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CREDIT OPINION
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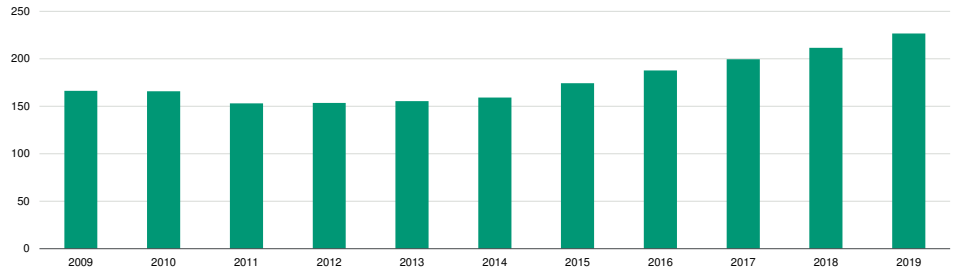
Honolulu (City & County of) HI

Update to credit analysis

Summary

The City and County of Honolulu's (Aa1 stable) credit profile is shaped by its large and growing tax base and economy, supported by a world-class tourism industry, large private and public construction projects, and a significant military presence. The city and county's finances are supportive of its strong credit profile, with long-term structural balance and sound reserve levels stemming from a strong management team and conservative budgeting practices. A key credit consideration is the city and county's high fixed costs, which include debt service, pension, and other post-employment benefits. The ongoing rail transit project is also an important credit consideration.

Exhibit 1
Honolulu's assessed value continues trajectory of strong growth
$ billions



Source: City and County of Honolulu

Credit strengths

» Strong economic conditions that include a healthy and growing tourism industry, extremely low unemployment levels, and an expanding tax base

» Solid history of prudent fiscal management

» Commitment to and progress toward reducing pension and OPEB liabilities

Credit challenges

» High cost of living and vulnerability to shifts in the tourism sector

» Elevated and rising fixed cost burden from pensions, debt and retiree medical costs

» Uncertainty surrounding the timing of rail construction, final construction costs, and size of future operating subsidy

Rating outlook

Moody's outlook on Honolulu's long-term ratings is stable. The stable outlook reflects the city and county's healthy economy and our expectation that the managers will maintain solid reserve levels while continuing to make planned progress in funding pension and OPEB liabilities. The outlook also incorporates our current view on challenges related to construction of the light rail.

Factors that could lead to an upgrade

» Increased economic diversification and improvement in wealth indices

» Significant improvement in the funding of OPEB and pension liabilities

» Greater certainty regarding rail costs and plans to address their impact on the city and county's finances

Factors that could lead to a downgrade

» Economic weakness leading to protracted declines in assessed values

» Material decline in the city and county's financial profile

» Inability to manage escalating fixed costs

Key indicators

Exhibit 2

Honolulu (City & County of) HI	2014	2015	2016	2017	2018
Economy/Tax Base					
Total Full Value ($000)	$159,095,727	$174,335,551	$187,718,834	$199,626,577	$211,569,917
Population	975,690	984,178	986,999	988,650	988,650
Full Value Per Capita	$163,060	$177,138	$190,192	$201,918	$213,999
Median Family Income (% of US Median)	131.2%	130.8%	132.4%	132.4%	132.4%
Finances					
Operating Revenue ($000)	$1,284,977	$1,387,777	$1,444,691	$1,573,455	$1,632,658
Fund Balance ($000)	$309,015	$323,742	$315,640	$326,511	$447,713
Cash Balance ($000)	$277,607	$401,309	$395,140	$279,631	$451,130
Fund Balance as a % of Revenues	24.0%	23.3%	21.8%	20.8%	27.4%
Cash Balance as a % of Revenues	21.6%	28.9%	27.4%	17.8%	27.6%
Debt/Pensions					
Net Direct Debt ($000)	$2,624,168	$2,891,752	$2,749,028	$2,821,693	$3,294,326
3-Year Average of Moody's ANPL ($000)	N/A	$2,447,229	$2,578,646	$3,383,118	N/A
Net Direct Debt / Full Value (%)	1.6%	1.7%	1.5%	1.4%	1.6%
Net Direct Debt / Operating Revenues (x)	2.0x	2.1x	1.9x	1.8x	2.0x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	N/A	1.4%	1.4%	1.7%	N/A
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	N/A	1.8x	1.8x	2.2x	N/A

Fund balance for 2018 excludes $420.3 million advance to HART in the General Obligation Bond and Interest Redemption Fund.
Source: Moody's Investors Service

Profile

Coterminous with the island of Oahu, the City and County of Honolulu is the capital city of the State of Hawaii (Aa1 stable) and the economic and political center of the state. Approximately one million people live on the island, constituting nearly 70% of the state's population.

