



University of Toronto Borrowing Strategy

**Review
December 2006**



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PURPOSE OF REPORT

The purpose of this report is to review the borrowing strategy that was approved by the Business Board June 17, 2004 to assess:

- Is the current strategy financially prudent?
- Are any additional parameters needed to ensure that it continues to be financially prudent?
- Does it continue to provide sufficient borrowing capacity to meet carefully reviewed priorities?

CURRENT BORROWING STRATEGY

The current borrowing strategy is to borrow both internally from the expendable funds investment pool (EFIP), and externally from third parties. The key elements of the current strategy are:

- 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 borrowing is permitted until such time as the actual outstanding external borrowing is not greater than 33% of net assets averaged over 5 years.
- Maximum internal borrowing capacity is \$200 million loaned from EFIP and excludes internal financing of fund deficits and short-term construction financing of capital projects.
- In the event that the funds invested by EFIP were needed for short-term expenditures, the borrowing would have to be re-financed externally.
- 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 parameters.

CURRENT STATUS

Maximum borrowing capacity:

The maximum external borrowing capacity is updated annually every April 30. At April 30, 2006, the maximum external borrowing capacity was \$621.2 million.

The utilization of up to \$200 million of internal borrowing from EFIP is also reassessed annually. At April 30, 2006, it was confirmed that \$200 million can continue to be allocated to internal borrowing.

Therefore, maximum external plus internal borrowing capacity was set at \$821.2 million, effective April 30, 2006.

Borrowing allocated to capital projects and other requirements:

The Business Board has allocated \$768.0 million to capital projects and other requirements to December 31, 2006. This leaves \$53.2 million to be allocated to future projects, at this time.

Actual borrowing:

At April 30, 2006 there was \$483.7 million in outstanding external long-term debt, comprised as follows:

\$ 48.7 million borrowing prior to 2001 (excluding \$1.9 million to be repaid during 06-07)

\$160.0 million Series A debenture

\$200.0 million Series B debenture

\$ 75.0 million Series C debenture

\$483.7 million

An additional \$75 million in external borrowing was added December 13, 2006 via the issuance of a Series D debenture.

Additionally, at April 30, 2006, outstanding internal long-term borrowing from EFIP was \$109.5 million.

BENCHMARKING

To assess the financial prudence of the current borrowing strategy, we have developed a number of balance sheet and income statement ratios for the University of Toronto, and have compared them to other universities.

The benchmarks that have been used as comparators are the Moody's Investors Service U.S. Public College and University Medians 2006. Moody's ratings cover "more than 90% of the [U.S.] public university sector through ratings assigned to both large systems and individual colleges and university. We currently rate 195 separate organizations in the sector based on their stand-alone credit quality, ranging from the large systems in California, New York, Texas and Pennsylvania with enrollment exceeding 100,000 students to much smaller colleges and universities with enrollment of under 5,000 students¹".

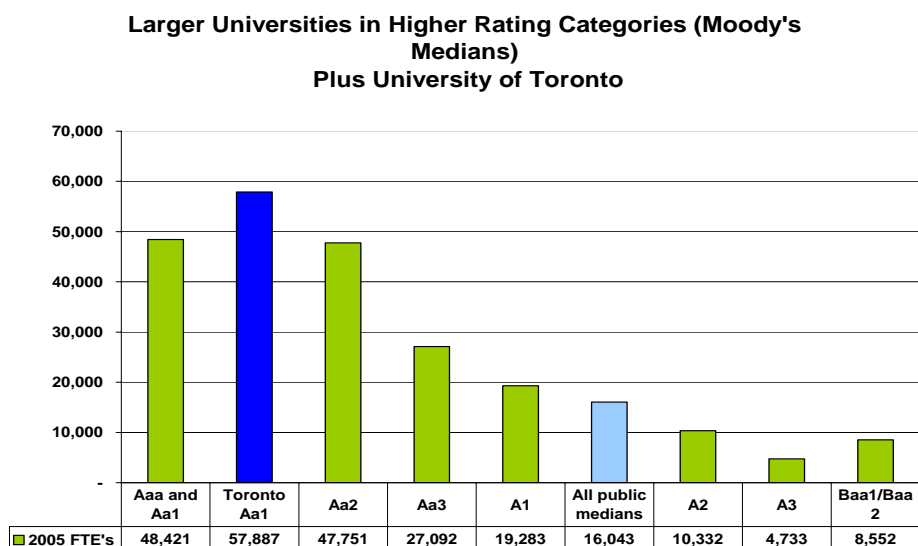
Moody's credit ratings applied to U.S. public colleges and universities in descending order are Aaa, Aa1, Aa2, Aa3, A1, A2, A3, and Baa1.

