# Annual Report on Debt Capital and External Finance Approvals

CFO DIVISION

University of California Office of the President

**December 31, 2014**

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# PREFACE

The *Annual Report on Debt Capital and External Finance Approvals* is intended to provide The Regents with an overview of the University's debt capital program. This document serves as a background piece that addresses questions related to the University's overall debt capital structure, the University's financial strength as viewed by the capital markets, and the outlook for future financing flexibility.

At the July 16, 2009 Meeting of the Committee on Governance, *The Schedule of Reports to The Regents* was amended to incorporate *The Report on External Finance Approvals* into this report. As such, this report also includes a summary of external finance approvals for capital projects for the fiscal year ending June 30, 2014.

The *Annual Report on Debt Capital and External Finance Approvals* contains the following information:

- Overview of the University's outstanding indebtedness;
- Summary of debt issuance over the past fiscal year;
- Review of projected debt issuance for the current fiscal year;
- Update of the University's credit ratings
- Briefing on launch of the University's Debt Task Force
- Analysis of the likely impact of the University's projected debt issuances on the University's overall financial strength and future financing flexibility; and
- Summary of external finance approvals for capital projects.

FINANCIAL MARKETS OVERVIEW

2014 proved to be very issuer-friendly, with both tax-exempt and taxable long-term rates decreasing by more than 100 basis points (bps). On the year, the 30-year MMD High Grade Index, the standard benchmark for the most highly-rated tax-exempt debt, once again dropped below the 3% threshold to 2.94%[1], down approximately 130 bps on the year and within about 50 bps of its all-time low. Similarly, the yield on the 30-year Treasury now stands at 2.82%, down from about 3.90% a year ago and within 25 bps of its historic low.

The improvement in rates is attributable primarily to a combination of reduced supply and increased demand coupled with ongoing economic uncertainty both domestically and around the world. Through the first three quarters of the year, municipal issuance lagged 2013 supply significantly, and at times by 30% or more, though a late surge in issuance means total issuance is comparable year-over-year. Higher education issuance, in particular, will end the year approximately 25% below last year's levels[2]. At the same time, municipal bond funds, which constitute the largest investor base in the municipal space, added approximately $21 billion in holdings in 2014[3]; in contrast, municipal bond funds saw outflows of about $63 billion last year[4].

Meanwhile, macro-economic conditions also contributed to the drop in rates in 2014. Domestic economic data has been mixed throughout the year, and there continues to be uncertainty surrounding the Federal Reserve's plans to raise rates. Geopolitical unrest around the globe, including in Russia and Ukraine, add to the uncertainty and have encouraged a flight-to-quality trade in favor of the relative safe harbor of Treasuries.

Municipal issuers continued to take advantage of the convergence of tax-exempt and taxable rates, in many instances opting to issue more flexible taxable debt for projects otherwise eligible for tax-exempt financing. Unlike tax-exempt debt, taxable debt is not subject to certain tax rules and ongoing surveillance and reporting requirements. As a result, the proportion of taxable higher education debt has continued to increase; this is also reflected in the increased issuance of ultra-long dated financing structures such as century bonds, which have a 100 year final maturity.

As a result of sequestration, Federal subsidies for Build America Bonds interest payments were cut by 7.3% for the Federal fiscal year beginning October 1, 2014. Federal subsidies were reduced by 7.2% for the previous Federal fiscal year. The University's May and November 2014 interest payments were affected by this cut.

