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Research Update:

Queen's University Ratings Affirmed At 'AA+'; Outlook Is Stable

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Research Update:

Queen's University Ratings Affirmed At 'AA+'; Outlook Is Stable

Overview

- We expect Queen's University will maintain robust unrestricted financial reserves and healthy operating margins in the next two years.
- We are affirming our 'AA+' long-term issuer credit and senior unsecured debt ratings on Queen's University.
- The ratings reflect our assessment of the university's stand-alone credit profile, which reflects our combined assessment of Queen's extremely strong enterprise and very strong financial profiles.
- The stable outlook reflects our expectations that, within our two-year outlook horizon, Queen's will maintain an exceptional market position and student demand profile, its adjusted operating margins will remain positive, and its financial resources will remain very robust; and the likelihood of extraordinary government support will not change.

Rating Action

On May 18, 2018, S&P Global Ratings affirmed its 'AA+' long-term issuer credit and senior unsecured debt ratings on Queen's University, in Kingston, Ont. The outlook is stable.

Outlook

The stable outlook reflects our expectations that, within our two-year outlook horizon, Queen's will maintain an exceptional market position and student demand profile, positive adjusted net margins, and abundant financial resources. We expect the university's available resources will continue exceeding 35% of adjusted operating expenses and cash and investments will be more than 3x total debt. The outlook also reflects our expectation that Queen's relationship with the Province of Ontario will be stable and that our assessment of the likelihood of extraordinary support will not change.

Downside scenario

We could revise the outlook to negative or lower the ratings in the next two years if the university's student quality were to deteriorate due to an increase in the selectivity ratio to more than 50%, and debt were to increase to a level where cash and investments-to-debt would be lower than 3x. All else being equal, a negative rating action on Ontario would result in a negative

rating action on Queen's, given our three-notch cap above the rating on the supporting government. Moreover, a negative government intervention from the province or a significant reduction in the university's resilience to an Ontario default scenario could cause us to lower the ratings.

Upside scenario

All else being equal, a positive rating action during our two-year outlook horizon is unlikely, given our three-notch cap above the rating on the supporting government. In addition, should the Province of Ontario be upgraded, Queen's may not necessarily be upgraded in tandem, given the university's significant operating pressures and reliance on provincial grants, which can be unilaterally altered, with a higher risk of cuts in times of provincial budget stress.

Rationale

The ratings on Queen's reflect the university's stand-alone credit profile, which S&P Global Ratings assesses at 'aa+' based on the university's extremely strong enterprise and very strong financial profiles. 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. Queen's strong financial resilience and legal and operating independence allow the ratings on the university to exceed those on Ontario under our government-related entities (GRE) criteria.

We assess Queen's enterprise profile as extremely strong. Supporting our opinion is our view of the higher education sector's low industry risk, characterized by countercyclicality and low competitive risk and growth. In addition, with 65.1% of its students coming from Ontario, the university benefits from the province's excellent economic fundamentals, measured by the province's GDP per capita, which we estimate at over US$49,000 in 2017; its good income indicators; and moderate employment and population growth projections.

Queen's solid market position and student demand also strengthen its enterprise profile. Full-time equivalent students continued to increase in fall 2017, by 4.4% to 25,044, supported by growth in both graduate and undergraduate enrollment. In our opinion, student quality metrics continue to be strong and compare well with those of rated Canadian peers. This is primarily reflected in Queen's historically high retention and average entry grade rates of 94.7% and 89.9%, respectively, in fall 2017. First-year selectivity (offers to applications) and six-year graduation rates remained superior to those of peers, at 42.5% and 85.7%, respectively. In our opinion, the university benefits from robust fundraising capabilities, and has consistently exceeded its official campaign and annual fundraising targets in the past years.

In our view, university management expertise and governance practices, as well

as financial management policies, are strong. Queen's has a five-year strategic plan that guides its long-term strategies based on its mission. Management reviews plan performance annually, tracks progress against specific activity indicators, and monitors identified risks. The university has an enterprise risk framework that guides its identification and management of risks. Overall, we view Queen's transparency and disclosure to be good, with policies and procedures in place to adequately mitigate risks. The university conducts its activities according to a three-year operating budget that is aligned with its strategic plan and contains what we view as reasonable assumptions. It prepares externally audited financial statements, which have been unqualified, and it has formal policies in place, including investment and debt policies.

Established by Royal Charter in 1841, Queen's is a midsize, research-intense university in Kingston that offers a variety of undergraduate and graduate degrees across its six faculties (arts and science, education, engineering, health sciences, law, and business) and two schools (graduate studies and policy studies). It provides leading-edge research in a variety of areas, including computational science and engineering, globalization studies, mental health, biomedical sciences, and energy systems. Queen's is a member of the U15, a group of leading research-intensive universities in Canada. In fiscal 2017, it received C$149.9 million in research-related grants and contracts, up 12.7% from the previous year's grants.

