University of Toronto

OFFICE OF THE VICE-PRESIDENT, BUSINESS AFFAIRS

TO: Business Board

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DATE: June 8, 2004 for June 17, 2004

AGENDA ITEM: 7(c)

ITEM IDENTIFICATION:

Borrowing Strategy

JURISDICTIONAL INFORMATION:

The Business Board approves the financing of capital projects.

PREVIOUS ACTION TAKEN:

The Business Board approved borrowing of $160 million on January 15, 2001 and borrowing of $200 million on June 19, 2003 for capital projects and other requirements.

HIGHLIGHTS:

The current borrowing strategy is to borrow both internally from the expendable funds investment pool (EFIP) and externally. Borrowing capacity is currently set at $200 million internally and $420 million externally, for a total of $620 million. The external borrowing capacity limit has been set at 1/3 capital, where capital equals assets minus liabilities. At April 30, 2003, capital was $1.264 billion. All of the current borrowing capacity of $620 million has been allocated to capital projects and other requirements.

New requirements for capital investment has been identified some portion of which need debt financing to enable us to meet target completion dates. Additional financing requirements have arisen to meet endowment matching needs.

We have reviewed the internal borrowing limit of $200 million and concluded that it continues to be the maximum amount that can be invested longer term and is thus available for loans to capital projects.

We have reviewed the external borrowing capacity determination of 1/3 capital and concluded that it continues to be a reasonable ratio to maintain balance sheet strength. However, it is important to recognize that the capital of $1.264 billion at April 30, 2003 was the lowest in several years and that annual capital is a volatile basis for determining maximum external borrowing capacity since it is heavily impacted by the annual investment return on the endowment.

To deal with this volatility, the target external borrowing capacity limit has been set at 1/3 of capital smoothed over 5 years. To provide further flexibility, the maximum external borrowing capacity is proposed to be 40% of capital smoothed over 5 years. This maximum provides a constraint to ensure that external borrowing does not get out of line. In the event that outstanding external borrowing exceeds the maximum, no further external borrowing can occur until external borrowing has returned to a ratio that is no greater than 1/3 of smoothed capital.

This methodology results in a target external borrowing capacity of $489 million and a maximum external borrowing capacity of $587 million for 2004-05. These external borrowing limits are 32.9% and 39.5% of capital of $1.487 billion at April 30, 2004.

The University's ability to borrow additional funds continues to be dependent on our ability to service and repay the debt. A sinking fund has been established to accumulate the funds to repay bullet debentures upon maturity.

To monitor our debt in comparison to our peers, we will continue to compare our debt ratios to others. These comparisons will provide guidelines, but not constraints over our borrowing levels.

Additional debt in the amount being considered at this time is expected to have little or no impact on credit ratings. If a downgrade were to occur as a result of this additional borrowing, it is expected to have very little impact on pricing spreads. The evidence for this is our Series B debenture where basis point pricing spreads actually narrowed despite S&P's downgrade of U of T from AA+ to AA.

The foregoing analysis indicates that the University can prudently borrow another $150 million externally, bringing total external borrowing to $565.1 million, which is less than the maximum borrowing capacity of $587 million. This $565.1 million represents 38% of capital of $1.487 billion at April 30, 2004

FINANCIAL AND/OR PLANNING IMPLICATIONS:

See highlights above.

RECOMMENDATION:

It is recommended that the Business Board approve:

1. The borrowing strategy that is described in this paper.

2. That the University be authorized to borrow such amount, not exceeding $150 million, as may be determined by the senior officer of the University responsible for financial matters, as so designated by the President, in addition to the $160 million approved by the Business Board on January 15, 2001 and the $200 million approved by the Business Board on June 19, 2003;

3. That such senior officer responsible for financial matters be authorized to determine, in consultation with the University's financial advisor, the most appropriate financing structure for this borrowing, including without limitation, by way of private debt placement, a public debenture issue, syndicated bank financing, or securitization and to negotiate, approve and execute and deliver for and on behalf of and in the name of the University, all agreements, documents, certificates and instruments, including without limitation any underwriting or agency agreement and any offering document and to take all such other actions as such officer may determine to be necessary or desirable to give effect to such financing and offering of debt securities, the execution and delivery of any such agreements, documents, certificates or instruments, and the taking of such actions being conclusive evidence of such determination;

4. That such senior officer responsible for financial matters is further authorized to authorize any other officer of the University to execute and deliver, for and on behalf of and in the name of the University, such certificates, documents and instruments as may be contemplated by the principal agreements entered into with respect to such debt offering or as may be required in connection with the closing of the offering of debt securities authorized hereby.

