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December 16, 2010

McMaster University

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McMaster University

Rationale

Issuer Credit Rating
AA-/Stable/--

The ratings on Hamilton, Ont.-based McMaster University reflects Standard & Poor's Ratings Services' opinion of the following factors:

- McMaster's strong demand and research profiles, due to its broad range of program offerings, high research intensity, and close proximity to the Greater Toronto Area. Its enrolment was 25,007 full-time equivalent students (FTEs) in fiscal 2010, exceeding the fiscal 2009 level and target fiscal 2010 level by 3.7% and 3.2%, respectively. Among the university's key strategic priorities is increasing graduate enrolment, which has risen 8% in fiscal 2010. This complements the province's goal of adding 3,300 new graduate spaces provincewide by 2012. It also supports the university's strong research profile. McMaster ranked second in Canada for research intensity (sponsored research income per full-time faculty) in a 2010 Infosource Inc. report;
- Sound government funding support. Stable operating grants from the Province of Ontario account for about half of McMaster's revenues, which help underpin the ratings. In addition to a base operating grant (which it provides on a weighted student enrolment basis), the province also has a history of providing additional grant envelopes, or one-time year-end disbursements for alleviating operating and capital pressures. Given Ontario's large deficit, however, its medium-term financial support for universities could be constrained. Nevertheless, the province can also enact a more flexible tuition-setting policy to replace the one expiring in 2012; and
- Prudent debt management. McMaster's debt was C$173 million or C$6,929 per FTE at April 30, 2010, up 12% from the previous year due exclusively to McMaster's guarantee on certain debt obligations related to the McMaster Innovation Park. Other than this additional obligation, the university has steadily reduced its debt stock ever since going to market with its first and only debenture issue in September 2002. McMaster has a relatively low debt burden compared with its rated peers; only McGill University (AA-/Stable/--) had a smaller burden. We also view its decision to temporarily shelve a C$100 million debenture issue in 2008 due to deteriorating operating prospects as further evidence of its prudent disposition. Additionally, the university established its own debt monitoring policy to guide financial planning, internally financed its capital projects, and created voluntary debt retirement funds for its debenture and mortgages.

We believe the following factors constrain these strengths:

- McMaster's sustained decline in unrestricted financial resources (internally restricted endowment plus internally restricted net assets). While still sound, the university's unrestricted financial resources fell to C$106 million or C$4,242 per FTE in fiscal 2010, from C$237 million or C$10,714 per FTE in fiscal 2006. Its decision to use its internal resources to fund certain one-time operating costs (going-concern pension deficit and early retirement program) helped fuel this decline. The university's unrestricted financial resources are likely to remain under pressure in the near term, reflecting continued internal financing of loans for capital projects. While this has kept debt at a relatively low level, the university's financial flexibility has diminished considerably and, in our view, is not likely to dramatically improve in the next few years.
- The tight operating environment, which, like all rated Canadian universities, McMaster has been subject to in recent years. Despite posting a consolidated operating surplus of C$12 million or 1% of revenues in fiscal 2010, the budget has been very strained and without one-time year-end government grants, the balance would have been negative. As a result, the university is undergoing structural adjustments to address the shortfalls. Like its

peers, the university's greatest pressure is compensation. Therefore, McMaster is focused on managing its salaries, unfunded postemployment benefit expenses (primarily medical benefits and dental care), special pension deficit amortization payments, and staff complement. The unexpected surplus increased the university's debt service coverage ratio to a sound, in our view, 4.30x in fiscal 2010, although Standard & Poor's does not expect this level to continue, given the operating environment and the nature of the fiscal 2010 surplus; and
- Potential postemployment deficit funding. In fiscal 2010, McMaster's pension assets rebounded from the negative market impact in 2009; however, a large unfunded liability position remains. The university estimated it had an unfunded pension liability of C$375 million at April 30, 2010, about flat from the prior year and three times larger than three years ago. McMaster filed its last actuarial valuation report in July 2008, which means that the next valuation is required by July 2011. The new valuation will in turn determine the university's special pension deficit payments starting in fiscal 2013. Although market conditions could be materially different at that time, the university is expecting to face considerable additional going concern funding requirements of between C$22 million and C$25 million per year beginning in fiscal 2013, compared with C$9 million in fiscal 2010. McMaster expects some temporary relief from funding solvency deficits in the next three years from the adjustments to the provincial legislation on pension deficit funding, however, the budget is likely to be strained over the medium term.

