

CREDIT OPINION

26 September 2016

New Issue

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Contacts

Dan Steed 415-274-1716
AVP-Analyst
 dan.steed@moodys.com

William Oh 415-274-1739
AVP-Analyst
 william.oh@moodys.com

City & County of Honolulu, HI

New Issue – Moody's assigns Aa1 rating to Honolulu, HI's GO Bonds 2016. Outlook is stable

Summary Rating Rationale

Moody's Investors Service has assigned a Aa1 rating to the City and County of Honolulu's General Obligation Bonds, Series 2016A (Tax-Exempt), 2016B (Tax-Exempt), 2016C (Tax-Exempt), Series 2016D (Taxable Green Bonds), Series 2016E (Taxable Green Bonds) to be issued in the aggregate amount of approximately \$584 million. At this time, Moody's also affirms the Aa1 rating on the city's approximately \$2.6 billion of outstanding general obligation bonds. The long-term ratings carry a stable outlook.

The city's Aa1 rating reflects a very large and growing property tax base, a strong and expanding economy supported by large private and public construction projects, growing tourism numbers and a significant, stable military presence. Financial operations benefit from a strong management team and prudent conservative budgeting policies. Operating reserve levels remain generally stable and comparable to similarly-rated large cities. Our review also takes into account the city's high budgetary burden from the combination of debt service, pension and employee and retiree healthcare costs.

Credit Strengths

- » Large economy with strong tourist appeal complemented by substantial military and government sectors
- » Prudent fiscal management demonstrated by conservative budgeting practices and recently improved reserve levels
- » Demonstrated willingness to raise revenues and reduce spending to achieve budget balance
- » Commitment to and progress toward reducing pension and OPEB liabilities, including plans to fund fully the OPEB ARC

Credit Challenges

- » High cost of living and vulnerability to shifts in tourism sector
- » High burden primarily from a combination of debt service, pension costs and retiree health care costs
- » Uncertainty surrounding timing of light rail construction completion, final construction costs and level of enterprise risk exposure to the city, especially during construction and ramp-up phases

Rating Outlook

Moody's outlook on Honolulu's long-term ratings is stable. The stable outlook reflects the city's improving economy and our expectation that the city will maintain solid reserve levels while continuing to make planned progress in funding its pension and OPEB liabilities and also challenges related to construction of the light rail.

Factors that Could Lead to an Upgrade

- » Increased local economic diversification and improvement in socioeconomic wealth indices
- » Significant improvement in funding OPEB and pension liabilities
- » Sustained financial and debt characteristics consistent with higher-rated entities
- » Greater certainty regarding rail costs and potential impact on City

Factors that Could Lead to a Downgrade

- » Economic weakening and prolonged declines in assessed valuation
- » Deterioration of financial operations and reserve levels
- » Inability to manage high fixed cost burden, or deterioration of pension funded ratios

Key Indicators

Honolulu (City & County of) HI	2011	2012	2013	2014	2015
Economy/Tax Base					
Total Full Value (\$000)	\$ 153,109,105	\$ 153,592,618	\$ 155,333,754	\$ 159,095,726	\$ 174,335,550
Full Value Per Capita	\$ 162,143	\$ 160,794	\$ 161,021	\$ 163,060	\$ 174,560
Median Family Income (% of US Median)	129.7%	131.0%	132.0%	131.2%	131.2%
Finances					
Operating Revenue (\$000)	\$ 1,152,137	\$ 998,594	\$ 1,013,901	\$ 1,039,124	\$ 1,140,483
Fund Balance as a % of Revenues	21.1%	25.0%	32.9%	29.7%	28.4%
Cash Balance as a % of Revenues	19.9%	22.7%	31.8%	21.7%	29.6%
Debt/Pensions					
Net Direct Debt (\$000)	\$ 1,963,793	\$ 1,996,901	\$ 2,166,413	\$ 2,061,593	\$ 2,315,729
Net Direct Debt / Operating Revenues (x)	1.7x	2.0x	2.1x	2.0x	2.0x
Net Direct Debt / Full Value (%)	1.3%	1.3%	1.4%	1.3%	1.3%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	N/A	2.0x	2.0x	2.2x	2.1x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	N/A	1.3%	1.3%	1.4%	1.3%

Source: Moody's Investors Service

Recent Developments

Recent developments are incorporated in the Detailed Rating Considerations below.

