

**CREDIT OPINION**

31 July 2018


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# Hawaii (State of) Airport Enterprise

## Update to credit analysis

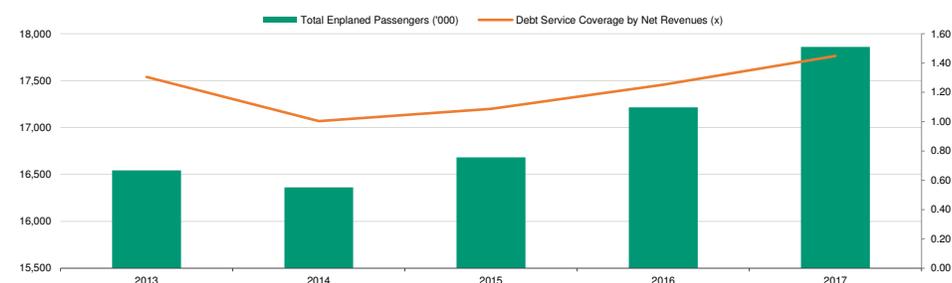
### Summary

The credit profile of Hawaii Airport Enterprise (A1 stable) reflects the strength of the airport system's monopoly over commercial air travel to and from the islands, the essentiality of air service for both tourism and intrastate travel, full cost recovery without airline subsidies, relatively low debt per passenger, continued traffic growth, and improving financial performance. The airport system's liquidity is a key measure of its financial strength and while restricted cash will decline as the large on-going capital improvement program (CIP) is implemented, unrestricted cash will be maintained above 600 days cash on hand (DCOH).

The credit profile of the certificate of participation (COP, A2 stable) is based on lease agreement payments made by the airport system to the lessor, Johnson Controls, Inc (JCI), that are backed by airport revenues on a subordinated basis.

Exhibit 1

### Enplanement growth supports strong revenue growth and improved debt service coverage ratios



Source: Moody's Investors Service

### Credit Strengths

- » Reliable and growing air service essential to Hawaii is bolstered by the state's remote location, popularity as a tourist destination, need for interisland travel, and a substantial military and government presence that requires frequent mainland service
- » Strong current financial position with relatively low debt and high liquidity provides the airport financial flexibility, though these strengths are expected to moderate as additional debt is issued for the CIP
- » Well-managed capital planning, financial operations and maintenance of healthy liquidity levels

## Credit Challenges

- » The current CIP is significantly larger than the airport has historically managed and will require an additional approximately \$679 million in debt through 2021
- » Unrestricted cash is expected to decline somewhat over the next five years, but remain within levels in line with the current rating category
- » Due to the discretionary nature of tourism, enplanement levels have shown above-average volatility in economic downturns
- » The COPS add a layer of financing complexity that could bring additional risks

## Rating Outlook

The stable outlook is based on Moody's expectation that system-wide enplanement levels will continue to steadily increase at or above the forecast rate of 2.1% CAGR through 2024 and that airline and non-airline revenues will support net revenue DSCRs above 1.0x. We also expect that the system will maintain DCOH above 600 days.

Prior to the expected Series 2018 bond issue the airport system has outstanding \$935 million of senior GARBs and \$216.2 million subordinate certificates of participation, plus \$244.8 million of customer facility charge (CFC) bonds secured solely by CFC revenues (A2 stable). The airport expects to issue an additional \$358 million in senior GARBs in 2020 and \$321 million in 2021 to complete the financing for the CIP.

## Factors that Could Lead to an Upgrade

- » A positive change in the economy of the service area that produces enplanement levels that significantly outperform projections on a sustained basis, though an upgrade is unlikely during the period that the debt-financed CIP is being financed and implemented
- » Net revenue DSCRs sustained above 1.25x through the completion of the capital program, while maintaining high liquidity to manage operational risks and financial risks

## Factors that Could Lead to a Downgrade

- » Inability or unwillingness by the airport system to fully recover costs from the airlines
- » Reduction of unrestricted liquidity balances below 600 days
- » Economic downturn or loss of a major carrier that negatively impacts enplanements and raises airline costs significantly above projected levels

## Key Indicators

Exhibit 2

Hawaii (State of) Airport Enterprise	2013	2014	2015	2016	2017
Enplanement Annual Growth (%)	6.1	-1.1	2.0	3.2	3.7
Debt Outstanding (\$'000)	918,030	1,045,465	1,011,255	1,227,847	1,237,285
Debt to Operating Revenues (x)	2.7	3.3	3.0	3.5	3.1
Debt per O&D Enplaned Passenger (\$)	53.20	52.53	57.10	70.26	64.14
Days Cash on Hand ('000)	998	983	938	955	940
Total Coverage by Net Revenues (x)	1.31	1.00	1.09	1.25	1.45

Source: Moody's Investors Service

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## Profile

The Department of Transportation (DOT) operates and maintains 15 airports at various locations within the state. Through the Airports Division all state airports are operated as a single integrated system for management and financial purposes. Virtually all non-military passenger traffic throughout Hawaii passes through the system, which includes five primary airports and ten secondary airports. The primary airports are Daniel K. Inouye (HNL on the Island of Oahu), Kahului (on the Island of Maui), Hilo International and Ellison Onizuka Kona International (both on the Island of Hawaii), and Lihue (on the Island of Kauai).

