Fitch Ratings

Fitch Rates Palomar Health (CA) Rev 'BB+'; Outlook Positive

Fitch Ratings-Austin-07 December 2017: Fitch Ratings has assigned a 'BB+' rating to the expected issuance of $56.18 million of certificates of participation (COPs) Evidencing Proportionate Undivided Ownership Interests of the Holders Thereof in Installment Payments to be Paid by Palomar Health (PH or the district) and $153.29 million of Palomar Health refunding revenue bonds, series 2017.

Additionally, Fitch has affirmed the 'BB+' Issuer Default rating (IDR) on the district, the 'BB+' rating on PH's outstanding revenue bonds and series 2007A, 2009A, and 2010A general obligation (GO) bonds.

The Rating Outlook is Positive for the ratings mentioned above.

Fitch has also affirmed the 'AAA' rating on the series 2016A&B GO bonds based on pledged special revenue analysis. The Rating Outlook on the series 2016A&B bonds is Stable.

The bonds are expected to sell as fixed rate the week of Dec. 18 via negotiation. The series 2017 refunding revenue bonds will be used to refund series 2010 COPs for savings. The series 2017 COPs will be used to finance design, construction, acquisition and improvement of hospital and healthcare facilities.

A full list of outstanding bonds and ratings is listed at the end of this press release.

SECURITY
Revenue bonds are secured by a gross revenue pledge of the obligated group (OG). Gross revenues exclude property tax revenue. The OG consists of PH's acute care facilities as well as other healthcare related entities and

will include AHP, a medical foundation as of fiscal 2018 (June 30 year end). GO bonds are payable from an unlimited ad valorem property tax that was approved by the voters in the district in a 2004 election.

KEY RATING DRIVERS

SOUND AND IMPROVING PERFORMANCE: PH improved its fiscal 2016 and 2017 profitability through performance improvement initiatives. Maintenance of the Positive Outlook reflects Fitch expectations for sustained profitability and liquidity growth associated with PH's service consolidation.

SERVICE CONSOLIDATION: In June 2015, the board of directors approved closure of the 295-bed Palomar Medical Center Downtown Escondido (PMCDE) in Escondido. State regulatory requirements contributed to delays in the full closure of PMCDE. Fitch expects PH to realize meaningful savings once the full consolidation is complete (by March 2019) based on resource allocation efficiencies.

GOOD MARKET POSITION: PH maintains a dominant 51% market share within its North San Diego County primary service territory and benefits from strategic affiliations with Kaiser Foundation Hospitals, Kindred Rehabilitation Services, the Mayo Clinic Network and Rady Children's Hospital. Its medical foundation, AHP provides a primary care base that will be integral in care coordination.

PLEDGED SPECIAL REVENUE ANALYSIS: Fitch rates the district's GO refunding bonds, series 2016A and 2016B 'AAA' based on a dedicated tax analysis without regard to district or hospital financial operations. Fitch has been provided with legal opinions by district counsel that provide a reasonable basis for concluding that the tax revenues are levied to repay the bonds would be considered pledged special revenues in the event of a district bankruptcy.

CERTAIN GO BONDS CAPPED AT IDR: Series 2007A, 2009A, and 2007A GO bonds are capped at PH's IDR absent comparable legal opinions as these bonds would not be protected by a pledge of special revenues, leaving them subject to an automatic stay in the unlikely event of the district's insolvency.

STRONG ECONOMIC RESOURCE BASE: The economic resource base supporting the district's GO bonds is strong, diverse, and growing. The tax base grew 200% between fiscal years 1999 and 2018. The unlimited nature of the tax offsets any concern about tax base volatility.

RATING SENSITIVITIES

IMPROVED LIQUIDITY: The continuation of solid operating performance and improved liquidity would likely result in upward rating movement of the 'BB+' rating over the next two years.

TAX BASE DRIVES GO SECURITY RATING: The district's 'AAA' rating on the GO refunding bonds, series 2016A and 2016B could come under downward pressure in a significant and long-lasting decline in the district's tax base and economy, which Fitch considers unlikely.

