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October 19, 2011

California Health Facilities Financing Authority Arizona Health Facilities Authority Catholic Healthcare West, California; Joint Criteria; System

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California Health Facilities Financing Authority Arizona Health Facilities Authority Catholic Healthcare West, California; Joint Criteria; System

Credit Profile		
US$349.9 mil Rev Bnds (Catholic Healthcare West) ser 2011A due 11/01/2042		
Long Term Rating	A/Positive	New
US$126.1 mil Rev Bnds (Catholic Healthcare West) ser 2011B due 11/01/2042		
Long Term Rating	A/Positive	New
Maricopa Cnty Indl Dev Auth, Arizona		
Catholic Healthcare West, California		
Maricopa Cnty Indl Dev Auth (Catholic Healthcare West)		
Long Term Rating	A/Positive	Affirmed

Rationale

Standard & Poor's Ratings Services assigned its 'A' rating to the California Health Facilities Financing Authority's (CHFFA) $349.9 million series 2011A fixed-rate revenue bonds and the Arizona Health Facilities Authority's $126.1 million series 2011B fixed-rate revenue bonds, both issued for Catholic Healthcare West (CHW), Calif. As part of the 2011 issuance, CHFFA expects to issue its $75 million series 2011B and $75 million series 2011C variable-rate demand bonds (VRDBs), which are expected to be supported by letters of credit (LOCs) provided by Bank of Montreal. We expect to issue dual ratings on these bonds based solely on the ratings of the LOC provider in the next 30 days

At the same time, we affirmed our 'A' long-term rating and underlying rating (SPUR) on tax-exempt bonds outstanding (various series and various issuers) issued on behalf of CHW. The outlook on the 'A' ratings and SPURs remains positive.

In addition, Standard & Poor's affirmed its 'AAA/A-1+' and 'AAA/A-1' ratings on several series of CHW's VRDBs, based on the application of our joint criteria. The long-term components of the joint criteria ratings are based jointly on CHW's SPUR and the long-term rating of each of the individual letter-of-credit (LOC) banks, while the short-term component is based solely on our rating of the LOC bank.

The rating and positive outlook reflect our view of CHW's strength as one of the nation's largest not-for-profit health systems, significant revenue diversity, and history of strong cash flow during the past several years. Moreover, the rating and outlook reflect our view that CHW's strengthened balance sheet has improved to a level that is consistent with a higher rating and our expectation that metrics will continue to incrementally grow based on management's projected capital spending and performance. However, we believe that a higher rating is currently precluded due to our assessment of an erosion of CHW's operating income quality in audited fiscal year 2011 as a result of a weakened payor mix that continues to burden operations. CHW posted a very modest operating profit of

0.6% in fiscal 2011, which we view as particularly disappointing given that the results include a large net benefit from the California Hospital Fee Program -- 21 months of the program are included in fiscal 2011 financials. The degradation in operating performance is a concern, but we believe that management's strategies to improve operations and its track record of delivering results, combined with the extension of the provider fee program, position CHW to continue to post positive margins over the coming years. In order to attain a higher rating, however, we believe that CHW will need to demonstrate improved operating results and exceed operating targets in fiscal 2012 while maintaining demonstrated balance sheet strength.

The 'A' long-term rating reflects our view of CHW's:

- Improved overall balance sheet in fiscal 2011 with continued growth in unrestricted liquidity and a decrease in leverage -- unrestricted cash and investments equal 104% of pro forma long-term debt, operational liquidity grew to 178 days' cash on hand, and pro forma leverage is 49%;
- Good bottom-line profitability and cash flow, despite the weakened operations, driven by robust investment income -- CHW's excess margin was 3.3% and pro forma coverage of maximum annual debt service (MADS) was 3.3x;
- Significant risk dispersion as one of the largest not-for-profit health care providers in the nation, with 40 hospitals in California, Arizona, and Nevada; and
- Strong management practices and exceptional senior leadership team that is forward-looking and is preparing the organization for health care reform.

An additional offsetting credit factor, in our view, is CHW's regional concentration in California, Arizona, and Nevada, which are three states hit hardest by the recession and still have high unemployment rates. Although CHW's revenue diversity is impressive, many local markets continue to be affected by the lingering effects of the economic downturn, and the effect is evident in CHW's unfavorable payor mix shift and increased bad debt.

