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Ratings

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Hamilton (City of)

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Table Of Contents

Table Of Contents (cont.)

Hamilton (City of)

This report supplements our research update "City of Hamilton Outlook Revised To Positive On Expected Very Low Debt Burden And Exceptional Liquidity," published on June 24, 2016. To provide the most current information, we may cite more recent data than that stated in the previous publication. These differences have been determined not to be sufficiently significant to affect the rating and our main conclusions.

Rationale

Issuer Credit Rating
AA/Positive/--

The ratings on the City of Hamilton, in the Province of Ontario, reflect our opinion that the city's tax-supported debt will remain below 30% of consolidated operating revenues in the next two years, despite the temporary increase in debt expected in 2016; and that Hamilton will continue to demonstrate healthy operating balances, and exceptional liquidity.

Hamilton has indicated it will not issue any debt in 2017 and 2018, which, coupled with significant repayments scheduled on its housing mortgages, would result in the tax-supported debt burden decreasing to about 23% of consolidated operating revenues in fiscal 2018. This is despite an estimated increase in the ratio in fiscal 2016, when the city intends to issue C$130 million of new debt to finance its capital needs. Moreover, we expect that interest costs will remain very modest at much less than 5% of operating revenue throughout the outlook horizon.

In our opinion, Hamilton demonstrates strong financial management. Disclosure and transparency are very good, annual financial statements are audited and unqualified, and the city prepares robust annual operating and capital budget documents. Well-defined financial policies also guide debt and liquidity management.

Hamilton's economy is what we view as very strong. We estimate that the city's GDP per capita is in line with the provincial average in 2013-2015 of about US$45,500, given its broad base and continuing diversification into sectors such as health care, construction, and educational services, which has counterbalanced a gradual decline in its traditional manufacturing base. Although population growth has been slower than that of Ontario, unemployment remains lower than the provincial level and we believe that the city has fair prospects for growth and further diversification.

We expect Hamilton's budgetary performance to be average in the 2014-2018 base-case forecast period, with strong operating balances averaging almost 12% of operating revenues (all figures S&P Global Ratings-adjusted) and after-capital deficits averaging about 5% of total revenues. We believe that high capital expenditures in the next several years could stress these ratios, resulting in higher after-capital account deficits; however, we expect them to stay below 10% of total revenues.

Constraining the ratings on Hamilton partially is what we view as average budgetary flexibility relative to that of its domestic peers. While modifiable revenues are high, averaging about 87% of operating revenues, the city, like other Canadian municipalities, is constrained in its ability to meaningfully cut expenditures due to several factors, including high capital requirements, provincially mandated service levels, labor contracts, inflation, and political pressures.

Although the ability to set property taxes, utility rates, and user fees gives municipalities significant revenue-raising tools, political and economic pressures also limit the degree to which a city will employ these. This is particularly true in Hamilton's case, given its residents' lower average household income and a large infrastructure deficit that limits the city's ability to materially defer capital spending, which will account for about 22% of total expenditures over the forecast period.

The city owns one large holding company, Hamilton Utilities Corp. (HUC), whose primary business activity, through its subsidiaries, is electricity distribution. We view this entity as self-supporting; it pays the city annual dividends of about C$10 million. We estimate the city's exposure to HUC at less than 20% of adjusted operating revenues. Our assessment of the likelihood of extraordinary support from the city is low and we believe HUC provides a service that another private entity could readily assume and its potential as a source of cash through an asset sale is substantial. We believe the city's other contingent liabilities, stemming largely from standard employee benefits and landfill postclosure liabilities, are very low. They represent about 13% of consolidated operating revenues at year-end 2015 (or 10% net of dedicated reserves), and do not have a significant impact on the credit profile.

In our view, Canadian municipalities benefit from 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 proportion of municipal spending, they also provide operating fund transfers and impose fiscal restraint through legislative requirements to pass balanced operating budgets. Municipalities generally have the ability to match expenditures well with revenues, except for capital spending, which can be intensive. Any operating surpluses typically fund capital expenditures and future liabilities (such as postemployment obligations and landfill closure costs) through reserve contributions.

