MOODY'S
INVESTORS SERVICE

Rating Update: Moody's maintains Hawaii Airports' A2 on senior lien and A3 on subordinate certificates of participation; Outlook is stable

Global Credit Research - 10 Apr 2015

Airport currently has $1.03 billion rated debt outstanding

HAWAII (STATE OF) AIRPORT ENTERPRISE
Airports
HI

NEW YORK, April 10, 2015 --Moody's Investors Service maintains an A2 rating on the $862.7 million Hawaii Department of Transportation - Airports Division's senior lien revenue bonds and an A3 rating on the $167.7 million State of Hawaii Department of Transportation - Airports Division Series 2013 Certificates of Participation (COP). The outlook is stable.

SUMMARY RATING RATIONALE

Both the rating and the outlook reflect the strength of the airport system's near monopoly over air travel to and from the islands, the essentiality of air service for tourism and intrastate travel, and the solid historical financial performance. The airport system's liquidity is a key measure of its financial strength and we expect that cash will continue to decline as the system moves forward with its extensive capital improvement plan (CIP), but not fall below one year days cash on hand. The airport does not anticipate providing rate relief to the airlines, and has not done so since FY 2010. This move toward full cost recovery is viewed as positive for the system's credit, especially as it moves forward with its large capital plan.

The A3 rating on the COPs is based on the lease agreement payments, as junior obligations, made by the airport system to the lessor, Johnson Controls, Inc (JCI, senior unsecured rated Baa2, stable outlook). The rating also considers the strong savings in operating expenses that the airport system expects to receive as a result of this contract. The expected savings are guaranteed by JCI for the term of the contract, which extends beyond the maturity of the COPs, and the system expects to purchase a policy to insure the first five years of potential JCI payment requirements. The rating includes our assessment that appropriation risk is low as the funds could not be shifted to non-airport purposes and because the trustee would have the ability to reclaim the equipment if non-appropriation causes the lease to default.

OUTLOOK

The stable outlook is based on Moody's expectation that system-wide enplanement levels will remain near or above current levels and airline and other revenues will maintain debt service coverage ratios based on net revenues above 1.0 times. Moody's expects that the system will maintain days cash on hand above the Moody's U.S. airport sector median currently at 551 days.

WHAT COULD MAKE THE RATING GO UP

- continued strong enplanement levels

- completion of major capital projects

- net revenue debt service coverage sustained above 1.25 times, while maintaining high liquidity to manage operational risks and financial risks

WHAT COULD MAKE THE RATING GO DOWN

- an inability or unwillingness by the airport system to fully recover costs from the airlines

- a reduction of unrestricted liquidity balances below the Moody's U.S. airport median

STRENGTHS

- Demand for air service is stabilized by Hawaii's remote location, need for inter-island travel, and a substantial military and government presence that requires frequent mainland service

- Position as a premier international tourist destination brings high demand for overseas flights, but the economy's reliance on that industry poses significant risks

- Strong current financial position with low debt and high liquidity provides the airport financial flexibility, though these strengths are expected to wane as additional debt is issued

CHALLENGES

- Debt service coverage and unrestricted cash are both expected to decline somewhat over the next five years, but remain within levels commensurate with the current rating category

- Economic conditions and enplanement levels have shown above-average volatility

- Airport system has extensive capital needs that will require a sizeable increase in debt in the next five years

- The Certificates of Participation add a layer of financing complexity that could bring additional risks to the system's finances

RECENT DEVELOPMENTS

Passenger levels are currently stable. Enplanements decreased 1.1% in FY 2014 due primarily to United Airline's reduced intercontinental offering and Mesa Airline's reduced intra-island business. These reductions outpaced improvements by Hawaiian Airlines, Hawaii Island Air, and Mokulele Flight Services which each increased intra-island service. The airport's capital program continues at a measured pace, but is entering a period of higher spending as the enabling projects for the construction of the Mauka Concourse at Honolulu airport are underway. Additional details are below.

