Manitoba’s budget was released today after being held over from last week. It showed that the province had expected to be able to run a modestly slimmer budget deficit in the upcoming 2020/21 fiscal year. That was, of course, before accounting for the majority of the forgone revenue and higher spending related to the coronavirus spread. In a supplementary document, the province estimated that the deficit impact related to COVID-19 could be anywhere between $160mn and $682mn. Note that Manitoba’s Rainy Day Fund is expected to stand at around $800mn at the end of the current fiscal year, versus $571mn previously. Also excluding the effects of COVID-19, the budget projects gross borrowing requirements of $5.7bn, within the $5-7bn range of the past few years. Of that amount, $476mn in pre-funding has been done in the current 2019/20 fiscal year. The largest share of the borrowing requirements is $3.7bn for debt refinancing, implying net new debt requirements of $2.7bn. Estimated repayments of $782mn from other sources further reduce this amount to $1.9bn. Also, excluding the potential impact of the COVID-19 pandemic, the province projects its net debt-to-GDP ratio to remain steady in around the 34-35% range. Summary net debt levels in dollar terms are projected to increase from $25.7bn at March 31, 2020 to $26.4bn at March 31, 2021. This excludes the debt of Manitoba-Hydro and other government business enterprises that are accounted for on a modified equity basis.

<table>
<thead>
<tr>
<th>Table 1</th>
<th>2018/19 Actual</th>
<th>2019/20 Budget</th>
<th>Change</th>
<th>2020/21 20 Budget</th>
<th>2021/22 20 Budget</th>
<th>2022/23 20 Budget</th>
<th>2023/24 20 Budget</th>
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<tbody>
<tr>
<td>Revenue</td>
<td>16,975</td>
<td>17,025</td>
<td>17,273</td>
<td>248</td>
<td>17,737</td>
<td>18,018</td>
<td>18,360</td>
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<td>Own Source</td>
<td>12,484</td>
<td>12,210</td>
<td>12,432</td>
<td>222</td>
<td>12,601</td>
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<tr>
<td>% change</td>
<td>4.1</td>
<td>0.1</td>
<td>-0.4</td>
<td>1.4</td>
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<tr>
<td>Federal Transfers</td>
<td>4,491</td>
<td>4,815</td>
<td>4,841</td>
<td>26</td>
<td>5,136</td>
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<tr>
<td>Expenditures</td>
<td>17,138</td>
<td>17,480</td>
<td>17,598</td>
<td>118</td>
<td>17,957</td>
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<td>Program Spending</td>
<td>16,138</td>
<td>16,392</td>
<td>16,575</td>
<td>183</td>
<td>16,956</td>
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<tr>
<td>% change</td>
<td>1.3</td>
<td>1.5</td>
<td>2.7</td>
<td>2.3</td>
<td></td>
<td></td>
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<tr>
<td>Public Debt Charges</td>
<td>1,000</td>
<td>1,088</td>
<td>1,023</td>
<td>-65</td>
<td>1,001</td>
<td></td>
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<tr>
<td>Contingency For Writedown</td>
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<tr>
<td>In-Year Adjustments/Lapse</td>
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<td>-95</td>
<td>0</td>
<td>95</td>
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<tr>
<td>Summary Budget Balance</td>
<td>-163</td>
<td>-360</td>
<td>-325</td>
<td>35</td>
<td>-220</td>
<td>-50</td>
<td>50</td>
</tr>
</tbody>
</table>

Modest Growth With Heightened Risk

Growth in Manitoba’s economy remained modest in 2019, with the 1.1% increase in real GDP now estimated more than ½%-pt below last year’s budget projection. Consumer spending was held back by weakness in auto sales. Although China’s ban on canola saw a 54% reduction in exports to that country in 2019, that was more than offset by an increase in trade with the US and, as a result, overall exports rose modestly.
For the current year, growth had been assumed to come in at 1.3% in real terms and 3.3% in nominal terms. However, the province admitted that there are a wide range of possible outcomes regarding the current coronavirus pandemic which will have differing impacts on those economic growth assumptions. In its special supplement related to the COVID-19 impact, the province stated that the impact on nominal GDP could be between 0.5% on the low end and 2.4% on the high end. The medium impact scenario would see nominal GDP growth of only 2%. Note that the forecast downgrades made by CIBC Economics over the past couple of weeks are consistent with the medium-high impact scenarios outlined by the province.