Liquidity

Hamilton has an exceptional liquidity profile. At the end of fiscal 2015, the city had cash and temporary investments of about C$883.7 million, down from C$1.0 billion at the end of the previous fiscal year, as it used previously amassed reserves to finance some capital projects and interest and principal payments increase. It holds cash equivalents and marketable securities in investment-grade bonds, government bonds, and money market instruments, and manages them internally. By our liquidity calculations, Hamilton's average free cash and liquid assets total about C$824 million in fiscal 2016. We estimate that they will represent about 11x the next 12 months' debt service. In addition, we believe the city's history of strong operating balances points to robust cash flow generation capability and bolsters its liquidity profile.

In our view, the city has satisfactory access to external liquidity, given its proven ability to issue into various markets, including that for public debt, and the presence of a secondary market for Canadian municipal debt instruments.

Outlook

The positive outlook reflects that there is at least a one-in-three chance we could upgrade Hamilton by one notch in the next two years if we saw an improvement in the city's budgetary performance such as after-capital deficits decreased to below 5% of adjusted operating revenues, on average, and tax-supported debt remained below 30% of consolidated operating revenues. It also reflects our expectation that Hamilton will preserve exceptional liquidity balances, and that operating performance will remain fairly stable. We could revise the outlook to stable should the city's capital plan require additional debt issuance resulting in a tax-supported ratio exceeding 30%, or if higher-than-expected spending forced the city to run after-capital account deficits of more than 10% of total revenue.

Institutional Framework: Very Predictable And Well-Balanced for Canadian Municipalities

We view the Canadian provincial-municipal intergovernmental system as being very predictable and well-balanced because of its maturity and stability, low-to-moderate degree of mismatching of revenues and expenditures, moderate levels of transparency and accountability, and strong likelihood of extraordinary support from provincial governments.

Provincial-municipal relationships have proven to be more dynamic than the federal-provincial one, largely because the municipal governments are established through provincial statute and not the constitution. Historically, the provinces have taken a more active role in municipal affairs than the federal government in provincial matters. Although there have been long periods of relative stability, provincially imposed large-scale changes to municipal revenue powers and expenditure responsibilities have occurred.

Provinces mandate a significant proportion of municipal spending and, through legislation, require municipalities to pass balanced operating budgets (although they also provide operating fund transfers). Nevertheless, municipalities generally have the ability to match expenditures well with revenues, except for capital spending, which can be intensive for some. Many have been limited in their ability to renew their infrastructure, roads, water, and wastewater, due to constraints on fee and property tax increases. Property taxes are the primary source of own-source revenues for Canadian municipalities, followed by fees and transfers from both the provincial and federal governments. Chief expenditure categories of Canadian municipalities are transportation services, which include roads and transit; environmental services, which include water distribution and treatment and wastewater collection; protection services such as fire and police; and recreation and cultural services. Small and rural municipalities generally receive higher provincial transfers, for both operating and capital programs, compared with those of their more urban counterparts, but there are no formal equalization schemes.

We believe financial information is quite timely. National accounting standards are strong and improving, in our view, although adoption can vary somewhat. Statutes require audited statements. While there are no national standards that apply to budgeting practices, a five-year capital budgeting process is usually the minimum. In addition, only current-year budgeting is required generally for operations.

The provinces have an established history assisting their distressed municipalities through grants.

Very Strong Economy

Hamilton is in southern Ontario, on the western edge of the Golden Horseshoe, and had a population of about 520,000 according to the 2011 Census. The population increased 3.1% since the 2006 Census; this is below the provincial growth rate of 5.7%. In our view, the city's economy is very strong. We estimate that Hamilton's GDP per capita is in line with the provincial average in 2013-2015 of about $45,514 (U.S.) given its broad base and continuing diversification.

The city is on major transportation corridors linking the nearby Greater Toronto Area (GTA) and the U.S., which are both within 100 kilometers. Its economy has evolved from its manufacturing roots, steel in particular, into other sectors such as advanced manufacturing, agribusiness and food processing, life sciences, digital media, and goods transport. The city is also home to a stable public sector workforce that has seen growth in areas such as health care and education. The top employers include many stable public sector entities such as hospitals, McMaster University, the city itself, and local school boards; large private sector employers include manufacturers of steel, rolling stock, and auto parts, as well as several food processing and production companies. The unemployment rate in 2015 improved to 5.5% from 5.9% in 2014.

