30 Jul 2018 11:45 AM (PDT)

Fitch Rates Hawaii Airport Revenue Bonds 'A+', Affirms Outstanding; Outlook Stable

Fitch Ratings-New York-30 July 2018: Fitch Ratings has assigned an 'A+' rating to $410 million in airport system revenue bonds, series 2018A and 2018B, $100 million series 2018C, and $150 million series 2018D, being issued by State of Hawaii, Department of Transportation (Airports Division). In addition, Fitch has affirmed its 'A+' rating on $935 million of outstanding parity airport system revenue bonds, as well as affirming its 'A' rating on $157 million of outstanding subordinate lien lease revenue certificates of participation (COPs), series 2013. The Rating Outlook for all bonds is Stable.

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

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 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 origin and destination base of approximately 17.9 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 risk surrounding slightly elevated carrier concentration, with Hawaiian Airlines (BB-/Stable) accounting for approximately half of total system enplanements.

Rolling Airline Agreement - Revenue Risk (Price): Stronger

The hybrid airline use and lease agreement, covering roughly 60% of operating costs, does not have an expiration date and automatically extends quarterly. CPE remains competitive at $9.60 in fiscal 2017, lower than previously expected. CPE is projected to rise on a modest incline to the $12-$13 range ($14-$15 in the rating case) as capital spending occurs; however, it is not anticipated to affect traffic demand given Hawaii's continued attractiveness as a tourist destination.

Partially Debt-Funded CIP - Infrastructure Development/Renewal: Midrange

The Airports Division's capital program through fiscal 2023 totals approximately $2.4 billion, with outstanding and future revenue bonds accounting for approximately $1.8 billion of the funding, or 75% ($708 million yet to be issued after the series 2018 bonds, accounting for roughly 30% of the current plan). This amount does not include $834 million total capital costs for the ongoing ConRAC projects at HNL and OGG. The CIP does not reflect projects for which airline concurrence has not yet been reached, or for which project completion falls outside the CIP period. Close oversight from the state government together with prudent management of capital spending and borrowings will be important to rating maintenance.

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 2048. The rated 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. In addition to the current 2018 issuance of $410 million in new money bonds, the Airports Division expects to issue approximately $358 million in 2020 and $321 million in 2021 to fund its CIP, though these figures remain preliminary.

Financial Profile

DOTA's leverage position is moderate compared to peers, with net debt-to-cash flow available for debt service (CFADS) at 2.8x in fiscal 2017 for senior debt and 4.7x on an all-in basis. Since fiscal 2007, senior debt service coverage has ranged from 1.6x to 2.1x, with fiscal 2017 at 1.7x (1.5x including COPs). Under Fitch's rating case all-in coverage averages 1.4x, while all-in airport leverage is anticipated to increase to the 8x range with CIP borrowings, then falls to the 6x range by 2024. Liquidity currently remains strong with 729 days cash on hand (DCOH) in fiscal 2017. 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 (rated AA-/A+/Stable) and Las Vegas (rated A/A/Positive) 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, coupled with sustained maintenance of all-in leverage below 5x.

TRANSACTION SUMMARY

The series 2018A and 2018B bonds (approximately $410 million) are being issued to pay the costs of various capital improvement projects for the Airport System. The series 2018C and 2018D refunding bonds, totalling $250 million, will provide for the refunding of approximately $245 million in outstanding series 2010A bonds. Bond proceeds will also fund capitalized interest through 2021; fund the Debt Service Reserve Fund Requirement for the new money portion of the bonds (approximately $6 million in additional DSRF); and cover costs of issuance. The bonds are fixed rate with escalating debt service through 2030, after which debt service on the 2018 bonds is steady at roughly $31 million through final maturity in July 2048. The refunding portion of the issuance is estimated to generate roughly $26 million in debt service savings over the life of the bonds.

CREDIT UPDATE

Performance Update

Total system enplanements and carrier service continue to trend positively for the airport system, with 2017 traffic surpassing pre-recession levels. Enplanements rose to 17.9 million in fiscal 2017, a 3.7% increase relative to the year prior, and building on a five-year CAGR of 2.8%. Overseas enplanement activity increased 2.4% in fiscal 2017, accounting for 58% of total enplanements. Interisland flights, which account for the remainder, grew 5.7% in fiscal 2017. Growth for international enplanements was slightly higher at 3.3% in 2017 (compares to 2.0% for domestic for the same period), reflecting new services as well as increased seat capacity being added on existing routes. The first six months of fiscal 2018 saw a further 3.8% increase in total enplanements over the same period in fiscal 2017. International enplanements grew at a faster rate of 7.5%, while domestic enplanements grew by 3.1%.

The Airports Division is benefitting from several service additions that are expected to drive traffic growth in the near to medium term, notably the entrance of Southwest Airlines into the Hawaiian market. Southwest announced it will begin service to Hawaii destinations including HNL, Kahului, Lihue, and Kona from four California markets: Oakland, Sacramento, San Diego, and San Jose. Southwest has received a permit to operate at Honolulu, and is waiting on FAA approval to operate the proposed trans-pacific routes. Service is expected to start in the end of 2018 or early 2019. Southwest's entrance into the Hawaii market may stimulate additional traffic with lower fares, and may capture some passenger share held by current carriers.

