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Hawaii Airport System; Airport

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Hawaii Airport System; Airport

Credit Profile		
US$297.81 mil arpt sys rev bnds refdg (Hawaii Arpt Sys)ser 2011 due 04/01/2021		
Long Term Rating	A/Stable	New
Hawaii		
Hawaii Arpt Sys, Hawaii		
Hawaii (Hawaii Arpt Sys)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services assigned its 'A' long-term rating to Hawaii Airport System's $297.81 million series 2011A airport system revenue bonds and affirmed its 'A' long-term rating and underlying rating (SPUR) on the system's previously issued airport system revenue bonds. The outlook on all ratings is stable.

The rating reflects our view of the airport system's:

- Monopolistic position and very high essentiality for transport within the state (serving a unique travel market with 15 airports throughout Hawaii and with no significant concentration of carriers);
- Historically very strong liquidity position for the rating, including an unaudited $497 million, or about 835 days of expenditures, in unrestricted cash as of June 2011;
- Management's plan to cease providing rate mitigation to airlines, which we believe improves the system's financial profile; and
- Moderately low overall debt combined with a good mix of capital program funding sources.

Partly offsetting the above strengths is our view of the airport system's:

- Dependence on a tourism-concentrated economy exposed to downturns associated with U.S. and global economic events (although given the essentiality of the system, we anticipate that the system will maintain a strong base level of demand), and
- Sizable-but-downsized 10-year capital improvement program totaling $1.3 billion that is exposed to cost escalation.

The bonds are secured by system revenues and aviation fuel taxes after operations and maintenance (O&M) costs. We understand that the bond proceeds will refund the system's series 2001 bonds, outstanding in the amount of $323 million. The system's total debt as of June 30, 2011, was $967 million, with total debt to enplaned passenger at a low $64.

Hawaii (AA/Stable general obligation rating) owns and operates the system through its Department of Transportation. This includes all commercial facilities in the state, which 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 includes one large-hub, one medium-hub, three small-hubs, 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 share.

After a significant 15.2% decline in enplaned passengers in fiscal 2009 to 14.8 million -- a more significant decline than that in fiscal 2002 after the terrorist attacks of Sept. 11, 2001 -- enplanements rose 1.6% in fiscal 2010 to 15.1 million. Leading the fiscal 2010 increase was a 10.5% increase in international passengers to 2.1 million and an 11.2% rise in average fares at Honolulu International Airport (HNL). Increased load factors during fiscal 2010 helped offset service reductions. Enplanement data for unaudited fiscal 2011 indicates enplanement rose a slight 0.9% to 15.2 million, up from 15.1 million in fiscal 2010. In calendar 2011, more than 200 new flights were added in the first two months alone. The system's consulting engineer projects annual enplanement growth of 1.1% annually through 2016. This growth rate, although conservative, is still higher than the compounded annual growth rate of the past 10 years. In fiscal 2011, the system's 15.2 million enplaned passengers consisted of three types: 41% westbound overseas domestic service passengers from the continental U.S., 14% overseas international (including Canada) passengers, and 45% inter-island or domestic passengers traveling among the Hawaiian Islands.

We view favorably the system's fundamental strengths, including its support of the tourism industry and its essential position providing transportation infrastructure within the state. HNL, serving the state's largest population center, is the workhorse of the system, representing 60% of the system's total passengers (72% of total overseas passengers) with long (12,000-foot) parallel runways and ample gate capacity, including 29 overseas gate positions, 13 inter-island gate positions, and 10 commuter aircraft parking positions. HNL is the 25th-largest airport in the U.S. by enplaned passengers and has very good airline diversity, in our view, with the largest airline -- Hawaiian Airlines Inc. -- having a 38% market share in 2011 across the system and a 45% market share at its HNL hub.

HNL, on the island of Oahu, is the largest of the system's five primary airports and is classified as a large hub. In fiscal 2011 it enplaned 9.1 million passengers, virtually unchanged from 2010 but up 2.5% from fiscal 2009. In fiscal 2011, the system's other four other primary airports enplaned 6.1 million passengers, up 2.2% from fiscal 2010, accounting for 40% of systemwide passenger traffic. As the visitor infrastructure expands, these airports have seen an increase in direct overseas flights and accounted for a combined 27% of the system's overseas passengers in fiscal 2010, in line with fiscal 2009 but up from 18% in fiscal 1995. HNL largely handles origin and destination (O&D) passengers, representing 80% of enplaned passengers in 2010, and serves as the hub of Hawaiian Airlines.

