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Research Update:

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

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Overview

- Following the municipal election in October, we expect the City of Hamilton's track record of strong fiscal performance to continue, allowing it to proceed with its capital agenda while maintaining robust liquidity and low debt.
- As a result, we are affirming our 'AA+' long-term issuer credit and senior unsecured debt ratings on Hamilton.
- The stable outlook reflects our view that the city's large operating surpluses, together with its high liquidity reserve and low debt, will allow Hamilton to prudently fund its infrastructure projects without impairing its creditworthiness over the next two years.

Rating Action

On Nov. 8, 2018, 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's sizable operating surpluses will continue over the next two years, supported by prudent fiscal policy. We believe that these surpluses, together with some debt issuance, will allow the city to maintain solid levels of capital spending and modest after-capital deficits. In our view, Hamilton will make these capital investments in the context of steady, although mild, economic growth; and these investments will reinforce Hamilton's ongoing economic diversification.

Downside scenario

Over the next two years, lower-than-expected economic growth--due to trade disputes, an abrupt downturn in the housing market, or another external shock--could hurt Hamilton's revenue base. This scenario might stress the rating if after-capital deficits grow to over 10% of revenue. We could lower our ratings if such an outcome caused the city to rely more heavily on debt issuance, increasing the debt burden substantially above 30% of operating revenue for a sustained period.

Upside scenario

Although we view the possibility of an upgrade as remote over the next two years, we could raise the ratings if Hamilton's economy were to grow significantly, causing operating surpluses to rise such that they would fully and consistently finance the city's capital program, leading to structural surpluses after capital spending. This, combined with substantial improvements in our assessment of financial management, and no deterioration in the other rating factors, could lead us to raise the rating.

Rationale

We have updated our base-case scenario for Hamilton and extended our forecasting horizon to 2020. In our view, the city's solid management that has executed fiscally prudent policies, leading to high and increasing operating surpluses, and modest deficits after capital spending will continue to represent a rating strength. This performance will allow Hamilton to maintain its large liquidity cushion and low debt levels. At the same time, we expect its economy will continue to expand modestly, supporting its increasing diversity, but 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.

Following the recent elections, management will likely continue to pursue prudent fiscal policy, while capitalizing on the economy's slow-but-steady growth.

We do not expect major policy deviations under the new administration elected Oct. 22, 2018, and taking office in December 2018. Fred Eisenberger was re-elected for his second consecutive term, and third overall, as Hamilton's mayor. Over the outlook horizon, we continue to believe that management will focus on making spending more efficient, enhancing the city's strong budgetary performance. In addition, we expect Hamilton to gradually improve its budgetary processes. In the 2018 budget, the city began implementing a four-year budget outlook and now has multiyear business plans. By next year, it intends to introduce performance measures across all service departments to strengthen surveillance. These plans will complement Hamilton's 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 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.

We forecast that Hamilton's economy will continue to expand slightly over the outlook horizon. By our estimates, the city's GDP per capita is in line with the province's, at about US$44,000. Unemployment has fallen below that of the province, and reached a low 4.7% as of July 2018. At the same time, we believe the economy will continue to broadly diversify in the next several years, continuing Hamilton's recent track record of being one of the most economically diversified cities in Canada. 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. In our view, this diversification should help mitigate any negative fallout should the U.S. maintain the tariffs it imposed on steel imports earlier this year. Nevertheless, we estimate that the steel industry continues to account for, directly and indirectly, just under 10% of Hamilton's labor force. It is unclear what direction the dispute over the tariffs, which the proposed United States-Mexico-Canada Agreement trade accord does not contemplate, will take.

Strong operating margins will allow Hamilton to keep debt low and liquidity high.

