Update to Key Rating Indicators

Virginia Commonwealth University, VA

Summary Rating Rationale

Virginia Commonwealth University’s (VCU) Aa2 rating incorporates its excellent strategic position as an urban comprehensive university, including its strong academic medical center affiliation with the Virginia Commonwealth University Health System (VCUHS, Aa3 stable). VCU benefits from a large scope of operations, steady enrollment, and manageable debt. Tempering the rating are modest prospects for significant revenue growth due to potential softening Commonwealth of Virginia (Aaa stable) support, student demographics prompting limited tuition growth, and heightened competition for federal research funding.

Credit Strengths

» Solid market profile as a public urban research university with strong ties to academic medical center
» Ongoing support for operations and capital from the Commonwealth of Virginia, including active state oversight
» Strong sponsored research enterprise with $174 million in research expenses in fiscal 2016
» Effective budgeting practices including oversight for strategic use of debt capacity

Credit Challenges

» Softening tuition revenue growth due to rising financial aid needs and flat enrollment
» Generally modest operating cash flow margins limit prospects for significant reserve growth
» State operating appropriation cuts for fiscal 2018 add pressure to expense containment
» Exposure to federal funding environment for sponsored research, a strategic element of university and health system collaboration

Rating Outlook

The stable outlook incorporates expectations that VCU will maintain a steady market position, with strong affiliation with VCUHS, generating operating cash flow margins of 8-10% annually. The outlook also acknowledges that VCU will be measured in its approach for increased debt in light of gradually growing cash and investments.
Factors that Could Lead to an Upgrade

» Marked increase in liquidity and other flexible reserves, including heightened donor support
» Sustained improvement in operating performance

Factors that Could Lead to a Downgrade

» Sustained weakening of operating performance
» Material erosion of unrestricted liquidity
» A change in the relationship with VCUHS leading to weakened strategic and revenue alignment

Key Indicators

Exhibit 1

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<tbody>
<tr>
<td>Total Fall Semester FTE Enrollment</td>
<td>27,710</td>
<td>27,690</td>
<td>27,775</td>
<td>27,709</td>
<td>27,702</td>
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<tr>
<td>Operating Revenue ($000)*</td>
<td>861,144</td>
<td>892,822</td>
<td>934,503</td>
<td>986,992</td>
<td>1,015,406</td>
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<tr>
<td>% Annual Change in Operating Revenue*</td>
<td>3.7</td>
<td>4.7</td>
<td>5.6</td>
<td>2.9</td>
<td></td>
</tr>
<tr>
<td>Total Cash &amp; Investments ($000)</td>
<td>1,895,027</td>
<td>2,206,968</td>
<td>2,710,219</td>
<td>2,858,012</td>
<td>2,783,635</td>
</tr>
<tr>
<td>Total Debt ($000)</td>
<td>715,915</td>
<td>797,297</td>
<td>1,018,141</td>
<td>1,013,417</td>
<td>1,002,136</td>
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<tr>
<td>Spendable Cash &amp; Investments to Total Debt (x)</td>
<td>2.3</td>
<td>2.4</td>
<td>2.4</td>
<td>2.5</td>
<td>2.4</td>
</tr>
<tr>
<td>Spendable Cash &amp; Investments to Operating Expenses* (x)</td>
<td>2.0</td>
<td>2.2</td>
<td>2.6</td>
<td>2.7</td>
<td>2.4</td>
</tr>
<tr>
<td>Monthly Days Cash on Hand (x)*</td>
<td>181</td>
<td>172</td>
<td>157</td>
<td>142</td>
<td>157</td>
</tr>
<tr>
<td>Operating Cash Flow Margin (%)*</td>
<td>14.2</td>
<td>10.4</td>
<td>9.7</td>
<td>11.7</td>
<td>8.8</td>
</tr>
<tr>
<td>Total Debt to Cash Flow* (x)</td>
<td>5.8</td>
<td>8.6</td>
<td>11.2</td>
<td>8.8</td>
<td>11.2</td>
</tr>
<tr>
<td>Annual Debt Service Coverage (x)*</td>
<td>3.5</td>
<td>2.2</td>
<td>1.6</td>
<td>2.6</td>
<td>1.8</td>
</tr>
</tbody>
</table>

* Some key indicators exclude VCU Health System income statement based financial information.
Source: Moody’s Investors Service

Detailed Rating Considerations

Market Profile: Stable Enrollment and Benefit as Urban Research University with Academic Medical Center

VCU is well positioned as a comprehensive urban research university in Virginia’s capital, with strong graduate health science programming through its affiliation with the VCUHS academic medical center. Enrollment has been steady, with 27,702 full-time equivalent (FTE) students in fall 2016. First-time freshman counts have been on the rise, to roughly 4,200 in fall 2016, up from 3,617 in fall 2012, drawn largely from the state (89% of fall 2016 freshman). Incoming transfer students of roughly 2,000 annually are an important component of enrollment, with nearly three-quarter from Virginia’s community colleges. The university aims to improve graduation and retention rates.

