MOODY'S
INVESTORS SERVICE

New Issue: Moody's changes Hawaii GO outlook to positive from stable; assigns Aa2 to $747M bonds

Global Credit Research - 12 Oct 2015

Approximately $6B of GO bonds outstanding

HAWAII (STATE OF)
State Governments (including Puerto Rico and US Territories)
HI

Moody's Rating

ISSUE		RATING
General Obligation Refunding Bonds of 2015, Series EX		Aa2
Sale Amount	$23,640,000	
Expected Sale Date	10/15/15	
Rating Description	General Obligation	
General Obligation Bonds of 2015, Series EU (Green Bonds)		Aa2
Sale Amount	$35,000,000	
Expected Sale Date	10/15/15	
Rating Description	General Obligation	
General Obligation Bonds of 2015, Series ET		Aa2
Sale Amount	$190,000,000	
Expected Sale Date	10/15/15	
Rating Description	General Obligation	
General Obligation Refunding Bonds of 2015, Series EW		Aa2
Sale Amount	$34,750,000	
Expected Sale Date	10/15/15	
Rating Description	General Obligation	
General Obligation Refunding Bonds of 2015, Series EY		Aa2
Sale Amount	$213,420,000	
Expected Sale Date	10/15/15	
Rating Description	General Obligation	
General Obligation Refunding Bonds of 2015, Series EV		Aa2
Sale Amount	$8,700,000	
Expected Sale Date	10/15/15	
Rating Description	General Obligation	
General Obligation Refunding Bonds of 2015, Series EZ		Aa2
Sale Amount	$216,915,000	
Expected Sale Date	10/15/15	
Rating Description	General Obligation	

Taxable General Obligation Bonds of 2015, Series FA	Aa2
Sale Amount	$25,000,000
Expected Sale Date	10/15/15
Rating Description	General Obligation

Moody's Outlook POS(m)

NEW YORK, October 12, 2015 --Moody's Investors Service has assigned Aa2 ratings to the State of Hawaii's 2015 General Obligation Bonds to be issued in an estimated total amount of $747 million in eight series: Series ET, Series EU (Green Bonds), Refunding Series EV, Refunding Series EW, Refunding Series EX, Refunding Series EY, Refunding Series EZ, and Taxable Series FA. We have also revised the state's general obligation outlook to positive from stable and affirmed the Aa2 rating on the state's outstanding general obligation bonds. Following this sale, the state will have approximately $6.0 billion general obligation bonds outstanding.

SUMMARY RATINGS RATIONALE

The Aa2 rating incorporates Hawaii's improved financial operations with increasing reserves and healthy revenue growth; high fixed costs for debt, pensions, and other post-employment benefits (OPEB); and a tourism-based economy that is vulnerable to national and international economic fluctuations. Pension reforms for new employees are expected to reduce the state's retirement costs over time, and financial plans incorporate a funding of 100% of the OPEB annual required contribution (ARC) by 2019 per statute or earlier per the current administration's proposal. However, the state's fixed costs will remain among the highest in the country at least over the medium term due to the increase in OPEB spending and the state's responsibility for financing K-12 capital needs. Hawaii has strong governance practices such as multi-year financial planning, quarterly binding consensus revenue forecasting, and timely financial reporting.

OUTLOOK

The revision of the rating outlook to positive from stable reflects Hawaii's restoration of reserves, and its pro-active measures to improve the funding of its pension and OPEB liabilities, including the state's plans to fund fully its OPEB ARC, combined with strong revenue trends.

WHAT COULD MAKE THE RATING GO UP

- Absorbing the full OPEB ARC into the budget without a significant erosion of reserve levels.

- Increased economic diversification and reduced economic volatility.

- Sustained reduction in debt ratios and significant improvement in pension funded ratios, sooner than currently projected.

WHAT COULD MAKE THE RATING GO DOWN

- Economic weakening leading to deteriorating revenue trends, budget imbalance, liquidity pressures, and narrowing of financial position.

- Return to reliance on non-recurring solutions to balance the budget.

- Increased debt or debt service ratios relative to other states or deterioration of pension funded ratios.

STRENGTHS

- Financial governance practices including multi-year planning, quarterly consensus revenue forecasting, and strong executive power to reduce spending.

- Historical fiscal conservatism; prompt action to address revenue shortfalls.

- Low unemployment rates; healthy growth in tourism industry; stable military presence.

- Strong liquidity position.

- Rapid amortization of debt; no exposure to variable rate debt or derivative products.

- Commitment to and progress toward reducing pension and OPEB liabilities, including funding fully the OPEB ARC.

CHALLENGES

- Vulnerability to shifts in Hawaii's tourism-based economy, resulting in revenue falloff and budget shortfalls.

- Large state and local government employment sector that contributes to spending pressure for salary and benefit settlements.

- Debt ratios that are among the highest in the nation, although these debt levels are largely attributable to the state's responsibility for funding all the capital needs of its centralized K-12 school system.

