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Hawaii Airport System; Airport

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Hawaii Airport System; Airport

Credit Profile		
US$222.54 mil airport system rev bnds ser 2015A due 07/01/2045		
Long Term Rating	A+/Stable	New
US$18.82 mil gen airport rev bnds ser 2015B due 07/01/2045		
Long Term Rating	A+/Stable	New
Hawaii Arpt Sys lse rev certs of part ser 2013 due 08/01/2028		
Long Term Rating	A/Stable	Upgraded
Hawaii		
Hawaii Arpt Sys, Hawaii		
Hawaii (Hawaii Airport System)		
Long Term Rating	A+/Stable	Upgraded
Hawaii (Hawaii Airport System) (AGM) (SEC MKT)		
Unenhanced Rating	A+(SPUR)/Stable	Upgraded

Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services raised its long-term rating and underlying rating (SPUR) to 'A+' from 'A' on Hawaii Airport System’s previously issued senior-lien revenue bonds, and its long-term rating to 'A' from 'A-' on the system's series 2013 lease revenue subordinate-lien certificates of participation (COPs). In addition, we assigned our 'A+' long-term rating to Hawaii Airport System's $222.5 million series 2015A (Alternate Minimum Tax [AMT]) and $18.8 million series 2015B (non-AMT) revenue bonds. The outlook is stable.

The rating action reflects our view of the system's consistently very strong liquidity, which management reports will be sustained, but also its moderately low debt burden and low cost structure. We believe both of these will remain moderately low and consistent with the raised ratings, despite a large capital plan. The rating action also reflects our view of the system's good enplanement trends and the state's generally positive economic and tourism trends, which, in our view, support continued strong demand for the airport system.

The ratings further reflect our view of the airport system's:

- Monopolistic position and very high essentiality for transport within, to, and from the state, serving a niche travel market with 10 primary airports and five secondary airports throughout Hawaii;
- Low cost per enplanement (CPE) of $8.96 in fiscal 2014, with CPE projected to remain in a low range of $9.57 to $12.17 through 2022 despite a relatively large $2.6 billion capital improvement program for fiscal years 2016 to 2021;
- Historically very strong liquidity position for the rating, including $547 million, or about 783 days of expenditures, in unrestricted cash as of unaudited fiscal 2015 and no less than 764 days' cash since fiscal 2010;
- Low debt burden at about $58 per enplanement combined with a good mix of capital program funding sources that limit the addition of excessive debt to the system;
- Generally good enplanement growth during fiscal years 2010 through 2015 with a compound annual growth rate of

2.0%, including a good 2.4% rebound in enplanements in fiscal 2015 after a 1.5% decline in fiscal 2014; and
- Good combined "all-in" senior- and subordinate-lien debt service coverage (DSC) of 1.3x in audited fiscal 2014 and 1.4x in unaudited fiscal 2015.

Partly offsetting the above strengths, in our view, are the airport system's:

- Moderately high carrier concentration, with Hawaiian Airlines representing 51% of enplanements in fiscal 2015, although other carriers' market shares would likely increase or new carriers would likely enter the market if Hawaiian Airlines terminated or reduced service at the airport;
- All-in DSC that management forecasts will decline when subordinate-lien debt service ramps up, dipping to a low of 1.1x in fiscal 2019, although we recognize that high DSC ratios are less likely given the airport system's residual hybrid rate-setting methodology;
- Sizable 10-year capital improvement program totaling $2.6 billion, 46% of which will be bond financed, although there is flexibility to adjust capital spending if demand wanes; and
- Hawaii's inherent susceptibility to exogenous shocks that have potential to hurt its important tourism sector, which accounts for 17% of state GDP, although we anticipate that the system will maintain a strong base level of demand in light of the system's essentiality.

The senior-lien airport revenue bond proceeds will be used to fund the costs of capital improvement projects at certain facilities of the airport system and are secured by senior-lien system revenue and aviation fuel tax revenue after operations and maintenance (O&M) costs. The COPs ($168 million outstanding) are special limited obligations of the airports division and represent assignment of a proportionate interest in the lease and in the right to receive rent payments under the lease. Lease payments are secured solely by revenue and aviation fuel tax revenue, but are junior in priority to the pledge of the [necessary? delete?] revenue securing the airport system revenue bonds outstanding, which are rated one notch higher at A+/Stable. We have applied the primary airport revenue bond criteria to determine the entity's general creditworthiness (issuer credit rating), including the calculation of all-in DSC including all liens of debt, and have applied this rating to the senior-lien airport system revenue bonds as well as assigned a rating one notch lower to the subordinate-lien COPs.

The COP proceeds were used to fund $150 million in costs related to the implementation of an energy performance contract (EPC) between the department and Johnson Controls Inc. (JCI). Hawaii Revised Statute 36-41 requires and the EPC guarantees that net energy savings will offset the cost of the installation, energy saving equipment, and additional debt and provide substantial savings. Net overall savings is estimated at $160 million through fiscal 2034 (net of COP debt), with the majority of savings realized in fiscal years 2030 through 2034, when COP debt has matured. The project is also referred to as the ESCO (Energy Service Co.) project and is now 98% complete. An initial study of the results for calendar 2014 indicates $3.0 million of actual savings, well above the guaranteed $1.9 million for that year.

