

**New Issue: MOODY'S ASSIGNS A2 LONG-TERM AND UNDERLYING RATINGS TO CATHOLIC HEALTHCARE WEST'S (CA) SERIES 2011 BONDS; A2 PARITY RATINGS AFFIRMED; OUTLOOK REVISED TO NEGATIVE FROM STABLE**

Global Credit Research - 21 Oct 2011

**RATING ACTION AFFECTS APPROXIMATELY \$4.6 BILLION OF PROFORMA DEBT**

California Health Facilities Fin.Auth  
Health Care-Hospital  
CA

**Moody's Rating**

<b>ISSUE</b>	<b>RATING</b>
2011 Series A (CA) Fixed Rate Revenue Bonds	A2
<b>Sale Amount</b> \$349,890,000	
<b>Expected Sale Date</b> 10/27/11	
<b>Rating Description</b> Healthcare Revenue Bonds	
2011 Series B (AZ) Fixed Rate Revenue Bonds	A2 <sup>1</sup>
<b>Sale Amount</b> \$126,130,000	
<b>Expected Sale Date</b> 10/27/11	
<b>Rating Description</b> Healthcare Revenue Bonds	
2011 Series B and C (CA) Variable Rate Demand Bonds	A2 <sup>1</sup>
<b>Sale Amount</b> \$150,000,000	
<b>Expected Sale Date</b> 11/08/11	
<b>Rating Description</b> Healthcare Revenue Bonds	

<sup>1</sup> Two series of variable rate bonds are expected to be supported by irrevocable direct pay letters of credit (LOC) from Bank of Montreal; enhanced short-term and long-term ratings reflecting these LOCs will be assigned separately

**Moody's Outlook Negative**

**Opinion**

NEW YORK, Oct 21, 2011 -- Moody's Investors Service has assigned A2 long-term and underlying ratings to Catholic Healthcare West's (CHW) Series 2011 revenue bonds. The 2011 Series A, Series B, and Series C (CA) bonds will be issued by the California Health Facilities Financing Authority; the 2011 Series B (AZ) bonds will be issued by the Arizona Health Facilities Authority. The 2011 Series B and Series C (CA) bonds are variable rate demand obligations and are expected to be supported by a five-year, irrevocable direct pay letter of credit (LOC) from the Bank of Montreal for each series of bonds. Enhanced long-term and short term ratings reflecting the letter of credit will be published separately. The series 2011 bonds altogether will increase CHW's total debt by approximately \$350 million. At this time, we are also affirming the A2 long term and underlying ratings on CHW's outstanding parity debt. The outlook has been revised to negative from stable.

**SUMMARY RATING RATIONALE:** The affirmation of the A2 rating reflects CHW's good balance sheet position, its acceptable debt coverage measures, and its core strategic strength as a large, multistate health system operating 40 hospitals, producing nearly \$10 billion in annual revenues, and generating over 412,000 of total inpatient admissions. The revision of the outlook to negative from stable reflects a second year of deteriorating operating performance and poor core operating results in FY 2011. (Moody's base calculations for CHW's FY 2011 operating income exclude \$199 million relating to the California State provider fee, and an additional \$203 million relating to other items; see below for additional information). Although operating cashflow declined by approximately 43% from FY 2009 to FY 2011, a downgrade is precluded at this time due in part to CHW's improved balance sheet position, and the receipt of significant funding under the California State provider fee program. Failure to improve the organization's core operating performance would likely result in a downgrade.

**STRENGTHS**

\*Large multistate system with 40 hospitals in three states organized into 10 service areas; revenues are nearing \$10 billion; total inpatient admissions are in excess of 412,000

\*Improved liquidity from prior years, with cash on hand improving to 177 days at fiscal year end (FYE) 2011 from a recent low of 149 days at FYE 2009

\*Passage and approval of the provider fee in the state of California provides significant additional support; net receipts improves FY 2011

operating income (inclusive of 21 months of net reimbursement) by approximately \$199 million (not included in our base calculations); a 6 month extension of the program through June 2011 (awaiting final CMS approval) would provide an additional \$98 million to CHW; a further 30-month extension of the program through December 2013 is also awaiting CMS approval and would provide an estimated \$435 million to \$495 million total of additional net proceeds to CHW; CMS' decision regarding the 30-month extension is likely a year away

