STANDARD & POOR'S

PUBLIC FINANCE

University of Guelph

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DOWNGRADED

ISSUER CREDIT RATING	***To***	***From***
University of Guelph		
Issuer Credit Rating	A+/Stable/—	AA-/Stable/—
Issuer credit rating history:		
Oct. 25, 2006	A+	
Sept. 24, 2002	AA-	

Rationale

The ratings on the University of Guelph, in the Province of Ontario, reflect its rapidly rising unfunded post-employment liabilities that could require significant cash contributions to comply with regulatory solvency requirements; a continuously weak operating performance that we expect to persist; a debt burden that is likely to rise; and a large deferred capital maintenance that threatens the university's operations if not immediately addressed.

Offsetting these risks are Guelph's solid demand characteristics and its firm academic niche and research profile in agriculture, veterinary medicine, and science, which enhance the university's demand profile, attract research funding, and provide revenue diversity. The ratings are also underpinned by a slim but adequate debt service coverage ratio and unrestricted financial resources, which, although not as strong as many of its peers, are rising.

Guelph's operating margin remained at a near break-even position at April 30, 2006. Such a weak operating position is not consistent with a 'AA-' rated entity, contributing to the downgrade. In Standard & Poor's Ratings Services' update published Nov. 21, 2005 we stated our expectation that Guelph would improve its operating position. In addition to posting the lowest operating position of its rated Canadian peers, the university's operating margin has been in a near break-even position since about 2003. When Guelph was initially rated on Sept. 24, 2002, its operating margin, based on its fiscal year-end 2001 results, was about 7.1%. Several significant operating pressures suggest that Guelph's weak operating position could continue. The university has accepted about 800 more students than targeted and is not certain to what extent, if any, the Province of Ontario (AA/Stable/A-1+) will fund these students. Also, although the province has committed to funding universities to expand graduate enrolment, Guelph expects to face additional pressures from supporting these additional expected graduate students.

Other operating pressures facing the university in the next couple of years include hiring additional faculty in anticipation of faculty retirements and enrolment growth; and raising student financial assistance to coincide with rising tuition. There have also been shifts in the programs that students demand in recent years, resulting in added pressures on the university's already overstretched resources.

Another operating pressure stems from Guelph's rising post-employment liabilities, which could require cash contributions of up to C$40 million in each of the next two years. As at year-end fiscal 2006, Guelph's unfunded pension liability was C$148.5 million, a 43% increase from fiscal 2005. Guelph's pension liability is substantially higher compared with fiscal 2002, when it had a C$42 million surplus. The swing to a deficit position largely stemmed from a lower discount rate used to value its pension obligation, with weaker equity returns also contributing.

Guelph also had about C$181.8 million in unfunded other post-employment benefit (health care and dental) liabilities at fiscal year-end 2006. These liabilities are up sharply from 2002.

The downgrade was largely spurred by the rapid current and expected increase in Guelph's liabilities. Although Guelph's unrestricted financial resources are up since fiscal 2005, its liabilities have risen more significantly and rapidly. In our Nov. 21, 2005, report, we stated that any further worsening of Guelph's unfunded post-employment liabilities without increases in offsetting asset plans would place downward pressure on the ratings.

Guelph also has critical deferred capital maintenance needs. The university estimates them to be at C$300 million, which is exceptionally high relative to that of its peers and for an institution of its size. Guelph's management team is of the opinion that any further delay of the required capital maintenance could threaten the university's operation. Guelph's board has therefore approved borrowing of up to C$90.8 million to help fund C$121 million in critical capital maintenance requirements and capacity expansion. This would bring Guelph's pro forma debt to C$249.4 million, or C$13,856 on a full-time equivalent (FTE) basis. Guelph's interest expense to adjusted revenue would rise to about 3%. Both these measures would be higher than those of Guelph's Canadian rated peers.

