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Fitch Rates Hawaii Airport Revenue Bonds 'A+' and Affirms Outstanding; Outlook Negative

Fitch Ratings-San Francisco-30 September 2020:

Fitch Ratings has assigned an 'A+' rating to \$296.1 million in airport system revenue bonds, series 2020A, 2020B, and 2020C and \$279.7 million series 2020D and 2020E, being issued by State of Hawaii, Department of Transportation (Airports Division). In addition, Fitch has affirmed the 'A+' rating on \$1.3 billion of outstanding parity airport system revenue bonds and the 'A' rating on \$151 million of outstanding subordinate lien lease revenue certificates of participation (COPs), series 2013.

The Rating Outlook for all of the bonds is Negative.

The Airports Division also has \$55 million outstanding in parity COPs that are not rated by Fitch.

RATING RATIONALE

Summary: The ratings reflect the essentiality of air services to the state's island system of airports, which encompasses a high degree of tourism and leisure-focused traffic from long-haul domestic and international passengers. Given this demand profile, Fitch believes that Hawaii is currently at risk to a longer recovery cycle relative to other U.S. airports.

The ratings also consider the ongoing capital program with a considerable budget, resulting in upward pressure to airline cost and leverage metrics, although the enterprise's overall financial position, with the funds from the Coronavirus Aid, Relief, and Economic Security (CARES) Act, as well as the existing strong liquidity profile, should remain intact. 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.

The Negative Outlook reflects the substantial adverse impact on operating performance due to the coronavirus and related containment measures, along with uncertainty around the timing and magnitude of recovery. An extended period of activity weakness in aviation activity and related revenues could lead to elevated risks resulting in a lower rating.

The outbreak of coronavirus and related government containment measures worldwide create an

uncertain global environment for the airport sector. Material changes in revenue and cost profile are occurring across the airport sector and will continue to evolve as economic activity and government restrictions respond to the ongoing situation. Fitch's ratings are forward-looking in nature, and Fitch will monitor developments in the sector as a result of the virus outbreak as it relates to severity and duration and incorporate rating and downside case qualitative and quantitative inputs based on expectations for future performance and assessment of key risks.

KEY RATING DRIVERS

Monopolistic Position; Leisure Exposure - Revenue Risk (Volume): Stronger

The necessity of air travel to, from and between Hawaii's various islands provides the airport system with a stable origin and destination base of approximately 18.7 million enplaned passengers, though these volumes have decreased substantially since the start of the coronavirus pandemic. State imposed isolation restrictions for in-bound passengers, which has been in place for months but will soon be adjusted, has also resulted in dampened demand. Enplanement recovery remains uncertain and will be linked to the virus conditions and a meaningful rebound to tourism. While Hawaiian Airlines (B+/Negative) accounts for approximately half of total system enplanements, the long-term trends for expansion of domestic and international services, as well as necessity of air travel for this market mitigates risk.

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. Cost per enplanement (CPE) remains competitive at roughly \$11 in fiscal 2020, lower than previously expected. Management expects CPE to rise to \$20 in the near term and step down to the \$17 range by 2024 as enplanements recover, capital spending occurs, and costs are charged to carriers. While the state has taken actions to alleviate the cost requirements to airlines, the AUL mechanisms allow for surcharges to carriers to meet all of the airport's operating and financing obligations.

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

The airport's capital plan encompasses fiscal 2020-2026, totals \$2.7 billion and is anticipated to be 52% debt funded, accounting for prior and planned debt issuances. Planned expenditures under the Airport Division's ongoing CIP through fiscal 2025 totals \$1.6 billion, with \$649 million spent as of June 2020. In light of the conditions created by the coronavirus, the airport is prioritizing its ongoing CIP, as these projects are already underway. These amounts do not include 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 generally declining debt service profile and final maturity in 2051. The rated COPs are also 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 series 2020D and 2020E refunding is anticipated to lower the airport's annual debt service through, reducing debt service by roughly \$99 million through 2022. 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 revenue bonds and COPs outstanding, the Airports Division expects to issue approximately \$1.1 billion in 2022 to fund its CIP, though these figures and timing remain preliminary.

Financial Summary:

Key financial metrics have historically been sound but will be pressured as the pandemic-led traffic decline and the potential recovery takes course over the next several years. While indenture-based debt service coverage was a solid 2.0x in FY 2020, Hawaii will be dependent in the near term on its Coronavirus Aid, Relief, and Economic Security (CARES) Act funds, as well as airline rate adjustments, cost-management actions and debt service savings through refinancings to maintain a comparable coverage profile. Elevated leverage also remains a concern at the 16x level and the debt associated for this new capital program will keep leverage high, at the 8x level through FY 2024.