Modestly Slimmer 2019/20 Deficit

The deficit for the outgoing 2019/20 fiscal year is now expected to be $325mn, which is $35mn lower than the Budget 2019 projection and $25mn lower than the mid-year fiscal update. Revenues are running almost $250mn above budget estimates. Despite the softer-than-expected economic growth witnessed in the past year, income tax revenues are tracking $106mn above previous estimates due largely to corporation tax receipts. That in turn was attributed to an increase in reported taxable income and lower-than-expected tax credit claims in 2018 which resulted in a higher prior-year settlement.

The improved revenue projections were offset somewhat by higher expenditure (+$118mn), predominantly linked to green initiatives. The forecasts no longer include the $95mn of in-year improvement which could have come from either lower spending or improved revenue. With the coronavirus impact coming toward the end of the fiscal year, the province stated that it should be able to accommodate recently announced investments in medical equipment within the existing budget, allowing it to maintain the $325mn deficit projection for fiscal 2019/20.

2020/21 Deficit Dependent on Virus Impact

The budget documents show that, at least before the coronavirus impact escalated in recent weeks, the deficit had been expected to slim to $220mn in the upcoming 2020/21 fiscal year. Of course, the economic impact of more severe containment measures on government revenue, as well as the need for greater spending on health care attributed to the spread of the coronavirus, means the 2020/21 deficit will be wider than this target. Projections from the province based on low, medium and high impacts from both of these channels suggest that the overall outcome for the deficit could range between $380mn and $902mn.

Announced prior to the budget, the Manitoba government will reduce the Provincial Sales Tax (PST) to 6%, from 7%. Effective July 1st, 2020, this would be the second 1% point reduction in PST in successive years. The government announced this change to offset the cost to households from its $25-per-tonne Green Levy which was announced alongside the PST reduction. The cost of the PST reduction in terms of forgone revenue ($326mn on a full-year basis for 2021/22) is actually expected to be higher than the revenue brought in by the carbon tax ($284mn in 2021/22).

The government also announced that it would raise the threshold of its Health and Post-Secondary Education Tax Levy, often referred to as the payroll tax, which is paid by employers. As of January 1st, 2021, employers with an
annual payroll of less than $1.5mn will be exempt (up from the current $1.25mn threshold). In addition, the threshold below which employers pay a reduced rate is raised from $2.5mn to $3.0mn.

The longer term projections for the budget balance saw a slimmer deficit in 2021/22 and then small surpluses after that, although of course those forecasts are very dependent on how big the impact of the coronavirus on the upcoming year’s deficit is.

A Boost to Government Capital Spending & Manitoba-Hydro Drive Drives Debt Higher

As stated previously, the Government of Manitoba took pro-active steps to provide some preliminary guidance on the potential negative impacts of the Covid-19 pandemic. In a supplementary guidance document it expresses the preliminary range of impacts to be $160mn to $682mn. These estimates combine the impacts on economic growth and potential health costs. By our estimates, this implies a deficit impact as a percentage of GDP in the range of 0.2%-1.0% from a deficit starting point of less than 0.5%. This would incrementally add to the net debt ratio which currently stands in the area of 34-35%. This information is not included in the budget borrowing table below.

Gross borrowing requirements are projected to be $5.7bn, within the $5-7bn range of the past few years. Of this amount, $476mn in pre-funding has taken place in the current 2019/20 fiscal year. The largest share of borrowings will be for $3.7bn in debt refinancing, implying net new debt requirements of $2.7bn. Estimated repayments of $782mn from other sources further reduce this amount to $1.9bn.

Driving the increase in debt are plans to boost capital spending in key priority areas of infrastructure, health, education and other services, as well as for large-scale projects and sustaining capital requirements of Manitoba-Hydro Electric Board (Manitoba-Hydro). The province borrows directly for both its own operations, as well as for the borrowing needs of Manitoba-Hydro. The borrowing requirements for 2020/21 are almost evenly split between the two. There are some relatively modest borrowing requirements of less than $100mn for the other principal government business enterprise — The Manitoba Liquor and Lotteries Corporation.

