**FOR APPROVAL** | **PUBLIC** | **OPEN SESSION**

**TO:** Business Board

**SPONSOR:** Trevor Rodgers, Chief Financial Officer
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**PRESENTER:** See above.
**CONTACT INFO:**

**DATE:** April 19, 2023 for April 26, 2023

**AGENDA ITEM:** 5

## ITEM IDENTIFICATION:

*Amendment 2023 Debt Strategy*

## JURISDICTIONAL INFORMATION:

Pursuant to Section 5 (1.) (b.) of the Business Board Terms of Reference, the Business Board has responsibility for:

- approval of policies governing the financial operations of the University, including policies delegating financial authority
- approval of policies with respect to financial programs and transactions, and
- approval of individual programs and transactions as required by those policies reviewing regular reports on matters affecting the finances of the University and on financial programs and transactions.

## GOVERNANCE PATH:

1. **Business Board [for approval] (April 26, 2023)**

## PREVIOUS ACTION TAKEN:

The debt strategy was initially approved by Governing Council in June 2004. A revision of this debt strategy was approved in November 2012. The latest annual review of the debt strategy was presented on February 1, 2023.

**HIGHLIGHTS:**

The debt strategy approved by Business Board in November 2012 established a single debt policy limit including both internal and external debt, with fungibility between them. The debt policy limit is calculated annually using the 5% debt burden ratio (debt service cost divided by total expenditures) as a key determinant, and the 0.8 viability ratio (total expendable resources divided by total debt) be taken into consideration in setting that debt policy limit. The purpose of this report is to recommend to the Business Board to expand the definition of debt for purposes of the University's debt strategy to include indirect debt exposure from joint venture partnerships and to increase the upper threshold debt burden ratio from 5% to 6%.

As the University moves forward in its development strategy for on-campus housing and other key services, many of these new projects will require long-term debt and may involve a partner who either shares in the University's debt exposure or carries additional debt related to their ownership stake in the project. The current debt strategy will need to take into account the impact of these arrangements. Although this debt may not be recorded on the University's balance sheet, due to the University's association with the project, the University may be exposed to reputational and financial risks in the event of the partner defaults.

In view of the above, and due to the potential pressure on available debt capacity for allocation in future years, the report recommends an amendment to the debt strategy. The amendment will address off balance sheet debt generated through such partnerships and their collective impact on the University's financial health. In keeping with the University's prudent approach to financial management, the proposed amendment requires continuous monitoring of debt levels, safeguarding the University's balance sheet resilience and future financial sustainability.

In order to calculate the amount of indirect debt that the University will include in its debt limit, the University will evaluate each commercial project individually as it is brought forward for approval, based on the nature and characteristics of the project. A project-specific risk assessment will be used to inform the proportion of total debt to be included in the debt limit. The University may use the Debt Service Coverage Ratio (DSCR) to determine whether a commercial real estate project can adequately pay its debt obligations over time. The DSCR measures the excess of operating income to cover annual debt service payments. Using this methodology, the University's existing partnership agreements to date include $116 million of debt held by JV partners, of which we recommend including $31 million of indirect debt exposure.

Indirect debt exposure associated with other joint ventures that are in the early stages of planning, including the Westbank development partnership for the Site 1: The Gateway project, will be assessed and reviewed as the capital projects proceed through governance approval.

In the future, if the University were to consider joint venture partnerships to support academic projects, these would be assessed based on the division's capacity to carry their share of the project's cost and, if appropriate, an allocation for indirect debt of the JV partner. This assessment would be included in the submission of the project for governance approval.

With the expansion of the definition of debt, the amendment proposes to increase the combined upper threshold for the debt burden ratio from 5% to 6%. This increase will provide flexibility to engage in partnerships while restraining the escalation of the risk that these projects may bring to the University. The revised 6% limit will continue to be lower than the 7% industry benchmark. The revised limit will be applied to direct and indirect debt, without specific ratios for each category, thereby continuing to keep the fungibility principle from the current debt strategy. The viability ratio will remain unchanged at 0.8, but will apply to external debt only. The present approach of including internal debt in this measure is overly conservative. The use of internal resources to fund debt already reduces expendable resources and mirrors the settlement of external debt using university's funds.

It is projected that the increase of the debt burden limit of 5% to 6% would add $389 million to the University's current debt capacity from $2,096.7 million to $2,485.7 million, of which $31 million would be allocated to existing indirect debt arrangements. The remaining debt capacity can be made available for future capital plans and any additional indirect debt arising from partnerships arrangements that will be entered into in the coming years.

To assess the prudence of the expanded debt policy, the University has evaluated the implications to the University's financial metrics in 2 scenarios. In the first likely case scenario where all debt allocations based on currently approved borrowing, plus indirect debt, plus planning assumptions of $765M of capital expansion, the University debt metrics remain in the low risk and there are no implications to the University's credit rating. In the unlikely worst-case scenario where borrowing is assumed entirely from external sources up to maximum allowed under policy at 6% debt burden ratio, some debt metrics may fall into the high risk area. As a result, there is risk of credit rating downgrade if all debt is issued externally. Such a scenario is extremely unlikely given regular monitoring by Business Board. The University has policies and practices in place to ensure a prudent and balanced approach to debt management. Furthermore, we will expand the regular reporting to Business Board to include information about indirect debt exposure and MCU Financial Health Indicators.

## FINANCIAL IMPLICATIONS:

The increase of the debt burden limit of 5% to 6% would add $389 million to the University's current debt capacity from $2,096.7 million to $2,485.7 million, of which $31 million would be allocated to existing indirect debt. The new limit will take effect from May 2023 onwards.

## RECOMMENDATION:

Be It Resolved

THAT the Business Board approve the proposed revisions to the *University of Toronto Debt Policy,* to be effective May 1, 2023.

## DOCUMENTATION PROVIDED:

- Proposed revised *Debt Policy (tracked changes)*
- Proposed revised *Debt Policy (clean)*
- Detailed Report *"Proposed Amendment to Debt Strategy April 2023"*

# University of Toronto

# Debt ~~Strategy~~Policy

# ~~2012~~May 2023

# ~~Recommended~~ Debt Policy~~Strategy~~

~~**Debt policy limit:**~~

The University's ~~proposed~~ debt policy limit, based on a ~~5~~6% debt burden ratio and a 0.8 viability ratio, ~~took~~ takes into account ~~all of the elements considered in this paper~~:

- the need for debt,
- the appetite for debt,
- ~~the~~ key financial parameters and indicators of financial health,
- ~~the~~ comparisons to industry benchmarks and credit rating assessments,
- the projected split between internal and external debt
- exposure to indirect debt and
- the projected timing of ~~actual additional~~ debt issuance.

