STANDARD & POOR'S
RATINGS SERVICES

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Summary:

Hawaii; Appropriations; General Obligation

Primary Credit Analyst:
Gabriel J Petek, CFA, San Francisco (1) 415-371-5042; gabriel.petek@standardandpoors.com

Secondary Contact:
John A Sugden, New York (1) 212-438-1678; john.sugden@standardandpoors.com

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Credit Profile		
US$635.0 mil GO bnds ser 2013EH due 11/01/2033		
Long Term Rating	AA/Positive	New
US$181.34 mil GO rfdg bnds ser 2013EI-EL due 11/01/2023		
Long Term Rating	AA/Positive	New
US$29.795 mil taxable GO bnds (QSCBs) ser 2013N due 11/01/2033		
Long Term Rating	AA/Positive	New
US$15.0 mil taxable GO bnds ser 2013EM due 11/01/2033		
Long Term Rating	AA/Positive	New
Hawaii GO		
Long Term Rating	AA/Positive	Outlook Revised

Rationale

Standard & Poor's Ratings Services has revised the outlook on all of Hawaii's debt to positive. In addition, we assigned our 'AA' long-term rating to the state's following planned bond issues:

- $635 million series 2013 EH general obligation (GO) bonds;
- $181.3 million series 2013 EI, EJ, EK, and EL GO refunding bonds;
- $15 million series 2013 EM taxable GO bonds; and
- $29.8 million taxable qualified school construction GO bonds (QSCBs).

At the same time, we affirmed our 'AA' long-term rating and underlying rating (SPUR) on Hawaii's GO bonds and our 'AA-' long-term rating on the state's certificates of participation (COPs).

Starting from a relatively strong fiscal position in our view, Governor of Hawaii, Neil Abercrombie's administration and the legislature have opted to prioritize shoring up state finances and to begin confronting its long-term liabilities. We recognize that, with the highest ending balance since before the recession, Hawaii had a range of policy objectives that lawmakers could have pursued. We believe that by choosing to recapitalize its rainy day reserves and initiate the process of reining in its retiree liabilities, the state has laid the groundwork for its credit quality to strengthen.

We have previously cited the state's large unfunded liabilities as a limiting rating factor. But now the state has turned to tackling its pension and other postemployment benefit (OPEB) liabilities as well. Recently enacted legislation initiates, in fiscal 2015, an upwardly trending contribution glide path so that, by fiscal 2019, the state's annual funding would match the annual required contribution (ARC). The state kick started its contributions with a $100 million appropriation in fiscal 2014, earlier than required by statute, to prefund its OPEB liability. The state has also enacted pension reforms with measures that, when taken together, have the effect of accelerating the projected full amortization of the state's unfunded accrued actuarial liability (UAAL) to 30 years from over 40 years. Estimates of the

state's long-term liabilities are likely to improve only gradually. But once the improving trajectory is established, assuming the state follows through on implementing the reforms, its credit quality could strengthen prior to the changes being fully reflected in the state's various liability ratios. In our view, state policy and lawmakers' commitment to the reforms -- including if they adhere to them in the next biennial budget -- will signal whether the state's credit quality could potentially strengthen.

The 'AA' GO rating reflects our view of:

- The state's strong financial position, which weathered several major economic stressors during the past 10 years -- including the Great Recession;
- Strong liquidity, particularly when including pooled cash balances available to the general fund for temporary interfund borrowing;
- Management's well-established, proactive budget monitoring practices, including frequent revenue forecast updates from the independent Council on Revenues (COR), which facilitates prompt identification of potential budget adjustments for budget alignment;
- The governor's executive authority to restrict all executive branch expenditures through such actions as cutting spending midyear without legislative approval or cutting or delaying education disbursements during the course of a fiscal year; and
- Other strong constitutional protections, including requiring budget balance, that allow for tax increases with legislative approval and give GO bonds first-lien priority before all other disbursements.

Partly offsetting the above strengths is our view of:

- The low-funded status of the state's retirement system and generally higher-than-average debt ratios because of the state's centralized provision of public sector services;
- Large, nearly unfunded OPEB liability despite new statutory requirement to increase annual contributions until fiscal 2019, when they would equal the actuarially recommended level; and
- A relatively high level of federal funding in the state budget, which has historically been a stable source revenue, but, in the face of federal sequestration and recent federal shutdown, presents a source of fiscal risk.

All GO bonds are secured by Hawaii's full faith and credit, which the state considers the highest priority in payment according to its constitution. None of the refunding bonds include lengthier maturity dates relative to the existing debt to be refunded.

