

Methodology

*Rating Canadian Universities*

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*Insight beyond the rating.*

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# Rating Canadian Universities

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## Overview

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DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. They are opinions based on forward-looking measurements that assess a debt issuer's ability and willingness to make timely payments on outstanding obligations (whether principal, interest or dividend) in accordance with the terms of an obligation. Ratings are not buy, hold or sell recommendations and they do not address the market price of a security.

DBRS rating methodologies consider a broad array of industry- and entity-specific risk factors, both quantitative and qualitative. In the case of universities, DBRS groups the risk factors into three broad categories:

- (1) Academic profile.
- (2) Operating risk profile.
- (3) Financial risk profile.

Collectively, these three categories form the basis of every DBRS university rating, although the factors related to the academic profile tend to be relatively more qualitative in nature and get incorporated into the analysis in a more subtle way.

The analysis of the academic profile is aimed primarily at assessing the role fulfilled by the institution within the national and international education network. DBRS looks at the reputation, prestige and location of the university; the relative strength and weaknesses of the programs and services offered; and the prospects for student enrolment going forward, which constitute the key determinant of revenue for universities. For the analysis of the operating profile, emphasis is placed on the day-to-day operations of the institution. DBRS focuses on the range of activities in which the institution is involved, the framework in place to manage the university's operations and infrastructure and the key revenue sources and expenditure requirements related to the delivery of core activities. Finally, the analysis of the financial risk profile mainly entails assessing the current and expected level of financial obligations carried by the university in relation to the financial resources currently available and projected to be generated by the institution going forward.

DBRS rating methodologies are underpinned by a stable rating philosophy. Consequently, DBRS takes a longer-term "through the cycle" view of the issuer, which means that in order to minimize the rating changes due primarily to global economic changes, DBRS generally factors the expected impact of a normal economic cycle into its rating. Rating revisions do occur, however, when it is clear that a structural change, either positive or negative, has transpired or appears likely to transpire in the near future. An equally important aspect of DBRS's analysis is its broad industry coverage, which it undertakes in order to better appreciate the major differences and subtle nuances within a particular industry and to develop an acute understanding of the issuer relative to its peers.

Critical in the determination of a rating is the application of the analyst's experience and expertise in forming an initial rating opinion and recommendation for the rating committee, as well as the role of the DBRS rating committee as the final decision maker. DBRS rating committees are made up of experienced and knowledgeable DBRS personnel and strive to provide objective and independent rating decisions that are based on all relevant information and factors, incorporate both global and local considerations, consistently apply DBRS-approved methodologies and reflect the opinion of DBRS.

The following is a more detailed discussion of the various factors considered by DBRS when assessing the creditworthiness of Canadian universities. Their relative importance can vary across institution or jurisdiction, as a major strength in one area can compensate for a marked weakness in another and vice versa.

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## Academic Profile

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In assessing the academic profile of a university, DBRS first endeavours to establish the role and relative importance of the institution regionally, nationally and internationally in order to acquire a solid understanding of the university's enrolment prospects. Despite the sharp gain in popularity of academic research in recent years, teaching remains the core mission of universities and the primary driver of university revenue, directly through tuition and grant revenue and indirectly through ancillary operations (e.g., food services and residences) and, to some extent, research activities. Therefore, understanding the relative academic strengths and challenges of the institution and the primary factors likely to influence enrolment going forward is paramount in understanding its financial prospects. In doing so, DBRS focuses on the following seven areas of interest.

### REPUTATION

The reputation of a university is ultimately its trademark. A strong reputation will often translate into stronger and less volatile student demand as it extends the boundaries of the university's draw beyond its regional catchment area and into more successful faculty recruitment and fundraising activities. Information often used by DBRS to assess a university's reputation includes reputable third-party university rankings, historical student application statistics across institutions and admission standards statistics (e.g., yield rates and entering grades).

### PROGRAM MIX

The range of programs offered defines the nature of the institution and plays an important role in its ability to attract students. Universities with a more diversified mix of programs that caters to the needs of the workplace will generally enjoy stronger student demand. In addition to existing programs, DBRS looks at the management team's track record of innovation with its program offering, and ability to detect and revamp programs for which student interest is fading.