~~The internal debt component is currently set at $350 million and it is assumed that this level would remain unchanged through the projection period. The current cash flow projections support that recommendation. Cash flows are projected to be sufficient to allow considerable flexibility in bridge-financing future external debt issuance. An upper limit of 40% of EFIP has been established to recognize the need for liquidity and to provide for any possible future changes in cash flow patterns.~~

**Commented [TR1]:** Moved to Internal Borrowing section.

~~Given the large obligation that the University has with respect to the pension contribution strategy to fund the pension deficit, an additional metric will also be calculated to monitor the combined impact of debt service and pension payments on the University's ability to pay.~~

**Commented [TR2]:** Moved to Accountability and Monitoring section

~~All other elements of the debt strategy, its associated processes and procedures, and the Business Board approvals that are currently in place are recommended to remain unchanged.~~ The ~~proposed~~ elements of the debt strategy ~~may be~~are summarized as follows:

## Definition of Debt:

**Debt** includes both direct debt and indirect debt exposure. **Direct Debt** includes all long-term external and internal borrowed funds obtained by any means (e.g. debenture, bank loan), and excludes letters and lines of credit and all short-term and medium term internal financing for purposes such as fund deficits. External debt includes all funds borrowed from third party lenders while internal debt includes funds borrowed by the University from its expendable cash flows. **Indirect debt** includes debt exposure through a partnership or joint venture arrangement

that is not recorded on the University's balance sheet, but which may expose the University to potential financial or reputational liability.

### Debt policy limit:

**The debt policy limit** includes ~~both~~ internal debt, ~~and~~ external debt, and indirect debt with fungibility between them. ~~It~~ The limit is determined on the basis of debt affordability, moderated when necessary and appropriate by considerations of debt capacity. Debt affordability is measured by the debt burden ratio (principal plus interest divided by total expenditures) and the maximum debt policy limit is calculated using a debt burden ratio of ~~5~~6%. Debt capacity is measured by the viability ratio (expendable resources divided by total external and indirect debt). Note that internal debt is excluded from the viability ratio as the use of internal resources to fund debt reduces expendable resources and mirrors the settlement of external debt using University funds.

~~Annually t~~The debt policy limit will be calculated annually on the basis of the ~~5~~6% debt burden ratio. If the viability ratio associated with that debt policy limit is less than 0.8, then consideration will ~~need to~~ be given to ~~decide whether to~~ moderat~~e~~ing the debt policy limit. ~~The debt policy limit includes both internal and external debt, and the internal debt component is limited to 40% of the Expendable Funds Investment Pool (internal debt outstanding divided by audited April 30 EFIP balance plus internal debt outstanding).~~

**Commented [TR3]:** Move down to Internal Borrowing section

### Credit ratings:

**Credit ratings** will ~~continue to~~ be excluded from policy determination because they are subject to many external factors, including changes in rating agency methodologies over time.

### Long-term borrowing pool (LTBP):

**The long-term borrowing pool** is the sinking fund that accumulates funds for repayment of external debt. Principal and interest payments related to bullet debenture borrowing will continue to be placed in the LTBP, and, together with investment income, will be used to pay periodic interest payments to lenders, and to pay issue and ongoing administrative costs, with the expectation that the net sum from these additions and drawdowns will be sufficient to repay the bullet debentures at maturity.

### Borrowing method:

**The borrowing method** (e.g. private placements, loans, debentures, or other method) ~~continues to be~~is determined by the senior officer responsible for financial matters.~~.~~ The senior officer responsible for financial matters is authorized to negotiate and finalize borrowing agreements with external or internal parties, and to issue ~~internal~~ loans from either internal or external debt for projects where borrowing has been authorized by the Business Board.

**Internal borrowing programme:**

The debt policy limit includes both internal and external debt, and the internal debt component is limited to 40% of the Expendable Funds Investment Pool (internal debt outstanding divided by audited April 30 EFIP balance plus internal debt outstanding). ~~The internal debt component is currently set at $350 million and it is assumed that this level would remain unchanged through the projection period. The current cash flow projections support that recommendation.~~ Cash flows are projected to be sufficient to allow considerable flexibility in bridge-financing future external debt issuance. An upper limit of 40% of EFIP has been established to recognize the need for liquidity and to provide for any possible future changes in cash flow patterns. Processes and procedures for internal loans ~~continue to be~~are determined by the University Administration. ~~The senior officer responsible for financial matters is authorized to issue internal loans from either internal or external debt for projects where borrowing has been authorized by the Business Board.~~

**Indirect debt programme:**

**Commented [TR4]:** NEW – to address indirect debt

The administration will evaluate the indirect debt exposure of each project undertaken via a development partnership as it is brought forward for approval, based on the nature and characteristics of the project and the development partner.

The administration will evaluate whether the University would remedy in an event of default and assess the risk of a partner to default on its debt using a combination of quantitative and qualitative factors, including metrics such as cash flow forecasts, operating income projections, and debt service coverage ratios, and will identify a percentage risk factor for each project. This percentage will determine the proportion of off-balance sheet debt to be included in the University's debt policy limit.

The risk exposure and indirect debt allocation associated with these projects will be re-evaluated on at least an annual basis, identifying any possible deterioration in the financial forecasts of each project. The senior officer responsible for financial matters is authorized to

determine the appropriate proportion of indirect debt to be included in the debt limit. Updates will be reported to the Business Board at least annually.

### Comparisons to others:

*Moody's U.S. Public College and University Medians* continues to be the key comparator because the data is readily available and published annually for a large comparison pool that is relevant for the University of Toronto.

Comparisons to other Canadian universities will ~~periodically also~~ be provided to governors periodically.

### Accountability to governors:

~~the~~ The ~~current~~ Business Board has authority for ~~approvals continue (~~approval of this debt strategy; approval of all capital projects with a borrowing component; and approval of the legal borrowing resolutions required from time to time for issuance of external debt~~)~~.

~~Regular reporting to~~The Business Board ~~continues.~~will receive regular reporting on the status of debt outstanding at each meeting, as well as an annual review of the University's debt strategy.

The University will report regularly on the debt limit and actual debt outstanding, including a breakdown of internal, external, and indirect debt exposures. Debt monitoring ratios will include the debt burden ratio, the viability ratio, and any financial health indicators established by the Ministry of Colleges and Universities to enhance financial transparency and prudent debt management.

