STANDARD & POOR'S

PUBLIC FINANCE

University of Guelph

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Issuer Credit Rating

A+/Negative/—

Major Ratings Factors

Strengths:

- Strong demand profile, and firm academic niche
- Healthy provincial support
- Solid research profile

Weaknesses:

- Significant near term liquidity challenges
- Balance sheet weakening
- Consolidated operating deficit

Rationale

The ratings on the University of Guelph, in the Province of Ontario (AA/Stable/A-1+), reflect its strong demand profile and firm academic niche, healthy provincial support, and strong research profile. Constraining the ratings are significant near-term liquidity challenges, recent balance-sheet weakening, and persistent consolidated operating deficits.

Supporting the ratings are:

- Guelph's strong demand profile and firm academic niche. Based on application statistics from the Ontario University's Application Centre for fall 2007 admission, as of Sept. 13, 2007, total applications to the university rose 4.4%, and applications to the Guelph-Humber campus (a partnership the university has with Humber College) by

17.3%. Guelph also ranks strongly in surveys conducted by both The Globe and Mail (in 2007) and Macleans magazine (in 2006), which ranked Guelph first for overall institution and second in reputation among Canada's comprehensive universities. Boosting Guelph's demand profile is the university's strong, well-defined niche in agricultural studies. In fiscal 2007, Guelph enrolment was 18,286 full-time equivalents (FTEs), slightly exceeding its target of 18,000. All the growth occurred at the undergraduate level, which increased almost 5% from fiscal 2006. As with most universities in Ontario, Guelph did not reach graduate expansion goals, for which the province promised to fund both operations and capital;

- Good operating and policy support from the province that largely helps underpin the ratings. The 2007 Ontario budget included C$210 million to alleviate Ontario universities' immediate cost pressures; Guelph's share was C$12.7 million. In addition to receiving operating grants from the Ministry of Training, Colleges and Universities (MTCU; accounting for 28% of total revenues), the university's unique agricultural grounding and research capacity provide it with additional funds from Ontario's Ministry of Agriculture, Food and Rural Affairs (OMAFRA), which makes up about 15% of total revenue. Standard & Poor's recognizes the province's vested interest in 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 OMAFRA. Further supporting Guelph's operations is the province's tuition policy that began September 2006. Ending a two-year tuition freeze, the policy gives universities limited tuition flexibility by allowing tuition for domestic students to increase by a maximum annual average of 5% institutionwide. Guelph's tuition schedule for the 2007-2008 academic year approximately reflects this framework; and
- A strong research profile. A major component of Guelph's research is its multifaceted agri-food initiative sponsored by OMAFRA. In addition to accounting for about 28% of Guelph's research funding, the contract with OMAFRA gives the university a strong niche among the province's 19 universities. Genetic barcoding to differentiate species is an example of the ground-breaking research at Guelph. The university receives more than C$100 million in research funding each year.

Constraining the ratings are:

- Significant near-term liquidity challenges. The outlook revision was spurred by the possibility of the university's cash flow dipping near or below zero by mid-2008, and dropping even further during the course of fiscal 2009. Standard & Poor's is concerned about this potential cash flow shortfall. Guelph's internally restricted net assets (C$37.4 million as of fiscal 2007) will likely not cover the cash shortfall, despite the university's hesitation to fully deplete these funds. The potential shortfall largely stems from the required C$48 million annual contribution to the defined benefit (DB) pension plan (which could continue during the next two-to-three years) and the time gap between tuition receipt flows and provincial funding flows. The university is seeking arrangements with lending institutions to establish flexible credit facilities, effectively matching requirements and providing flexibility when cash flows fluctuate. Furthermore, Guelph is strategically evaluating its allocations for achieving greater efficiencies, as well as value for investment to strengthen its in-year cash flow balances, operations, and balance sheet. Standard & Poor's will continue to closely monitor the situation;

