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Rating Update: MOODY'S DOWNGRADES TO A2 FROM A1 THE LONG-TERM RATINGS ASSIGNED TO CATHOLIC HEALTH EAST'S (PA) OUTSTANDING BONDS; OUTLOOK REVISED TO STABLE FROM NEGATIVE AT THE A2 RATING

Global Credit Research - 20 Jun 2011

DOWNGRADE AFFECTS \$1.1 BILLION OF DEBT OUTSTANDING

Health Care-Hospital
PA

Opinion

NEW YORK, Jun 20, 2011 – Moody's Investors Service has downgraded to A2 from A1 the ratings assigned to Catholic Health East's (CHE) \$1.1 billion of outstanding bonds (see RATED DEBT list below). The outlook has been revised to stable from negative at the A2 level.

SUMMARY RATING RATIONALE

The downgrade of CHE's ratings to A2 from A1 reflects an operating cash flow margin in FY 2010 of 6.4% for this large \$4.1 billion revenue system which is below the multi-state A median of 8.4%. FY 2010 results, while an improvement over FY 2009, represents weaker financial performance for the organization since FY 2006. FY 2010 results were largely suppressed by unbudgeted downturns in two Regional Health Corporations (RHC): Mercy Health System in Portland, Maine and St. Michael's Medical Center in Newark, New Jersey which reported combined operating losses in 2010 of \$36 million. These are highly competitive markets and management is heavily involved in improving both RHCs.

The revision of the outlook to stable from negative at the A2 level reflects CHE's improved cash position, and a relatively low leverage position. Additionally, the stable outlook also reflects significant operational improvements in 2010 due to steps taken by management including: 1) freezing nearly all (15) of CHE's defined benefit pension plans; 2) divesting Mercy Hospital (Miami, FL) effective May 1, 2011; 3) the expected partnership with Emory University Health for St. Joseph's Health System (Atlanta) to be finalized and closed by the end of this year. The senior management team has been expanded and maintains a heightened sense of urgency to address CHE's challenging markets and achieve stronger financial performance.

CHALLENGES

*Below average performance for multistate A medians with a 0.8% operating margin and 6.4% operating cash flow margin in FY 2010 compared to the A medians for multistate systems of 2.1% and 8.4%, respectively; FY 2010 results, while an improvement over FY 2009, represents weaker financial performance for the organization since FY 2006

*Large unbudgeted losses at two RHCs: \$22.4 million loss at St. Michael's in Newark, NJ and \$13.9 million loss at Mercy in Portland, Maine; management does not expect to reach budget for these two markets in FY 2011 based on first quarter FY 2011 results; losses evidence the highly competitive and fluid physician communities in these markets.

*System wide admission decline of 4.1% in FY 2010 over FY 2009; admissions are down 5.5% in the first quarter of FY 2011 with notable shifts from inpatient to outpatient and increase in observation visits

*Below average revenue growth in FY 2010 of 1.5%; some improvement to 2.8% in first quarter of FY 2011 although it evidences the difficult locations of some of the CHE markets

STRENGTHS

*Management's ability to execute three significant strategies over the past year: 1) freezing of nearly all of CHE's defined benefit pension plans; 2) divestiture of Mercy Hospital in Miami; and 3) identification of a partner for St. Joseph's Health System in Atlanta (planned finalization and completion by end of FY 2011)

*Operational improvement at Our Lady of Lourdes in Camden, NJ with a \$10 million loss in FY 2010 following a \$33 million loss in FY 2009

*Growth in unrestricted cash and investments to \$1.6 billion or 152 days cash on hand at the end of FY 2010 and favorable to multistate A medians

*Largely fixed rate bond structure (78%); \$200 million line of credit provides additional working capital

*Deleveraging of the balance sheet with the sale of Mercy Hospital (Miami) which removed \$120 million of debt on May 1, 2011

CREDIT DISCUSSION

LEGAL SECURITY: Gross revenue pledge of the obligated group which includes the parent and all member hospitals with the exception of the New York hospitals. 1.10 times rate covenant. Substitution of notes permitted with written consent from bond insurers. The New York hospitals have \$266 million of Series 2008A-E and Series 2011 bonds outstanding (rated Baa2) and are not guaranteed by CHE. Likewise, in May 2008, \$249.6 million of bonds were issued by the State of New Jersey (rated A1) to fund the acquisition, repay debt and fund the capital needs of Saint Michael's Medical Center, St. James Hospital and Columbus Hospital in Newark (the latter two were closed subsequent to purchase). While the New York and New Jersey bonds are not part of CHE's obligated group, our financial analysis and debt coverage measures include all non-obligated entities. St. Michael's did not maintain its debt service coverage ratio in FY 2010 and has hired a consultant to deliver a consultant report to the New Jersey Health Care Facilities Financing Authority.