The total value of building permits in 2015 decreased slightly, by 3.1%, to C$1.11 billion. This remains high relative to historical norms and follows the record set in 2012 at C$1.5 billion. Residential building accounted for almost two-thirds of the total value and the downtown has attracted some new development in recent years. The city is also redeveloping some of its waterfront lands, aiming for them to be development-ready by 2018. It estimates that these mixed-use projects could eventually include 1,600 residential units and large amounts of commercial and institutional space, and could generate up to C$7 million in new tax revenue annually.

Strong Financial Management

Hamilton demonstrates what we view as strong financial management practices. It provides thorough and transparent disclosure and has a long-term financial sustainability plan to better integrate its budgeting process with the strategic direction set by council. The city prepares detailed tax-supported and rate-supported operating budgets annually and the rate-supported budget also contains a three- and 10-year operating forecast. Its capital budgets include updated 10-year spending and funding forecasts. It also maintains a robust set of financial policies in place, including ones for reserves, investments, and debt, for prudent risk management.

The city council consists of the mayor, elected citywide; and 15 councilors, elected individually by ward. The most recent election in October 2014 resulted in four new councilors and a new mayor, who had previously served as mayor from 2006-2010. Unlike Canada's members of federal or provincial parliaments, municipal councilors do not operate under a political party system.

Average Budgetary Flexibility

In our view, Canadian municipalities have relatively strong budgetary flexibility, with modifiable revenues (those the municipality has direct control over) often exceeding 70% of operating revenues (Hamilton's have averaged more than 85% in the past five years) and capital expenditures typically accounting for more than 15% of total expenditures. In general, we view Canadian municipalities' financial flexibility as moderately constrained on the expenditure side due to a high degree of municipal services that the provinces mandate and provide municipal governments little discretion over the costs of delivery. The city's largest operating expenses relate to protective (predominately fire and police), transportation, environmental, and social and family services, which together consumed over 60% of all adjusted operating expenditures in 2015. Wages and benefits accounted for about 55% of adjusted operating expenditures and exert significant and growing stress on operating budgets. These expenses are often subject to collective agreements, which can further limit budgetary flexibility.

Although we believe that Canadian municipalities have more flexibility on the revenue side and derive the vast majority of operating revenues from modifiable sources, such as property taxes (53.7% of Hamilton's adjusted operating revenue in 2015) and user fees and service charges (32.9%, predominately from water and sewer rates), councils often try to keep tax increases low and competitive. Although the city has passed rather modest tax increases in recent years, its rates are already fairly high relative to household income and compared with those of other Canadian municipalities, which can exacerbate the pressure to keep tax rate increases down.

We expect that Hamilton will allocate about 22% on average of its total spending toward capital in our base-case scenario (2014-2018). In our view, the city's ability to defer a significant portion of its capital plan to preserve financial flexibility under a stress scenario is somewhat hindered by its significant infrastructure deficit, which Hamilton estimates to be about C$3.5 billion with an annual gap in funding of C$195 million. However, the city did push some large wastewater treatment projects further out in the long-term capital plan and included a 0.5% tax increase to the capital levy in the 2016 budget.

Average Budgetary Performance

To improve comparability across local and regional governments globally, S&P Global Ratings adjusts the published figures of all municipalities to reflect their budgetary balances on a cash basis. This includes adjusting for major accruals, restating capital spending to a cash basis by removing the influence of capital amortization and net income of certain government business enterprises, and adjusting for one-time revenues.

Hamilton's operating balances were fairly stable in the past three years, averaging almost 13% of operating revenue in 2013-2015. While we believe that rising expenditures, particularly for employee-related costs, will continue to pressure operating budgets, we expect that operating balances will remain healthy, averaging about 12% of operating revenue during the 2014-2018 forecast period. Although capital expenditures were higher in 2015, smaller capital revenues, mainly grants from senior levels of government, resulted in a higher after-capital deficit of 5.2% of total revenues. Under our base-case scenario, budgetary performance will remain strong overall with capital spending averaging about C$380 million in the next three years, which we believe will lead to after-capital deficits averaging about 5% of total revenues in 2014-2018.

