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March 16, 2012

University of Western Ontario

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University of Western Ontario

Rationale

The ratings on the University of Western Ontario reflect Standard & Poor's Ratings Services' view of the following factors:

Issuer Credit Rating
AA/Negative/--

- Strong student demand. Excluding its affiliates, Western had about 30,600 full-time equivalent (FTE) students in the fall of 2011. The average entry grade of full-time first-year students was 87%, slightly below that of Queen's University (AA+/Negative/--). Western's selectivity is improving; its acceptance rate of Ontario high school students fell to 57% for fall 2011 students from 66% in fall 2005. Graduate students made up about 17% of fall 2011 enrollment. It has increased its graduate enrollment to a proportion more similar to that of other rated Canadian research-intense universities. Graduate growth has also helped support the university's strong research profile, which ranks among the top 10 in Canada;
- A sound management team that has implemented several difficult initiatives to contain expenditures and nonpension postemployment liabilities (such as dental and prescription drugs). Furthermore, management has stipulated that the university will maintain a minimum ongoing operating reserve. Western is addressing its infrastructure maintenance backlog by lifting the two-year freeze on increases to its annual operating transfer to capital reserves in the 2012 budget;
- Western's pension plans, which it administers on a defined contribution basis and are therefore essentially balanced with no past service liability. This provides a significant boost to the university's balance-sheet strength compared with that of its peers, some of whom could be facing large deficits payments in the next few years; and
- Historically stable government support. Operating grants from the Province of Ontario (AA-/Stable/A-1+) and other government grants account for about 46% of Western's revenues, which helps underpin the ratings. In addition to a base operating grant (which it provides per FTE), the province also has a history of providing additional grant envelopes and one-time, year-end disbursements to alleviate operating and capital pressures. However, a recently released report that the province commissioned to take a comprehensive look at spending contains recommendations that, if implemented, could alter how postsecondary institutions are funded. In light of this and given Ontario's large deficit projections through 2017, we believe that medium-term financial support for universities is likely to be constrained.

We believe credit concerns include:

- Our expectation of rising debt in the near-term. Rising enrollment and Western's guarantee of residence accommodation for first year students has pressured its residence operations to the point where a new residence is required. We expect that Western will borrow up to C$100 million by fiscal 2014 (fiscal year end is April 30) to help finance construction and that debt could increase to more than C$10,000 per FTE and 30% of adjusted revenue, levels higher than similarly rated domestic peers; and
- Continuing pressure on operating budgets. The Canadian university sector continues to face a tight operating environment despite, for the most part, having recovered from a recession that severely impaired the value of financial assets and negatively affected investment returns. In our view, Western has exhibited stronger operating performance relative to most of its rated peers, posting a surplus 4.3% of operating revenue in fiscal 2011, down only slightly from 4.8% in 2010. Western's surpluses (and deficits) have been partially affected by and generally move in tandem with investment income, which rebounded substantially in 2010 and continued to be robust in

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2011. The other key attribute of the university's budget that has made it more resilient than that of its peers is its essentially balanced pension plan, for which it does not have the same special payment funding concerns that nearly all other rated Canadian universities must budget. Given that salaries and benefits are by far the most significant spending pressure at Canadian universities, Western has a notably better performance outlook.

Outlook

The negative outlook reflects our expectation that Western's debt burden will rise significantly within the two-year rating horizon, during which time we also believe that investment returns are likely to be low and government financial support could diminish. We could lower the ratings if the level of unrestricted financial resources were to be stagnant or operations were to return to deficit (Standard & Poor's-adjusted). We could revise the outlook to stable if unrestricted financial resources continue increasing to support the additional debt, the university continued to post modest adjusted operating surpluses, and any change in provincial support does not meaningfully impair Western's grants and other revenues.