We assess Queen's financial profile as very strong, with a history of adequate financial performance, excellent levels of available resources, and a moderate debt burden.

The university expects to continue to balance its operating budget until fiscal 2021, primarily after drawing down unit carryforward balances. Although it does not prepare consolidated forecasts, we expect that, including ancillary operations (which tend to generate positive cash flow), it will maintain consolidated surpluses in the near term. Queen's projects a C$11.6 million operating fund surplus in fiscal 2018, well above the C$11 million budgeted net operating deficit. This was primarily because of higher student fee revenues from above-target international undergraduate enrollment. Together with slight increases in grants, investment income, and donations, these more than offset increased faculties and schools allocations. In fiscal 2017, Queen's adjusted operating margin (S&P Global Ratings-calculated) of 2.7% was higher than historical levels, except for 2016's exceptional level of 9.9% due to significantly higher income on investments realized on that year, mainly fueled by strong investment returns and efforts to constrain spending.

Similar to that of Canadian peers, the university's limited flexibility to increase its student-generated revenues somewhat offsets its financial performance strength. This is primarily because Ontario monitors and guides domestic tuition rates and student aid (through the tuition framework), and domestic enrollment expansion (through operating grants).

In our view, the university has a moderate debt burden given its good

operating performance and healthy level of available resources at fiscal year-end 2017, at 211% of total debt. Maximum annual debt service remained modest, at about 2.9% of 2017 adjusted operating expenditures. As of fiscal 2017, Queen's had C$276 million in debt. This includes three fixed-rate bullet bonds (representing 77.9% of total debt) due in 2032 and 2040, and an amortizing bank loan maturing in 2030. As of April 30, 2017, the university held C$83.7 million in sinking funds to repay its three bullet debentures outstanding, which we include in our measure of internally restricted net assets. Although Queen's is contemplating new capital projects and is dealing with a deferred maintenance backlog of C$235 million, it does not expect to fund them with additional debt issuance; therefore, we expect debt metrics will remain adequate in the next two years. The university expects total funding for deferred maintenance initiatives to grow to C$11.9 million in fiscal 2019 from C$10.3 million in fiscal 2018, which includes C$3.3 million in provincial funding and C$8.6 million in contributions from the operating budget.

We believe that postemployment liabilities continue to offset Queen's financial profile strengths, despite the steps both the province and university have taken to address the solvency deficit. The university maintains a defined contribution pension plan with a defined-benefit component that provides a minimum level of benefits; the plan is in a deficit position and requires ongoing deficit payments, putting some pressure on the university's cash flows. As of the most recent actuarial valuation (Aug. 31, 2017), Queen's estimated its going-concern pension deficit to be C$12.6 million on a market basis and C$31.6 million on a smoothed basis, and projected a solvency deficit of C$313 million. Based on these valuations, the university's annual going-concern deficit payments will decrease to C$3.4 million starting in fiscal 2018, from C$20.7 million in fiscal 2017.Queen's qualified for the temporary solvency funding relief program, a province-sponsored program via the Pension Benefit Act, under which solvency special payments will be C$5.3 million in fiscal 2018 and $15.6 million in fiscal 2019 and 2020. The university took several initiatives to manage its pension deficit, including increased employee contributions. It is continuing to work with the province, the University of Toronto, and the University of Guelph on the creation of a jointly sponsored pension plan (JSPP) for Ontario universities. They are now looking to finalize the project's design and governance elements. A move to a JSPP, which would not be subject to solvency payment regimes, could help improve Queen's cash flows and provide longer-term pension sustainability. It would not eliminate the university's going-concern obligations.

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

Liquidity

Queen's liquidity is exceptional, in our view. At fiscal year-end 2017, consolidated cash and investments increased to C$1.6 billion, or 5.8x total

debt, from C$1.4 billion in 2016, or about 5.0x total debt. Unrestricted financial resources available for debt service stood at C$582.5 million, significantly above the previous year's C$505.9 million. This equaled 67.6% of adjusted operating expenses, and covered 211.1% of debt, compared with the previous year's 61.1% and 180.9%, respectively. These ratios compare well with those of the university's peers. We believe that available resources could decline somewhat in the next two years because Queen's will draw on these to fund its capital projects. However, we believe these ratios will remain fairly strong and in line with historical levels in the next two years. In addition, strong market returns in fiscal 2017 helped to boost the market value of the university's endowment to C$1 billion from C$930.9 million at fiscal year-end 2016. It is the second-largest endowment among Ontario universities, after the University of Toronto's, and it almost doubled since 2009. Queen's has a conservative endowment draw, in our view, with a long-term payout target rate of 4% of the endowment's market value. In fiscal 2017, the endowment paid out C$35.5 million, or about 6% higher than the previous year's spending, reflecting a strong increase in total endowment value.

