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Tight Provincial Relationships Strengthen Credit Quality of Universities in Ontario, British Columbia and Québec

Table of Contents:

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Strong provincial relationships overall bolster the credit strength of universities in Ontario, British Columbia and Québec. However, certain policies and controls can offset the benefits by limiting universities' independent financial health. This leaves their credit profiles exposed to factors beyond their control, including changing provincial financial conditions and restraints on revenue growth.

» **The three provinces provide significant oversight and funding that support universities' high credit quality.** Québec has stronger control of its universities than Ontario or British Columbia (BC), though all three exercise significant oversight in key areas such as enrolment, tuition, and debt. We rate 10 public universities in Ontario, BC and Québec. Our ratings for these universities range from A3 to Aa1.

» **Provinces would likely take extraordinary measures to prevent universities from defaulting.** Both Québec and Ontario have stepped in to provide extraordinary support for struggling universities. Canadian public policy stresses the importance of higher education. Provinces are incentivized to avoid market contagion that might be fueled by a default.

» **Provincial policies hamper universities' independent financial strength through tuition caps and enrolment restrictions**. Universities are unable to capitalize on excess student demand to increase revenues because of governmental limits.

» **Significant deterioration in a province's financial condition would impair a university's credit quality**. High intrinsic financial strength could result in a university being rated above the provincial government.

Our analysis for public universities in Canada is based on both the intrinsic financial strength of the university and its relationship with its associated province. A university with high stand alone financial strength but weak financial support and oversight from a province could therefore have the same overall credit quality as a university with weaker independent financial strength but very strong linkages with a highly rated province.

Provinces provide significant oversight and funding that support universities' high credit quality

The provinces of Ontario, BC and Québec have policies that strongly link them to universities in their respective provinces. The strength of the relationship supports the high investment-grade university ratings (see Exhibit 1). All three provinces exercise substantial oversight of universities. This oversight includes reviewing financial performance, requiring regular updates, limiting operating funds to a certain enrolment number, appointing members to the board of governors and reserving the power to intervene in operations, if necessary.

Québec has stronger regulatory control and oversight

We consider Québec's oversight and controls over universities to be the strongest among the three provinces. As a result, the credit quality of universities in Québec is more directly linked to the province than in Ontario or BC. Québec reviews operating budgets, sets enrolment targets, approves capital budgets and authorizes new debt.

The province of Québec requires universities to charge a uniform tuition fee based on residency with mandated increases from the province. The province reviews all universities' financial performance and can force financially struggling universities to follow budgetary redress plans.

Ontario's universities have more operating flexibility compared with universities in the other two provinces. This gives them greater ability to translate their market strengths into financial strength. However, the comparatively more limited day to day oversight and control increases the likelihood that Ontario universities could experience significant financial difficulties prior to provincial intervention.

In British Columbia, there is a strong collaborative relationship between the universities and the province, with controls and oversight falling between the two examples of Québec and Ontario. BC sets limits on annual tuition increases as Ontario does. The province also consolidates university debt on its books and oversees and approves debt issuance by universities in a similar manner as Québec.

We rate most Canadian universities within two notches of the province's rating reflecting these close ties. Two exceptions are the Université du Québec à Montréal (UQAM, A3 positive) and University of Ontario Institute of Technology (UOIT, A2 stable), which we rate three or more notches below the province's rating. The provincial relationship helps provide a floor to the ratings of these universities. The ratings are low because of the universities' weak financial condition, which has required extraordinary financial support from the province in the past.

EXHIBIT 1

Close Ties with Provinces Bolster Canadian Universities' Ratings

Province	Provincial Rating	University	University Rating
British Columbia	Aaa	Simon Fraser University	Aa1
		University of British Columbia	Aa1
Ontario	Aa2	University of Toronto	Aa2
		University of Ottawa	Aa2
		University of Windsor	Aa3
		Lakehead University	A1
		University of Ontario Institute of Technology	A2
Québec	Aa2	Concordia University	Aa2
		McGill University	Aa2
		Université du Québec á Montreal	A3