- High pension and OPEB liabilities.

RECENT DEVELOPMENTS

Recent developments are included in the Detailed Rating Rationale, below.

DETAILED RATING RATIONALE

ECONOMY

Although Hawaii's economy has shown some diversification, its large tourism industry remains key to the economy and the state's economic performance closely tracks tourism trends. As a highly desirable tourist destination for international and domestic visitors, the tourism industry is somewhat insulated from US economic cycles and has at times been counter-cyclical. The recent recession was particularly challenging since both national and international visitations were affected at the same time. Visitor arrivals did not surpass the pre-recession peak (2007) until 2012. Growth since that time has been strong, however, and visitor arrivals and hotel room rates are on track to hit record levels in 2015.

A sizable military presence adds stability, and military housing construction has contributed to expanding construction activity. Federal defense spending in Hawaii, dictated by the island's strategic geographic importance, plays a large part in the state's economy. Federal activity amounts to about 15% of Hawaii's gross state product, with much of it defense related. This is augmented by federal transfer payments for Social Security and federal retirement benefits which also support the state's economy. The state economy has benefited from military expansion plans and the privatization of military housing. Thus far, the effects of federal budget cuts and sequestration have been relatively modest. Active duty military personal totaled 51,045 in 2014, the highest level since World War II and up from 33,930 in 2000.

The economy is also boosted by strong construction activity. The value of building permits issued has returned to pre-recession levels. Major projects include high-rise condos in Central Honolulu targeted at both visitors and residents, as well as retail commercial projects in Honolulu and new hotel/resort projects primarily on the neighbor islands. Large public projects include the Honolulu rails system and improvements at the airports and port.

The state's employment trends are generally less volatile than in other tourism dependent states such as Florida and Nevada. Unlike most mainland states, Hawaii did not experience a severe housing market bust during the recession. Hawaii's unemployment rate of 3.9% in August 2015 remains well below the national average as it was throughout the recession.

FINANCES AND LIQUIDITY

General Fund tax revenue growth was particularly strong in fiscal 2013, 10.0% on a budget basis and 8.2% on a GAAP basis. This growth reflected a continuation of the underlying economic strength that produced strong growth in 2010, 2011, and 2012. But it also reflected some one-time factors including the acceleration by taxpayers of capital gains income into calendar 2012 due to federal tax law changes and delays in processing certain payments related to tax collection makeup for the City and County of Honolulu in late fiscal 2013.

Growth in tax revenues stalled in fiscal 2014. Total tax revenues dropped 1.8% from 2013. This decline reflected, in part, the one-time factors in fiscal 2013. Additionally, a $55.5 million deposit in the Hawaii Hurricane Relief Fund

(HHRF) was excluded from General Fund revenues. Nevertheless, recurring tax revenues remained essentially flat. Officials estimate that after adjusting for the makeup payments to Honolulu and the HHRF deposit, total tax revenues declined by 0.2%.

Driven by the underlying economic trends, strong growth resumed in fiscal 2015. General fund tax revenues increase by an estimated 6.8% for the year.

In its September forecast, the Hawaii Council of Revenues projects that General Fund tax revenues to increase by 6.0% in fiscal 2016, although year-to-date figures suggest that actual revenues may exceed this projection. The council is currently projecting revenue growth of 4.5% to 5.5% per year in the out years (2017-2020) of its multi-year forecast period.

Strong reserve levels are important for Hawaii given the state's vulnerability to national and international shifts in its essential tourism-based economy. Balance sheet deterioration during the recent recession reflected the state's use of one-time actions for budget relief, including the use of reserve balances from both the emergency budget reserve (EBR) and the Hawaii Hurricane Relief Fund (HHRF). At the low point, the state reported negative GAAP balances for fiscal years 2009 and 2010. In the prior 2001 recession, the state's available reserves hit a low of about 7.5% operating revenues at the end of fiscal 2003, but were never negative.

As its economy has recovered, Hawaii has rebuilt its balances to a healthy position relatively quickly. Combined available reserves (unassigned General Fund balance plus the EBR) grew to a strong 20.1% of operating revenues at the end of fiscal 2013, up from 11.7% at the end of fiscal 2012 and essentially equal to the pre-recession peak of 21% at the end of fiscal 2006. Reserves remained essentially unchanged in fiscal 2014 after the state increased it OPEB contribution to $100 million greater than planned. Reserves are projected to increase by approximately $325 million in fiscal 2015. Earlier projections showed total reserves being drawn down after 2015, as the state ramped up its OPEB contributions. But current projections show reserves remaining relatively steady through 2020.

