North Carolina State University
Debt Management Guidelines
Revised June 2018

Summary

Debt financing, especially tax-exempt debt, provides a low-cost source of capital for the University to fund capital investments to achieve its mission and strategic objectives. As the economic landscape continues to evolve and change, the use of debt will become an increasingly important tool that enables our institution to move its strategy forward. In this environment, appropriate financial leverage plays a key role and is considered a long-term component of the University's balance sheet. Given that the University has limited debt repayment resources, the allocation and management of debt is a limited resource. The guidelines provided in this document are the framework by which decisions will be made regarding the issuance of debt to finance particular capital improvements.

Authority

North Carolina General Statutes Chapter 116D Article 3 authorize the Board of Governors of the University of North Carolina (the Board) to issue special obligation bonds for improvements to the facilities of the University of North Carolina System.

Prior to a bond issue, the Board designates the capital improvements financed as "special obligation bond projects" and the University's Board of Trustees approves the issuance of special obligation bonds for those projects.

The State Energy Conservation Finance Act, Article 8 of Chapter 142 of the North Carolina General Statutes authorizes the Board to solicit and, through G.S. 143-64.17A , finance guaranteed energy conservation measures. These financing agreements must have the approval of the Office of State Budget and Management, the State Treasurer, and Counsel of State prior to closing.

Criteria

The University's debt capacity is a limited resource. Only projects that directly or indirectly relate to the mission of the University will be considered for debt financing. In general, projects that will be approved are broader in scope than college, or unit-based, projects. However, certain mission-critical school-based projects can also receive approval. Before beginning the planning-for-fundraising process for any project which might require debt financing, the approval of the Vice Chancellor for Finance and Administration and the Vice Chancellor for University Advancement is required.

Projects financed through a bonding program will have received approval through the NC State Legislature annual non-appropriated capital improvements bill and will have been designated as "special obligation projects" by the North Carolina Board of Governors. Energy conservation measures will have received state agency approval as required.

A project that has a related revenue stream (self-liquidating project) will receive priority consideration. All of these projects must be self-funding, and the use of debt must be supported by an achievable financial plan that includes servicing the debt(including interest expense), financing related infrastructure and utilities, meeting any new or increased operating costs (including security applications), and providing for appropriate replacement and renovation costs. Any bonded project must have a minimum debt-coverage ratio of 1.25X cash flow-to-debt service (debt service being the annual sum of required minimum principal and interest payments). Projects must meet the criteria of serving an institutional purpose for the betterment of the University and be compelling within the guidelines of the University's long-term plan. In addition, bonded project priority will be reserved for those projects that cannot be more efficiently financed using external, private resources. Energy conservation measures must show that savings will be adequate to service the debt and all annual monitoring costs. Other projects funded by budgetary savings, gifts, and grants will be considered on a case-by-case basis. Any projects that will require gift financing, or include a gift financing component, must be jointly approved by the Vice Chancellor for University Advancement and the Vice Chancellor for Finance and Administration before approaching any prospective donors about gifts to the project. Because of the ancillary costs of projects, the amount of gifts raised must also include an associated endowment for any projects that are to be 100% gift financed. In all cases, institutional strategy and not donor capacity must drive the decision to build a project.

The analysis of the University's debt capacity must also include the other, off-balance sheet items, such as space leases, that are incorporated into the long-term plan. Management will closely monitor all obligations of the University, factor its findings into decisions on all additional debt issuance, and retain complete discretion for approval based on such findings. Stated debt-like obligations and responsibilities need to be weighed carefully as they could cause a decline in University resources for other projects and objectives deemed essential to the long-term mission and overall enhancement of the University's operations.

Maintenance of Credit Rating

Maintaining a high credit rating will permit the University to continue to issue debt and finance capital projects at favorable interest rates while meeting its strategic objectives. The University's decision to issue additional debt will be focused on both the strategic importance of the new capital improvement(s) and the change in the overall debt portfolio and any associated impact on the credit rating. The University recognizes that external economic, natural, or other unanticipated events may from time to time affect the creditworthiness of its debt. Nevertheless, the University is committed to ensuring that the overall debt portfolio is prudently managed and all stakeholder interests are balanced. Management will provide the rating agencies with full and timely access to required information.

Methods of Sale

The standard methods of sale are competitive, negotiated, and private placement. University management will evaluate each method of sale and determine the best type for each bond issue.