Hamilton's capital budget for 2016 includes C$193 million for user rate-supported projects, predominately related to wastewater and water, and C$218.6 million for projects related to tax-supported services, largely transportation (roads, specifically). A large proportion of funding will come through reserves and contributions from operations, while development charges and government grants and subsidies are also expected to fund large portions of the plan. The combined 10-year capital forecast is about C$3.6 billion and directs significant spending toward sustaining existing infrastructure, as well as expanding the city's water and wastewater capacity. We expect that actual spending will average about C$380 million through 2018. The provincial government recently announced that it would fund 100% of the capital costs (up to C$1 billion) for a light rail project in Hamilton, although the current capital plan does not include this and construction would not start until 2018.

Exceptional Liquidity

Hamilton continues to benefit from exceptional internal liquidity support and satisfactory access to external liquidity for refinancing needs, given its proven ability to issue into various markets, including that for public debt, and the presence of a secondary market for Canadian municipal debt instruments. At the end of fiscal 2015, the city had cash and temporary investments of about C$883.7 million, down from C$1.0 billion at the end of the previous fiscal year, as the city used previously amassed reserves to finance some capital projects, and interest and principal payments increases. It holds cash equivalents and marketable securities in investment-grade bonds, government bonds, and money market instruments, and manages them internally.

By our liquidity calculations, Hamilton's average free cash and liquid assets total about C$824 million in fiscal 2016. We estimate that they will represent about 11x the next 12 months' debt service.

Very Low Debt Burden

Hamilton's capital plan financing did not require any debt issuance in fiscal 2015. As a result, its outstanding tax-supported debt totaled C$391.1 million at the end of 2015, consisting of long-term debentures, mortgages on social housing properties, and a small amount relating to capital leases. This equaled 26% of the year's consolidated operating revenue, lower than that of many similarly rated domestic peers. We expect this ratio to rise above 30% of operating revenues in 2016, as the city will issue C$130 million of new debt to cover its capital needs. However, Hamilton has indicated it will not issue any debt in 2017 and 2018, which, coupled with significant repayments scheduled on its housing mortgages, would result in the tax-supported debt burden decreasing to about 23% of consolidated operating revenues in fiscal 2018.

This reflects the continued evolution of the city's capital plan, which has resulted in the deferral of some water and wastewater treatment-related projects and the removal of others from the plan. Despite the new debt load, we believe that interest costs will remain very modest at much less than 5% of operating revenue throughout the outlook horizon.

Hamilton has three defined benefit pension plans and other retirement benefits with a total liability at the end of 2015 of C$181 million, which represents 12% of operating revenue, a level we do not view as having a material impact on the city's credit profile. All three pension plans are legacy plans, but one still has active workers and continues to accrue obligations. However, we believe the annual service cost for these plans is not significant and is comfortably incorporated into Hamilton's operating budget.

Very Low Contingent Liabilities

The city owns HUC, whose primary business activity is electricity distribution. We view this entity as self-supporting; it pays the city annual dividends of about C$10 million. We estimate the city's exposure to HUC at less than 20% of adjusted operating revenues. Our assessment of the likelihood of extraordinary support from the city is low and we believe HUC provides a service that another private entity could readily assume and its potential as a source of cash through an asset sale is substantial.

We view the city's contingent liabilities, stemming largely from standard employee benefits and landfill postclosure liabilities, as very low. They represent about 13% of consolidated operating revenues at year-end 2015 (or 10% net of dedicated reserves), and do not have a significant impact on the credit profile.

Ratings Score Snapshot

Key Statistics

Table 1

City of Hamilton -- Economic Statistics

	--Fiscal year ended Dec. 31--				
(%)	2011	2012	2013	2014	2015
Population	519,949	524,038	540,000	545,850	550,700
Population growth	0.7	0.8	3.0	1.1	0.9
Unemployment rate	6.4	6.5	6.4	5.8	5.5

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. Sources typically include national statistical offices.