Standard & Poor's believes that the medium- to long-term profile of the university remains solid. As the most recent application statistics illustrate, the university has exceptionally strong demand metrics. In addition to the university's strong, well-defined niche in agriculture studies, Standard & Poor's recognizes the province's vested interest in the successful operation of the university, not only in its role as a reputable postsecondary institution, helping advance government initiatives to promote a knowledge-based economy, at both the provincial and federal levels, but also in its critical role to Ontario's Ministry of Agriculture, Food and Rural Affairs (OMAFRA). Standard & Poor's also notes the university's impressive progress with its unrestricted financial resources, almost doubling the value on a per FTE basis since fiscal year-end 2004.

Outlook

The stable outlook underpins Standard & Poor's belief that the solid track record of Guelph's prudent management team should revitalize and maintain the capital foundations, which will enable the successful long-term operation of the university. At the same time, we expect the university to cautiously and conservatively manage, and minimize whenever possible, the university's external financing needs. The outlook also reflects the expectation that Guelph will not increase its debt significantly further than expected. Further rapid and significant increases in Guelph's debt or unfunded post-employment liabilities could exert further downward pressure on the ratings. The ratings could be raised after a significant and sustained improvement in Guelph's operating position, the university bringing its pro forma debt to a level significantly lower than expected, or a significant drop in its unfunded post-employment liabilities and its related cash contributions.

Demand Remains Strong

For fiscal 2006, Guelph nearly reached its enrolment target of 18,000 FTEs, experiencing a marginal enrolment decrease of 0.7% from fiscal 2005, to 17,583 FTEs, but not significant enough to noticeably lower tuition revenue or enrolment-based provincial funding.

Despite the marginal drop, demand for Guelph remains strong. In fact, fall 2006 confirmation statistics show that the number of undergraduate applicants to Guelph from Ontario secondary schools increased 33%, compared with 3% for the provincial system as a whole. This was the largest increase of any Ontario university. In fall 2006, Guelph accepted 800 more students than expected, bringing enrolment slightly above the 18,000-FTE target.

After substantial enrolment growth from the double cohort (when two classes graduated simultaneously in 2003 after the elimination of Grade 13) and a demographic bulge of university-age students, some of these students are now beginning to make their way through graduate studies. In the same vein, Guelph is continuing with its plan to change its FTE composition by slightly scaling back undergraduate intake and targeting to raise graduate FTEs. This is in line with the province's initiative to raise graduate enrolment by 14,000 by 2009, while promising to fund the graduate spaces fully on the operations side and make available C$550 million in funding on the capital side.

In recent years, the university has had to respond to shifts in the programs that students are demanding at the university. There has been a trend away from Guelph's traditional science and agriculture base toward the social sciences and arts, which has required Guelph to significantly change the way it delivers its programs, and placed additional pressure on the university's resources.

Operating Position Still Weak

With its operating surplus at 1.3% of operating revenues, Guelph's operating margin remained at a near break-even position at fiscal year-end 2006. Such weak operating positions are not consistent with a 'AA-' rated entity, which contributed to the downgrade (the Nov. 21, 2005, report stated our expectation that the university would improve its operating position). In addition to posting the lowest operating position of its rated Canadian peers (see table 1), the university's operating margin has been in near break-even position since about 2003. When Guelph was initially rated, its operating margin, based on its fiscal year-end 2001 results, was about 7.1%.

