Budget and Finance Committee

March 11, 2022

Minutes

The meeting was called to order at 10:51 a.m. by Governor Barnhill via in the Student Center Ballroom. Secretary Miller called the roll. A quorum was present.

Committee Members Present: Governors Barnhill, Gaffney, Kelly, Stancato and Thompson; Paul Beavers, Faculty Representative, Linda Beale, Faculty Alternate Representative; Zachary Thomas, Student Representative and Anthony DiMeglio, Student Alternate Representative

Also Present: Governors Busuito and Kumar President Wilson; Provost Kornbluh; Vice Presidents Burns, Ezzeddine, Lanier, Johnston, Massaron, Schweitzer, Staebler, and Wright; and Secretary Miller

APPROVAL OF MINUTES, JANUARY 28, 2022

ACTION: Upon motion made by Governor Kelly and supported by Professor Beale, the Minutes of the January 28, 2022, Budget and Finance Committee were approved as presented. The motion carried.

CONTINGENCY RESERVE

There were no proposed transfers from the FY 2022 Contingency Reserve this month.

AUDITED FINANCIAL STATEMENTS

Senior VP Massaron introduced Tamaka Butler, Senior Associate Vice President of Finance and Deputy Chief Financial Officer, for the presentation of the audited of the fiscal year 2021 financial statements. The audit was conducted by external auditors Plante Moran PLLC and Katie Thornton, a partner from Plante Moran, was present for questions. Ms. Butler advised that the audit provides reasonable but not absolute assurance that the financial statements are presented fairly in all material aspects important to the institution. There are four components to the audit engagement: the annual financial statements, the federal award audit (student financial aid and research), the audit of WDET, which is required by the Corporation of Public Broadcasting, and a separate engagement for NCAA Procedures. The combined University and Foundation audits received an unmodified opinion, the highest assurance that can be provided. Ms. Butler next spent some time providing highlights of the University's financials. Total revenue for the combined University and Foundation for fiscal year 2021 exceeded $1 billion dollars with total expenses of over $894 million. Operating revenues increased overall by about $2.4 million, which includes a decrease in net tuition and fees of about $9.4 million.

Grants and contracts revenue increased by $20.8 million, including an increase in nongovernmental grants and contracts of $14 million. This was related to an increase in revenue for the PEPPEP program, nonrecurring costs in fiscal year 2021, a slight decrease in federal revenue of $2.2 million and an increase of state and local grants of $4.6 million attributable to new COVID grants. Departmental, Auxiliaries, and other revenue saw a pandemic related decline of $9 million. Nonoperating and other revenues increased by $130.2 million. State appropriations increased by of $3.5 million, including an increase in operating appropriations of about $7.9 million, a one-time non-base increase from the state partially offset by a decline in capital appropriations related to completion of the STEM project.

The federal economic relief funds, otherwise known as the HEERF funds, increased by $29 million. This included an increase for students of $5 million, and institutions of $24.7 million. Higher investment income for the University increased by $10.8 million, driven by increases in unrealized and realized gains.

Foundation revenues saw an overall increase of $73.9 million driven by an increase in unrealized income. Operating expenses declined by $22.9 million, attributable to the pandemic and University efforts to reduce costs. Compensation and benefits saw a decline of $23.8 million, attributable to suspension of merit increases for non-represented employees, turnover and an inability to fill certain positions. Scholarships saw an increase consistent with the increase in the federal economic relief funds for students, and there was a decline in supplies and services. Overall, the combined University and Foundation saw an increase in net position of $168 million in fiscal year 2021. The Foundation's net position increased $93.5 million while the University's net position increased $74.5 million. VP Massaron advised that the University had a successful year in fiscal year 2021 that was attributable primarily to one-time funds which could not be expected to recur. He noted that the University has structural budget deficits that will need to be addressed on a long-term basis.
He concluded by advising that with the operating numbers and the continual growth in costs, the financial results will allow the University breathing room to make needed structural changes.

