July 21, 2017

Credit ratings: Manitoba downgraded to 'A+' by S&P [Outlook "Stable"]

S&P slapped Manitoba with another credit rating downgrade after the close Friday, lowering the province's long-term rating from 'AA-' to 'A+'. The outlook on the new, lower rating is "stable". Manitoba's short-term rating was also knocked down a notch from 'A-1+' to 'A-1', which you can trace to a methodology change S&P had previously announced (details below).

The downgrade of the long-term rating isn't entirely shocking, given the province had previously been on "negative" outlook. Recall that S&P downgraded Manitoba this time last year, lowering the long-term rating from 'AA' to 'AA-'. At that time, S&P warned that a failure to take the revenue/spending measures needed to really rein in the deficit (and slow debt accumulation) could result in a further downside rating adjustment. Although the relatively new government gets credit for taking "clear steps to improve its fiscal sustainability in the long term", fiscal progress is likely to be slow with Manitoba facing "large, expenditure-driven structural deficits". Associated borrowing, meanwhile, is expected to keep Manitoba's already-high debt burden "well above that of its Canadian provincial peers".

So Manitoba joins six other provinces in the single-A camp according to S&P, leaving only Québec (AA-), Saskatchewan (AA) and British Columbia (AAA) rated double-A or higher. For reference, Moody's currently rates Manitoba 'Aa2' with a "stable" outlook, having downgraded the province a single notch two years ago. Meanwhile, DBRS recently confirmed Manitoba at 'A(high)' with a "stable" outlook—a rating/outlook that's in-line with the new S&P assessment.

More detailed rating considerations

- The downgrade stems from weak budgetary performance. As per S&P: "The downgrade reflects the large, expenditure-driven structural deficits currently facing Manitoba."
- Manitoba's government, in power for a bit more than a year, has pledged to balance the budget by 2024. This year's budget laid out details of a deficit-elimination strategy, including a focus on wage growth restraint and public sector restructuring. Although these measures are expected to bolster the medium term outlook, core funding for health/education has expanded and the budget did not introduce significant revenue-raising measures. Indeed, the indexation of personal income tax brackets and an as-yet-unfulfilled pledge to lower the provincial sales tax rate by 1%-pt by 2020 could be viewed as leaning the other way. Thus, S&P sees Manitoba's ability to hit its revenue targets hinging on continued economic performance.
- S&P anticipates a "gradual" fiscal turnaround, with the base-case scenario seeing modest operating deficits through fiscal 2020. Meanwhile, a large capital spend (focused on the development of new hydro generation/transmission assets) should propel after-capital deficits beyond 10% of revenues (on average).
- These deficits will push an already high debt burden higher still. Note that when it comes to debt, S&P fully incorporates the liabilities of Manitoba Hydro. In other words, Hydro-related debt is deemed "tax-supported" and *not* "self-supporting", owing to the utility's "very high and rising leverage". S&P also views it likely that the province would provide the utility extraordinary support in the event of financial distress.
- From S&P's vantage point then, Manitoba has the highest debt burden of all the provinces, with the ratio of tax-supported debt to operating revenue expected to exceed 300% by fiscal 2020. We would note, however, that an alternative approach of looking at provincial net debt-to-GDP would place Manitoba closer to Ontario; that is, above average, but by no means the highest debt burden in the land. Clearly, various measures of government debt tell quite different stories—just ask Alberta—and when it comes to S&P's formal methodology, Manitoba is wearing a "very high" and rising debt load.
- The province benefits from significant budgetary flexibility, while a majority mandate eases the practical constraints around implementation of fiscal recovery measures. The province boasts a diversified and wealthy economy. Although Manitoba's broad economy insulates against sector-specific shocks, there's still an exposure to commodity prices, alongside risks posed by US trade protectionism, weaker global demand and climate-related damages/disruptions. As always, the very predictable and well balanced institutional framework is a noted strength in Manitoba, as it is in every other provincial jurisdiction.
- Liquidity is deemed "adequate", bolstered by "strong access to capital markets". Liquidity is expected to remain sufficient to cover at least 40% of annual debt service over the coming years. The characterization of liquidity has some important implications for the short-term rating. As per S&P's new approach for linking short- and long-term ratings, for those issuers with a 'A+' long-term rating, liquidity must be considered a key strength in order to warrant a top-notch short-term rating. Since Manitoba's liquidity is *not* considered a key strength, S&P applies its "standard mapping", whereby the 'A+' long-term rating equates to a short-term rating of 'A-1'. So, as we saw with Ontario last month, the downgrade to the short-term rating reflects changing methodology perhaps more than anything else.
- Finally, the "stable" outlook on the 'A+' long-term rating incorporates an expectation that fiscal results gradually improve (as the government moves forward with its recovery plan) and that liquidity remains adequate (>40% of annual debt service). Under a downside scenario, ratings could come under pressure if revenue/spending targets were missed or if liquidity was drawn down notably. Alternatively, an upgrade would require a notable and consistent improvement in budgetary performance (i.e., after-capital deficits <10% of total revenues) and a more moderate capital plan that allowed for a "winding-down" of the tax-supported debt burden (<270% of operating revenue).

Fixed Income Trading Desk Research

Public Sector Research
Warren Lovely
+1 416-869-8598 | Warren.Lovely@nbc.ca

Corporate Credit
Connor Sedgewick
+1 514-879-3182 | Connor.Sedgewick@nbc.ca

Relative Value Models
Drew Lloyd
+44 (0)20-7488-9379 | Drew.Lloyd@nbc.ca

Important Disclosures

General

This Report was prepared by National Bank Financial, Inc. (NBF), (a Canadian investment dealer, member of IIROC), an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on the Toronto Stock Exchange.

