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Credit Opinion: London, City of

Global Credit Research - 11 Sep 2015

Canada

Ratings

Category	Moody's Rating
Outlook	Stable
Senior Unsecured -Dom Curr	Aaa

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Key Indicators

London, City of (Year Ending 12/31)	2010	2011	2012	2013	2014
Net Direct and Indirect Debt/Total Revenue (%)	30.2	38.2	38.3	35.7	33.7
Gross Operating Balance/Operating Revenue (%)	18.9	14.3	16.2	19.1	16.0
Cash Financing Surplus (Requirement)/Total Revenue (%)	-1.3	3.6	8.2	8.2	3.0
Interest Payments/Operating Revenue (%)	1.4	1.2	1.2	1.1	1.1
Debt Service/Total Revenue (%)	4.8	9.4	7.5	5.4	5.2
Capital Spending/Total Expenditures (%)	34.5	20.5	17.2	17.9	20.0
Self-Financing Ratio	1.0	1.2	1.5	1.5	1.2

Opinion

SUMMARY RATING RATIONALE

The City of London's Aaa debt rating is supported by its sizeable levels of reserves and prudent, conservative approach to fiscal planning. London's cash and investments, which measured 191.4% of net direct and indirect debt at December 31, 2014, provide considerable liquidity and a measure of safety for debenture holders. The rating also reflects the city's strong track record of achieving positive operating results and the generation of internal financing for capital expenditures.

National Peer Comparisons

The City of London is rated at the high end of Canadian Municipalities, whose ratings remain in a narrow range of Aaa-Aa2. Compared with other Canadian municipalities, London maintains a lower debt burden, while the city's liquidity, as measured by the level of net cash and investments relative to debt and revenue, is considered healthy and in line with national peers of a similar rating. The institutional framework governing municipalities in Ontario is mature and well developed, similar to that of other Canadian provinces where Moody's rates municipalities.

Credit Strengths

Credit strengths for the city of London include:

- High levels of cash and investments providing strong liquidity

- Low debt levels supported by conservative policies and strong capital planning

- Mature, supportive, institutional framework governing municipalities in Ontario

- Prudent fiscal plan with track record of generating positive outcomes

Credit Challenges

Credit challenges for the city include:

- Operating budget pressures continue to build

Rating Outlook

The outlook for London's Aaa debt rating is stable.

What Could Change the Rating - Down

Given the history of prudent expenditure and debt management, relative stability of the local economy and high fund balances, it is unlikely that conditions could deteriorate by a large enough margin, in the near term, to cause a downgrade of London's rating. Nonetheless, a sustained loss of discipline, leading to a significant increase in debt or a substantial reduction in the level of reserves, would apply downward pressure on the rating.

DETAILED RATING CONSIDERATIONS

The City of London's Aaa rating combines (1) a baseline credit assessment (BCA) of Aaa, and (2) a high likelihood of extraordinary support coming from the Province of Ontario (Aa2, negative) in the event London faced acute liquidity stress.

Baseline Credit Assessment

The City of London's BCA of aaa reflects the following factors:

HIGH LEVELS OF CASH AND INVESTMENTS PROVIDING STRONG LIQUIDITY

London's credit rating is supported by a strong liquidity position which provides a significant measure of safety for bondholders. The city's cash and investments measured CAD717.8 million as of December 31, 2014 compared to CAD621.7 million in 2013. The city's cash and investments represented 191.4% of net direct and indirect debt in 2014, and 84.4% of operating expenses. Over the past decade the city's cash and investment holdings have increased substantially, rising to their current level from 47% of net direct and indirect debt in 2005, highlighting the prudent fiscal management and liquidity strength that London possesses. The city is in the process of increasing their level on pay-as-go funding for capital projects and decreasing the amount of debt required for financing, which may lead to a slight decrease of the city's cash reserves over time.

London's investment policies ensure that the city minimizes credit risk and maintains liquidity of its investment portfolio. The city's policies outline various limits placed on investment decisions, such as limiting the overconcentration of investments in specific sectors or issuers, limiting investments to only highly rated securities and ensuring a variety of maturities. The presence and adherence to these policies offers reassurance that the city's investment management policies provide security to liquidity, which along with the level of liquidity, is a strong credit positive.

LOW DEBT LEVELS SUPPORTED BY CONSERVATIVE POLICIES AND STRONG CAPITAL PLANNING

The city of London's net direct and indirect debt expressed as a percentage of revenues measured 33.7% in 2014, down from 49.9% in 2005. The city's debt burden has declined slightly over the past several years, propelled by the conservative debt policies that the city employs such as the self-imposed "debt cap" which limits debt issuance for capital projects as well as the move to a greater reliance on pay-as-you-go financing. Debt issuance is also limited through the use of a policy that applies year-end debt service savings and 50% of unallocated assessment growth towards financing needs that would have come from authorized, but unissued, debt.