## Detailed Credit Considerations

### Revenue Generating Base

Economic conditions in the State of Hawaii (GO, Aa1) remain stable and support growth in service additions by several airlines, most notably Southwest Airlines with service to four California cities expected by year-end 2018 or early 2019. The state's low unemployment at 2.4%, a substantial military presence, and a robust tourism industry undergird its credit strength. The state's economy benefits from substantial revenues attributed to tourism, and as noted by Moody's Economy.com has seen continued expansion in the tourism sector since 2017. Visitor spending is increasing and the leisure/hospitality industry is creating jobs twice as fast as the US average. The defense industry is also noted as a critical anchor in Hawaii's economy, with military focus shifting to the Asia-Pacific region. Military construction spending will increase in 2018 creating high-wage construction jobs and the US Congress has lifted the defense spending cap allowing for an increase in spending. Continued airline seat growth in West Coast US cities, Shanghai, Osaka, and Auckland as well as the addition of Southwest flights to Hawaii attests to an expanding tourism industry that will continue to serve as a basis of revenue generation for the state.

Hawaii's tourism sector benefits from a tightening US labor force, which increases household budgets positively effecting travel to Hawaii. Also undergirding visitor arrival growth is the weakening of the US dollar compared to the Japanese yen and Canadian dollar, making Hawaiian vacations more affordable for Japanese and Canadian tourists. Approximately 54% of international visitors come from Japan. Hawaii's job growth has accelerated over the last six months, though it is lower than the US average. However, the 2.4% unemployment rate is among the lowest for US states and the stability and continued expected growth of the tourism industry bodes well for continued strong performance trends.

### Financial Operations and Position

Enplanements grew a strong 3.7% in FY 2017 following 3.2% growth in FY 2016, and based on year-to-date results are expected to grow by 3.5% in FY 2018. For FY 2017, the DSCR for all senior and subordinate debt was 1.45x based on Moody's net revenue calculation and 1.71x based on the system's bond indenture calculation. From FYs 2014 through 2016 the airport used balances in the Prepaid Airport Use Charge Fund (PAUCF) to reduce airline costs. This resulted in a significant gap between Moody's calculated DSCRs and the bond ordinance basis. Going forward CPE is expected to reflect the full rate base charged to the airlines so that the Moody's net revenue calculation will be more in line with the bond ordinance calculation.

Moody's expects financial margins to narrow and CPE to increase above the rate of inflation as the airport issues additional debt for the CIP, but the current rating accounts for some of that additional risk. Based on the current enplanement forecast of 2.1% CAGR through 2024 and the \$1.2 billion total planned airport revenue debt through 2024, CPE is projected to rise to \$11.09 by 2021, and to \$13.03 by 2024. While this is above Moody's median of \$8.42 for all airports and \$10.23 for large hubs, it is in line with costs at airports that have a large number of international enplanements as these generate higher yields for the airlines. Further, we expect these median costs to rise as large airports undertake large capital plans to upgrade and expand their facilities.

A sensitivity case assuming a 15% decrease in forecasted enplanements starting in FY 2020, and 15% decrease on revenues forecasts CPE to increase to \$13.06 in 2020 and peak at \$16.73 in 2024.

If debt issuance ramps up more rapidly or in greater amounts than currently planned, this could negatively pressure the credit, particularly if it is combined with lower enplanement growth, or if financial liquidity is reduced.

### LIQUIDITY

The airport system's cash balances help underpin the credit strength. While decreasing slightly year-over-year from 2012 to 2017, the airport's DCOH as calculated by Moody's has remained above 900 for each of the past six fiscal years, which is well above Moody's US

airport median of 615 days. The airport is expected to maintain strong liquidity given its stable growth trends in enplanements and CFC collections. If unrestricted liquidity falls below 600 the credit would be negatively pressured.