5. That the borrowed funds be added to the Long-Term Borrowing Pool and invested by University of Toronto Asset Management Corporation until the funds are required for each project;

6. That the senior officer of the University responsible for financial matters be authorized to allocate borrowing as internal financing for spending that has been approved by the Business Board or is within the approval authority of the administration;

7. That principal and interest repayments related to debenture borrowing be placed in the Long-Term Borrowing Pool, or other sinking fund mechanism, and, together with investment income, be used to pay periodic interest payments to lenders, to pay issue and ongoing administrative costs, with the expectation that the net sum from these additions and draw downs will be sufficient to repay the bullet debentures at maturity.

8. That the senior officer of the University responsible for financial matters report periodically to the Business Board on the status of the Long-Term Borrowing Pool.

University of Toronto

OFFICE OF THE VICE-PRESIDENT, BUSINESS AFFAIRS, FINANCIAL SERVICES

June 8, 2004

TO: Members of the Business Board

FROM: Catherine Riggall, Interim Vice-President, Business Affairs

SUBJECT: **Borrowing Strategy**

The purpose of this report is to recommend a borrowing strategy that is prudent in light of the University's overall financial condition.

CURRENT BORROWING STRATEGY

The current borrowing strategy is to borrow both internally from the expendable funds investment pool (EFIP) and externally.

a) Internal borrowing capacity – EFIP:

The expendable funds investment pool (EFIP) contains expendable funds that are pooled and invested until spent. It includes the University's cash for operations, capital projects, ancillary operations, expendable donations, expendable payouts from endowments and research grants. It excludes endowment funds and the supplemental retirement arrangement, which are part of the long term capital appreciation pool (LTCAP).

The size of EFIP varies over the course of a year. Its average cash balance for 2003-04 was about $400 million, ranging from a low of $264 million in July 2003 to a high of $525 million in January 2004. Multi-year analysis of actual cash inflows and outflows shows that the University's outflows generally do not exceed inflows by more than about $50 million in a particular month. Even with a margin of safety, this historical data would suggest that we need to keep only about $75 million on average in short term investments and that the remainder of EFIP can be invested for medium and longer periods of time.

Taking account of the overall fluctuation in the size of EFIP over the course of each year and historical analysis of EFIP cash balances over several years, the maximum amount that can be invested longer term is $200 million.

The current strategy is that EFIP will provide all short-term construction financing and up to $200 million in long-term borrowing, which generates predictable investment returns for EFIP. The $200 million is a fixed amount, and is an upper limit on internal borrowing from EFIP. If the funds invested by EFIP were needed for short-term expenditures, the borrowing would have to be re-financed externally.

b) External borrowing capacity:

The external borrowing capacity is currently set at 1/3 capital, where capital is defined as assets minus liabilities on the balance sheet. For 2003-04, the external borrowing capacity was $420 million, 1/3 of capital of $1.264 billion at April 30, 2003.

Outstanding external borrowing at April 30, 2004 totaled $415.1 million, including $55.1 million pre-existing loans, a $160 million Series A debenture due July 18, 2031, and a $200 million Series B debenture due December 15, 2043.

c) Total internal and external borrowing capacity:

Total internal and external borrowing capacity was set at $620 million for 2003-04. This sum has been allocated in full to the current capital plan and other requirements.

WHAT HAS CHANGED?

New requirements for capital investment have been identified, some portion of which need debt financing to enable us to meet target completion dates. Additional financing requirements have arisen to meet endowment matching needs.