INTEREST RATE DERIVATIVES: Since 1998, CHE has effectively managed an extensive interest rate swap program to reduce interest cost with more than \$48 million of program income since inception. Currently, CHE has several swaps outstanding with a total notional amount of \$903 million. Collateral is required at any rating level if the losses reach a certain level; at the A1 to A3 rating category the mark-to-market losses must reach \$20 million before collateral is required. Any excess loss over the \$20 million will be collateralized. CHE did not have any collateral posted in FY 2010 nor does it have any collateral posted at this time.

RECENT DEVELOPMENTS/RESULTS

In FY 2010 CHE's operating cash flow margin of 6.4% improved from 6.1% in FY 2009. FY 2009 and FY 2010 results exclude the operations of two large RHC's: Mercy Hospital in Miami and St. Joseph's Health System in Atlanta, historically challenged markets that the Board of Directors decided to divest toward the end of FY 2009. Even with the operational improvements in FY 2010, results remain below the 8.4% operating cash flow margin for A rated multistate systems and represents weaker operating cash flow margins since FY 2006.

Results were suppressed by unbudgeted losses at Mercy Hospital in Maine (\$13.9 million loss in FY 2010 following a history of largely profitable performance) and St. Michael's Hospital in Newark (\$22.4 million loss in FY 2010 following a \$10 million loss in FY 2009). Both of these markets are very competitive with very fluid physician communities. These markets also saw a material shift from inpatient care to outpatient and observation visits which also hampered financial performance. Mercy Maine reported a material 11% decline in inpatient admissions in FY 2010 while St. Michael's showed a significant 19% decline from the prior year. Performance at both markets through the first quarter of FY 2011 is unfavorable to budget and management has revised its year end projections for these two markets downward.

The system, in total, experienced below average 1.5% growth in net patient revenues in FY 2010. The FY 2011 budget anticipates 7.5% revenue growth over FY 2010, largely carried by some of CHE's more favorable markets: Holy Cross in Ft. Lauderdale; St. Mary's in Athens, GA; St. Mary's in Langhorne, PA and St. Peter's in Albany, NY. These are CHE's stronger markets and continue to be consistent contributors of cash flow. Also, Mercy of South Eastern Pennsylvania is expected to contribute to the higher revenue growth largely due to the favorable impact of the state's Medicaid Modernization Act. Some traction is being gained. Through the first quarter of FY 2011, revenues are up 2.8% over the prior year comparable period.

CHE remains very focused on cost and committed to its Vision 2017 which centers on providing high quality, person-centered care in a low cost setting. Through a recent expansion of the senior management team, its willingness to make tough decisions and a new heightened sense of urgency, CHE is also committed to improving its operating performance. CHE's long term goal includes a 10.0% operating cash flow margin by FY 2017 with heavy analysis and planning underway for each RHC and corporate services to reach this goal. Outside consultants have been engaged in this effort.

During FY 2010 CHE took several significant steps to position the system for the future. As outlined to Moody's during our 2010 review, CHE divested of Mercy Hospital in Miami (sold to HCA on May 1, 2011); froze 15 out of 16 defined benefit pension plans which materially reduced pension expense and related cash contributions; and identified a partner for St. Joseph's Health System in Atlanta. By the end of FY 2011, CHE is expected to enter into a 49%/51% partnership with Emory University Health (majority owner) through a joint operating company. Most of the cash and investments at St. Joseph's will remain within the CHE obligated group. Mercy Hospital's sale to HCA removed \$120 million of debt from CHE. We also acknowledge the improvement at Our Lady of Lourdes with a \$10 million loss in FY 2010 a significant improvement over the \$33 million loss incurred in FY 2009.

CHE maintains good balance sheet metrics with a relatively low debt position with a total of \$1.6 billion (includes the New York debt and St. Michael's debt, neither of which is in the CHE obligated group although included in CHE audits and our analysis). Debt to revenue is 43% will decline when removing the debt of Mercy (Miami). Over three fourths of the debt is fixed rate with over 700% coverage of variable rate debt with monthly liquidity. 91.4% cash to debt in FY 2010 is favorable to the A median 84%; Coverage is favorable with 3.3 times MADS coverage and 4.6 times debt to cash flow in FY 2010. Capital spending is budgeted to increase to about 2 times depreciation in FY 2011, up from 1.2 times in FY 2010. Additional debt for IT needs is currently being considered.