Financing Team Professionals

Selection of financing team professionals will be accomplished based on guidance from the UNC System Office. Bond Counsel, Financial Advisor, and Underwriter pool will be selected using the RFP (request for proposals) method.

General Revenue Pledge

The University will utilize general revenue secured debt (available funds) for all financing needs, unless for energy conservation measures or other certain projects where management desires to structure specific revenue pledges independent of general revenue projects. The general revenue pledge provides a strong, flexible security that captures the strengths of not only auxiliary and student related revenues, but also of the University's research programs. General revenue bonds price better than corresponding auxiliary or facilities and administrative cost recovery bonds. Historically, general revenue debt has been subject to fewer operating or financial covenants and lower coverage levels imposed by the market and external constituents.

Refunding

Refunding and/or restructuring opportunities will be evaluated on a regular basis. Costs incurred by the refunding activity will be taken into consideration with a general target of 3% present value savings, but other factors will also be considered, including the impact on the University's overall risk profile, credit ratings, and future debt capacity. The University will also consider refinancing for other strategic reasons including the elimination of certain limitations, covenants, payment obligations, or reserve requirements that reduce flexibility.

Types of Instruments

Tax-exempt debt – The University recognizes the benefits associated with tax-exempt debt, and will manage the tax-exempt portfolio to maximize the use of it subject to changing market conditions and tax laws.

Taxable debt – The University will manage its debt portfolio to implement taxable strategies based primarily on private use considerations, and secondarily on tax laws and current market conditions. Taxable debt is likely to be a perpetual component of the University's liabilities, and will be utilized to fund projects ineligible for tax-exempt financing.

Commercial paper – The University recognizes that a commercial paper (CP) program can provide low-cost working capital and provide bridge financing for projects. However, as with other debt structures, the level of CP outstanding impacts the University's overall debt capacity. The University retains the right to reduce the amount of CP available in the event it needs to increase its tax-exempt and taxable debt capacity.

Variable rate debt – Variable rate debt is a desirable component of a debt portfolio in declining-rate environments, as it provides typically lower rates. The use of variable rate debt does expose the debt portfolio to interest rate fluctuations and often comes with liquidity needs. Therefore, the University will balance the mix of variable and fixed rate debt so that variable is between 0-30% of the total debt portfolio and will include variable interest rate instruments and products when advantageous.

Derivatives –The use of derivative products can be appropriate and advantageous for the purposes of limiting interest rate exposure and reducing debt-service costs. The use of swaps will be employed primarily to enhance the University's financial strategy by managing its variable-rate exposure. Derivative products can help the University lock-in a favorable cost of capital for a future project or to ensure a specific level of cash flow savings for a refinancing. The University's strategic objectives and outlook on the interest-rate environment would determine the appropriate approach.

The University will evaluate potential derivative instruments through evaluation of its variable rate allocation, market and interest rate conditions, and the compensation for undertaking counterparty exposure. The University will evaluate each transaction relative to counterparty, basis, and termination risk. No derivative transaction will be undertaken that is not fully understood by the University or that imposes inappropriate risk on the University.

Public Private Partnerships - Given limited debt capacity and substantial capital needs, opportunities for alternative and non-traditional transaction structures may be considered, including off- balance sheet financings. While on the surface these transactions can appear to be more expensive than traditional debt structures on a pure cost of capital basis, the actual entire cost may be lower due to more efficient operations that are generally experienced by using a private sector manager. Because of this, all factors need to be carefully considered when selecting a method to finance and complete a project. Chief considerations in deciding whether to pursue a Public Private Partnership are whether a third party financing model can produce results that are: (1) faster; (2) better; or (3) cheaper. Non-traditional structures can be considered when the economic benefit and likely impact on the University's debt capacity and credit have been determined to be accretive to the mission, the benefits of the potential transaction outweigh the costs, or the transaction best aligns with the long-term vision and strategic plan of the University. If it is determined that the use of third party financing or public private partnerships is closer to University debt than predicted, or if it is perceived to be University debt by University auditors, we will endeavor to use traditional financing methods. For this reason, any public private partnership projects that occur on University-or Endowment-owned land must include the involvement of the University Treasurer. Our debt guidelines anticipate that rating agencies will consider any debt that is built on state-owned or university-owned land for purposes similar to that which is typically financed by special obligation debt to be virtually the same as debt of the University. Economic interest and control drive whether a project is considered to be debt of the University. If the university has an economic interest (i.e. gains the net operating income or participates in the income or losses) and control, then the project is considered by most financing professionals to be materially tied to the University. Ultimately, pursuing this type of financing is also a function of regulations—a project may be feasible but may not be allowed under existing regulations.