> **Commented [TR5]:** NEW – to address financial health reporting aligned with MCU requirements

Given the large obligation that the University has with respect to the ~~pension contribution strategy to fund the pension deficit~~ past service pension liability, an additional metric will ~~also~~ be calculated to monitor the combined impact of debt service and any pension special payment obligations on the University's ability to pay.

UNIVERSITY OF TORONTO

# University of Toronto

# Debt Policy

# May 2023

# Debt Policy

The University's debt policy limit, based on a 6% debt burden ratio and a 0.8 viability ratio, takes into account:

- the need for debt,
- the appetite for debt,
- key financial parameters and indicators of financial health,
- comparisons to industry benchmarks and credit rating assessments,
- the projected split between internal and external debt
- exposure to indirect debt and
- the projected timing of debt issuance.

The elements of the debt strategy are summarized as follows:

## Definition of Debt:

**Debt** includes both direct debt and indirect debt exposure. **Direct Debt** includes all long-term external and internal borrowed funds obtained by any means (e.g. debenture, bank loan), and excludes letters and lines of credit and all short-term and medium term internal financing for purposes such as fund deficits. External debt includes all funds borrowed from third party lenders while internal debt includes funds borrowed by the University from its expendable cash flows. **Indirect debt** includes debt exposure through a partnership or joint venture arrangement that is not recorded on the University's balance sheet, but which may expose the University to potential financial or reputational liability.

## Debt policy limit:

**The debt policy limit** includes internal debt, external debt, and indirect debt with fungibility between them. The limit is determined on the basis of debt affordability, moderated when necessary and appropriate by considerations of debt capacity. Debt affordability is measured by the debt burden ratio (principal plus interest divided by total expenditures) and the maximum debt policy limit is calculated using a debt burden ratio of 6%. Debt capacity is measured by the viability ratio (expendable resources divided by total external and indirect debt). Note that internal debt is excluded from the viability ratio as the use of internal resources to fund debt reduces expendable resources and mirrors the settlement of external debt using University funds.

The debt policy limit will be calculated annually on the basis of the 6% debt burden ratio. If the viability ratio associated with that debt policy limit is less than 0.8, then consideration will be given to moderating the debt policy limit.

### Credit ratings:

**Credit ratings** will be excluded from policy determination because they are subject to many external factors, including changes in rating agency methodologies over time.

### Long-term borrowing pool (LTBP):

**The long-term borrowing pool** is the sinking fund that accumulates funds for repayment of external debt. Principal and interest payments related to bullet debenture borrowing will continue to be placed in the LTBP, and, together with investment income, will be used to pay periodic interest payments to lenders, and to pay issue and ongoing administrative costs, with the expectation that the net sum from these additions and drawdowns will be sufficient to repay the bullet debentures at maturity.

### Borrowing method:

**The borrowing method** (e.g. private placements, loans, debentures, or other method) is determined by the senior officer responsible for financial matters. The senior officer responsible for financial matters is authorized to negotiate and finalize borrowing agreements with external or internal parties, and to issue loans from either internal or external debt for projects where borrowing has been authorized by the Business Board.

### Internal borrowing programme:

The debt policy limit includes both internal and external debt, and the internal debt component is limited to 40% of the Expendable Funds Investment Pool (internal debt outstanding divided by audited April 30 EFIP balance plus internal debt outstanding). Cash flows are projected to be sufficient to allow considerable flexibility in bridge-financing future external debt issuance. An upper limit of 40% of EFIP has been established to recognize the need for liquidity and to provide for any possible future changes in cash flow patterns. Processes and procedures for internal loans are determined by the University Administration.

## Indirect debt programme:

The administration will evaluate the indirect debt exposure of each project undertaken via a development partnership as it is brought forward for approval, based on the nature and characteristics of the project and the development partner.

The administration will evaluate whether the University would remedy in an event of default and assess the risk of a partner to default on its debt using a combination of quantitative and qualitative factors, including metrics such as cash flow forecasts, operating income projections, and debt service coverage ratios, and will identify a percentage risk factor for each project. This percentage will determine the proportion of off-balance sheet debt to be included in the University's debt policy limit.

The risk exposure and indirect debt allocation associated with these projects will be re-evaluated on at least an annual basis, identifying any possible deterioration in the financial forecasts of each project. The senior officer responsible for financial matters is authorized to determine the appropriate proportion of indirect debt to be included in the debt limit. Updates will be reported to the Business Board at least annually.

## Comparisons to others:

*Moody's U.S. Public College and University Medians* continues to be the key comparator because the data is readily available and published annually for a large comparison pool that is relevant for the University of Toronto. Comparisons to other Canadian universities will be provided to governors periodically.

## Accountability to governors:

The Business Board has authority for approval of this debt strategy; approval of all capital projects with a borrowing component; and approval of the legal borrowing resolutions required from time to time for issuance of external debt.

The Business Board will receive regular reporting on the status of debt outstanding at each meeting, as well as an annual review of the University's debt strategy. The University will report regularly on the debt limit and actual debt outstanding, including a breakdown of internal, external, and indirect debt exposures. Debt monitoring ratios will include the debt burden ratio, the viability ratio, and any financial health indicators established by the Ministry of Colleges and Universities to enhance financial transparency and prudent debt management.

Given the large obligation that the University has with respect to the past service pension liability, an additional metric will be calculated to monitor the combined impact of debt service and any pension special payment obligations on the University's ability to pay.

# University of Toronto
# Proposed Amendment to Debt Policy
# to Address the Use of Indirect Debt
# April 2023

In recent years, the University, as well as other institutions in the higher education sector, have explored innovative capital financing structures beyond the traditional use of external or internal debt. This is partly due to pressures caused by changes in the funding environment, but also a desire to leverage expertise that other industries can bring to a capital project development partnership.

In late 2018, the University launched its "Four Corners" real estate development strategy to deliver amenities to support the academic mission and simultaneously grow revenue from sources other than enrolment. The Four Corners Strategy sets an ambitious goal of generating $50 million in operating funding per year by 2033 through the development of roughly 3.5 million square feet of new space devoted to campus services, amenities, office, and retail spaces. Many of these new projects will involve a partner who may either share in the exposure of the University's long-term debt, or obtain their own debt related to their ownership stake.

Under these arrangements, the University may not be legally liable for a development partner's debt, and it may not be recorded in the University's balance sheet. However, the University may be exposed to financial risk or pressure to take full ownership of the project in case of a partner's default.

