

Rating Update: [Maryland Health & Higher Edl. Fac. Auth.](#)

Moody's affirms University of Maryland Medical System's A2; Outlook remains negative

Action Affects \$1.05B

MARYLAND HEALTH & HIGHER EDUCATIONAL FACILITIES AUTHORITY
Hospitals & Health Service Providers
MD

Opinion

NEW YORK, December 16, 2013 --Moody's Investors Service has affirmed the A2 long-term ratings assigned to the University of Maryland Medical System's (UMMS) bonds issued through the Maryland Health and Higher Educational Facilities Authority (See Rated Debt). The rating outlook remains negative.

SUMMARY RATING RATIONALE:

The A2 rating continues to remain supported by UMMS's strong brand and leadership position as the clinical training venue for the University of Maryland's School of Medicine, expanded geographic reach and notable market share growth and our assessment of the strength of the System's relationship with the State of Maryland (rated Aaa), which carries a demonstrated history of financial support for UMMS services on an annual basis and for strategic capital investment. The rating is limited by exceptionally weak operating margins in FY 2013 and modest balance sheet dilution, primarily brought on by the acquisition of St. Joseph Medical Center, which is of particular concern given UMMS historically leveraged position and already modest balance sheet ratios. The negative rating outlook reflects UMMS limited capacity to absorb ongoing operational weakness given already stressed balance sheet and leverage metrics. The negative rating outlook also reflects our concerns that UMMS faces heightened execution risk and potential for management distraction with accelerated expansion and affiliation strategies executed over the last two fiscal years and its very recent assumption of the remaining interest in Upper Chesapeake Health System that carries capital investment commitments. Failure to materially improve system wide operating performance, with specific emphasis on an improved operating trajectory at St. Joseph's and system wide

same store improvement, will pressure the rating.

STRENGTHS

*Long record of financial support from the State of Maryland in the form of annual appropriations, approximately \$3.0 million annually, for uncompensated care related to University of Maryland Medical Center's (UMMC) role as the state-wide trauma center, and sizable capital funding grants over the last twenty years. Additionally, there is State Legislative leadership at the UMMS Board level.

*Geographic and clinical diversity through the operation of an academic medical center, UMMC, nine acute care community hospitals and two specialty hospitals. The health system offers a wide range of health services, including primary, secondary, tertiary and quaternary care, as well as trauma, rehabilitation, chronic care, and skilled nursing care

*The strategic relationships between the academic medical center as hub and community and specialty hospitals as spokes have translated into enterprise growth with transfers to UMMC growing each year since 2006. The acquisition of St. Joseph's (December 1, 2012) provides UMMS significant service capacity and an existing certificate of need approved cardiac surgery program in the growing north Baltimore Service area. Similarly, UMMS's recent completion of its staged acquisition of Upper Chesapeake Health System should afford the System referral access to the northern Maryland service area which boasts a population of over one million people.

*Barriers for entry into acute care services are high and likely to remain largely unchanged given the State of Maryland's Certificate of Need (CON) requirements

*Reimbursement rates regulated by the Maryland Health Services Cost Review Commission (HSCRC) provide relative predictability for the majority of System revenue

CHALLENGES

*Acquisition of St. Joseph's in FY 2013 meaningfully diluted UMMS consolidated financial profile with margins dropping to levels well below historic levels; of particular concern is St Joseph's operating performance which was markedly weaker than anticipated at the time of our last review

*All liquidity and leverage metrics are stressed unfavorably to their maximum tolerance points for the rating level, as absolute balances tempered modestly in FY 2013, an increasing investment in alternatives (now 28% of total cash and investments) and a very modest level of monthly liquidity to demand debt of 88% (A2 median is 430%) elevate risk at the current rating level

*Capital spending plans are material through 2017, including investment in northern Maryland markets with the completion of acquisition of UCHS, replacement of Shore Health facilities, significant technology investment and an ambulatory care center at Maryland General. Additionally the potential for partnering with

the State to revitalize health care services in Prince George's County could carry investment on the part of UMMS.

