MOODY'S INVESTORS SERVICE

CREDIT OPINION
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Update

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Pinnacle Health System, PA

Update – Moody's upgrades Pinnacle Health System's (PA) to A2; stable outlook

Summary Rating Rationale

Moody's Investors Service upgrades Pinnacle Health System's (PHS) (PA) rating to A2 from A3, affecting close to $300 million of debt. The rating outlook is stable.

The upgrade is based on multiple years of sustained strong margins, completion of a large capital program, meaningful increase in liquidity, and improved competitive position from volume and enterprise growth. The A2 rating also reflects challenges of operating in a competitive region and moderately high balance sheet and operating leverage.

Credit Strengths

» Sizable 3-hospital system with close to $1 billion in revenue and leading market position in the Central Pennsylvania region

» Strong operating cashflow margins averaging 13% over four years, sustained during a period of major strategic initiatives

» High 3-year revenue CAGR of 8%, driven by good volume growth from facility investments and physician recruiting

» Very good liquidity with 263 days cash on hand and 66% allocated to cash or fixed income at FYE15

» Manageable capital needs, which will allow further deleveraging

» Termination of defined benefit pension plan in 2015

Credit Challenges

» Moderately leveraged balance sheet and operation with modest 133% cash-to-debt, high direct debt-to-revenue of 49%, and moderate maximum annual debt service coverage of 4.5 times

» Competitive market with most competitors owned by larger organizations with resources

» Sizable bank-related debt obligations over the next two years

Rating Outlook

The stable rating outlook reflects expected sustainability of operating cashflow margins, some deleveraging as moderate capital spending will allow liquidity growth, and no material new debt.

Factors that Could Lead to an Upgrade

» Marked reduction in balance sheet leverage, demonstrated with improved cash-to-debt

» Reduction in operating leverage, demonstrated with improved debt service coverage

» Continued enterprise growth to improve competitive position

Factors that Could Lead to a Downgrade

» Material decline in margins

» Sizable increase in leverage

» Sustained volume declines

Key Indicators

Exhibit 1

Pinnacle Health System, PA

	2011	2012	2013	2014	2015
Operating Revenue ($'000)	680,767	748,209	830,551	859,245	950,009
3 Year Operating Revenue CAGR (%)	6.3	9.7	12.2	9.9	8.3
Operating Cash Flow Margin (%)	8.8	13.0	14.7	12.7	11.9
PM: Medicare (%)	45.1	44.5	45.7	45.0	45.6
PM: Medicaid (%)	12.7	12.7	12.0	12.4	12.3
Days Cash on Hand	199	204	209	207	263
Cash to Debt (%)	113.6	114.2	98.5	102.5	133.4
Debt to Cash flow (x)	3.7	2.7	2.8	3.1	3.2

Based on financial statements for Pinnacle Health System, fiscal year end June 30
Adjustments: $10.8 million gain related to transaction with Select Medical Corporation eliminated from other revenue in FY15
Investment returns normalized at 6% prior to FY 2015 and 5% in FY 2015 and beyond
Source: Moody's Investors Service

Recent Developments

In May 2015, the System entered into a strategic affiliation agreement with The Pennsylvania State University (PSU) and its wholly-owned subsidiary, Penn State Health (PSH). Under the agreement, the operations of the System and PSH would be aligned into an affiliated group health enterprise with PSU as the sole member of the parent entity. In December 2015, the FTC and the Commonwealth of Pennsylvania's Office of the Attorney General filed a complaint challenging the affiliation. The entities involved have voluntarily agreed to a temporary restraining order. A hearing is expected mid-April 2016.

Detailed Rating Considerations

Market Position: Volume and Enterprise Growth Enhance Advantage in Competitive Market

PHS completed a number of major facility and physician-related strategies, driving volume and enterprise growth. Admissions grew 6% in FY2015 and 3% in the first quarter of FY2016. Based on management provided data, market share grew to 51% in calendar year

2014, compared with 44% in 2011. Growth strategies include the new West Shore Hospital (opened May 2014) and a free-standing cancer center on the same campus, and renovations at both Harrisburg and Community General hospitals to increase private beds. The system has also aligned with a number of large physician groups. Current strategies are focusing on expansion of ambulatory capabilities and the medical group.

