FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Hawaii's IDR at 'AA+'; Revises Outlook to Negative

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Fitch Ratings - San Francisco - 27 Apr 2020: Fitch Ratings has affirmed the following State of Hawaii ratings:

--Issuer Default Rating (IDR) at 'AA+';

--$6.9 billion in outstanding GO bonds at 'AA+';

--$4 million in outstanding certificates of participation (COPs), series 2009A (State Office Building) at 'AA'.

The Rating Outlook has been revised to Negative from 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.

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. Medium-term prospects for ongoing revenue gains appear strong based on the state's 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'

Over the medium-term, 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 given its increased reserves and control over a broad array of budget balancing options. Budget management is guided by frequent revenue forecasts and multi-year financial plans that provide input for policy adjustments as required.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--The Rating Outlook could be revised back to Stable if the state is able to effectively absorb the fiscal challenges triggered by a short but severe economic contraction and rebuild its financial resilience swiftly.

--The state's actions in managing retiree obligations reduce those long-term liabilities over time.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--An inability to address effectively the fiscal challenges triggered by the expected short-term but severe economic contraction, as evidenced by failure to make needed budget adjustments to the enacted fiscal 2019-2021 biennium budget, leaving the state less financially resilient at the end of the recovery period.

--Deterioration in operating performance tied to cyclicality beyond Fitch's expectations and slower than expected return to revenue growth and financial resilience.

--Economic performance that does not support Fitch's medium-term expectations for strong financial flexibility and revenue growth from a solid, increasingly diversified economic base.

--A diminished commitment to addressing the state's retiree liabilities.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

CREDIT PROFILE

ANALYTICAL CONCLUSION

The revision of the Rating Outlook to Negative on Hawaii's 'AA+' IDR and GO bond ratings reflects the considerable economic pressure faced by the state as it confronts the economic impacts of the coronavirus pandemic. The sudden economic shock brought by the pandemic and the severe recession now unfolding as being well beyond the routine cyclicality typically faced by state and local governments and reflected in IDRs. While Hawaii has a track record of very strong operating performance, its ability to absorb the shock and maintain financial resilience will be tested by the duration of the lockdown and the trajectory of its recovery. Hawaii's globally important tourism industry, a pillar of the economy, is most affected, and its recovery will depend in part on the trajectory of the downturn in markets from which visitors originate and potential changes in travel patterns.

The Negative Outlook indicates the direction the rating is likely to move over a one- to two-year period; however, it does not imply that a rating change is inevitable. The Outlook revision, and evaluation of the state's credit quality going forward, are informed by Fitch's coronavirus downside scenario as described further below. In the near term, the state will need to carefully manage the considerable economic and fiscal uncertainty caused by the coronavirus pandemic.

Liquidity is ample in the form of reserves, available balances in other funds, and other cash resources. Although the immediate cash flow impact of tax filing delays appears limited, reduced economic activity poses a more significant budget risk through the balance of the state's fiscal 2019-2021 biennium. The governor is already taking actions to curb spending, aided by frequent revenue forecast updates.

The state's increasingly diversified economic base will help the state maintain its financial flexibility in the medium-term as it continues to successfully absorb the costs arising from its pension and other post-employment benefit (OPEB) liabilities. 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.

The 'AA' COPs rating, one notch below the IDR, reflects Fitch's approach to rating appropriation-backed debt, which has slightly higher optionality.

ECONOMIC RESOURCE BASE

The State of Hawaii encompasses seven inhabited islands and a total population of 1.4 million, over two-thirds of whom reside on 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, atypical relative to historically steady to strong annual population growth. These declines appear largely tied to 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.

In recent years, 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 with 33% in 1988. This means that economic activity generated by its own residents has become increasingly important to the state. For calendar year 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 (26%). While tourism activity has been subject to periodic declines historically, it has proven resilient over the long-term. Historical data indicate that major economic shocks suppress visitor arrival growth for around three years at the most, before resumption of the upward growth trend.