- Balance-sheet weakening. Guelph's unrestricted financial resources-to-debt plus unfunded postemployment liabilities dropped to 12.5% in fiscal 2007 from 31% in fiscal 2005. The weakening stems from declining internally restricted net assets, which have mostly been drawn down to make the portion of the mandatory C$48 million solvency payment that was due in fiscal 2007 to the DB pension plan it sponsors. Balance-sheet worsening also resulted from higher nonpension postemployment liabilities (dental, medical, and prescription drugs), although Guelph's pension liability payments have offset this. In fiscal 2007, Guelph's debt was C$159.3 million, or C$8,712 per FTE and 29% of adjusted revenues. These debt metrics fit well within the rating category. The university's balance sheet, nevertheless, should further weaken as Guelph plans to increase its debt by up to C$91 million and could further draw down its unrestricted net assets; and
- Persistent annual consolidated operating deficits. Guelph nearly balanced its books in fiscal 2007, posting a consolidated operating loss of 0.5% of total consolidated revenues. One of the primary reasons for the annual deficit is the university's postemployment expenses, which increased 21% in fiscal 2007 to C$51.1 million. Salaries are another significant pressure. Accounting for about 47% total expenditures, salary expenditure increased 6.1% in fiscal 2007 to C$265.2 million. The increase resulted from negotiated salary increases for various employee groups and hiring to support the enrolment growth. Insufficient operating margins require universities to stretch their resources or erode their net assets to service liabilities, such as pension funding or debt. Adjusting for amortization and interest, Guelph's operations were in surplus of almost 2.9% of adjusted revenues in fiscal 2007. Based on these adjusted figures, the university's debt service coverage ratio was about 2.5x (interest only). Although adequate, this is significantly low for the sector, and if the university borrows C$91 million, this should drop further.

Outlook

The negative outlook reflects the university's significant cash flow challenges, as Guelph makes its mandatory annual solvency payments to the pension plan its sponsors during the next two to three years. It also reflects the incremental stress on cash flows from higher debt servicing charges and immediate funding of Guelph's critical deferred capital maintenance. Further balance-sheet weakening, including issuing substantially more debt than expected, additional deterioration of unrestricted financial resources, or increased pension liabilities could also lead to us lowering the ratings. An outlook revision to stable, all else being equal, hinges on Guelph's ability to effectively manage its liquidity shortfalls and keep its cash flows at a sustained, positive position throughout the year. It also depends on Guelph's ability to balance operations, after pension funding, on a sustained basis.

Demand Profile Remains Strong

In fiscal 2007, Guelph's enrolment was 18,286 FTEs, slightly exceeding its enrolment target of 18,000 FTEs. All the growth was at the undergraduate level, which increased almost 5% from fiscal 2006. The province is nevertheless funding these students. Funding graduate expansion, however, is the province's priority. Ontario has committed to fund up to 14,000 additional graduate spaces provincewide by 2009, by promising up to C$220 million per year for graduate spaces on the operations side and up to C$550 million on the capital side. Like many Ontario universities, Guelph planned to increase its graduate enrolment. This plan, however, did not materialize, as system-wide demand for graduate programs is lower than expected. Guelph and many other university administrators across the province nevertheless believe that many students are delaying graduate enrollment, and that these students will eventually enroll.

In recent years, the gender composition of Guelph's enrolment has largely shifted toward women, who account for about 70% of total enrolment. This along with general demand trends has driven a greater demand for social sciences and arts, and away from Guelph's niche programs in science and agriculture. The university has had to respond to demand shifts in programs, which has required Guelph to significantly change the way it delivers its programs, placing additional pressure on the university's resources.

Operations Nearly Balanced, But Challenges Loom

Guelph's consolidated operations nearly balanced in fiscal 2007 at negative 0.5% of total consolidated revenues. Guelph's budgetary difficulties, however, remain a concern for Standard & Poor's. One of the primary reasons for the annual deficit is the university's postemployment expenses, which increased 21% in fiscal 2007 to C$51.1 million. This increase reflects lower interest rate assumptions used in the discount rate when calculating postemployment benefit liability and higher health benefit costs. On a cash basis, payments for benefits in fiscal 2007 increased by 58%, to C$61.9 million. The increase was virtually all from contributions to post-employment liabilities, which increased to a substantial C$30.7 million from C$9.3 million the previous year. The significant employer cash contribution was based on actuarial valuations, as required by the Pensions and Benefits Act of Ontario. At Sept. 30, 2007, the pension plan had a deficit of about C$71 million. Provincial regulators, such as the Financial Services Commission of Ontario, which enforce funding these deficits, require the university to pay C$48 million annually into the pension deficit. Fiscal 2007 results only partially reflect this payment; payments at this rate commenced in January 2007.

Salaries are another significant pressure for the university. Accounting for about 47% of total expenditures, salary expenditure increased 6.1% in fiscal 2007, to C$265.2 million. The rise resulted from negotiated salary increases for various employee groups and hiring to support enrolment growth that has occurred. Also during the year, the cost of general expenses related to operations, which account for about 26% of total expenditures and includes such items as the purchase of supplies, services and equipment, increased by 12.7%. Almost half of the increase was related to the OMAFRA agreement. As of fiscal 2006, Guelph assumed additional responsibilities for the operating cost of physical facilities related to OMAFRA. Guelph, however, received additional provincial funding to cover this.

