

# RatingsDirect®

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## Hawaii Hawaii Airports System; Airport

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# Hawaii

## Hawaii Airports System; Airport

Credit Profile		
US\$387.4 mil arpt sys rev bnds (Hawaii Arpt Sys) ser 2018A due 07/01/2048		
<i>Long Term Rating</i>	AA-/Stable	New
US\$150.0 mil arpt sys rev bnds (Hawaii Arpt Sys) ser 2018D due 07/01/2034		
<i>Long Term Rating</i>	AA-/Stable	New
US\$100.0 mil arpt sys rev bnds (Hawaii Arpt Sys) ser 2018C due 07/01/2028		
<i>Long Term Rating</i>	AA-/Stable	New
US\$26.2 mil arpt sys rev bnds (Hawaii Arpt Sys) ser 2018B due 07/01/2030		
<i>Long Term Rating</i>	AA-/Stable	New
Hawaii Arpt Sys airport system rev bnds ser 2015A due 07/01/2045		
<i>Long Term Rating</i>	AA-/Stable	Upgraded
Hawaii Arpt Sys AIRPORTS		
<i>Long Term Rating</i>	A+/Stable	Upgraded
<b>Hawaii</b>		
Hawaii Arpt Sys, Hawaii		
Hawaii (Hawaii Airport System)		
<i>Long Term Rating</i>	AA-/Stable	Upgraded
Hawaii (Hawaii Airport System) (AGM) (SEC MKT)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Upgraded

Many issues are enhanced by bond insurance.

## Rationale

S&P Global Ratings raised its long-term rating and underlying rating (SPUR) to 'AA-' from 'A+' on Hawaii Airports 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). The outlook is stable.

The rating action reflects the application of our updated rating criteria, "U.S. And Canadian Not-For-Profit Transportation Infrastructure Enterprises," published March 12, 2018 on RatingsDirect.

We also assigned our 'AA-' long-term rating to Hawaii Airports System's proposed series 2018 bonds, consisting of the following subseries:

- \$387.4 million series 2018A airports system revenue bonds (alternative minimum tax, or AMT);
- \$26.2 million series 2018B airports system revenue bonds (Non-AMT);
- \$100 million series 2018C airports system revenue refunding bonds (direct purchase by Bank of America Merrill Lynch); and

- \$150 million series 2018D airports system revenue refunding bonds (direct purchase by Morgan Stanley).

The ratings on Hawaii Airports System's obligations reflects our opinion of the system's extremely strong enterprise risk profile and strong financial risk profile. The extremely strong enterprise risk profile reflects our view of the system's role as a large, mostly (88%) origin-and-destination (O&D) hub of extremely high regional essentiality and importance that has favorable demand characteristics as a result of its monopoly status within the Hawaiian Islands, its role as a popular visitor destination, and its diversifying and strengthening service area economy. The strong financial risk profile reflects coverage (S&P Global Ratings-calculated) and debt and liabilities capacity we view as strong, and liquidity and financial flexibility that we view as very strong.

The extremely strong enterprise risk profile further reflects our view of the airports system's:

- Extremely strong market position. The system has a monopolistic position and very high essentiality for transport within, to, and from the state, serving a niche travel market with five primary airports and 10 secondary airports throughout Hawaii. It also has relatively high activity levels (averaging almost 17 million enplanements over the past five years), and very favorable enplanement trends. We expect this to continue given its strong 88% O&D enplanement levels, and despite the system's moderately high carrier concentration in Hawaiian Airlines, which handles roughly 51% of the airport's total enplanements.
- Extremely strong service area economic fundamentals, which include favorable economic activity as measured by GDP per capita, below-average unemployment levels and the strength of the state's tourism industry
- Low (very strong) industry risk relative to that of other industries and sectors
- Very strong management and governance, with management generally achieving or exceeding financial and operational goals, detailed financial projections, an experienced and deep management team, and generally well-defined project plans and targets with prudent risk mitigation

The strong financial risk profile reflects our view of the system's:

- Coverage (S&P Global Ratings-calculated) that we expect will continue at levels we consider strong at approximately 1.25x, not including the funded coverage account balance, although the hybrid-residual nature of airline use agreements somewhat offsets this, as does our view of management's conservative forecasting practices;
- Debt and liabilities capacity that we expect will be maintained at a level we consider strong, even when taking into consideration the airports system's debt burden increasing to about \$2.1 billion by 2022 from \$1.2 billion (as of June 30, 2018) after issuance of additional debt in fiscal years 2019 through 2022; and
- Very strong liquidity position, including \$576 million, or about 729 days of expenditures, in unrestricted cash as of audited fiscal 2017, a level that management anticipates will be sustained.

The series 2018 bond proceeds will be used to fund various systemwide capital needs and to refund certain bonds outstanding. As of June 30, 2018, the airport had about \$1.19 billion in debt outstanding, and, once the series 2018 bonds are issued total system debt will increase 32% to \$1.57 billion. The series 2018C and 2018D refunding revenue bonds are being directly placed with Morgan Stanley and Bank of America Merrill Lynch, respectively, through forward bond purchase contracts. These bonds will be issued on parity with the airport system's senior-lien revenue bonds and will contain bond provisions and events of default in line with parity debt.

The senior-lien airport revenue bonds are secured by senior-lien system revenue and aviation fuel tax revenue after operations-and-maintenance (O&M) costs. The airports system's series 2013 COPs are special limited obligations of the airports division and were issued to fund \$150 million in costs related to the implementation of an energy performance contract (EPC) between the department and Johnson Controls Inc. (JCI). The COPs 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 revenue securing the airport system revenue bonds outstanding, which are rated one notch higher at AA-/Stable.

We have applied the aforementioned Transportation Infrastructure Enterprise criteria to determine the entity's general creditworthiness (issuer credit rating), including the calculation of all-in debt service coverage (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 series 2013 subordinate-lien COPs. For the COPs, the rating is also based on the application of our "Issue Credit Ratings Linked To U.S. Public Finance Obligors' Creditworthiness" criteria, published Jan. 22, 2018. The airports system includes the lease payments in its annual budget, which is subject to appropriation by the State Legislature, but this annual appropriation by the State Legislature is the same process as the airports system's overall budget, which includes revenue bond debt service. Appropriation and payment of debt service is not contingent on verification of energy savings or receipt of any energy savings shortfall payments, and the project has strong, unanimous support and approval through a concurrence letter from the signatory airlines, which have agreed to include lease payments in their rates and charges.

The State of Hawaii owns and operates the system through its Department of Transportation, Airports Division. The system includes all commercial facilities in the state, and the state accounts for them as a single integrated enterprise fund. The airports division has the authority to levy rates and charges that, along with aviation fuel taxes, are sufficient to comply with the bond indenture's requirement. 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 are a growing trend) and interisland flights, and this helps diversify system risk. Hawaii continues to be one of the most-visited states in the U.S. More than one airport can process international passengers now, too.

The system's key strengths include its critical support of the tourism industry and its essential position providing transportation infrastructure within the state. Daniel K. Inouye International Airport, or Honolulu International Airport (HNL), serving the state's largest population center, has by far the largest share of systemwide traffic. HNL handles 58% of enplanements with long (12,000-foot) parallel runways and ample gate capacity, including 29 overseas gate positions, 13 interisland gate positions, and 12 commuter aircraft parking positions. The system has taken steps to control expenditure growth, especially with regard to the Energy Service Company (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.

Our assessments considered the airport system's updated financial forecast, reflecting the impact of the airport's

capital improvement plan (CIP) and related debt issuances, with additional debt of about \$700 million through 2021, not including the series 2018 bonds. We do not expect additional significant increases to the CIP.

## 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 strong levels, and that demand will not significantly deteriorate.

### Upside scenario

We do not expect to change the rating over the next two years given our view that coverage and liquidity metrics are not likely to improve materially. Also limiting additional rating upside is the airport's large \$2.4 billion capital plan through 2024, more than 75% of which is funded by debt.