VCU and the VCU health system are closely aligned by governance and by the fact that the full-time medical faculty account for the majority of hospital admissions. The hospitals facilitate programming for VCU’s Schools of Medicine, Dentistry, Nursing, Pharmacy, and Allied Health Professions. VCUHS maintains a solid market position, serving as a regional referral center and the most comprehensive academic medical center for much of central Virginia. Though VCUHS operates in a competitive market, it maintains a notable 22% market share. Favorably, the higher mix of high acuity diagnoses has benefited the VCUHS’s patient care reimbursements.

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The university, in association with the VCUHS, has a robust research enterprise, recording $174 million in research expenses in fiscal 2016, up a significant 28% from FY (fiscal year) 2012. With National Cancer Institute designation and other biomedical strengths, the university is somewhat reliant on funding from the National Institutes of Health, which comprised 32% of total FY 2016 awards of $271 million. Management has a clear assessment of the likely challenges to federal research funding in the coming years and is undertaking efforts to maintain its competitive position.

**Operating Performance: Modest Margins Will Be Pressured by FY 2018 State Cuts**

Operating performance of the university will remain modest into fiscal 2018. VCU has been adjusting to the rising financial aid needs of its students through expense reallocation, gifts and securing additional state appropriation aid for this purpose. Preliminary discussions for fiscal 2018 state aid cuts will add pressure to already softened margins. The FY 2016 operating cash flow margin on the university’s $1 billion in operating revenue moderated to 9% from prior years (average 11%), with softer revenue growth outpaced by expenses. Favorably, VCU is in the midst of rolling out a new budget model that will focus on departmental level fiscal objectives.

Debt service coverage remains sound, at 1.8 times for fiscal 2016. Management reports that fiscal 2017 results are likely to be similar to FY 2016 due to a limited 2.5% tuition increase for FY 2017, nearly flat enrollment, and a 9% increase in state funding. The strong increase in state funding reflected additional financial aid support.

On a consolidated basis, combining VCU, the health system and other component units, the university recorded total operating revenues of a significant $3.9 billion. The consolidated operating cash flow margin was 6.6% in FY 2016. The magnitude of patient revenue on the consolidated entity is evident by its revenue concentration of 73% versus 11% for student charges.

**Exhibit 2**

*University Operations are 25% of Consolidated VCU and VCUHS Entity Revenues*

VCU’s Aa2 rating is underpinned by the history of strong state support from the Aaa-rated Commonwealth of Virginia for capital and operating support. The commonwealth’s operating support held firm for fiscal 2017, reflecting Virginia’s commitment to higher education. However, with limited improvement in state revenues for fiscal 2017, the governor had notified agencies, including VCU, to prepare for a 7.5% cut in FY 2018. Favorably, subsequent actions by the legislature may limit VCU to a 3.6% reduction. Though the final outcome for the extent of FY 2018 cuts has yet to be determined, we expect that the university will incorporate prudent budgeting proposals to maintain its steady cash flow.

**Wealth and Liquidity: Growing Cash and Investments with Retained Surpluses and Gift Support**

Total wealth of VCU and its component institutions, including VCUHSA, was a sizeable $2.8 billion at fiscal end 2016, up a significant 45% for the FY 2012-16 period. The rise in cash and investments across all units is attributable to retained surpluses, particularly at the health system, and success of the current VCU capital campaign.
Excluding the Health System’s $1.7 billion wealth, VCU and its direct components (medical college, foundation and real estate foundation) recorded total cash and investments of $1.1 billion. Spendable cash and investments of the university and its direct components of $782 million covered university expenses 0.8 times, favorably exceeding the Aa2-median of 0.7 times.

Philanthropic support will remain an important source of capital investment, program funding and endowment growth. As of February 28, 2017, VCU has garnered $479 million in gifts and pledges toward its $750 million comprehensive capital campaign slated to end in 2020.

A new independent not-for-profit foundation, VCU Investment Management Company (VCIMCO), was formed in fiscal year 2016 to provide investment management services for VCU, VCUHS and affiliated units. When fully operational, VCIMCO expects to oversee investment assets in a manner commensurate with risk and return profiles that will benefit all of the VCU entities. VCIMCO currently has an 11-member independent board. Senior leadership of the new organization have relevant experience aiding measured growth prospects to the new entity. VCIMCO is early in the process of building and gradually transitioning cash proceeds into new assets under management, with over $640 million through February 2017, and a goal to have over $1 billion under management by fiscal end 2018.

The university’s direct investments are currently invested in two tiers: short-term ($195 million at fiscal end 2016) and long-term ($210 million), with a growing portion of the long-term portfolio invested with VCIMCO. The short term pool returned 1.1% during fiscal 2016, while the combined long-term portfolio had a return of -2.7%, relative to the NACUBO -2.4% aggregate return for endowments of similar size.