The 2011 plan of finance totals $626 million, and includes $350 million of new borrowing, with the rest representing refinancing. The bond amounts in the 2011 plan of finance are preliminary and subject to change. CHW's bonds are secured by a pledge of gross revenues pursuant to the terms of the master indenture. On a pro forma basis, CHW has about $4.5 billion in debt, inclusive of taxable and tax-exempt long-term debt, capital leases, and notes payable. CHW has 16 swaps outstanding, designed to hedge interest rate risk. Standard & Poor's assigned CHW a Debt Derivative Profile (DDP) overall score of '2' on a four-point scale, with '1' representing the lowest risk. The overall DDP score of '2' represents, in our opinion, low credit risk.

Outlook

The positive outlook reflects CHW's overall solid credit profile and our view that a higher rating is possible over the next year if CHW can improve its operating profitability. We would consider raising the rating if CHW exceeds budgeted expectations and posts an operating margin in excess of 1% (inclusive of the provider fee program, but exclusive of what we view as one-time items) and we believe margins can be sustained at least at this level going forward. At the minimum, the maintenance of existing balance sheet strength with key metrics in line with 'A+' medians will also be important in our assessment.

If operating targets are not attained or we believe the underlying operating environment is weakening further, we will likely revise the outlook to stable. Also, if the balance sheet deteriorates unexpectedly and metrics became more in line with our expectations of 'A' rated systems, we could consider revising the outlook to stable. While not expected within the broader two-year horizon of our outlook, a lower rating would be premised on a combination of both income and balance sheet deterioration to levels consistent with an 'A-' rating.

Diminished Operations But Strong Bottom-Line Profitability

In our view, CHW's operating performance in fiscal 2011 (audited full-year results through June 30, 2011) was only adequate, but solid from a bottom-line perspective due to significant investment income. In the last two years, CHW's overall operations have been burdened by a weaker payor mix, an effect of the challenged economy. Management estimates that the payor mix shift to governmental from commercial payors had a $150 million negative impact on CHW's operations in fiscal 2011. In our view, CHW has benefited significantly from the California Hospital Fee Program and through quality improvement and cost containment initiatives. This allowed CHW to mitigate some of the negative payor mix shift and still maintain positive operations. Standard & Poor's financial calculations exclude revenues and losses related to CHW's affiliation with Scripps Health and other expenses that we view as one-time in nature -- we treat these as extraordinary items and a change to net assets -- as well as adjustments for analytical comparability that may not directly match with CHW's internal calculations.

The California Hospital Fee Program was initially approved for a 21-month term extending from April 2009 to December 2010. The net benefit to CHW from this term of the program was $198.8 million, and was all recorded in the fiscal 2011 financial statements due to the timing of the program's approval. The program was subsequently extended two times by the state, lengthening the program's term to December 2013 -- as of the date of this report, approval from the Centers for Medicare & Medicaid Services is still pending. Since the program has a finite term (albeit longer than previously expected), we consider the underlying run-rate of operations without the provider fee in our analysis as well. In our opinion, CHW's underlying operating run rate has weakened considerably, and we expect this may continue in the near term. We consider this a concern given the finite term of the program and because we expect a more challenging operating environment for the broader sector in the coming years. Regardless, we consider the program a benefit for CHW as it has effectively improved Medi-Cal reimbursement during the term of the program. In our opinion, this provides the organization some flexibility to navigate the current period of time when underlying operating performance is challenged and to implement the operational improvement initiatives that are planned or underway. The organization's success with these initiatives will be important in our subsequent review.

CHW is pursuing strategies to improve the organization's payor mix through targeted growth, to reduce costs through operational efficiencies, and to enhance the revenue cycle. Also, management is considering alternatives surrounding markets that are dilutive to the financial profile and how those assets fit into the long-term strategy of the organization. CHW recently announced that it is in the due diligence phase with a large for-profit health care system (Community Health Systems) regarding a potential future sale of Saint Mary's Regional Medical Center (SMRMC) in Reno. Full details regarding the possible sale are not known presently, but we believe that should this divestiture come to fruition, it would likely benefit operations, as SMRMC has historically been dilutive to CHW's overall financial profile. We understand that CHW is also in the process of evaluating the future of another facility, St. Mary Medical Center in Long Beach.

Operating income was about $61.6 million on revenues of $10.4 billion, which resulted in a 0.6% operating margin. Fiscal 2011's operating income is extremely dependent on the $198.8 million net benefit (21-month impact) of the California Provider Fee Program and compares unfavorably to fiscal 2010's 0.8% operating margin.

CHW's investment portfolio had solid returns in fiscal 2011, and CHW realized an excess income of $354.1 million (a 3.3% excess margin). The solid excess income levels and total cash flow in fiscal 2011 generated what we consider good pro forma MADS coverage of 3.3x, based on MADS of $299.4 million in 2013. MADS includes all of CHW's long-term debt outstanding and capital leases. The interest rate on VRDBs is assumed at 3.0%. When adjusting for CHW's sizable operating leases, adjusted MADS coverage is lower, but appropriate for the rating, in our opinion, at 2.7x.

