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Research Update:

City of Thunder Bay Upgraded To 'AA-' From 'A+' Following Strong Financial Performance; Outlook Stable

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Research Update:

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Overview

- We are raising our long-term issuer credit and senior unsecured debt ratings on the City of Thunder Bay to 'AA-' from 'A+'.
- The upgrade reflects our view of the city's sustained strong financial performance.
- In part, the rating reflects our view of Thunder Bay's robust liquidity, healthy budgetary performance, and moderate debt; offsetting this somewhat are an economy with limited diversification and limited budgetary flexibility.
- The stable outlook reflects our expectation that, in the next two years, the city's financial risk profile will remain strong, with solid operating surpluses exceeding 5% of operating revenue with modest after-capital deficits and robust liquidity.

Rating Action

On June 27, 2013, Standard & Poor's Ratings Services raised its long-term issuer credit and senior unsecured debt ratings on the City of Thunder Bay, in the province of Ontario, to 'AA-' from 'A+'. The outlook is stable.

The upgrade reflects our view of Thunder Bay's sustained strong financial performance, as its robust liquidity and healthy budgetary performance illustrate.

Rationale

The ratings on Thunder Bay reflect Standard & Poor's assessment of the city's robust liquidity, healthy budgetary performance, and moderate debt. We believe that somewhat mitigating these strengths are the city's economy, which has limited growth prospects, and somewhat limited budgetary flexibility.

Standard & Poor's expects that free cash and liquid assets will remain strong and relatively stable in the next two years. At fiscal year-end 2012 (Dec. 31), free cash and liquid assets covered slightly less than 3x coverage of 12 months of debt service and stood at about C\$84 million (Standard & Poor's-adjusted). We believe that the city's credit quality continues to benefit from liquidity levels that are very high and comparable with those of more highly rated domestic and international peers.

In our opinion, with an increased focus on addressing its infrastructure gap, Thunder Bay's after-capital budgetary performance will remain near balance in the next two years. Nevertheless, we expect that the city will continue to produce a strong operating surplus of greater than 5% of operating revenue. In 2012, after incorporating TBayTel, Thunder Bay's wholly owned telephone utility, the city's 2012 consolidated operating surplus was about 8.7% of operating revenues, a moderate decline from 9.6% the previous year. Excluding TBayTel's operations but incorporating its dividend to the city, Thunder Bay's operating performance was about 8.6%, slightly below the three-year average of 9.7%, which according our statistics is a little below-average compared with that of domestic and global rated peers. The city's overall budgetary position, which includes capital revenues and expenditures, remained near-balanced year-over-year. Thunder Bay's after-capital spending surplus at fiscal year-end 2012 represented about 1.4% of total revenues, excluding TBayTel's operations, a modest improvement compared with the 1.9% deficit recorded in 2011.

In the next two years, we believe that, tax-supported debt (Standard & Poor's-defined) will remain relatively stable at about 55%-60% of consolidated operating revenues. At fiscal year-end 2012, tax-supported debt remained relatively stable at 56.0% of consolidated operating revenues, compared with 54.8% at fiscal year-end 2011.

We estimate the city's GDP per capita was close to, but slightly less than, the provincial average of about C\$48,000 at the end of 2011. Thunder Bay's economy focuses largely on the public sector (more than 20% of total employment), which provides it with a stable base. In addition, Bombardier Inc., a major player in the manufacturing sector, has secured long-term contracts to produce subway cars. In the past five years, the city has made some gains in diversifying the economy into other noncyclical fields, particularly in knowledge-based sectors such as biomedicine, research, and health care. Nevertheless, compared with other domestically rated peers, Thunder Bay has limited near-term growth prospects. According to the most recent Census results, from 2006-2011, its population decreased at an annual compound rate of 0.15%. Although the city's economy has begun to diversify into mining, a volatile, commodity-based sector, we expect the sector might contribute to Thunder Bay's medium-term growth prospects.

We expect that the city's budgetary flexibility will remain adequate in the next two years as reflected by capital expenditures that represent greater than 15% of total expenditures and modifiable revenues of greater than 50% of operating revenues. Nevertheless, in our opinion, Thunder Bay's limited ability to cut expenditures somewhat constrains its budgetary flexibility. Similar to other Canadian municipalities, the city is constrained in its ability to meaningfully cut expenditures due to several factors, including provincially mandated service levels, labor contracts, inflation, and political pressures. More specifically, given Thunder Bay's greater focus on addressing its infrastructure deficit and maintaining a state of good repair, we believe that management has little ability to defer the capital program.

Outlook

The stable outlook reflects Standard & Poor's expectation that Thunder Bay will continue to produce healthy operating surpluses (that exceed 5% of operating revenues) and modest after-capital deficits in the next two years. We also expect that the city's tax-supported debt will remain at 55%-65% of consolidated operating revenues. We believe that an upgrade is unlikely in this period. Downward pressure on the outlook or ratings could result from a material deterioration in budgetary performance, including after-capital deficits of more than 10% of total revenues, a material decrease in liquidity to less than 100% of the next 12 months' debt service, or significant problems with the local economy.

Related Criteria And Research

Methodology For Rating International Local And Regional Governments, Sept. 20, 2010

Ratings List

Ratings Raised

	To	From
Thunder Bay (City of)		
Issuer credit rating	AA-/Stable/--	A+/Positive/--
Senior unsecured debt	AA-	A+

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