Although personal income levels are above average on a nominal basis, real spending power is curtailed by the state's high cost of living. Housing affordability has become a significant issue for Hawaii with well above average median single family house prices (when comparing Honolulu with other similarly 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 and significant public sector capital investments are being made in transportation infrastructure, schools and universities, and water and wastewater systems. The military continues to make sizeable capital investment in its Hawaiian bases.

CURRENT DEVELOPMENTS

Sector-Wide Coronavirus Implications

The recent outbreak of coronavirus and related government containment measures worldwide creates an uncertain global environment for U.S. state and local governments and related entities in the near-term. As severe limitation on economic activity only began very recently, most state governments' fiscal and economic data do not reflect any credit impairment. Material changes in revenues and expenditures are occurring across the country and are likely to worsen in the coming weeks and months as economic activity suffers and public health spending increases. Fitch's ratings are forward-looking and Fitch will monitor developments in state and local governments as a result of the virus outbreak as it relates to severity and duration, and incorporate revised expectations for future performance and assessment of key risks.

In its coronavirus baseline scenario, Fitch assumes sharp economic contractions hit major economies in the first half of 2020 at a speed and depth that is unprecedented since World War II. Recovery begins from third-quarter 2020 onward as the health crisis subsides after a short but severe global recession. GDP remains below its fourth quarter of 2019 level through most of 2021. Additional details, including key assumptions and implications of the baseline scenario and a downside scenario, are described in the full report at http://www.fitchratings.com/site/re/10116778 (Fitch Ratings Coronavirus Scenarios: Baseline and Downside Cases, April 2020).

Coronavirus Impacts on Hawaii

Due to the governor's relatively strong powers, a comparatively centralized governmental structure, and the state's relatively isolated geographic location, Hawaii was able to take relatively early effective steps to control the spread of the coronavirus and test its population for exposure to the disease. A shelter-in-place order was proclaimed on March 23 and mandatory quarantining of visitors was imposed on March 26. Public facilities are closed, including schools and universities through the end of the academic year. Consequently, the state is confident that its health system can absorb the current and projected coronavirus-related caseload. A majority of the state's residents have health insurance coverage. To date, Hawaii has a relatively low number of confirmed cases (42 per 100,000 residents, the second lowest state in the nation, compared to the U.S. rate of 265), a lower coronavirus-related mortality rate (2.0%, compared to a national rate of 5.6%), and a reducing rate of community transmission.

Nevertheless, the state is experiencing the economic impact of the pandemic primarily through world-wide containment efforts that affect its tourism sector, one of the pillars of its economy. The year-over-year domestic and international passenger count is down 99% (April 24). State officials estimate that each month of lost tourism represents around $176 million in foregone tax revenues. For the week ending April 18, STR, Inc. reports that Oahu Island experienced the lowest hotel occupancy in the top 25 U.S. hotel markets (8%, compared to a national average of around 23%) and the biggest decline in revenue per available hotel room relative to the prior year (94%, compared to a national average of around 79%).

That same week, weekly initial unemployment claims (186,295) shot up 819% compared to the same time a year prior. Since March 14, the state's job loss is almost 26% of its labor force, the highest of any state. This largely reflects the shock to the service sector from the abrupt drop in tourism, which will likely persist until consumers consider it safe to travel again and can afford to do so. However, to date the military and construction sectors remain stable.

Fitch's March 2020 credit outlook updates for both the U.S. gaming, lodging and leisure sector and the global lodging and leisure sector shifted to negative from stable, given the disruption to global travel demand, an unknown recovery trajectory, the potential impact of a prolonged disruption on operators, and broader demand disruption due to property closures and social distancing. Hawaii is inarguably exposed to broader tourism industry dynamics and the economic recoveries of other states and countries.

