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# Rating Update: Moody's revises outlook to negative and affirms Aa2 for University of Hawaii

Global Credit Research - 25 Aug 2014

**$609M rated debt**

BOARD OF REGENTS OF THE UNIVERSITY OF HAWAII
Public Colleges & Universities
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**Opinion**

NEW YORK, August 25, 2014 --Moody's Investors Service affirms University of Hawaii's (UH) Aa2 issuer and revenue bond ratings and revises outlook to negative. The university also has $0.7 million of reimbursable State-issued general obligation bonds which are rated Aa2 based on the State of Hawaii's rating, with the university reimbursing the state for debt service.

SUMMARY RATING RATIONALE:

The negative outlook reflects University of Hawaii's deepening deficits with further operating pressure expected as it makes incremental other post-retirement benefits (OPEB) contributions beyond the earmarked state appropriations in fiscal year (FY) 2015 to meet the state's mandate to fully fund the OPEB Actuarially Required Contribution (ARC) liability by FY 2019.

The University of Hawaii's Aa2 rating reflects its essential role in the State of Hawaii (rated Aa2, stable) as the sole provider of public higher education with large enrollment at its two- and four-year campuses across the state, diversified revenues including strong state support for operations (including employee benefits and debt service) and capital, and good financial resources cushioning debt. Offsetting challenges are increasing deficits caused by expenses growing at a faster pace than revenues, which have stagnated due to slowed enrollment growth and flat state operating support in FY 2013. Other credit challenges include a rising non-cash OPEB liability that is substantially depressing net assets on a GAAP basis and Moody's calculated financial resources.

CHALLENGES

*Deepening deficit operations are eroding the university's financial resources. Cash flow declined to just 3.2% in FY 2013.

*The state's plan to fully fund the OPEB ARC liability by FY 2019 will further pressure the university's operations in the near term as the OPEB expense rises by 20% in FY 2015 and the university is required to pay additional contributions.

*Substantial and rising post-retirement health benefit (OPEB) liability of $514 million in FY 2013 depresses financial resources as calculated by Moody's, with the liability representing the university's share of the Hawaii Employer-Union Health Benefits Trust Fund, an agent, multi-employer defined benefit plan providing healthcare benefits to governmental employees.

*The university has a large backlog of deferred maintenance (over $400 million) which could result in additional debt and increased leverage over time.

STRENGTHS

*University of Hawaii plays a vital state role as the sole public higher education institution, with substantial enrollment of over 40,000 full time equivalent (FTE) students) across its 10 campus system.

*Total revenue growth is expected to resume as state operating support is increasing (3.3% and 12% for FYs 2014 and 2015, respectively), and the university increases tuition 7% for fall 2014 and 7% in fall 2015.

*Diverse revenue sources include a strategically important research enterprise in the US Pacific, reflected in relatively stable grants and contracts (almost one third of total revenue). Primary funding agencies are the National Science Foundation and the Departments of Defense, Commerce and Education.

*When adjusting for the OEPB liability, which the state primarily funds, the university's expendable financial coverage of debt and operations (1.2 and 0.46 times, respectively) is in line with the Aa2 public university medians of 1.17 times and 0.48 times coverage.

*Flexible reserves continue to provide adequate financial flexibility to manage through deficits, with $494 million of monthly liquidity available at June 30, 2013, translating to a solid 128 monthly days cash on hand.

DETAILED CREDIT DISCUSSION

We expect University of Hawaii to continue to face a challenging operating environment in the near term as it adapts to additional OPEB expenses while instituting expense control measures across the 10 campuses. Act 268 requires that each public employer's contribution to be equal to the full ARC amount by FY 2019. This reform will be a long term credit positive for the university by reducing the university's OPEB liability over time. However in the near to medium-term it will result in rapid expense growth with a scheduled five year phase-in of the contribution requirements of 20% increments in FYs 2015-2019. The required additional contribution in FY 2015 is approximately $12 million. The state will continue to make the OPEB pay-go payments on behalf of the university.

