

Research Update:

City of Thunder Bay Ratings Affirmed At 'AA'; Outlook Remains Stable

June 19, 2019

Overview

- We expect that over 2019-2021, the City of Thunder Bay will maintain its healthy operating surpluses, which will primarily finance its sizable capital program.
- The city benefits from a low debt burden and an exceptional liquidity position.
- We are affirming our 'AA' long-term issuer credit and senior unsecured debt ratings on the city.
- The stable outlook reflects our expectation that, in the next two years, the city's healthy budgetary performance results will help Thunder Bay to maintain a robust liquidity position and a decreasing debt burden.

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Rating Action

On June 19, 2019, S&P Global Ratings affirmed its 'AA' long-term issuer credit and senior unsecured debt ratings on the City of Thunder Bay, in the Province of Ontario. The outlook remains stable.

Outlook

The stable outlook reflects our expectation that, in the next two years, Thunder Bay will maintain sound financial results, even if expected higher capital expenditures generate modest average after-capital deficits of 1% of total revenues in 2019-2021, supported by prudent financial management practices and a steady economy. We also expect the city will maintain a low debt burden and a healthy liquidity position.

Downside scenario

We could lower the ratings over the next two years if weaker-than-expected economic growth and rising operating pressures were to cause sustained negative after-capital results of more than 5% of total revenues, and eroded the liquidity balances to less than 1x debt service coverage.

Upside scenario

We could raise the rating in the next two years if Thunder Bay demonstrated consistent political willingness to further improve its long-term planning and budget sustainability, while maintaining sufficient internal capital funding. In conjunction, if the tax-supported debt burden (S&P Global Ratings calculated) fell below 30% of consolidated operating revenue, we could take a positive rating action.

Rationale

The ratings reflect the city's strong projected budgetary performance throughout 2019-2021, supported by prudent financial management practices. We expect that over the next two years, capital spending will trend higher but will not require significant issuance of net new debt, given Thunder Bay's efforts to increase ongoing internal contributions to capital funding. We also believe that Thunder Bay will continue to benefit from a supportive institutional framework and sound financial management under the city's new council.

Operating balances and liquidity to remain high, and will allow Thunder Bay to keep debt low.

In our base-case scenario for 2017-2021, we expect modifiable revenues and operating balances to remain high at 88% and 16% of operating revenues on average, respectively. These robust surpluses facilitate the city's ability to internally finance Thunder Bay's capital plan and limit the requirement for debt financing. Also, we project the city's after-capital balances will show moderate deficits averaging 1% of total expenditures in 2019-2021, given Thunder Bay's plans to increase capital spending in the next several years to help address infrastructure needs. Even if projected higher capital expenditures in the next couple of years pressure the after-capital balances, on average over our 2017-2021 base-case scenario, we expect that Thunder Bay will generate a very modest after-capital surplus, which has improved our assessment of its budgetary performance to very strong from strong.

The city has indicated that average capital spending in 2019-2021 could hover at about C\$122 million, equivalent to 20% of total expenditures, with the majority of the tax-supported plan designated for maintenance-related road work, facilities renewal, and fleet and equipment replacement. The forecast also includes the capital plan of Tbaytel, the city's wholly owned and fully consolidated telecommunications company.

The high level of modifiable revenues (totaling 88% of adjusted operating revenues on average in our 2017-2021 forecast period) grants the city substantial budgetary flexibility, in our view. However, in line with our view of other Canadian municipalities, we believe that Thunder Bay has limited ability to materially cut spending due to a high degree of municipal services that the provinces mandate and that leaves local governments little discretion concerning the costs. Wages and benefits account for more than half of operating expenditures and are almost always subject to collective agreements, which can further limit budgetary flexibility.

The increasing internal contributions to the capital program will help to limit Thunder Bay's debt requirements in the next several years, despite the increased level of capital expenditures. In 2019-2021, we expect the city to borrow C\$65 million in gross debt, about one-quarter of which will help finance the expansion of Tbaytel's fiber optic network. However, given large principal payments due over the same period, we expect Thunder Bay's tax-supported debt burden to

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decline to 34% of operating revenues by 2021 from 41% in 2018, while interest costs will account for a very manageable 1.4% of operating revenues.

Thunder Bay's credit profile benefits from what we view as a robust liquidity position. We estimate its free cash and liquid assets (S&P Global Ratings-adjusted) will total C\$96 million on average in 2019 and will be enough to cover more than 2x the estimated debt service for the year. Although we view this level of coverage to be healthy, it remains weaker than that of domestic peers, which tend to carry large liquid balances. In our view, Thunder Bay generates robust internal cash flow, as measured by its operating balance (before interest) exceeding twice its annual debt service requirements. We believe Thunder Bay's access to external liquidity is satisfactory through the city's access to a strong and diversified pool of domestic banks.

