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Research Update:

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

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Overview

- We expect McMaster University to maintain healthy financial management policies and robust unrestricted financial reserves in the next two years, which should allow it to adequately manage increasing operating pressures.
- We are affirming our 'AA' long-term issuer credit and senior unsecured debt ratings on McMaster.
- 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, in the next two years, the university will maintain a very strong market position and student demand profile, robust levels of unrestricted financial resources, and a manageable debt burden; and the likelihood of extraordinary government support will not change.

Rating Action

On May 11, 2018, 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 will maintain a healthy enrollment and demand profile, robust consolidated financial performance, and a manageable debt burden. We expect the university's cash and investments will stay at over 3x total debt. 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 not change.

Downside scenario

We could revise the outlook to negative or lower the ratings in the next two years if lower enrollment and operating pressures led to adjusted net margins weakened to near-balance or a sustained deficit, available resources eroded 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 more than one notch would result in a negative rating action on McMaster, given our three-notch cap above the rating on the supporting government. Moreover, a negative government intervention from the province or a significant reduction in the university's resilience to an Ontario default scenario could cause us to lower the ratings.

Upside scenario

Although unlikely, 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 full-time equivalent (FTE) students in the next two years, could result in a positive rating action.

Rationale

The ratings on McMaster 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. Strong financial resilience and independence allow the ratings on the university to exceed those on the province under our government-related entities (GRE) criteria.

We assess 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 92.2% of its students coming from Ontario, the university benefits from the province's excellent economic fundamentals, measured by the province's GDP per capita, which we estimate at over US$49,000 in 2017; its good income indicators; and moderate employment and population growth projections.

McMaster's robust market position and stable student demand and enrollment also strengthen the enterprise profile. The university's FTEs totaled 29,758 in fall 2017, or 2.2% 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 91.0% and 88.1%, respectively. In fall 2017, the university's first-year acceptance rate (offers-to-applicants) of 52.6% was lower than in previous years, while the six-year graduation rate, at 79.0%, was slightly higher than its historical levels. McMaster typically exceeds the annual target of C$21.5 million under its current fundraising campaign, demonstrating effective fundraising capacity.

In our view, the university's management expertise and governance practices, as well as financial management policies, are strong and in line with those of other Canadian universities. McMaster has a strategic plan, 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 it has formal policies in place, including investment and debt policies.

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. It ranked 78th in the 2018 Times Higher Education list of the top universities globally and ranked #1 as Canada's most research intensive university as per 2017 Research Infosource rankings.

We assess McMaster's financial profile as very strong, with a history of robust financial performance, excellent levels of available resources, and a moderate debt burden.

The university expects to achieve an operating fund surplus of about C$12 million in fiscal 2018, versus a C$1.4 million budgeted surplus, due primarily to higher-than-expected tuition income and student fees. Although it has not published 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 (S&P Global Ratings-calculated) was 5.9% in fiscal 2017, which was higher than the previous year's level of 3.8%, mainly fueled by a 16% return on investment income (compared with negative 2.8% the previous year).

Along with the potential for lower government grants, the university will face ongoing operating pressures primarily related to the tuition framework, and increasing employee-related expenditures. 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 domestic tuition rates and student aid (through the tuition framework), and domestic enrollment expansion (through operating grants). However, universities decide these matters and their long-term strategies.

In our view, the university has a very manageable and relatively moderate debt burden given its good operating performance and healthy level of available resources at fiscal year-end 2017, at 195% of total debt. As of fiscal 2017, McMaster had C$277.8 million in debt. This includes two fixed-rate bullet bonds totaling C$240 million due in 2052 and 2065, C$15.9 million of amortizing bank loan, and guaranteed debt of C$21.9 million on behalf of the First Longwood Innovation Trust. As of April 30, 2017, the university held C$28.4 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$12.6 million in fiscal 2017. Management has accumulated trust funds of C$12.54 million to offset this obligation. McMaster's estimated maximum annual debt burden represented 2.3% of its adjusted fiscal 2017 expenses. Although McMaster is contemplating financing strategies for its capital projects that could include new debt, it has no approved plan to issue more debt in the next year.

We believe McMaster has some exposure to contingent liabilities, but also believe that these will not 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$166 million that a limited partnership will finance. The project will be in two phases, with an expected completion date of 2020 or 2021. The second P3 initiative, which is in early in early approval stages, is a downtown graduate student residence and parking garage. 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 both the province and university have taken to address the solvency deficit. McMaster's two defined benefits plans, of which the largest has over 97% of net assets, had a going-concern salaried pension plan deficit of about C$30.8 million, while the solvency deficit totaled C$342 million as of the most recent actuarial valuation (July 1, 2017). The university qualified for temporary solvency funding relief through Ontario's program, under which it has elected to defer solvency deficit payments until fiscal 2019. In the meantime, it will make going-concern deficit special payments of C$21 million. McMaster believes 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.

