Honolulu (City & County), Hawaii

New Issue Report

Ratings

Long-Term Issuer Default Rating	AA+

New Issues

$212,185,000 (Honolulu Rail Transit Project) General Obligation Bonds, Series 2019A	AA+
$38,155,000 (Honolulu Rail Transit Project) General Obligation Bonds, Series 2019B	AA+

Outstanding Debt

General Obligation Bonds	AA+

Rating Outlook

Stable

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New Issue Summary

Sale Date: The bonds are scheduled to sell via negotiation during the week of Jan. 21, 2019.

Series: (Honolulu Rail Transit Project) General Obligation Bonds, Series 2019A and 2019B.

Purpose: To fund ongoing construction of the Honolulu Rail Transit Project and to refund outstanding commercial paper

Security: The bonds are backed by the city's full faith and credit and supported by an unlimited pledge of ad valorem property tax.

Analytical Conclusion

The 'AA+' Issuer Default Rating (IDR) reflects Honolulu's (the city) strong revenue framework, affordable long-term liabilities and robust operating performance, somewhat offset by its high fixed carrying costs for debt service and retiree benefits.

Economic Resource Base: Honolulu's economy is driven by tourism. The city is also the center for the state of Hawaii's business services, trade, transportation, healthcare, defense and government sectors. Honolulu's population of almost one million represents about 70% of the statewide total. Median household income is strong at almost 140% of the national level.

Key Rating Drivers

Revenue Framework: 'aaa'
Property taxes account for more than 80% of general fund revenues. Fitch Ratings expects solid revenue growth, exceeding inflation but below nominal U.S. GDP growth. The city has unlimited independent legal ability to raise property tax revenues.

Expenditure Framework: 'aa'
Based on recent spending practices and continued strong revenue performance, Fitch expects that the city's expenditure increases will be in line with to marginally above revenue growth. However, carrying costs for debt service and retiree benefits are high relative to similarly rated entities and could challenge the city's ability to reduce expenditures in a downturn.

Long-Term Liability Burden: 'aa'
Long-term liabilities for debt service and pensions are moderate relative to total personal income but OPEB liabilities are large and inflexible. Recent statewide reforms to retiree benefits will help slow the growth of related liabilities but funded ratios remain low.

Operating Performance: 'aaa'
The city is well-positioned to address economic challenges as a result of its limited revenue volatility, ability to raise revenues and substantial reserves. Financial management is conservative, and budgets are consistently balanced.

Rating Sensitivities

Financial Flexibility: The rating is sensitive to continued strong operating performance and could be pressured by sustained reductions in reserves or uncontrolled expenditure growth. The Stable Rating Outlook reflects Fitch's expectation that such actions are unlikely.

Rating History (IDR)

Rating	Action	Outlook/ Watch	Date
AA+	Affirmed	Stable	1/17/19
AA+	Revised	Stable	4/30/10
AA	Affirmed	Stable	3/20/09
AA	Affirmed	—	10/26/07
AA	Affirmed	Stable	3/24/04
AA	Assigned	—	3/12/99

Related Research

Fitch Rates Honolulu, HI's $294 MM 2019 A&B GOs 'AA+'; Outlook Stable (January 2019)

Related Criteria

U.S. Public Finance Tax-Supported Rating Criteria (April 2018)

Credit Profile

Honolulu's economy has performed strongly in recent years, with steady growth in tourism and a continued substantial military presence. Tourism activity is economically cyclical but has proven resilient over the long term, and unemployment rates have been consistently below the U.S. average.

Honolulu's economic growth has been bolstered in recent years by substantial new construction activity. Major infrastructure projects include an $8.3 billion rail transit project, as well as improvements to the local water and sewer system, airport and harbors. Honolulu's Kaka'ako neighborhood has seen the recent completion of several residential towers, and large resort and master-planned residential developments are also underway in West Oahu.

Revenue Framework

Property taxes provide the chief source of general fund support for the city, with no other revenue source accounting for more than 5% of total revenues. Tax rates are set based on property type, allowing the city to limit the tax burden on residents relative to commercial and resort properties.

Fitch expects Honolulu's revenue growth, absent policy actions, to increase more rapidly than inflation but less rapidly than U.S. GDP, reflecting continued solid gains in taxable assessed values. While revenue gains may be affected by periodic economic shocks, growth has proven solid on average over the long term. Revenues grew at a 3.1% compound annual growth rate over the past decade. Growth was closer to inflation excluding the impact of tax policy changes.

The city has unlimited legal authority to raise property tax revenues and has regularly adjusted tax rates and property classifications to serve its fiscal needs.

Expenditure Framework

The city provides a broad range of municipal services with the notable exception of elementary and secondary education, which are operated and funded at the state level. Employee pension and benefit costs and public safety account for about half of total general fund expenditures.

Fitch expects the natural pace of spending growth to be in line with to marginally above expected revenue growth based on the city's current spending profile. The recent trend of steady expenditure growth will continue, but ongoing revenue gains are likely to keep pace.