Government-Related Entity Methodology

In accordance with our criteria for government-related entities, our view of a "moderately high" likelihood of extraordinary government support reflects our assessment of Western's "important" role in the province, given that postsecondary education is one of Ontario's top priorities in both expenditure and mandate (after health care and school boards), and that there are no viable private alternatives. It also reflects our view of the university's strong reputation, and its significant research capacity. In our opinion, the provincial oversight and directive Western receives through tuition regulation and program approval suggests a "strong" link with the province. Also supporting this view is that provincial operating grants account for about 46% of the university's operating revenues.

Background

Founded in 1878, Western is a research-intense, doctoral university. It is in the southwestern Ontario city of London, which has a population of almost 366,000. Western has over 36,700 FTEs with its three affiliated colleges, and is the third-largest of 20 public universities in Ontario. It 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. In January 2012 the university rebranded itself as Western University. Although the legal name is unchanged, the new brand name is part of an ongoing attempt at becoming a more international institution and to deemphasize the legal name's regional connotations.

Demand Profile Continues To Improve

In fall 2011, Western had about 30,600 FTEs (excluding about 6,100 FTEs at its affiliates, which the consolidated audited statements do not reflect). The fall 2011 cohort was the university's largest ever, at about 5,000 new students, and overall enrollment was up 2.4%, continuing the growth trend of the past 10 years. Western's selectivity is slowly improving; its acceptance rate decreased to 57% for fall 2011 students from 66% in fall 2005. Moreover, the average entry grade of full-time first year students was 87%, slightly below that of Queen's

University in Kingston, Ont.

Graduate students made up about 17% of fiscal 2011 enrollment. Strong graduate enrollment growth has improved this proportion from 15% in 2008, putting it closer in line with other research-intensive universities such as the University of Toronto, Queen's, and McGill University (in Montreal), which average about 20%. However, graduate enrollment across Ontario universities has been below the provincial expectation of an additional 15,000 graduate spaces by 2012, which has led to intense competition for graduate students. Western will have to dedicate more resources to achieve its graduate enrollment targets over the next several years and we expect the overall proportion of graduate students to stay at current levels. In the next five years, the university expects its growth rates will moderate slightly and plans to increase its total full-time enrollments modestly to about 32,300.

A major goal of Western's growth plan is to increase international student enrollment. Currently, international students make up 3.1% of undergraduates, significantly lower than other research-intensive peers and the Ontario average of 6.0%. The university has dedicated significant resources towards recruiting international students and supporting them once they are on campus.

We believe that Western's strong demand metrics will continue partially because demographic projections show that growth in the university age population will remain fairly stable in the Greater Toronto Area (GTA) through 2022, indicating a significant need for additional spaces at universities in and around the GTA in the coming decade. This rising demand should help Western achieve its growth targets as the university is fairly close to the GTA (about 200 kilometers away).

Potential Changes To Provincial Funding Could Affect Operating Environment

The Ontario government announced in its 2011 budget (March 29) that it would allocate funding for 60,000 new postsecondary spaces over five years (19,000 for colleges and 41,000 for universities). Beginning in January 2012, the province introduced a tuition rebate program that returns 30%, or C$1,600, of tuition fees to university students with household income of less than C$160,000 per year. A provincially commissioned review of government program spending, released Feb. 15, 2012, and known as the Drummond Report, contained 30 specific recommendations for postsecondary education that could, if implemented, significantly affect the operating environment for Ontario universities.

Among the report's findings was that Ontario expects enrollment to increase an average of 1.7% per year through 2017-2018 and that Ontario provides the lowest per-student provincial operating grant funding in Canada. The report posits that the per-FTE funding formula emphasizes higher enrollment with the potential side effect of undermining teaching quality, and recommends changing the formula to reward quality objectives, such as degrees awarded, and varying mandates for institutions to reduce the competition for limited research funding. The report also concludes that tuition freezes are likely to hurt the learning environment and recommends maintaining the existing tuition framework, which is due to expire in 2012 and allows for annual tuition increases of five per cent per year. It also recommends that Ontario consider eliminating the newly minted tuition rebate, which will cost the province an estimated C$420 million annually.

