Research Update:

McMaster University Ratings Affirmed At 'AA'; Outlook Remains Stable

May 14, 2020

PRIMARY CREDIT ANALYST

Adam J Gillespie
Toronto
(1) 416-507-2565
adam.gillespie
@spglobal.com

SECONDARY CONTACTS

Bhavini Patel, CFA
Toronto
(1) 416-507-2558
bhavini.patel
@spglobal.com

Sabrina J Rivers
New York
+ 1 (212) 438 1437
sabrina.rivers
@spglobal.com

Overview

- The COVID-19 pandemic will likely have negative implications for McMaster University's financial results in fiscal 2021 (ended April 30), the severity of which will depend on the duration of the outbreak and associated travel and social distancing restrictions, and their impact on campus activity and international enrollment.
- However, despite these near-term challenges, we believe that McMaster will maintain its overall excellent student demand characteristics and robust liquidity over the longer term, underpinning the rating.
- We are affirming our 'AA' long-term issuer credit and senior unsecured debt ratings on McMaster.
- The stable outlook reflects our expectation that despite pressures on enrollment, revenues, and liquidity stemming from the pandemic, the university will maintain a very strong market position and student demand profile, a manageable debt burden, and high levels of unrestricted financial resources in the next two years.

Rating Action

On May 14, 2020, 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 McMaster's levels of cash and investments will remain high, at more than 3x the university's debt, helping the university to weather the potential near-term revenue shocks stemming from the pandemic. We also believe that on a sustained basis, the university will continue to generate positive consolidated operating margins, and maintain a healthy enrollment and demand profile. The outlook also reflects 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

Prolonged social distancing measures caused by a second or third wave of COVID-19 could lead to extended disruptions in the university's operations, impairing enrollment levels and revenues, and leading to a material drawdown on liquidity. We could take a negative rating action if, in the next two years, consolidated net margins declined to near-balance or sustained deficit, and enrollment and liquidity eroded significantly. 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

Although we consider it unlikely during the two-year outlook horizon, we could take a positive rating action if our assessment of the enterprise profile improves, with a selectivity ratio consistently below 50% and increased geographic diversification of the student body. Specifically, we would expect out-of-province students to account for more than 30% of total full-time equivalent (FTE) students in the next two years, which could enhance the university's enrollment 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'. This reflects our combined assessment of 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.

We believe the COVID-19 pandemic and resulting prevention measures represent a short-term risk to McMaster and other universities we rate. For McMaster, the three areas most likely to face pressures stemming from the virus are: enrollment, revenues, and liquidity. It is our view that the impact of the coronavirus will peak in second-quarter 2020; however, due to widespread social distancing measures that include lockdowns and border closures, McMaster, similar to universities worldwide, will most likely see weakness in international student enrollment if the coronavirus and related travel restrictions persist. We believe that the retention of students already enrolled is not likely to erode materially, but expect that a decline in international matriculations might be more pronounced among first-year students if the coronavirus is not contained and restrictions are not lifted by the start of classes in fall 2020. This could be offset somewhat by a potential increase in domestic enrollments. A decline in international enrollments would add significant pressure to the university's revenues because international students pay much higher tuition fees than domestic students. Due to the university's decision to transition classes to online and shut down most non-critical campus services before the end of the winter term, restrictions that will remain in place through the spring and summer terms at least, there will be some weakness in ancillary revenues (residences, food services, parking) in fiscal 2020 and extending into fiscal 2021.

McMaster was founded in 1887 and is a research-intense, medical-doctoral university dedicated to teaching, research, and service. Its main campus (94% of the student population) is in Hamilton, the fifth-largest city in Ontario; its smaller, regional campuses are in downtown Hamilton, Burlington, Waterloo, and St. Catharines. The university offers a variety of undergraduate and graduate degrees across its six faculties (business, engineering, health sciences, humanities, science, and social sciences). McMaster is a member of the U15, a group of leading research-intensive universities in Canada. It ranked 72nd in the 2020 Times Higher Education list of the top universities globally (up from 77th in 2019), fourth in Canada, and placed 17th worldwide in the 2020 Times Higher Education Impact Ranking.

