Research Update:

University of Toronto Ratings Affirmed At 'AA+'; Outlook Remains Stable

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Overview

- We believe that recent changes by the provincial government to domestic tuition rates and core operating grants will ratchet up budgetary pressure for the University of Toronto (UofT) and could lead to a moderate decline in operating margins in the next several years.
- However, in our view, UofT's exemplary student demand and research capacity will continue to support its flagship status among Canadian universities, while a moderate debt burden and very strong liquidity will underpin its financial profile in the next several years.
- We are therefore affirming our 'AA+' long-term issuer credit and senior unsecured debt ratings on UofT.
- The stable outlook reflects our expectation that, within our two-year outlook horizon, the university will maintain its exceptional market position and student demand profile, its adjusted operating margins will remain positive, and its level of available resources will remain very robust.

Rating Action

On Nov. 14, 2019, S&P Global Ratings affirmed its 'AA+' long-term issuer credit and senior unsecured debt ratings on the University of Toronto (UofT). The outlook is stable.

Outlook

The stable outlook reflects our expectations that, within our two-year outlook horizon, UofT will maintain its exceptional market position and student demand profile, and very high levels of available resources. At the same time, we expect that the university's debt burden will be largely stable and that UofT's relationship with the province will not alter materially. Although we expect that provincially imposed changes to domestic tuition fees and the operating grant formula will add to budgetary pressures in the near term, we believe that the university's robust internal resources and capable management will allow it to adapt in order to continue generating positive adjusted operating margins.

Downside scenario

We could lower the ratings if adjusted net margins weakened to near-balance, on a sustained basis, because of a significant reduction in government grants, enrollment falling well short of targets, or greater-than-expected operating expenses. We could also lower the ratings if UofT issued substantial debt in the next two years, resulting in the level of available resources falling to less than the total debt outstanding and the estimated maximum annual debt service rising to greater than 2% of operating expenses. A negative rating action on Ontario would also result in a similar rating action on UofT, given the maximum three-notch rating differential between the university and the province allowed under our government-related entities criteria. All else equal, we could also lower the ratings if we significantly reduce our estimate of UofT's resilience to an Ontario default scenario. Moreover, although highly unlikely, a strengthening of our assessment of the link between UofT and the province would cause us to equalize the ratings with those on Ontario.

Upside scenario

We could raise our assessment of UofT's stand-alone credit profile in the next two years if the provincial government relaxed its restrictions on tuition increases, while maintaining its supporting operating grants, resulting in a material increase in student-derived revenues and increased financial flexibility. However, we consider the possibility of this scenario resulting in a positive action to our issuer credit rating on UofT during our two-year outlook horizon unlikely, given our three-notch cap above the rating on the supporting government.

Rationale

The ratings reflect UofT's stand-alone credit profile, which S&P Global Ratings assesses at 'aa+'. This reflects our combined assessment of the university's extremely strong enterprise profile and very strong financial profile. The ratings also reflect our opinion of a moderately high likelihood that the Ontario government would provide extraordinary support in the event of financial distress.

The Ontario government has announced several changes to the tuition framework and its funding formula that will have a modest impact on UofT 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 in fiscal 2020 by $65 million year over year and C$88 million from its previous budget plan. In response, UofT has constrained investments in new initiatives for fiscal 2020 and its budget describes a mix of strategies that divisions will use to absorb the revenue reduction, including changes to faculty and staff hiring plans, deferral of capital projects, service reductions, and operating cost efficiencies. The other significant change is to the formula for calculating the operating grant that each university in the province receives. Currently, the operating grant is based largely on enrollment metrics but the government is accelerating a shift toward a more performance-based model. Starting in fiscal 2021, 25% of core provincial operating grants will be performance-based, increasing to 60% by 2025. The model will focus on 10 metrics that will be phased in over a three-year period and that will be more clearly articulated in updated strategic mandate agreements that each university will file with the province by the end of March 2020. Six of the metrics are skills and jobs outcomes-based (e.g., skills and competencies, graduation rate, and graduate employment) and four are related to economic and community impact (e.g., research funding and funding from industry). Although the change to the funding formula will likely result in some shifts to UofT's long-term strategy, we do not expect that it will result in a material decline in the amount of operating grants that it receives in the next two years. In addition, we believe that UofT's high levels of financial resources and strong management will enable it to adapt without negatively affecting its credit profile.