Expenditure flexibility is just adequate, reflecting elevated fixed costs, a safety-dominated expenditure profile and limited policymaker control over labor costs. The fixed carrying cost of debt service and retiree benefits was elevated at about 31% of governmental expenditures in the fiscal year ended June 30, 2018. Carrying costs are elevated in part due to the city's practice of fully funding actuarially determined contributions for OPEB but even without that, carrying costs would be somewhat elevated. Pension and OPEB costs have risen significantly in recent years as policymakers sought to improve funded ratios but Fitch's supplemental pension metric, which assumes a 20-year level payoff of the Fitch-adjusted pension liability, indicates that even contributions at the actuarial level are likely to be insufficient to reduce pension liabilities. Fitch expects pension contributions to continue to rise.

For more information see "Revised Pension Risk Measurements (Revised Pension Risk Measurements: Enhancing Pension Analysis in U.S. Public Finance Tax-Supported Rating Criteria)," dated May 2017. The city's ability to control personnel expenses is somewhat limited by negotiation of contracts at the state level and relatively strong labor protections, including binding arbitration of contract terms.

Long-Term Liability Burden

Long-term liabilities for debt and pensions are affordable relative to Honolulu's large economic resource base at approximately 11% of personal income. The city's unfunded OPEB liability is substantial at $1.9 billion as of fiscal 2018, equivalent to an additional 3.3% of personal income. The city has made notable progress in funding its OPEB program, moving from pay-as-you-go funding to full funding of the annual required contribution within the span of several years but city policymakers have limited ability to reduce accrued benefits.

Direct debt of about $3.2 billion (excluding self-supporting GO bonds issued on behalf of enterprises) makes up about one-half of the long-term liability burden. As a city and county, Honolulu has no overlapping debt, and its debt portfolio overwhelmingly comprises fully amortizing, fixed-rate GO bonds. The city has about $1.6 billion of authorized but unissued GO bonds. Fitch expects the city to borrow gradually and does not expect future issuance to increase debt to a degree that would pressure the rating given that the city's liability burden is currently at the low end of the range and is consistent with an 'aa' attribute assessment for long-term liabilities.

Pensions make up the other one-half of the long-term liability burden. The city participates in the Employees' Retirement System (ERS) of the state of Hawaii. ERS' ratio of pension assets to liabilities was about 55% based on its assumed 7% investment return rate as of 2018 and about 48% based on Fitch's more conservative 6% rate of return assumption. Actuarial contribution rates are determined by statute and adjusted periodically if the funding period exceeds 30 years. In recent years the state legislature has lowered assumed investment returns, extended mortality assumptions and phased in higher employer contribution requirements. As with OPEB reforms, these changes have increased the reported net pension liability and expenses but improve the longer-term sustainability of the plan.

The current transaction will fund ongoing construction of the Honolulu Authority for Rapid Transportation's $8.3 billion, 20-mile rail transit project. The authority was created to construct the rail project, the largest infrastructure investment in state history. The Hawaii State Legislature and city have approved an excise tax and a transient accommodation tax (TAT) that will fund the bulk of the project costs ($7.2 billion), with most construction funded on a pay-as-you-go basis, which is unusual for large transit projects. The federal government has also committed to a substantial $1.55 billion contribution via its New Starts program. Project costs have risen significantly from initial estimates of $5.1 billion, requiring significant additional funding via the extension of excise taxes as well as the extension and increase of the TAT. The Hawaii State Auditor recently released a report criticizing management of the rail project and cost overruns.

The city's role in the project is substantial, providing a cash flow borrowing capacity via its GO bonds and commercial paper issued in anticipation of excise and TAT revenues as well as a modest equity contribution funded by GO bonds that it will repay from local property tax revenues. But the city's exposure to cost overruns has thus far been very manageable, including a contribution of an additional $44 million of equity to the project to be funded by the 2019B bonds, raising the total city subsidy to $214 million. The 2019A bonds are expected to be repaid from excise tax and TAT revenues, not local property taxes.

The impact of cost overruns on Honolulu's credit appears limited. Given the city's current long-term liability burden at the low end of the 'aa' category, Honolulu would have to incur several billion dollars of unanticipated borrowing to change Fitch's assessment of the long-term liability burden. Fitch believes such an outcome is quite unlikely even with some further cost overruns assumed.

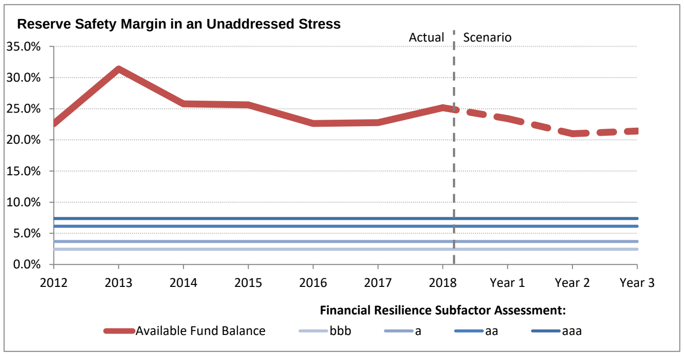
Operating Performance

The city has the highest level of gap-closing capacity and is expected to manage through downturns while maintaining a high level of fundamental financial flexibility, reflecting strong reserves relative to expected revenue volatility and its high inherent budget flexibility. For details, see Scenario Analysis, page 5.

