MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns Aa2 to approximately $1.1B Hawaii G.O. Bonds of 2014; outlook stable

Global Credit Research - 24 Oct 2014

Approximately $6.0B GO bonds outstanding

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

Moody's Rating

ISSUE		RATING
General Obligation Refunding Bonds of 2014, Series EP		Aa2
Sale Amount	$503,325,000	
Expected Sale Date	11/24/14	
Rating Description	General Obligation	
Taxable General Obligation Bonds of 2014, Series EQ		Aa2
Sale Amount	$25,000,000	
Expected Sale Date	11/24/14	
Rating Description	General Obligation	
General Obligation Bonds of 2014, Series EO		Aa2
Sale Amount	$575,000,000	
Expected Sale Date	11/24/14	
Rating Description	General Obligation	

Moody's Outlook STA(m)

Opinion

NEW YORK, October 24, 2014 --Moody's Investors Service has assigned Aa2 ratings to the State of Hawaii's General Obligation Bonds of 2014, Series EO, Refunding Series EP, and Taxable Series EQ. Proceeds of the Series EO and Taxable Series EQ bonds will be used for statewide capital projects. Proceeds of the Series EP bonds will be used to refund outstanding debt for debt service savings. Following this sale, the state will have approximately $6.0 billion general obligation bonds outstanding. The outlook on the ratings is stable.

SUMMARY RATING RATIONALE

The Aa2 rating incorporates Hawaii's improved financial operations with increasing reserves and healthy, albeit moderating, 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.

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

- Large state and local government employment sector that 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

REVENUES RESUME MODERATE GROWTH IN FISCAL 2015 AFTER STALLING IN 2014

General Fund tax revenue growth was particularly strong in fiscal 2013, 10.0% on a budget basis and 8.2% on a GAAP basis. This growth reflected a continuation of the underlying economic strength which produced strong growth in 2010, 2011, and 2012. But it also reflected some one-time factors including the acceleration by taxpayers of capital gains income into calendar 2012 due to federal tax law changes and delays in processing certain payments related to tax collection makeup for the City and County of Honolulu in late fiscal 2013.

Growth in tax revenues stalled in fiscal 2014. Total General Fund tax revenues dropped 1.8% from 2013. This decline reflected, in part, the one-time factors in fiscal 2013. In addition, a $55.5 million deposit in the Hawaii Hurricane Relief Fund (HHRF) was excluded from General Fund revenues. Nevertheless, recurring tax revenues remained essentially flat. Officials estimate that after adjusting for the makeup payments to Honolulu and the HHRF deposit, total tax revenues declined by 0.2%.

In its September forecast, the Hawaii's Council of Revenues is projecting fiscal 2015 General Fund tax revenues of $5.56 billion. This figure is $186 million less than projected in May and $557 million less than forecast one year earlier. Nevertheless, the current projection would represent a 3.5% increase over 2014. The council is currently projecting revenue growth of 5.5% per year in the out years (2016-2012) of its multi-year forecast period, a more moderate rate than the 5.3% to 7.7% projected in its September 2013 forecast.

BALANCE SHEET IMPROVES AS RESERVES ARE REPLENISHED

Strong reserve levels are important for Hawaii given the state's 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). At the low point, the state reported negative budgetary balances at the end of fiscal years 2009 and 2010. In the prior 2001 recession, the state's available reserves hit a low of about 7.5% operating revenues at the end of fiscal 2003, but were never negative.

As its economy has recovered, Hawaii has rebuilt its balances relatively quickly. Combined available reserves (unassigned General Fund balance plus the EBR) grew to 20.1% of operating revenues at the end of fiscal 2013, up from 11.7% at the end of fiscal 2012 and essentially equal to the pre-recession peak of 21% at the end of fiscal 2006.

While the state expects to continue to rebuild the EBR and the HHRF, it is not clear whether it will be able to maintain total reserves at the 2013 levels. The state currently projects a reduction in the ending fund balance of approximately $180 million in fiscal 2014 and a more modest reduction in total reserves (ending fund balance plus EBR and HHRF) of approximately $14 million. In years 2015 and beyond, the state will have to fund higher labor costs and its increasing OPEB contribution in the context of more moderate revenue growth than it experienced in post-recession years through 2013. The state's most recent forecast shows total reserves declining by $530 million by 2019.

ECONOMY STRENGTHENS WITH STRONG VISITOR TRENDS AND LOW UNEMPLOYMENT

Hawaii's large tourism industry is key to its economy and the state's economic performance closely tracks tourism trends. As a highly desirable tourist destination for international as well as domestic visitors, the tourism industry is somewhat insulated from US economic cycles and has at times been counter-cyclical. The state's employment trends are generally less volatile than in other tourism dependent states such as Florida and Nevada. A sizable military presence adds stability, and military housing construction has contributed to expanding construction activity. Unlike most mainland states, Hawaii did not experience a severe housing market bust during the recession. Hawaii's unemployment rate of 4.1% in August 2014 remains well below the national average as it was throughout the recession.

Although the recent recession was particularly challenging since both national and international visitations were affected at the same time, Hawaii is likely to remain a premier tourism destination over the long term. Visitor data all indicate steady growth in recent years although arrivals did not surpass the pre-recession peak (2007) until 2012. Visitor arrivals increased 1.8% in calendar year 2013, and increased 0.6% in the first eight months of 2014. 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. 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. Thus far, the effects of federal budget cuts and sequestration 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, pension funding levels, and OPEB liabilities. Debt per capita is $4,727 ranking Hawaii third highest among the states and about four times Moody's 50-state median of $1,054. As a percentage of personal income, Hawaii's debt is the highest in the country at 10.6%, compared with the median of 2.6%.

These debt ratios are, in part, attributable to the fact that unlike other states Hawaii is entirely responsible for the capital needs of its K-12 schools. Total state and local government debt ratios suggest that the state's debt is a more manageable burden on the state's economy than suggested by comparison to the state medians. Nevertheless, the state's high levels of direct debt contribute to its high fixed costs. Hawaii's fiscal 2013 debt service ratio (debt service costs relative to total revenue available for debt service) is also high at 11.1%, ranking the state third and well above the median of 5.1%.

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

The state's pension liabilities are well above average contributing to its high fixed costs. Moody's 2012 Adjusted Net Pension Liability (ANPL) for Hawaii was 199.1% of state governmental revenues, the fourth highest of the 50 states and more than three times the median of 63.9%. Hawaii's three-year average ANPL was 155.4% of revenues, also the fourth highest and well above the median of 52.1%.

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 focused on reducing the "spiking" of final compensation. These later changes have 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 to decline significantly for nearly twenty years.

Hawaii's OPEB obligation is also quite sizeable at $13.6 billion as of July 1, 2011, reflecting health benefits for state employees including teachers. 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 more than the required 20% of the state's ARC in fiscal 2015 and the financial plan reflects annual increases in payments. Notably, the state also made a $100 million contribution in fiscal 2014, which is in addition to its planned contributions.

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

- Maintenance of strong reserve levels and 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 rating was US States Rating Methodology published in April 2013. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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