

# MOODY'S INVESTORS SERVICE

## New Issue: Moody's assigns Aa2 rating to approximately \$821M State of Hawaii G.O. Bonds of 2013; stable outlook

Global Credit Research - 10 Oct 2013

### Approximately \$5.4 billion G.O. debt outstanding

HAWAII (STATE OF)  
State Governments (including Puerto Rico and US Territories)  
HI

#### Moody's Rating

#### ISSUE

#### RATING

General Obligation Refunding Bonds of 2013, Series EJ

Aa2

**Sale Amount** \$58,445,000

**Expected Sale Date** 11/06/13

**Rating Description** General Obligation

Taxable General Obligation Bonds of 2013, Series EM

Aa2

**Sale Amount** \$15,000,000

**Expected Sale Date** 11/06/13

**Rating Description** General Obligation

General Obligation Bonds of 2013 Series EN (Taxable Qualified School Construction Bonds) Aa2

**Sale Amount** \$29,795,000

**Expected Sale Date** 11/06/13

**Rating Description** General Obligation

General Obligation Bonds of 2013, Series EH

Aa2

**Sale Amount** \$635,000,000

**Expected Sale Date** 11/06/13

**Rating Description** General Obligation

General Obligation Refunding Bonds of 2013, Series EI

Aa2

**Sale Amount** \$35,505,000

**Expected Sale Date** 11/06/13

**Rating Description** General Obligation

General Obligation Refunding Bonds of 2013, Series EK

Aa2

**Sale Amount** \$26,895,000

**Expected Sale Date** 11/06/13

**Rating Description** General Obligation

General Obligation Refunding Bonds of 2013, Series EL

Aa2

**Sale Amount** \$50,285,000

**Expected Sale Date** 11/06/13

**Rating Description** General Obligation

## **Moody's Outlook**

### **Opinion**

NEW YORK, October 10, 2013 --Moody's Investors Service has assigned Aa2 ratings to the State of Hawaii's \$635 million General Obligation Bonds of 2013, Series EH; General Obligation Refunding Bonds of 2013, Series EI (\$35.5 million), EJ (\$58.4 million), EK (\$26.9 million), and EL (\$50.3 million); \$15 million Taxable General Obligation Bonds of 2013, Series EM, and General Obligation Bonds of 2013 Series EN (Taxable Qualified School Construction Bonds) (\$29.8 million) . Concurrently, Moody's has affirmed the Aa2 rating on the state's outstanding general obligation bonds (\$5.4 billion), the Aa3 rating on Hawaii's outstanding 2009 certificates of participation (\$35.2 million); and the A1 rating on the outstanding 2006 certificates of participation (\$21.7 million). The outlook is stable.

The state plans to sell the Series 2013 bonds the week of November 4. Proceeds of the new money bonds will be used for statewide capital projects; the refunding series proceeds will be used to refund outstanding bonds for debt service savings.

### **SUMMARY RATING RATIONALE**

The Aa2 rating incorporates Hawaii's improved financial operations with increasing reserves and healthy revenue growth; high fixed costs for debt, pensions, and other post employment benefits (OPEB); and a tourism-based economy that is vulnerable to national and international economic fluctuations. Pension reforms for new employees are expected to reduce the state's retirement costs over time, and financial plans incorporate a phased-in funding of 100% of the OPEB annual required contribution (ARC) by 2019. However, the state's fixed costs will remain among the highest in the country at least over the medium term. Hawaii has relatively strong governance practices such as multi-year financial planning and quarterly binding consensus revenue forecasting, and timely financial reporting, after a period of late audits from fiscal 2007 to fiscal 2010.

The 2009 certificates of participation are rated one notch below the state's general obligation rating, reflecting the subject-to-appropriation nature of the obligation. The two-notch distinction between the general obligation rating and the 2006 certificates of participation incorporates the appropriation risk as well as the more limited essentiality of the project financed, a new office building for the Department of Hawaiian Homelands' headquarters.

### **STRENGTHS**

- Financial governance practices include well-established multi-year planning, quarterly consensus revenue forecasting, and strong executive power to reduce spending
- Historical fiscal conservatism; prompt action to address revenue shortfalls
- Low unemployment rates; healthy growth in tourism industry; stable military presence
- Sufficient liquidity position to avoid short-term cash flow borrowing
- Rapid amortization of debt; no exposure to variable rate debt or derivative products

### **CHALLENGES:**

- Vulnerability to shifts in Hawaii's tourism-based economy, resulting in revenue falloff and budget shortfalls
- Reserve levels remain below pre-recession peak
- Large state and local government employment sector contributes to spending pressure for salary and benefit settlements
- Debt ratios that are among the highest in the nation and likely to remain there given state-level capital funding, especially for education; relatively low pension funding levels despite recent reforms

