S&P Global Ratings

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Summary:

Hawaii Airport System; Airport

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Summary:

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Hawaii (Hawaii Airport System)		
Long Term Rating	A+/Stable	Affirmed

Rationale

S&P Global Ratings affirmed its 'A+' long-term rating and underlying rating (SPUR) on Hawaii Airport System's previously issued senior-lien revenue bonds, and its 'A' long-term rating on the system's series 2013 lease revenue subordinate-lien certificates of participation (COPs). The outlook is stable.

The ratings reflect our view of the airport system's:

- Historically very strong liquidity position for the rating, including $558 million, or about 785 days of expenditures, in unrestricted cash as of audited fiscal 2016 and no less than 764 days' cash since fiscal 2010;
- Generally good enplanement growth during fiscal years 2011 through 2016 with a five-year compound annual growth rate of 2.5%, including a good 2.4% and 3.2% rebound in enplanements in fiscal years 2015 and 2016, respectively, after a 1.5% decline in fiscal 2014;
- Monopolistic position and very high essentiality for transport within, to, and from the state, serving a niche travel market with five primary airports and 10 secondary airports throughout Hawaii;
- Low cost per enplanement (CPE) of $9.08 in fiscal 2016, with CPE projected to remain in a moderately low range of $9.64 to $12.69 through 2021 despite a relatively large $2.6 billion capital improvement program for fiscal years 2016 to 2021;
- Low debt burden at about $69 per enplanement combined with a good mix of capital program funding sources that limit the addition of excessive debt to the system; and
- Good combined "all-in" senior- and subordinate-lien debt service coverage (DSC) of 1.3x and 1.2x in audited fiscal years 2015 and 2016, respectively.

Partly offsetting the above strengths, in our view, are the airport system's:

- Moderately high carrier concentration, with Hawaiian Airlines representing 52% of enplanements in fiscal 2016, although in our view other carriers' market shares would likely increase if Hawaiian Airlines terminated or reduced service at the airport;
- All-in DSC that management forecasts will decline when subordinate-lien debt service ramps up, dipping to a low of 1.05x in fiscal 2021, although we recognize the forecast is conservative and that high DSC ratios are less likely given the airport system's residual hybrid rate-setting methodology;
- Sizable 10-year capital improvement program totaling $2.6 billion, 44% of which will be bond financed, although there is flexibility to adjust capital spending if demand wanes; and
- Inherent susceptibility to exogenous shocks that have potential to hurt it and the rest of the state's tourism sector, which accounts for about 17% of state GDP, although we anticipate that the system will maintain a strong base level

of demand in light of the system's essentiality.

The senior-lien airport revenue bonds are secured by senior-lien system revenue and aviation fuel tax revenue after operations and maintenance (O&M) costs. The COPs are special limited obligations of the airports division and represent assignment of a proportionate interest in the lease and in the right to receive rent payments under the lease. Lease payments are secured solely by revenue and aviation fuel tax revenue, but are junior in priority to the pledge of the revenue securing the airport system revenue bonds outstanding, which are rated one notch higher at A+/Stable. We have applied the primary airport revenue bond criteria to determine the entity's general creditworthiness (issuer credit rating), including the calculation of all-in DSC including all liens of debt, and have applied this rating to the senior-lien airport system revenue bonds as well as assigned a rating one notch lower to the subordinate-lien COPs.

The series 2013 COP proceeds were used to fund $150 million in costs related to the implementation of an energy performance contract (EPC) between the department and Johnson Controls Inc. Hawaii Revised Statute 36-41 requires and the EPC guarantees that net energy savings offset the cost of the installation, energy saving equipment, and additional debt and provide substantial savings. Net overall savings is estimated at $160 million through fiscal 2034 (net of COP debt), with the majority of savings realized in fiscal years 2030 through 2034, when COP debt has matured. The project is also referred to as the ESCO (Energy Service Co.) project and is now essentially complete. As a result of energy savings and lower utility rates, utility expenses declined from $42 million in fiscal 2015 to $34 million in fiscal 2016, and, according to management, are expected to decline to $30 million in fiscal 2017.

