

Research Update:

University of Western Ontario 'AA' Ratings Affirmed; Outlook Is Stable

February 12, 2020

Overview

- The University of Western Ontario has again achieved strong financial results and is well-positioned to respond to the government's recent changes to tuition rates.
- We expect the university will maintain its very strong financial and enterprise profiles over the next two years.
- We are affirming our 'AA' long-term issuer credit and senior unsecured debt ratings on the university with a stable outlook.

Rating Action

On Feb. 12, 2020, S&P Global Ratings affirmed its 'AA' long-term issuer credit and senior unsecured debt ratings on the University of Western Ontario (Western), in London, Ont. The outlook is stable.

Outlook

The stable outlook reflects our expectation that Western will maintain excellent net operating margins, high levels of unrestricted financial resources, and a healthy enrollment and demand profile over the next two years. The outlook also reflects our expectation that the university's relationship with the province will be stable.

Downside scenario

We could lower the ratings if, in the next two years, net operating margins unexpectedly declined to balance or slight deficits, on average, and eroded unrestricted financial assets. Lower financial assets would likely cause debt service and debt coverage ratios to decline. This combination of events would strain Western's financial profile and could lead to a negative rating action. Furthermore, evidence of negative government intervention, a strengthening of our assessment of the link between the university and province, or a significant reduction in our assessment of

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Western's resilience to an Ontario default scenario could also cause us to lower the ratings on the university, potentially to on par with or below those on the province, depending on the severity.

Upside scenario

An improvement in Western's already healthy enterprise profile could lead to a positive rating action. Specifically, a selectivity ratio below 50% or increased geographic diversification of the student body, with out-of-province students accounting for more than 30% of total full-time equivalents (FTEs), could lead to a positive rating action in the next two years.

Rationale

The ratings on Western reflect the university's stand-alone credit profile, which S&P Global Ratings assesses at 'aa' based on very strong enterprise and financial profiles. Over the past 20 years, Western has remained committed to improving student quality metrics, which has translated into superior average entering grades and remarkable graduation and retention rates. Our assessment of the university's enterprise profile reflects a healthy enrollment and demand profile, strong management and governance practices, low industry risk, and Ontario's extremely strong economic fundamentals. We base our assessment of the financial profile on Western's robust financial management policies, history of strong financial performance, and high levels of cash and available financial resources. We believe that the university's robust cash and investments, which cover over 6x its debt, strengthen Western's credit profile. In our opinion, the university's challenging operating environment, with newly mandated tuition cuts, relatively limited geographic student draw, and its moderate debt burden, offset these strengths somewhat.

The Ontario government has announced several changes to the tuition framework and its funding formula that will have a modest impact on Western starting in fiscal 2020 (ended April 30). Most significantly, the province imposed a 10% reduction in domestic tuition for the 2019-2020 academic year and a freeze the following year. The tuition cut applies to all domestic students enrolled in programs that are funded through the provincial operating grant and the university estimates that this will reduce revenue by C\$43 million at the end of fiscal 2021. In response to the tuition changes, Western plans to increase international enrollment, carefully manage expenses, and draw from reserves.

Founded in 1878, Western is a research-intensive, doctoral university. It is in the southwestern Ontario city of London, which has a population of about 384,000. Western has about 33,750 FTE students on its main campus. The university has 12 faculties and schools, including a school of medicine and dentistry, law, engineering, and business. It also has affiliations with three research institutes, three university colleges, and two teaching hospitals.

Western's very strong enterprise profile supports the credit profile assessment. Supporting this is our view of the higher education sector's low industry risk, with counter-cyclicality and low competitive risk and growth. In addition, the university benefits from excellent economic fundamentals, as measured by the province's GDP per capita, which we estimate to be more than US\$45,000 in 2019; good income indicators; and moderate employment and population growth projections. However, because a high proportion of students (76%) are from Ontario, Western's student draw has, we believe, limited geographic diversity relative to that of some peers. The university says it would like to increase its international student body, which could support revenue diversity.

We believe the credit profile benefits from a healthy and fairly stable demand and enrollment profile. Western benefits from solid student quality metrics; a robust selectivity rate below 60%;

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excellent first-year retention rates of over 90% in recent years; and exceptional faculty quality, with substantially all faculty members having PhDs or equivalent degrees. Headcount has increased modestly in the past several years. The university will focus its enrollment growth efforts on attracting more international and graduate students, although competition for these students is high. The university is a member of the U15, a group of leading research-intensive universities in Canada. In fiscal 2019, it received C\$239 million in research-related grants and contracts, which have been slowly increasing in the past several years. Western has exceeded its C\$750 million fundraising goal under its Be Exceptional campaign, launched in 2007, demonstrating its fundraising capacity.