Detailed Rating Considerations

Economy and Tax Base

Honolulu's economy is strong and supported by a combination of record visitor volumes, numerous, large public and private construction projects and anchored by the military's significant, stable presence. The City/County (the "City") is coterminous with the island of Oahu and includes Waikiki beach and Pearl Harbor. The city is home to an estimated 998,714 residents (2015), or about 70% of the state's population with an area encompassing 597 square miles. According to Moody's Economy.com (August 2016), the record tourism activity and active construction industry has led to very little slack in the labor market. Indeed, at 3.1% (July 2016), the city's

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unemployment rate remains very low compared to the nation (5.1%). However, the Moody's Economy.com forecast for construction anticipates slower growth as the current construction boom is not sustainable. For now though, multiple projects are spurring non-residential building, including hotel demand from tourists, multimillion-dollar contracts with the Department of Defense, and the multi-billion dollar light rail project. Strong employment and income gains are expected to keep a floor under housing demand, despite affordability issues on the island.

Between 2012 and 2017, assessed valuation (AV) increased an average of 5.4% annually, including healthy growth of 7.7% (2016) and 6.3% (2017) in recent years; AV adjustments lag the market by 18 -24 months. The city's AV is very large at \$199.6 billion. Moody's notes Honolulu historically has not experienced much foreclosure activity given the relative rarity of sub-prime financing in Hawaii. The 2014 estimated median family income was a healthy 131% of national levels and the city's full value per capita is strong at \$199,884.

Real estate has been an important element of Honolulu's economic growth. Single family home prices increased 8.7% (YOY) as of January 2016. However, these rising prices add to the island's CPI growth and further weigh down affordability for residents.

A sizable military presence adds stability, and military housing construction has also contributed to expanding construction activity. Federal defense spending in Hawaii, dictated by the island's strategic geographic importance, plays a large part in the state's economy. Aside from the tourism and military sectors, Honolulu is also anchored by a significant public sector and health care, banking and agriculture to some degree add further diversity.

Total visitor arrivals reached another record in 2015 and has been increasing by about 3% annually each year since 2013. Tourism will drive growth in the short and medium term as the U.S. expansion matures and households take more vacations. We also believe, the local economy's susceptibility to shifts in tourism activity is partially mitigated by the large military presence and the military's increasing focus on the Pacific theater, as well as our expectation that visitor counts and above average hotel occupancy rates will remain stable.

HONOLULU RAIL CONSTRUCTION DELAYED AND OVER-BUDGET

The city, through the Honolulu Authority for Rapid Transportation (HART) continues construction of the new 20-mile mass transit system along Oahu's east-west corridor. An estimated 60% of the city's population lives within this corridor and the city projects that population growth within this area will outpace the balance of Oahu. To date, more than \$1.9 billion has been expended for planning and design, site acquisition and guideway and track construction. Construction of the light rail system is expected to be completed in 2024, compared to original estimates of a 2019 completion.

Costs related to construction of the system, which have increased from its original estimate of \$5.2 billion to over \$7 billion, are expected to be funded primarily with revenue generated by the 0.5% general excise and use tax surcharge (the surcharge) implemented by the city on January 1, 2007. The surcharge's original expiration was extended another five years and by the expiration date (2027) is projected to generate a total of \$5.3 billion. Additional funding is expected from a \$1.55 billion grant from the U.S. Department of Transportation, Federal Transit Administration under a full funding grant agreement (FFGA) dated December 2012. Cost increases have been a result of various factors including lawsuits in earlier years and rapid growth in construction prices.

As of June 2016, the city had received \$1.7 billion from the surcharge, net of administrative fees charged by the State, and \$806 million had been obligated by the Federal Transit Administration under the full-funding grant agreement dated December 19, 2012.

In anticipation of receiving future surcharge revenue and the balance of the federal grant, construction of the project is expected to be financed with a combination of general obligation commercial paper notes, bond anticipation notes, and general obligation bonds issued by the city. Notably, the city and HART have entered into a memorandum of understanding prior to any debt issuance that would entitle the city to reimbursement from HART for debt service and other costs associated with such obligations.

