STANDARD & POOR'S

RATINGSDIRECT®

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McMaster University

Primary Credit Analyst:
Paul Judson, CFA, Toronto (1) 416-507-2523; paul_judson@standardandpoors.com

Secondary Credit Analyst:
Suleman Souleyman, Toronto (1) 416-507-2514; suleman_souleyman@standardandpoors.com

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McMaster University

Major Ratings Factors

Issuer Credit Rating
AA/Stable/--

Strengths:

- Strong demand and research profile
- Good balance sheet strength
- Healthy provincial support

Weaknesses:

- Tight operating environment
- Liquidity pressures

Rationale

In Standard & Poor's Ratings Services' opinion, the ratings on Hamilton Ont.-based McMaster University (McMaster or the university) reflect 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 (GTA). Its enrolment was 23,530 full-time equivalent students (FTEs) in fiscal 2008, exceeding the fiscal 2007 level and target fiscal 2008 level by 2.7% and 3.4%, respectively. Among the university's key strategic priorities is increasing graduate enrolment, which has risen 10% in fiscal 2008. This complements the Province of Ontario's (AA/Stable/A-1+) goal of adding 3,300 new graduate spaces provincewide by 2012. It also supports the university's strong research profile. McMaster ranked third in Canada for research intensity (sponsored research income per full-time faculty) in a 2008 Infosource Inc. report;
- The university's good balance-sheet strength. Its unrestricted financial resources (internally restricted endowment plus internally restricted net assets) exceeded total debt by 122% in fiscal 2008. Only Queen's University (AA+/Stable/--) and McGill University (AA-/Stable/--) had higher ratios among rated Canadian universities. However, we believe 2008's steep decline in global stock markets eroded the university's ratios in fiscal 2009. McMaster's debt burden was C$155 million, or C$6,601 per FTE in fiscal 2008. Only Queen's and McGill had smaller burdens. In response to tightened operating conditions, the university postponed a C$100 million debenture issue in 2008, opting instead to finance capital projects on a pay-as-you-go basis at this time. Accordingly, we expect its debt burden to trend down in the near term due to amortization of bank debt; and
- The university's strong funding support, with provincial grants constituting nearly half of its revenues. The Ontario Ministry of Training, Colleges, and Universities allocates operating grants per FTE. It also addresses the sector's various operating and capital pressures by providing one-time strategic funding programs and year-end funding disbursements, including one for C$150 million in March 2009. Given its large budget deficit, however, the province could scale back university funding. That said, Ontario could enact a more flexible university tuition fee-setting policy to replace the one expiring this year.

We believe the following factors constrain these strengths:

- The university's tightening operating environment. Most rated Canadian universities have seen their operating environments shrink in recent years, and McMaster is no exception. It posted a consolidated operating deficit of

C$14 million or 2% of revenues in fiscal 2008, marking its first shortfall since fiscal 2002. Like its peers, the university's greatest pressure is compensation, with unfunded postemployee benefit expenses, special pension deficit amortization payments, and a faculty retirement incentive program fueling the deficit in fiscal 2008. The weaker operating performance also narrowed the university's debt service coverage ratio (DSCR) to 1.83x in fiscal 2008, from 5.29x in fiscal 2007. This is not only below McMaster's internal DSCR policy target of 2.75x-3.25x, it's thin for the 'AA' rating, in our opinion. However, the university has enacted cost-containment initiatives that it hopes will restore fiscal balance and improve its DSCR in the next few years; and

- McMaster's recent decline in unrestricted financial resources. While still sound, the university's unrestricted financial resources fell to C$189 million or C$8,030 per FTE in fiscal 2008, from C$236 million or C$10,299 per FTE in fiscal 2007. Its decision to use its internal endowment to fund certain operating costs (going-concern pension deficit and early retirement program) helped fuel this. We also think its negative investment returns in the wake the stock market decline accelerated the trend in fiscal 2009. The university's unrestricted financial resources are likely to remain under pressure in the near term, reflecting challenging investment conditions, possible donor fatigue amid the recession, and continued internal funding of certain operating and capital costs. However, we believe a potential stabilization in global markets, coupled with McMaster's efforts to reduce spending and rely less on its balance sheet to fund one-time expenditures, would go a long way toward slowing or reversing this trend.

