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Research Update:

County of Essex Upgraded To 'AA+' From 'AA' On Strong Budgetary Flexibility And Performance; Outlook Stable

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Overview

- The County of Essex's sustained efforts to control operating and capital costs, while meeting rising spending requirements, resulted in a significantly improved budgetary flexibility and performance, which we expect to continue over the next two years.
- We are therefore raising our long-term issuer credit and senior unsecured debt ratings on the County of Essex to 'AA+' from 'AA'.
- The stable outlook reflects our expectations that, in the next two years, Essex will continue to generate very healthy operating and after-capital balances; its debt burden will remain very low; and local economic growth will continue its slow-but-positive trend.

Rating Action

On Nov. 27, 2017, S&P Global Ratings raised its long-term issuer credit and senior unsecured debt ratings on the County of Essex, in the Province of Ontario, to 'AA+' from 'AA'. The outlook is stable.

Outlook

The stable outlook reflects our expectations that, in the next two years, Essex will maintain exceptional liquidity and its tax-supported debt will remain very low. It also reflects our belief that local economic growth will continue gradually, and the county's budgetary performance will remain sound, with operating surpluses of well above 5% and consistent after-capital surpluses.

All else equal, we could take a positive rating action in the next two years if the local economy substantially strengthened, supported by higher-than-expected growth and notable sector diversification; and if management's response to this growth fully met the increased complexity of the county's needs.

Conversely, we could lower the ratings in the next two years if higher-than-expected borrowing pushed tax-supported debt to more than 60% of operating revenue; and the county's budgetary flexibility was constrained by a lack of willingness to raise tax revenues to meet growing funding requirements.

Rationale

The upgrade reflects our assessment of the county's consistently improved budgetary flexibility and performance; and our view of lower contingent liabilities. Essex has gradually strengthened its budgetary performance in the past five years, and has managed to address its operating and capital needs while maintaining tax rates at very reasonable levels compared with those of peers. While the county has historically deferred some of its capital projects, it has continued to accumulate significant cash reserves. Its new asset management plan should allow it to ensure better cost effectiveness and efficiencies for its corporate infrastructure and assets, and continue to bring actual capital spending more in line with budget levels. Also, the county's strategy to pay-as-you-go and use existing reserves for financing its capital plan should prevent it from issuing additional debt, and support continued generation of robust operating and after-capital surpluses.

The county is likely to continue using pay-as-you go funding to meet its rising capital spending, while maintaining low tax rates versus peers and preserving its strong budgetary performance.

We believe that the county has sufficient cash reserves to fund its operating and capital needs and maintain tax rates at very reasonable levels compared with those of peers. Capital expenditures accounted for 16.4% of total expenditures in 2016, above the weaker levels recorded in the past five years. We expect the county to continue addressing its capital needs at a faster pace in the near future, and maintain its capital expenditures to total expenditures ratio above 15%, on average, from 2015-2019. Essex has historically maintained its tax rates below 2%, despite incorporating its 1.5% capital tax levy associated with infrastructure expansion and new funding for the New Windsor-Essex Hospital System (NWEHS). On average, rates rose an annual 1.3% in the past 15 years, consistently below inflation; the tax increase for 2017 was 1.76%. Essex relies moderately on transfers from senior levels of governments and has significant revenue-raising tools such as property taxes and user fees. We believe modifiable revenues will account for about 79% of operating revenues in 2015-2019. Nevertheless, like most Canadian municipalities', Essex's budgetary flexibility is somewhat constrained on the expenditure side, given provincially mandated service levels, labor contracts, and inflation. With the construction of the NWEHS, the county may be required to increase rates more, and we believe Essex has the ability to realize it.

The new health system's cost is estimated at about C$2 billion, for which municipalities are required to fund 10%. This would translate to close to C$100 million funding provided by the county, and a similar contribution from Windsor. While the construction timing has not been finalized, Essex's preliminary funding strategy includes an upfront commitment of C$50 million, funded via a minimum annual levy of 0.5% for 10 years, as well as commitment transfers; with the balance potentially being covered through debt issuance.

We expect Essex's budgetary performance to remain superior in our 2015-2019 base-case forecast period, with sound operating balances averaging over 20% of operating revenues. In addition, despite a planned increase in capital spending in the medium term, we estimate that its after-capital balances will remain above

5% of total operating revenues, on an average basis.

In our view, Essex continues to benefit from exceptional internal liquidity support and satisfactory access to external liquidity for refinancing needs. In addition, we believe the county's strong operating balances point to robust cash flow generation capability and boost its liquidity profile. We estimate that, on an adjusted basis, Essex's next 12 months' cash and liquid assets total about C$117.5 million, which is sufficient to cover about 18x debt service.

We estimate that the tax-supported debt ratio will decrease slowly to less than 40% of total consolidated operating revenues in the next two years, as the county continues to fund its capital plan primarily with internal resources. The county's tax-supported debt outstanding includes debt borrowed under Essex's name on behalf of its lower-tier municipalities and on behalf of Windsor. Because the county has no debt prospects in the next two years, we expect these items to total about C$62.3 million at the end of 2019, or 36.9% of consolidated operating revenues. In addition, tax-supported debt is less than three years of operating surpluses, which together with very low interest costs (2.4% of operating revenues on average for 2015-2017) support our assessment of the very low debt burden.

