MOODY'S
INVESTORS SERVICE

Rating Update: Moody's affirms Memorial Health System of East Texas' Baa3 rating; outlook stable

Global Credit Research - 28 Jun 2013

Affirmation affects $109.1 million of rated debt outstanding

LUFKIN HEALTH FACILITIES DEVELOPMENT AUTHORITY, TX
Hospitals & Health Service Providers
TX

Opinion

NEW YORK, June 28, 2013 --Moody's Investors Service has affirmed Memorial Health System of East Texas's (MHSET) Baa3 bond rating on $109.1 million of outstanding bonds issued by the Lufkin Health Facilities Development Corporation (see RATED DEBT section at end of report). The outlook remains stable.

SUMMARY RATING RATIONALE

The affirmation of the Baa3 bond rating and stable outlook reflect MHSET's improved financial performance in fiscal year (FY) 2012 under the direction of a new management agreement with Community Hospital Corporation (CHC) which was instrumental in implementing the turnaround plan. The agreement was recently extended through July 2014. MHSET also benefits from leading market share in its primary service area, maintenance of absolute cash levels over the last several years and all fixed rate debt structure. The system is challenged by a downturn in performance in the first quarter of FY 2013 as it converted information technology systems at all four hospitals simultaneously. With the continued assistance of CHC, management should continue to implement process improvement and growth strategies that will improve performance during the remainder of FY 2013.

STRENGTHS

*Extension of the management agreement with Community Hospital Corporation (CHC) to the end of July 2014; CHC was instrumental in developing and implementing a multipronged approach to improve revenue cycle, supply spending, financial forecasting and other areas of focus which strengthened financial performance at MHSET in FY 2012; CHC gives MHSET access to market and business data previously unavailable in order to better monitor its performance and benchmarks

*Improved financial performance in FY 2012 with operating cash flow of $17.9 million (9.4% margin; Moody's has removed nonrecurring Medicare Rural Floor settlement of $1.6 million) compared to operating cash flow of $12.1 million (6.8% margin) in FY 2011

*Stable unrestricted cash and investments position despite challenged cash flow for the last three years, with 122 days cash on hand and 55% cash-to-debt as of fiscal year end (FYE) 2012, similar to prior years' levels; cash position has been aided by Foundation grants for clinical projects, the Medicare Rural Floor Settlement in FY 2012 and improved cash flow

*Leading market share of 60% in its primary service area (PSA) of Angelina County (According to management provided data); the unemployment rate in the county has continue to improved in 2013 to 6.1% from 6.6% in 2012 (According to Moody's Analytics)

*All fixed rate debt structure and a frozen defined benefit pension plan alleviate some pressure on the balance sheet; however a lower discount rate at FYE 2012 increased the system's underfunded liability

*Conservative investment allocation with the majority of assets invested in cash and certificates of deposit and a small portion in fixed income; 100% is liquid on a monthly basis

*Multi-year support from a large foundation of $9.6 million to support partnerships for stroke and cardiovascular care with Methodist Hospital System in Houston (Methodist); historical support for capital has ranged between $3 million and $5 million annually from FY 2003 to FY 2010

CHALLENGES

*Material decline in financial performance in the first quarter of FY 2013 with low operating cash flow of $2.5 million (5.4% margin) compared to the operating cash flow of $4.0 million (8.6% margin) recorded in the first quarter of FY 2012, mainly due to an information technology (IT) conversion causing an increase in expenses and lower productivity; management is striving to achieve budget projections for FY 2013 by continuing to implement revenue enhancing and expense saving initiatives

*Low cash flow in the first quarter of FY 2013 leading to unfavorable annualized debt ratios with Moody's adjusted maximum annual debt service (MADS) coverage at a low 1.6 times and adjusted debt-to-cash flow at a very high 16.4 times compared to 2.6 times and 8.2 times, respectively, recorded in FY 2012

*Multi-year trend of declining inpatient admissions held stable in FY 2012 but down 7.9% in the first quarter of FY 2013 compared to the prior year period

*Challenging payor mix with Medicare making up 54% of gross revenue, Medicaid 11.1% and self pay 12.1%, limiting future revenue growth

*Competition from a for-profit hospital located one mile away that includes a joint venture agreement with 55 local physician investors; competitors in the secondary service area developing relationships with larger systems in Texas

DETAILED CREDIT DISCUSSION

LEGAL SECURITY: Bonds are secured by a revenue pledge from the Obligated Group that includes Memorial Medical Center of East Texas (acute care hospital in Lufkin), Memorial Specialty Hospital (Lufkin) and Memorial Medical Center - Livingston and a mortgage on Memorial Medical Center of East Texas (acute care hospital in Lufkin). Memorial Medical Center - San Augustine is leased by MHS and is not a member of the Obligated Group. Covenants include debt service coverage of not less than 1.1 times (below which would require the hiring of a consultant, but in no event less than 1.0 times); liquidity of at least 70 days cash on hand and debt to capitalization of no more than 65%.

