Tax Supported
New Issue

City and County of Honolulu, Hawaii

Rating

General Obligation Bonds,
Series 2003A .... AA

Analysts

Amy S. Doppelt
1 415 732-5612
amy.doppelt@fitchratings.com

Jenny Poree
1 415 732-5618
jenny.poree@fitchratings.com

Issuer Contact

Ivan Lui-Kwan
Director of Budget and Fiscal Services
1 808 523-4617

New Issue Details

$250,000,000 General Obligation Bonds, Series 2003A, are scheduled to sell on or about July 29 through negotiation by Citigroup and UBS Financial Services. The bonds mature serially March 1, 2008–2028. Call features will be determined at pricing.

Security: The bonds are secured by the City and County of Honolulu's full faith and credit unlimited ad valorem tax pledge.

Purpose: Bond proceeds will finance various capital projects included in the city's capital improvement plan.

■ Outlook

The City and County of Honolulu's credit strength rests in the sound fundamentals of its tourism-based economy, good financial operations and reserves, low debt burden, and strong fiscal management. Honolulu's tourism base has adapted well to a series of events that reduced activity, while elements such as its role as the area's commercial center, state capital, and a sizable military presence have added stability. Tourism on the island is highly developed and has long-lasting underpinnings providing continual demand, albeit at a reduced level. The city's spending growth has been restrained and kept in line with revenues. The resulting general fund balances have been above average, which is prudent given tourism's volatility. The low debt burden reflects the state's sizable role in financing capital needs. Expected annual issuance will increase debt levels, although they will remain affordable.

■ Rating Considerations

Coterminous with the Island of Oahu, the city encompasses much of the state's economic activity. Honolulu makes up 72% of Hawaii's population, about two-thirds of the visitors, and about one-half of the hotel rooms statewide. The island's tourism draw is based on sustainable elements, such as natural beauty, diverse accommodations and activities, and proximity to sizable North American markets.

As the area's commercial and business center, the state capital, and the home of the University of Hawaii, nontourism private sector employment is substantial. The U.S. military also is a major economic element, taking advantage of the island's strategic location. Federal defense spending makes up about 8% of the gross state product, with most of the activity on Oahu. Tourism is recovering from a long decline and is more dependent on U.S. visitors than those from Asia. While domestic visitors represent much lower spending than Asian tourists on average, they provide more stable demand. Oahu's visitor count stabilized in 2002, following a 10% decline in 2001. The hotel occupancy rate rose to 70% from 69%, as facilities reduced rates to attract visitors. Figures for 2003 to date show an increase to 72%, as well as a 5% increase in average room rate.

The city's real estate market is in good condition, as evidenced by low-to-moderate vacancy rates, rising home sales and prices, and significant new construction. Commercial construction was aided by tax abatements, although the program recently closed. Assessed value grew for the third consecutive year in fiscal 2004, following several annual declines as the inflated market adjusted to reduced foreign demand. Total assessed value now exceeds the fiscal 1999 level. Current and future investment includes several large projects, which should continue to feed the tax base.

July 25, 2003

Financial operations have been good to date, as strong fiscal management responded to declining assessed value and, more recently, rising expenditures. The city relies primarily on property taxes, creating a need for restrained spending through fiscal 2001. Honolulu's revenue base includes only a small amount that is directly reliant on tourist activity. The general fund had operating surpluses in four of the past five fiscal years, with another positive year expected for fiscal 2003. The good results reflect primarily expenditure growth kept to low levels through organizational restructuring, privatization, and employee reductions. Operations in fiscal 2002 also benefited from a sizable capital spending reimbursement, with these payments expected to continue through fiscal 2004. These additional funds are needed to meet rising expenditures for employee health costs and pension fund contributions.

The city raised property tax rates for fiscal 2004, funding needed spending increases, including a rise in pension costs. The general fund unreserved balance in fiscal 2002 was $35.2 million, a prudent 5.5% of spending. An increase to about 8% of spending is expected for fiscal 2003. In addition, the city maintains a $5 million rainy day reserve.

