

The official minutes of the University of South Carolina Board of Trustees are maintained by the Secretary of the Board. Certified copies of minutes may be requested by contacting the Board of Trustees' Office at trustees@sc.edu. Electronic or other copies of original minutes are not official Board of Trustees' documents.

University of South Carolina

BOARD OF TRUSTEES

Ad Hoc Committee on Strategic Planning

August 26, 2009

The Ad Hoc Committee on Strategic Planning of the University of South Carolina Board of Trustees met on Wednesday, August 26, 2009, at 12:25 p.m. in Osborne Building Room 206B.

Members present were: Mack I. Whittle, Jr., Chairman; Mr. William C. Hubbard; Ms. Darla D. Moore; and Mr. John C. von Lehe, Jr. Dr. C. Edward Floyd and Mr. Miles Loadholt were absent. Mr. Eugene P. Warr, Jr. was also present.

Others present were: President Harris Pastides; Secretary Thomas L. Stepp; Vice President for Academic Affairs and Provost Michael D. Amiridis; Vice President for Finance and Planning William T. Moore; Associate Vice President for Finance and Budget Director, Division of Business and Finance, Leslie Brunelli; Special Assistant to the President J. Cantey Heath, Jr.; Associate Vice President for Resource Planning Edward L. Walton; Assistant Director of Periodicals, USC Publications, Marshall S. Swanson; Director of Capital Budgets and Financing, Division of Business and Finance, Charles D. Fitzsimons; Public Information Officer, Office of Media Relations, Karen Petit; Director of Media Relations, Division of University Advancement, Margaret Lamb; Editorial Manager and Bulletins Editor, University Publications, Thom Harman; Media Consultant Lee Goodman; and Board staff member Karen L. Tweedy.

Chairman Whittle called the meeting to order and welcomed everyone. Ms. Petit introduced a member of the media from the Columbia campus who was in attendance. Chairman Whittle stated that notice of the meeting had been posted and the press notified as required by the Freedom of Information Act; the agenda had been circulated; and a quorum was present to conduct business.

Chairman Whittle directed the attention of the Committee to the first agenda item and called on Dr. Moore who stated that the purpose of the meeting was to review University strategic financial planning within two broad categories: (1) the operating budget focusing particularly on the five-year academic planning model, management of budget cuts, and stimulus funding strategy; and, (2) capital financing focusing on a debt capacity analysis. A long term financial strategy would be discussed at the conclusion of the presentation.

I. Five Year Planning Model: Chairman Whittle called on Ms. Brunelli who stated that the Five Year Planning Model had been developed in Fall 2007 for academic units to

complete twice a year providing the opportunity to recalibrate expenditures; this model listed both the sources as well as uses of "A" funds (operating budget). Types of funds included state appropriations, carry forward dollars, funds from other units and institutional transfers to cover service unit costs. The largest source of funding was student tuition and fees. Under the Value Centered Management system, tuition dollars were returned to the academic units to generate that funding. The primary focus was personnel expenditures, which consumed 75-78 percent of the operating budget.

In addition, Ms. Brunelli explained that this model displayed five years of previous activity so that academic units had a sense of their history going into the new year. After completing the current year budget planning model, they could build on the next five years. The impact of changes in enrollment as well as faculty hiring was easily tracked. She stressed that no state appropriations were factored into the planning process since no new state funding was anticipated. Also, Ms. Brunelli emphasized that the trend of growing fringe benefit costs could not be controlled.

Dr. Moore advised that this process was a planning tool for the deans and a management tool for the Provost and President. "We monitor this very carefully to ensure that the actual expenses are following the projected budget expenses. In fact, during the budget cut issues we are dealing with now, the budget office is doing that once a month."

Dr. Amiridis reported that the deans had been using the model for the past three years. "It has become part of the culture by now and is a great tool because it shows you a five-year effect, for example, of increasing tuition by 50 students or making two hires instead of one in a given year and how this affects my bottom line for the next five years."

II. Management of Budget Cuts: Chairman Whittle called on Ms. Brunelli who directed attention to a chart in the committee handout regarding budget cuts for each of the campuses in the University System.