The university also faces pressures similar to other universities. These include:

- Unfunded inflationary pressures;
- Unfunded graduate students. These students have exceeded time limits to completion for funding eligibility, and account for about 33% of total domestic graduate students. Guelph is aiming to bring this figure down; and
- Underfunded indirect costs of federal research. The university estimates indirect costs of research at 40%-60%. For its research, the federal government only funds indirect costs at 25%.

Furthermore, in the province's efforts to demonstrate accountability and value for public dollars, it is increasingly tying its funding to specific operational priorities, and the achievement of these targets. The university's strategic goals, however, could involve giving other initiatives higher priorities.

Operating and policy support from the province is good, however, and in part underpin the ratings. MTCU operating grants account for about 41% of Guelph's operating revenues. Furthermore, the 2007 Ontario budget included C$210 million to alleviate Ontario's universities' immediate cost pressures; Guelph's share was C$12.7 million. Also in fiscal 2007, the university received C$5 million from the province through the Access to Higher Quality Education program.

Further supporting operations is the province's tuition policy that began September 2006. Ending a two-year tuition freeze, the policy provides universities with limited tuition flexibility by allowing tuition for domestic students to increase by a maximum annual average of 5% institution-wide. Guelph's tuition schedule for the 2007-2008 academic year approximately reflects this framework. For most programs, tuition will increase by 4.5% for entering students and 4.0% for continuing students. Coinciding with rising tuition fees, however, student aid has also been a growing pressure. In fiscal 2007, spending on scholarships and bursaries increased 15.4% to C$21.8 million.

In addition to MTCU operating grants, the university's unique agricultural grounding and curriculum provide it with additional funds from OMAFRA, which make up about 15% of total revenue. Although the OMAFRA funding is restricted, it is part of the university's total operating budget and helps fund 95 faculty FTEs, 464 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 from OMAFRA increased by C$4.3 million.

Furthermore, the federal government's 2007 budget promised a minimum C$820 million post-secondary transfer of new base support to the provinces starting in 2008-2009. The allocation's details, however, are subject to federal-provincial negotiations.

Significant cash flow challenges

During summer 2008, the university's cash could be near or below zero, and could be even lower during the course of fiscal 2009. Guelph's internally restricted net assets (C$37.4 million as of fiscal 2007), which have decreased by 30% from the previous year, will likely not cover the cash shortfall. The shortfall largely stems from the required C$48 million annual contribution to the DB pension plan (which could continue during the next two to three years) and the time gap between tuition receipt flows and provincial funding flows. Another contributing factor will be Guelph's five-year capital renewal financing plan, in which C$30 million in spending for critical deferred capital maintenance has been approved over two years. The university is therefore in negotiations with lending institutions to establish flexible credit facilities to effectively match requirements and provide flexibility when cash flows fluctuate. This potential cash flow short fall is a concern to Standard & Poor's.

The university is evaluating its allocations to achieve greater efficiencies and value for investment to strengthen its in-year cash flow balances, operations, and balance sheet. This includes proposed initiatives such as increasing enrolment programs that are under capacity but attract higher levels of funding, and eliminating others that are not in demand. Standard & Poor's will continue to closely monitor the university's budgetary struggles.

Higher pension costs (which includes the C$48 million required payment) are also contributing to the university's accumulated net asset deficit, which increased 36.5% in fiscal 2007 to C$67.6 million. Other contributing items include the funding of Guelph's significant deferred capital maintenance, and lower-than-expected provincial funding.

Capital Plans Focus On Deferred Capital Maintenance

In fiscal 2007, the university acquired C$68.7 million in capital assets on a cash basis. Similar to previous years, the majority (C$26.1 million) was for science and teaching facilities, followed by C$23.9 million in major equipment purchases and building renovations. The university received C$12.2 million in capital contributions during the fiscal year, although it received C$52.6 million the previous year for projects in that and future years.

Guelph has essentially completed all its capital expansion initiatives. The second phase of the Science Complex, the largest of these initiatives, was finished in 2007. The total cost of the complex cost was about C$144 million. The funding for Guelph's capital expansion has come from a variety of sources, the majority being from both the province and C$75 million from its C$100 million senior unsecured bullet debenture issued in 2002.

Guelph is now focusing its capital plans on addressing deferred capital maintenance. The university estimates its deferred maintenance needs at just less than C$300 million, which is exceptionally high relative to that of its peers. In 2006, Guelph's board of governors stated that the university's deferred maintenance backlog had reached a critical state and for reasons of health, safety, and continuity of operations, can no longer be postponed. The requirements across the campus are C$200 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 March 23, 2007, Guelph's consolidated FCI, which excludes residence but includes adaptation or renewal renovations, was 0.19, the highest among Ontario's 19 universities and severely above the system FCI average of 0.12 (a rating above 0.10 is considered poor).

