

## Fitch Affirms Palomar Health Rev Bonds 'BB+'; Outlook to Negative

Written by Australian Business

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SAN FRANCISCO--( [BUSINESS WIRE](#) )--Fitch Ratings has affirmed the 'BB+' rating on Palomar Health's (PH) outstanding debt, which is listed at the end of the press release.

The Rating Outlook is revised to Negative from Stable.

### SECURITY

The bonds are secured by a gross revenue pledge of the obligated group (OG). The obligated group is comprised of PH's acute care facilities as well as other healthcare related entities, but excludes Arch Health Partners, a medical foundation. The OG accounted for 100% of total assets and 90% of total revenue of the consolidated entity in FY 2013 (June 30 fiscal year end). Fitch's analysis is based on the consolidated entity.

### KEY RATING DRIVERS

**DECLINE IN LIQUIDITY MORE THAN ANTICIPATED:** The revision in Outlook to Negative from Stable reflects a greater decline in liquidity than expected during Fitch's last rating review, in conjunction with stressed financial operations that is just beginning to rebound.

**OPERATIONAL IMPROVEMENT INITIATIVES TAKING HOLD:** After a difficult fiscal 2013 due to transition expenses related to the move to the new facility in addition to a volume short fall and increased depreciation and interest expense, several operational improvement measures were implemented and most notably included a reduction in force of 133 FTEs in July and August of 2013. Through the six months ended December 2013, operating cash flow has rebounded.

**SIGNIFICANT CAPITAL INVESTMENT COMPLETE:** In August 2012, PH opened its 288-bed Palomar Medical Center (PMC) in Escondido, California. The opening and

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subsequent relocation of most service lines into PMC was the centerpiece of PH's large and ambitious \$1.06 billion facilities master plan. Future capital needs are minimal and projected to be \$25 million a year in fiscal 2014-2016, or approximately 40% of depreciation expense.

**HIGH DEBT BURDEN:** PH's debt burden remains very high and MADS coverage is weak and barely met its covenant requirement in fiscal 2013.

**GOOD MARKET POSITION:** PH's rating remains at the BB+ level despite the deterioration in financial performance given its market position in a good service area. PH has the opportunity to capture additional volume growth through its strategic partnerships and investment in its medical foundation.

### RATING SENSITIVITIES

**LACK OF LIQUIDITY IMPROVEMENT:** A downgrade is precluded at this time given the improved cash flow through the six months ended Dec. 31, 2013. However, PH's liquidity position is particularly concerning and Fitch expects that with the improved cash flow and minimal capital needs, liquidity should improve in the near term. The lack of a demonstrated improvement in liquidity or a reversal in the operating improvement trend would result in negative rating pressure.

### CREDIT PROFILE

PH, formerly known as Palomar Pomerado Health System, is a California hospital district that operates three hospitals in northern San Diego County. For fiscal 2013, PH's consolidated audited results included its medical foundation, Arch Health Partners. Total operating revenue in fiscal 2013 was \$670 million. Interim financial results are for the OG only.

### Opening of Palomar Medical Center

In August 2012, PH opened its new 288-bed Palomar Medical Center in North San Diego County and successfully relocated the majority of its service lines to the new hospital from its downtown Escondido facility. The downtown facility will remain operational and house an urgent care center, labor and delivery, behavioral, and acute rehab service lines.

PMC was a key component of PH's sizable \$1.06 billion facilities master plan, which also included expanding its Pomerado Hospital in Poway and building outpatient satellite clinics. PH operates a total of 508 beds and all the acute care facilities are seismically compliant.

### Fiscal 2013 Performance Challenged by New Hospital Opening

During Fitch's last rating review, PH's fiscal 2013 year to date performance had significantly deteriorated due to challenges with the transition to the new facility. In February of 2013, management implemented several operational improvement measures to reduce losses the last five months of the fiscal year. These initiatives included implementing a hiring freeze and productivity improvement targets, flexing staffing levels to volume and reducing non-labor expenses. Fiscal 2013 ended with a negative 8% operating margin (\$53.6 million operating loss) compared to a 3.4% operating margin (\$19 million operating income) the prior year. Included in these results are the operations of Arch Health Partners, which contributed \$14.5 million to the loss in fiscal 2013. This resulted in very weak MADS coverage of 0.9x in fiscal 2013 compared to 1.2x in fiscal 2012. Per bond covenant calculations based on OG only, MADS coverage was 1.18x for fiscal 2013, barely meeting the requirement of 1.15x.

