# Honolulu (City & County), Hawaii

## New Issue Report

### Ratings

| | |
|---|---|
| Long-Term Issuer Default Rating | AA+ |

### New Issues

| | |
|---|---|
| $189,105,000 General Obligation Bonds, Series 2019C | AA+ |
| $58,795,000 General Obligation Bonds, Series 2019D | AA+ |
| $183,290,000 (Honolulu Rail Transit Project) General Obligation Bonds, Series 2019E | AA+ |
| $8,115,000 General Obligation Bonds, Series 2019F | AA+ |
| $8,385,000 General Obligation Bonds, Series 2019G | AA+ |
| $2,000,000 General Obligation Bonds (Taxable), Series 2019H | AA+ |
| $1,100,000 General Obligation Bonds (Taxable), Series 2019I | AA+ |
| $96,320,000 General Obligation Bonds (Taxable), Series 2019J | AA+ |

### Outstanding Debt

| | |
|---|---|
| General Obligation Bonds | AA+ |

### Rating Outlook

Stable

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## New Issue Summary

**Sale Date:** Scheduled to sell via negotiation on Aug. 7, 2019.

**Series:** $189,105,000 Series 2019C; $58,795,000 Series 2019D; $183,290,000 Series 2019E (Honolulu Rail Transit Project); $8,115,000 Series 2019F; $8,385,000 Series 2019G; $2,000,000 Series 2019H (Taxable); $1,100,000 Series 2019I (Taxable); and $96,320,000 Series 2019J (Taxable).

**Purpose:** To finance the city and county's capital improvement project and equipment purchase costs. The series 2019E bond proceeds will fund the ongoing construction of the Honolulu Rail Transit Project. A portion of the series 2019F, 2019G, 2019H, 2019I and 2019J bond proceeds will refund certain outstanding GO bond maturities for cash flow savings.

**Security:** The city and county's full faith and credit, and an unlimited pledge of ad valorem property taxes.

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

## Key Rating Drivers

**Revenue Framework: 'aaa'**
Property taxes account for the majority of general fund revenues. Fitch Ratings expects solid revenue growth, exceeding inflation but below nominal U.S. GDP growth. The city and county 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 expenditure increases will be in line with, to marginally above, revenue growth. However, carrying costs for debt service and retiree benefits are high and could challenge the city and county's ability to reduce expenditures in a downturn.

**Long-Term Liability Burden: 'aaa'**
Long-term liabilities for debt service and pensions are low relative to the tax base. While other post-employment benefit (OPEB) liabilities are large and inflexible, recent statewide reforms to retiree benefits are expected to slow the growth of related liabilities.

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

## Rating Sensitivities

**Financial Flexibility:** The IDR 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 | 7/25/19 |
| AA+ | Revised | Stable | 4/30/10 |
| AA | Affirmed | Stable | 3/20/09 |
| AA | Affirmed | Stable | 10/26/07 |
| AA | Affirmed | Stable | 3/24/04 |
| AA | Assigned | — | 3/12/99 |

## Credit Profile

The city and county of Honolulu includes the entire island of Oahu and a number of small outlying islands. While a significant portion of the city and county's economy is driven by tourism, it is also the state's center for business services, trade, transportation, healthcare, defense and government. The city and county's population of around 980,000 is approximately two-thirds of the statewide total. Median household income is strong at 139% of the national level.

The city and county'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.

The city and county's economic growth has been bolstered in recent years by substantial new construction activity. Major infrastructure projects include HART's $9.1 billion rail transit project, as well as improvements to the local water and sewer system, the airport and harbors. The numerous hotel projects recently completed, currently under construction or in the planning stages signal tourism's continued strength. Significant property investments are being made across Oahu. Overall tax base growth has been strong, with annual increases of between 2% and 10% during fiscal years 2014 to 2020.

### Revenue Framework

Property taxes provide the chief source of general fund support for the city and county. Hawaii counties' power to levy and collect real property taxes is enshrined in the state constitution, which allows each county to adjust its real property tax rates up or down annually with its council's approval. Tax rates are set based on property type, allowing the city and county to limit the tax burden on residents relative to commercial and hotel/resort properties. For example, while non-residential properties represent 22% of the fiscal 2020 tax base, they are projected to generate 47% of property tax revenues. Recent property tax rate increases for hotels/resorts and residential A (tier 2) second homes are projected to generate an additional $31 million in fiscal 2020. The general residential property tax rate has remained unchanged since 2011.

