FITCH AFFIRMS THE UNIVERSITY OF HAWAII AT 'AA'; OUTLOOK STABLE

Fitch Ratings-Chicago-23 September 2019: Fitch Ratings has affirmed the 'AA' rating on approximately $507 million in Board of Regents of the University of Hawaii (UH) University Revenue Bonds. Fitch has removed the rating from Under Criteria Observation. In addition, Fitch has assigned a Long-Term Issuer Default Rating (IDR) of 'AA' to the University of Hawaii.

The Rating Outlook is Stable.

SECURITY

University revenue bonds are secured by a first lien on the net revenues of UH's auxiliary network (the network, including the net revenues of various housing and auxiliary activities), and by a subordinate lien on legislative appropriations in special and revolving funds appropriated or allocated to the Board of Regents, UH, or the network, which includes tuition and fees.

ANALYTICAL CONCLUSION

The 'AA' IDR and revenue bond rating reflects the University of Hawaii's role as the sole provider of post-secondary education in the state of Hawaii, the strong operating and capital support provided by the state of Hawaii (AA/Positive) and an expectation that the University's financial profile will continue to moderately improve as enrollment steadies and it addresses its sizable capital improvement program.

KEY RATING DRIVERS

Revenue Defensibility: 'aa'; Statewide System with Strong State Support

The 'aa' assessment for revenue defensibility is anchored by UH's role as the state's only public provider of higher education, with a largely in-state draw across the system. UH has revenue diversity with strong levels of state operating support, research grants and fundraising, which have all sufficiently supported relatively modest total revenue growth in a flat tuition revenue environment.

Operating Risk: 'a'; Strong Capital Support for Related Needs; Variable Cash Flow

The University's operating risk profile is consistent with an 'a' assessment, reflecting somewhat thin and inconsistent cash flow driven by fluctuations in fringe benefit transfers and expenses, as well as meaningful flexibility on and strong external support for capital needs.

Financial Profile: 'aa'; Elevated Leverage; Strong Support for Debt Service and Debt-Equivalents

With a comparatively thin 22% available funds to adjusted debt (including pension liabilities) ratio in fiscal 2018, UH maintains a financial profile through Fitch's stress case scenario that is more consistent with an 'a' assessment under the parameters of the rating positioning table. However, consideration of this metric is strengthened by the state's consistent operating support including for fringe benefits, which lessens the burden of adjusted debt relative to the calculated level and warrants a financial profile assessment in the 'aa' category.

RATING SENSITIVITIES

STATE SUPPORT OF PENSION AND OPEB: The consistent level of state support for the University of Hawaii's pension and OPEB contributions are integral to support the 'aa' financial profile assessment and the 'AA' rating. An indication of diminishing state support, for either long-term liability contributions or for other forms of operating and capital support, would very likely pressure the rating.

EROSION IN DEMAND: The University of Hawaii is vulnerable to demographic and economic pressures within the state, at levels that affect in-state demand or introduce volatility in state funding. Material pressures on enrollment that pressure net tuition revenue or research funding could affect the rating, particularly if cash flow levels are materially strained.

CREDIT PROFILE

The University of Hawaii was founded in 1907 and is the sole provider of public higher education within the state. The system comprises three university campuses, seven community college campuses, three university centers, and multiple learning, research, and service sites across six of Hawaii's islands.

UH's flagship campus Manoa is located in Honolulu. Manoa represented over 70% of the four-year campus enrollment in 2019 and houses the great majority of UH's research activity. The UH system supported 51,063 enrolled students and reported $1.6 billion in total revenue (Fitch-adjusted to include state appropriations and certain other items classified as non-operating) in unaudited fiscal 2019 (year ending June 30).

Revenue Defensibility

The 'aa' assessment for revenue defensibility is anchored by UH's role as the state's sole provider of public higher education in the state, which has supported steady enrollment at its four-year institutions, very strong levels of state operating support, a robust land, space, and ocean research grant platform, and solid fundraising history.

UH's demand assessment reflects a mix of demand indicators, as expected across a system with both four-year and community college institutions. For the four-year institutions, demand characteristics reflect a very strong in-state role as the sole provider of post-secondary education countered with a somewhat more competitive graduate environment against mainland universities. Student quality indicators are relatively consistent with state and national averages, though they are slightly stronger at the four-year institutions.