INTEREST RATE DERIVATIVES: Two floating-to-fixed rate long-dated swaps are outstanding (notional amounts of $52.8 million). These swaps previously were creating a synthetic hedge on the Series 2005 and 2005A variable rate demand bonds. These bonds were refinanced with fixed rate debt in 2009. There is no collateral posting requirement for either swap. The current mark-to-market is a negative value of $10.2 million at December 31, 2012. MHSET will look to terminate the swaps when the mark-to-market becomes more palatable.

RECENT DEVELOPMENTS/RESULTS

The affirmation of the Baa3 rating and stable outlook reflect MHSET's improved performance in FY 2012 largely due to a new management agreement with Community Hospital Corporation (CHC) in August 2011. In FY 2012, MHSET recorded improved financial performance with an operating loss of $4.5 million (-2.4% margin) and operating cash flow of $18.0 million (9.4% margin; Moody's has excluded nonrecurring Medicare Rural Floor settlement of $1.6 million). These results are a material improvement when compared to performance in FY 2011, when the System recorded an operating loss of $11.8 million (-6.6% margin) and operating cash flow of $12.1 million (6.6% margin; bad debt reflected as a revenue deduction for comparison).

The improved performance is driven by a number of key projects initiated by senior management after CHC did a full operational assessment and developed a specific action plan. These projects include: (1) hiring a consulting firm to review inpatient admissions and the lower acuity observation stay for correct classification; (2) improving productivity standards resulting in salary and benefit savings and increased capacity; (3) with the assistance of a CHC, renegotiating managed care contracts; (4) increasing specific charges at the hospital resulting a benefit of just below $1 million in income; (5) consolidating back office functions such as human resources, case management, supply chain and revenue cycle, still need to consolidate patient scheduling; (6) joining CHC's group purchasing organization for improved savings on supplies; and (7) eliminating operating leases of $2.8 million annually at a cost of $3.5 million paid in FY 2012. MHSET also benefited from increased disproportionate share funding in FY 2012.

CHC is a not-for-profit organization whose mission is to help not-for-profit hospitals succeed as not-for-profit enterprises. The organization focused on three areas that MHSET needed to improve: financial management, physician alignment and positioning the system for the future of healthcare. Over the last two years, CHC worked with MHSET's board and senior management team to begin implementation of many of the strategies (discussed above) that improved financial performance in FY 2012. In June 2013 the agreement with CHC was extended to July 2014. We view the agreement with CHC as positive and the board, the senior management team and the staff at MHSET have been supportive of the changes as well. The board is also open to considering a long-term partner although concrete strategies in this area have not commenced.

Performance in the first quarter of FY 2013 has declined due to the hospital's IT conversion and a reduction in the disproportionate share funding. On March 11, 2013, all four of MHSET's hospitals went through an IT system conversion. Prior and during to the conversion there were increased salary expenses for training, preparation and over time and during the conversion productivity levels dropped lower than anticipated creating a decline in inpatient admissions (-7.9%) and outpatient visits (-2.0%) as compared to the prior year. Through three months of FY 2013 MHSET recorded an operating loss of $2.7 million (-5.8% margin) compared to the loss of $1.2 million (-2.7% margin) in the prior year period. Operating cash flow was $2.5 million (5.4% margin) compared to $4.0 million (8.6% margin) in FY 2012. No disproportionate share funding is being accrued for in FY 2013.

MHSET is budgeting performance in FY 2013 to be similar to performance levels of FY 2012 with a -2.3% operating margin and a 9.2% operating cash flow margin. Currently the hospital is performing below budget, however, according to management, volumes have started to return in the second quarter and productivity levels have improved. Furthermore, the system has partnerships for stroke and cardiovascular care with Methodist which is expected to grow volumes and is expecting to receive stage one Medicare meaningful use funds by the end of the fiscal year. Management is striving with these new benefits, the continued process improvement and the engaged medical and nursing staffs, to achieve the FY 2013 budget.

With the improved operating performance in FY 2012, Moody's-adjusted debt measures improved but remain unfavorable compared to the medians. Moody's adjusted debt-to-cash flow improved to 8.2 times from 15.2 times in FY 2011; adjusted MADS coverage improved to 2.6 time from 1.9 times in FY 2011; and debt-to-operating revenue improved to 58% from 63% in FY 2011. Baa3 median debt-to-cash flow is 4.3 times, MADS coverage is 3.0 times and debt-to-operating revenue is 47% (all ratios and medians calculated with bad debt as a revenue deduction).

