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McMaster University

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McMaster University

Rationale

Issuer Credit Rating
AA-/Stable/--

The ratings on McMaster University, in Hamilton, Ont., reflect its stand-alone credit profile (SACP), which Standard & Poor's Ratings Services assesses at 'aa-'. The ratings also reflect our opinion of a "moderately high" likelihood that the Ontario government would provide extraordinary support in the event of financial distress. The SACP on McMaster reflects Standard & Poor's view of the university's strong enterprise and financial profiles, owing to McMaster's good budgetary performance, rising financial assets, and low debt burden. In our opinion, the university's rising unfunded postemployment liabilities remain a credit concern, but we believe it is taking steps to mitigate this. The ratings also reflect our assessment of the tight operating environment in which Canadian universities and their supporting provincial governments operate.

In accordance with our criteria for government-related entities, our view of McMaster's moderately high likelihood of extraordinary government support reflects our assessment of its "important" role in the province, given that postsecondary education is one of Ontario's priorities in both expenditure and mandate (after health care and school boards), and that there are no viable private alternatives. It also reflects the province's oversight, program approval rights, and tuition regulation over the university, all of which suggest a "strong" link to it. We rate the university 'AA-' with a stable outlook in line with the 'aa-' SACP, which is equal to the rating on Ontario (AA-/Negative/A-1+), because the independence of the university's governing bodies, its considerable financial resources, and a track record of non-interference from the province convince us that there is a measurable likelihood that it would not default on its obligations under a provincial stress scenario in which all government funding was temporarily disrupted. McMaster's ability to mitigate a disruption in government funding is related to its low debt burden and high financial resources. Should debt rise to levels such that we believe it could default on its debt obligations under a provincial stress scenario, we could cap the ratings on the university with those on Ontario.

In our view, McMaster benefits from what we consider to be strong demand and a good research profile, due to its broad range of program offerings, high research intensity, and close proximity to the Greater Toronto Area. Its enrollment was 27,796 full-time equivalent students (FTEs) in fiscal 2014 (year ended April 30), exceeding fiscal 2013's enrollment by 1%. We believe student quality is good; the average entering grades are high, as are graduation rates.

McMaster's financial profile is strong, in our opinion. Management has been effective in controlling expenditures, resulting in what we view as good budgetary performance. The university has budgeted for deficits in its operating fund (the most significant fund) through 2015; however, it forecasts the consolidated results to have an accrual surplus. In addition, McMaster has taken steps to improve its unfunded postemployment benefits, including increasing the employee contribution rate for the pension plans and changes to other postemployment benefits. Moreover, the university is exploring options to improve revenue diversity, which include new programs and degrees, increased international students and better student retention.

McMaster's unrestricted financial resources are increasing and average among its peers, at $5,630 per FTE. They had been higher but declined as a result of the university's decision to internally finance loans for capital projects. Although internal financing of capital projects has kept debt at a relatively low level, it also limited McMaster's financial flexibility somewhat.

In our opinion, the university exhibits prudent debt management and benefits from a low debt burden. McMaster's debt was C$160.3 million, or C$5,824 per FTE, at fiscal 2013 year-end. It has steadily reduced its debt stock in every year but one since going to market with its first and only debenture issue in September 2002. The university has the lowest debt burden of its rated peers, although we believe it might issue debt to fund capital and strategic projects. In addition, it has established its own debt-monitoring policy to guide financial planning, internally financed capital projects, and created voluntary debt retirement funds for the debenture.

We believe McMaster's large unfunded postemployment benefits, which include two defined benefit pension plans, constrain the ratings. Although the university has taken steps to reduce these liabilities, the ongoing funding requirements put pressure on its budget. McMaster estimates its unfunded pension liability in its registered pension plans has increased to C$471.6 million, from C$281.6 million in 2012. Moreover, the total unfunded postretirement liability (which is primarily attributable to pensions and health benefits) was C$770.78 million in fiscal 2013, up considerably from C$570.7 million in 2012. The university will make special payments of C$20.8 million per year in fiscal years 2014 and 2015 for its pension liability and will continue to pay the other postemployment liabilities as they arise.

