FitchRatings

RATING ACTION COMMENTARY

Fitch Assigns 'AA' to University of Hawaii Series 2020 Revs; Outlook Stable

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Fitch Ratings - Chicago - 06 Oct 2020: Fitch Ratings has assigned the 'AA' rating to the following Board of Regents of the University of Hawaii (UH) University Revenue Bonds:

--$10,045,000 Series 2020A (Taxable)

--$42,260,000 Series 2020B (Refunding)

--$54,300,000 Series 2020C (Taxable Refunding)

--$49,455,000 Series 2020D (Refunding)

--$62,240,000 Series 2020E (Taxable Refunding)

In addition, Fitch has affirmed the University of Hawaii's 'AA' Issuer Default Rating (IDR) and bond rating.

The Rating Outlook is Stable.

The series 2020 bonds will be issued as a mix of taxable and tax exempt and will be used to finance approximately $10 million in new projects and refund the series 2010A-1 and series 2010B-1 bonds. The bonds are expected to sell the week of Oct. 12, 2020.

SECURITY

University revenue bonds are secured by a lien on the net revenues of UH's auxiliary network (the network, including the net revenues of various housing and auxiliary activities) and legislative appropriations in special and revolving funds appropriated or allocated to the Board of Regents, UH, or the network, including tuition and fees. Certain bonds are additionally secured by a pledge of collections of a portion of the excise tax on cigarettes (including the series 2020B and 2020C bonds) and a lien on a portion of the moneys in the Hawaii Tobacco Settlement Special Fund.

ANALYTICAL CONCLUSION

The 'AA' IDR and revenue bond rating reflect UH's role as the sole provider of post-secondary education in Hawaii and the strong operating and capital support provided by the state (IDR, AA+/Negative). The ratings further reflect an expectation that the university's financial profile will weather the near-term pressures of the pandemic as enrollment steadies and it manages a sizable capital improvement program. Enrollment across the system has been relatively stable for fall 2020, with modest increases at the four-year institutions offsetting a modest decrease across the community colleges. The Stable Outlook is supported by Fitch's expectation that the state will continue its steady support to the university in the face of significant economic pressures and that the university will maintain generally stable enrollment at its four-year institutions and manage costs effectively to preserve of balanced operations.

Coronavirus Impacts

The ongoing coronavirus pandemic and related government-led containment measures create an uncertain environment for the U.S. public finance higher education sector. Fitch's forward-looking analysis is informed by management's expectations coupled with Fitch's common set of baseline and downside macroeconomic scenarios. Fitch's scenarios will evolve as needed during this dynamic period. Fitch's current baseline scenario incorporates the sharp economic contraction in 2Q20, with an initial bounce in 3Q20 followed by a slower recovery trajectory from 4Q20. For the higher education sector, the baseline case assumes the closure of most residential campuses for a three- to four-month period with continued sporadic closures through fall 2020. Rating sensitivities address potential rating implications under a downside scenario, which assumes slower economic recovery and prolonged or recurring disruptions related to the coronavirus into fiscal 2021, including enrollment and related revenue pressures for higher education.

UH shifted to a fully remote learning model in March 2020 and substantially vacated its university-owned residence halls and campus. The University received a total of $44.9 million in Coronavirus Aid, Relief and Economic Security (CARES) Act proceeds, of which $20.9 million is available for institutional use. Fall 2020 courses have resumed with a mix of in-person, remote and hybrid structures, with remote learning as the predominant model. Student housing capacity has been limited, and according to management, a rigorous testing, quarantine, and contact tracing system has limited the number of active cases to date.

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's overall enrollment has been steady over time, including for fall 2020. Further, UH has revenue diversity with strong levels of state operating support (29% of 2019 operating revenues), research grants, and fundraising, which have all sufficiently offset more 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 margins driven by fluctuations in fringe benefit transfers and expenses, as well as meaningful flexibility and strong external support for capital needs and debt service on certain obligations. Fitch expects that UH will manage its variable costs and capital expenditures effectively against expected revenue pressure.

Financial Profile: 'aa'

Elevated leverage; Strong Support for Debt Service and Debt-Equivalents

With a comparatively thin 26% available funds to adjusted debt (including pension liabilities) ratio in fiscal 2019, 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 effectively lessens the burden of adjusted debt relative to the calculated level and supports a financial profile assessment in the 'aa' category.

ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS

No asymmetric factors were incorporated into the rating.

RATING SENSITIVITIES

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

-- Improvement in demand, particularly at the pressured community colleges, that supports net tuition revenue growth and lessens long-term reliance on state support.

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

-- Material declines in enrollment that constrain net tuition revenue or research funding could pressure the rating, particularly if cash flow margin levels fall below 5%-6% over a prolonged period.

--Diminished state support (whether declining or failing to keep pace with expenditure growth) for long-term liability contributions, operating or capital support would very likely pressure the rating.

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].

CREDIT PROFILE

UH, founded in 1907, is the sole provider of public higher education within the state. The system comprises three comprehensive universities, seven community colleges, three university centers, and multiple learning, research and academic 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 majority of UH's research activity. The UH system supported 51,063 enrolled students and reported $1.6 billion in total revenue (Fitch-adjusted total revenue includes state appropriations and certain other items classified as non-operating) in 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, which has supported steady enrollment at its four-year institutions, very strong levels of state operating support, a robust land, space, and ocean research 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 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 2008 recession, driven primarily by declines at the community colleges against more stable enrollment at the four-year schools. Of note, fall 2020 preliminary headcount enrollment of 24,305 at the four-year institutions reflects over a decade of stability and improved 1.6% over fall 2019. 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. In fall 2020, the percentage of in-state students increased slightly over the prior year, and the international percentage increased commensurately, with stability in students from the mainland. UH is focused on attracting a greater proportion of private high school graduates, who have a greater rate of seeking post-secondary education in the mainland U.S. than those students graduating from public K-12 schools.