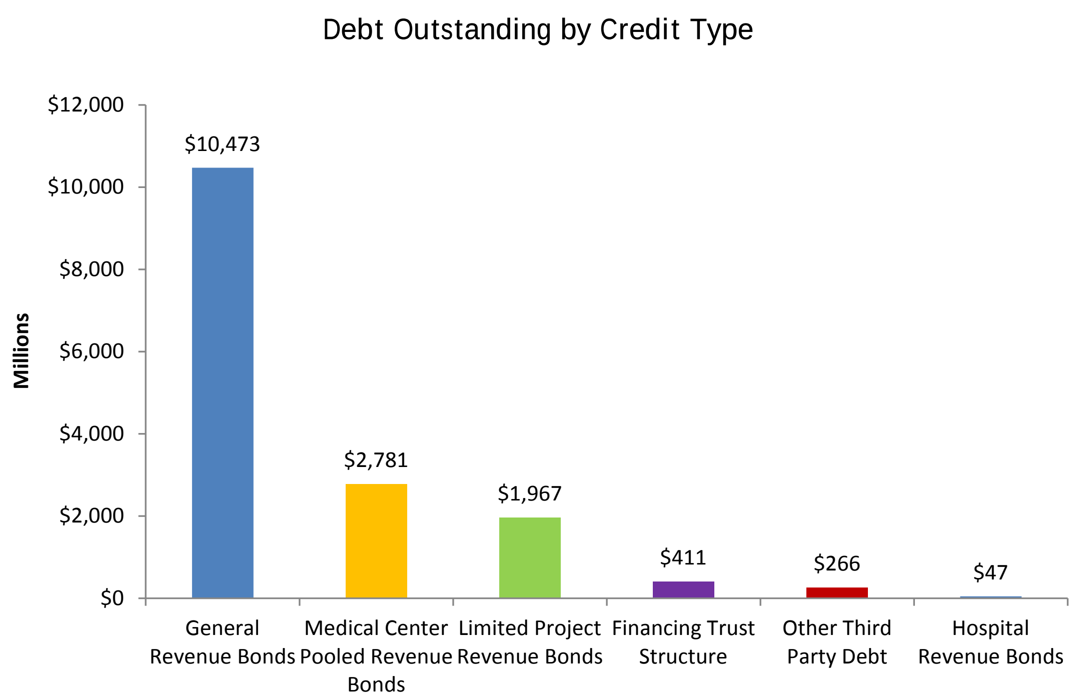
[1] As of December 18, 2014
[2] Securities Data Corporation
[3] As of December 18, 2014
[4] Barclays Municipal Research

## OVERVIEW OF UC DEBT

As of December 31, 2014 the University has $15.9 billion of outstanding debt, and $2 billion in authorized commercial paper. The weighted average coupon of the outstanding debt is 4.03% and the average life is 18.1 years.[5]

University's Debt by Credit Type

The University generally issues debt under one of three different credit types- General Revenue Bond, Medical Center Pooled Revenue Bond, and Limited Project Revenue Bond. The University has also issued debt through a financing trust structure and third party conduits. In addition, the University also has debt outstanding under its Hospital Revenue Bond credit, which has been replaced by the Medical Center Pooled Revenue Bond credit.




As of December 31, 2014

5
- Average coupon takes into account BABs subsidy
- Excludes non-core credits and FTS debt
- GRB Series AD (Century Bond) is included as a bullet maturity amortizing in 2042
- GRB Series Y interest rate is assumed at fixed payor swap rates until 7/1/15, then 3%
- GRB Series Z is assumed at 3%
- GRB Series AH is assumed at 1.796% through 7/1/19, then 3% (30-year term bond due in 2044 with five years of sinking fund payments)
- GRB Series AL assumes interest at fixed payor swap rates until 10/1/23; then 2.75%
- MCPRB Series K assumes the hedged portion pays interest at the fixed payor swap rate and the unhedged portion (about $2.8 MM) pays interest at 2.75%

**General Revenue Bonds.** The General Revenue Bond (GRB) credit serves as the University's primary borrowing vehicle and is utilized to finance projects that are integral to the University's core mission of education and research. The GRB credit is secured by the University's broadest revenue pledge, and was introduced in 2003 to replace and consolidate several purpose-specific credits. This credit consolidation serves to increase the University's overall debt capacity by pledging a broad revenue base (totaling $13.0 billion for FY 2014), facilitate the capital markets' understanding of the University's credit, and improve our overall ratings by recognizing the financial strength of the UC system. The University has just under $10.5 billion of outstanding GRB debt.

