

Global Credit Research - 03 Dec 2014

Canada

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Aa2
Senior Unsecured -Dom Curr	Aa2

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Key Indicators

University of Toronto (Year Ending April 30)	2009	2010	2011	2012	2013	2014
Total Enrolment (FTE)	62,934	65,402	66,611	68,088	70,311	72,371
Provincial Funding as a % of Revenue [1]	32.0	32.6	31.9	31.1	29.7	28.4
Net Tuition as a % of Revenue [1][2]	24.2	27.4	28.7	29.7	32.0	33.8
Interest Expense as a % of Revenue [1]	1.7	1.6	1.5	1.5	1.7	1.6
Funds From Operations as a % of Revenue [1]	6.2	6.0	6.4	2.5	8.6	7.1
Net Debt as a % of Revenue [1]	27.2	25.5	24.1	32.0	30.5	29.0
Net Cash and Investments/Net Debt (x)	2.0	2.5	2.7	1.9	2.3	2.4

[1] Revenue is net of scholarship expenses and adjusted to smooth investment returns. [2] Tuition fees are net of scholarship expenses.

Opinion

SUMMARY RATING RATIONALE

The University of Toronto's (U of T) Aa2 senior unsecured ratings reflect (1) the university's solid operating performance and operating cash flow generation despite continued operating pressures, (2) a moderate debt burden and (3) strong balance sheet. These positives are balanced against significant unfunded pension liabilities as well as persistent operating pressure as a result of cost inflation and continued modest decline in provincial funding as a percentage of revenue. The university retains strong fiscal flexibility and is able to make ongoing adjustments to its budgets in order to ensure the posting of satisfactory fiscal outcomes. The ratings also take into account U of T's strong market position as Canada's largest post-secondary institution and as a national and international leader in research.

Credit Strengths

- Excellent academic reputation and extensive research programs support strong market position
- Low debt burden, solid liquidity profile and endowments provide financial flexibility and balance sheet strength

- Governance and management practices support prudent fiscal management

Credit Challenges

- Persistent operating budget pressures due to cost inflation and regulations that limit revenue growth
- Unfunded pension liabilities

Rating Outlook

The rating outlook is stable.

What Could Change the Rating - Up

Increased flexibility to set tuition fees, leading to higher revenue growth and increased financial flexibility, combined with growth in the university's endowment could apply upward pressure on the rating. If the university were to also successfully resolve its significant unfunded pension liabilities, this could put upward pressure on the rating.

What Could Change the Rating - Down

Sustained deterioration in financial performance and/or sustained losses in the asset value of the university's endowment, leading to a deterioration of the university's financial and liquidity profile, could exert downward pressure on the rating. An inability to address the significant unfunded pension liabilities could also put downward pressure on the rating.

Issuer Profile

The University of Toronto (U of T), Canada's largest post-secondary institution, is a comprehensive teaching and research university offering programs in 18 faculties, including Applied Science & Engineering, Arts & Science, Medicine, Law and Management. Enrolment exceeds 72,000 full-time-equivalents (FTE).

Like other universities in the Province of Ontario, the U of T was created by a separate act of the provincial legislature. While the province is ultimately responsible, constitutionally, for the delivery of post-secondary education, U of T operates at arm's-length from the province, as do other Ontario universities. The provincial government establishes broad strategies and targets for each university, provides operating grants and has the authority to control tuition fees, but each university retains autonomy to carry out its activities. While the Ontario Ministry of Training, Colleges and Universities monitors developments at individual universities and demands that universities be accountable, the "hands-off" approach to the university sector in Ontario is unlike that in some other Canadian provinces, such as Quebec and British Columbia, where the level of provincial control and oversight is considerably greater. U of T's strong standalone characteristics including strong governance and management mitigate any concerns posed by the relative independence of Ontario universities from the provincial government

DETAILED RATING CONSIDERATIONS

U of T's rating combines (1) a baseline credit assessment (BCA) for the entity of aa2, and (2) a high likelihood of extraordinary support coming from the Province of Ontario (Aa2 negative) in the event that the entity faced acute liquidity stress.

