MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns A1 to Valley Health System's (VA) Ser, 2014 bonds; outlook negative

Global Credit Research - 05 Aug 2014

Parity ratings affirmed; $193.2 M affected

ECONOMIC DEVELOPMENT AUTHORITY OF THE CITY OF WINCHESTER, VA
Hospitals & Health Service Providers
VA

Moody's Rating

ISSUE		RATING
Hospital Revenue Refunding Bonds, Series 2014		A1
Sale Amount	$19,115,000	
Expected Sale Date	08/14/14	
Rating Description	Revenue: Other	
Hospital Revenue Refunding Bonds, Series 2014A		A1
Sale Amount	$43,815,000	
Expected Sale Date	08/14/14	
Rating Description	Revenue: Other	

Moody's Outlook NEG

Opinion

NEW YORK, August 05, 2014 --Moody's Investors Service has assigned A1 bond ratings to Valley Health System's (VHS) $19.1 million of Series 2014 fixed rate bonds and $43.8 million of Series 2014A fixed rate bonds to be issued by the Economic Development Authority of the City of Winchester (VA) and the West Virginia Hospital Finance Authority (WV). At the same time Moody's is affirming the A1 long-term rating on $193.2 million of outstanding bonds (see RATED DEBT section). The rating outlook remains negative.

VHS is also issuing approximately $12.0 million of Series 2014B direct placement bonds to be purchased by Wells Fargo Bank, N.A. which Moody's is not rating. These bonds are on parity and have an initial five year period. Covenants are the same as VHS's other direct placement debt and include: 1.25x debt service (calculated quarterly), 100 days cash on hand (calculated semi-annually) and 65% debt to capitalization (calculated annually).

SUMMARY RATING RATIONALE

The assignment and affirmation of the A1 rating incorporates VHS's distinctly leading market position in its broad seven-county primary service area in the demographically favorable northern Shenandoah Valley region of Virginia where the system faces little competition and benefits from its proximity to Washington, DC. VHS has also maintained a good balance sheet position. The negative rating outlook, revised earlier this year, is based on a second year of softer performance that failed to meet the higher levels of performance anticipated to support additional debt incurred in FY 2013, resulting in softer debt coverage metrics. Through six months of FY 2014, performance is on budget, similar to the prior year. If full year performance in FY 2014 does not meet expectations resulting in further weakening of debt measures, a rating downgrade would likely result.

STRENGTHS

*VHS has a distinctly leading market position in a large seven county primary service area (PSA) in the northern Shenandoah Valley region of Virginia that encompasses the City of Winchester (general obligation rated Aa2) where the flagship hospital is located. The system faces very little competition for acute care services in the PSA.

*VHS is located in the demographically favorable Winchester area with a low unemployment rate and good population growth of retirees and exurbanites from the Washington, DC, metropolitan area.

*VHS is reporting improved operating performance through six months of FY 2014 with an operating cash flow margin of 12.7% compared to the full year FY 2013 operating cash flow margin of 9.5%.

*VHS's balance sheet position has remained strong as of June 30, 2014 with $457 million of unrestricted cash and investments equating to 258 days cash on hand (the A1 median is 219 days).

*VHS has a new non-equity partnership with Inova Health System (rated Aa2/stable) that is expected to result in immediate expense savings and other benefits as the relationship grows.

CHALLENGES

*VHS has a high debt load and debt coverage ratios weakened in FY 2013 with the addition of new debt and the failure to meet performance expectations needed to manage the additional debt. When including current additional debt of $12 million, debt coverage ratios moderate further, however, if the improved performance in FY 2014 continues the additional debt is manageable.

*VHS's operating performance moderated over the last two fiscal years and in FY 2013 failed to achieve anticipated levels of performance to support increased leverage, VHS incurred an operating loss of $2.6 million (-0.4% margin) and generated an operating cash flow margin of 9.5%. The softer performance was mainly due to volume declines in key services and one-time expenses for a new information technology system.