Strengths

- Tourism-based economy has strong underpinnings, such as physical beauty, public and private infrastructure, and location.
- Role as regional economic center and state capital provides some diversity and stability.
- Good financial operations despite strained revenues and good ending balances.
- Prudent management actions in recent years, including tax rate and fee increases, organization consolidation, and spending controls.
- Low debt burden (average including state bonds).

Risks

- Tourism-based economy's volatile performance in the past decade.
- Vulnerability to numerous domestic and international events and economic conditions.

Debt

Honolulu generally has issued debt annually and expects to continue this pattern with about $150 million in debt sold per year for the next several years. The city's most recent general obligation bond sale was a variable-rate issue sold in December 2001. The increase in par size for the 2003 issuance primarily reflects the period since the prior sale, as well as an increase in spending plans. The debt burden should remain affordable given the city's slightly above-average amortization schedule. About 59% of the city's debt matures in the next 10 years.

Debt Statistics

($000)

This Issue	250,000
Outstanding General Obligation Bonds	1,766,313
Other Debt	94,043
Less: Self-Supporting Debt	(187,523)
Total Direct Debt	1,922,833
Overlapping Debt	—
Total Overall Debt	1,922,833

Debt Ratios

Direct Debt Per Capita ($)*	2,175
Overall Debt Per Capita ($)*	2,175
As % of Market Value**	2.4

*Population: 884,176 (2003).
**Market value: $79,154,540,000 (fiscal 2004).

Honolulu's overall debt burden is low at $2,175 per capita and 2.4% of market value. These figures are net of general obligation debt paid from sewer and housing funds. The low debt burden partially results from the highly centralized nature of Hawaii's state government. The state finances and performs many functions usually done by local governments, including capital financing for schools.

Total outstanding debt includes $400 million in variable-rate bonds. Variable-rate debt now makes up 21% of the city's long-term debt portfolio, an acceptable level. In addition, the city has a $150 million commercial paper program, with proceeds used as interim financing for various capital projects. About one-half of the series 2003A bond proceeds will refund outstanding commercial paper.

The debt ratios reflect the city's effort to replace self-supporting general obligation bonds with revenue debt. Much of this change was done through a fiscal 1999 refunding. Honolulu's wastewater system first and second bond resolution revenue bonds are rated 'AA–' and 'A+' by Fitch Ratings, respectively.

Finances

Honolulu's financial operations are good and reflect strong fiscal management that has adapted well to a number of varying conditions. From fiscal years

Financial Summary — General Fund
($000, Audited Fiscal Years Ended June 30)

	2000	2001	2002
Taxes	399,115	380,098	407,270
Intergovernmental	33,680	35,742	32,063
Licenses and Permits	25,969	26,820	25,987
Other	129,445	110,179	109,319
Total Revenues	588,209	552,839	574,639
Public Safety	178,544	193,692	199,990
General Government	83,464	86,444	95,817
Retirement and Health	53,663	51,565	81,647
Culture and Recreation	24,859	38,792	41,339
Other	39,683	36,094	40,790
Total Expenditures	380,213	406,587	459,583
Results	207,996	146,252	115,056
Transfers In and Other Sources	51,331	50,421	83,106
Transfers Out and Other Sources	(250,211)	(213,996)	(185,348)
Net Income/(Deficit)	9,116	(17,323)	12,814
Total Fund Balance	58,859	41,536	54,350
Unreserved Fund Balance	38,176	23,347	35,159
As % of Expenditures and Transfers Out	6.1	3.8	5.5

1996–2001, faced with consecutive years of property tax base decline, the city raised fees, established new charges, and in one year increased the property tax rate. The city also restrained and reduced spending through sweeping organizational restructuring and some privatization. More recently, the city's property tax revenue has been growing, but nondiscretionary spending in employee health care costs and pension contributions have risen significantly. Fiscal discipline has enabled the city to have operating surpluses in four of the past five fiscal years. However, fiscal 2002's positive operations resulted largely from a nonpermanent capital spending reimbursement. This transfer continued in fiscal 2003, contributing to another operating surplus based on recent estimates.