Although the government is under no obligation to follow the recommendations, the report provides insight into some of the challenges that Ontario universities are grappling with. The report does not suggest that funding to postsecondary institutions be cut, which provides some comfort for the sector, but does recommend that growth in

total spending on postsecondary education be capped at 1.5% per year to 2017-2018 (when the government expects to balance its budget).

We believe Ontario generally provides good support to its universities; provincial operating and other government grants account for about 46% of Western's total revenues. Nevertheless, the province's operating environment has become restricted, and we expect financial support for universities to be constrained in the medium term. Although the recommendations in the Drummond Report could result in changes to the provincial funding models if followed, and Ontario is projecting a budget deficit of C$16 billion in fiscal 2012 (March 31), we believe that it will continue to provide solid financial support to universities and we expect that postsecondary education will continue to play a vital public policy role.

Western's operating performance has been fairly strong in the past two fiscal years despite the tight operating environment. It posted a surplus of 4.3% of operating revenue (Standard & Poor's adjusted) in fiscal 2011, which despite being slightly lower than the 4.8% in 2010 and below the historical average, is strong compared with that of its peers. Before the weak performance in fiscal years 2008 and 2009, its annual operating balance averaged 7% of total revenues since fiscal 2004. Western's surpluses (and deficits) have been partially affected by and generally move in tandem with investment income, a pattern that appears to have continued in fiscal 2011. Investment income contributed C$50 million in 2011, down from C$59 million in 2010, and typically accounts for 3%-6% of total revenues. We expect that investment returns will be weaker in fiscal 2012 and in the near term as economic growth continues to be soft. The other key attribute of Western's budget that has made the university more resilient than its peers is the structure of its postemployment benefits. Because its pension plan is essentially balanced, it does not have the same special payment funding concerns for which nearly all other rated Canadian universities must budget. Given that salaries and benefits are by far the most significant spending pressure at Canadian universities, Western has a notably better performance outlook.

Western expects its operations to have a moderate surplus in fiscal 2012, although it is likely to post deficits in fiscals 2013 to 2015 due to stagnant grant revenue growth and one-time allocations. By the end of 2015, we believe the cumulative deficits will result in drawdowns to the operating reserve so that it is likely to approach the board-mandated minimum of C$2.5 million. Management has initiated some difficult cost-containment efforts; however, we believe that the potential for changes to the provincial funding model in combination with continuing budgetary pressures, particularly from salaries and benefits which account for 60% of total expenses, will continue to strain operations. Nevertheless, without having to fund significant postemployment liability deficits like many other universities, Western is in a much better position to protect its balance sheet.

New Residence Likely To Open By 2013

Western is building a new 1,000 bed residence to meet demand for on-campus student housing, particularly among first-year undergraduates. The total project is expected to cost more than C$90 million and construction is underway, with 600 beds planned to be available by September 2013 and the remainder open by the following fall.

The university has budgeted about C$139 million in capital projects for fiscal 2012 (see table 1), of which it will fund about 37% through debt, 18% with its operating budget, 13% through fundraising, 12% from government sources, and 10% from investment returns. Major projects, in addition to the new residence, include the new building for the Richard Ivey School of Business, which received C$50 million in federal grants through the Knowledge Infrastructure Program, and several major renovations to academic buildings aimed at addressing

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deferred maintenance issues.