### Operational Turnaround in Effect

Additional initiatives have been identified in fiscal 2014 to continue the improved performance trajectory and most notably, a reduction in force in July and August 2013 resulted in annualized savings of \$29 million. The other initiatives total at least \$17 million for the fiscal year and include capitation management improvement, pharmaceutical expense management and information systems outsourcing as well as other operational initiatives. PH continues to focus on reducing its expense per adjusted discharge and the fiscal 2014 excess income budget for the OG is negative \$25 million. Operating cash flow has improved through the six months ended Dec. 31, 2013 with an operating EBITDA margin of 10.6% and MADS coverage was 1.7x and year to date performance is ahead of budget.

Volume continues to be a concern especially from its strategic partnership with Kaiser, which has not achieved targeted expectations. Adjusted discharges remain below budget through December 2013 but are ahead of the prior year by 10%. There are various initiatives that are being undertaken to focus on revenue growth including its investment in Arch Health Partners.

### Lower Liquidity Than Expectations

Arch Health Partners is a medical foundation located in Poway, CA with nine other locations in the service area. PH became aligned with Arch Health Partners in 2010 and over the last year has provided significant support to the organization, which totaled \$12 million in fiscal 2013 and was one of the reasons for the drop in liquidity. There is new management at Arch Health Partners and PH is implementing better oversight, which should reduce losses.

As of June 30, 2013, unrestricted cash and investments dropped to \$119 million from \$178 million the prior year driven by the equity contribution for the completion of its facilities master plan, Arch Health Partners support, philanthropy shortfall and increase in accounts receivable. This resulted in 65 days cash on hand and 20.6% cash to debt. For the OG, days cash on hand was 77 days as of June 30, 2013 but still below the 80 days cash on hand covenant for the series 1999 and 2006 insured bonds (65 days cash on hand covenant for uninsured bonds). PH advised the insurers of the initiatives which PH has implemented to remedy the underachievement, which have been acknowledged as acceptable by the insurers. Per bond covenant calculations, total expenses exclude interest expense. Days cash on hand for the OG was 69 days at Dec. 31, 2013 per Fitch's calculation and excluding interest expense from total expenses, days cash on hand was relatively stable from fiscal year end 2013 at 73 days. Management indicated that its initiatives are targeted toward covenant compliance for fiscal year end 2014 with incremental improvements thereafter. The failure to improve liquidity would result in negative rating pressure.

### High Debt Burden

PH has a significant debt burden due to its facilities master plan. As of June 30, 2013,

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total debt outstanding was \$1.1 billion and included \$ 575 million of revenue bonds and \$559 million of general obligation (GO) bonds. Fitch rates the GO bonds 'A+'. The revenue bonds are 70% fixed rate and 30% variable rate (auction mode; series 2006). PH has three fixed payor interest rate swaps with Citi related to the series 2006 bonds and the swaps are insured by Assured Guaranty. There are currently no collateral posting requirements, but would occur if Assured Guaranty's rating falls below the 'A' category and would be at a zero threshold based on PH's current rating. The mark to market valuation as of June 30, 2013 was negative \$26 million. In addition, there is an additional termination event if Assured Guaranty's rating falls below 'BBB'.

### Good Market Position

Fitch believes that PH's location in North San Diego County is one of its main credit strengths with opportunity to capture the population growth along the I-15 corridor. Its strategic operating relationships with Kaiser Permanente and Rady Children's Hospital (both rated 'A+' by Fitch) and its investment in Arch Health Partners provides a foundation to drive volume.

As a California hospital district, PH receives unrestricted property tax revenues from a fixed share of the 1% property tax levied by the County of San Diego on all taxable real property in PH's boundaries. PH received \$12.9 million and \$12.7 million in unrestricted property tax revenues in fiscal 2013 and 2012, respectively. This tax revenue is included in other operating revenue. PH also receives ad valorem tax revenues generated by the separate voter-approved tax levy that is pledged solely for the payment of principal and interest on PH's series 2005, 2007, 2009, and 2010 GO bonds. Fitch's financial analysis excludes the GO bonds and related property tax revenue and interest expense.

### Disclosure

PH covenants to provide annual audited financial reports and unaudited quarterly financial statements to bondholders. Quarterly information, including a balance sheet, income statement, and statement of changes in net assets will be provided within 45 days after the end of each of the first three fiscal quarters.

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### Outstanding Debt:

\$159,449,000 Palomar Health (CA) COPs series 2010

\$228,724,000 Palomar Health (CA) COPs series 2009

\$171,673,000 Palomar Health (CA) COPs series 2006A-C

\$15,227,000 Palomar Health (CA) insured refunding revenue bonds series 1999

Additional information is available at '[www.fitchratings.com](http://www.fitchratings.com)'.

### Applicable Criteria and Related Research:

--'Nonprofit Hospitals and Health Systems Rating Criteria', dated May 20, 2013.

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U.S. Nonprofit Hospitals and Health Systems Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=708361](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=708361)

### Additional Disclosure

Solicitation Status

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