Liquidity

We believe McMaster exhibits limited liquidity under our criteria as it has unrestricted financial resources of 27.6% of operating fund expenses. However, it has cash and investments of 160% of operating fund expenses. The university has unrestricted financial resources of C$154.9 million, and cash and investments of C$897.3 million, compared to debt of C$120.0 million and total long-term liabilities of C$160.3 million. Unrestricted financial resources are 96.7% of long-term liabilities (including a guarantee outstanding).

Outlook

The stable outlook reflects our expectations that both McMaster's enterprise and financial profiles will remain strong and that it will continue to generate consolidated surpluses, maintain its unrestricted financial resources near current levels and not significantly increase debt. Furthermore, we assume Ontario will not significantly cut the university's funding without providing greater tuition-setting flexibility. Standard & Poor's could lower the ratings if these assumptions do not materialize, or if McMaster's debt rises significantly and if we downgrade the province. Conversely, we could raise the ratings if the university's unrestricted financial resources rise to their former levels and debt remains relatively low.

Government-Related Entity Methodology

In accordance with our criteria for government-related entities, our view of McMaster's moderately high likelihood of extraordinary government support reflects our assessment of its 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 there are no viable private alternatives. Our view also reflects the university's role as one of Canada's most reputable, and its significant research capacity. The province's oversight, program approval rights, and tuition regulation over McMaster suggests a "strong" link with the province, in our judgment. The government, although not a shareholder, has a policy and track record of providing financial support to Ontario universities. Government grants account for about half the university's consolidated revenues.

Our stand-alone rating on McMaster incorporates the province's ongoing financial support. It also incorporates the university's "important" public policy role; its independent board and overall strong governance structure; and its substantial endowment. Although Ontario is facing significant fiscal challenges as it attempts to rein in a C$14 billion deficit, we believe that postsecondary education will remain a top priority for the province and that overall support for the university sector will remain fairly stable.

Background

Founded in 1887, McMaster is a research-intense, doctoral university in Hamilton, the fifth-largest city in Ontario. McMaster is the fourth-largest of 20 public universities in the province and has regional campuses in Burlington, Waterloo, and St. Catharines, Ont. It draws students primarily from the province. The university celebrated its 125th anniversary in 2012.

Enterprise Profile

University demand and enrollment

We believe McMaster's strong research profile contributes to it enrollment growth and strong demand profile. It was ranked as one of Canada's top research universities (achieving sixth place in a 2013 Infosource Inc. report). Moreover, the university has garnered international attention, placing fifth in Canada and within the top 100 universities internationally in the Times Higher Education rankings.

McMaster has a broad range of program offerings and high research intensity. It has six faculties: engineering, humanities, sciences, business, health sciences, and social sciences. The university was the first choice for about 22% of applicants (in 2012). About 89% of first year (2011) undergraduates continued to their second year. 92% of students came from Ontario for the 2011-2012 school year. Its selectivity (offers divided by applicants) was 59% in the fall 2013, and its yield (registrants divided by applicants) was 15%. Average entering grades for McMaster are high, in our opinion, at 86.3%. Its four-year undergraduate graduation rate in 2012 was 51.4% (rising to 73% in 6 years). We expect enrollment demand and selectivity to remain strong.

The university's fall 2013 (fiscal 2014) FTE enrollment was 27,796 up about 1% from the previous year. In fiscal 2012 (the most recent data available), 89.3% of students (graduates and undergraduates) were from Ontario, while 3.2% came from the rest of Canada and 7.5% were international students. Although McMaster's historical enrollment growth has been good, we expect it could become limited owing to space constraints at the university.

Tenured and continuing appointment without annual review make up 68% of faculty, and 93% of faculty hold a doctoral degree.

