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Research Update:

City of Hamilton 'AA+' Ratings Affirmed; Outlook Is Stable

Primary Credit Analyst:
Julia L Smith, Toronto (54) 114-891- 2186; julia.smith@spglobal.com

Secondary Contact:
Adam J Gillespie, Toronto (1) 416-507-2565; adam.gillespie@spglobal.com

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Overview

- After the City of Hamilton outperformed our base-case scenario in 2016, we expect its strong budgetary performance will continue over the next three years, particularly given management's demonstrated commitment to prudent fiscal policy.
- This, together with robust liquidity and low debt, will allow the city to gradually advance its infrastructure agenda and capitalize on an increasingly diversified economy.
- We are affirming our 'AA+' long-term issuer credit and senior unsecured debt ratings on Hamilton.
- The stable outlook reflects our expectation that, over the next two years, the city's large operating surpluses, combined with its high liquidity reserve and low debt, will allow Hamilton to sustainably finance its capital projects without weakening its creditworthiness.

Rating Action

On Nov. 14, 2017, S&P Global Ratings affirmed its 'AA+' long-term issuer credit and senior unsecured debt ratings on the City of Hamilton, in the Province of Ontario. The outlook is stable.

Outlook

The stable outlook reflects our expectation that Hamilton will maintain large operating surpluses through 2019, supported by a prudent spending policy. We believe that these surpluses, together with some cash drawdowns and debt issuance, will allow the city to increase capital spending and maintain modest after-capital deficits. In our opinion, the city will make these capital investments in the context of steady, although mild, economic growth, and these investments will reinforce the ongoing diversification of Hamilton's economy.

Downside scenario

We could lower the ratings over the next two years if lower-than-expected economic growth were to cause significant deterioration in the city's budgetary performance, leading to after-capital account deficits of over 10% of total revenue. If this were to cause Hamilton to rely more heavily on debt issuance, causing the debt burden to rise significantly above 30% of operating revenue for a sustained period, we could lower our ratings.

Upside scenario

Although we view an upgrade as unlikely over the next two years, we could raise the ratings if the city's economy were to expand significantly, causing operating surpluses to rise such that they would fully and consistently finance Hamilton's capital program, leading to structural surpluses after capital spending. This, combined with improvements in management's long-term financial planning, including realistic and detailed long-term targets over a longer period and a stronger budgeting process with approvals before the fiscal year's start and limited revisions, could lead us to strengthen our assessment of the city's financial management. If all other ratings factors are unchanged, we could raise the rating under such a scenario.

Rationale

We are affirming the ratings on Hamilton to realign our surveillance schedule for the city. However, there have been no material updates to our base-case scenario since our most recent review in June 2017. We expect that Hamilton will maintain high and stable operating surpluses over the next three years, particularly following its improved budgetary performance in 2016 and given management's commitment to fiscal prudency. We believe that this performance will support modest deficits after capital spending, averaging below 5% of total expenditures, and allow the city to maintain its large liquidity cushion and low debt levels. At the same time, we expect Hamilton's economy will continue to expand modestly, supporting its increasing diversity, while we believe that budgetary flexibility--although moderate--will continue to be constrained by spending mandates and management's sensitivity to the population's fiscal burden.

Spending restraint will support high operating margins, allowing Hamilton to keep debt low and liquidity high.

We expect that steady, if mild, assessment growth and conservative spending policies will lead to strong and stable operating surpluses averaging just over 13% of operating revenue for the 2015-2019 period. These operating surpluses will partially finance the city's steadily increasing capital spending, which we expect will average just over 22% of total spending over the next three years. In turn, we believe that Hamilton's after-capital deficits will average about 3% of total revenues in 2015-2019. While we forecast positive assessment growth in 2017, lower-than-historical-growth of just below 1% along with sensitivities to the city's residential property tax burden will push Hamilton to focus on opportunities for spending efficiencies rather than on significant residential property tax increases to maintain its strong operating surplus. At the same time, a 0.5% tax increase to the capital levy in the 2017 budget, in line with the city's 10-year capital plan, will help finance infrastructure projects. While one such investment--the light rail transit line set to be tendered in 2018--will be fully financed, constructed, operated, maintained, and owned by the provincial government through Metrolinx, other projects will likely require the city to issue debt. These projects include Hamilton's West Harbour plan, which involves making the city's waterfront lands development-ready to potentially house about 1,600 new residential units. In addition, transit investments under the federal Public Transit Infrastructure Fund project, which funds 50% of transit investments, requires Hamilton to fund the other 50%.