This paper recommends an amendment to the current debt policy to incorporate off balance sheet debt generated through partnerships (indirect debt). It also proposes an increase in the allowable debt service ratio that corresponds to this expanded definition of debt. In keeping with the University's prudent approach to financial management, the proposed amendment requires continuous monitoring of debt levels, safeguarding the University's balance sheet resilience and future financial sustainability.

## Background

In November 2012, the University revised its borrowing strategy to set an upper limit on long-term debt based on a 5% debt burden ratio. Under this policy, annual debt service cost (principal and interest) on long-term debt should not exceed 5% of total expenditures (adjusted for non-cash items)

***Debt is defined to include all long-term borrowed funds obtained by any means (e.g. debenture, bank loans, capital leases, etc.), including internally borrowed funds, but excluding letters and lines of credit and short- and medium-term financing for purposes such as construction financing and fund deficits***. External debt includes all funds borrowed from third party lenders while internal debt includes funds borrowed by the University from its expendable cash flows.

When the University developed its Debt Strategy in 2012, it relied on the guidance provided in *Strategic Financial Analysis for Higher Education*[1] *– Seventh Edition* by Prager, Sealy & Co., LLC. At that time, the University did not use (or contemplate the use of) indirect debt, but some institutions in the higher education sector in the United States had started to develop some innovative financing structures. These included the use of affiliated foundations and subsidiaries to access financing, execution of long-term leases, guaranteeing an affiliate's debt and employing off-balance sheet debt structures.

[1] A publication commissioned by NACUBO (The U.S. National Association of Colleges and University Business Officers)

The authors provided some guidance to institutions in relation to these arrangements and transactions. They suggested that while indirect debt cannot be ignored, it should not be viewed as the same level of commitment as direct debt obligations of the institution. The authors argued that indirect debt arrangements should be included in debt-ratio calculations but recognized that this treatment is not consistent across institutions and credit rating agencies. One clear point is the need for consistency in the treatment of similar transactions when they are incorporated in the calculation of any debt-related ratios.

Many institutions have a comprehensive definition of debt that includes all obligations that are viewed as a draw on credit, regardless of their legal or accounting treatment. However, other institutions have taken different approaches in defining debt. For example:

- Some exclude all "non-project" debt. If debt is utilized for cash management purposes, it is excluded.
- Some apply a factor to alternative financing structures. For example, an institution may apply a factor of 100% to direct third-party debt, 0-50% to leases and guarantees, etc.
- Some exclude debt issued for noncapital purposes.
- Some include or exclude debt issued by affiliated foundations or subsidiaries, which are often considered "indirect" debt by the rating agencies.

In the case of the University, when its Debt Strategy was established in 2012, debt was defined to include all long-term "project-related" debt (which included pension funding), obtained either externally or internally. The guidance above focused on external debt and did not include any internal debt as part of the calculation of the debt ratios, since internal debt is not widely utilized by U.S. universities and not disclosed in their financial statements. The University decided to take a more conservative approach by including its internally borrowed funds in the calculation of the debt ratios given that the internal debt may need to be converted into external debt if cash flow requirements restricted the use of internal funds for financing. However, the definition of debt did not include indirect debt since the University did not have any nor did not contemplate its use at that time.

Due to the increasing number of alternative financing structures that the University is exploring for its capital developments, it is now proposing to amend the Debt Strategy to expand the definition of debt to include indirect debt.

## Defining Direct and Indirect Debt

For purposes of the University's debt policy, **Direct Debts** are defined as contracts or arrangements that create obligations to make future long-term payments by the University for the acquisition or long-term use of capital assets or other projects of long-term nature.

Direct debt includes:

- Internally borrowed funds to be repaid over a long-term period from the University's future revenues or from future donations.
- Contracts that bind the University to make long-term future payments to a third party. These obligations can be in the form of, but not limited to, bank loans, debt obtained through capital markets, or capital leases and are recorded on the University's balance sheet.

Direct debt excludes:

- Letters of credits and guarantees.

- Lines of credit intended to be used in support of operational working capital.
- Short-term and medium-term internal financing for purposes such as construction financing and funding of temporary fund deficits.
- Arrangements used for investment and hedging purposes that may bind the University to make future payments such as interest rate swaps and equity and bond swaps.

**Indirect debt** is defined as alternative financing structures or arrangements for capital related projects that create current or potential future financial obligations, which are not recorded on the University's balance sheet. The potential future financial obligation is not limited to contractual legal liability, but it includes potential liability that the University may be willing to assume due to its interest in the success of a project or its reputation associated with a project.

Similar to the approach taken with direct debt, excluded from the definition of indirect debt are any short-term and medium-term internal financing for purposes such as construction financing and funding of temporary fund deficits as well as financial payments arising from derivative transactions (such as interest rate swaps and equity and bonds swaps) held for investment or interest rate hedging purposes.

The following are examples of indirect debt:

1. **Long-term partnership debt that is partially recorded on the University's balance sheet**. In these cases, the University owns a portion of a capital asset (e.g. a student residence) on its lands through a partnership arrangement and only records its proportionate share of the project's assets, liabilities, revenues, and expenses on the University's financial statements. While the capital project is expected to generate sufficient cash flows to service its long-term debt, and the University may not be legally liable for its partner's debt, the University is exposed to potential reputational and financial risk generated though these partnerships. Under this arrangement, **the portion of the long-term debt that is not recorded on the university's financial statements would be considered for inclusion in indirect debt.**
2. **Long-term debt obtained though a limited partnership arrangement that is not recorded on the University's balance sheet**. In these cases, the University enters into a limited partnership arrangement to fund a capital project (e.g. a student residence) on its lands and only records its proportionate share of the project's net revenues on the University's financial statements. Under these arrangements, **all of the project's long-term debt would be considered for inclusion in indirect debt.**

Indirect debt excludes:

- **Long-term operating leases**. These arrangements allow the University to use capital assets and commit the University to future long-term lease payments. At April 30, 2022, the University had long-term operating lease commitments over the next twenty five years of $224 million in total. Under Canadian accounting rules, obligations from operating leases are not presented as liabilities on the balance sheet and therefore will not be included in the definition of indirect debt.
- **Contingent liabilities – Guarantees.** The University has a program under which it guarantees bank loans to faculty and staff members to assist in the purchase or refinancing of their homes. The University holds mortgages as collateral security against such guarantees. As at April 2022, the amount of loans guaranteed was $12 million. Given that the University has a security in place, the University

estimated financial exposure under these guarantees is not material and will not be considered in the calculation of indirect debt.