### 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 essentiality and monopolistic market position, we are unlikely to lower the rating during the next two years. Nevertheless, if activity levels materially weaken, leading to materially weakened coverage or liquidity, we could lower the rating.

## Enterprise Risk Profile

Our assessment of the system's enterprise risk profile as extremely strong reflects our view of its low industry risk as well as its extremely strong economic fundamentals and market position, and very strong management and governance.

### Economic fundamentals

The service area has extremely strong economic fundamentals because of favorable income levels and economic activity as measured by very high GDP per capita of more than \$61,000 and very low unemployment levels, and despite below-average expected population growth. The state continues to show strong economic growth with relatively flat population growth (population 1.41 million as of 2017) but very strong visitor arrivals, up 15% in the 2013-2017 period. In terms of visitor activity to the state, westbound visitors by air from the U.S. accounted for 63.1% of total visitors in 2017, with Japan accounting for 16.9% and Canada 5.6%. Korean visitors represent a rapidly growing segment, accounting 2.8% of visitors in 2017. Following declines of 10.6% in 2008 and 4.5% in 2009, visitor arrivals have rebounded, increasing 7.7% in calendar 2010, 4.0% in 2011, 10.0% in 2012, 1.8% in 2013, 1.6% in 2014, 4.5% in 2015, 2.3% in 2016, and 5.0% to 9.4 million in 2017. The state estimates visitor arrival growth of 6% for 2018. Visitor spending increased 6.2% during 2017 and 4.2% in 2016. Hotel occupancy reached 80% (the highest since 2005) for 2017. Growth in services such as AirBnB for vacation rentals and timeshares has also created additional visitor capacity, helping to fuel growth. The state's seasonally unadjusted unemployment rate was just 2%, the lowest in the nation, in May 2018.

Although economic metrics continue their positive trends with record visitors, with a record number of air seats

projected in 2018, risks remain. Despite the system's essential role, it and the state it serves remain exposed to cyclicity associated with the discretionary travel related to the tourism industry. In our view, the system has outperformed the U.S. in recent economic expansions and underperformed during recent recessions. 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.

### **Market position**

We consider the system's overall market position extremely strong given its essentiality to the state and its status as a virtual monopoly. The system handled about 17.9 million enplanements in fiscal 2017, estimated to grow 3.5% to 18.5 million enplanements in fiscal 2018 (ended June 30). The system's workhorse, HNL (58% of total systemwide enplanements), was the 28th-largest airport in the U.S. by enplaned passengers in calendar 2016 (according to the Federal Aviation Administration). As a system, the airport's division would be the 18th-largest in the nation among large hub airports. In our view, the system has adequate airline diversity, with the largest airline--Hawaiian Airlines Inc.--having a 51% market share in fiscal 2017 across the system. Southwest Airlines has recently announced that it will begin service to four Hawaii destinations from four California airlines in late 2018 or early 2019. The extent to which this will affect pricing, overall enplanements, and airline concentration is unknown, but we believe this is a positive credit development. Forecasts indicate that the introduction of Southwest will increase traffic by fiscal 2024 by a net 445,000 enplanements, which is about 3% of total combined mainland U.S. and interisland enplanements.

The compound annual growth rate in enplanements from 2009 to 2017 was 4.7%, conservatively forecast at 2.5% annually from 2017 to 2021. 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 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 growth since fiscal 2009 is generally the result of improving U.S. and overseas economics, and despite the decline in overall enplanements in fiscal 2014, international enplanements rose 4.3% that year. Enplanements resumed growth in fiscal years 2015 to 2017 at 2.4%, 3.2%, and 3.7%, sequentially. Management estimates enplanement growth of 3.5% for unaudited fiscal 2018 and about 2.1% on average through fiscal 2024, which we view as conservative and reasonable. Systemwide enplanements in fiscal 2017 totaled 17.86 million and are estimated at 18.5 million in fiscal 2018, which would put it above the fiscal 2000 peak of 18.28 million, a milestone. Fiscal 2017 enplaned passengers were 58% overseas passengers and 42% interisland passengers, consistent with recent years. There has been no operational disruption to air service on the Big Island because of the significant increase in volcanic activity that began in May 2018 and continues to this day, although Hawaiian Airlines eliminated one daily flight to Hilo (out of 15) and one daily flight to Kona (out of 23). (Separately, Hawaiian Airlines is making significant investments in new aircraft and remains committed to serving the islands.) Despite these adjustments, no material impacts have been seen thus far, and Hilo, the closest airport to the eruptions, represents just 3.8% of total system enplanements.

