UNIVERSITY OF
TORONTO

FINANCIAL SERVICES

APPENDIX "A" TO REPORT NUMBER 200 OF THE BUSINESS BOARD – November 5, 2012

TO: Business Board

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DATE: October 22, 2012 to November 5, 2012

AGENDA ITEM:

ITEM IDENTIFICATION:

Debt Strategy.

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. Additional internal borrowing reserved for pensions, was approved by Business Board on January 31, 2011. Regular periodic reporting on debt is also provided to Business Board.

HIGHLIGHTS:

Since 2004, the borrowing strategy has defined the maximum amount of external and internal long-term debt that the University of Toronto can take on and provides important discipline around debt and its repayment.

Debt includes all long-term external and internal borrowed funds obtained by any means (e.g. debentures, bank loans, capital leases, etc.), 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.

The internal debt policy limit is currently set at $350 million, composed of $200 million for capital and other requirements and $150 million for pension purposes. Some or all of the $350 million internal debt might need to be refinanced externally at some time, if future cash flow patterns would deteriorate.

The external debt policy limit is set at 40% of net assets averaged over 5 years (set at $746.6 million for 2012-13). In the event that actual outstanding external debt exceeds 40% of net assets averaged over 5 years, no further external borrowing can occur until the external debt has returned to a ratio that is no greater than one third of net assets averaged over 5 years. There is an internal sinking fund requirement to accumulate repayment of the external debt.

The current borrowing strategy and its related processes and procedures have been in place since 2004. This strategy has worked quite well in most respects, and most aspects of it are being retained in the revised debt strategy, but the debt policy limit has presented some challenges which need to be addressed. The internal and external debt policy limits are separately defined and not fungible. There is no mechanism for external re-financing of internal debt. The external debt policy limit is heavily affected by fluctuations in investment returns and by endowed donations but is not influenced to any great degree by the growth in the size of the University and by the University's ability to pay interest and principal on borrowed funds.

Going forward, a single debt policy limit is proposed, including both of the former internal and external debt policy limits. The key characteristic of this single debt policy limit is that, however it is calculated, it would specify the total maximum debt, both internal and external, that the University chooses to take on. In future, the split between internal debt and external debt would be determined by expendable cash flows deemed to be available for long-term investment and could fluctuate between the two over time, but within the overall debt limit. In other words, in future, the availability of more internal cash would not increase the overall debt policy limit, but it would affect the amount that the University would seek from outside lenders. This is a significant change from current practice.

This change makes it much easier to think about and manage debt, and effectively deals with the issues of fungibility and possible future re-financing of internal debt with external debt. With this change, it is also easier to analyze the consequences of debt.

Debt affordability and debt capacity were selected as the key financial parameters for determining the debt policy limit.

Debt affordability is defined as the amount that can be made available to pay interest and repay outstanding debt, both external and internal. It is measured via income statement ratios. A 5% debt burden ratio (principal plus interest divided by total expenditures) was selected as a key determinant of the debt policy limit.

Debt capacity is defined as the amount that can be borrowed based on funds on hand that could be used to repay the outstanding debt as of the balance sheet date. It is measured by

balance sheet ratios. The viability ratio (expendable resources divided by debt) of 0.8 was selected to be considered when determining the annual debt policy limit.

Although internal and external debt are considered to be fungible within the overall debt policy, there are no current plans to increase the current $350 million internal debt limit, and a maximum of 40% of expendable cash was also established for this component to recognize the need for liquidity and to provide for possible future changes to cash flow patterns.

An additional metric was also developed to monitor the combined impact of the debt and of the pension contribution strategy on the University's ability to pay.

At April 30, 2012, the debt policy limit calculated using the 5% debt burden ratio is $1.33 billion, $233 million higher than the $1.0966 billion calculated under the current strategy (40% of an average of 5 years of net assets). At April 30, 2017, the debt policy limit calculated using the 5% debt burden ratio is projected to be $1.56 billion, $76 million less than the debt policy limit projected under the current strategy. In all years from 2012 to 2017, the viability ratios associated with the projected debt policy limit are projected to be greater than 0.8.

At April 30, 2012, actual debt service, including both internal and external debt, and including notional principal payments on external debentures, was 3.5%. At April 30, 2017 it is projected to be 3.8%, in both cases well below the proposed debt policy limit.

Comparisons to selected Canadian and U.S. universities reinforced our view that the proposed debt policy limit is reasonable.

In summary, taking into account the financial parameters, the need for debt and the University's appetite for debt, **it is recommended that the debt policy limit be calculated annually using the 5% debt burden ratio as a key determinant and that the 0.8 viability ratio be taken into consideration in setting that debt policy limit.**

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.

FINANCIAL AND/OR PLANNING IMPLICATIONS:

See highlights above.

RECOMMENDATION:

THAT the Business Board approve the Debt Strategy, as outlined in 'University of Toronto: Debt Strategy, 2012 (Attachment 1) replacing the Borrowing Strategy outlined in the June 8,

2004 memorandum, ‘Borrowing Strategy’ (Attachment 2), as approved by the Business Board on June 17, 2004.