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Research Update:

McMaster University 'AA' Ratings Affirmed; Outlook Stable

Primary Credit Analyst:
Nineta Zetea, Toronto (416) 507-2508; nineta.zetea@spglobal.com

Secondary Contact:
Adam J Gillespie, Toronto (1) 416-507-2565; adam.gillespie@spglobal.com

Research Contributor:
Pooja Hingorani, CRISIL Global Analytical Center, an S&P affiliate, Mumbai

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Overview

- We are affirming our 'AA' long-term issuer credit and senior unsecured debt ratings on McMaster University.
- The ratings reflect our assessment of the university's stand-alone credit profile, which reflects our combined assessment of McMaster's very strong enterprise and financial profiles.
- The stable outlook reflects our expectations that, within our two-year outlook horizon, the university will maintain a robust market position and demand, excellent levels of unrestricted financial resources, and a manageable debt burden; and the likelihood of extraordinary government support will not change.

Rating Action

On May 26, 2017, S&P Global Ratings affirmed its 'AA' long-term issuer credit and senior unsecured debt ratings on McMaster University, in Hamilton, Ont. The outlook is stable.

Rationale

The ratings on McMaster reflect the university's stand-alone credit profile (SACP), which S&P Global Ratings assesses at 'aa' based on the university's very strong enterprise and financial profiles. 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. McMaster's strong financial resilience and independence allow the ratings on the university to exceed those on the Province of Ontario under our government-related entities (GRE) criteria.

Founded in 1887, McMaster is a research-intense, medical-doctoral university, dedicated to teaching, research, and service. Its main campus (95% of student population) is in Hamilton, the fifth-largest city in Ontario. The university offers a variety of undergraduate and graduate degrees across its six faculties (engineering, humanities, sciences, business, health sciences, and social sciences). McMaster also has four small, regional campuses in Hamilton, Burlington, Waterloo, and St. Catharines, Ont. The university is a member of the U15, a group of leading research-intensive universities in Canada. In fiscal 2016, it received C$196.7 million in research-related grants and contracts, which have been slowly increasing in the past several years.

We assessed McMaster's enterprise profile as very strong. Supporting our opinion is our view of the higher education sector's low industry risk, characterized by counter cyclicality and low competitive risk and growth. In addition, with 92.1% of its students coming from Ontario, the university benefits from excellent economic fundamentals, measured by the province's GDP per capita of US$48,200 in 2015, its good income indicators, and moderate employment and population growth projections.

McMaster's robust market position and stable student demand and enrollment also strengthen its enterprise profile. The university's full-time equivalent students (FTEs) totaled 29,130 in fall 2016, or 4.5% above the previous year's level. Except for fall 2015, McMaster's enrollment increased steadily over the past 10 years, supported by both graduate and undergraduate enrollment. In our opinion, student quality metrics continue to be strong and compare well with those of similarly rated Canadian peers. This is primarily reflected in McMaster's historically high retention and average entry grade rates of 90.9% and 87.6%, respectively. The university's selectivity rate (offers-to-applicants) was 56.4% in fall 2016, while the six-year graduation rate, at 77.5%, remained close to its historical levels. In our opinion, the university benefits from robust fundraising capabilities, and has exceeded its official campaign and annual fundraising targets in past years.

Management expertise and governance practices, as well as financial management policies, are strong in our view. McMaster has a strategic plan, updated every three-to-five years, that guides its long-term strategies based on its mission. Management reviews plan performance annually, tracks progress against specific activity indicators, and monitors identified risks. The university has an enterprise risk framework that guides its identification and management of risks. Overall, we view McMaster's transparency and disclosure to be good, with policies and procedures in place to adequately mitigate risks. The university conducts its activities according to a three-year operating budget that is aligned with its strategic plan and contains what we view as reasonable assumptions. McMaster prepares externally audited financial statements, which have been unqualified, and it has formal policies in place, including investment and debt policies.

In our opinion, the university has a very strong financial profile, with a history of robust financial performance, excellent levels of available resources, and a moderate debt burden.

McMaster expects to achieve an operating surplus in fiscal 2017, versus a C$17.9 million budgeted deficit, primarily as result of higher-than-expected tuition income. Although the university does not prepare consolidated forecasts, we expect that, including ancillary operations (which tend to generate positive cash flow), it will maintain consolidated surpluses in the near term. McMaster's adjusted operating margin was 3.8% in fiscal 2016, which was below the previous years' levels due to exceptionally weak investment income.

Similar to that of Canadian peers, the university's limited flexibility to increase its student-generated revenues, somewhat offsets its financial performance strength. This is primarily because Ontario monitors and guides tuition rates and student aid (through the tuition framework), and enrollment expansion (through operating grants). However, universities decide these matters and their long-term strategies.