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Detailed credit consideration

Economy and tax base: tourism continues to show strength as assessed values rise, but housing affordability may present future challenges

Honolulu's economy and tax base are key credit strengths. Tourism, a primary economic driver, continues to show strength: through November 2018, visitors counts to Honolulu were up 4.4% year-over-year to 5.4 million, and expected to surpass the full year record set in 2017 of 5.7 million visitors. Since the end of the recession in 2009, overall visitor counts are up 40.9%. Visitors to Honolulu, which is coterminous with the island of Oahu, are a mix of both US domestic as well as international travelers, which helps moderate the effects of economic swings in any particular market. Other metrics of a strong tourism economy, including hotel room occupancy and revenue per available room have had similarly strong trends.

Given the island's strategic location in the middle of the Pacific, military activity has been an important and stabilizing factor for the local economy for decades. The island serves as headquarters to US Pacific Command with large operational footprints at Joint Base Pearl Harbor-Hickam and Marine Corps Air Station Kaneohe Bay. Aside from the tourism and military sectors, Honolulu is also anchored by a significant public sector while health care, banking and agriculture add further diversity.

The city and county's assessed value is large and has shown robust growth over the last five years, driven by large residential and commercial development activity, particularly in the urban core. Between 2014 and 2019, assessed valuation (AV) increased by 42.5%, from $159.1 billion to $226.6 billion. It is also notable that AV adjustments lag the market by 18 -24 months, leading to our expectation that AV will continue to grow in the near term. Honolulu historically has not experienced much foreclosure activity given the relative rarity of sub-prime financing in Hawaii.

Socioeconomic measures are healthy, with median family income at 132.4% of the US and unemployment at an extremely low 2.4% as of September 2018, according to data from the US Bureau of Labor Statistics (seasonally unadjusted). However, Honolulu has been identified as one of the least affordable housing markets in the nation, creating potential challenges to future economic expansion. According to data provided with the city and county, the median price of single family home on Oahu is just under $800,000.

Financial operations and reserves: stable operating reserves; rising fixed costs and support for rail are risks

The city and county's finances are a credit strength but are not without its challenges. On an operating funds basis (which Moody's defines here as including the General Fund, debt service fund, and Highway Fund), Honolulu ended fiscal 2018 with available reserves of $447.7 million, equal to 27.4% of operating revenues, a level comparable to similarly rated peers of its size. This figure excludes a sizeable $420.3 million receivable in the form of an advance to the Honolulu Authority for Rail Transit in the General Obligation Bond Interest and Redemption Fund that was the net proceeds of a $350 million bond issuance and $100 million in commercial paper less $29.7 million for a project bond account reserve. Available reserve levels as a percentage of revenues are slightly above the city and county's five year average of 23.5% and reflect a strong General Fund performance and the effects of financing activities. Management expects fiscal 2019 results to be consistent with fiscal 2018.

Honolulu's operating revenues are principally generated from property taxes (79.6% in 2018), followed by licenses and permits (12.0%). Operating revenues have grown at a healthy compound annual growth rate of 5.3% since 2013, despite very modest changes to property tax rates (and no changes to rates on primary residences), reflecting very strong new development and increases in valuations on existing properties. Because assessed values lag real market activity by 18-24 months, the city is able to project the bulk of its revenues with a high degree of accuracy. As an added credit strength, property taxes for operations (including debt repayment) are not restricted by rate or amount and are not subject to voter approval, giving the city and county considerable revenue raising flexibility. Hotel room taxes, which are distributed by formula and capped, are accounted for in transfers from the state and fall under intergovernmental revenue, comprised just 2.8% of operating funds revenues. The 0.5% general excise tax surcharge, which generated $297.7 million in 2018, is transferred to HART for construction of the rail project.

Managers have consistently budgeted expenditures very conservatively: in 2018 budgeted General Fund expenditures exceeded actual expenditures by $96.1 million, while in 2017 budgeted General Fund expenditures exceeded actual expenditures by $72.4 million. Operating expenses are principally for public safety (28.1%), followed by retirement and health benefits (22.0%), net transfers out (15.0%, primarily reflective of support for public transit and solid waste), and general government (10.0%). Notably, operating expenses

have grown at a faster CAGR (6.6%) than revenues between 2013 and 2018, but revenues have exceeded expenses overall during this period.

Although the city and county's financial support for the Honolulu Authority for Rapid Transportation (HART) to date has been limited to the issuance of a combined $494 million in bonds in 2017 and 2019 to be repaid by HART, the city and county will likely provide a substantial annual operating subsidy in excess of any passenger fares once operations begin. The size of such a subsidy is unknown at the moment. The GET surcharge expires in 2030 and is currently being used to fund construction of the project in conjunction with federal funds. The project has faced significant delays and cost overruns; originally expected to be finished in 2019, completion of the rail system is currently expected by 2026, with interim operations of a limited portion of the western segment of the line expected in December 2020. Project costs have also swelled from an initial estimate of $5.2 billion to $8.2 billion, including an expected $160 million settlement with one of the system's contractors.