DETAILED RATING RATIONALE

REVENUE GENERATING BASE

Economic conditions in the State of Hawaii (GO rated Aa2) remain stable and support stability and limited passenger growth. The State does not have year-to-date FY 2015 enplanement data available, but according to the USDOT passengers at Honolulu decreased 1.5% during calendar year 2014. We believe enplanements will increase slightly in 2015 driven by stable economic conditions and strong growth in available seats from several airlines. Over the past 12 months seats have increased 5.1% driven primarily by Hawaiian Holdings, Inc (corporate family rated B3, stable) and United Continental Holdings, Inc (corporate family B1, positive), but also supported by double digit seat growth from smaller players in the market such as Delta Air Lines, Inc (corporate family rated Ba3, positive) and American Airlines Group, Inc (corporate family rated B1, positive). Visitor arrivals continued to grow in 2013 and 2014 and are now well above the pre-recession level. Moody's Economy.com expects visitor arrivals to remain robust and closely tied to US business cycles.

FINANCIAL OPERATIONS AND POSITION

The airport system's financial position remains solid and coverage for all debt requirements was at 1.00 times based on Moody's net revenue calculation and 1.63 times based on the system's bond indenture calculation. The DSCR per the bond indenture has remained at similar ranges over the past 3 years, but DSCR per Moody's calculated net revenues has declined. Revenues were lower due to lower spending from Japanese tourists as a result of a weaker Yen to Dollar ratio; fewer total passengers, and lower rental car concession revenues due to operational impediments at the rental car facilities. Net revenue debt service coverage was also lower because the airport used previously collected funds from the airlines to reduce airline costs in FY2014. In FY 2012 airline landing fees were over-charged due to increases in passengers, the overage was deposited into the Prepaid Airport Use Charge Fund (PAUCF) per the amended lease agreement. In FY 2014 $19 million from the PAUCF, approved by the signatory airlines, was used to reduce 2014 airline payments by applying the overage against interest expense, revenues were lower as an offset and were charged just enough to reach the 1.00 times . As a result airline cost per enplanement only rose to $8.95 from $8.63 in 2013 despite higher operating expenses and passengers that were lower by 1.1%.

Moody's expects financial margins to narrow substantially as the airport system issues additional debt, but the current rating accounts for some of that additional risk. If the issuance occurs more rapidly or in a higher amount than planned then there could be additional negative pressure on the credit, particularly if it is combined with lower enplanement growth or if financial liquidity is reduced. The system has received approval from the FAA to apply PFCs to pay-as-you-go projects and to debt service, primarily for the Mauka concourse project. Management states that they may use some PFCs for debt service in 2016, but expects to begin using them to a greater extent in FY 2017 as the project advances.

Liquidity

The airport system's cash balances remain a driver for the rating. The airport system's cash has consistently grown from 2009 to 2013 with a slight reduction in FY 2014. FY 2014 days cash on hand of 983 is still much higher than Moody's US airport median of 551 days. The strong cash position is due to solid financial performance and delays in CIP expenditures. Management expects cash balances to slowly fall to approximately one year of days cash on hand as it continues its large CIP. If financial liquidity falls below 400 days cash on hand according to Moody's calculations, the current rating on the airport system will be negatively pressured.

DEBT AND OTHER LIABILITIES

The airport continues to move forward with extensive capital plans to develop and improve facilities across the system. The capital improvement plan (CIP) includes 165 projects totaling $2.72 billion through 2019, of which $708 million had been expended through September 2014 an increase from the $567 million that had been spent through June of 2013. Funding still includes over $1.2 billion of additional bonds, of which $94 million are unspent Series 2010 bond proceeds. The CIP includes projects at all airports, though the majority of the plan is focused on the two largest airports in Honolulu and Kahului.