Thunder Bay's exposure to contingent liabilities is low and these are not a significant credit risk, in our opinion. The city has exposure to litigations, the operations of Thunder Bay Hydro Corp. (a wholly owned provider of regulated and unregulated electric utility services and complementary commercial services), and standard future employee benefits and liabilities and landfill postclosure costs (the latter two total about 10% of operating revenues and the city has reserves in place to cover a portion of these liabilities). We believe that in the unlikely event of financial stress at the utility, the city's support would be limited to less than 2% of its operating revenues.

Institutions remain broadly supportive, and a very strong economy, grounded by a large public-sector presence, helps to mitigate broader challenges.

We believe that management's adequate expertise in implementing policy changes and accountability will continue following the October 2018 municipal election. Mayor Bill Mauro was elected for his first term, and a total of seven out of council's 13 members are new. We expect broad policy continuity under the newly elected government in part due to the high degree of institutional stability the city enjoys.

In addition, we expect that Thunder Bay will continue to benefit from its location. The city is the center for many government services in northwestern Ontario and thus its economy focuses largely on the public sector (health care, school boards, and municipal and provincial administration), which acts as a stabilizing force, in our view. The manufacturing, retail, and mining sectors also contribute to the local economy. While GDP data are not available at the local level, we believe the city would generate nominal GDP per capita largely in line with the provincial three-year average of US\$44,500, based on its income levels and higher value-added of some local industries.

We believe that a weaker demographic profile, characterized by a declining population and a larger proportionate number of elderly residents, constrains the city's economic profile and could affect future revenue growth and expenditure needs. According to the 2016 Census, Thunder Bay's population was 107,909, a decline of 0.4% since 2011. The city's proportion of residents aged 65 and over was 20.0%, compared with 16.7% in Ontario, reflecting Thunder Bay's aging population.

Thunder Bay, as do other Canadian municipalities, benefits 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.

Key Statistics

Table 1

City of Thunder Bay -- Selected Indicators

(Mil. C\$)	--Fiscal year ended Dec. 31--				
	2017	2018	2019bc	2020bc	2021bc
Operating revenues	532	555	567	578	591
Operating expenditures	451	465	473	483	492
Operating balance	81	90	94	96	99
Operating balance (% of operating revenues)	15.3	16.2	16.5	16.6	16.8
Capital revenues	16	7	23	21	20
Capital expenditures	85	82	133	121	114
Balance after capital accounts	12	15	(16)	(4)	5
Balance after capital accounts (% of total revenues)	2.2	2.7	(2.7)	(0.6)	0.8
Debt repaid	28	29	31	32	28
Gross borrowings	26	28	33	17	16
Balance after borrowings	11	14	(14)	(19)	(7)
Modifiable revenues (% of operating revenues)	87.7	87.9	88.3	88.5	88.8
Capital expenditures (% of total expenditures)	15.9	15.0	21.9	20.0	18.8
Direct debt (outstanding at year-end)	228	226	228	213	200
Direct debt (% of operating revenues)	42.8	40.8	40.2	36.7	33.8
Tax-supported debt (outstanding at year-end)	228	226	228	213	200
Tax-supported debt (% of consolidated operating revenues)	42.8	40.8	40.2	36.8	33.8
Interest (% of operating revenues)	1.4	1.3	1.4	1.4	1.3
National GDP per capita (single units)	58,440	60,163	61,966	63,704	65,542

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.

Ratings Score Snapshot

Table 2

City of Thunder Bay -- Ratings Score Snapshot

Key rating factors	Assessment
Institutional Framework	Very predictable and well balanced

Table 2

City of Thunder Bay -- Ratings Score Snapshot (cont.)

Key rating factors	Assessment
Economy	Strong
Financial Management	Satisfactory
Budgetary Flexibility	Strong
Budgetary Performance	Very Strong
Liquidity	Exceptional
Debt Burden	Low
Contingent Liabilities	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, April 11, 2019. Interactive version available at <http://www.spratratings.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: U.S. Data Starts To Improve At First Quarter's End, April 24, 2019
- Public Finance System Overview: Canadian Municipalities, July 18, 2018
- Default, Transition, And Recovery: 2017 Annual International Public Finance Default Study And Rating Transitions, June 11, 2018

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.

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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

Thunder Bay (City of)

Issuer Credit Rating	AA/Stable/--
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Senior Unsecured	AA
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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.

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