- **Contingent liabilities – Letters of Credit**. The University issues irrevocable standby letters of credit for its capital construction projects that guarantee payments to the City of Toronto if the University fails to perform certain restorative work at the completion of its capital construction projects. The letter of credit facility is provided through CIBC Bank with a maximum credit limit of $70 million. As at April 30, 2022, the amount of outstanding letters of credit issued was $19 million. Given that this letter of credit facility through CIBC is supported by the University's healthy cash balances held with CIBC and typically short term in nature, the University estimated financial exposure under these letters of credits are not material and will not be considered in the calculation of indirect debt.

## Assessing Risk and Indirect Debt Exposure

To calculate the amount of indirect debt that the University will include in its debt limit, the University will evaluate each project individually as it is brought forward for approval, based on the nature and characteristics of the project. A project-specific risk assessment will be used to inform the proportion of total debt to be included in the debt limit.

1. **Evaluate whether the University would remedy in an event of default on the indirect debt associated with a project.** If the University is not likely to take any action on such an event of default, because its reputational or financial risk associated with the project is low, then the University would exclude the project in the consideration of indirect debt. However, if it is determined that the University would likely make an effort to remedy a default, then the indirect debt exposure of the project would be calculated using a factor-based approach.

2. **Assess the risk of a project to default on its debt and calculate an amount of indirect debt based on this risk.** To determine the amount of debt to be captured as indirect debt, the University will apply a factor (percentage) to each project based on the additional risk that the project is expected to add to the University's debt profile. If the indirect debt were expected to add an obligation similar to that of direct debt, then the University would apply a factor that approximates 100%. However, if the project is viewed to be financially healthy and self-sufficient, then the factor assigned should reflect the lower risk to assume debt generated by these projects. To assess the financial strength of a capital project that is established through a partnership, the University will focus on certain financial ratios based on the type of the project as follows:

   **(a) Commercial Projects**

   These are partnerships, including Four Corners projects, whose goals include profit generation. These projects align with the University academic mission (e.g. student residences), but the partners participate in the project as an investment venture with the goal to generate a profit. For-profit companies are the likely partners of these kinds of projects.

   The University may use the Debt Service Coverage Ratio (DSCR) to determine whether a commercial real estate project can adequately pay its debt obligations. The DSCR measures the excess of operating income over adjusted expenses (without depreciation and interest expense) available to cover annual debt service payments. It is calculated by dividing the project's net annual cash flows from operations by annual debt service payments (principal and interest).

A DSCR of 1.0 means that the operations will generate cash equal to its annual debt payments. Most lenders would assign a minimum DSCR in their debt covenant, below which the agreement would be considered to be in default. However, since these minimum requirements may vary from project to project, the University will establish benchmarks based on industry standards to assist in the evaluation of projects.

The following table shows the factors that will be assigned to the project based on the project's financial health and the project's ability to service its financial debt:

| Commercial Projects - Proposed Debt Service Coverage Ratios (DSCR)* | Financial Health Assessment | Range of Factors to be assigned to Indirect Debt |
|---|---|---|
| Higher than 1.2 | Very Healthy | 0% - 10% |
| Between 1.15 to 1.2 | Healthy | 11% - 25% |
| Between 1.1 to 1.15 | Moderate | 26% - 40% |
| Between 1.0 to 1.1 | Break-even | 41% - 60% |
| Below 1.0 | Unhealthy | 60% - 100% |

* Note: Debt Service Coverage Ratio is calculated as the project's net operating Income divided by its debt service cost. (See Prager, Sealy & Co LLC, KPMG LLP; and Attain LLC; Strategic Financial Analysis in Higher Education – Seventh edition (2010), p.119). As a general rule, a DSCR above 1.2 is often considered strong, whereas ratios below 1.00 could indicate that the company or project is facing financial difficulties. Credit rating agencies such as Moody's typically uses a similar score to support ratings for entities with AA to AAA ratings. In addition, as a recent comparison, the University has undertaken an external bank loan for a sustainability linked project that requires the University to maintain a minimum DSCR of 1.2.

The University will use the table above as a guideline, but it may also use judgement to make further adjustments based on other known factors. When a new project is approved by Business Board, the University may rely initially on pro-forma financials and/or business models, for example, to determine the initial factor that will be assigned to the project. During construction, discussions will continue with partners and the risk of the projects will be monitored and adjusted accordingly.

Furthermore, if the University becomes aware of an event or change that will significantly impact the risk previously attributed to the project, it will reassess the factors assigned and recalculate the indirect debt for the project at that point.

**(b)** **Academic projects** – These are partnerships that the University enters with the goal to further its academic mission or for the benefit of the public good. Long-term sustainability (not necessarily profit generation) is the main financial goal of these projects. Government agencies and other not-for- profit organizations are likely partners of these projects. The University may follow the guidance from *Strategic Financial Analysis for Higher Education* and may adopt one or more suitable metrics to assess the project's long-term sustainability. As an example, for a project to be viable, it should operate at a surplus or at least, at a break-even position. Such academic projects will be reviewed on a case-by-case basis to determine if a proportionate allocation to indirect debt is appropriate as they proceed through governance approval.

**3.** **Review and adjust the calculated amount of indirect debt based on the revised risk.** The factor for each project will be re-valuated and adjusted annually, depending on the project's actual and expected strength and ability to service its debt. Based on this periodic review, the University will re-assess the amount of indirect debt exposure based on the updated risk. If the University becomes aware of a major change that would affect the indirect debt assigned to a project, it will make an adjustment upon detection of the event.

**Application of the indirect debt principles above to existing partnerships arrangements:**

1. Spadina-Sussex University Residence Inc. ("Joint Venture"). The University entered into a Joint Venture with Daniels Corporation for the construction and operation of a mixed-use development project that is located on lands owned by the University. The University owns 75% of the Joint Venture and it has the intention to sell 25% of the joint venture to a third party after the construction is completed, at which time it will own 50% of the joint venture. This arrangement is a financing structure that allows the University to have a residence operation that is 50% financed (after sale), while remaining in control of the operations. For this Joint Venture to attract future investors, operations must be designed to generate profits similar to other real estate investments. Therefore, this project will be considered a Commercial Project and the DCSR will be used as the ratio to determine its ability to service its debt.