Although McMaster is contemplating different financing strategies for its capital projects that could include new debt, it currently has no approved plan to issue more debt in the next year. As of fiscal 2016, McMaster's debt outstanding was C$279.2 million. It includes two fixed-rate bullet bonds (representing 86% of total debt), an amortizing bank loan, a small mortgage, and guaranteed debt of C$22.7 million on behalf of the First Longwood Innovation Trust. As of March 31, 2016, the university held C$24.4 million in sinking funds to repay its two bullet debentures outstanding, which we include in our measure of internally restricted net assets. It also has a long-term obligation for a nuclear reactor decommissioning, which equaled C$12 million in fiscal 2016. Trust funds of C$10.87 million have been accumulated to offset this obligation. McMaster's estimated pro forma maximum annual debt burden represented 2.4% of its adjusted fiscal 2016 expenses. We view this as a moderate debt burden for the current rating especially in light of the healthy level of available resources at the end of fiscal 2016, at 160.2% of total pro forma debt.

We believe that postemployment liabilities continue to offset McMaster's financial profile strengths, despite the steps both the province and university have taken to address the solvency deficit. McMaster's two defined benefits plans had a going-concern salaried pension plan deficit of about C$253 million, while solvency deficit totaled C$197 million as of the most recent actuarial valuation (July 1, 2014). The university qualified for temporary solvency funding relief program, under which it has elected to defer solvency deficit payments for another three years, until fiscal 2019. In the meantime, it will continue to make going-concern deficit special payments of C$30.4 million in fiscal 2017 and slightly higher thereafter. McMaster estimates that its initiatives to manage its pension deficit, including increased employee and employer contributions, will allow it to cover rising special going-concern and solvency pension deficit payments in the upcoming years.

Liquidity

We believe McMaster benefits from an exceptional liquidity. At fiscal year-end 2016, consolidated cash and investments totaled C$1.2 billion, or 4.4x total debt. Unrestricted financial resources available for debt service stood at C$447.4 million, significantly above the previous year's level of C$322.1 million due to an increase in the central reserve related to the new borrowing earmarked for new capital projects. This equaled 47.6% of adjusted operating expenses, and covered 160% of debt. We expect these ratios to decrease in the near term, as the university will draw on these resources to fund its capital projects. However, we believe they will remain fairly strong and in line with historical levels in the next two years.

McMaster's endowment had a fair value of C$541 million at April 30, 2016, down 6% from the previous year, primarily due to weak investment returns. The university has a conservative endowment draw, in our view, with a long-term payout target rate of about 4% of the endowment's market value. In fiscal 2016, the endowment paid out was C$18.7 million or 7.4% more than the previous year's spending.

Moderately high likelihood of extraordinary provincial government support

In accordance with our criteria for GREs, our view of the university'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, which suggests a strong link to it. Also supporting this view is that the province provides substantial operating grants, which account for 27% of the university's total revenue, and it appoints six of 37 board of governors members.

We believe that the province's overall financial support to universities will remain relatively stable in the near term, given the postsecondary education sector's vital public policy role. The Ontario government has made strides in reducing its annual deficit and budgets to return to balance in 2017-2018. Under the new grant funding formula, the provincial government is shifting focus toward measurable student outcomes and away from a more enrolment-based formula. It has committed to maintaining the 2016-2017 funding level for all universities stable until 2019-2020. Moreover, in December 2016, the province announced it would extend its tuition framework for the next two years, maintaining the annual increases capped to an average of 3% for undergraduate programs and 5% for professional and graduate programs.

We rate McMaster two notches above Ontario. The maximum differential allowed is three notches, in accordance with our methodology for rating GREs that we believe depend on ongoing government support. The difference reflects our view of the university's substantial financial assets. We believe there is a measureable likelihood that McMaster's financial resources would meet ongoing operational and debt service requirements should the government default and temporarily suspend payments to the university. In addition, the difference reflects McMaster's ownership structure, in which the government is neither an owner nor shareholder. We consider the risk of extraordinary negative government intervention to be low, given the university's operational independence, important public policy role, and the government's hands-off approach to the sector.

Outlook

The stable outlook reflects our expectations that, within our two-year outlook horizon, McMaster will maintain a robust market position and demand, excellent levels of unrestricted financial resources, and a manageable debt burden. We expect its cash and investments to stay over 3x total debt; and that provincial support to the university will not decline beyond our current estimates. The outlook also reflects our expectation that McMaster's relationship with the province will be stable.

Downside scenario

We could revise the outlook to negative or lower the ratings if the ratio of cash and investments to debt were to decrease below 3x. All else equal, a negative rating action on Ontario is unlikely to result in a similar rating action on McMaster. However, a negative government intervention from the province, or a significant reduction in McMaster's resilience to an Ontario default scenario as our GRE criteria specify could cause us to lower the ratings, potentially to on par with or below those on Ontario, depending on the severity.