Total system enrollment has been on a mild downward trajectory since the end of the recession, driven primarily by declines at the community colleges against more stable enrollment at the four-year schools. Of note, fall 2018 final enrollment of 24,244 at the four-year institutions reflects over a decade of stability, and was improved over fall 2017. UH's position as sole provider of higher education in the state means that its demand is driven more by state policy and demographic trends than by competition. UH retains the great majority of public school graduates in Hawaii, and is generally not constrained by price sensitivity. UH is also focused on attracting a greater proportion of private high school graduates, who have a greater rate of seeking post-secondary education in the mainland United States.

The state of Hawaii has a diverse employment base and economy, with key sources of external support provided by tourism and a substantial federal presence. Its population has a history of steady to strong population growth; small declines in the past two years are not expected to persist. The high school graduate trajectory is a bright spot; Hawaii is projected to see material growth in graduating high school students between now and the 2026 school year, countering national trends of flat or declining high school graduate levels.

As classified by permanent address, approximately 85% of total UH system students are from Hawaii, with 11% coming from the US mainland, followed by 4% international. At Manoa, just under 70% of students are from Hawaii, reflective of its heavy research role and somewhat wider geographic reach.

The University of Hawaii's revenue sources are diverse, with strong trends in research and fundraising, along with steady state support. With nearly 29% and 26% of total operating revenues derived from state appropriations and grants/contracts (respectively), UH's reliance on student fee revenue (21%) is lower than that its other 'AA' category peers (39% median student fee revenue). Unlike many other public universities, UH has benefitted from strong and consistent state support over time. Since 2010, operating appropriations have increased an average of 3% annually, and represented about 29% of total operating revenues in fiscal 2017 and 2018.

Total state direct and indirect funding equaled $1.5Bn in fiscal 2018, increased 1.3% in unaudited fiscal 2019, and is expected to increase 1.9% for fiscal 2020. Included in that fiscal 2018 total was $476 million in general fund appropriations for operations, $108 million in direct support of debt service, and $257 million in support of retirement benefit and health premium payments.

The University has a Federal Land, Sea and Space Grant designation and its Manoa campus carries a R1 designation by the Carnegie classification. Extramural research awards have been very steady over the past decade, and total awards are expected to increase to $422 million in fiscal 2019 ahead of fiscal 2018's $386 million. Federal awards have been steady at two-thirds of the total, and relatively diverse in source.

The University of Hawaii has no legal limitation on setting tuition rates; the Board of Regents (BoR) has final approval. Regents are appointed by a Regents Candidate Advisory Council; that council is appointed by the Governor and confirmed by the legislature. Under the currently approved schedule, tuition rates increased just under 2% for in-state undergraduate students and less than 1% for out of state undergraduate students, and will remain flat through the fall 2023 incoming class. The tuition differential is material; at Manoa average non-resident tuition is 3x that of resident tuition. Historically, UH's net tuition revenue per FTE compound annual growth rate has been above 4%; Fitch expects this to temper somewhat as strategic efforts to steady tuition bear out.

The spending rate policy for the University's self-managed endowment is to limit the immediate impact that significant changes in the fair value of the endowment portfolio have on annual distributions. The spending rate policy provides for an annual distribution, ranging between three percent and five percent of the five-year moving average of the endowment portfolio's fair value. In fiscal years 2018, 2017 and 2016, the University instituted a 4.5 percent distribution rate on restricted and unrestricted endowments. The total restricted and unrestricted distributions available to the University amounted to $2.7 million, $2.6 million and $2.6 million in fiscal years 2018, 2017 and 2016, respectively.

The University of Hawaii Foundation is a component unit of the university and is the central fundraising organization of UH. While the endowment is excluded from available funds, unrestricted Foundation investments are included in AF due to UH's blended reporting.

Operating Risk

The University's operating risk profile is consistent with an 'a' assessment. UH is expected to maintain generally balanced operations and steadier cash flow. Capital outlays will be aimed at reducing deferred maintenance with a substantial level of external funding support, with meaningful flexibility as to timing.