*VHS's investment allocation has approximately 28% of the portfolio held in hedge funds, real estate investments, and other asset classes that could not be accessed within 30 days. 72% is accessible in less than 30 days compared to the A1 median of 95%, which provides less protection against unforeseen liquidity demands.

DETAILED CREDIT DISCUSSION

USE OF PROCEEDS: The bond proceeds will be used to (1) currently refund portions of Valley Health Series 2009 and 2009E bonds, and (2) pay the costs of issuance.

LEGAL SECURITY: Debt service on Series 2014 and 2014A bonds are expected to be secured, along with all outstanding bonds, by a pledge of revenues, receipts, and pledged assets comprising accounts receivable from Winchester Medical Center, Inc. (WMC); Warren Memorial Hospital, Inc. (WMH); Shenandoah Memorial Hospital, Inc. (SMH); Page Memorial Hospital (Page); and Hampshire Memorial Hospital, Inc. (HMH) (collectively the Obligated Group). Our analysis is based on the consolidated financial statements of Valley Health and Subsidiaries (the System). At FYE 2013, the Obligated Group represented 94% of the System's total assets, and in FY 2013, the Obligated Group represented 90% of the System's total revenues.

INTEREST RATE DERIVATIVES: VHS is a party to two interest rate swap agreements with a total notional amount of $185 million. The counterparty on one swap (a fixed spread basis swap) is Bank of America Merrill Lynch; the total notional amount of this swap is $85 million. The counterparty on the second swap (a fixed payer swap that was entered into to hedge the interest rate risk on the unrated Series 2009A though D variable rate bonds placed directly with three different banks) is Wells Fargo Bank, N.A.; the notional amount of this swap is $100 million, which corresponds to the total outstanding par amount on the Series 2009A through D bonds. As of June 30, 2014 the market to market valuation on the swaps was a cumulative -$26.5 million (negative to VHS). No collateral is required under the swap agreements. The rating trigger for termination of all swaps is a downgrade of VHS's rating to below Baa2.

MARKET POSITION/COMPETITIVE STRATEGY: DISTINCTLY LEADING MARKET SHARE IN FAVORABLE SERVICE AREA

We view VHS's distinctly leading market share in its seven-county PSA surrounding Winchester, VA, as one of its primary credit strengths and supports the maintenance of the A1 bond rating. The system is made up of six hospitals: the flagship hospital, WMC located in Winchester, VA, which serves as a regional referral center for a broad 18-county service area in northern Virginia and northeastern West Virginia; the five remaining hospitals are small acute care community providers, four of which are critical access hospitals. VHS has maintained more than 73% market share in the PSA over the last several years and more than 52% when including the primary and secondary service area (according to management provided data). VHS has expanded its footprint through the acquisition of several smaller regional hospitals, the latest being War Memorial Hospital (War), a 25 bed critical access hospital in the City of Berkeley Springs, WV, acquired in April 2010. Management has no plans for further mergers or acquisitions at this time and Virginia's strict certificate of need (CON) regulations should protect VHS's favorable market position.

Along with the leading market share, the service area's favorable demographics are also a credit strength for VHS. Winchester, VA (Aa2 GO bond rating) is 75 miles west of Washington, DC and has enjoyed strong population growth of retires and exurbanites over the last several years. While this growth has slowed recently the area remains attractive due to its proximity to metro DC and lower cost of living (Moody's Analytics). VHS also benefits from its proximity to and acute care facilities in West Virginia. West Virginia expanded Medicaid as of January 1, 2014, which has lead to lower levels of uncompensated care for the system. Combined bad debt and charity care declined by 11% in the first half of FY 2014 compared to the prior year period, contributing to the better performance through the first half of FY 2014. Virginia has not expanded Medicaid at this time.