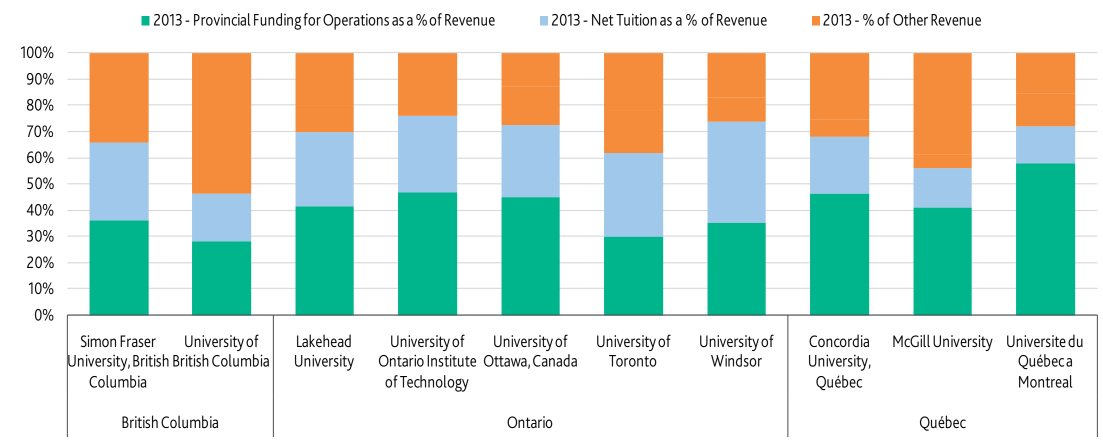
Source: Moody's Investors Service

Universities are heavily reliant on provincial operating support

Canadian universities in all three provinces benefit from a relatively high level of operating grants from the provinces. Direct provincial operating support for Canadian universities ranged from 30% to 50% of our adjusted operating revenue calculation in fiscal year 2013 (see Exhibit 2). The federal government, which does not have direct responsibility for education in Canada, provides the majority of research grants.

EXHIBIT 2

Universities in All Provinces Are Highly Reliant on Provincial Funds



Note: Different accounting standards and revenue categories may limit the ability to compare the revenue mix of universities across provinces.
Source: Universities' audited financial statements 2013

Provinces would likely take extraordinary measures to prevent a default and support financially struggling universities

Our ratings incorporate the high likelihood that the provincial government would act to prevent a default by one of its public universities. The strong regulatory and legislative framework in Canada that stresses the importance of higher education as a key public service, as well as the potential market contagion of a defaulting entity on other institutions in the same province, contribute to this underlying assumption. In addition, provincial governments have provided extraordinary aid to universities in the past. However, intrinsic financial strength of a university still matters as support by the province is highly likely but not guaranteed. In addition, provincial support might only be forthcoming following a material deterioration in the university's credit profile, as was demonstrated by UQAM and UOIT.

Evidence of extraordinary provincial support

The governments of Québec and Ontario have provided extraordinary financial support to universities, and British Columbia would likely take similar actions if necessary.

Québec provided extraordinary support to UQAM when the university was financially strained by a failed multi-use real estate project. The province assumed responsibility for the debt and placed the university on an action plan to restore fiscal equilibrium over the period of 2009-16.

The University of Ontario Institute of Technology (UOIT) has routinely faced financial difficulties because of its high debt burden. UOIT required special funds from the province of Ontario to help pay its debt service, as well as access to lines of credit. Following an agreement in 2011, the province will provide permanent debenture payments of about CAD13.5 million for UOIT's CAD16.5 million annual debt payments until the maturity of the debenture in 2034.

Provincial policies can limit universities' independent financial strength

Though provincial government policies and practices generally help credit quality, they can also inhibit a university's stand-alone financial strength by affecting enrolment and tuition policies; operating performance and liquidity; and debt issuance.

Enrolment caps and tuition restrictions limit tuition revenue growth

Constraints on tuition pricing and enrolment caps hamper a university's ability to fully capitalize on its student demand and pricing power. Canadian public universities face excess student demand that they cannot meet, owing to enrolment caps that limit the funding for domestic students but not the number of students. Since provinces will only provide per-pupil operating funds up to a set enrolment target, the policy constrains revenue growth beyond established goals.

Tuition controls are most strict in Québec, leading universities in the province to rely less on tuition revenue. British Columbia and Ontario do not set specific tuition levels for universities, but instead set caps for tuition increases. Universities in British Columbia have some flexibility in setting tuition rates for new programs.

» Québec sets a uniform tuition rate across its universities based on residency, with different rates for Québec residents, Canadian (non-Québec) residents and international students.

» Tuition fees in British Columbia have remained relatively stable in recent years, following an annual 2% tuition fee cap introduced in 2005.

» Universities in Ontario are more reliant on tuition revenue. The provincial government allowed tuition to increase by an average of 5% per year from 2006-07 to 2012-13. Beginning in 2013-14, the government reduced the limit to 3%.