   The cost of the project is estimated at $116.0 million of which $81.2 million is expected to be financed by an external party. When construction in complete, the University will review the appropriate accounting consolidation. For example, the University can account for this joint venture using the proportionate consolidation method where 75% (or 50% after sale) of the JV's assets and debt is recorded on its balance sheet, and the same percentage of revenues and expenses on its statement of operations. To fund its equity contribution of $26.1 million, the University made a $10 million contribution in cash and took an internal loan of $16.1 million. The table below shows the total direct debt allocated for this project and the additional indirect debt of $2.0 million that would be allocated to the project based on the revised strategy.

| | Joint Venture's Debt | Joint Venture's DSCR | Direct Debt | Factor | Indirect Debt | Total Debt Counted by UofT |
|---|---|---|---|---|---|---|
| Portion of U of T's equity contribution | | | $16.1M | | | $16.1M |
| Debt that will be recorded by U of T (75%) | $60.9M | | $60.9M | | | $60.9M |
| Debt that will not be recorded (25%) | $20.3M | 1.44 | | 10% | $2.0M | $2.0M |
| Total | $81.2M | | $77.0M | | $2.0M | $79.0M |

   The University's legal liability is only limited to its 75% share of the Joint Venture's debt. The indirect debt assigned to this project represents the risk that the operations will not generate sufficient cash to cover for its expenses and that the University would step in to buy the remaining 25% to ensure the continued operation of the residence.

2. UTSC Residence Limited Partnership ("UTSC LP"). The University entered into a limited partnership arrangement as a financing structure to obtain alternative funding for the construction and operation of a new residence at UTSC. The University as General Partner holds less than 1% of UTSC LP, while Fengate, the limited partner holds all the remaining interest of UTSC LP. The University will initially own the building, which is constructed on University's lands. However, after initial occupancy, the building will be purchased by UTSC LP. The project cost is estimated at $137.9 million. $42.1 million of this amount will be contributed by Fengate as equity contribution and at least $95.8 million of the

remaining initial cost is expected to be financed currently and in the future by debt from external parties. The University will account for this partnership using the equity method. The University will record its $1 dollar contribution as an investment on its balance sheet. No debt of the UTSC LP is recorded on its balance sheet. Under the current debt strategy, no direct debt has been allocated to this project.

Fengate participation in this partnership is purely for profit purposes and, therefore, the success and continuation of this partnership is dependent on the financial profitability of the project. This project is considered a Commercial Project and the University will use the DSCR to measure its ability to service its debt.

Under the proposed policy, after the construction and sale of the building to UTSC LP, the University would initially include $28.8 million as indirect debt based on the following calculation:

| | **UTSC LP's Debt** | **UTSC LP's DSCR** | **Direct Debt** | **Factor** | **Indirect Debt** | **Total Debt Counted by UofT** |
|---|---|---|---|---|---|---|
| Debt that will be recorded (0%) | $0.0M | | $0.M | | | $0.0M |
| Debt that will not be recorded (100%) | $95.8M | 1.14 | | 30% | $28.8M | $28.8M |
| Total | $95.8M | | $0.0M | | $28.8M | $28.8M |

The University has no legal liability for UTSC LP's debt. The indirect debt assigned to this project represents the risk that the operations will not generate sufficient cash to cover for its expenses and that the University would step in to buy the entire or part of the operation to ensure the continuation of the residence. Each subsequent year, the University will reassess the indirect debt based on the actual external debt obtained by Fengate on this project.

3. MaRS Phase 2 Investment. During fiscal 2016, the University acquired a 20% interest in MaRS Phase 2 Investment Trust (the "Trust"), a unit trust governed by the laws of the Province of Ontario, established by deed of trust dated July 15, 2011, with MaRS Discovery District, a charitable organization, as settlor for $31 million. The Trust was established to develop and manage a 20-storey state-of-the-art building that is a world-class convergence centre dedicated to improving commercial outcomes from Canada's science, technology and social innovations. The investment is accounted using the equity method, and none of the debt of the Trust is recorded in the University's balance sheet. The University has assessed the investment value in the Trust upon acquisition and as a result, the University has written down the investment to nil at April 30, 2016. There have been no changes to the investment value for the years 2019, 2020, 2021 and 2022.

   The primary goal of this investment is not for financial profit. At the time of investment, it was expected that no cash distribution to UofT will occur until 2035 and the University has written down the investment to nil. Therefore, the University has categorized this project as an academic project and it will use the net operating ratio to assess its financial health.

   At December 31, 2021, the Trust reported $327M of long-term debt in its balance sheet. Under the terms of the deed of Trust, the University's liability as unitholder is limited to the amount invested in

the Trust. As unitholder, the University has no legal obligation in connection with the Trust's debt. This debt is expected to be paid from the income generated by its operations, and from the disposition of its assets in the case of default. The debt is guaranteed by MaRS Discovery District. To ensure that the debt is serviced, the lenders have enforced a stipulation in the Unitholder agreement, which states that no cash distribution to unitholders will occur until the debt of the Trust is fully repaid. Furthermore, there is no obligation to provide further additional funding by the University to the Trust in case of deficiency of funding. The University therefore has no legal liability for the debt of the Trust, and its exposure is limited to the invested amount.

As indicated above, the University will calculate indirect debt related to the project only if it would be likely to assume a portion of the Trust's debt to enable the successful continuation of the project or the University's association with it. In the case of the Trust, MaRS Discovery District and other parties would most likely step in first in case of financial trouble and the University will not likely assume further debt. Therefore, the University will not calculate any indirect debt associated with the Trust.

In summary, existing partnership agreements would generate indirect debt of $30.8 million as summarized below. Indirect debt exposure associated with other joint ventures that are in the early stages of planning, including the Westbank development partnership for the Site 1: The Gateway project, will be assessed and reviewed as the capital projects proceed through governance approval.

| Indirect Debt | Off-Balance Sheet Debt Amount | Factor | Indirect Debt Exposure |
|---|---|---|---|
| Spadina-Sussex University Residence Inc. (Joint Venture) | $20.3M | 10% | $2.0M |
| UTSC Residence Limited Partnership | $95.8M | 30% | $28.8M |
| **Total Indirect Debt Exposure to U of T** | | | **$30.8M** |

## Assessing Debt Burden using the Expanded Definition of Debt

As noted in *Strategic Financial Analysis for Higher Education,* the benchmark upper threshold for debt capacity in higher education institutions is a debt burden ratio of 7% (see Prager, Sealy & Co LLC, KPMG LLP; and Attain LLC; Strategic Financial Analysis in Higher Education – Seventh edition (2010), p.117). When the University's Debt Strategy was developed in 2012, the University set a debt burden ratio of 5% as the primary factor to determine the maximum debt limit, and a viability ratio of 0.8 as a secondary monitoring ratio. Furthermore, the 5% limit included internal and external debt, while the industry threshold only includes external debt.