The University of Toronto was ranked Aa1, with a stable outlook, by Moody's in its most recent review.

Moody's publishes many ratios for public colleges and universities. We have selected

several ratios and have compared

University of Toronto to other universities with similar ratings. The chart shows that universities with larger numbers of students tend to be in the higher rating categories.



¹ Moody's Public College and University Medians, 2006 (p. 3).

Here are the comparators in the Aaa, Aa1 and Aa2 categories:

Aaa

University of Michigan

University of Virginia

University of Texas System

Aa1

Purdue University

Univ. of North-Carolina Chapel Hill

[University of Toronto](#)

Texas A&M University System

University of Washington

Aa2

Georgia Institute of Technology

Michigan State University

Ohio State University

State University of Iowa

University of California

University of Minnesota

University of Nebraska

University System of Maryland

Indiana University

New Mexico Military Institute

Pennsylvania State University

State University System of Florida

University of Kansas

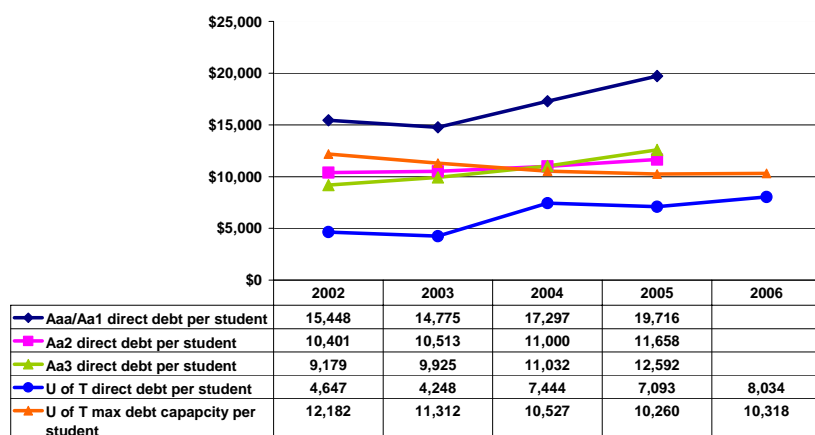
University of Missouri System

University of Pittsburgh

Direct Debt per Student:

Moody's compares the direct debt to the size of the student body. Direct debt is defined as the legal obligations of the institution, e.g. bonds, notes, commercial paper, capital leases, bank loans and draws upon lines of credit. The size of the

Direct Debt per Student
Comparing University of Toronto to Moody's Medians for Aaa/Aa1, Aa2 and Aa3



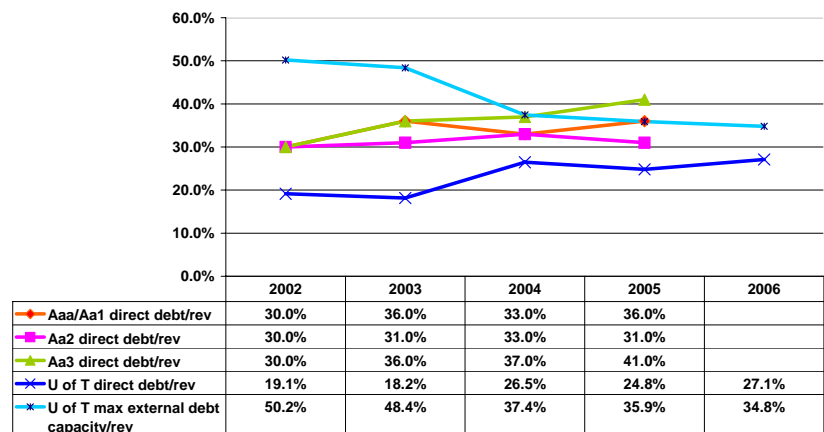
student body is the FTE (full-time equivalent enrollment).

