UNIVERSITY OF WASHINGTON
Debt Management Annual Report

Board of Regents Finance and Asset Management Committee

April 9, 2020

AGENDA

- External Borrowing and Internal Lending Overview
- External Borrowing
  - Why issue debt?
  - Institutional Credit Overview
  - Higher Education Sector Outlook
- Internal Lending
  - Benefits of the ILP
  - ILP Sufficiency
  - Rate Recommendation

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
- Semi-Annual Debt Report 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
- Review and approve Financial Stability Plans

Reporting

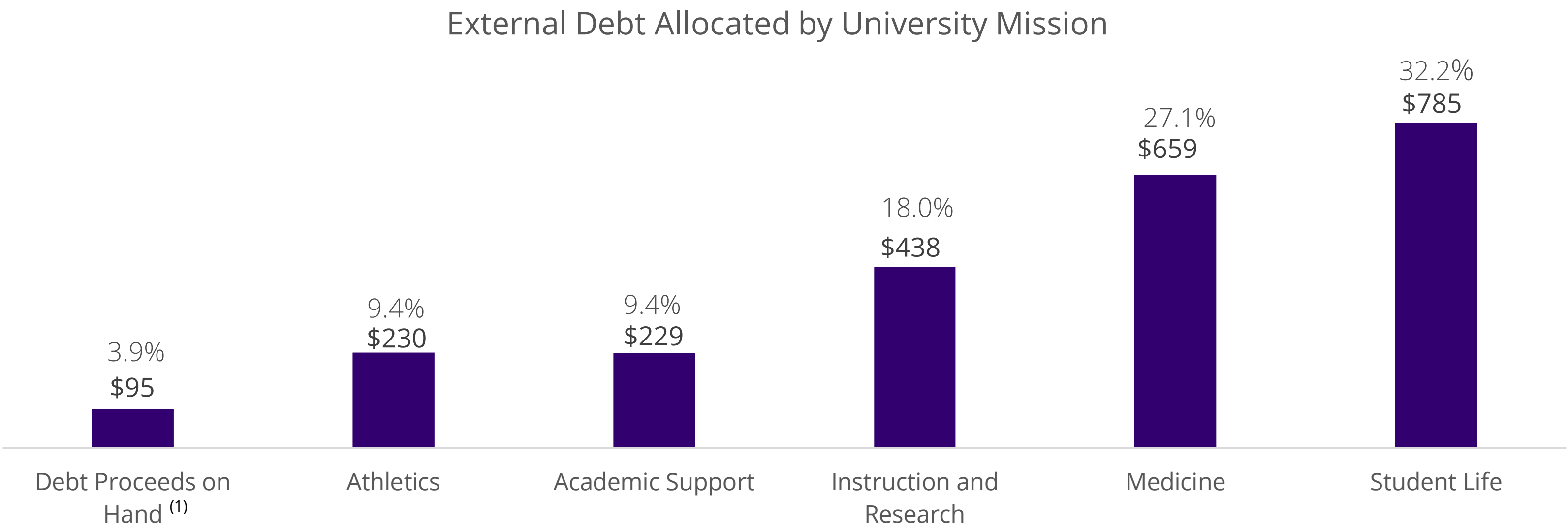
- Annual Borrower Reports[1]
- Annual ILP Report[2]
- Debt Management Annual Report
- Annual ILP Audit

(1) Formerly known as the "Semi-Annual Borrower's Report"
(2) Formerly known as the "Semi-Annual ILP Report"

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 incremental revenue, repurposing of existing revenue, or capacity from the expiration of existing debt service



(1) Represents outstanding external debt as of 2/29/20. Debt proceeds on hand represents proceeds from 2020 bond sale to be used for Destination One, Childbirth Center, Kincaid Hall, and other University projects

INSTITUTIONAL CREDIT OVERVIEW

Weaker operational results and lower liquidity could result in rating pressure

> An institutional credit rating is a broad reflection of financial health

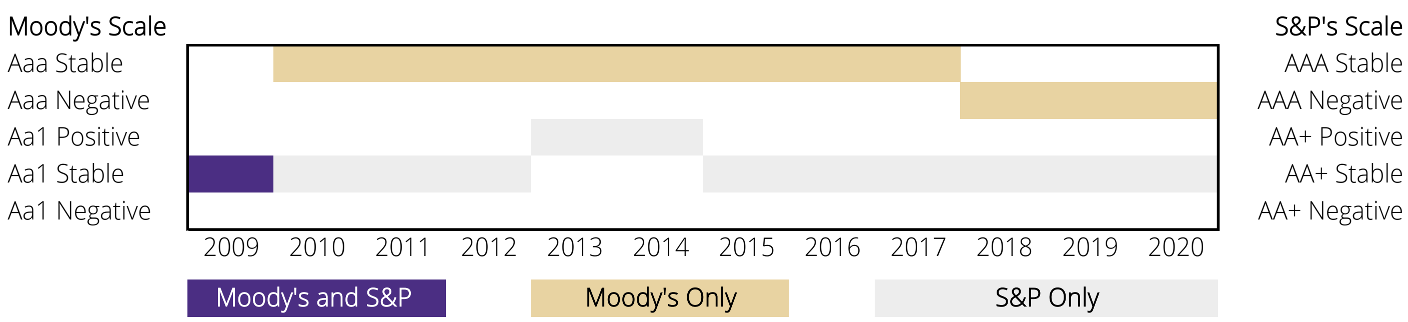
> The University's ratings remain at Aaa (negative outlook) /AA+ (stable) (Moody's/S&P)