OPERATING PERFORMANCE: MARGINS BUDGETED TO IMPROVE ON MANAGEMENT INITIATIVES BUT HIGH DEBT LOAD REMAINS A CONCERN

The recent revision of the rating outlook to negative factors in VHS's softer performance over the last two years and failure to meet the higher levels of performance expected in FY 2013 given management's performance improvement plan. In FY 2013, VHS reported an operating loss of $2.6 million (-0.4% margin) compared to the budgeted operating income of $28.6 million (3.8% margin). Operating cash flow was $68.5 million (9.5% margin) in FY 2013 compared to the budget of $94.2 million (12.5% margin). Performance in FY 2013 is similar to the level of operating performance in FY 2012 when the system reported an operating margin of 0.8% (adjusted as noted below) and an operating cash flow margin of 10.1%. Both years are a departure from the historical results when VHS averaged 13.9% operating cash flow margins over the last ten years. Management attributes the softer performance to volume declines and $4.4 million of one-time expenses related to a new information technology system.

Through the second quarter of FY 2014, performance has improved as the system realizes benefits from management's performance improvement initiatives. Through six months of FY 2014, VHS reported operating income of $7.8 million (2.2% margin) and operating cash flow of $45.8 million (12.7% margin). This is similar to the comparable period in FY 2013 when the system reported a 3.0% operating margin and a 12.3% operating margin. For the full year FY 2014, the system is budgeting an operating margin of 0.9% and an operating cash flow margin of 12.0%. Management expects to achieve this level of performance through initiatives it has already implemented, including: 1) an 80 FTE reduction through attrition and layoff; 2) supply chain savings and coding improvements; 3) changes to employee benefit programs resulting in a material reduction in the defined benefit pension plan expense; 4) a change to the DC wage index for Medicare equating to a $3.5 million benefit; and 5) improved rates for the ambulatory surgery system at the flagship hospital. Inability to achieve the FY 2014 budget could result in negative rating action.

VHS's high debt load remains the main weakness of this credit. When factoring in the current plan of finance FY 2013 debt measures remain modest for the rating category. Based on FY 2013 results, including $12 million of new debt, pro forma Moody's-adjusted debt-to-cash flow is 5.1 times and debt-to-operating revenue is 57%. Maximum annual debt service (MADS) amount is reduced with the current plan of finance and MADS coverage is 3.9 times. A1 median debt-to-cash flow is 3.1 times, median debt-to-operating revenue is 37% and median MADS coverage is 5.3 times, Debt coverage ratios improve with the better performance through the first half of FY 2014. Beyond this borrowing, plans for additional new debt are not anticipated. Given the leveraged operations and balance sheet at the A1 rating level, an increase in debt beyond this borrowing could result in a rating downgrade.

BALANCE SHEET POSITION: STRONG UNRESTRICTED LIQUIDITY AND FUTURE CAPITAL IS MANAGEABLE GIVEN THE PROJECTED OPERATIONAL IMPROVEMENT

VSH's unrestricted cash and investments improved at FYE 2013 (December 31) to $456 million (249 days cash on hand) from $392 million (220 days cash on hand) at FYE 2012. Management attributes the growth to positive investment returns and $35 million reimbursement for prior capital spending. With the increase in unrestricted cash and investments and despite the additional debt, pro forma cash-to-debt improved to 112% at FYE 2013 from 107% at FYE 2012, however, given the high debt load, this ratio remains unfavorable to the A1 median of cash-to-debt of 151%.

VHS's comprehensive debt is manageable. At FYE 2013 VHS's pension liability dropped materially to $52 million (82% funded ratio based on the projected benefit obligation of $282 million) from a liability of $125 million at FYE 2012. The improvement is a function of an increase in the discount rate and the system's freeze of the plan as of

January 1, 2014. With the improved liability, the pension expense for FY 2014 is reduced to $4 million from $20 million in FY 2013. Cash-to-comprehensive debt (including long and short-term debt and pension and lease liability) was 98% at FYE 2013 compared to the A1 median of 113%.