**Medical Center Pooled Revenue Bonds.** The Medical Center Pooled Revenue Bond (MCPRB) credit serves as the primary financing vehicle for hospital debt. The University has approximately $2.8 billion of MCPRBs outstanding. These bonds are secured by gross revenues of the five medical centers, which are excluded from general revenues pledged for GRBs. In FY 2014 gross revenues of the medical centers totaled $8.6 billion. The first MCPRBs were issued in January 2007, and this credit has since replaced the Hospital Revenue Bond credit (see below). Previously, the medical centers issued debt on a stand-alone basis, secured by their individual revenue streams. The pooled credit lowers borrowing costs, facilitates access to the financial markets, and increases debt capacity for the medical centers. The medical center pooled revenue bonds are subordinate in payment priority to the prior pledges given to the Hospital Revenue Bonds. It is management's intent to refinance these senior lien bonds under the new credit when economically feasible, which will ultimately eliminate this senior lien.

**Limited Project Revenue Bonds.** The Limited Project Revenue Bond (LPRB) credit, established in 2004, is used to finance primarily auxiliary services such as student housing and parking. Pledged revenues for FY 2014 was $729.8 million. The University has approximately $2.0 billion of outstanding LPRB debt. The LPRB credit provides the University's bondholders with a subordinated pledge of gross revenues derived only from facilities financed under the structure. This credit was created to conserve debt capacity in the GRB credit for mission-based projects.

**Financing Trust Structure.** The University has approximately $411 million of outstanding third party housing debt (i.e. debt issued by a party other than the University but for a project in which the University has an economic interest) under its Financing Trust Structure (FTS) credit. Currently the projects in the FTS are all housing projects on the Irvine campus. The FTS credit was created to reduce the financing cost of non-core projects, but with a smaller impact on the University's debt capacity (debt issued under the FTS credit is not counted against the University's debt capacity on a 1:1 basis). The bonds are secured solely by gross revenues of the projects financed.

**Other Third Party Debt.** Currently, the University has $266 million outstanding through the California Infrastructure and Economic Development Bank (CIEDB). This financed the costs of a Neurosciences Building at the San Francisco campus and a new research facility at the San Diego campus for the Sanford Consortium for Regenerative Medicine. The Neurosciences Building transaction was facilitated through a lease-leaseback structure. For the Sanford Consortium project, the University provided credit support on $60 million to finance the costs of a stem cell research facility for a consortium of institutions, including the San Diego campus, conducting stem cell research. All Series of Bonds were issued in calendar year 2010.

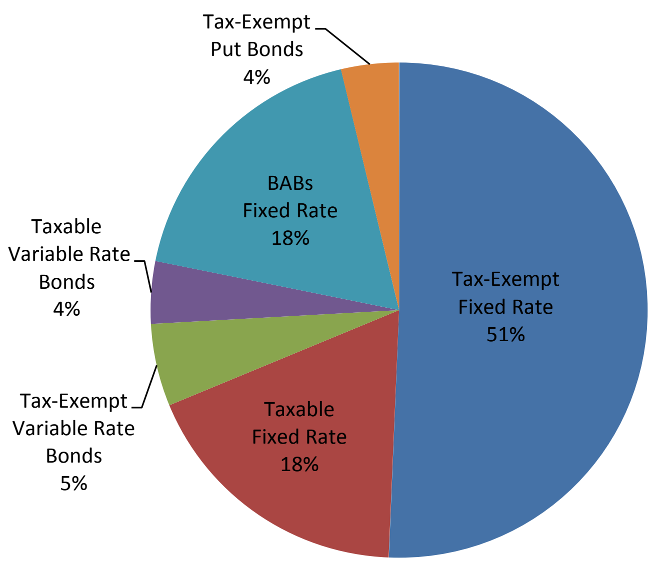
**Commercial Paper.** The University's commercial paper program has an authorized amount of $2.00 billion. In calendar year 2014, the average amount of CP outstanding was approximately $1.25 billion. Total CP outstanding at the end of calendar year 2014 is just over $1.27 billion. The program, which is a combination of both taxable and tax-exempt commercial paper, is used for a variety of purposes, including the funding of working capital and to provide interim funding for approved projects that are eventually to be funded using permanent financing.

**Hospital Revenue Bonds.** The University has just over $47 million of outstanding Hospital Revenue Bonds remaining (also see "Medical Center Pooled Revenue Bonds" above). These bonds are secured by individual medical center revenues and are senior in payment priority to Medical Center Pooled Revenue Bonds. No new debt is expected to be issued under this credit. This structure has been replaced by the University's Medical Center Pooled Revenue credit and existing debt is expected to be refinanced under the pooled revenue credit.