Table 1 |

University Of Guelph--Peer Comparison

	University of Guelph			York University			University of Toronto			McMaster University		Queen's University		McGill University		University of British Columbia		
(Thou. C$)	**2006**	**2005**	**2004**	**2006**	**2005**	**2004**	**2006**	**2005**	**2004**	**2005**	**2004**	**2005**	**2004**	**2005**	**2004**	**2006**	**2005**	**2004**
Rating	A+/Stable/--	AA-/Stable/--	AA-/Stable/--	AA-/Stable/--	AA-/Stable/--	AA-/Negative/--	AA/Stable/--	AA/Stable/--	AA/Stable/--	AA/Stable/--	AA/Stable/--	AA+/Stable/--	AA+/Stable/--	AA-/Stable/--	AA-/Stable/--	AA+/Stable/--	AA/Stable/--	AA/Stable/--
FTEs (total)	17,538	18,968	18,082	44954	43,108	40,910	60,203	57,887	55,763	20,664	19,777	18,500	18,360	25,972	25,591	34,678	34,254	34,024
Total revenue	510,789	499,739	476,487	794,288	731,276	653,344	1,784,300	1,653,800	1,568,100	637,186	606,233	653,284	611,039	767,199	792,547	1,569,762	1,254,946	1,133,553
Deferred capital	18,670	16,977	16,667	9,661	8,256	6,504	42,600	36,900	34,300	36,899	33,243	21,441	20,035	N/A	N/A	57,488	48,279	36,098
Adjusted revenue	492,119	482,762	459,820	784,627	723,020	646,840	1,741,700	1,616,900	1,533,800	600,287	572,990	631,843	591,004	767,199	792,547	1,512,274	1,206,667	1,097,455
Total expenditure	521,694	516,893	491,084	738,833	689,163	617,703	1,709,300	1,612,600	1,521,500	631,095	558,302	614,390	586,945	755,811	700,177	1,447,755	1,241,144	1,131,589
Interest	10,523	10,686	10,807	21,728	21,424	11,806	29,300	26,600	19,800	10,256	10,221	5,394	5,414	N/A	N/A	33,906	14,000	13,960
Depreciation	35,930	33,143	31,416	39,206	36,221	28,780	91,400	83,500	76,800	53,700	48,094	39,389	38,253	N/A	N/A	119,104	103,708	85,552
Adjusted expenditure (for debt service coverage ratios, or DSCRs)	475,241	473,064	448,861	677,899	631,518	577,117	1,588,600	1,502,500	1,424,900	567,139	499,987	569,607	543,278	755,811	700,177	1,294,745	1,123,436	1,032,077
Consolidated surplus (%)	1.3	(0.20)	0.0	10.8	9.7	9.0	7.1	5.4	5.8	3.8	11.0	9.0	7.2	1.5	11.7	12.1	5.7	4.7
DSCR (interest only) (x)	1.60	0.91	1.01	4.91	4.27	5.91	5.23	4.30	5.50	3.23	7.14	11.54	8.82	1.23	10.01	6.42	5.95	4.68
Total debt	158,607	161,197	164,664	361,283	369,419	275,860	558,700	410,600	415,100	157,974	158,752	96,120	96,440	150,000	150,000	305,090	184,747	174,634
Unfunded post-employment liabilities	330,229	256,442	186,127	70,385	92,707	60,476	688,900	640,800	478,700	297,194	220,784	53,982	50,738	58,000	60,700	4,750	7,200	10,879
Interest expense to adjusted revenue (%)	2.1	2.2	2.4	2.8	3.0	1.8	1.7	1.6	1.3	1.7	1.8	0.9	0.9	4.3	4.0	2.2	1.2	1.3
Debt per FTE (C$)	9,044	8,498	9,107	8,037	8,570	6,743	9,280	7,093	7,444	7,645	8,027	5,196	5,253	5,775	5,861	8,798	5,393	5,133
Debt to adjusted revenue (%)	32.2	33.4	35.8	46.0	51.1	42.6	32.1	25.4	27.1	26.3	27.7	15.2	16.3	19.6	18.9	20.2	15.3	15.9
(Debt plus unfunded)/adjusted revenue (%)	99.3	86.5	76.3	55.0	63.9	52.0	71.6	65.0	58.3	75.8	66.2	23.8	24.9	27.1	26.6	20.5	15.9	16.9
Internally restricted net assets	54,004	31,595	30,439	134,330	93,463	55,470	134,800	91,700	59,100	104,247	129,987	138,865	116,222	75,907	57,712	138,698	120,173	132,072
Internally restricted endowments	19,182	18,253	21,006	43,454	20,526	6,524	285,800	258,700	249,800	131,515	129,465	170,547	159,100	176,576	172,982	227,400	177,700	302,000
Externally restricted endowments	131,165	118,845	103,200	169,659	156,105	134,167	1,343,000	1,164,100	1,037,900	204,640	159,093	346,263	302,400	738,460	732,003	484,522	598,154	604,446
Unrestricted financial resources	73,186	49,848	51,445	177,784	113,989	61,994	420,600	350,400	308,900	235,762	259,452	309,412	275,322	252,483	230,694	366,098	297,873	434,072
As % of total debt	46.1	30.9	31.2	49.2	30.9	22.5	75.3	85.3	74.4	149.2	163.4	321.9	285.5	168.3	153.8	120.0	161.2	248.6
Per FTE	4,173	2,628	2,845	3,955	2,644	1,515	6,986	6,053	5,540	11,409	13,119	16,725	14,996	9,721	9,015	10,557	8,696	12,758
Total endowment value per FTE (at market value; C$)	8,573	7,228	6,869	4,741	4,097	3,439	27,055	24,579	23,092	16,268	14,591	27,936	25,136	35,232	35,363	20,529	22,650	26,641

