

## **FITCH RATES \$800MM HAWAII GOS 'AA'; OUTLOOK STABLE**

Fitch Ratings-New York-08 November 2012: Fitch Ratings has assigned an 'AA' rating to the following State of Hawaii general obligation (GO) bonds:

- \$374 million GO bonds of 2012, series EE;
- \$400 million GO refunding bonds of 2012, series EF;
- \$26 million Taxable GO bonds of 2012, series EG.

The bonds are scheduled to price through negotiation the week of Nov. 12, 2012.

In addition, Fitch affirms the 'AA' rating on approximately \$5 billion of outstanding state GO bonds.

The Rating Outlook is Stable.

### **KEY RATING DRIVERS**

**SOUND FINANCIAL MANAGEMENT:** The state employs quarterly revenue forecasting and long-term planning, and has shown a commitment to restoring budget balance when revenues underperform.

**ECONOMIC CONCENTRATION IN TOURISM AND DEFENSE:** Hawaii's extensive tourist infrastructure underpins an economy dominated by tourism, and there is also a large federal military presence. The state's geographic location somewhat limits economic diversification efforts.

**ELEVATED DEBT BURDEN:** Hawaii's debt levels are high for a U.S. state government, and Fitch expects them to remain so. This largely reflects the state's responsibility for many functions handled by local governments in other states, particularly K-12 education.

**HIGH LONG-TERM LIABILITY LEVELS:** Pension funding levels are weak, and the unfunded liability as a percentage of personal income is at the highest end of states rated by Fitch. Other post-employment benefit obligations (OPEB) are also significant.

### **SECURITY**

General obligations of the state of Hawaii that carry the full faith and credit pledge of the state.

### **CREDIT PROFILE**

The state of Hawaii's 'AA' GO rating reflects the state's sound financial management practices, its highly developed and resilient tourism-heavy economy, high debt levels, and a large long-term liability burden. Following significant revenue declines in the recession, which resulted in the drawdown of previously large reserves despite extensive budget balancing action, solid economic and revenue recovery and continued prudent budget management have stabilized Hawaii's financial position. The state has begun to rebuild its fund balance to provide a cushion against unforeseen events. Although debt and other long-term liabilities are likely to remain well above average for a U.S. state, Hawaii has demonstrated its ability to manage these costs.

### **FINANCES**

Prior to the recession, the combined general fund and Emergency and Budget Reserve Fund (EBRF) balances peaked at \$786 million, or 16% of total general fund resources, in fiscal 2006, with the EBRF accounting for \$54 million of the total and the rest fund balance. As tax revenue

growth slowed in fiscal years 2007 and 2008, and declined by almost 10% in fiscal 2009, balances were drawn down. The state closed the fiscal year with a negative ending balance of \$36.8 million after accounting for an overstatement of certain tax revenues, though \$60.4 million remained in the EBRF.

The fiscal plan for the fiscal 2010-2011 biennium was initially balanced through a mix of tax increases, spending reductions, modest debt restructuring, the application of federal stimulus monies, and employee furloughs. Projected revenues were revised downward several times over the course of the biennium, and despite delaying the payment of income tax refunds to be paid in fiscal 2010 into fiscal 2011 and a draw from the separate Hurricane Relief Fund (HRF) which had been funded at approximately \$180 million, the state again ended fiscal 2010 in a slightly negative position (\$22.2 million), offset by monies in the EBRF and remaining HRF funds.

Continuing revenue weakness in fiscal 2011 resulted in a projected \$220 million shortfall following an off-cycle meeting of the state's council on revenues in late March 2011, prompted largely by the Japanese earthquake and tsunami. The state planned to maintain balance through spending cuts, fund transfers, and the drawdown of remaining balances in the HRF and EBRF. Ultimately, revenue performance for fiscal 2011 was above those projections. Combined with the effects of lapsed spending, full draws on the reserve balances were not necessary. Fiscal 2011 ended with a general fund balance of \$126 million, 2.5% of fiscal 2011 resources. An additional \$30 million in available balances remained between the HRF and EBRF at the close of the fiscal year.