### **DETAILED CREDIT DISCUSSION**

#### **SEPTEMBER 2013 FORECAST SHOWS HEALTHY REVENUE GROWTH**

Hawaii's Council of Revenues incorporated a 4.1% General Fund revenue growth rate for fiscal 2014. The pace is slower than the 8% forecast in May 2013 but reflects stronger than expected revenue growth in fiscal 2013 (9.9% versus 6.7%) as well as the impact of transferring \$55.5 million from the General Fund to the Hurricane Relief Fund in each of fiscal years 2014 and 2015. The latest forecast also incorporated tax law changes adopted in the 2013 legislative session. The biggest revenue impact comes from making permanent a higher transient accommodations tax (TAT) rate that was raised temporarily in 2011, and raising the cap on TAT allocations to special funds. While these actions will lower General Fund revenues by \$11 million in 2014 and 2015, revenues are expected to increase by \$177 million in FY2016 up to \$246 million in fiscal 2020.

Healthy revenue growth is expected to continue with 7.5% and 7.7% annual General Fund revenue increases projected for fiscal years 2015 and 2016, and between 5.3% and 6.1% annually through fiscal 2020. Hawaii's revenue forecast is closely tied to its visitor sector, which could be negatively affected by higher hotel room rates and airfares, and the potential effects of future unfavorable exchange rate shifts.

#### BALANCE SHEET IMPROVES AS RESERVES ARE REPLENISHED

Strong reserve levels are important for Hawaii given the state's heightened vulnerability to national and international shifts in its essential tourism-based economy. Balance sheet deterioration during the recent recession reflected the state's use of one-time actions for budget relief, including the use of reserve balances from both the emergency budget reserve (EBR) and the Hawaii Hurricane Relief Fund (HHRF). As its economy has recovered, Hawaii has rebuilt its balances relatively quickly. Combined available reserves (unassigned General Fund balance plus rainy day funds or EBR) amounted to 11.7% of operating revenues at the end of fiscal 2012, up from 7% at the end of fiscal 2011. While well below the peak of 21% at the end of fiscal 2006, the higher level of reserves reflects a continuing positive trend and a significant improvement over the negative GAAP balances recorded at fiscal year-end 2009 and 2010. In the prior 2001 recession, the state's reserves hit a low of about 7.5% at the end of fiscal 2003, but were never negative.

With a General Fund surplus and EBR fund balance of \$24 million expected for fiscal year end 2013, available reserves should continue to grow. Deposits to the EBR include appropriations by the legislature as well as a portion of the state's tobacco settlement moneys. The legislature appropriated \$50 million in general funds in fiscal 2014 to recapitalize the EBR. Including tobacco settlement funds, the balance at the end of fiscal 2014 is expected to total \$81.7 million.

#### ECONOMY STRENGTHENS WITH STRONG VISITOR TRENDS AND LOW UNEMPLOYMENT

Hawaii remains a highly desirable tourist destination for domestic as well as international visitors. Visitor data such as arrivals, expenditures, and room occupancy rates all indicate steady growth in recent years although arrivals did not surpass the pre-recession peak (2007) until 2012. A strong military presence also adds stability to the state's labor market, and military housing construction has helped offset weakness in residential and commercial markets, although Hawaii did not experience a severe housing market bust during the recession.

Hawaii has typically exhibited countercyclical employment patterns. However, trends in recent years have followed the national and international economies, indicating a shift toward more cyclical performance. Hawaii is likely to remain a premier tourism destination over the long term although the recent recession was particularly challenging since both national and international visitations were affected at the same time. Hawaii's unemployment rate of 4.3% in August 2013 remained well-below the national average (7.3% the same month) as it did during the recession, and the state's employment trends are less volatile than in other tourism dependent states such as Florida and Nevada. Visitor arrivals increased 10% in calendar year 2012, up from the 8.6% forecast, and 4% growth is projected for calendar year 2013. Other positive visitor indicators include higher rates for hotel occupancy, average room costs, and revenue per available room, underscoring healthy growth in the state's tourism-based economy.

Federal defense spending in Hawaii, dictated by the island's strategic geographic importance, plays a large part in the state's economy. Federal activity amounts to about 15% of Hawaii's gross state product, with much of it defense related. The large federal defense presence provides a continuing and stable source of employment and income which helps to offset the state's dependence on tourism. This is augmented by federal transfer payments for Social Security and federal retirement benefits which also support the state's economy. The state economy has benefited from military expansion plans and the privatization of military housing. However, even with these significant investments, Hawaii could be hurt by federal spending cuts, particularly reductions to the federal defense budget. Thus far, the effects of sequestration and the federal shutdown have been relatively modest, according to state officials.