Hawaii ended fiscal year 2013 in a strong position, with general fund revenues outpacing expenditures by $568.8 million, resulting in an ending balance of $844 million, which equals 14.9% of expenditures. The state's September 2013 COR forecast projected general fund tax revenue growth in fiscal year 2014 of 4.1% followed by greater than 7% growth in each of the two subsequent years. The longer-term forecast is also favorable, with the COR projecting annual general fund tax revenue growth of no less than 5.3% through fiscal 2020 (after 2014). Some of the future growth rates are of the state's making. For example, the legislature passed an adjustment to the state's transient accommodation tax (TAT), preserving the current rate of 9.25%, which previously was scheduled to decline by 2% in fiscal 2016. The legislature also capped the amount of TAT revenue distributed to local governments. Both of these permanent changes boost the state's future year revenue forecast projections, allowing for future-year Emergency Budget Reserve Fund (EBRF) contributions.

In addition to the favorable forecasts, actual revenues have outperformed the COR's projections in recent years. For example, in September 2012, the COR projected that general fund revenues would increase 4.9% in fiscal 2013. Actual tax collections grew by 9.9%.

Despite its favorable fiscal direction, the state's economic reliance on the leisure and hospitality sector (tourism) has traditionally been a constraining rating factor. We have previously regarded a dependence on tourism as an area of economic vulnerability because of the sector's susceptibility to downturns in consumer confidence given that it is an inherently discretionary activity. But some nuance is also warranted, in our view. First, even in the face of numerous global potentially disruptive events (i.e., the Sept. 11 attack, SARS, and the Japan earthquake and tsunami) the state's tourism industry has proven relatively resilient. Dating to 1995, the state's average annual hotel occupancy rates have fallen below 70% just three times and under 65% just once (they dipped to 64.8% in 2009 in the wake of the Great Recession). According to data from the Hawaii Tourism Authority, the largest year-over-year decline in visitor arrivals since 1932 was about 10% in 2008. Even then, at the nadir of the recession, the state was able to maintain a combined ending balance and rainy day reserves of $211.6 million, or 3.9% of budget expenditures. Second, the origination of visitors to the state has diversified. In 2008, 69% of visitors were from the U.S. mainland. More recently, however, during the12 months ending in July, the share of visitors originating from the U.S. mainland had declined to 64.4%. As a share of the total, U.S. mainlanders were replaced by visitors from South Korea, China, and Australia. (In absolute terms, visitors from all destinations increased.) Finally, the state has become less economically dependent on tourism than popularly perceived. According to estimates devised by the state, as of 2013, around 18% of the state's GDP is linked to tourism, down from 33% in 1988.

Federal government employment also plays a relatively outsized role in Hawaii's economy. All four branches of the U.S. military have military base presence, and the state has more than 50% of the Defense Department's global command activity. The latter point reflects that the Defense Department has been implementing a longer-term rebalancing of its strategic focus to the Asia-Pacific region, with key elements of its assets located in Hawaii. One result is that, as of 2012, total active military personnel in Hawaii reached a historic high, at more than 49,000. The effects of federal sequestration, therefore, are significantly offset by the military's broader rebalancing and consolidation of operations in the Asia-Pacific region and, specifically, in Hawaii.

That said, although federal spending has historically served as a stabilizing source of spending in the economy, we don't take it for granted. The state reports that federal government spending accounted for 15.3% of state GDP in 2013, much of it military-related. Its strategic advantages notwithstanding, we view Hawaii as economically exposed to potential contraction if the recent federal government shutdown and federal fiscal consolidation efforts result in a sharp reduction in federal spending.

Apart from these structural economic characteristics, the state's economy is in the midst of a slow expansion, in our view. Total nonfarm employment trends have leveled off somewhat after posting a relatively healthy 2.1% increase in 2012, which was faster than the 1.42% increase seen nationally. The state's annualized unemployment rate has fallen for four consecutive years (to 5.8% in 2012) and, as of August 2013, it is even lower, at 4.2%. However, year over year since August 2012, the state has only added 2,300 jobs, for a 0.38% increase, which lags the 1.64% increase for the nation. Examining the total nonfarm payroll trends belies somewhat better private sector job creation. Through

August, total private sector jobs have increased 2.3%, or by 11,000. But in the same period, government employment (all levels) has fallen 6.7%, or by 8,700 jobs. Federal employment in Hawaii has been slightly less negative, down 3.7%. However, most of the federal job losses materialized in July and August. In our view, this suggests that, despite the state's strategic location vis-à-vis the U.S. Defense Department's global strategy shift, Hawaii is not immune to cutbacks or the effects of sequestration. It also contributes to our view that the state's economic growth in the ensuing years is likely to be somewhat subdued.