In addition to Southwest's new service, traffic is also buoyed by ongoing upgrading of aircraft by majority carrier Hawaiian Airlines; and new service from low cost carriers (Air Asia X, Sun Country, Scoot Airlines) as well as traditional carriers (Alaska adding Sacramento service, Hawaiian adding Portland service, among others). Overseas air seats based on forward schedules are currently set to grow 8.0% in calendar 2018, well above management's forecast enplanement growth of 3.5% for fiscal 2018. These expected service additions counteract the effects of Island Air's bankruptcy filing in October 2017 and cessation of service, resulting in a state-wide 1.3% reduction in interisland seat capacity for fiscal 2018. Hawaiian Airlines and Mokulele Airlines continue to serve the interisland passenger market.

Regarding any effects on the Airport System from the ongoing eruption of the Kilauea volcano which began in May of 2018 on the island of Hawaii, management indicates there has been no operational disruption to air service. Some airlines did modify service offerings following the eruption, with Hawaiian Airlines eliminating one of its 15 daily flights from Honolulu to Hilo, as well as one of its 23 daily flights from Honolulu to Kona. Five cruise ship lines also initially changed their routes to avoid portions of the Big Island, though Norwegian Cruise Line's Pride of America, which has the largest impact on visitor counts, reinstated weekly calls to the Big Island in June. Management indicates no negative impact has been observed to passenger or revenue levels to date, and does not anticipate any major impacts to either the Airport System or to state tourism activity as a result of the volcanic activity.

Fiscal 2017 operating revenue grew 12.6% to $398 million, resulting from increased revenue from airport landing fees, aeronautical rentals, nonaeronautical rentals and concessions revenue. Airline revenues, which represented 51.3% of operating revenues in 2017, increased 12.4% while non-airline revenue increased approximately 12.8%, driven largely by improvements in the concession program and nonaeronautical rentals, partly due to a one-time lump sum payment from the DOT Harbors Division of $4 million. Overall airline and fuel tax revenues are expected to increase 5.8% for 2018, driven in part by expected improvements in concessions, higher MAGs for duty free operations, and $10 million from rental car revenues. Fitch views positively the system's ability to generate additional non-aviation revenue, allowing for offsets to increasing airline costs as the CIP progresses.

Cost management remains important to maintaining the rating. Operating expenses have been increasing moderately with annual growth of 4.8% from 2012-2017, and utility savings from the Airports Division's energy conservation project should help to offset increasing expenses. Verification reports for 2017 indicate actual energy savings were 10.6% greater than the guaranteed savings of $18.8 million for the period. Airlines currently support the system's costs under a strong hybrid agreement, covering roughly 60% of operating costs through rates and charges. In fiscal 2017, CPE compared favourably to peers at $9.60, and is forecast to increase to the $12-$13 range through 2024 ($14-$15 in Fitch's rating case) as the Airports Division progresses with its capital program.

Debt service coverage for senior revenue bonds was 1.7x in fiscal 2017, up from 2017 and slightly above the prior five-year average. 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 were applied in fiscal 2017, but if billing leads to an over collection in the future, the Airports Division and the airlines may continue applying this money to reduce airline rates and charges. Leverage was 2.8x senior and 4.7x all-in, reflecting incorporation of principal from the 2015 borrowing.

The CIP through fiscal 2024 totals $2.4 billion, including $784.0 million already expended through March 2018 (33%). Management indicates that over 50% of projects are in the Construction or Closeout stages. The CIP excludes $834 million of total capital costs for ongoing ConRAC projects at HNL and OGG, as well as excluding projects for which airline concurrence has not yet been reached, or for which project completion falls outside the CIP period. The CIP is expected to be funded in part with the current 2018 issuance, as well as additional debt issued in 2020 and 2021 totalling $708 million. Current and future borrowing accounts for roughly 75% of funding, with federal grants, PFC paygo funds, and airport cash balances making up the remainder.

Fitch Cases
Fitch viewed management's forecast as reasonable, and adopted it as the base case: enplanements grow 3.5% in 2018, followed by 1.8%-1.9% growth through 2024 (2.1% CAGR); total revenue increases 4.8% through 2024, reflecting additional increases in rates and charges as continued portions of the CIP come online, as well as uplift from new services including Southwest, and an increase in concessions due to new agreements. Expenses increase at a 6.1% CAGR through 2024. Additional issuances in 2018, 2020, and 2021 totalling $1 billion are included. Senior coverage averages 1.8x through 2024 on an indenture basis, and 1.5x including COPs. CPE rises to the $12-$13 range through 2024. Senior leverage rises to 6.5x in 2020 (approximately 8x all-in) due to CIP debt coming online; however, leverage rapidly declines to levels comparable with the current level by 2024.

Fitch's rating case assumes an 8.0% stress to enplanements in 2020, followed by a year of zero growth then moderate recovery of 2.5% through 2024, resulting in a traffic CAGR of 0.6%. Expenses rise at an annual growth rate of 6.5%, 50 basis points above the base case. Senior coverage averages 1.7x with all-in at 1.4x, and airline costs are assumed to increase at a greater rate than the base case to account for lower activity levels and higher costs. Under this scenario, CPE rises to the $14-$15 range. Total leverage increases to approximately 9.4x in 2020, before falling to the 6.0x range by 2024 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 2048. 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

Airports Rating Criteria (pub. 23 Feb 2018)
Rating Criteria for Infrastructure and Project Finance (pub. 27 Jul 2018)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
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