Fitch expects the city and county's revenue growth, absent policy actions, to increase above 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. Revenue growth was closer to inflation excluding the impact of frequent property tax rate changes.

The city and county 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 and county provides a broad range of municipal services with the exceptions of elementary and secondary education and health and human services, which are funded and operated at the state level. Public safety and general government account for over one-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 and county's current spending profile. The recent trend of steady expenditure growth will continue, but ongoing revenue gains are likely to keep pace.

The city and county's general fund-supported transit system operating costs will increase as the HART rail transit project comes on line. Operations and maintenance is expected to cost

#### Related Research

Fitch Rates Honolulu, HI's $547MM 2019 GOs 'AA+'; Outlook Stable (July 2019)

#### Related Criteria

U.S. Public Finance Tax-Supported Rating Criteria (April 2018) approximately $39 million in the second half of fiscal 2021 when interim service begins and grow to approximately $127 million annually (less $40 million of projected annual fare box recovery) upon full service beginning in fiscal 2026. While city and county officials view these cost increases as absorbable, $127 million represents approximately 7% of current governmental spending.

Expenditure flexibility is just adequate, reflecting elevated fixed costs, a safety-dominated expenditure profile and limitations on policymaker control over labor costs. Fitch expects pension contributions to continue to rise. Even after adjusting for the nearly 9% of the primary government net pension liability and almost 11% of the primary government net OPEB liability attributable to the city and county's enterprise departments, carrying costs consumed 29% of total governmental spending in fiscal 2018, somewhat constraining the city and county's expenditure flexibility. (This analysis excludes the city and county's component units.) Carrying costs will remain elevated in part due to full funding of actuarially determined annual pension and OPEB contributions, as well as state-mandated OPEB pre-funding.

Pension and OPEB costs have risen significantly in recent years as policymakers seek to improve funded ratios. However, 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. For more information on the supplemental pension metric, 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 and county'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 for eight bargaining units and the ability to strike for one. Although state law characterizes arbitration as "final and binding", the city and county can still reject any cost item and force the parties to return to the bargaining table. While the city and county has limited ability to set or adjust terms beyond layoffs and/or furloughs, it does have strong control over headcount.

## Long-Term Liability Burden

Long-term liabilities for debt and pensions are low relative to the tax base at nearly 3% of market valuation and more moderate at 11% of personal income. (These metrics adjust for the nearly 9% of primary government net pension liability burden that is carried by the city and county's enterprises.) Since a material portion of the city and county's resource base is excluded from its total personal income given the high level of tourism-related development, Fitch elevates consideration of the property value metric.

Direct debt of about $3.4 billion makes up over one-half of the long-term liability burden. This excludes certain GO bonds issued on behalf of self-supporting city and county enterprises but includes HART-related GO bonds (in the absence of any revenue history for HART). The city and county has no overlapping debt, and its debt portfolio is overwhelmingly composed of fully amortizing, fixed-rate GO bonds.

Although voter approval is not required to issue debt, Fitch anticipates the city and county will issue new debt gradually. The city and county is currently considering a $25 million GO bond issuance in February 2020 to further fund its contribution to the HART rail transit project. Beginning later in 2020, the city expects to sell more HART-related GO bonds that will be fully repaid from dedicated general excise tax surcharge and transient accommodation tax (TAT) revenues before they sunset in 2030. Fitch does not expect future issuance to increase debt to a degree that would pressure the rating, given that the city and county's liability burden is currently in the middle of the range, consistent with a 'aaa' attribute assessment for long-term liabilities (using the property value metric).

Pensions make up the balance of the long-term liability burden. The city/county participates in the state Employees' Retirement System. The city and county's portion had a 2018 ratio of pension assets to liabilities of about 55% based on an assumed 7% investment return rate and about 48% based on Fitch's 6% rate of return assumption. Actuarial contribution rates are determined by statute and adjusted periodically. In recent years, the state Legislature has lowered assumed investment returns, extended mortality assumptions and phased in higher employer contribution requirements. While these changes have increased the reported net pension liability and expenses, they have also improved the longer-term sustainability of the pension plan.