### LOCATION

Although students generally tend to be fairly mobile, the location of an institution may often significantly influence its ability to attract students and high-quality faculty members. Larger cities offer larger local student catchment areas while facilitating interaction with the private sector through, for example, student internship, fundraising or research activities. However, some of these benefits may be offset by more intense competition to attract better students, with larger cities often having a greater number of post-secondary institutions.

### COMPETITION

The relative proximity of a university to other institutions with similar program offerings may hinder student recruitment and introduce volatility in enrolment. For this reason, DBRS seeks to understand the factors that differentiate the institution from its closest competitors and the factors that are likely to continue to stimulate student demand and ensure the institution's existence going forward. The issue of competition is usually analyzed in conjunction with other considerations, such as the location, the program mix and any specialization that may exist at the institution.

### SIZE

Larger universities are generally believed to have more flexibility to absorb declining enrolment than smaller institutions because they can consolidate classes more easily. In some cases, however, the benefits provided by size may be accompanied by inefficiencies resulting from cumbersome management and policies.



## ACADEMIC RESOURCES

The resources available to a university to fulfill its academic mission may have a considerable impact on its academic and financial performance. In this regard, the size, seniority, profile and qualifications of faculty members as well as the adequacy of the facilities available to deliver core academic services will deserve particular attention because weakness at either level may hamper student and/or faculty recruitment.

## ENROLMENT TREND

The trend in student enrolment is reviewed in relation to the provincial average and the institution's enrolment strategy and is viewed by DBRS as a key indicator of the quality of an institution's academic profile. Although not all universities are in a growth mode, first-choice institutions generally exhibit above-average enrolment stability and superior ability to achieve enrolment targets. Particular emphasis is placed on the programs that have driven enrolment growth in recent years in order to identify the areas of relative strength of the institution. The student mix is also analyzed carefully (foreign versus domestic and full-time versus part-time) because it provides insight into the geographical reach of the institution and may reveal sources of potential volatility. For example, part-time students have historically had a much more volatile demand profile than full-time students.

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### Key Academic Profile Statistics

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FTE enrolment and application growth trend	Part-time enrolment/total enrolment
Offer rate (i.e., per cent of applications subject to offers)	Per cent of tenured faculty
Yield rate (i.e., per cent of offers accepted by students)	FTE enrolment/full-time faculty
Average entering grades	Size and growth trend of local catchment area

FTE = full-time equivalent.

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## Operating Risk Profile

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The primary objectives of this part of the analysis are to establish the volatility and predictability of major spending items, the adequacy of the financial resources available to the university to fulfill its mission and the ability of the management team to manage operations within its means. As such, DBRS primarily focuses on the institution's revenue and expenditure bases by core activities (e.g., teaching, research and ancillary services), the framework in place to plan and manage day-to-day operations, the track record of operating results and management's planning and cost-control efficiency. Through this detailed analysis, DBRS also identifies the areas of relatively high operating risk and develops an understanding of the likely trajectory of operating results for the years to come.

## MANAGEMENT FRAMEWORK

The system of checks and balances established by a university to manage its affairs can have considerable influence on operating results and, ultimately, the financial soundness of that institution. For this reason, DBRS conducts an in-depth review of the governance structure and the various policies and procedures in place to ensure adequate planning, management and monitoring of resources. Particular attention is paid to the budgeting process and to management's ability to develop and comply with clearly defined guiding principles relating to the key aspects of university activities. Major areas of interest include the following:

- Clarity and allocation of responsibilities (senate, board, departments, budget units, etc.).
- Quality and expertise of the management team.
- Management policies, particularly with regards to budgeting, borrowing and facility and investment management.

- Transparency and accountability in the management process.
- Frequency of reviews for policies and procedures.
- Budget process:
  - Allocation of authority.
  - Timing.
  - Method to produce revenue and expenditure projections.
  - Sources of operating flexibility to weather unexpected adverse developments (e.g., reserves and stabilization funds).
- Internal spending monitoring and controls.
- Medium-term management plans (programs, enrolment and facilities).

