

Tax Supported  
New Issue

## City and County of Honolulu, Hawaii

### Ratings

#### New Issue

General Obligation Bonds,  
Series 2005A, B, and C..... AA

#### Outstanding Debt

General Obligation Bonds ..... AA

Rating Outlook ..... Stable

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### New Issue Details

\$328,495,000 General Obligation Bonds,  
Series 2005A, B, and C, are scheduled to sell  
on or about May 19 through negotiation by a  
syndicate led by UBS Financial Services Inc.

**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 and advance refund outstanding  
general obligation bonds.

### ■ 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. The city's tourism base has adapted to a shift to more domestic-based visitors as well as reduced activity, while elements such as its role as the area's commercial center and state capital and a sizable military presence add stability. Tourism in the city is highly developed and has strong underpinnings, providing continual demand. The city has restrained spending growth to keep it in line with revenues, resulting in prudent general fund balances. 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

Honolulu is coterminous with the island of Oahu, and 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. Tourism activity exhibits volatility typical of the sector, surging in 2004 following a long decline. Total visitors rose a very strong 9.1% in 2004, bringing the amount to about 5% below the 2000 peak. This rise follows a precipitous drop in 2001 and relative stability through 2003 at about 10% below the high.

The number of international visitors, largely from Asia, rose faster than domestic visitors last year, although Fitch Ratings does not view this one-year gain as indicative of a return of the higher spending foreign tourists. Rather, with domestic visitors now making up 58% of the total, the city's tourism sector is expected to retain balance. Other tourism indicators were strongly positive in 2004 as well, with hotel occupancy rising for the second consecutive year to nearly 80%, the highest level experienced in 10 years. The increase is also for a second consecutive year and, notably, occurred along with an average room rate rise to the 1998 peak.

Honolulu's nontourism economy is substantial and adds balance, with the city acting as the state's commercial and business center, the state capital, and home of the University of Hawaii. The U.S. military also is a major economic element, taking advantage of the city's strategic location. Federal defense spending makes up about 8% of the gross state product, with most of the activity on Oahu. Honolulu makes up 72% of Hawaii's population, about two-thirds of the visitors, and about one-half of the hotel rooms statewide. The real estate market has returned to strong activity, with taxable values rising considerably since recovery began in 2002.

May 17, 2005

Financial operations are sound, relying primarily on property taxes. Honolulu's revenue base includes only a small amount that is directly reliant on tourist activity. The general fund ran operating surpluses in three of the past five fiscal years. Fiscal 2004 resulted in an operating deficit, reducing the fund balance to \$62.3 million, above average at 8.5% of spending. While this level is below fiscal 2003's 11%, it is near the 8.8% average over the past five years. In addition, the city maintains \$5 million in a rainy day fund. Fitch views the reserve current levels as about the right amount to be a prudent financial cushion.

The good results primarily reflect expenditure growth kept to low levels through organizational restructuring, privatization, and employee reductions. Operations in fiscal years 2002–2004 also benefited from a sizable capital spending reimbursement, which has ended. Projections for fiscal 2005 suggest about break-even operations, as a strong property tax gain offsets rising employee costs and the capital reimbursement loss. Honolulu's fiscal future should continue to be sound but will be challenged by a general trend of sizable increases in pension costs, as well as ongoing salary raises.

## ■ 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.
- Financial operations benefit from sound management actions, resulting in preservation of satisfactory reserves.
- 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

- Economic volatility inherent to tourism-based economies.
- Ongoing financial pressures, including labor and pension cost increases.

## ■ Debt

Honolulu is a regular general obligation debt issuer, with future sales expected to retain low to moderate debt ratios. About 59% of the city's debt matures in the next 10 years. Proceeds from the series 2005A bonds will redeem about \$200 million in outstanding commercial paper. The commercial paper was used

## Debt Statistics

(\$000)

This Issue	328,495
Outstanding General Obligation Bonds	1,588,752
Other Debt	83,919
Less: Self-Supporting Debt	(239,873)
Total Direct Debt	1,761,293
Overlapping Debt	0
Total Overall Debt	1,761,293

## Debt Ratios

Debt per Capita (\$)*	1,972
As % of Market Value**	1.5

\*Population: 893,358 (2004 estimate).

