MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns A3 to Dignity Health's (CA) September 2014 financings; Outlook stable

Global Credit Research - 29 Sep 2014

$5.6B proforma debt outstanding

CALIFORNIA HEALTH FACILITIES FINANCING AUTHORITY
Hospitals & Health Service Providers
CA

Moody's Rating

ISSUE		RATING
2014 Bank Loan with Citibank, N.A		A3
Sale Amount	$100,000,000	
Expected Sale Date	10/07/14	
Rating Description	Revenue: Other	
Taxable Bonds Series 2014A		A3
Sale Amount	$888,000,000	
Expected Sale Date	10/07/14	
Rating Description	Revenue: Other	
Fixed Rate Revenue Bonds Series 2014B		A3
Sale Amount	$300,000,000	
Expected Sale Date	10/07/14	
Rating Description	Revenue: Other	

Moody's Outlook STA

Opinion

NEW YORK, September 29, 2014 --Moody's Investors Service has assigned A3 ratings to Dignity Health's Series 2014A taxable bonds (of up to $888 million), Series 2014 B tax-exempt fixed rate revenue bonds ($300 million, to be issued by the California Health Facilities Financing Authority and to be sold as a direct placement), and 2014 direct loan with Citibank N.A. ($100 million). At this time, Dignity Health is also entering into a $100 million unrated direct loan with Fifth Third Bank. As the result of these financings, Dignity Health's direct debt will increase by up to $600 million, to a total of $5.6 billion. At this time, Moody's is also affirming the A3 long-term and underlying ratings on Dignity Health's rated parity debt. The outlook is stable.

SUMMARY RATING RATIONALE

The affirmation of the A3 rating and the maintenance of the stable outlook is a function of: Dignity Health's large size, diversity, and market share strength; relatively healthy unrestricted investment balances (equal to 197 days cash on hand as of FYE 2014); the likely continuation of the California State Provider Fee Program for at least another three years; and the organization's strategy to coordinate operations regionally and to optimize its portfolio of operating entities. Dignity Health's core margins (excluding the provider fee) are stable but low, and the organization intends to improve them over time. Other challenges of the organization include a high overall debt burden, increased riskiness in its investment allocation, and increased reliance on market access in its debt structure. A further increase in debt, or increased exposure to asset liability risks, could pressure the rating or outlook.

STRENGTHS

*Dignity Health is a large multistate system with 39 hospitals in California, Arizona, and Nevada generating over 360,000 admissions system-wide in fiscal year (FY) 2014. Together with other business lines, Dignity Health generated over $10 billion in total revenues in FY 2014, making it one of the 5 largest not-for-profit healthcare systems in Moody's rated portfolio.

*Dignity Health has been investing in diversification, both geographically and within business lines, and has been looking to optimize its portfolio of hospitals.

*Investment balances have continued to improve, with days cash on hand improving to 198 days at fiscal year end (FYE) 2014 (June 30), compared to 188 days at FYE 2013.

*Dignity Health is a significant beneficiary of the California State provider fee program, receiving a total of $750 million from 2010 through 2013 and expects to receive $1.1 billion over the next three years, pending final approval by CMS. (Due to the program's variability and inconsistencies, Moody's excludes the revenues and expenses associated with the program from our base calculations, but nevertheless we view the program's existence as a key positive credit factor for Dignity Health.)

CHALLENGES

*Dignity Health continues to operate at a stable but low level of core profitability. For the last four years, operating margin averaged -1.6%, and operating cashflow margin averaged 5.1% (excluding the California State Provider Fee). Core results were slightly improved in FY 2014, but remain well below the medians for this rating level, with operating margin at -1.0% and operating cashflow margin at 5.7%.

*Dignity Health's debt burden is high and increasing, with proforma cash to debt measuring 100%, Moody's-adjusted peak debt service coverage at 2.4 times, and debt to cashflow at 7.6 times. Furthermore, due to the increased use of bullet maturities, Dignity's debt structure is becoming increasing reliant on market access for ongoing debt management, although a $680 million bank liquidity facility mitigates some of this risk.

*Dignity Health's investment allocation has shifted towards somewhat riskier and less liquid asset classes, with hedge funds, real estate, and private equity equal to 25% of all assets.

*Dignity Health has one of the most challenging gross payer mixes among the rated multistate health systems, with 41% Medicare and 23% Medicaid.

*Dignity Health faces competition in most major markets from large and financially solid healthcare systems.

DETAILED CREDIT DISCUSSION

USE OF PROCEEDS: Proceeds from the four issuances will be used to refund approximately $800 million of debt, and provide up to $600 million of new money. Up to $300 million of the new money will reimburse the organization for prior capital investment, which will go on the balance sheet as unrestricted cash.

