

Fitch Affirms Scottsdale Healthcare, AZ's Rev Bonds at 'A'; Outlook Stable

Written by Australian Business

SAN FRANCISCO--([BUSINESS WIRE](#))--Fitch Ratings has affirmed the 'A' rating on the following Scottsdale Healthcare Corporation's (SHC) outstanding debt.

--\$122,655,000 Scottsdale Industrial Development Authority (AZ) (Scottsdale Healthcare) hospital revenue refunding bonds series 2008A

--\$89,700,000 Scottsdale Industrial Development Authority (AZ) (Scottsdale Healthcare) hospital revenue bonds series 2006F (insured: Assured Guaranty Municipal Corp.)

--\$37,400,000 Scottsdale Industrial Development Authority (AZ) (Scottsdale Healthcare) hospital revenue refunding bonds series 2006D (insured: Assured Guaranty Municipal Corp.)

--\$58,350,000 Scottsdale Industrial Development Authority (AZ) (Scottsdale Healthcare) hospital revenue refunding bonds series 2006C (insured: Assured Guaranty Municipal Corp.)

The Rating Outlook is Stable.

SECURITY

Debt payments are secured by a pledge of the gross revenues of SHC. A fully funded debt service fund and a deed of trust (mortgage) provide additional security for the bonds.

KEY RATING DRIVERS

INTEGRATION UNDERWAY: SHC affiliated with John C. Lincoln Health Network (JCL) as of Oct. 1, 2013, and a new parent organization was created, Scottsdale Lincoln Health Network (SLHN), which provides a common governance and management structure over the two entities. Integration is underway and a major milestone will be implementing a common information technology platform, which is a priority. The debt of SHC and JCL remains separately obligated at this time, however, management continues to evaluate opportunities to consolidate the debt.

SOLID FINANCIAL PROFILE: SHC's liquidity and profitability is solid for its rating level although operating performance through the five months ended May 31, 2014 is slightly behind budget due to costs associated with the integration as well as lower volumes than expected. SLHN has a long term plan to reduce costs to offset future pressure on reimbursement.

UPCOMING CAPITAL NEEDS: SHC plans to install Epic and its information technology capital budget totals near \$200 million over the next three years in addition to routine capital needs of about \$60 million a year. Management may finance a portion of the increased capital needs over the next year. Fitch will evaluate the impact of the financing on SHC's rating when plans are finalized.

MODERATE DEBT BURDEN: SHC's debt burden is moderate and debt service coverage is strong. MADS accounted for less than 3% of total revenue and debt service coverage by EBITDA was 5.4x in fiscal 2013 (Sept. 30 year end).

RATING SENSITIVITIES

BENEFITS FROM AFFILIATION: Fitch expects SHC to benefit from the affiliation with JCL due to its enhanced market position, greater scale and increased strategic opportunities. Additional debt plans will be evaluated at the time of issuance.

CREDIT PROFILE

SHC includes three acute care community hospitals: Scottsdale Healthcare, Osborn (346 licensed acute care beds), Scottsdale Healthcare, Shea (413 licensed acute care beds), and Scottsdale Healthcare - Thompson Peak (92 licensed acute care beds). JCL includes two hospitals in Phoenix: John C. Lincoln North Mountain Hospital (266 beds) and John C. Lincoln Deer Valley Hospital (204 beds). JCL's total annual revenue is approximately \$580 million. There is no SLHN audit. SHC's total revenue in fiscal 2013 was \$885 million. Fiscal 2013 figures referenced in this report are for the 12 months ended Sept. 30, unless otherwise noted. SHC's fiscal year was changed to Dec. 31 from Sept. 30 in 2013.

SCOTTSDALE LINCOLN HEALTH NETWORK CREATED

As of Oct. 1, 2013, SLHN was formed from the affiliation between SHC and JCL. SHC's board is now the same as SLHN's board, which comprises an equal number of board members from the preceding SHC and JLC boards. There is one management team and strategic planning for SLHN is underway. Fitch views the affiliation positively as the two entities have the ability to collaborate on strategic initiatives especially in the fairly competitive greater metropolitan Phoenix area. Areas of focus include a common information technology platform as well as growing an aligned physician base. Fitch believes that the combined entity's operating performance is in line with Fitch's A category medians.

SOLID FINANCIAL PROFILE

SHC has good liquidity, solid profitability, and strong debt service coverage. At Dec. 31, 2013, SHC had \$550.6 million of unrestricted cash and investments that equated to 230.4 days cash on hand and 140.3% cash to debt.

Profitability has been consistent, but is slightly behind budget through the five months ended May 31, 2014 due to integration costs as well as softer volume than expected with an operating margin of 3.1% compared to a budget of 4.5%. Operating margin (\$20.6 million operating income) was 2.3% in fiscal 2013 compared to 3.3% in fiscal 2012. Operating EBITDA margin (\$91 million operating EBITDA) was a solid 10.3% in fiscal 2013 compared to 11% in fiscal 2012 and the A category median of 10.7%. SHC has a

favorable payor mix with less than 10% of revenue from Medicaid.

Management has an overall plan to reduce costs and improve revenue for SLHN by \$200 million for fiscal 2014 - 2016 to offset the expected decline in reimbursement. Although operating performance is behind budget year to date 2014, management believes that benefits from the integration should be realized in the latter half of the year and result in fiscal 2014 performance in line with its original fiscal 2014 budget.

INCREASED CAPITAL NEEDS

SHC plans to install Epic which will increase its capital plan over the next three years. A portion of this is expected to be financed by additional debt and Fitch will evaluate the impact of the financing when plans are finalized.

CONSERVATIVE DEBT PROFILE

SHC's total outstanding debt was \$393 million at Sept. 30, 2013 with 63% underlying fixed and 37% underlying variable rate. SHC's bonded variable-rate debt includes \$34.3 million direct bank loan at an indexed floating-rate, with a put option by the bank in 2018; and \$89.3 million in seven-day auction-rate bonds.

SHC has floating to fixed rate swaps outstanding for a total notional amount of \$110.275 million. These swaps are insured and currently require no collateral posting. SHC also has fixed receiver swaps outstanding for a total notional amount of \$150 million and no collateral posting has been required (\$25 million threshold).

Overall debt burden is moderate as MADS of \$23 million accounts for a relatively low 2.6% of fiscal 2013 revenue. Debt service gradually declines over the life of the bonds. Debt service coverage by operating EBITDA is strong at 4.1x for the five months ended May 31, 2014, 3.9x for fiscal 2013 and 4.1x for fiscal 2012 compared to the A category median of 3.4x.

DISCLOSURE

SHC has covenanted to provide annual and quarterly disclosure through the Municipal Securities Rule Making Board's EMMA system.

Additional information is available at 'www.fitchratings.com'.

Applicable Criteria and Related Research:

--'Nonprofit Hospitals and Health Systems Rating Criteria' (May 20, 2014).

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U.S. Nonprofit Hospitals and Health Systems Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=746860

Additional Disclosure

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