CREDIT PROFILE

PH is California's largest local health care district serving approximately 539,000 residents over approximately 800 square miles of northern inland San Diego County. The service area is primarily residential, with some light industrial and commercial activity. PH owns and operates two hospitals in northern San Diego County: 286-bed Palomar Medical Center Escondido that opened in August 2012 and 95-bed Palomar Medical Center (PMCP); as well as a downtown campus hospital that is currently in transition to close. PH also owns and operates Villa Pomerado - a 129-bed skilled nursing facility that is located adjacent to PMCP. AHP is a medical foundation with 60 FTE physicians in eight clinic locations providing alignment between PH and its physicians.

Fitch's financial analysis is based on the consolidated entity and excludes the GO bonds and related property tax revenue and interest expense since the GO debt is self-supporting. Fiscal 2017 (June 30 year-end) operating revenues total $803 million. As a California healthcare district, PH receives unrestricted tax revenues that account for about 2% of its operating revenue.

SOUND FINANCIAL PROFILE

Unrestricted cash and investments of $223.7 million (June 30, 2017) reflect four years of steady growth and equate to 106.9 days cash on hand (DCOH), favorable to Fitch's below investment grade ('BIG') category median of 87.5 days. However, cash-to-debt of 37.7% as of June 30, 2017 is unfavorable to Fitch's 'BIG' category median of 58.7% reflecting PH's elevated leverage.

Operating EBITDA margins of 9.7% in fiscal 2016 and 9.1% in fiscal 2017 represent progressive improvement over the past four years driven by a focus on operating efficiencies. Near term improvement initiatives are focused on revenue cycle savings and PH projects achievement of its 9.2% operating EBITDA target for fiscal 2018. Fitch expects the PMCDE closure and service consolidation to provide additional savings by 2020. The remaining services at PMCDE (radiation therapy, acute rehabilitation, and behavioral health) will be transitioned to other facilities.

MANAGEABLE DEBT BURDEN; ELEVATED LEVERAGE
Total debt outstanding of $1.2 billion (Sept. 30, 2017) consists of revenue bonds ($566 million) and GO bonds ($619 million). Outstanding 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 if Assured Guaranty's rating falls below the 'A' category, collateral posting would be required at a zero threshold. There is an additional termination event if Assured Guaranty's rating falls below 'BBB'. The mark to market value on the swap as of June 30, 2017 was negative $26.5 million.

The $56 million new money Series 2017 revenue bond issuance will finance the design, construction, acquisition and improvement of hospital and healthcare facilities to enhance the district's competitive profile. Maximum annual debt service (MADS) remains materially unchanged due to the refunding bond savings and structure of the series 2017 bond terms through 2048. Routine capital needs average $15 million per year over the next several years and will be funded through cash flow.

Leverage is elevated as measured by debt to capitalization of 76.3% as of June 30, 2017 (77.5% inclusive of the series 2017 new money issuance) in relation to Fitch's 'BIG' median of 56%.

Proforma MADS of $39.4 million is covered 1.9x by fiscal 2017 operating EBITDA, consistent with the BIG category median of 1.8x.

GO BOND ANALYSIS

The specific features of the GO refunding bonds, series 2016A and 2016B meet Fitch's criteria for rating special revenue obligation debt without consideration of the district's general credit quality. Fitch believes bondholders are effectively insulated from hospital operations risk as expressed in its IDR. Fitch sets a high bar for considering local government tax-supported debt to be secured by special revenues, which provide security that survives the filing of a municipal bankruptcy (in preservation of the lien) and benefit from relief from the automatic stay provision of the bankruptcy code. Fitch gives credit to special revenue status only if, in its view, the overall legal framework renders remote a successful challenge to the status of the debt as secured by special revenues under Section 902 (2) (e) of the U.S. Bankruptcy Code.

Fitch has identified a number of elements it considers sufficient to reduce the incentive to challenge the special revenue status given the definitions outlined in the bankruptcy code. These include clear restrictions on the use of pledged revenues for identified projects and clear separation from the entity's operations. Fitch has undertaken an extensive review of the statutory provisions that govern the use of the pledged property tax revenues. Those provisions, along with the legal documents governing the bond issuance, provide sufficient strength for Fitch to rate the district's GO bonds higher than its IDR. As a result, Fitch analyzes the GO refunding bonds, series 2016A and 2016B as dedicated tax bonds. This analysis focuses on the district's economy, tax base, and debt burden without regard to the IDR. Fitch typically calculates the ratio of available revenues to debt service for dedicated tax bonds, but the unlimited nature of the tax rate pledge on the district's bonds eliminates the need for such calculations.