Improving Balance Sheet Metrics

CHW's core balance sheet metrics have historically been a credit weakness, but these measures have continued to improve in the last fiscal year. As a result of strong cash flow, solid investment performance, and prudent capital spending, unrestricted liquidity increased by almost 15% to $4.7 billion as of fiscal 2011, comparing very favorably to that of fiscal 2010 and representing 178 days' cash on hand, a level that we consider strong for the current rating. Our days' cash on hand excludes the provider fee expense from the average daily expenditure component of the calculation. Despite the planned debt issuance, the decrease in unrestricted cash to pro forma debt is minimal and remains good, in our view, at 104% of pro forma long-term debt. CHW's unrestricted net assets improved tremendously in fiscal 2011, soaring by $1.3 billion due to good bottom-line profitability, strong unrealized investment gains, and favorable pension adjustments. As a result, CHW's leverage declined by about eight percentage points to 47%. On a pro forma basis, leverage increases to 49%, which is slightly elevated in comparison to similar systems, but still at its lowest level in CHW's recent history. CHW's cash to puttable debt is strong, in our view, at over 4x.

CHW spent significantly on capital expenditures in fiscal 2009 and prior years, but has prudently scaled back spending in the last two audited years given the economic conditions affecting the nation, and with the health care delivery system changing on fundamental levels. Capital plans stand at approximately $3.9 billion over the next five-year period, with more budgeted for information technology (IT) and ambulatory/physician development, and less for major (traditional bricks-and-mortar) projects. CHW's capital plan includes the required spending to bring its remaining facilities in compliance with California's seismic compliance regulations. Some of the seismic spending may be deferred a few years, due to recently passed legislation that allows qualifying hospitals to defer the seismic deadline to 2020 if certain guidelines are met.

CHW has a pension liability of approximately $750 million, and stands at about a 75%-funded status based on projected benefit obligation (PBO). This is an improvement compared to fiscal 2010 when the funded status was only 60%. The improvement was driven by solid returns on plan assets and plan amendments for specified employee groups implemented by CHW during the year, which thereby lowered the PBO. The plan changes will likely help lower future pension expense as well. CHW contributed approximately $270 million in fiscal 2011 to the defined benefit pension plan, and CHW is planning on contributing about the same amount in fiscal 2012. In our view, the unfunded status remains large in nominal terms and does limit CHW's financial flexibility somewhat, but the lengthy funding period mitigates this to a certain extent.

Organizational Profile: Significant Risk Dispersion And Strong Management

We believe one of CHW's core strengths is its large size and geographic dispersion. In our view, CHW has considerable market diversification and breadth, which provides significant risk dispersion. CHW operates 40 hospitals in California, Arizona, and Nevada, providing for significant revenue diversity. Management has a history of measured growth and continues to evaluate opportunities for appropriate additions to the system, both organically in existing markets and through entering new markets. Management reported that systemwide admissions declined very slightly, by less than 1%, to 412,480 in fiscal 2011. Adjusted admissions grew by 1.0% to more than 630,175 due to outpatient growth.

As one of the largest not-for-profit health systems in the nation, CHW has, in our view, a strong central management team with depth and experience that has demonstrated vision and discipline in achieving organizational strength while articulating a strategy for balanced growth. We believe that this management team has a track record of being able to make tough decisions to strengthen the organization, as evidenced in the possible SMRMC divestiture. Also, in our opinion, management has a keen focus on adapting CHW for the future under health care reform. The team clearly articulates strategies surrounding quality enhancements, physician integration, IT improvements, and cost controls.

CHW recently reorganized its regional structure into 10 markets, each with an individual leader managing the clinical, growth, and alignment strategies for the region. The 10 leaders report up to a single system-level chief operating officer. Management believes the new structure will help facilitate growth and will streamline decision making.

Debt Derivative Profile: Low Risk

After terminating four swaps in December 2010, CHW has 16 swaps associated with its debt issuances, designed to hedge interest rate risk. J.P. Morgan, Citibank, and Deutsche Bank are counterparties for CHW's swaps. CHW diversified its swap counterparties in August 2011 by novating certain swaps from Citibank to Deutsche Bank. CHW had a swap notional amount outstanding of about $944.5 million on June 30, 2011, and the duration of the swaps vary. Market conditions have resulted in a negative mark-to-market of about $111 million (at June 30, 2011), which is significant though improved from the prior year, but CHW has no collateral posting requirements, and its sizable unrestricted liquidity mitigates immediate credit concerns on the swaps. Market conditions are, in our view, still volatile, and the mark-to-market may continue to fluctuate over the short term.