We continue to expect that UofT will maintain its position as a flagship institution, being the largest and most research-intensive university in Canada, with a solid international reputation and strong student demand characteristics. Growth in full-time equivalents (FTEs) has slowed in the past three years, although this is in line with the university's plan, and it expects overall enrollment to increase only modestly in the next five years, mainly in graduate and international students. We believe that UofT is well placed to compete for these students, but that slower student growth, against a backdrop of constrained provincial funding and inflationary cost pressures, could result in smaller operating margins than it has enjoyed in the past several years.

Founded in 1827, UofT is Canada's largest university based on enrollment and has three campuses (St. George, Scarborough, and Mississauga) that together accounted for 91,286 students in fall 2018. The university offers a variety of undergraduate, graduate, postgraduate, and professional degrees across its 18 faculties and schools. It also has affiliations with seven colleges, 65 centers and institutes, and nine Toronto hospitals. UofT employs more faculty and staff and offers a greater range of courses than any other Canadian university. It is also Canada's most important research institution and has been the highest-ranked Canadian university in recent years in several international surveys.

We believe the university has an extremely strong enterprise profile. Supporting our opinion is our assessment of the higher education sector's low industry risk, characterized by countercyclicality and low competitive risk and growth. In addition, the university benefits from excellent economic fundamentals, measured by the province's GDP per capita, estimated to be about US$46,000 in 2018; good income indicators; and moderate employment and population growth projections. In addition, with about a third of students coming from outside Ontario, the university's enterprise profile benefits from a geographically diversified student body.

Furthermore, UofT's leading market position and healthy demand strengthen the university's enterprise profile. FTE growth through fall 2018 slowed to an average of 1.5% per year in the past three years, from an average of more than 3% in the preceding three years, reaching 80,652. About 23% of FTEs were graduate students, a ratio that is in line with that of most Canadian research-intensive universities. As part of its negotiated agreement with the province, UofT plans for a slight decrease in the number of provincially funded domestic undergraduate students in the next five years. However, it expects that planned growth in graduate and international students will result in overall FTEs growing about 2.6% in the next five years while the proportion of graduate students will increase to 26% of total FTEs. In our opinion, student quality continues to be strong, as reflected by the university's historically stable retention and graduation rates of about 92% and 75%, respectively, in the past several years, as well as a robust selectivity rate well below 75%.

In our view, UofT's management expertise and governance practices, as well as financial management policies, are very strong and in line with those of other highly rated Canadian universities. The university's academic and operational priorities are guided by its strategic plan, Towards 2030 (most recently revised in 2012), and its Strategic Mandate Agreement with the province. These in turn inform the detailed annual budget and long-range plan, which incorporate operating and capital plans. UofT reviews its performance relative to the plan annually and tracks its progress against specific activity indicators and financial metrics. In addition, it identifies and monitors risks to the plan. The university has formal policies for endowment, liquidity and investments, debt, and reserves, and meets standard annual disclosure requirements. Overall, we view UofT's transparency and disclosure to be very good, with policies and procedures in place to adequately mitigate risks, and we believe that the university's overall financial policies are not likely to negatively affect its ability to pay debt service.

In our opinion, UofT has a very strong financial profile, bolstered by healthy adjusted operating margins averaging a little more than 8% in the past five fiscal years. It has budgeted for balanced results in its long-range operating budget plan out to fiscal 2024, partially through including unallocated funds that it can adjust to meet unforeseen contingencies. However, we believe that ongoing challenges stemming from the changes to domestic tuition rates and provincial operating grants, and increasing employee-related expenditures could result in a modest decline in margins for combined funds in the next two years. Similar to that of Canadian peers, the university's limited flexibility to increase its student-generated revenues somewhat offsets its strong financial performance. This is primarily because Ontario monitors and guides domestic tuition rates and student aid (through the tuition framework), and enrollment expansion (through operating grants).