The system largely handles O&D passengers, with such passengers representing 88% 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. It enplaned 9.2 million passengers in fiscal 2017, up 2.8% from 2016.

The system's other four other primary airports enplaned 7.4 million passengers, up a strong 5.5% from fiscal 2016, accounting for 42.0% of systemwide passenger traffic. These airports have continued to add direct overseas flights.

Because of the airport's demand characteristics and historical enplanement trends, we expect the system's enplanement trends will remain generally favorable with some modest fluctuations as a result of the airport's moderate air carrier concentration, potential for weak economic cycles, fuel price changes, airline service decisions, constrained terminal facilities, and potential disruptions from redeveloping the terminal facilities.

### **Management and governance**

We believe the airport's management and governance are very strong, reflecting our view of the airport's strategic positioning, risk management, financial management, and organizational effectiveness. The management team is very experienced with over 70 years of combined experience within the airports system, and management has a strong track record of achieving most of its financial and operational goals. To further enhance its role in the region and to address aging infrastructure, the airports division put together a revised \$2.4 billion CIP to increase capacity and efficiency and to enhance the customer experience. Management has historically operated in a fiscally prudent manner, budgeting conservatively, maintaining strong cash reserves, and modernizing and enhancing terminal facilities. The CIP, supported by the airlines, is demand-driven and modular, and the commission has several measures in place to mitigate construction risk. The airports system also has a relatively simple and low-risk debt profile, with all fixed-rate amortizing debt. The commission maintains prudent insurance policies, including business interruption insurance.

The airline rate-setting methodology under the 2007 First Amended Lease Extension Agreement hybrid-residual consists of a residual landing fee methodology to recover the net costs of airfield and a residual terminal rate methodology for the primary airports to recover the net costs of the respective terminals, except that only 50% of the net costs at Hilo will be recovered before the enplaned passenger level surpasses 2 million. An Airports System Support Charge (ASSC) is used, if needed, to recover all costs of the system, net of all other applicable revenue and aviation fuel taxes; the ASSC ensures that the rate covenant is met, so long as the signatory airlines continue to operate at the airports. The airports system retains the surplus from all other costs centers, and, in case other costs centers generate a deficit, it can impose the ASSC.

### **Financial Risk Profile**

Our assessment of the system's financial risk profile as strong reflects our view of the system's strong financial performance, strong debt and liabilities capacity, and very strong liquidity and financial flexibility. Our financial profile risk assessment in some cases considered pro forma figures, which reflect the impact of the \$1.8 billion in debt needed to fund the CIP (an additional \$726 million by 2022). Our financial profile risk assessment also considered the system's financial policies, which we consider credit neutral.

Our assessment considered the system's updated financial forecast, which assumes issuance of the additional debt aforementioned, 2.1% compound annual growth rate in enplanements for fiscal years 2017 to 2024, increasing airline cost per enplanement (CPE) to \$13.03 in 2024 from \$9.60 in fiscal 2017, and increasing debt per enplanement to around \$97 by 2024 from \$69 in fiscal 2017. The system has \$1.2 billion of debt outstanding. We consider the forecast

reasonable given economic and enplanement trends and the system's track record of exceeding prior years' forecast metrics. In addition, any growth in enplanements and revenue that could result from Southwest Airlines serving the islands has not been included in forecasts.