PHS operates in a competitive region with Hershey Medical Center (an academic medical center focusing on quaternary care, research and education owned by The Pennsylvania State University) and Holy Spirit Hospital (owned by Geisinger Health System) as primary competitors, both of which benefit from their ownership by larger organizations with deep financial resources.

Operating Performance, Balance Sheet, and Capital Plans: Sustained Strong Margins, Investment Growth and Moderating Capital Spending

Following a history of moderate margins, the system generated strong margins over the last four years even during a period of significant capital and operating investments. While slightly variable year-to-year, operating cashflow margins averaged 13% over this time period. Performance was driven by very good volume and revenue growth from initiatives discussed above as well as cost reductions in the areas of benefits and supplies. The system absorbed several unusual costs in fiscal years 2014 and 2015, including West Shore Hospital startup expenses, information systems investments, sequestration cuts and merger integration costs.

Margins for the first quarter of FY2016 are consistent with recent trends and the full year FY2016 budget is anticipated to sustain margin performance. Primary challenges for FY2016 and early FY2017 are absorbing merger-related costs and managing related distractions to operations, and installing a new medical information and revenue cycle system.

LIQUIDITY

PHS's liquidity position strengthened to 263 days cash on hand at FYE15, compared with 207 days at FYE14. The increase is primarily due to $166 million in proceeds from a lease-leaseback transaction. Capital spending is moderating, which will allow further cash growth. The system is budgeting $75 million in capital spending in FY2016. The largest project in fiscal years 2016 and 2017 is the installation of a new electronic medical system.

Debt Structure and Legal Covenants: System Balance Sheet and Operation Moderately Leveraged

Although improved, PHS's balance sheet and operation is still leveraged relative to similarly rated peers. Based on FY2015, cash-to-debt is modest at 133% and direct debt-to-revenue is high at 49%. Maximum annual debt service coverage is moderate at 4.5 times and debt-to-cashflow is adequate at 3.2 times. While the system has terminated its defined benefit pension obligation, operating leases contribute to comprehensive debt and result in a modest cash-to-comprehensive debt of 102%. Management reports there are no plans for incremental debt at this time.

DEBT STRUCTURE

Based on FYE15, PHS had $139 million of short-term bank-related obligations (out of total debt of $461 million), partly mitigated by good liquidity. The Series 2011A bonds ($94 million) are held by Wells Fargo Bank with an initial bank purchase period to June 2018. The system has a $45 million bank note with PNC, the proceeds of which provided funds to terminate the pension plan. The PNC bank note matures June 2017 and the system is making monthly payments. The system's liquidity provides over 400% coverage of these obligations.

The system has adequate headroom under covenants. The Series 2011A bank-related covenants include 1.25 debt service coverage and 90 days cash on hand.

DEBT-RELATED DERIVATIVES

In August 2015, PHS terminated its sole interest rate swap.

PENSIONS AND OPEB

The system terminated its defined benefit pension plan in 2015. The system offers a defined contribution plan to employees.

Management and Governance

The system's recent major strategic plan was executed with minimal disruption to operations as the system maintained strong margins and grew volumes and market share. The strategy to reposition the system competitively involved risks related to opening a new hospital, investing heavily in multiple capital projects, and aligning with several large physician groups.

Legal Security

Bonds are secured by a gross revenue pledge of the Obligated Group and a mortgage on the Harrisburg Hospital and the Community General Hospital facilities. PHS' obligated group consists of the parent, hospital campuses noted below, and Pinnacle Health Medical Services (physician practice operation).

Use of Proceeds

Not applicable

Obligor Profile

Pinnacle Health System is based in Harrisburg, Pennsylvania, and operates three hospitals in the region including the Harrisburg Hospital campus, Community General Hospital campus and West Shore Hospital campus. The system is sizable with close to $1 billion of revenue and approximately 38,000 discharges and 11,400 observation cases.

Methodology

The principal methodology used in this rating was Not-For-Profit Healthcare Rating Methodology published in November 2015. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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