We believe UofT's tuition discounting, which we define as total financial aid costs as a percentage of gross tuition and fees, is fairly stable and lower than the median for U.S. public universities and colleges in the 'AA' rating category. It suggests greater flexibility to address affordability concerns, which bolsters the university's competitive position. We also believe that UofT has superior fundraising capabilities relative to most Canadian peers. The university and its affiliated colleges raised more than C$2.6 billion in the most recent fundraising campaign, which ended in 2018 and exceeded the C$2.4 billion goal, and have set an ambitious annual fundraising target of C$200 million.

In our view, UofT has a relatively moderate debt burden that is very manageable, given its good operating performance and robust liquidity. At fiscal year-end 2019, its total gross debt outstanding stood at C$713 million. The debt consists primarily of five series of fixed-rate, 30- and 40-year bullet debentures maturing from 2031-2051, along with about C$2 million of mortgage and other debt. We believe that the high level of bullet debentures makes UofT's debt structure more aggressive than that of peers with amortizing debt; however, the university has established a self-imposed sinking fund to help repay these obligations with assets totaling C$397 million at the end of fiscal 2019. Our estimate of UofT's maximum annual debt service is equal to a modest 1.6% of adjusted fiscal 2019 operating expenses, which is lower than the median for peers in the 'AA' rating category. The university has identified a potential need for up to C$615 million in additional funding to the end of fiscal 2025 for capital projects that are under consideration but have yet to be approved. However, some or all of this funding could come from grants, fundraising, or internal sources and we do not believe that the debt will exceed UofT's internally approved debt limits or lead to a material erosion of the university's financial profile in the next two years.

UofT has several funded and unfunded defined-benefit programs that provide pension and other postemployment benefits (OPEB) to its employees. At fiscal year-end 2019, the pension plan's deficit decreased moderately to C$308 million, from C$319 million the previous year. The university also had a C$518 million deficit in its OPEB plan. Because there is no legislative requirement to maintain assets against these liabilities (unlike pensions), UofT funds them on a pay-as-you-go basis, similar to other universities. We do not believe that funding employee future benefits will have a material impact on the university's overall credit profile in the next two years, as the pension plan is in a healthy funded status (about 85% on a solvency basis as at July 1, 2018) and the university continues to make required payments. In addition, the university has no material off-balance-sheet or exposure to contingent liability risks.

Liquidity

In our view, the university has very robust liquidity. It continued to increase its total cash and investments to C$5.26 billion at the end of fiscal 2019 from C$4.82 billion in 2018. At the same time, our measure of UofT's available resources (internally restricted net assets plus internally restricted endowments) had increased to C$1.63 billion from C$1.37 billion the year before; equal to 50.2% of adjusted operating expenses on a three-year, weighted-average basis. We believe that the level of available resources could decline somewhat in the next several years if the university internally finances a larger portion of its capital plan. However, in our opinion, with total cash and investments being greater than 2x the available resources and more than 7x the debt outstanding, UofT's liquidity will remain more than sufficient to finance all debt service requirements and provide a significant buffer against any likely medium-term stress scenario. In addition, a very strong fundraising year in fiscal 2019 helped to boost the market value of the university's endowment, which is the largest among Canadian universities, to C$2.59 billion from C$2.50 billion at the end of fiscal 2018.

Moderately high likelihood of extraordinary provincial government support

In accordance with our criteria for government-related entities, our view of UofT'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 our assessment of the university's role as Canada's largest university in enrollment and research capacity. The province's oversight, program approval rights, and tuition regulation over UofT suggest a strong link to it. Also supporting our assessment of the link are the significant operating grants received from the province, accounting for about 20% of the university's total revenue, and the province's appointment of some board members.