The chart illustrates that U of T's direct debt per student is well below the medians. The maximum external borrowing capacity is very much in line with the medians for the Aa2 and Aa3 comparators and well below the median for the Aaa/Aa1 group. This means that U of T has borrowed less to date and has set a maximum external borrowing capacity to date per student that is less than the actual outstanding external borrowing of its rating peers.

Direct Debt to Total Revenues:

This Moody's ratio compares direct debt and the annual revenues of the institution. Direct debt is as defined above. Total revenues are the total revenues of the institutions. The chart illustrates that U of T's actual direct debt to revenues is well below the median while the maximum debt capacity is comparable to the current medians for its rating peers. This means that U of T has a better ratio of direct debt to revenues than its peers and that its external borrowing capacity to total revenues would be within the range of that of its rating peers.

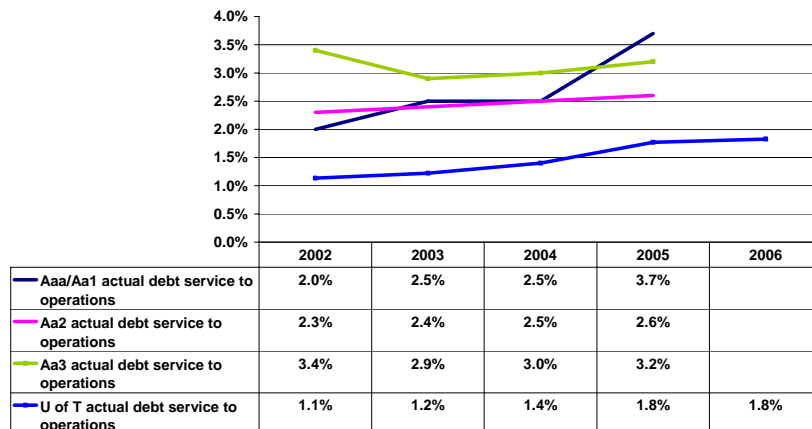
Direct Debt to Total Revenues
Comparing University of Toronto to Moody's Medians for
Aaa/Aa1, Aa2 and Aa3



Debt Service to Operations:

This Moody's ratio measures the debt service burden on expenses. Debt service is defined as the actual direct interest expense. Total expense is the total expenses as stated in the audited financial statements plus interest on capital asset-related debt.

Actual Debt Service to Operations (Total Expense)
Comparing University of Toronto to Moody's Medians for Aaa/Aa1, Aa2, and Aa3



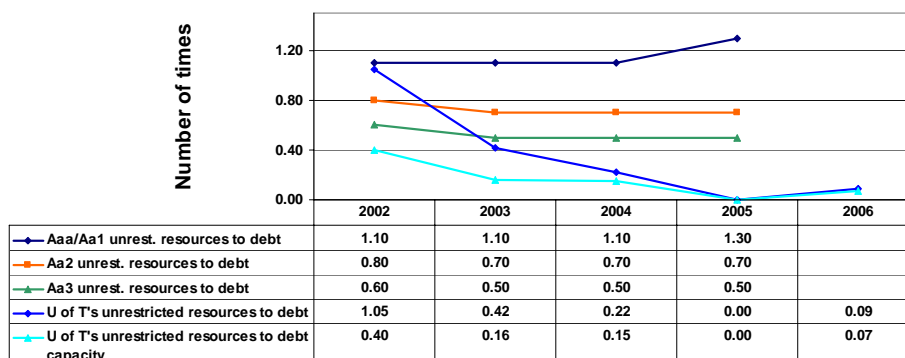
U of T's ratio of direct debt service to operations was 1.8% at April 30, 2006, well below the medians for its rating comparators. This means that the U of T interest expense as a % of total operations was much less than its rating peers.

Unrestricted Resources to Long-Term Debt:

This Moody's ratio measures the coverage of direct debt by the most liquid resources, which it defines as unrestricted net assets.

The chart illustrates that U of T's unrestricted resources to long-term debt ratio of 0.09 is well below the medians for its rating comparators. This means that U of T has fewer unrestricted resources to support long-term debt than its rating peers.