Standard & Poor's assigned CHW's swaps a DDP overall score of '2' on a four-point scale, with '1' representing the lowest risk. The overall score of '2' indicates that, in our opinion, CHW's swaps pose a low credit risk.

Specific factors include our view of CHW's:

- Low counterparty risk, as CHW has participated only in swaps with highly rated counterparties and has some counterparty diversification;
- Manageable termination risk, with termination triggers should CHW be downgraded to less than 'BBB+' or 'BBB-';
- Adequate economic viability of the swap portfolio over stressful economic cycles per Standard & Poor's model; and

- Very strong management oversight of the swap portfolio, including a well-defined board-approved swap policy, and a strong swap management plan.

In our opinion, CHW's oversight of the swap program is very strong: senior managers are responsible for the swap program, and policies and procedures are clearly defined. CHW's board-approved policies address the system's goals in using derivatives and define parameters for variable-rate exposure through an annual board review of the fixed/variable mix, minimum counterparty ratings, basis risk, and termination risk. Under CHW's master trust indenture, CHW is not permitted to collateralize swaps, but as a policy it aims to require counterparty collateral triggers on swap transactions. Standard & Poor's considers CHW's monitoring processes strong, including its monthly reviews of swap positions, which CHW uses as the basis for its mark-to-market accounting entries.

Table 1

Catholic Healthcare West and Subordinate Corporations, California Financial Statistics

	Fiscal year ended June 30			
	2011	**2010**	**2009**	**2008**
Income Statement and Cash Flow*				
Operating revenue ($000s)¶	10,423,048	9,361,677	8,942,602	8,354,249
Total expenses ($000s)	10,408,787	9,287,317	8,685,270	8,133,893
Operating income ($000s)	61,561	74,360	257,332	220,356
Operating margin (%)	0.6	0.8	2.9	2.6
Net nonoperating revenues ($000s)	292,577	204,853	4,037	228,472
Excess income ($000s)	354,138	279,213	261,369	448,828
Excess margin (%)	3.3	2.9	2.9	5.2
Change in net assets ($000s)	1,342,023	283,953	(799,131)	452,156
EBIDA/total revenue (%)	9.3	9.3	9.1	11.2
Cash flow/total liabilities (%)	10.0	8.9	8.6	12.1
Capital expenditures ($000s)	595,871	499,623	703,876	796,084
Debt				
Net available for debt service ($000s)	996,823	892,195	814,962	957,638
Pro forma maximum debt service ($000s)	299,416	299,416	299,416	299,416
Pro forma maximum debt service coverage (x)	3.3	3.0	2.7	3.2
Pro forma maximum debt service-to-total revenue (%)	2.8	3.1	3.3	3.5
Balance Sheet				
Unrestricted cash and investments ($000s)	4,668,994	4,068,878	3,407,299	3,407,790
Unrestricted days' cash on hand	178	168	150	160
Unrestricted cash/debt (%)	113	97.5	80.4	85.1
Cushion ratio (x)	15.6	13.6	11.4	11.4
Net fixed assets ($000s)	4,102,551	3,894,111	3,782,449	3,404,351
Long-term debt ($000s)	4,130,817	4,174,469	4,239,526	4,002,865
Unrestricted fund balance ($000s)	4,715,076	3,426,489	3,155,600	3,905,187
Debt/capitalization (%)	46.7	54.9	57.3	50.6
Average age of plant (years)	10.4	10.0	10.3	10.5

Table 1

Catholic Healthcare West and Subordinate Corporations, California Financial Statistics (cont.)
*Fiscal year 2011 income statement and cash flow metrics include $583.7 million in revenue and $384.9 million in expense associated with the California Hospital Fee Program, ¶Gain of $47.3 million from Phoenix Children's Hospital transaction excluded from operating revenue but included in operating income calculation. EBIDA--Earnings before interest, depreciation, and amortization.

