



THE UNIVERSITY
of NORTH CAROLINA
at CHAPEL HILL

Debt Policy Ratio Review

March 25, 2009

1. Ratio definitions.
2. Key assumptions.
3. Historical & Projected Ratios
4. Peer Comparisons
5. Closing Points.

Ratio Definitions

- ❖ **Expendable Resources to Debt:** This ratio is used by the rating agencies as a relative indicator of the financial health of an institution in terms of balance sheet strength. More specifically, it is viewed as a measure of cushion available to repay debt in the event of an interruption of the primary source of repayment – cash flow. Expendable resources include unrestricted net assets and restricted, but expendable, net assets, as referenced on the institution's balance sheet. A higher ratio indicates a stronger position. The University's debt policy sets the floor for this ratio at 1.50X.

- ❖ **Debt Service to Operations:** This ratio is a relative indicator of the University's ability to repay annual debt service associated with all outstanding debt by measuring debt service as a percentage of annual operating budget. The University's debt policy sets a ceiling for this ratio of 4%.

Key Assumptions

- ❖ Projection time horizon includes fiscal year ending 2009 through and including fiscal year ending 2014.
- ❖ Changes in “Expendable Resources” are highly (but not completely) correlated with investment returns. For the purposes of this analysis, projected changes year over year in “Expendable Resources”, beginning with Fiscal Year Ending 2009, are -25%, 0%, 8%, 8%, and 8%.
- ❖ These projected returns are based upon separate discussions with UNC Management Company and with Prager, Sealy, & Co, the University’s financial advisor, on the investment return scenarios being used, in general, by other peer institutions (Endowments > \$1B).
- ❖ For operating expenses in the ratio “Debt Service to Operations”, the growth rate for the projection period is 4%, 4.5%, 5%, 5.5%, 6%, which compares to an average of 7.5% over the last three historical fiscal years and an average annual growth rate of 6.63% from fiscal year ending 1998 through and including fiscal year ending 2008.
- ❖ The assumed interest rate used for new long-term borrowings during the projection period is 6%, and the assumed interest rate for short-term (Commercial Paper) borrowings during the projection period is 4%.
- ❖ Including the \$78 million in project-allocated Commercial Paper outstanding at fiscal year ending 2008, total expected long-term borrowings in support of University capital projects is approximately \$618 million through and including fiscal year ending 2014.
- ❖ This pipeline was based on those projects that are under construction and/or in the biennium six-year plan for self-liquidating projects. Some projects on the biennium plan were not included based upon feedback from respective areas.
- ❖ The below list includes the significant projects included in the above-referenced capital project debt-funding pipeline.

<u>Summary of large projects (in decreasing order by size)</u>	<u>Total</u>
Infrastructure	133,198,302
Science Complex II	77,200,000
ERP	58,656,881
Granville Towers	45,750,000
Bell Tower Development (does not include infrastructure portion)	44,500,000
Annual Total	<u><u>359,305,183</u></u>



Historical and Projected Ratio Measures

(in 000s)

Fiscal Year Ending	2004	2005	2006	2007	2008	PROJECTED					
						2009	2010	2011	2012	2013	2014
Expendable Resources to Debt											
Expendable Resources	\$1,283,478	\$1,471,660	\$1,686,706	\$2,097,760	\$2,263,950	\$1,720,602	\$1,720,602	\$1,858,250	\$2,006,910	\$2,167,463	\$2,340,860
Debt	\$487,880	\$604,669	\$920,344	\$970,618	\$1,155,909	\$1,181,773	\$1,400,768	\$1,455,659	\$1,515,351	\$1,528,837	\$1,510,364
Measure	2.63	2.43	1.83	2.16	1.96	1.46	1.23	1.28	1.32	1.42	1.55
Policy Threshold	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
Debt Service to Operations											
Debt Service	\$33,423	\$37,757	\$57,397	\$60,493	\$73,252	\$82,167	\$90,807	\$102,683	\$105,160	\$113,069	\$114,797
Operating Expenses	\$1,603,386	\$1,681,901	\$1,802,431	\$1,948,282	\$2,089,290	\$2,172,862	\$2,270,641	\$2,384,173	\$2,515,302	\$2,666,220	\$2,839,525
Measure	2.08%	2.24%	3.18%	3.10%	3.51%	3.78%	4.00%	4.31%	4.18%	4.24%	4.04%
Policy Ceiling	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%



Peer Comparisons

(in descending order based upon FYE 2008)

<u>School</u>	<u>Moody's Long-Term Rating</u>	Expendable Resources to Debt				
		<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Michigan	Aaa	5.36	7.36	6.95	6.46	6.65
UVA	Aaa	5.04	6.42	5.28	5.41	5.50
Purdue	Aa1	2.60	2.71	2.43	2.72	2.63
University of Washington	Aa1	2.47	2.24	2.10	2.11	2.70
UNC-Chapel Hill	Aa1	2.00	2.20	1.80	2.40	2.60
NCSU	Aa2	1.40	1.43	1.15	1.17	1.52
Indiana	Aa1	1.17	1.12	1.03	1.13	0.92

(in ascending order based upon FYE 2008)

<u>School</u>	<u>Moody's Long-Term Rating</u>	Debt Service to Operations				
		<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Michigan	Aaa	1.43%	1.62%	1.13%	1.12%	1.04%
NCSU	Aa2	1.75%	1.86%	1.89%	1.38%	1.47%
UVA	Aaa	1.99%	2.44%	2.13%	1.87%	1.78%
University of Washington	Aa1	2.66%	2.71%	2.47%	3.25%	3.28%
Purdue	Aa1	3.23%	3.26%	3.18%	3.42%	3.82%
Indiana	Aa1	3.42%	3.26%	3.26%	3.22%	3.19%
UNC-Chapel Hill	Aa1	3.50%	3.20%	3.20%	2.20%	2.10%

Closing Points

- ❖ The University will likely experience a deterioration in its “Expendable Resources to Debt” ratio measure beginning with fiscal year ending 2009 due to the systemic decline in investment returns as a result of the instability in financial markets and the associated economic downturn.
- ❖ Other peer institutions will likely experience an erosion in this measure based upon similar experience with investment returns.
- ❖ In the current environment, most peers still have capital funding needs in the pipeline but are taking steps to reduce the scale and/or pace of their capital spending, where possible.
- ❖ Debt capacity and bond rating are determined by both qualitative and quantitative factors and is regarded as more art than science.
- ❖ With debt having been a planned funding source in the University’s substantial capital improvement program, the University has a relatively high leverage profile compared to its public peers in the combined Aaa/Aa1 rating category.
- ❖ Positive rating factors for the University include: strong academic and research reputation, management, diversified revenue base, management team, low tuition levels, student demand statistics and selectivity measures, and strong support from the State of North Carolina (Aaa/AAA).
- ❖ Given the University’s leverage profile, the qualitative factors play a significant role in the University’s current rating.
- ❖ Although the qualitative factors are very important in the ratings analysis, given the current economic environment and the higher degree of scrutiny on the rating agencies, analysts are likely to be more rigorous in their financial analyses.
- ❖ The University typically meets with the rating agencies on an annual basis to provide a financial update on the institution and to provide an update on the University’s capital improvement program and associated funding needs.
- ❖ The University reserves debt funding for those projects that advance the mission and strategic initiatives of the institution and that possess a strong primary source of repayment.