Outlook

The stable outlook reflects our expectation that McMaster will steadily improve its consolidated operating deficit in the next few years, and not further significantly erode its unrestricted financial resources. Furthermore, we assume the province will not significantly cut McMaster's funding without providing greater tuition-setting flexibility. Standard & Poor's could lower the ratings if these assumptions are not met, or if the ratings on the province are lowered. Conversely, we could raise the ratings if the university's unrestricted financial resources rise sharply to their former levels and debt remains at a relatively low level.

Government-Related Entity Methodology

In accordance with our criteria for government-related entities, our view of a "moderately high" likelihood of extraordinary government support reflects our assessment of McMaster's "important" role in the province, given that postsecondary education is one of Ontario's top priorities in both expenditure and mandate (after health care and school boards), and that there are no viable private alternatives. The assessment also reflects our view of the university's strong reputation in the country, and its significant research capacity. In our opinion, the provincial oversight and directive McMaster receives through tuition regulation and program approval suggests a "strong" link with the province. Also supporting this view is that provincial operating grants account for about 47% of the university's operating revenues.

The stand-alone rating on McMaster incorporates our opinion of the province's ongoing financial support as well as the university's public policy role Ontario. In view of this, the province's financial support for universities could be constrained in the medium term. Ontario's public accounts showed a C$19 billion deficit in fiscal 2010; according to its March 2010 budget, the province projects annual deficits for at least the next seven years. However, given the priority that it places on higher education, we expect Ontario's grants to McMaster will not diminish.

Strong Graduate Enrolment Growth

McMaster's enrolment stood at 25,007 FTEs in fiscal 2010. This was 3.7% larger than the fiscal 2009 level, and 3.2% above its target for the year. Applications were up slightly in fiscal 2010, but the yield (registrants divided by applicants) was stable, at 16%.

The university continued to make strong gains in graduate enrolment, which rose 7.9% in fiscal 2010. This was in keeping with its plan that calls for graduate students to eventually reach 20% of the total, from 13% in fiscal 2010. It complements the province's own objective of adding up to 3,300 new graduate student spaces across Ontario by 2012. The government intends to give operating and capital funding to universities to accommodate the new spaces.

Preliminary estimates indicate McMaster's yield has further improved in fiscal 2011 and that enrolment has moderately increased. We expect enrolment demand to remain strong. Contributing to that view is a projected rise in the GTA's university-age population during the next decade which bodes well for enrolment demand at all universities near the GTA.

Tight Operating Environment

The operating environment that all Ontario universities face has become more restricted in recent years. Despite posting a consolidated operating surplus of C$12 million or 1% of revenue in fiscal 2010, McMaster's budget has been very strained; without one-time year-end government grants, the balance would have been negative. Nevertheless, the university is beginning to see the impact of its cost-containment efforts, which have also contributed to improved results. The large swing in investment income also helps explain the significant difference between 2009 and 2010 results. Investment income was C$48.7 million in 2010, compared with negative C$14.7 million in fiscal 2009.

McMaster will likely remain in a tight operating position for the next few years, reflecting further special pension deficit amortization payments, a constrained funding environment, and necessary deferred maintenance spending. It filed an actuarial valuation on its pension as of July 2008 and will require another by July 2011. The valuation next year will likely reveal going-concern and solvency deficiencies. Under provincial regulation, the actuarial valuation determines the university's special payments for both deficiencies for a three-year period. Current estimates point to notably higher special payments, which the university is budgeting for on a cash basis.

Ontario gives universities some tuition-setting flexibility, allowing them to increase tuition a maximum annual average of 5% institutionwide. Given the limited growth in government grants, and that tuition is the second-largest source of revenue, McMaster has made full use of this limit in the past several years. In fiscal 2010, the government extended the current tuition framework to fiscal 2012. Beyond then, we believe that there will continue to be some form of limited tuition flexibility.

The strained operating environment, volatile investment returns, and extra payments for postemployment benefits will continue to pressure McMaster's budget in coming years. Cost-containment efforts, which include a control of discretionary spending, review of all job vacancies, and a more accountable operating budget model, should help alleviate these strains. Nevertheless, while management budgets ongoing operating results to balance during the next three years, including one-time costs, the budget is in deficit until at least 2013. Moreover, given the amount of draw-downs already taken from reserves and or its internal endowment, there is limited room to continue funding one-time operating costs.