PEER GROUP

Hawaii's peers include Greater Orlando Aviation Authority (AA-/A+/Negative) and Las Vegas (A+/Negative) given the similar relationship to leisure passenger traffic. Hawaii has the highest carrier concentration of the three, and has the highest liquidity position as measured by DCOH. Hawaii's aggregate leverage levels are comparable to both Orlando and Las Vegas under the Fitch rating case, with future leverage hovering at the 8x level in 2024. Lastly, both Hawaii and Orlando will see rising CPE in connection with lower enplanement levels induced by the conditions created by the coronavirus and elevated leverage as their CIPs progress.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

A positive rating action is not expected in the near future given uncertainty regarding recovery;

A return to a Stable Outlook and affirmation of the ratings could be possible in the next one to two years if Fitch sees sustained recovery in traffic and revenues due to the easing of the pandemic, resulting in normal air traffic patterns and credit metrics in line with indicative guidance.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

A continued period of material traffic declines in line with the downside cases that result in leverage increasing to and remaining above 8x-10x on a sustained basis;

Heightened volatility or sustained negative trends in enplanement levels.

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [<https://www.fitchratings.com/site/re/10111579>].

TRANSACTION SUMMARY

The Hawaii Airport System intends to issue series 2020A, 2020B, 2020C, 2020D and 2020E bonds (\$575.8 million par) to pay the costs of various capital improvement projects for the Hawaii Airports System, and refund series 2010A and series 2011 bonds. Series 2020A, 2020B, and 2020C are being issued as new money bonds to advance the airport's capital program. Additionally, bond proceeds will fund capitalized interest through 2022, fund the debt service reserve fund requirement for the new money portion of the bonds, and cover issuance costs.

The 2020 bonds are senior secured, fixed rate, and fully amortizing. The refunding portion of the issuance is estimated to generate debt service savings of roughly \$46.6 million in FY 2021 and \$52.2 million in FY 2022, with an estimated NPV savings of \$49.2 million throughout the debt's tenor. The series 2020 bonds are secured by net revenue pledges and aviation fuel taxes, and have the same overall structural features, including a debt service reserve, rate covenant, and additional bonds test, as the outstanding GARBs.

CREDIT UPDATE

FY 2019 added another year of strong financial performance for Hawaii's Airport Division with senior DSCR of 2.2x. The division entered FY 2020 with strong operating and financial momentum that continued through February 2020, with enplanements increasing 7.6% in the first eight months of FY 2020. Financial and operational performance was negatively impacted by the circumstances created by the coronavirus pandemic, leading to significant declines in revenues and enplanements in March 2020. Although facing financial pressures caused by the coronavirus, Hawaii's Airport Division did not use reserve funds and had no issue making their FY 2020 debt service payment, achieving DSCR of 2.0x. In an effort to offset the revenue declines, Hawaii implemented a number of cost savings measures and deferred non-essential expenditures.

Hawaii experienced a significant decline in both domestic and international passenger volumes beginning in March 2020 as air travel was sharply curtailed by the effects of coronavirus. Despite strong growth for the first eight months of FY 2020, total enplanements declined 23.3% from FY 2019 levels. During the months of April and May, the airport experienced its greatest year over year declines of 96% and 95%, respectively. Enplanements have rebounded slightly to 84.7% as of July 2020. At this level of performance, Hawaii's 2020 volumes are tracking in line with Fitch's coronavirus downside case assumptions.

While the coronavirus represents a unique shock to the air travel sector, Fitch continues to view Hawaii as an airport with an important role in the national aviation system, and the essentiality of air travel for this market partially mitigates risk. A five-year compounded growth rate since 2014 of 2.8% highlights the positive trends to underlying demands, as well as airline's support for increased services. Interisland travel remains a significant component of traffic, representing nearly 39% of total passengers.

Effective Oct. 15, 2020, there will be a new process for traveling to Hawaii without a 14-day quarantine. The new process stipulates that upon arrival, passengers must provide verification of a negative COVID-19 test administered within three days prior to departure and if results are not available, passengers must quarantine. CVS and Kaiser Permanente are currently approved testing

partners that provide the required nucleic testing at CLIA certified labs. In connection to the Airport System's enplanement recovery, management views this development favorably as it will make travelling to Hawaii less prohibitive for prospective travelers.

Hawaii's two leading carriers, United and Hawaiian, account for 44.1% market share of overseas traffic, and Hawaiian maintains 83.9% of the interisland travel traffic. While both carriers are facing financial and operational stresses from the pandemic, both airlines continue to demonstrate a continuing commitment to the Hawaii market. The stability of the airlines is important, as their presence and operations are influential in Hawaii's future capital investment and leveraging commitments. Additionally, management views Hawaiian Airlines as part of the Hawaii brand of being a premier leisure destination.