Baseline Credit Assessment

EXCELLENT ACADEMIC REPUTATION AND EXTENSIVE RESEARCH PROGRAMS SUPPORT STRONG MARKET POSITION

U of T, and its affiliated institutions, including several hospitals, continues to be the leader among Canadian universities in securing federal government research funding from the three granting councils and from other federal programs. Research funding from all sources is substantial and the university continues to rank highly in terms of research output and international rankings. Nevertheless, total research grants and contracts earned by U of T have declined modestly over the last two years (CAD387 million in 2013-14). In addition to this amount, there are also substantial research grants and contracts awarded to university faculty and administered by the affiliated teaching hospitals.

U of T's strong market position is also reflected in a consistent increase in enrolment. In the 2013-14 academic

year, enrolment reached 72,370 on a full-time equivalent (FTE) basis, up 2.9% from the prior year. The increase in enrolment was largely driven by a 11% increase in international students, which represent approximately 16% of total FTE, as well as a 2.6% increase in domestic graduate students.

Despite its ongoing fiscal pressures, the government of Ontario is supporting the creation of 60,000 new post-secondary spaces to be created between 2011-12 and 2015-16. It has also recognized U of T as a flagship university. Due to this support, in combination with U of T's strong academic reputation and consistently strong domestic and international student demand, we expect the university can reach its target of over 78,000 FTEs by the 2017-2018 academic year.

LOW DEBT BURDEN, SOLID LIQUIDITY PROFILE AND ENDOWMENTS PROVIDE FINANCIAL FLEXIBILITY AND BALANCE SHEET STRENGTH

U of T's credit profile benefits from the university's low debt burden (29% of revenue as of April 30, 2014), low interest burden (1.6% of revenue as of April 30, 2014) and substantial liquidity (net cash and investments/net debt 2.4x as of April 30, 2014). Net cash and investments excludes externally restricted endowments. We currently do not expect any new debt issuance in the next 12 months.

Capital projects have been financed in recent years to a significant degree with solid internal operating cash flow generation. Over the last five years, annually generated funds from operations were around 6% of revenue and around 22% of debt on average.

At April 30, 2014, the university's endowment assets totalled CAD1.9 billion, up from CAD1.7 billion a year earlier. The university's Long-Term Capital Appreciation Pool, which includes assets of the endowment fund, had a formidable investment return of 14.6% in 2013-14, which compares to a ten-year rolling average return of 4.5%. The spending rate of the endowment fund is set between a range of 3-5% of the fair value of the endowment. The University of Toronto has traditionally been successful in its fundraising activities. Its CAD2 billion Boundless campaign continues and the university has now secured more than CAD1.5 billion in donations. Over the fiscal year 2013-14, CAD169 million in new pledges and gifts were raised. Supported by its solid market position, we expect U of T will continue to be successful in its fundraising campaigns despite international and national competition for fundraising dollars.

GOVERNANCE AND MANAGEMENT PRACTICES SUPPORT PRUDENT FISCAL MANAGEMENT

U of T's academic mission is clearly articulated and the Governing Council possesses the tools necessary to effectively oversee and monitor management's activities.

The success of U of T in maintaining a strong balance sheet, while meeting academic goals, is underpinned by the development and execution of multi-year frameworks for academic and financial planning. These plans identify performance benchmarks and facilitate the development of operating budgets and capital plans. Internal financial management policies are comprehensive and support both growth in the university's net asset position and the management of investment and debt related risks. University of Toronto Asset Management Corporation (UTAM), a non-share capital corporation controlled by the university, is tasked with managing the investment assets of the university's Long-Term Capital Appreciation Pool (which includes assets of the endowment fund), the Expendable Funds Investment Pool (including short- to medium-term funds) and assets of the university's pension plans. The university made changes to the governance arrangements of UTAM following the financial crisis to improve oversight over investment activities and has also modified its investment strategies, placing greater emphasis on risk management and stress-testing the portfolio from both a liquidity and an asset allocation standpoint.