\*\*Market value: \$114,100,000,000 (fiscal 2006).

for various capital projects. Proceeds from the series 2005B and C bonds will advance refund about \$131.7 million in outstanding parity general obligation bonds. The city expects about \$3.7 million in net present value savings from the refunding, about 3% of refunded par.

Honolulu's overall debt burden is low at \$1,972 per capita and 1.5% of market value. The latter figure is well below prior years' levels, the result of strong taxable value growth. The debt burden is 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 \$388.5 million in variable-rate bonds, 20% of the city's gross general obligation long-term debt portfolio. Fitch views this level as appropriate given the city's overall credit characteristics. In addition, the city has a \$250 million commercial paper program, with proceeds used as interim financing for various capital projects.

## ■ Finances

Honolulu's financial operations are good and reflect strong fiscal management that has adapted well to changing economic conditions. Fiscal management has been prudent, utilizing tax and fee increases and restrained expenditure growth to keep operating losses low to moderate in amount. As a result, fund balance levels have been reduced but remain satisfactory. However, Fitch notes that current reserves are approaching the minimum level needed to retain the existing high rating. Fitch expects reserve levels to rise over time as economic conditions continue to improve.

## General Fund Financial Summary

(\$000, Audited Fiscal Years Ended June 30)

	2002	2003	2004
Taxes	407,270	411,043	458,116
Intergovernmental	32,063	32,763	35,584
Licenses and Permits	25,987	29,340	34,258
Other	109,319	97,146	94,312
Total Revenues	574,639	570,292	622,270
Public Safety	199,990	222,366	229,602
General Government	95,817	94,835	94,690
Retirement and Health	81,647	71,524	85,664
Culture and Recreation	41,339	44,578	42,917
Other	40,790	22,994	25,270
Total Expenditures	459,583	456,297	478,143
Results	115,056	113,995	144,127
Transfers In and Other Sources	83,106	99,490	96,230
Transfers Out and Other Uses	(185,348)	(195,019)	(250,856)
Net Income/(Deficit)	12,814	18,466	(10,499)
Total Fund Balance	54,350	72,816	62,317
Unreserved Fund Balance	35,159	51,496	41,479
As % of Expenditures, Transfers Out, and Other Uses	5.5	7.9	5.7

Recent financial performance has benefited from strong tax base growth and the city's prudent actions to restrain expenditure growth. Nonetheless, spending has risen as a result of nondiscretionary increases in employee health care costs and pension contributions, as well as salary gains granted through the statewide collective bargaining process. Fiscal discipline and nonpermanent revenue enabled the city to show operating surpluses in two of the past three fiscal years, with a loss occurring in fiscal 2004.

The general fund's small operating deficit in fiscal 2004 occurred despite strong assessed value growth and a property tax rate increase. The loss resulted largely from lower transfers in, as a nonpermanent capital reimbursement ended and higher transfers out were needed for debt service and to support golf and special event operations. Despite the loss, the general fund ended fiscal 2004 with a \$62.3 million total fund balance and \$41.5 million unreserved balance, satisfactory levels at 8.5% and 5.7%, respectively, of the year's \$729.0 million in expenditures, transfers out, and other uses. Adding in the \$5.0 million in the special reserve, the year-end unreserved cushion rises to 6.4%.

The city expects to increase its financial cushion over the next few years. Operating results for fiscal 2005 suggest about break-even operations, with higher than budgeted revenue offsetting certain expenditure increases. The fiscal 2006 proposed budget projects

continued revenue growth and moderate spending gains, resulting in year-end reserve levels being maintained at around the current level. Plans for fiscal 2007 suggest a moderate fund balance gain.

Honolulu's recent financial operations mark a reversal from fiscal years 1996–2001, when a weak real estate market resulted in several consecutive years of property tax base declines. Along with increased fees, new charges, and in one year a property tax rate increase, the city restrained and reduced spending through sweeping organizational restructuring and some privatization. These actions enabled the city to end fiscal 2001 with a \$23.5 million total general fund balance, satisfactory at 3.8% of expenditures, transfers out, and other uses given the extended economic strain.