The district's bond counsel has determined that it cannot opine that the district's outstanding GO bonds election of 2004, series 2007A, 2009A, and 2010A are secured by a pledge of special revenues. These outstanding GO bonds would not be protected by a pledge of the special revenues, leaving them subject to the automatic stay upon a potential insolvency of the district. Absent an opinion that the tax revenues constitute pledged special revenues under Chapter 9, the series 2007A, 2009A, and 2010A GO bonds cannot be rated distinct from and higher than the IDR.

GROWING TAX BASE
The district's tax base is strong, having grown 200% between fiscal years 1999 and 2018. An almost 6% recessionary decline through fiscal 2013 has been more than offset by a strong 30% rebound through fiscal 2018 when taxable assessed valuation (TAV) nearly reached $80 billion.

The ability to make debt service payment is unlikely to be reduced by expected cyclical variations in the tax base and economy. The district's service area retains good potential for long-term growth due to its location, availability of relatively affordable land for development, and a growing labor force. There is no taxpayer concentration; the top 10 property taxpayers collectively accounted for less than 3% of fiscal 2018 TAV. Approximately three quarters of the tax base is residential.

Tax rates are low and unlikely to rise to a level that would pressure the rating even under relatively severe stress scenarios. The general tax rate of 1% of TAV is capped by Proposition 13 and cannot be increased. The total levy, including debt service overrides for the district and overlapping jurisdictions, is low and varies automatically with debt service and TAV changes. Fitch considers the tax base to be very unlikely to suffer losses that would meaningfully erode repayment capacity.

While wealth levels within the district vary considerably, all residents are well located to benefit from employment opportunities in the growing, diverse economies of both San Diego and southern Orange Counties.

VARIATION FROM PUBLISHED CRITERIA
Fitch applied a variation to its 'U.S. Public Finance Tax-Supported Rating Criteria' in assigning the security rating above PH's IDR. Even though bondholders have a claim on general revenues of the district, the presence of the statutory lien serves as an effective mitigant, resulting in an overall

structure that Fitch believes sufficiently reduces the incentive to challenge the bonds' special revenue status under 902(2)(E) in a bankruptcy. Statutory liens survive bankruptcy filing in the same way that special revenue status would.

Outstanding Debt:

Bonds rated 'BB+'/Positive Outlook:
--$241,390,000 COPs series 2016;
--$156,175,000 COPs series 2010;
--$180,000,000 COPs series 2006A-C;
--$64,916,679 GO bonds election of 2004 series 2010A;
--$110,000,000 GO bonds election of 2004 series 2009A;
--$66,083,319 GO bonds election of 2004 series 2007A.

Bonds rated 'AAA'/Stable Outlook:
--$46,345,000 GO refunding bonds series 2016A;
--$162,835,000 GO refunding bonds 2016B.

Contact:
Primary Analyst
Rebecca Meyer
Director
+1-512-215-3733
Fitch Ratings, Inc.
111 Congress Ave., Suite 2010
Austin, TX 78701

Secondary Analyst
Kevin Holloran
Senior Director
+1-512-813-5700

Tertiary Analyst
Ryan Pami

Associate Director
+1-212-908-0803

Committee Chairperson
Eva Thein
Senior Director
+1-212-908-0674

Media Relations: Sandro Scenga, New York, Tel: +1 212-908-0278, Email: sandro.scenga@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
Rating Criteria for Public Sector Revenue-Supported Debt (pub. 05 Jun 2017) (https://www.fitchratings.com/site/re/898969)
U.S. Nonprofit Hospitals and Health Systems Rating Criteria (pub. 09 Jun 2015) (https://www.fitchratings.com/site/re/866807)
U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017) (https://www.fitchratings.com/site/re/898466)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/site/dodd-frank-disclosure/1033634)
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