Unrestricted resources to long-term debt
Comparing University of Toronto to Moody's medians



Expendable Resources to Long-Term Debt:

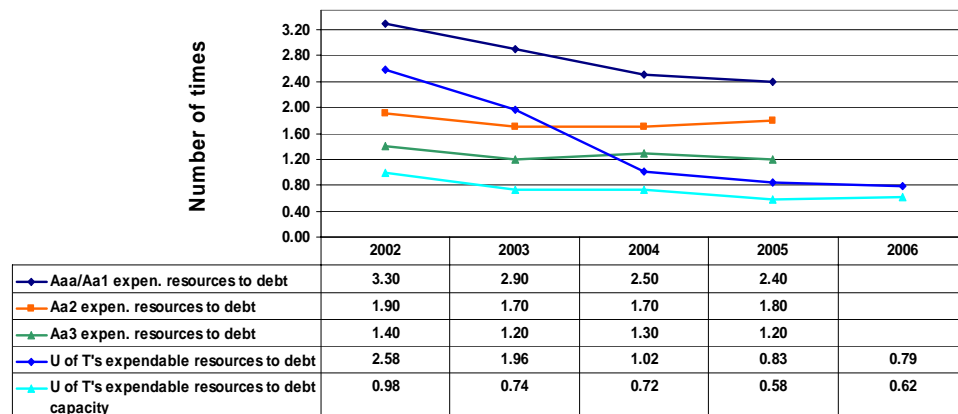
This Moody's ratio measures the coverage of direct debt by financial resources that are ultimately expendable, which it defines as the sum of unrestricted net assets plus restricted expendable net assets.

The chart illustrates that U of T's expendable resources to long-term debt ratio of 0.79 is well below the medians for its rating peers.

This means that

U of T has fewer expendable resources to support long-term debt than its rating peers.

**Expendable resources to long-term debt
Comparing University of Toronto to Moody's medians**

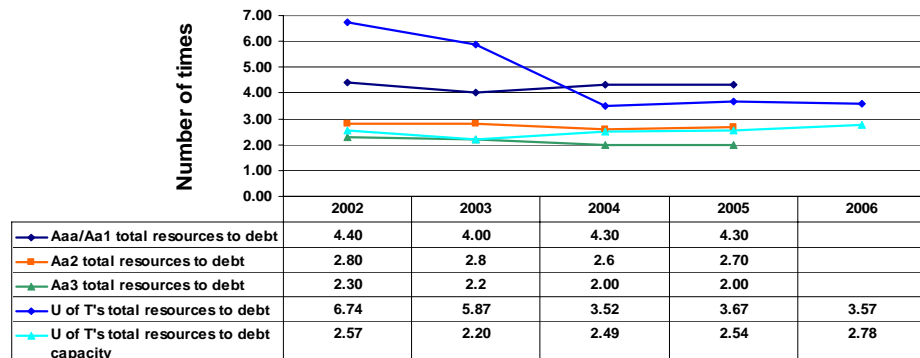


Total Resources to Long-Term Debt:

This Moody's ratio measures the coverage of direct debt by total financial resources including permanent endowments. U of T's total resources to long-term debt ratio

of 3.57 is within the range of medians for its rating peers. This means that U of T has similar levels of total resources to support long-term debt as its rating peers.

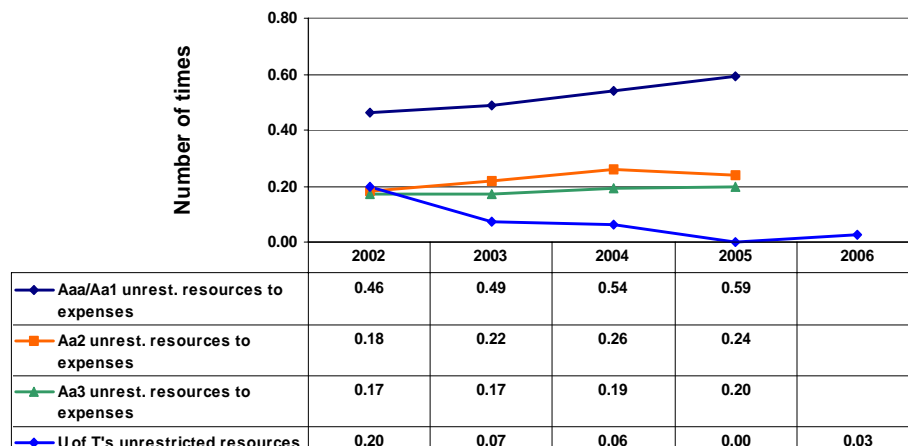
**Total resources to long-term debt
Comparing University of Toronto to Moody's medians**



