

New Issue: Moody's assigns Aa1 to Honolulu, HI's \$879M GO Series 2015A-E Bonds; outlook is stable

Global Credit Research - 12 Mar 2015

\$2.98 billion of debt affected

HONOLULU (CITY & COUNTY OF) HI
Cities (including Towns, Villages and Townships)
HI

Moody's Rating

ISSUE		RATING
General Obligation Bonds Series 2015A (Tax Exempt)		Aa1
Sale Amount	\$375,675,000	
Expected Sale Date	03/16/15	
Rating Description	General Obligation	
General Obligation Bonds Series 2015B (Tax Exempt)		Aa1
Sale Amount	\$212,490,000	
Expected Sale Date	03/16/15	
Rating Description	General Obligation	
General Obligation Bonds Series 2015C (Tax Exempt)		Aa1
Sale Amount	\$240,600,000	
Expected Sale Date	03/16/15	
Rating Description	General Obligation	
General Obligation Bonds Series 2015E (Taxable)		Aa1
Sale Amount	\$22,060,000	
Expected Sale Date	03/16/15	
Rating Description	General Obligation	
General Obligation Bonds Series 2015D (Tax Exempt)		Aa1
Sale Amount	\$27,980,000	
Expected Sale Date	03/16/15	
Rating Description	General Obligation	

Moody's Outlook STA

NEW YORK, March 12, 2015 --Moody's Investors Service has assigned a Aa1 rating to the City and County of Honolulu's General Obligation Bonds, Series 2015A (Tax-Exempt), 2015B (Tax-Exempt), 2015C (Tax-Exempt), Series 2015D (Tax-Exempt), Series 2015E (Taxable) to be issued in the aggregate amount of approximately \$879 million. The Series 2015A (\$375.6 million) and 2015E (\$22.0 million) bonds will finance various capital improvement needs and refund commercial paper. The remaining bonds (Series 2015B - Series 2015D) will refund general obligation bonds for debt service savings. In conjunction with the current credit review, Moody's has also affirmed the Aa1 rating with the stable outlook on the city's approximately \$2.6 billion of outstanding general obligation

bonds.

SUMMARY RATING RATIONALE

The city's Aa1 rating reflects its very large property tax base and emergence from the economic downturn with key credit factors not only intact, but improved. The city's assessed value stands at an all time high following a relatively small decline in 2011. The labor market has recovered and the unemployment rate remains low relative to historical results and compared to state and US levels. Financial operations are well managed and large surpluses in prior years further enhance the city's operational flexibility. Reserve levels are generally in line with similarly rated cities. The debt position is average. The city's unfunded pension and Other Post Retirement Benefits (OPEB) liability represent long term risks for the city's rating but are currently manageable.

OUTLOOK

Moody's outlook on Honolulu's long-term ratings is stable. The stable outlook reflects the city's improving economy and management's demonstrated ability to improve its financial position through challenging economic and financial cycles. How the city manages its fiscal challenges in the coming years will be an important contributor to future rating considerations.

WHAT COULD MAKE THE RATING GO UP

- Substantial local economic diversification and improvement in socioeconomic wealth indices
- Material progress in funding OPEB and pension liabilities
- Sustained financial and debt characteristics consistent with higher-rated entities

WHAT COULD MAKE THE RATING GO DOWN

- Deterioration of financial operations and reserve levels
- Prolonged declines in assessed valuation
- A significant increase in debt

STRENGTHS

- Large economy with strong tourist appeal complemented by substantial military and government sectors
- Prudent fiscal management demonstrated by conservative budgeting practices and recently improved reserve levels
- Demonstrated willingness to raise revenues and reduce spending to achieve budget balance
- Above average amortization of debt

CHALLENGES

- Above average cost of living and vulnerability to shifts in tourism sector
- Rising pension, health and benefit costs
- Uncertainty surrounding sequestration and possible downsizing of military presence
- New rail operations expose city to enterprise risk, especially during construction and ramp-up phases

RECENT DEVELOPMENTS

Recent developments are incorporated in the Detailed Rating Rationale

DETAILED RATING RATIONALE

ECONOMY AND TAX BASE: HONOLULU'S ECONOMY KEEPS GROWING; ASSESSED VALUES EXPERIENCE ABOVE AVERAGE INCREASES

Honolulu's economic recovery has strengthened in recent years and although near-term risks remain from potential military cutbacks and ongoing housing affordability issues, we expect long-term growth will track the national average supported by the leisure/hospitality industry and local employment gains in the healthcare and professional services sectors. Between 2009 and 2014, assessed valuation (AV) increased an average of 4.2% annually, including a decline of 7.6% in 2011. Since then, AV growth has increased at an above average pace growing a healthy 9.6% and 7.7% in 2015 and 2016, respectively; AV adjustments lag the market by 18 -24 months. The city's AV is very large at nearly \$188 billion. Moody's notes Honolulu historically has not experienced much foreclosure activity given the relative rarity of sub-prime financing in Hawaii. The city's 2009 median family income was a healthy 129% of national levels and the city's full value per capita is strong at \$190,882. Honolulu's unemployment rate continues to improve and was a low 3.4% as of December 2014, on an unadjusted basis, compared with 3.7% for the state and 5.4% for the nation.

