

Research Update:

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

May 5, 2020

Overview

- The COVID-19 pandemic will likely have negative implications for Queen's University's financial results for the current fiscal year, and possibly also international student enrolment, depending on the duration of the outbreak.
- However, Queen's entered into the pandemic with a strong financial profile and exceptional student demand characteristics, which support the ratings.
- We are affirming our 'AA+' long-term issuer credit and senior unsecured debt ratings on Queen's.
- 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 the university will maintain an exceptional market position and student demand profile, its adjusted operating margins will remain largely balanced, and its financial resources will remain robust.

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Rating Action

On May 5, 2020, 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.

Rationale

The ratings on Queen's reflect the university's stand-alone credit profile (SACP), which S&P Global Ratings assesses at 'aa+' based on Queen'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 to the university 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)

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criteria.

We believe the COVID-19 pandemic represents a short-term risk to Queen's and other universities we rate. For Queen's, the three areas most likely to face pressures stemming from the virus are: enrolment, revenues, and liquidity. It is our view that the impact of the coronavirus will peak in the second quarter of 2020; however, due to widespread social distancing measures that include lockdowns and border closures, Queen's, similar to universities worldwide, will most likely see weakness in international student enrolment if the virus and related travel restrictions persist. We believe that enrolments are less likely to decrease among those students already enrolled, but expect that a decline in international matriculations might be more pronounced among first-year students if the virus is not contained and restrictions are not lifted by the start of classes in fall 2020. This could be offset somewhat by a potential increase in domestic enrolments. Other pressures include the impact of the COVID-19 pandemic on revenues stemming from international student enrolments. Due to the university's decision to conduct classes remotely in March and April, there could also be some softness in ancillary revenues, primarily related to campus services in fiscal 2020.

Queen's was established in Kingston, Ont., by Royal Charter in 1841. It is a midsize, research-intensive university offering a variety of undergraduate and graduate degrees across six faculties (arts and science, education, engineering, health sciences, law, and business) and two schools (graduate studies and policy studies). Queen's undertakes cutting-edge research in many fields, including applied artificial intelligence and analytics, particle astrophysics, cancer clinical trials, clean technology, geotechnical engineering, surveillance studies, and art conservation.

The university is a member of the U15, an association of leading public Canadian research universities. Members undertake 80% of all competitive university research in the country, and rank among the world's premier institutions. In fiscal 2019, Queen's received about C\$178 million in external research funding, an increase of approximately 16% over 2018, and reflecting a steadily improving trend over the past four years (31% increase since fiscal 2016).

The enterprise profile assessment reflects our view of the higher education sector's low industry risk, Queen's solid market position and demand profile, the university's strong management and governance practices, and Ontario's extremely strong economic fundamentals. Over the past three years, an average of 64% of the student body originated from Ontario; therefore, we measure the latter metric with the province's GDP per capita (estimated at about US\$46,000 in 2019), good income indicators, and moderate employment and population growth projections.

In our opinion, student quality metrics continue to demonstrate strength and compare well with those of rated Canadian peers. The university's full-time equivalent students (FTEs) increased by 2.6% in fall 2019, continuing a steady upward trend and supported by growth in both graduate and undergraduate enrolments (5.8% and 2%, respectively). As do many other universities worldwide, Queen's will focus its enrolment growth efforts on attracting more international students; in autumn 2019, approximately 15.4% of FTEs were from outside of Canada, an increase from 14.6% in 2018. At this time, we believe that management will keep enrolment stable over the near term.

Queen's benefits from exceptional faculty quality, with substantially all faculty members possessing terminal degrees (PhDs or equivalents), a trend consistent over at least the past five years. Moreover, Queen's retention rate and average entry grades in fall 2019 were very strong, at 94.7% and 88.9%, respectively; the retention rate is one of the highest among Canadian peers. First-year selectivity (offers to applications) and six-year graduation rates remained superior to those of peers, at 38.2% and 86.9%, respectively. We believe Queen's tuition discounting, which we define as total financial aid costs as a percentage of gross tuition and fees, has decreased steadily over the past four years and is lower than that of several Canadian peers. This suggests greater flexibility to address affordability concerns, which bolsters the university's competitive

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position. In our opinion, the university has demonstrated effective fundraising capacity, raising an average of C\$60 million annually over the past three years.

