APPENDIX C TO REPORT NUMBER 116 OF THE PLANNING AND BUDGET COMMITTEE.

University of Toronto

OFFICE OF THE VICE-PRESIDENT, BUSINESS AFFAIRS - FINANCE

TO: Business Board

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AGENDA ITEM: 8

ITEM IDENTIFICATION: Borrowing Strategy review and recommendations

JURISDICTIONAL INFORMATION:

The Business Board approves the financing of capital projects.

PREVIOUS ACTION TAKEN:

The Business Board approved the Borrowing Strategy on June 17, 2004. Regular updates have been provided to the Board, most recently on November 9, 2006.

HIGHLIGHTS:

The current borrowing strategy is financially prudent and provides sufficient capability to meet key priorities for the next several years.
It is projected to enable additional borrowing of $251 - $349 million by April 30, 2010 over and above the $768.0 million allocated by Business Board to December 31, 2006 under current accounting rules.

The borrowing strategy approved by Business Board in June 2004 included the following key elements:

- Maximum external borrowing capacity equals 40% of net assets averaged over 5 years.
- In the event that outstanding external borrowing exceeds 40% of net assets averaged over 5 years, no further external borrowing will be permitted until such time as the actual outstanding borrowing is not greater than 33% of net assets smoothed over 5 years.
- Maximum internal borrowing capacity equals $200 million of internal funds.
- An internal financing program.

- An internal sinking fund to accumulate funds for repayment of debentures.
- No credit rating parameters.
- No external borrowing debt service or debt repayment requirements.

The borrowing strategy review asked:

- What is the current status?
- How do we compare to others?
- Where are we going? Will this strategy meet our priority needs?
- Should we add credit rating parameters to our strategy?
- Should we add debt service or debt repayment parameters to our strategy?

Current status

This borrowing strategy currently provides for maximum external plus internal borrowing capacity of $821.2 million at April 30, 2006, of which $768.0 million has been allocated by Business Board to projects to December 31, 2006. Actual external borrowing at April 30, 2006 was $483.7 million (excluding $1.9 million to be repaid to lenders during 2006-07). (Additional external borrowing of $75 million on December 13, 2006 brought the external borrowing to about $558.7 million minus any amounts paid to external lenders during 2006-07). Actual internal borrowing to April 30, 2006 was $109.5 million.

Benchmarking

We compared the University of Toronto to selected Moody's U.S. Public College and University Medians 2006, with respect to our external borrowing:

\+ Actual debt per student of $8,034 was well below medians.
\+ Actual debt to total revenue of 27.1% was well below medians.
\+ Actual debt service to operations (expense) of 1.8% was below medians.
\+ Total resources to long-term debt of 3.57 was similar to medians.
\- Unrestricted resources to long-term debt of 0.09 was below medians.
\- Expendable resources to long-term debt of 0.79 was well below medians.
\- Unrestricted resources to expenses of 0.03 was well below medians.
\- Expendable resources to expenses of 0.24 was well below medians.

Conclusion: to date we have borrowed externally less than our rating peers, but we also have fewer resources to support debt issuance, and we have internal debt.

Projecting maximum borrowing capacity

Net assets increase due to 1) net income (revenues minus expenses) for the year across all funds and 2) growth in endowment, including endowed donations and grants and reinvested investment earnings. Growth in maximum borrowing capacity and availability was projected as follows:

- Net assets were projected to be between $2.0 and $2.5 billion by 2010 under current accounting rules, reflecting the long-term operating budget, ancillary long-term budgets, projections of donations, other receipts, and capital expenditures and under several investment return scenarios.
- Maximum external borrowing capacity was projected to be between $773 and $871 million by 2010 at 40% of those results averaged over 5 years.
- The continuing use of $200 million of EFIP funds was confirmed.
- About $46 million in amortizing loan (bank loans, EFIP) repayments and adjustments is expected to be available for reallocation by 2010.

