FitchRatings

Fitch Upgrades Hawaii's IDR to 'AA+'; Outlook Stable

Fitch Ratings-San Francisco-10 December 2019: Fitch Ratings has upgraded the following State of Hawaii ratings:

--Issuer Default Rating (IDR) to 'AA+' from 'AA';
--$7.7 billion in outstanding general obligation (GO) bonds to 'AA+' from 'AA';
--$4 million in outstanding certificates of participation (COPs), series 2009A (State Office Building) to 'AA' from 'AA-'.

Fitch has also affirmed the rating on $408 million in outstanding highway revenue bonds at 'AA'.

The Rating Outlook is Stable.

SECURITY
The GO bonds are general obligations of the state of Hawaii that carry the full faith and credit pledge of the state. The COPs are secured by lease payments subject to legislative appropriation.

The highway revenue bonds are special, limited obligations of the state, payable from pledged funds that consist primarily of the fuel license (gas) tax, vehicle registration fees and weight taxes, and rental motor vehicle, tour vehicle, and car-sharing vehicle surcharges.

IDR ANALYTICAL CONCLUSION

The upgrade of the state's IDR and GO bond ratings to 'AA+' and Stable Outlook reflects Fitch's expectations for a resilient economy and continued strong operating performance. The upgrade of the COPs rating to 'AA' with a Stable Outlook maintains the one notch distinction below the state's IDR, consistent with Fitch's approach to rating appropriation-backed debt, which has slightly higher optionality. Given the state's solid, increasingly diversified economic base, Fitch expects that the state will maintain its existing strong financial flexibility as it continues to successfully absorb the costs arising from its pension and other post-employment benefit (OPEB) reforms. The state's commitment to elevating pension and OPEB contributions, and a requirement to report to the legislature annually on a range of pension stresses, establishes a solid basis for managing the risks posed by its retirement obligations, which Fitch expects to remain high for the foreseeable future.

DEDICATED TAX ANALYTICAL CONCLUSION
The 'AA' rating and Stable Outlook on the state's highway revenue bonds reflects Fitch's assessment of the strong resiliency of the pledged revenue stream and slow prospects for further growth. The rating is capped by the state's 'AA+' IDR.

(SEE BELOW FOR DEDICATED TAX ANALYSIS)

Economic Summary
The State of Hawaii encompasses seven inhabited islands and a total population of 1.4 million, over 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. In the past two years, the state experienced small population declines, which are atypical relative to its history of steady to strong annual population growth. These declines appear largely tied to recent military redeployments to the mainland (which are not expected to continue), reduced international in-migration (in response to current federal immigration policy) and a slightly declining birthrate.

IDR KEY RATING DRIVERS

Revenue Framework: 'aaa'
General excise taxes (GET) and corporate and personal income taxes provided around 88% of Hawaii's fiscal 2019 general fund revenues. Total general fund revenues have performed solidly historically, in line with U.S. GDP over the past 10 years. Prospects for ongoing revenue gains appear strong based on the state's growing economy where long-term diversification trends have bolstered economic resiliency. 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 for a U.S. state but are expected to remain manageable.

Long-Term Liability Burden: 'a'
Long-term liabilities for debt and retiree pension benefits are well above the median for U.S. states and are elevated but still in the moderate range relative to total personal income. Fitch's long-term liability burden calculation includes liabilities for the state's public schools, which are paid for by local governments in most other jurisdictions. Reforms to retiree benefits and higher contributions have helped to slow the growth of related liabilities. However, considerable progress on pension system and OPEB prefunding will take place only gradually.

Operating Performance: 'aaa'
The state is well-positioned to address economic challenges as a result of limited revenue volatility and increased reserves. Budget management is guided by frequent revenue forecasts and multi-year financial plans that provide input for policy adjustments as required.

RATING SENSITIVITIES
STRONG LONG-TERM FINANCIAL FLEXIBILITY: The state's IDR and ratings on its GO bonds and COPs are sensitive to changes in overall fiscal and operating performance, particularly in light of the state's commitment to making full actuarial contributions for pensions and OPEB. The current rating assumes the state will maintain a high degree of financial flexibility through economic cycles consistent with the rating level while simultaneously addressing retirement liabilities. Deterioration in operating performance tied to cyclicality beyond Fitch's expectations, slower than expected revenue growth, or a diminished commitment to addressing its retiree liabilities, could result in downward rating pressure.

SOLID ECONOMIC PERFORMANCE: Economic performance that does not support Fitch's expectations for revenue growth from a solid, increasingly diversified economic base could pressure the ratings.

PLEDGED REVENUE PERFORMANCE: The highway revenue bond ratings are sensitive to pledged revenue declines, or additional debt issuance beyond current expectations, that materially affect debt service coverage on the bonds.