We rate UofT three notches above Ontario, the maximum differential allowed in accordance with our methodology for rating government-related entities that depend on ongoing government support. The differential reflects our view that there is a measureable likelihood that UofT's substantial financial resources would meet ongoing operational and debt service requirements should the government default and temporarily suspend payments to the university. In addition, the differential reflects UofT's status as an autonomous legal entity with ownership of its assets and our view that UofT operates independently of the Ontario government. The board is responsible for the management, administration, and control of the university's property and other assets and all business affairs. We consider the risk of extraordinary negative government intervention low, given UofT's operational independence, its important public policy role, and the government's hands-off approach to the sector.

Ontario elected a new provincial government in June 2018 and since then it has announced several changes that we expect will add to pressures on university budgets in the next several years, particularly the cut to domestic tuition discussed previously. The government has pledged to reduce the province's large fiscal deficit and although we continue to believe that there is a moderately high likelihood that the province would provide support to UofT in a distress scenario, we are not anticipating any material increase in ongoing operating or capital funding from the province in the medium term.

University of Toronto -- Financial Statistics

	--Fiscal year ended April 30--					Medians for 'AA' U.S. public colleges & universities, 2018*
	2015	2016	2017	2018	2019	
Enrollment and demand						
Headcount	85,383	87,639	88,766	90,077	91,286	MNR
Full-time equivalent	74,516	77,130	78,292	79,262	80,652	35,846
First-year acceptance rate (%)	64.8	67.6	71.5	63.7	62.9	67.8
First-year matriculation rate (%)	26	25.2	25.7	25.2	25.2	MNR
Undergraduates as a % of total enrollment (%)	80.5	80.4	79.7	79.4	78.8	78.6
First year retention (%)	92.1	91.7	91.3	91.7	N.A.	86.0
Graduation rates (six years) (%)	71.7	73.7	75.2	75.6	N.A.	MNR
Income statement						
Adjusted operating revenue (C$000s)	2,786,200	2,940,200	3,022,000	3,230,000	3,423,000	MNR
Adjusted operating expense (C$000s)	2,572,500	2,725,600	2,821,000	2,973,000	3,138,000	MNR
Net adjusted operating income (C$000s)	213,700	214,600	201,000	257,000	285,000	MNR
Net adjusted operating margin (%)	8.3	7.9	7.1	8.6	9.1	1.5
Provincial grants to revenue (%)§	25.6	24.3	23.6	22.4	21.2	19.2
Student dependence (%)	41.6	43.9	47.4	49.0	50.5	39.7
Investment income dependence (%)	6.9	3.7	7.3	5.6	6.0	1.4
Debt						
Debt outstanding (C$000s)	721,100	718,600	718,000	715,000	713,000	828,692
Current debt service burden (%)	1.57	1.48	1.42	1.35	1.27	MNR
Current MADS burden (%)	1.95	1.84	1.77	1.66	1.57	3.5
Financial resource ratios						
Cash and investments (C$000s)	3,794,700	3,886,600	4,558,000	4,821,000	5,259,000	MNR
Adjusted UFR (C$000s)	1,194,500	1,266,600	1,522,000	1,369,000	1,628,000	MNR
Cash and investments to operations (%)	147.5	142.6	161.6	162.2	167.6	58.2
Cash and investments to debt (%)	526.2	540.9	634.8	674.3	737.6	167.8

University of Toronto -- Financial Statistics (cont.)

	--Fiscal year ended April 30--					Medians for 'AA' U.S. public colleges & universities, 2018*
	2015	2016	2017	2018	2019	
Adjusted UFR to operations (%)	46.4	46.5	54	46	51.9	34.3
Adjusted UFR to debt (%)	165.6	176.3	212	191.5	228.3	100.5
Endowment per FTE	28,747	27,197	30,399	31,591	32,150	37,432
Average age of plant (years)	17.9	18.2	18.5	18.1	18.1	13

*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.

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

- 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 Toronto	
Issuer Credit Rating	AA+/Stable/--
Senior Unsecured	AA+