FitchRatings

Fitch Rates Hawaii's $861MM GOs 'AA'; Outlook Stable

Ratings Endorsement Policy

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Fitch Ratings-New York-11 October 2013: Fitch Ratings has assigned an 'AA' rating to the following State of Hawaii general obligation (GO) bonds:

--$635 million GO bonds of 2013, series EH;
--$181.34 million GO refunding bonds of 2013, series EI, EJ, EK, EL;
--$15 million taxable GO bonds of 2013, series EM;
--$29.795 million taxable (qualified school construction bonds), series EN.

The bonds are scheduled to price through a retail order period and negotiation the week of Nov. 1, 2013.

In addition, Fitch affirms the 'AA' rating on approximately $5.409 billion of outstanding state GO bonds and the 'AA-' rating on $30.575 million of outstanding series 2009A (state office building) certificates of participation (COPs).

The Rating Outlook is Stable.

SECURITY
General obligations of the state of Hawaii that carry the full faith and credit pledge of the state. 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 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 and high long-term liabilities burden.

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 2012 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 2012 and the state projects further gains in 2013.

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 though the impact should be manageable given the state's expectations of additional military investment in the area. Effects of the federal shutdown should also be modest, so long as it is resolved relatively quickly. 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 (y-o-y) monthly non-farm employment growth remains positive, but recently dipped below the national trend. Through August 2013, the state's 3-month moving average y-o-y gain was 1.1%, below the national 1.7% gain. Declines in government sector employment (6.1% y-o-y in August 2013) are dragging down overall growth led by the leisure and hospitality (3.2%) and construction sectors (8.8%). Hawaii's unemployment rate has been consistently below that of the nation since 2001. Unemployment for August 2013 was 4.3%, well below the U.S. rate of 7.3%.

Personal income growth has outpaced the nation for the last decade, with average annual growth of 5.1% versus the nation's 4.1% rate. Per capita personal income (PCPI) growth has been closer to the national trend, reflecting Hawaii's above-average population growth over that span. 2012 PCPI equals 103.1% of the U.S. level, ranking Hawaii 18th amongst the states. Fitch views the state's relatively high cost of living as a partial offset to the above-average income levels. For the second quarter of 2013, the National Association of Realtors reports the Honolulu MSA was the third most expensive metro area in the nation with a median single family home price of over $660 thousand.

IMPROVING FINANCIAL PROFILE
Prior to the recession, the state built up a sizable cushion with reserves peaking at $786 million (16% of total general fund resources) in fiscal 2006. During the recession, fiscal performance proved volatile as the state's economy contracted and the state implemented policy changes to boost revenues and cut expenditures. As part of its budget-balancing measures, the state also drew down significantly on reserves, leaving limited flexibility.

The state's fiscal profile now appears to be on the upswing, with robust tax revenue growth driven by positive economic trends. On a preliminary basis, Hawaii reports it ended the last biennium on June 30 with a nearly $600 million general fund surplus and a strong $844 million ending balance. General excise tax (53.9% of fiscal 2013 general fund tax revenues) and personal income tax (31.7%) revenues increased 9.1% and 12.7% over the prior year, respectively. Total general fund tax revenues increased 9.9%. Hawaii anticipates continued solid growth of 4.1% in fiscal 2014 and 7.4% in fiscal 2015, which Fitch views as achievable but subject to risks from macro-economic setbacks such as a prolonged federal shutdown or U.S. debt ceiling breach.

Looking forward, Fitch views positively the state's commitment to reserve replenishment and addressing its long-term liabilities burden. Hawaii's current biennial budget include draws on the large fiscal 2013 ending general fund balance, to support cash-funding of the capital improvement plan, reserve funding, and OPEB pre-funding. At the end of the biennium on June 30, 2015, Hawaii expects to have $357.1 million in general fund balance and $371 million in additional reserves providing a combined 10.9% of projected general fund revenues. The five-year financial plan projects surpluses over the following three years, increasing reserves, and the statutory commitment to reach full OPEB ARC funding by fiscal 2019 (see discussion below).

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. As of July 1, 2012, net tax-supported debt totaled approximately $5.8 billion, which equates to 9.4% of 2012 personal income. Principal is retired at a

rapid pace, with 66% of GO bonds repaid in 10 years. The vast majority of the state's debt is in GO bonds.

Despite a history of funding the 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 was only 54.7% funded at June 30, 2012. 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 21.6% of 2012 personal income, over three times the median for states rated by Fitch.

OPEB FUNDING COMMITMENT
The state's OPEB obligations are also large, with a June 30, 2011 reported unfunded actuarial accrued liability (UAAL) of over $13 billion. The 2013-2015 biennial budget includes over $220 million towards pre-funding the obligation. 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 positively as a strong indication of the state's commitment to manage its high liabilities. Act 268, SLH 2013 also establishes a taskforce to study OPEB reform and deliver recommendations to the 2014 legislature convening next January.

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

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U.S. State Government Tax-Supported Rating Criteria

Additional Disclosure
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