State of Hawaii

New Issue Report

Ratings

Long-Term Issuer Default Rating	AA

New Issues

$648,500,000 General Obligation Bonds of 2018, Series FT	AA
$50,000,000 Taxable General Obligation Bonds of 2018, Series FU	AA
$76,500,000 Taxable General Obligation Bonds of 2018, Series FV	AA

Outstanding Debt

General Obligation Bonds	AA
Certificates of Participation	AA–

Rating Outlook

Positive

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New Issue Summary

Sale Date: Week of Jan. 29

Series: General Obligation Bonds of 2018, Series FT; Taxable General Obligation Bonds of 2018, Series FU, FV.

Purpose: To fund various capital improvements

Security: Full faith and credit of the state

Analytical Conclusion

The state's 'AA' Issuer Default Rating (IDR) and GO rating reflect a history of strong revenue growth and rising reserves, as well as a resilient economy. The 'AA–' certificates of participation rating is one notch below the state's IDR, consistent with Fitch Ratings' approach to rating appropriation-backed debt. The Positive Rating Outlook reflects ongoing improvements in the state's management of its substantial long-term liabilities and Fitch's expectation that the state will maintain its existing strong financial flexibility as it continues to implement pension and OPEB reforms.

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 are 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 between 2006 and 2016, and personal income levels are above average on a nominal basis, although below average in real terms as a result of the state's high cost of living.

Key Rating Drivers

Revenue Framework: 'aaa'
General excise taxes (GET) 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 just below U.S. GDP but well above inflation over the past 10 years. Prospects for ongoing revenue gains appear strong based on the state's resilient economy and further population growth. The state has full control over its revenues with no legal limits on potential increases.

Expenditure Framework: 'aa'
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 absent offsetting policy action. Carrying costs for debt service and retiree benefits are somewhat elevated but are expected to remain manageable.

Long-Term Liability Burden: 'aa'
Long-term liabilities for debt service and retiree benefits are above the median for U.S. states but remain moderate relative to personal income. These totals include liabilities for the state's public schools, which are accounted for as local government obligations 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.

Rating History (IDR)

Rating	Action	Outlook/ Watch	Date
AA	Affirmed	Positive	1/22/18
AA	Affirmed	Positive	4/28/17
AA	Downgraded	Stable	6/15/11
AA+	Revised	Negative	4/5/10
AA	Affirmed	Negative	6/3/09
AA	Affirmed	Stable	4/13/06
AA	Upgraded	—	2/16/06
AA–	Assigned	—	10/29/98

Operating Performance: 'aaa'

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 multiyear financial plans that provide input for policy adjustments as required.

Rating Sensitivities

Maintained Financial Flexibility: The rating is sensitive to overall fiscal and operating performance, particularly in light of ongoing expenditure increases from recent pension and OPEB reforms. Deterioration in the state's operating performance could result in a revision of the Rating Outlook to Stable from Positive, while continued strong operating performance accompanied by the implementation of recent reforms would be a positive credit factor. Fitch expects that the state's efforts to maintain budgetary balance, particularly as expressed in the 2019–2021 biennium budget, will inform future rating actions.

Credit Profile

Hawaii's economic performance has been strong in recent years with steady growth in tourism and a continued substantial military presence. Tourism 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 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 about 45% of general fund revenues. Policy-adjusted performance for all general fund revenues has been strong historically, exceeding inflation but slightly below overall U.S. economic performance.

Fitch expects Hawaii's revenue growth, absent policy actions, generally to increase in line with GDP based on the state's resilient economy and population growth. While revenue gains may be affected by periodic economic shocks, strong 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 governmental fund expenditures. Elementary, secondary and higher education comprised approximately 34% of general fund expenditures in fiscal 2017. Health and welfare spending combined for 38% of governmental expenditures.

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 growth in spending for retiree benefits, education and healthcare, in particular, but ongoing revenue gains are likely to keep pace with expenditure increases.

Rising costs for Medicaid, in particular, may pressure future operating budgets. The fiscal challenge of Medicaid is common to all U.S. states, and the nature of the program as well as federal government rules limits the states' options in managing the pace of spending growth.

Related Research

Fitch Rates Hawaii's $775MM GO Bonds 'AA'; Outlook Remains Positive (January 2018)

Related Criteria

U.S. Public Finance Tax-Supported Rating Criteria (May 2017)

Federal action to revise Medicaid's programmatic and financial structure remains a possibility given recent federal legislative and administrative efforts. Most proposals to date include a basic restructuring of federal Medicaid funding to a capped amount. Whether a change in Medicaid funding has consequences for Fitch's assessment of a state's credit quality would depend on the state's fiscal response to those changes. Responses that create long-term structural deficits or increased liability burdens could negatively affect both the expenditure framework assessment and the IDR.

