S&P Global
Ratings

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Summary:

Hawaii
Hawaii Harbor Division; Ports/Port Authorities

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Summary:

Hawaii
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Credit Profile		
Hawaii		
Hawaii Harbor Div, Hawaii		
Hawaii (Hawaii Harbor Division)		
Long Term Rating	AA-/Stable	Upgraded
Hawaii (Hawaii Harbor Div)		
Unenhanced Rating	AA-(SPUR)/Stable	Upgraded

Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings raised its long-term rating and underlying rating (SPUR) to 'AA-' from 'A+' on Hawaii's harbor system revenue bonds issued for Hawaii Harbor Division. The outlook is stable.

The rating action reflects our view of the harbor division's historical willingness to make ample tariff increases to support rising operating costs, debt service, and capital needs, and the division's maintenance of very strong coverage and exceptional liquidity in recent years. We also note the division recent formalized its liquidity policy, which requires it to maintain no less than 1,000 days (2.74 years) of operating cash. Despite a large capital plan, management projects that recent and pending approved tariff increases will continue to support very strong debt service coverage (DSC).

The rating also reflects our view of the harbor division's:

- Monopolistic position as Hawaii's sole provider of maritime facilities and services;
- Dominant business position and importance to Hawaii's economy, as approximately 80% of the total volume of goods consumed in Hawaii is imported and roughly 98% is processed through the system;
- Recent and frequent tariff increases that have allowed for consistently strong debt service coverage given rising costs, with incremental revenue providing key funding support for the harbor division's capital improvement program (CIP), and recently approved larger tariff increases of 15% to 17% for fiscal years 2017 to 2019 that will also support growing debt service requirements;
- Exceptional liquidity position, with $236 million in unrestricted cash, equal to almost five years of operating expenses, as of audited fiscal 2016; and
- Strong all-in DSC in audited fiscal 2016 of 2.42x that includes both revenue bond debt and the system's share of state-issued general obligation (GO) bonds, projected at a range of 2.2x to 2.8x for fiscal years 2017 to 2020.

Partly offsetting the above strengths, in our view, are the system's significant capital needs to address the large port system's expansion and maintenance requirements, with debt service projected to increase 18% in fiscal 2018 and 20% in fiscal 2019. We understand that the capital plan is prioritized and that projects will be undertaken as funding

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becomes available. Management also reports that it plans to spend down about $60 million of its cash balance in the next 18 months, although cash balances should nevertheless remain extremely strong at more than two years' of operating expenses.

A senior lien on the system's net revenue secures the bonds, which are 100% fixed rate. In addition to the revenue-secured bonds, the division is obligated to pay from revenue on a subordinated basis annual debt service associated with approximately $27.4 million in reimbursable state GO bonds outstanding as of June 30, 2016, the proceeds of which it used to finance harbor and waterfront improvements.

The division entered into four direct purchase transactions (private placements) in 2016, two with Banc of America Preferred Funding Corp. and two with Bank of America N.A. The purpose was to refinance various debt outstanding. Based on our evaluation of the transaction documents, we view the direct purchases as not adding significant financial risk to either bondholders or the system itself.

The division oversees a system of 10 harbors on six islands throughout the state and is a landlord port operator with terminal operators directly hiring stevedoring firms. Unlike other large landlord container ports, the division is more exposed to revenue swings associated with volume fluctuations, with containers alone accounting for about 70% of fiscal 2016 operating revenue, consistent with previous years. The two harbor facilities supporting the most populous island, Oahu, are responsible for about 78% of operating revenue. Honolulu Harbor, the system's largest, was the 13th-largest port in North America by 20-foot equivalent units (TEUs) in 2015 (1.21 million), accounts for approximately 54% of system tonnage, and operates as the trans-shipment hub for cargo to all islands but Oahu from the U.S. mainland. It has a main harbor basin with a depth of 40 feet, 5 linear miles of berthing space, 27 acres of covered storage, and more than 200 acres of cargo handling area. The federal government and private companies own some facilities, and the state owns the majority of the land although both the U.S. Coast Guard and Chevron Corp. have significant holdings.