In terms of visitor activity, westbound visitors from the U.S. accounted for 65% of total visitors in 2010, with 18% from Japan. Visitor arrivals increased 8.8% in 2010 and 3.4% during the first seven months of 2011. Overall passenger counts increased 2.5% during the first seven months of 2011, with total air seats up 1.4%. International flights from Japan dropped sharply right after the earthquake and tsunami of March 2011, falling by as much as 30% by the middle of April but recovering to normal by August 2011. For 2011, the state forecasts total population growth of 0.8%, a visitor arrival increase of 3.0%, a visitor expenditure increase of 12.0%, and personal income growth of 3.8%.

Despite its essential role, the system and the state it serves remain exposed to cyclicality associated with the tourism industry. In our view, the system has performed better than the U.S. in recent good periods and worse during recent bad periods. The system has historically experienced larger passenger volume swings due to 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.

The system's financial performance has mirrored its operational performance, with generally good margins before

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rate mitigation offsets and excellent liquidity during the growth years of 2005 through 2008, but with some erosion in both metrics in 2009 as operations weakened and as the system spent down cash on capital. Indenture-based debt service coverage (DSC) did improve to 2.15x in audited fiscal 2010 from 1.74x in 2009, and unrestricted cash rose to $415 million, or 711 days' cash, in 2010 from $337 million, or 521 days' cash, in 2009. For unaudited fiscal 2011, management estimates unrestricted cash balances of $497 million, or 835 days' cash, and DSC of 1.99x. Management plans to maintain unrestricted cash near historical levels, which we consider extremely strong. The system has taken steps to control expenditure growth, but expects the overall cost structure to increase significantly as it addresses capital needs and as airline-generated revenue from increased rates becomes a larger proportion of the total. Despite the steady income stream from the division's mix of operational revenue sources, reduced passenger traffic due to the downturn has required the system to implement increases in signatory airline fees to sustain decreases in concession revenues, interest income, and federal operating grants. Management has, however, been instrumental in implementing operational cost savings measures relating mainly to personnel, security, and utilities.

In the face of enplanements that are below levels of 15 years ago (17.6 million) and its 2000 peak (18.2 million), the system is undertaking a number of improvement and modernization projects totaling $1.3 billion. These projects are exposed to potential cost increases that could pressure its cost structure, which management projects will increase to more than $14.50 per enplaned passenger by 2016 from $7.65 in 2010. Other rating concerns include a moderate-but-increasing debt burden and a multiyear pattern of management actions to mitigate airline rates with the effect of reducing financial margins that are already forecast to narrow.

Airlines serving the airport system operate either under an airline agreement (28 signatory airlines) or in accordance with state administrative rules (nonsignatory airlines). In light of the economic slowdown and operating challenges of the airline tenants, the system took action to substantially reduce airline rates and charges through fiscal 2010 by applying cash to reducing debt service requirements. This reduces rates such as landing and terminal rental fees. We had previously viewed the new airline lease agreements for the system as of Jan. 1, 2008, positively, because the adoption of industry-accepted standards relative to rate-setting and cost-recovery methodologies were likely to produce more predictable financial results. Although the system reports that it does not plan further rate mitigation and that it will not require keeping airline payments below any preset level, increased costs could pressure management to provide rate mitigation. We believe rate mitigation and application of revenues to reduce interest payments before setting airline rates do not optimize the enterprise's financial overall performance under the applied rate methodology, and that they have reduced financial margins from operating revenues. Projected airport system DSC declines to a low of 1.36x in 2013 (calculated as per the indenture), or 1.09x on an operating cash-flow basis. The system treats dedicated passenger facility charges (PFC) as revenues while excluding amounts in the DSC account.

Revenue diversity is well balanced, in our view, but this will change, with airline revenues forecast to generate 59% of the total by fiscal 2016 from 30% in fiscal 2007 as airline costs increase and concession revenues lag due to projected slow passenger growth. Airline revenues in unaudited fiscal 2011 consist of airline landing fees and aeronautical rentals (48%), concession fees and nonaeronautical rentals (46%), and nonoperating revenues (8%).

Historical DSC performance has complied with the lenient airport rate covenant requirement, but has been adequate, in our view, based on operating cash flow. In fiscal 2005 through 2010, the system provided rate mitigation (in the form of offsets to debt service) of $10 million to $28 million. As a result, DSC calculated as per the indenture, which allows these offsets as well as the addition of amounts from the coverage account, has ranged from 1.6x to 2.3x. However, cash flow coverage (adjusted net revenues compared with gross debt service) compares

less favorably with DSC, ranging from less than 1.0x to 1.4x. Although this DSC range is of little concern when liquidity is very strong, it could become more of a concern if the system spends down liquidity. Indenture-based coverage is forecast at 1.33x for 2012, or 1.08x when not including the funded coverage account.