The system's total debt (airport system revenue bonds and COPs) as of June 30, 2015 was $976 million, all fixed rate, with total debt to enplaned passenger a low $58.

The State of Hawaii owns and operates the system through its Department of Transportation. The system includes all commercial facilities in the state, and the state 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 consists of one large-hub airport, one medium-hub airport, three small-hub airports, 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 can match. Multiple airports in the system can accommodate overseas flights (direct flights from the U.S. mainland to the neighboring islands is a growing trend) and inter-island flights, and this helps to diversify system risk. Hawaii continues to be one of the most-visited states in the U.S.

The system's key strengths include its critical support of the tourism industry and its essential position providing transportation infrastructure within the state. Honolulu International Airport (HNL), serving the state's largest population center, has by far the largest share of systemwide traffic, covering 58% of enplanements in fiscal 2015 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 was the 27th-largest airport in the U.S. by enplaned passengers in calendar 2013 (according to the Federal Aviation Administration) and has adequate airline diversity, in our view, with the largest airline--Hawaiian Airlines Inc.--having a 51% market share in fiscal 2015 across the system.

After the 15.2% decline in enplanements in 2009 resulting from the Great Recession (which was actually larger than the 12.2% decline in 2002 after Sept. 11, 2001), the airport system realized four consecutive fiscal years of positive enplanement growth--1.6% in 2010, 0.9% in 2011, 2.5% in 2012, and 6.3% in 2013--but a decline of 1.5% in fiscal 2014. The positive growth since fiscal 2009 is generally the result of improving U.S. and overseas economics, and despite the overall enplanement decline in fiscal 2014 international enplanements rose 4.3% that year. Management estimates enplanement growth of 2.4% for fiscal 2015 (comfortably above the previous 1.5% estimate), 2.9% in fiscal 2016, and about 1.5% each year thereafter through fiscal 2022. We view this assumed enplanement growth rate as conservative and reasonable. Systemwide enplanements in fiscal 2015 totaled 16.68 million, or 9% below fiscal 2000 peak levels of 18.28 million, whereas more than half of U.S. large hub airports are now past historical peak enplanement levels. The enplaned passengers consisted of 58% overseas passengers and 42% inter-island passengers.

The system largely handles origin-and-destination passengers, with such passengers representing 86% of enplaned passengers, or 98% when including neighboring island traffic. HNL serves as the hub of Hawaiian Airlines, is the largest of the system's five primary airports, and is classified as a large hub. In fiscal 2015 it enplaned 9.7 million passengers, up a slight 0.1% from 2014. The system's other four other primary airports enplaned 6.8 million passengers, up a strong 5.5% from fiscal 2014, accounting for 42.0% of systemwide passenger traffic. These airports have continued to increase direct overseas flights. Several additional seats have been added in 2014, including Seattle and San Francisco. Scheduled air seats for fiscal 2015 are projected at 11.9 million, and this number, if achieved, would eclipse fiscal 2014 seats by 11%. In November 2015 Virgin America will start daily flights between San Francisco and Honolulu, and AirAsia X will start four flights per week between Kuala Lumpur and Honolulu. In December 2015 Virgin America will start flights between San Francisco and Maui, and Jin Air will start five flights per week between Seoul and Honolulu.

In terms of visitor activity to the state, westbound visitors from the U.S. accounted for 61% of total visitors in calendar 2014, with 18% from Japan and 6% from Canada. Following declines of 10.6% in 2008 and 4.5% in 2009, visitor arrivals have rebounded well, increasing 7.7% in calendar 2010, 4.0% in 2011, 10.0% in 2012, 1.8% in 2013, and 1.6%

in 2014 to 8.3 million. For 2014, the state reports total population growth of 0.8% (a decline from the 1.1% growth in 2013), an increase in visitor spending of 2.9%, and household income growth of 2.3%. Continued upward momentum is projected for 2015, with 1.0% population growth, a 3.8% increase in visitor expenditures, and a 4.2% increase in total visitors. Hotel occupancy reached 77% for 2014 (a multiyear high), and total wage and salary jobs also grew, by 2.1% in 2013 and 1.0% in 2014. The state's unemployment rate was just 3.4% in September 2015, the third lowest in the U.S. and the lowest in seven years.

Although economic metrics are trending favorably, risks remain. Despite the system's essential role, it 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 because of 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. Also, state GDP, the broadest measure of the state's economy, suggests that Hawaii remains stuck in a slow growth mode, as it has expanded more slowly than national GDP for six consecutive years.

