S&P Global Ratings

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Summary:

Hawaii; Appropriations; General Obligation

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Credit Profile		
US$755.0 mil go bnds of 2018 ser FT due 01/01/2038		
Long Term Rating	AA+/Stable	New
US$50.0 mil Taxable go bnds of 2018 ser FU due 01/01/2020		
Long Term Rating	AA+/Stable	New
Hawaii GO		
Long Term Rating	AA+/Stable	Affirmed

Rationale

S&P Global Ratings assigned its 'AA+' long-term rating to the following planned general obligation (GO) bond issues belonging to Hawaii:

- $775 million series 2018 FT GO bonds, and
- $50 million series 2018 FU taxable GO bonds.

At the same time, we affirmed our 'AA+' long-term rating and underlying rating (SPUR) on Hawaii's outstanding GO bonds, and our 'AA' long-term rating on the state's certificates of participation (COPs). The outlook on all the state's debt ratings is stable.

The 'AA+' GO rating reflects our view of:

- The state's strong financial position, which has weathered several major economic stressors during the past 15 years;
- Strong liquidity, particularly when including pooled cash balances available to the general fund for temporary interfund borrowing;
- The prioritizing of contributions to the retiree health care benefits system, resulting in lower actuarial estimates for the state's long-term liability;
- 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 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:

- Hawaii's inherent susceptibility to exogenous shocks that have the potential to hurt its tourism sector, which accounts for 17% of state GDP;

- The weak 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; and
- Large, other postemployment benefit (OPEB) liability, although a 2013 statutory requirement increases annual contributions until fiscal 2019, by which time contributions would equal the actuarially recommended level.

The proceeds from the series FT and FU bonds will be used to finance expenditures for appropriated public purposes and the costs of various public improvement projects. All GO bonds are secured by Hawaii's full faith and credit, which the state considers as its highest payment priority, according to its constitution. In 2017, the state entered into a privately placed loan bond-purchase contract with Bank of America to refinance some outstanding GO bonds for interest cost savings. The bonds are secured by the state's GO pledge and are subject to the same covenants as the rated GO bonds. The state will make debt payments through 2033 totaling $293.2 million plus interest payments. While the debt was privately placed, we view the events of default as standard and the new contract does not pose additional risks to the state's liquidity.

After having used a significant portion of its emergency budget reserve fund (EBRF) and Hawaii Hurricane Relief Fund (HHRF, or rainy day reserves) during and after the Great Recession, Hawaii has rebuilt these balances and began 2017 in a strong position. On a combined basis, its fiscal 2016 general fund ending balance ($1.1 billion), together with its EBRF ($100.9 million), equaled 16.4% of general fund expenditures. The state also has reserved funds in its HHRF ($186.4 million), which equaled an additional 2.7% of general fund expenditures. The state has accumulated these balances in recent years by maintaining conservative fiscal practices even as the economy has continued to expand. Chief among these are budgetary controls, including the governor's requirement that agencies restrict 5% of budget appropriations. This practice has given rise to larger-than-budgeted spending lapses, which have resulted in a larger ending balance than anticipated. In fiscal 2016, for example, there was $149.1 million in lapsed spending versus the $80 million assumed in the enacted budget.

For fiscal 2017, slower revenue growth contributes to the state's estimated $134 million (3% of expenditures) deficit on budgetary basis. However, the expected deficit stems from the state's scheduled prefunding of its retiree health care benefits liability and further capitalizing its EBRF. The state projects to end the year with combined reserves of $832 million, or 10% of expenditures. The operating results incorporate lower-than-expected revenue estimates from the COR for fiscal 2017, revising growth from 5.5% in January 2017 and 2.5% in March to 2% by September 2017, based on year-to-date collections. The state, however, believes that revenue collections have met expectations in fiscal 2017, but the COR analysis does not take into account certain one-time adjustments made to general excise tax (GET) collection in the current year, thereby underestimating collections. The GET is the leading revenue source comprising about 52% of general fund revenue. The COR forecast shows revised revenue growth for fiscal 2018 of 5% from 4% and for fiscal 2019 to 4% from 4.4% in prior reports. Likewise, the multiyear forecast shows that in fiscal 2018, the state's operating position would show deficits of $95.2 million and $21.9 million for fiscal years 2017 and 2018, respectively. At the end of fiscal 2018, Hawaii's general fund would have almost $743 million in combined reserves, equal to 10% of expenditures, which we view as strong. Similar to recent forecasts, the COR continues to anticipate slowing economic growth. Consistent with this, the COR slightly increased its annual revenue growth projection for fiscal years 2020 through 2023 to 4.3% from 4.0% in September while lowering annual growth through 2023 from 4.5% to 4.0%. We believe, however, that the state has positioned itself to accommodate the somewhat slower economic and revenue growth anticipated in its multiyear general fund forecast and the governor will continue its practice of using budget controls to manage its discretionary operations and maintain its finances. The state's multiyear general fund forecast illustrates that even in the context of more gradual growth, the state's fiscal capacity could enable it to make continued progress toward more fully funding its large pension and other long-term obligations while maintaining strong budgetary reserves. At the end of fiscal 2023, Hawaii's general fund is projected have about $564 million in combined reserves, equal to 6.3% of expenditures, which we view as strong. An outright recession, as opposed to just slower growth, however, would likely test the state's capacity to sustain a weaker revenue environment while adhering to its current multiyear fiscal plan.

