FitchRatings

FITCH UPGRADES HAWAII AIRPORT REVENUE BONDS TO 'A+'/'A'; OUTLOOK TO STABLE

Fitch Ratings-New York-26 October 2017: Fitch Ratings has upgraded $1.015 billion of outstanding Hawaii Department of Transportation (Airports Division) airport system revenue bonds to 'A+' from 'A', and $167 million of outstanding series 2013 lease revenue certificates of participation (COPs) to 'A' from 'A-'. The Rating Outlook has been revised to Stable from Positive.

The Airports Division also has $59 million outstanding in parity COPs that are not rated by Fitch.

The upgrade reflects continued strong operational and financial performance with credit metrics remaining above previously forecast levels, even as the Airports Division favorably progresses with its capital improvement plan (CIP).

KEY RATING DRIVERS
The ratings reflect the essentiality of air traffic to an island system of airports that generates a solid base of origination and destination (O&D) traffic in a stable service area. The ratings also reflect the competitive, albeit rising cost per enplanement (CPE), low overall leverage, and strong cash position which partially mitigate the risks associated with the airport system's predominantly leisure traffic base. 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 those of the senior debt.

Monopolistic Position; Leisure Exposure - Revenue Risk (Volume): Stronger
The necessity of air travel to, from, and between the archipelago's various islands provides the airport system with a stable O&D base of approximately 17.2 million enplaned passengers. The economy is anchored by tourism, but the large military presence somewhat stabilizes the traffic base. The monopolistic nature of the system further mitigates the risk of its slightly elevated carrier concentration, with Hawaiian Airlines (B+/Positive) accounting for approximately half of total system enplanements.

Rolling Airline Agreement - Revenue Risk (Price): Stronger
The hybrid airline use and lease agreement, covering more than 60% of operating costs, does not have an expiration date and automatically extends quarterly. CPE remains competitive at $9.08 in fiscal 2016, lower than previously expected. CPE is projected to rise on a modest incline to the $12-$14 range as capital spending occurs; however, it is not anticipated to affect traffic demand given Hawaii's continued attraction as a tourist destination.

Partially Debt-Funded CIP - Infrastructure Development/Renewal: Midrange
The Airports Division's capital program through fiscal 2022 totals approximately $2.7 billion, with additional revenue bond borrowing of approximately $630 million expected over the period. Close oversight from the state government together with prudent management of capital spending and borrowings will be important to maintaining the rating. The timing and amount of borrowing is subject to change prior to issuance.

Conservative Debt Structure - Debt Structure: Stronger (Senior); Midrange (Subordinate)
Revenue bond debt is 100% fixed-rate with a declining debt service profile and final maturity in 2045. The COPs are fixed-rate with final maturity in 2029, and have 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. 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 those of the senior debt. The Airports Division expects to issue approximately $300 million in 2018 and $330 million in 2019 to fund its capital improvement plan (CIP), though these figures remain preliminary.

Financial Profile
DOTA's leverage position as measured by net debt to cash flow available for debt service (CFADS)is moderate compared to peers, at 3.9x in fiscal 2016 for senior debt and 5.5x on an all-in basis. Since fiscal 2007, senior debt service coverage has ranged from 1.6x to 2.1x, with fiscal 2016 at 1.6x (1.5x including COPs). Under Fitch's rating case contemplating an 8% decline in enplanements followed by modest recovery, all-in airport leverage is anticipated to increase from its current level to the 7x range with the borrowings associated with the capital plan, while all-in coverage averages 1.4x. Liquidity remains strong with 786 days cash on hand (DCOH) in fiscal 2016. Management intends to maintain liquidity at comparable levels going forward, though some cash may be used to offset additional borrowing costs.

PEER GROUP
Hawaii's peers include Greater Orlando Aviation Authority (AA-/A+/Stable) and Las Vegas McCarran International Airport (A/A/Stable) given similar enplanement bases and traffic trends as well as debt amounts. Hawaii has the highest carrier concentration of the three, but also has the strongest liquidity position as measured by DCOH. Both Hawaii and Orlando will see rising but competitive CPE and leverage as their CIPs progress.

RATING SENSITIVITIES
Future Developments That May, Individually or Collectively, Lead to Negative Rating Action:
--Sustained all-in leverage above 8x;
--Heightened volatility or sustained negative trends in enplanement levels.

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action:
--Successful execution of the CIP under stable traffic performance, coupled with sustained maintenance of all-in leverage below 5x.

CREDIT UPDATE
Performance Update
Total system enplanements and carrier service continue to trend positively and have achieved pre-recession levels. Enplanements rose to 17.2 million in fiscal 2016, a 3.2% rise over the year prior, and building on a five-year CAGR of 2.4%. Overseas enplanement activity continues to outpace interisland travel, as carriers add direct overseas service to additional island airports. Overseas flights grew 4.1% in fiscal 2016, accounting for 59% of total enplanements. Interisland flights, which account for the remainder, grew 2% in fiscal 2016. The first six months of fiscal 2017 saw a further 3% increase in total enplanements over the same period in fiscal 2016, driven primarily by increased overseas traffic. Fitch views this diversification of traffic across the system positively, as it reduces the exposure to a single airport.

