

FITCH UPGRADES HAWAII DOT'S HARBOR SYSTEM REVS TO 'AA-'; OUTLOOK REVISED TO STABLE

Fitch Ratings-New York-14 February 2018: Fitch Ratings has upgraded the rating on Hawaii Department of Transportation's (HI) \$165.8 million of harbor system revenue bonds Series 2010 A and 2010 B to 'AA-' from 'A+'. The Outlook is revised to Stable from Positive.

The upgrade reflects the harbor system's continued strong financial performance in terms of coverage, liquidity, and leverage. Favorable metrics are driven by positive operational activities and enacted tariff adjustments, providing cash funding for the multi-year capital program in addition to anticipated additional borrowings.

KEY RATING DRIVERS

The rating reflects the harbor system's natural monopoly position serving the islands of Hawaii. The system benefits from stable volume growth since 2011 along with implemented multi-year tariff rate increases that provide revenue stability. Despite a sizeable capital plan that calls for additional borrowing, the harbor system is expected to maintain its historically robust financial profile with strong coverage, relatively low leverage, and high liquidity providing over 1,000 days cash on hand (DCOH). Recent coverage levels have been above 3.0x while leverage has been trending downward to below 1.0x.

Stable Volume Supported by Natural Monopoly - Revenue Risk (Volume): Stronger
Port volumes are rising and are also anchored by the essentiality of the port to the state's economy. The port system provides essential maritime services and serves a state without an efficient alternative means of transporting goods to and throughout it. This partially mitigates the system's exposure to fluctuations in the tourism industry.

Scheduled Tariff Increases - Revenue Risk (Price): Midrange
The harbor system has a history of adopted scheduled tariff increases for cruise, cargo, and pipelines. Recent increases included a mechanism to increase cargo tariffs annually by the greater of 3% or CPI from 2015 onwards. Greater escalations were implemented in fiscal 2017 (17% increase in cargo tariffs) and continue with 15% increases in cargo tariffs in both fiscal 2018 and 2019. No material elasticity to port demand has been observed in response to historical tariff adjustments.

Considerable Capital Plan - Infrastructure Development and Renewal: Midrange
The five-year capital improvements program (CIP) of \$568 million, with \$471 remaining from 2018-2021, focuses largely on the Harbors Modernization Plan and consists of various projects to enhance the system's efficiency and capacity by addressing long-term capital needs. While management is focused on cash funding an increasing share of the projects, the plan is expected to necessitate additional leverage, with \$250 million in revenue bonds anticipated in early calendar year 2019.

Conservative Debt Structure - Debt Structure: Stronger
The harbor system has relatively low leverage consisting of all fixed-rate bonds with a rapid amortization schedule on existing debt, somewhat mitigating the limited protection provided by the 1.25x rate covenant and additional bonds test (1.0x excluding contingency account and other allowable funds). With the additional borrowing of \$250 million, annual debt service is expected to step up beginning in 2019.

Financial Profile

The harbor system benefits from stable operating margins with a sizable liquidity cushion of approximately 1,320 DCOH in 2017. While balances may vary with spending for the CIP, management targets maintaining at least 1,000 DCOH. Coverage has been relatively strong at over 2.0x historically (3.2x in fiscal 2017), and is expected to remain at or above these levels through the forecast period. All-in leverage is expected to remain in the 1x-3x range in the next five years when incorporating additional borrowing for the CIP.

PEER GROUP

San Diego Unified Port District (A+/Stable) serves as a comparable peer to the harbor system. The district has a strong total debt service coverage ratio (DSCR) of 4.9x and a cash position greater than its net debt for fiscal 2016. The Hawaii Harbor System has similar strong metrics with a DSCR of 3.2x and low leverage of 0.9x. Hawaii and San Diego both have solid demand and utilization, along with consistently favorable metrics on total obligations. However, Hawaii Harbor System has greater passenger and cargo levels than San Diego, and also has less revenue risk given its essentiality in serving island populations.

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action:

- Increased volatility in throughput volumes that result in coverage sustained below 2.0x.
- Leverage that increases to and is maintained above 5.0x net debt to CFADS.

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action:

- Given the current rating level and the ongoing capital program with additional borrowings expected, further upward rating migration is unlikely.