The state has a strong track record of expenditure reductions despite the large share of its budget devoted to education and health and human services. General fund spending fell by approximately 14% during fiscal years 2010 and 2011, largely due to employee furloughs and executive department spending restrictions, in response to reduced revenues. Looking ahead, the state's substantial expenses for debt service and retiree benefits could present a greater challenge for expenditure flexibility. Carrying costs for these items accounted for 16% of governmental funds expenditures in fiscal 2017, among the highest shares for states. Recent efforts to increase OPEB funding to full actuarial levels and to implement more conservative pension assumptions appear likely to increase this ratio further, and Fitch expects carrying costs to remain high relative to other states.

Long-Term Liability Burden

Long-term liabilities for debt and pensions are elevated but still moderate at 18.8% of personal income as of fiscal 2017, more than three times the median for states, as reported in Fitch's 2017 State Pension Update. This ratio excludes the net pension liability attributed to the University of Hawaii and appears to be on an upward trajectory in the short-term based on more conservative assumptions included in recent actuarial valuations. Long-term liabilities include debt on behalf of the state's elementary and secondary schools, which represents about 40% of total debt. Amortization is fairly rapid, with 63% of outstanding principal due for repayment within 10 years.

The state reported a low 51% ratio of assets to liabilities in its pension plan as of fiscal 2017 based on actuarial results through June 30, 2016 and an assumption of 7% investment returns. Under an assumption of 6% returns, Fitch estimates a 45% ratio of assets to liabilities for the system. Contribution rates are determined by statute and adjusted periodically if the actuarial funding period exceeds 30 years. The state increased contribution rates in in 2012 and again in 2017, and has consistently budgeted for its full statutory contribution.

Substantial pension reforms were approved by the state legislature in 2011, and included lower benefit levels for new hires and provisions to discourage pension spiking, in addition to higher contribution rates. In addition, the state's pension system has reduced investment return assumptions by 0.75% since 2014. Fitch expects these changes to continue to increase both pension system assets and reported liabilities over the next several years. The state pension system projects modest annual improvements in reported funded ratios leading to full funding by 2043, but this outcome relies on a variety of assumptions regarding investment returns, retiree mortality, and other actuarial factors that have been subject to periodic revision in recent years. Nonetheless, Fitch anticipates ongoing improvements in the state's pension funding based on increased contribution rates and reduced benefits for new employees.

The state has also made notable progress in funding OPEBs, moving from pay-as-you-go to nearly full funding of the actuarially determined annual required contribution within the span of several years. Legislation adopted in 2013 established a schedule for full funding by 2019 and the state has made steady progress toward this target.

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. For details, see Scenario Analysis, page 5.

The state has made key improvements to financial flexibility in the wake of the great 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 $311 million (4.4% of prior year revenues) in 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 $182.5 million in its Hawaii Hurricane Relief Fund, which has functioned as an additional reserve in times of economic stress.

Recent Budgetary Performance

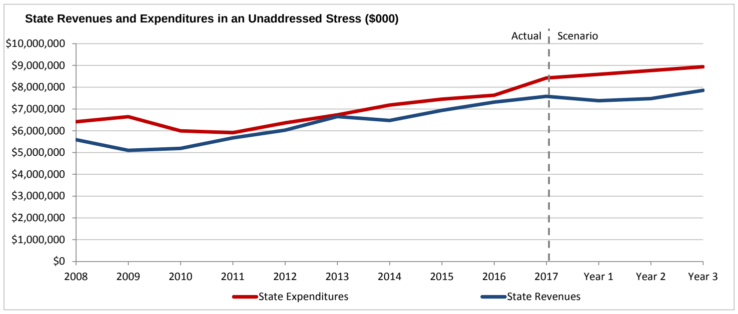
The state reported a small general fund deficit for fiscal 2017 based primarily on slower than anticipated revenue growth. Management reported an ending fund balance for the year on a budgetary basis of 12% of general fund revenues, as compared to 14.5% in 2016. The state currently projects that expenditures may exceed revenues in fiscal 2018 through 2023 based on recent increases in funding for retiree benefits and collective bargaining increases. The executive supplemental budget for 2019 calls for limited increases in general fund appropriations in response to these challenges. Potential federal budget changes and other policy actions that could affect state finances add to uncertainty about these projections. Fitch expects the state to address such challenges as they arise and to maintain its strong financial flexibility.

Hawaii, State of (HI)

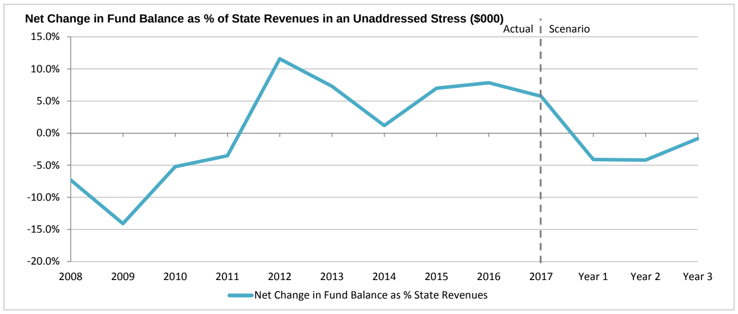
Scenario Analysis

v. 2.0 2017/04/14

State Revenues and Expenditures in an Unaddressed Stress ($000)



Net Change in Fund Balance as % of State Revenues in an Unaddressed Stress ($000)



Analyst Interpretation of Scenario Results:

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 2.6%. Combined general fund balances and reserves, which Fitch estimates at 19% of general fund revenues in fiscal 2017, provide a considerable cushion against revenue declines expected in a moderate recession.