While the external borrowing limit of 1/3 capital continues to be appropriate from the perspective of maintaining balance sheet health, we need to address the volatility of capital associated with its dependence on investment return. External borrowing, once assumed, is outstanding for a long time. Capital, on the other hand, varies considerably from year to year due largely to variability in investment returns. We need a smoother, more predictable basis for determining external borrowing capacity.

Proposed Borrowing Strategy

a) Internal borrowing capacity – EFIP:

Internal borrowing capacity is determined in relation to the University's available cash flow and cash flow forecasts. $200 million has been determined to be the maximum amount that can be invested longer term and is thus available for loans to capital projects.

No change is recommended to this $200 million maximum and it is still important to recognize that some, or all, of this sum may need to be re-financed externally at some time in future if cash flow patterns were to change.

b) External borrowing capacity:

We have reviewed the external borrowing capacity determination of 1/3 capital and concluded that it continues to be a reasonable ratio to maintain balance sheet strength. Together with the targeted $200 million of internal borrowing from EFIP, actual borrowing for 2003-04 was about 49% of capital at April 30, 2003.

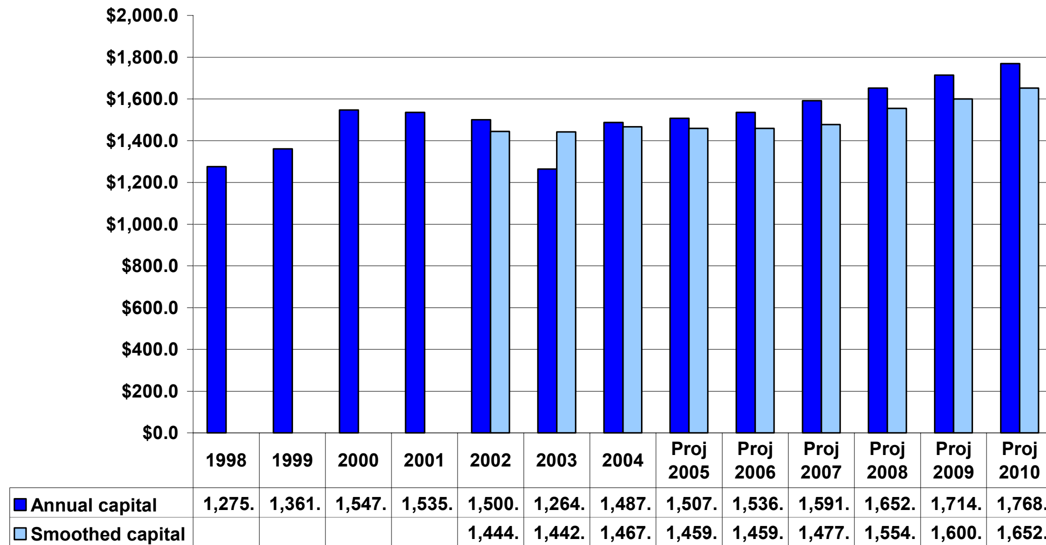
It is important to recognize that the capital of $1.264 billion at April 30, 2003 was the lowest in several years, and that annual capital is a volatile basis for determining maximum external borrowing capacity since it is heavily impacted by the annual investment return on the endowment. Actual capital at April 30, 2004 was $1.487 billion. The chart # 1 illustrates actual capital from 1998 to 2004, and projected capital to 2010, based on the following key assumptions:

-7% investment return on the endowment.
-7% investment return on the pension fund.
-endowment payout at $6.60 compounded by annual inflation of 2% per annum
-operating fund results as per long-range budget plan 2004-2010.
-endowed donations and grants projected at $60 million annually 2005-2007 to reflect OSOTF II, then reverting to $40 million annually.
-ancillaries at break-even.
-internal borrowing from EFIP at $200 million.
-continuing and growing unfunded employee future benefits based on current employee benefits provisions.

This chart illustrates the variability of capital over the past several years from 1998 to 2004, due partly to variability in investment returns and partly to the inclusion of unfunded employee future benefits liabilities. Projected capital in future years appears somewhat more predictable due to the 7% endowment return assumption, but sensitivity analysis on investment return shows that varying this assumption would produce similar volatility in the projected capital.