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete and may be subject to change without notice. The information is current as of the date of this document. Neither the author nor NBF assumes any obligation to update the information or advise on further developments relating to the topics or securities discussed. The opinions expressed are based upon the author(s) analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein, and nothing in this Report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances. In all cases, investors should conduct their own investigation and analysis of such information before taking or omitting to take any action in relation to securities or markets that are analyzed in this Report. The Report alone is not intended to form the basis for an investment decision, or to replace any due diligence or analytical work required by you in making an investment decision.

Any opinions expressed herein reflect a trading perspective. NBF, or its affiliates may publish fundamental research on the subject issuer(s), which may reflect a different opinion. This Report is not produced by the NBF Research Department and has not been reviewed by the NBF Research Department.

This Report is for distribution only under such circumstances as may be permitted by applicable law. This Report is not directed at you if NBF or any affiliate distributing this Report is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that NBF is permitted to provide this Report to you under relevant legislation and regulations.

National Bank of Canada Financial Markets is a trade name used by National Bank Financial and National Bank of Canada Financial Inc.

National Bank Financial Inc. or an affiliate thereof, owns or controls an equity interest in TMX Group Limited ("TMX Group") and has a nominee director serving on the TMX Group's board of directors. As such, each such investment dealer may be considered to have an economic interest in the listing of securities on any exchange owned or operated by TMX Group, including the Toronto Stock Exchange, the TSX Venture Exchange and the Alpha Exchange. No person or company is required to obtain products or services from TMX Group or its affiliates as a condition of any such dealer supplying or continuing to supply a product or service.

Canadian Residents

NBF or its affiliates may engage in any trading strategies described herein for their own account or on a discretionary basis on behalf of certain clients and as market conditions change, may amend or change investment strategy including full and complete divestment. The trading interests of NBF and its affiliates may also be contrary to any opinions expressed in this Report.

NBF or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. As well NBF and its affiliates and/or their officers, directors, representatives, associates, may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise. NBF and its affiliates may make a market in securities mentioned in this Report. This Report may not be independent of the proprietary interests of NBF and its affiliates.

This Report is not considered a research product under Canadian law and regulation, and consequently is not governed by Canadian rules applicable to the publication and distribution of research Reports, including relevant restrictions or disclosures required to be included in research Reports.

UK Residents

This Report is a marketing document. This Report has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and it is not subject to any prohibition on dealing ahead of the dissemination of investment research. In respect of the distribution of this Report to UK residents, NBF has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). This Report is for information purposes only and does not constitute a personal recommendation, or investment, legal or tax advice. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this Report, or may act or have acted as investment and/or commercial banker with respect hereto. The value of investments, and the income derived from them, can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. If an investment is denominated in a foreign currency, rates of exchange may have an adverse effect on the value of the investment. Investments which are illiquid may be difficult to sell or realise; it may also be difficult to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain transactions, including those involving futures, swaps, and other derivatives, give rise to substantial risk and are not suitable for all investors. The investments contained in this Report are not available to retail customers and this Report is not for distribution to retail clients (within the meaning of the rules of the Financial Conduct Authority). Persons who are retail clients should not act or rely upon the information in this Report. This Report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. NBF is authorised and regulated by the Financial Conduct Authority and has its registered office at 71 Fenchurch Street, London, EC3M 4HD.

NBF is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

U.S. Residents

National Bank of Canada Financial Inc. (NBCFI), a broker-dealer registered with the U.S. Securities and Exchange Commission and a member of the Financial Industry Regulatory Authority (FINRA), and a member of the Securities Investor Protection Corporation (SIPC), is distributing this Report in the United States. NBCFI operates pursuant to a 15 a-6 Agreement with its Canadian affiliate, NBF Inc.

This Report has been prepared in whole or in part by personnel employed by non-US affiliates of NBCFI that are not registered as broker/dealers in the US. These non-US personnel are not registered as associated persons of NBCFI and are not licensed or qualified as research analysts with FINRA or any other US regulatory authority and, accordingly, may not be subject (among other things) to FINRA restrictions regarding communications by a research analyst with the subject company, public appearances by research analysts and trading securities held in a research analyst account.

The author(s) who prepared these Reports certify that this Report accurately reflects his or her personal opinions and views about the subject company or companies and its or their securities, and that no part of his/her compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed in this Report as to the securities or companies.

NBF compensates the authors of this Report from a variety of sources, and such compensation is funded by the business activities of NBF including, Institutional Equity and Fixed Income Sales and Trading, Retail Sales, the correspondent clearing business and Corporate and Investment Banking.

Because the views of its personnel may differ, members of the National Bank Financial Group may have or may in the future issue Reports that are inconsistent with this Report, or that reach conclusions different from those in this Report. To make further inquiry related to this Report, United States residents should contact their NBCFI registered representative.

This document is intended for institutional investors and is not subject to all of the independence and disclosure standards under FINRA rules applicable to debt research Reports prepared for retail investors. This Report may not be independent of the proprietary interests of NBF, NBCFI, or their affiliates. NBF, NBCFI, or their affiliates may trade the securities covered in this Report for their own account and on a discretionary basis on behalf of certain clients. Such trading interests may be contrary to the recommendation(s) offered in this Report.

HK Residents

With respect to the distribution of this email in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA") which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) regulated activity, the contents of this email are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this email may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates' businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments. No other entity within the National Bank of Canada group, including NBF, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public