New Issue: Moody's assigns A3 to Hawaii Airports' Series 2013 Lease Revenue Certificates of Participation; Senior lien A2 affirmed

Global Credit Research - 22 Nov 2013

Airport currently has $877.7 million rated debt outstanding

HAWAII (STATE OF) AIRPORT ENTERPRISE
Airports
HI

Moody's Rating

ISSUE		RATING
Series 2013 Lease Revenue Certificates of Participation (AMT)		A3
Sale Amount	$170,000,000	
Expected Sale Date	11/27/13	
Rating Description	Lease Rental: Appropriation	

Moody's Outlook STA

Opinion

NEW YORK, November 22, 2013 --Moody's Investors Service has assigned an A3 rating to the $170.0 million State of Hawaii Department of Transportation - Airports Division Series 2013 Certificates of Participation (COP). Moody's has also affirmed the A2 rating on the airport's outstanding senior lien debt in the amount of $877.7 million. 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 financial liquidity is a key measure of its financial strength and that cash is expected to continue to decline as the system moves forward with its extensive capital improvement plan (CIP). The airport system has not provided any rate relief to the airlines in FY 2011, FY 2012 or FY 2013 and none is planned. This move toward full cost recovery is a key 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 made by the airport system as a junior obligation to the lessor, Johnson Controls, Inc (JCI, senior unsecured rated Baa1, stable outlook). The rating also considers the strong operating expense benefits the airport system will likely 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.

The rating of the COPs is predicated on the inclusion of an opinion that the lease payments would be remote from a JCI bankruptcy. Moody's has not yet reviewed this opinion.

USE OF PROCEEDS: The proceeds of the certificates will be used to finance certain costs related to implementing an Energy Performance Contract (EPC) with JCI including the purchase and installation of certain equipment to reduce energy costs across the airport system.

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.

INTEREST RATE DERIVATIVES: None.

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 the failure of Aloha airlines in FY 2008 caused a sharp reduction in enplanement levels that have not yet recovered

* 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

DETAILED CREDIT DISCUSSION

The airport system is entering into this EPC 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. Other entities in the state have entered into similar agreements dating back to 1990. Not only do we expect the EPC will bring overall savings, but it also reduces the uncertainty around future energy cost increases.

The department will enter into a 20 year EPC that will require approximately $150 million of projects to implement the savings. The projects include items such as lighting fixtures; heating, ventilation and air conditioning (HVAC) system equipment upgrades; HVAC chiller improvements; and the installation of solar and thermal systems. The projects are anticipated to create an estimated utility cost savings of more than $17 million (approximately 44% of utility costs) over the 2011 baseline year. The net savings are calculated each year as the difference between the baseline utility costs (growth rate expected from the 2011 baseline year) and the total of actual utility costs, utility maintenance costs, service contract costs with JCI, and debt service on the COPs. Upon project completion these net savings are expected to remain near $1.2 million annually through 2028. Net savings is projected to increase to over $25 million annually after COP debt service fully amortizes in 2029. These projections account for a 20-year useful life on most of the equipment, but Moody's notes that additional reinvestment may likely reduce savings particularly in the outer years.

JCI guarantees 91.7% of the annual utility and O&M cost savings. This amounts to $15.8 million in the first year and the guarantee escalates at 5% annually during the 18-year performance period of the contract following the 2 year installation phase.

The department is issuing 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.

Economic conditions in the State of Hawaii (GO rated Aa2) have stabilized and visitor growth continues. Visitor arrivals in 2012 rose above the pre-recession level of 7.6 million in 2007 and is projected to increase another 4.3% in 2013. The state also benefits from low unemployment which has fallen to 4.3% through August 2013 and has historically remained approximately 3% below the national average. Moody's Economy.com expects visitor arrivals to remain robust, but for economic growth for the entire state to underperform national levels due to the remote location and high business costs.

Enplanements have also grown steadily since falling 15.2% in FY 2009. Although total enplanements remain below peak levels from 2007, enplanements from overseas travelers, which now accounts for 57% of total passengers, have returned to pre-recession levels and were 9.4 million in FY 2013. Inter-island traffic remain lower and Moody's expects this to remain the case as Hawaiian Airlines (49% total enplanements) has a dominant position accounting for 81% of interisland enplanements.