## DEBT RATIOS AMONG THE HIGHEST IN THE NATION

Hawaii compares unfavorably with other states on measures such as debt ratios that are among the highest in the nation, pension funding levels that are below average, and OPEB liabilities that are more than twice the size of the state's annual operating budget. Debt per capita is \$4,246 ranking Hawaii third and about four times Moody's 2013 50-state median of \$1,074. As a percentage of personal income, Hawaii's debt is the highest in the country at 10% compared with the median of 2.8%. Hawaii's fiscal 2012 debt service ratio (debt service costs relative to total revenue available for debt service) is also high at 10.4%, ranking the state fifth and also well above the median of 4.9%.

Hawaii does not engage in short-term borrowing for cash flow purposes and relies on pooled treasury cash for temporary internal borrowing as needed. During the recession, when the state's General Fund reserves were depleted, some liquidity strain was indicated by payment deferrals at the end of fiscal 2009 and the delay of fiscal 2010 personal income tax refunds until fiscal 2011. Hawaii has no exposure to variable rate debt or derivative products, and payout of the state's general obligation debt is relatively rapid with 90% of principal repaid in 15 years.

## PENSION REFORMS EXPECTED TO LOWER SOME FIXED COSTS IN LONG TERM; PLANS TO FUND OPEB ARC

Pension reforms adopted in 2011 are expected to improve the funding levels of the state's retirement system over the long term. Benefits were reduced for new hires after June 30, 2012, and employer contributions will incrementally grow from 15% to 17% of payroll as they are phased in from fiscal 2013 through fiscal 2016. A moratorium on any enhancement of retirement benefits remains in effect until the funded ratio reaches 100%. Additional reforms approved by the legislature and the governor in 2012 included: 1) an anti-spiking measure that revised the definition of compensation for retirement purposes to exclude overtime and various supplemental pay for new employees hired after June 30, 2012; and 2) a requirement that public employers pay the additional unfunded liability costs of significant non-base pay increases (spiking) of employees who retire. This provision has the largest potential impact on counties who employ most of the police and fire workers. While the retirement system reforms will stem the steep increase in the projected unfunded liability pre-reform and lead to a steady improvement in the funded ratio, the state does not expect the total unfunded liability to begin declining for nearly twenty years.

Based on the Hawaii's fiscal 2011 pension data, we have calculated that the employee retirement system's adjusted net pension liability (ANPL) was 132.5% of revenues. This amount far exceeds the median (45.1%) based on 2011 data, but is well below Illinois (241.1%) and Connecticut (189.7%). Other pension ratios such as ANPL to personal income, GDP, and population are similarly very high for Hawaii.

Hawaii's OPEB obligation is quite sizeable at \$13.6 billion as of July 1, 2011, reflecting full health benefits for state employees as well as teachers paid by the state. These amounts are significantly larger than the size of Hawaii's annual general fund revenues which totaled about \$6.2 billion in fiscal year 2013. As in most states, Hawaii has funded its OPEB costs on a pay-go basis. However, in the 2013 legislative session, the state adopted a plan to require phasing in higher annual required contribution (ARC) payments by the state and counties beginning in fiscal 2015. By fiscal 2019, the payments would reach 100% of the ARC. The state has appropriated an amount equal to 20% of the state's ARC in fiscal 2015 and the financial plan reflects annual increases in payments. Hawaii is the only state that has adopted a plan to fully fund its OPEB ARC payments. While the move is credit positive, it will substantially increase Hawaii's annual fixed costs relative to budget. In fiscal 2013, the estimated pay-go was \$312 million and the ARC would have been \$995 million.

## Outlook

The rating outlook for Hawaii is stable reflecting expectations of continued revenue growth; healthy economic performance; and continued improvement in the state's available reserves. The state's proactive measures to improve the funded status of its retirement systems and OPEB obligations should yield positive results over the long term, although significant increases in OPEB funding could add budget challenges.

## WHAT COULD MAKE THE RATING GO UP

- Continued rebuilding and maintenance of strong reserve levels and restoration and maintenance of structural budget balance
- Reduced economic volatility and sustained job growth

- Sustained reduction in debt ratios and significant improvement in pension funded ratios, sooner than currently projected

#### WHAT COULD MAKE THE RATING GO DOWN

- Economic weakening leading to sustained employment erosion or deterioration of revenue trends leading to budget imbalance, liquidity pressure, and narrowing of financial position
- Return to reliance on non-recurring solutions to balance budget
- Increased debt or debt service ratios relative to other states or deterioration of pension funded ratios below already low levels

The principal methodology used in this general obligation rating was US States Rating Methodology published in April 2013. The additional methodology used in the certificates of participation ratings was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011. Please see the Credit Policy page on [www.moodys.com](http://www.moodys.com) for a copy of these methodologies.

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