We believe McMaster has a very strong enterprise profile. Supporting our opinion is our assessment of the higher education sector's low industry risk, characterized by countercyclicality and low competitive risk and growth. In addition, the university benefits from excellent economic fundamentals, measured by the province's GDP per capita, estimated to be about US$46,000 in 2019; good income indicators; and moderate employment and population growth projections.

McMaster's robust market position and stable student demand and enrollment trends underpin the university's enterprise profile. In fall 2019, FTEs totaled 31,657, or approximately 2% above the previous year's level. The university's enrollment growth plan is centered largely on attracting more international students, with a target enrollment of 25%, gradually increasing from the current 15%. In our opinion, student quality metrics remain strong, comparing well with those of similarly rated Canadian peers. These are primarily reflected in McMaster's high retention and average entry grade rates of 91% and 89%, respectively. In fall 2019, the university's first-year selectivity rate (offers as a proportion of applicants) improved to 51.9%, continuing a downward trend from 58.6% in 2015. The six-year graduation rate also improved to 80.7% from 80.1% in fall 2018 and 77% in 2014.

In our view, McMaster's management expertise and governance practices, as well as financial management policies, are very strong and in line with those of other highly rated Canadian universities. The university's academic and operational priorities are guided by McMaster's strategic plan (most recently issued in 2011), and Strategic Mandate Agreement with the province. These in turn inform the detailed three-year operating budget and capital plans. Management reviews plan performance annually, tracks progress against specific activity indicators, and monitors risks identified through its enterprise risk management framework. The university has formal policies for endowments, investments, and debt, and meets standard annual disclosure requirements. Overall, we view McMaster's transparency and disclosure to be very good, with policies and procedures in place to adequately mitigate risks, and we believe that overall financial policies are not likely to negatively affect the university's ability to pay debt service.

We expect McMaster to maintain a very strong financial profile over the outlook horizon with a diversified source of revenues from student tuition, fees, and government operating grants. The university's adjusted operating margin was 12.8% in fiscal 2019, an improvement from the previous year fueled by higher-than-anticipated international student enrollment and domestic tuition fee increases allowable under provincial legislation. In preparation for a potential economic downturn, management originally anticipated a deficit in the operating fund of approximately C$30 million for fiscal 2020. Although fall 2019 enrollment was ahead of plan, the operational impacts of the pandemic late in the fiscal year could lead to year-end results closer to budget. We believe that results in the current fiscal year could be materially weaker, depending on the duration of campus restrictions and actual enrollment this fall, but that the university will continue to generate consolidated operating surpluses over the longer term.

Similar to that of Canadian peers, the university's limited flexibility to increase student-generated revenues somewhat offsets McMaster's strong financial performance. This is primarily because Ontario monitors and guides domestic tuition rates and student aid (through the tuition framework), and domestic enrollment expansion (through operating grants). However, universities can ultimately decide their enrollment targets and have control over their long-term strategies.

McMaster, in our view, has a very moderate debt burden backed by good operating performance and a healthy level of available resources. At fiscal year-end 2019, available resources represented 221% of total debt of C$274.3 million. The debt mainly consists of two fixed-rate bullet bonds totaling C$240 million due in 2052 and 2065, as well as C$14 million in amortizing bank loans and guaranteed debt of C$20 million on behalf of the First Longwood Innovation Trust. McMaster's estimated maximum annual debt service burden represented a modest 2.1% of adjusted operating expenses in fiscal 2019. In our view, McMaster's debt structure is somewhat aggressive, given the high proportion of bullet maturities. However, the university held C$34.7 million in sinking funds at the end of fiscal 2019 to repay these, which helps mitigate the refinancing risk and which we have included in our measure of internally restricted net assets. McMaster also has a long-term obligation of C$13.7 million for the gradual decommissioning of its nuclear reactor. To offset this obligation, management has accumulated trust funds of approximately C$11.7 million. Although the university is contemplating financing strategies for its long-term capital plan, we do not expect it to issue any additional debt in the current fiscal year.

