STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

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Summary:

Hawaii; Appropriations; General Obligation

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Credit Profile		
US$500.0 mil GO bnds of 2016 ser FB due 06/30/2036		
Long Term Rating	AA/Positive	New
US$182.385 mil GO rfdg bnds of 2016 ser FE due 10/01/2028		
Long Term Rating	AA/Positive	New
US$137.165 mil GO rfdg bnds of 2016 ser FF due 10/01/2028		
Long Term Rating	AA/Positive	New
US$25.0 mil taxable GO bnds of 2016 ser FC due 06/30/2036		
Long Term Rating	AA/Positive	New
US$6.0 mil GO rfdg bnds of 2016 ser FD due 06/01/2016		
Long Term Rating	AA/Positive	New
Hawaii GO		
Long Term Rating	AA/Positive	Outlook Revised

Rationale

Standard & Poor's Ratings Services revised its outlook to positive from stable and affirmed its 'AA' long-term rating and underlying rating (SPUR) on Hawaii's general obligation (GO) bonds and its 'AA-' long-term rating on the state's certificates of participation (COPs), reflecting our view of appropriation risk. At the same time, we assigned our 'AA' long-term rating to Hawaii's following planned bond issues:

- $500 million series 2016 FB GO bonds,
- $25 million series 2016 FC taxable GO bonds,
- $6 million series 2016 FD GO refunding bonds,
- $182.4 million series 2016 FE GO refunding bonds, and
- $137.2 million series 2016 FF GO refunding bonds.

Following Hawaii's independent Council on Revenue's (COR) upward revision to its fiscal 2016 revenue forecast and even stronger-than-forecast actual collections year to date, we see the state's finances as on a trajectory whereby they could weather the COR's anticipated fiscal 2017 slowdown in revenue growth with a still very strong fiscal position. The state-projected fiscal 2016 budgetary performance benefits from strong revenue trends that have enabled Hawaii to build impressive general fund ending and reserve balances that could lead us to raise the state's credit rating within the next two years. For Hawaii, a favorable fiscal position underscored by strong budgetary reserve balances is particularly important, in our view, because of the state's above-average fixed costs that stem from its relatively high debt, pension, and retiree health care benefits liabilities.

The 'AA' GO rating reflects our view of:

- The state's strong financial position, which has weathered several major economic stressors during the past 10

years;
- Strong liquidity, particularly when including pooled cash balances available to the general fund for temporary interfund borrowing;
- The prioritizing of contributions to the retiree health care benefits system, resulting in a lowering of actuarial estimates of the state's long-term liability;
- Management's well-established, proactive budget monitoring practices, including frequent revenue forecast updates from the independent COR, which facilitates prompt identification of potential budget adjustments for budget alignment;
- The governor's executive authority to restrict all executive branch expenditures through such actions as cutting spending midyear without legislative approval or cutting or delaying disbursements during the course of a fiscal year; and
- Other strong constitutional protections, including requiring budget balance, that allow for tax increases with legislative approval and give GO bonds first-lien priority before all other disbursements.

Partly offsetting the above strengths is our view of:

- Hawaii's inherent susceptibility to exogenous shocks that have potential to hurt its tourist sector, which accounts for 17% of state GDP;
- The below-average funded status of the state's retirement system and generally higher-than-average debt ratios because of the state's centralized provision of public sector services; and
- Large, other postemployment benefit (OPEB) liability although a 2013 statutory requirement will increase annual contributions until fiscal 2019, when they would equal the actuarially recommended level.

All GO bonds are secured by Hawaii's full faith and credit, which the state considers the highest priority in payment according to its constitution. None of the refunding bonds include later maturity dates than the existing debt to be refunded.

Economic performance -- and whether macro and state trends meet to exceed the COR forecast -- stands out as the key variable for the state's rating trajectory going forward, in our view. As it is, the state anticipates ending fiscal 2016 with $1.3 billion -- or 18.4% of expenditures -- in combined reserves, which we view as very strong. According to the COR's forecast, economic growth is likely to slow somewhat in the coming years, contributing to an operating deficit in fiscal 2017 and a small imbalance in fiscal 2018. Despite this, at the end of fiscal 2018, Hawaii's general fund would have almost $900 million in reserves, equal to 11.7% of expenditures, which we view as very strong.