The general fund had a $12.8 million operating surplus in fiscal 2002, 2.0% of the year's $644.9 million in spending and transfers out. This result reversed an operating deficit in fiscal 2001, which followed two years of small surpluses. Positive results in fiscal 2002 include a 58% rise in employee health care and pension spending, which was offset by a $42.3 million transfer in from the sewer fund. This amount represents the first installment of a $148.0 million reimbursement for capital projects. While the transfer is expected to continue through fiscal 2004, it is not a permanent revenue source. The city is challenged to find an ongoing revenue source or spending reduction to accommodate these expenditures over the long term.

Estimates for fiscal 2003 suggest a moderate operating surplus, as continued property tax revenue growth and another sewer fund capital reimbursement more than offset spending gains. Health and retirement benefits again represent the city's greatest expenditure growth, led by the pension fund contribution rising to about $52 million from $34 million.

Honolulu's fund balance levels have been good, rising to strong based on estimates for fiscal 2003. The higher level is prudent given the recent financial challenges. The city's total general fund balance in fiscal 2002 was $54.4 million, a sound 8.4% of expenditures and transfers out. The unreserved fund amount also is good at $35.2 million, or 5.5% of spending. Estimates for fiscal 2003 suggest a rise to about $65.0 million for the total balance and $50.5 million unreserved. These amounts equal 10.1% and 7.8% of total spending, respectively. This represents the city's highest balance in the past several years, above the prior peak in fiscal 2000, when the total balance made up 9.3% of expenditures and transfers, and the unreserved amount was 6.1%. In addition to growing balances in the general fund, the city recently set aside an additional $5.0 million rainy-day fund reserve.

The general fund's primary revenue source is property taxes. Total property tax revenue for fiscal 2002 was $382.4 million, or 58% of general fund revenues and transfers in. Property taxes rose in that year for the second time, following six consecutive years of declines. The city acted prudently during the tax base loss period, raising the property tax rate in fiscal years 1999 and 2000 to compensate partially for the assessed value decline. Through fiscal 2003 the tax rate has been stable for most property classes, although the weighted average has decreased slightly because of small reductions in the apartment rate. The city again raised most property tax rates for fiscal 2004, increasing the weighted average by 3% and bringing the rate back to about the fiscal 2002 level. The city's utility tax is its other local tax source, making up about 4% of total general fund resources. The reliance on property and utility taxes and the willingness to raise property tax rates has somewhat insulated financial operations from the economic volatility experienced over the past several years.

In contrast, Honolulu received $31.6 million in state-shared transient accommodations tax (TAT) revenue in fiscal 2002, a relatively small 5% of general fund revenue and transfers. This revenue source had been as much as 7% of general fund resources prior to the state changing the allocation formula in fiscal 1999. These taxes are more volatile than other city revenue, as evidenced by an 11.3% decline in Honolulu's TAT revenue in fiscal 2002.

General fund expenditures are dominated by public safety and general government, making up 31% and 15% of general fund expenditures and transfers out in fiscal 2002, respectively. Retirement and health benefits also have become a major spending category, rising to 13% in fiscal 2002. The sizable increase, from about 8% in the prior two years, results from a dramatic rise in health care costs for city employees, as well as a temporary and significant decline in required pension fund payments. These expenditures are expected to continue at the higher level at least for the next few years.

In general, spending has been restrained to match revenue gains, the result of strong fiscal control and a broad organizational restructuring that combined departments and eliminated overhead positions. Over several years, the city reduced its employment to 7,910 in 2003 from 8,729 in 1994, a 9.4% decline. The reduction also results from privatization of select services. The city now believes its structure is efficient and stable and does not expect further reductions. However, the city may consider other privatization opportunities that provide savings without compromising service quality. Expenditures also were controlled through planned program changes, including limiting overtime spending primarily in the police department and early retirement incentive programs.