The city and county's unfunded OPEB liability was substantial at $1.9 billion as of fiscal 2018, equivalent to over 3% of personal income and 0.7% of market valuation (when adjusted for the nearly 11% of the unfunded OPEB liability attributable to the city and county's enterprises). The city/county has made notable progress in funding its OPEB program, moving from pay-go to full funding of the annual actuarially required contribution within the span of several years. Such full funding would be a credit positive but is offset by Hawaii local governments' inability under state statute to change OPEB benefits for current members or accrued OPEB liabilities.

The current transaction will fund ongoing construction of HART's $9.1 billion, 20-mile rail transit project. HART was created to construct the rail transit project, the largest infrastructure investment in state history. The project is approximately three-quarters complete or under construction, with interim service expected in December 2020 and full service expected by September 2026. The city and county plans to complete the remaining quarter of the project through a public-private partnership. This will complete the project's final 4.1 miles of track in downtown Honolulu, eight stations, and four power substations, plus oversee the completed system's first 30 years of operations and maintenance. The public-private partnership contract will be a joint procurement by the city and county and HART.

The Hawaii State Legislature and the city and county have approved a dedicated general excise tax surcharge and a dedicated TAT that will fund the bulk of the project costs ($7.2 billion) with most construction funded on a pay-go basis, which is unusual for large transit projects. The federal government has also committed to a substantial $1.6 billion contribution via its New Starts program. Project costs have risen significantly from initial estimates of $5.1 billion, requiring significant additional funding via extension of the general excise tax surcharge as well as an increase of the TAT.

The city and county's role in the project is substantial, providing a cash flow borrowing capacity via its GO bonds and commercial paper issued in anticipation of general excise tax surcharge and TAT revenues, as well as a modest equity contribution funded by GO bonds to be repaid from local property tax revenues. The city and county's exposure to cost overruns has thus far been manageable, including raising the total city and county subsidy to $214 million, just over 2% of the project's construction costs. Of this amount, $130 million represents contingency funds.

## Operating Performance

The city and county 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 6.

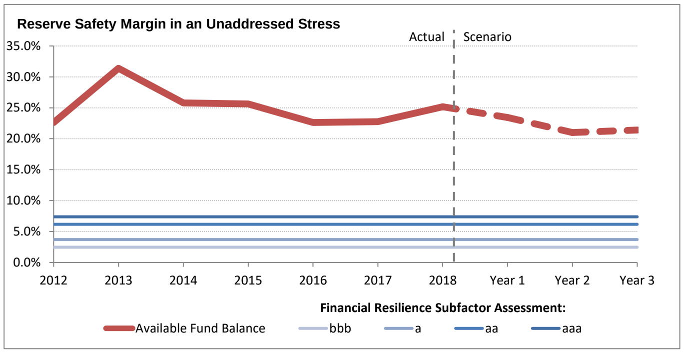
The city/county expects to increase its unrestricted general fund balance for fiscal year-end 2019.

Budget management in times of recovery is strong. Budget management is conservative, and budgets appear structurally balanced. The city/county has used the current economic expansion to position itself well for the next downturn given the growth in unrestricted reserves since the last recession. Recent increases in pension and OPEB contributions aim to improve ongoing funding of retiree liabilities. The city and county forecasts its contributions might increase by over 10% in fiscal 2020 and 8% in fiscal 2021, before stabilizing from fiscal 2022 onwards. However, Fitch's supplemental pension metric indicates that even contributions at the actuarial level are likely to be insufficient to reduce pension liabilities.

The city/county maintains a reserve for fiscal stability fund outside of the general fund. It is available for appropriation only in the event of an emergency or certain economic and revenue triggers. Deposits to this reserve fund are made from general fund and highway fund surpluses. The reserve fund is targeted to be between 5% and 8% of expenditures. The reserve fund balance was almost $112 million in fiscal 2018 and is expected to exceed $125 million by June 30, 2020 (about 7% of expenditures).

## Honolulu (City & County) (HI)

### Scenario Analysis




**Analyst Interpretation of Scenario Results:**

The city and county 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 and county's adequate expenditure flexibility and unlimited independent legal ability to raise revenues. The city and county's $375 million unrestricted 2018 general fund balance equaled 25% of spending, which is quite robust relative to the 2.5% revenue decline that the Fitch Analytical Sensitivity Tool suggests the city and county could experience in Fitch's standard moderate economic downturn scenario (a 1% decrease in U.S. GDP). Fitch expects that policymakers would 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.