S&P Global
Ratings

RatingsDirect®

Research Update:

McMaster University 'AA' Ratings Affirmed; Outlook Is Stable

May 16, 2019

PRIMARY CREDIT ANALYST

Omar A De la Torre Ponce De Leon
Mexico City
(52) 55-5081-2870
omar.delatorre
@spglobal.com

SECONDARY CONTACT

Nineta Zetea
Toronto
+ 1 (416) 507 2508
nineta.zetea
@spglobal.com

Overview

- In our view, McMaster University's commitment to disciplined financial policies, coupled with a history of solid financial performance, should enable the university to maintain robust unrestricted financial reserves in the next two years.
- We do not anticipate the province's change to the tuition framework will affect our assessment of McMaster's financial profile, as we expect the university will undertake effective policies to mitigate the impact.
- We are affirming our 'AA' long-term issuer credit and senior unsecured debt ratings on McMaster.
- The stable outlook reflects our expectation that, in the next two years, the university will maintain a very strong market position and student demand profile, a manageable debt burden, and robust levels of unrestricted financial resources.

Rating Action

On May 16, 2019, 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.

Outlook

The stable outlook reflects our expectations that, within our two-year outlook horizon, McMaster's cash and investments will remain 3x greater than its debt, consolidated operating margins will remain positive, and the university will maintain a healthy enrollment and demand profile. The ratings also reflect our expectation that McMaster's relationship with the Province of Ontario will be stable and that our assessment of the likelihood of extraordinary support will remain moderately high.

Downside scenario

We could take a negative rating action if, in the next two years, adjusted net margins unexpectedly declined to near-balance or sustained deficit on average, available resources erode to less than 25% of adjusted expenditures, or cash and investments were less than 3x debt outstanding. All else being equal, a negative rating action on Ontario of up to one notch is unlikely to result in a similar rating action on McMaster. However, negative government intervention or a significant reduction in the university's resilience to an Ontario default scenario could cause us to lower the ratings.

Upside scenario

We could take a positive rating action if our assessment of the enterprise profile improves following a selectivity ratio consistently below 50% and increased geographic diversification of the student body, with out-of-province students accounting for more than 30% of total full-time equivalent (FTE) students in the next two years, which could enhance the university's enrolment flexibility and contribute to more diversified revenue sources.

Rationale

The ratings reflect the university's stand-alone credit profile, which S&P Global Ratings assesses at 'aa' based on McMaster'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 legal and operating 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 the 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. It ranked 77th in the 2019 Times Higher Education list of the top universities globally and placed No. 2 worldwide in the Times Higher Education Impact Ranking.

The enterprise profile assessment reflects our view of the higher education sector's low industry risk, characterized by counter cyclicality and low competitive risk and growth. In addition, with 86.2% of its students coming from Ontario, the university benefits from the province's excellent economic fundamentals. We measure the latter with the province's GDP per capita, which we estimate to be about US$45,000 in 2019; good income indicators; and moderate employment and population growth projections. In addition, McMaster's robust market position and stable student demand and enrollment strengthen the university's enterprise profile. In fall 2018, FTEs totaled 31,082, or 4% above the previous year's level. The university intends to focus on attracting more international students, with a target enrollment of 20% over the next three-to-five years, up from the current 15%. In our opinion, student quality metrics continue to be strong and compare well with those of similarly rated Canadian peers. These are primarily reflected in McMaster's historically high retention and average entry grade rates of 91.6% and 88.2%, respectively. For fall 2018, the university's first-year acceptance rate (offers-to-applicants) continued to decline and was 51.2%, down from 58.6% in 2015, while the six-year graduation rate, at 80.1%, was slightly higher than historical levels. McMaster benefits from an exceptional faculty quality, with substantially all faculty members having PhDs or equivalent degrees. In our opinion, the university has demonstrated effective fundraising capacity in the past few years.

In our view, the management team's expertise and governance practices, and financial management policies, are strong and have demonstrated consistent operational effectiveness. McMaster has a Strategic Mandate Agreement, updated every three 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 as good, with policies and procedures that 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 and unqualified annual financial statements, and has formal policies, including investment and debt policies.

We expect McMaster's financial profile will remain very strong in the next two years. The university expects to achieve a operating surplus of about C$2 million in fiscal 2019, versus a C$3.7 million budgeted surplus, mainly due to lower-than-budgeted tuition revenues. 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 balanced results in the near term. McMaster's adjusted operating margin (S&P Global Ratings-calculated) was 10.1% in fiscal 2018, which was higher the previous year's level, fueled by higher-than-expected student enrollment and efforts to constrain spending.

