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CREDIT OPINION
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Contacts

William Oh +1.415.274.1739
VP-Senior Analyst
william.oh@moodys.com

Eva Bogaty +1.415.274.1765
VP-Sr Credit Officer/Manager
eva.bogaty@moodys.com

Patrick Liberatore +1.415.274.1709
AVP-Analyst
patrick.liberatore@moodys.com

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Americas	1-212-553-1653
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Japan	81-3-5408-4100
EMEA	44-20-7772-5454

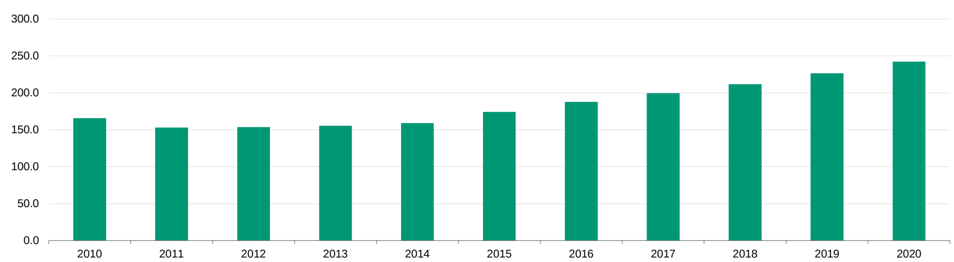
Honolulu (City & County of) HI

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, excellent revenue raising capacity 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 that are expected to moderate in the near term.

Exhibit 1
Honolulu's tax base continues to grow strongly
$ 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

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 that challenges related to construction of the light rail will remain financially manageable.

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	990,060	990,060
Full Value Per Capita	$163,060	$177,138	$190,192	$201,631	$213,694
Median Family Income (% of US Median)	131.2%	130.8%	132.4%	131.8%	131.8%
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)	$2,488,457	$2,447,229	$2,578,646	$3,383,118	$4,054,323
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 (%)	1.6%	1.4%	1.4%	1.7%	1.9%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	1.9x	1.8x	1.8x	2.2x	2.5x

Source: City and County of Honolulu, US Census Bureau, 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.

Detailed credit considerations

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 May 2019, visitors counts to Honolulu were up 4.6% year-over-year to 2.5 million, and on pace to surpass the record 5.9 million visitors in 2018. Since 2009, overall visitor counts are up 47.5%. 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 Indo-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%, to $226.6 billion from $159.1 billion, and 2020 assessed value is up an additional 6.9% to $242.3 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. Despite several large hotel and commercial properties, no single taxpayer represents more than 0.89% of AV, and the ten largest taxpayers represent just 5.4% of 2020 AV.

Socioeconomic measures are healthy, with median family income at 131.8% of the US and unemployment at an extremely low 2.5% as of May 2019, 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 by the city and county, the median price of single family home on Oahu is approximately $770,000.

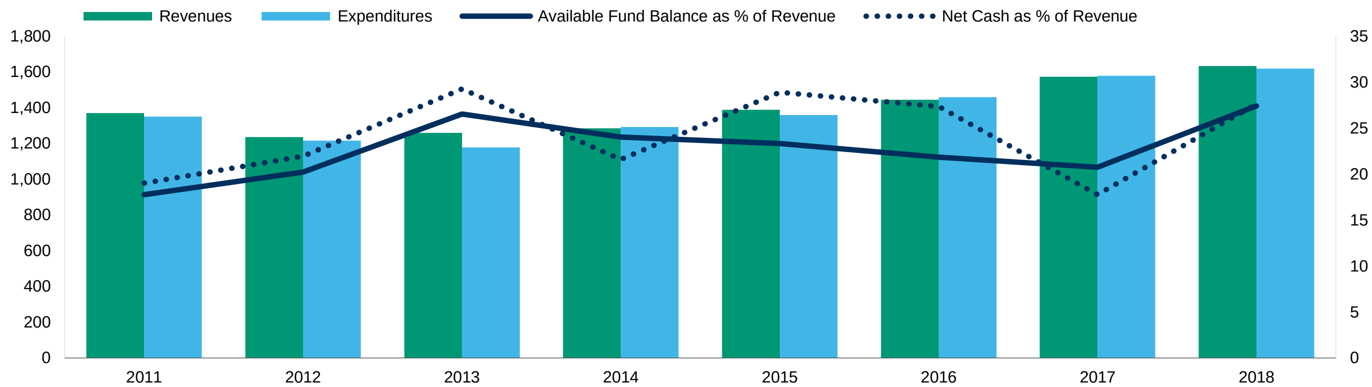
The high cost of living, driven principally by the cost of housing but also by the cost of having to import nearly all consumer goods, is likely a key factor in Honolulu experiencing two (albeit small) consecutive years of population decline in 2016 and 2017. Positively, the city and county, along with the state, appear to be taking steps to support affordable housing development. How the city and county addresses affordability and its downstream effects will be an area of focus in our future credit reviews.

Financial operations and reserves: solid financial position, but fixed costs are high and support for the rail project is a potential risk

The city and county's finances are a credit strength that help to mitigate high fixed costs and potential greater operating support for the rail project. 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 strong, with nominal increases in reserves and liquidity.

Exhibit 3

Honolulu's finances are healthy, with solid reserve levels and liquidity



Source: City and County of Honolulu, Moody's Investors Service

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 adding to operating stability: 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.