Maturity and Debt Service

The useful life of the capital project financed will be taken into consideration when determining the length of financing. No capital project will be financed more than 120% of its useful life. Call features should be structured to provide the highest degree of flexibility relative to cost. Structure of debt service will take into consideration existing debt and future capital plans. In addition, the University's amortization of debt service may be spread along the full yield curve depending on market conditions.

Disclosures and Compliance

The University will review compliance with covenants and requirements under outstanding bond indentures on an annual basis. The University will continue to meet its ongoing disclosure requirements in accordance with SEC rule 15c2-12. The University will submit financial reports, statistical data, and any other material events as required under outstanding bond indentures. The University will comply with arbitrage requirements on invested bond funds. The University will comply with Internal Revenue Service rules related to private use and use of proceeds on tax-exempt debt.

Use of Benchmarks and Debt Ratios

In order to maintain an understanding of the University's standing in comparison to other like institutions, analysis using standard ratios and benchmarks must be made comparing the University to others in its peer group. This analysis can be used as an ongoing tool in determining trends, weaknesses, and target strengths relating to the debt portfolio, its credit rating, and the health of the institution. On a regular basis, the University will review its ratios and compare them to published benchmarks from the rating agencies and others in its peer group.

The University uses the following key ratios to provide a quantitative assessment of debt affordability and debt capacity. ***Current guidelines, which will be updated annually using published rating-agency median data, establish internal covenant levels that are 15% higher or lower than the Median level for similarly-rated peers. A transaction or series of transactions that violate the covenant levels without returning to compliance within 2 years following the transaction will require additional approval and diligence within the long-term (10 year) University plan.***

1. **Financial Leverage (Spendable Cash & Investments to Total Debt):** This ratio highlights the ability of the University to repay bondholders from wealth that can be accessed over time or for a specific purpose. **Internal covenant level = 1.9X.**

Cash and Investments (University and Affiliated Foundations) + Funds Held in Trust by Others + Pledges Receivable Reported in Permanently Restricted Net Assets – Permanently Restricted Net Assets

Total Debt

2. **<u>Debt Affordability (Total Debt to Cash Flow)</u>:** Measures the ability of the University to repay its debt from the profitability of its current operations, as opposed to financial reserves, and is a measure of debt affordability. **<u>Internal covenant level = 3.8X.</u>**

$$\frac{\textit{Total Debt}}{\textit{Operating Income + Depreciation + Amortization + Interest + Other Non-Cash Expenses}}$$

3. **<u>Total Debt to Operating Revenue</u>:** Measures the University's debt load relative to the scope of its current operations, economies of scale, and brand recognition. **<u>Internal covenant level = 0.45X.</u>**

$$\frac{\textit{Total Debt}}{\textit{Operating Revenue}}$$

<u>Indirect Debt</u>

The University understands that debt issued by affiliated foundations can have an effect on the University's bond rating. University management will take steps to be aware of and participate in debt discussions and new borrowings undertaken by those affiliated entities. As per Operating Guidelines for Associated Entities, all debt that exceeds $500K for major associated entities and $100K for minor associated entities must be approved by the Vice Chancellor for Finance and Administration.

<u>Centralized Lending and Blended Portfolio</u>

The University has adopted a central loan program under which it provides funding for projects under the guidance of the Vice Chancellor for Finance and Administration and the University Treasurer. The benefits of this program include: (i) structuring of transactions on an aggregate basis, rather than by project; (ii) continual access to capital for borrowers; (iii) predictable financial terms for borrowers; (iv) minimizing interest rate volatility; (v) permitting prepayment of loans at any time without penalty; and (vi) equity for borrowers through a blended rate.

The University charges a blended rate to its borrowers based on its cost of funding. This interest rate may change periodically to reflect changes in the University's average aggregate expected long-term cost of borrowing. The blended rate may also include a reserve for interest rate stabilization or other purposes.

Each borrower is responsible for the repayment of all funds borrowed from the central loan program, plus interest, regardless of the internal or external source of funds. The University provides for flexible financing terms in order to accommodate individual entities as determined by the project scope and repayment source. The Senior Director of Strategic Debt Management is the primary contact for divisional and auxiliary loans.