The general fund's primary revenue source is property taxes, making up 65% of fiscal 2004 revenue and transfers in. Property taxes have experienced extraordinary growth in recent years, resulting from substantial new construction and strong gains in market value. Property tax revenue also reflects a tax rate increase, the first such increase since fiscal 2000. The rise was implemented to mitigate overall spending growth and higher debt service costs. The transient accommodations tax (TAT), the city's only revenue source directly related to tourism activity, makes up a small 5% of general fund resources. The utility tax is Honolulu's other local tax source, making up about 3% 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.

State-shared TAT revenue rose in fiscal 2004 to \$35.4 million, reflecting higher occupancy and rising room rates. While this revenue source represents a small 5% of general fund resources, it once made up as much as 7% before the change to 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 13% of general fund expenditures, transfers out, and other uses in fiscal 2004, respectively. Retirement and health benefits also have become a major spending category, rising to 11% in fiscal 2004. Like many municipalities, these costs have risen substantially in recent years. Pension costs are expected to continue at the higher level at least for the next few years, although the city believes health care costs are under control.

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 by about 9% through reorganization, consolidation, and privatization of select services. Future budgets will be challenged to provide for 5%–6% annual salary increases granted under statewide agreements. However, the city's fiscal planning benefits from having the labor agreements determined through June 30, 2007. Fitch expects that the city's previous prudent actions to retain good financial operations will prevail.

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 approval from both the state assembly and each local government

board. Lack of consensus among the various government entities and certain noncounty labor unions has prolonged negotiations in prior years.

### ■ 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. Despite economic fluctuation, the unemployment rate remains low at 2.9% for 2004 — the lowest in the nation — and compares well with the state's 3.3%.

Tourism activity is rebounding following two cyclical declines throughout the 1990s and in the aftermath of the events of Sept. 11, 2001. Oahu's visitor count peaked in 2000, registering 4.7 million visitors, only to drop to 4.2 million in each of the following two years. This decline was more pronounced among international visitors, leading to a higher than average reliance on domestic tourists to sustain the tourism sector.

Visitor data for 2004 show a healthy increase in the number of overall visitors to Honolulu (9.1%). Most encouraging is the 12.1% rise in the number of international visitors. Other visitor measures for Honolulu reflect a stabilization of the tourism sector. Domestic visitors' average stay remains at 9.9 days, while international visitors' average declined slightly to 7.1 from 7.4 days. Oahu's hotel occupancy rose to 79.7% in 2004 from 73.2% in 2003 and remained above the state's 77.8% in 2004. These occupancy rates are above the island's and the state's prior peaks in 2000. Oahu's occupancy rate gain is notable given the rise in the average room rate to its 1998 level — again, reflecting a tourism sector that is rebounding.

The city's economic development efforts have been sizable and focused. The efforts have aimed to increase retail, restaurant, and other recreational activity by both 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.

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 is the largest employment sector, followed by government and trade.

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 risen 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 2000, 2001, 2002, and 2003 following several years of small annual declines in the 1990s. Total jobs increased by 1.9% in 2003, led by a rebounding tourism-related sector, with many of the other sectors and subsectors experiencing similar job growth patterns. Since 2000, Honolulu's labor force has grown by a

slight 0.8%, which, when coupled with the recent job growth, has resulted in low unemployment levels. The city's jobless rate has been below the state's and under the national average since 2000. The city's 2004 unemployment rate was 2.9%, down from 3.9% in 2003 and a peak 5.4% in 1998. Monthly levels for 2005 suggest improvement, with Honolulu's unemployment in March 2005 at 3.4%, down from 3.8% in March 2003.

Honolulu's real estate market is improving in all sectors, resulting in rising assessed value. The city's tax base rose for fiscal 2006 for the fifth consecutive year. The annual gains include an astounding 23.5% increase for fiscal 2006. 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 899,593. The city makes up about 72% of the state's population. Income levels are above the state and national averages. 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.

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