Moderately high likelihood of extraordinary provincial government support

In accordance with our criteria for GREs, our view of Queen'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), and that there are no viable private alternatives. It also reflects our view of Queen's role as one of Canada's most reputable higher education institutions, and its significant research capacity. The province's oversight, program approval rights, and tuition regulation over the university suggest a strong link to it. Also supporting our assessment of the link are the large operating grants received from the province, accounting for about 23% of Queen's total revenue.

We rate Queen's three notches above Ontario, the maximum differential allowed in accordance with our methodology for rating GREs that we believe depend on ongoing government support. The difference reflects our view of the university's substantial financial assets. We believe there is a measureable likelihood that Queen's financial resources would meet ongoing operational and debt service requirements should the government default and temporarily suspend payments to the university. In addition, the difference reflects Queen's ownership structure, in which the government is neither an owner nor shareholder. Moreover, the province appoints none of its board of trustees' members. 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.

The Ontario government has improved its fiscal position in the past several years and although we believe that the province's overall support for universities will remain solid, we do not expect overall funding for the sector to increase materially in the medium term. Under the new grant funding

formula, the provincial government is shifting focus toward measurable student outcomes and away from a more enrollment-based formula. It has committed to maintain the 2016-2017 funding level for all universities until 2019-2020. Moreover, in December 2016, the province announced it would extend its tuition framework for the next two years, maintaining the annual increases capped at an average of 3% for most undergraduate programs and 5% for professional and graduate programs.

Queen's University Financial Statistics

		--Fiscal year ended April 30--				
	2018 demand data	**2017**	**2016**	**2015**	**2014**	**Medians for 'AA' U.S. public colleges & universities, 2016****
Enrollment and demand						
Headcount	26,513	25,395	24,802	24,027	23,018	MNR
Full-time equivalent	25,044	23,994	23,575	22,869	21,899	32,506
First year acceptance rate (%)	42.5	43.1	44.9	43.5	41.8	69.3
First year matriculation rate (%)	39.4	40.8	40.5	41.4	40.7	MNR
Undergraduates as a % of total enrollment (%)	77.2	77.6	77.7	77.8	77.5	77.7
First year retention (%)	94.70	94.73	94.4	94.9	94.6	86.0
Graduation rates (six years) (%)*	85.7	85.49	86.3	85.3	86.0	MNR
Income statement						
Adjusted operating revenue (C$000s)		884,324	909,786	814,859	806,128	MNR
Adjusted operating expense (C$000s)		861,445	828,085	800,502	795,193	MNR
Net adjusted operating income (C$000s)		22,879	81,701	14,357	10,935	MNR
Net adjusted operating margin (%)		2.7	9.9	1.8	1.4	1.5
Provincial grants to revenue (%)§		22.7	21.9	24.2	24.6	19.4
Student dependence (%)		36.0	32.1	33.0	30.3	41.8
Investment income dependence (%)		9.0	3.3	9.0	8.1	0.8
Debt						
Debt outstanding (C$000s)		275,966	279,708	241,354	224,683	698,540
Pro forma debt (C$000s)		275,966	279,708	279,400	224,683	MNR
Current debt service burden (%)		2.07	1.88	2.03	2.38	MNR
Current MADS burden (%)		2.88	2.99	2.97	3.28	3.60
Pro forma MADS burden (%)		2.88	2.99	3.23	3.28	MNR

Queen's University Financial Statistics (cont.)

		--Fiscal year ended April 30--				
	2018 demand data	**2017**	**2016**	**2015**	**2014**	**Medians for 'AA' U.S. public colleges & universities, 2016****
Financial resource ratios						
Endowment market value (C$000s)		1,046,531	930,868	918,978	800,238	748,837
Cash and investments (C$000s)		1,611,055	1,378,323	1,303,432	1,116,892	NMR
Adjusted UFR (C$000s)		582,457	505,866	476,364	425,569	MNR
Cash and investments to operations (%)		187.0	166.4	162.8	140.5	54.7
Cash and investments to debt (%)		583.8	492.8	540.0	497.1	159.6
Cash and investments to pro forma debt (%)		583.8	492.8	466.5	497.1	MNR
Adjusted UFR to operations (%)		67.6	61.1	59.5	53.5	31.9
Adjusted UFR to debt (%)		211.1	180.9	197.4	189.4	89.7
Average age of plant (years)		16.4	14.3	13.0	12.2	12.9
OPEB liability to total liabilities (%)		8.6	7.7	7.9	7.8	NMR

*Median figure is five-year graduation rate. §Median figure is state appropriations to revenue. U.S. median figures are in U.S. dollars. 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

- Fiscal Median Ratios Of Public Universities In Australia, Canada, Mexico, And The U.K.: Operating Margins Remain Mostly Solid Despite Lower Government Transfers, July 27, 2017
- U.S. Public College And University Fiscal 2016 Median Ratios: Lower Rated Entities Pressured In An Otherwise Relatively Stable Sector, July 20, 2017

Ratings List

Ratings Affirmed

Queen's University	
Issuer Credit Rating	AA+/Stable/--
Senior Unsecured	AA+

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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