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McMaster University

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McMaster University

Rationale

Issuer Credit Rating
AA/Stable/--

The ratings on McMaster University reflect the university's 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 view that McMaster's strong financial resilience and independence allow the ratings to exceed those on the Province of Ontario under our government-related entities (GRE) criteria.

We assessed McMaster's enterprise profile as very strong, characterized by its robust market position and stable student demand and enrollment. The university's full-time equivalent students (FTEs) totaled 27,883 in fall 2015. Although slightly lower in fall 2015, McMaster's enrollment showed steady growth over the past 10 years, supported by both graduate and undergraduate enrollment. In our opinion, student quality metrics continued to be strong and compare well with those of similarly rated Canadian peers. The university's selectivity rate (offers-to-applicants) improved to 55.4% in fall 2015, while six-year graduation rates grew slightly to 78.9%. At the same time, the average entry grade and the retention rate of first-year students were also higher at 87.9% and 90.3%, respectively. In our opinion, the university also benefits from strong management and governance practices, and excellent economic fundamentals given Ontario's very strong economy.

We believe McMaster's very strong financial profile is primarily supported by a sound financial performance, excellent levels of available resources, and a moderate debt burden. The university's adjusted operating margin was 9.3% in fiscal 2015, which was above the fiscal 2014 median for U.S. public universities in the 'AA' category and that of most rated Canadian peer institutions. In our view, although the university issued C$120 million in fiscal 2016, its debt burden remained moderate especially in light of the healthy level of available resources at the end of fiscal 2015, at 117% of total pro forma debt. As well, its pro forma maximum annual debt service was modest, at 2.4% of 2015 adjusted operating expenditures. With the university issuing no debt in the near term, we expect that debt metrics will remain in line with current levels. We believe that McMaster's operating pressures related to the tuition framework, potential for flat or even lower government grants, and increasing salaries and benefits expenditures, as well as its considerable postemployment liabilities, and a significant deferred maintenance backlog somewhat offset its financial profile strengths.

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 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. Although the Ontario government faces fiscal challenges and projects it will not return to fiscal balance until fiscal 2017-2018, we do not expect provincial operating grants for postsecondary education to diminish significantly, given this sector's vital public policy role.

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 located 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 2015, it received C$194 million in research-related grants and contracts, which have been slowly increasing in the past several years.

Liquidity

We believe McMaster benefits from an exceptional liquidity. At fiscal year-end 2015, consolidated cash and investments totaled C$1.1 billion, up about 11% from fiscal 2014. Total cash and investments represented 4.1x total pro forma debt. Unrestricted financial resources available for debt service stood at C$326 million, which was about 12% higher than the previous year's C$291.8 million. This equaled 36% of adjusted operating expenses, and covered 117% of pro forma debt. In our opinion, these ratios are strong and compare well with those of the university's peers.

McMaster has the third-largest endowment among Ontario universities, after University of Toronto and Queen's University. The endowment had a fair value of C$575 million at April 30, 2015, up 8% from the previous year. 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 2015, the endowment paid out C$17.4 million or 5.5% higher than the previous years' spending, reflecting a strong increase in total endowment value.

Outlook

The stable outlook reflects our expectations that, within our two-year outlook horizon, McMaster will maintain a strong consolidated financial performance, excellent levels of unrestricted financial resources, and a manageable debt burden. We expect its available resources to remain in excess of 25% of adjusted operating expenses and cash and investments to be 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.

We could revise the outlook to negative or lower the ratings if cash and investments to outstanding 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.

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.

Government-Related Entities Methodology: Moderately High Likelihood Of Extraordinary Provincial Government Support

In accordance with our criteria for government-related entities, 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 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. Although the Ontario government faces fiscal challenges and projects it will not return to fiscal balance until fiscal 2017-2018, we do not expect provincial operating grants for postsecondary education to diminish significantly, given this sector's vital public policy role.

Although we believe that the province's overall support for universities will remain good, Ontario has imposed some savings targets on the universities. Moreover, in March 2013, the province announced changes to the tuition framework, reducing the cap on annual increases to an average of 3% for undergraduate programs and 5% for professional and graduate programs over the next four years (from a maximum annual average of 5% institutionwide). As well, the government is undertaking a formula funding review in fiscal 2015-2016, which is focusing on student outcomes and institutional differentiation. The SACP on McMaster incorporates the ongoing support from Ontario, and we believe that the province's budgetary constraints and limiting of tuition increases will not materially affect the SACP within the two-year outlook horizon.

Enterprise Profile

Low industry risk

Industry risk addresses the higher education sector's overall cyclicality and competitive risk and growth by applying various stress scenarios and evaluating barriers to entry, levels and trends of profitability, substitution risk, and growth trends observed in the industry. We believe the higher education sector represents a low credit risk compared with other industries and sectors.