\*Stable management team with proven track record of being able to deliver significant operating improvements

\*Decision to divest from two ailing hospitals provides immediate relief to operations

#### CHALLENGES

\*Second year of operating pressures due in part to high unemployment and poor economic conditions in a number of CHW's largest regions; several of CHW's operating regions did worse in FY2011 than the prior year; overall, operating income dropped to a loss of \$205 million (-2.1% margin) in FY 2011 from an already relatively weak \$38.4 million (0.4% margin) in FY 2010; operating cashflow dropped to \$456 million (4.6% margin) from \$683 million (7.3% margin) over the same time period; (results exclude the California provider fee and adjust for a number items, discussed in more detail below)

\*Higher-than-average leverage position (inclusive of the additional debt) with 8.2 times proforma debt-to-cashflow and a moderate 3.0 times (Moody's adjusted) proforma peak debt service coverage

\*Improved though still significant indirect debt levels; pension liability at FYE 2011 was equal to \$758 million (which represents an improvement of the PBO funded level to 75% from 61% at FYE 2010); total non-cancelable operating leases (calculated at six times current lease expense) are equal to another \$653 million in debt

\*Challenges in managing labor costs with approximately 59% of the system's workforce unionized; annual wage increases exceed national averages; major negotiations with both of the organization's top unions are scheduled to take place over the next two years, one of which is commencing imminently

\*Competition in most major markets from large and financially solid healthcare systems

#### DETAILED CREDIT DISCUSSION

**USE OF PROCEEDS:** Proceeds of the Series 2011 bonds will: 1) refund a total of \$285.6 million of outstanding bonds (including the Series 1993A (CA) bonds, the Series 1996E (CA) bonds, the Series 1997A (CA) bonds, the Series 1998A (CA) bonds, and taxable put bonds issued earlier this year); and 2) contribute approximately \$350 million towards various capital projects.

**LEGAL SECURITY:** Bonds are a joint and several obligation of the CHW Obligated Group (which represents 99% of CHW consolidated revenues) and is backed by a pledge of gross revenues. The MTI contains adequate rate covenant and additional indebtedness tests. CHW must maintain certain debt and liquidity covenants required by the insurers and banks.

**INTEREST RATE DERIVATIVES:** CHW is counterparty to sixteen LIBOR-based, fixed payer swap contacts, with a total current notional amount of approximately \$941 million. CHW recently expanded its number of counterparties, which now includes Deutsche Bank in addition to Citibank and JPMorgan. CHW's swaps do not have collateral posting requirements.

**MARKET POSITION/COMPETITIVE STRATEGY:** MOST OF SYSTEMS HOSPITALS OPERATE IN COMPETITIVE MARKETS; ECONOMIC CHALLENGES ARE AFFECTING MOST REGIONS

CHW operates 40 hospitals in California, Arizona, and Nevada organized into 10 service areas. Moody's considers a core credit strength of CHW to be the size and relative diversification of the organization, which produced revenues nearing \$10 billion excluding provider fee revenue and other items, and generated inpatient admissions in excess of 412,000. The organization has historically had a strong service mission, and among Moody's portfolio of 16 large multi-state systems, CHW has the highest exposure to Medicaid, at 21%.

Many of CHW's markets are experiencing economic stress, which has had an impact on financial performance organization wide in each of the last two years. Most of CHW's hospitals operate in competitive markets and compete against large not-for-profit and for-profit healthcare systems, several of which have been significantly investing in their facilities over the last several years. CHW's strategies include investing in existing markets to enhance key service lines, adding capacity to capture growth, and more closely aligning with physicians through various models. CHW is also investing in ambulatory services, either directly or through joint ventures. The organization is growth oriented, and may expand into contiguous markets.

CHW recently announced the intended sale of one of its most ailing hospitals (Saint Mary's in Reno, Nevada) to a for-profit health system, and it has disclosed that it is seeking a partner for Saint Mary's in Long Beach, which has also had a history of challenged operating performance. From a credit perspective, we view management's willingness to make decisions which improve core operating measures as a significant positive. In line with this goal, management recently restructured the organization around ten different geographical markets in order to increase regional responsiveness and improve profitability. The senior management team is seasoned and stable, and has a history of executing significant operational improvements, which is an important strength in the current environment.