To finance its capital plan, the city will, we expect, issue C$90 million in new debt in 2018 and C$140 million in 2020. Despite this, significant repayments on Hamilton's core debt, along with large repayments scheduled on its housing mortgages, will reduce Hamilton's tax-supported debt burden to just below 23% of consolidated operating revenues in 2019 from 31% in 2016. The city's debt consists of long-term debentures, mortgages on social housing properties, and a small amount related to capital leases. At the same time, we expect interest costs will remain very modest, at much less than 5% of operating revenues throughout the outlook horizon.

In addition to its very low debt burden, Hamilton has exceptionally high internal liquidity levels it can draw on, complemented by very robust internal cash flow generation reflected in its very high operating surpluses. By our liquidity calculations, the city's average free cash and liquid assets will total about C$811 million over the next 12 months. We estimate that they will represent about 14x debt service over the same period. Beyond internal liquidity, Hamilton benefits from satisfactory access to external liquidity for refinancing needs, given its proven ability to issue debt into various markets, including that for public debt, and the presence of a secondary market for Canadian municipal debt instruments. The city holds cash equivalents and marketable securities in investment-grade bonds and money market instruments, and manages them internally.

While Hamilton's sustainable debt levels and high liquidity would facilitate funding in a stress scenario, we believe that its moderate budgetary flexibility is constrained in its ability to meaningfully cut operating expenditures. Similarly, we believe that capital spending, which we expect will average 22% of total spending from 2017-2019, would also be difficult to materially defer given the city's large infrastructure deficit, which Hamilton estimates to be about C$3.5 billion. In our opinion, provincially mandated service levels, labor contracts, inflation, and political pressures limit operating expenditure cuts. On the revenue side, although we expect Hamilton to continue to collect a large portion of its own operating revenues (87% on average over the next three years), we believe that political and economic strains limit the degree to which the city will employ significant increases in property taxes, utility rates, and user fees.

Hamilton's contingent liabilities are modest and don't present significant risks to the debt burden or liquidity, in our opinion. The city owns one large holding company, Hamilton Utilities Corp. (HUC), whose primary business, through its subsidiaries, is electricity distribution. HUC's main subsidiary, Horizon Holdings, was amalgamated in January 2017 with three other companies to create Alectra Inc. In 2016, HUC's total liabilities reached C$247.8

million, or 16% of Hamilton's operating revenues. However, we believe that, similar to other rated Ontario local distribution companies', HUC's credit quality is investment-grade with a low likelihood of extraordinary support due to its regulatory business structure. We also believe that Hamilton's other contingent liabilities are low. These liabilities relate to standard employee benefits and landfill postclosure. As of year-end 2016, these liabilities represented 13.3% of consolidated operating revenues (or 9% net of dedicated reserves), and do not have a significant impact on the credit profile.

Management will be sensitive to the city's residential tax burden, while implementing policies to capitalize on the economy's slow-but-steady growth.

We expect that, over the outlook horizon, Hamilton's financial management will continue to be sensitive to how the city's tax burden has disproportionately fallen on the residential sector, as opposed to the commercial sector, and will be cognizant of the impact of high growth in housing costs on lower-income earners' disposable income. In our view, these sensitivities will inform policies to make spending more efficient, rather than implementing high tax hikes, to maintain strong budgetary performance. Reflecting this, Hamilton's 2017 budget called for cost cuts of nearly C$12 million, or about 0.8% of expected 2017 operating revenues, including the elimination of some full-time positions. We believe that this fiscal prudence demonstrates the city's strong financial management. Complementing these policies are thorough and transparent disclosure, long-term financial sustainability plans, long-term operating and spending forecasts, and robust policies for investments, debt, and risk management. Hamilton's strong management also operates in what we deem to be a very predictable and well-balanced local and regional government framework that has demonstrated a high degree of institutional stability. Although provincial governments mandate a significant portion of municipal spending, they also provide operating fund transfers and impose fiscal restraint through legislative requirements to pass balanced operating budgets.

