FitchRatings

Fitch Rates Hawaii's $757MM GO Bonds 'AA'; Outlook Stable

Fitch Ratings-San Francisco-13 September 2016: Fitch Ratings has assigned an 'AA' rating to the following general obligation (GO) bonds of the State of Hawaii:

--$375 million GO bonds of 2016, series FG;
--$353 million GO refunding bonds of 2016, series FH;
--$3.9 million GO refunding bonds of 2016, series FI;
--$25 million taxable GO bonds of 2016, series FJ.

The bonds are expected to be offered via negotiated sale during the week of Sept. 26. Series FH and FI par amounts are subject to change prior to sale. Proceeds of series FG and FJ will fund costs for various public improvement projects, including public facilities, schools, community colleges, universities, public libraries and parks, while series FH and FI will refund outstanding debt for interest savings.

In addition, Fitch affirms the following ratings:

--Issuer Default Rating (IDR) at 'AA';
--$6.2 billion in outstanding state GO bonds at 'AA';
--$20.6 million in outstanding state certificates of participation (COPs) at 'AA-'.

The Rating Outlook is Stable.

SECURITY
The GO 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

Hawaii's 'AA' IDR reflects the state's solid operating performance, supported by a history of strong revenue growth and rising reserves as well as a resilient economy. Long-term liabilities are well above average for a U.S. state, reflecting consolidation at the state level, but Hawaii has a strong record of managing these liabilities. The 'AA-' rating on the COPs is linked to the state's IDR as lease payments are subject to legislative appropriation.

Economic Resource Base
The State of Hawaii encompasses seven inhabited islands and a total population of 1.4 million, two-thirds of whom reside on the island of Oahu. The state's employment base and economy is diverse, with key sources of external support provided by tourism and a substantial federal presence. Population and labor force growth have exceeded U.S. medians over the past 10 years and nominal personal income levels are relatively high, although below average in real terms as a result of the state's high cost of living.

Revenue Framework: 'aaa' factor assessment
General excise taxes on gross business receipts and personal income taxes provide approximately three-quarters of Hawaii's general fund revenue and have performed strongly historically, with growth rates exceeding U.S. GDP and inflation over the past 10 years. Prospects for ongoing revenue gains appear strong based on the state's resilient economy and above-average population growth. The state has full control over its revenues with no legal limits on potential increases.

Expenditure Framework: 'aa' factor assessment
Based on recent spending practices and continued strong revenue performance, Fitch expects that state expenditure increases will be in line with to marginally above revenue growth. Carrying costs for debt service and retiree benefits are somewhat elevated but are expected to remain manageable.

Long-Term Liability Burden: 'a' factor assessment
Long-term liabilities for debt service and retiree benefits are high relative to personal income as compared to most other U.S. states. These totals, however, include liabilities for the state's public schools, which are accounted for independently in most other jurisdictions. Recent reforms to retiree benefits have helped to slow the growth of related liabilities but asset levels remain relatively low, particularly for the state's pension plan.

Operating Performance: 'aaa' factor assessment
The state is well-positioned to address economic challenges as a result of limited revenue volatility and substantial additions to reserves in recent years. Budget management is guided by frequent revenue forecasts and multi-year financial plans that provide input for policy adjustments as required.

RATING SENSITIVITIES
Long-Term Liabilities Key: The rating is sensitive to overall fiscal and operating performance, including maintenance of the state's strong commitment to funding retirement liabilities. Material improvement in the state's liability position could result in an upgrade.

CREDIT PROFILE

Hawaii's economy has performed strongly in recent years with steady growth in tourism and a continued substantial military presence. Tourism activity has been subject to periodic declines historically but has proven resilient over the long term, and unemployment rates have been below the U.S. average for the past 15 years. The state also appears likely to benefit from ongoing consolidation of U.S. military activity in the Pacific.

Revenue Framework
The state relies on general excise taxes (GET) on business income and personal income taxes for three-quarters of general fund revenues. The GET is broad-based and captures income from the sale of services as well as goods, accounting for 45% of general fund revenues on its own. Policy-adjusted performance for all general fund revenues has been strong historically, exceeding both inflation and overall U.S. economic performance.

Fitch expects Hawaii's revenue growth, absent policy actions, to continue to increase more rapidly than U.S. GDP based on the state's resilient economy and above-average population growth. While revenue gains may be affected by periodic economic shocks, solid growth is expected over the long term.

The state has full legal authority to raise revenues and has regularly adopted measures to modify revenue sources and amounts.