Total state appropriation for the system was \$170,743,680. Included in the handout was a graph which depicted the total cut for each campus in 1 percent increments up to 12 percent. It was anticipated that the Budget and Control Board would implement a 4.04 percent reduction across-the-board for all state agencies on September 18th. For Columbia, that amount would total \$4,956,643. "We believe it will be easier if we make a larger cut to our units early, hold those funds, and have them available for future cuts; if those future cuts do not come, we can return the funding to the units."

Under consideration was a 10 percent reduction to the Columbia units, which would total \$12.2 million. That reduction would address the projected first state cut of \$4.9 million as well as an additional amount for potential future cuts; the system campuses were initially planning for a 4 percent reduction.

Ms. Brunelli advised that in FY 09 units had been slightly overcut in the December reduction (10 percent versus a 7 percent state cut) to prepare for the possibility of a spring reduction; that cut was handled centrally. In addition, a small amount of funding - less than \$5 million in Columbia - was still available to address a portion of the next cut early.

She particularly noted that Georgia was experiencing large cuts in FY 10; they were currently addressing a 9 percent cut and were automatically furloughing everyone for 10 days.

Ms. Brunelli further commented that stimulus funding somewhat protected the University this year because the state could not require more from higher education institutions than other state agencies. For the October cut last year, however, higher education experienced a disproportionately large portion of the state cut.

III. Stimulus Funding Strategy: Chairman Whittle called on Mr. Walton who stated that the University was awarded a total of \$29.2 million from the State Fiscal Stabilization Fund (SFSF). This federal money carried "all of the strings normally attached" as well as additional restrictions including reporting, bureaucratic and access requirements not usually attached to state money. Most important was the requirement that the money must be used for educational and general expenditures in a manner that mitigated the need to raise tuition.

The American Recovery and Reinvestment Act required that SFSF funds may not be used to increase an endowment; or maintain systems, equipment, or facilities; or modernize, renovate, or repair athletics facilities used for events for which admission is charged to the general public; or modernize, renovate, or repair facilities used for sectarian instruction or worship, or for a facility that is substantially subsumed in a religious mission; or new construction; or to restore or supplement a "rainy day" fund.

Mr. Walton advised that the President very wisely decided not to use stimulus funding as an across-the-board increase; rather, he wanted to use the funding strategically in order make it fit with the Focus Carolina initiative and the blueprints that the deans issued every year as well as "make it be something that was transformational."

He noted that a subsequent call for proposals to the deans for spending the money generated requests totaling approximately \$164 million. "Without a doubt, therefore, there is a great demand for things that need to be done with new money."

Currently, senior vice presidents had been asked to submit recommendations to the President for applying a portion of the \$29 million of stimulus funding. It was hoped that this process will be completed the first part of September because the money will be available in early October.

President Pastides considered the use of this money as "my one opportunity working

with the Board of Trustees, the vice presidents and the new provost to advance the University. There will be a focused concentration on how the monies are used always with our core values of quality of student education and faculty creativity and research in mind. Ultimately, there will be a weighted system that looks at where the University is headed relative to our stated priorities and how far every dollar will get us in that way."

Dr. Amiridis commented that the majority of the submitted proposals were requests for deferred maintenance work that needed to be done.

Mr. Walton further expounded that even though the state had approved two stimulus funding appropriations, in light of the struggles that it had faced to distribute this one, he was not confident about the second one. "There is some thought in Washington that we do not need all of the stimulus money and they may retract when they are faced with overwhelming federal budget deficits; therefore, it is only appropriated for this one year."

IV. Debt Capacity: Chairman Whittle called on Dr. Moore who initially remarked that as Chairman Ben Bernanke of the Federal Reserve System and others had stated, the stimulus funding next year may very well go out if employment increased substantially which could inflate the currency. Therefore, it was unclear whether the University would receive stimulus funding in the second year even though it had been budgeted.

Several months ago, the University had commissioned Barclays to perform a debt capacity study. He noted that tax-exempt credit spreads had widened significantly during the past 18 months especially for institutions rated below the "AA" level. If the spreads were zero, the market would essentially be saying that the risk of one was the same as the risk of the other; for example, a AAA rating versus AA rating would not matter. When there was real risk in the world, the market priced that risk into the bonds. When they priced it into the bonds, that meant they paid less for a bond that was risky, which elevated the yield.

If the University lost its current rating from AAA to AA, it could cost 100 basis points on money the University would raise. Therefore, it would have a substantial impact on the cost of going to the bond market. Dr. Moore emphasized that in today's market risk was very real and it was being priced into the markets.