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

INTEREST RATE DERIVATIVES: Dignity Health is counterparty to sixteen LIBOR-based, fixed payer swap contracts, with a total current notional amount of approximately $940 million. Contracts are with Deutsche Bank, Sumitomo, Barclays, and JPMorgan. Dignity Health's swaps do not have collateral posting requirements. In 2012, Dignity Health entered into additional rate agreements with BMO and Deutsche Bank. These rate agreements are SIFMA-indexed, five year, fixed receiver swaps with formula-based termination payments potentially due at the end of five years, on notional of approximately $200 million. In conjunction with the current offering, Dignity Health plans to enter into $300 million of additional fixed receiver swaps similar to those executed in 2012. In total, Dignity Health will have rate agreements equal to approximately 26% of its debt.

MARKET POSITION/COMPETITIVE STRATEGY: LARGE SIZE AND DIVERSIFYING BASE ADDS STABILITY AND STRENGTH

Dignity Health operates 39 hospitals in California, Arizona, and Nevada organized into 9 service areas. Moody's considers a core credit strength of Dignity Health to be the size and relative diversification of the organization, which produced revenues in excess of $10 billion in 2014 and generated inpatient admissions in excess of 360,000. The organization has historically had a strong service mission, and among Moody's portfolio of large multi-state systems, Dignity Health has the highest exposure to Medicaid, at 23%.

Many of Dignity Health's markets have experienced economic stress over the past several years, and since 2011, the organization has operated at an overall lower level of core operating performance. Most of Dignity Health'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. Dignity Health's strategies include investing in existing markets to enhance key service lines, investing in ambulatory services, and more closely aligning with physicians through various models. Dignity Health has also been investing in revenue diversification, including key investments in occupational health (US Healthworks) and revenue cycle management (Optum360). In August 2012, Dignity Health purchased US Health Works (a prominent for-profit healthcare provider specializing in occupational health with approximately $400 million in revenues at time of purchase) giving Dignity Health a presence in 17 additional states. Additionally, in September 2013 Dignity Health and Optum Insight, Inc. formed a joint venture called Optum360 which focuses on revenue cycle management.

With respect to its portfolio of hospitals, in 2012 Dignity Health divested from Saint Mary' Regional Medical Center in Reno, eliminating significant on-going operating losses, and in the Summer of 2014, Dignity Health entered into a letter of intent to form a joint venture to operate a hospital system in Tucson Arizona. Dignity Health is growth oriented, and has considered sizable joint ventures, and more direct affiliations. Going forward, we expect Dignity Health to continue to consider both traditional and alternative investment opportunities, while working to improve the profitability of its core assets.

OPERATING PERFORMANCE: STABLE BUT MODEST OPERATING PERFORMANCE RECEIVES KEY BOOST FROM THE CALIFORNIA STATE PROVIDER FEE PROGRAM

While Dignity Health's core operating measures have been relatively low for the last four years, and are well below the medians for the rating category, they have improved each year, and results are expected to continue to improve in 2015, and beyond (core measures exclude revenue from the California State Provider Fee, discussed below). In FY 2014, operating margin improved to -1.0% from -1.5% in FY 2013, and operating cashflow margin increased to 5.7% from 5.3%. Inclusive of the provider fee, which expired half way through the year, the FY 2014 operating margin measured -0.1% and operating cashflow margin was 6.4%. (Moody's makes other adjustments, including the exclusion of Dignity's interest in Scripps Health, and a variety of one time items. Please see the calculations at the bottom of the report for more information.) The affirmation of the A3 rating and the maintenance of the stable outlook assumes Dignity Health will continue to improve its core performance going forward.

Operating pressures to date have included: reduced utilization; overall high exposure to Medicaid; ongoing high bad debt expense; weak same store revenue growth; governmental reimbursement pressures; and ongoing economic pressures in specific markets, including the LA region, Nevada, the Inland Empire, and Arizona. Efforts to improve profitability have included: investment in more profitable service lines; divestiture of underperforming assets; investment in the organization's brand and brand awareness; significant negotiations with its unions; investment in workplace standardization; efficiency improvements; revenue cycle enhancement; and targeted cost cutting measuring.

Passage and approval of the provider fee in the state of California has provided Dignity Health with significant additional support, and it is a key component of our current credit view. Net receipts in FY 2011 improved operating income (inclusive of 21 months of net reimbursement) by approximately $199 million; in FY 2012, operating income improved by $233.7 million; in FY 2013 net receipts totaled $230.2 million; and in FY 2014 they totaled $86.8 million. The program was initially approved for 21 months, was extended for six months (through June 2011), and was then extended for an additional 30 months through December 31, 2013. The State of California has approved an additional 36 month extension (to be back dated to January 1, 2014), which currently awaits CMS approval. We expect the most recent extension to be implemented during Dignity Health's 2015 fiscal year. The new extension is expected to provide a net benefit of $1.1 billion to Dignity Health over the next three years. Discontinuation of the program would have a significantly negative credit impact on the organization.