Budget management in times of recovery is also strong. Budget management is conservative, and budgets appear structurally balanced. The city has used the current economic expansion to position itself well for the next downturn, with unrestricted reserves increasing five-fold since the last recession. Recent increases in pension and OPEB contributions have significantly improved ongoing funding of retiree liabilities.

Honolulu (City & County) (HI)

Scenario Analysis



Analyst Interpretation of Scenario Results:

The city has the highest level of gap-closing capacity and is expected to manage through downturns while maintaining a high level of fundamental financial flexibility, reflecting strong reserves relative to expected revenue volatility and its high inherent budget flexibility. Inherent budget flexibility is judged to be high based on the city's adequate expenditure flexibility and unlimited independent legal ability to raise revenues. The city's $375.2 million unrestricted 2018 general fund balance equaled 25.2% of spending, which is quite robust relative to the 2.5% revenue decline that the Fitch Analytical Sensitivity Tool suggests the city could experience in Fitch's standard moderate economic downturn scenario (a 1% decrease in U.S. GDP). Fitch expects policymakers to use a combination of revenue raising measures, reserve spending and limited expenditure cuts to offset cyclical revenue losses while maintaining reserves consistent with a 'aaa' resilience assessment.

Scenario Parameters:	Year 1	Year 2	Year 3
GDP Assumption (% Change)	(1.0%)	0.5%	2.0%
Expenditure Assumption (% Change)	2.0%	2.0%	2.0%
Revenue Output (% Change)	(2.5%)	1.2%	4.9%
Inherent Budget Flexibility		High	

Revenues, Expenditures, and Fund Balance	Actuals							Scenario Output		
	2012	2013	2014	2015	2016	2017	2018	Year 1	Year 2	Year 3
Total Revenues	997,263	1,012,408	1,039,068	1,140,345	1,203,597	1,285,573	1,367,297	1,333,689	1,350,160	1,416,696
% Change in Revenues	-	1.5%	2.6%	9.7%	5.5%	6.8%	6.4%	(2.5%)	1.2%	4.9%
Total Expenditures	743,148	733,510	762,755	830,195	885,055	947,713	997,137	1,017,080	1,037,421	1,058,170
% Change in Expenditures	-	(1.3%)	4.0%	8.8%	6.6%	7.1%	5.2%	2.0%	2.0%	2.0%
Transfers In and Other Sources	114,435	135,950	146,729	137,372	182,247	158,670	173,272	169,013	171,100	179,532
Transfers Out and Other Uses	361,917	330,684	434,975	432,795	508,890	485,659	494,558	504,449	514,538	524,829
Net Transfers	(247,482)	(194,734)	(288,246)	(295,423)	(326,643)	(326,989)	(321,286)	(335,436)	(343,438)	(345,297)
Bond Proceeds and Other One-Time Uses	-	-	-	-	-	-	-	-	-	-
Net Operating Surplus(+)/Deficit(-) After Transfers	6,633	84,164	(11,933)	14,727	(8,101)	10,871	48,874	(18,827)	(30,699)	13,229
Net Operating Surplus(+)/Deficit(-) (% of Expend. and Transfers Out)	0.6%	7.9%	(1.0%)	1.2%	(0.6%)	0.8%	3.3%	(1.2%)	(2.0%)	0.8%
Unrestricted/Unreserved Fund Balance (General Fund)	249,858	334,022	308,849	323,576	315,475	326,346	375,220	356,393	325,694	338,923
Other Available Funds (GF + Non-GF)	-	-	-	-	-	-	-	-	-	-
Combined Available Funds Balance (GF + Other Available Funds)	249,858	334,022	308,849	323,576	315,475	326,346	375,220	356,393	325,694	338,923
Combined Available Fund Bal. (% of Expend. and Transfers Out)	22.6%	31.4%	25.8%	25.6%	22.6%	22.8%	25.2%	23.4%	21.0%	21.4%

Reserve Safety Margins	Inherent Budget Flexibility				
	Minimal	Limited	Midrange	High	Superior
Reserve Safety Margin (aaa)	39.3%	19.7%	12.3%	7.4%	4.9%
Reserve Safety Margin (aa)	29.5%	14.7%	9.8%	6.1%	3.7%
Reserve Safety Margin (a)	19.7%	9.8%	6.1%	3.7%	2.5%
Reserve Safety Margin (bbb)	7.4%	4.9%	3.7%	2.5%	2.0%

Notes: Scenario analysis represents an unaddressed stress on issuer finances. Fitch's downturn scenario assumes a -1.0% GDP decline in the first year, followed by 0.5% and 2.0% GDP growth in Years 2 and 3, respectively. Expenditures are assumed to grow at a 2.0% rate of inflation. Inherent budget flexibility is the analyst's assessment of the issuer's ability to deal with fiscal stress through tax and spending policy choices, and determines the multiples used to calculate the reserve safety margin. For further details, please see Fitch's US Tax-Supported Rating Criteria.

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.