MOODY'S
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Update

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Hawaii State Department Hawaiian Homelands

Update - Moody's upgrades Hawaiian Home Lands revenue bonds and COPs to Aa3 from A1; outlook stable

Summary Rating Rationale

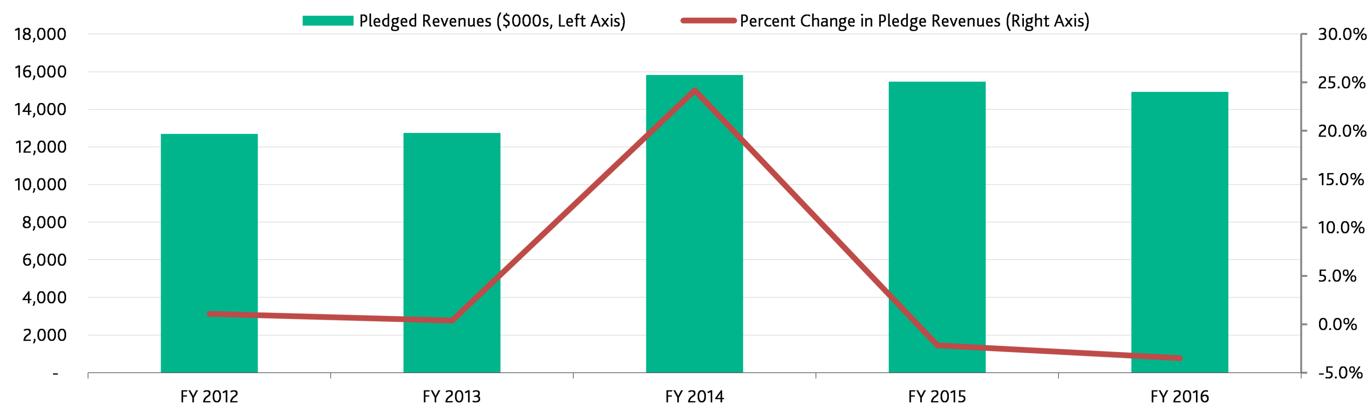
Moody's Investors Service has upgraded the rating on the Hawaii State Department of Hawaiian Home Lands' Revenue Bonds, Series 2009, to Aa3 from A1 and the rating on the department's Certificates of Participation (Kapolei Office Facility), 2006 Series A, to Aa3 from A1. The department is an executive agency of the State of Hawaii (Aa1 stable), responsible, pursuant to federal and state statutes, for the management of certain trust lands for the benefit of native Hawaiians. Through its homestead lease program, the department leases much of the trust land to native Hawaiians for residential and agricultural purposes. Trust land not needed for homestead purposes is made available for commercial, industrial and other uses through leases, licenses and permits, to generate revenues to fund the department's core homestead programs.

The revenue bonds are secured by a first lien on the department's income derived from these non-homestead trust lands (the pledged revenues). In addition, the Office of Hawaiian Affairs (OHA) has contracted to make a payment of $3 million per year to the department, to be used for the payment of debt service, as long as the revenue bonds are outstanding, although the payment is not pledged. OHA's obligation to make the payment is not subject to appropriation, and debt service is roughly $3 million per year. The Aa3 rating on the revenue bonds reflects the satisfactory coverage of debt service by pledged revenues, the inherent volatility and lessee concentration of these real estate-derived revenues, and the availability of the state's payment through OHA.

The certificates of participation are paid from lease payments made by the state for the department's headquarters facility. The lease payments are subject to appropriation by the state legislature from the same revenue stream pledged to the revenue bonds. The Aa3 rating on the certificates reflects the strong credit quality of the state and the essentiality of the leased asset, balanced against the narrowness and volatility of the revenue stream from which lease payments are to be appropriated.

Exhibit 1

Pledged Revenues Have Been Volatile but Generally Increasing



Source: Department of Hawaiian Home Lands audited financial statements.

Credit Strengths

» Strong credit quality of the State of Hawaii and the commitment by the state, the department, and the OHA to the development of homesteads for native Hawaiians on the trust lands.

» Positive trend for income from non-homestead trust lands and satisfactory coverage, at present, of debt service on both the revenue bonds and the certificates by this income.

» For the revenue bonds, the availability of the OHA payment.

» For the certificates, the essentiality of the leased asset.

Credit Challenges

» The inherent volatility and the lessee concentration of the department's real estate-derived income.

» For the revenue bonds, a weak additional bonds test of 1.25 times.

» For the certificates, the narrowness of the revenue stream from which lease payments are appropriated.

Rating Outlook

The outlook on both the revenue bonds and the certificates of participation is stable reflecting the state's general credit quality and the recent performance of the state's economy and commercial real estate market.

Factors that Could Lead to an Upgrade

» Significant expansion and diversification of the revenue stream pledged to the revenue bonds and from which lease payments are appropriated.