The Airports Division expects near-term traffic results will be better than projected due to Island Air expanding interisland traffic, more than doubling capacity over last year; United Airlines announcing expanded service; and Hawaiian Airlines and ANA deploying larger planes for their Hawaiian services. Departing seats are currently scheduled to increase 10% over the year prior in the first half of fiscal 2018, well above management's forecast enplanement increases of 4.3% and 1.6% for 2017 and 2018, respectively.

Fiscal 2016 operating revenue increased 6.4% to $353 million, reflecting a rise in landing fees from increased passenger traffic. Airline revenues, which represented 51.4% of operating revenues in 2016, increased 15.4%, while non-airline revenue decreased approximately 1.7% due to decreased concessions and a drop in airport fuel tax revenues following a reduction in the aviation fuel tax from $.02 to $.01 per gallon effective Jan. 1, 2016. Overall airline and fuel tax revenues are expected to increase 7.8% for 2017, and management indicates non-airline revenues are preforming better than expected. Fitch views positively the system's ability to generate additional non-aviation revenue, allowing for offsets to increasing airline costs as the CIP progresses.

Continued discipline in managing costs remains important to maintaining the rating. Operating expenses have been increasing moderately with annual growth of 3.7% from 2011-2016, and utility savings from the Airports Division's energy conservation project should help to offset increasing expenses. Airlines currently support the system's costs under a strong hybrid agreement. In fiscal 2016, CPE was lower than expected at $9.08, and is forecast to increase to the $12-$14 range through 2023 as the Airports Division progresses with its capital program.

Debt service coverage for senior revenue bonds was 1.6x in fiscal 2016, down slightly from 2015 but in line with ratios seen since 2008, while all-in coverage including COPs totaled 1.5x. The Airports Division and the airlines agreed to apply $4 million of prepaid interest to reduce airline rates for fiscal 2016. No such offsets are foreseen for fiscal 2017, but if billing leads to an overcollection, the Airports Division and the airlines may continue applying this money to reduce airline rates and charges. Leverage was 3.9x senior and 5.5x all-in, slightly higher than the prior year due to incorporation of principal from the 2015 borrowing.

The Airports Division received approval from the Federal Aviation Administration to use $414 million of passenger facility charge (PFC) revenues for PFC-eligible debt service. PFCs totaling $321,000 were available for debt service in fiscal 2016, and PFC offsets are expected to rise to $20 million annually by 2023. Management indicates they have begun a new PFC application process, seeking more than $340 million in imposed and use authorization for miscellaneous airport projects. While preliminary, if the application is successful these additional PFC funds will be available to help cover expected future CIP costs.

The CIP through fiscal 2022 totals $2.7 billion, including $888 million already expended as of December 2016 (33%). Projects are expected to be funded with additional debt issued in 2018 and 2019 totalling $630 million, customer facility charges, grants, PFCs funded on a pay-as-you-go basis, and also from airport cash balances. Additionally, the 2017 Hawaii State Legislative Session approved an additional $771 million of capital projects, mainly terminal renovation and airfield maintenance. The Airports Division is in discussion with airlines about scheduling and costs for these projects. Once these discussions are concluded, these projects may be added to the CIP.

Fitch Cases
Fitch viewed management's forecast as reasonable, and adopted it as the base case: enplanements grow 4.3% in 2017, followed by 1.4%-1.6-% growth through 2023 (1.5% CAGR); total revenue increases 5.7% through 2023, reflecting additional increases in rates and charges as continued portions of the CIP come online, as well as an increase in concessions due to new agreements. Expenses increase at a 5.9% CAGR through 2023. Additional issuances in 2018 and 2019 totalling $630 million are included. Senior coverage averages 1.6x through 2023, and 1.4x including COPs. CPE rises to the $12-$13 range through 2023. Senior leverage rises to 5.7x in 2019 (approximately 7x all-in) as additional issuances begin amortizing; however, leverage rapidly declines to below its current level by 2023.

Fitch's rating case assumes an 8% stress to enplanements in 2018 with moderate recovery of 2.5% through 2021 followed by slight growth of 1.0% until 2023, resulting in a traffic CAGR of 0.8%. Expenses rise at an annual growth rate of 6.4%. Coverage is managed to 1.60x on the senior lien, causing airline costs to increase at a greater rate than the base case. Under this scenario, CPE rises above $14 by 2022. Total leverage increases to approximately 7.5x in 2019, before falling to the 4x-5x range by 2023 as airline revenues increase to offset additional debt requirements.

SECURITY
The revenue bonds are secured by net revenues of the airport system and aviation fuel taxes with final maturity expected in 2045. The lease revenue COPs are secured by payments pursuant to the lease, and payable by revenues of the airport 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.

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Applicable Criteria
Rating Criteria for Airports (pub. 14 Dec 2016)
https://www.fitchratings.com/site/re/891804
Rating Criteria for Infrastructure and Project Finance (pub. 24 Aug 2017)
https://www.fitchratings.com/site/re/902689