Prudent Capital Management

McMaster has managed capital pressures from enrolment, research, and maintenance in a fairy prudent manner, with a history of appropriate budgeting. It internally finances capital spending when possible and for the most part approves projects to the extent it has identified stable and reliable sources of funding. Given the tight operating position, McMaster is only considering pursuing projects that it can fully fund from outside sources. Until conditions improve, we expect the university will maintain this prudent approach. We also take comfort in McMaster's demonstrated expertise in executing construction projects. Since we started rating it in 2002, the university has completed all major capital projects on budget (after adjusting for changes in scope).

McMaster's two key initiatives are set to be complete by March 2011 and are currently on time and budget (see table 1).

Table 1

McMaster University--Major Capital Projects

Project	Budget (mil. C$)	Funding	Expected completion
KIP--Nuclear research building renovations	22	Federal and provincial grants	2011
KIP--Centre for Spinal Cord Education, Research and Rehabilitation	20	Federal and provincial grants, fundraising	2011

KIP--Knowledge Infrastructure Program.

Like most Canadian universities, McMaster faces a backlog of deferred maintenance. It estimates this at C$119 million (or 9% of replacement value), compared with C$140 million for the previous year's estimate. The decline can be partly attributed to the capital-focused funding received during the past two years from both the federal and provincial governments.

McMaster Innovation Park

In 2005, the university purchased a strategically located site in west Hamilton for C$13 million on which to build McMaster Innovation Park (MIP). Officials envision the research park to have more than a million square feet of laboratory, office, teaching, training, and conference facilities, for research and development in areas such as advanced manufacturing and materials, nanotechnology, and biotechnology. The province provided C$10 million to develop the park, and the City of Hamilton (AA/Stable/--) provided C$5 million in 2005. Officials have leased a portion of the park to the federal government to house the CANMET Material Technology Laboratory. The park is to be completed in several phases. MIP's business development model is based on property development and leasing revenues to service any associated debt. McMaster's financial support to the park includes occasional short-term recourse debt financing, as well as the guarantee of certain long-term debt obligations as per a Debt Service Deficiency Agreement. Standard & Poor's includes in the university's debt metrics all direct recourse related to MIP.

Postemployment Liabilities Remain High

McMaster sponsors a defined benefit pension plan. The university estimated it had an unfunded pension liability of C$375.4 million at April 30, 2010, about flat from an estimated liability of C$373.0 million in the previous fiscal year, but more than three times higher than three years ago. After the current service cost and interest on liabilities, a decrease in the discount rate assumption more that offset the remaining amount from 2010's strong investment returns. This means that despite an 18% return on salaried pension plan investments in fiscal 2010, the fund deficiency remained very large.

McMaster filed its last actuarial valuation report in July 2008, which means that the next valuation is required by July 2011. The new valuation will in turn determine the university's special pension deficit payments starting in fiscal 2013. Although market conditions could be materially different then, McMaster expects to have additional funding requirements for both solvency and going concern deficits. These special funding requirements will place significant pressure on the university's budget. McMaster estimates its special pension deficit amortization payment will be from C$22 million-C$25 million beginning in fiscal 2013, compared with C$9 million in fiscal 2010.

The university has made considerable gains in managing the growth of the postemployment liabilities, such as changes in plan design away from defined benefit, revised eligibility rules for certain new employees, the introduction of a group RRSP for certain new employees, and increased employee contributions. Nevertheless, the funding deficit remains very large and will continue to pressure the budget greatly in the medium term.

Balance Sheet Has Weakened Considerably

In our opinion, McMaster's combination of large investment holdings and low debt has been a key attribute supporting the ratings. The significant decline in unrestricted financial resources in the past two years and our expectation that they will not recover in the medium term is what led to the downgrade. At fiscal 2010 year-end, its unrestricted financial resources (internally restricted endowments plus internally restricted net assets) as a share of debt were 61%, down from 151% in 2006. Unrestricted financial resources are now C$4,242 per FTE compared with more than C$10,000 before 2007. This trend is primarily the result of McMaster's decision to use its internal endowment to fund certain operational and capital costs. While this has kept debt at a relatively low level, the university's financial flexibility has diminished considerably and is not likely to improve dramatically in the next few years.

