Fitch Rates Hawaii Airport Lease Revenue COPs 'A-'; Affirms Rev Bonds at 'A'; Outlook Stable

Ratings Endorsement Policy
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Fitch Ratings-Chicago-26 November 2013: Fitch Ratings has assigned an 'A-' to $170 million in Lease Revenue Certificates of Participation (COPs) being issued by the State of Hawaii's Department of Transportation (Airports Division) on behalf of the Airports System (the system). In addition, Fitch has affirmed its underlying long-term 'A' rating on approximately $878 million of outstanding airport system revenue bonds.

The Rating Outlook on all bonds is Stable.

KEY RATING DRIVERS

MONOPOLISTIC POSITION WITH LEISURE EXPOSURE: Air travel is essential for Hawaii due to a lack of alternative forms of transportation, providing the airport system with a stable origin and destination base of approximately 16.5 million enplaned passengers. The economy is anchored by tourism, but the large military presence somewhat stabilizes the traffic base. Revenue Risk Resilience: Midrange.

ROLLING AIRLINE AGREEMENT IMPOSING REASONABLE RATES: The hybrid airline use and lease (AUL) agreement, covering more than 60% of operating costs, does not have an expiration date and automatically extends quarterly. Cost per enplaned passenger (CPE) remains competitive at $8.56 in fiscal 2013 and, although it is anticipated to rise to around $12 as capital spending occurs, this is not anticipated to affect traffic demand given Hawaii's continued attractiveness as a tourist destination and necessity of air travel to, from and between the archipelago's various islands. Revenue Risk Price: Stronger.

Large Capital Plan Partially Debt Funded: The airports division's capital program through fiscal 2018 totals approximately $2.7 billion, with additional revenue bond borrowing of around $870 million expected over the period. Prudent management of capital spending and borrowings will be important. Infrastructure Development/Renewal Risk: Midrange.

Conservative Debt Structure: Revenue bond debt is 100% fixed rate with a declining debt service profile and final maturity in 2039. The COPs are fixed rate with a 15 year maturity, and an increasing debt service profile that is structured to match the increase in the annual energy savings guarantee from Johnson Controls Inc. (JCI) under the energy performance contract. Additional airport revenue bonds related to the capital improvement plan (CIP) will be issued beginning in late 2014. Debt Structure Risk: Stronger.

Historically Sound Financial Metrics May Face Pressure: The airports division's leverage position is currently low compared to peers with debt per enplanement at $65 and net debt-to-cash flow available for debt service (CFADS) at 2.1x in fiscal 2013. However airport leverage is anticipated to increase from its current level to the 6x range with the borrowings associated with the capital plan. Since fiscal 2007, debt service coverage has ranged from 1.61x to 2.14x, and in 2013 was 1.75x. Liquidity remains strong, with days cash on hand in fiscal 2013 being 853. Debt Service Risk: Midrange.

RATING SENSITIVITIES

--Material increases in the overall capital spending plans or higher leveraging to support the current CIP.
--Trends that indicate lower coverage levels due to weaker than expected operating revenues or expenses for a sustained period may lead to rating pressure.
--A sustained decline or higher volatility in airport traffic performance could weaken credit quality.
--The ratings are unlikely to be considered for upgrade in the near future on account of the airport system's exposure to tourism as well as its significant capital plan.

SECURITY

The airport system revenue bonds are secured by net revenues of the airports system and aviation fuel taxes with final maturity expected in 2039.

The proposed lease revenue COPs will be secured by payments pursuant to the lease, and payable by revenues of the airports system, junior to the position of the outstanding revenue bonds and subject to annual appropriation. The projects associated with the COPs have been approved by the carriers serving the airport system and can be included in airline charges to support repayment of the COPs.

The rating distinction between the revenue bond liens reflects the subordinated nature of the obligation securing the COPs, and weaker coverage covenants when compared to the senior debt.