As an island-economy state, Hawaii is inherently vulnerable to the negative effects of certain types of exogenous shock-events. Certain broad economic metrics, moreover, suggest a more resilient economy than popularly perceived. For instance, although Hawaii was not immune to the Great Recession, relative to the nation, per capita personal income in the state actually increased to 105% in 2009 from 101% in 2007. A strong U.S. dollar and flagging U.S. consumer confidence since 2015 have weighed on the pace of improvement in the various trends throughout the tourism industry. Some of the strongest gains occurred from 2011 through 2013, with more incremental improvement since then. Relative to the U.S. as a whole, personal income in Hawaii reversed trends and then improved slightly in 2016, to 102% (from 101% in 2015) after years of decline from its peak level in 2009. Growth of Hawaii's GDP, the broadest measure of its economy, suggests that the state remains stuck in a slow-growth mode as it has expanded more slowly than national GDP over the last ten years. Nevertheless, the economy has proved relatively resilient to exogenous shocks (e.g., the Sept. 11 terrorist attacks, the SARS epidemic). Still, we view Hawaii's economy as having some unique vulnerability to unanticipated shocks originating from external events.

Notwithstanding the longer term expectation of more subdued economic growth, Hawaii's financial position has benefited from a strengthening tourism industry, which in 2016 enjoyed a fifth consecutive year of record-setting visitor arrivals. Those numbers are on track to reach a new record again in 2017 with a projected 4.6% increase from 2016. Total visitor expenditures in 2016 increased 4.2% from 2015 and are projected to rise 6.7% in 2017, having grown by 39% since 2011. Revenue per available room was up by 4.7% in 2016, and the state projects similar growth for 2017, at which point revenue will have grown by 51% since 2011. These trends, along with consistently high occupancy rates, suggest the state's key industry, leisure and hospitality (which makes up 18.3% of its employment base versus 10.8% for the nation), is currently healthy. Contributing to the strength of the tourism industry is the diversity of international travelers, mainly from high-income economies which somewhat insulates the island from national contracting trends in disposable income. While a majority of 2017 visitor arrivals were recorded from the contiguous U.S. (63%), significant percentages were from Japan (17.1%), Canada (5.5%), and Australia (3.5%). We expect the recent certification of Kona Airport as the state's second international airport to boost international tourism further. Hawaiian and Japanese airlines started non-stop flights to Kona in December 2016 and September 2017, respectively, contributing to the increase in visitors in the last 12 months. In our view, strength in the tourism sector has contributed to pushing down Hawaii's unemployment rate to 3.02% for 2016, well below 4.5%, which the state's economist considers to be Hawaii's natural jobless rate.

Conversely, a strong U.S. dollar, especially vis-à-vis the Japanese yen, can be a source of drag on Hawaii's economy, given that visitors from Japan make up an increasing proportion of international arrivals. The state's tourist base is diversifying, however, with arrivals from Canada having almost doubled since 2006. Likewise, visitors from China have increased about three-fold in the last ten years. However, we see potential for some softening ahead when it comes to tourists from Canada and China (who made up 1.7% of 2017 visitors). Both countries, which have entered weaker economic patches, still represented a combined and relatively minor 7.2% of total arrivals in 2017.

Hawaii's economy is also subject to changes in federal spending. The federal government accounted for 24.9% of state GDP in 2015, according to the Council of State Governments' most recently available data. The state was the seventh largest in per capita federal spending in 2016. More than half of federal spending in the state is military related, making Hawaii's economy susceptible to cutbacks under the federal Budget Control Act of 2011 (BCA). Most significantly, the BCA's sequestration has translated to $400 million in reduced military contracts being awarded in Hawaii ($2 billion compared to $2.4 billion). The effects of the cutbacks emerged in 2015, when the number of military personnel fell by 8.4% to 46,764 following a record level of personnel in 2014. Still, the 2015 level of military personnel based in Hawaii remained higher than in all but three years since 1960, contributing over 6% to the state's GDP. The incomes of these personnel and households have a stabilizing influence on the rest of the state economy, in our view.