Hawaii's ongoing CIP through FY 2025 is estimated at \$1.6 billion and \$658.9 million has been spent through June 30, 2020. Included are projects in the construction phase in addition to ongoing planning, design, and program support expenses. The series 2020 bonds will support \$273.9 million of funding to the ongoing CIP, and Hawaii has received all of the necessary airline concurrence and approvals for the project costs.

The 2022-2026 CIP is estimated at \$1.1 billion and includes projects in design, which are not expected to enter the construction stage until January 2022 and beyond. The division will revisit these projects with the signatory airlines and may further defer some projects upon traffic recovery. Management expects that roughly 52% of the total \$2.7 billion in capital projects will be debt funded, accounting for prior and planned issuances.

In Fitch's view, the overall airline cost and financial profile reflects both the operating agreement and growing fixed costs associated with debt issuances that supported the capital programs. Hawaii's financial operations historically produced stable debt service coverage while CPE stayed competitive for a large-hub facility at \$11.09 in 2020.

To address the activity reductions across all areas of operations, including flight operations, parking, car rentals and concession spending, among others, management took a number of measures that will affect its revenues for the current fiscal year but are intended to preserve a stable debt coverage level. Key actions include the removal of minimum annual guaranteed revenue (MAGS) requirement from concessionaires, as well as payment accommodations to terminal concessionaires and rental car operators. The airport has set its rates and charges for FY 2021 with the assumptions that enplanements would reach 9.9 million, representing 53% of FY 2019 levels. The division has agreed to maintain FY 2020 HNL terminal rental rate and user fees unchanged through Oct. 31, 2020 and will adjust airline rates and charges effective November 1, 2020. While defensive measures were also effectuated for operating and capital costs, the infusion

of CARES Act federal grants totaling \$133 million provides a key component of fiscal support to mitigate deferred and permanent revenue losses.

Fitch expects coverage levels on overall airport debt to continue to exceed the required minimum of 1.25x by FY 2021 (inclusive of fund balances); however, given the airport's capital plans and sharp decline in enplanements in connection with the coronavirus, increases in airline rates and charges will be imperative to the airport's overall financial health. Leverage is expected to be elevated in future fiscal periods as gross debt levels are anticipated to nearly double over the next few years.

FINANCIAL ANALYSIS

The sponsor's latest base and low case forecasts developed for the airport's series 2020ABCDE bond issuance, in Fitch's view, assume reasonably conservative traffic activity over the next five-year period, including peak passenger volume reductions of about 58% in FY 2021 compared with 2019 actuals. Considering multiple recovery assumptions over six- and eight-year time horizons, Hawaii could maintain a largely stable range of coverage levels while airline costs rise to as high as \$27 per enplanement. Fitch-calculated total leverage would average 11.2x through FY 2021-2024, stepping down to the 8x level by FY 2024.

Given the traffic volumes observed, Fitch tested Hawaii's performance using the coronavirus downside and severe downside scenarios. The downside case assumes, relative to FY 2019, a 45% enplanement decline in 2021 followed by recoveries reverting the losses to 10% and 5% in FY 2022 and 2023, respectively, and a full recovery by FY 2024. While non-aeronautical revenues are mostly fluctuating with passenger traffic, airline payments are driven by cost-recovery terms under the rate agreements and adjusted by CARES funding for costs in 2020-2021. Additionally, Fitch incorporated the planned debt issuances in FY 2022 to support the airport's capital plan, causing additional fluctuation in airline payments. Results indicate a total Fitch-calculated debt service coverage ratio remaining in the 1.4x-1.6x range, while CPE peaks at about \$18 in 2024. Total leverage averages 11.2x through FY 2024, stepping down to the 8x level by FY 2024.

The coronavirus severe downside scenarios also show a maximum traffic reduction of 45% in FY 2021, relative to FY 2019, followed by a slower pace of recovery in the following fiscal periods. Under these scenarios, DSCR and leverage profile are largely similar relative to the rating case. However, CPE levels would be modestly higher in each year to generate these results.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

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Hawaii, State of (HI) [Airports]

---Hawaii, State of (HI) /Airport Revenues - Subordinate Lien/1 LT; Long Term Rating; Affirmed; A; Rating Outlook Negative

---Hawaii, State of (HI) /Airport Revenues/1 LT; Long Term Rating; Affirmed; A+; Rating Outlook Negative

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Applicable Criteria

[Airports Rating Criteria \(pub. 24 Mar 2020\) \(including rating assumption sensitivity\)](#)

[Infrastructure and Project Finance Rating Criteria \(pub. 24 Mar 2020\) \(including rating assumption sensitivity\)](#)

Applicable Model

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

GIG AST Model, v1.1.2 (1)

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