TRANSACTION SUMMARY:

The airports division is issuing $170 million in 2013 lease revenue COPs, Series 2013, on behalf of the airport system. Proceeds from the issuance will finance the implementation of an energy performance contract between the department and Johnson Controls, Inc (JCI), including the purchase and installation of certain equipment, and will finance energy efficiency projects at airports throughout Hawaii, as well as fund a debt service reserve in the amount of $17 million. The COPs will pay a fixed rate and mature in 2029.

The 2013 COPs will be a newly established credit vehicle of the airports division and structured to comply with requirements of applicable state law for energy performance related financings. The lease agreement is between the airports division and JCI with title, rights and payments assigned to the trustee on behalf of the COPs investors. The airports division selected JCI in 2012 to implement various energy conservation measures (ECMs) across the airports system. Lease obligations are payable from net revenues of the airports system, but are junior to the payment of revenue bond debt service. The project is expected to generate significant benefits, reducing energy usage by approximately 49 and translating into $17.2 million in energy savings in the first year following implementation.

The 20-year agreement comprises two years of construction followed by an 18-year performance period, and contractual protections include a performance bond covering 100% of construction costs. In addition, JCI will provide an energy savings guarantee and pay shortfall payments to the airports division to the extent verified energy savings are less than the guaranteed amount. This guarantee will be insured for the initial five years of the performance period, and may be renewed.

The airport system's signatory airlines have approved the related energy projects and have agreed to include lease payments in their rates and charges. They are therefore obliged to cover debt service on the COPs in the event JCI fails to perform or pay its obligations.

Passenger activity has slowly recovered following the severe decline of 15.2% in fiscal 2009, with system enplanements growing at a 2.8% compound annual growth rate (CAGR) since then, and- in fiscal 2012 enplanements reached 15.57 million, increasing a further 6.3% in 2013. Year-to-date (YTD) fiscal 2014 enplanements are up an additional 1.1%. Overseas enplanements have been more resilient than inter-island traffic, growing at a five-year CAGR of 1.6% as compared to an annual decline of 4.1% for the latter.

Operating revenues have increased in recent years despite fluctuations in enplanements, growing at a CAGR of 6.8% between fiscal 2008 and 2013 (unaudited). In addition, although operating expenses in 2013 were 7.3% higher than the year prior, they are largely flat on a 5-year basis. Going forward, continued discipline in managing costs will be important to maintenance of the rating: should expense escalation return to levels seen prior to 2009 the rating may be pressured. Nevertheless, airlines currently support the airports' costs under a strong hybrid agreement. In fiscal 2013, CPE was $8.56, although the airports division expects CPE to increase to $12 as it implements its capital program.

Debt service coverage (DSC) was 1.75x in fiscal 2013, up from the previous year but down from above 2x, recorded in fiscal years 2010 and 2011, and is expected to decline to the 1.5x range for the revenue bonds in the coming years as debt service requirements increase. COPs coverage is expected to be in the 1.4x range. The airport division will benefit from the application of certain passenger facility charge (PFC) funds to offset debt service starting in 2015.

The CIP through fiscal 2018 totals $2.7 billion, including $567 million already expended as of June 2013. Projects are expected to be 47% bond funded, including $395 million in proceeds from the 2010 revenue bond issuance, 26% CFC funded , 13% grant funded, and 8% PFC funded on a 'pay as you go' basis, with the balance funded from airport cash balances.

In addition to the 2013 COPs issuance for energy efficiency projects, near term debt issuances are expected to include

$250 million of CFC backed bonds for consolidated rental car facility improvements in 2014 and $252 million airport system revenue bonds for other airport projects in late 2014 or early 2015. As a result of the expected revenue bonds, Fitch anticipates leverage will increase to 6x in 2015 from current levels of 2.12x.

The airports system consists of 15 airports located throughout the state operating under the airports division. Hawaii's location (over 2,000 miles from the nearest continent) combined with the distance between the islands make commercial air service essential for both inter- and intra-state travel.

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Applicable Criteria & Related Research:
--'Rating Criteria for Infrastructure and Project Finance' (July 11, 2012);
--'Rating Criteria for Airports' (Nov. 27, 2012).

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Rating Criteria for Infrastructure and Project Finance
Rating Criteria for Airports

Additional Disclosure
Solicitation Status