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CREDIT OPINION
11 February 2020

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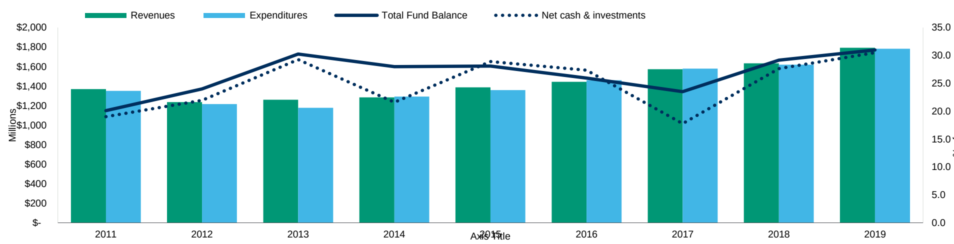
Honolulu (City & County of) HI

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, excellent revenue raising capacity and conservative budgeting practices. A key credit consideration is Honolulu'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 finances show long-term structural balance, with solid reserve levels and liquidity



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

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 Honolulu'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	2015	2016	2017	2018	2019
Economy/Tax Base					
Total Full Value ($000)	$174,335,551	$187,718,834	$199,626,577	$211,569,917	$226,641,985
Population	984,178	992,692	990,060	980,080	980,080
Full Value Per Capita	$177,138	$189,101	$201,631	$215,870	$231,248
Median Family Income (% of US Median)	130.8%	132.4%	131.8%	131.8%	131.8%
Finances					
Operating Revenue ($000)	$1,387,777	$1,444,691	$1,573,455	$1,632,658	$1,792,994
Fund Balance ($000)	$323,742	$315,640	$326,511	$447,548	$513,264
Cash Balance ($000)	$401,309	$395,140	$279,631	$450,959	$546,723
Fund Balance as a % of Revenues	23.3%	21.8%	20.8%	27.4%	28.6%
Cash Balance as a % of Revenues	28.9%	27.4%	17.8%	27.6%	30.5%
Debt/Pensions					
Net Direct Debt ($000)	$2,891,752	$2,749,028	$2,821,693	$3,294,326	$3,576,787
3-Year Average of Moody's ANPL ($000)	$2,447,229	$2,578,646	$3,383,118	$4,054,323	$4,651,088
Net Direct Debt / Full Value (%)	1.7%	1.5%	1.4%	1.6%	1.6%
Net Direct Debt / Operating Revenues (x)	2.1x	1.9x	1.8x	2.0x	2.0x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	1.4%	1.4%	1.7%	1.9%	2.1%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	1.8x	1.8x	2.2x	2.5x	2.6x

Source: City and County of Honolulu, HI, US Census Bureau, and 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: strong tax base growth showing moderation; coronavirus impact expected to have minimal impact on tourism