Table 2

City of Hamilton -- Financial Statistics

	--Fiscal year ended Dec. 31--								
(Mil. C$)	2013	2014	2015	2016bc	2017bc	2018bc	2016uc	2017uc	2018uc
Operating revenues	1,360	1,414	1,504	1,535	1,577	1,620	1,560	1,622	1,686
Operating expenditures	1,181	1,231	1,306	1,350	1,394	1,438	1,343	1,382	1,419
Operating balance	179	183	199	185	183	182	217	240	267
Operating balance (% of operating revenues)	13.2	12.9	13.2	12.1	11.6	11.2	13.9	14.8	15.8
Capital revenues	68	151	62	97	105	114	85	93	114
Capital expenditures	272	364	342	350	380	411	309	335	411
Balance after capital accounts	(24)	(30)	(81)	(68)	(92)	(115)	(6)	(3)	(31)
Balance after capital accounts (% of total revenues)	(1.7)	(1.9)	(5.2)	(4.2)	(5.5)	(6.6)	(0.4)	(0.2)	(1.7)
Debt repaid	40	40	47	55	60	41	55	60	41

Table 2

City of Hamilton -- Financial Statistics (cont.)

	--Fiscal year ended Dec. 31--								
(Mil. C$)	**2013**	**2014**	**2015**	**2016bc**	**2017bc**	**2018bc**	**2016uc**	**2017uc**	**2018uc**
Balance after debt repayment and onlending	(64)	(70)	(128)	(123)	(152)	(156)	(61)	(63)	(72)
Balance after debt repayment and onlending (% of total revenues)	(4.5)	(4.5)	(8.2)	(7.5)	(9.0)	(9.0)	(3.7)	(3.7)	(4.0)
Gross borrowings	0	99	0	130	0	0	130	0	0
Balance after borrowings	(64)	29	(128)	7	(152)	(156)	69	(63)	(72)
Operating revenue growth (%)	3.6	4.0	6.4	2.0	2.7	2.7	3.7	3.9	3.9
Operating expenditure growth (%)	2.1	4.3	6.1	3.4	3.3	3.1	2.9	2.8	2.7
Modifiable revenues (% of operating revenues)	86.4	86.8	86.5	86.7	87.0	87.2	86.7	86.9	87.0
Capital expenditures (% of total expenditures)	18.7	22.8	20.7	20.6	21.4	22.2	18.7	19.5	22.5
Direct debt (outstanding at year-end)	380	438	391	466	406	365	466	406	365
Direct debt (% of operating revenues)	27.9	31.0	26.0	30.4	25.8	22.6	29.9	25.1	21.7
Tax-supported debt (% of consolidated operating revenues)	27.9	31.0	26.0	30.4	25.8	22.6	29.9	25.1	21.7
Interest (% of operating revenues)	1.1	0.9	1.0	1.1	1.1	0.9	1.1	1.1	0.9
Debt service (% of operating revenues)	4.0	3.8	4.1	4.7	4.9	3.5	4.6	4.8	3.3

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.

Table 3

City of Hamilton -- Rating Score Snapshot

Key Rating Factors	Assessment
Institutional Framework	Very predictable and well-balanced
Economy	Very strong
Financial Management	Strong
Budgetary Flexibility	Average
Budgetary Performance	Average
Liquidity	Exceptional
Debt Burden	Very low
Contingent Liabilities	Very low

*S&P Global Ratings' ratings on local and regional governments are based on 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 government's foreign currency rating.

Key Sovereign Statistics

Sovereign Risk Indicators, May 3, 2016. Interactive version available at http://www/spratings.com/sri

Related Criteria And Research

Related Criteria

- Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 2014
- 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
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Institutional Framework Assessments For Non-U.S. Local And Regional Governments, April 21, 2016
- Global Credit Conditions Weaken Broadly Amid Increasing Market Volatility, April 19, 2016

Ratings Detail (As Of July 13, 2016)	
Hamilton (City of)	
Issuer Credit Rating	AA/Positive/--
Senior Unsecured	AA
Issuer Credit Ratings History	
24-Jun-2016	AA/Positive/--
12-Nov-2008	AA/Stable/--
05-Oct-2006	AA/Positive/--

*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. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.