Essex's contingent liabilities are low, in our opinion. They consist of the county's share of the Windsor-Essex County Health Unit, employee benefits, and the regional landfill's postclosure costs totaling C$4.2 million or about 3% of operating revenues in 2016. Essex has sufficient reserves to cover a significant portion of these liabilities.

A very predictable and well-balanced institutional framework and strong economy support the ratings.

Essex is in the southwest corner of Ontario and is composed of seven lower-tier municipalities. It neighbors the City of Windsor and borders the City of Detroit across the Detroit River. The county's economy has historically focused on the manufacturing (primarily auto) and agricultural sectors; it also accounts for large public-sector employers. Essex is increasing its efforts to diversify its economy into service-based sectors (including tourism, health care and social assistance, and education), which we believe could contribute to slow-but-positive medium-term growth prospects. Nevertheless, we estimate that the auto sector, which tends to be volatile, continues to account for close to 20% of the county's employment. Although the county's GDP per capita is not available, we estimate it to be somewhat below the provincial average of about US$44,208 in 2014-2016, but above our US$38,000 threshold. This is primarily based on our assumption that most of the county's population (about 60%) lives in municipalities forming the Windsor Census Metropolitan Area (excluding the city), which has a household income close the provincial one. The local economy improved in 2016, with a lower unemployment rate (5.4% in on average, for the eight months ended August 2017, from 6.9% for the same period last year), higher property assessment values, and steady construction activity, as reflected in stronger value of building permits and housing starts. Based on the 2016 Census, the county's population was 2.2% higher in 2016 than in 2011 and was below the provincial growth rate of 4.6%. In our opinion, Essex's competitive tax rates versus those of peers and measures to attract retirees could stimulate the local economy and increase the population, but also raise the dependent population, which could put pressure on services such as emergency medical services.

We believe Essex demonstrates strong financial management practices. The county benefits from generally broad political consensus on fiscal policies. We believe the management team is well qualified and has been largely stable; it has demonstrated its ability to find cost efficiencies to adhere to the council's fiscal decisions. Its financial statements have a good level of transparency and disclosure and have been independently audited with no qualifications. The county produces consolidated one-year operating budgets and actual variations from budget are moderate. Since 2016, Essex prepares an annual asset management plan allowing it to ensure better cost effectiveness and efficiencies for its corporate infrastructure and assets. In our opinion, financial information is sufficiently detailed and comprehensive. We also believe that debt and liquidity management is prudent. Essex's council is composed of the mayors and deputy mayors of the seven lower-tier municipalities within the county; members serve a four-year term. The current council is in place since November 2014. Unlike Canada's members of federal or provincial parliaments, municipal councilors do not operate under a political party system.

Like other Canadian municipalities, Essex benefits from a very predictable and well-balanced local and regional government framework that has demonstrated high 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.

KeyStatistics

Table 1

County of Essex – Selected Indicators

Fiscal year ended Dec. 31

Mil. C$	2014	2015	2016	2017bc	2018bc	2019bc
Operating revenues	144	147	154	158	164	169
Operating expenditures	121	118	121	124	127	131
Operating balance	23	29	33	35	36	38
Operating balance (% of operating revenues)	16.0	19.8	21.5	21.9	22.3	22.5
Capital revenues	6	6	8	8	8	9
Capital expenditures	16	17	24	26	27	30
Balance after capital accounts	13	19	17	17	17	17

Table 1

County of Essex – Selected Indicators (cont.)

Fiscal year ended Dec. 31

Mil. C$	2014	2015	2016	2017bc	2018bc	2019bc
Balance after capital accounts (% of total revenues)	8.7	12.2	10.7	9.9	10.2	9.6
Debt repaid	2	2	2	2	2	3
Gross borrowings	0	0	0	0	0	0
Balance after borrowings	11	17	15	15	15	14
Modifiable revenues (% of operating revenues)	77.6	77.6	78.6	79.4	79.9	80.5
Capital expenditures (% of total expenditures)	11.8	12.5	16.4	17.3	17.6	18.6
Direct debt (outstanding at year-end)	73	71	69	67	65	62
Direct debt (% of operating revenues)	50.4	48.2	44.9	42.5	39.7	36.9
Tax-supported debt (outstanding at year-end)	73	71	69	67	65	62
Tax-supported debt (% of consolidated operating revenues)	50.4	48.2	44.9	42.5	39.7	36.9
Interest (% of operating revenues)	3.1	3.0	2.8	2.7	2.5	2.4
National GDP per capita (single units)	55,807	55,430	55,910	58,448	60,211	61,903

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. 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

County of Essex – Ratings Score Snapshot

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

Note: S&P Global Ratings' credit ratings on local and regional governments are based on eight main rating factors listed in the table above. Section A of Standard & Poor's "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. 13, 2017. Interactive version available at 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 Economics Snapshot, Nov. 22, 2017
- Institutional Framework Assessments For Non-U.S. Local And Regional Governments, Sept. 21, 2017
- Default, Transition, and Recovery: 2016 Annual Non-U.S. Local and Regional Government Default Study and Rating Transitions, May 8, 2017
- Public Finance System Overview: Canadian Municipalities, Dec. 1, 2016

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 agreed that the assessments of budgetary flexibility and contingent liabilities, respectively, improved. Key rating factors are 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

Upgraded

Essex (County of)	**To**	**From**
Issuer Credit Rating	AA+/Stable/--	AA/Stable/--
Senior Unsecured	AA+	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 the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.