Expenditure Framework
Hawaii provides a broad range of services to its residents with education and health and human services accounting for the bulk of general fund expenditures. Elementary and secondary education comprised approximately 39% of total general fund expenditures in fiscal 2015, with higher education contributing an additional 11%. Health and welfare spending combined for 32% of general fund spending.

Fitch expects that the natural pace of spending growth will be in line with to marginally above expected revenue growth based on the state's current spending profile. The state will continue to see demands for increased spending on education and health care, in particular, but ongoing revenue gains are likely to maintain pace with expenditure increases.

The state's large share of expenditures for education and health and human services would appear to challenge its ability to reduce expenditures in a downturn. In practice, however, general fund spending fell by approximately 14% during fiscal years 2010 and 2011, largely due to employee furloughs and executive department spending restrictions, before returning to growth in 2012. The state's substantial expenses for debt service and retiree benefits may present a greater challenge for expenditure flexibility. Carrying costs for these items accounted for 14% of governmental funds expenditures in fiscal 2015, among the highest shares for states. The state has notably sought to reduce expenditure growth for retiree benefits through the creation of a new pension tier and related reforms, but carrying costs appear likely to remain relatively high for a U.S. state.

Long-Term Liability Burden
Long-term liabilities for debt and pensions are elevated but still moderate at 21.7% of personal income as of fiscal 2015, close to four times the median for states. This amount includes debt on behalf of the state's elementary and secondary schools, which represents roughly 40% of total debt. Amortization is fairly rapid, with 64% of outstanding principal due for repayment within 10 years.

The state reported a low 62% ratio of assets to liabilities in its pension plan for fiscal 2015 under an assumption of 7.65% investment returns. Based on an assumption of 7% returns, Fitch estimates a funded ratio of 57% for the system. Contribution rates are determined by statute and adjusted periodically if the funding period exceeds 30 years. The most recent adjustments to contribution rates were adopted in 2011 with a package of pension reforms, including reduced benefits for new hires and anti-spiking provisions. The state has also reduced investment assumptions incrementally. Such efforts have helped to slow the growth of the state's pension obligations but material reductions in this liability will likely require both adherence to current contribution practices and achievement of investment return assumptions over the long term.

The state has also made notable progress in funding of its other post-employment benefits (OPEB) program, moving from pay-go to full funding of the annual required contribution within the span of several years. Legislation adopted in 2013 established a schedule for full funding by 2019 and the state currently expects to reach this target in fiscal 2018. Annual state contributions for OPEB have exceeded the thresholds required by the 2013 legislation.

Operating Performance
Substantial reserves and a history of limited revenue volatility contribute to an assessment of strong financial resilience for the state in a moderate economic downturn. Based on historical results adjusted for the impact of policy action, Fitch estimates that a 1% decline in U.S. GDP would reduce state revenues by 2.2%, as compared to a median decline of 3.1% for all states. Combined general fund balances and reserves, which Fitch estimates at 16.7% of general fund revenues in fiscal 2015, provide a considerable cushion against revenue declines expected in a moderate recession.

The state has made key improvements to financial flexibility in the wake of the recession, increasing budgetary and emergency reserves substantially. Balances in the state's Emergency and Budget Reserve Fund rose from $9.7 million in fiscal 2011 to $100.9 million in fiscal 2016, with an increase to $305.7 million (4.3% of prior year revenues) planned for fiscal 2017. A new reserve policy adopted in 2016 sets a goal of 10% for such savings, committing a portion of ongoing tobacco revenues and general fund balance in years of strong revenue performance. In addition, the state has restored balances of $182 million in its Hawaii Hurricane Relief Fund, which has functioned as an additional reserve in times of economic stress.

Recent Budgetary Performance
The state recorded strong preliminary results for fiscal 2016 based upon an 8% increase in general fund revenues. Management estimates an ending fund balance for the year on a budgetary basis of 15.6% of prior year revenues, as compared to 13.6% in fiscal 2015. More modest revenues gains of 5.5% are projected for fiscal 2017. The state's budgetary basis ending fund balance for 2017 is expected to decline to 9.3%, largely due to one-time actions to supplement reserves, fund capital needs, and write off internal debts.

Contact:

Primary Analyst
Stephen Walsh
Director
+1-415-732-7573
Fitch Ratings, Inc.
650 California Street, 4th Floor
San Francisco, CA 94108

Secondary Analyst
Eric Kim

Director
+1-212-908-0241

Committee Chairperson
Karen Krop
Senior Director
+1-212-908-0661

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

In addition to the sources of information identified in the applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

Applicable Criteria
U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016) (https://www.fitchratings.com/site/re/879478)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1011606)
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