## REVENUES

DBRS closely examines the composition and diversification of the revenue base of each university in order to assess the resilience and growth potential of each major revenue source; namely, government grants, tuition fees, ancillary revenues, donations and endowment income. Given the significance of provincial funding in the revenue base of Canadian universities (generally 40% to 60%), one could expect ratings on universities to be closely related to those of their sponsoring provincial government, more so since provincial governments also define key aspects of university operations, such as governance structure, fee-setting autonomy, program offering and, in certain cases, borrowing capacity. Nonetheless, Canadian universities are independent, non-government entities. As such, despite the importance allocated to the provincial rating in the analysis, the rating on a university is primarily based on the institution's own merits and may diverge substantially from that of its sponsoring government.

Listed below are the major areas scrutinized by DBRS when assessing the revenue base of a university;

### *Government Funding*

- Dependence on public funding.
- Provincial rating.
- Stability of public funding and attitude of the government toward post-secondary education.
- Historical relationship between the province and its universities.
  - Desire of a province to financially support its institutions and concrete examples of such actions in recent years may be important considerations in the analysis, especially for weaker credits.

### *Tuition Fees*

- Relative importance of tuition fee revenue.
- Tuition fee levels relative to competing institutions.
- Government constraints over fee-setting autonomy.
- Trend and restrictions on fee increases (internal or external).

### *Enrolment Outlook*

- Primary areas of growth and volatility of enrolment.
- Student recruitment strategy, provincial demographic profile, university participation rate.

### *Housing, Dining and Parking Revenues*

- Relative importance and stability of revenues.
- Average pricing and pricing power in the local market.
- Current and projected demand for services.
- Financial sustainability of activities and efficiency at managing operations.

### *Fundraising, Endowment and Investment Income*

- Relative importance in revenue base.
- Major sources of donations (corporations, governments, individuals).

- Restrictions on the use of fundraising proceeds.
- Fundraising growth potential (strength of alumni base, success of past campaigns, fundraising infrastructure).
- Sources, trend and stability of investment income (e.g., endowment funds, reserves and cash balance).
- Sustainability of endowment payout ratio.
- Investment strategy and historical returns on investments.

## EXPENDITURES

As part of the expenditure analysis, DBRS takes a close look at the nature and volatility of major spending items, especially labour costs. Historical and expected trends are analyzed extensively, along with the management team's track record of spending discipline and expected ability to control future cost pressures.

### *Operating Expenditures*

- Fixed versus variable expenses.
- Labour costs (faculty, support staff and ancillary operations).
  - Proportion unionized employees.
  - Relationship with unions.
  - Level of compensation relative to peer institutions.
  - Terms of major labour agreements, including annual salary and benefit increases.
  - Appropriateness of staffing level, expected staff recruitment and staff turnover.
- Utilities and maintenance.
- Ancillary operations (e.g., dining, housing and parking).
- Other voluntary and mandatory expenditures (e.g., student aid).

### *Debt Servicing*

- Current and projected debt service costs in relation to revenues and operating cash flows (interest coverage).
- Stability of interest charges.

### *Research*

- Nature and relative importance of research activities.
- Stability and management of related cash flows.
  - Impact of research on the university's profile and bottom line.
  - Related infrastructure and labour requirements; since research funding tends to be more volatile than operating funding, does the university have the flexibility to terminate research staff if funding dries up?
- Pressure exerted by research activities on infrastructure or other spending areas.

## REGULATORY ENVIRONMENT

Since Canadian universities are under provincial jurisdiction, significant components of their operating environment are defined by provincial legislation, regulations and/or policies. These generally relate to the governance structure, degree-granting powers, program offering, borrowing, government funding and fee-setting autonomy of universities. DBRS reviews the policy framework, with a particular focus on the complexity, consistency and reasonableness of the framework in place.

Given the significance of provincial funding to the revenue base of universities, the government funding policy warrants attention. It is analyzed in relation to the level of fee-setting autonomy granted to the institutions because less generous grant funding often tends to be offset by greater charging flexibility (or vice versa). The extent of government oversight is also considered in the analysis and generally viewed as positive by DBRS because it fosters discipline in the system.