In 2007, the system developed a 10-year, $2.4 billion capital program to fund improvement and modernization projects for the system, including the HNL terminal modernization program (TMP). Reflecting the recession, the system reduced this program in July 2009 to a subset of projects totaling $1.3 billion. With an estimated cost of $444 million, the TMP's largest component is a new Mauka concourse and apron. The concourse is a 220,000-square-foot facility parallel to the inter-island terminal and includes wider taxiways to provide aircraft access as well as relocated cargo and maintenance facilities and commuter terminal. The environmental review process has delayed the next bond sale to supplement funding for this project, and management estimates the next issuance at $426 million in fiscal 2013. Funding sources are varied and include federal grants, PFCs, internally generated cash, and bond proceeds that officials expect will represent $683 million, or 52% of the overall program.

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 strong, and that demand will not significantly deteriorate. We do not expect to raise the rating over the next two years, given additional bond issuance plans that will increase the system's overall cost structure and debt ratios. Given the system's robust cash position and improving enplanement and tourism trends, we are unlikely to lower the rating over the next two years.

Economy

After sustained economic expansion in 2003 through 2007, when many sectors performed at record levels, Hawaii's (population 1.3 million) economic trends decelerated and, in many cases, turned negative in 2008 through 2010. However, some positive trends are emerging and some economic metrics indicate that the state was relatively more resilient than the national economy during the recession. Job counts fell 1% in 2008 and 3.4% in 2009, but only a slight 0.4% in 2010. For the first seven months of 2011, job counts are up 1.4%. Officials conservatively project 1.5% job growth in 2011 as a whole. Unemployment, at 6.4% in July 2011, was still well below the national rate of 9.3%, and the state's 2010 rate of 6.6% was the seventh-lowest in the nation. Since 2003, Hawaii's unemployment rate has generally been 2% to 3% below the national rate.

Where Hawaii's economy remains most vulnerable, and perhaps where it has been most affected, is tourism, an industry that is weak due to reduced consumer spending, job losses, the recent seismic and tsunami events in Japan, and competitive marketing campaigns from multiple tourism destinations (e.g., Las Vegas). Visitor arrivals declined 10.9% in 2008 (versus 12.2% for the U.S.) and 4.5% in 2009, but rebounded by a moderate 8.7% in 2010. Prior to the March 11 Tohoku earthquake in Japan, officials had projected visitor arrivals to grow 4% in 2011, but revised figures indicate growth will be 3%. Despite that several airlines reduced flights to and from Japan due to the natural disaster, with a projected 10.5% reduction in April through June 2011, air seats increased 1.4% in the first seven months of 2011. Hotel occupancy fell to 64.8% in 2009 from 70.5% in 2008, but rebounded to 70.7% in 2010 and was at 72.8% through the first half of 2011. Visitor spending, after declining 12.3% in 2009, rose 16% in 2010 and is forecast to rise 12% in 2011.

Bond Provisions

The bonds are secured by system revenues and aviation fuel taxes after O&M costs. PFC revenues are excluded from revenues unless explicitly identified in a supplemental certificate. Bond provisions for the recently issued series 2010 bonds are, in our view, weaker than the industry standard, mostly due to the system's ability to add to operating revenues and reduce the debt service requirements to satisfy the rate covenant. In our view, these modifications, in combination with existing certificate provisions, will likely reduce the system's cash flow from rates and charges.

The 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, which we consider to be weak. This is in addition to a funded DSC account maintained at 25% of gross annual debt service. The use of certain unencumbered funds to satisfy the rate covenant calculation occurred in fiscal 2009 and 2010, when the system deposited $17.5 million and $16.8 million, respectively, to the interest account to mitigate airline rates. The system does not expect any further rate mitigation. The additional bonds test is industry standard and is a two-part historical or prospective test. The historical test requires that net revenues and taxes -- plus unencumbered funds in the airport revenue fund not exceeding 25% of the maximum annual adjusted debt service requirement -- are not less than 125% of the maximum total annual adjusted debt service 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 requirement from net revenues and taxes for three years after construction of the financed projects.

Related Criteria And Research

USPF Criteria: Airport Revenue Bonds, June 13, 2007

Ratings Detail (As Of September 12, 2011)		
Hawaii		
Hawaii Arpt Sys, Hawaii		
Hawaii (Hawaii Airport System)		
Long Term Rating	A/Stable	Affirmed
Hawaii (Hawaii Airport System) (wrap of insured) (FGIC) (ASSURED GTY) (SEC MKT)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Hawaii (Hawaii Airport System) (AGM) (SEC MKT)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Hawaii (Hawaii Airport System) (FGIC) (SEC MKT)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

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