FITCH AFFIRMS UNIVERSITY OF HAWAII'S REVS AT 'AA'; OUTLOOK STABLE

Fitch Ratings-New York-04 February 2014: Fitch Ratings affirms its 'AA' on the following series of bonds issued by the Board of Regents of the University of Hawaii (UH):

--$477.2 million university revenue bonds, series 2006A, 2009A, 2010A, 2010B, and 2012A;
--$131.5 million university bonds, series 2006A.

The Rating Outlook is Stable.

SECURITY
University revenue bonds are secured by net revenues of UH's auxiliary network (the network); a subordinate pledge on legislative appropriations. Additionally, the series 2010A bonds are secured by amounts on deposit in the Hawaii Cancer Research Special Fund.

The series 2006A university bonds are secured by a portion of moneys in the state of Hawaii's Tobacco Settlement Special Fund; a senior pledge on legislative appropriations; and a subordinate pledge of net revenues of the network.

KEY RATING DRIVERS

FLAGSHIP CHARACTERISTICS: The 'AA' rating reflects UH's deep integration in the state of Hawaii's (the state; general obligation bonds rated 'AA' by Fitch) public education system and economy, evidenced by substantial state support.

SOLE PROVIDER STATUS: UH benefits from its broad system of campuses, university centers and other facilities stretching across six of the state's eight main islands. However, fall 2013 headcount fell slightly from the prior year, following flat growth in fall 2012. Enrollment is up modestly since fall 2009 and UH continues to enroll nearly 40% of Hawaii's high school graduates.

HIGH RELIANCE ON STATE: While UH has some revenue diversity, state operating appropriations account for one-quarter of annual operating revenues, with other transfers from the state providing another 11%-12%. Funding declines over the past few years along with expenditure growth challenged UH's operating performance. Even after adjusting for annual OPEB costs attributable to UH but paid directly by the state, UH's operating margin turned negative in fiscal years 2012 and 2103 after several years of breakeven to positive operations.

SOUND FINANCIAL CUSHION: UH's balance sheet resources continue to provide a sound financial cushion relative to operations and debt, though this cushion also weakened over the past two fiscal years. However, the university's conservatively structured debt portfolio and significant state capital support result in a low debt burden.

RATING SENSITIVITIES

MARGIN IMPROVEMENT: The Stable Outlook assumes gradual operating improvement starting with fiscal 2014 and near balanced operations for fiscal 2015 due primarily to improved state funding and planned tuition increases. An inability to return to at least a breakeven operating performance (as calculated by Fitch to exclude annual OPEB costs) over the near term could yield negative rating pressure.

ADDITIONAL LEVERAGE: Incurrence of additional debt before a commensurate increase in available financial resources or sustained operating improvement could erode the university's financial cushion.

STATE AND FEDERAL BUDGETS: With more than half of UH's revenues derived from state appropriations and federal sources, primarily via sponsored research, materially adverse shifts in these two funding sources could negatively affect the rating.

CREDIT PROFILE

Founded in 1907, UH is the sole provider of public higher education in the state of Hawaii, with 10 campuses located on six of the state's eight main islands. It is comprised of three universities, seven community colleges, and various educational training and research centers. The University of Hawaii at Manoa, located in Honolulu, serves as the flagship campus.

Relative Enrollment Stability Reflects Sole Provider Status

Overall student demand remains relatively stable, benefiting from UH's sole provider status encompassing four-year and community colleges. However, following flat enrollment growth in fall 2012, enrollment dipped in fall 2013. Headcount fell 2.2%, while full-time equivalents (FTEs) fell 1.5%. The decline was mostly seen at the graduate and community college level, which management partly attributes to the state economy and Fitch notes is consistent with national trends. Management is conservatively planning for flat enrollment for fall 2014 and beyond, with growth at the new West Oahu campus expected to offset the maturing enrollment profile at the flagship Manoa campus, as well as efforts to attract more nonresident and international students.

Various university initiatives are underway to improve UH's graduation rates, and which are aligned with state economic development initiatives aimed at increasing higher education degrees and bolstering Hawaii's work force. This is further evidence of the integrated relationship between UH and the state and could potentially serve to grow enrollment going forward.

