University has generated an average operating margin of 3.4% over the last three years. Operating cash flow margins have consistently been approximately 10% in the last three years. Average debt service coverage has remained healthy as well, reaching 3.9x in FY2007.

The University's revenue sources are varied, but somewhat concentrated in healthcare activities (64%). In addition, grant and contract revenue, primarily reflecting the research activity of the University represents 16% of operating revenues, with student derived tuition and auxiliary service revenue representing just 9% of the total. 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.

The health care entities generated a ninth consecutive year in annual improvement in operating cash flow with a $110.4 million (9.6% margin) in FY 2007, up from 102.3 million (9.6% margin) in FY 2006. Despite a decline in case mix, operating revenues grew 7.7% due to aforementioned volume growth and payment rate increases. SMH and HH were not materially impacted by Recovery Audit Contractors (RAC), with less than $1.0 million impact in FY 2007 and do not expect any material impact in FY 2008. SMH continues to address capacity constraints and decompress the main campus and ramp up services at HH. Future financial performance will depend on management's ability to address capacity constraints through securing a certificate of need for future bed expansion. We do caution that the governor has recently proposed cuts in the Medicaid budget, which could have a negative impact on SMH, given its relatively high mix of Medicaid...
Grant and contract revenue has grown rapidly in past years and somewhat flattened recently. Declines in a particularly large program from the Department of Energy have been off-set by growth in core funding from NIH. Grant and contract revenue reached $362 million in FY2007 compared to $205 million in FY2000.

The University's ability to continue to attract stable enrollment should ensure that tuition revenues continue to grow. In addition, as the University has invested in development and fundraising efforts, gift revenue has grown, with $42 million in unrestricted gifts and $75 million in total gift revenue in FY2007, compared to $23 million and $43 million respectively in FY2006. Expanded fundraising staff and investment should fuel additional annual fund and endowment growth to support operations.

BALANCE SHEET POSITION: FINANCIAL RESOURCES EXPECTED TO REMAIN STRONG DESPITE WEAKER INVESTMENT ENVIRONMENT DUE TO DIVERSIFIED INVESTMENT STRATEGIES AND RENEWED FOCUS ON DEVELOPMENT EFFORTS

Moody's believes that the University's balance sheet profile will continue to provide a strong underpinning for credit quality. The majority of the University's $2.2 billion in total financial resources are liquid, with $1.9 billion of expendable financial resources, covering pro-forma debt over 2.6 times.

The University's fundraising activities are expected to expand substantially as the university leadership embarks on a significant capital campaign. Senior management projects a large increase in headcount within the development office. In addition, the University has invested in a new development system and expansion of related expenses. This expansion will occur at a difficult time economically, but the investment is expected to produce higher levels of support over the long-term.

The University's investments are well diversified across traditional equities (42%), traditional fixed income (12%), hedge funds and other alternatives (46%). The investments are spread across 75 different managers, providing strong diversification. The one-year return as of June 30, 2007 was 19% and management expects a fairly minimal loss for FY2008, despite difficult investment markets. Investments are managed by an investment office, although the investment committee of the board remains involved in certain key decisions, including any significant changes to asset allocation and the addition of any new strategies.

The University's debt structure is somewhat unique in that a large portion of principal is retired annually and future debt service declines substantially over time. In each of the last three years, the University has paid down approximately $30 million in debt annually. The University is likely to continue significant capital investment and renewal spending over time, including for an expansion of over 100 beds at the hospital, leading to new money issuance in excess of $200 million projected for 2009.

Outlook

The stable outlook is based on Moody's expectation of expansion of fundraising success while maintaining positive operating performance.

WHAT COULD CHANGE THE RATING - UP

Ability to expand fundraising success leading to growth in financial resources relative to debt and operations, without deterioration in performance of healthcare enterprises

WHAT COULD CHANGE THE RATING - DOWN

Operating deficits; rapid expansion of debt without offsetting financial resource growth

KEY DATA AND RATIOS (Fiscal year 2007 financial data; fall 2007 enrollment data):

Total Enrollment: 8,274 full-time equivalent students

Total Pro-forma Direct Debt: $710 million
Expendable Resources to Pro-forma Debt: 2.66x

Expendable Resources to Operations: 0.87x

Three-Year Average Operating Margin: 3.4%

RATED DEBT:

University Backed Bonds:

Series 1999A and B, 2004A, 2007A and B: Aa3 rating


Series 2001A: Aa3 rating; Insured by Ambac whose current financial strength rating is Aa3 with a negative outlook

Series 2003A, B and C, and 2006A-1 and B-1: Aa3 underlying rating; enhanced rating based on letters of credit

Highland Hospital Backed Bonds: Fixed Rate Series 2005C, Direct Note Obligation (Taxable) Series 2005: Baa1 rating

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