With the expansion of the definition to include indirect debt, we propose to **increase the combined upper threshold for the debt burden ratio from 5% to 6%**. This 1% increase will provide the University with some flexibility to continue to engage in new alternative partnerships while restraining the escalation of the risk that these projects may bring to the University. The revised 6% will continue to be lower than the upper 7% industry benchmark. For clarity, this revised maximum limit of 6% will be applied to the combined total of direct and indirect debt, without assigning specific ratios for each category, thereby continuing to keep the fungibility principle from the current debt strategy.

**The viability ratio will remain unchanged at 0.8, but we propose to apply this ratio only to external direct and indirect debt.** The viability ratio measures the institution's ability to pay for its debt if it needs to settle

the obligation as of the balance sheet date. Our previous approach to include both external and internal debt was overly conservative. The use of internal resources to fund debt already reduces expendable resources and it mirrors the settlement of external debt using university's funds.

The **Debt burden ratio** to determine the maximum debt limit will continue to be calculated the same way:

$$\frac{\text{Annual Debt Service (Principal + Interest)}}{\text{Total expenses adjusted for non-cash items}} \leq 6.0\%$$

The monitoring **Viability ratio** will be based only on external debt:

$$\frac{\text{Expendable Resources}}{\text{External Direct and Indirect Debt}} \geq 0.8$$

As noted in the 2023 Debt Strategy Review submitted to the Business Board on February 1st, 2023, the debt policy limit will continue to provide sufficient financing for the highest priority projects under active consideration. Up to December 31, 2022, the Business Board had approved $1,689.2 million of debt for capital and other projects, leaving $407.5 million for future projects. However, there will be significant pressure on the debt available for allocation beyond 2024.

**An increase to the maximum debt burden ratio from 5% to 6% would add $389 million to the University's current debt capacity**, of which $30.8 million would be allocated to existing indirect debt arrangements. The remaining debt capacity can be made available for future capital plans and any additional indirect debt arising from partnerships arrangements that will be entered into in the coming years.

| Debt policy limit April 20, 2022 | Total in $ Millions |
|---|---|
| At 5% Debt Burden | 2,096.7 |
| At 6% Debt Burden | 2,485.7 |
| **Increase in debt limit** | **389.0** |

## Monitoring and Financial Health

### 1. Province of Ontario's University Financial Accountability Framework (UFAF)

The Ministry of Colleges and Universities (MCU) is developing a new University Financial Accountability Framework which is projected to be implemented in April 2023. The framework is intended to ensure transparency of financial information and proactive monitoring of the financial health of universities in the province. Although the details have not be finalized, it is expected that the framework will establish thresholds for monitoring the debt levels of Ontario Universities as noted below.

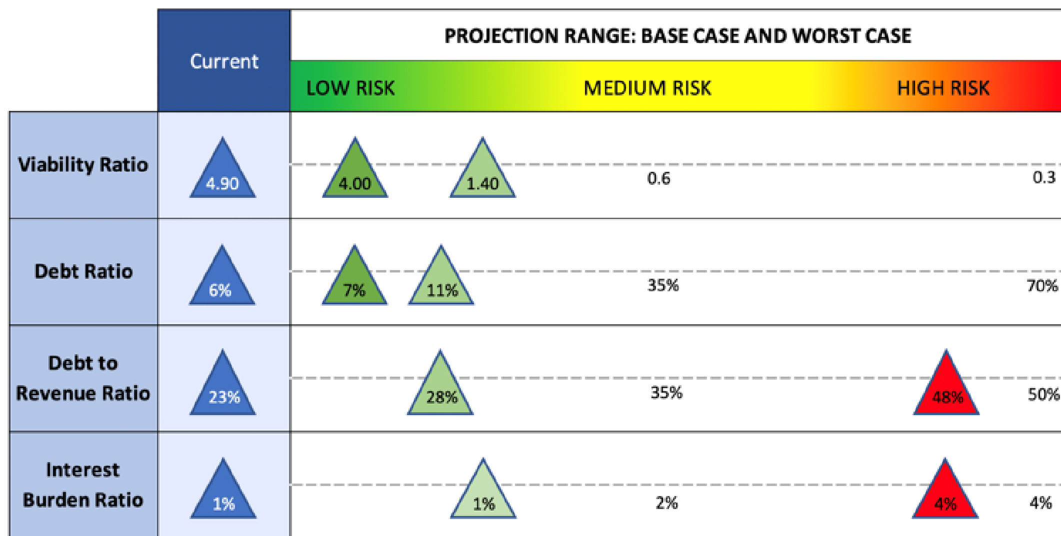
| Financial Accountability Framework Ratios and Thresholds | | Thresholds | |
|---|---|---|---|
| | | Medium-risk Threshold | High-risk Threshold |
| SUSTAINABILITY RATIOS | | | |
| Viability ratio | Expendable net assets / Long-term debt | < 60% | < 30% |
| Debt ratio | Total debt / Total assets | > 35% | > 70% |
| Debt to revenue ratio | Long-term debt / Total revenue | > 35% | > 50% |
| Interest burden ratio | Interest expense / Total expenses less amortization | > 2% | > 4% |

To test the proposed debt limit against this framework, we have assumed 2 possible scenarios:

| | |
|---|---|
| **Base Case Projections:** | Likely case - debt allocations based on currently approved borrowing, plus existing Indirect Debt, plus projected borrowing needs of $765M for capital expansion program over 5 years |
| **Maximum External Debt:** | Worst case – borrowing entirely from external sources up to the maximum allowed under policy at 6% debt burden ratio |

In the Base Case scenario, all four MCU financial health indicators relating to debt capacity remain comfortably below the medium risk thresholds.

In the Maximum External Debt scenario, the viability ratio and the debt ratio remain below the respective medium risk thresholds. However, the debt-to-revenue ratio and the interest burden ratio would deteriorate and fall into the high-risk threshold.




DRAFT: pending details from MCU on final metrics, definitions, and data sources

## 2. Implications to Credit Ratings

The University contracts with two agencies – Moody's Investors Service and Standard and Poor's Global – to provide credit ratings. The University continues to maintain excellent credit ratings in comparison to our peers in Canada and the US. The University is rated Aa1 by Moody's and AA+ by Standard & Poor's Global. In addition, Dominion Bond Rating Service Morningstar issues a credit rating for the University on an unsolicited basis. As part of their ratings, each agency assesses the University's ability to service debt as a key indicator of financial health. In their analysis of the University's debt, their focus is on external debt only, excluding any internal borrowing. They do, however, consider non-traditional debt (such as Public-Private Partnerships), and off-balance sheet debt in their evaluation of the University's credit rating. All three agencies include the following as debt:

- Capital leases.
- Expected external borrowing over a 3- to 5-year horizon.
- Partnership arrangements that have strong affiliation to the University and are critical to the University's mission.