Unrestricted Resources to Expenses:

This Moody's ratio measures the coverage of annual expenses by the most liquid resources, the unrestricted net assets. The chart illustrates that U of T's

Unrestricted resources to expenses
Comparing University of Toronto to Moody's medians

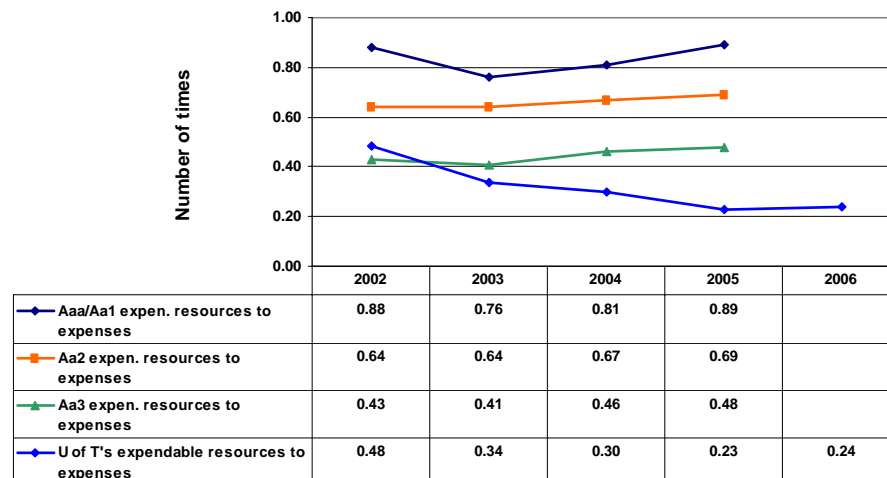


ratio of 0.03 is well below its rating peers. This means that U of T has fewer unrestricted resources in comparison to its annual expenses than its rating peers.

Expendable Resources to Expenses:

This Moody's ratio measures coverage of annual expenses by financial resources that are ultimately expendable, defined as unrestricted net assets plus restricted

Expendable resources to expenses
Comparing University of Toronto to Moody's medians



expendable net assets. The chart illustrates that the U of T ratio of 0.24 is well below that of its rating peers. This means that U of T has fewer expendable resources in comparison to its annual expenses than its rating peers.

What do these comparisons tell us?

- + Debt per student is below medians
- + Debt to total revenue is below medians
- + Actual debt service to expenses is below medians
- + Total resources to long-term debt is above medians
- Unrestricted resources and expendable resources to long-term debt are below medians
- Unrestricted resources and expendable resources to expenses are below medians.

In summary, 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.

Those ratios where it was possible to test maximum borrowing capacity also indicate that the maximum borrowing capacity to date is within the appropriate range as compared to our rating peers.

PROJECTING MAXIMUM BORROWING CAPACITY

The University performed the following steps to project maximum borrowing capacity under the current borrowing strategy:

- Projected net assets.
- Calculated maximum external borrowing capacity as 40% of net assets averaged over 5 years.
- Assessed continued ability to provide \$200 million internal borrowing from EFIP.

Projecting Net Assets

Net assets increase due to 1) net income for the year across all funds, defined as revenues minus expenses, and 2) growth in endowments from endowed donations and grants and from net reinvested investment earnings.

At April 30, 2006, net assets were \$1.88 billion. By 2010, net assets were projected to be between \$2.0 billion and \$2.5 billion, using the following assumptions:

- Long range operating budget to 2010.
- Divisional carry forwards projected to increase by \$5 million per year.
- Ancillary budgets to 2010.
- Income on internal restricted endowments and other long-term funds increase by 7% per year.
- No additional net losses for the capital fund, assuming that transfers from operating fund will offset.
- Endowed donations of \$35 million per year.
- Endowed grants of \$6 million per year.
- Endowment payout increases by 2% inflation annually from \$7.00 per unit.
- A variety of endowment return assumptions: 4%, 7%, 10%, variable at 0% 2007, 12% 2008, 9% 2009, 6% 2010.

Projecting borrowing capacity:

The projected net assets of between \$2.0 billion and \$2.5 billion by 2010 would result in a projected maximum external borrowing capacity of between \$773 million and \$871 million by 2010.