- With a "split" credit rating, the University's bonds price closer to the lower "AA+" rating than to the higher "Aaa" rating

> Similar to last year, the following factors could lead to a rating downgrade:

- Failure to continue to achieve improved operations at the health system
- Inability to rebuild unrestricted liquidity
- Material debt plans beyond those outlined given already moderately high leverage
- Significant reduction in research funding and revenue

Agency Credit Rating by Year



External Borrowing

HIGHER EDUCATION SECTOR OUTLOOK NEGATIVE

Coronavirus outbreak increases downside risks of sector

- On March 18, 2020, Moody's changed the outlook for the higher education sector to negative from stable
  - Reflects both the immediate negative financial impact of the coronavirus outbreak as well as other significant downside risks
  - Expectation that universities' response to the outbreak will immediately reduce revenue and drive expenses higher
  - For FY21, universities face unprecedented enrollment uncertainty, risks to multiple revenue streams, and potential material erosion in their balance sheets.
- Factors that led to change in sector outlook:
  - Ability to respond to rapidly increasing downside risks varies widely across the sector
  - Operating performance will tighten across the sector as colleges shift to online educational delivery and incur other emergency preparedness costs
  - The sector faces disruption in enrollment patterns, state support, endowment income and philanthropy, and research grants and contracts
  - Significant investment losses will most immediately hit reserves, decreasing the buffer for responding to operating volatility
- A sustained recovery in the financial markets, reversal of the projected economic slowdown in the later part of the year, and stable enrollment for fall 2020 would contribute to a reversion to a stable outlook

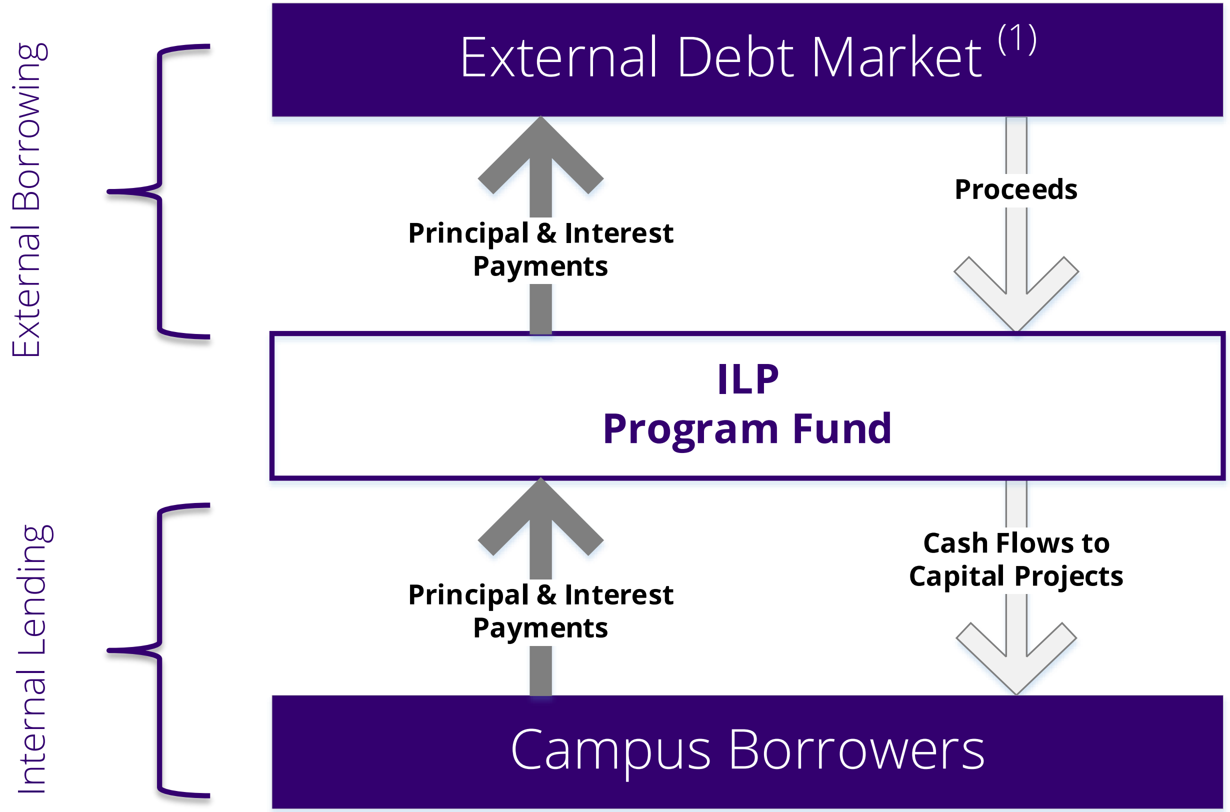
WHY HAVE AN INTERNAL LENDING PROGRAM (ILP)?