After a prolonged period of elevated capital spending (which average 2.1 times depreciation from 2005 to 2009), CHW more recently has reduced capital spending in order to preserve liquidity and strengthen the organization's balance sheet. Capital spending dropped to 1.2 times depreciation in 2010, and increased just slightly to 1.4 times depreciation in 2011. We view positively management's ability to respond quickly to market realities and to curb spending in order to achieve certain balance sheet objectives. CHW's largest capital project currently is to improve its electronic medical record system organization wide. Management has committed to a capital expenditure level that approximates operating cashflow (unadjusted) to maintain its financial profile.

**OPERATING PERFORMANCE:** SECOND YEAR OF OPERATING CHALLENGES UNDERMINES CORE PERFORMANCE MEASURES; CALIFORNIA STATE PROVIDER FEE MONIES HELP FILL GAP

FY 2011 represented a second year of significant operating challenges for CHW, and poor fundamental operating results are a primary driver of the negative outlook. Excluding \$199 million related to the California state provider fee program and adjusting for certain one-time and non-cash

items, operating income dropped to a loss of \$205 million (-2.1% margin) in FY 2011 from an already relatively weak \$38.5 million (0.4% margin) in FY 2010. Operating cashflow dropped to \$456 million (4.6% margin) from \$683 million (7.3% margin) over the same time period. Overall, operating cashflow dropped 43% over the last two years after reaching a peak of \$807 million in 2009. (Moody's adjustments include: exclusion of the change of the mark-to-market on swaps from interest expense (which in 2011 reduced reported interest expense by \$40.9 million); inclusion of CAPI in interest expense (\$20.2 million in 2011); exclusion of investment income related to the system's interest in Scripps (\$31 million in 2011) and reclassification of operating revenue related to Scripps to non-operating income (\$48.7 million in 2011); exclusion of income relating to a non-cash one-time gain resulting from the transfer of services to Phoenix Children's Hospital in 2011 (\$47.3 million); and the reclassification of contributions to non-operating income).

The poor core operating results in 2011 are due to a number of factors. Overall, CHW's exposure to Medicaid increased to 21%, from 20% in 2010 and 19% in 2009. More significantly, bad debt expense increased another 14% in 2011, after increasing by 9.5% in 2010, increasing to \$848.9 million, from \$680.6 million in 2009. Volumes continued to be weak, with inpatient admissions dropping overall for the first time in recent history (to 412,480 from 413,548). Operating pressures were experienced across the system, and several regions experienced a decline in operating income.

Passage and approval of the provider fee in the state of California provides CHW with significant additional support. Net receipts in FY 2011 improved operating income (inclusive of 21 months of net reimbursement) by approximately \$199 million (which is not included in our base calculations). Inclusion of the full 21 month results in FY 2011 operating income improves the operating margin to -0.1%, the operating cashflow margin to 6.3%, and maximum annual debt service coverage to 3.7%. A 6 month extension of the program through June 2011 has been approved by the California State legislature and is nearing final approval by CMS. This would provide CHW with an additional \$98 million. A further 30-month extension of the program through December 2013 has also been approved by the California State legislature, and is also awaiting CMS approval, which is likely up to a year away. The 30-month extension would provide an estimated \$435 million to \$495 million total of additional net proceeds to CHW over the full time horizon. We believe the provider fee is an important bulwark against CHW's current operating challenges.

Looking forward, CHW faces a number of additional challenges, including two major union contract negotiations over the next two years (one of which is commencing; 59% of the system's workforce is unionized) and uncertainty around Medicaid (California state is currently implementing a new payment system for MediCal; Arizona state has announced cuts to its state Medicaid program, which could result in significant reductions for CHW). Management has articulated a number of operational improvement measures, a number of which began to be implemented over a year ago. We note that much of current senior management was in place approximately 10-years ago at the time when the organization underwent a significant and fundamental operational turn around. This experience is extremely valuable in light of the scope of current challenges.