The airport continues to move forward with extensive capital plans to develop and improve facilities across the system. The capital improvement plan (CIP) includes 174 projects totaling $2.72 billion through 2018, of which $567 million had been expended through June. Funding includes over $1.2 billion of additional bonds, of which $213 million are unspent Series 2010 bond proceeds. The CIP includes projects at all airports, though over $2.1 billion of the plan is focused on the two largest airports in Honolulu and Kahului.

Expenditures have been slower than expected as the environmental review process of the largest general airport revenue bond-funded (GARB) project, construction of the Mauka Concourse, had been delayed for review by the new gubernatorial administration. 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 late 2014 or 2015. The airport system is progressing with its largest project, a consolidated rental car facility, for which it expects to issue approximately $250 million in bonds separately secured by customer facility charges (CFC).

Slower than expected capital expenditures have kept financial metrics strong. Debt service coverage, which the department had previously projected to fall to 1.4 times by 2012 , remained at 1.75 times unaudited for FY 2013. Cost per enplanement, expected to reach over $13 by 2009 projections and over $10 by 2011 projections, have remained below $9 and is $8.56 for FY 2013 based on unaudited results. Metrics have also been aided by strong revenue growth from increasing enplanements and other revenues such as concessions which increased 5.4% in FY 2012. 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 higher amount than planned then there could be additional weakening of the credit, particularly if it is combined with lower enplanement growth or if financial liquidity is reduced.

The airport system's cash balances remain a driver for the rating. The system's historic use of cash to subsidize airline rates and charges would be viewed as an important credit negative if it were used again and affected cash balances. The airport system's cash has consistently grown since 2009 and remains very strong. FY 2012 days cash on hand of 1,033 is almost twice the Moody's US airport median of 522 days. The improved 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 under pressure.

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 522 days.

What could change the rating--UP

Continued strong enplanement levels, completion of major capital projects, and net revenue debt service coverage sustained above 1.25 times, while maintaining high internal liquidity to manage operational risks and financial risks could place upward pressure on the rating.

What could change the rating--DOWN

An inability or unwillingness by the airport system to fully recover costs from the airlines or a reduction of unrestricted liquidity balances below the Moody's U.S. airport median could negatively pressure the rating.

KEY INDICATORS

Type of Airport: O&D

FY2013 Enplanements: 16,542,000

FY 2013 v FY 2012 Enplanements:5.8%

FY 2014YTD v FY2013YTD Enplanements:1.1%

5-Year Enplanement CAGR 2008-2013: 2.2%

% O&D FY 2012:98%

% Inter-island of Total FY201243.0%

Largest Carrier by Enplanements, System (share): Hawaiian (47.9%)

Airline Cost per Enplaned Passenger, FY 2012:$8.26

Debt per Enplaned Passenger, FY 2012: $50.90

Bond Ordinance Debt Service Coverage, FY 2012: 1.67

Net revenue Debt Service Coverage, FY 2012:1.41

Utilization Factor, FY 2012: 11.05

METHODOLOGY SCORECARD FACTORS:

Factor 1 - Market Position- Total Enplanements: Aaa

Factor 1 - Market Position- Size of Service Area: A

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

Factor 2 - Service Offering- Enplanement 5-year CAGR: Ba

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

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

Factor 4 - Financial Metrics - Debt Service Coverage: A

Factor 4 - Financial Metrics - Debt per O&D Passenger: A

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

Scorecard Indicated Rating: Aa3

The scorecard indicated rating is different from the actual rating primarily because the scorecard is based on backward looking metrics and the system has a history of governance impacts on financial performance and capital planning.

Outstanding Bonds:

Series 2010A, Airport System Revenue Refunding Bonds, $478.1 million, A2

Series 2010B Airport System Revenue Refunding Bonds, $135.8million, A2

Series 2011 Airport System Revenue Refunding Bonds, $263.9 million, A2

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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.

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