As an island-economy state, Hawaii is inherently vulnerable to the negative effects of certain types of exogenous shock-events. On the other hand, as an importer of diesel and oil fuels -- which Hawaii relies on to generate over 70% of its electricity -- the state has been a clear beneficiary from what appears to be a secular decline in oil prices. In the 12 months ended September 2015, residential, industrial, and commercial customers realized 18% to 32% savings in the cost of electricity. Certain broad economic metrics, moreover, suggest a more resilient economy than popularly perceived. For instance, although Hawaii was not immune to the Great Recession, relative to the nation, per capita personal income in the state actually increased to 104% in 2009 from 101% in 2007.

Regarding tax revenues, the COR in January 2016 raised its revenue growth forecast for fiscal 2016 to 6.7% from 6.0%. But for fiscal 2017, the COR held its forecast at 5.5% after having lowered it from 6.0% in September 2015. More than any specific source of weakening, the fiscal 2017 forecast begins a transition to the COR's longer-term revenue growth

forecast, which falls in the range of 4.5% to 5.0%, reflecting the effect that demographic changes will have on Hawaii's economy -- and an inevitable cyclical U.S. economic downturn at some point. The state's multiple-year general fund forecast illustrates, however, that, even in the context of more gradual growth, the state could still progress toward more fully funding its large long-term obligations while maintaining strong budgetary reserves. If the forecast holds for the next two years, allowing the state to fund its liabilities according to schedule -- which we view as important, given the magnitude of the state's liabilities -- we could raise the state's rating. An outright recession, as opposed to just slower growth, however, would likely test Hawaii's capacity to sustain a weaker revenue environment while adhering to its current multiple-year fiscal plan.

Looking ahead to fiscal 2017, the reduced pace of revenue growth contributes to the state's projected $449 million (5.8% of expenditures) operating deficit. However, a significant portion -- $264 million of the expected deficit -- stems from the state's scheduled prefunding of its retiree health care benefits liability and further capitalizing its emergency and budget reserve fund (EBRF). And even with the deficit, the state would end the year with combined reserves of $923 million, or 12% of expenditures. There would be another relatively small, $36 million deficit in fiscal 2018, bringing reserves to $893 million, or 11.7% of expenditures. We believe the state has positioned itself to accommodate the somewhat slower economic and revenue growth anticipated in its multiple-year general fund forecast.

Notwithstanding the longer-term expectation of more subdued economic growth, Hawaii's financial position has improved in the current year thanks to a strengthening visitor industry, which enjoyed a fourth consecutive year of record-setting visitor arrivals. Total visitor expenditures in 2015 increased 3.2% from 2014 and are on track in 2016 to have grown by 44% compared with 2010. Revenue per available room was up by 8% in 2015 and has grown by 63% since 2010. These trends, along with consistently high occupancy rates, suggest the state's key industry, leisure and hospitality (which makes up 18.1% of Hawaii's employment base versus 10.1% for the nation), is currently healthy. In our view, strength in the tourist sector has contributed to pushing down Hawaii's unemployment rate to 3.7% for 2015, well below 4.5%, which the state's economist considers to be Hawaii's natural jobless rate.

Throughout late 2015 and continuing recently, however, a strong U.S. dollar and flagging U.S. consumer confidence has weighed on the pace of improvement in the various trends throughout the visitor industry. Some of the strongest gains occurred from 2011 through 2013, with more incremental improvement since then. Relative to the U.S. as a whole, personal income in Hawaii has slid slightly, to 100%, from its prior level, which was slightly above that of the U.S. State GDP, the broadest measure of the state's economy, suggesting that Hawaii remains stuck in a slow growth mode, as it has expanded more slowly than national GDP for six consecutive years. Nevertheless, the state's economy has proved relatively resilient to exogenous shocks (i.e., the Sept. 11 terrorist attacks, the SARS epidemic). Still, we view Hawaii's economy as having some unique vulnerability to unanticipated shocks originating from external events.

The persistent trend of a strengthening U.S. dollar, especially vis-à-vis the Japanese Yen presents a risk to Hawaii's economy. Visitors from Japan make up 17.6% of arrivals, making it easily the second most significant source of origination, behind only the U.S. mainland, which still constitutes the majority, at 62.2%. The state's tourist base is diversifying, however, with arrivals from Canada having almost doubled since 2006. Likewise, visitors from China have increased more than three-fold. As with Japan, however, we see potential for some softening ahead when it comes to tourists from Canada and China. Despite having increased visitors from these two countries -- both of which have

entered weaker economic patches -- they still represented a combined and relatively minor 8.2% of total arrivals in 2015.