Similar to that of Canadian peers, McMaster'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.

In our view, McMaster has a very moderate debt burden backed by its good operating performance and healthy level of available resources at fiscal year-end 2018, at 202% of total debt. As of fiscal 2018, McMaster had C$276.3 million in debt. This includes two fixed-rate bullet bonds totaling C$240 million due in 2052 and 2065, C$15.3 million in amortizing bank loans, and guaranteed debt of C$21 million on behalf of the First Longwood Innovation Trust. As of April 30, 2018, the university held C$29.9 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$13.1 million in fiscal 2018. Management has accumulated trust funds of C$13.3 million to offset this obligation. McMaster's estimated maximum annual debt burden represented 2.2% of its adjusted fiscal 2018 expenses. Although the university is contemplating financing strategies for its capital projects that could include new debt, it has not yet approved a plan to issue more debt in the next year, although a C$75million issuance is tentative for 2020-2021.

We believe McMaster has some exposure to contingent liabilities, but also believe that these will not likely lead to new financial obligations. The contingent liabilities we have identified are two new public-private partnerships (P3). The first approved P3 project is McMaster's Main Street Student Residence, with an estimated construction cost of C$198.6 million that a limited partnership will finance. The project will be in two phases with the first phase scheduled for completion by 2020-2021. The second P3, with the partner's contract awarded in 2019, is a downtown graduate student residence and parking garage, scheduled for completion by

2022-2023. We believe that these projects are structured such that there is no recourse to the university, but represent an economic interest for McMaster given the facilities' location in the university's main campus, where they will serve an important role in students' lives. Therefore, we believe that if the projects were to experience significant stress, McMaster might be compelled to provide more direct oversight or support. Based on McMaster's public disclosures, we do not believe the university has any additional contingent liabilities that could materially affect our view of its credit profile.

We believe that postemployment liabilities continue to offset McMaster's financial profile strengths, despite the steps the province and university have taken to address the solvency deficit. The university conducted an actuarial valuation in July 2018 to apply new pension provisions early rather than waiting for the regularly scheduled three-year valuation. McMaster's defined-benefit salaried pension plans had a going-concern excess before provision for adverse deviation of about C$91.9 million and funding deficit after provision for adverse deviation of about C$142.9 million, while the solvency deficit totaled C$197.2 million as of the most recent actuarial valuation (July 1, 2018), which positively contrast with July 1, 2017 actuarial valuation's deficits of C$30.8 million and C$342 million, respectively. McMaster believes its initiatives to manage its pension deficit, including increased employee and employer contributions, will allow it to cover rising special solvency pension deficit payments.

Liquidity

The university's liquidity is very robust, in our view. At fiscal year-end 2018, McMaster had C$1.5 billion in total cash and investments, equal to 2.6x available resources, 146% of adjusted operating expenses, and about 5.3x its debt outstanding. Unrestricted financial resources available for debt service totaled C$558.4 million, or 55% of adjusted operating expenditures and 202% of debt. These levels were slightly higher than those of the last two years. We believe that available resources could decline somewhat in the next two years because McMaster will draw on these to fund its capital projects. However, we believe that available resources will remain more than sufficient to finance all debt service requirements and sufficiently buffer any likely medium-term stress scenario. In addition, the total market value of McMaster's endowment increased to C$727 million (of which C$629 million was held in the investment pool and C$98 million was in deferred contributions) from C$705 million at fiscal year-end 2017. The university has a conservative endowment draw, in our view, with a long-term payout target rate of 4% of the endowment's market value.

Moderately high likelihood of extraordinary provincial government support

In accordance with our criteria for GREs, 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. Our view also reflects the province's oversight, program approval rights, and tuition regulation over McMaster, which suggests a strong link to it. Also supporting our assessment of the link are the large operating grants received from the province, accounting for about 27% of the university's total revenue, and the province's appointment of six of 37 board of governors members.

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 differential 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 differential reflects McMaster's ownership structure, in which the government is neither an owner nor shareholder. We consider the risk of extraordinary negative government intervention low, given the university's operational independence, its important public policy role, and the government's hands-off approach to the sector.