<u>University's Debt by Tax Status and Interest Rate Mode</u>

The University's debt is composed of tax-exempt and taxable debt, and fixed rate and variable rate debt. In recent years, the University has taken advantage of low rates to issue more taxable and variable rate debt. Relative to tax-exempt bonds, taxable bonds provide the University more flexibility with regards to private use in debt-financed buildings. Most of the variable rate debt has been hedged with fixed rate swaps.

Debt Outstanding by Tax Status and Interest Rate Mode[6]




**$15.9 Billion Total Outstanding**

[6] All variable rate debt has been swapped to fixed rate, except GRB Series Z ($150 MM outstanding) and MCPRB Series K ($5.55 MM)

Debt Issuance in 2014

In Calendar Year 2014 the University issued approximately $970 million of debt.

| **Debt Issuance in 2014** | | | |
|---|---|---|---|
| **Dated Date** | **Series Name** | **Par Amount (in 000's)** | **Use of Proceeds** |
| April 3, 2014 | General Revenue Bonds 2014 Series AM and AN | $970,360 | New Money |

**General Revenue Bonds AM and AN.** In April the University issued $970 million in GRB Series AM and AN. The financing included a $411 million taxable component to allow for flexibility with regards to private use.

## CREDIT RATINGS

The credit ratings of the University's bonds directly impact the cost of funding: the higher the credit rating, the lower the cost of borrowing, and vice versa. The University's debt management program is designed to maintain its credit strength in order to minimize the cost of funding for core projects supporting its mission of teaching, research, and public service, and to maximize future financial flexibility. Generally, the credit ratings of major public research universities are a function of several factors. These factors include the following: student quality and demand issues; State support; the amount of debt outstanding, the amortization of the debt and the security features of the debt; operating performance, including nature and diversity of revenue base; asset base, including endowment and the liquidity of the asset base; and non-financial issues such as the quality of leadership and management.

In February and March 2014 the University's credit ratings for its GRB, LPRB, and MCPRB credits were downgraded one notch by Fitch and Moody's. The GRB credit was downgraded to Aa2/AA/AA, while the LPRB and MCPRB credits were downgraded to Aa3/AA-/AA- by Moody's, S&P, and Fitch, respectively. As part of the downgrade, Moody's revised its outlook on the University's credits from negative to stable. The University's short-term ratings were not affected.

The following table illustrates the current underlying ratings of the University's various credits. Please see Appendix A for an overview of credit rating definitions.

| The University's Ratings/ Outlooks | | | |
|---|---|---|---|
| | **Moody's** | **Standard & Poor's** | **Fitch** |
| General Revenue Bonds | Aa2/ Stable | AA / Stable | AA / Stable |
| Limited Project Revenue Bonds | Aa3/ Stable | AA-/ Stable | AA-/ Stable |
| Medical Center Pooled Rev Bonds | Aa3/ Stable | AA-/ Stable | AA-/ Stable |
| Commercial Paper | P-1 | A-1+ | F-1+ |
| *FTS and Other Third Party Debt:* | | | |
| Financing Trust Structure | Baa2 | NR | NR |
| CIEDB UCSF Neurosciences | Aa3/ Stable | AA-/ Stable | NR |
| CIEDB UCSD Sanford Consortium | Aa2/ Stable | AA / Stable | NR |

Ratings as of December 31, 2014

NR = Not Rated

In the reports relating to the rating downgrade, Moody's and Fitch cite fiscal challenges that include negative operating margins resulting from inconsistent State funding and rising post-retirement health benefit and pension benefit expenses. The University's world-class status as a research university, robust balance sheet, diverse revenue base, and strong management are cited as strengths. In its March 12, 2014 report, Moody's cites, "The magnitude of the university's operations, global academic and research reputation, economic importance, as well as its role in providing high-end healthcare services throughout the state of California anchor the rating at Aa2. The university's robust financial reserves and strong fundraising capacity allow it to absorb continued moderate operating losses at this rating level while it implements strategic initiatives to balance operations."