Management

The McMaster University Act (1976) establishes a board of governors and senate. The president and senior administrative officers exert the central influence in university policy as well as providing the dominant force in management under the board's authority; however, board members play an important role in university governance. Also, the board is the legal owner of, and the final authority for, the institution's assets held in trust. The senate has ultimate responsibility for determining academic policy and regulating the system of education. In April 2013, Suzanne Labarge was named McMaster chancellor.

Financial Profile

McMaster, like all Ontario universities, is facing financial constraints owing to lower provincial funding levels; lower allowable tuition increases; and rising expenses, particularly in salaries and benefits. The university's management has undertaken many initiatives to address these constraints including the adoption of a new budget model, which have resulted in a return to budget surpluses and changes to pension benefits and postretirement benefits.

McMaster's management has implemented new financial models, policies, and IT tools. The university is adopting a new budget model for fiscal 2015. This model will be partially activity-based and will allocate revenues to the unit that through their activities generates that income. McMaster believes the model will contribute to greater transparency and facilitate long-term planning. The university also adopted a new debt policy in 2012. In 2013, it approved and began implementing a system renewal initiative that will support students, research human resources, finance, and business intelligence, as well as help the university to standardize and simplify its processes.

Management has been effective in controlling expenditures, resulting in what we view as good budgetary performance. A key initiative has been successful labor negotiations that led to lower employee costs through reducing salary increases and changes to pension benefits and postretirement benefits. We expect the budgetary improvement from changes to McMaster's post-retirement benefits to increase over time. Currently, employee costs represent 70% of operating costs. The university also limited increases to non-academic departmental budgets since 2009, requiring departments to absorb inflationary costs. We expect this will result in drawdowns from departmental reserves, causing unrestricted financial resources to decline.

Historically, McMaster has prepared separate budgets for its six funds, with the university's core operating budget being the most significant, at about 64% of its 2013 consolidated results (its other funds relate to ancillary, research, trust, endowments, and capital). McMaster is forecasting operating fund deficits of C$26.7 million and C$2.2 million in 2014 and 2015, respectively, before turning into a surplus of C$4.4 million in 2016.

The university posted a consolidated surplus of C$60.7 million or 6.5% or revenues in fiscal. It had budgeted for a consolidated surplus of C$4.6 million for fiscal 2014.

McMaster is exploring means to improve and diversify its revenues. The university plans to introduce and expand certain programs, increase tuition to the extent possible, increase international student recruitment and improving student retention. In 2013, McMaster's total revenue was C$938.8 million, up 6.6% from the previous year, while expenses rose to C$878.1 million (up less than 1%). Operating and research grants from the provincial and federal governments are the source of 44% of the university's revenues (C$416 million). Other important sources of revenues are tuition, at 21.5% of revenues (C$201.5 million); and ancillary sales and services, at 7.3% (C$68.1 million). Staff compensation and benefits are the largest expense, at C$558.4 million, or 63.6% of total expenses.

Deferred maintenance has been a challenge for McMaster. The university estimates its deferred maintenance was approximately C$335 million in 2013. Although it does receive funding from the province for maintenance, it is insufficient to cover all deferred maintenance costs. To address its maintenance needs, McMaster has allocated an additional C$2 million per year to its current budget for deferred maintenance projects.

The Ontario government recently announced a new tuition framework that caps yearly increases for undergraduate tuition fees at 3% (down from 5% under the previous framework), and caps the increases in graduate and professional fees to 5% (down from 8%). The new framework will be effective for four years starting in fiscal 2014. Consequently, the university has incorporated the framework into its budget assumptions.

Financial resources

McMaster's financial assets, which include its endowment funds and internally restricted assets, have increased in value in the past two years, but remain below both their historical high levels and the average level of their peers. The university's endowment funds stood at C$480.5 million in fiscal 2013, up 7.9% from the previous year, while its internally restricted financial assets were C$39.2 million, up almost 300%. Total unrestricted financial assets are C$155 million, or about 97% of debt outstanding, which is strong and consistent with that of peers.