The system's financial performance has been good in recent years, with senior-lien DSC ranging from 1.3x to 1.7x per our calculations during fiscal years 2010 to 2014. Unaudited fiscal 2015 results indicate senior-lien DSC of 1.52x and combined senior- and subordinate-lien DSC of 1.44x. Indenture-based senior-lien DSC includes the funded coverage account as revenue and includes rate mitigation, available passenger facility charge (PFC) revenue, and airline-contributed interest as offsets to debt service. Indenture-based senior lien DSC was 1.75x in 2013 and 1.63x in 2014, and unaudited fiscal 2015 results indicate senior-lien DSC of 1.85x. Management's forecasts indicate indenture-based senior lien DSC ranging from 1.52x to 1.64x during fiscal years 2016 to 2022. According to management's forecast, we calculate all-in DSC to decline to 1.1x by fiscal 2019 given the ramp-up in subordinate-lien debt service related to the series 2013 COPs, with net revenue not keeping pace. In our view all-in DSC is thin; this is less of a risk when liquidity is very strong but could become more of a risk if the system spends down liquidity. We also note that, given the airport system's residual rate-setting methodology, we recognize that higher DSC is not usually sustainable. Our senior-lien rating takes into account all-in DSC, and we rate subordinate-lien debt one notch lower, per our criteria "Assigning Issue Credit Ratings of Operating Entities," published May 20, 2015 on RatingsDirect. System liquidity has improved significantly since 2009, when it dipped to $337 million, or 526 days' cash. Cash balances have risen by $211 million to $547 million, equal to 783 days' cash, as of fiscal 2015. Management plans to maintain unrestricted cash near current levels, which we consider extremely strong.

The system has taken steps to control expenditure growth, especially with regard to the ESCO project, and management forecasts that the overall cost structure will increase gradually as it addresses capital needs and as airline-generated revenue from increased rates becomes a larger proportion of the total. The system is undertaking a number of improvement and modernization projects totaling $2.6 billion over the next six years, with about $710 million already spent. Despite its projected large capital improvement plan (CIP), and given revised cost estimates and enplanement forecasts, management projects that CPE will rise to only $10 by 2017 and $12 by 2021, which we consider in line with the rating category. Also among credit risks is an increasing debt burden, as airport bonds will fund about $1.2 billion, or 46%, of capital needs. The airport system anticipates issuing airport revenue bonds in 2017

and 2018 in the combined amount of $511 million to fund projects within the CIP. Revenue bond outstanding once the series 2015 bonds are issued will total $1.01 billion. Pro forma debt per enplanement, including the 2015 bonds and two subsequent issues planned for 2017 and 2018 (and net of amortizing principal), totals $1.6 billion, or $90 per projected enplanement. Although this may be higher than the median of $78 per enplanement for the rating category, we view the discrepancy as not meaningful.

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 at or near very strong levels, that DSC will be maintained at adequate levels, and that demand will not significantly deteriorate.

Upside scenario

We could raise the rating during the next two years in the unlikely event that demand strengthens materially and, in our view, sustainably, and if management successfully completes its major capital projects such that the system's overall cost per enplanement and debt ratios come in materially below forecast. This scenario also assumes liquidity is maintained at or above currently very strong levels.

Downside scenario

Given the system's robust cash position and generally good enplanement and tourism trends, including what we believe is a strong base level of demand given the system's monopolistic market position, we are unlikely to lower the rating during the next two years. That said, if liquidity materially declines or enplanements suffer sustained declines, we could lower the rating.

Bond And Certificate Provisions

The senior-lien airport revenue bonds are secured by senior-lien system revenue and aviation fuel tax revenue after O&M costs. The COP payments are junior to revenue bond debt service; to payments to the maintenance, renewal, and replacement account; and to transfers to the state's general fund for reimbursable GO bonds, improvements to the system, and transfers to special reserves. PFC revenue is excluded from revenue unless explicitly identified in a supplemental certificate.

Bond provisions are, in our view, weaker than the industry standard, mostly because of the system's ability to add to operating revenue and reduce the debt service requirements to satisfy the rate covenant. In our view, these provisions, in combination with existing certificate provisions, reduce the system's cash flow from rates and charges.

The senior-lien bond 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, and we consider these provisions permissive. Although the 1.25x rate covenant does not include COP debt service in the calculation of the annual adjustment debt service requirement, the signatory airlines have consented to the ESCO project, and payments under the lease are included in the department's expenses for purposes of the rate covenant. The additional bonds test is industry standard and is a two-part historical or prospective test. The historical test requires that net revenue and

taxes--plus unencumbered funds in the airport revenue fund not exceeding 25% of the adjusted maximum annual debt service (MADS) requirement--are not less than 125% of the total adjusted MADS 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 by net revenue and tax revenue for three years after construction of the financed projects. A reserve fund at MADS is required.

Certificate provisions include a debt service reserve fund funded at the least of 10% of par, 125% of average annual debt service, or MADS. COP interest was partly capitalized until Feb. 1, 2015. The COPs are structured to be retired after 13 years of the 18-year "performance period" (15 years from date of issuance), and this reduces financing costs and results in substantial cost savings in the final years of the performance period while remaining compliant with Hawaii Revised Statute 36-41.

Related Criteria And Research

Related Criteria

- Criteria: Airport Revenue Bonds In The U.S. And Canada, Nov. 15, 2013
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

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