Upside scenario

Conversely, a significantly improved enterprise profile, with a selectivity ratio below 50% and increased geographic diversification of the student body, with out-of-province students accounting for more than 30% of total FTEs, could result in a positive revision to the outlook or the ratings.

McMaster University -- Financial Statistics

	--Fiscal year ended April 30--					Medians for 'AA' U.S. public colleges & universities, 2015**
	2017	**2016**	**2015**	**2014**	**2013**	
Enrollment and demand						
Headcount	31,746	30,283	30,509	30,113	29,735	MNR
Full-time equivalent	29,130	27,884	28,157	27,796	27,518	32,632
First year acceptance rate (%)	56.4	55.4	58.6	59.3	58.9	71.7
First year matriculation rate (%)	28.6	25.8	26.0	26.1	26.2	MNR
Undergraduates as a % of total enrollment (%)	85.5	85.6	85.4	85.5	85.4	77.7
First year retention (%)	90.9	90.3	89.9	90.3	88.7	85.5
Graduation rates (six years) (%)*	77.5	78.9	76.9	77.4	78.4	MNR
Income statement						
Adjusted operating revenue (C$000s)	N.A.	976,271	974,088	949,026	938,829	MNR

McMaster University -- Financial Statistics (cont.)						
		--Fiscal year ended April 30--				Medians for 'AA' U.S. public colleges & universities, 2015**
	2017	2016	2015	2014	2013	
Adjusted operating expense (C$000s)	N.A.	940,622	906,700	884,932	867,502	MNR
Net adjusted operating income (C$000s)	N.A.	35,649	67,388	64,094	71,327	MNR
Net adjusted operating margin (%)	N.A.	3.79	7.4	7.2	8.2	2.1
Provincial grants to revenue (%)§	N.A.	27.1	27.2	28.2	27.6	21
Student dependence (%)	N.A.	28.2	26.9	26.1	24.0	42.4
Investment income dependence (%)	N.A.	1.3	5.8	6.7	5.0	0.8
Debt						
Debt outstanding (C$000s)	N.A.	279,220	159,275	159,092	160,271	646,050
Pro-forma debt	N.A.	279,220	278,620	159,092	160,271	MNR
Current debt service burden (%)	N.A.	1.12	1.01	1.03	1.11	MNR
Current MADS burden (%)	N.A.	2.43	1.45	1.49	1.57	3.70
Pro-forms MADS burden (%)	N.A.	2.43	2.43	1.49	1.57	MNR
Financial resource ratios						
Endowment market value (C$000s)	N.A.	541,053	575,033	533,412	480,472	642,929
Cash and investments (C$000s)	N.A.	1,237,853	1,129,633	1,016,536	897,273	612,539
Adjusted UFR (C$000s)	N.A.	447,416	322,091	291,795	246,584	MNR
Cash and investments to operations (%)	N.A.	131.6	124.6	114.9	103.4	51.7
Cash and investments to debt (%)	N.A.	443.3	709.2	639.0	559.8	162.6
Cash and investments to pro-forma debt (%)	N.A.	443.3	405.4	639.0	559.8	MNR
Adjusted UFR to operations (%)	N.A.	47.6	35.5	33.0	28.4	30.3
Adjusted UFR to debt (%)	N.A.	160.2	202.2	183.4	153.9	86.7
Adjusted UFR to pro-forma debt (%)	N.A.	160.2	115.6	183.4	153.9	MNR
Average age of plant (years)	N.A.	11.7	13.9	13.8	13.7	12.4
OPEB liability to total liabilities (%)	N.A.	13.1	16.1	14.7	16.8	MNR

*Median figure is five-year graduation rate. §Median figure is state appropriations to revenue. **U.S. median figures are in U.S. dollars. N.A.--Not available. MNR--Median not reported. MADS--Maximum annual debt service. UFR--Unrestricted financial resources. Average age of plant = accumulated depreciation/depreciation and amortization expense.

Related Criteria

- General Criteria: Methodology: Not-For-Profit Public And Private Colleges And Universities, Jan. 6, 2016

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- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- 2017 Outlook For Not-For-Profit Public Universities In Australia, Canada, Mexico, And The U.K.: A Stable Trend For All, Despite Funding Concerns, Jan. 17, 2017
- U.S. Public College And University Fiscal 2015 Median Ratios: Sector Adjusting To The 'New Normal' As Industry Pressure Remains, July 11, 2016

Ratings List

Ratings Affirmed

McMaster University	
Issuer Credit Rating	AA/Stable/--
Senior Unsecured	AA

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.