Cargo volume tonnage has grown steadily since 2010. Cargo volume in short tons rose 6% in fiscal 2011, 1% in fiscal 2012, 4% in fiscal 2013, 3% in fiscal 2014, and 2% both in fiscal years 2015 and 2016 to 21,309 short tons. Cargo volume experienced a significant decline in the recent recession, declining 2% in 2008, 13% in 2009, and 3% in 2010 to 17,706 short tons. For container volume alone, growth has also been good since the 2008-2010 recession, with TEUs increasing 6% in 2011, declining 3% in 2012, and increasing 3% in 2013 and 7% in 2014 and 2015 to 1.506 million TEUs, eclipsing the previous peak of 1.5 million TEUs in 2007. Container volume was virtually flat in fiscal 2016, growing only slightly to 1.511 million TEUs. The number of cruise passengers declined by a significant 19% in 2008 and 43% in 2009 to 1.15 million passengers, and has declined gradually since, although cruise passengers represent a small 7% of total operating revenue (and were just 11% in 2007).

The port system is extremely important to Hawaii, as the state imports 80% of its required goods, 98% of those goods by water. We view the division's monopolistic position and essential role as fundamental credit strengths. But despite the harbor division's near-monopoly (private operators largely handle oil), operating performance reflects statewide economic trends. Hawaii's harbor system was not alone in the port sector when it experienced large declines in operating performance measures (e.g., tonnage, ship calls, and cruise passengers) as a result of the recent recession. Its revenue declined (13% in 2009) and its financial metrics eroded (all-in DSC fell to 1.2x in 2009 from 1.7x in 2008), but

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fairly large and frequent tariff increases in fiscal years 2011 through 2017 as well as improved economic activity have resulted in improved revenue, coverage, and operating performance. We take a positive view of management's actions to adjust tariffs to compensate for volume declines and finance needed capital improvements.

Management began implementing tariff increases effective March 1, 2010. (The most recent prior increase was 25% in 1997.) The higher tariffs support new debt associated with the capital program and have bolstered financial performance. The rate structure simplifies and equalizes rates of some cargo types, with intra-island cargo still charged lower tariffs and with empty containers charged no fee. Most important, in our opinion, cargo rates have increased annually, by 20% in fiscal 2011, 15% in fiscal 2012, 10% in fiscal 2013, 7% in fiscal 2014, 5% in fiscal 2015, and the higher of 3% or a Consumer Price Index escalator thereafter through fiscal 2017. The state has approved even higher tariff increases ranging from 15% to 17% for fiscal years 2017 to 2019, with the first increase, of 17%, effective Feb. 1, 2017. These tariff increases had strong support from the harbor's primary users and are designed to support the harbor's large CIP and resulting growth in debt service. Cruise passenger fees increased to $5 per person beginning in 2012 and have increased 50 cents per year through 2017.

As a result of the tariff increases and steady growth in volume, total operating revenue grew by a very strong 17% to $86 million in fiscal 2011, and by an even stronger 21% in fiscal 2012 to $104 million. In fiscal years 2013 to 2016, revenue increased 2% to 8% each year, including 6% in fiscal 2016, to a total of $130 million. Projected results indicate operating revenue growth of 8% for fiscal 2017, with projected increases of 21% in fiscal 2018 and 14% in fiscal 2019 mostly as a result of the aforementioned tariff increases, but also as a result of some growth.

Revenue-bond-only (excluding subordinate-lien state GO debt service requirements) DSC excluding eligible fund balances was strong in fiscal 2016, in our view, at 2.7x, up from 1.3x to 2.5x in fiscal years 2009 to 2015. Projections on revenue bond coverage indicate 2.4x DSC in fiscal 2017. DSC of revenue-bond-only debt including eligible fund balances was also strong in fiscal 2016, in our view, at 3.2x, up from 1.9x to 3.0x in fiscal years 2009 to 2015, with a projection of 2.9x DSC in fiscal 2017. We calculate all-in DSC including reimbursable state GO debt service at 2.4x in fiscal 2016, up from 2.1x in fiscal 2014 and a low of 1.2x in fiscal 2009. Management forecasts that debt service requirements will increase 18% in fiscal 2018 and 20% in fiscal 2019 as a result of additional bond issuance to fund capital projects. But given pending and future tariff increases, the added leverage will not reduce DSC metrics. S&P Global Ratings' forecast all-in DSC including reimbursable GO debt ranges from 2.2x to 2.8x during fiscal years 2017 to 2020.