University of Hawaii's operating results fluctuate with changes to state support due to a relatively higher 38% dependence on state and government appropriations for operating revenues, by Moody's calculation. The university is projecting continued deficit operations in FY 2014, but expects improved cash flow in the current 2015 fiscal year ending June 30, 2015 due to a 7% tuition increase and 12% increase to state appropriations.

Enrollment is expected to remain relatively stable, with some modest contraction due to non-traditional and community college students returning to the workforce as the economy improves.

The university has instituted some positive governance and management practices recently which should help it attain greater expense control. Beginning in FY 2015 the board is instituting productivity and efficiency metrics, and will be assigning goals to each. In addition, the board and senior management will do quarterly reconciliation of the operating budgets by campus, allowing it to measure expense control and revenue growth throughout the year.

DEBT STRUCTURE: The university's approximately $635 million of debt (as of June 30, 2013) is all fixed rate with regular long-term amortization schedules. All university revenue bonds are secured by a first lien on the Network revenue, including System revenues consisting of various housing and auxiliary activities, a subordinate lien on Legislative Appropriations in special and revolving funds appropriated or allocated to the Board of Regents, the university, the System or the Network, to the extent permitted by law, which includes tuition and fees. FY 2013 system gross revenues of $102 million provided debt service coverage of 2.9 times. The special and revolving fund balance is approximately $200 million for FY 2013.

The lien on special and revolving funds is subordinate to payment on the Series 2006A University (School of Medicine) Bonds, as well as the reimbursement to the state for debt service on its general obligation bonds issued for university purposes.

Approximately 43% of the university's total bonds have debt service paid by state funds. The Series 2010A-1 and A-2 (Cancer Center) bonds are additionally secured by amounts on deposit in the Hawai'i Cancer Research Special Fund. As long as any Series 2010A-1 or A-2 bonds remain outstanding, the Legislative Appropriation is to be allocated to the University's Cancer Research Center to be used solely for repayment of debt service on these bonds and current expenses and capital expenditure of the Cancer Research Center. For FY 2013, the university received $14.4 million of funds from the State for the center, compared to $9.9 million in debt service, providing 145 times debt service coverage.

The Series 2006A University (School of Medicine) Bonds are additionally secured by tobacco settlement receipts. Under its Master Settlement Agreement with tobacco companies, the state has pledged to provide 28% of the state annual tobacco settlement receipts for the payment of debt service on the bonds. To date, coverage has remained consistent. In FY2013, the university received $12.6 million of funds for debt service, providing 1.28 times debt service coverage.

OUTLOOK

The negative rating outlook reflects expectations of continued deficit operations in FY 2014 and some further deterioration of flexible reserves. Failure to make expected progress toward improved operations in FY 2015 will result in negative rating action.

WHAT COULD MAKE THE RATING GO UP

The university's rating could be upgraded with positive change to the State of Hawaii's credit profile, as well as sustained improvement to operations and substantial growth in financial resources. The outlook could return to stable with consistently improved operations, combined with stable to growing monthly liquidity, enrollment and net tuition revenue.

WHAT COULD MAKE THE RATING GO DOWN

Continued deficit operations or declines in flexible reserves would cause negative rating pressure, as would negative rating action to the State of Hawaii.

KEY INDICATORS (Fall 2013 enrollment, FY2013 Financial Results)

*Total FTE Enrollment: 40,458 students

*Total Financial Resources: $445 million

*Total Direct Debt: $626 million

*Total Operating Revenues: $1.44 billion

*Contribution to Revenue from Government Appropriations: 38%

*Monthly days cash: 128 days

*Operating Cash Flow Margin: 3.2%

*Three Year Average Debt Service Coverage: 1.9 times

*State of Hawaii General Obligation Rating: Aa2, stable outlook

METHODOLOGY

The principal methodology used in this rating was U.S. Not-for-Profit Private and Public Higher Education published in August 2011. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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