A review of internal borrowing capacity indicated that the \$200 million from EFIP could be continued and would not need to be replaced with comparable external borrowing during the period.

Adding the internal borrowing capacity limit of \$200 million would increase

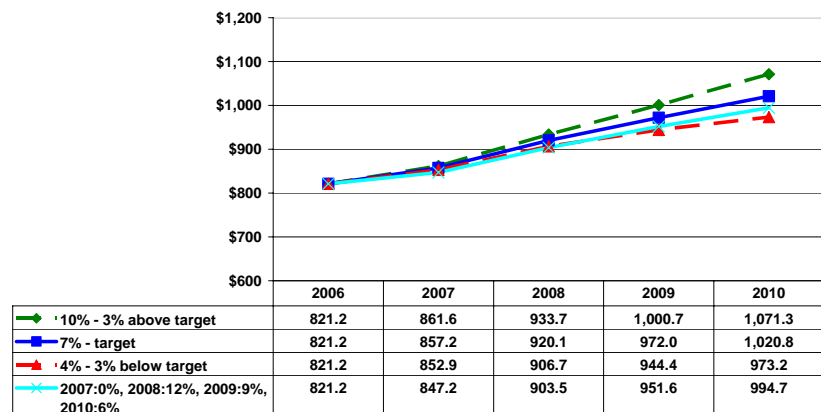
capacity to between \$973 million and \$1071 million, as shown in the chart.

Additionally bank loans issued prior to 2001 are almost all amortizing loans, with principal being repaid to lenders each year. Similarly the internal loans from EFIP will decline over time as principal is repaid. (External debenture borrowing is all repaid at maturity with no intervening principal repayments). The principal repayments from bank loans and EFIP loans provide another \$46 million in loan potential by 2010.

Therefore, assuming that the projections of net assets are reasonable, we would expect to have available between \$973 million and \$1,071 million in borrowing capacity by 2010. With the additional \$46 million in principal repayments on amortizing loans, this is projected to be \$251 million to \$349 million more than the \$768.0 million allocated to projects and other requirements by Business Board to December 31, 2006.

This is projected to provide debt capacity for the borrowing needed for increased medical and graduate enrolments (which are expected to be serviced by a stream of payments from the province for interest and principal repayment) and capacity for other key priorities. The following chart illustrates the projected growth in borrowing capacity using a 7% investment return rate.

**Projected Maximum External Borrowing at 40% Net Assets
Smoothed over % Years Plus \$200 Million Internal Borrowing
from EFIP, at various Endowment Return Assumptions**
(millions of dollars)



University of Toronto Borrowing Strategy
Borrowing Available Under Strategy compared to Allocated Borrowing (millions of dollars)
Sample: Projected at 7% Return

	Actual	Proj. 2007	Proj. 2008	Proj. 2009	Proj. 2010
Maximum borrowing capacity:					
Maximum external 40% of smoothed assets @ 7% return	621.2	657.2	720.1	772.0	820.8
Maximum internal borrowing \$200 million	200.0	200.0	200.0	200.0	200.0
Total maximum borrowing under current policy	821.2	857.2	920.1	972.0	1,020.8
Allocated borrowing					
Approved by Business Board up to Oct 31, 2006	768.0	768.0	768.0	768.0	768.0
Repayments of principal that can be re-allocated:					
Bank loans from prior to 2001-cumulative repayments	3.4	5.3	7.3	9.4	11.6
Internal borrowing-cumulative repayments and adjustments	4.1	10.1	18.0	27.2	34.6
Total repayments that can be reallocated	7.5	15.4	25.3	36.6	46.2
Total Updated Allocations:	760.5	752.6	742.7	731.4	721.8
Borrowing available to be allocated	60.7	104.6	177.4	240.6	299.0

The benchmark comparisons profiled in the previous section demonstrate that the current borrowing strategy is financially prudent.

The requirement that the increase in maximum borrowing capacity is dependent on the growth in the University's net assets, along with an annual review and assessment of the University borrowing ratios in comparison to its rating peers provide an appropriate methodology to regularly review and confirm the continuing financial prudence of this strategy on a go forward basis.