Outlook

The stable outlook reflects our expectation that McMaster will steadily improve its consolidated operating deficit in the next few years, and at least stabilize its unrestricted financial resources in fiscal 2010. While the university continues to review its plan to issue debt, we assume it will not take on material new debt until its DSCR recovers. Furthermore, we assume the province will not significantly cut McMaster's funding without providing greater tuition-setting flexibility. We could lower the ratings if these assumptions are not met, or if the ratings on the province fall. Although unlikely in the near term, we could raise the ratings if the university's unrestricted financial resources rise sharply and we think its total debt will continue falling in the long term.

Graduate Students Driving Enrolment Growth

McMaster's enrolment stood at 23,530 FTEs in fiscal 2008. This was 2.7% larger than the fiscal 2007 level, and 3.4% above its target for the year. Applications dropped slightly in fiscal 2008, with a decline in Ontario student and part-time applications outweighing increased out-of-province applicants. Nevertheless, the university saw the caliber of its applicant pool improve. The number of level 1 students with an average entering grade of 80% or higher reached 77.5% of enrolment in fiscal 2008, up from 73.7% in fiscal 2007.

McMaster continued to make strong gains in graduate enrolment, which rose 10.1% in fiscal 2008. This was in keeping with the university's Refining Directions strategic plan that calls for graduate students to eventually reach 20% of the total, from 12% in fiscal 2008. This 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.

However, as was the case with many Ontario universities, McMaster has seen demand among international students moderate in recent years. We think this was party due to the fluctuating Canadian dollar alongside the federal

government's policy requiring visa students to leave the country 90 days after graduation should they fail to secure employment. However, the federal government repealed its student visa policy in 2008 and the Canadian dollar exchange rate has returned to more historical levels in the recent months. Nevertheless, while the university's international enrolment rebounded 5.8% in fiscal 2008, it remained 6.4% below its fiscal 2006 peak.

Preliminary estimates indicate the university's enrolment was little changed in fiscal 2009. Undergraduate enrolment, constituting the lion's share of total enrolment, remained fairly stable. On the other hand, graduate enrolment rose an estimated 12%. We think the recession could favorably affect university enrolment demand. Displaced workers could seek to improve skills by taking part-time courses, while recent graduates could defer entry into the difficult job market by enrolling in additional degree programs. We also think a projected rise in the GTA's university-age population during the next decade bodes well for enrolment demand.

Tight Operating Environment

McMaster's operating environment has become more restricted in recent years. The university's consolidated operating balance swung to a deficit of C$14 million or 2% of revenue in fiscal 2008, reflecting its decision to use its internal endowment to fund a C$7 million one-time faculty retirement incentive program, an C$8 million special pension deficit amortization payment, and a standard C$5 million spending allocation to the operating fund. The deficit also reflects McMaster's practice of budgeting for nonpension postemployment benefits on a cash basis, whereas its consolidated operating balance incorporates a larger accrued benefit expense. The university's reduced investment revenue also contributed to the deficit.

We believe McMaster's consolidated operating balance remained under pressure in fiscal 2009. In order to fund another C$8 million special pension deficit amortization payment, the university used an existing operating reserve previously set aside for that purpose. In addition, a C$5 million spending allocation to the operating fund will not be replaced with investment earnings due to the market losses. What's more, to the extent the university's cash payments for nonpension postretirement benefits remained smaller than the associated accrued benefit expense, its consolidated operating balance would have weakened further. On the revenue side, we believe 2008's steep drop in global stock markets significantly impaired the university's investment revenues. On the other hand, the province's year-end funding injection for universities gave McMaster some relief.

McMaster will likely remain in a tight operating position for the next few years, reflecting further special pension deficit amortization payments, challenging investment conditions, and a constrained funding environment. It is completing a pension actuarial valuation filing as of July 2008 and will decide on whether to file by June. This valuation will likely reveal another going-concern deficiency. Under provincial regulation, the actuarial valuation determines the university's special going-concern debt amortization payments for a three year period. Accordingly, McMaster will likely continue making special pension deficit amortization payments through fiscal 2012. It estimates the size of these payments will be similar to those it made in recent years, at about C$9 million in fiscal 2010.