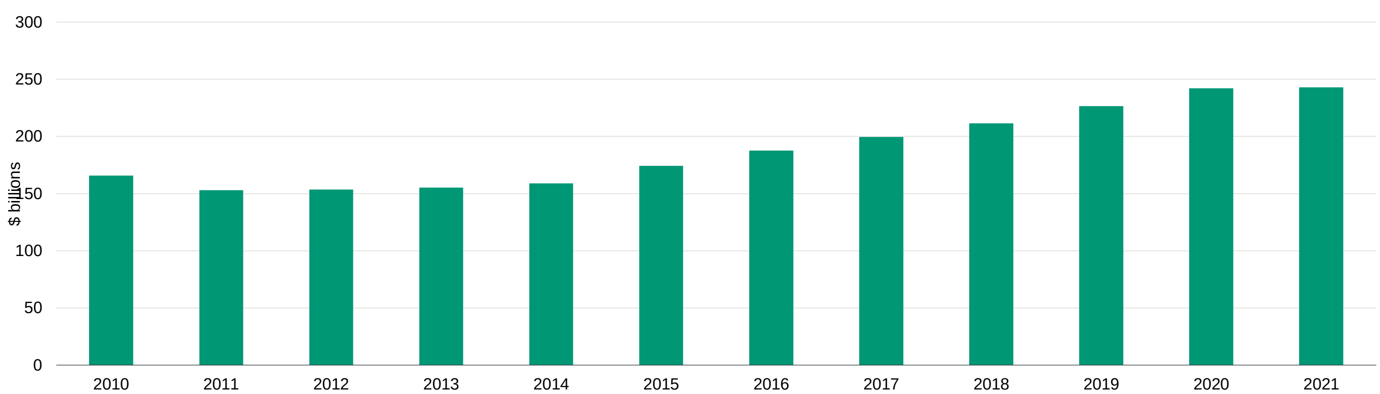
Honolulu's economy and tax base are key credit strengths. Tourism, a primary economic driver, continues to show strength: visitor counts to Honolulu in 2019 reached 6.2 million, up 5.6% from 2018. Since 2009, visitor counts to Honolulu have increased 53.9%. Visitors to Honolulu, which is coterminous 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. While we expect some impact from the coronavirus currently impacting China and East Asia, we expect the effect to be minimal if the outbreak is contained quickly. Visitors from China and Hong Kong represented 1.3% of visitors in 2018, and visitors from other Asian countries, primarily Japan, represented 17.8%. 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 decade, driven by large residential and commercial development activity, particularly in the urban core. Between 2010 and 2020, assessed valuation (AV) increased by 46.1%, reaching $242.3 billion. Assessed values for 2021 are flat, with a 0.3% increase (to $242.9 billion) reflective primarily of growth in the commercial and industrial space. It is also notable that AV adjustments lag the market by 18 -24 months, leading to our expectation that AV will continue to grow, albeit modestly, in the near term as residential property prices stabilize and commercial construction continues. 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.

Exhibit 3

Assessed value is moderating after a decade of strong growth



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

Socioeconomic measures are healthy, with median family income at 131.8% of the US and unemployment at an extremely low 2.4% as of November 2019, according to data from the US Bureau of Labor Statistics (seasonally unadjusted).

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 2019 with available reserves of $513.3 million, equal to 28.6% of operating revenues, a level comparable to similarly rated peers of its size. This figure excludes a sizeable $553.1 million receivable in the form of an advance to the Honolulu Authority for Rail Transit in the General Obligation Bond Interest and Redemption Fund for previously issued bonds, less

$45.6 million for the project bond reserve account. Available reserve levels as a percentage of revenues are slightly above the city and county's five year average of 24.4% and reflect a strong General Fund performance and the effects of financing activities. Management expects fiscal 2020 results to be flat on a nominal basis.

Honolulu's operating revenues are principally generated from property taxes (78.6% in 2019), followed by licenses and permits (12.7%). Operating revenues have grown at a healthy compound annual growth rate of 6.9% since 2014, 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 2.5% of operating funds revenues. The 0.5% general excise tax surcharge, which generated $324.7 million in 2019, is transferred to HART for construction of the rail project.

Managers have consistently budgeted expenditures very conservatively adding to operating stability: in 2019 budgeted General Fund expenditures exceeded actual expenditures by $102.0 million, similar to the $96.1 million favorable variance in 2018. Operating expenses are principally for public safety (26.4%), followed by retirement and health benefits (22.7%), net transfers out (15.8%, primarily reflective of support for public transit and solid waste), and general government (10.1%). Operating expenses grew at a slightly slow pace (6.7% annually) than revenues between 2014 and 2019, and revenues exceeded expenses overall during this period by $23.8 million.

The city and county's direct support for the construction of rail built by the Honolulu Authority for Rapid Transportation (HART) appears manageable, as it will be limited to $214 million of the project's expected $9.1 billion costs (including financing). 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. Project costs have also swelled from an initial estimate of $5.2 billion to $8.3 billion (excluding financing costs).