*Variable inpatient demand trends as services continue to shift to short stay and outpatient settings; UMMS decline in inpatient demand has been half the rate of decline experienced by the State (6.7%)

*Revenue growth will come under pressure as flat to limited HSCRC rate adjustments are expected to continue with the payment methodology shifting to a newly defined structure aimed at the concept of population health

*Unfavorable demographics in local service area of the City of Baltimore, though somewhat mitigated by Maryland's "all-payer" reimbursement methodology and diversity of access points across the health system

*Intensifying challenges including: increasing consolidation of a market that boasts formidable competition from two sizable organizations, Johns Hopkins Health System and MedStar Health

DETAILED CREDIT DISCUSSION:

LEGAL SECURITY: All parity obligations are currently secured by a security interest in the revenue of the Obligated Group. Effective December 6, 2013, UMMS completed its acquisition of Upper Chesapeake Health System (UCHS), and simultaneously admitted the UCHS hospitals (Upper Chesapeake Medical Center and Harford Memorial Hospital) into the Obligated Group. The Obligated Group includes all the system's wholly-owned hospitals: University of Maryland Medical Center, Baltimore Washington Medical Center, Inc., The James Lawrence Kernan Hospital, Maryland General Hospital, Shore Health System, which owns Memorial Hospital at Easton and Dorchester General Hospital, University of Maryland St. Joseph Medical Center, LLC, which owns and operates University of Maryland St. Joseph Medical Center; Civista Medical Center, Inc., which owns and operates Civista Medical Center; Chester River Hospital Center, Inc., which owns and operates Chester River Hospital and the UCHS Hospitals. In addition the UMMS Foundation is a member of the Obligated Group.

INTEREST RATE DERIVATIVES: Swaps with a total outstanding notional amount of \$606.9 million. The counterparties are Bank of America and JP Morgan Chase Bank. UMMS does have collateral posting requirements for certain swaps, but the Bank of America swaps do not require collateral posting requirements unless UMMS's ratings fall below investment grade or is in default under the terms of its loan agreements. Collateral posting under the JPMorgan Chase Bank swaps occurs when the fair value of the related swaps falls below a minimum threshold. As of June 30, 2013 the amount of such posted collateral was \$65.0 million.

RECENT DEVELOPMENTS:

UMMS has pursued an effective strategy to develop an integrated and full service system that has resulted

in broad geographic coverage. With the addition of St. Joseph Medical Center, UMMS encompasses an academic medical center and nine acute care facilities and is closely aligned with approximately 1,500 physicians through either employment contracts or long-term contractual arrangements. According to management, UMMS continues to maintain a leading market position in their primary service area, defined as the City of Baltimore and the eleven surrounding counties, with a 23.1% share as compared with MedStar Health's 16.5% market capture and Johns Hopkins Health System's (JHHS) 16.9% (though these relative market share counts do not include admissions of affiliates of MedStar and JHHS that are situated outside of UMMS defined PSA). When including Upper Chesapeake Health System's market capture, which UMMS now owns, UMMS market share increases to over 28% of the service area. University of Maryland Medical Center (UMMC) remains the System's flagship hospital and captures the second highest individual hospital market share in the service area at 7.8% (just behind Johns Hopkins Hospital at 8.0%). Despite good regional and local market positions, the majority of UMMS's hospitals are facing increased competition. Over the last year there have been several notable mergers or acquisitions announced, as well as increasing physician alignment and acquisition activity.

Despite growing the core business to leverage size and scope to address the industry's shift to population health management, UMMS pace of expansion has tempered margins, diluted resources and may distract management in the near term, risk elements that underscore our negative rating outlook. Prior to its acquisition by UMMS, St. Joseph Medical Center had been experiencing operating losses of about \$3 million a month as a result of material declines in patient volume (with admissions falling to 18,163 in FY 2012 from 25,895 in FY 2008) and revenue, related to a 2009 controversy involving its cardiac care unit. Under the terms of the Agreement, UMMS has not assumed any financial liability or obligation associated with the business operations at St. Joseph Medical Center that existed prior to December 1, 2012. However, in FY 2013 the acquisition costs as well as the ongoing challenge related to rebuilding the medical staff at St. Joseph's was carried by UMMS core operating profits, diluting all operating and leverage measures (see discussion below). In addition, Maryland's healthcare environment has continued to be affected by the national economic slowdown. Some of UMMS operating challenges have included decreasing inpatient volumes with a shift to outpatient settings, multi-year rate tightening by the HSCRC, and an increased use of quality indicators to determine hospital rates. With very recent conclusion of UMMS multi-year acquisition of the Upper Chesapeake Health System (UCHS), integration and execution risk are also elevated.