The university's senior administration has been largely stable. In our view, it has sufficient depth and expertise, and has demonstrated consistent operational effectiveness, which we believe lends stability to the credit profile. Overall, we view Western's transparency and disclosure to be good, with policies and procedures that adequately mitigate risks. The university conducts its activities according to a four-year operating and capital plan that contains what we view as appropriate assumptions. It prepares externally audited financial statements, which have been unqualified; and has formal policies for endowments, investments, debt, and reserves.

In our opinion, Western has a very strong financial profile, largely in line with the medians for 'AA' rated public colleges and universities. Its adjusted weighted-average operating margin was 12.9% in the past three fiscal years because enrollment growth has been stronger than the university had forecast, resulting in higher tuition revenue. Western, along with other Ontario universities, will face increased budget pressure from the government's requirement to cut domestic tuition fees by 10% in fiscal 2020 and freeze them the following year. Based on Western's strong balances and the possibility of expenditure control and enrollment growth, we believe the university will be able to accommodate these cuts without falling into a deficit position.

In our view, the university has a relatively moderate debt burden. At fiscal year-end 2019, its total gross debt outstanding was C\$360.8 million. The debt consists of: a fixed-rate, C\$189.2 million, 40-year bullet debenture due 2047; a fixed-rate, C\$99.4 million, 40-year bullet debenture due 2057; C\$0.507 million in mortgages; C\$10.3 million related to Western's research park; and C\$61.3 million in amortizing banker's acceptances (from a C\$100 million nonrevolving facility maturing in fiscal 2027). We view Western's debt structure as aggressive because more than 50% of its total debt is non-amortizing; however, the bullet maturities are years away and the university's strong liquidity partially mitigates the associated risks. To help repay its bullet debentures, Western has set aside C\$32.4 million in an internal sinking fund. Our estimate of maximum annual debt service (which includes an estimated principal component for non-amortizing debt) equals 3.7% of adjusted fiscal 2019 expenses. In our view, the university's debt burden is manageable, given Western's good operating performance and the healthy level of available resources equal to 2.3x debt based on a three-year weighted average. The university does not expect to take on additional external debt in the next several years and we believe that debt service coverage will remain more than adequate throughout our outlook horizon.

Among rated Canadian universities, Western is the only one to sponsor a pure defined-contribution pension plan for current employees that shifts the plan's investment risks away from itself. This contrasts with some institutions that face the potential requirement to make special solvency payments on their pension plan deficits. The university has a legacy defined-benefit plan that was in a very modest surplus position of C\$615,000 at fiscal year-end 2019, and we do not consider the liabilities associated with this plan significant. The majority of Western's postemployment liabilities relate to unfunded nonpension benefits, such as medical and dental. At fiscal year-end 2019, these liabilities amounted to C\$546.5 million, up 10.3% from the previous year. The university has taken steps to contain the costs of these liabilities in previous labor negotiations.

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Based on public disclosures, we do not believe that Western has any additional contingent liabilities that could materially affect our view of its credit profile.

Liquidity

At fiscal year-end 2019, total cash and investments increased to C\$2.2 billion from C\$1.9 billion in 2018, equal to over 6x our debt estimate and more than 2x our measure of available resources, and indicating very robust liquidity. Western's available resources (internally restricted net assets plus internally restricted endowments) increased to C\$907 million from C\$782 million the year before. 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.

Moderately high likelihood of extraordinary provincial government support

In accordance with our criteria for government-related entities, our view of Western'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), despite recent changes to university funding. Moreover, our assessment of Western's important role recognizes the absence of viable private alternatives. It also reflects the university's size, strong reputation, and research capabilities, which would make it hard to replace. The province's oversight, program-approval rights, and tuition regulation over Western suggest a strong link to the government. Also supporting this view is that the province provides substantial operating grants, which account for about a quarter of the university's total revenue, and it appoints four of 26 board members.