The airport system also entered into a direct purchase (private placement) with Banc of America Public Capital Corp in April 2016 to finance improvements to Honolulu International Airport's cooling infrastructure. Based on our evaluation of the transaction documents, we view the direct purchase as not adding significant financial risk to other bondholders or the system itself.

The system's total debt (airport system revenue bonds and COPs) as of June 30, 2016 was $1.2 billion, all fixed rate, with total debt to enplaned passenger a low $69.

The State of Hawaii owns and operates the system through its Department of Transportation. The system includes all commercial facilities in the state, and the state accounts for them as a single integrated enterprise fund. The department has the authority to levy rates and charges that, along with aviation fuel taxes, are sufficient to comply with the bond indenture. The extensive 15-airport system consists of one large-hub airport, one medium-hub airport, three small-hub airports, and 10 nonhub or small secondary airports. It is the sole provider of commercial aviation facilities in the state, and we believe this a key credit strength that few other U.S. airports or systems can match. Multiple airports in the system can accommodate overseas flights (direct flights from the U.S. mainland to the neighboring islands is a growing trend) and interisland flights, and this helps to diversify system risk. Hawaii continues to be one of the most-visited states in the U.S.

The system's key strengths include its critical support of the tourism industry and its essential position providing transportation infrastructure within the state. Honolulu International Airport (HNL), serving the state's largest population center, has by far the largest share of systemwide traffic, covering 58% of enplanements with long (12,000-foot) parallel runways and ample gate capacity, including 29 overseas gate positions, 13 interisland gate positions, and 11 commuter aircraft parking positions. HNL was the 28th-largest airport in the U.S. by enplaned passengers in calendar 2015 (according to the Federal Aviation Administration) and has adequate airline diversity, in our view, with the largest airline--Hawaiian Airlines Inc.--having a 52% market share in fiscal 2016 across the system.

After the 15.2% decline in enplanements in 2009 resulting from the Great Recession (which was actually larger than the 12.2% decline in 2002 after Sept. 11, 2001), the airport system realized four consecutive fiscal years of enplanement growth--1.6% in 2010, 0.9% in 2011, 2.5% in 2012, and 6.3% in 2013--but a decline of 1.5% in fiscal 2014. The growth since fiscal 2009 is generally the result of improving U.S. and overseas economics, and despite the overall enplanement decline in fiscal 2014 international enplanements rose 4.3% that year. Despite the decline in fiscal 2014, enplanements resumed growth in fiscal years 2015 and 2016 at 2.4% and 3.2%, respectively, exceeding forecast growth of 1.5% and 2.9%, respectively. Management estimates enplanement growth of about 1.2% on average through fiscal 2021, which we view as conservative and reasonable. Systemwide enplanements in fiscal 2016 totaled 17.21 million, or 6% below the fiscal 2000 peak of 18.28 million, whereas more than half of U.S. large hub airports are now past historical peak enplanement levels. The enplaned passengers consisted of 59% overseas passengers and 41% interisland passengers.

The system largely handles origin-and-destination passengers, with such passengers representing 86% of enplaned passengers, or 98% when including neighboring island traffic. HNL serves as the hub of Hawaiian Airlines, is the largest of the system's five primary airports, and is classified as a large hub. It enplaned 9.9 million passengers in fiscal 2016, up 2.3% from 2015. The system's other four other primary airports enplaned 7.3 million passengers, up a strong 7% from fiscal 2015, accounting for 41% of systemwide passenger traffic. These airports have continued to add direct overseas flights.