Hawaii's economy is also subject to changes in federal spending. The federal government accounted for 12.6% of state GDP in 2013, according to the Bureau of Economic Analysis' most recently available data. More than half of federal spending in the state is military related, making Hawaii's economy susceptible to cutbacks under the federal Budget Control Act of 2011 (BCA). Most significantly, the BCA's sequestration has translated to $400 million in reduced military contracts being awarded in Hawaii ($2.0 billion, compared to $2.4 billion). The effects of the cutbacks emerged in 2015 when the number of military personnel receded by 8.4% to 46,764 following a record level of personnel in 2014. Still, the 2015 level of military personnel based in Hawaii remained higher than all but three years since 1960. The incomes of these personnel and households have a stabilizing influence on the rest of the state economy, in our view.

The state's real estate market is healthy, with low foreclosure rates (just 0.02% in Honolulu, which is 70% of Hawaii's real estate market) and rising home prices. Indeed, a chronic shortage of housing relative to demand keeps upward pressure on home prices throughout the state and poses a threat to the state's longer-term economic growth prospects. Whereas Hawaii saw roughly 6,000 new housing units per year constructed throughout the 1980s, the number has fallen to approximately 2,000 to 3,000 in recent years. In our view, construction trends in the 1980s likely reflected unsustainably strong demand from Japanese investors at that time. State officials attribute the more recent slower construction trends to increased environmental, zoning, and permitting process rules.

Although Hawaii's debt burden of $6.48 billion of tax-supported state GO, COP, and highway (gas tax) debt is high, in our view, translating to $4,520 per capita (based on estimated 2015 population), it reflects the centralized nature of state and local government in Hawaii. Hawaii's debt level stands out as high relative to other states' in part because the state assumes numerous functions that are performed at the local level in other states.

Based on the analytic factors we evaluate for states, we have assigned Hawaii a composite score of '1.9' on a four-point scale in which '1' is strongest.

Outlook

We have revised to positive from stable our outlook on Hawaii's rating. If Hawaii's revenue performance matches its multiple-year financial plan, enabling the state to maintain very high reserve levels while adhering to its OPEB prefunding schedule, we could raise the state's rating within two years. Hawaii's annual pension contribution and funded ratio levels are also likely to influence the direction of the state's rating. A more formalized budget reserve target level that could facilitate the state's commitment to a strong fiscal position despite changes in administration would also contribute favorably to the likelihood we could raise the state's rating.

Conversely, if the state materially underperforms its fiscal forecast, we would likely revise the outlook back to stable. Nevertheless, we believe the state's current rating can withstand most reasonable downside scenarios, given its currently very strong reserve level. If the state's annual pension contributions fall short of actuarial levels or if the system's funded ratio materially declines from its current level, we would likely revise the outlook to stable.

We expect that global and macro-U.S. economic conditions -- and the implications both could have to Hawaii's economy -- will be key determinants in whether the state's fiscal capacity can accommodate these objectives.

Related Criteria And Research

Related Criteria

- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Financial Management Assessment, June 27, 2006
- USPF Criteria: Debt Statement Analysis, Aug. 22, 2006
- USPF Criteria: Appropriation-Backed Obligations, June 13, 2007
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Ratings Detail (As Of March 1, 2016)		
Hawaii GO (wrap of insured) (AMBAC & AGM) (SEC MKT)		
Unenhanced Rating	AA(SPUR)/Positive	Outlook Revised
Hawaii GO (wrap of insured) (FGIC & AGM) (SEC MKT)		
Unenhanced Rating	AA(SPUR)/Positive	Outlook Revised
Hawaii GO (MBIA) (National)		
Unenhanced Rating	AA(SPUR)/Positive	Outlook Revised
Hawaii GO (MBIA) (National) & (AGM)		
Unenhanced Rating	AA(SPUR)/Positive	Outlook Revised
Hawaii APPROP		
Long Term Rating	AA-/Positive	Outlook Revised
Hawaii GO		
Unenhanced Rating	AA(SPUR)/Positive	Outlook Revised

Many issues are enhanced by bond insurance.

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.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.