Assuming these projections are reasonable, we would expect between $1.019 billion and $1.117 billion available borrowing by 2010 under current accounting rules. This is about $251 million to $349 million more than the $768.0 million allocated to December 31, 2006 by the Business Board.

Please note that, apart from the uncertainties contained in the assumptions used to project net assets, there is a risk that the accounting rules, particularly with respect to unfunded employee future benefits, could change in future, negatively affecting net assets.

Conclusion: the current strategy should provide the necessary capacity to satisfy graduate and medical enrolment expansion needs with room for other academic priorities over the next few years. No change to the current strategy for determining maximum borrowing capacity is recommended.

Credit ratings

The purpose of credit ratings is to give investors an assessment of a borrower's ability to repay debt.

U of T credit ratings are Aa1 (Moody's), AA (S&P) and AA (DBRS). U of T has ratings higher than those of most of our peers.

Credit ratings are refreshed at least annually by the rating agencies, and may be changed at any time for many reasons including student demand, government policy and funding, debt per student, levels of unrestricted resources, investment performance and quality of management.

Conclusion: since credit ratings reflect financial health, levels of borrowing and the other factors noted above, no minimum credit rating parameters are considered necessary, and no change in strategy is recommended.

Debt service and debt repayment

How much do we want to spend ON the classroom and other facilities rather than IN the classroom? The following constraints guide our ability to service and repay debt:

- Interest rates are FIXED.
- Allocation of borrowing to any particular project continues to be dependent on the ability of that particular project or division to service the debt and repay the borrowing with low risk of default.
- The internal financing program requires regular principal and interest payments at specified interest rates that are linked to market rates.
- The long-term borrowing pool, an internal sinking fund, accumulates funds for repayment of debentures at maturity.

At April 30, 2006, interest expense as a percent of operations, as defined by Moody's, was 1.8%, well below Moody's medians. Interest expense was 1.6% of total revenues, allocated as follows: 0.8% of operating fund revenues and 14.2% of ancillary revenues.

To December 31, 2006 actual and projected interest plus principal repayments on allocated borrowing of $768.0 million were $65.3 million annually and represented 3.1% ($39.3 million) of operating revenues and 19.4% ($26.0 million) of ancillary revenues.

Conclusion: The debt service ratios are well below Moody's medians. Debt service and debt repayment load on a particular division or project is subject to the internal financial parameters outlined above. Therefore, no overall debt service or debt repayment parameters are considered necessary and no change to the current strategy is recommended. Continued careful review of each new project is important to the continued prudence of this approach.

Overall Conclusion

In conclusion, the current borrowing strategy, as approved by the Business Board in June 2004, continues to be financially prudent and is projected to provide sufficient capacity to meet key priorities over the next several years:

- This strategy provides debt capacity for key priorites while maintaining a prudent approach to debt.
- Ability to pay is assessed on a project by project basis.
- A comprehensive and disciplined internal financial program requires regular principal and interest payments for each project at fixed interest rates linked to market rates.
- An internal sinking fund to accumulate the principal repayments collected through the internal financing program to repay the debentures.
- Interest rates are fixed. Debt service and repayment allocations are a reasonable proportion of total revenues and expenses.
- The discipline that this strategy represents has been well received by the lending community based on our selected enquiries.

We will continue to update the maximum external borrowing capacity annually in June, once the net assets for the year are finalized, and will report it to the Business Board at that time.

To facilitate planning, we expect to allocate borrowing based on projected borrowing capacity as contained in this report, to be updated annually during the Fall. This will enable planning to continue at an appropriate pace. However, such projects will only be executed (including awarding of contracts and actual construction) after the necessary maximum borrowing capacity to permit the borrowing to occur has been reached through the achievement of the required net assets level.

FINANCIAL AND/OR PLANNING IMPLICATIONS: Enables a continuation of capital investment on key priorities.

RECOMMENDATION: For information.