Governor Busuito asked about the status of the University Physicians Group (UPG) loan and whether the University had been reimbursed. Ms. Butler noted that the University has not yet been reimbursed. She advised that principal payments were not due and some interest payments are being paid throughout the year and are current. SVP Massaron added that the UPG loans are repayments that are credited when a payment is made. Governor Busuito then asked about the status of the FMRE loan. VP Massaron advised that the University uses University funds to cover the impact to the budget while the loan is still on FMRE's books. He added that it is likely that FMRE will not have a source to pay for it and he anticipates future action to be brought to the Board to address the issue.

Governor Kelly expressed her appreciation for the meticulous and accurate report. She noted that that the statistics were difficult to evaluate given today's unusual times and the yearly comparisons could be misleading to the Board at a time that it is trying to determine the best fiscal health for the University. She asked to hear a more specific statement of the University's standing.

VP Massaron responded that the University is in a strong fiscal position with a solid investment grade rating in the A category. There are structural issues with respect to growth in annual expenses, which is expected to be between $13 to $15 million. He added that there should be no expectation that enrollment and tuition will keep up with expenses. He advised that action needs to be taken to ensure the University's future financial health. If the University continues to operate where operating costs are higher than revenues, at some point the University's reserves will be exhausted. While the University's reserves have been managed responsibly, the reserves are smaller. Provost Kornbluh and Vice President Ahmad Ezzeddine are working on strategy for growth and a cost containment model.

Governor Kelly asked whether VP Massaron is satisfied with Governor Barnhill's Board Committee work in financial strategic planning. VP Massaron responded that he believes the Board is driving the University toward a long-term look at the budget, to provide accurate reporting related to the budget, and to increased transparency. This will allow the Board and the public to be able to understand the assumptions made about the future, and the hard action to be taken when assumptions are not met.

Governor Thompson asked how long the one-time federal economic relief funds will cover the University. She noted that this is a substantial amount of the revenues, and asked how they, as well as the UPG loan, impact the University's financial position. VP Massaron advised that the University should undertake continued work in a community-led budget council to decide the framework for this coming fiscal year. The Board's budget meeting on June 24 will be the target time to answer that question. The one-time funds allowed the University to manage over the last 2 years and into the next fiscal year. Beyond that, the University will need to make sure it is operating towards a balanced budget.

He further advised that the University Foundation had a really good year from an investment perspective. However, given the very specific support of financial scholarships and particular programs, those increases do not translate to operating revenues, and believes that it is an overstatement of the University's financial position. One potential answer would be to move to a long-term 5 year look at the budget.
Governor Thompson asked if that would include a transition to a RCM model. VP Massaron agreed but noted that there is no set timeline to transition to RCM. As advised by the University's financial consultants, there is still foundational work to be completed before transitioning into RCM, the largest of which is a move to an all-funds budget. As an example of why this move is needed, VP Massaron explained that the Medical School's general fund, which is what currently is reviewed when the budget is presented to the Board, is less than $60 million but the total expenditures for the School exceed $290 million. If RCM is done on a quarter of the University budget, or only the general fund,

that is not RCM. There needs to be a fuller picture before moving forward with that type of model.

Governor Barnhill asked about additional opportunities for the Board to be able to evaluate the financial performance of the University. How can the Board get a deeper look at the processes in place to make sure that things do not get too far off as the administration operates the University? SVP Massaron advised that this is completely consistent with the budget reform work underway. He noted the process involved a series of detailed financial reports distributed to the individual units, with a series of less detailed reports distributed up levels throughout the organization, and it is appropriate at to share the highest level of those reports with the Board. Governor Barnhill asked what type of support the administration needs from the Board to implement that process. VP Massaron advised that budget reform will need a one-time additional investment in IT infrastructure to better produce reports on an all-funds basis.

Ms. Butler advised that currently the financial reporting team is the same team completing the accounting and the budgeting and that it would be useful to have some dedicated resources to support that function to move toward consistent data reporting. This will ensure accuracy and consistency across the University, so resources to support that function would be essential. Governor Barnhill advised that he has every confidence in the team and looks forward to continuing that conversation in the future.