On March 31, Fitch affirmed the State of Hawaii Department of Transportation's 'A+' and 'A' ratings on its airport system revenue bonds and certificates of participation, respectively, but revised the Rating Outlook to Negative from Stable in line with other large airports and major airline hub facilities. This rating action reflects the current stressed aviation environment. Due to Hawaii's geographic position, it is vulnerable to significant changes in the aviation industry. However, individual airlines are now signaling their intention to recommence some flights to Hawaii after April 30.

Federal Aid Provides Some Support for State Budgets

Federal aid measures enacted in recent weeks will benefit state budgets, although details remain fluid. The Families First Coronavirus Response included a 6.2% increase in the Federal Medical Assistance Percentage (FMAP) for Medicaid for every quarter of the national emergency declared by the president on March 13. FMAP is the rate at which the federal government reimburses states for Medicaid spending. The Center on Budget and Policy Priorities estimates the 6.2% increase could provide Hawaii with $110 million in federal aid over a full year, or almost $28 million each quarter. The ultimate value of the FMAP rate increase will depend on states' actual Medicaid spending, among other factors.

Under the Coronavirus Aid, Relief and Economic Security (CARES) Act enacted on March 27, the U.S. Treasury department will distribute $150 billion to state and local governments within 30 days of enactment under a population-based formula. The statute limits the use of funds to coronavirus expense reimbursement rather than to offset anticipated state tax revenue losses. The U.S. Treasury estimates that Hawaii is eligible for $1.25 billion, with approximately $863 million allocated to the state and $387 million allocated to the city and county of Honolulu, the state's sole local government with more than 500,000 residents. Cumulatively, the state, counties, individuals, and private businesses expect to receive around $4 billion from the CARES Act through all its various funding channels.

The Federal Reserve's recently announced $500 billion Municipal Lending Facility (MLF) provides a potentially valuable source of short-term liquidity for state and local governments. Under the MLF, a Federal Reserve Bank will set up a special purpose vehicle (SPV) to directly purchase short-term debt issued by states, the District of Columbia, and the largest counties and cities. Given the program's terms, Fitch estimates that Hawaii could borrow up to $2.1 billion to address the state's own cashflow needs. Critical details for this program, including how quickly purchases will begin, are yet to be determined.

Coronavirus - Hawaii Liquidity Impacts

Fitch anticipates that Hawaii, consistent with all states, will address short-term liquidity pressure with no interruption in timely payments for key operating expenses, including debt service. Hawaii extended its deadline for filing personal and corporate income tax payments to July 20, slightly exceeding the federal government's extension. State officials do not expect the delay in income tax receipts to create any liquidity issues. Net income taxes represented 23% of the state's total governmental revenues in fiscal 2019. Approximately 41% of those net income taxes were collected during the last four months of the fiscal year. While the state's extension will delay collection of final income tax payments for the 2019 tax year, importantly it will not delay withholding taxes or estimated state income taxes for the 2020 tax year. However, lower personal and corporate income tax collections attributable to the economic downturn will reduce cashflow further.

Hawaii has the necessary financial flexibility to meet its altered cashflow demands. During fiscal years 2016 to 2019, the state consistently ended each year with between 184 and 186 days cash on hand. As of Feb. 29, the state's treasury portfolio had a total market value of approximately $6.4 billion, primarily consisting of 'AAA'-rated U.S. treasuries and agency securities, plus bank CDs. The state can inter-fund borrow from its harbors, highways, and housing funds. The governor has considerable flexibility to modify the fiscal 2019-2021 biennium budget, as outlined below.

The state made key improvements to financial flexibility in the wake of the 2008 Great Recession, increasing budgetary and emergency reserves. The Emergency Budget and Reserve Fund (EBRF) balance rose to over $378 million in fiscal 2019 (nearly 5% of prior fiscal year budgeted revenues), from just under $10 million in fiscal 2011. Before the coronavirus crisis, the state aimed to maintain the EBRF at between 4.7% and 5.0% going forward. The state also has around $185 million in its Hawaii Hurricane Relief Fund, which functions as an additional working reserve in times of economic stress. State officials expect to draw down on these reserves to address the economic impacts of the coronavirus, subject to legislative approval. Until that happens, the reserves are available for liquidity.