UH's cash flow has been somewhat volatile in the prior four years, driven in part by shifts in pension and OPEB expenses. Better performance in fiscal 2018 reflected some enhanced financial management policies implemented in prior years that have begun to result in improved cash flow, as well as stronger state support of operations and fringe benefit expenditures. Fitch expects generally balanced operations to continue at levels sufficient to produce steady coverage and incremental improvement in leverage.

With an average age of plant near 12 years, UH has flexibility on its capital spending. In any given year approximately half of UH's Capital Improvement Plan (CIP) is slated routine rather than project spending, and UH continues to focus its resources on deferred maintenance ahead of projects.

The University has a material level of deferred maintenance of about $722 million, and about $125 million in ongoing annual deferred maintenance needs. The current six-year CIP calls for nearly $1.8 billion in total spending from FY 2020-FY 2025, funded in part with state support. UH receives state GO bond appropriations for capital as well as capital appropriations approved by the legislature in support of its capital needs.

Positively, a total of $1.2 billion in state GO bond funds were made available over four biennial budgets (FY 2013-FY 2021), with another $148 million in revenue bond issuance currently authorized to UH. Approximately $282 million is expected from those sources in the next two years ($893 million has been appropriated already through fiscal 2019), with sustained support expected through the remainder of the CIP. The majority of needs are at UH Manoa, which is the oldest campus (1907). Manoa carries nearly 60% of the deferred maintenance and will accordingly receive nearly 60% of CIP outlays.

UH's fundraising has been steady, and it has a new Foundation CEO in 2019 with a strong track record of campaign work and annual philanthropy. Its last major campaign was for $500 million (Journey Beyond, FY 2012-FY 2018), which UH achieved 15 months ahead of schedule. Annual giving is relatively steady, with an average $37 million in operating gifts/contributions over the prior four years along with an additional $8 million in capital gifts last year.

Financial Profile

As of unaudited fiscal 2019, the University had $293.6 million in revenue bonds, $114.8 million in cancer center bonds and $98.2 million in medical school bonds outstanding. It has an entirely fixed-rate bond debt mix, with somewhat front-loaded debt service through 2041. Of note, the cancer center and medical school bond debt service is currently fully offset by cigarette tax and tobacco securitization revenues. The state also issues general obligation bonds in support of certain university projects, for which funds are directly appropriated by the state to pay debt service.

Debt service coverage (as Fitch calculates) is expected to remain comparatively thin but sufficient going forward, likely returning to more historical levels between 1x-1.3x following more robust 2.3x coverage in fiscal 2018. UH's available funds (defined as cash and investments less nonexpendable restricted net assets and unspent bond proceeds) of $613 million equaled more than 100% of bonded debt and 34% of operating expenses, both comparable with similarly rated peers and reflecting the solid capital support provided by the state.

State capital support has kept UH's leverage low; however, debt-equivalent obligations are material, including a $1.9 billion reported net pension liability (NPL) for employees in the Hawaii Employees Retirement Plan (ERP), the statewide cost-sharing system in which UH participates.

Fitch adjusted UH's NPL to $2.1 billion using a 6% discount rate per Fitch's criteria, below the ERP's 7% rate as of the fiscal 2018. The state has taken significant actions in recent years to improve the funding level for ERP and to prefund the OPEB liabilities of public employees, leading to a steady increase in contributions; contributions for both pension and OPEB are budgeted at the actuarially determined level. State operating appropriations to UH include a fringe benefit transfer that consistently covers actuarial contributions on behalf of UH general fund employees (approximately 80% of the total). The consistent presence of state fringe benefit appropriations shields UH's financial profile from the rising burden of retirement obligations, although UH would be exposed to these obligations should the state change its current practice for supporting fringe benefits.

ESG Considerations
Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3 - ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity.

For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

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Additional information is available on www.fitchratings.com

Applicable Criteria
Public Sector, Revenue-Supported Entities Rating Criteria (pub. 28 May 2019)
https://www.fitchratings.com/site/re/10064680
U.S. Public Finance College and University Rating Criteria (pub. 03 Jun 2019)
https://www.fitchratings.com/site/re/10075131