Debt Management

Policy 109

1 Introduction

1.1 Appalachian State University ("Appalachian" or "University") views its debt capacity as a limited resource that should be used, when appropriate, to help fund the capital investments necessary for the successful implementation of the University's strategic vision to prepare its students to lead purposeful lives as engaged global citizens who understand their responsibilities in creating a sustainable future for all. The University recognizes the important role that debt- related strategies may play as it makes the necessary investments in its infrastructure in order to become and remain the destination institution for dedicated students seeking challenging academic programs, engaged faculty and a vibrant campus culture.

1.2 This Policy has been developed to assist the University's efforts to manage its debt on a long-term, portfolio basis and in a manner consistent with the University's stated policies, objectives and core values. Like other limited resources, the University's debt capacity should be used and allocated strategically and equitably.

2 Scope

2.1 Policy Objective and Scope

The objective of this Policy is to provide a framework that will enable the University's Board of Trustees (the "Board") and finance staff to:

1. Identify and prioritize projects eligible for debt financing;
2. Limit and manage risk within the University's debt portfolio;
3. Establish debt management guidelines and quantitative parameters for evaluating the University's financial health, debt affordability and debt capacity;
4. Manage and protect the University's credit profile in order to maintain the University's credit rating at a strategically optimized level and maintain access to the capital markets; and
5. Ensure the University remains in compliance with all of its post-issuance obligations and requirements.

2.2 This Policy is intended solely for the University's internal planning purposes. The Vice Chancellor of Finance and Operations will review this Policy annually and, if necessary, recommend changes to ensure that it remains consistent with the University's strategic objectives and the evolving demands and accepted practices of the public higher education marketplace.

3 Definitions

3.1 "Board of Trustees" or "Board"

Means the Board of Trustees of Appalachian State University

3.2 UNC

Means the University of North Carolina System

4 Policy and Procedure Statements

4.1 Identifying and Prioritizing Capital Projects Requiring Debt

Only projects that directly or indirectly relate to the mission of the University will be considered for debt financing.

1. Self-Liquidating Projects – A project that has a related revenue stream (self-liquidating project) will receive priority consideration. Each self-liquidating project financing must be supported by an achievable plan of finance that provides, or identifies sources of funds, sufficient to (1) service the debt associated with the project, (2) pay for any related infrastructure improvements, (3) cover any new or increased operating costs and (4) fund appropriate reserves for anticipated replacement and renovation costs.
2. Energy Conservation Projects – Each energy conservation project financing must provide annual savings sufficient to service the applicable debt and all related monitoring costs.
3. Other Projects – Other projects funded through 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 Business Affairs before any project-restricted donations are solicited. The fundraising goal for any project to be financed primarily with donations should also include, when feasible, an appropriately sized endowment for deferred maintenance and other ancillary ownership costs. In all cases, institutional strategy, and not donor capacity, must drive the decision to pursue any proposed project.

4.2 Benchmarks and Debt Ratios

4.2.1 When evaluating its current financial health and any proposed plan of finance, the University takes into account both its debt affordability and its debt capacity. Debt affordability focuses on the University's cash flows and measures the University's ability to service its debt through its operating budget and identified revenue streams. Debt capacity, on the other hand, focuses on the relationship between the University's net assets and its total outstanding debt.

4.2.2 Debt capacity and affordability are impacted by a number of factors, including the University's enrollment trends, reserve levels, operating performance, ability to generate additional revenues to support debt service, competing capital improvement or programmatic needs, and general market conditions. Because of the number of potential variables, the University's debt capacity cannot be calculated on the basis of any single ratio or even a small handful of ratios.

4.2.3 The University believes, however, that it is important to consider and monitor objective metrics when evaluating the University's financial health and its ability to incur additional debt. To that end, the University has identified three key financial ratios that it will use to assess its ability to absorb additional debt based on its current and projected financial condition:

1. Debt to Obligated Resources
2. Expendable Resources to Debt
3. Debt Service to Operating Expenses

Note that the selected financial ratios are also monitored as part of the debt affordability study for The University of North Carolina delivered each year under Article 5 of Chapter 116D of the North Carolina General Statutes (the "UNC Debt Affordability Study"), which the University believes will promote clarity and consistency in the University's debt management and planning efforts.

4.2.4 The University has established for each ratio a floor or ceiling target, as the case may be, with the expectation that the University will operate within the parameters of those ratios most of the time. To the extent possible, the policy ratios established from time to time in this Policy should align with the ratios used in the report the University submits each year as part of the UNC Debt Affordability Study. The policy ratios have been established to help preserve the University's financial health and operating flexibility and to ensure the University is able to access the market to address capital needs or to take advantage of potential refinancing opportunities. Attaining or maintaining a specific credit rating is not an objective of this Policy.