Table 1

University of Western Ontario--Capital Projects Underway As Of April 30, 2011

	Start	End	Cost (mil. C$)
IT network and infrastructure upgrades	May 2008	Septembert 2012	4.6
Stevenson Hall and Lawson Hall renovations	January 2009	August 2011	18.8
UCC Renovations--a follow-up on renovations to existing facilities	May 2009	December 2010	9.4
New Ivey building	August 2009	September 2012	102.1
Physics and astronomy building renovations	Mar 2010	June 2012	26.5
Electrical infrastructure	May 2010	April 2011	1.0
Addition to the Museum of Ontario Archaeology	June 2010	May 2011	2.4
UCC renovations	September 2010	April 2011	4.8
The Wind engineering, energy, and environment facility	December 2010	November 2012	9.1
Universitywide energy efficiency initiatives	January 2011	November 2011	1.5
Site servicing at the advanced manufacturing park	April 2011	August 2011	1.9
Total	N/A	N/A	182.1

Source: University of Western Ontario's 2011-12 Capital Budget. UCC--University Community Centre. N/A--Not applicable.

The current replacement value (CRV) of Western's physical assets was C$1.8 billion at the end of March 2011. Management estimates its deferred capital maintenance at about C$187 million (including C$24 million for its residence buildings), or 10.7% of CRV. The university receives a small amount of funding from the province for deferred capital maintenance, but it has a long-term strategy for tackling the problem by raising its annual transfer from operations toward its backlog by C$750,000 each year until it reaches C$15.5 million per year. The university froze the increase for the past two years due to budget constraints but will continue with them starting in fiscal 2012. The outlook for federal and provincial capital grants is uncertain given the significant budget deficits at both levels, and we believe that Western will continue to become more dependent on capital revenues from competitive research sources, private fundraising, transfers from the operating budget, and debt to fund its capital plans.

Debt To Increase Significantly By 2014

In fiscal 2011, Western's debt was about C$216 million, or C$7,222 per FTE, down from C$7,535 in 2010. The bulk of existing debt is the C$190 million senior unsecured bullet debenture issued in 2007 that was used to refinance about C$80 million of maturing debt and to finance capital projects to accommodate enrollment growth.

Of the university's debt, student housing mortgages accounted for C$11 million; and about C$16 million was for related organizations, mostly for a research development park. Western has entered what we consider a low-risk swap agreement. Included in the C$216 million debt is C$13 million that it borrowed from The Toronto-Dominion Bank; the university then entered a five-year swap with the bank for that amount. The agreement fixes Western's interest rate at 4.9% and ends Oct. 25, 2012. The loan repaid an existing one related to the research park.

In September 2011, Western entered a credit agreement that would allow for up to C$130 million in additional unsecured borrowing through a C$30 million revolving demand facility and a C$100 million committed nonrevolving term facility payable by September 2026. At the same time, the university entered an interest rate swap to fix the long-term rates on the principal at 2.987%. The facilities will be unsecured and rank pari passu with the

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university's senior secured debenture outstanding. Both facilities are currently undrawn and the C$100 million is interest-only payable until April 2013, after which monthly principal and interest payments are due. We expect that the C$100 million term facility will be fully drawn by the end of fiscal 2014 to finance the construction of the new residence but that the C$30 million revolver will only be tapped for short-term cash flow management if necessary.

In fiscal 2011, Western's debt-to-adjusted revenue improved slightly to 22%, from 24% in 2010 and 29% in 2009, although this ratio remains weaker than the 16% to 19% range before the debt issuance in 2007. The improvement in the debt service coverage ratio (DSCR) to 7.3x in fiscal 2011, from 6.8x in fiscal 2010, indicates strengthening liquidity. Liquidity levels compare well with those of many peers, and have been sound through the past several years despite the pressure on budgets. However, with the additional borrowing expected in the next two years, pro forma debt could climb to more than C$300 million by the end of fiscal 2014. Based on our conservative forecasts, we expect that debt-to-adjusted revenue could rise to more than 30% and that DSCR could weaken to under 4.0x, which is still favorable compared with many of Western's peers. We expect debt to exceed the limit allowed under Western's debt policy, but the university's board has approved a temporary relaxation of the policy to accommodate the additional debt in fiscal years 2013 and 2014.