Manitoba-Hydro’s debt was $21.6bn at the end of 2018/19. It makes up over 40% of the province’s gross issued debt of around $51bn. Debt is projected to peak in the next 3-4 years with major projects. Growth reflects the construction of the Keeyask Generating Station, a major hydro-electric project that will generate 695-megawatt (MW) of electricity, the majority of which will initially be destined for export markets under long-term contract. Eventually, growing baseload requirements domestically will keep more of the output internal. Manitoba-Hydro
has been successful in obtaining fixed price long-term export contracts for most of the capacity for the Keeyask Project. The details of export contracts are unknown, but industry conditions are generally such that there is growing demand for clean energy sources in the United States as the country transitions away from coal. However, low wholesale electricity prices are exerting pressure on margins. This trend is due in large part to the imbalance between supply and demand. On the demand side, there is low load growth, while on the supply side, low natural gas prices that fuel gas-fired generation along with declining costs for renewable energy from wind and solar are plentiful and weighing down prices. The Keeyask project is scheduled to be fully in service by 2023/24 (first full fiscal year) with multiple staged in-service dates beginning October 2020 — a full ten months ahead of schedule (project was around 75% complete at December 31st).

An associated project that will transmit electricity to the United States is the Manitoba-Minnesota Transmission Project (MMTP) — a 213 kilometer, 500 kV AC transmission line from Winnipeg to the US border to connect with the Great Northern Transmission Line (GNTL) project. The MMTP has a projected cost of $490mn (estimated completion 2020), while Manitoba Hydro’s share of the GNTL is $300mn.

The province projects its net debt-to-GDP ratio to remain steady within the 34-35% range. Summary net debt levels in dollar terms are projected to increase from $25.7bn at March 31, 2020 to $26.4bn at March 31, 2021. This excludes the debt of Manitoba-Hydro and other government business enterprises that are accounted for on a modified equity basis.

Manitoba funds a majority of its debt in the domestic market, but is also active in the international markets. It has stepped up its foreign issuance in recent years. YTD 2019/20, it has raised 35.7% of its borrowings in foreign markets — mostly USD (30%), with the rest in Euro, New Zealand Dollar, and Swedish Krona. The province does not have a foreign market borrowing target, but expects to do a meaningful percentage of international borrowing each year to take advantage of cost-effective funding opportunities and to diversify funding sources. Internationally, the province has historically funded in USD, EUR, JPY, HKD, GBP, CHF, NZ and AUD. Substantially all foreign-dollar borrowings are swapped back to Canadian dollars, eliminating currency risk. The province tends to favour mid-to-long tenors. The weighted average term of Manitoba’s borrowings in the current 2019/20 fiscal year is 14.9 years, which is down modestly from 15.2 years at the same time last year. Manitoba has already completed its borrowing program for the outgoing fiscal year, and has commenced pre-funding for the upcoming year.

To complement its funding program, the province announced that it would work with the City of Winnipeg to explore the feasibility of using the public-private financing model (i.e. P3s) to upgrade the City of Winnipeg’s North End wastewater treatment plant.

Tangible Results Boosted Manitoba’s Credit Profile Outlook, But COVID-19 Now Casting A Shadow

Credit Ratings*: DBRS A (high) Stable, Moody’s Aa2 Stable, S&P A+ Positive

*Ratings of the Province of Manitoba and guaranteed debt of crown-energy corporation, Manitoba Hydro-Electric Board

In line with our view of the provincial sector as a whole that reflects the sudden change in the economic environment, we expect that Manitoba’s credit metrics will be pressured. This will be a change from the progress the government has made to stabilize its financial position in recent years. At the same time, however, given the downgrades of Manitoba’s ratings in the past few years, we believe that it has gained additional flexibility and
.rating stability in the current environment. We therefore don’t rule out the possibility of no change in the ratings for the majority of the rating agencies.

Moreover, although ratings are both quantitative and qualitative, they are also relative; thus it remains to be seen if the rating agencies will be accommodative recognizing that the pandemic is an extraordinary event that is impacting the global economy. Therefore, all governments around the world will be challenged financially.

The temporary nature of some elements of the COVID-19 shock, such as the temporary self-isolation/social distancing directives that are restraining demand, may also help to cushion the impact on the ratings.

In October 2019, S&P revised the province’s rating outlook to positive citing that better-than-expected financial results in 2018/19 strengthened its operating performance and liquidity position. The agency indicated that it expects liquidity to remain greater than 80% of debt service costs. As well, the province’s strong cost containment is helping to reduce its after-capital deficits. The rating agency goes on to say that “the positive outlook reflects at least a one-in-three chance that we could raise the long-term ratings by one notch over the next 12 to 24 months, should Manitoba achieve its revenue and expenditure growth targets and manage global economic headwinds, enabling it to post after-capital deficits of less than 5% of total revenues.” We anticipate that S&P will likely revise its rating outlook to stable in the current economic environment.