STATE CREDIT QUALITY: Deterioration in the state's credit quality could affect the highway revenue bond ratings, which are capped by the state's IDR.

CURRENT DEVELOPMENTS

The state has been active in addressing retirement liabilities in recent years. Although the changes made will not meaningfully lower liabilities in the near term, they improve the chances that the liabilities will be sustainable over time. Most importantly, Hawaii remains on the course laid out by 2017 legislation to accelerate the state pension system's funding progress by requiring a four-year phase-in to higher employer contribution rates by fiscal 2021. The June 30, 2018 annual actuarial valuation for the pension system estimated that the remaining rate increases to be made in fiscal years 2020 and 2021, held constant thereafter, would result in a 25-year funding period.

The most recently published, legislatively-mandated annual stress test of the pension system indicates that funded ratios would deteriorate under the test's most severe scenario assumptions, but that sustained payment of higher contributions would prevent the plan's depletion. The most severe alternate stress test indicates that the pension system's funded ratio would dip just below 36% but the trust would not be exhausted. Compliance with both the legislatively-mandated employer contribution increases and annual stress testing supports the pension system's sustainability over time and demonstrates management's ongoing commitment to address the state's long-term liability burden.

The state's irrevocable OPEB trust now has an estimated fiscal 2019 balance of $1.8 billion (16% funded ratio), up from $1.3 billion in fiscal 2018 (12% funded ratio), given the state's commitment to making full actuarial contributions. Nevertheless, the net OPEB liability continues to grow (to $9.4 billion in fiscal 2019), representing a very high 12% of personal income.

ECONOMIC RESOURCE BASE

Hawaii's economic performance has been solid with increasing economic diversification, steady growth in tourism, and a continued substantial military presence. As evidence of increasing economic diversification, state officials calculate tourism's current share of GDP at 17%, compared to 33% in 1988. For the first nine months of 2019, state officials estimate that the leisure and hospitality sector accounted for 18% of the state's employment, comparable to the trade, transportation and utilities sector (17%), but noticeably less than the government/military sector (25%).

Tourism activity has been subject to periodic declines historically but has proven resilient over the long term. Visitor numbers and spending are at record levels, airline seat capacity to Hawaii is growing, and hotel room capacity is expanding. However, the rate of growth for visitor arrivals and spending is expected to slow relative to recent years' rapid growth, in part due to expected national and global economic headwinds.

For well over a decade, the state's unemployment rate has been below the U.S. average and it is now exceptionally low. Personal income levels are above average on a nominal basis, although real spending power is curtailed by the state's high cost of living.

Housing affordability is a growing issue for Hawaii with well above average median single family house prices (when comparing Honolulu with other comparably sized U.S. cities). State officials advise that considerably fewer houses are being constructed than local and out-of-state demand could absorb. Although high construction costs appear to be a barrier for some already permitted projects, many residential, commercial, and hotel projects are currently underway across the state. In addition, significant public sector capital investments are currently being made in the state's transportation infrastructure, schools and universities, and water and wastewater systems, while the military continues to make sizable capital investment in its Hawaiian bases.

IDR CREDIT PROFILE
Revenue Framework
The state relies on general excise taxes (GET) on business income and corporate and personal income taxes for the majority of its general fund revenues. The GET is broad-based and captures income from the sale of services as well as goods, accounting for half of general fund revenues in fiscal 2019. The state continues to focus on improving GET collections from on-line retailers and individual vacation rental units. Net income taxes from corporations and individuals account for over a third of general fund revenues. Policy-adjusted performance for all general fund revenues has been solid historically, exceeding inflation but slightly below overall U.S. economic performance.

Fitch expects Hawaii's revenue growth, absent policy actions, generally to perform in line with GDP based on the state's resilient and growing economy. While revenue gains may be affected by periodic economic shocks, strong growth is expected over the long term. The state's multiyear forecast anticipates general fund revenue growth of between 2.9% and 3.8% annually during fiscal years 2021 to 2025.

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 total governmental fund expenditures (inclusive of federal funding). Elementary, secondary and higher education comprised over a third of total governmental fund expenditures in fiscal 2018. Health and welfare spending combined for another third. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules limit the states' options in managing the pace of spending growth. Federal action to revise Medicaid's programmatic and financial structure appears less likely in the near term given divided control in Congress. The state does not have expenditure risk associated with voter initiatives.

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 health care in particular, but ongoing revenue gains are likely to keep pace with expenditure increases. The state's multiyear forecast anticipates general fund expenditure growth of between 1.5% and 2.4% annually during fiscal years 2021 to 2025, which is less than projected general fund revenue growth over that period. There is a constitutional expenditure ceiling that can only be exceeded with a two-thirds vote of the legislature. Apart from fiscal 2007, appropriations for recent years have not exceeded that expenditure ceiling.