In 2004, C$13.5 million of the C$100.0 million debenture proceeds went to deferred maintenance projects. Also, 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.

Typically, Guelph only receives C$1.6 million per year from the province to address deferred maintenance issues. Therefore, in 2007, Guelph's board approved an additional C$127.7 million five-year financing plan (2007-2011) for high-priority deferred maintenance projects including residence buildings. The plan will be funded from a combination of the annual provincial facilities renewal grant, residence fees and external borrowing of up to C$91 million, which in the absence of any government capital funding, will be serviced from Guelph's operating fund.

One recommendation of a provincial postsecondary review conducted in 2004 was that the province invest C$200 million a year to address the deferred maintenance backlog in postsecondary 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.

Debt To Rise

In fiscal 2007, Guelph's debt was C$159.3 million, or C$8,712 per FTE and 29% of adjusted revenues. These debt metrics fit well within the rating category. Included in these figures is an additional C$6.9 million that was incurred in fiscal 2007, mostly for real estate. 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, although it is not required by covenant to do so. As of fiscal 2007, Guelph contributed C$9.2 million to the fund, C$2.4 million of which will be reinvested for the purpose of retiring the C$100.0 million debenture; the remainder is for student housing mortgages.

Approximately 37% (C$59.3 million) of Guelph's total debt consists of leases, mortgages, and loans for student housing, which covers 5,000 beds across 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; C$14 million was for Guelph's deferred maintenance.

The board has approved borrowing of up to C$91 million for capital expenditures related to maintenance and capacity expansion (both of which would be scaled back if the province meaningfully funded capital maintenance). This would bring Guelph's pro forma debt to C$248 million, or C$13,570 on a FTE basis (based on the university's fiscal 2007 enrolment) and its interest expense-to-adjusted revenue would rise to about 3.0% from 1.9%. Both these measures would be high, but are reflected in the rating. The rise in Guelph's debt would lower the university's DSCR to about 1.9x from 2.5x (as at fiscal 2007), which, although adequate, is unusually low for the sector. 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. However, given Guelph's deficit position in its consolidated operations for the past four years, and its expected cash flow difficulties, the university's capacity to generate funds to service the additional debt is a concern for Standard & Poor's. The table provides a peer comparison.

University of Guelph—Peer Comparison						
	University of Guelph		***McMaster University***	***York University***		***University of Western Ontario***
(Thou. C$)	***2007***	***2006***	***2006***	***2007***	***2006***	***2006***
Issuer credit rating	A+/Negative/—	A+/Stable/—	AA/Stable/—	AA-/Stable	AA-/Stable/—	AA/Stable/—
Acceptance rate (offers/applicants; %)	N/A	54	62	75	77	14
Matriculation rate (registrants/offers; %)	N/A	14	14	N/A	N/A	N/A
FTEs	18,286	17,538	22,140	45,611	44,954	27,880
Total revenue	567,044	510,789	693,717	824,481	794,288	764,543
Deferred capital	20,901	18,670	40,753	10,384	9,661	23,887
Adjusted revenue	546,143	492,119	652,964	814,097	784,627	740,656
Total expenditure	569,944	521,694	685,155	783,901	738,833	721,930
Interest	10,635	10,523	11,383	23,314	21,728	7,250
Depreciation	39,378	35,930	58,806	38,315	39,206	51,542
Adjusted expenditure (for DSCR)	519,931	475,241	614,966	722,272	677,899	663,138
Consolidated surplus (%)	(0.5)	(2.1)	1.2	4.9	7.0	5.6
Consolidated surplus (for calculating DSCR; %)	2.9	1.3	4.1	8.4	10.8	9.5
DSCR (interest only; x)	2.46	1.60	3.34	3.94	4.91	10.69
Total debt	159,307	158,607	157,146	352,716	361,283	127,198
Unfunded postemployment liabilities	308,395	330,229	276,600	137,270	70,385	174,941
Interest expense to adjusted revenue	1.9	2.1	1.7	2.9	2.8	1.0
Debt to FTE	8,712.0	9,043.6	7,097.8	7,733	8,036.7	4,562.3
Debt to adjusted revenue (%)	29.2	32.2	24.1	43.3	46.0	17.2
(Debt plus unfunded)/adjusted revenue (%)	85.6	99.3	66.4	60.2	55.0	40.8
Internally restricted net assets	37,406	54,004	93,327	172,699	134,330	121,303
Internally restricted endowments	21,149	19,182	143,878	44,053	43,454	16,523
Externally restricted endowments	152,118	131,165	245,170	201,394	169,659	250,055
Unrestricted financial resources	58,555	73,186	237,205	216,752	177,784	137,826
As % of total debt	36.8	46.1	150.9	61.5	49.2	108.4
As % of total debt plus unfunded postemployment liabilities	12.5	15.0	54.7	44.2	41.2	45.6
Per FTE	3,202	4,173	10,714	4,752	3,955	4,944
Total endowment value per FTE (at market value)	10,112	9,363	20,289	$6,687.0	5,895	9,562