We believe McMaster has some exposure to contingent liabilities through its two ongoing public-private partnerships (PPPs), though they are, in our opinion, unlikely to lead to additional direct financial obligations for the university. The first, McMaster's Main Street Student Residence, is underway and located on land wholly owned by the university, and will be financed by a limited partnership. The project is scheduled for completion in 2023-2024. The second PPP is a downtown graduate student residence and parking garage for which the university has entered into a 99-year land lease with four 25-year renewal options and that is scheduled for completion by 2022-2023. Although these projects are structured such that there is no recourse to McMaster, they will provide important services to students in support of the university's mission and at end of the partnership the ownership of the projects will revert to McMaster. 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 taken by both the province and the university to address the solvency deficit. McMaster's defined-benefit salaried pension plans had a going-concern deficit before provision for adverse deviation of about C$82.6 million.

McMaster believes its initiatives to manage its pension deficit, including increased employee and employer contributions, will allow it to cover any special solvency pension deficit payments.

Liquidity

We view the university's liquidity as very robust. At fiscal year-end 2019, McMaster had C$1.6 billion in total cash and investments, equal to 2.6x its available financial resources, 148% of adjusted operating expenses, and about 5.7x its debt outstanding. Unrestricted available financial resources totaled C$608 million, or 58% of adjusted operating expenditures, slightly higher than in previous years on both accounts. We believe that available resources could decline somewhat in the next two years due to potential pressures stemming from the COVID-19 pandemic. However, we believe that available resources will remain more than sufficient to weather near-term stresses and finance all debt service requirements. In addition, the university has an undrawn committed credit facility totaling C$75 million. At the end of fiscal 2019, the total market value of McMaster's endowments increased to C$758 million (of which C$651 million was held in the Investment Pool and C$107 million was in deferred contributions) from C$727 million at fiscal year-end 2018. 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 government-related entities (GREs), our view of McMaster's moderately high likelihood of extraordinary government support reflects our assessment of the university's 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 suggest a strong link to it. Also supporting our assessment of the link are the large operating grants received from the province, accounting for about 26% of the university's total revenue over the last four years, 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 that there is a measureable likelihood that McMaster's substantial 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, its status as an autonomous legal entity with ownership of its assets, and our view that it operates independently of the Ontario government. The board is responsible for the management, administration, and control of the university's property and other assets and all business affairs. We consider the risk of extraordinary negative government intervention low, given McMaster'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, the most significant of which was a 10% reduction in domestic tuition for the 2019-2020 academic year and a freeze the following year. Furthermore, the province has stated that there will be no additional grant revenue to offset the tuition cut and that universities must comply or risk losing some of their core operating grants from the province. Neither the federal or provincial governments has announced any direct financial support for universities to offset impacts stemming from the COVID-19 pandemic, although the federal government has introduced an income support program for students, which should help mitigate affordability concerns. Although we are not anticipating any material increase in ongoing operating or capital funding from the province in the medium term, we continue to believe that there is a moderately high likelihood that the province would provide support to McMaster in a distress scenario.

Environmental, social, and governance factors

In S&P Global Ratings' view, higher education entities face elevated social risk due to the ongoing uncertainty regarding the duration of the COVID-19 pandemic, and the unknown impact on fall 2020 enrolment levels and mode of instruction. We view the risks posed by COVID-19 to public health and safety as a social risk under our environmental, social, and governance (ESG) factors. Despite the elevated social risk, we believe McMaster's environmental and governance risks are in line with our view of the sector as a whole.