To deal with volatility, capital has been smoothed over 5 years. Chart # 1 illustrates the impact of smoothing on the capital value that would be used as the base for determining borrowing capacity.

Chart # 1



	1998	1999	2000	2001	2002	2003	2004	Proj 2005	Proj 2006	Proj 2007	Proj 2008	Proj 2009	Proj 2010
Annual capital	1,275.	1,361.	1,547.	1,535.	1,500.	1,264.	1,487.	1,507.	1,536.	1,591.	1,652.	1,714.	1,768.
Smoothed capital					1,444.	1,442.	1,467.	1,459.	1,459.	1,477.	1,554.	1,600.	1,652.

The impact of smoothing is to flatten the variations and to provide a more stable base for determining external borrowing capacity. For example:

-actual capital at April 30, 2003 was $1.264 billion. Smoothed capital would have been $1.442 billion.
-actual capital at April 30, 2004 was $1.487 billion. Smoothed capital would be $1.467 billion.
-projected capital at April 30, 2010 is $1.768 billion. Smoothed capital would be $1.652 billion.

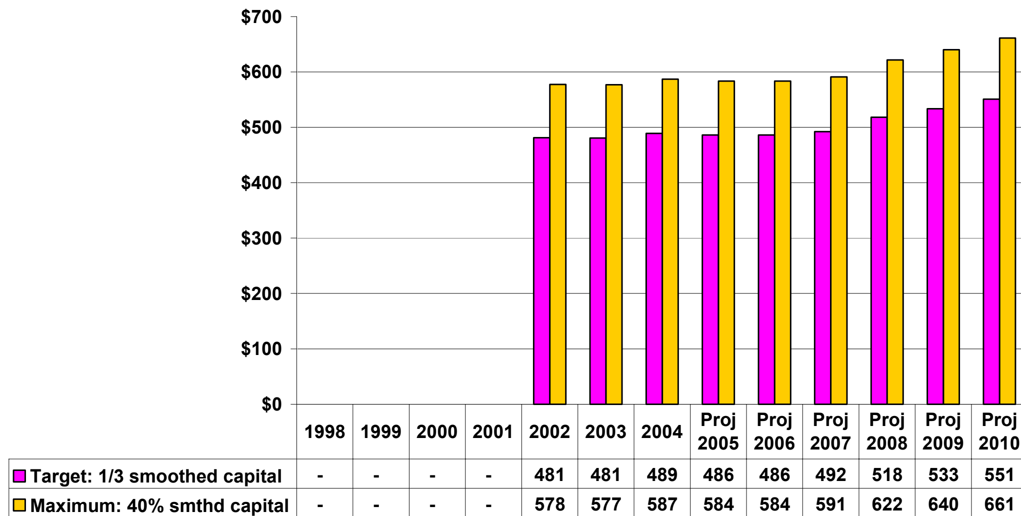
This is important because external debt, once assumed, remains outstanding for many years. It cannot be adjusted downward rapidly if capital declines in the short-term.

The **target** external borrowing capacity limit at 1/3 capital is then illustrated in chart # 2. To provide further flexibility to deal with volatility in capital, the **maximum** external borrowing capacity is proposed to be 40% of capital smoothed over 5 years.

This maximum provides a constraint to ensure that external borrowing does not get out of line. In the event that outstanding external borrowing exceeds the maximum, no further external borrowing can occur until external borrowing has returned to a ratio that is no greater than 1/3 of smoothed capital. Chart # 2 illustrates the projected target

borrowing capacity and the maximum borrowing capacity using the projected smoothed capital balances shown in chart # 1.