**LIQUIDITY**

The university will maintain sound unrestricted liquidity. Monthly liquidity of $407 million at fiscal year-end 2016 translates to 157 monthly days cash on hand, nearly on par with the Aa2-median of 152 days.

**Leverage: University’s Debt Service Policy Ensures Manageable Leverage: Recent P3 Housing Project**

The university’s internal policy for debt capacity (debt service on general revenue debt will not to exceed 6% of operating expenses) will continue to ensure manageable leverage. Spendable cash and investments (excluding VCUHS) to university-related debt of $471 million was an ample 1.7 times, compared to the Aa2-median of 1.4 times. Relative to operations, debt to cash flow of 5.3 times was slightly more moderate than the Aa2-median of 4.9 times.

On a combined basis, inclusive of the health system, spendable cash and investments of $2.5 billion compared to overall debt of $1.0 billion was a robust 2.5 times.
Future borrowing plans should remain manageable with an additional $54 million of incremental debt supporting capital investments planned through FY 2018, partially offset by amortization in the intervening years.

VCU recently (August 2016) entered into a public-private partnership (P3) with student housing developer American Campus Communities (ACC) for a new 12-story 1,524-bed residence facility. The facility is currently under construction, and is expected to open in fall 2018. The ACC facility is located on land that is ground leased from VCU. The project will be owned and managed by ACC and will house freshman students. While the university has limited its legal financial obligation to this project, the strategic importance of the housing and reputational risks create strong incentives for involvement should the projects not perform as expected. The credit impact of the project could vary over times based on project performance.

DEBT STRUCTURE
Overall debt of VCU, VCUHS and affiliated foundations was $1.0 billion as of FY-end 2016. Total debt excluding the VCUHS was $493 million, with the majority ($479 million) held at the university. VCU’s direct debt includes: $60 million of Section 9(c) bonds issued through the commonwealth; $228 million of notes issued through the Virginia College Building Authority; $176 million of general revenue pledge bonds, and $14 million in line of credits at the real estate and school of engineering foundations.

The majority of VCU’s debt is fixed rate, though $58 million are direct placements (with US Bank) with demand debt features. The general revenue bonds Series 2012A and 2012B have a put date of May 20, 2019. VCU’s monthly liquidity covers this demand debt by over 7 times.

DEBT-RELATED DERIVATIVES
The university has two swaps with a $58 million total notional amount with Deutsche Bank AG (as of June 30, 2016). As of February 28, 2017, the swaps had a combined negative market value to the university of $8 million.

Under these agreements, VCU receives a variable interest rate from the counterparty and pays a fixed interest rate. Additional termination events beyond standard termination events with relation to the university include a ratings downgrade below Baa2. Given VCU’s ample liquidity relative to the derivative exposure, the risks associated with the swap are manageable within the Aa2 rating category.

PENSIONS AND OPEB
The university has additional debt-like obligations largely through its participation in the state’s multiple employer, cost-sharing defined benefit plans. The largest is the Virginia Retirement System State Employee Retirement Plan. The Moody’s three-year average adjusted net pension liability was $581 million for FY 2016, well above the $320 million net pension liability reported on the university’s statement of net assets. Total adjusted debt (excluding the VCUHSA) of $11 billion remains manageable, at 1.0 times operating revenue, well below the public university median of public university median of 1.4 times.
The university does not administer an OPEB plan, but instead participates in the state's Employee Retirement System. The OPEB liability is reported in aggregate in the state's annual financial report.

**Governance and Management: Excellent Strategic Positioning Reflects AMC Affiliation and State Support**

VCU’s excellent strategic positioning incorporates the close coordination and strategic alignment of the health system and university, as well as the long-standing operating and capital support from the commonwealth. A Virginia statutory requirement holds that the president of the university and vice-president for the health sciences of the university, as well as five non-legislative members of the university's board of visitors, serve as voting members of the board of directors for the health system. In addition, the president of the university serves as chairman of the health system board.

The university is in the early stages of developing a new strategic plan, expected to be rolled out in fiscal 2018. Incorporated in this plan will be a master campus plan vision. Though the university provides a six-year capital plan to the state each year, a fully vetted master plan will be essential for future capital funding by the state or university.

**Legal Security**

The general revenue bonds are secured by the irrevocable pledge of general revenues of the university, including student fees and tuition, auxiliary revenues, and unrestricted gifts, but excluding state appropriations. The university does have certain Qualifying Senior Obligations (Section 9(c) bonds issued by the Commonwealth of Virginia on behalf of VCU) that enjoy a senior pledge on a portion of the university’s revenues. Moody’s maintains ratings on the General Revenue Pledge Series 2013A Refunding Bonds and Series 2014A Bonds.

**Obligor Profile**

Virginia Commonwealth University is a comprehensive public university and academic medical center, established from the merger of two organizations in 1968. VCU is located in Virginia’s state capital of Richmond. For fiscal 2016, university-only revenues totaled $1 billion and in fall 2016, served 27,702 FTE students.

**Moody’s Related Research**


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