

**Honolulu City & County, Hawaii**

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**Credit Profile**

**UPGRADED**

	<i>To</i>	<i>From</i>
\$410.527 mil. Honolulu City & Cnty GO	AA	AA-
\$671.625 mil. Honolulu City & Cnty GO (FGIC)	AAA/AA(SPUR)	AA-
\$26.290 mil. Honolulu City & Cnty GO (FSA)	AAA/AA(SPUR)	AA-
\$470.900 mil. Honolulu City & Cnty GO (MBIA)	AAA/AA(SPUR)	AA-
\$91.255 mil. Honolulu City & Cnty go unLtd tax imp rfdg bonds ser 2004A (MBIA)	AAA/AA(SPUR)	AA-
\$192.850 mil. Honolulu City & Cnty go unLtd tax imp rfdg bonds ser 2004B (MBIA)	AAA/AA(SPUR)	AA-
<b>OUTLOOK: REVISED</b>	TO	FROM
<b>Status</b>	STABLE	POSITIVE

**Rationale**

Standard & Poor's Ratings Services raised its rating and underlying rating (SPUR) to 'AA' from 'AA-' on Honolulu City and County, Hawaii's GO debt, reflecting strengthened financial reserve policies designed to provide credit stability and strength in the event of potential negative economic or fiscal events, such as a decline in property values or tourism activity, coupled with strong recent financial performance and increases in total taxable property values.

Additional factors include:

- The city's role as the service, trade, and government center for the state of Hawaii, coupled with the anchoring presence of all four branches of the U.S. armed services;
- A strong tourism sector, with strong visitor trends after some declines following Sept. 11, 2001;
- Very strong increases in property values since fiscal 2001, including more than 20% annual growth in fiscals 2006 and 2007;
- Strong recent financial performance, including a solid general fund surplus in fiscal 2005 and projected fiscal 2006 (unaudited); and
- A manageable debt burden, with no additional debt plans until fiscal 2007.

Standard & Poor's expects that current increases in property values may be more sustainable than in previous cycles, though a history of volatility prior to the current rebound continues to be a tempering factor, in addition to the possibility of decreased affordability of housing for residents given only average resident income levels. The bonds are secured by the full faith, credit, and unlimited ad valorem taxing authority of the City and County of Honolulu.

With roughly 900,000 residents, or 72% of the state's total population, Honolulu is Hawaii's economic center and the center of government, transportation, finance, and education. Tourism accounts for about 25% of the gross state product, and more than 50% of the state's hotel rooms are located in Honolulu. Waikiki, located adjacent to downtown Honolulu, remains the state's most visited destination. Honolulu's tourism market has rebounded strongly along with the rest of the state. The city and island are additionally anchored by the presence of the U.S. military; there are roughly 34,000 active service men and women on the island, and nearly 15% of the total island population is either employed by or a direct dependent of one of the four branches of the armed services. Unemployment has been steadily declining and was 2.7% in 2005, below the state level and one of the lowest rates for a U.S. city with a population above 750,000. Effective buying income levels are above the state but average overall, at 105% and 90% of the nation on a household and per capita basis, respectively.

The continued economic rebound on Oahu has been led by a boom in real estate values after an extended period of weakness during the mid- and late-1990s. Since 2001, total taxable market value has risen by a very strong 86% (or nearly 11% per year, on average), to \$146 billion in fiscal 2007, including a very significant 23% and 28% increase in fiscals 2006 and 2007, respectively. Property values are high on a per capita basis, at \$162,000. Single-family homes account for 61% of this valuation, followed by apartments (22%), commercial (7%), industrial (4%), and hotel and resort properties (only 4%). Historic volatility prior to the recent strong recovery was due primarily to concentration of Japanese capital in the real estate market, which is now diminished, though tourism and second-home investment by domestic "baby-boomers" and retirees remain primary drivers for economic growth. Still, the pace of recent increases will almost certainly moderate, as will the potential for rising concerns about affordability as well as sustainability of currently appreciated market prices.

The city's financial position continues to strengthen due to very strong revenue growth, leading to solid year-over-year increases in fund balances after a period of revenue contraction prior to fiscal 2001. At the end of fiscal 2005, the city reported a total general fund balance of \$77.2 million, or 11.2% of expenditures after transfers, with 57.3 million, or 8.3% of expenditures, unreserved. This reflects a strong \$15.9 million (or 2.3% of budget) increase in the unreserved portion of the fund balance from fiscal 2004 to 2005 and an overall surplus of \$14.8 million after transfers. At the end of fiscal 2006 (unaudited), the city anticipates a \$22.4 million surplus, equal to 2.7% of expenditures after transfers, boosting the total and unreserved fund balances to \$98.6 million (12.6% of expenditures after transfers) and \$76.6 million (9.8% of expenditures), respectively.

In June 2006, the mayor and city council approved a city ordinance to strengthen financial reserve policies, creating a reserve for fiscal stability funded from an existing special reserve fund maintained outside the general fund and available for appropriation only in the event of certain economic and revenue triggers, including an increase in unemployment by more than 2% over three quarters, a decline in real property value by more than 2% from the previous fiscal year, or a decline in general fund revenues of more than 2% from the previous fiscal year. Deposits to the fund will be made from general fund surpluses and, by resolution, the fund is targeted to be at least 5% of expenditures, with an optimal target equal to 8% of expenditures. At the end of fiscal 2005, the city had a balance in this fund of \$5.0 million, and appropriated an additional \$5.0 million to be added to the fund during fiscal 2007.