Like many other universities, personnel expenditures continue to place a significant fiscal burden on the university's operations. Guelph's salary and benefit expense growth, at about 1.4% for fiscal 2006, is down from 13% in fiscal 2004. Nevertheless, it still comprises about 62% of the university's total expenditure. In an effort to mitigate future salary and other personnel-related pressures, the university undertook a restructuring initiative that offered some employees an enhanced buyout program to leave voluntarily or retire early. Guelph incurred a one-time deficit of C$11 million for the buyout program in 2005 and expects the cost to be recovered by 2011 at an annual rate of at least C$2 million per year from the efficiency-derived savings of the buyout program. Personnel expenditures could, however, continue to place pressure on the university's finances. Faculty at the university recently voted to unionize. Although this could introduce salary and benefit pressures, Guelph is currently working on its first collective agreement with faculty.

On March 8, 2006, the Ontario government ended its tuition freeze, and introduced a new tuition policy that began September 2006 that gives universities in the province greater tuition-setting autonomy. The new policy allows tuition for arts and sciences programs and other selected undergraduate programs to increase by up to 4.5% in the first year of study and 4.0% in following years. Tuition for university graduate programs, some undergraduate professional programs, and high-demand college programs could increase by up to 8% in the first year of study and 4% in subsequent years, but only if the institutional average is 5% or less. Guelph's tuition schedule for the 2006-2007 academic year approximately reflects this framework. For most programs, tuition will increase by 4.5% for entering students and 4.0% for continuing students. Based on its tuition schedule, Guelph expects tuition revenue to rise by about C$3.2 million in 2006-2007. Representing just less than 1% of operating revenues, however, this is not expected to provide any significant operating relief to the university.

Guelph expects to encounter other operating pressures in the next couple of years.

- The 800 more-than-targeted students present some operating uncertainties to the university for fiscal 2007. Although Guelph expects C$2 million more in tuition revenue from these students, fee revenue only accounts for about 44% of operating revenues for an Ontario university, and Guelph is unsure to what extent, if any, the province will fund these students.
- As part of its 2006 budget, the province also announced graduate expansion funding. Funding will be tied to negotiated growth targets. Although both the province's initiative and the university's target to expand graduate enrolment present an opportunity for Guelph, adequately supporting these students could also present challenges for the university.
- Rising pension and nonpension post-retirement liabilities may require higher annual cash contributions. For example, on Sept. 30, 2006, the university closed the books on its latest actuarial valuation, and depending on actuarial assumptions, the university could have to raise its contribution to upward of C$40 million in fiscal 2007, and possibly again in fiscal 2008. This annual cash flow contribution to the pension plan could put a strain on the university's barely balanced operating margins and free cash flow that might otherwise be dedicated to the university operating, capital, or research activities.
- The university faces costs associated with deferred capital maintenance that is in a critical state.
- Some strategic cost pressures facing the university in the next couple of years include hiring additional faculty in anticipation of faculty retirements and enrolment growth, and raising student financial assistance to coincide with rising tuition. There have also been shifts in the programs that students demand in recent years, resulting in changes that are adding pressures to the university's already overstretched resources.