Factors that Could Lead to a Downgrade

» A weakening of the state's general credit quality, economy or commercial real estate market.

» A reduction in coverage below current levels.

» The unexpected, early termination of the contract between the department and OHA, or the issuance of additional revenue bonds without amending the contract with OHA to cover the additional debt service.

Key Indicators

Exhibit 2

Coverage by Pledge Revenues plus OHA Payment is Satisfactory

Department of Hawaiian Home Lands	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Pledged Revenues ($000s)	12,686	12,736	15,817	15,474	14,933
Percent Change in Pledge Revenues	1.1%	0.4%	24.2%	-2.2%	-3.5%
Revenue Bond Debt Service ($000s)	3,009	3,008	3,011	3,010	3,012
Coverage of Rev Bond Debt Service by Pledge Revenues (x)	4.22x	4.23x	5.25x	5.14x	4.96x
Coverage by Pledge Revenues + OHA Payment (x)	5.21x	5.23x	6.25x	6.14x	5.95x
COP Debt Service ($000s)	1,711	1,712	1,711	1,713	1,712
Coverage of Rev Bds & COPs by Pledge Revenues (x)	2.69x	2.70x	3.35x	3.28x	3.16x
Coverage by Pledge Revenues + OHA Payment (x)	3.32x	3.33x	3.99x	3.91x	3.80x

Source: DHHL audited financial statements; offering documents.

Recent Developments

Recent developments are incorporated into the Detailed Rating Considerations.

Detailed Rating Considerations

Economy

Although Hawaii's economy has shown some diversification, its large tourism industry remains key to the economy and the state's economic performance closely tracks tourism trends. As a highly desirable tourist destination for international and domestic visitors, the tourism industry is somewhat insulated from US economic cycles and has at times been counter-cyclical. The recent recession was particularly challenging since both national and international visitations were affected at the same time. Visitor arrivals did not surpass the pre-recession peak (2007) until 2012. Growth since that time has been particularly strong, however, with visitor arrivals reaching record levels in 2015 and 2016

A sizable military presence adds stability, and military housing construction has contributed to expanding construction activity. Federal defense spending in Hawaii, dictated by the island's strategic geographic importance, plays a large part in the state's economy.

The economy is also boosted by strong construction activity. The value of building permits issued has returned to pre-recession levels. Major projects include high-rise condos in Central Honolulu targeted at both visitors and residents, as well as retail commercial projects in Honolulu and new hotel/resort projects primarily on the neighbor islands. Two new master planned communities with a total of 15,250 housing units have been approved in Honolulu and are expected to begin construction in late 2016/early 2017. Large public projects include the Honolulu rail system and improvements at the airports and port. Unlike most mainland states, Hawaii did not experience a severe housing market bust during the recession.

Finances and Liquidity

The Department of Hawaiian Homelands is responsible, pursuant to the federal Hawaiian Homes Commission Act of 1920 and related state statutes, for the management of a land trust known as the "Hawaiian Homelands" for the benefit of native Hawaiians. The Hawaiian Homelands consist of more than 203,000 acres on the four main Hawaiian islands plus Molokai and Lanai. In general, the trust land may not be sold. Through its homestead lease program, the department leases much of the trust land to native Hawaiians for residential and agricultural purposes. The department also provides direct loans to lessees for construction, repair and replacement of residences, and makes infrastructure improvements needed for development of homestead land.

Certain trust land not needed for homestead purposes is made available for commercial and industrial development through leases. These non-homestead lands are referred to as "available lands" and the non-homestead leases are referred to as "general leases". General leases are offered at competitive market rates through public auction. Land is also leased to other state agencies for the various purposes including the establishment of environmental reserves and to public utilities. In addition, land is made available for temporary use by community, government, and military agencies through licenses and permits. Income from the general leases, licenses and permits supports the department's housing programs. The department also receives state appropriations and federal grants.

While revenues from general leases are somewhat volatile from year to year, they have grown significantly in recent years due to the strength of the commercial real estate market in Hawaii and the limited amount of land available for commercial development. The compound annual growth rate for revenue from general leases was 5.1% from 2006 to 2016. As of June 30, 2016, there were 123 general leases in place with a combined annual rent of $14.3 million. But this revenue stream is highly concentrated--12 leases, all on Oahu and the Big Island of Hawaii, primarily retail commercial properties, account for $8.8 million or 63% of this rent. Revenue from licenses and permits has been relatively flat.

LIQUIDITY

Revenues from general leases, licenses, permits and investment income from the department's management of the available lands, which represent both the pledged revenues for the revenue bonds and the revenue stream from which lease payments for the certificates are appropriated, are accounted for in the department's Hawaiian Home Administration Account. The account has a trend of sizable cash and fund balances. The cash balance at the end of fiscal 2016 equaled $30.1 million, equivalent to 201.4% of pledged revenues.