Debt Capacity

As the previous section illustrates, credit ratings are based on a quantitative and qualitative assessment of an institution's financial position and various other factors. While some of its financial metrics are challenged, the University benefits from many credit strengths that support the "AA" category, including, among others, essentiality, tremendous student demand, world-renowned academic and research programs, a large and diverse revenue base, and strong liquidity. Based on these factors, we estimate that the University has up to an additional $3 billion in debt capacity in the "AA" category over the next five years. This estimate is contingent on the University continuing to move toward financial equilibrium. Given continued unpredictability in State funding, the University remains focused on debt capacity and market access at an attractive cost of capital. The Debt Strategy Task Force (see "Debt Strategy Task Force" section) was convened to address this concern.

## DEBT STRATEGY TASK FORCE

Over the past several years, the University has had to adapt to a changed environment: State divestment in the University's capital and operating activities; a pension funding gap; and enrollment growth in the face of constrained tuition increases. These factors combined with ongoing strategic needs have forced an emphasis on heightened fiscal discipline and caused the University's debt burden to grow. Meanwhile, the University continues to have significant capital needs. The Debt Strategy Task Force (the "Task Force") was convened to formulate strategies that begin to address these needs within the context of the changed environment.

The Task Force, which was convened by CFO Nathan Brostrom in July 2014, is comprised of representatives from eight campuses, two medical centers and the Office of the President. In addition, the Task Force is drawing on the expertise of external partners, including its municipal advisor, banking team and outside counsel.

The Task Force has been charged with the following objectives:

- Review the capital needs across the system;
- Assess the institution's debt capacity; and
- Provide strategies to start to bridge the gap between needs and capacity in the absence of State funding.

The Task Force is scheduled to present its initial findings and recommendations to the Long Range Planning Committee of the Regents at their January 2015 meeting. It is expected that the work of the Task Force will culminate in a debt policy to help guide capital markets activities going forward.

# Appendix A: Definitions of Financial Ratios

| Moody's | S&P | Fitch | Description |
|---|---|---|---|
| "Aaa" | "AAA" | "AAA" | Bonds rated in this category are judged to be the highest quality. |
| "Aa1" | "AA+" | "AA+" | Bonds in the Aa/AA rating category are judged to be of high quality and standards. Together with the AAA category are generally known as high grade bonds. |
| "Aa2" | "AA" | "AA" | |
| "Aa3" | "AA-" | "AA-" | |
| "A1" | "A+" | "A+" | Bonds rated in the A/A category are considered upper medium grade obligations. |
| "A2" | "A" | "A" | |
| "A3" | "A-" | "A-" | |
| "Baa1" | "BBB+" | "BBB+" | Bonds rated in the Baa/BBB category are considered medium grade obligations. They are neither highly protected nor poorly secured. |
| "Baa2" | "BBB" | "BBB" | |
| "Baa3" | "BBB-" | "BBB-" | |

# Appendix B: Summary of External Finance Approvals for Capital Projects

The summary of External Finance Approvals for Capital Projects and Real Estate describes the approval actions taken for the Fiscal Year 2013-14. It incorporates the following information:

- Delegated actions from the Regents to the President for projects that have been presented in campus' 10-year Capital and Financial Plans
- Regental actions (total project cost above $20 million).
- Actions by Concurrence (approval by the Chair of the Board, the Chair of the Committee on Grounds and Buildings, and the President) (total project cost between $10 million and $20 million).
- Presidential approvals (total project cost between $5 million and $10 million).

A total of approximately $1.245 billion was approved by the Regents/President in external financing for capital projects in fiscal year 2013-14. The following two tables summarize the debt and associated capital projects by campus in the fiscal year.