We expect the city and county's finances will remain strong in the near-term but will be challenged by high fixed obligations and likely operational subsidies in the out years for the city's rail system. In fiscal 2018, debt service, pension and OPEB costs represented about 36.7% of operating revenues, which is high relative to cities and counties nationally and within the rating category. Going forward, Moody's will monitor annual revenue increases and the city's ability to absorb these costs. The city's commitment to maintaining budget balance and adequate reserve levels remains an important factor in Moody's credit evaluation of Honolulu.

LIQUIDITY

Despite a high dependence on property tax revenues, Honolulu has not engaged in short-term borrowing to manage its operating cash flow needs. At the end of fiscal 2018, the city and county held $451.1 million on cash and investments in its operating funds, or a solid 27.6% of revenues.

Debt and pensions: manageable debt but escalating fixed costs, including pensions and OPEB

The city and county has a very large debt portfolio in absolute terms but is manageable relative to its tax base and operating revenues. Following the issuance of the 2019A and 2019B general obligation bonds, the city and county will have just over $4.0 billion in general obligation debt. Of this amount, $830.7 million is self-supporting or reimbursable, resulting in net direct debt of $3.2 billion. This is equal to 1.4% of full value and 2.0 times operating funds revenues, which is manageable. 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 education, health, and justice. Notably, the state constitution prohibits the state from levying a property tax.

DEBT STRUCTURE

The city and county's debt structure is conservative, with a rapidly declining debt service schedule that reaches final maturity in 2044.

The Series 2017H bonds are the city's only variable rate debt outstanding ($350 million), issued to fund a portion of the rail project. The city's outstanding commercial paper ($144 million), also issued for the rail project, is expected to be refunded and fixed out with the 2019A and 2019B bonds.

The 2017H bonds bear a variable interest rate based on a spread to the tax-exempt SIFMA index and pose a modest level of interest rate risk to the city. As the notes are not associated with an interest rate swap, increases in SIFMA would impose higher debt service costs on the city. The interest rate cap is 8%. Even in a worst-case scenario where the interest rate spikes to that level just after issuance, the additional debt service would represent a still manageable risk. The nominal maturity range from 2022 through 2028 coincides with construction completion and mature prior to the General Excise and Use Tax surcharge sunset date of 12/31/2030.

DEBT-RELATED DERIVATIVES

The city has no derivative instruments in its GO borrowing program.

PENSIONS AND OPEB

Pensions and OPEB liabilities are significant credit challenges for Honolulu that are being actively addressed with increased contributions that will substantially increase fixed costs. Eligible employees of the city and county are participants in the State of Hawaii's Employees' Retirement System (ERS), a multi-employer cost-sharing defined benefit pension system. The city and county has an above average defined-benefit pension burden based on Moody's approach to evaluating pension liabilities. Reported unfunded liabilities in fiscal 2018 were approximately $2.3 billion. Net of shares allocated to business enterprises based on actual contributions

from those entities, the three year average Moody's adjusted net pension liability (ANPL) for the city, under our methodology for adjusting reported pension data, is $3.4 billion. In the three years through fiscal 2017, the ANPL has averaged a somewhat high 3.09 times annual operating revenue and 2.4% of full valuation. 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.

In recent years the state legislature has enacted higher employer contribution rates to address the system's large unfunded liability, which grew significantly in 2016 with a lowering of the discount rate to 7.0% from 7.65%. Given the timing difference between lowering the discount rate, updated mortality tables and the legislature enacting higher contribution rates, the city and county's 2017 contribution was below the "tread water" indicator, resulting in a tread water gap equal to 8.3% of operating revenues. The tread water indicator measures the annual government contributions required to prevent reported net pension liabilities from growing, under reported assumptions.

Employer contributions will increase to 41% of payroll for police and fire and 24% for general employees by 2020. The increased rates are projected to eliminate the unfunded actuarial accrued liabilities by 2045 and should significantly reduce the aforementioned "tread water" gap. The next several years will be critical in how the city addresses these rising costs given the multiple budgetary tools it has available, including the legal flexibility to raise revenue or to trim other operating expenses.

The city's OPEB liability is sizeable and remains a challenge. As of July 1, 2018 the unfunded OPEB liability was $1.87 billion. Positively, Honolulu began setting aside amounts to pre-fund its OPEB liability beginning in 2008, and the 2019 payment is equal to 100% of its annual OPEB ARC.

Management and governance: strong institutional framework

Hawaii Counties have an Institutional Framework score of Aa, which is high. Institutional Framework scores measure a sector's legal ability to increase revenues and decrease expenditures. The sector's major revenues source is property taxes which is not subject to any caps. Unpredictable revenue fluctuations tend to be minor, or under 5% annually. Across the sector, fixed and mandated costs are generally greater than 25% of expenditures. Hawaii has public sector unions and additional constraints, which limit the ability to cut expenditures. Unpredictable expenditure fluctuations tend to be moderate, between 5-10% annually.

The City and County of Honolulu has historically had strong management teams and practices. Honolulu is governed by an elected mayor and nine-member council and operates under a city charter. The state handles most activities typically performed by local governments, including education, health, and justice.

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