The state has a strong track record of making expenditure reductions when needed 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 prefunding of retiree benefits could present a greater challenge for expenditure flexibility. Carrying costs for these items accounted for 16% of governmental expenditures in fiscal 2018, among the highest shares for states. This is partly driven by Hawaii's commitment, unusual for a state, to make actuarial rather than pay-as-you-go contributions for OPEB, necessitated by the size and inflexibility of that liability. OPEB contributions at the full actuarial level from fiscal 2019 onwards and higher scheduled employer pension contribution rates appear likely to increase this ratio further, and therefore Fitch expects carrying costs to remain high relative to other states.

Long-Term Liability Burden

Long- term liabilities for debt and pensions are high for a U.S. state. They are elevated but still in the moderate range at 21% of personal income as of fiscal 2018, more than three times the median for states, as reported in Fitch's 2018 State Pension Update. This ratio excludes the net pension liability attributed to the University of Hawaii. The ratio appears to be on an upward trajectory in the short-term based on debt issuance plans and more conservative assumptions included in recent pension valuations.

Long-term liabilities include debt issued for the state's elementary and secondary schools; historically, almost a third of the state's general fund debt has been for K-12 education (local governments pay for this in most other states). Amortization is moderate, with 62% of outstanding principal due for repayment within 10 years.

The pension system reported a relatively low 56% ratio of assets to liabilities as of its fiscal 2018 measurement date and an assumption of 7% investment returns. Under Fitch's standard 6% return assumption, this would drop to 49%. Contribution rates are determined by statute and adjusted periodically if the actuarial funding period exceeds 30 years. The state increased contribution rates in 2012 and again in 2017. The state remains on track with the current four-year phase-in of higher employer contributions, with the goal of eliminating the UAAL by fiscal 2043.

The state has implemented several rounds of retirement reforms since the Great Recession. Despite the immediate negative impact on the plan's funded condition, Fitch expects that these changes along with rising contributions will position the plan for funding progress, assuming current assumptions are achieved. Fitch views positively the state's proactive support of pension system sustainability, most notably through the contribution increases, and its annual mandate of stress testing pension investments and their impact on contributions. The latter provides significant transparency for the state's management on how contributions would have to change in the event of asset underperformance.

The state also carries a high liability for accrued OPEBs, which it regards as legally protected. Unusually for a state, Hawaii has made notable progress in prefunding OPEBs, moving from pay-as-you-go to full funding of the annual required contribution (ARC). Under the new accounting standard, OPEB liabilities are discounted at 7%, reflecting the actuarial determination of contributions. Legislation adopted in 2013 established a schedule for full ADC funding by 2019, which the state achieved, with full prefunding of accrued benefits forecast for 2045, if plan assumptions are achieved. The 2013 legislation also established an irrevocable OPEB trust that now has an estimated fiscal 2019 balance of $1.8 billion (16% funded ratio), up from $1.3 billion in fiscal 2018 (12% funded ratio). Nevertheless, the net OPEB liability continues to grow (to $9.4 billion in fiscal 2019) and it represents a very high 12% of personal income.

Operating Performance
Increased 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 2.5%. The state's reserves provide a considerable cushion against revenue declines expected in a moderate recession.

The state made key improvements to financial flexibility in the wake of the Great Recession, increasing budgetary and emergency reserves. A budget reserve policy adopted in 2016 sets a goal of 10% of prior year budgeted revenues for such savings, committing a portion of ongoing tobacco revenues and general fund balance in years of strong revenue performance. Balances in the state's Emergency Budget and Reserve Fund (EBRF) rose to over $378 million in fiscal 2019 (nearly 5% of prior fiscal year budgeted revenues), from just under $10 million in fiscal 2011. The EBRF is budgeted to grow to $391 million (nearly 5% of prior fiscal year budgeted revenues) in fiscal 2020.

In addition, the state has a balance of almost $184 million in its Hawaii Hurricane Relief Fund, which has functioned as an additional working reserve in times of economic stress. This fund is projected to grow slightly to $185 million in fiscal 2020.

The state reported a fiscal 2018 net general fund deficit of $228 million (3% of total general fund expenditures and transfers out), up from a 1% deficit the prior year. These deficits reflect expenditure pressure related to increased pension and OPEB contributions. However, total governmental funds showed only a slight deficit of $39 million in fiscal 2018 (0.3% of spending) and positive operations in fiscal 2017.

The state's September 2019 revised general fund financial plan projects balanced general fund operations in fiscal 2019 (adding just under $2 million to the general fund balance), a small deficit in fiscal 2020 and positive operations thereafter. Fitch expects the state to address budget balancing challenges as they arise and to maintain its strong financial flexibility.