Hawaii's budget for the current fiscal 2012 - 2013 biennium addressed a projected gap of more than \$1 billion. The gap was closed through a mix of spending reductions, savings resulting from labor concessions, and temporary revenue measures. Fiscal 2012 is projected to have ended on June 30 with a balance of \$275 million (almost 5% of resources) and another \$46 million in the combined reserves. Fiscal 2013 is forecast to increase the ending fund balance to \$348 million, with growth of 4.9% in overall general fund tax revenues and 8.1% in the general excise tax that represents about 55% of that total.

## ECONOMY

Hawaii's economy is dominated by tourism and government, with a significant federal military presence. The tourist industry relies heavily on California and Japan, although increased visitation from other countries, most recently Korea and Australia, has provided diversification. The state is focused on increasing the diversification of its visitor base.

Following a sharp drop in 2001, the tourism sector saw strong growth that began in 2004 and continued to a record high in 2007. The industry saw significant declines in the recession, but has recovered strongly since 2010 to reach projected new highs in 2012. The state is currently projecting continued recovery at a slower pace in the next few years.

Although a large military presence makes Hawaii vulnerable to federal deficit reduction, the state has benefitted from military consolidations and serves a strategic role that should somewhat limit downside risk. Fitch will closely monitor federal budget decisions as they develop for the potential impact on Hawaii.

Following several years of strong gains, employment in the recession generally mirrored the national experience, with a decline of 6.1% between 2007 and 2010. The state and country added jobs at a similar pace in 2011, and gains in Hawaii have accelerated in 2012, with year-over-year growth of 2.1% in September exceeding 1.4% for the nation. Leisure and hospitality employment was up 5.1% over September 2011 levels. Although tourism as a percentage of total employment remains well above the national average, Hawaii's employment in the service sectors is relatively near national levels.

Hawaii's unemployment rate has been consistently below that of the nation since 2001. Unemployment for September 2012 was 5.7%, well below the U.S. rate of 7.8% for the month.

Personal income growth has outpaced the nation for most of the last decade, and 2011 per capita

personal income equals 103% of the U.S. level. Hawaii ranks 18th among the states by this measure.

## DEBT AND OTHER LONG-TERM LIABILITIES

Hawaii's government is highly centralized, and the state is responsible for many functions, such as K-12 education, normally handled at the local level. Largely as a result of this structure, debt is high for a U.S. state and expected to remain so. As of July 1, 2012, net tax-supported debt totaled approximately \$5.5 billion, which equates to 9.4% of 2011 personal income. Principal is retired at a rapid pace, with 66% repaid in 10 years. The vast majority of the state's debt is in the form of general obligation bonds.

Despite a history of funding an actuarially calculated annual required contribution, funding levels for Hawaii's pension system remain weak. Using Fitch's 7% discount rate assumption rather than the 7.75% used by the system, the statewide employees retirement plan is 55% funded. Fitch notes that the state has passed legislative changes, including changes to the benefit structure and increased employee contributions that are designed to limit the growth in pension liabilities.

On a combined basis, the burden of net tax-supported debt and adjusted unfunded pension obligations in Hawaii is almost four times the median for states rated by Fitch. The state's OPEB obligations are also large, and the state has indicated its intent to undertake reform efforts in this area in the near term.

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In addition to the sources of information identified in Fitch's U.S. Tax-Supported Rating Criteria, this action was additionally informed by information from IHS Global Insight.

### Applicable Criteria and Related Research:

--'Tax-Supported Rating Criteria' (Aug. 14, 2012);  
--'U.S. State Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

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Tax-Supported Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=686015](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015)

U.S. State Government Tax-Supported Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=686033](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686033)

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