ANNUAL REPORT ON LONG-TERM INVESTMENT (ENDOWMENT)

Ms. Marianne Cunningham, Assistant Vice President and Assistant Treasurer, presented the highlights of 3 annual treasury reports. The first is the long-term investment report. This report is the endowment program, the Foundation, which was established by the University to assist with various functions and focuses on fundraising and oversight of the investment portfolio. The Foundation established an Investment Committee to oversee and manage the investments of the endowments. The Investment Committee selected the Strategic Investment Group to serve as the Foundation's Outsourced Chief Investment Officer or OCIO. The OCIO manages all the funds held in the pool. The Strategic Investment Group served in this capacity through the end of the fiscal year. After review of performance and subsequent discussion, an RFP was issued for a new OCIO. Effective March 1, 2022, a new OCIO, Commonfund, was chosen to manage the portfolio.

At the fiscal year end, the market value of the portfolio was $519 million, a growth of $160 million since 2017. The investment returns were 22.6%, above the benchmark of 19.1%. Absolute and relative investment returns were exceptionally strong in fiscal year 2021. Stock markets were all supported by expansionary policies, ample liquidity and the expectation of continued global economic rebound.

Fiscal Year 2022 presents a different picture, dominated by a changing Federal Reserve Board position to deal with the rising inflation, ending the bond buying program, and the war in Ukraine. From October to January, 4 months of data was received, highlighting a 1% return on the portfolio with a benchmark set at 3%.

TREASURY UPDATE: ANNUAL INVESTMENT AND DEBT UPDATE

Ms. Cunningham next turned to the annual investment and debt update. She began by highlighting the cash flow data representing cash reserves and the working capital of the University. There was variability of inflows and outflows for these reserves. Inflows include tuition, sponsored programs, and state appropriations in a January-February timeframe and August-September timeframe. Outflows include debt service payments consistent throughout the year, except in May and November, when these payments are larger.

As of September 30, the cash pool was $592 million, which includes $161 million of proceeds from 3 debt issuances. The operating fund was approximately $431 million. The cash pool investment returns were 5.5% for the fiscal year ending September 30, 2021. Approximately 85% of the portfolio is cash and fixed, with a very small allocation to some equities. The data for returns for the first 4 months of FY 2022, were negative 6%, in line with benchmark.

In terms of debt service, there is $539 million of debt. The last debt issuance was in 2020; there were no new debt issuances in 2021. In June of 2021, S&P reviewed the University's credit rating, and upgraded the University from a negative outlook to a rating of A+ with a stable outlook. Moody's gave the University an AA3 rating with a negative outlook. There is an upcoming credit review with Moody's and the administration hopes that the negative outlook will change. Ms. Cunningham then reviewed charts highlighting the balance outstanding and the debt amortization schedule. Governor Thompson asked about the drivers for the negative outlook from Moody's. Ms. Cunningham advised that the last Moody's rating occurred when the University went to market in 2020, at the height of the pandemic. At that time, it downgraded the entire public higher education industry.

Governor Barnhill asked for an explanation of the change in the OCIO from SIG, and what could be expected moving forward. Ms. Cunningham advised that after an RFP was conducted a year ago, the Investment Committee and the Foundation Board concluded that SIG was underperforming according to benchmark. Search consultants gave an unbiased view in terms of OCIO's and they offered several options before the RFP was conducted. Commonfund was selected after thorough review. The SIG engagement ended at the end of February, and work began to transition to provide the Foundation Investment Committee and the Foundation Board time to review the investment policy statement and asset allocation.

DEBT CAPACITY UPDATE

Ms. Cunningham advised that the report links the budget to debt capacity and deferred maintenance and will begin the process of educating the community regarding options and aid in development of a strategy to address these issues. The analysis will highlight the current resources and inform future priorities. The report will be speculative considering the effects of COVID and global unrest on interest rates and debt service cost and it will be difficult to predict exactly what will happen in the new year. Ms. Cunningham advised that a debt capacity analysis and a debt financing plan will test the feasibility of the University's significant needs. The capital master plan identified important strategies and necessary investments in physical planning and implementation over the short and long term. The University has more than $3 billion in replacement value and $436 million in total capital deficiencies.

The debt financing plan was determined by the amount of prudent new debt that could be issued while maintaining a solid financial condition. Deterioration of financial position will directly affect the University's credit profile, agency ratings and interest rates going forward.

A credit rating indicates an institution's capacity to meet financial commitments, including their debt servicing costs. Debt capacity analysis includes 4 steps and the University worked with Blue Rose capital markets advisors on the analysis of economic scenarios, with a 10-year view. Results informed new measures including assumptions for growth, like cash and investments, revenue and expenses, with a final focus on stability.