McMaster University -- Enterprise And Financial Statistics

		--Fiscal year ended April 30--				Medians for 'AA' U.S. public colleges & universities, 2018*
	2020 demand data	2019	2018	2017	2016	
Enrollment and demand						
Headcount	34,267	33,147	31,843	31,265	29,865	MNR
Full-time equivalent	31,657	31,082	29,758	29,130	27,884	35,846
First-year acceptance rate (%)	51.9	51.2	52.6	56.4	55.4	67.8
First-year matriculation rate (%)	25.7	26.7	27.6	28.6	25.8	MNR
Undergraduates as a % of total enrollment (%)	85.4	85.3	85.7	85.7	85.7	78.6
First year retention (%)	91.3	91.6	91	90.9	90.3	86.0
Graduation rates (six years) (%)	80.7	80.1	79	77.5	78.9	MNR
Income statement						
Adjusted operating revenue (C$000s)		1,186,262	1,100,665	1,013,520	976,271	MNR
Adjusted operating expense (C$000s)		1,051,833	1,017,149	973,384	940,622	MNR
Net adjusted operating income (C$000s)		134,429	83,516	40,136	35,649	MNR
Net adjusted operating margin (%)		12.8	8.2	4.1	3.8	1.5
Provincial grants to revenue (%)§		23.1	24.8	26.7	27.1	19.2
Student dependence (%)		31.9	31.1	30.2	28.2	39.7
Investment income dependence (%)		6.0	4.7	9.7	1.3	1.4
Debt						
Outstanding debt (C$000s)		274,988	276,312	277,798	279,220	828,692
Current debt service burden (%)		1.32	1.37	1.44	1.22	MNR
Current MADS burden (%)		2.1	2.17	2.27	2.43	3.5
Financial resource ratios						
Endowment market value† (C$000s)		651,229	629,112	610,300	541,053	990,083
Cash and investments (C$000s)		1,555,387	1,465,139	1,402,421	1,237,853	MNR
Adjusted UFR (C$000s)		607,700	558,397	528,885	447,416	MNR

McMaster University -- Enterprise And Financial Statistics (cont.)

	--Fiscal year ended April 30--					Medians for 'AA' U.S. public colleges & universities, 2018*
	2020 demand data	2019	2018	2017	2016	
Cash and investments to operations (%)		147.9	144	144.1	131.6	54
Cash and investments to debt (%)		565.6	530.2	504.8	443.3	168.3
Adjusted UFR to operations (%)		57.8	54.9	54.3	47.6	35.3
Adjusted UFR to debt (%)		221	202.1	190.4	160.2	97.8
Average age of plant (years)		15.1	14.8	14.8	11.7	13
OPEB liability to total liabilities (%)		16.4	16.2	14.8	13.0	MNR

**U.S. median figures are in U.S. dollars. §Median figure is state appropriations to revenue. †Endowments held in the university's investment pool. Including deferred contributions, the endowments' market value was: C$757.7 million (2019), C$727.4 million (2018), C$704.7 million (2017), and C$631.7 million (2016). 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

- The Higher Education Sector Outlook Is Now Negative For Australia, Canada, Mexico, And The U.K., May 14, 2020
- Outlooks Revised On Certain U.S. Not-For-Profit Higher Education Institutions Due To COVID-19 Impact, April 30, 2020
- Hitting the Books: Could COVID-19 Affect Australian University Ratings?, April 21, 2020
- COVID-19 Means International Students Could Give English Universities A Pass, April 9, 2020
- COVID-19 Causes More Severe Disruption For Canada's Economy, April 17, 2020
- Australia, Canada, Mexico, and U.K. Universities Medians Report: Government Support Is Still Declining, Tuition Revenue Holds, And New Risks Arise, Aug. 29, 2019
- U.S. Public College And University Fiscal 2018 Median Ratios: The Disparity Between Higher- and Lower-Rated Entities Persists, June 25, 2019

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.