The state's real estate market is stable, with low foreclosure rates (just 0.01% in Honolulu, which is 70% of Hawaii's market) and generally rising home prices. However, a chronic shortage of housing relative to demand keeps upward pressure on home prices throughout the state and poses a threat to its longer term economic growth prospects. Whereas Hawaii saw roughly 6,000 new housing units per year constructed throughout the 1980s, the number has fallen to approximately 2,000 to 3,000 in recent years. Upward pressure on home prices is likely to persist given that Hawaii estimates there is demand for 6,500 new units per year, leading to a current annual statewide deficit of 7,000 units. In our view, construction trends in the 1980s likely reflected unsustainably strong demand from Japanese investors at that time. We note, however, that the construction sector remains stronger than the rest of the nation and has expanded, albeit slowly, in recent years, rising above its prerecession peak in 2016 before declining slightly in 2017. State officials attribute the more recent slower construction trends to increased environmental, zoning, and permitting process rules.

Although Hawaii's debt burden of $6.9 billion of tax-supported state GO, COP, and highway (gas tax) debt is high, in our view, translating to $4,815 per capita (based on the estimated 2016 population), it reflects the centralized nature of state and local government in Hawaii. Hawaii's debt level stands out as high relative to other states' in part because it assumes numerous functions that are performed at the local level elsewhere. The above-average fixed costs for debt and retiree benefits liabilities is somewhat offset by Hawaii's below-average Medicaid-related expenditures.

We consider the state's three-year average pension funded ratio weak at 59%. The plans reported what we still consider a weaker pension actuarial market funded ratio of 51.3% as of June 30, 2016, stemming from weaker-than-average investment returns and more conservative actuarial assumptions. Estimates from the state, however, suggest higher funding levels in 2017 given the fund's strong 13.7% investment returns in the past year. The funding level decreased steadily through 2016 from a high of more than 95% in fiscal 2000. The ERS board elected to change its actuarial assumed rate of return to 7% from 7.65% and revised its mortality expectations to better reflect long-term market expectations in light of recent experience study concerns. Although such changes put additional negative pressure on the system's funded ratio, it reflects a more conservative orientation with regard to managing long-term pension liabilities. Notably, the state passed legislative bill 936 in the 2017 legislative session to restore the Employees' Retirement System (ERS) to full funding within the statutorily required 30-year timeframe by phasing in higher systemwide contribution rates through 2021. The bill requires contribution rates to increase from the current 17% to 24% by fiscal 2021 for the general plan and a more aggressive increase from the current 25% to 41% by fiscal 2021 for police and fire. In our opinion, the successful implementation of the higher contribution rate is vital to the state's long-term financial capacity and is essential to maintain its credit quality. Pension costs as a percentage of budgetary general fund expenditures is estimated at 10.3% for fiscal 2017 and is expected to increase to about 11.3% in 2018 as a result of higher contribution rates. Based on S&P Global Ratings' calculated estimates, we anticipate that pension costs could rise to about 13.5% by fiscal 2021. To the extent that the implementation of increased contribution rates leads to significant strain on future budgets operations or reserves, we could view this indication of weakening financial capacity.

Based on the analytic factors we evaluate for states, we have assigned Hawaii a composite score of '1.8' on a four-point scale in which '1' is strongest.

For more information on the state's general credit characteristics, please see the most recent full analysis on Hawaii's GO debt, published April 28, 2017, on RatingsDirect.

Outlook

We have assigned a stable outlook to Hawaii's ratings considering its currently strong financial reserves, which remain particularly important for the state given its above-average fixed costs stemming from its relatively large long-term liabilities. Despite the progress and commitment Hawaii has demonstrated with regard to its pension and other long-term liabilities, we believe these obligations currently represent a constraint on upward movement of the ratings. We specifically do not expect to raise the rating until the state has shown a steady trend toward a well-funded pension system, which we believe is beyond the current outlook period. The main downside risk we see to the state's ratings stems from the potential for economic underperformance that could lead to deteriorating fiscal performance. We believe the ratings can withstand most reasonable downside scenarios, however, given its reserve position. We also expect the ratings will be sensitive to any material deterioration in its pension funded status from its current level or significantly higher contribution rates which are not adequately absorbed in the future budgets, weakening its overall financial position.

Ratings Detail (As Of January 5, 2018)		
Hawaii APPROP		
Long Term Rating	AA/Stable	Affirmed
Hawaii GO		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.