Other Considerations - Credit Ratings

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

The credit rating also influences the interest rate paid by the borrower, reflecting how much the lender wants to be compensated for assuming the risk related to repayment of the debt. Note that other influences on the interest rate are the underlying interest rates for benchmark Government of Canada bonds and spreads between Canada and Ontario bonds at the moment of debt issue.

The following chart compares U of T credit ratings with our Canadian peers and with our U.S. AAU (Association of American Universities) peers and with the Province of Ontario, all at June 2006 (Moody's has since upgraded the Province of Ontario to Aa1).

Credit Rating Comparison
University of Toronto with US and Canadian Peers at June 2006

Rating Definitions	Moody's Investors Service	Standard & Poor's	Dominion Bond Rating Service
Best quality	Aaa	AAA	AAA
Next highest quality	Aa1	AA+	AA(high)
and so on, declining	Aa2	AA	AA
	Aa3	AA-	AA(low)
	A1	A+	A(high)
	A2	A	A
	and so on	and so on	and so on

University	Moody's Investors Service	Standard & Poor's	Dominion Bond Rating Service
PROVINCE OF ONTARIO	Aa2	AA	AA
University of Texas system	Aaa	AAA	
University of Michigan	Aaa	AA+	
Queen's University		AA+	AA(high)
University of Toronto	Aa1	AA	AA
University of Washington	Aa1	AA	
University of British Columbia	Aa1	AA	
Ohio State University	Aa2	AA	
University of Pittsburgh	Aa2	AA	
University of Minnesota	Aa2	AA	
University of California	Aa2	AA-	
McGill University	Aa2	AA-	
University of Illinois	Aa3	AA-	
University of Arizona	Aa3	AA-	

Source: Credit rating agencies' websites and reports.

The table above indicates the credit rating definitions and the ratings assigned to those of our US and Canadian peers that have been rated by the University of Toronto's rating agencies.

As the above chart illustrates, the University of Toronto continues to maintain excellent credit ratings, absolutely and in comparison to our peers.

The current borrowing strategy does not specify a minimum credit rating. Many factors affect credit ratings at any point in time, such as:

- Student demand.
- Government policy and funding.
- Debt per student ratios.
- Levels of unrestricted resources.
- Investment performance.
- Quality of management

While the University of Toronto should continue to maintain good credit ratings, both as comfort to our lenders regarding our ability to repay debt, and as a general indicator of financial health, we continue to believe that it is not necessary to set credit rating floors. There are too many variables involved, some of which can be quite short-term to enable credit ratings in themselves to act as a constraint to ensure the continued financial prudence of the borrowing strategy.

OTHER CONSIDERATIONS - DEBT SERVICE AND DEBT REPAYMENT

The question facing the University of Toronto is how much more do we want to spend ON the classrooms and other facilities rather than IN the classroom?

It is important to note that current outstanding debt is at fixed rates of interest, so that debt service and debt repayment on those obligations are declining as a percent of revenues and expenses over time.

Evaluation of ability to service and repay debt is done on a project by project basis, and it is assumed that the sum of these individual evaluations will aggregate to an overall ability to service and repay the debt with low risk of default.

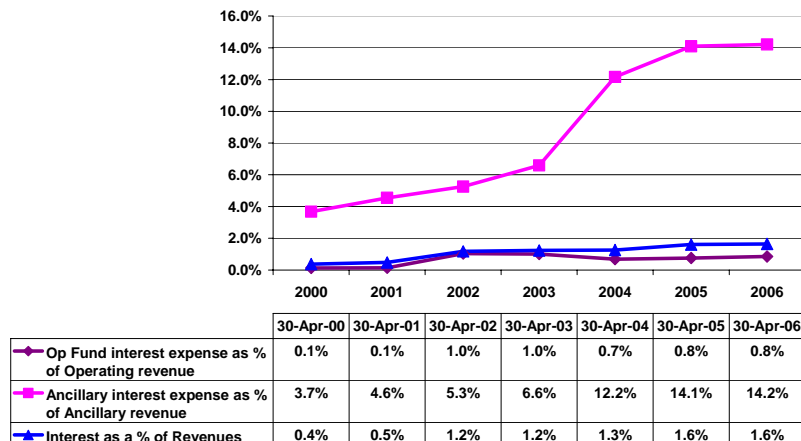
Internal borrowers, such as academic divisions or residence operations, are required to sign loan agreements under the University's internal financing program, which require regular principal and interest payments at specified fixed interest rates that are linked to market rates.