Extremely strong economic fundamentals

McMaster's students predominantly come from Ontario (89% in fall 2015). This level has been fairly stable in the past five years, while international student intake and the share of students coming from the rest of Canada continued to grow.

In our view, Ontario's real GDP per capita, which in 2014 was US$46,500, anchors our assessment of the university's economic fundamentals. The province's population was about 13.8 million in 2015, with good income indicators and some moderate employment and population growth projected.

Market position and demand

We believe McMaster has a strong competitive position, supported by historically growing enrollment and solid student quality. The university's full-time equivalent students (FTEs) totaled 27,883 in fall 2015, which is somewhat below the student population of most of its similarly rated peers. McMaster views the slight decline in fall 2015 enrollment as exceptional and believes that it is well positioned to modestly increase enrollment in the coming years, despite a decrease in the demographic pool of applicants mainly affecting some universities in northern Ontario. This will primarily be achieved through a combination of higher number of offers and applications, and international enrollment.

Demand, as measured by freshmen applications for McMaster, is good, in our view, with a 2.8% increase for fall 2015 from the previous year, totaling 36,388. Selectivity measures are adequate for the rating category, comparing well with those of its peers. More recently, selectivity, as measured by the freshmen acceptance rate, has improved down to 55.4% for fall 2015 from 58.6% for fall 2014. The university's first-year students had a high average entry grade of 87.9% for fall 2015. The fall 2015, six-year graduation rate was what we view as competitive, at 78.9%, as was its first-year retention rate of 90.3%.

Management

McMaster has a bicameral government composed of a board of governors and a senate. The board consists of 37 governors, six of which the province appoints. It is responsible for the university's conduct, management, and control of the university and of its property, revenues, business, and affairs. The senate exercises general control and supervision over academic affairs.

There have been three new appointments to senior management in the past year, including a Vice-President Research, Vice-President and Dean of Faculty of Health Sciences, and Dean of Social Services. We expect the senior management team to be stable in the next two years. The university prepares externally audited financial statements, which have been unqualified, and operating and capital budget documents are robust and transparent. It approves annually three-year plans for its operating budget, which is prepared on a cash basis and uses conservative revenue and expenditure assumptions. McMaster also has a number of transparent, conservative financial policies in place, including investment and debt policies.

McMaster has a strategic plan, updated every three to five years, that guides its long-term strategies based on its mission. Plan performance is reviewed annually and progress is tracked against specific activity indicators and identified risks are also monitored. The university prepares operating budgets and interim reports comparing its actual results to plans. It has an enterprise risk management program in place that guides its identification and management of risks. Management breadth and expertise are good, in our opinion.

Financial Profile

Financial management policies

Our analysis of financial policies includes a review of McMaster's financial reporting and disclosure, investment allocation and liquidity, debt profile, contingent liabilities, and legal structure and a comparison of these policies with those of peers. 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.

Financial results

In our view, McMaster's financial performance remained superior in fiscal 2015. Its operating margin was 9.3% of adjusted operating expenses, primarily as result of the new pension accounting standards adopted in fiscal 2015, under which measurement of pension liabilities is no longer flowing through the statement of operations. At this level, McMaster's fiscal 2015 margin is well above the fiscal 2014 median for U.S. public universities in the 'AA' category and that of most rated Canadian peer institutions. Like those of its Canadian peers, McMaster's salaries and benefits expenditures remain a significant strain, typically accounting for 60%-65% of total expenses. They increased 0.6% in fiscal 2015.

The university expects that its 2016 operating fund deficit will be below the C$12.7 million budgeted, primarily due to higher grants revenues. Although McMaster's fiscal 2016 budget indicates that the university will continue to record a slight operating fund deficit in fiscal 2017, we expect that, including ancillary operations, which tend to generate positive cash flow, the university will maintain consolidated surpluses in the next two years.

McMaster's revenue base is fairly diversified, with no source of revenues exceeding 30% of 2015 total adjusted revenues. Its dependence on student-generated revenues grew slightly in the past several years and represented 26.3% of 2015 adjusted operating revenues. This was below that of other Canadian and 'AA' rated U.S. public universities.

Similar to Canadian peers, McMaster has somewhat limited flexibility to increase these revenues. Ontario monitors and guides tuition rates and student aid (through the tuition framework), and enrollment expansion (through operating grants). However, universities have the final decision on these matters and on their long-term strategies. The current tuition framework reduces the cap on annual increases to an average of 3% for undergraduate programs and 5% for professional and graduate programs until fiscal 2017 (from a maximum annual average of 8% institutionwide under the previous framework). Universities have some flexibility on how they increase tuition among programs as long as the total increase entitywide is below the cap. The province has also made some changes that have affected the entire university sector, including reduced base operating grants and reduced grants based on enrollment of full-time international students and new requirements to meet efficiency targets.

