Fitch Ratings

FITCH RATES HAWAII'S $1.1B GOS 'AA'; OUTLOOK STABLE

Fitch Ratings-New York-24 October 2014: Fitch Ratings has assigned an 'AA' rating to the following State of Hawaii general obligation (GO) bonds:

--$575 million GO bonds of 2014, series EO;
--$503.325 million GO refunding bonds of 2014, series EP;
--$25 million taxable GO bonds of 2014, series EQ.

The bonds are scheduled to price via negotiated sale the week of Nov. 10, 2014.

In addition, Fitch affirms the 'AA' rating on approximately $5.7 billion of outstanding state GO bonds and the 'AA-' rating on $25.7 million of outstanding series 2009A (state office building) certificates of participation (COPs).

The Rating Outlook is Stable.

SECURITY
The bonds are general obligations of the state of Hawaii that carry the full faith and credit pledge of the state. The COPS are secured by lease payments subject to legislative appropriation.

KEY RATING DRIVERS

SOUND FINANCIAL MANAGEMENT: The state's positive management practices include frequent revenue forecasting and long-term planning, and a commitment to restoring budget balance when revenues underperform. Fitch also views positively the state's commitment to dedicating a portion of revenue gains to rebuilding financial reserves and prepaying long-term liabilities.

RESILIENT ECONOMY, DESPITE CONCENTRATION: Hawaii's well-established tourist infrastructure underpins an economy dominated by leisure and hospitality, and there is also significant federal military exposure. Despite this concentration, the state's overall economic growth trend has proved relatively stable.

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 OTHER LONG-TERM LIABILITY LEVELS: The state's unfunded pension liability as a percentage of personal income is at the high end for states rated by Fitch. Other post-employment benefit obligations (OPEB) are also significant, though the state has demonstrated a commitment to address this liability. Despite these efforts, the burden will likely remain well above-average for the foreseeable future.

APPROPRIATION SECURITY: COP payments require biennial state legislative appropriation, resulting in a rating one notch below the state's 'AA' GO rating. Statutorily, the governor's executive budget requests must include amounts sufficient to make lease payments, equivalent to debt service, on the COPs.

RATING SENSITIVITIES
The rating is sensitive to shifts in the state's fundamental credit characteristics, particularly its prudent fiscal management.

CREDIT PROFILE

Hawaii's 'AA' GO rating reflects the state's sound financial management practices, its concentrated but resilient economy, high debt levels for a U.S. state, and a large but manageable long-term liability burden. After facing significant challenges during the recession, solid economic and revenue growth coupled with prudent budget management have stabilized Hawaii's financial position. Although long-term liabilities are likely to remain high, Hawaii has demonstrated its ability to manage these costs and a willingness to mitigate their long-term effect through reforms and advance funding. The 'AA-' rating on the COPs is tied to the state's GO rating as lease payments are subject to legislative appropriations for essential state facilities.

CONCENTRATED BUT REBOUNDING ECONOMY

Hawaii's economy is dominated by leisure and hospitality and government, with a significant federal military presence. Together they accounted for nearly one third of the state's 2013 real GDP. Tourism trends recovered quickly from event-driven declines over the past two decades, providing an important cornerstone for the state's economic growth. Most recently, the industry saw significant declines in the recession, but has grown steadily since 2010. Two key indicators, visitor arrivals and visitor expenditures, reached historic highs in calendar year 2013, continuing a trend, and the state projects further gains in 2014.

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 limits downside risk. Fitch anticipates federal deficit reduction efforts could negatively affect the state's economy over time though the impact should be manageable given the state's expectations of additional military investment in the area. Fitch will continue to closely monitor federal budget decisions for their effect on Hawaii.

Fitch expects growth in private sector employment, barring another broad economic downturn, will drive continued employment gains in the state over the near-term. Hawaii's year-over-year (yoy) monthly non-farm employment growth remains positive, but dipped below the national trend in the second half of 2013 and has generally remained there. Through September 2014, the state's three-month moving average y-o-y gain was 1.3%, below the national 1.9% gain. Hawaii reached a milestone in September, finally recovering all of the jobs lost during the recession. Nationally, the U.S. reached that milestone back in May, but the majority of states are still lagging in their jobs recovery.

Hawaii's unemployment rate has been consistently below that of the nation since 2001 and remains so. Unemployment for September 2014 was 4.2%, well below the U.S. rate of 5.9% and down from 4.7% last year. Solid yoy labor force gains of 2.5% indicate the improvement is due to jobs growth, rather than labor pool shrinking as seen in some other states.

Personal income growth has outpaced the nation for the last decade, increasing 59.4% versus 49.3% for the nation. Per capita personal income (PCPI) growth has been closer to the national trend, reflecting Hawaii's above-average population growth over that span. 2013 PCPI equals 101% of the U.S. level, ranking Hawaii 22nd amongst the states. Fitch views the state's relatively high cost of living as a partial offset to the slightly above-average income levels. For the second quarter of 2014, the National Association of Realtors reports the Honolulu MSA was the fourth most expensive metro area in the nation with a median single family home price of over $678 thousand.