To achieve economies of scale, McMaster pools its long term financial assets into one common investment pool. The investment pool generated strong returns in 2013 (year ended Dec. 31, 2013) of 17.2%, outperforming its benchmark by 2.5%. The university's payout policy for its endowed funds is an annual allocation of 4.0% of a five-year average of the endowment's market value (an additional 1% goes to administration). It also manages a pool of financial assets invested in short-term assets. This fund is primarily for working capital needs.

McMaster's fundraising efforts support the growth of financial assets. In 2013, the university surpassed its annual goal by raising C$22.8 million in new pledges and gifts and C$6.9 million in discounted future gifts.

Liquidity

We believe McMaster exhibits limited liquidity under our criteria because it has unrestricted financial resources of 27.6% of operating fund expenses. However, it has cash and investments of 160% of operating fund expenses. The university has unrestricted financial resources of $154.9 million, and cash and investments of C$897.3 million, compared to debt of C$120 million and total long-term liabilities of C$160.3 million. Unrestricted financial resources are 96.7% of long-term liabilities (including a guarantee outstanding).

Debt

In fiscal 2013, the university's debt totaled C$160.3 million and included C$138.4 million of long-term debt and a C$21.9 million loan guarantee. This represented C$5,824 per full-time equivalent and 18.7% of adjusted revenues

(Standard & Poor's-calculated). McMaster's debt service coverage ratio rose to 5.4x in fiscal 2013 up from 2.7x in 2012.

The university's long-term debt consists mainly of a C$120 million bullet debenture, with principal repayment in 2052. It also includes a bank loan and a mortgage, which totaled C$18.4 million. McMaster has also guaranteed the debt service obligations of its research park (The First Longwood Innovation Trust) up to C$23 million. The university has indicated that it may issue additional debt to fund capital and growth initiatives.

McMaster also has a long-term obligation, the decommissioning of a nuclear reactor, which was C$9.2 million. Trust funds of C$8.5 million have been accumulated to offset this obligation.

The university's practice of establishing offsetting sinking funds diminishes its debt burden somewhat, including one sinking fund set up to repay the bond issue outstanding (valued at C$11.9 million at fiscal year-end). Payments to the sinking funds are voluntary. Accordingly, we include the sinking funds in internally restricted net assets, but do not consider them in our calculation of its debt burden.

McMaster maintains two defined benefit pension plans, which are in deficit and require ongoing deficit payments putting some pressure on the university's cash flows. In fiscal 2013, McMaster's pension assets continued to increase; however, a large unfunded liability remains. Although the fair value of plan assets rose to C$1.36 billion from C$1.20 billion in 2012, the university estimated that its unfunded pension liability in its registered pension plans has grown to C$471.6 million, from C$281.6 million in 2012. Moreover, McMaster's total unfunded postretirement liability (which is primarily attributable to pensions and health benefits) stands at C$770.8 million in fiscal 2013, up considerably from C$570.7 million in 2012, and is one of the highest among its rated peers.

The university will make special going-concern payments of C$20.8 million per year in fiscal years 2014 and 2015 for its pension liability; this rises to C$37.8 million in fiscal 2016. In addition, it makes annual service payments to the pension fund. It will continue to pay the other postemployment liabilities (in respect of the supplemental plans and health and dental benefits) as they arise.

McMaster also has a pension solvency deficit that will require it to make special solvency payments. The amount and timing of these solvency payments will depend on the most recent estimate of the solvency deficit and if the university receives stage 2 solvency relief. McMaster filed a pension plan valuation for hourly rate workers in July 2013 and will file the next valuation for salaried employees (the larger plan) in July 2014. The university could be required to make solvency payments as soon as fiscal 2015, although it has filed for stage 2 solvency relief. Under stage 2 relief the solvency payment exemption would last for an additional three years, after which the solvency deficit would be amortized over seven years. We expect greater clarity concerning the amount and timing of the pension deficit payments after McMaster files its valuation for July 2014. At that time, the university will be required to submit a plan for funding its deficits.