We highlight that since the implementation of new rating methodology guidelines, S&P no longer treats Manitoba-Hydro’s debt as taxpayer-supported in spite of the utility’s weak credit metrics. S&P’s new approach leans less on the relative positioning of the utility’s credit risk profile on a stand-alone basis and more on the likelihood that the utility will require support from the province, which S&P deems as unlikely. According to S&P’s latest report of October 4, 2019: “We believe that MHEB, as a regulated, vertically integrated utility with an effective monopoly position, has the capacity and demonstrated willingness to repay its debt obligations as they become due.”

DBRS Morningstar and Moody’s have always considered Manitoba Hydro-Electric Board to be self-supporting and, therefore, do not include the crown utility’s debt in their computation of taxpayer-supported debt. DBRS Morningstar’s latest report (pre-COVID-19) articulated an expectation that Manitoba’s adjusted-debt/GDP ratio, which it calculates to exclude Manitoba-Hydro, but includes unfunded pension liabilities and other adjustments, would stabilize between 41-42% over the next three years before gradually declining. DBRS Morningstar’s debt burden threshold for the A rating is relatively wide at 35-70% and we anticipate that a deterioration in Manitoba’s ratio would remain comfortably within that range.

Moody’s rating of Aa2 on the province is derived by first establishing a Baseline Credit Assessment (BCA) rating of a1—a measure of intrinsic strength. The rating is then notched up two levels under Moody’s Joint Default Analysis (JDA) methodology to reflect a high likelihood of extraordinary support from the federal government in the event of an acute liquidity stress event. The rating agency’s most recent report of August 8, 2019 projects that “The province’s debt burden remains elevated near 165-170% of revenue although low interest rates continue to support debt affordability. The increasing debt of the province’s utility company, Manitoba Hydro, also increases the province’s contingent liability risk.” We highlight that the province’s ratio is currently in the area of 168%, with some flexibility within Moody’s debt anchor score range of 100-200%.

Risks and uncertainties with respect to Manitoba-Hydro’s Keeyask Hydro-Electric project remain, but are abating with the passage of time. According to the latest construction update (fall 2019), successful schedule advances
have helped to lower the forecasted projected costs, increasing the likelihood that the project will meet its control budget of $8.7bn.

However, another matter that will need to be addressed is future electricity rate increases that must go through a formal application process with the Public Utilities Board of Manitoba (PUB). Past allowable rate increases have come in below the applied rates, settling in around 3-4%. More future rate increases will be required to cover Keeyask’s projected cash costs when it is in full service by 2023/24. To address these concerns, Manitoba-Hydro embarked on a major restructuring and efficiency initiative that included a voluntary employee departure program, Strategic Sourcing Initiative, and other efficiency measures.

The Manitoba-Hydro Electric Board aims to improve the utility’s financial profile over time by targeting three primary financial metrics: (1) minimum equity ratio of 25%; (2) interest coverage ratio of 1.80x; and (3) a capital coverage ratio of greater than 1.20x – cash flow from operations to fund sustaining capex. These ratios improved modestly year-over-year in 2018/19, but are still substantially below target levels as follows:

- Consolidated debt/equity 86:14%
- Interest coverage 1.57x
- Capital coverage 0.89x

Nonetheless, the Manitoba-Hydro Electric Board has acknowledged that these targets will not be achieved during times of major capital expansion, hence it is currently reviewing them. Moreover, in a disappointing PUB rate decision in 2016 that approved a rate increase of 3.6%, substantially below the applied rate of 7.9%, Manitoba-Hydro’s Board expressed the view that the decision signaled that the “PUB no longer acknowledged the validity of the 25% equity ratio for the purposes of rate-setting.”

Last year, the Progressive Conservative government called an early snap election that was held on September 10th and successfully won a second majority term. A positive factor from this outcome is continuity in current fiscal priorities. The strength of the government’s commitment to achieve this objective has been demonstrated by the introduction of The Fiscal Responsibility and Taxpayer Protection Amendment Act in 2017 which enhanced previous balanced budget legislation. The legislation imposes financial penalties on cabinet ministers (i.e. withheld salaries) for not reducing deficits according to a baseline amount.

Finally, we highlight that the Parliamentary Budget Officer’s (PBO) 2020 Fiscal Sustainability Report — a periodic sustainability assessment conducted over a 75-year horizon to identify if policy changes are required to avoid unsustainable public debt accumulation — shows that more work is required by Manitoba to close its fiscal gap. On the plus side, Manitoba will experience relatively less drag on economic growth from population ageing compared to many other Canadian provinces. It will also experience one of the highest rates of population growth supporting an expansion in the tax basis, while also creating demand for services and infrastructure.
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