Stress testing debt loads in the analysis showed the impact on various metrics and evaluated the credit ratings impact. Comparisons of the results were made against peer university medians using Moody's, because they are much easier to model than Standard and Poor's. Economic scenarios also included a cash and investments models, and a revenues and expenses model. The analysis then used stress tests on these metrics to both the A1 rating and A2 rating over a 10-year horizon, assuming new debt would be issued equally every 2 years. The analysis continued using conservative interest rates increased by 75 bps, , every 2 years above current market levels.,

Assumptions showed that the University would be at A1, but that issuing more debt would move the University to a negative outlook. That scenario's estimate was that the University could issue an additional $300 million in debt, split for $75 million every 2 years, 2023 to 2029, before facing significant downgrade pressure. The balance sheet stress factors were cash flow impact metrics. Another scenario with an A2 rating with A3 downgrade pressure, estimated that debt could be issued at an additional $460 million between four $115 million issuances every 2 years. The balance sheet metrics held up better than the cash flow metrics in that scenario. Ratings agencies were not looking just at absolute debt levels, but at the institution's capabilities, resources and abilities to meet those financial commitments on incremental debt, so the University should have a plan to service it. A summary of all the results of assumptions indicated the rating projected would be A1 negative with an issuance of about $300 million, and A2 negative with an issuance of about $460 million.

President Wilson asked about the ratings for most of the Michigan public universities. Ms. Cunningham advised that most are rated A1, except for Michigan State University and the University of Michigan, who have not yet been subjected to the new ratings methodology. VP Massaron advised that many other institutions were facing significant enrollment pressure that could erode their financial results and affect relative ratings across the state. Professor Beale asked about the basis points assumptions of 300 by fiscal year 2029, and whether that was a conservative estimate, given the inflationary environment. Ms.

Cunningham noted this is a 75 basis point increase every 2 years, and she believes that is a conservative estimate, and is also impacted by credit spread.. VP Massaron advised that credit spread tends to increase as the economy gets tighter or more uncertain, and the impact is that people move towards more secure investments. Governor Gaffney asked for any future discussion to include a payment schedule and the impact of the annual payment on the interest and the principal. Governor Thompson asked when would this issue would return to the Board for decisions. VP Massaron advised that there are two decisions to be made. One is on long-term strategy, which will occur through conversations with the Board and decided on by the institution. The second decision is on an alternate vote for a debt issuance. A final long-term strategy would come with clarity around the School of Medicine and the KCI project, which will take a significant investment on the part of the University and the state. Regarding total debt service, options include structuring of the debt service on the basis of goals to be achieved, which will come to the Board for approval. Governor Thompson asked if there were funds allocated School of Medicine project. VP Massaron advised that the answer would come from the governor's recommended budget appropriation.

Governor Kelly asked if it is accurate to conclude that the credit quality and debt capacity are less certain than in recent years. Ms. Cunningham advised Moody's has always had some qualitative factors in their scorecard to give them flexibility in terms of how they rate universities. That is why they meet with the Provost and the CFO to gain some insight into some of those qualitative factors. Standard and Poor's has not changed their thinking or the ratings, so there is a little bit more uncertainty.

Governor Kelly asked whether the University should be more reluctant to increase debt as a consequence, until there is a better rating on its financial position. Ms. Cunningham advised that the University should look at a very prudent and balanced plan of increasing debt. This gives rating agencies time to evaluate financial resources and the institution's ability to service that debt, including steady enrollment and financial resources. Multi-year budgeting will be helpful in demonstrating this to the agencies. Governor Kelly suggested that there should be a broader process used to issue debt than just the ratings agencies. It is important for the University to have the ability to execute and implement the many capital projects in process, and the University should ensure the facilities team is fully supported. She then asked if the added costs of the indebtedness as a result of the lowering of the rating would be weighed against these other factors. VP Massaron agreed and noted that it is 5 to 10 basis points depending on the day, and could be as high as 15 or 20. With rising construction costs, those types of factors will have to be part of the conservation. It will be important for the agencies to see a unified management view including that of the Board, administration, faculty and the community.