Chart # 2



	1998	1999	2000	2001	2002	2003	2004	Proj 2005	Proj 2006	Proj 2007	Proj 2008	Proj 2009	Proj 2010
Target: 1/3 smoothed capital	-	-	-	-	481	481	489	486	486	492	518	533	551
Maximum: 40% smthd capital	-	-	-	-	578	577	587	584	584	591	622	640	661

This methodology results in a target external borrowing capacity of $489 million and a maximum external borrowing capacity of $587 million for 2004-05. These external borrowing limits are 32.9% and 39.5% of capital of $1.487 billion at April 30, 2004.

c) Proposed total internal and external borrowing capacity:

Adding the $200 million internal borrowing limit to these figures produces total internal and external borrowing of $689 million target and $787 million maximum, representing 46.3% and 53% of capital of $1.487 million at April 30, 2004.

d) Debt service and debt repayment:

Borrowing requires debt service. Overall borrowing and allocation to any particular project will continue to be dependent on our ability to service the debt with low risk of default.

Both external and internal borrowing are managed within the University via an internal financing program. Internal borrowers, such as academic divisions or residence operations, are required to sign loan agreements which require regular principal and interest repayments at specified interest rates that are linked to market rates.

Principal and interest payments for internal borrowing and for external amortizing loans are used to make interest payments and principal repayments to lenders (EFIP and external lenders).

Bullet debentures have periodic interest payments, and principal repayment at maturity. The Series A $160 million debenture matures July 18, 2031 and the Series B $200 million debenture matures December 15, 2043. Principal and interest payments with respect to this bullet debenture borrowing are placed in the long-term borrowing pool, which serves as a sinking fund for accumulating the funding necessary to repay the bullet debentures at maturity.

The long-term borrowing pool increases via receipt of debenture funds at issue which are then loaned to internal borrowers. The long-term borrowing pool is replenished over time by principal and interest repayments by internal borrowers and via investment income and is drawn down by periodic interest payments to lenders, and by payment of issue and ongoing administrative costs, such as commissions, legal, and accounting fees, and by ongoing trustee and rating fees. The expectation is that the net sum of the additions and draw downs will be sufficient to repay each debenture upon maturity.

e) Benchmarks:

To monitor our debt in comparison to our peers, we will continue to compare our debt ratios to debt ratios for U.S. public college and university medians as calculated by Moody's Investor's Service to the extent that Moody's provides this information over time. These medians will provide guidelines for comparison, but not constraints over University of Toronto borrowing levels.

f) Credit Ratings:

Currently, University of Toronto's rating profile is as follows (with DBRS and Moody's rated one "notch" higher than S&P):

	Issuer/Debenture Rating	History
Moody's	Aa1 negative outlook	Aa2 to Aa1 to Aa1 negative outlook
DBRS	AA (high) stable outlook	AA (high) stable outlook
Standard & Poor's	AA stable outlook	AA+ stable to AA stable outlook

Credit rating agencies assess many factors when determining credit ratings, including such factors as student demand, critical mass, location, research and program diversity, financial reserves and liquidity, revenue diversity, tuition flexibility and fundraising strengths. The amount of debt outstanding is considered against the overall financial health and strength of the institution.

Additional debt at this time is expected to have little or no impact on credit ratings. If a downgrade were to occur as a result of this additional borrowing, it is

expected to have very little impact on pricing spreads. The evidence for this is our Series B debenture where basis point pricing spreads actually narrowed despite S&P's downgrade of U of T from AA+ to AA.

In conclusion, many factors are brought to bear in determining credit ratings at any given point in time. The University will continue to use credit ratings as a guideline, but not a constraint, in determining borrowing levels.

RECOMMENDATIONS

The proposed borrowing strategy incorporates the following key elements:

- That the internal borrowing capacity limit of $200 million of internal loans for from EFIP for the current capital plan and other requirements be maintained, along with the recognition that, some or all of this sum may need to be refinanced externally at some time, if future cash flow patterns would change.

- That the target external borrowing capacity limit be defined as 1/3 of capital, smoothed over 5 years, and the maximum borrowing capacity limit at 40% of capital smoothed over 5 years.

- In the event that outstanding external borrowing exceeds the maximum, no further external borrowing will be permitted until such time as the actual outstanding borrowing is no greater than the target external borrowing capacity of 1/3 capital smoothed over 5 years.

- That principal and interest repayments related to bullet debenture borrowing be placed in the Long-Term Borrowing Pool, or other sinking fund mechanism, and, together with investment income, 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 draw downs will be sufficient to repay the bullet debentures at maturity.