BALANCE SHEET POSITION: ASSET LIABILITY STRATEGY PROVIDES CHALLENGES

A credit challenge of Dignity Health is its relatively high amount of direct debt, which is increasing by up to 11% in the current offering (Dignity Health is presently considering various sizes for the taxable bonds; our analysis assumes the highest amount being considered: $888 million). In addition to the amount of debt, the structure of the debt is also becoming a credit factor. On a proforma basis, 27% of the organization's debt will be taxable bonds (most of which is structured with bullet maturities), another 25% is direct placements or bank-backed variable rate demand bonds, and just 40% is traditional, amortizing, tax exempt fixed rate bonds, which is low for the rating category. The bullet maturities present an increased reliance on market access and creates lumpy actual debt service, which peaks in FY 2019 at $709 million (compared to smoothed peak debt service of $393 million). Somewhat offsetting the increase in direct debt, is a reduction in Dignity Health's overall indirect debt (consisting of Dignity Health's unfunded pension liability and the debt equivalent of operating leases). Total indirect debt dropped to $1.4 billion at FYE 2014 from $1.6 billion at FYE 2013, and is equal now to 25% of Dignity Health's direct debt; reduction of indirect debt is largely attributable to improvement in the funded status of the pension plan

A credit strength of Dignity Health is the organization's balance of unrestricted cash and investments, which is relatively strong for the rating category, and measured 197 days at FYE 2014. This is expected to further increase to 208 days after the bond issuance due to $300 million of reimbursement, and is further supplemented by lines of credit equal to approximately $680 million and in place for the next four years. An additional challenge is Dignity Health's recent reallocation of its investment portfolio, which decreased allocations to cash and fixed income to 39% from 46%. Approximately 65% of Dignity Health's total unrestricted cash and investment is available in 30 days or less, which is a lower percentage of relative functional liquidity compared to many of the organizations peers. We do note that the portfolio is well diversified among managers, has strong internal oversight, and has performed well in recent years.

OUTLOOK

The stable outlook is a function of: Dignity Health's large size, diversity, and market share strength; relatively healthy unrestricted investment balances (equal to 197 days cash on hand as of FYE 2014); the likely continuation of the California State Provider Fee Program for at least another three years; and the organization's renewed strategy to coordinate operations regionally and to optimize its portfolio of operating entities.

WHAT COULD CHANGE THE RATING UP

Factors which could contribute to an upgrade include: a significant and sustained improvement in operating income, cashflow and associated margins while maintaining improved balance sheet measures

WHAT COULD CHANGE THE RATING DOWN

Factors which could contribute to a downgrade include: the further issuance of material additional debt; the further decline in operating performance; or the launching of major strategic initiatives that are expected to generate further pressure to the balance sheet or the income statement.

KEY INDICATORS

Assumptions & Adjustments:

-Based on financial statements for Dignity Health and Subordinate Corporations

-First number reflects audited financial statements for year ended June 30, 2013

-Second number reflects proforma on audited financial statements for year ended June 30, 2014. Proforma includes $600 million of additional debt, $30 million of additional interest expense, and $300 of additional unrestricted cash and investment.

-Investment income is normalized at 6% of unrestricted cash and investments, unless stated otherwise

-Comprehensive debt includes direct debt, operating leases (calculated at 6 times current lease expense), and unfunded pension liability.

-Calculations exclude the California State Provider Fee; operating revenue excludes operating income and investment income related to Dignity Health's investment in Scripps; interest expense excludes the change in the mark to market on Dignity Health's swap portfolio; operating revenue in FY 2013 excludes a $37.6 million gain related to the sale of certain lab assets; operating revenue in FY 2014 excludes a $230.5 million gain related to the Optum360 transaction.

*Inpatient admissions: 370,263; 363,357

*Observation stays: 75,076; 87,869

*Medicare % of gross revenues: 40.0%; 41.0%

*Medicaid % of gross revenues: 20.0%; 23.0%

*Total operating revenues: $9.6 billion; $10.1 billion

*Revenue growth rate (3 yr CAGR): 3.6%; 1.0%

*Operating margin: -1.5%; -1.3%

*Operating cash flow margin: 5.3%; 5.7%

*Debt-to-cash flow: 7.7 times; 7.6 times

*Days cash on hand: 188 days; 208 days

*Maximum annual debt service (MADS): $366.7 million; $392.9 million

*MADS Coverage with reported investment income: 2.3 times; 3.2 times

*Moody's-adjusted MADS Coverage with normalized investment income: 2.3 times; 2.4 times

*Direct debt: $5.030 billion; $5.563 billion

*Cash-to-direct-debt: 95%; 100%

*Comprehensive debt: $6.637 billion; $6.985 billion

*Cash-to-comprehensive-debt: 71.9%; 79.9%

*Monthly liquidity to demand debt: 211%; 246%

RATED DEBT

-Fixed rate bonds issued by Dignity Health and various conduit issuers including: California Health Facilities Financing Authority; Arizona Health Facilities Authority; IDA of the County of Maricopa, Arizona; California Statewide Communities Development Authority; City of Henderson, Nevada; City of Reno, Nevada; rated A3

-Auction rate bonds issued by California Health Facilities Financing Authority and California Statewide Communities Development Authority; rated A3

-Variable rate demand bonds backed by irrevocable letters of credit; underlying rating A3

-2013 direct loan with Citibank, N.A.; rated A3

PRINCIPAL METHODOLOGY USED

The principal methodology used in this rating was Not-for-Profit Healthcare Rating Methodology published in March 2012. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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