Liquidity

McMaster's liquidity is very robust, in our view. At fiscal year-end 2017, consolidated cash and investments increased to C$1.4 billion, or 5x total debt, from C$1.2 billion in 2016, or 4.4x total debt. Unrestricted financial resources available for debt service stood at C$541.7 million, significantly above the previous year's C$447.4 million due to an increase in the university's central bank reserve related to the 2015 borrowing earmarked for new capital projects. This equaled 55.7% of adjusted operating expenses, and covered 195% of debt, compared with the previous year's 47.6% and 160%, respectively. 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 these ratios will remain fairly strong and in line with historical levels in the next two years. In addition, strong market returns in fiscal 2017 helped to boost the market value of McMaster's endowment to almost C$610 million from C$541 million at fiscal year-end 2016. The university has a conservative endowment draw, in our view, with a long-term payout target rate of 5% 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 to be low, given the university's operational independence, important public policy role, and the government's hands-off approach to the sector.

The Ontario government has improved its fiscal position in the past several years and although we believe that the province's overall support for universities will remain solid, we do not expect overall funding for the sector to increase materially in the medium term. Under the new grant funding formula, the provincial government is shifting focus toward measurable student outcomes and away from a more enrollment-based formula. It has committed to maintain the 2016-2017 funding level for all universities 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 at an average of 3% for most undergraduate programs and 5% for professional and graduate programs.

McMaster University--Selected Indicators

		--Fiscal year ended April 30--				
	2018 demand data	2017	2016	2015	2014	Medians for 'AA' U.S. public colleges and universities, 2016†
Enrollment and demand						
Headcount	32,404	31,746	30,283	30,509	30,113	MNR
Full-time equivalent	29,758	29,130	27,884	28,157	27,796	32,506
First year acceptance rate (%)	52.6	56.4	55.4	58.6	59.3	69.3
First year matriculation rate (%)	27.6	28.6	25.8	26.0	26.1	MNR
Undergraduates as a % of total enrollment (%)	85.6	85.5	85.6	85.4	85.5	77.7
First-year retention (%)	91.0	90.9	90.3	89.9	90.3	86.0
Graduation rates (six years) (%)*	79.0	77.5	78.9	76.9	77.4	MNR
Income statement						
Adjusted operating revenue (C$000s)	N.A.	1,030,677	976,271	974,088	949,026	MNR
Adjusted operating expense (C$000s)	N.A.	973,384	940,622	906,700	884,932	MNR
Net adjusted operating income (C$000s)	N.A.	57,293	35,649	67,388	64,094	MNR
Net adjusted operating margin (%)	N.A.	5.89	3.79	7.43	7.2	1.46
Provincial grants to revenue (%)§	N.A.	26.2	27.1	27.2	28.2	19.4
Student dependence (%)	N.A.	29.7	28.2	26.9	26.1	41.8
Investment income dependence (%)	N.A.	9.6	1.3	5.8	6.7	0.8
Debt						
Debt outstanding (C$000s)	N.A.	277,798	279,220	159,275	159,092	698,540
Pro forma debt	N.A.	277,798	279,220	278,620	159,092	MNR
Current debt service burden (%)	N.A.	1.44	1.22	1.01	1.03	MNR
Current MADS burden (%)	N.A.	2.27	2.43	1.45	1.49	3.60
Pro forma MADS burden (%)	N.A.	2.27	2.43	2.43	1.49	MNR
Financial resource ratios						
Endowment market value (C$000s)	N.A.	610,300	541,053	575,033	533,412	748,837
Cash and investments (C$000s)	N.A.	1,402,421	1,237,853	1,129,633	1,016,536	NMR
Adjusted UFR (C$000s)	N.A.	541,710	447,416	322,091	291,795	MNR
Cash and investments to operations (%)	N.A.	144.1	131.6	124.6	114.9	54.7
Cash and investments to debt (%)	N.A.	504.8	443.3	709.2	639.0	159.6
Cash and investments to pro-forma debt (%)	N.A.	504.8	443.3	405.4	639.0	MNR

McMaster University--Selected Indicators (cont.)

		--Fiscal year ended April 30--				
	2018 demand data	2017	2016	2015	2014	Medians for 'AA' U.S. public colleges and universities, 2016†
Adjusted UFR to operations (%)	N.A.	55.7	47.6	35.5	33.0	31.9
Adjusted UFR to debt (%)	N.A.	195.0	160.2	202.2	183.4	89.7
Adjusted UFR to pro forma debt (%)	N.A.	195.0	160.2	115.6	183.4	MNR
Average age of plant (years)	N.A.	14.8	11.7	13.9	13.8	12.9
OPEB liability to total liabilities (%)	N.A.	15.0	13.0	16.1	14.7	MNR

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

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

- Fiscal Median Ratios Of Public Universities In Australia, Canada, Mexico, And The U.K.: Operating Margins Remain Mostly Solid Despite Lower Government Transfers, July 27, 2017
- U.S. Public College And University Fiscal 2016 Median Ratios: Lower Rated Entities Pressured In An Otherwise Relatively Stable Sector, July 20, 2017

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.