The Hawaiian state government assumes several functions that are normally the responsibility of local government, including education, health and welfare, judicial operations, and operation and maintenance of all airports and harbors. Honolulu's operational responsibilities are limited to functions such as public safety, highways and streets, sanitation, culture and recreation, planning and development, several utilities, and general administrative services.

The state also assumes a central role in labor negotiations, with contracts executed statewide and covering all state and local government employees. Furthermore, the agreements are not final until both the state assembly and each local government board approves. Lack of consensus among the various government entities and certain noncounty labor unions have prolonged negotiations in prior years.

All of the city's eight bargaining groups extended contracts expiring on June 30, 2003, some with no increase and others sent to arbitration. Only the police agreement remains in arbitration, with an outcome expected this fall. The agreements encompassing no salary increase for 2004 are for that year only and include an option for either party to terminate the contract with 30-day notice.

■ Economy

Honolulu's economy is diversifying somewhat but remains dominated by a well developed tourism sector that is itself in a transition period. Diversity comes from the city's role as the regional commercial, business, and finance center, as well as the state capital and the home of the University of Hawaii. Also, Honolulu contains a strong military presence, which likely will continue given the island's strategic location. The city's job base is growing following several years of decline. The unemployment rate remains low despite economic fluctuations at 3.9% for 2002. This compares well to the state's 4.2% and the city's 5.4% recent peak in 1998.

Tourism activity has become more U.S. visitor-based than in prior years, although Asian travel remains sizable, as well. The tourism industry is recovering from a series of negative conditions and events, beginning with weakness in the California economy (a large tourist market for Hawaii) in the early 1990s, followed by the prolonged economic troubles in Japan and throughout Asia and reluctance to travel following the events of Sept. 11, 2001.

Oahu's visitor count peaked in 1990 before declining through 1993 and then nearly fully recovered by 1996. The visitor count declined through 1999 before rising in 2000. Since then, Oahu's number of visitors has dropped, with the 2002 figure of 4.2 million at 14% below the 1996 peak. In contrast, the statewide visitor count has been more stable, peaking in 1997 before declining for one year and rising in 1999 and 2000. The state's total number of visitors fell in 2001 but rose in 2002, with the total now 6% below the 1997 peak.

Visitor measures vary for Honolulu but generally reflect stabilization with beginning signs of improvement. Total visitors to Oahu declined a small 0.4% in 2002, following a much sharper loss in 2001. However, the 2002 figures represent a 1.4% increase in visitors from mainland U.S. (domestic) that partially offset a 2.7% decline in international visitors. Domestic visitors' average stay rose to 7.8 days from 7.7 days, while international visitors' average remained steady at 5.9 days. Oahu's hotel occupancy rose to 70.3% in 2002 from 68.6% in 2001 and remains above the state's 63.3% in 2002. However, the island's 2002 figure is below its prior peak of 77.2% in 2000. The occupancy increase partially reflects a 4.3% drop in average room rate.

Visitor data to date in 2003 suggests improvement, with hotel occupancy rising to 72.3%. This gain particularly is notable because of a rise in average room rate to the 2001 level. Future domestic tourism activity is projected to continue to improve slowly, as Americans seek vacation sites that are unique and exotic but safe and have relatively easy access. This travel ease is dependent somewhat on airline flights, particularly nonstop travel, which adds some instability given the current strain of several U.S.-based airlines. Honolulu visitor experts also site an increase in flight service from major Canadian cities as increasing visitors.

While a high 43% of Honolulu's 2002 visitor count came from non-U.S. residents, this figure is well below prior years' levels, such as 55% in 1997. A majority of these visitors come from Asia and are important to the economy statewide because their average daily spending per visitor is much higher than for U.S. visitors. In fact, prior to the Asian economic decline, visitors from that area spent nearly twice as much on average per day than Americans. With the length and consistency of the international visitor decline, the Honolulu tourism industry has begun to recognize that this element is likely not to return. Rather, private investment is focusing more on U.S. and other North American visitors. This shift should result in greater stability, albeit with lower commercial activity.