**BALANCE SHEET POSITION: POSITIVE INVESTMENT RETURNS AND CALIFORNIA STATE PROVIDER FEE MONIES HELP BOLSTER CASH POSITION; LEVERAGE MEASURES REMAIN RELATIVELY MODEST**

CHW's unrestricted investments further improved in FY 2011, with cash on hand improving to 177 days at FYE 2011, from 166 days at FYE 2010 and from 150 days at FYE 2009. The increase in cash was the result of positive investment performance, continued moderation in capital spending, and the receipt of significant monies from the California State provider fee program. The system has recently somewhat changed its asset allocation (inclusive of operating cash and long term investments), from 60% cash and fixed income (and 40% equities and alternatives); to 50% cash and fixed income (and 50% equities and alternatives). Also, the allocation of cash and fixed income has moved starkly away from cash, and more towards fixed income, reflecting the gradual redeployment of the high cash position that CHW had built during the financial crisis. CHW's investments are highly liquid, with 91% of investments available within 30 days.

The series 2011 bonds will increase CHW's debt load by approximately 8.5%. CHW's debt measures remain relatively moderate, with proforma debt-to-cashflow of 8.2 times, Moody's adjusted proforma peak debt service coverage of 2.5 times, proforma debt to operating revenues of 47%, and proforma cash to debt of 101% (which, however, is significantly improved over year's past). Approximately 29% of CHW's debt is putable, and approximately 26% has a variable interest rate. Nearly 100% of CHW's variable rate debt has been swapped to fixed rate with LIBOR-based fixed payer swaps (CHW recently expanded its number of counterparties, which now includes Deutsche Bank in addition to Citibank and JPMorgan; CHW's swaps do not have collateral posting requirements). CHW's ratio of monthly liquidity to demand debt is good at 329%.

CHW's pension was underfunded by \$758 million as of June 30, 2011, which represents an improvement of the PBO funded level to 75% from 61% at FYE 2010. The system has been funding its pension obligation at expense levels, which is an increase from prior years. As CHW's plan is a church plan, it has more funding flexibility than plans that follow ERISA guidelines. Other indirect debt includes non-cancelable operating leases, which at FYE 2011 was equal to another \$653 million in debt (calculated at six times current lease expense).

## **Outlook**

The revision of the outlook to negative from stable reflects a second year of deteriorating operating performance and poor core operating results in FY 2011, (excluding provider fee revenue). Although operating cashflow declined by 43% from FY 2009 to FY 2011, a downgrade is precluded at this time due in part to CHW's improved balance sheet position, and its receipt of significant funding under the California State provider fee program. Failure to improve the organization's core operating performance would likely result in a downgrade.

### **WHAT COULD MAKE THE RATING GO UP**

Sustained improvement in operating income, cashflow and associated margins; continued improvement in liquidity and balance sheet measures.

### **WHAT COULD MAKE THE RATING GO DOWN**

Failure to improve operating performance net of provider fee monies; the issuance of additional debt beyond what can be accommodated by cash flow and liquidity growth; material decline in unrestricted cash

### **KEY INDICATORS**

Assumptions & Adjustments:

-Based on financial statements for Catholic Healthcare West and Subordinate Corporations

-First number reflects audit year ended June 30, 2010

-Second number reflects proforma on audit year ended June 30, 2011, including the series 2011 bonds

-Investment income related to the system's interest in Scripps is excluded; revenue related to Scripps is reclassified to non-operating income from revenue; both income and expenses related to the California state provider fee program are excluded; income relating to a one-time gain to net assets from the transfer of services to Phoenix Children's Hospital in 2011 is excluded; contributions are reclassified as non-operating income; interest expense includes capitalized interest and excludes changes in fair value of interest rate swaps

-Investment returns smoothed at 6%

\*Inpatient admissions: 413,548; 412,480

\*Total operating revenues: \$9.4 billion; \$9.8 billion

\*Moody's-adjusted net revenue available for debt service: \$985 million; \$810 million

\*Total debt outstanding: \$4.2 billion; \$4.6 billion

\*Maximum annual debt service (MADS): \$275 million; \$275 million

\*Moody's-adjusted MADS coverage with normalized investment income: 3.6 times; 3.0 times

\*Debt-to-cash flow: 5.6 times; 8.2 times

\*Days cash on hand: 167 days; 170 days

\*Cash-to-debt: 96%; 101%

\*Operating margin: 0.4%; -2.3%

\*Operating cash flow margin: 7.3%; 4.6%

#### CONTACTS

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#### PRINCIPAL METHODOLOGY USED

The principal methodology used in this rating was Not-for-Profit Hospitals and Health Systems published in January 2008. Please see the Credit Policy page on [www.moodys.com](http://www.moodys.com) for a copy of this methodology.

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