Queen's management team's expertise, governance practices, and financial management policies, in our view, are strong. Management has demonstrated consistently positive operational effectiveness, which we believe lends stability to the credit profile. The university follows 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. Moreover, it has a robust university-wide enterprise risk framework that guides its identification and management of risks. Overall, we view 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 (most recently revised in 2014) and contains what we view as reasonable assumptions. Queen's prepares externally audited financial statements, which have been unqualified; and it has formal policies in place, including investment and debt policies.

In our view, Queen's has a very strong financial profile, with a history of adequate financial performance, excellent levels of available resources, and a moderate debt burden. The university's adjusted weighted-average operating margin was 7.4% in the past three fiscal years, and should provide some cushion during the pandemic. Management attributes this strong trend to favorable investment returns, higher-than-anticipated student enrolments, and cost management. In addition to pressures from the ongoing COVID-19 outbreak, Queen's and other Ontario universities face increased budgetary pressure from the provincial government's directive to cut domestic tuition fees by 10% in the current fiscal 2020 and freeze them in fiscal 2021.

At the end of the third quarter of fiscal 2020, Queen's projected an operating deficit of approximately C\$5.7 million, below the originally budgeted C\$17.8 million deficit. This was primarily due to one-time savings in utilities spending and in the allowance for greater-than-allocated unit spending. This was somewhat offset by the increase in spending in miscellaneous allocations, including infrastructure renewal and strategic priorities. Queen's has sufficient reserves to cover the operating deficit and we believe the university will successfully accommodate the cuts in the future. The university expects to continue to balance its operating budget through fiscal 2022 after drawing down on carryforward balances. Although Queen's does not prepare consolidated forecasts, we expect that, including ancillary operations (which tend to generate positive cash flow), the university will post balanced consolidated results, on average, over the medium term.

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 enrolment expansion (through operating grants). However, universities decide these matters and their long-term strategies.

In our view, Queen's has a moderate debt burden. At fiscal year-end 2019, its total gross debt outstanding stood at C\$268.4 million. The debt consists of three fixed-rate bullet bonds due at the earliest in 2033, and an amortizing bank loan maturing in 2030. As of April 30, 2019, the university held approximately C\$103 million in sinking funds to repay the three bullet debentures outstanding, which we include in our measure of internally restricted net assets. Queen's pro forma maximum annual debt service remained modest, at about 3.8% of 2019 adjusted operating expenditures, which is lower than the median for peers in the 'AA' rating category. Pro forma debt includes a C\$125 million bullet debenture maturing in 2060, which Queen's issued in April 2020. The university plans to use the proceeds of borrowing to fund capital projects.

We believe that available resources could decline somewhat in the next two years if Queen's uses

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reserves to meet any financial shortfalls from the COVID-19 pandemic or capital projects over the next two years. However, we believe these ratios will remain fairly strong, on average, in line with historical levels.

We believe that postemployment liabilities somewhat offset Queen's financial profile strengths, despite the steps both the province and university have taken to address the solvency deficit. Queen's maintains a defined-contribution pension plan with a defined-benefit component that provides a minimum level of benefits, which is in a deficit 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 million on a market basis and C\$31 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 are C\$3.4 million, down from C\$20.7 million previously. Queen's qualified for a temporary solvency funding relief program, under which solvency special payments are \$15.6 million. The university previously took several initiatives to manage its pension deficit, including increased employee contributions. Queen's 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, and expects to implement it by July 2021. A move to a JSPP, which would not be subject to solvency payment regimes, could help improve Queen's cash flows and provide long-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

In our view, the university has very robust liquidity. At fiscal year-end 2019, Queen's total cash and investments increased somewhat to C\$ 1.8 billion, from C\$1.7 billion in 2018, which is almost 7x the university's debt outstanding, and almost 5x the pro forma debt outstanding. Unrestricted financial resources totaled a little more than C\$712 million, a significant increase from C\$625 million in 2018 and C\$582 million in 2017. This covers approximately 74% of adjusted operating expenses (up from 70.5% in 2018) and 181% of pro forma debt (229.7% in 2018). These ratios compare well with those of peers. At the end of fiscal 2020, Queen's issued C\$125 million of bullet debentures, maturing in 2060. The bonds will be used to finance the construction of a 334-bed student residence building, and to renovate the St. Mary's of the Lake site for administrative purposes. We have included this debt in our pro forma calculations, and expect that Queen's debt metrics will remain adequate in the next two years. We believe that Queen's balance sheet and liquid resources will help the institution to offset medium-term pressures that might arise.