Past Funding Cuts Pressured Operations, But State Budget Improving

Following several years of breakeven to positive operations (as adjusted for annual OPEB costs) through fiscal 2011, UH posted negative operating margins in each of the past two fiscal years of negative 1.6% and negative 4% in fiscal years 2012 and 2013, respectively. Before adjusting for OPEB costs, which are reported under GAAP as university expenses but paid by the state, the margins were negative 10.9% and negative 13.7% over the same period. The weaker operating performance was driven primarily by significant state funding cuts in the aftermath of the last downturn. Funding was reduced significantly (about $108 million) from fiscal years 2009-2011, with cuts easing during the last biennium (2012-2013).

As the state's fiscal position has been recovering, with a budget surplus estimated for fiscal 2014, planned funding to UH improved slightly in fiscal 2014 and is expected to improve further for fiscal 2015. While, management anticipates another negative operating margin for fiscal 2014 (after the OPEB adjustment), results are expected to be better than that of fiscal 2013. Operating improvement is anticipated to be sustained going into fiscal 2015 due to planned tuition increases (7% for fall 2014), along with enrollment levels remaining stable and improved state funding. Lack of measureable progress towards returning to balanced operations could yield negative rating pressure.

Typical of flagship/sole provider university systems, UH benefits from a fairly diverse revenue base. Grant and contract revenues make up the largest funding source (33.5% of fiscal 2013 operating revenues), followed closely by state appropriations (26%) and student-generated revenues (22.7%).

Fiscal 2013 research funding was stable from fiscal 2012, though management reported that awards for the first half of fiscal 2014 were slightly below the prior year period. Primary federal sponsors include the National Institute of Health, Department of Defense and the National Science Foundation. UH launched a partnership with local community and business groups to grow Hawaii's research industry, focusing on attracting and retaining top researchers to the state. UH's recently completed Cancer Care Center, Hawaii's first National Cancer Institute, is expected to playing a key role in this effort.

Sound Liquidity and Low Debt Burden Mitigate Capital Needs

UH's balance sheet liquidity remains adequate for the rating category, though its cushion weakened slightly from fiscal 2012. Available funds totaled $549.4 million as of June 30, 2013, down from $603.1 million at fiscal-year-end 2012, but up 26% since 2009. For fiscal 2013, available funds covered debt by a sound 87%, but operating expenses by a more modest 36%. The decline in cash and investments is partly attributed to UH's purchase of certain capital assets and spend down of reserves at certain campuses for one-time expenditures to offset state funding declines. The university's asset allocation remains fairly conservative, with a moderate 20% exposure to alternative investments.

UH's current liquidity metrics are low for the current rating level, but based on approved tuition increases in conjunction with the recently improved state funding environment, Fitch expects the university's financial resources to gradually increase in the near-term.

UH's debt structure is conservative, with all fixed-rate debt and level amortization. It took on an $18 million, five-year unsecured loan in fiscal 2013 to fund construction at its new West Oahu campus, with $17 million advanced to date. Repayment of this loan is limited and subject to specific appropriations by the state. Moreover, the size of the loan is close to that of the annual amortization on UH's revenue bonds, leaving its overall debt position unchanged.

The university's debt burden remains low and in line with the Fitch's expectation for the rating category. Pro forma MADS of $46.5 million consumed a low 3.2% of fiscal 2013 operating revenues ($1.5 billion), roughly even with past years. UH receives significant state capital support which helps to keep its burden manageable. Economic debt service coverage from net operating income had been over 2.0x over the past several years. The recent weakening in operating performance caused coverage to fall to a still adequate but lower 1.5x in fiscal 2013 (adjusted for OPEB costs). Coverage falls below 1x when including annual OPEB expenses. Fitch notes positively that in addition to UH sources, additional security is derived from dedicated non-UH revenues, including transfers from state tobacco settlement revenues and from the Hawaii Cancer Center ($27.1 million in total for fiscal 2013).

Due to its size and scope, UH has ongoing capital needs that are expected to lead to periodic debt issuance, particularly as it addresses sizeable outstanding deferred maintenance issues. While its debt burden is currently low, additional indebtedness without sustained operating improvement could stress coverage levels and further erode balance sheet liquidity to the point where liquidity metrics are potentially inconsistent with the rating level.

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Applicable Criteria and Related Research:
--‘U.S. College and University Rating Criteria’ (May 10, 2013);
--‘State of Hawaii’ (Jan. 13, 2014);
--‘Fitch Rates University of Hawaii Revs ‘AA’; Outlook Stable' (Feb. 6, 2012).

Applicable Criteria and Related Research:
U.S. College and University Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=708049
State of Hawaii
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=726915