## INFRASTRUCTURE

The analysis of the infrastructure base of a university may provide considerable insight into the capacity of the institution to accommodate enrolment growth and into the potential capital financing requirements. The review primarily focuses on the capacity of existing facilities in relation to enrolment projections for the foreseeable future, as well as any evidence of deferred maintenance based on third-party assessments. Also considered is the approach used by the university to maintain capital assets in a state of good repair and to finance and manage capital projects (e.g., fixed-price contracts and cost recovery from operating units). The purpose of each major project being financed through a debenture issue is carefully analyzed by DBRS, along with the certainty of expected cash flows associated with those projects.

## OPERATING BALANCE

The historical operating performance of a university may provide valuable information on the management style of a university, the risk related to its core activities and the challenges likely to be faced by the institution going forward. DBRS analyzes the size and stability of past surpluses as well as the key factors behind past deficits (if any) in order to obtain a clearer picture of the trend likely to be followed by operating results and cash flow generation in the years ahead. This segment of the assessment is fairly broad and brings together the findings gathered through the assessment of the academic profile and the previous steps of the operating profile analysis along with the following considerations:

- Accounting policies.
  - Composition of the reporting entity and method of consolidation.
  - Revenue and expenditure recognition (cash compared with accrual accounting).
  - Inter-fund transfers.
  - Recognition of non-cash expenditures, such as pension and post-employment benefits.
  - Depreciation rates.
- Cash flow generation (operating and free cash flows).

DBRS recognizes that Canadian universities are non-profit organizations. Therefore, as opposed to corporations, universities are not expected to attempt to maximize their surpluses. Nonetheless, consolidated results should at least be balanced on a fairly consistent basis and management should have demonstrated a strong commitment to managing within its means.

While special circumstances may sometimes warrant a shortfall, a track record of repeated deficits could materially damage the credit profile of a university. In such a situation, DBRS would, at a minimum, expect to see a clear and realistic plan to restore fiscal soundness within a reasonable time frame in order to prevent undue erosion in the credit profile.

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### Key Operating Statistics

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Surplus or deficit (size and growth trend)

Revenue breakdown and growth trend

Total revenue per FTE

Provincial funding per FTE

Tuition fee revenue per FTE

Fundraising per FTE

FTE = full-time equivalent.

Total expenditure growth trend

Actual expenditures/budgeted expenditures

Labour cost growth trend

Interest charges/total expenditures

Deferred maintenance/asset base replacement cost

Maintenance capex/total expenditures

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## Financial Risk Profile

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The main objective of the financial risk analysis is to evaluate the extent of financial flexibility enjoyed by the institution through its balance sheet and the level of protection provided to bondholders. Accordingly, DBRS pays particular attention to the level of financial obligations carried by the university in relation to the resources expected to be available to fulfill those obligations going forward. The review is comprehensive and encompasses a wide range of financial commitments in addition to traditional debt, including leases and post-employment benefit obligations, which are allocated varying weightings by DBRS depending on the certainty of future disbursements. This is the most forward-looking portion of the credit rating assessment, with DBRS endeavouring to develop a medium-term financial scenario for each rated university.

### DEBT

A key factor in the assessment of a university's credit profile, debt is measured and assessed by DBRS in relation to enrolment (i.e., debt per full-time equivalent (FTE)), academic revenue and expendable financial resources. DBRS does not assess debt in relation to consolidated revenue, however, as such a measure is often misleading and subject to distortions due to items that may boost revenue without necessarily adding to the financial flexibility of a university. This is the case, for example, for government research funding, which is generally non-discretionary and earned as matching expenditures are incurred. In addition to current debt, DBRS includes in its rating assessment any new leverage expected within a reasonable level of certainty to be incurred by the university over a three- to five-year horizon, highlighting the forward-looking nature of DBRS ratings.

Debt is only measured net of assets when those assets are set aside for debt retirement and held with a trustee, which guarantees the integrity of the funds until the maturity of the debt. Otherwise, debt is presented on a gross basis, with the related assets included as part of expendable financial resources. However, DBRS may allocate a lower weighting to debt directly or indirectly serviced by high-quality third parties. This is the case for Québec universities, which generally carry debt issued by the provincial government in their name to fund provincial grants awarded to them. These are direct obligations of the institution and do not benefit from the guarantee of the government. For analytical purposes, however, DBRS views this debt as a government obligation because the government dictates its issuance and ensures its servicing through grants paid directly to the trustee.