### Debt and Other Liabilities

The airport continues to advance extensive capital plans to develop and improve facilities across the system. The capital plan includes a significant amount of bond financing, with an additional \$358 million to be issued in 2020, and \$321 million in 2021. The CIP includes projects at all airports, though the majority of the plan is focused on the largest airport, with HNL accounting for \$1.4 billion or 58% of the program, in addition to the \$438 million consolidated rental car facility (ConRAC) at that airport. The current capital plan is significantly larger and more complex than the airport has previously managed, and Moody's believes the system's large capital program remains exposed to potential cost increases, particularly if it does not remain near its original schedule. However, thus far the cost and schedule have been generally on track.

Projected costs on the Mauka Concourse have increased from \$676 million in FY 2016 to \$717 million in FY 2017. Construction for the project is underway and completion is anticipated for 2020. The airport system is also progressing with its other major project, the ConRAC, for which it is planning to issue \$226 million in 2019. The ConRAC facilities currently under construction are located at HNL and Kahului. The HNL project has three phases and the first, improvements to the connecting roadway system, is complete. Phase 2A, construction of temporary consolidated rental car maintenance facilities and modification of the existing parking structure, began operating in November 2015. Phase 2B, the permanent ConRAC facility, is 27% complete and is scheduled to be completed in 2021. The Kahului ConRAC facility is 75% complete and is scheduled to be completed in 2019. There is also a proposed Lihue ConRAC for which \$21.3 million has thus far been allocated for land acquisition and initial development. At most this facility is expected to cost \$100 million.

The airport system entered into a 20-year Energy Performance Contract (EPC) with Johnson Controls, Inc. to derive operating expense savings by reducing future energy expenses. 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. The actual savings for FY 2017 were \$20.78 million, which is 10.6% greater than the guaranteed savings of \$18.79 million. The JCI contract was amended in March 2017 to implement \$49 million of additional lighting and solar PV, which will return the investment within the original contract period of 15 years and provide \$6 million in annual savings thereafter.

### DEBT STRUCTURE

All of the airport's debt is fixed-rate and amortizing. FY 2017 debt service for the senior revenue bonds is \$84 million and will continue to increase until peaking in 2024 at \$150 million for senior bonds, plus \$23.9 million for subordinate bonds, inclusive of future 2020, and 2021 bond issues, but not including savings from possible refundings. Senior debt service drops in FY 2025 and then remains flat through final maturity in 2048. We note that this profile does not include potential debt issues for an additional \$1.1 billion in projects to be undertaken to reconstruct the Diamond Head Concourse at Honolulu beyond 2025.

### DEBT-RELATED DERIVATIVES

None.

### PENSIONS AND OPEB

Currently the state's pension system is 54.9% funded on an actuarial basis and the state has enacted legislation to improve that ratio. Act 17 of 2017 requires employers to increase their contribution rates to pensions from 25% to 41% for public safety and 17% to 24% for general employees. For FY 2017, the airport's reported net pension liability (NPL) was \$353.361 million and its funding contribution was \$11.6 million. Moody's adjusted net pension liability (ANPL) calculation for FY 2017 was \$368.661 million.

### Management and Governance

The DOT is one of 18 principal executive departments of the state and is empowered to establish, maintain and operate the transportation facilities of the state, including highways, airports, harbors and other transportation facilities. The department is headed by the director, who is appointed by the governor and confirmed by the state senate. The Airports Division is managed by a deputy director and the airports administrator. 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: mapping to the grid

The grid is a reference tool that can be used to approximate credit profiles in the US airport industry in most cases. However, the grid is a summary that does not include every rating consideration. Please see the Publicly Managed Airports and Related Issuers rating methodology for more information about the limitations inherent to grids.

The grid implied rating is A1, which is the same as the published rating.

Exhibit 3

#### Hawaii (State of) Airport Enterprise Methodology Scorecard

Factor	Subfactor	Score	Metric
1. Market Position	a) Size of Service Area (Millions)	A	1.43
	b) Economic Strength & Diversity of Service Area	A	
	c) Competition for Travel	Aaa	
2. Service Offering	a) Total Enplanements (Millions)	Aaa	17.86
	b) Stability of Traffic Performance	A	
	c) Stability of Costs	Baa	
	d) Carrier base (Primary Carrier as % of Total Enplanements)	Baa	51.3%
3. Leverage and Coverage	a) Debt Service Coverage by Net Revenues	A	1.45x
	b) Debt in USD per O&D Enplaned Passenger	A	\$64.14
		<b>Notch</b>	
4. Liquidity		1.0	
5. Connecting Traffic		0.0	
6. Potential for Increased Leverage		-0.5	
7. Debt Service Reserves		0.0	
<b>Scorecard Indicated Rating:</b>		<b>A1</b>	

Source: Moody's Investors Service

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