VP Massaron thanked AVP Cunningham for her presentations, and advised the committee that Ms. Cunningham would be retiring in July. He added that she built out the university's cash management investment portfolio, and it became a national model. He thanked her for her tremendous work and service to the University.

CAPITAL ANALYSIS AND PLANNING

Mr. Rob Davenport, Associate Vice President, Facilities Planning & Management, presented the report on capital analysis and planning. He noted that in 2018, Sightlines, now Gordian, reported a deferred maintenance balance for the university that was around $1.2 billion. The report contained many contingencies and assumptions, and a Facilities Condition Index score was done as a result. He added that the University is now in a great position to know what needs to be done and when, with a plan in place.

The FCI score consists of a compilation of mechanical and electrical plumbing assets, along with the building envelopes. Items that inform the index include the age, the condition of these items, and the critical nature of the pieces of equipment. With a $3 billion replacement value across campus and a $436 million capital need, the FCI score is 13%, with low being better and zero being the best, but impossible to attain.

The $436 million consists of $168 million in immediate needs, $114 million total deferred maintenance, and interior needs at $53 million. Dashboards within the Gordian information allow the University to have capital planning at a moment's notice. The most important piece to note was that more than 50% of the university's buildings are greater than 50 years old, and that affects capital needs. This includes the Macabees and Scott Hall, and important significant infrastructure needs at Matthaei.

Mr. Davenport reviewed several charts in his powerpoint presentation. The top ten buildings with the greatest monetary needs were reviewed and discussed. The FCI score for Macabees is 31%, highlighting a lack of maintenance and some inherited deferred maintenance when the building was purchased. The top ten buildings with the least monetary needs were also reviewed, and offered a different perspective. The $46 million for Macabees includes the building's exterior, services, plumbing, HVAC and electrical needs. The $45 million for Scott Hall included the building's exterior, building maintenance, services and HVAC. The building has a lot of lab space in need. Building automation and equipment needs also have to be addressed.

Slides presented also indicated the capital outlook needs in subsequent years, with the focus on MEP, Mechanical, Electrical, Plumbing, as well as roofing, elevators, and building envelopes. In response to a request made by Governor Gaffney for a capital gains and pipeline list of projects planned for the year, Mr. Davenport advised they will not all be completed this year but there is intention to get them on the docket and begin the process of construction.

The cost of waiting has doubled since the beginning of the year. Inflation for January and February was at 4.5%, with rising inflation reported at near 8% for the month of February. Capital projects cost is predicted to increase with larger contingencies needed because of the nature of materials, supplies, equipment and labor. The cost of waiting also includes managing deferred maintenance with a preventative maintenance program that has been in process for year and a half. With the information needed to move forward, the first action will be office consolidation, beginning with the AAB building, and a move of academic programming out of FAB and Maccabees to make room for administrative space. Consolidation will also include other buildings on campus. For example, 110 East Warren has been unoccupied for 6 years, and has a maintenance cost of $175,000 a year. Reducing the University's footprint will enhance and improve operating expenses.

Professor Beale asked, in terms of the pipeline, how items are being prioritized with respect to teaching, learning and recruitment. Mr. Davenport advised that a holistic and comprehensive approach will be developed with regard to capital strategy so that the money is directed based on the condition of the University plant. Other factors include incorporating energy sustainability opportunities, taking advantage of performance contracting, reducing utility spend, and reducing operating costs in conjunction with capital projects, master planning and the academic mission. VP Massaron agreed. He noted that all of the resources needed are not available and decisions are made with constrained resources. Professor Beale asked about the importance of switching from deferred maintenance to preventative maintenance and how long that switch was taking.

Mr. Davenport responded that while he hoped to have started already, July 1 is the go live date. Delays were attributed to the Gordian report and its FCI score. The catalog of all of the assets had to be put into the work order system to generate preventative maintenance work orders automatically, as per industry standard. That has now been accomplished. The Skilled Trades department now includes IUOE and maintenance trades. Negotiations with IUOE continue. Delays were also caused by issues surrounding the previous flooding on campus.

