STANDING COMMITTEES

Finance and Asset Management Committee

Debt Management Annual Report

INFORMATION

For information only.

BACKGROUND

The Board of Regents is charged with oversight of the University's external and internal debt portfolios.

Oversight of the University's external debt portfolio is accomplished by adopting the University's Debt Management Policy, guiding credit standards, authorizing the issuance of external debt, and ensuring compliance with bond covenants and IRS regulations.

Internally, the Board approves the use of financing programs to fund projects, monitors internal loans, and approves Financial Stability Plans. The Board also approves changes to the Internal Lending Program rate and authorizes withdrawals other than those described in the Debt Management Policy.

The Debt Management Annual Report provides the Board with a broad overview of the external and internal debt portfolios, macro challenges, and how the University is managing those challenges. Its purpose is to provide the Board with information and context to inform decisions about the University's external borrowing and internal lending activities. This report does not require Regental action.

Attachment
University of Washington 2019 Debt Management Annual Report

UNIVERSITY OF WASHINGTON
Debt Management Annual Report

Board of Regents Finance and Asset Management Committee

June 13, 2019

AGENDA

- External Borrowing and Internal Lending Overview
- External Borrowing
  - Why issue debt?
  - Credit Overview
  - Debt Capacity Update
- Internal Lending
  - Benefits of the ILP
  - Rate Recommendation / ILP Sufficiency

EXTERNAL BORROWING AND INTERNAL LENDING OVERVIEW

The University manages two separate but related portfolios

External Borrowing

Mission

- Achieve the lowest risk adjusted cost of capital
- Assure continued access to capital markets

Regental Roles

- Adopt Debt Policy
- Approve annual Bond Resolution
- Review portfolio performance
- Guide University credit and issuance standards, including debt capacity

Reporting

- Bondholders Report including audits to investors
- Monthly Debt Report (MODRe) to Regents
- Future debt issuance and liquidity information to rating agencies

Internal Lending

Mission

- Offer stable and predictable interest rates to campus borrowers and allow for capital funding in a rising rate environment

Regental Roles

- Approve and monitor ILP loans
- Approve distributions and ILP rate changes
- Approve use of Capital Assets Pool
- Approve Financial Stability Plans
- Affirm exit from Financial Stability Plan

Reporting

- Semi-Annual Borrower Reports
- Semi-Annual ILP Report
- Debt Management Annual Report
- Annual ILP Audit

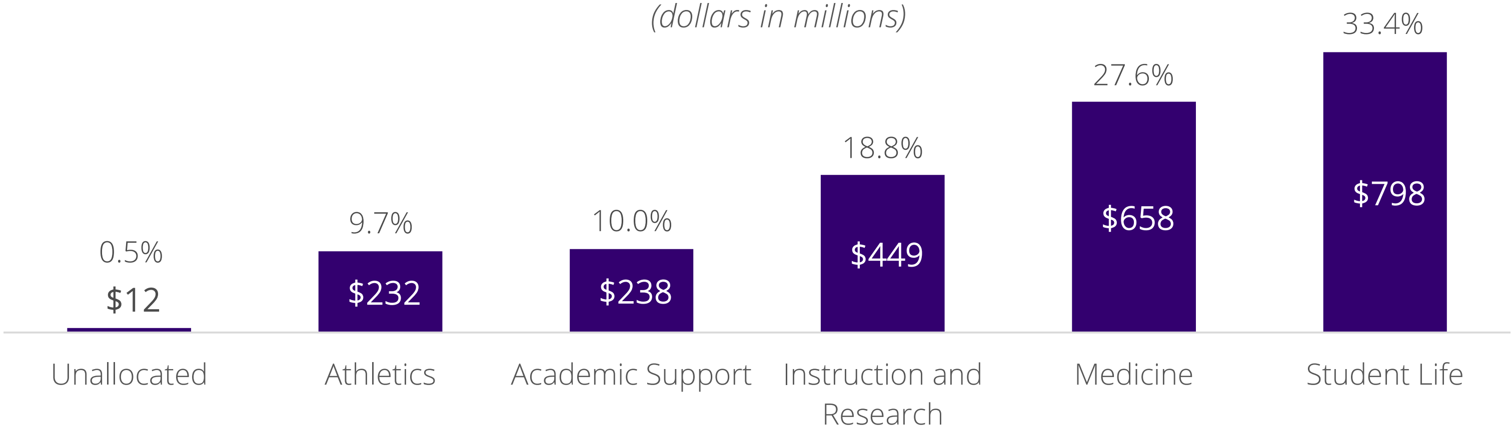
WHY ISSUE DEBT?