FTE—Full-time equivalent. DSCR—Debt service coverage ratio.

Decline In Unfunded Pension Liability Offset By Rise In Other Benefit Liabilities

As a result of Guelph's C$48 million annual required contribution to its DB pension plan, its unfunded liability decreased 52% to C$71.4 million in fiscal 2007. In addition, Guelph also had unfunded nonpension benefit plan (such as medical, dental and drug plans) liabilities totaling C$237 million, a 30% increase from fiscal 2006. This significant swing is largely resulting from a 40 basis point-decrease in the discount rate used in the actuarial valuation of Guelph's nonpension postemployment benefits.

Guelph's total liabilities (debt plus unfunded postemployment liabilities) were 85.6% of total adjusted revenues at fiscal year-end 2007. This significantly exceeds that of any of Guelph's rated peers, and would increase to more than 100% if the potential C$91 million issuance was incorporated.

Good Endowment But Unrestricted Financial Resources Decline

Largely resulting from strong investment returns, the market value of Guelph's endowment increased 12.6% in fiscal 2007 to C$184.9 million, or C$10,112 per FTE, above that of York University (AA-/Stable/—) and the University of Western Ontario (AA/Stable/—). Net capital additions of C$8.7 million also contributed to the increase.

Guelph's fiscal 2007 investment return of 12.8% is near the market benchmark of 13.1%, and exceeds its annual return of the last two years (7.4% and 6.7% in 2006 and 2005, respectively). For fiscal 2007, the annual spending rate of the general endowment, which accounts for 68% of total endowments, and goes mainly towards student assistance, was 4.5%. In accordance with the spending policy, C$6.3 million of total accumulated investment earnings were available for disbursement. The remaining investment income of C$14.2 million was added to the accumulated earnings of previous years for capital protection and growth.

The portion of endowments that contribute to the university's balance-sheet flexibility or internally restricted funds is about C$21.2 million on a book value basis. The university also had about C$37.4 million in internally restricted net assets, bringing its total internally restricted resources (internally restricted endowments plus its internal funds) to about C$58.6 million. This is about C$3,202 per FTE, considerably lower than the C$4,173 reported in 2006. The drop largely stems from the draw down from its net assets to meet its mandated pension payments during the year. Although Guelph's internally restricted resources per FTE is the lowest of its rated peers, is consistent with the rating category.

About 88% of Guelph's endowments have external restrictions. But even these funds provide strength, through producing spendable endowment income and freeing up other operating funds that can be used for other purposes. Furthermore, endowments restricted for scholarships or faculty chairs enhance a university's profile, and further attract quality students and faculty.

Research Profile Remains Strong

Despite its near-term challenges, Guelph's longer-term prospects remain strong. This is largely helped by its solid research profile. Guelph was ranked number twelve in Canada, just behind Queen's University (AA+/Stable/—) in a survey, published by Research Infosource Inc. Nov. 2, 2007, that ranks universities on sponsored research income and research funding per full-time faculty. A major component of Guelph's research is its multifaceted agri-food initiative that OMAFRA sponsors. In addition to accounting for about 28% of Guelph's research funding, the OMAFRA contract gives the university a strong niche among the province's 19 universities.

In fiscal 2007, Guelph received C$128.4 million in research funding. Although this is about 12% below the amount received in fiscal 2006, it is more typical than the 2006 funding. Guelph received higher research funding that year as a result of higher provincial funding for research related infrastructure. Despite being restricted, research grants significantly contribute to Guelph's operations by attracting faculty and covering the costs of expanding faculty and capital, which are related to research.

Ratings Detail (As Of 30-Nov-2007)*	
University of Guelph	
Issuer Credit Rating	A+/Negative/—
Senior Unsecured	
Local Currency	A+
Issuer Credit Ratings History	
08-Nov-2007	A+/Negative/—
25-Oct-2006	A+/Stable/—
24-Sep-2002	AA-/Stable/—

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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