IMPROVING FINANCIAL PROFILE

Hawaii remains focused on rebuilding reserves, despite some recent revenue volatility. Prior to the recession, the state built up a sizable cushion with reserves reaching over $700 million (including general fund balance and reserve funds). During the recession, fiscal performance proved volatile as Hawaii's economy contracted and the state implemented policy changes to boost revenues and cut expenditures. As part of its budget-balancing measures, Hawaii also significantly drew down reserves, leaving limited flexibility.

Hawaii's reserve funding commitment since then has led to steady improvement and fiscal 2014 ended with an estimated $209.8 million in the state's reserve funds, or 3.4% of general fund revenues versus just 0.7% in the prior year. Total reserves including the ending general fund balance were $874.8 million.

After a strong rebound from the recession, revenue growth unexpectedly weakened in fiscal year 2014, partially due to taxpayer behavior related to a federal tax changes, as well as state policy changes. Hawaii ended the prior biennium (on June 30, 2013) with a nearly $600 million general fund surplus and a strong $844 million ending balance. General excise tax (GET, 53.9% of fiscal 2013 general fund tax revenues) and personal income tax (PIT, 31.7%) revenues increased 9.1% and 12.7% over the prior year, respectively. Total general fund tax revenues increased 9.9%.

But in fiscal 2014, general fund tax revenues declined 1.8% yoy with GET revenues down 4.1% and PIT revenues up 0.6%. Last year at this time, the state's financial plan forecast 4.1% growth in general fund tax revenues. The state attributed the weakening of PIT growth mainly to acceleration of income into the prior year because of a federal tax law change, which is consistent with trends Fitch observed in other states. State policy changes included various adjustments in GET allocations to the general fund, including a $55.5 million transfer to one of the state's reserve funds. Adjusting for state policy changes, Fitch estimates general fund tax revenues increased a modest 1% in fiscal 2014 with GET up 1.7%.

Fitch attributes the slowed tax revenue growth, even on an adjusted basis, to some tempering of the robust economic gains Hawaii saw in prior years. Going forward, the state's council on revenues (COR) forecasts projects solid revenue growth in fiscal 2015 and beyond, well ahead of the fiscal 2014 results. After the 1.8% decline in general fund tax revenues in fiscal 2014, the September 2014 COR estimate is for 3.5% growth in fiscal 2015 and then 5.5% yoy growth through fiscal 2021. Given the slowdown in fiscal 2014, Fitch views this forecast as somewhat aggressive. Importantly, the state retains executive authority to manage expenses in line with a changing revenue picture and did so during fiscal 2014.

Fitch views positively the state's commitment to reserve replenishment and addressing its long-term liabilities burden despite recent revenue volatility. Hawaii's current biennial budget includes draws on the large fiscal 2013 ending general fund balance for reserve funding and OPEB pre-funding. At the end of the biennium on June 30, 2015, Hawaii's most recent multi-year general fund financial plan forecasts $427.9 million in general fund balance and $273.5 million in additional reserves providing a combined 11.3% of projected general fund revenues. The financial plan projects declining general fund ending balances through fiscal 2018 and a small increase in 2019, inclusive of the state's statutory commitment to full OPEB actuarially calculated annual required contribution (ARC) funding by fiscal 2019 (see discussion below). Reserve levels increase modestly over the financial plan period.

SIGNIFICANT LONG-TERM LIABILITIES BURDEN

Hawaii's state government 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. On a pro forma basis (inclusive of $600 million in new money for the series EO and EQ GO bonds) Hawaii's net tax-supported debt (NTSD) totaled approximately $6.8 billion, which equates to 10.7% of 2013 personal income. Principal is retired at a rapid pace with nearly two-thirds of GO bonds repaid in 10 years. The vast majority of the state's debt is in GO bonds.

Despite a history of funding at or near the ARC, 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 was only 55.4% funded at June 30, 2013. Over the past few years, Hawaii enacted reforms, including changes to the benefit structure and increased employee contributions, which are designed to limit pension liability growth. On a combined basis, net tax-supported debt and the state share of adjusted unfunded pension obligations represent a very high 22.8% of 2013 personal income, more than three times the median for states rated by Fitch.

OPEB FUNDING COMMITMENT
The state's OPEB obligations are also substantial, but improved following statutory adoption of a pre-funding plan. As of June 30, 2013, Hawaii reported an OPEB unfunded actuarial accrued liability (UAAL) of $8.5 billion which was down notably from the June 30, 2011 reported OPEB UAAL of over $13 billion. The improvement largely reflects the actuarial recognition of the state's statutory pre-funding plan and subsequent use of a higher discount rate assumption. The current biennial budget includes $217 million towards pre-funding OPEB. The legislature also adopted legislation (Act 268, SLH 2013) that requires full funding of the OPEB ARC by fiscal 2019. The bill includes a mechanism to divert state tax revenues to ensure full ARC payments. Fitch views the statutory commitment to ARC funding as a positive indication of Hawaii's commitment to manage its high liabilities.

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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 HIS and the National Association of Realtors.

Applicable Criteria and Related Research:
--'U.S. State Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

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U.S. State Government Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686033