Although Guelph is budgeting for these pressures, and the additional tuition revenue and additional funding from the province should provide some offset in addressing these expenditure pressures, Guelph's operating performance could further deteriorate.

Quality improvement funding of about C$6 million announced by the previous Ontario government was not rolled in to the university's base operating grant, and Guelph is unsure if it will in fact receive this funding. Standard & Poor's does not expect, however, that the province's overall funding commitment to the university system will weaken. In 2005, the province announced C$6.2 billion in additional funding by 2009-2010 for universities and colleges, which it reaffirmed in its 2006 budget. As part of this funding, the province confirmed an operating grant increase of C$290 million (an 8% increase) in 2006-2007 for colleges and universities. The province, however, did not provide details. Furthermore, there was no direct funding for inflation provided, nor was there incremental funding for deferred maintenance. Nevertheless, Guelph's management is working with its departments to reduce their budgets by at least 2% per year. Those proceeds will go to the university's annual inflationary costs associated with salaries and benefits.

In addition to receiving operating grants from the Ministry of Training, Colleges and Universities, the university's unique agricultural grounding and curriculum provide it with additional funds from OMAFRA, which makes up about 16% of total revenue. Although the funding from OMAFRA is restricted, it is considered part of the university's total operating budget and funds 90 faculty FTEs, 457 full-time staff, and operating and infrastructure costs. Effective April 1, 2006, Guelph's agreement with OMAFRA was amended to include responsibilities for facilities operations and maintenance of sites occupied by the university for OMAFRA under the agreement. As a result, annual funding to the university from OMAFRA increased by C$4.3 million.

Guelph also has an unrestricted net asset deficit, including ancillary enterprises, of C$49.5 million (or about 10% of operating revenues) at year-end fiscal 2006, increasing by about 82% from fiscal 2005. A large majority of the deficit is the accrual accounting of pension and other post-employment benefits. For several reasons, this unrestricted net asset deficit should decline in the next few years. If interest rates sufficiently rise, then the discount rate employed to arrive at Guelph's accrual post-employment pension obligations could rise, lowering the university's actuarially determined post-employment obligations. The next most significant portion of the deficit is the voluntary early retirement program. Although this currently accounts for about C$8.5 million of the deficit, Guelph expects it to be reduced by no less than C$2 million per year, and for the program to fully fund itself by 2010. The remainder of the deficit (C$3.1 million) is due to the university's share of start-up costs related to the Guelph-Humber College joint venture. Guelph has begun receiving repayment from the revenues of the joint venture, and thereby begun reducing its unrestricted net asset deficit related to the joint venture.

Deferred Capital Backlog In Critical State

In fiscal 2006, on a cash basis, the university acquired C$100.7 million in capital assets (the most significant of these was the C$38 million for its science and teaching facilities), and received C$52.6 million in major capital contributions for current and future capital projects. About half the contributions were from OMAFRA, which, together with federal contributions, provided the university with C$60 million (as at April 30, 2006) for the redevelopment of Guelph's Ontario Veterinary College. The college is estimated to cost a total C$80 million. The university expects that more funding from the province could be coming to cover the C$20 million difference.

Guelph has nearly completed most of its capital expansion initiatives. The largest of these projects, the Science Complex, will cost a total of C$144 million when the second phase of the project is complete.

Facilitating science programs, where most of Guelph's enrolment occurred, the building of the science complex was broken into two phases. Phase I had a total capital cost of C$66 million and was completed in 2004, while Phase II, with a price tag of C$78 million, has an expected completion date of 2007. The funding from these projects has come from a variety of sources, the majority of which is C$52.9 million in SuperBuild funding from the province and C$75 million from the C$100 million debenture issue.