DEDICATED TAX KEY RATING DRIVERS
RATING CAPPED BY STATE CREDIT QUALITY: The highway revenue bond rating is capped by the state's general credit quality. Pledged revenues, a relatively narrow basket of motor vehicle-related taxes and user charges, are structurally protected from general government operations and restricted to the support of the state highways system.

SLOW PLEDGED REVENUE PERFORMANCE: Pledged highway revenue growth has been above inflation but less than national economic performance over the past 10 years, in part due to state policy actions to adjust tax rates and charges to offset economic volatility. Pledged revenues have provided robust coverage of debt service in a scenario that considers leveraging up to 4.5x MADS, in combination with revenue declines anticipated in a moderate economic downturn.

DEDICATED TAX CREDIT PROFILE

Legal provisions for the bonds provide solid protection for bondholders. Senior bonds (the only active lien) have a first lien on the pledged funds once deposited in the state highway fund. Subordinate lien debt is permitted, though none has been issued. Hawaii's general revenue bond law requires the state to maintain pledged revenues in amounts sufficient to meet commitments to bondholders. While not anticipated, such commitments could be modified by the state legislature. Pledged revenues are not subject to annual appropriation by the state legislature.

Transfers out of the state highway fund are permitted, but only after senior and subordinate debt service obligations, operations and maintenance expenses, and required capital improvements have been funded. Further, transfers are only allowable if monies remaining in the fund exceed 135% of the next year's revenue requirements. Since 2006, the legislature has supported revenue increases to support the highway fund and transferred $37 million from the general fund in fiscal 2017.

Highway revenue bonds are supported by both a cash-funded debt service reserve and sureties sized at 50% of maximum annual debt service (MADS). The state has proposed to eliminate the reserve on future debt issuances upon receipt of 100% bondholder consent, which is not expected to occur until the series 2005, 2008, 2011, and 2014 highway revenue bonds mature or are refunded. Such changes are not a rating consideration given the credit's underlying strength.

Pledged revenues consist of highway fuel license taxes assessed at a per-gallon rate; a fixed per vehicle registration fee; a tax based on motor vehicle weight; surcharges on rental motor vehicles, tour vehicles, and car-sharing vehicles applied on a per day, month, or hour basis; and other miscellaneous fines, charges, and fees. In fiscal 2019, vehicle registration and weight fees provided approximately 45% of pledged revenues and fuel taxes accounted for an additional 29%.

Revenues are sensitive to fuel usage and efficiency, vehicle ownership levels, motor vehicle size, total mileage and tourism activity. Revenues dipped by a cumulative 13% between fiscal years 2008 and 2010, during the Great Recession, but the combination of a recovering economy and repeated state policy actions have resulted in cumulative growth of almost 53% over the following eight years.

Between 2008 and 2018, pledged revenues rose at a compound annual growth rate of 2.8%, well above inflation but below national economic growth. The state is projecting future pledged revenue growth at around 1% annually from fiscal 2021 onwards, a more modest rate of growth than historical performance. However, baseline pledged revenues will increase significantly in fiscal 2020 primarily due a 67% increase in the rental motor vehicle surcharge enacted on July 1, 2019 (Act 174). This increase is projected to generate an additional $33 million annually.

To evaluate the sensitivity of the dedicated tax revenue stream to cyclical decline, Fitch considers both a revenue sensitivity scenario (using a 1% decline in national GDP scenario) and the largest decline in revenues over the 10-year period covered by the revenue sensitivity analysis. Based on this history, Fitch's analytical sensitivity stress test (FAST) generates a 4% decline in pledged revenues during the first year of a moderate recession while the largest cumulative revenue decline historically was the 13% described above.

Management has typically limited debt service expenses to less than 20% of total annual revenues to ensure sufficient funding for operations and maintenance; it plans to continue this practice in the future.

The state expects to issue a substantial amount of additional revenue bonds in fiscal years 2020 and 2021. The pro forma debt amortization schedule indicates that pledged revenues held constant at fiscal 2019 levels would maintain a minimum of 5.0x MADS coverage, the state's minimum coverage assumption when evaluating future bonding plans. Fiscal 2019 pledged revenues were 5.6x MADS.

Conservatively assuming leverage down to 4.5x MADS, pledged revenues could withstand a 78% drop before not fully covering MADS. This represents 18.6x the scenario-generated decline and 5.8x the largest recorded decline.

EXPOSURE TO ISSUER OPERATIONS
The dedicated tax bond rating is capped by the state's 'AA+' IDR. While pledged highway revenues are structurally protected from general government operations and restricted to supporting the state highways system, the state has considerable discretion over the appropriation of state highway fund monies. Transfers out of the state highway fund are permitted once certain conditions are met, and in 2017 the fund received support from the general fund.

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Sources of Information
In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

ESG Considerations
Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3' - ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity.

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Applicable Criteria
U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018)

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