The city's financial management practices are considered 'good' under Standard & Poor's Financial Management Assessment (FMA). An FMA of 'good' indicates that government practices are deemed currently good, but not comprehensive. Highlights include the formal fiscal stability reserve policy, a debt management policy limiting the conditions and amount of debt issuance, and quarterly presentation of actual financial performance to the mayor and city council. Investments are managed by the city treasurer, which publishes an annually reviewed investment policy; investment performance is disclosed annually in the city financial statements. Expenditures are historically budgeted on a conservative basis with significant positive annual variances generally between actual and budgeted expenditures. The city finance staff maintains a six-year financial forecast that is formally presented to city council for review via the annual budget process.

The city's debt burden is moderate, at \$1,810 per capita and 2.0% of assessed value (AV), excluding self-supported GO debt. Annual general fund-related capital expenditures over the past two years have been \$134 million and \$147 million, respectively, lower than in prior years. In practice, the city's capital plan has been between 4% and 20% cash-funded, and annual debt service carrying costs have been relatively high, at approximately 19% of total general fund expenditures. The city anticipates issuing additional GO debt during fiscal 2007.

## Outlook

The stable outlook reflects the additional financial cushion provided by a strengthening of the city's fiscal reserve policies, as well as Standard & Poor's expectation that growth in taxable property values may slow from the recently torrid pace, which has exceeded 20% per year in fiscals 2006 and 2007. The outlook further reflects the expectation that city staff and council will continue to manage surpluses without aggressive increases in recurring expenditures, as they have to date, providing stability and credit strength should revenue growth slow or decline during future economic cycles.

## Economy: Property Values Continue To Increase

From 1995 to 2001, property values dropped 23%, due primarily to the aftermath of a boom in construction and property values in the late 1980s driven by Japanese investment. After the departure of this capital, beginning in 1990, the property market weakened significantly. Since 2001, however, total AV has increased 86%, or more than 11% per year on average and more than 20% in both fiscals 2006 and 2007.

The rating and outlook on Honolulu's debt reflect Standard & Poor's expectation that current values may be more supportable than in previous cycles due to a more stable source of investment, strong demand characteristics, and more limited housing supply. The pace of growth, however, is unlikely to continue, and home values may continue to exhibit some volatility as well as affordability challenges for long-term residents. In addition, strengthened financial reserve policies as well as the city and county's demonstrated ability in previous cycles to make expenditure reductions should provide some cushion should property values decline. To date, there has been little political momentum toward a decrease in property tax rates, which are implemented at the discretion of the mayor and city council, though there has been an active movement to improve and expand certain exemptions for resident homeowners and lower-income residents.

In addition to the recent growth in property values, economic growth is likely to be supported in the longer term by approved funding through a half-cent county-wide sales tax that has been approved by the state and city and county governments to fund construction of a sizable mass transportation project on Oahu, most likely fixed rail, to connect downtown Honolulu with the developing western portions of Oahu as well as, potentially, the University of Hawaii at Manoa. The city will begin to collect the sales tax beginning in January

2007 and currently anticipates initial groundbreaking for the project in 2009. Preliminary plans, including designs and budget, are being studied currently.

### **Finances Bolstered By Strong Revenue Growth**

The city depends primarily on property taxes, which accounted for 72% of general governmental revenues, not including charges for services or grants and contributions derived from property values that are relatively predictable from year-to-year, even during periods of decline in real market value. As a result of property tax dependence, city revenues experienced significant pressure during the 1990s but have since rebounded strongly. During the period of property tax declines, the city was able to cut expenditures, but also maintained lower-than-average fund balances. The average property tax rate was increased in 2004 after several years of reductions. The new city administration, elected in November 2004, has stated its intent to maintain property tax rates in order to support current service levels while paying close attention to the cost versus benefit of some more discretionary government expenditures. Property taxes in Honolulu and in Hawaii in general are currently among the lowest in the nation, as is the state's 4% sales tax. Property tax delinquencies are currently at record lows.

A fuel tax, public utility franchise tax, public service company tax, and transient occupancy tax make up the majority of additional tax sources. Transient accommodation tax (TAT) collections, which are more susceptible to fluctuations in tourism activity, account for a less significant part of discretionary general revenues, providing some additional economic cushion. The city does not currently collect a sales tax but is distributed a portion of the state-collected TAT, another major revenue source.

Fiscal 2005 was the new administration's first year of financial results and represented a significant improvement over both the original budget and May 2005 projections (which anticipated balanced performance), primarily due to the administration's focus on expenditure control. In addition, financial staff has implemented monthly budgetary reviews with department staff to track expenditures to budget and generally tighten city budgetary practices, so that budgeted expenditures map more directly to actual costs at year-end. In practice, many departments had regularly delivered sizable positive expenditure variances, reducing budgeted-but-not-realized general fund deficits. Continued attention to such financial controls should provide increased predictability and tighter control over budgets and reserves.

The city's general fund has delivered cumulative surpluses totaling \$35.6 million after transfers from fiscals 2002 through 2005, though it reported a \$10.5 million deficit in fiscal 2004 due to a budgeted use of a portion of the existing unreserved fund balance. In fiscal 2005 a surplus of \$14.8 million was achieved, primarily through strong revenue growth and mid-year cuts across various departments. In practice, the city budgets the unreserved fund balance for use during the following fiscal year but does not expend the entirety of those appropriations.

### **Debt Manageable Amid Restructuring, Scaled Down Capital Plans**

In the late 1990s, the city restructured some of its debt profile to extend maturities and reduce some annual debt service carrying costs. The current amortization schedule achieves 59% payout of principal over the next 10 years. Upon taking office, the new city administration eliminated approximately \$60 million in anticipated capital expenditures during fiscal 2005 deemed less essential than other core needs, such as road improvements. Additionally, fees and user charges have been increased substantially for the city's wastewater fund. This ensures that the wastewater enterprise will continue to be self-supporting both for operations and for additional debt, which is anticipated in order to upgrade the treatment facility to meet current environmental requirements.

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