Unrestricted cash and investments increased to $236 million, or 1,780 days' operating cash (almost five years' worth), which we consider exceptionally strong, in fiscal 2016. Management estimates that unrestricted cash will be spent down by about $60 million by fiscal 2018 to $175 million, or a still very strong 2.5 years of operating expenses. The port recently established a reserve policy requiring the maintenance of at least 1,000 days (2.74 years) of unrestricted cash balances. The port has maintained no less than two years' operating cash since at least 2007.

In our view, the division's capital plan is large and could pressure debt levels (and possibly liquidity) in the medium term, but management operates the system with a prudent approach toward fiscal and capital issues. The division's five-year CIP totals $568 million, the largest project of which is the first, $248 million phase of a container terminal facility, known as Kapalama Container Terminal (KCT), at Kapalama military reservation in Honolulu Harbor. The

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harbor division is integrating the container handling needs of two of its leading 10 customers, Young Brothers Ltd. and Pasha Hawaii Transport Lines LLC, in a phased approach to the development of KCT. The harbors division estimates a bond issuance, refunding, and use of cash to support the first phase, and $250 million in bonds may be sold in 2018 with the potential for an additional bond sale in 2019 or 2020. The harbor division is reprioritizing its capital plan to take into account the latest master plans, development plans, and customer needs. Management expects that the various modernization projects will enhance the harbor division's efficiency and future capacity, and reports that it will take a disciplined approach with the phasing of projects to ensure the system has the capacity for the required debt. Although the system's expansive and essential nature provides for a strong business position, it also requires significant investment in facilities that individually sometimes lack the commercial activity to fully support capital and operational costs.

In our opinion, Hawaii's economy is very closely tied to traffic at the system's ports, more so than for many other port credits, because of its location more than 2,000 miles from the nearest continent. It imports much of what it needs to support 1.4 million residents and 8.6 million annual visitors, so the state economy directly affects port volumes and overall financial performance. As the state continues to rebound from the recent recession, several positive trends are emerging and some economic metrics indicate that the state was relatively more resilient than the national economy during the recession. Since 2003, Hawaii's unemployment rate has generally been 2% to 3% below the national rate. The state's unemployment rate was just 2.9% in November 2016, the fourth-lowest rate in the U.S. and the state's lowest rate in eight years. The value of building permits in 2015 reached the levels achieved in 2006, but in 2016 permit values declined by more than $100 million, or about 33%.

Where Hawaii's economy historically has been most affected is tourism, an industry that weakened during the recent recession as a result of reduced consumer spending, job losses, seismic and tsunami events in Japan, and competitive marketing campaigns from multiple tourism destinations (e.g., Las Vegas). However, visitor arrivals, visitor spending, and revenue per available room (RevPAR) have all grown in 2010 through 2015. Visitor arrivals declined 10.9% in 2008 (versus 12.2% for the U.S.) and 4.5% in 2009 to 6.5 million, but increased in 2010 through 2015 to 8.6 million. Visitor expenditures fell to $10 billion in 2009 but rose to $15.11 billion in 2015, and were up 4% through the first 11 months of 2016. RevPAR declined to $115 in 2009 but grew to $192 in 2015. The state's economy continues to diversify through 2015, with more than 80% of economic activity in nontourism sectors. In addition to the ongoing diversification of the state economy away from tourism-based industries, the state has experienced growing diversity within its tourism base. We note that despite these positive trends, the port's revenue remains vulnerable to economic cycles that affect the state's key economic drivers, including tourism.

Outlook

The stable outlook reflects our anticipation that the capital program will not pressure the cost structure significantly more than forecast by management, that liquidity may decline but remain at levels we consider very strong, that DSC will remain near current levels, and that volume will not significantly deteriorate.

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Upside scenario

We do not anticipate raising the rating during the next two years given the system's sizable CIP and plans to issue debt, but also given the division's historical moderate vulnerability to volume swings during economic downturns.

Downside scenario

Given the system's robust cash position and improving volumes, as well as the state's positive economic trends and upcoming tariff increase, we are unlikely to lower the rating during the next two years. But if capital needs grow significantly and affect DSC ratios or liquidity materially, we could lower the rating.

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