The foregoing analysis indicates that the University can prudently borrow another $150 million externally, bringing total external borrowing to $565.1 million. It is recommended that the Business Board approve:

1. The borrowing strategy that is described in this paper.

2. That the University be authorized to borrow such amount, not exceeding $150 million, as may be determined by the senior officer of the University responsible for financial matters, as so designated by the President, in addition to the $160 million approved by the Business Board on January 15, 2001 and the $200 million approved by the Business Board on June 19, 2003;

3. That such senior officer responsible for financial matters be authorized to determine, in consultation with the University's financial advisor, the most appropriate financing structure for this borrowing, including without limitation, by way of private debt placement, a public debenture issue, syndicated bank financing, or securitization and to negotiate, approve and execute and deliver for and on behalf of and in the name of the University, all agreements, documents, certificates and instruments, including without limitation any underwriting or agency agreement and any offering document and to take all such other actions as such officer may determine to be necessary or desirable to give effect to such financing and offering of debt securities, the execution and delivery of any such agreements, documents, certificates or instruments, and the taking of such actions being conclusive evidence of such determination;

4. That such senior officer responsible for financial matters is further authorized to authorize any other officer of the University to execute and deliver, for and on behalf of and in the name of the University, such certificates, documents and instruments as may be contemplated by the principal agreements entered into with respect to such debt offering or as may be required in connection with the closing of the offering of debt securities authorized hereby.

5. That the borrowed funds be added to the Long-Term Borrowing Pool and invested by University of Toronto Asset Management Corporation until the funds are required for each project;

6. That the senior officer of the University responsible for financial matters be authorized to allocate borrowing as internal financing for spending that has been approved by the Business Board or is within the approval authority of the administration;

7. That principal and interest repayments related to debenture borrowing be placed in the Long-Term Borrowing Pool, or other sinking fund mechanism, and, together with investment income, be used to pay periodic interest payments to lenders, to pay issue and ongoing administrative costs, with the expectation that the net sum from these additions and draw downs will be sufficient to repay the bullet debentures at maturity.

8. That the senior officer of the University responsible for financial matters report periodically to the Business Board on the status of the Long-Term Borrowing Pool.

Borrowing Strategy

June 2004

Current Situation

- Guideline restricts external debt to one third of capital, where capital is defined as assets minus liabilities
- Internal debt is limited to $200 M
- For 2003-04, external borrowing limit was $420M, based on a year end 2003 capital of $1264M.
- Current external debt consists of:
  - Debenture series A $160M due July 2031
  - Debenture series B $200M due December 2043
  - Other loans $55 M due over next few years

Issues

- 2003 was a historically low capital position
- Still many unmet demands for debt financing (new construction and renovations)
- Other projects will be identified
- Matching programs will require debt $25M
- Miscellaneous items need financing
- Varsity $30M

Questions

- How much more external debt can we afford to take on?
- Have we defined capital appropriately? Is a single point in time appropriate for monitoring long term liabilities?
- Is one third of capital the right limit? If not, how much higher could we go without impacting our credit rating? Our ability to service the debt?
- Are we willing to accept more restrictive covenants or provide security?

##

Questions

- Will an excess debt load impact our ability to raise funds?
- Should we differentiate between debt serviced from the operating budget and debt serviced by ancillaries and student levies?
- Are there other forms of debt or financing structures that could meet our needs?

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Analysis

- Reviewed capital levels from 1998 through projected 2010
- Assessed impact of various smoothing methods
- Reviewed impact of various investment returns on capital
- Projected impact of donations on capital
- Used long range budget as basis for operating results

Analysis

- Reviewed impact of borrowing within a range
- Assessed cost of debt service in relation to other cost items as a test of reasonableness
- Looked at how current debt has been allocated (ancillaries versus operating)

Analysis

- Reviewed possible strategies and debt levels with external consultants for input on likely reaction of rating agencies and buyers of our debentures

Recommendations

- Capital should be redefined to use a running five year average, instead of a single year end point.
- Continue with the one third target limit for external debt, but permit a range up to a maximum of 40% as an outside limit
- If capital drops so that debt ratio exceeds the 40% level, no further borrowing until we have come back to target level

Recommendations

- Debt service capability must remain a priority decision criteria. Repayment sources must be clearly identified for any project to be financed with debt.
- Avoid taking on debt that requires covenants or security. This means maintaining good credit ratings, well in line with our peers. Use the Moody's Universe as our guideline.