We expect that steady assessment growth and conservative spending policies will lead to strong and stable operating surpluses averaging 14.8% of operating revenue for 2016-2020. These surpluses will partially finance the city's sizable capital spending, which we expect will average 20% of total spending from 2016-2020, and will lead to average deficits after capital spending of 0.4% of total revenues. At the same time, a 0.5% annual tax increase to the capital levy in the 2018 budget, in line with Hamilton's 10-year capital plan, along with an additional 0.4% increase to fund the city's share of a provincial transit infrastructure funding (PTIF), and an incremental 0.2% increase to finance road infrastructure projects, will also help finance infrastructure projects. While we expect the provincial government (through transit agency Metrolinx) to finance, construct, operate, maintain, and own one such investment--the light rail transit line for which a Request for Proposal has been issued and a contract will likely be awarded in 2019--other projects will likely require Hamilton to issue debt. These projects include Hamilton's West Harbour plan, which involves making the city's waterfront lands development-ready to house about 1,600 new residential units. In addition, transit investments under PTIF, which funds 50% of transit investments, require Hamilton to fund the other 50%.

We expect that, to finance its capital plan, the city will issue C$154 million over the next two years, in addition to the C$110.8 million issued in October 2018. This includes about C$14 million for City Housing Hamilton's housing projects. Nevertheless, we expect the city's debt burden to remain just below 30% of consolidated operating revenues through 2020. Hamilton'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 the city's 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$900 million in 2019. We estimate that they will represent about 12x debt service. 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 the moderate budgetary flexibility is constrained by the city's limited ability to meaningfully cut operating expenditures. Similarly, we believe that capital spending would also be difficult to defer materially given the 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 (85% on average over the next three years), we believe 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 Inc., was amalgamated in 2017 with several other companies to create Alectra Inc. In 2017, HUC's long-term borrowings were about C$11 million, or less than 1% of Hamilton's operating revenues. 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 being needed 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 costs. As of year-end 2017, these liabilities represented about 13% of consolidated operating revenues (or 9% net of dedicated reserves), and do not have a significant impact on the city's credit profile.

Key Statistics

Table 1

City of Hamilton -- Selected Indicators

	--Fiscal year ended Dec. 31--					
(Mil. C$)	**2015**	**2016**	**2017**	**2018bc**	**2019bc**	**2020bc**
Operating revenues	1,504	1,526	1,575	1,624	1,680	1,739
Operating expenditures	1,306	1,324	1,340	1,380	1,424	1,466
Operating balance	199	202	234	244	257	273
Operating balance (% of operating revenues)	13.2	13.3	14.9	15.0	15.3	15.7

Table 1

City of Hamilton -- Selected Indicators (cont.)						
	--Fiscal year ended Dec. 31--					
(Mil. C$)	**2015**	**2016**	**2017**	**2018bc**	**2019bc**	**2020bc**
Capital revenues	62	131	97	94	99	104
Capital expenditures	342	301	351	356	372	392
Balance after capital accounts	(81)	32	(20)	(17)	(17)	(15)
Balance after capital accounts (% of total revenues)	(5.2)	2.0	(1.2)	(1.0)	(0.9)	(0.8)
Debt repaid	47	48	55	53	63	49
Gross borrowings	0	130	0	111	5	149
Balance after borrowings	(128)	114	(74)	41	(75)	85
Modifiable revenues (% of operating revenues)	85.8	85.9	85.4	85.4	85.3	85.3
Capital expenditures (% of total expenditures)	20.7	18.5	20.7	20.5	20.7	21.1
Direct debt (outstanding at year-end)	391	473	418	476	418	518
Direct debt (% of operating revenues)	26.0	31.0	26.6	29.3	24.9	29.8
Tax-supported debt (outstanding at year-end)	391	473	418	476	418	518
Tax-supported debt (% of consolidated operating revenues)	26.0	31.0	26.6	29.3	24.9	29.8
Interest (% of operating revenues)	1.0	0.8	0.9	0.7	0.8	0.7
National GDP per capita (single units)	55,673	56,129	58,440	60,109	61,755	63,347

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. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario.

Ratings Score Snapshot

Table 2

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

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. 11, 2018. 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

- Americas Economic Snapshots--October 2018, Oct. 16, 2018
- Global Trade At A Crossroads: USMCA, NAFTA's Successor--It Could Have Been Worse, Oct. 8, 2018
- Public Finance System Overview: Canadian Municipalities, July 18, 2018
- Default, Transition, and Recovery: 2016 Annual Non-U.S. Local and Regional Government Default Study and Rating Transitions, May 8, 2017

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 S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.