The city and county's direct support for the construction of rail built by the Honolulu Authority for Rapid Transportation (HART) will be limited to $214 million of the project's expected $9.1 billion costs (including financing). To date, the city and county has contributed $44 million, with an additional $25 million contribution expected in early 2020. The bulk of the construction costs are expected to be provided from a 0.5% general excise tax (GET) surcharge, which expires in 2030. The GET surcharge is expected to provide just under $6.0 billion, with the remaining funding coming from federal grants ($1.6 billion) and a state transient accommodation tax ($1.2 billion). The size of the city and county's capital contributions are modest and manageable.

The city and county is expecting to provide an annual operating subsidy of $87 million once full system operations begin in 2026 out of a total operating cost of $127 million, with operating costs additionally supported by a projected $40 million in farebox revenues. At this size, the annual operating subsidy would be a relatively manageable share of Honolulu's annual operating budget. However, the size of the subsidy will likely be determined by the ridership figures and pricing structure of the system, which remain uncertain.

Notably, 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 $8.3 billion (excluding financing costs). To manage the construction of the final segment of the rail project, as well as the operations and maintenance of the system, HART and Honolulu are evaluating the use of a public-private partnership model to manage construction risks. The question of how the critical city center portion of the project will be completed remains a significant unresolved credit risk.

Overall, 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 of cash and investments in its operating funds, or a solid 27.6% of revenues. Managers expect liquidity levels, at least on a nominal basis, to improve in 2019.

Debt and pensions: growing fixed costs expected to moderate as pension and OPEB reforms are fully implemented

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 2019C-J general obligation bonds, the city and county will have just over $4.1 billion in general obligation debt. Of this amount, $817.5 million is self-supporting or reimbursable, resulting in net direct debt of $3.3 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 and county and HART have a memorandum of understanding that requires HART to reimburse the city and county for debt service and costs associated with the issuances of GO bonds related to rail. The city and county has issued $760 million in GO bonds for rail since 2017 (including the 2019E 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 is 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 have materially increase fixed costs recently but are expected to moderate substantially beginning in 2022.

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 $4.1 billion through 2018, equal to a somewhat high 2.5 times operating revenues and 1.9% of full value.

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 have increased over the last several years, and will increase to 41% of payroll for police and fire and 24% for general employees in fiscal 2021 (July 1, 2020). The increased rates are projected to eliminate the unfunded actuarial accrued liabilities by 2045 and should significantly reduce the aforementioned “tread water” gap.

Additionally, the city's OPEB liability is sizeable. 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. City and county managers believe the cost increases associated with both pension and OPEB are manageable within the existing budget framework, with pension and OPEB contributions expected to increase by approximately 10% in 2020 and 8% in 2021, but moderating to 3%-3.5% annual increases from 2022 through 2030.

Management and governance: strong institutional framework; city and county working to address climate risks

Hawaii counties have an institutional framework score of “Aa,” or strong. Revenues are primarily derived from highly predictable property taxes, while state-distributed transient accommodations taxes represent a small fraction of resources. Counties have a high level of flexibility to raise property tax revenues annually, without limit. Expenditures primarily consist of personnel and an increasing level of pension and OPEB-related costs, which are highly predictable. Although counties can adjust personnel costs, elevated fixed costs and collective bargaining lead to low expenditure reduction ability.

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.

Climate change is a risk for Honolulu, with weather events and rising sea levels threatening major commercial, military, tourism, and residential properties across the island. In response, the city and county recently published the “Oahu Resilience Strategy,” including a 44-point action plan to prepare for and mitigate the impacts of climate change.

Rating methodology and scorecard factors

The US Local Government General Obligation Debt methodology includes a scorecard, a tool providing a composite score of a local government's credit profile based on the weighted factors we consider most important, universal and measurable, as well as possible notching factors dependent on individual credit strengths and weaknesses. Its purpose is not to determine the final rating, but rather to provide a standard platform from which to analyze and compare local government credits.

Exhibit 4

City and County of Honolulu

Rating Factors	Measure	Score
Economy/Tax Base (30%) [1]		
Tax Base Size: Full Value (in 000s)	$242,256,423	Aaa
Full Value Per Capita	$247,180	Aaa
Median Family Income (% of US Median)	131.8%	Aa
Notching Factors:[2]		
Institutional Presence		Up
Economic Concentration		Down
Other Analyst Adjustment to Economy/Taxbase Factor: international tourism destination		Up
Finances (30%)		
Fund Balance as a % of Revenues	27.4%	Aa
5-Year Dollar Change in Fund Balance as % of Revenues	7.0%	A
Cash Balance as a % of Revenues	27.6%	Aaa
5-Year Dollar Change in Cash Balance as % of Revenues	5.1%	A
Notching Factors:[2]		
Outsized Enterprise or Contingent Liabliity Risk		Down
Management (20%)		
Institutional Framework	Aa	Aa
Operating History: 5-Year Average of Operating Revenues / Operating Expenditures (x)	1.0x	A
Debt and Pensions (20%)		
Net Direct Debt / Full Value (%)	1.4%	Aa
Net Direct Debt / Operating Revenues (x)	2.0x	A
3-Year Average of Moody's Adjusted Net Pension Liability / Full Value (%)	1.7%	Aa
3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues (x)	2.5x	A
Notching Factors:[2]		
Other Analyst Adjustment to Debt and Pensions Factor (specify): risks associated with climate change		Down
	Scorecard-Indicated Outcome	Aa2
	Assigned Rating	Aa1

[1] Economy measures are based on data from the most recent year available.
[2] Notching Factors are specifically defined in the US Local Government General Obligation Debt methodology dated December 16, 2016.
[3] Standardized adjustments are outlined in the GO Methodology Scorecard Inputs Updated for 2019 publication

Source: City and County of Honolulu, US Census Bureau, Moody's Investors Service

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