The city economic development efforts have been sizable and focused. The efforts have aimed to increase retail, restaurant, and other recreational activity both by city and state residents, as well as to increase out-of-state and international visitors. These goals have been achieved through local event development, as well as spending to enhance existing recreational facilities. Also, the city has built several new sports venues, designed to attract tournaments and international media attention.

Development and tax base growth also has been assisted by a property tax abatement program that ended recently. The city granted abatements for commercial improvements begun through June 30, 2003. City management credits this program for much of the private investment in the Waikiki area. A number of hotels and retail properties in this area have renovated and expanded their holdings.

The number of visitors to Honolulu has been cyclical, peaking in 1990 and recovering to nearly that level by 1997. The 2000 estimated visitor count, while improved, remains 4.8% below the 1997 peak. Visitors dropped annually through 1993, reflecting the U.S. recession and its particularly strong effect in California. The visitor count rose steadily from 1994–1997, reaching 99% of the 1990 peak.

Honolulu's economy benefits from elements that add diversity and stability: a large military presence; the state capital; the University of Hawaii; and being the business and commercial center of the state. About three-quarters of all state jobs are located in Honolulu. Services are the largest employment sector at 55% of total jobs, followed by government at 23% and trade at 14%. Leisure and hospitality leads the service subsectors at 14% of jobs citywide, followed closely by professional and business services at 13%. Financial services make up 5% of total employment, which, along with professional and business services, reflect the city's nontourism element.

The sizable military presence results from Honolulu's strategic Pacific location, as well as the historic significance of Pearl Harbor. While military employment declined through 1993, it has been rising slowly since and is expected to remain at least at the current level. The U.S. Army, Navy, Air Force, Marine Corps, and Coast Guard all have a presence on Oahu. The U.S. Pacific Fleet's commander-in-chief is located at Pearl Harbor, as is the headquarters of the Third Fleet. Pearl Harbor's tourist appeal is enhanced with the permanent berthing of the battleship USS Missouri. A bridge now connects Pearl Harbor with the Navy's Ford Island. Plans are under way for a mixed-use development there.

Honolulu's employment base has been volatile, rising in 1999, 2000, and 2001 following several years of small annual declines. Total jobs declined slightly (0.1%) in 2002, led by tourism-related losses. Job reductions in many of the other sectors and subsectors were offset partially by steady gains in government employment since 1997. Honolulu's labor force has declined slowly, which, when coupled with the job losses, resulted in moderate unemployment levels. The city's jobless rate has been below the state's and under the national average since 2000. The city's 2002 unemployment rate was 3.9% in 2002, down slightly from 4.0% in 2001 and a peak 5.4% in 1998. Monthly levels for 2003 suggest improvement, with Honolulu's unemployment in May 2003 at 3.4%, down from 3.8% in May 2002.

Honolulu's real estate market is improving in all sectors, resulting in rising assessed value. The city's tax base rose for fiscal 2004 for the third consecutive year. The annual gains include a sizable 7.6% increase for fiscal 2004. This trend reverses six consecutive years of decline beginning in fiscal 1996, reflecting a substantial run-up in property values as speculation and international investment fueled market activity. Residential sales and average prices have increased steadily since the late 1990s, reversing several years of price declines. The change results from low interest rates and pent-up demand for housing. The retail vacancy rate now is 7.5%, and substantial new construction is under way. Several Waikiki area hotel properties have begun major renovation and expansion programs. Building permits for 2002 showed their first gain and rose a sizable 28%. Office vacancy rates in downtown Honolulu have been relatively stable at about 14% since 1999.

The population grew 4.5% during the 1990s and has risen slowly since then to 884,176. The city makes up about 72% of the state's population. Income levels are 11% above the state average and 20% greater than the nation's. Exceeding the national average partially reflects the high cost of living on the island. Despite the recent and prolonged downturn, per capita income has risen every year since 1990.