According to management, the total number of departing seats in fiscal 2017 is forecast to be 3.4% above the fiscal 2016 level primarily because of a higher number of scheduled seats from Hawaii Island Air, which resumed air service at KOA (Kona) and LIH (Kauai) in spring 2016. In addition, Hawaiian Airlines added Kapalua (JHM-Maui) in fiscal 2017, and Jin Air started service from Incheon to Honolulu in December 2015. Allegiant Airlines, carrying 80,000, or 0.5% of total enplaned passengers in fiscal 2016, recently announced it would exit the Hawaiian market.

In terms of visitor activity to the state, westbound visitors by air from the U.S. accounted for 62.5% of total visitors in the first 11 months of 2016, with Japan accounting for 17.1% and Canada 5.2%. Following declines of 10.6% in 2008 and 4.5% in 2009, visitor arrivals have rebounded, increasing 7.7% in calendar 2010, 4.0% in 2011, 10.0% in 2012, 1.8% in 2013, 1.6% in 2014 and 4.5% in 2015 to 8.6 million. Visitor spending increased 4.1% during the first 11 months of 2016. Hotel occupancy reached 78.8% for 2015 (a multiyear high). The state's unemployment rate was just 2.9% in November 2016, the fourth-lowest rate in the U.S. and the state's lowest rate in eight years.

Although economic metrics continue their positive trends, risks remain. Despite the system's essential role, it and the state it serves remain exposed to cyclicality associated with the tourism industry. In our view, the system has outperformed the U.S. in recent good periods and underperformed during recent bad periods. The system has historically experienced larger passenger volume swings because of U.S. and international economic fluctuations; security, weather, and geological events such as the March 2011 earthquake and tsunami in Japan; health concerns (e.g., H1N1 and SARS); and airline service-level decisions. Also, state GDP, the broadest measure of the state's economy, suggests that Hawaii remains stuck in a slow growth mode, as it has expanded more slowly than national

GDP in recent years. In addition, many of Hawaii's industries are still in recovery mode.

The system's financial performance has been good in recent years, with senior-lien DSC ranging from 1.3x to 1.5x per our calculations during fiscal years 2012 to 2016. Audited fiscal 2016 results indicate senior-lien DSC of 1.34x and combined senior- and subordinate-lien DSC of 1.20x. Indenture-based senior-lien DSC includes the funded coverage account as revenue and includes rate mitigation, available passenger facility charge (PFC) revenue, and airline-contributed interest as offsets to debt service. Indenture-based senior-lien DSC was 1.62x in 2016 and 1.75x in 2015. Management's forecasts indicate indenture-based senior-lien DSC ranging from 1.52x to 1.56x during fiscal years 2017 to 2021. According to management's forecast, we calculate that all-in DSC will decline to 1.05x by fiscal 2021 given the ramp-up in subordinate-lien debt service related to the series 2013 and 2016 COPs, with net revenue not keeping pace. In our view all-in DSC is thin; this is less of a risk when liquidity is very strong but could become more of a risk if the system spends down liquidity. We also note that, given the airport system's residual rate-setting methodology, we recognize that higher DSC is not usually sustainable. Our senior-lien rating takes into account all-in DSC, and we rate subordinate-lien debt one notch lower, per our criteria "Assigning Issue Credit Ratings of Operating Entities," published May 20, 2015 on RatingsDirect. System liquidity has improved significantly since 2009, when it dipped to $337 million, or 526 days' cash. Cash balances have risen by $221 million to $558 million, equal to 785 days' cash, as of fiscal 2016. Management plans to maintain unrestricted cash near current levels, which we consider extremely strong.

The system has taken steps to control expenditure growth, especially with regard to the ESCO project, and management forecasts that the overall cost structure will increase gradually as it addresses capital needs and as airline-generated revenue from increased rates becomes a larger proportion of the total. The system is undertaking a number of improvement and modernization projects totaling $2.6 billion over the next five years. Despite its projected large capital improvement plan (CIP), and given revised cost estimates and enplanement forecasts, management projects that CPE will rise to only $10 by 2018 and $12 by 2020, which we consider in line with the rating category. Also among credit risks is an increasing debt burden, as airport bonds will fund about $1.1 billion, or 44%, of capital needs. The airport system anticipates issuing $250 million in airport revenue bonds in late calendar 2017 or early 2018 and another $250 million 18 months later to fund projects within the CIP. Revenue bonds outstanding as of fiscal 2016 total $1.01 billion. Pro forma debt per enplanement, including the next two series of bonds anticipated to be issued (and net of amortizing principal), is estimated at $1.5 billion, or about $87 per projected enplanement. Although this may be higher than the median of $78 per enplanement for the rating category, we view the discrepancy as insignificant.