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. The state's 'AA+' rating was affirmed in July, though with a Negative Outlook, reflecting the considerable financial and economic pressures it faces from the coronavirus pandemic. The state benefits from its history of steady to strong population growth and an increasingly diversified economic base away from the globally important tourism industry. The high school graduate trajectory is solid, with Hawaii projected to see material growth in graduating high school students between now and the 2026 school year, in contrast to national trends of flat or declining high school graduates.

Approximately 85% of total UH system students are from Hawaii, with 11% from the U.S. mainland and 4% international. At Manoa, just under 70% of students are from Hawaii, reflecting its heavy research role and somewhat wider geographic reach.

UH's revenue sources are diverse, with strong trends in research and fundraising, along with steady state support. With 29% and 25% of total operating revenues derived from state appropriations and grants/contracts, respectively, UH's reliance on student fee revenue (20%) is lower than other 'AA' category peers (35% median student fee revenue). Unlike many other public universities, UH has benefited from strong and consistent state support over time.

For fiscal 2021, total state direct and indirect funding is expected to increase slightly by 1% following a flat fiscal 2020. However, the general fund appropriation will fall in 2021, and the university will also face tuition and student fee pressures, together totaling a nearly 11% decline over prior year. Of note, the state's direct support of university debt service and retirement benefit and health premium payments is expected to remain steady.

The university has a Federal Land, Sea and Space Grant designation and its Manoa campus carries an R1 Carnegie research classification. Extramural research awards have been very steady over the past decade, and total awards increased to over $430 million in fiscal 2020 (unaudited), ahead of about $410 million in fiscal 2019.

UH has no legal limitation on setting tuition rates; the Board of Regents has final approval. Regents are appointed by a Regents Candidate Advisory Council, whose members, in turn, are appointed by the governor and confirmed by the legislature. Under the currently approved schedule, tuition rates 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%; however, Fitch expects this to temper somewhat as strategic efforts are made to increase access.

OPERATING RISK

The university's operating risk profile is consistent with an 'a' assessment. UH is expected to maintain generally balanced operations and steady cash flow going forward. The university identified approximately $70 million in budgetary shortfall for fiscal 2021, which it plans to address with a combination of operating adjustments and limited cash reserves. Capital outlays will be adjusted as necessary and aimed at reducing deferred maintenance with a substantial level of external funding support from the state and meaningful flexibility as to timing.

UH's cash flow has been somewhat volatile in recent years, driven in part by shifts in pension and OPEB expenses. Better performance in fiscal years 2018 and 2019 reflect enhanced financial management policies implemented in prior years that have since resulted in improved cash flow, as well as stronger state support of operations and fringe benefit expenditures. Going forward, we expect some pressure in fiscal 2021 before a return to generally balanced operations at levels sufficient to produce steady and sufficient coverage and incremental improvement in leverage.

With an average age of plant of nearly 13 years, UH has flexibility in its capital spending. In any given year, approximately 50% of UH's capital improvement plan (CIP) is slated for 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 $778 million, up slightly from prior year. The current six-year CIP calls for nearly $1.6 billion in total spending from FY20-FY25, funded in part with state support. It was last updated in fall 2019 and will be revised by the end of calendar year 2020. UH receives state GO bond proceeds for capital as well as capital appropriations approved by the legislature in support of its capital needs; $330 million in capital appropriations were received for fiscal years 2020 and 2021. The majority of needs are at UH Manoa, which is the oldest campus (1907). Manoa carries nearly 60% of the deferred maintenance needs 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, FY12-18), 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

The $218 million series 2020 transaction will provide $10 million in project proceeds and refund the existing series 2010A-1 and 2010B-1 for present value savings. As of 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 and MADS of about $46 million. Of note, approximately 40% of future debt service is supported by non-university revenues, including tobacco and cigarette tax revenue ($17.3 million in debt service against $22.1 million in revenue for unaudited fiscal 2020). 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.

UH's available funds (defined as cash and investments less non-expendable restricted net assets and excluding unspent bond proceeds) of $734 million equaled a more than 130% of bonded debt and nearly 40% of operating expenses, both comparable to similarly rated peers and reflecting the solid capital support provided by the state.

State capital support has kept UHs leverage low; however, debt-equivalent obligations are material, including a $2.1 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 adjusts UH's NPL to $2.2B billion using a 6% discount rate per Fitch's criteria, below the ERP's 7% rate as of fiscal 2019. 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 (~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.

ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS

No asymmetric rating considerations.

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

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

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means 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.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
University of Hawaii (HI)	LT IDR	AA Rating Outlook Stable	Affirmed	AA Rating Outlook Stable

ENTITY/DEBT	RATING			PRIOR
• University of Hawaii (HI) /General Revenues/1	LT	AA Rating Outlook Stable	Affirmed	AA Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

U.S. Public Finance College and University Rating Criteria (pub. 26 Mar 2020) (including rating assumption sensitivity)

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

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

Portfolio Analysis Model (PAM), v1.3.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

University of Hawaii Board of Regents (HI)	EU Endorsed

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