VHS's capital spending for FY 2014 is expected to be $89 million, approximately 1.3 times depreciation expense, similar to the capital spending level over the last two years. Spending over the next five years is expected to be approximately $312 million. The highest spending, $91 million, is planned for FY 2015. This level of spending will be manageable with the projected improved performance. Management states it has the ability to hold off on spending if projected cash flow levels are not achieved. Projects include a new information technology system, a new Cancer Center and a new long term care facility at the main campus, a medical office building at the Shenandoah campus, and an emergency department improvement project. VHS's age of plant is good at 9.4 years at FYE 2013, compared to the national median of 10.6 years.

OUTLOOK

The negative rating outlook is based on the softer performance in second half of FY 2013 despite management's performance improvement plans. The softer performance fell short of our expectations given the additional debt and resulted in softer debt coverage ratios. If performance in full year FY 2014 does not show improvement a rating downgrade would likely result.

WHAT COULD MAKE THE RATING GO UP

A rating upgrade would be considered if the system materially expands its enterprise while reporting and sustaining high double-digit operating cash flow margins resulting in improved debt coverage ratios.

WHAT COULD MAKE THE RATING GO DOWN

A rating downgrade would be considered if softer performance is reported in FY 2014 similar to the level reported in FY 2013 leading to weaker debt measures. Additional debt would also cause a rating downgrade, beyond what was considered in this report.

KEY INDICATORS

Assumptions & Adjustments:

-Based on consolidated financial statements for Valley Health and Subsidiaries, Inc.

-First number reflects audit year ended December 31, 2012

-Second number reflects audit year ended December 31, 2013, including Series 2014 and 2014A&B

-Pro forma factors $63.1 million of Series 2014 and 2014A bonds, $12.0 million of Series 2014B direct placement bonds, and the repayment of a portion of Series 2009 and 2009E bonds

-Investment returns normalized at 6% unless otherwise noted

-One-time Medicare Rural Floor settlement in FY 2012 of $4.7 million removed from operating revenue

-Comprehensive debt includes direct debt, operating leases, and pension obligation, if applicable

*Inpatient admissions: 29,793; 28,168

*Observation stays: 5,710; 8,429

*Medicare % of gross revenues: 45.9%; 47.6%

*Medicaid % of gross revenues: 10.8%; 10.3%

*Total operating revenues ($): $704.1 million; $722.2 million

*Revenue growth rate (%) (3 yr CAGR): 4.2%; 2.9%

*Operating margin (%): 0.8%; -0.4%

*Operating cash flow margin (%): 10.1%; 9.5%

*Debt to cash flow (x): 4.4 times; 5.1 times

*Days cash on hand: 220 days; 249 days

*Maximum annual debt service (MADS) ($): $27.7 million; $24.4 million

*MADS coverage with reported investment income (x): 4.0 times; 3.7 times

*Moody's-adjusted MADS Coverage with normalized investment income (x): 3.6 times; 3.9 times

*Direct debt ($): $365.5 million; $408.8 million

*Cash to debt (%): 107%; 112%

*Comprehensive debt ($): $504.7 million; $474.3 million

*Cash to comprehensive debt (%): 78%; 96%

*Monthly liquidity to demand debt (%): 150%; 159%

RATED DEBT (amount outstanding as of December 31, 2013)

Issued through the Winchester Industrial Development Authority (VA):

-Series 1993, Inverse Floating Rate Notes/Step Up Recovery Floaters, $4.9 million outstanding, A1 underlying rating

-Series 2007, Fixed Rate, $88.3 million outstanding, A1 underlying rating

-Series 2009E, Fixed Rate, $75.0 million outstanding, A1 underlying rating

Issued through the West Virginia Hospital Finance Authority (WV):

-Series 2009, Fixed Rate, $25.0 million outstanding, A1 underlying rating

UNRATED DEBT (amounts outstanding as of December 31, 2013)

-Series 2009A-D, Variable Rate Demand Bond, $100 million outstanding

-Series 2013A&B, Variable Rate Bank Qualified Loans, $105.7 million outstanding

THE 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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