Ontario elected a new provincial government in June 2018. In January 2019, the government announced changes to university funding, which included a plan to cut domestic tuition fees by 10% for the 2019-2020 fiscal year, a freeze in tuition rates for the following fiscal year, and changes to its student assistance program and some student fees. Furthermore, the province has stated that there will be no additional grant revenue to offset the tuition cut. The university must comply or risk losing some of its core operating grants from the province. We believe that McMaster will avoid consolidated deficits, and will mitigate the loss in tuition revenue through increases in international enrollment and appropriate budgetary adjustments. Although the requirement to cut tuition fees was unexpected, it does not change our assessment of the government's likelihood of support based on McMaster's strong link to and important role in the province.

McMaster University -- Selected Indicators

		--Fiscal year ended April 30--				
	2019 demand data	2018	2017	2016	2015	Medians for 'AA' rated public colleges & universities, 2017**
Enrollment and demand						
Headcount	33,147	32,404	31,746	30,283	30,509	MNR
Full-time equivalent	31,082	29,758	29,130	27,884	28,157	34,653
First year acceptance rate (%)	51.2	52.6	56.4	55.4	58.6	66.0
First year matriculation rate (%)	26.7	27.6	28.6	25.8	26.0	MNR
Undergraduates as a % of total enrollment (%)	85.3	85.6	85.5	85.6	85.4	79.2
First year retention (%)	91.6	91.0	90.9	90.3	89.9	86.0
Graduation rates* (six years) (%)	80.1	79.0	77.5	78.9	76.9	MNR
Income statement						
Adjusted operating revenue (C$000s)		1,108,035	1,013,520	976,271	974,088	MNR
Adjusted operating expense (C$000s)		1,006,377	973,384	940,622	906,700	MNR
Net adjusted operating income (C$000s)		101,658	40,136	35,649	67,388	MNR
Net adjusted operating margin (%)		10.10	4.12	3.79	7.43	1.22
Provincial grants to revenue§ (%)		24.7	26.7	27.1	27.2	19.5
Student dependence (%)		30.8	30.2	28.2	26.9	42.4

McMaster University -- Selected Indicators (cont.)

	2019 demand data	--Fiscal year ended April 30-- 2018	2017	2016	2015	Medians for 'AA' rated public colleges & universities, 2017**
Investment income dependence (%)		4.7	9.7	1.3	5.8	1.4
Debt						
Debt outstanding (C$000s)		276,312	277,798	279,220	159,275	798,089
Pro forma debt		276,312	277,798	279,220	278,620	MNR
Current debt service burden (%)		1.38	1.44	1.22	1.01	MNR
Current MADS burden (%)		2.20	2.27	2.43	1.45	3.51
Pro forma MADS burden (%)		2.20	2.27	2.43	2.43	MNR
Financial resource ratios						
Endowment market value† (C$000s)		629,112	610,300	541,053	575,033	858,805
Cash and investments (C$000s)		1,465,139	1,402,421	1,237,853	1,129,633	NMR
Adjusted UFR (C$000s)		558,397	528,885	447,416	322,091	MNR
Cash and investments to operations (%)		145.6	144.1	131.6	124.6	58.2
Cash and investments to debt (%)		530.2	504.8	443.3	709.2	167.8
Cash and investments to pro forma debt (%)		530.2	504.8	443.3	405.4	MNR
Adjusted UFR to operations (%)		55.5	54.3	47.6	35.5	34.4
Adjusted UFR to debt (%)		202.1	190.4	160.2	202.2	89.7
Adjusted UFR to pro forma debt (%)		202.1	190.4	160.2	115.6	MNR
Average age of plant (years)		14.8	14.8	11.7	13.9	13.1
OPEB liability to total liabilities (%)		16.2	14.8	13.0	16.1	NMR

*Median figure is five-year graduation rate. §Median figure is state appropriations to revenue. **U.S. median figures are in U.S. dollars. †Endowments held in the university's investment pool. Including deferred contributions, the endowments' market value was: C$727.4 million (2018), C$704.7 million (2017), C$631.7 million (2016), and C$655.5 million (2015). 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

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

Related Research

- Global Not-For-Profit Higher Education 2019 Sector Outlook: Credit Pressures Proliferate, January 24, 2019
- Ontario's 10% Domestic Tuition Cut Ratchets Up Pressure On University Budgets, Jan. 21, 2019
- Australia, Canada, Mexico, And U.K. Universities 2018 Medians Report: Increased International Tuition Revenues Preserve The Sector's Stability Amid Stagnant Government Support, Aug. 20, 2018
- U.S. Public College And University Fiscal 2017 Median Ratios: Lower-Rated Entities Continue To Face Financial Stress, July 16, 2018

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.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.