The acquisition of St. Joseph's, which incurred a \$52.8 million operating loss in FY 2013 including the losses generated by aligned physicians, had a meaningful impact on all measures of operating performance of the System's consolidated performance. As UMMS applied for a new Medicare provider number for St Joseph's, operating losses accelerated with the inability to bill for services for more than 6 weeks, accounting for a \$14.8 million of the loss, which is a non-recurring obstacle for FY 2014. Additionally, the HSCRC held rates flat to 2012, pressuring top line growth for all Maryland entities. For the full fiscal year 2013, UMMS incurred a \$20 million operating loss (-0.8% margin), excluding a FICA settlement of \$6.3 million, and \$173.7 million of operating cash-flow (6.8% margin); reflecting a low point

for System wide performance. Through three months of FY 2014 (period ended September 30, 2013) UMMS consolidated performance shows a marked improvement with a 1.1% operating margin and an 8.7% operating cash flow margin over the same period in FY 2013 (0.2% and 8.7% margins, respectively). Giving effect to the acquisition of UCHS, by combining full FY 2013 of UMMS (FYE 6/30) with UCHS FY 2012 (FYE 12/31) and adding the recent bank line draw of \$150.0 million, has a mixed impact on the UMMS financial profile. The combined operating margin and operating cash-flow margin improve to -.01% and 7.5%, respectively, while days cash remains relatively flat at 127 (UMMS reported 124 days at FYE 2013) but pro-forma cash to debt declines to 53% from UMMS 56% at FYE 2013 and a stronger 66% at FYE 2012. Debt to cash-flow is unfavorably high at 8.6 times for both the UMMS audit FYE 2013 and the pro-forma FYE 2013 (including UCHS and new borrowings) as compared with UMMS historic level of 4.8 times at FYE 2012.

We expect the system's operating margins to improve in FY 2014. UMMS is aggressively pursuing operational improvements at St. Joseph's. Initiatives include reduction in corporate supports costs, improvements to labor productivity and supply chain savings, and expected improved patient volume due to synergies with UMMS faculty. Management projects the ability to improve upon performance at St Joseph's each FY through 2017 when the operating loss is reduced by more than half of its current run rate.

Absolute unrestricted cash and investments dropped modestly to \$825.7 million, or 124 days cash on hand, providing 56% coverage of debt at FYE 2013. Following the \$150 million bank draw the balance sheet remains a limiting credit factor at the A2 rating level, with pro-forma debt rising to nearly \$1.8 billion (including debt of UCHS, a line of credit borrowing used to satisfy UMMS swap collateral posting and capital leases) and cash to debt falling to a weak 53% as compared to A2 median of 140%. Operating leases and unfunded pension liabilities add an additional \$200 million of comprehensive liabilities diluting cash to comprehensive debt to 47.3%. Cash to demand debt is a weak 132% and monthly liquidity provides a more modest 88% coverage of demand debt with just 72% of UMMS investments liquid and accessible within one month (down from 79% at FYE 2011). UMMS investment allocation is the following: 25.9% in equities, 46.2% in fixed income and cash and the balance (28%) in alternative investments, a level which has been growing.

Capital spending will remain high, exacerbating already high leverage, another key driver of the maintenance of the negative rating outlook. Over the next several years, UMMS is considering an ambulatory footprint at Maryland General, investments in northern Maryland, significant IT investment and replacement facilities for the Shore Health campuses. Also, in exchange for 100% ownership of UCHS UMMS has paid \$150 million, borrowed on a bank line. The funds will be used by UCHS for future capital improvements, to be made over the next several years. UMMS has also entered into a memorandum of understanding with the State, Prince George's County and Dimensions Healthcare to explore the revitalization of health care services in Prince George's County, though no financial commitment has been made by UMMS at this point. Funding sources for these anticipated capital expenditures are expected to include cash flow from operations, proceeds of debt, state and federal grants, and philanthropic support;

at this time we have only incorporated the impact of the current bank line draw for UCHS in the rating and outlook. Finally, management reports that future growth strategies, focused on geographic reach, may include additional clinical relationships with Maryland hospitals. The magnitude of future capital expenditures and potential bond issuance by 2017, may temper further strengthening in cushion measures over the next several years and pressure the rating, particularly if operating margins remain under pressure.