Given the current capital plan and scheduled expiration of the general excise and use tax surcharge in 2027, it is projected that the city would need to subsidize rail system operations with approximately \$80 million per year beginning in fiscal 2020 to offset operating costs not paid from passenger fares.

Going forward, we will monitor the likelihood and potential magnitude of the costs associated with the construction and operation of the rail on the city. Given the city's intent to provide contingent support for rail construction and operation, we will incorporate rail-

related debt into the city's debt profile to gauge the potential strain on the city's operations. We will also monitor the rail's need for financial support from the city; we would consider continued construction cost overruns, below average surcharge collections and/or operational subsidies above current projections as red flags. Finally we also monitor changes in public and political support and the willingness of the city to continue to provide contingent support.

Financial Operations and Reserves

The city is well managed and operating reserve levels provide the city sound operating flexibility. The city's fiscal 2015 available operating reserve increased slightly and was equal to a healthy 28.4% of revenue, which is in line with the fiscal 2015 Aa1-rated large local government median fund balance of 25.9%. The city's General Fund balance includes a Reserve for Fiscal Stability (RFS) Fund that was established back in fiscal 2010. Since 2012, the city has increased the RFS Fund annually and in fiscal 2015 the fund totaled 6.3% of general fund revenues (\$72 million). Operating funds include the city's General and Debt Service Fund, although all resources flow through the General Fund. In 2015, the city also adjusted the recently created 'Residential A' property tax rate as well as the property tax rate for hotels and resorts to offset an otherwise modest operating deficit and also boost property collections for that year by about 10%. General Fund resources are comprised primarily by property taxes which totaled 87% of General Fund revenues in fiscal 2015.

In fiscal 2016 the city maintained flat property tax rates for each of the eight property classifications which, when combined with solid AV growth, increased property tax collections by a healthy 8%. Although the total operating fund balance declined slightly due to various one-time needs, the city again increased the Reserve for Fiscal Stability to \$103 million (estimated/unaudited), equal to about 8%, which is at the high end of the city's targeted RFS Fund balance.

The city's zero-based budgeting approach balanced the 2017 budget after identifying another comparatively small budget gap. A combination of continued growth in tax collections and maintaining a relatively flat employee count and continuation of efficiency savings will result in stable financial metrics for the year and no draw down of reserves.

Despite the city's demonstrated ability to maintain healthy and stable reserve levels, the city's financial profile will continue to be challenged by high fixed obligations and likely operational subsidies in the out years from the city's rail system. In fiscal 2015, debt service, pension and OPEB costs represented about one-third of operating revenues. 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 has been an important factor in Moody's credit evaluation of Honolulu.

LIQUIDITY

The city's available liquidity is healthy with general fund cash equal to 29.6% of revenues in fiscal 2015. The city does not anticipate any material reductions to available cash.

Debt and Pensions

The city's debt position is average with a net direct debt burden of 1.6%, which is above the median for similarly-rated cities and counties nationally. 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 transportation, health, justice, and education. Including the current offering, the city has approximately \$2.87 billion of outstanding general obligation bonds; the city has no exposure to long-term variable rate debt or derivative instruments in its G.O. borrowing program. Approximately 61% of the city's general obligation debt is retired in ten years. The city has typically borrowed about \$250 million annually for its CIP, however, specific future borrowing amounts and timing are uncertain at this time.

DEBT STRUCTURE

The city has \$2.87 billion in general obligation bonds outstanding, post-sale, with the latest maturity in 2040. Total debt service is flat through 2018 before declining through final maturity. All of the city's debt is fixed rate.

DEBT-RELATED DERIVATIVES

The city has no variable rate debt and no debt-related derivatives.

PENSIONS AND OPEB

Honolulu has an average defined-benefit pension burden, based on unfunded liabilities for a multi-employer plan and for its Moody's-estimated share of a cost-sharing plan administered by the state. Reported unfunded liabilities in fiscal 2015 were approximately \$1.2 billion, or 63% funded.