The University utilizes tax-exempt bonds to support institutional missions and priorities

- Debt is a powerful tool to fund campus capital projects
  - Accelerates the timeline for completing projects versus waiting to cash fund
  - Spreads the project cost over the useful life of the asset
  - Represents a commitment of future revenues to make debt payments (principal and interest)
  - Is a finite resource that must be prudently allocated
- Debt funding must have a repayment source from growth (i.e. incremental revenue) or capacity from the expiration of existing debt service

External Debt Allocated by University Mission (1)

(dollars in millions)



(1) Represents outstanding external debt as of 4/30/19

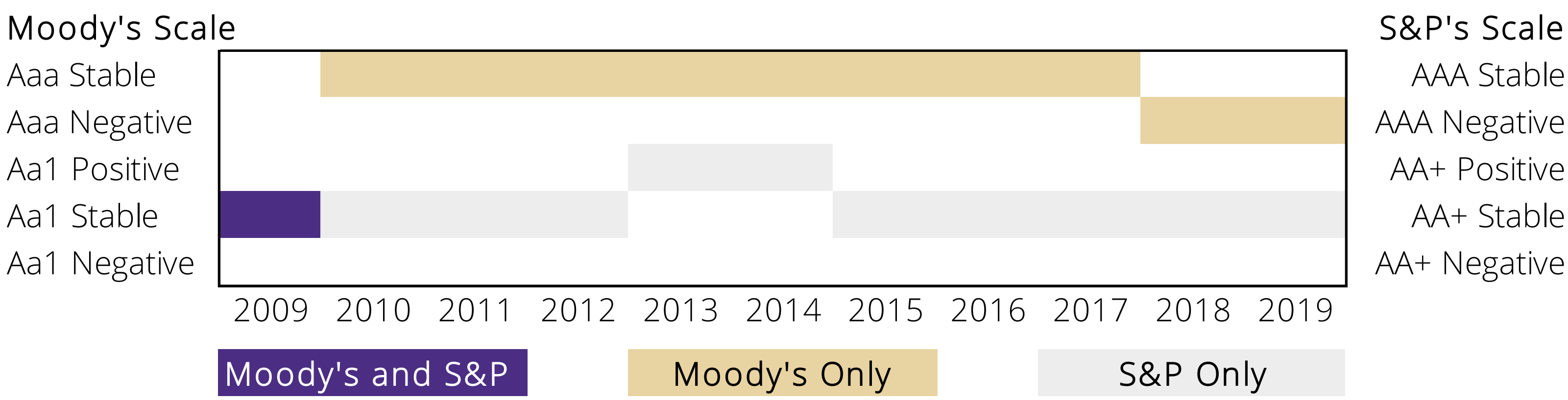
UNIVERSITY of WASHINGTON

INSTITUTIONAL CREDIT OVERVIEW

Weaker operations and lower liquidity could result in rating pressure

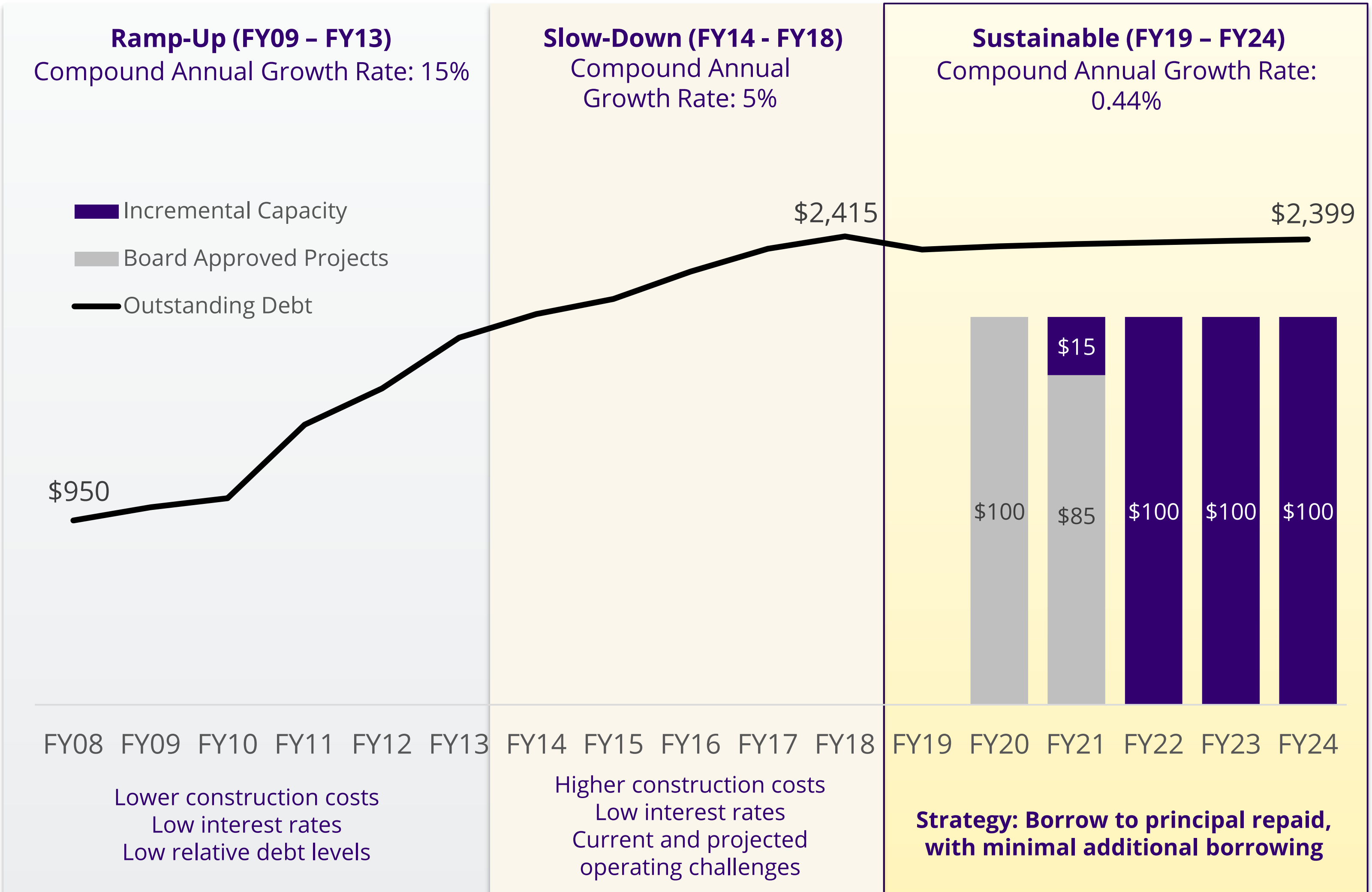
- An institutional credit rating is a broad reflection of financial health
- The University's ratings remain at Aaa/AA+ (Moody's/S&P). The change in outlook did not have a measureable impact on borrowing cost
  - With a "split" credit rating, the University's bonds price closer to the lower "AA+" rating than to the higher "Aaa" rating