Work on the $234 million Mauka Concourse is moving forward with a number of the enabling projects underway. Moody's believes the system's large capital program is exposed to significant cost increases, particularly if it does not remain near its original schedule. However, we also see a slowing of capital expenditures as a credit positive as it has kept financial metrics above projections and may give added flexibility if the operating environment changes. Currently the department is planning the first GARB issuance for July 2015. The airport system is also progressing with its other major project, a consolidated rental car facility, for which it expects to issue approximately $250 million in bonds separately secured by customer facility charges (CFC) in early 2016. The project has three phases and the first, improvements to the connecting roadway system is complete. Work on Phase 2, construction of a temporary parking structure, is 75% complete.

The airport system entered into a 20 year Energy Performance Contract (EPC) with Johnson Controls, Inc (JCI, senior unsecured rated Baa2, stable) to derive operating expense savings by reducing future energy expenses. Energy costs in Hawaii are among the highest in the nation and Moody's views the move toward more efficient use as a credit positive. Not only do we expect the EPC will bring overall savings, but it also reduces the uncertainty around future energy cost increases. JCI guarantees 91.7% of the annual utility and O&M cost savings. This amounts to $15.7 million in 2017 and the guarantee escalates at 5% annually during the 18-year performance period of the contract following the 2 year installation phase. In 2014, cost savings were approximately $3 million.

Debt Structure

All of the airport's debt is fixed-rate, amortizing debt. Debt service is level at approximately $77 million through 2024 before beginning to taper down and fully mature in 2039.

The COP lease payments escalate from $9.3 million in 2015 to $13.0 million in 2017 and continue to escalate to a peak of $24.9 million by maturity in 2029. The department issued the COPs to finance the energy savings projects. The COP structure is being used because Hawaii state law (Hawaii Revised Statute 36-41) requires, among other things, an "annual dependency clause" for EPCs. This clause requires the state Legislature to appropriate lease payments annually in order to continue the lease, so the EPC cannot be paid from normal debt service or operating expenses. The COPs structure is subject to appropriation risk; however we believe the risk is limited because the appropriation for this project is an appropriation of airport funds that could not be used for other non-airport purposes and because it is for a lease that is almost critical for the airport to operate. The risk is mitigated by the lease provision that makes non-appropriation an event of default under the lease and allows the certificate trustee to remove the equipment in the event the lease is terminated. While the equipment may have little residual value for the certificate holders, it is essential for the airport and would be difficult to replace so it serves as a deterrent to non-appropriation.

Debt-Related Derivatives

None.

Pensions and OPEB

These liabilities are not a major factor in the rating; however, the underfunding of these liabilities will need to be recovered through future revenues. Currently the state's pension system is 61.4% funded on an actuarial basis and the state has enacted legislation to improve that ratio. The airport system had a required contribution of $9.0 million to the pension system in FY 2014. According to Moody's adjustments to reported state and local government pension data, the airport's share of the plan's Adjusted Net Pension Liability as of fiscal 2014 is $278.4 million. This incorporates certain adjustments we make to improve the comparability of reported pension information. If this amount was recovered levelly over a 20 year period, we estimate it would add an expense of $21.1 million per year or an additional $1.29 cost per enplanement.

MANAGEMENT AND GOVERNANCE

The Department of Transportation is one of 18 principal executive departments of the State of Hawaii and it is empowered to establish, maintain and operate the transportation facilities of the State, including highways, airports, harbors and other transportation facilities. The Airports Division operates all State airports as a single integrated system for management and financial purposes.

The Department is headed by the Director, who is appointed by the Governor and confirmed by the State Senate. The Governor also appoints, without State Senate confirmation, four Deputy Directors of Transportation. The Director and Deputy Directors of Transportation serve four-year terms conterminous with the Governor's term.

OTHER CONSIDERATIONS

The scorecard indicated rating is different from the actual rating primarily because the scorecard is based on historical metrics and the system has had a history of government decisions impacting financial performance and capital planning.

The grid is a reference tool that can be used to approximate credit profiles in the airport industry in most cases. However, the grid is a summary that does not include every rating consideration. Please see Airports with Unregulated Rate Setting for more information about the limitations inherent to grids.