Outlook

The negative rating outlook reflects UMMS limited capacity to absorb ongoing operational weakness given already stressed balance sheet and leverage metrics. The negative rating outlook also reflects our concerns that UMMS faces heightened execution risk and potential for management distraction with accelerated expansion and affiliation strategies executed over the last two fiscal years and its very recent assumption of the remaining interest in Upper Chesapeake Health System that carries capital investment commitments. Failure to materially improve system wide operating performance, with specific emphasis on an improved operating trajectory at St. Joseph's and system wide same store improvement, will pressure the rating.

What could change the rating--UP

A rating upgrade could occur if UMMS demonstrates significantly improved and sustained financial performance, to levels that are at least consistent with historic performance, and all measures of liquidity improve materially. In addition, evidence of increased State financial support could pressure the rating upward. Given the negative rating outlook, a rating upgrade is unlikely in the near term.

What could change the rating--DOWN

A rating downgrade would occur if UMMS is unable to improve financial performance in FYE 2014 to levels more in-line with historic levels. A downgrade could also occur if UMMS experiences a reduction in cash or increase in debt as both are stressed unfavorably to their maximum tolerance points for the rating level. A permanent reduction of State support may also pressure the rating.

KEY INDICATORS

-Based on audits for University of Maryland Medical System Corporation and Affiliates

-First number reflects audited year ended June 30, 2012

-Second number reflects pro-forma for the fiscal year end June 30, 2013 including UCHS 2012 audit (FYE 12/31) and \$150 million bank borrowing

- 2012 performance excludes a \$16.2 million one-time expense item related to closure of a facility

-FICA refund of \$1.9 million and \$6.3 million excluded from other operating revenue in FY's 2012 and 2013, respectively

-Investment returns smoothed at 6% unless otherwise noted

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

-Monthly liquidity to demand debt ratio is not included if demand debt is de minimis

*Inpatient admissions: 89,352; 94,545 (excludes UCHS; St. Joseph's included for partial year 2013)

*Observation stays: NA; NA

*Medicare % of gross revenues: 32%; 36% (excludes UCHS)

*Medicaid % of gross revenues: 27%; 23% (excludes UCHS)

*Total operating revenues: \$2.3 billion; \$2.9 billion

*Revenue growth rate (%) (3 yr CAGR): 6.9%; 8.3% (historic, not pro-forma)

*Operating margin: 3.6%; -0.1%

*Operating cash flow margin: 11.1%; 7.5%

*Debt-to-cash flow: 4.8 times; 8.6 times

*Days cash on hand: 141 days; 127 days

*Maximum annual debt service (MADS): \$82.1 million; \$94.5 million

*MADS Coverage with reported investment income: 3.3 times; 2.4 times

*Moody's-adjusted MADS Coverage with normalized investment income: 3.8 times; 2.8 times

*Direct debt: \$1.2 billion; \$1.8 billion

*Cash-to-direct debt: 66%; 53%

*Comprehensive debt: \$1.4 billion; \$2.0 billion

*Cash-to-comprehensive debt: 59%; 47%

*Monthly liquidity to demand debt (%): 136%; 88%

RATED DEBT

University of Maryland Medical System:

-Series 1991B, fixed rate, FGIC-insured, A2 underlying rating

-Series 2005, fixed rate, Ambac insured, A2 underlying rating

-Series 2006A, fixed rate, rated A2

-Series 2008D, variable rate demand bonds, letter of credit provided by Toronto Dominion, A2 underlying rating

-Series 2008E, variable rate demand bonds, letter of credit provided by BMO, A2 underlying rating

-Series 2008F, fixed rate, rated A2

-Series 2010, fixed rate, rated A2

-Series 2013A, fixed rate, rated A2

-Series 2013B, fixed rate, rated A2

METHODOLOGY

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.moody.com for a copy of this methodology.

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