| Summary of 2013-14 External Finance Approvals for Capital Projects | | |
|---|---|---|
| **Campus** | **Debt Approved ($000s)** | **Total Project Cost ($000s)** |
| Berkeley | $237,398 | $480,155 |
| Davis | 31,331 | 33,831 |
| Irvine | 143,757 | 153,757 |
| Los Angeles | 31,970 | 31,970 |
| Merced | 4,220 | 4,220 |
| Riverside | 15,984 | 19,440 |
| San Diego | 143,200 | 839,360 |
| San Francisco | 108,600 | 108,600 |
| Santa Barbara | 180,440 | 192,480 |
| Santa Cruz | 13,320 | 16,374 |
| GFF | 335,121 | 335,121 |
| **Total** | **$ $1,245,341** | **$ 2,215,308** |

| Summary of 2013-14 External Finance Approvals for Capital Projects | | | | | |
|---|---|---|---|---|---|
| Campus | Project Name | Approval Date | Approval Type | Debt Approved ($000s) | Total Project Cost ($000s) |
| **Berkeley** | | | | | |
| | Solar Energy Research Center | 11/2013 | Regental | $30,000 | $44,400 |
| | Li Ka Shing Center | 1/2014 | Regental | 30,898 | 255,755 |
| | Tolman Hall Seismic Replacement[7] | 3/2014 | Regental | 150,000 | 150,000 |
| | Capital Renewal Program FY 13-14 | 8/2013 | Delegated | 26,500 | 30,000 |
| | **Berkeley Sub-total** | | | **237,398** | 480,155 |
| **Davis** | | | | | |
| | International Complex Phase I | 9/2013 | Delegated | 26,021 | 28,521 |
| | Crystal Lake Camp Grounds[8] | 2/2014 | Delegated | 5,310 | 5,310 |
| | **Davis Sub-total** | | | **31,331** | 33,831 |
| **Irvine** | | | | | |
| | Mesa Court Expansion | 1/2014 | Regental | 123,757 | 133,757 |
| | Capital Renewal & Infrastructure Improvement Prog. | 11/2013 | Delegated | 20,000 | 20,000 |
| | **Irvine Sub-total** | | | **143,757** | 153,757 |
| **Los Angeles** | | | | | |
| | Saxon Suites Renovation | 9/2013 | Delegated | 31,970 | 31,970 |
| | **Los Angeles Sub-total** | | | **31,970** | 31,970 |
| **Merced** | | | | | |
| | Science & Engineering 2 (Equipment) | 3/2014 | Regental | 4,220 | 4,220 |
| | **Merced Sub-total** | | | **4,220** | 4,220 |
| **Riverside** | | | | | |
| | Environmental Health & Safety Expansion | 1/2014 | Presidential | 15,984 | 19,440 |
| | Lothian Seismic Upgrade | 2/2014 | Delegated | 11,202 | 11,630 |
| | **Riverside Sub-total** | | | **15,984** | 19,440 |
| **San Diego** | | | | | |
| | UCSD East Campus Bed Tower (Medical Center) | 7/2013 | Regental | 143,200 | 839,360 |
| | Nimitz Marine Facility Berth. Wharf & Pier Rplc. | 7/2013 | Regental | 8,013 | 25,053 |
| | Outpatient Pavilion (Medical Center) | 11/2013 | Regental | 4,780 | 4,780 |
| | **San Diego Sub-total** | | | **143,200** | 839,360 |
| **San Francisco** | | | | | |
| | Blocks 33-34, Mission Bay, San Francisco[8] | 11/2013 | Regental | 108,600 | 108,600 |
| | **San Francisco Sub-total** | | | **108,600** | 108,600 |
| **Santa Barbara** | | | | | |
| | San Joaquin Apartments | 1/2014 | Regental | 167,240 | 175,000 |
| | Faculty Club Renovation & Guest House Addition | 3/2014 | Delegated | 13,200 | 17,480 |
| | **Santa Barbara Sub-total** | | | **180,440** | 192,480 |
| **Santa Cruz** | | | | | |
| | Telecom Infrastructure Improvements Phase A | 7/2013 | Delegated | 13,320 | 16,374 |
| | **Santa Cruz Sub-total** | | | **13,320** | 16,374 |
| **State General Funds Financing (GFF)** | | | | | |
| | FY 2013-14 Projects Subtotal | 3/2014 | Regental | 132,309 | 132,309 |
| | FY 2014-15 Projects Subtotal | 3/2014 | Regental | 202,812 | 202,812 |
| | **GFF Sub-total** | | | **335,121** | **335,121** |
| **Total** | | | | **1,245,341** | **2,215,308** |

[7] Includes $75 million under the State GFF FY 2014-15 funding request

[8] Real Estate transactions (previously excluded from this report)