While the province typically delivers some level of year-end funding to the university sector, it has not adjusted its per-FTE base grant allotment for inflation since 1997. McMaster has relied on growth funding and investment income from its large endowment, together with strict cost containment, to keep up with inflation and other cost pressures. Under its current policy, the university spends up to 5% (4% for spending and 1% for administration) of the three-year average market value of its endowed on operating expenditures each year. However, McMaster saw

its endowment drop sharply in 2008 due to the global stock market turmoil. Consequently, absent a strong recovery in markets or a change in the payout policy, the university's annual payout of endowment capital to operations will gradually decline. The payout stood at C$13.1 million, or about 3% of operating budget expenditures, in fiscal 2008. While this is relatively small, we think it's still important, given McMaster's tight operating environment. As such, we believe the lower payout will put additional pressure on the university's existing cost containment efforts, which include a control of discretionary spending, review of all job vacancies, and a more accountable operating budget model.

We also think the province's lack of guidance on tuition regulation beyond fiscal 2010 clouds McMaster's near-term revenue prospects. Tuition accounted for about 18% of the university's revenue in fiscal 2008. Under the province's fiscal 2007-2010 tuition framework, universities could raise fees by a maximum annual average of 5% per year. McMaster made full use of the 5% cap in each of the past three fiscal years. The province has yet to put in place a tuition policy covering fiscal 2011 and beyond.

Despite this environment, McMaster remains on track toward reestablishing a balanced operating fund budget in fiscal 2010, excluding one-time expenditures funded from reserves. Its operating fund has been in a moderate structural deficit position since fiscal 2004. However, its return to balance would omit one-time costs, such as special deficit amortization payments. The university expects to continue funding one-time operating costs with its reserves and or its internal endowment, although it is making efforts to slowly build these into its operating budget.

Prudent Capital Management

McMaster has managed capital pressures from enrolment, research, and maintenance without unduly eroding its sound financial profile. 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. We also take comfort in the university'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).

Table 1 provides an overview of McMaster's current major capital projects. With most initiatives nearing completion, we think the university's construction risk profile is fairly modest. We also think the late stage of these projects is somewhat fortuitous, as it gives McMaster the chance to evaluate its next round of developments in the context of its tight operating position, and potentially defer noncore projects until conditions improve.

Table 1

McMaster University--Major Capital Projects

Project	Budget (mil. C$)	Description	Funding	Expected completion
Michael G DeGroote Centre for Learning (MDCL) refit	18.5	Repurchase and refit of MDCL's second floor for the health science faculty.	Fundraising, internal resources, and a share of MOHLTC grants for program.	2009
New engineering building	48	125,000 square-foot building, the first phase of a complex for the faculties of engineering, science, and health sciences.	Provincial and federal grants, fundraising, internal resources.	2009
Surgical skills laboratory	3.1	Facility to enable students to practice clinical skills.	Provincial grants, internal resources.	2009

McMaster also continues to proceed with a new campus for its MBA program in nearby Burlington, Ont.

Burlington city council has approved the campus, and the building permit process is underway. The university estimates the campus's construction costs at C$26.8 million, with funding coming from Burlington, the Regional Municipality of Halton (AAA/Stable/--), and fundraising.

Like all Canadian universities, McMaster faces a backlog of deferred maintenance. It estimates this at C$140 million or 8% of replacement value, compared with C$125 million or 9% of replacement value for the prior year estimate. The province gave the university C$9.1 million in March 2008 and C$13.5 million in June 2008 to help control the backlog. Recently, the university submitted funding applications for both federal and provincial infrastructure programs, and is hopeful some additional shovel-ready projects will be approved.

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/Positive/--) provided C$5 million in 2005. The project represents a potential long-term investment of C$100 million, the majority of which will come from the private sector and government partnerships. Officials expect to lease 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 MIP includes C$16 million in recourse debt financing. Standard & Poor's intends to include in the university's debt metrics all direct recourse related to MIP.