Contingent liabilities

McMaster has also guaranteed the debt service obligations of its research park (The First Longwood Innovation Trust) up to C$23 million, which we include in our calculation of debt. Other contingent liabilities are minor, in our opinion, and include an insurance exchange, legal claims, and leases.

McMaster University -- Peer Comparison

	--McMaster University--		--York University--		--University of Western Ontario--		--Queen's University--	
	2013	2012 (restated)	2013	2012	2013	2012	2013	2012
Rating at year-end	AA-/Stable/--	AA-/Stable/--	AA-/Stable/--	AA-/Stable/--	AA/Stable/--	AA/Stable/--	AA+/Stable/--	AA+/Stable/--
Enrollment and demand								
Headcount	29,765	29,411	54,590	54,507	38,454	38,038	24,042	24,343
Full-time equivalent (FTE) students	27,518	27,042	48,967	48,323	31,018	30,679	21,904	21,713
Acceptance rate (offers to applications; %)	58.7	61.7	83.0	76.4	51.0	54.2	41.1	40.5
Matriculation rate (registrants to offers; %)	26.1	27.6	20.1	20.4	21.9	22.1	42.6	45.1
Undergraduate FTEs as % of total FTEs (%)	86.8	86.8	78.2	78.3	81.3	81.3	82.3	82.6
Income statement								
Adjusted operating revenues (C$000s)	938,829	880,532	983,060	956,883	1,049,744	1,030,914	782,858	762,227
Adjusted operating expenses (C$000s)	867,502	860,650	984,090	944,919	987,065	955,810	776,298	761,692
Adjusted operating balance (% of adjusted operating expenses)	8.2	2.3	-0.1	1.3	6.4	7.9	0.8	0.1
Adjusted operating balance before depreciation and amortization (C$000s)	98,865	47,041	28,693	41,264	100,953	111,814	37,070	32,740
Tuition and student fee dependence (% of adjusted operating revenue)	21.5	20.9	46.1	45.3	29.4	27.9	29.8	28.1
Debt								
Debt outstanding (C$000s)	160,271	161,300	305,881	306,511	316,185	216,319	221,074	227,266

McMaster University -- Peer Comparison (cont.)								
Current debt service burden (% of adjusted operating expenses)	1.1	1.1	2.0	2.1	2.4	1.5	2.4	2.5
Current adjusted debt service coverage (x)	11.7	5.7	2.4	3.0	4.9	8.7	2.6	2.4
Financial resource ratios								
Endowment market value (C$000s)	480,472	445,368	372,321	331,127	431,853	371,732	710,251	616,797
Endowment per FTE (C$)	17,460	16,469	7,604	6,852	13,923	12,117	32,426	28,407
Cash and investments ($000s)	897,273	857,464	677,589	611,081	1,074,178	694,573	977,887	880,893
Cash and investments to adjusted operating expenses (%)	103.4	99.6	68.9	64.7	108.8	93.1	126.0	115.6
Cash and investments to debt (%)	559.8	532.6	221.5	199.4	339.7	411.3	442.3	387.6
Adjusted unrestricted financial resources (UFR; C$000s)*	154,926	122,993	133,016	145,892	391,981	292,715	371,580	331,177
Adjusted UFR to adjusted operating expenses (%)	17.9	14.3	13.5	15.4	39.7	30.6	47.9	43.5
Adjusted UFR to debt (%)	96.7	76.3	43.5	47.6	124.0	135.3	168.1	145.7
Unfunded liabilities to total liabilities (%)	59.9	45.3	25.9	29.9	24.4	25.7	17.0	20.7

*Adjusted UFR equals adjusted internally restricted net assets plus internally restricted endowments.

Related Criteria And Research

Related Criteria

- Principles Of Credit Ratings, Feb. 16, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- USPF Criteria: Higher Education, June 19, 2007

Ratings Detail (As Of May 23, 2014)	
McMaster University	
Issuer Credit Rating	AA-/Stable/--
Senior Unsecured	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.