In fiscal 2019, the market value of the university's endowment grew to C\$1.2 billion from C\$1.1 billion at fiscal year-end 2018. This is one of the largest endowments among Canadian universities, and the second-largest in Ontario after the University of Toronto; since 2009, Queen's endowment's market value has more than doubled. The university has a conservative endowment draw, with a long-term payout target rate of 4% of the endowment's market value. In fiscal 2019, the endowment paid out \$42.2 million, a payout approximately 8% larger than the previous year's spending.

Moderately high likelihood of extraordinary provincial government support

In accordance with our criteria for GREs, our view of Queen's moderately high likelihood of

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extraordinary government support reflects our assessment of its important role in the province, given that postsecondary education is one of Ontario's priorities in both expenditure and mandate (after health care and school boards), and that there are no viable private alternatives. It also reflects our 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 20% 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 the university's board of trustees' members. We consider the risk of extraordinary negative government intervention low, given the university's operational independence, important public policy role, and the government's hands-off approach to the sector.

Ontario elected a new provincial government in June 2018. In January 2019, the government announced changes to university funding, which included a plan to cut domestic tuition fees by 10% for the 2019-2020 fiscal year, a freeze in tuition rates for the following fiscal year, and changes to its student assistance program and some student fees. Furthermore, the province has stated that there will be no additional grant revenue to offset the tuition cut. The university must comply or risk losing some of its core operating grants from the province. We believe that Queen's will avoid consolidated deficits, and will mitigate the loss in tuition revenue through increases in international enrolment and appropriate budgetary adjustments. While the requirement to cut tuition fees was unexpected, it does not change our assessment of the government's likelihood of support based on Queen's strong link and important role with the province.

Environmental, social, and governance factors

In S&P Global Ratings' view, higher education entities face elevated social risk due to the ongoing uncertainty regarding the duration of the COVID-19 pandemic, and the unknown impact on fall 2020 enrolment levels and mode of instruction. We view the risks posed by COVID-19 to public health and safety as a social risk under our environmental, social, and governance (ESG) factors. Despite the elevated social risk, we believe Queen's environmental and governance risks are in line with our view of the sector as a whole.

Outlook

The stable outlook reflects our view that the COVID-19 pandemic will have a temporary impact on the university, but that, on average, over our two-year outlook horizon, Queen's will maintain an exceptional market position and student demand profile, close-to-balanced adjusted net margins, abundant financial resources, and will not increase its debt burden. 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

Although we do not expect it, prolonged social distancing measures caused, for instance, by flare-ups in COVID-19 could lead to a longer-term disruption to the university's operations. This could temporarily impair enrolment levels and revenues, putting pressure on operating margins, and potentially requiring it to rely on its substantial liquidity position to help fund operations and debt service until the negative effects of the pandemic subside. Should this cause the university's cash and investments to fall below 3x on a sustained basis, we could lower the rating. All else being equal, a negative rating action on Ontario would also 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. However, even if we were to raise the rating on the Province of Ontario, we might not necessarily raise the rating on Queen's in tandem. This is due to the university's significant operating pressures and reliance on provincial grants, which can be unilaterally altered and have a higher risk of cuts in times of provincial budget stress.