- The following factors could lead to a rating downgrade:
  - Reversal of improved consolidated and health system operations in fiscal year 2019 and beyond
  - Sustained decline in unrestricted liquidity
  - Material debt issuance plans beyond those outlined given already moderately high leverage
  - Significant reduction in research funding and revenue

Agency Credit Rating by Year



DEBT HISTORY AND FUTURE

(in millions)



External Borrowing

ESTIMATING DEBT CAPACITY

The University estimates debt capacity annually by projecting institutional growth and benchmarking to credit peers

> Five-year debt capacity for FY20 – FY24 is $500 million, roughly equal to principal paid

> The main drivers of the quantitative analysis are:

- Financial Forecast and Ratios
- Credit Peers
- Ratio Weighting

Projected Debt Balances FY20 - FY24

(in millions)

	Beginning Balance	Debt Retired	Committed Capacity*	Estimated Incremental Capacity	Ending Balance
FY20	2,347	(83)	100	0	2,364
FY21	2,364	(89)	85	15	2,375
FY22	2,375	(91)	0	100	2,384
FY23	2,384	(92)	0	100	2,392
FY24	2,392	(93)	0	100	2,399
Totals		**(448)**	**185**	**315**	

* Reflects debt capacity allocated to Board approved projects. Authorized projects include Destination One, NWH Childbirth Center, and Kincaid Hall