Those principal and interest payments are deposited into an internal sinking fund (the long-term borrowing pool, or LTBP) along with investment earnings on the LTBP balance. That sinking fund is drawn down by periodic interest payments to lenders and by payment of issue and ongoing administrative costs such as commission, legal and accounting fees and by ongoing trustee and rating fees. The expectation is that the net sum of additions and draw downs will be sufficient to repay each debenture upon maturity.

Debt Service – Interest Expense on External Debt

At April 30, 2006, the interest expense on outstanding external debt was \$29.3 million for the year. This was 1.6% of revenues, and 1.8% of expenses. Operating fund interest expense was 0.8% of operating fund revenues while ancillary interest expense was 14.2% of ancillary revenues.

Long-term Debt
Interest Expense as a % of Revenues
for the year ended April 30



Principal and Interest on External and Internal Debt:

Borrowing, whether internally or externally financed, is covered by the internal financing program, which requires formal loan agreements with regular principal and interest payments for set periods, with interest charged at fixed rates linked to market rates at the issue date of the loan agreement. Therefore, evaluating the principal and interest payment load on the University must take this into account.

The \$768.0 million in borrowing allocated by the Business Board to December 31, 2006 has been distributed as follows: \$467.2 million to academic buildings and other requirements and \$300.8 million to ancillary operations. The actual and estimated principal and interest repayment on this allocated borrowing is projected to be \$65.3 million per annum distributed as follows: \$39.3 million per annum to the operating fund, representing 3.1% of operating fund revenues, and \$26.0 million per annum to ancillaries, representing 19.4% of ancillary revenues. Given that interest rates are fixed and that revenues are expected to continue to increase, the percentages will fall over time on this amount of allocated borrowing.

The current borrowing strategy does not place any limits on debt service or debt repayment percentages.

External debt service is partly dependent on total debt and partly dependent on interest rates. Since interest rates are fixed, debt service on currently outstanding debt will fall over time as a percent of revenues and expenses.

Allocation of debt to individual projects or divisions is based on their ability to repay that specific loan, while the aggregation of individual assessments provides the overall assessment of ability to repay debt.

The various measures that have been put in place are deemed to be sufficient control over debt service and debt repayment and no specific limits are considered necessary.

Conclusion

This review has considered the current borrowing strategy and has found the following:

- The current strategy is projected to make available between \$251 and \$349 million in additional borrowing capacity by 2010 under current accounting rules as compared to the \$768.0 million allocated by the Business Board to December 31, 2006.
- Comparisons to Moody's medians indicate that 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. Certain ratios where we were able to test maximum borrowing capacity also indicate that the maximum borrowing capacity to date is within the appropriate range as compared to our rating peers.
- Credit rating limits are not considered to be necessary.
- Debt service and debt repayment processes and current internal controls are considered to be sufficient.

In conclusion, the current borrowing strategy, as approved by the Business Board on June 17, 2004, continues to be financially prudent and is projected to provide sufficient capacity to meet key priorities for the next several years, under current accounting rules.

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.

Borrowing Strategy Glossary of Terms

Maximum borrowing capacity:

Maximum borrowing capacity is defined as the level constrained by the borrowing strategy and includes both internal and external maximum borrowing capacity.

Maximum external borrowing capacity:

Maximum external borrowing capacity is 40% of net assets (assets minus liabilities) averaged over 5 years.

Maximum internal borrowing capacity:

Maximum internal borrowing capacity is \$200 million in loans from the University's expendable funds investment pool (EFIP). This \$200 million limit excludes short-term borrowing from EFIP in respect of fund deficits and short-term construction financing.

Approved borrowing:

Even though the Business Board has agreed to a maximum borrowing capacity, issuance of a debenture requires a specific borrowing resolution to be approved by the Business Board.

Outstanding external borrowing:

Even though the Business Board approves the external borrowing, the actual borrowing is at the discretion of the administration and will be timed to achieve a balance between rates, forecast movement of rates and specific needs driven by the completion status of projects. Outstanding external borrowing is what is shown on the balance sheet of the University as a liability.

Allocated borrowing:

When capital projects are approved, there is a requirement that all funding sources be identified, and, if debt is required, the source of repayment must also be identified. This is referred to as allocated borrowing.