METHODOLOGY SCORECARD FACTORS:

Factor 1 - Market Position- Total Enplanements: Aaa, 16.4 million

Factor 1 - Market Position- Size of Service Area: A, 1.4 million

Factor 1 - Market Position- Economic Strength/Diversity of Area: A

Factor 1 - Market Position- Competition for Travel: Aaa

Factor 2 - Service Offering- Carrier Base (Primary): Baa, Hawaiian 50.4%

Factor 2 - Service Offering- Enplanement 5-year CAGR: Baa, 1.97%

Factor 2 - Service Offering- O&D Passenger Mix: Aaa, 98%

Factor 3 - Capacity and Capital- Growth & Operational Restrictions: A

Factor 3 - Capacity and Capital- Construction Risk: Baa

Factor 4 - Financial Metrics - Airline Cost per Enplanement: Aa, $8.95

Factor 4 - Financial Metrics - Debt Service Coverage: Baa, 1.00x

Factor 4 - Financial Metrics - Debt per O&D Passenger: Aa, $46

Notching: 1 Notch Increase for Liquidity; 0 Notch Decrease for Reserve Weakness; 0 Notch Increase for Revenue Diversity

Scorecard Indicated Rating: Aa3

KEY STATISTICS

- Type of Airport: O&D

- Rate-making methodologyResidual

- FY 2014 v FY 2013 Enplanements:-1.1%

- % Inter-island of Total FY2014:43.1%

- Debt per Enplaned Passenger, FY 2014: $45.39

- Bond Ordinance Debt Service Coverage, FY 2014: 1.63

- Net revenue Debt Service Coverage, FY 2014:1.00

- Utilization Factor, FY 2014: 11.33

OBLIGOR PROFILE

The Department operates and maintains 15 airports at various locations within the State. The Airports Division has jurisdiction over and control of the Airports System. Virtually all non-military passenger traffic throughout Hawaii passes through the Airports System, which includes five primary airports and ten secondary airports. The primary airports are Honolulu International (on the Island of Oahu), Kahului (on the Island of Maui), Hilo International and Kona International (both on the Island of Hawaii), and Lihue (on the Island of Kauai).

LEGAL SECURITY

Senior lien bonds are secured by gross revenues of the airport system and Aviation Fuel Tax revenues.

The COPS are secured by a proportionate interest in the rights of the lease agreement, including the lease agreement payments made by the airport system as a junior obligation to the lessor, Johnson Controls, Inc. JCI will assign its rights as lessor, including the right to receive rent payments, to the trustee for payment of debt service of the COPS. The airport system's obligation to make payments under the lease agreement from year to year is subject to annual appropriation by the State of Hawaii (GO rated Aa2, stable outlook) under a separate line item for capital leases in the department's budget. The payments are treated as "other lawful purposes" of the airports system. If the state fails to appropriate the lease, the EPC can be terminated at the end of the fiscal year for which money has been appropriated and the holders of the certificates would gain recourse to the equipment. Moody's believes this equipment would have little to no value outside of its use with the airport system, but its removal would be significantly detrimental to the operations of the airport system.

USE OF PROCEEDS

Not applicable.

ISSUER CONTACTS

Mr. Kurt Yamasaki

Acting Fiscal Management Officer

Phone: (808) 838-8646

RATING METHODOLOGY

The principal methodology used in this rating was Airports with Unregulated Rate Setting published in July 2011. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

Please see Moody's Rating Symbols and Definitions on the Rating Process page on www.moodys.com for further information on the meaning of each rating category and the definition of default and recovery.

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Analysts

Kurt Krummenacker
Lead Analyst
Public Finance Group
Moody's Investors Service

Chee Mee Hu
MANAGING_DIRECTOR
Public Finance Group
Moody's Investors Service

Duston Hodgkins
Additional Contact
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
USA

MOODY'S
INVESTORS SERVICE