Debt and Pensions

DEBT STRUCTURE

The revenue bonds were outstanding in the amount of $37.1 million at the end of fiscal 2016. The bonds are structured with level debt service of slightly more than $3 million per year through final maturity in 2039. Pledged revenues provided debt service coverage in the last five years, fiscal years 2012-2016, of 4.22 times to 5.25 times. Pledged revenues plus the OHA payment provided debt service coverage in the last five years of 5.21 times to 6.25 times.

The Series 2009 revenue bonds have a cash-funded debt service reserve equal to maximum annual debt service. The additional bonds test is very weak--parity bonds may be issued if projected pledged revenues in each of the 5 years following the issuance of the new bonds provide 1.25 times coverage of debt service.

The certificates of participation were outstanding in the amount of $19.3 million at the end of fiscal 2016. The certificates are structured with level debt service of $1.7 million per year though final maturity in 2031. The certificates have a cash-funded debt service reserve funded a maximum annual debt service. Property insurance is provided through the state's blanket real and personal property insurance policy.

DEBT-RELATED DERIVATIVES

The department has no debt-related derivatives.

PENSIONS AND OPEB

The department has only a small number of employees and personnel costs represent only a small portion of total expenditures. Pensions and OPEB for department employees are provided through the state's systems.

The state's pension liabilities are above average. Moody's 2014 Adjusted Net Pension Liability (ANPL) for Hawaii was 141% of state governmental revenues, the seventh highest of the 50 states and more than twice times the median of 59%. Hawaii's three-year average ANPL was 149% of revenues, the fifth highest and well above the median of 53%.

Pension reforms adopted in 2011 are expected to improve the funding levels of the state's retirement system over the long term. Benefits were reduced for new members after June 30, 2012, and employer contributions were increased to 17% of payroll. A moratorium on any enhancement of retirement benefits remains in effect until the funded ratio reaches 100%. Additional reforms approved by the legislature and the governor in 2012 focused on reducing the "spiking" of final compensation. These later changes have the largest potential impact on counties who employ most of the police and fire workers. The state currently projects that the unfunded liability will be fully amortized in 26 years.

Hawaii's OPEB unfunded obligation is also quite sizeable. The valuation report for July 1, 2015 showed an total unfunded obligation of $11.8 billion, of which approximately $9.1 billion was the state's portion. As in most states, Hawaii historically funded its OPEB costs on a pay-go basis. However, in the 2013 legislative session, the state adopted a plan to require phasing in higher annual contributions by the state and counties beginning in fiscal 2015. By fiscal 2019, the payments would reach 100% of the ARC. Notably, the state also made a supplemental contributions to the OPEB trust beyond the statutorily-required amounts--$100 million in fiscal 2014, $34 million in 2015, $86 million in 2016, and $98 million (budgeted) in 2017.

Governance

The Department of Hawaiian Home Lands in an executive agency of the state, governed by the Hawaiian Home Lands Commission an executive board with members appointed by the governor and approved by the State Senate. The chairman of the commission serves as the full-time administrator of the department. The department's budget is appropriated by the state legislature.

The State of Hawaii has very strong governance practices, including consensus revenue forecasts, updated quarterly, and multi-year financial planning. The governor has power to restrict spending during the fiscal year, if necessary. The constitution does not provide for voter initiatives.

Legal Security

The revenue bonds are special limited obligations of the department secured by a first lien on revenues from general leases, licenses, permits, and investment income collected from management and operation of the available lands. In addition, pursuant to a contract between the department and the Office of Hawaiian Affairs (OHA), a separate state agency, OHA has agreed to pay the department $3 million annually as long as the revenue bonds are outstanding. Although not pledged to the bonds, the OHA payments are specifically designated in the contract for the payment of debt service on the revenue bonds. In practice, the department has always used the OHA payments and interest earnings on the payments to pay debt service on the revenue bonds. OHA's obligation to make the annual payments is absolute and unconditional, and not subject to appropriation by the state legislature.

The certificates of participation are secured by and paid from lease payments made by the state for the department's headquarters building in the Kapolei area of West Oahu. The lease payments must be appropriated annually by the state legislature. The source of funds to be appropriated for lease payments are the revenues of the Administration Account, which consist of revenues from general leases, licenses, permits, and investment income associated with the management of the available lands, the same revenues pledged to the revenue bonds.

Obligor Profile

Hawaii is the 40th largest state by population, at 1.4 million. Its state gross domestic product is 38th largest. The population's income levels are above average, with per capita personal income equal to 100% of the US level and a median household income equal to 133%. Its poverty rate is in the bottom third among states.

Methodology

The principal methodology used in this rating was the Lease, Appropriation, Moral Obligation and Comparable Debt of US State and Local Governments published in July 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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