In our view, the strong student demand for additional residence spaces and the history of positive cash flows from Western's residence operations, which can be used to fund debt service such that we expect the associated debt to be fully amortizing, makes for a solid business case for the project. However, we believe that the increased debt will weaken the university's credit profile relative to similarly rated Canadian universities.

Rebound In Endowment Funds Helps Buttress Balance Sheet

The market value of endowments across most of the Canadian university sector continued to recover in fiscal 2011 from the lows of 2009. The market value of Western's endowment in fiscal 2011 was C$362 million, up 36% from fiscal 2009, in which the value dropped 18% from the previous year. This brought the market value above the previous high-water mark of the fund of C$325 million in 2008. We do not expect that the fund will continue this impressive performance through the rating horizon given the expectations of slowing investment returns during the next two years and continuing market turbulence threatening another downturn in the global economy.

About 95% of Western's fiscal 2011 endowment carries external restrictions. But even this provides the university pragmatic strength through scholarships and faculty chairs, which help attract and maintain students and faculty. The remainder of the university's endowments are internally restricted, which along with C$166 million in internally restricted net assets (net of investments in capital assets), gives it total unrestricted financial resources of C$185 million. This is a significant improvement from 2009, and brings the level above pre-2008 levels. Unrestricted financial resources now cover 86% of total debt, compared with 60% in 2010 but still lower than 124% in 2007. Nevertheless, this ratio highlights an important difference between Western and its peers when nonfunded postemployment liabilities are added in the denominator; for Western, the ratio is improving, compared with deterioration at most other institutions.

Although these ratios are no longer weak compared with those of similarly rated domestic peers, relieving some near-term downward pressure on the ratings, we believe that the ratio of unrestricted financial resources to pro forma debt could decline to 60%-70% by 2013.

Effective May 2011, Western's payout policy for its endowed funds, including underwater funds with market values

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less than the donated capital, is an annual allocation of 4.0% of a five-year average of the endowment's market value. Its current fundraising campaign, launched in 2007, is aiming to raise C$750 million by 2018. The university plans to use 36% of the funds for student support, 29% for chairs and faculty leaders, 22% for academic and research programs, and 13% for infrastructure. At the end of February 2012, the university had raised more than C$280 million in donations and pledges.

Postemployment Liabilities Are Higher But Manageable

At the end of fiscal 2011, Western had C$272 million in unfunded nonpension postemployment liabilities (such as medical, dental, and life insurance), a 10% increase (or C$25 million) from the previous year. The expense for these plans is funded with cash, which in fiscal 2011 amounted to C$6.2 million. In the past few years, the university has made efforts to moderate the growth of these liabilities by initiating some cost-containment measures. For faculty, Western has:

- Introduced a 15% co-pay;
- Reduced the age limit for dependent coverage; and
- Increased the threshold for eligibility to 10 years from five for all new hires.

For staff, the university has:

- Limited cost increases for active and retiree benefits to no greater than CPI (3% maximum) in each year;
- Reduced the age limit for dependent coverage; and
- Increased service requirements to qualify for postretirement benefits to 10 years.

Among Canadian rated universities, Western stands out as the only university with an essentially balanced pension plan (its deficit position was only C$376,000 at the end of fiscal 2011). This is largely because it predominately sponsors a pure defined contribution (DC) pension plan. In contrast, many peers, such as Queen's, McGill, and the University of British Columbia, extend a hybrid DC pension plan to their members, whereby a minimum payout is guaranteed but is less generous than the typical term of a defined benefit plan, and the benefit payout calculation is not linked to annual inflation adjustments. Western is in a stronger position given the pension funding pressures that nearly all other rated Canadian universities face.