4.2.5 The University recognizes that the policy ratios, while helpful, have limitations and should not be viewed in isolation of the University's strategic plan or other planning tools. In accordance with the recommendations set forth in the initial UNC Debt Affordability Study delivered April 1, 2016, the University has developed as part of this Policy specific criteria for evaluating and, if warranted, approving critical infrastructure projects even when the University has limited debt capacity as calculated by the UNC Debt Affordability Study or the benchmark ratios in this Policy. In such instances, the Board may approve the issuance of debt with respect to a proposed project based on one or more of the following findings:

1. The proposed project would generate additional revenues (including, if applicable, dedicated student fees or grants) sufficient to support the financing, which revenues are not currently captured in the benchmark ratios.
2. The proposed project would be financed entirely with private donations based on pledges already in hand.
3. The proposed project is essential to the implementation of one of the University's strategic priorities.
4. The proposed project addresses life safety and/ or health issues or addresses other critical infrastructure needs.
5. Foregoing or delaying the proposed project would result in significant additional costs to the University or would negatively affect the University's credit rating.

At no point, however, should the University intentionally operate outside an established policy ratio without conscious and explicit planning.

4.2.6 Ratio 1 – Debt to Obligated Resources

Measures- The University's aggregate outstanding debt as compared to its obligated resources—the funds available to service its debt under the General Revenue Bond Statutes

Purpose- The ratio, which is based on the legal structure proscribed by the General Revenue Bond Statutes, provides a general indication of the University's ability to absorb debt on its balance sheet and is the primary ratio used to calculate the University's "debt capacity" under the methodology used in the UNC Debt Affordability Study

Calculation- Aggregate debt divided by obligated resources*

Policy Ratio: Not to exceed 1.50x (UNC Debt Affordability Study Target Ratio = 1.00x)

*Available Funds, which is the concept commonly used to capture each UNC campus's unobligated resources in its loan and bond documentation, has been used as a proxy for unobligated resources. The two concepts are generally identical, though Available Funds may include additional deductions specifically pledged revenues, making it a conservative measure of the University's obligated resources.

4.2.7 Ratio 2 – Expendable Resources to Debt

Measures- The number of times the University's liquid and expendable net assets covers its aggregate debt

Purpose- The ratio, which is widely tracked by rating agencies and other capital market participants, is a basic measure of financial health and assesses the University's ability to settle its debt obligations using only its available net assets as of a particular date.

Calculation- The sum of (1) Adjusted Unrestricted Net Assets and (2) Restricted Expendable Net Assets divided by aggregate debt

Policy Ratio: Not less than 0.70x Ratio 3 – Debt Service to Operating Expenses

4.2.8 Ratio 3 – Debt Service to Operating Expenses

Measures- The University's debt service burden as a percentage of its total expenses, which is used as the denominator because it is typically more stable than revenues

Purpose- The ratio, which is widely tracked by rating agencies and other capital market participants, evaluates the University's relative cost of borrowing to its overall expenditures and provides a measure of the University's budgetary flexibility

Calculation- Annual debt service divided by annual operating expenses

Policy Ratio: Not to exceed 5.00%

4.3 Reporting

The Vice Chancellor of Finance and Operations will review each ratio in connection with the delivery of the University's audited financials and will provide to the Board an annual report, substantially in the form of Appendix A detailing (1) the calculation of each ratio for that fiscal year and (2) an explanation for any ratio that falls outside the University's stated policy ratio, along with (a) any applicable recommendations, strategies and an expected timeframe for aligning such ratio with the University's stated policy or (b) the rationale for any recommended changes to any such stated policy ratio going forward (including any revisions necessitated by changes in accounting standards or rating agency methodologies).

4.4 Debt Portfolio Management and Transaction Structure Considerations

4.4.1 The University's Vice Chancellor of Finance and Operations is responsible for the day-to-day management of the University's financial affairs in accordance with the terms of this Policy and for all of the University's debt financing activities. Each University financing will conform to all applicable State and federal laws, and Board of Governors policies.

4.4.2 The Board will consider for approval each proposed financing in accordance with the requirements of any applicable State laws and Board of Governors policies.

4.4.3 General Structure - Numerous types of financing structures and funding sources are available, each with specific benefits, risks, and costs. Potential funding sources and structures will be reviewed and considered by the Vice Chancellor of Finance and Operations within the context of this Policy and the overall portfolio to ensure that any financial product or structure is consistent with the University's stated objectives. As part of effective debt management, the University must also consider its investment and cash management strategies, which influence the desired structure of the debt portfolio.

4.4.4 Method of Sale - the University will consider various methods of sale on a transaction-by-transaction basis to determine which method of sale (i.e., competitive, negotiated or private placement) best serves the University's strategic plan and financing objectives. In making that determination, the University will consider, among other factors: (1) the size and complexity of the issue, (2) the current interest rate environment and other market factors (such as bank and investor appetite) that might affect the University's cost of funds, and (3) possible risks associated with each method of sale (e.g., rollover risk associated with a financing that is privately placed with a bank for a committed term that is less than the term of the financing).

4.4.5 Tax Treatment - When feasible and appropriate for the particular project, the use of tax-exempt debt is generally preferable to taxable debt. Issuing taxable debt may reduce the University's overall debt affordability due to higher rates but may be appropriate for projects that do not qualify for tax-exemption, or require interim funding. For example, taxable debt may be justified if it sufficiently mitigates the University's ongoing administrative and compliance risks. When used, taxable debt should be structured to provide maximum repayment flexibility and rapid principal amortization.