We rate Western two notches above Ontario. The differential reflects our view that there is a measurable likelihood that the university's substantial financial resources would meet ongoing operational and debt service requirements should the government default and temporarily suspend payments to Western. In addition, the differential reflects our belief that the university operates independently of the Ontario government as an autonomous legal entity with ownership of its assets. The board is responsible for the management, administration, and control of Western's property and other assets and all business affairs. 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.

In January 2019, the Ontario 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 on 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. Of the changes, we expect cuts to tuition will have the largest impact on Western's finances. The university must comply or risk losing some of its core operating grants from the province. We expect Western will mitigate the loss of tuition revenue through increases in international enrollment, expense control, and reserves, and ultimately will maintain a positive net operating margin. While the requirement to cut tuition fees was unexpected, it does not change our assessment of the government's likelihood of support based on Western's strong link and important role with the province.

University of Western Ontario -- Enterprise And Financial Statistics

	--Fiscal year ended April 30--					--Medians for 'AA' rated public colleges and universities--
	2020	2019	2018	2017	2016	2018
Enrollment and demand						
Headcount	33,097	32,739	32,519	31,922	31,062	MNR
Full-time equivalent	33,754	33,353	33,059	32,528	31,772	35,846
First-year acceptance rate (%)	53.4	54.9	51.5	58.1	56.1	67.8
First-year matriculation rate (%)	18.1	18.6	20.2	20	20.8	MNR
Undergraduates as a % of total enrollment (%)	79.9	80.5	80.5	81.5	81.6	78.6
First-year retention (%)	N.A.	93.6	93.4	93.1	93.2	86
Graduation rates (six years) (%)	N.A.	83.4	83.2	83.4	83.6	MNR
Income statement						
Adjusted operating revenue (C\$000s)	N.A.	1,305,612	1,259,352	1,169,093	1,170,496	MNR
Adjusted operating expense (C\$000s)	N.A.	1,146,388	1,100,306	1,084,310	1,053,850	MNR
Net adjusted operating income (C\$000s)	N.A.	159,224	159,046	84,783	116,646	MNR
Net adjusted operating margin (%)	N.A.	13.89	14.45	7.82	11.07	1.5
Provincial grants to revenue (%)	N.A.	21.6	22.3	23.7	23.2	19.2
Student dependence (%)	N.A.	35.3	34.6	34.9	32.5	39.7
Investment income dependence (%)	N.A.	7.1	6.3	10.5	2.4	1.4
Debt						
Outstanding debt (C\$000s)	N.A.	360,770	376,576	288,042	294,057	828,692
Current debt service burden (%)	N.A.	2.52	2.05	1.89	1.96	MNR
Current MADS burden (%)	N.A.	3.67	3.88	3.19	3.69	3.5
Financial resource ratios						
Endowment market value (C\$000s)	N.A.	803,793	746,466	678,960	580,615	990,083
Cash and investments (C\$000s)	N.A.	2,175,731	1,933,753	1,661,799	1,416,635	MNR
Adjusted UFR (C\$000s)	N.A.	907,202	782,486	697,138	603,537	MNR
Cash and investments to operations (%)	N.A.	189.8	175.7	153.3	134.4	54
Cash and investments to debt (%)	N.A.	603.1	513.5	576.9	481.8	168.3

University of Western Ontario -- Enterprise And Financial Statistics (cont.)

	--Fiscal year ended April 30--					--Medians for 'AA' rated public colleges and universities--
	2020	2019	2018	2017	2016	2018
Adjusted UFR to operations (%)	N.A.	79.1	71.1	64.3	57.3	35.3
Adjusted UFR plus debt service reserve to debt (%)	N.A.	251.5	207.8	242	205.2	97.8
Average age of plant (years)	N.A.	15.3	16	15.1	14.5	13
OPEB liability to total liabilities (%)	N.A.	30.1	28.6	29.4	32.3	MNR

*U.S. median figures are in U.S. dollars. §Median figure is state appropriations to revenue. 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. OPEB--Other postemployment benefits.

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 2020 Outlook: Despite Some Silver Linings, The Sector Continues To Struggle, Jan. 16, 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
- Recession, Recovery, Rivalry: 10 Years Of U.S. Higher Education Medians, July 2, 2019
- Ontario's 10% Domestic Tuition Cut Ratchets Up Pressure On University Budgets, Jan. 21, 2019

Ratings List

Ratings Affirmed

University of Western Ontario

Issuer Credit Rating AA/Stable/--

University of Western Ontario

Senior Unsecured AA

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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.

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