Governor Barnhill asked when the board will have conversations around the Treasury and the debt capacity update in order to enable proactive decision making. Mr. Davenport advised that this is a process that will require all hands-on deck to have a true strategy and then begin to allocate funding to the projects. VP Massaron advised that the conversation will happen soon and noted that Mr. Davenport's department will need the capacity to execute because this will be a larger volume of work than FPM has done in the recent past. Governor Gaffney advised that this is a strategy, and involved Chairman Barnhill from the very beginning. Governor Gaffney then asked about Governor Barnhill's question regarding the timeline for conversations on these issues. Mr. Davenport advised there will be some formal action before the end of the calendar year. VP Massaron added that the adoption of the strategy will come forward in 2022.

STATE HALL RENOVATION – PHASE II OF III

Mr. Davenport advised that State Hall is in the second of three phases. For the first phase, the administration asked for $6 million for design, schematic design, design development and the completion of construction documents. Phase II, before the Board today, is for $8 million is to purchase long lead items including roofing material and insulation and large pieces of equipment, demolition and abatement.

> **ACTION**: Upon motion made by Governor Thompson and supported by Governor Kelly, the Budget and Finance Committee recommended that the Board of Governors authorize the President, or his designee, to authorize $8,000,000 for Stage II of the State Hall Renovation Project. The purpose of this request is to

award contracts for demolition, abatement and to purchase long lead time equipment. The project will be funded by 2020 Bond Sale Funds. The motion carried.

COMMUNITY ART COMPLEX HVAC IMPROVEMENTS SUPPLEMENT

Mr. Davenport provided an overview of this project, and advised that it involves a combination of the restoration of cooling in Community Arts, Music, McGregor and Alumni House. The chillers were damaged due to the flood and a rebate was received from the insurance carrier, FM Global to cover the cost of repairs.

There are plans for a holistic cooling solution within the five building complex by combining the Art building with cooling restoration for the other four. This approach is the first performance contracting approach with partner JCI, Johnson Controls. This program will not only address all of the mechanical needs across this particular five building complex but also drive energy efficiency within that scope with a guaranteed savings projected at $1.4 million for this project. He believed that that number is very conservative and will grow. Professor Beale asked how high he thought the energy savings could go. Mr. Davenport advised that along with utility costs avoidance it could likely be in the 25% range, and could approach the $2 million mark. Mr. Thomas asked what specific benefit a holistic cooling solution will provide. Mr. Davenport advised that benefit would be modular cooling. The 2 chillers, at 325 tons a piece, will be broken down into about 6 units, so they are not all running necessarily and save on electricity.

Governor Kelly advised that when approaching the Legislature asking for appropriations, particularly capital appropriations, it is a good idea to demonstrate the intent and effort to save money with this kind of planning. Mr. Davenport agreed and advised it was the intention going forward.

ACTION: Upon motion made by Governor Thompson and supported by Mr. Thomas, the Budget and Finance Committee recommended that the Board of Governors authorize the President, or his designee, to approve spending of $3,300,000 to restore cooling at four of the five art complex buildings. This project will create a holistic cooling solution for the art complex which includes Community Arts, Schaver Music, Alumni House & McGregor. The motion carried.

INFORMATIONAL REPORT: MAJOR CAPITAL PROJECTS SUMMARY

Mr. Davenport advised that there were no changes since the last report.

PURCHASING EXCEPTIONS

Governor Gaffney asked for additional information on #23, Colliers International Holdings. Governor Thompson asked a question about number 51, the MF Digital Marketing, Inc. referring to the $98,000 for general funds for Law School instruction that instead described the School of Medicine. Mr. Doherty advised that he will correct the report and provide the information requested. Governor Barnhill added that as it applies to purchasing, and any future expenditures, if there could be some overall ESG objectives that could be achieved as a University.. How much of purchasing is going to companies with connections to the University, including to alumni?. How much money remains within local companies and businesses?. How much supports development of disadvantaged businesses. He asked if there was any reporting on those roles and objectives. Mr. Doherty advised that there is some information that he could compile for the Board, if not at the May meeting, then at the September meeting. He noted that information on former alums may be difficult as it is not a usual part of information provided about companies.

ADJOURNMENT

There being no further business, the meeting adjourned at 12:21 p.m.

Respectfully submitted,

Julie H. Miller
Secretary to the Board of Governors