Hamilton's capital plan seeks to facilitate the city's slow-but-steady economic growth, which we forecast will continue through the outlook horizon. We estimate that the city's GDP per capita is in line with the provincial average in 2014-2016 of about US$44,208. At the same time, we believe the economy will continue to diversify in the next several years, following the Conference Board of Canada's recognition of Hamilton as the most economically diversified city in Canada for the past four years. Although historically rooted in steel production, the city's economy has moved into other sectors, including advanced manufacturing, agribusiness, food processing, life sciences, digital media, and goods transport. Top employers include a network of hospitals and medical centers operated by Hamilton Health Sciences Corp.; McMaster University; the city itself along with local school boards; and Arcelor-Mittal Dofasco Inc., a steel and mining company.

Key Statistics

Table 1

City of Hamilton -- Selected Indicators

	--Fiscal year ended Dec. 31--					
(Mil. C$)	**2014**	**2015**	**2016**	**2017bc**	**2018bc**	**2019bc**
Operating revenues	1,414	1,504	1,526	1,574	1,631	1,693
Operating expenditures	1,231	1,306	1,324	1,368	1,417	1,469
Operating balance	183	199	202	206	215	224
Operating balance (% of operating revenues)	12.9	13.2	13.3	13.1	13.2	13.2
Capital revenues	151	62	131	115	113	120
Capital expenditures	364	342	301	357	414	440
Balance after capital accounts	(30)	(81)	32	(36)	(87)	(96)
Balance after capital accounts (% of total revenues)	(1.9)	(5.2)	2.0	(2.1)	(5.0)	(5.3)
Debt repaid	40	47	48	66	44	67
Gross borrowings	99	0	130	0	90	0
Balance after borrowings	29	(128)	114	(103)	(41)	(163)
Modifiable revenues (% of operating revenues)	86.8	85.8	85.9	86.3	86.8	87.2
Capital expenditures (% of total expenditures)	22.8	20.7	18.5	20.7	22.6	23.1
Direct debt (outstanding at year-end)	438	391	473	406	452	386
Direct debt (% of operating revenues)	31.0	26.0	31.0	25.8	27.7	22.8
Tax-supported debt (outstanding at year-end)	438	391	473	406	452	386
Tax-supported debt (% of consolidated operating revenues)	31.0	26.0	31.0	25.8	27.7	22.8
Interest (% of operating revenues)	0.9	1.0	0.8	0.9	0.7	0.9
National GDP per capita (single units)	55,807	55,430	55,910	58,448	60,211	61,903

Note: The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. Base case reflects S&P Global Ratings' expectations of the most likely scenario. Downside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with a downgrade. Upside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with an upgrade. bc--Base case.

Ratings Score Snapshot

Table 2

City of Hamilton -- Ratings Score Snapshot

Key rating factor	Assessment
Institutional Framework	Very predictable and well-balanced
Economy	Very strong
Financial Management	Strong
Budgetary Flexibility	Average
Budgetary Performance	Strong
Liquidity	Exceptional

Table 2

City of Hamilton -- Ratings Score Snapshot (cont.)	
Key rating factor	**Assessment**
Debt Burden	Very low
Contingent Liabilities	Very low

Note: S&P Global Ratings bases its ratings on local and regional governments on the eight main rating factors listed in the table above. Section A of S&P Global Ratings' "Methodology For Rating Non-U.S. Local And Regional Governments," published on June 30, 2014, summarizes how the eight factors are combined to derive the foreign currency rating on the government.

Key Sovereign Statistics

Sovereign Risk Indicators, Oct. 13, 2017. Interactive version available at http://www.spratings.com/sri

Related Criteria

- Criteria - Governments - International Public Finance: Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 2014
- Criteria - Governments - International Public Finance: Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs, Oct. 15, 2009
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Public Finance System Overview: Canadian Municipalities, Dec. 1, 2016

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Ratings Affirmed

Hamilton (City of)	
Issuer credit rating	AA+/Stable/--
Senior unsecured	AA+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.