CREDIT UPDATE

Performance Update

Overall cargo volumes (measured in short tons) decreased in fiscal 2017 by 2.2% with 20.8 million tons of cargo moving through the Hawaii ports. Despite this decrease, the system's cargo volumes have surpassed pre-recession levels, growing at a five-year CAGR of 1.8%. The throughput recovery since 2012 reflects the rebound of tourism activity in Hawaii.

The fiscal 2017 decrease in cargo volumes is offset by annual tariff rate increases as wharfage revenue from cargo movements increased approximately 7.5%. The harbor system's tariff schedule includes annual tariff rate increases of 17%, 15%, and 15% from fiscal 2017 through fiscal 2019 for cargo and pipeline tariffs. Passenger tariffs also increased \$0.50 to \$7.50 in fiscal 2017. In addition, the Harbors Division conducted public hearings pertaining primarily to increasing Port Entry Fees and Dockage Fees in effect as of July 1, 2018 (fiscal 2019). These fee increases of 20% (fiscal 2020), 15% (fiscal 2021) and 15% (fiscal 2022), if approved, will occur annually and commence on July 1, 2019.

Total operating revenues for the harbor system increased 5.8% in fiscal 2017, reflecting the harbor system's two increases in tariff rates during the year. In fiscal 2017, there was one increase of 3% on July 1, 2016 and another increase of 17% on Feb. 1, 2017. Service revenues, which account for 82% of operating revenues, increased by 6.8% due to tariff rate and embark and debark fee increases in addition to passenger growth. Meanwhile, rental revenues (17% of total operating revenues) decreased approximately 1.7% due to a settlement of a tenant dispute.

Debt service coverage in fiscal 2017 was robust at 3.2x, and higher than Fitch's prior year base case forecast of 2.9x. The stronger DSCR in comparison to expectations is attributed to the two tariff rate increases of 3% and 17% that took place in fiscal 2017 in addition to lower than expected expenses, which were 13.7% below the forecast. Going forward, Fitch expects more normalized increases in the system's operating expense profile as harbor operations return to pre-recession levels and labor costs covered under collective bargaining agreements drive future operating costs. The system has strong liquidity with more than 1,320 DCOH in fiscal 2017, and management intends to maintain at least 1,000 DCOH going forward.

Fitch Cases

Fitch's base case reflects the harbor system's forecast through 2021, which includes scheduled tariff increases and the proposed dockage entry fee increases. Thereafter, revenues experience moderate growth of 3.0% per year and expenses grow at 3.5% per year. The base case scenario also considers the harbor system's anticipated borrowing of \$250 million in late fiscal 2019, reflected in increased debt service payments commencing fiscal 2019 and increased debt outstanding. Under this scenario, total operating revenues net of tariff increases average 1.1% growth through 2023. Debt service coverage ratios (DSCRs) average 3.0x, with a minimum of 2.6x in 2020. Leverage levels average 1.8x through the forecast period, with a maximum of 2.5x in 2019 and falling to 1.5x by 2023.

Fitch's rating case considers a scenario of combined throughput reduction resulting in greater sustained revenue stress and operating expense increases throughout the forecast period. The rating case also includes the anticipated borrowing of \$250 million in fiscal 2019. Total growth in operating revenues net of tariff increases averages -1.2% through 2023. Under this scenario, DSCRs average 2.6x with a minimum of 2.2x in 2020. Leverage levels are expected to initially increase to approximately 2.8x in fiscal 2019, but should fall to below 2.0x by 2023, averaging 2.1x.

ASSET DESCRIPTION

The State of Hawaii Department of Transportation harbors division consists of 10 commercial harbors on six islands, with Honolulu serving as the state's principal port and trans-shipment station for cargo that is bound for the other islands. As a monopoly, the harbor system benefits from the lack of alternative means of transporting cargo to and throughout the state, as well as the state's limited commodity and manufacturing base, which results in an inelastic demand for imported goods.

SECURITY

The revenue bonds are special limited obligations of the state of Hawaii, payable from and secured solely by net revenue generated by the harbor system.

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Applicable Criteria

Ports Rating Criteria (pub. 02 Oct 2017)

<https://www.fitchratings.com/site/re/904491>

Rating Criteria for Infrastructure and Project Finance (pub. 24 Aug 2017)

<https://www.fitchratings.com/site/re/902689>

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