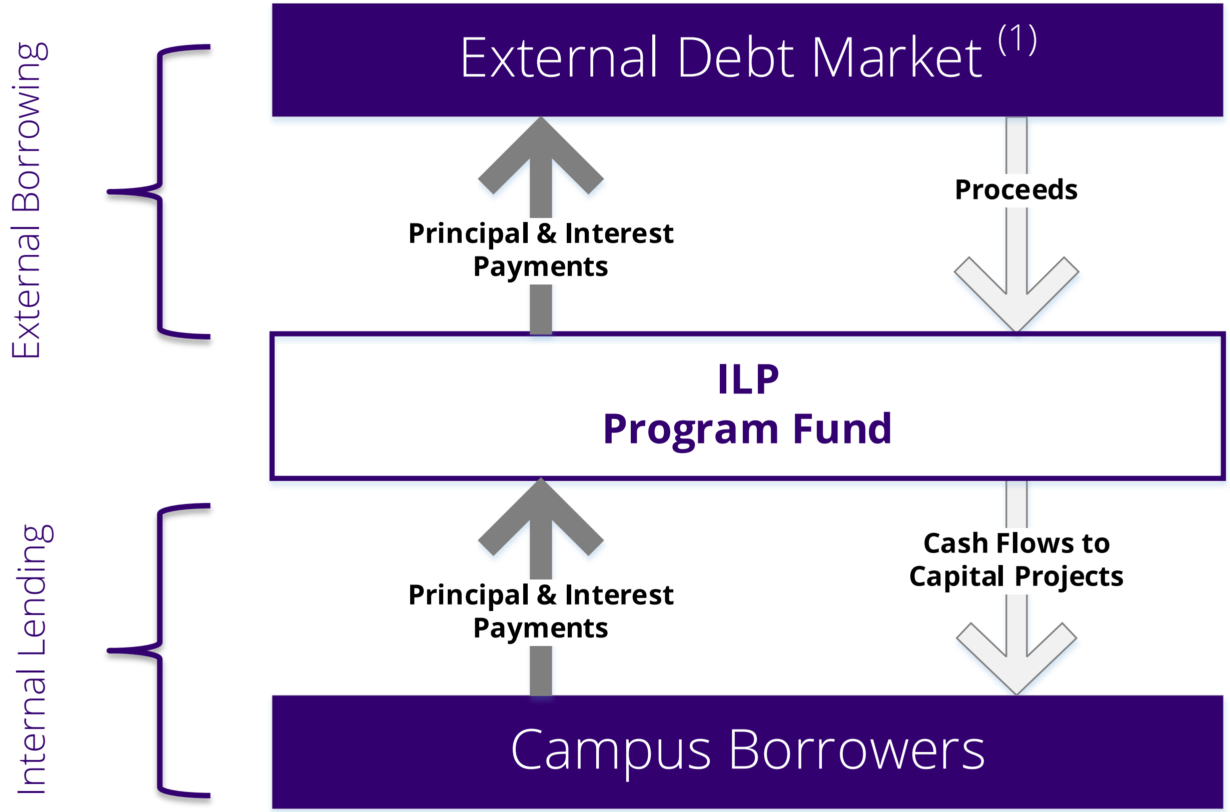
WHY HAVE AN INTERNAL LENDING PROGRAM (ILP)?

The primary mission of the ILP is to make loans to campus borrowers at a stable and predictable long-term rate

- There are numerous additional benefits of the ILP:
  - Rigorous due diligence for debt funded projects
  - Greater transparency into unit performance through audited financial statements, Board reporting (SABRe), and performance metrics
  - Easier project funding with more flexibility for campus borrowers
  - Reduced net borrowing cost versus issuing as a stand-alone credit by unit
  - Substantial flexibility in structuring internal loans, including more favorable internal loan covenants
  - Ability to pre-pay loan at any time without penalty
  - Opportunity to fund additional lending programs to campus using ILP balances (e.g. Bridge, FAST, University Housing Assistance Program)
  - Ongoing financial support to University Provost through the Credit Support Fee and annual interest earnings (an estimated $4-6 million per year)

UNIVERSITY LENDING OVERVIEW

External borrowing and internal lending come together in the Program Fund. The Program Fund is insurance against future higher interest rates



(1) The Capital Assets Pool (CAP) program is also a funding source to the ILP

ILP RATE EVALUATION AND SUFFICIENCY

- The current ILP rate of 4.50% is:
  - Close to current market rates (within 0.50%)
  - At or below most higher education peer institutions
  - Very unlikely to increase, which assures long-term access to capital for internal borrowers
- In a rising external rate environment, sufficiency equals the number of years the ILP rate can be held stable for internal borrowers
- As of FY18, the ILP had a cash balance of $137 million, which includes:
  - Funding for future principal payments
  - 10-15 years of rate sufficiency
  - Potential for future distribution
  - Minimum requirement for ILP programs
- The Board must approve any changes to the ILP rate or distributions from the ILP
- No recommended change to the ILP rate