Coronavirus - Hawaii Budgetary Update

The governor has the executive authority to control spending by restricting, delaying, or suspending appropriations. Although the governor cannot make supplemental appropriations without the legislature's approval, he does have sufficient authority to make budget balancing decisions for the rest of the fiscal 2019-2021 biennium. This includes the power to pass emergency actions to achieve necessary labor and non-labor cost savings. The governor has already suspended collective bargaining, although his administration continues to work with the bargaining units on potential labor concessions. There is no intention to reduce the state's legislatively required contribution to its pension system in fiscal 2020 (such an action would require legislative change), but prefunding of retiree health care benefits could be modified if necessary to balance the budget.

The state legislature has the ability to increase taxes and authorize debt without voter approval. It can also unilaterally adjust the county transient accommodations tax allocation and has done so in the past. If the legislature is prepared to reconvene for a special session in 2020, it could consider authorizing an almost $1 billion capital improvement program of shovel-ready projects as an economic stimulus package.

Until the coronavirus crisis hit, the state had been anticipating $180 million in extra revenues in the current budget year. Instead, because of a sharp decline in revenues, state departments are preparing 10% budget reduction proposals and labor concessions are under discussion. Preliminary estimates suggest that there is $900 million in non-labor appropriations that could be cancelled to reduce spending immediately.

The state does not anticipate needing to provide extraordinary support for any of its four counties that would not be reimbursed by federal moneys, since the counties are in good financial position and supported by stable property tax revenues, or for its department of transportation, since the airports, harbors, and highways each have sufficient cash to fund operations and will likely receive federal funding support. While the Hawaii Health Systems Corporation could require state support, given losses associated with cancelled elective procedures and unbudgeted coronavirus-related expenses, eligible costs could be reimbursed from the $863 million in CARES moneys to be received by the states.

Updated FAST Analysis for Hawaii

The Fitch Analytical Stress Test (FAST) scenario analysis tool relates historical tax revenue volatility to GDP to support the assessment of operating performance under Fitch's criteria, providing a relative sense of the risk exposure of a particular state compared to other states. The tool's downside scenario most closely reflects the GDP parameters in Fitch's updated global coronavirus forecast assumptions (April 22), whereby annual GDP falls 5.6% in year one, followed by growth of 4.3% in year two.

Under the tool's downside scenario, Hawaii would experience a first year revenue contraction of 18.4% (compared to a state median decline of 17.5%) and a cumulative decrease over the three year scenario of 5.5% (compared with a state median cumulative decline of 13.0%). These results suggest, at the end of three years, that the recession's impact on revenues could weaken the state's financial resilience, although to a significantly lesser degree than in other states, potentially resulting in a lower assessment for operating performance. Fitch notes, however, that the state has already identified budgetary savings that would offset the majority of the tool's first year revenue contraction. Further, the state's response to revenue declines in the Great Recession points to its ability to address significant revenue downturns. The state reduced its general fund spending by approximately 14% during fiscal years 2010 and 2011, largely due to employee furloughs and executive department spending restrictions.

FAST is not a forecast but Fitch's estimate of possible revenue behavior in a downturn, based on historical revenue performance. Hence, actual revenue declines will vary from FAST results.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING

ENTITY/DEBT	RATING		
Hawaii, State of (HI) [General Government]	LT IDR	AA+	Affirmed
• Hawaii, State of (HI) /General Obligation - Unlimited	LT	AA+	Affirmed

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST States & Locals - Fitch Analytical Stress Test Model, v2.4.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Hawaii, State of (HI)	EU Endorsed

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