There is a C$16 million funding shortfall to cover the cost of Phase II of the Science Complex. Because the balance of the money to complete the project is not needed until fiscal 2007-2008, from a cash flow perspective, the university is focusing on fundraising efforts to bridge the shortfall. Although Guelph has raised some the funds from its fundraising efforts, should the full amount of the shortfall not be raised, university officials plan to cover the remainder of the funds by diverting funds from the science colleges, including a levy on overhead from research contracts awarded to the colleges. No additional debt financing is envisaged, however, to cover the shortfall.

About C$11 million of the C$100 million debenture proceeds from the 2002 issue is going to an extension to an arts and social science faculty office building (MacKinnon Building) to create about 73 new faculty offices. The remainder of the C$100 million debenture proceeds, about C$13.4 million, is going to Guelph's deferred maintenance backlog, which can no longer be delayed.

Guelph's board of governors has stated that the university's deferred maintenance backlog has reached a critical state and for reasons of health, safety, and continuity of operations, can no longer be postponed. The deferred maintenance needs are estimated at C$300 million, which is exceptionally high relative to that of its peers, and for an institution of its size. The requirements across the campus are C$215 million for campus buildings, C$40 million for repair of residences, and C$45 million for utilities infrastructure. As many other universities also face this challenge (total deferred maintenance in the Ontario university system is estimated at C$2 billion), a measure of the deferred capital backlog across Ontario's universities is estimated, called the Facilities Condition Index (FCI). As at October 2005, Guelph's consolidated FCI, which excludes residence, but includes adaptation or renewal renovations, was 0.21, severely above the system FCI average of 0.13 (a rating above 0.10 is considered poor). As at Oct. 1, 2005, Guelph had the highest rated FCI (except for Nipissing University) among Ontario's 19 universities.

The university is seeking to address these deferred maintenance requirements. Guelph's board of governors approved a 10-year plan to address the university's deferred maintenance issues, which provides for spending of up to C$121 million in five years (starting in fiscal 2007) to make some significant strides in addressing its vital deficiencies. Of the C$121 million, C$83.7 million will go toward academic and administrative buildings, which includes:

- C$35.9 million for building deferred maintenance (safety code compliance items, HVAC systems, and building interiors);
- C$29.3 million for utilities infrastructure;
- C$15.7 million for capacity planning (increasing central utilities plant capacity, including a new cooling tower and additional chiller and boiler capacity), and;
- C$2.8 million as contingency for emergency repairs and renovations.

The remainder (C$37.7 million) will go toward addressing the deferred maintenance of student residences.

The total amount of borrowing is, however, largely dependent on the level of government funding to address the maintenance backlog. One of the recommendations of a provincial post-secondary review conducted in 2004 was that the province invest C$200 million a year to address the deferred maintenance backlog in the province's post-secondary institutions. Although the province has not moved on this matter, co-ordinated lobbying efforts are under way across the province to secure more provincial funding for deferred capital maintenance. In April 2005, Guelph received a one-time, C$8.3 million grant from the province (as a result of year-end provincial budget adjustments), targeted at deferred maintenance. The C$1.7 million per year Guelph typically receives from the province to address deferred maintenance issues, however, is insignificant. Guelph's board of governors has therefore approved borrowing of up to C$91 million to help fund the C$121.4 million expenditure on the critical maintenance backlog.

Debt Expected To Rise

As of year-end fiscal 2006, Guelph had C$158.6 million in debt outstanding, or C$9,044 per FTE. The ratio is high relative to that of its peers. The majority of Guelph's debt consists of the C$100 million in senior unsecured bullet maturity debentures, issued in 2002 and maturing in 2042. Guelph has established an internal sinking fund to provide for debt retirement of the C$100 million debentures, although it is not required by any covenant to do so. As of fiscal 2006, Guelph contributed C$7.7 million to the fund, C$1.5 million of which will be reinvested for the purpose of retiring the C$100 million debenture; the remainder is for student housing mortgages.