Through fiscal 2019, the city and county contributed $44 million, with an additional $25 million contribution in 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 federal government has delivered $806 million of the expected $1.6 billion in grant funding, though the remaining $744 million appears predicated on the receipt and acceptance of bids for the construction of the final 4.1 mile portion of the rail serving downtown Honolulu. 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 have committed to using a public-private partnership model, though no bid has been accepted and the contract award process has been delayed several times. The question of how the critical city center portion of the project will be completed remains a significant unresolved credit risk.

Although the current size of the city and county's capital contributions are modest and manageable, significant uncertainty remains the completion of the final portion of the rail. Additionally, 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. The city conservatively expects to subsidize most of the operating costs during interim operations.

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 2019, debt service, pension and OPEB costs represented about 33.7% 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 2019, the city and county held $546.7 million of cash and investments in its operating funds, or a strong 30.5% of revenues.

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 manageable relative to its tax base and operating revenues. With the issuance of the 2020 general obligation bonds, the city and county will have $4.1 billion in general obligation debt. Of this amount, $677.0 million is self-supporting or reimbursable, resulting in net direct debt of $3.5 billion. This is equal to just under 1.4% of full value and 1.9 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 governmental (non-enterprise) debt structure is conservative, with a rapidly declining debt service schedule that reaches final maturity in 2045. The Series 2017H bonds were the city's only variable rate debt outstanding ($350 million), issued to fund a portion of the rail project, and will be fixed out with the issuance of the 2020B bonds. 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 $776 million (net) in GO bonds for rail.

The district has a modest capital lease for LED streetlighting of $37.3 million with annual lease payments of just over $4.0 million annually through 2029.

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 multiemployer 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 2019 were approximately $2.4 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 $4.8 billion through 2019, equal to a somewhat high 2.6 times operating revenues and 2.1% 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%. The city and county's 2018 contribution was below the "tread water" indicator, resulting in a tread water gap equal to 4.0% 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, 2019, the reported unfunded OPEB liability was $1.90 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 9.1% in 2020 and 7.9% in 2021, but moderating to 3%-3.4% annual increases from 2022 through 2030.

Environmental, social, and governance considerations: strong management and institutional framework; city and county working to address climate risks, affordable housing

Governance for the city and county is strong, with 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.

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.

As noted in the financial discussion above, the city and county's management team has delivered long-term structural balance, reflective of both the tools available to management as well as the decisions and actions undertaken by them.

Climate change is the primary environmental 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.

Honolulu faces similar social risks to other major Western US cities. 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. 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 sales price of single family home on Oahu is approximately $820,000. 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.

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

Honolulu (City & County of) HI

Rating Factors	Measure	Score
Economy/Tax Base (30%) [1]		
Tax Base Size: Full Value (in 000s)	$242,938,240	Aaa
Full Value Per Capita	$247,876	Aaa
Median Family Income (% of US Median)	131.8%	Aa
Notching Factors:[2]		
Institutional Presence		Up
Regional Economic Center		Up
Economic Concentration		Down
Finances (30%)		
Fund Balance as a % of Revenues	28.6%	Aa
5-Year Dollar Change in Fund Balance as % of Revenues	11.4%	Aa
Cash Balance as a % of Revenues	30.5%	Aaa
5-Year Dollar Change in Cash Balance as % of Revenues	15.0%	Aa
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	1.0x	A
Notching Factors:[2]		
State Oversight or Support		Up
Debt and Pensions (20%)		
Net Direct Debt / Full Value (%)	1.4%	Aa
Net Direct Debt / Operating Revenues (x)	1.9x	A
3-Year Average of Moody's Adjusted Net Pension Liability / Full Value (%)	1.9%	Aa
3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues (x)	2.6x	A
Notching Factors:[2]		
Unusual Risk Posed by Debt Structure		Down
Other		
Credit Event/Trend Not Yet Reflected in Existing Data Sets: 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.
[3] Standardized adjustments are outlined in the GO Methodology Scorecard Inputs publication.
Source: City and County of Honolulu, HI, US Census Bureau and Moody's Investors Service

REPORT NUMBER 1213712

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