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:
  - Substantial flexibility in structuring internal loans, including more favorable internal loan covenants. **Ability to respond quickly and support campus in emergency situations**
  - Rigorous due diligence for debt funded projects
  - Greater transparency into unit performance through audited financial statements, Board reporting (e.g. Annual Borrower Reports), 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
  - 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 <u>insurance</u> against future higher interest rates



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

ILP SUFFICIENCY

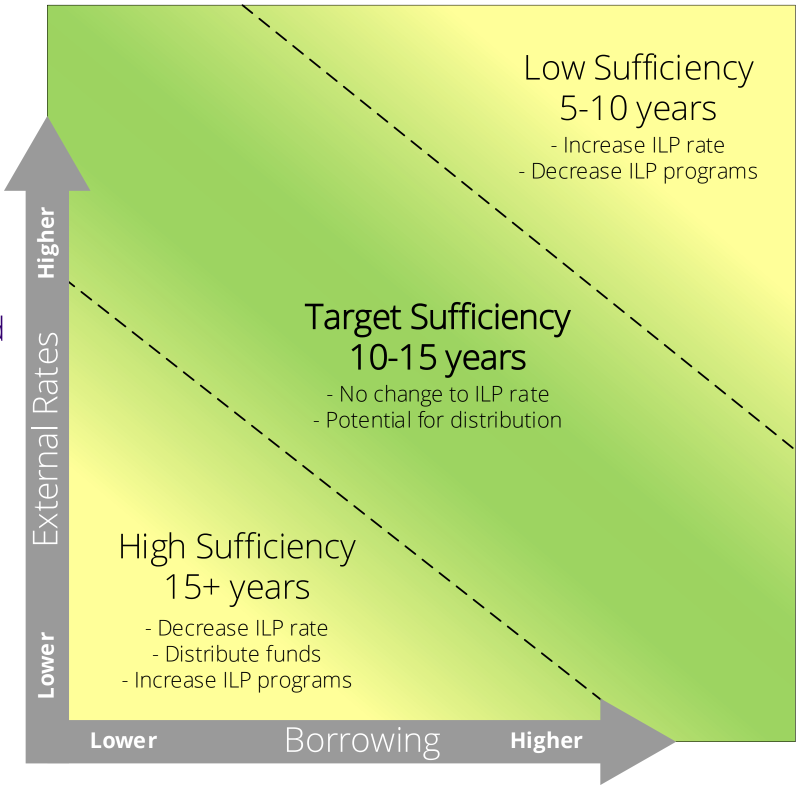
> The current ILP rate of 4.50% is:
  – Close to historic averages (within 0.50%)
  – At the higher end of range for similar programs at higher education peer institutions
  – Very unlikely to increase, which assures long-term access to capital for internal borrowers

> In a rising external rate environment, sufficiency equals the number of years the ILP rate can be held stable for internal borrowers

> As of FY19, the ILP had a cash balance of $115 million[1], which includes:
  – Funding for future principal payments
  – 9-13 years of rate sufficiency
  – Funds earmarked for $50 million distribution for Finance Transformation (assumes $33 million in FY20 and $17 million in FY21)
  – Minimum requirement for ILP programs

> The Board must approve any changes to the ILP rate or distributions from the ILP

ILP Sufficiency Ranges



(1) Reduction in ILP cash balance from FY18 to FY19 reflects $25 million in commercial paper that was paid off using ILP balances

RATE RECOMMENDATION

Treasury recommends lowering the ILP rate from 4.50% to 4.25%

> ALM reviews account balances and projections annually as part of its ILP rate setting recommendation to the Board
  - Rate change would be effective as of May 1, 2020
  - Sufficiency would be reduced by two years to be between 7-11 years
  - Provides immediate relief to internal borrowers
  - Moving to 4.25% better aligns ILP rate to peer institutions

> Next Steps
  - Calculated debt capacity to be provided to Board in May along with institutional financial forecast
  - Borrowing estimates in the Long-Term Capital Planning framework include modest growth in outstanding debt over the next 15 years