Approximately 34% (C$53.7 million) of Guelph's total debt consists of leases, mortgages, and loans for student housing, which covers 5,000 beds in various buildings on the university's campus. The balance of the debt (C$104.9 million) consists of the C$100 million debenture for financing major academic buildings. Of the C$100 million, C$86 million was for Rozanski Hall, the McKinnon extension, and the Science Complex; and C$14 million for Guelph's deferred maintenance.

At year-end fiscal 2006, Guelph's debt-to-total adjusted revenue was 32.2%, which is high compared with that of its rated peers. The university's debt servicing expense was C$13.3 million. Of that, C$10.7 million was in interest payments, representing 2.1% operating revenues, which is average for this sector. According to Guelph, about 55% (C$7.3 million) of the debt servicing costs are carried by its operating budget (particularly that which is related to the C$100 million debenture). The remainder, Guelph estimates, is borne by the revenues generated by its ancillary units (particularly residency rental income).

The board has approved borrowing of up to C$90.8 million to fund capital expenditures related to the maintenance and capacity expansion. This would bring Guelph's pro forma debt to C$249.4 million, or C$13,856 on a FTE basis (based on 18,000 FTEs, the amount Guelph plans to hold enrolment at) and its interest expense-to-adjusted revenue would be expected to rise to about 3%. Both these measures would be higher than those of Guelph's Canadian rated peers. Given the likelihood that Guelph will require external debt financing, this also contributed to the downgrade on the university, although to a lesser extent (Standard & Poor's mentioned in its 2005 update its expectation that the university's debt burden would remain moderate in the next three to five years). The university plans to build the additional debt servicing costs into its budget planning process of both its operating budget fund and the student housing services fund. Given Guelph's near break-even position in the past three years, however, the university's capacity to generate funds to service the additional debt is a concern for Standard & Poor's.

A rise in Guelph's debt would also lower its debt service coverage ratio (DSCR). As at April 2006, Guelph's DSCR was 1.60x, at the lower end of its rated peers. Should Guelph issue an additional C$90.8 million, its DSCR is expected to decline to approximately 1.16x, which, although adequate, does not provide for any added coverage and is unusually low for the sector.

In 2003, Guelph's board approved a capital debt policy that establishes limits on the amount of total external debt that may be carried by the university: as a percent of total revenues, 4.5% for debt servicing costs, and 45%

for total debt. Guelph predicts that the additional C$90.8 million debt will not exceed its established limits (based on a 5% borrowing rate over a 25-year amortization period, and estimated revenue growth of 3.5% per year). Although a balance-sheet test is not necessarily the best measure of an institution's cash flow ability to service its debt, it does provide an internal yardstick for management to limit its externally financed capital program.

Unfunded Pension Liability Worsens

As at year-end fiscal 2006, Guelph's unfunded pension liability rose 43% from year-end fiscal 2005, to C$148.5 million. Guelph's pension liability is up substantially from fiscal 2002, when it had a C$42 million surplus, largely stemming from a lower discount rate used to value its pension obligation. Weaker equity returns also contributed to the swing.

Guelph sponsors three defined-benefit (DB) pension plans, each compromises a guaranteed, partially indexed stream of retirement income until the beneficiary dies, based primarily on the beneficiary's work history, and is typically expressed as a percentage of an employee's salary and years of service; this situation transfers all funding risk to the plan's sponsor. Also, the pension funding position is very sensitive to actuarial revisions. For example, from fiscals 2003-2006, the university's discount rate (linked to market interest rates) dropped to 5.15% from 6.60%, falling from 25 to 50 basis points each year.

As a result of its latest actuarial valuation in Sept. 30, 2003, in fiscal 2004, Guelph contributed C$10 million to help achieve a solvency position of its pension plan. More recently, the university closed its books for an actuarial valuation on Sept. 30, 2006, and depending on actuarial assumptions, the university could be required to raise its contribution to an upward amount of C$40 million in fiscal 2007, and possibly again in fiscal 2008. This annual cash flow contribution to the pension plan is expected to put a strain on the university's barely balanced operating margins and free cash flow that might otherwise be dedicated to the university operating, capital, or research activities.