Along with debt measures, DBRS incorporates the following debt-related considerations into its analysis:

- Internal and external restrictions on borrowing activity (e.g., provincial legislation and university policy).
- Debt instruments utilized (e.g., security, seniority, bullet versus amortizing and covenants).
- Purpose of existing and new debt.
- Projected impact of new debt on cash flows, including projected interest coverage (operating cash flow-to-interest charges).
- Plans to retire debt over time (e.g., internal sinking fund).



## DEBT SERVICING

Interest charges are also an important consideration in the analysis and are measured in relation to revenues and operating cash flows in order to assess the affordability of outstanding debt. A look into the debt structure and the university's debt management strategy also helps assess the potential volatility of the servicing requirements. More particularly, analysts examine the maturity structure of the debt stock and its sensitivity to changes in interest rates. In keeping with the forward-looking nature of DBRS ratings, analysts will generally seek to develop a three- to five-year outlook for debt and debt servicing requirements.

## OTHER COMMITMENTS AND CONTINGENCIES

Other financial obligations may also weigh down the credit profile of a university if they represent a fairly certain future draw on cash flows. The major types of other financial obligations incorporated into DBRS analysis include the following:

- Pension plan deficit (nature of plan, adequacy of contributions, trend of deficiencies).
- Capital leases (e.g., computers and buildings).
- Unfunded post-employment benefits (e.g., health and dental benefits and accumulated sick leaves).
- Capital commitments.
- Other off-balance-sheet liabilities (e.g., operating leases, lawsuits and derivatives).

While generally less constraining than debt, the other types of financial obligations are important considerations in the credit analysis and are allocated varying weightings that reflect the materiality, certainty and timing of the associated potential cash flows. For example, pension plan liabilities will warrant a greater weighting than post-employment benefit liabilities because employers often have some flexibility to unilaterally modify post-employment benefits for employees still active, if necessary, which is not the case for pension benefit liabilities.

## FINANCIAL RESOURCES

Although DBRS incorporates into its credit assessments of universities all types of financial resources, two categories of liquid financial assets warrant particular attention: short-term unrestricted liquidity and expendable financial resources. DBRS believes these two measures best reflect the flexibility a university has to meet short-term liquidity requirements and weather longer-term unforeseen adverse developments. DBRS short-term liquidity measure includes cash balances and short-term, high-quality securities held by a university for operating purposes. Expendable financial resources, on the other hand, constitute a broader measure of financial flexibility that encompasses short-term sources of liquidity as well as longer-term assets with more volatile realizable value.

In calculating such indicators, DBRS will generally include operating cash balances, unrestricted short-term and long-term marketable securities and internally restricted endowments, which can generally be "un-endowed" to meet financial obligations, if necessary. However, assets subject to external restrictions or whose realizable value appears too uncertain are excluded because the objective is to obtain a conservative and reliable indicator of the resources accessible to meet unexpected financial obligations within a reasonably short time frame. As a result, items such as externally restricted endowments and non-core real estate assets will be excluded from DBRS's primary measures of financial flexibility but will usually still carry positive implications for the overall credit profile. On the following page are the primary sources of financial resources scrutinized by DBRS.

### *Short-Term Liquidity*

- Unrestricted cash and marketable short-term securities.
- Reserves.
- Undrawn lines of credit (committed versus uncommitted, maturity date, provider, covenants).



### *Endowments*

- Size and growth outlook of assets (externally restricted versus internally restricted).
- Management policies (e.g., payout, asset mix, minimum credit quality and asset diversification).
- Investment performance.

### *Other*

- Unrestricted investment portfolios.
- Non-core real estate (e.g., commercial and residential properties and land).
- Business partnerships.
- Royalties and patents.

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### **Key Financial Statistics**

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Debt per FTE

Operating cash flow/interest charges

Debt and other commitments per FTE

Expendable financial resources/total debt

Per cent of floating rate debt

Endowment assets per FTE

FTE = full-time equivalent.

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