In addition, the bond insurance market essentially evaporated; formerly, 50 percent of municipal debt was bond insured and currently it was 10 percent. Therefore, a slip in the University's bond rating would cost additional money. One year ago, that would not have been the case.

Investors were now saying there was real risk even in the A rated bond; therefore, they were placing more restrictions in the debt (restrictive covenants) which could ultimately limit the University's borrowing ability. Investors were often requiring that

borrowers offer a broader package of security features including mortgage on campus property; restricted profit and loss statements; and balance sheet ratio requirements.

Dr. Moore explained that the current environment had a far-reaching impact on the management of debt portfolios. In particular was the fact that state budget difficulties and investment performance were putting pressure on operating budgets and testing bond covenants. That is, as state appropriations were reduced and as institutions discovered that their portfolios were not doing well, certain required ratios were being violated; the University was not in danger of that right now.

In January 2009, Moody's announced that its outlook for the higher education sector was now negative. In addition, in April 2009 Moody's published "U.S. Colleges and Universities Rating Roadmap: Focus on Special Risks During Recession and Credit Crisis." The report identified six factors - four credit risks and two risk mitigants - that the agency will focus on in these challenging economic times to determine whether rating action may be warranted.

In June 2009, S&P (Standard & Poor's) published "The Recession is Testing U.S. Higher Education's Resilience and Credit Quality." The report highlighted various new challenges facing the higher education sector including: investment losses, liquidity challenges and student affordability. Despite these challenges, however, S&P believed that the higher education business model, having been tested repeatedly in times of recession and slow economic growth, will allow many institutions to remain strong, even though there may be some deterioration in credit quality.

Dr. Moore discussed the University's current debt profile which was approximately \$370 million with a weighted average cost of 4.61 percent per year. He noted that the University utilized three primary credits: Higher Education Revenue Bonds ("Aa3" Moody's rating); Athletic Facilities Revenue Bonds ("Aa3" Moody's rating); and State Institution Bonds ("Aaa" Moody's rating).

As compared to other institutions, the University was rated "Aa"; most flagship state universities also maintained that rating.

Dr. Moore reviewed the credit determinants that agencies such as Moody's, S&P, and Fitch applied toward various aspects of credit quality. For example, student demand totaled 15 percent; state support totaled 40 percent.

Dr. Moore also reviewed the following debt capacity considerations: Selectivity; Matriculation; Total Debt; Total Financial Resources per Student; Total Financial Resources-to-Debt; Expendable Financial Resources-to-Debt; Expendable Resources-to-Operations; and Debt Service-to-Operations.

Ms. Moore commented that the percentages associated with these particular debt capacity figures suggested that the University had been "extremely conservative over the

years financially which is consistent with our heritage and at the same time we have been anti-intellectual because we have never pushed the quality of the students until the last several years."

Currently, the University would add another \$131.7 million of debt to finance those capital projects already approved by the Board of Trustees; capital projects currently under consideration would increase the debt \$123 million.

Dr. Moore commented that Barclays had been asked to explain how the University would fare financially under three different scenarios over the next several years: (1) if the University did nothing new (Scenario I); (2) if the University did all the things that the Board had approved to date (Scenario II); and, (3) if the University did all the things that were contemplated (Scenario III). Dr. Moore emphasized that the resulting scenarios were generated before the construction of a new law school was formally included in the financial planning process.

Dr. Pastides indicated that the various projects had been presented individually before the Buildings and Grounds Committee without prioritization within the context of Focus Carolina or to the University's financial well being relative to debt. "Therefore, what we are getting to now is taking a more comprehensive approach so that every single project that is brought to you can be weighed not only by its importance, its priorities, its aesthetics, or its need, but also its impact on our finances."

Dr. Moore explained that the President had directed the Administration to present an annual capital budget to the Buildings and Grounds Committee and to the full Board. Most likely that process will begin in February with a preliminary presentation at the September 18th Buildings and Grounds Committee meeting.

Dr. Moore reviewed charts outlining a Peer Group Analysis of Total Financial Resources-to-Debt as well as Expendable Financial Resources-to-Debt, Expendable Financial Resources-to-Operations, and Debt Service-to-Operations. In addition, Moody's median rating lines for "Aa2," "Aa3" and "A1" were indicated. Institutions included in the analysis were: Auburn University, Clemson University, Florida State University, North Carolina State University, University of Alabama - Tuscaloosa, University of Arkansas System, University of Florida, University of Georgia, University of Houston System, University of Kentucky, Virginia Polytechnic University, and the University of South Carolina System. A further analysis of the University was also displayed using the three different scenarios under each heading from 2006-2014.