Operating performance and liquidity are also linked to provincial policies

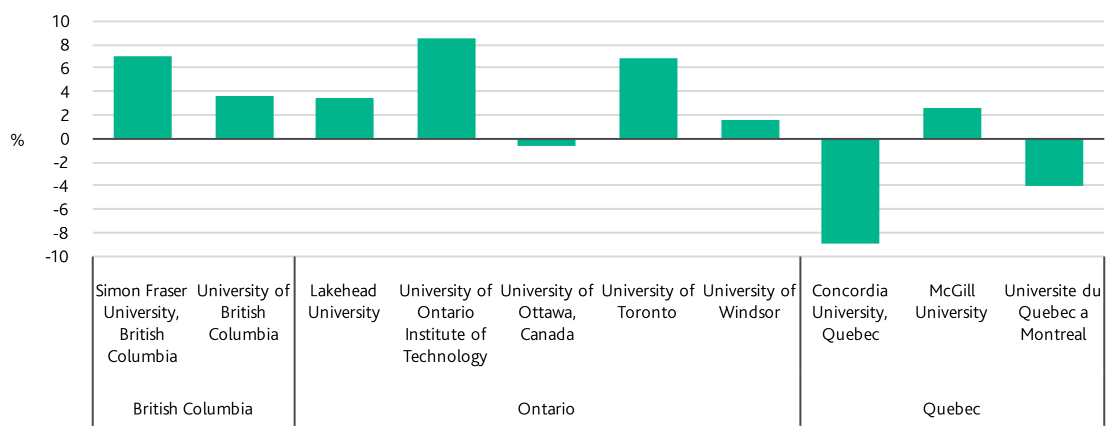
Canadian universities' operating performance and liquidity management are closely tied to the timing of operating grants as well as provincial policies on enrolment and tuition. Most universities have maintained modestly positive operating margins (see Exhibit 3) even though provinces have not increased funding as much as in the past as they confront their own fiscal challenges.

In recent years, Québec universities have experienced more financial strain than universities in Ontario and British Columbia. Most Québec universities had operating deficits over the last two fiscal years as the province mandated annual university funding reductions of CAD 125 million over the past two fiscal years. The late timing of the announcement of reductions, with only four months of the 2012-13 fiscal year remaining, posed particular pressure on 2012-13 results. We expect that the operating performance of Québec universities will improve in 2013-14 given additional time to adjust expenditures. Although the timing of these recent cuts was extraordinary in nature, they have since been made permanent. As the province continues to move towards a balanced budget, we will evaluate the risk of future cuts to university funding. Evidence of a sustained reduction in support, which we currently believe is unlikely, absent freedom to capitalize on market strengths would negatively affect credit quality.

EXHIBIT 3

Consistent Provincial Grants Support Healthy Margins at Ontario and British Columbia Universities; Budget Reductions Hurt Québec Schools

Annual Operating Margin (%)

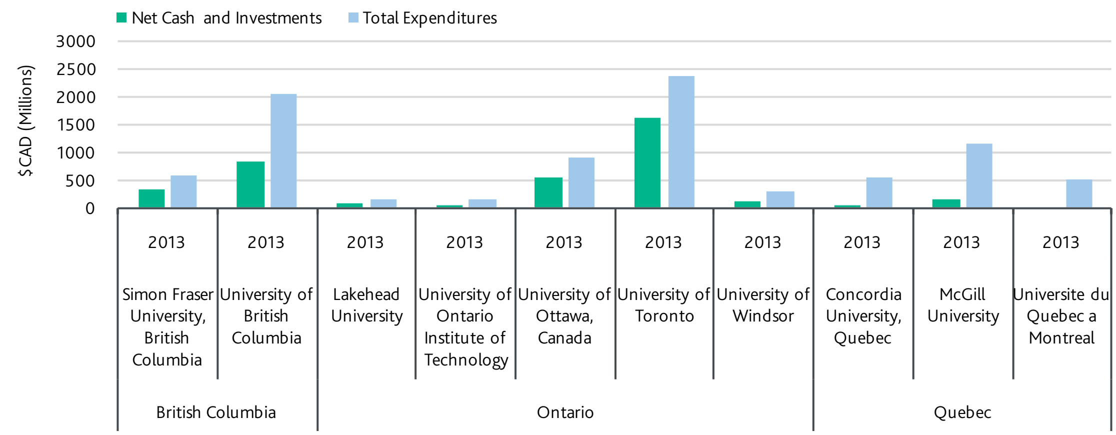


Source: Universities' audited financial statements 2013. Operating margin defined as net income as a % of revenues.

Compared with their US peers, most Canadian universities have low levels of unrestricted cash and investments relative to their operating size (see Exhibit 4). Québec universities hold notably low or even zero cash on hand, and rely on bank credit lines to finance their immediate working capital needs in advance of provincial transfers or financing transactions. The province has never missed a payment, partially offsetting this significant credit weakness on a standalone basis. However, as a result of this relatively unique reliance on liquidity support from the province, the credit quality of Québec universities is even more exposed than universities in Ontario and BC.

EXHIBIT 4

Canadian Universities Have Low Liquidity Levels Relative to Expenses, Particularly in Québec



Source: Universities' audited financial statements 2013. Net cash and investments defined as total cash and investments net of externally restricted endowments and unspent debenture proceeds.