Since the credit rating agencies already include indirect debt and non-traditional arrangements in their credit assessment of the University, the inclusion of indirect debt in the University's policy would better align the debt policy to the considerations taken by the credit rating agencies in determining the University's ratings.

Using the same 2 scenarios above, our sensitivity analysis forecasts the following:

Base Case Projections: **No negative credit rating implications**. Financial metric and debt affordability remains within existing AA1/AA+ ratings envelope.

Maximum External Debt: **In the very remote case, the use of external debt to the maximum extent on a long-term basis would cause deterioration in financial metrics and would risk a credit rating downgrade**.

To avoid this remote worst-case untenable outcome, the University has policies and practices in place to ensure a prudent and balanced approach to debt management. Furthermore, it will expand the regular reporting to Business Board to include information about indirect debt exposure and MCU Financial Health Indicators:

- Monthly Status Report on Debt to the Business Board shall be revised to set out the total university-wide allocated internal direct debt, external direct debt, and indirect debt, which collectively should not exceed the prescribed debt burden limit of 6% (see Appendix A).
- Monthly Status Report on Debt to the Business Board shall be revised to include MCU Financial Health Indicators, including Debt Ratio, Debt to Revenue Ratio, and Interest Burden Ratio (see Appendix A).
- Annual Debt Strategy Review shall be revised to include an assessment of existing indirect debt exposures and factors. Sponsors of capital projects which include indirect debt shall provide the Chief Financial Officer with updates on cash flow forecast, net operating income, and debt service coverage ratios at least annually, identifying any possible deterioration in these financial forecasts.

## Recommendation

The table below summarizes the treatment of different forms of debt in debt policies across comparable industries and credit rating agencies. It suggests that the University proposed amendment to the debt policy limit is conservative and prudent.

| | University of Toronto (Existing Policy) | U.S. Universities | Credit Agencies | University of Toronto **(PROPOSED)** |
|---|---|---|---|---|
| Direct debt – External | Yes | Yes | Yes | Maintain |
| Direct debt – Internal loans | Yes | Not included | Not included | • Maintain for Debt Limit Calculation<br>• Not included for Viability Ratio |
| Indirect Debt | Not included | Limited | Yes | **To be included** |

**Based on the analysis above, the administration recommends to the Business Board:**

- **Expand the definition of debt for purposes of the University's debt strategy to include indirect debt exposure from joint venture partnerships**
- **Increase the upper threshold debt burden ratio from 5% to 6% based on the expanded definition of debt noted above**
- **Revise the definition of the viability ratio used for monitoring purposes to exclude internal debt, while maintaining the threshold at 0.8**
- **Expand the monitoring ratios included in the debt policy to include any MCU Financial Health Indicators that are applicable to the University**

## Appendix A: Revised Monthly Status Update on Debt

The schedule below shows the monthly status update on debt as at March 31, 2023 using the new debt burden ratio limit of 6% including indirect debt. The increase of $389 million limit and the debt allocations of $30.8 million of indirect debt are reflected in yellow below. Ratios are re-calculated to factor in the addition of indirect debt.

**University of Toronto**
**Status Report on Debt to March 31, 2023**
**(Amendments to the indirect debt and increase in debt burden from 5% to 6% are highlighted in yellow)**

| **Financial Ratios in accordance with Policy** | **Total** | External | | Internal |
|---|---|---|---|---|
| | | Direct Debt | Indirect Debt | Debt |
| Debt burden ratios: | | | | |
| Debt policy limit at April 30, 2022 | **6.0%** | | | |
| Actual debt outstanding at March 31, 2023* | **2.2%** | 1.7% | - | 0.5% |
| Viability ratios: | | | | |
| Debt policy limit at April 30, 2022 | **1.4** | | | |
| Actual debt outstanding at March 31, 2023* | **4.7** | 4.9 | 112.8 | - |

*Calculated using the Total expenditures or Total expendable resources at April 30, 2022

| **Debt Policy Limit April 30, 2022** | **Total in Millions** | External | | Internal |
|---|---|---|---|---|
| | | Direct Debt | Indirect Debt | Debt |
| Debt Policy Limit (pro-forma increase of $389 million) | **2,485.7** | 1,523.0 | | 962.7 |

| **Allocations** | **Total in Millions** | External | | Internal |
|---|---|---|---|---|
| | | Direct Debt | Indirect Debt | Component |
| Opening balance at February 28, 2023 | **1,796.8** | 837.3 | 30.8 | 928.7 |
| Changes in allocation | **5.9** | - | - | 5.9 |
| Closing balance at March 31, 2023 | **1,802.7** | 837.3 | 30.8 | 934.6 |
| **Unallocated** | **683.0** | 654.9 | | 28.1 |

| **Actual Debt Outstanding** | **Total in Millions** | External | | Internal |
|---|---|---|---|---|
| | | Direct Debt | Indirect Debt | Debt |
| Opening balance at February 28, 2023 | | | | |
| Debentures due 2031 to 2051 | **710.0** | 710.0 | - | |
| Internal debt | **164.7** | - | | 164.7 |
| Indirect debt | **30.8** | - | 30.8 | |
| | 905.5 | 710.0 | 30.8 | 164.7 |
| Changes | 21.1 | - | - | 21.1 |
| Closing balance at March 31, 2023 | **926.6** | 710.0 | 30.8 | 185.8 |

**Definitions:**

**Direct debt** includes all long-term external and internal borrowed funds obtained by any means (e.g. debentures, bank loans) and excludes letters and lines of credit and all short-term and medium term internal financing for purposes such as construction financing and fund deficits.

**Indirect Debt** includes off-balance sheet debt such as long-term debt obtained through a limited partnership arrangement that is not recorded in the University's balance sheet, but exposes the University to a potential financial liability

**Debt burden ratio,** key determinant of debt policy limit, equals interest plus principal divided by total expenditures.

**Debt policy limit** is the maximum debt that can be taken on based on a debt burden ratio of 6%.

**Viability ratio, be** taken into consideration in setting debt policy limit, equals expendable resources divided by external debt. The debt strategy has set a preference of a viability ratio of 0.8 or greater.

**Allocations** are all borrowings approved by Business Board, including indirect debt plus contingency for donations pledges.

**Actual debt outstanding** is the sum of actual internal loans issued, actual external debt issuance and indirect debt