Dr. Moore advised that the \$131.7 million of currently Board-approved capital projects constituted a significant increase in the University's debt, especially for athletics. Athletics Facilities debt would essentially double, from \$68 million to \$133 million. This increase would most likely result in a rating downgrade of the Athletics Facilities credit from "Aa3" to "A" or "A1". In addition, the University's Higher

Education credit (revenue bonds for housing, etc.) should be able to absorb the approved \$38.1 million in debt at its present rating level; that amount would include the Patterson Hall renovation and would be paid using Housing revenue.

He noted that there was a high probability the Athletics rating would be downgraded if they proceeded forward with the currently Board-approved projects. As a result, the Athletics revenue bonds would carry a higher interest rate.

Barclays indicated that an athletics bond rating downgrade would most likely not result in an overall University downgrade because (1) it was fairly typical for athletics revenue bonds at any other institution to be rated a notch lower than the overall institution; therefore, the University was somewhat of an "anomaly because athletics carried a high credit rating basically because 4-5 years ago there was little athletics debt;" and, (2) because the University was a public flagship institution, Moody's and S&P were reluctant to drop its rating below "Aa" based on past history.

Of particular note was the fact that Barclays believed that if there was no deterioration in the state's credit strength and support of the University, Carolina should be able to absorb the Moore School building project at its current rating level. This project was aided by a repayment source (the Department of Justice lease payments of the current Business building) which helped to significantly mitigate the project's impact on the University's debt capacity.

Additional near-term borrowing over the next 2-3 years beyond the already Board-approved projects and the Moore School project may result in a rating adjustment (one notch downgrade), though the rating agencies were unlikely to move the University from the "AA" category as long as the operations were in good financial equilibrium.

The timing of future borrowings was important with respect to the impact on credit ratings. To a certain extent, drawing out the financing of future capital projects may allow the University to absorb more easily the impact of the additional debt as financial resources and the operating budget presumably grow in tandem. Dr. Moore noted that the University was in the process of assembling certain capital projects on a timeline.

A discussion of short term versus long term interest rates ensued. Chairman Bernanke had advised that if the employment rates increased and the U.S. economy improved next year, control of the money supply will be required (open market operations and elevating the rates).

Of fundamental importance was the Board perspective about how seriously they weighted "AA" rating versus "A" rating.

Mr. Whittle commented that the institutional rating would have a dramatic impact on cash flow based on the spread which the Committee had reviewed earlier.

Ms. Moore believed that state funding of the University would continue to decrease

dramatically.

Dr. Moore advised that the University was anticipating a 10-12 percent cut in state funding this year. Another prominent factor was the possibility of a bond bill within the next couple of years. "If we received \$50-\$60 million of state bond bill money, we could make some choices. For example, we could consider the possibility of building a new Law School or scaling back on borrowing on other things."

Mr. Hubbard emphasized the importance of regulatory and procurement relief in light of the large state funding decreases.

Ms. Brunelli indicated that procurement relief did pass the House this year and it was in the Senate Education Subcommittee. Senator Coursen had advised that this Committee will address the issue this fall in order to bring it out early in the spring. The bill, she noted, contained relief from various lengthy capital processes.

Mr. Warr interjected that the University's current average weighted interest rate was 4.61 percent and total debt was nearly \$370 million. "If we went up 1 percentage point by dropping a notch, we would be at about 5.6 percent and our interest costs per year would factor into an additional \$3.7 million per year assuming the same debt we have now."

Dr. Moore asked whether the Board was willing to risk a downgrade to "A" and what other parameters members needed to know in order to make an informed decision. Mr. Whittle suggested that a more positive academic reputation should allow the University to have more leverage and to keep the current bond rating.

Mr. Hubbard asked the tradeoff between academic quality and selectivity versus the cash flow from the number of students. Dr. Moore responded that the first two numbers in the selectivity/matriculation table were really demand indicators: how strong was the demand for the University of South Carolina. Therefore, Mr. Hubbard concluded, anything to drive up applications would be a helpful factor. Dr. Amiridis concluded that "all of this rating is not an exact science. Primarily what they care about are the economic indicators."