While McMaster's balance sheet still benefits from a relatively large endowment fund, investment returns and draw-downs for one-time operating expenditures have led to a decline to C$396 million in 2010 from a market value peak of C$499 million at fiscal 2007. Moreover, the decline has primarily affected the internally restricted endowment, which highlights the diminishing financial flexibility of the university, in our view. About 73% of McMaster's endowment is restricted by donors (external endowment), while the rest is subject only to internal restrictions (internal endowment). Although we think internal endowments represent a greater source of financial flexibility, we also view external endowment funds as a positive credit factor. External endowments tend to generate investment income the university can spend in accordance with the agreements with donors. They also fund research-enhancing initiatives that can improve an institution's reputation while freeing up operating funds for other purposes. At April 30 2010, the total endowment compared well with those of most other rated domestic peers (see table 2), at C$18,400 per FTE.

After turbulent conditions in 2009 led to a significant decline in the endowment's market value, returns in 2010 recovered a good portion of the losses. However, we do not expect that market returns will continue the 17% annual return of the past year. Moreover, the one-time costs associated with addressing the structural imbalance could further erode financial resources.

Table 2

McMaster University--Peer Comparison

	--McMaster University--			--York University--			--University of Guelph--		
(C$000s)	**2010**	**2009**	**2008**	**2010**	**2009**	**2008**	**2010**	**2009**	**2008**
Issuer credit rating	AA-/Stable/--	AA/Stable/--	AA/Stable/--	AA-/Stable/--	AA-/Stable/--	AA-/Stable/--	A+/Stable/--	A+/Stable/--	A+/Stable/--
Applicants	30,970	30,652	31,086	58,210	53,387	58,378	N.A.	25,114	23,448
Offers	19,644	20,095	20,400	41,812	41,777	43,730	N.A.	14,666	14,107
Registrants	5,016	4,959	5,131	N.A.	N.A.	N.A.	N.A.	4,484	4,478
Acceptance rate (offers/applicants; %)	63	66	66	72	78	75	N.A.	104	60
Yield (registrants/applicants; %)	16	16	17	N.A.	N.A.	N.A.	N.A.	32	19
FTEs	25,007	24,104	23,530	45,169	45,169	45,165	19,772	18,664	18,298
Total revenue	828,373	731,819	735,034	890,385	846,709	846,060	634,034	620,798	569,267
Deferred capital	36,386	37,146	41,047	12,846	11,729	12,410	21,372	21,469	21,644
Adjusted revenue	791,987	694,673	693,987	877,539	834,980	833,650	612,662	599,329	547,623
Total expenditure	816,723	785,772	748,553	894,803	858,416	847,099	636,624	627,177	581,441
Interest	9,969	10,034	10,128	21,060	22,778	22,997	11,278	15,283	12,166
Depreciation	62,474	62,659	63,846	41,225	44,754	37,905	38,541	38,442	39,889
Adjusted expenditure (For DSCR)	744,280	713,079	674,579	832,518	790,884	786,197	586,805	573,452	529,386
Current portion of long-term debt (for calculating DSCR)	1,128	1,060	997	4,181	30,355	3,724	3,658	4,307	2,326
Consolidated surplus/total revenue (%)	1.4	(7.4)	(1.8)	(0.5)	(1.4)	(0.1)	(0.4)	(1.0)	(2.1)
Consolidated surplus (for calculating DSCR; %)	6.0	(2.6)	2.8	5.1	5.3	5.7	4.2	4.3	3.3
DSCR (interest and principal; x)	4.30	(1.66)	1.74	1.78	0.83	1.78	1.73	1.32	1.26
DSCR (interest only; x)	4.79	(1.83)	1.92	2.14	1.94	2.06	2.29	1.69	1.50
Total debt	173,270	154,331	155,329	315,123	345,477	349,201	179,082	175,473	167,654
Unfunded postemployment liabilities	589,945	567,969	361,197	353,581	141,805	123,196	409,976	372,734	371,556
Interest expense to adjusted revenue	1.3	1.4	1.5	2.4	2.7	2.8	1.8	2.6	2.2
Debt to FTE	6,929	6,403	6,601	6,977	7,649	7,732	9,057	9,402	9,162
Debt to adjusted revenue (%)	21.9	22.2	22.4	35.9	41.4	41.9	29.2	29.3	30.6
(Debt plus unfunded postemployment liabilities)/adjusted revenue (%)	96.4	104.0	74.4	76.2	58.4	56.7	96.1	91.5	98.5
Internally restricted net assets	(1,740)	9,794	55,790	142,145	179,426	152,019	115,117	80,324	37,361
Internally restricted endowments	107,817	98,832	133,166	36,324	33,747	51,570	18,561	16,009	18,425