4.4.6 Structure and Maturity –

1. To the extent practicable, the University should structure its debt to provide for level annual payments of debt service, though the University may elect alternative structures when the Vice Chancellor of Finance and Operations determines it to be in the University's best interest. In addition, when financing projects that are expected to be self-supporting (such as a revenue-producing facility or a facility to be funded entirely through a dedicated fundraising campaign), the debt service may be structured to match future anticipated receipts.
2. The University will use maturity structures that correspond with the life of the facilities financed, not to exceed 30 years. Equipment should be financed for a period not to exceed 120% of its estimated useful life. Such determinations may be made on a blended basis, taking into account all assets financed as part of a single debt offering. As market dynamics change, maturity structures should be reevaluated. Call features should be structured to provide the highest degree of flexibility relative to cost.

4.4.7 Variable Rate Debt

1. the University recognizes that a degree of exposure to variable interest rates within the University's debt portfolio may be desirable in order to (1) take advantage of repayment or restructuring flexibility, (2) benefit from historically lower average interest costs and (3) provide a "match" between debt service requirements and the projected cash flows from the University's assets. The University's debt portfolio should be managed to ensure that no more than 20% of the University's total debt bears interest at an unhedged variable rate.
2. The University's finance staff will monitor overall interest rate exposure and will analyze and quantify potential risks, including interest rate, liquidity and rollover risks. The University may manage the liquidity risk of variable rate debt either through its own working capital/investment portfolio, the type of instrument used, or by using third party sources of liquidity. The University may manage interest rate risk in its portfolio through specific budget and central bank management strategies or through the use of derivative instruments.

4.4.8 Public Private Partnerships

1. To address the University's anticipated capital needs as efficiently and prudently as possible, the University may choose to explore and consider opportunities for alternative and non-traditional transaction structures (collectively, "P3 Arrangements"). Because rating agencies will generally treat a P3 Arrangement as University debt if the project is located on the University's campus or if the facility is to be used for an essential University function, the structure and terms of any P3 Arrangement for a university-related facility to be located on land owned by the State, the University or a the University affiliate must be reviewed in advance by the Vice Chancellor of Finance and Operations.
2. P3 Arrangements may be pursued in accordance with applicable State law when (1) the Chancellor has determined that the P3 Arrangement serves a compelling strategic interest and (2) the Vice Chancellor of Finance and Operations, in consultation with the University's advisors, has determined that the University has sufficient debt capacity to undertake its obligations under the P3 Arrangement after taking into account the P3 Arrangement's likely impact on the University's debt-related metrics and credit profile.

4.4.9 Refunding Considerations - the University will actively monitor its outstanding debt portfolio for refunding or restructuring opportunities. Absent a compelling economic or strategic reason to the contrary, the University should evaluate opportunities to issue bonds for the purpose of refunding existing debt obligations of the University ("Refunding Bonds") using the following general guidelines:

1. The life of the Refunding Bonds should not exceed the remaining life of the bonds being refunded.
2. Refunding Bonds issued to achieve debt service savings should have a target savings level measured on a present net value basis of at least 3% of the par amount refunded.
3. Refunding Bonds that do not achieve debt service savings may be issued to restructure debt or provisions of bond documents if such refunding serves a compelling interest.
4. Refunding Bonds may also be issued to relieve the University of certain limitations, covenants, payment obligations or reserve requirements that reduce operational flexibility.

4.5 Derivative Products

4.5.1 The University recognizes that derivative products may provide for more flexible management of the debt portfolio. In certain circumstances, interest rate swaps and other derivatives permit the University to adjust its mix of fixed- and variable-rate debt and manage its interest rate exposures. Derivatives may also be an effective way to manage liquidity risks. The University will use derivatives only to manage and mitigate risk; the University will not use derivatives to create leverage or engage in speculative transactions.

4.5.2 As with underlying debt, the University's finance staff will evaluate any derivative product comprehensively, taking into account its potential costs, benefits and risks, including, without limitation, any tax risk, interest rate risk, liquidity risk, credit risk, basis risk, rollover risk, termination risk, counterparty risk, and amortization risk. Before entering into any derivative product, the Vice Chancellor of Finance and Operations must (1) conclude, based on the advice of a reputable swap advisor, that the terms of any swap transaction are fair and reasonable under current market conditions and (2) ensure that the University's finance staff has a clear understanding of the proposed transaction's costs, cash flow impact and reporting treatment.

4.5.3 The University will use derivatives only when the Vice Chancellor of Finance and Operations determines, on the basis of the foregoing analysis, that the instrument provides the most effective method for accomplishing the University's strategic objectives without imposing inappropriate risks on the University.

5 Additional References

6 Authority

The Code of the Board of Governors, section 502

7 Contact Information

Finance and Operations - 828-262-2030

8 Original Effective Date

April 13, 2017

9 Revision Dates