Dr. Pastides summarized: "I wanted to say that this meeting signifies a breakthrough in a way. Every time we come to the Board with a project no matter how lovely it is to look at, you need to have a comprehensive picture of the finances and the bond implications, but also the academic relevance and the priority. We do capital planning now with the Provost having a key seat at the table and with the CFO having a key seat at the table. My goal is to let you see it from every angle and then I will come to you as well and tell you what I think or what I propose. Then you will tell me what you think and what you propose and then we will decide if it is a good project. Ultimately, it will be driven by our academic priorities (mission and resources)."

IV. Long Term Financial Planning: Dr. Moore directed the attention of the

Committee to various diagrams in the handout which essentially displayed a 30-year capital budget prototype. He stressed that it was not the final budget, but rather a work in progress which would eventually be presented to the Board.

The prototype encapsulated nearly everything the University was currently considering timed according to projected affordability.

The Capital Inflows chart included such financial activities as leases from the Department of Justice, Bookstore proceeds, Bond proceeds, Athletics revenue - everything that was coming to the University on the capital side.

Capital Outlays represented the expenditure side. Examples included: building a new Moore School of Business, renovating Patterson Hall, building a Health Center for students, and building a new Law School (2016-2017).

A third chart outlined Capital Inflows & Carryforward (accumulated amount from the previous year) Compared to Outlays. This Capital Plan, which had been outlined for the next 30 years, included a built in cushion.

Another set of charts displayed the information within a 10-year timeframe. This model revealed the impact of a new building on the inflow/outlay plan in relationship to projected tuition rates moving forward.

A third set of charts displayed a 5-year timeframe. Mr. Fitzsimons indicated that the University was working toward bringing to the Board for approval a 5-year plan with a list of specific capital projects to be completed within the next fiscal year. He explained that in the second year there will be another list of capital projects that will be reviewed in terms of planning stages.

For years 3-5, it will be a matter of looking at potential projects with respect to feasibility. He stressed that the Board will ultimately adopt a firm capital plan for the next 5 years which will be in synch with the state capital permanent improvement process so that the University planning process "marries into the state planning process."

Years 6-10 will allow the University to look into the future for known capital projects possibly under serious consideration (e.g., Law School). "When you look at the tuition revenue coming in and the existing debt, we know that we don't have tremendous capacity until we retire some of the existing debt."

One caveat to this plan was the possibility that individual projects may come up on a periodic basis that had not been specifically planned for far in advance. The opportunity still existed for the Administration to bring a project to the Board on an ad hoc basis for approval. Again, however, everything had to be considered within context.

Dr. Moore reiterated that the Administration will present an annual capital budget which will be updated quarterly. If there was an emergency construction project that

arose, a new plan would be devised. "That's the President's approach to capital planning."

Mr. Whittle summarized that the purpose of today's meeting was "to set the benchmark of where we are, what is going on and what we will do going forward. We wanted to show you the logic behind what we are doing and the benefit it will have for the University. Academics, capital expenditures, the state of the economy - all these things have an impact on what we need to be doing strategically. This model is dynamic enough to incorporate modifications when needed and to see what it does to the University strategically."

Chairman Whittle believed that this information should be presented to the Buildings and Grounds Committee because it will place parameters on the manner in which business will be conducted in the future.

He stressed the importance of thinking creatively moving forward. "There are ways to do things that will allow us to expand and to accelerate the mission of the University without changing the bond rating and without taking additional risk. This Committee needs to be open minded about things we could do to accomplish that goal."

Chairman Whittle anticipated another meeting before the end of the calendar year. President Pastides recommended that the Committee focus on academic priorities at that meeting.

Mr. Hubbard inquired whether there was an incentive to move forward quickly with this analysis in order to take advantage of the low interest rates. Chairman Whittle suggested a sensitivity analysis to determine the cost of proceeding now and a bond downgrade versus waiting to allow rate increases. It was a matter of risks versus rewards: bond downgrade which will cost a certain amount versus maintain bond rating which will save a certain amount.

Since there were no other matters to come before the Ad Hoc Committee on Strategic Planning, Chairman Whittle declared the meeting adjourned at 2:10 p.m.

Respectfully submitted,

Thomas L. Stepp
Secretary