Postemployment Liabilities Continue To Rise

McMaster sponsors a defined benefit pension plan. The university estimated it had an unfunded pension liability of C$158.1 million at April 30, 2008, up from an estimated liability of C$98.8 million in the previous fiscal year. Weak investment returns, an upward revision to the assumed rate of compensation increases, offset by an increase in the discount rate, contributed to the funded pension deterioration.

Like most organizations with large investment funds, McMaster was not immune from 2008's global stock market decline. Its salaried pension plan investments posted a return of negative 17% in calendar 2008, in sharp contrast with previous annual investment returns of about 2%-13%. Accordingly, the university's estimated pension fund deficiency weakened substantially in 2008.

Nevertheless, McMaster is considering filing its next actuarial valuation report in June. This would capture its pension plan status as at July 1, 2008--before last year's global stock market decline. The valuation will in turn determine the university's special pension deficit payments from fiscals 2010-2012. As a result, we do not expect the stock market's impact on pension assets to factor into the university's special pension deficit amortization payments until 2013, at which time market conditions could be materially different. McMaster estimates its special pension deficit amortization payment will be C$9 million in fiscal 2010, compared with C$8 million in fiscal 2009.

Balance Sheet Has Weakened, But Remains Solid

In our opinion, McMaster's combination of large investment holdings and low debt has been a key attribute supporting its ratings. At fiscal 2008 year-end, its unrestricted financial resources (internally restricted endowments plus internally restricted net assets) as a share of debt was 122%, which is high relative to most rated Canadian universities. However, we have observed some erosion in the university's balance sheet strength since fiscal 2007. Its decision to use its internal endowment to fund certain operational costs helped fuel this. We also think the university's negative investment returns in 2008 accelerated the trend in fiscal 2009.

Underpinning McMaster's strong balance sheet is a large endowment fund, which had a market value of C$490 million at fiscal 2008 year-end, down 1.7% from the previous fiscal year. The university's weak investment performance fueled the decline. So too did its decision to fund a C$7 million faculty retirement incentive plan, an C$8 million special pension deficit payment, along with its standard C$5 million spending allocation to the operating fund from its internal endowment. Nevertheless, we think the endowment compared fairly well with those of most other rated domestic peers, at C$20,827 per FTE in fiscal 2008.

We think difficult market conditions caused McMaster's endowment to fall significantly in fiscal 2009. For calendar 2008, the university's total long term investment pool's performance (which invests endowments, sinking funds, and other long term reserves) was negative 19%, in sharp contrast with annual returns of 3%-14% from calendar years 2005-2007. That said, we think this loss was broadly consistent with those of other rated Canadian universities. We also believe McMaster's decision to maintain its standard C$5 million spending allocation to the operating fund will place downward pressure on the endowment in fiscal 2009.

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 credit positive. 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 intuition's reputation while freeing up operating funds for other purposes. The university's total investment fund policy mix is 40% fixed income/real estate and 60% equity securities, which is similar to that of its domestic peer group.

Debt Burden Remains Stable, Although DSCR Weakens

We think McMaster has displayed prudent and cautious debt management practices, resulting in a debt burden that fits very well among those of 'AA' rated Canadian universities. It has steadily reduced its debt stock ever since going to market with its one and only debenture issue in September 2002. It managed this by internally financing capital expenditures 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).

McMaster had C$155.3 million in debt at fiscal 2008 year-end, down 0.6% from fiscal 2007 due to amortization of bank debt. Its debt consisted of C$120 million bullet debentures maturing in 2052, C$22.8 million in bank loans,

and C$12.6 million in mortgage debt. All debt is unsecured. Our measure of debt omits the university's voluntary internally-restricted sinking funds for the debentures and a residence mortgage of C$10.4 million and C$4.8 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 banks loans for fixed-rated interest payment obligations. At fiscal 2008 year-end, the fair market value of the university's swap contracts was negative C$4.4 million. The contracts have expirations dates matching those of the underlying bank loans.