Liquidity

Hawaii does not engage in short-term borrowing for cash flow purposes and relies on pooled treasury cash for temporary internal borrowing as needed. During the recession, when the state's General Fund reserves were depleted, some liquidity strain was indicated by payment deferrals at the end of fiscal 2009 and the delay of fiscal 2010 personal income tax refunds until fiscal 2011. But liquidity levels have improved substantially since that time and the state has not engaged in any additional deferrals. For fiscal 2014, the state averaged 300 monthly days cash on hand, among the strongest levels at any rating level.

DEBT AND PENSIONS

Debt Structure

Hawaii compares unfavorably with other states on measures such as debt ratios, pension funding levels, and OPEB liabilities. Debt per capita is $4,867 ranking Hawaii third highest among the states and over four times Moody's 50-state median of $1,012. As a percentage of personal income, Hawaii's debt is the highest in the country at 10.8%, compared with the median of 2.5%.

These debt ratios are, in part, attributable to the fact that unlike other states Hawaii is entirely responsible for the capital needs of its centralized K-12 school system. Total state and local government debt ratios suggest that the state's debt is a more manageable burden on the state's economy than suggested by comparison to the state medians. Nevertheless, the state's high levels of direct debt contribute to its high fixed costs. Hawaii's fiscal 2014 debt service ratio (debt service costs relative to total revenue available for debt service) is also high at 10.4%, ranking the state third and well above the median of 5.1%.

Hawaii's general obligation bonds are conservatively structured with a maximum maturity of 20 years and level annual debt service. As a result, payout of the state's general obligation debt is relatively rapid. Prior to the current offering, 67% of principal is repaid in 10 years.

Debt-Related Derivatives

The state has no variable rate debt and no debt-related derivatives.

Pensions and OPEB

The state's pension liabilities are above average contributing to its high fixed costs. Moody's 2013 Adjusted Net Pension Liability (ANPL) for Hawaii was 125.8% of state governmental revenues, the tenth highest of the 50 states and more than twice times the median of 60.3%. Hawaii's three-year average ANPL was 143.0% of revenues, the sixth highest and well above the median of 52.8%.

Pension reforms adopted in 2011 are expected to improve the funding levels of the state's retirement system over the long term. Benefits were reduced for new members after June 30, 2012, and employer contributions will incrementally grow from 15% to 17% of payroll as they are phased in from fiscal 2013 through fiscal 2016. A moratorium on any enhancement of retirement benefits remains in effect until the funded ratio reaches 100%. Additional reforms approved by the legislature and the governor in 2012 focused on reducing the "spiking" of final compensation. These later changes have the largest potential impact on counties who employ most of the police and fire workers. While the retirement system reforms will reverse the steep increase in the projected unfunded liability pre-reform and lead to a steady improvement in the funded ratio, the state does not expect the total unfunded liability to begin declining for approximately 8 to 10 years.

Hawaii's OPEB obligation is also quite sizeable at $11.2 billion as of July 1, 2013, of which the state's portion is approximately $8.5 billion, reflecting health benefits for state employees as well as teachers paid by the state. This liability is equivalent to 129.7% of state governmental revenues, the highest of the 50 states. As in most states, Hawaii has funded its OPEB costs on a pay-go basis. However, in the 2013 legislative session, the state adopted a plan to require phasing in higher annual required contribution (ARC) payments by the state and counties beginning in fiscal 2015. By fiscal 2019, the payments would reach 100% of the ARC. Notably, the state also made a $100 million contribution in fiscal 2014, which is in addition to its planned contributions. The current administration has proposed increasing OPEB contributions to reach 100% of the ARC in fiscal 2017.

GOVERNANCE

Hawaii has very strong governance practices, including consensus revenue forecasts, updated quarterly, and multi-year financial planning. The governor has power to restrict spending during the fiscal year, if necessary. The constitution does not provide for voter initiatives. The state plans to adopt a debt affordability study and debt polices in fiscal year 2017.

KEY SCORECARD STATISTICS

Per capita income relative to U.S. average: 100.6%

Industrial diversity (1=most diverse): 0.47

Employment volatility (U.S.=100): 121

Available balances as % of operating revenue (5-yr. avg.): 6.9%

NTSD/total governmental revenue: 73.5%

3-year avg. adjusted net pension liability/total governmental revenue: 143%

OBLIGOR PROFILE

Hawaii is the 40th largest state by population, at 1.4 million. Its state gross domestic product is 38th largest. The population's income levels are above average, with per capita personal income equal to 101% of the US level and a median household income equal to 146%. Its poverty rate is in the bottom third among states.

LEGAL SECURITY

The eight series of bonds that comprise the current offering are general obligations of the state, to which the state has pledged its full faith, credit and resources. The bonds have a first charge on all general fund resources.

USE OF PROCEEDS

Proceeds of the Series ET and FA bonds will fund various state public improvement projects. Proceeds of the Series EU bonds will be used to acquire land for open space and a conservation easement. Proceeds of the Series EV, EW, EX, EY and EZ bonds will be used to refund outstanding bonds for debt service savings.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was US States Rating Methodology published in April 2013. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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