Real estate has been an important element of Honolulu's economic growth. Since 2011, single family home prices increased 8% in 2012, followed by 5% annual increases in 2013 and 2014. To the downside, these rising prices could further tighten an already land-constrained housing market and push living costs upward even further.

Economic development projects we will be monitoring over the forecast horizon include the \$1 billion, 60-acre Ward Village mixed-use redevelopment in Kaka'ako and the \$1 billion Park Lane Ala Moana luxury condo project, both in the city's urban core and adjacent to the planned rail line. Nearby, General Growth Properties is undertaking a \$572 million expansion and renovation of the Ala Moana Shopping Center which will also include a significant luxury condo piece. In addition to a number of other developments in this area, other major developments throughout Oahu will further add to the city's AV growth including Ho'Opili with over 1,550 acres of agricultural land in West Oahu reclassified for a 12,000 home community to be built over the next 20 years and other residential projects in Central Oahu.

Honolulu's large military presence faces near-term risk due to recent budget cuts which could potentially reduce the military footprint on the island and have a moderately adverse effect on the overall economy. Although the magnitude of the federal cuts for the city's largest employer are an uncertainty, the military's emphasis on the Pacific ensures Honolulu is in better shape relative to other defense-heavy areas. Further, in the event the military is downsized to some degree we note that due to Honolulu's high cost of living, military incomes on average do not have a pronounced impact as other military-reliant areas and most other sectors in Honolulu largely rely on visitor spending rather than spending by the military. Aside from the tourism and military sectors, Honolulu is also anchored by a significant public sector and health care, banking and agriculture to some degree add further diversity.

Total visitor arrivals reached another record in 2014 increasing a modest 2% over the prior year and slightly lower than the five year annual average of 5% since 2010. Looking ahead, this trend of increased visitor volume will continue as the mainland economic expansion drives income improvements, making a vacation to Honolulu more attainable considering Honolulu is somewhat more accessible and affordable than other parts of Hawaii. In addition, although historically comprising a smaller percentage of total visitor volume, international visitors are gradually making up a larger number of total visitors to Honolulu and this trend is also expected to continue over the medium term. Similarly, hotel occupancy percentages improved beginning in 2010 and have continued to average just over 80% through 2014.

DESPITE OBSTACLES, HONOLULU RAIL CONSTRUCTION CONTINUES; 2019 COMPLETION ESTIMATE

The city, through the Honolulu Authority for Rapid Transportation (HART) is in the beginning stages of constructing a new 20-mile mass transit system along Oahu's east-west corridor. An estimated 60% of the city's population lives within this corridor and the city projects that population growth within this area will outpace the balance of Oahu. To date, more than \$1 billion has been expended for planning and design, site acquisition and guideway and track construction. Construction of the light rail system is expected to be completed in 2019.

Costs related to construction of the system, which have increased from its original estimate of \$5.2 billion to approximately \$5.5 - \$5.9 billion, are expected to be funded primarily with revenue generated by the 0.5% general excise and use tax surcharge (the surcharge) implemented by the city on January 1, 2007. The surcharge is projected to generate about \$3.3 billion through the 2022 expiration. Additional funding is expected from a \$1.55 billion grant from the U.S. Department of Transportation, Federal Transit Administration under a full funding grant agreement (FFGA) dated December 2012. Cost increases have been a result of a combination of lawsuits and bids coming in far above original estimates; both lawsuits have since been resolved but the delays pushed costs up by about \$200 million.

As of December 2014, the city had received \$1.4 billion from the surcharge, net of administrative fees charged by

the State, and \$806 million from the Federal Transit Administration. The remaining \$210 million in construction costs were expected to be funded with federal Section 5307 funds, although the specific use of these funds is still under discussion.

In anticipation of receiving future surcharge revenue and the balance of the federal grant, construction of the project is expected to be financed with a combination of general obligation commercial paper notes, bond anticipation notes, and general obligation bonds issued by the city. Notably, the city and HART are required to enter into a memorandum of understanding prior to any debt issuance that would entitle the city to reimbursement from HART for debt service and other costs associated with such obligations.