Table 2

Catholic Healthcare West and Subordinate Corporations, California Pro Forma Ratios	
	June 30, 2011
Debt service and coverage	
Net available for debt service ($000s)	996,823
Maximum annual debt service ($000s)	299,416
Maximum annual debt service coverage (x)	3.3
Maximum annual debt service to total revenue (%)	2.8
Balance sheet	
Unrestricted cash and investments ($000s)	4,668,994
Long-term debt ($000s)	4,489,797
Unrestricted cash/long-term debt (%)	104
Debt to capitalization (%)	48.8

Related Criteria And Research

- USPF Criteria: Not-For-Profit Health Care, June 14, 2007
- USPF Criteria: Debt Derivative Profile Scores, March 27, 2006
- Criteria: Methodology And Assumptions: Approach To Evaluating Letter Of Credit-Supported Debt, July 6, 2009
- USPF Criteria: Municipal Applications For Joint Support Criteria, June 25, 2007
- Criteria: Joint Support Criteria Update, April 22, 2009

Ratings Detail (As Of October 19, 2011)		
Arizona Hlth Fac Auth, Arizona		
Catholic Healthcare West, California		
Series 2008A		
Unenhanced Rating	A(SPUR)/Positive	Affirmed
Long Term Rating	AAA/A-1+	Affirmed
Series 2008B		
Unenhanced Rating	A(SPUR)/Positive	Affirmed
Long Term Rating	AAA/A-1	Affirmed
Series 2009D &E		
Long Term Rating	A/Positive	Affirmed
Series 2009 F		
Unenhanced Rating	A(SPUR)/Positive	Affirmed
Long Term Rating	AAA/A-1	Affirmed
Ser 2005B		

Ratings Detail (As Of October 19, 2011) **(cont.)**		
Unenhanced Rating	A(SPUR)/Positive	Affirmed
Long Term Rating	AAA/A-1+	Affirmed
California Hlth Facs Fin Auth, California		
Catholic Healthcare West, California		
California Hlth Facs Fin Auth (Catholic Healthcare West) hlth fac rfdg rev bnds (Catholic Hlthcare West)ser 1994B dtd 01/01/94 due 07/01/1994-2008 201		
Unenhanced Rating	NR(SPUR)	Current
California Hlth Facs Fin Auth (Catholic Healthcare West) hlth (Catholic Hlthcare West) ser 1996B & fix ser 1996D dtd 05/30/1996 due 07/01/2006, 2012,		
Unenhanced Rating	NR(SPUR)	
California Hlth Facs Fin Auth (Catholic Healthcare West) hlth (Catholic Hlthcare West) ser 1996B & fix ser 1996D dtd 05/30/1996 due 07/01/2006, 2012,		
Unenhanced Rating	NR(SPUR)	
California Hlth Facs Fin Auth (Catholic Healthcare West)		
Unenhanced Rating	A(SPUR)/Positive	Affirmed
California Hlth Facs Fin Auth (Catholic Healthcare West) hosp ser 1996CD		
Unenhanced Rating	A(SPUR)/Positive	Affirmed
Series 1988 B&C		
Unenhanced Rating	A(SPUR)/Positive	Affirmed
Long Term Rating	AAA/A-1+	Affirmed
Ser 1998 A , 2004 G & I ,2008 G-L , 2009 A-G		
Long Term Rating	A/Positive	Affirmed
Ser 2004 K		
Unenhanced Rating	A(SPUR)/Positive	Affirmed
Long Term Rating	AAA/A-1	Affirmed
Ser 2005H		
Unenhanced Rating	A(SPUR)/Positive	Affirmed
Long Term Rating	AAA/A-1	Affirmed
Ser 2005I		
Unenhanced Rating	A(SPUR)/Positive	Affirmed
Long Term Rating	AAA/A-1	Affirmed
California Statewide Communities Dev Auth, California		
Catholic Healthcare West, California		
California Statewide Comntys Dev Auth (Catholic Healthcare West) Series D,E &F		
Unenhanced Rating	A(SPUR)/Positive	Affirmed
California Statewide Comntys Dev Auth (Catholic Healthcare West) (ASSURED)Series 2007 L &K		
Unenhanced Rating	A(SPUR)/Positive	Affirmed
Series 2008 A,B,C,D&E		
Long Term Rating	A/Positive	Affirmed

Ratings Detail (As Of October 19, 2011) **(cont.)**		
Henderson, Nevada		
Catholic Healthcare West, California		
Series 2004A & 2007B		
Unenhanced Rating	A(SPUR)/Positive	Affirmed
Ser 2004A & 2007B		
Long Term Rating	A/Positive	Affirmed
Reno, Nevada		
Catholic Healthcare West, California		
Reno (Catholic Healthcare West)		
Long Term Rating	A/Positive	Affirmed
Reno (Catholic Healthcare West) (ASSURED GTY) (SEC MKT)		
Unenhanced Rating	A(SPUR)/Positive	Affirmed
Series 2007A		
Unenhanced Rating	A(SPUR)/Positive	Affirmed

Many issues are enhanced by bond insurance.