Financial resources

Unrestricted financial resources available for debt service stood at C$326 million, which was 12% higher than the previous year's total of C$291.8 million. This equaled 36% of adjusted operating expenses, and covered 117% of pro forma debt. In our opinion, these ratios are strong and compare well with those of peers. At fiscal year-end 2015, consolidated cash and investments totaled C$1.1 billion, up 11% from fiscal 2014. Total cash and investments represented about 4.1x pro forma total debt and 2.7x the university's available financial resources.

McMaster has the third-largest endowment among Ontario universities, after University of Toronto and Queen's University. The endowment had a fair value of C$575 million at April 30, 2015, up 8% from the previous year. 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 2015, the endowment paid out C$17.4 million or 5.5% higher than the previous years' spending, reflecting a strong increase in total endowment value.

The university's investment portfolio as of Dec. 31, 2015 included 64.0% of Canadian and international equities, and 35.5% of fixed-income securities and other, and 0.5% of cash. Annual return was 4.8% at calendar year-end 2015, below the benchmark's performance of 5.5% and the previous year's return of 8.7%. Endowment per FTE has also strengthened significantly and in 2015, it was up 6.4% at C$20,422.

We believe McMaster's fundraising capacity remains good. As of Dec. 31, 2015, the university raised C$29.3 million, excluding discounted future gifts of C$9.6 million. This exceeded its C$21 million annual internal fundraising target.

Debt and contingent liabilities

As of fiscal 2015, McMaster's pro forma debt outstanding was C$278.6 million, including the university's C$120 million senior unsecured notes issued in November 2015. We believe it has an aggressive debt structure, which includes two fixed-rate bullet bonds (one due in 2052 and the other in 2065, representing 86% of total debt), an amortizing bank loan (maturing in 2033), a small mortgage, and C$22.1 million of debt on behalf of the First Longwood Innovation Trust, for which McMaster guarantees the debt service payment in case of default. The university also has a long-term obligation for a nuclear reactor decommissioning, which equaled C$11.2 million in fiscal 2015. Trust funds of C$10.8 million have been accumulated to offset this obligation. To repay its bullet debentures, McMaster sets aside principal payments into a self-imposed sinking fund. These assets include C$15 million (as of April 30, 2015, for the bonds due 2052). The university has also set aside C$10 million for its recent debt issuance due 2065; it invests this sum in its investment pool (endowments).

McMaster's estimated pro forma maximum annual debt service is about C$22.1 million (after smoothing its bullet debenture's principal repayments over 30 years), or 2.4% of its adjusted fiscal 2015 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 2015, at 117% of total pro forma debt.

Although McMaster's capital plan requires significant spending over the next years (the largest projects include the Living and Learning Centre: C$118 million, Wilson Building: C$66 million, Biomedical Engineering and Advanced Manufacturing: C$18.4 million), and deals with a significant deferred maintenance backlog estimated at C$322 million, the university does not expect to fund them with additional debt issuance. Therefore, we believe the university's debt metrics will remain in line with current levels in the next two years. As well, management expects that debt burden metrics, pro forma for the new debt issuance, will stay well within McMaster's debt management policy limits. To address its deferred maintenance spending, the university has increased permanent annual spending gradually and expects it will reach C$10 million in fiscal 2017. The university is also expecting to see its portion of provincial funding growing in the near term, in light of Ontario's commitment to supplement its facility renewal funding across the system from fiscal years 2016-2020.

Pension

McMaster has two defined benefits plans that provide pension and other postemployment benefits to most of its full-time employees. As of the most recent actuarial valuation (July 1, 2014), its going-concern salaried pension plan deficit was about C$252 million, while solvency deficit totaled C$197 million.

In fiscal 2015, McMaster's accrual deficit (on an accounting basis) for its registered and supplemental pension plans was C$63.3 million, down from C$165.9 million in fiscal 2014. The university also had a C$217 million nonpension postemployment deficit. Nonpension postemployment benefits include extended medical and dental coverage. Because there is no legislative requirement to maintain assets against these liabilities (unlike pensions), the university funds these on a pay-as-you-go basis, similar to other universities.