Pension and OPEB budgetary pressures have been growing and will continue to constrain the city's financial flexibility going forward. However, we feel these costs are manageable and the city has multiple tools available to address these increased costs, including the legal flexibility to raise revenue or to trim other operating expenses. Net of reimbursements from the city's self-sufficient enterprises, the city's fiscal 2015 contribution was approximately \$117 million, or 10% of operating revenue. Fixed costs have gradually consumed a greater proportion of the city's budget and in fiscal 2015, pension contributions, debt service and PAYGO costs for OPEB benefits represented 32% of operating revenues.

Net of proportional 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 \$2.29 billion. In the three years through fiscal 2015, the ANPL has averaged a moderate 1.9 times annual operating revenue and 1.3% of full valuation. Moody's ANPL reflects certain adjustments we make to improve comparability of reported pension liabilities. The adjustments are not intended to replace Honolulu's reported liability information, but to improve comparability with other rated entities.

The city's OPEB liability is sizeable and remains a challenge. As of July 1, 2013 the unfunded OPEB liability was \$1.67 billion or 1.5 times fiscal 2015 operating revenues.

Importantly, in the 2013 legislative session, the state adopted a plan to require phasing in higher annual required contribution (ARC) payments by all counties and the state beginning in fiscal 2015. By fiscal 2019, the payments would reach 100% of the ARC. Honolulu began setting aside amounts to pre-fund its OPEB liability beginning in 2008, and is currently ahead of the required schedule and the 2017 operating budget reflects continued increases in payments which are estimated to equal 80% of its annual OPEB ARC.

Hawaii is the only state that has adopted a plan to fully fund its OPEB ARC payments. While the move is credit positive, it will substantially increase all local government's (including Honolulu) annual fixed costs relative to budget.

Management and Governance

Hawaii counties have an institutional framework score of Aa, or strong. Revenues, mainly property taxes and state distributed transient accommodations taxes, are highly predictable and counties have a strong ability to raise property tax revenues. However, state mandated benefits present a high exposure to the state budget and limits counties' expenditure flexibility which weakens the institutional rating somewhat.

Legal Security

The bonds are secured by an unlimited property tax pledge; debt service payments represent a first charge on the city's General Fund.

Use of Proceeds

The Series 2016A (\$86.6 million) and 2016B (\$37.2 million) bonds will finance various capital improvement needs. The 2016C (\$98.4 million) will refund previously issued general obligation bonds for debt service savings. The Series 2016D (\$6.6 million) and 2016E (\$354.8 million) will refund previously issued reimbursable general obligation bonds that financed or refinanced capital needs for the City's H-Power waste disposal facility.

Obligor Profile

Honolulu, the capital and principal city of the State of Hawaii was incorporated in 1907 and is coterminous with the island of Oahu. The City and County of Honolulu has an area of 597 square miles and includes the entire island of Oahu.

Methodology

The principal methodology used in this rating was US Local Government General Obligation Debt published in January 2014. Please see the Ratings Methodologies page on www.moodys.com for a copy of this methodology.

Ratings

Exhibit 2

Honolulu (City & County of) HI

Issue	Rating
General Obligation Bonds Series 2016A (Tax Exempt)	Aa1
Rating Type	Underlying LT
Sale Amount	\$86,605,000
Expected Sale Date	10/05/2016
Rating Description	General Obligation
General Obligation Bonds Series 2016B (Tax Exempt)	Aa1
Rating Type	Underlying LT
Sale Amount	\$37,240,000
Expected Sale Date	10/05/2016
Rating Description	General Obligation
General Obligation Bonds Series 2016C (Tax Exempt)	Aa1
Rating Type	Underlying LT
Sale Amount	\$98,435,000
Expected Sale Date	10/05/2016
Rating Description	General Obligation
General Obligation Bonds Series 2016D (Taxable Green Bonds)	Aa1
Rating Type	Underlying LT
Sale Amount	\$6,600,000
Expected Sale Date	10/05/2016
Rating Description	General Obligation
General Obligation Bonds Series 2016E (Taxable Green Bonds)	Aa1
Rating Type	Underlying LT
Sale Amount	\$354,845,000
Expected Sale Date	10/05/2016
Rating Description	General Obligation

Source: Moody's Investors Service

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REPORT NUMBER 1043226

Contacts

Dan Steed
AVP-Analyst
dan.steed@moodys.com

415-274-1716

William Oh
AVP-Analyst
william.oh@moodys.com

415-274-1739

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454