Table 2

University of Western Ontario--Peer Comparison

	--University of Western Ontario--			--York University--			--McMaster University--		
(C$000s)	**2011**	**2010**	**2009**	**2011**	**2010**	**2009**	**2011**	**2010**	**2009**
Issuer credit rating at year-end	AA/Negative/--	AA/Negative/--	AA/Stable/--	AA-/Stable/--	AA-/Stable	AA-/Stable	AA-/Stable/--	AA-/Stable/--	AA/Stable/--
FTEs	29,913	28,987	28,171	47,894	46,644	45,273	25,399	25,007	24,104
Total revenue	994,995	961,065	834,929	923,016	890,385	846,709	859,507	828,373	731,819
Deferred capital	29,962	31,765	32,017	11,698	12,846	11,729	34,688	36,386	37,146
Adjusted revenue	965,033	929,300	802,912	911,318	877,539	834,980	824,819	791,987	694,673
Total expenditure	952,204	915,262	905,280	926,551	894,803	858,416	837,556	816,723	785,772
Interest	10,790	11,163	12,665	19,591	21,060	22,778	9,900	9,969	10,034
Depreciation	66,066	67,199	67,180	39,959	41,225	44,754	61,115	62,474	62,659

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Table 2

University of Western Ontario--Peer Comparison (cont.)									
Adjusted expenditure (For DSCR)	875,348	836,900	825,435	867,001	832,518	790,884	766,541	744,280	713,079
Consolidated surplus (%)	4.3	4.8	(8.4)	(0.4)	(0.5)	(1.4)	2.6	1.4	(7.4)
Consolidated surplus (for calculating DSCR; %)	9.3	9.9	(2.8)	4.9	5.1	5.3	7.1	6.0	(2.6)
DSCR (interest and principal; x)	7.3	6.8	(0.8)	1.8	1.8	0.8	2.6	4.3	(1.7)
DSCR (interest only; x)	8.3	8.3	(1.8)	2.3	2.1	1.9	5.9	4.8	(1.8)
Total debt	216,034	218,411	230,527	310,941	315,123	345,477	174,143	173,270	154,331
Unfunded postemployment liabilities	272,486	247,332	229,015	361,997	353,581	141,805	480,964	579,116	567,969
Interest expense to adjusted revenue	1.1	1.2	1.6	2.1	2.4	2.7	1.2	1.3	1.4
Debt to FTE	7,222.1	7,534.8	8,183.1	6,492.3	6,755.9	7,631.0	6,856.3	6,928.9	6,402.7
Debt to adjusted revenue (%)	22.4	23.5	28.7	34.1	35.9	41.4	21.1	21.9	22.2
(Debt plus unfunded)/adjusted revenue (%)	50.6	50.1	57.2	73.8	76.2	58.4	79.4	95.0	104.0
Internally restricted net assets	165,680	115,046	85,479	148,502	160,199	179,426	6,416	(1,740)	9,794
Internally restricted endowments	19,567	15,949	13,975	40,533	36,324	33,747	114,833	107,817	98,832
Externally restricted endowments	342,840	302,930	251,650	290,799	257,496	202,112	329,272	287,854	246,139
Unrestricted financial resources	185,247	130,995	99,454	189,035	196,523	213,173	121,249	106,077	108,626
As % of total debt	85.7	60.0	43.1	60.8	62.4	61.7	69.6	61.2	70.4
As % of total debt plus unfunded post-employment liabilities	37.9	28.1	21.6	28.1	29.4	43.7	18.5	14.1	15.0
As a % of operating Expense	19.5	14.3	11.0	20.4	22.0	24.8	14.5	13.0	13.8
Per FTE	6,193	4,519	3,530	3,947	4,213	4,709	4,774	4,242	4,507
Total endowment value per FTE (at market value)	12,115	11,001	9,413	7,057	6,303	5,412	20,201	18,425	17,300

FTE--Full-time equivalent. DSCR--Debt service coverage ratio.

Related Criteria And Research

Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010

Ratings Detail (As Of March 16, 2012)	
University of Western Ontario	
Issuer Credit Rating	AA/Negative/--
Senior Unsecured (1 Issue)	AA
Issuer Credit Ratings History	
14-Dec-2010	AA/Negative/--
04-May-2007	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.

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