Moderate debt burdens with ongoing provincial capital support

Most rated universities in Québec, Ontario and BC have manageable debt burdens because they rely on governmental and non-governmental grants to fund capital expenditures. Universities direct-debt-to-revenue ratios ranged from less than 20% to 50% in 2013.

The strict provincial controls over debt issuance in BC and Québec, as well as debt service subsidies in Québec, indicate that universities will continue to keep debt manageable. However, as higher education becomes increasingly globally competitive for students, research dollars, and top-tier faculty, inability to appropriately invest in facilities could become a comparative disadvantage.

» In BC, university debt is reported on the province's balance sheet. The province must approve new debt issuance. Currently, the province does not allow any new university related debt.

» Universities in Québec have issued more debt as the province provides 100% debt service subsidies for academic-related infrastructure instead of direct capital grants. A few universities have recently issued unsubsidized bonds to obtain greater financing than is currently available from the province. All debt issuance requires provincial authorization.

  Québec's practice of requiring universities to assume debt also weakens universities' independent financial strength, making them more reliant on the province for debt service support.

» Universities in Ontario have relative autonomy over debt issuance and receive limited provincial support for capital projects. However, rated institutions follow prudent internal debt policies. We do not expect Ontario universities to materially increase debt funding over the next five years.

Pension liabilities have debt-like characteristics and are a growing burden

Our credit assessment incorporates pension liabilities as indirect debt. Each Canadian university administers and manages its pension plans (the Université du Québec network administers UQAM's pensions plans). UOIT has a defined contribution plan and therefore has no pension deficit. University of British Columbia (UBC) does not have any pension liabilities as it administers a defined contribution plan as well as a hybrid plan that limits the amount the university has to pay.

Most Moody's-rated universities have experienced a rise in pension deficits because of the low-interest-rate environment, pressure on asset values, longer life expectancy, and rising salaries and benefits. In order to address pension deficits, some universities have made lump-sum payments to their plans, renegotiated annual contribution rates to plans, and/or implemented other reforms such as reducing other post-employment benefits and altering early retirement penalties.

As universities seek to grow international enrolment, with attendant facilities needs, we expect that more universities will seek alternative sources of funding to meet their strategic objectives. This could include public-private partnerships. Depending on the structure of these arrangements, they can have debt-like characteristics.

Significant deterioration in a province's financial condition would likely affect universities' credit quality

Although universities receive a credit boost from close ties to their provinces, any weakening in the relationship would directly affect the universities' credit quality, though it may not drive a rating or outlook change if offset by the university's other financial strengths.

The following changes at the provincial level could lead to a university rating or outlook change:

» a sustained reduction in provincial operating or capital support

» changes in legislation, policy or practices indicating higher education no longer represents a key public service in Canada

» financial deterioration of the province

» a province's failure to take meaningful and timely action when a university experiences financial distress.

A Canadian university could have a higher rating than its associated province, depending upon its independent financial strength.[1] For example, in July we changed our outlook on the province of Ontario's Aa2 rating to negative, but we did not change the Aa2 rating or stable outlook on the University of Toronto (Aa2 stable) and the University of Ottawa (Aa2 stable) because these schools have diverse programs, strong research programs and robust student demand (including growing international demand). These attributes help the universities to offset potential financial pressures on the province of Ontario.

1 See How Sovereign Credit Quality May Affect Other Ratings, February 2012.

Among the factors we would assess in reaching this determination are:

» **Degree of reliance on governmental support**. The credit quality of universities with more diverse revenue sources and less reliance on provincial appropriations would be less directly linked to the province.

» **Ability to translate market strength into growing revenues**. This is rooted in a university's ability to attract students and manage provincial policies regarding caps on tuition levels. It also involves an ability to garner philanthropic support to bolster operations and invest in strategic initiatives.

» **Historical and projected operating performance**. Universities with an established track record of generating healthy operating performance would be better positioned than those with thin margins.

» **Strength of management and governance.** We would assess strategic, financial and capital planning; analyze stress tests; and evaluate management's demonstrated willingness, or lack thereof, to implement cost containment when necessary to sustain fiscal balance.

» **Liquidity and other wealth levels.** Universities with greater liquidity have more flexibility to respond to multi-year financial stress. Greater wealth, evidenced by endowment levels, highlights historic success at gaining philanthropic support as well as strength of financial management.

Moody's Related Research

Rating Methodologies:

» How Sovereign Credit Quality Affect Other Ratings, February 2012 (139495)

» Methodology for Rating Public Universities, August 2007 (103498)

Rating Action:

» Moody's announces impact of the Province of Ontario's negative outlook on related ratings

Special Comment:

» Increased Policy Focus on International Students Credit Positive For Canadian Universities, August 2014 (174041)

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