Queen's University -- Enterprise And Financial Statistics

	--Fiscal year ended April 30--					--Medians for 'AA' rated public colleges and universities--
	2020	2019	2018	2017	2016	2018
Enrollment and demand						
Headcount	28,358	27,516	26,513	25,395	24,802	MNR
Full-time equivalent	26,638	25,972	25,044	23,994	23,575	35,846
First-year acceptance rate (%)	38.2	39.4	44.2	44.3	46.6	67.8
First-year matriculation rate (%)	34.0	33.5	35.5	37.0	37.0	MNR
Undergraduates as a % of total enrollment (%)	76.7	77.2	77.2	77.6	77.7	78.6
First-year retention (%)	94.7	94.5	94.7	94.7	94.4	86.0
Graduation rates (six years) (%)	86.9	86.4	85.7	85.5	84.0	MNR
Income statement						
Adjusted operating revenue (\$000s)	N.A.	1,051,792	965,394	884,171	909,786	MNR
Adjusted operating expense (\$000s)	N.A.	969,779	887,398	861,445	828,085	MNR
Net adjusted operating income (\$000s)	N.A.	82,013	77,996	22,726	81,701	MNR

Queen's University -- Enterprise And Financial Statistics (cont.)

	--Fiscal year ended April 30--					--Medians for 'AA' rated public colleges and universities--
	2020	2019	2018	2017	2016	2018
Net adjusted operating margin (%)	N.A.	8.46	8.79	2.64	9.87	1.50
Provincial grants to revenue (%)**	N.A.	19.7	21.4	22.7	21.9	19.2
Student dependence (%)	N.A.	37.2	36.7	36.0	32.1	39.7
Investment income dependence (%)	N.A.	7.1	4.9	9.0	3.3	1.4
Debt						
Outstanding debt (\$000s)	N.A.	268,397	272,239	275,966	279,708	828,692
Total pro forma debt (\$000s)	N.A.	393,397	N.A.	N.A.	N.A.	MNR
Pro forma MADS	N.A.	36,878	N.A.	N.A.	N.A.	MNR
Current debt service burden (%)	N.A.	1.83	2.00	2.07	1.88	MNR
Current MADS burden (%)	N.A.	3.00	2.82	2.88	2.99	3.50
Pro forma MADS burden (%)	N.A.	3.80	N.A.	N.A.	N.A.	MNR
Financial resource ratios						
Endowment market value (\$000s)	N.A.	1,152,622	1,085,486	1,046,531	930,868	990,083
Cash and investments (\$000s)	N.A.	1,844,130	1,684,575	1,611,055	1,378,323	MNR
Adjusted UFR (\$000s)	N.A.	712,012	625,338	582,457	505,866	MNR
Cash and investments to operations (%)	N.A.	190.2	189.8	187.0	166.4	54.0
Cash and investments to debt (%)	N.A.	687.1	618.8	583.8	492.8	168.3
Cash and investments to pro forma debt (%)	N.A.	468.8	N.A.	N.A.	N.A.	MNR
Adjusted UFR to operations (%)	N.A.	73.4	70.5	67.6	61.1	35.3
Adjusted UFR plus debt service reserve to debt (%)	N.A.	265.3	229.7	211.1	180.9	97.8
Adjusted UFR plus debt service reserve to pro forma debt (%)	N.A.	181.0	N.A.	N.A.	N.A.	MNR
Average age of plant (years)	N.A.	16.4	17.1	16.4	14.3	13.0
OPEB liability to total liabilities (%)	N.A.	8.3	9.0	8.6	7.7	MNR

*U.S. median figures are in U.S. dollars. §Median figure is state appropriations to revenue. N.A.--Not available. MNR--Median not reported. MADS--Maximum annual debt service. UFR--Unrestricted financial resources. Average age of plant = accumulated depreciation/depreciation and amortization expense. OPEB--Other postemployment benefits.

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

- Hitting the Books: Could COVID-19 Affect Australian University Ratings?, April 21, 2020
- COVID-19 Deals A Larger, Longer Hit To Global GDP, April 16, 2020
- Australia, Canada, Mexico, and U.K. Universities Medians Report: Government Support Is Still Declining, Tuition Revenue Holds, And New Risks Arise, Aug. 29, 2019
- U.S. Public College and University Fiscal 2018 Median Ratios: The Disparity Between Higher- and Lower-Rated Entities Persists, June 25, 2019
- Ontario's 10% Domestic Tuition Cut Ratchets Up Pressure On University Budgets, Jan. 21, 2019
- Global Not-For-Profit Higher Education 2019 Sector Outlook: Credit Pressures Proliferate, Jan. 24, 2019

Ratings List

Ratings Affirmed

Queen's University

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