### **Financial performance**

The strong financial performance assessment reflects our evaluation of the system's updated financial forecast, the hybrid-residual nature of the airport's airline use and lease agreements, and a gradually rising airline cost structure. We expect coverage (S&P Global Ratings-calculated) to be near 1.25x through 2024 given the airport's conservative budgeting practices and reasonable assumptions. According to the forecast, coverage per our calculations will decline to near 1.11x by fiscal 2024, exclusive of the application of \$37 million in funded coverage account balance that the indenture permits (1.32x including the transfer). Our coverage calculation includes passenger facility charges (PFCs) pledged or committed to general airport revenue bond debt service as part of revenue rather than as a debt service offset and excludes the system's funded coverage account.

While coverage is forecast to slightly decline from the 1.25x achieved in 2017 (S&P Global Ratings-calculated) and CPE is anticipated to rise 36% by 2024, we also believe the forecast is conservative; the system has a history of outperforming the airport consultant's projections, especially over the past 10 years. Thus, we anticipate that these metrics will be more favorable than the forecast indicates, with coverage likely to be near 1.25x. We consider the system's airline cost structure moderately low, at slightly less than \$10 in fiscal 2017.

### **Debt and liabilities**

We assessed the system's debt and liabilities capacity as strong based on pro forma figures that, in our opinion, accurately reflect our forward-looking view of leverage, but we note that pro forma figures for debt to net revenue do not materially differ from recent or current-year figures. Consequently, our assessment assumes the system's pro forma debt to net revenue to be about 10x by 2024, including all projected debt issuances and considering that a portion of PFCs will be committed to paying debt service. Our assessment also considered the airport's pro forma debt per enplanement that we project will peak at about \$107 over the 2018-2024 period, reflecting the impact of all anticipated bond issuances. To the extent that enplanement growth exceeds the airport consultant's forecast, these metrics will be more moderate.

The system is undertaking a number of improvement and modernization projects totaling \$2.4 billion over the fiscal 2019-2024 period, with 33% already spent. Despite its projected large CIP, and given revised cost estimates and enplanement forecasts, management projects that CPE will rise to only \$10 by 2020 and \$13 by 2024, which we consider in line with the rating category. Also among credit risks is an increasing debt burden, as airport bonds will fund about \$1.8 billion, or 76%, of capital needs. The airport system anticipates issuing \$358 million in airport revenue bonds in 2020 and another \$321 million in 2021 to fund projects within the CIP. Revenue bonds outstanding as of fiscal 2018 totaled \$976 million. Pro forma debt by 2022, including the next two series of bonds anticipated to be issued (and net of amortizing principal), is estimated at \$2.1 billion. Given our view of management's conservative forecast assumptions with regard to enplanement growth, we anticipate debt per enplanement to come in below the \$107 we calculated.

Several major capital projects are planned or underway that are aimed at modernizing the facilities, increasing system



capacity, enhancing revenue, and improving passengers' overall experience. Key projects within the airports system CIP include:

- Mauka Concourse Program at HNL (\$717 million),
- Terminal improvements at HNL (\$457 million),
- Kahului general projects (\$210 million),
- Various Kona projects (\$217 million),
- Energy Savings Projects (\$207 million), and
- Airfield projects at HNL (\$181 million).

Not included yet in the CIP is the Diamond Head Concourse, a new 800,000-square-foot concourse with 12-14 wide-body gates that would also include a 200,000-square-foot customs and border protection facility. The project is in the pre-design state and does not yet have a final scope, schedule, or formal cost estimate.

The system carefully manages construction risk and cost escalation through value engineering, maintenance of several contingencies, and identification of deferrable projects or project components.

### **Liquidity and financial flexibility**

Unlike our financial performance and debt and liabilities assessments, our liquidity and financial flexibility assessment did not consider pro forma figures in terms of cash or available liquidity to debt, because long-term liquidity projections for 2024 were not available. Management plans to maintain cash near current levels, but we anticipate that the nominal amount will grow with the airport's budget. We assessed the system's liquidity and financial flexibility as very strong, reflecting about \$576 million in unrestricted cash, or 729 days' cash on hand, in fiscal 2017, with available liquidity to debt at 47%.

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