Scenario Parameters:	Year 1	Year 2	Year 3
GDP Assumption (% Change)	(1.0%)	0.5%	2.0%
Expenditure Assumption (% Change)	2.0%	2.0%	2.0%
Revenue Output (% Change)	(2.6%)	1.3%	5.1%

Revenues, Expenditures, and Net Change in Fund Balance	Actuals										Scenario Output		
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Year 1	Year 2	Year 3
Expenditures													
Total Expenditures	8,220,571	8,737,426	8,429,715	8,476,625	8,600,890	9,103,240	9,829,887	10,254,158	10,628,399	11,362,828	11,590,085	11,821,886	12,058,324
% Change in Total Expenditures	4.2%	6.3%	(3.5%)	0.6%	1.5%	5.8%	8.0%	4.3%	3.6%	6.9%	2.0%	2.0%	2.0%
State Expenditures	6,413,195	6,647,368	5,997,346	5,909,359	6,362,251	6,730,760	7,179,011	7,450,169	7,632,631	8,424,271	8,592,756	8,764,612	8,939,904
% Change in State Expenditures	4.1%	3.7%	(9.8%)	(1.5%)	7.7%	5.8%	6.7%	3.8%	2.4%	10.4%	2.0%	2.0%	2.0%
Revenues													
Total Revenues	7,396,658	7,193,308	7,623,018	8,239,489	8,264,770	9,024,984	9,125,004	9,737,152	10,309,851	10,516,019	10,379,292	10,532,989	10,976,144
% Change in Total Revenues	1.7%	(2.7%)	6.0%	8.1%	0.3%	9.2%	1.1%	6.7%	5.9%	2.0%	(1.3%)	1.5%	4.2%
Federal Revenues	1,807,376	2,090,058	2,432,369	2,567,266	2,238,639	2,372,480	2,650,876	2,803,989	2,995,768	2,938,557	2,997,328	3,057,275	3,118,420
% Change in Federal Revenues	4.6%	15.6%	16.4%	5.5%	(12.8%)	6.0%	11.7%	5.8%	6.8%	(1.9%)	2.0%	2.0%	2.0%
State Revenues	5,589,282	5,103,250	5,190,649	5,672,223	6,026,131	6,652,504	6,474,128	6,933,163	7,314,083	7,577,462	7,381,963	7,475,714	7,857,723
% Change in State Revenues	0.9%	(8.7%)	1.7%	9.3%	6.2%	10.4%	(2.7%)	7.1%	5.5%	3.6%	(2.6%)	1.3%	5.1%
Excess of Revenues Over Expenditures	(823,913)	(1,544,118)	(806,697)	(237,136)	(336,120)	(78,256)	(704,883)	(517,006)	(318,548)	(846,809)	(1,210,793)	(1,288,897)	(1,082,180)
Total Other Financing Sources	416,177	825,071	535,189	37,889	1,034,507	563,476	781,465	1,001,870	906,013	1,282,607	907,086	975,808	1,014,677
Net Change in Fund Balance	-407,736	-719,047	-271,508	-199,247	698,387	485,220	76,582	484,864	574,165	435,798	-303,707	-313,089	-67,503
% Total Expenditures	(5.0%)	(8.2%)	(3.2%)	(2.4%)	8.1%	5.3%	0.8%	4.7%	5.4%	3.8%	(2.6%)	(2.6%)	(0.6%)
% State Expenditures	(6.4%)	(10.8%)	(4.5%)	(3.4%)	11.0%	7.2%	1.1%	6.5%	7.5%	5.2%	(3.5%)	(3.6%)	(0.8%)
% Total Revenues	(5.5%)	(10.0%)	(3.6%)	(2.4%)	8.5%	5.4%	0.8%	5.0%	5.6%	4.1%	(2.9%)	(3.0%)	(0.6%)
% State Revenues	(7.3%)	(14.1%)	(5.2%)	(3.5%)	11.6%	7.3%	1.2%	7.0%	7.9%	5.8%	(4.1%)	(4.2%)	(0.9%)

Notes: Scenario analysis represents an unaddressed stress on issuer finances. Fitch's downturn scenario assumes a -1.0% GDP decline in the first year, followed by 0.5% and 2.0% GDP growth in Years 2 and 3, respectively. Expenditures are assumed to grow at a 2.0% rate of inflation. For further details, please see Fitch's US Tax-Supported Rating Criteria.

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.