Given the current capital plan and scheduled expiration of the general excise and use tax surcharge in 2022, it is projected that the city would need to subsidize rail system operations with approximately \$80 million per year beginning in Fiscal Year 2020 to offset costs not paid from passenger fares.

The city recently requested that the State Legislature make the 0.5% surcharge on the general excise and use tax permanent. As of this writing, positive action by the state legislature has indicated support for some form of tax extension although Committees in the House and Senate differ in their approach. The House currently appears to support a surcharge in perpetuity but at half the current surcharge rate while the Senate currently supports a five year extension on the current surcharge.

Going forward, we will monitor the likelihood and potential magnitude of the costs associated with the construction and operation of the rail on the city. Given the city's intent to provide contingent support for rail construction and operation, we will incorporate rail-related debt into the city's debt profile to gauge the potential strain on the city's operations. We will also monitor the rail's need for financial support from the city; we would consider continued construction cost overruns, below average surcharge collections and/or operational subsidies above current projections as red flags. Finally we also monitor changes in public and political support and the willingness of the city to continue to provide contingent support.

FINANCIAL OPERATIONS AND RESERVES: HISTORICALLY WELL MANAGED FINANCIAL OPERATIONS WITH GROWING RESERVES AFFORD THE CITY OPERATING FLEXIBILITY

The city is well managed and operating reserve levels provide the city sound operating flexibility. In 2014 the city realized a modest operating deficit (equal to about 1% of operating expenditures) following a four year stretch of surpluses. Still, at 29.7% of operating revenues the city's available operating fund balance was only slightly lower than the prior year and one of the highest reserve levels for the city in recent years. In addition, these levels approximated similarly-rated large cities and counties nationally. Going forward, we expect that the city's currently healthy reserve levels and sound financial profile positions it well to mitigate a growing burden from somewhat high long-term fixed costs and potential operating subsidies in the out years from the city's rail system. The city's commitment to maintaining budget balance and adequate reserve levels has been an important factor in Moody's credit evaluation of Honolulu.

For the current fiscal year (2015) the city was faced with a relatively small general fund budget gap of roughly \$47 million, or about 4% of budgeted general fund revenues. To close the gap, the city adjusted the recently created 'Residential A' property tax rate as well as the property tax rate for hotels and resorts to offset nearly three-fourths of the budget gap. In addition to various other revenue adjustments, the city's zero-based budgeting approach identified savings which provided the remaining funds to balance the budget. The city expects the total general fund balance will end lower than the prior year due largely to one-time capital projects but reserves will also reflect another improvement to the city's reserve for fiscal stability (RFS) within the general fund. Since FY 2012 the city has steadily increased the RSF balance towards its target of between 5 - 8% of general and highway fund expenditures; the FY 2015 ending RSF balance is estimated to end at 6.0% (\$71.7 million).

The 2016 proposed budget is balanced after identifying another comparatively small budget gap of \$37.7 million (or about 3% of budgeted revenues). These measures include maintaining a relatively flat employee count compared to the prior year, continuation of efficiency savings, and increased property tax revenues as assessed values continue to grow and importantly, also adding to the RSF fund to equal nearly 8% of general fund and highway revenues (\$100 million).

The city's strong financial and budgeting management team will continue to take timely and prudent action in order to conservatively manage its budget and generate a fiscal position that will remain steady and satisfactory for the rating level. Similar to most major municipalities, Honolulu will continue to face its share of budget challenges due to the rising pension, health and benefit costs. In fiscal 2013, debt service, pension and OPEB costs represented about one-third of operating revenues.

Liquidity: HEALTHY GENERAL FUND LIQUIDITY

The city's available liquidity is healthy with general fund cash equal to 21.7% of revenues in fiscal 2014. The city has no short-term borrowing plans and does not anticipate any material reductions to available cash.

DEBT AND OTHER LIABILITIES: CITY'S DEBT POSITION IS MANAGEABLE

The city's debt position is average with a net direct debt burden of 1.4%, which is above the median for similarly-rated cities and counties nationally. Honolulu benefits from the active role the state government plays in financing traditional municipal capital needs more typically funded at the local level throughout the rest of the country including transportation, health, justice, and education. Including the current offering, the city has approximately \$2.98 billion of outstanding general obligation bonds; the city has no exposure to long-term variable rate debt or derivative instruments in its G.O. borrowing program. Approximately 58.9% of the city's general obligation debt is retired in ten years.

Debt Structure

The city has \$2.98 billion in general obligation bonds outstanding with the latest maturity in 2038. Total debt service increases slightly through 2018 before declining through final maturity.

All of the city's debt is fixed rate.

Debt-Related Derivatives

The city is not exposed to derivatives.