Table 2

McMaster University--Peer Comparison (cont.)									
Externally restricted endowments	287,854	246,139	300,860	257,496	202,112	247,039	162,230	124,108	139,653
Unrestricted financial resources	106,077	108,626	188,956	178,469	213,173	203,589	133,678	96,333	55,786
As % of total debt	61.2	70.4	121.6	56.6	61.7	58.3	74.6	54.9	33.3
As % of total debt plus unfunded post-employment liabilities	13.9	15.0	36.6	26.7	43.7	43.1	22.7	17.6	10.3
As a % of operating expense	13.0	13.8	25.2	19.9	24.8	24.0	21.0	15.4	9.6
Per FTE	4,242	4,507	8,030	3,951	4,719	4,508	6,761	5,161	3,049
Total endowment value per FTE (at market value)	18,400	17,300	20,800	6,509	5,424	6,709	9,574	7,726	9,394

FTE--Full-time equivalent. DSCR--Debt service coverage ratio. N.A.--Not available.

Debt Burden Remains Stable

In our view, McMaster has exhibited prudent debt management practices, resulting in a debt burden that fits well among those of 'AA' category Canadian universities. The higher debt in fiscal 2010 is exclusively due to the university's guarantee on certain debt obligations related to the MIP, which we note do not necessarily represent cash requirements. Other than this, McMaster has reduced its debt stock steadily ever since going to market with its first and only debenture issue in September 2002. The university has managed this by financing capital expenditures internally and taking on bank debt with amortizing repayment profiles. We also view its decision to temporarily shelve a C$100 million debenture issue in 2008 due to deteriorating operating prospects as further evidence of its prudent disposition. The university also established its own debt monitoring policy to guide financial planning. The policy's financial targets include a DSCR of 2.75x-3.25x and an expendable resources to total debt ratio above 80% (expendable resources is similar to our measure of unrestricted financial resources). The university is also considering adding a third target ratio--available expendable resources greater than 15% of revenue--to monitor its financial flexibility.

McMaster had C$173.3 million in debt at fiscal year-end 2010, up 12% from a year earlier due to the additional MIP obligation. Its debt consisted of C$120 million bullet debentures maturing in 2052, C$20.9 million in bank loans, C$12.4 million in mortgage debt, and C$20.0 million in obligations through the Debt Service Deficiency Agreement with MIP. All debt is unsecured. Our measure of debt omits the university's voluntary internally restricted debt retirement funds for the debentures and a residence mortgage of C$9.6 million and C$5.9 million, respectively. McMaster has also entered two interest-rate swap contracts with an investment grade-rated financial institution. Its rationale was to substitute its floating-rated interest exposure on bank loans for fixed-rated interest payment obligations. At fiscal year-end 2010, the fair market value of the university's swap contracts was negative C$4.7 million. The contracts have expirations dates matching those of the underlying bank loans.

McMaster's debt burden represented C$6,929 per FTE, or 21.9% of adjusted revenues in fiscal 2010. These are fairly low relative to those of its similarly rated domestic peers. Improved consolidated operating performance brought the DSCR back to a sound level at 4.3x, although much of the surplus was due to unexpected year-end provincial funding and strong investment returns in 2010. We believe its DSCR will be relatively thin in the near term, given its tight budget position. Moreover, negative investment returns and internal funding of certain operating costs and capital expenditures have eroded its unrestricted financial resources-to-total debt ratio considerably, and we do not expect that it will recover in the next few years.

However, we expect McMaster's debt burden to continue following a steady downward trend in the near term, thanks to amortization of bank debt. The university has advised us that it does not expect to undertake any significant debenture issuance in the near term. As a result, we expect its debt-per-FTE ratio to slowly trend downward in the near term.

Fundraising Surpasses Target

As of September 2010, McMaster had raised C$473 million, surpassing its four-year fundraising target of C$400 million. These fundraising efforts have helped the university mitigate the downward pressure that capital spending and challenging investment markets have exerted on its endowment balance.

Related Criteria And Research

Enhanced Methodology And Assumptions For Rating Government-Related Entities, June 29, 2009

Ratings Detail (As Of December 16, 2010)*	
McMaster University	
Issuer Credit Rating	AA-/Stable/--
Senior Unsecured (1 Issue)	AA-
Issuer Credit Ratings History	
08-Dec-2010	AA-/Stable/--
09-Sep-2002	AA/Stable/--

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.