In fiscal 2015, McMaster made another going-concern deficit payment of C$20.8 million and projects such payments will increase to C$30.4 million per year in fiscal years 2016 and 2017. In fiscal 2015, McMaster qualified for temporary solvency funding relief program, under which it has elected to defer solvency deficit payments for another three years, to Sept. 1, 2018. We expect greater clarity around the amount and timing of the solvency pension deficit payments after the university formalizes its valuation as of July 1, 2017 (it currently estimates them at about C$27.9 million after fiscal 2019). As part of the valuation process, McMaster will be required to submit a plan for funding its deficits.

McMaster took several initiatives to manage its pension deficit, including increased employee contributions and the introduction of a defined contribution group registered retirement savings plan for new employees. The provincial government is studying initiatives regarding a university sectorwide jointly sponsored pension plan (JSPP). A move to a JSPP, which would not be subject to solvency payment regimes, could help improve McMaster's cash flows. It would not eliminate the university's going-concern obligations.

Contingent liabilities

McMaster has guaranteed the debt service obligations of its research park, The First Longwood Innovation Trust, in the event of default. This equals up to C$23 million, which we include in our debt calculation. There was no expense related to these obligations in fiscal 2015. We believe that other contingent liabilities (insurance exchange, legal claims, and leases) do not have a material impact on the university's financial profile.

McMaster University -- Selected Statistics

	--Fiscal year ended April 30--					Medians for 'AA' U.S. public colleges & universities, 2014***
	2016	2015	2014	2013	2012	
Enrollment and demand						
Headcount	30,283	30,509	30,113	29,735	29,222	34,431
Full-time equivalent	27,883	28,157	27,796	27,518	27,042	32,265
First year acceptance rate (%)	55.4	58.6	59.3	58.9	61.7	68.6
First year matriculation rate (%)	25.8	26.0	26.1	26.2	27.6	MNR
Undergraduates as a % of total enrollment (%)	85.6	85.4	85.5	85.4	85.7	77.7
First year retention (%)	90.3	89.9	90.3	88.7	86.8	85.0
Graduation rates (six years) (%)*	78.9	76.9	77.4	78.4	78.4	55.4
Adjusted operating revenue (C$000s)	N.A.	990,831	972,903	938,829	880,532	MNR
Adjusted operating expense (C$000s)	N.A.	906,700	884,932	867,502	860,650	MNR
Net adjusted operating income (C$000s)	N.A.	84,131	87,971	71,327	19,882	MNR
Net adjusted operating margin (%)	N.A.	9.3	9.9	8.2	2.3	1.8
Provincial grants to revenue (%)**	N.A.	26.8	27.5	27.6	26.9	21.4
Student dependence (%)	N.A.	26.3	25.4	24.0	23.4	32.4
Investment income dependence (%)	N.A.	5.7	6.5	5.0	2.1	2.4
Debt outstanding (C$000s)	N.A.	159,275	159,092	160,271	161,300	689,891
Pro forma debt	N.A.	278,620	159,092	160,271	161,300	
Current debt service burden (%)	N.A.	1.01	1.03	1.11	2.49	3.30
Current MADS burden (%)	N.A.	1.45	1.49	1.57	2.96	3.50
Pro forma MADS burden (%)	N.A.	2.43	1.49	1.57	2.96	
Endowment market value (C$000s)	N.A.	575,033	533,412	480,472	445,368	631,508
Cash and investments (C$000s)	N.A.	1,129,633	1,016,536	897,273	857,464	MNR
Adjusted UFR (C$000s)	N.A.	326,038	291,795	246,584	225,029	MNR
Cash and investments to operations (%)	N.A.	124.6	114.9	103.4	99.6	63.5
Cash and investments to debt (%)	N.A.	709.2	639.0	559.8	531.6	163.0
Cash and investments to pro-forma debt (%)	N.A.	405.4	639.0	559.8	531.6	
Adjusted UFR to operations (%)	N.A.	36.0	33.0	28.4	26.1	36.1
Adjusted UFR to debt (%)	N.A.	204.7	183.4	153.9	139.5	102.1
Adjusted UFR to pro-forma debt (%)	N.A.	117.0	183.4	153.9	139.5	
Average age of plant (years)	N.A.	13.9	13.8	13.7	13.5	12.2

McMaster University -- Selected Statistics (cont.)						
	--Fiscal year ended April 30--					Medians for 'AA' U.S. public colleges & universities, 2014***
	2016	**2015**	**2014**	**2013**	**2012**	
OPEB liability to total liabilities (%)	N.A.	16.1	14.7	16.8	16.5	5.4

*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 And Research

Related Criteria

- Methodology: Not-For-Profit Public And Private Colleges And Universities, Jan. 6, 2016
- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Ratings Detail (As Of June 7, 2016)	
McMaster University	
Issuer Credit Rating	AA/Stable/--
Senior Unsecured	AA
Issuer Credit Ratings History	
20-May-2016	AA/Stable/--
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. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.