PERSISTENT OPERATING BUDGET PRESSURES DUE TO COST INFLATION AND REGULATIONS THAT LIMIT REVENUE GROWTH

U of T, similar to other universities in Ontario, targets a balanced budget every year. Annual surpluses and deficits are largely a result of investment return and savings from divisions while the university has been successful in most years to balance its core operations. In 2013-14, the university achieved a solid reported net income of CAD204million supported by CAD179 million in investment income. On a Moody's-adjusted basis, which makes adjustments to the university's annual fiscal outcomes to smooth the impact of investment returns and remove scholarships, fellowships and bursaries from both revenues and expenses, reflecting the "flow-through" nature of these expenses, U of T posted a net income of CAD177million (7.0% of adjusted revenues) in 2013-14.

Due to the need to remain competitive with other top institutions and attract academic talent, the University of Toronto continues to face challenges from rising costs of salaries and benefits, the university's largest expense

item (around 60% of operating expenditures). This is further pressured by significant pension expenses arising from the university's pension plan deficit in recent years. The university's prudent budgetary policies have helped to manage these cost pressures and over the last two years the university was successful in maintaining personnel expenditure growth below revenue growth.

Pressures on the revenue side mainly arise from stable operating government grants, which have not been increased over the last two years, as well as regulatory limits on the ability to increase tuition in Ontario for domestic students. The university's growth in enrolment and focus on international students, to which tuition caps do not apply, have still supported a cumulated average growth rate in tuition revenue of 10% over the last five years. Beginning in 2013-14, the Ontario government allows tuition to increase by an average of 3% for domestic students compared to 5% previously which will put some pressure on future tuition revenue.

UNFUNDED PENSION LIABILITIES

U of T had a pension deficit of CAD684 million as of April 30, 2014 (27.5% of revenue); an improvement compared to the prior fiscal year (CAD1,123 million, 47.6% of revenue) driven by better asset returns and a slightly lower discount rate. New mortality tables have not been incorporated yet and could put some pressure on the existing pension deficit in fiscal year 2014-15. The university had increased the special payment it makes to the defined benefit plans over recent years. In each of 2011 and 2014 the university made a CAD150 million lump sum payment in order to reduce its pension liability. The university recently negotiated an increase in the employee contributions to the fund, however this was partially at the cost of higher wages over the life of the new collective bargain.

U of T has applied for the provincial solvency funding relief program, and has received Stage 1 approval whereby the university has developed a plan to make its pension plans more sustainable. If the university received Stage 2 approval (based on actuarial filing date July 1, 2014), this would allow the university to amortize special pension payments required to address the solvency deficiency over either 7 years starting in 2018 or 10 years starting in 2015, instead of five years.

Extraordinary Support Considerations

Moody's assigns a high likelihood that the Province of Ontario would act to prevent a default by the university. The high support level reflects a perceived risk to the province's reputation as regulator of the university sector if the University of Toronto or any Ontario university were to default.

Moody's also assigns a very high default dependence between the university and the Province of Ontario reflecting our assessment of the university's and the province's joint exposure to the impact of prolonged economic shocks. It also reflects the university's reliance on provincial government grants for a sizeable portion of its overall revenues.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale credit ratings, please refer to Moody's Credit rating Methodology published in June 2014 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings".

The Moody's Global Scale rating for issuers and issues allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a Government Related Issuer (GRI) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0 - 30%), moderate (31 - 50%), strong (51 - 70%), high (71 - 90%) and very high (91 - 100%).

Default Dependence

Default dependence reflects the likelihood that the credit profiles of two obligors may be imperfectly correlated. Such imperfect correlation, if present, has important diversifying effects which can change the joint-default outcome. Intuitively, if two obligors' default risks are imperfectly correlated, the risk that they would simultaneously default is smaller than the risk of either defaulting on its own.

In the application of joint-default analysis to GRIs, default dependence reflects the tendency of the GRI and the supporting government to be jointly susceptible to adverse circumstances leading to defaults. Since the capacity of the government to provide extraordinary support and prevent a default by a GRI is conditional on the solvency of both entities, the more highly dependent -- or correlated -- the two obligors' credit profiles, the lower the benefits achieved from joint support. In most cases GRIs demonstrate moderate to very high degrees of default dependence with their supporting governments, which reflects the existence of institutional linkages and shared exposure to economic conditions that draw credit profiles together.

Default dependence is described as either low (30%), moderate (50%), high (70%) and very high (90%).

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