In its 2013-2015 biennial budget, Hawaii's general fund expenditures are projected to grow by 12.9% and 9.7% in fiscal 2014 and 2015, respectively. The rate of expenditure growth marks a sharp acceleration from the 2.8% increase in fiscal 2013. But it's not an embrace of profligate fiscal policy. On the contrary, a significant portion of the spending increases reflect the state's appropriation of $211 million in rainy day and hurricane relief funds recapitalization, a $100 million down payment on prefunding its OPEB annual required contribution, $295 million in pay-as-you-go capital financing, and about $105 million in higher Medicaid spending. The latter of these reflects that the state is expanding its Medicaid program as envisioned under the federal Affordable Care Act (ACA). While the expansion will drive up state expenditures during the biennium, it covers 70,430 additional enrollees and leverages additional federal funds. For fiscal 2014, the state budget assumes a general fund ending balance of $698.1 million, equal to 11% of expenditures. Including reserves held in the Hawaii Hurricane Relief Fund (HHRF; ($126.3 million) and EBRF ($81.7 million), the state's total reserves will reach $906.1 million, or 14.2% of expenditures, which is strong in our view. The HHRF has traditionally functioned as a secondary budgetary reserve for the state. Additional fiscal capacity also resides in the fact that the state could revert to funding its planned capital spending with long-term bonds instead of cash.

Although Hawaii's debt burden of $5.1 billion of tax supported state GO, COP, and highway (gas tax) debt is high in our view, translating to $4,306 per capita, it reflects the centralized nature of state and local government in Hawaii. Compared to other states, Hawaii's debt level stands out as high in part because, in Hawaii, the state assumes numerous functions that are performed at the local level in other states.

Based on the analytic factors we evaluate for states, we have assigned Hawaii a composite score of '1.9' on a four-point scale in which '1' is strongest.

Outlook

Due in large part to the state's current and projected fiscal position, as well as its recently formalized commitment to addressing its retirement liabilities, we see Hawaii's credit quality poised to strengthen. Specifically, we believe there is at least a one-in-three chance that we will raise the state's rating within the next two years. The state's liability management and fiscal performance will be among the keys to our ongoing evaluation. The state's adherence to new legislation requiring escalating annual OPEB contributions and its plan to increase its reserves will be important indicators of the state's follow-through on both fronts. In addition, we expect that the state's credit quality will only strengthen if it can accomplish its objectives while maintaining a balanced budget structure. As with other states, much of the above is likely to hinge on the economy -- both nationally and within the state -- and revenue performance.

The current federal continuing resolution and debt limit deliberations create significant uncertainty to the state and national economic forecast, in our view, and could create weaker credit conditions for the sector if there is a protracted breakdown in negotiations among federal policymakers. We will continue to monitor developments in this area as it relates to state revenues and overall budget balance. We could potentially revise the outlook to stable in the event of a sharp pullback in federal spending. The threat posed by the potential for a sharp pullback in federal spending is greater for Hawaii than it is for many states because of the larger relative role the federal government plays in the state's economy.

Related Criteria And Research

- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Appropriation-Backed Obligations, June 13, 2007
- U.S. State And Local Government Credit Conditions Forecast, Oct. 1, 2013

Ratings Detail (As Of October 9, 2013)		
Hawaii rfdg GO bnds ser 2008DL & ser 2009DS		
Long Term Rating	AA/Positive	Outlook Revised
Hawaii COPs ser 2009A		
Long Term Rating	AA-/Positive	Outlook Revised
Hawaii GO bnds ser 1992BZ		
Unenhanced Rating	AA(SPUR)/Positive	Outlook Revised
Hawaii GO bnds ser 2012EE due 11/01/2032		
Long Term Rating	AA/Positive	Outlook Revised
Hawaii GO rfdg bnds ser 2012EF due 11/01/2024		
Long Term Rating	AA/Positive	Outlook Revised
Hawaii GO (wrap of insured) (AMBAC & AGM) (SEC MKT)		
Unenhanced Rating	AA(SPUR)/Positive	Outlook Revised
Hawaii GO (wrap of insured) (FGIC & AGM) (SEC MKT)		
Unenhanced Rating	AA(SPUR)/Positive	Outlook Revised
Hawaii GO (MBIA) (National)		
Unenhanced Rating	AA(SPUR)/Positive	Outlook Revised
Hawaii GO (MBIA) (National) & (AGM)		
Unenhanced Rating	AA(SPUR)/Positive	Outlook Revised
Hawaii Taxable GO bnds ser 2008DM		
Long Term Rating	AA/Positive	Outlook Revised
Hawaii Tax Exempt GO		
Long Term Rating	AA/Positive	Outlook Revised
Hawaii GO		
Unenhanced Rating	AA(SPUR)/Positive	Outlook Revised

Many issues are enhanced by bond insurance.

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