Recommendations

- Use debenture financing for as long as possible, since it is unsecured and lowest cost. (Structured debt will be treated as debt by the rating agencies and debenture holders, regardless of accounting treatment, and is generally more expensive.)

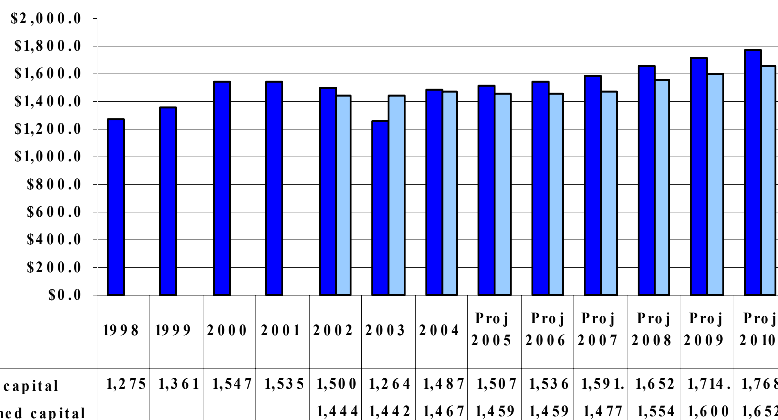
Recommendations

- Distinguish between debt serviced by ancillaries and debt serviced from the operating budgets only for setting priorities and assessing risk of repayment.
- Recognize that debt is debt in the eye of the lender. Any commitment that depends on the reputation and assets of the University is part of the same limit.

Implications of Using Five year Average Capital

- Five year average capital for year end 2003 would have been $1442 versus $1264
- Anticipated five year average capital for year end 2004 is $1467 versus $1487 actual
- Anticipated year end 2010 smoothed capital $1652 versus $1768

Capital as of April 30,Smoothed Over Five Years
Assuming Endowment Investment Return of 7%
(millions of dollars)



	1998	1999	2000	2001	2002	2003	2004	Proj 2005	Proj 2006	Proj 2007	Proj 2008	Proj 2009	Proj 2010
Annual capital	1,275	1,361	1,547	1,535	1,500	1,264	1,487	1,507	1,536	1,591.	1,652	1,714.	1,768
Smoothed capital					1,444	1,442	1,467	1,459	1,459	1,477	1,554	1,600	1,652

Smoothing provides a more predictable basis for determining borrowing capacity.

Implications of range 33% to 40%

- Five year smoothed capital 2004 – external debt range $489 to $587
- Most likely external debt will be an additional debenture of $150mm which takes us to $565 or 38%
- Going above this leaves no flexibility for market declines, budget problems or donation declines.

Impact on credit rating

- Current ratings are down slightly over the past three years, but still very good
- Advisors believe we can add another $150mm without material adverse impact on credit rating (and therefore cost of debt)
- Pro forma benchmarks to most recent year, indicates we are still in line with peer universe

Credit ratings

Moody's Investors Service (Moody's):

2001	Aa2 stable outlook.
2002	Aa1 stable.
2003	Aa1 negative outlook.

Standard and Poor's (S&P):

2001	AA + stable.
2002	AA + stable.
2003.	AA stable.

Dominion Bond Rating Service (DBRS):

2002	AA high stable.
2003	AA high stable.

Recognize that credit rating levels may vary over time.

Impact on debt service costs

- Principal and interest current debt service costs $53.7mm of which $27.7 is serviced by ancillaries and student levies
- Adding another $150mm will increase debt service costs by $12.3mm to a total of $66.0mm

- The University can reasonably take on another $150M of debt, within the controls described in the strategy.