McMaster's debt burden represented C$6,601 per FTE, or 22.5% of adjusted revenues in fiscal 2008. These are fairly low relative to those of its similarly-rated domestic peers. However, the university's weak consolidated operating performance resulted in a thin DSCR of 1.83x in fiscal 2008. We also believe its DSCR stayed relatively thin in fiscal 2009, given its tight budget position. What's more, its negative investment returns and internal funding of certain operating costs and capital expenditures probably eroded its unrestricted financial resources-to-total debt ratio in fiscal 2009.

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 at the moment. As a result, we expect its debt-per-FTE ratio to trend downward, save for a new C$16 million recourse debt obligation related to MIP in fiscal 2009.

Fundraising Remains On Track

As of October 2008, McMaster had raised C$327 million in the third year of its four-year C$400 million campaign ending in 2010. These fundraising efforts should help the university mitigate the downward pressure that challenging investment markets have exerted on its endowment balance in recent years.

Table 2

McMaster University --Peer Comparison

	--McMaster University--		--University of Western Ontario--		--Queen's University--	
(C$000s)	**2008**	**2007**	**2008**	**2007**	**2008**	**2007**
Issuer credit rating	AA/Stable/--	AA/Stable/--	AA/Stable/--	AA/Stable/--	AA+/Stable/--	AA+/Stable/--
Applicants	40,617	40,849	30,373	28,118	30,657	30,168
Offers	22,931	23,881	17,641	17,752	12,846	12,095
Registrants	5,364	5,281	4,221	3,662	4,940	4,715
Acceptance rate (offers/applicants; %)	56	58	58	63	42	40
Yield (registrants/applicants; %)	13	13	14	13	16	16
FTEs	23,530	22,903	27,980	28,164	18,217	18,134
Total revenue	731,989	730,966	848,747	829,130	779,961	733,246
Deferred capital	41,047	38,268	28,332	24,601	21,978	22,367
Adjusted revenue	690,942	692,698	820,415	804,529	757,983	710,879
Total expenditure	745,508	707,304	844,913	762,251	779,261	694,802
Interest	11,144	11,145	13,129	7,728	5,168	5,287
Depreciation	63,846	62,430	58,914	53,139	44,505	43,713
Adjusted expenditure (For DSCR)	670,518	633,729	772,870	701,384	729,588	589,184
Consolidated surplus (%)	(1.8)	3.2	0.5	8.1	0.1	5.2

Table 2

McMaster University --Peer Comparison (cont.)						
Consolidated surplus (for calculating DSCR; %)	1.3	6.9	4.2	11.9	3.1	8.4
DSCR (interest only; x)	1.83	5.29	3.62	13.35	5.49	23.02
Total debt	155,329	156,265	233,114	126,181	93,719	93,981
Unfunded postemployment liabilities	361,197	322,141	208,172	188,170	95,855	50,017
Interest expense to adjusted revenue	1.6	1.6	1.6	1.0	0.7	0.7
Debt to FTE	6,601.3	6,822.9	8,331.5	4,480.2	5,144.7	5,182.6
Debt to adjusted revenue (%)	22.5	22.6	28.4	15.7	12.4	13.2
(Debt plus unfunded)/adjusted revenue (%)	74.8	69.1	53.8	39.1	25.0	20.3
Internally restricted net assets	55,790	81,056	104,205	139,021	192,742	188,452
Internally restricted endowments	133,166	154,823	16,803	17,579	190,096	198,094
Externally restricted endowments	356,900	343,700	308,505	291,437	379,313	352,620
Unrestricted financial resources	188,956	235,879	121,008	156,600	382,838	386,546
As % of total debt	121.6	150.9	51.9	124.1	408.5	411.3
As % of total debt plus unfunded postemployment liabilities	36.6	49.3	27.4	49.8	201.9	268.4
As a % of operating Expense	25.3	33.3	14.3	20.5	49.1	N.A.
Per FTE	8,030	10,299	4,325	10,972	21,016	21,316
Total endowment value per FTE (at market value)	20,827	21,766	32,650	32,437	34,298	35,818

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

Ratings Detail (As Of May 6, 2009)*	
McMaster University	
Issuer Credit Rating	AA/Stable/--
Senior Unsecured (1 Issue)	AA
Issuer Credit Ratings History	
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.