Bond And Certificate Provisions

The senior-lien airport revenue bonds are secured by senior-lien system revenue and aviation fuel tax revenue after O&M costs. The COP payments are junior to revenue bond debt service; to payments to the maintenance, renewal, and replacement account; and to transfers to the state's general fund for reimbursable general obligation bonds, improvements to the system, and transfers to special reserves. PFC revenue is excluded from revenue unless explicitly identified in a supplemental certificate.

Bond provisions are, in our view, weaker than the industry standard, mostly because of the system's ability to add to operating revenue and reduce the debt service requirements to satisfy the rate covenant. In our view, these provisions, in combination with existing certificate provisions, reduce the system's cash flow from rates and charges.

The senior-lien bond rate covenant requirement is set to 1.25x annual adjusted debt service requirements for the next 12 months and allows for the use of unencumbered funds to meet the test, and we consider these provisions permissive. Although the 1.25x rate covenant does not include COP debt service in the calculation of the annual adjustment debt service requirement, the signatory airlines have consented to the ESCO project, and payments under the lease are included in the department's expenses for purposes of the rate covenant. The additional bonds test is industry standard and is a two-part historical or prospective test. The historical test requires that net revenue and taxes--plus unencumbered funds in the airport revenue fund not exceeding 25% of the adjusted maximum annual debt service (MADS) requirement--are not less than 125% of the total adjusted MADS requirement for issued and proposed debt. The prospective test requires both satisfaction of the rate covenant and a consulting engineer's projections of 125% coverage of annual adjusted debt service by net revenue and tax revenue for three years after construction of the financed projects. A reserve fund at MADS is required.

Certificate provisions include a debt service reserve fund funded at the least of 10% of par, 125% of average annual debt service, or MADS. COP interest was partly capitalized until Feb. 1, 2015. The COPs are structured to be retired after 13 years of the 18-year "performance period" (15 years from date of issuance), and this reduces financing costs and results in substantial cost savings in the final years of the performance period while remaining compliant with Hawaii Revised Statute 36-41.

Outlook

The stable outlook reflects our anticipation that the capital program will not pressure the cost structure significantly more than forecast, that liquidity will remain at or near very strong levels, that DSC will be maintained at adequate levels, and that demand will not significantly deteriorate.

Upside scenario

We could raise the rating during the next two years in the unlikely event that demand strengthens materially and, in our view, sustainably, and if management successfully completes its major capital projects such that the system's overall CPE and debt ratios come in materially below forecast. This scenario also assumes liquidity is maintained at or above strong levels.

Downside scenario

Given the system's robust cash position and generally good enplanement and tourism trends, including what we believe is a strong base level of demand given the system's monopolistic market position, we are unlikely to lower the rating during the next two years. That said, if liquidity materially declines or enplanements suffer sustained declines, we could lower the rating.

Ratings Detail (As Of January 31, 2017)

Ratings Detail (As Of January 31, 2017) (cont.)		
Hawaii Arpt Sys airport system rev bnds ser 2015A due 07/01/2045		
Long Term Rating	A+/Stable	Affirmed
Hawaii Arpt Sys AIRPORTS		
Long Term Rating	A/Stable	Affirmed
Hawaii		
Hawaii Arpt Sys, Hawaii		
Hawaii (Hawaii Airport System) (AGM) (SEC MKT)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
Many issues are enhanced by bond insurance.		

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