London's current 2015-19 tax and rate-supported capital plan calls for expenditures of nearly CAD975 million. Of this, CAD128.5 million, 13.2%, will require debt financing, a ratio that continues to decrease as the city shifts to greater reliance on to pay-as-you-go capital financing. In 2015, pay-as-you-go financing reached CAD29.2 million, compared to CAD27.0 million in 2014, and is expected to reach CAD38 million by the end of the current planning cycle in 2019. The majority of the increase in the capital plan for 2015-19 is in the non-taxpayer supported portion of the capital plan, much of which is expected to be covered through development charges. If the current capital plan comes to fruition, we anticipate that the city's debt burden will stabilize around its current level, supporting the Aaa rating. In 2014, interest expense consumed only 1.1% of operating revenues, unchanged from 2013, and the city's debt service costs as a percentage of revenue are expected to remain low in the intermediate term.

In May 2015 the city approved the use of multi-year budgets for both operating and capital projects. The city will use 4-year capital budgets, updated annually, that will be based on the overall 10 year capital plan. The move to long-term capital planning and approvals will make it easier to plan for the financing and expenditures related to large infrastructure projects, such as the planned bus rapid transit system. In our opinion the implementation of a revolving multi-year capital budget is a credit positive for the city.

MATURE, SUPPORTIVE INSTITUTIONAL FRAMEWORK GOVERNIN MUNICIPALITIES IN ONTARIO

The institutional framework governing municipalities in Ontario is mature and highly developed. The division of roles and responsibilities between the province and municipalities is clearly articulated. Historically, changes to the institutional framework have occurred at a measured, evolutionary pace, following discussions between both parties. Nevertheless, in certain cases, changes have occurred more rapidly.

London's creditworthiness benefits from the stability inherent in the provincial institutional framework. Provincial legislation dictates a high degree of oversight, including limits on debt servicing costs, while policy flexibility, on both the revenue and expenditure sides of the ledger, helps London to manage pressures as they arise.

PRUDENT FISCAL PLAN WITH TRACK RECORD OF GENERATING POSITIVE FISCAL OUTCOMES

Much like other highly rated Ontario municipalities, the city of London displays strong governance and management practices which helps to promote stable operations. In addition to the multi-year planning for operations and capital, a recent history of posting positive operating results, and applying strict controls on debt issuance, the city also employs conservative debt and investment policies which limits their exposure to market related risks and helps ensure relatively smooth debt servicing costs.

In 2014 the city posted a consolidated surplus of CAD117.4 million, equivalent to 10.6% of total revenues continuing the trend of positive fiscal outcomes seen in recent years. Operating revenue increased by 4.2% in 2014, however operating expenses grew by 8.2%, the first major increase since 2011.

OPERATING PRESSURES CONTINUE TO BUILD

Despite the city's strong fiscal performance again in 2014, the 8.2% increase in operating expenditures highlights the pressure that the city faces. Although expenditure pressures have been present over the past several years, the city avoided raising property tax rates, and therefore limiting revenue growth, opting instead to attempt to find service efficiencies and use one-time measures to offset potential deficits. The 2014 municipal election yielded significant turnover, with 11 of 15 councilors being replaced and a new mayor being elected. The new council has stated their willingness to increase own-source revenues to help cope with increasing costs. Through the 2014-19 term of council, property tax increases are expected to be in the 2.2% - 2.9% range annually (2.5% for 2015), compared to an average of 1% over the 4 years of the previous council's term.

The willingness to raise property taxes and user fees, in addition to finding long term savings through efficiencies and structural changes, will both be required for the city to deal with expenditure pressures. Potential pressures may arise as the city negotiates new collective agreements, most notably with fire services which have tended to have pay increases at rates higher than other city staff. In our opinion, after years of finding savings through service efficiencies it will be difficult to continue to find efficiencies significant enough to have a meaningful impact. As a result, the city will likely have to pursue more structural, long-term changes in order to curb expenditure growth.

In our opinion, failing to address expenditure pressures on a more sustainable basis raises the risk that the city's planned approach of funding capital projects through pay-as-you-go may not proceed as planned, as these funds may be directed to operations, resulting in greater debt issuance for capital projects than currently planned.

Extraordinary Support Considerations

Moody's assigns a high likelihood of extraordinary support from the Province of Ontario (Aa2, stable), reflecting

Moody's assessment of the incentive provided to the provincial government of minimizing the risk of potential disruptions to capital markets if London, or any other Ontario municipality, were to default.

Output of the Baseline Credit Assessment Scorecard

In the case of London, the BCA matrix generates an estimated BCA of aa1, close to the BCA of aaa assigned by the rating committee.

The matrix-generated BCA of aa1 reflects (1) an idiosyncratic risk score of 2 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a systemic risk score of Aaa, as reflected in the sovereign bond rating (Aaa, stable).

The idiosyncratic risk scorecard and BCA matrix, which generates estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools provide a good statistical gauge of stand-alone credit strength and, in general, higher ratings can be expected among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in these tools cannot fully capture the breadth and depth of our credit analysis.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale ratings, please refer to Moody's Credit rating Methodology published in June 2014 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings."

The Moody's Global Scale rating for issuers and issues in local currency allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of an entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0% - 30%), moderate (31% - 50%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

Rating Factors

London, City of

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total

Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	5	95.43	70%	3.8	20%	0.76
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	1	20%	0.20
Financial flexibility	1		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	1	16.91	12.5%	2.25	30%	0.68
Interest payments / operating revenues (%)	3	1.11	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	3	37.10	25%			
Short-term direct debt / total direct debt (%)	3	11.80	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			1	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						1.94(2)
Systemic Risk Assessment						Aaa
Suggested BCA						aa1

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