Guelph also had about C$181.8 million in unfunded other post-employment benefit (health care and dental) liabilities at fiscal year-end 2006. These liabilities are also up significantly since 2002. Guelph's total liabilities (debt plus unfunded post-employment liabilities) were 99.3% of its total adjusted revenues for fiscal year ended 2006. This significantly exceeds that of any of Guelph's rated peers, and would increase to more than 100% if the expected C$90.8 million issuance was incorporated.

The downgrade on the university was largely spurred by the rapid current and expected increase in Guelph's liabilities. Although Guelph's unrestricted financial resources are up since fiscal 2005, its liabilities have risen more significantly and rapidly. In Standard & Poor's Nov. 21, 2005, report, we stated that any further worsening of Guelph's unfunded post-employment liabilities without increases in offsetting asset plans would place downward pressure on the ratings.

Guelph's liabilities could decrease, given the sensitivity of Guelph's DB pension funding position to interest rates. The university's funding position could improve should interest rates continue to rise and general market returns significantly improve. Should this have the effect of substantially lowering Guelph's unfunded post-employment liabilities, Standard & Poor's might consider an upward change to the rating. In addition, the university is looking into renegotiating the post-employment benefits it extends to its beneficiaries, such as greater cost sharing with its beneficiaries, or implementing an eligibility period.

Research Profile Remains Strong

Research funds received for the year increased by about 17% to C$145.4 million. Most of the increase stemmed from provincial research funding (excluding that associated with OMAFRA). Research grants are an important revenue source for universities such as Guelph. Although these grants are of a restricted nature, they significantly contribute to the university's operations by attracting faculty and covering the costs of expanding faculty and capital, which are related to research.

Unrestricted Financial Resources Low But Rapidly Rising

At year-end fiscal 2006, the market value of Guelph's endowment was C$164.2 million, a 9.7% increase from the previous year. This exceeds the 7% growth averaged in each of the past two years. The fiscal 2006 growth largely stems from investment returns of 7.4%, which appear to have stabilized from the severe market swings the endowment experienced in fiscals 2003 and 2004 (see table 2), and the additional donations to capital received during the year. For fiscal 2006, the annual spending rate of the general endowment (about 70% of total endowments) was 4.5% (C$5.4 million), which goes mainly towards student assistance. The remaining investment income of C$5.2 million was added to the accumulated earnings of previous years for capital protection and growth.

Table 2

University of Guelph—Endowment

	Year ended April 30						
(Mil. C$)	***2006***	***2005***	***2004***	***2003***	***2002***	***2001***	***2000***
General endowment	113.5	104.7	97.9	83.9	91.0	87.9	85.4
Heritage fund	50.7	45.0	41.6	36.9	43.0	38.5	33.1
Total market value	164.2	149.7	139.5	120.7	134.0	126.4	118.5
Externally restricted	131.2	118.8	103.2	86.4	97.1	89.7	82.7
Internally (board) restricted	19.2	18.3	21.0	18.4	20.4	20.2	21.7
Total endowments (book value)	150.3	137.1	124.2	104.8	117.4	109.9	104.4
Endowment returns (general endowment; %)	7.4	6.7	17.0	(11.9)	3.2	1.3	10.6

About 87% of Guelph's endowments carry external restrictions, which provide little, if any, fiscal flexibility benefits for the university. The remainder of Guelph's endowment is internally restricted, which, along with C$54 million in internally restricted net assets, gives the university total unrestricted financial resources of C$73.2 million. Although on a per FTE basis (C$4,173), this is at the lower end when compared with its Canadian rated peers, it is significantly higher (by about 60%) than its 2004 level of C$2,628. Strong internally restricted financial resource balances could allow higher education institutions to manage temporary operating budget shortfalls without drawing on external liquidity, since a university's board of governors council could subsequently remove a designation.