Outlook

The revision of the outlook to stable from negative at the lower rating level reflects CHE's improved cash position and a relatively low leverage position. It also reflects the expanded management team that has shown an ability to execute many strategies and address various challenged markets.

WHAT COULD CHANGE THE RATING UP

Much improved financial performance and continued growth in liquidity

WHAT COULD CHANGE THE RATING DOWN

Deterioration in financial results and liquidity, inability to execute the outlined strategy for St. Joseph's in Atlanta; unexpected downturn in other markets

KEY INDICATORS

Based on audited financial statements for Catholic Health East

-First number represents audited financial statements ending December 31, 2009

-Second number represents audited financial statements ending December 31, 2010

-Investment income restated as non-operating income and normalized at 6%

-Moody's includes the operating income related to the FL and NY joint ventures as non-operating income which is provided by management annually

*Total operating revenue: \$3.991 billion; \$4.057 billion

*Moody's-adjusted net revenue available for debt service: \$406.3 million; \$435.6 million

*Total debt outstanding: \$1.6 billion; \$1.6 billion (includes debt of St. Peter's, NY and Saint Michael's, NJ)

*Maximum annual debt service (MADS): \$125.0 million; \$129.0 million (includes debt of St. Peter's, NY and Saint Michael, NJ)

*MADS Coverage with reported investment income: 3.2 times; 3.3 times

*Moody's-adjusted MADS Coverage with normalized investment income: 3.3 times; 3.4 times

*Debt-to-cash flow: 5.1 times; 4.6 times

*Days cash on hand: 145 days; 152 days

*Cash-to-debt: 86.0%; 91.4%

*Operating margin: 0.2%; 0.8%

*Operating cash flow margin: 6.1%; 6.4%

RATED DEBT (debt outstanding as of December 31, 2010)

All debt has A2 underlying or long-term rating unless otherwise noted:

-Series 1998A-2; (also Ambac insured): \$29.8 million

-Series 1998A-3; (also MBIA insured): \$63.5 million

-Series 1998A; (also Ambac insured): \$46.7 million

-Series 1998E; (also Ambac insured): \$5.4 million

-Series 1998C; (also Ambac insured): \$17.8 million

-Series 1999G (also MBIA insured): \$5.0 million

-Series 2002B: \$1.2 million

-Series 2002C: \$3.2 million

-Series 2003A-5: \$1.7 million

-Series 2003B: \$29.3 million

-Series 2003D: \$17.4 million

-Series 2004A: \$10.4 million

-Series 2004B: \$7.3 million

-Series 2004C: \$1.3 million

-Series 2007A, C-F: \$37.7 million

-Series 2008: \$27.4 million; LOC from JP Morgan Chase

- Series 2009: \$156.080 million

- Series 2010: \$396.820 million

CHE Debt Guarantees:

Mercy (Daphne, Alabama):

-Series 1997: \$21.8 million; LOC from Bank of America

-Series 2000: \$14.7 million; LOC from Wachovia Bank

(CHE provides a guarantee to both banks for reimbursement)

Mercy Hospital (Miami) (debt has subsequently been redeemed)

-Series 1998: \$10.0 million; LOC from Bank of America

-Series 2002: \$35.0 million private placement guaranteed by CHE

-Series 2003C: \$13.9 million

-Series 2008: \$31.8 million; LOC from PNC Bank

-Series 2009:\$29.3 million (liquidity facility: BONY Mellon)

Private Placement debt:

Mercy Health System of Southeastern Pennsylvania (Philadelphia):

-Series 2001: \$16.9 million private placement guaranteed by CHE

Other Debt:

Mercy (Maine): through the Maine Reserve program:

Series 2006H: \$68.4 million

Series 2010C: \$11.2 million

St. Peter's Hospital, NY:

Series 2008A-E: \$219.61 million, rated Baa2

Series 2011: \$34.2 million, rated Baa2

Saint Michael's Medical Center, Newark, NJ

Series 2008: \$245.5 million; A1 based on State of New Jersey Asset Transformation Program

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The principal methodology used in this rating was Not-for-Profit Hospitals and Health Systems, published in January 2008.

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