CITY'S PENSION AND OPEB POSITION CAN POSE A LONG TERM CREDIT RISK

Honolulu has an average defined-benefit pension burden, based on unfunded liabilities for a multi-employer plan and for its Moody's-estimated share of a cost-sharing plan administered by the state. Reported unfunded liabilities in fiscal 2013 were approximately \$1.3 billion, or 60% funded.

Pension costs have pressured the city's budget somewhat in recent years and will likely continue as contributions are budgeted to increase. The city has multiple tools available to address these increased costs, including the legal flexibility to raise revenue or to trim other operating expenses. Net of reimbursements from the city's self-sufficient enterprises, the city's fiscal 2013 contribution was approximately \$76.6 million, or 8% of operating revenue. From 2012 through 2014, the city's pension contributions fell short of amounts recommended by plan actuaries. In addition, the 2014 audit also shows that the city may have underpaid its ERS amounts in those years resulting in a small aggregate current liability of \$31 million. The city and ERS are verifying required amounts and after any liability is paid in the current fiscal year (2015) the city is confident there will be no deficiencies going forward.

Moody's fiscal 2013 adjusted net pension liability (ANPL) for the city, under our methodology for adjusting reported pension data, is \$2.0 billion (net of self-support), or 2.0 times operating revenues which is high for the rating category. The three-year average of Honolulu's ANPL to Operating Revenues is similar at 2.0 times, while the three-year average of ANPL to full value is average at 1.3%. Moody's ANPL reflects certain adjustments we make to improve comparability of reported pension liabilities. The adjustments are not intended to replace Honolulu's reported liability information, but to improve comparability with other rated entities.

The city's OPEB liability is sizeable and remains a challenge. As of July 1, 2013 the unfunded OPEB liability was \$1.67 billion or 1.6 times fiscal 2014 operating revenues. Together, the city's pension and OPEB liabilities equaled about 1.2% of the city's AV, similar to the city's direct debt burden.

Importantly, in the 2013 legislative session, the state adopted a plan to require phasing in higher annual required contribution (ARC) payments by all counties and the state beginning in fiscal 2015. By fiscal 2019, the payments would reach 100% of the ARC. Honolulu began setting aside amounts to pre-fund its OPEB liability beginning in 2008, and is currently ahead of the required schedule and the 2016 operating budget reflects continued increases in payments which are estimated to equal 79% of its annual OPEB ARC.

Hawaii is the only state that has adopted a plan to fully fund its OPEB ARC payments. While the move is credit positive, it will substantially increase all local government's (including Honolulu) annual fixed costs relative to budget. In fiscal 2013, the city's total payment was \$82 million (net of self-support) or about 8% of operating revenue and well above the national median of 1.5%.

By themselves, pension and OPEB costs are above average and will soon grow into a larger portion of the city's budget going forward. In fiscal 2013, pension contributions, debt service and PAYGO costs for OPEB benefits represented 33% of operating expenses.

MANAGEMENT AND GOVERNANCE

Hawaii counties have an institutional framework score of Aa, or strong. Revenues, mainly property taxes and state distributed transient accommodations taxes, are highly predictable and counties have a strong ability to raise property tax revenues. However, state mandated benefits present a high exposure to the state budget and limits counties' expenditure flexibility which weakens the institutional rating somewhat.

KEY STATISTICS

Net Assessed Value, Fiscal 2016: \$187.7 billion

Assessed Value Per Capita, Fiscal 2016: \$190,882

Median Family Income as % of US Median: 131.05%

Fund Balance as % of Revenues, Fiscal 2014: 29.72%

5-Year Dollar Change in Fund Balance as % of Revenues: 20.68%

Cash Balance as % of Revenues, Fiscal 2014: 21.69%

5-Year Dollar Change in Cash Balance as % of Revenues: 11.94%

Institutional Framework: "Aa"

5-Year Average Operating Revenues / Operating Expenditures: 1.02x

Net Direct Debt as % of Assessed Value: 1.4%

Net Direct Debt / Operating Revenues: 2.3x

3-Year Average ANPL as % of Assessed Value: 1.2%

3-Year Average ANPL / Operating Revenues: 2.2x

OBLIGOR PROFILE

Honolulu, the capital and principal city of the State of Hawaii was incorporated in 1907 and located on the island of Oahu. The City and County of Honolulu has an area of 597 square miles and includes the entire island of Oahu.

LEGAL SECURITY

The bonds are secured by an unlimited property tax pledge; debt service payments represent a first charge on the city's General Fund.

UES OF PROCEEDS

Series A: Provide funds for capital projects, general fund reimbursement and commercial paper redemption

Series B-D: Refund previously issued debt for annual debt service savings.

Series E: Provide funds for various capital projects

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was US Local Government General Obligation Debt published in January 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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