MHSET's unrestricted cash and investments have remained relatively stable over the last several years, despite the operating losses. At FYE 2012 (December 31) unrestricted cash and investments declined slightly to $60.5 million (122 days cash on hand) from $61.3 million (128 days cash on hand; bad debt excluded from expenses for both years for comparison) at FYE 2011. Management attributes this decline to eliminating $3.5 million of the system's operating leases in FY 2012 by purchasing the equipment. Cash-to-debt measured 55% at FYE 2012, the same level as at FYE 2011. MHSET benefits from two Foundation Trusts: the T.L.L Temple Foundation and the Kurth Trust. The Temple Foundation pledged $44.5 million to fund capital projects from 2003 to 2010 and is supporting the service line partnerships with Methodist with $9.6 million in grant money. The Kurth Trust supports MHSET in the form of investment income. The System invests its unrestricted cash conservatively in 100% cash and fixed income which is 100% liquid on a monthly basis.

MHSET's100% fixed rate debt structure and frozen defined benefit pension plan alleviate pressure on the balance sheet. Management also eliminated the remainder of the system's operating leases in FY 2012. Management is waiting until interest rates are more favorable to terminate the two floating to fixed rate swaps and close out the pension plan. The underfunded pension liability increased in FY 2012 as the discount rate declined, however, with MAP-21 legislation, the contribution in FY 2012 was lower. Cash-to-comprehensive debt (including long- and short-term debt and pension liability and operating leases) is 44% but is expected to improve with the elimination of its operating lease liability as of June 2012.

Capital spending for FY 2013 is budgeted at $9.3 million, below depreciation expense; however MHSET's average age is 10.8 years, only slightly above the national median of 10.5 years. The budget includes $2.3 million for IT; this is following the $6.1 million budgeted for IT in FY 2012. Management expects to achieve savings of $50 million over the next 10 years with the recent conversion to a new IT system. The IT spending will be offset by meaningful use funds of $10 million expected to be received over a three year period, with the first installment by the end of FY 2013.

MHSET's consistent and leading market share of 60% in its primary service area (PSA) of Angelina County and its flagship hospital's position as the largest provider in a 90-mile radius are credit positives. The flagship faces some competition from the for-profit Community Health Systems (CHS) owned 146-bed Woodland Heights Hospital, which is one mile away in Lufkin. Woodland Heights Hospital has 55 physician investors which has challenged MHSET in establishing a stable referral base. The hospital expects to open a Level II neonatal intensive care unit with Texas Children's Hospital (Aa2/stable) in late 2013 and has gained market share in newborn admissions.. In an effort to maintain its market share, MHSET has focused on physician engagement and alignment strategies by employing a small number of physicians, creating exclusive referring relationships with different groups in the area and including local physicians as members of the hospital's board of directors. MHSET has enjoyed market share growth in women's services, orthopedics and general medicine.

MHSET's PSA is characterized by average demographics and experienced slow recovery from the economic recession, with prolonged high unemployment rates leading to increased levels of bad debt and charity care. In fiscal years 2012 and 2013, however, the unemployment rate in Angeline County (the PSA) improved to 6.6% and 6.1%, respectively (According to Moody's Analytics). Despite this improvement, MHSET's payor mix remains challenged with Medicare making up 54% of gross revenue, Medicaid 11.1% and self pay 12.1%, limiting future revenue growth.

OUTLOOK

The stable outlook reflects our belief that, despite the downturn in performance in FY 2013, ongoing performance improvement strategies, with the assistance of CHC will reverse the current level of performance and show improvement by year end.

WHAT COULD MAKE THE RATING GO UP

Material and sustainable improvement in operating performance leading to materially improved debt ratios; building of balance sheet ratios; sustained volume growth leading to stronger operating revenue growth and market share gain

WHAT COULD MAKE THE RATING GO DOWN

Inability to improve performance levels through the remainder of FY 2013; continued decline in volumes leading to loss of market share; decline in liquidity

KEY INDICATORS

Assumptions & Adjustments:

-Based on financial statements for Memorial Health System of East Texas (d/b/a Memorial Medical Center of East Texas) and Affiliates

-First number reflects audit year ended December 31, 2011

-Second number reflects audit year ended December 31, 2012

-Investment returns normalized at 6% unless otherwise noted

-One-time Medicare Rural Floor settlement in FY 2012 of $1.6 million removed from operating revenue

-Bad debt included as an expense in FY 2011 and as a revenue deduction in FY 2012

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

*Inpatient admissions: 11,848; 11,852

*Observation stays: 1,683; 1,567

*Medicare % of gross revenues: 53.1%; 54.0%

*Medicaid % of gross revenues: 11.9%; 11.1%

*Total operating revenues ($): $259.7 million; $190.7 million

*Revenue growth rate (%) (3 yr CAGR): 0.1%; -1.1%

*Operating margin (%): -4.6%; -2.4%

*Operating cash flow margin (%): 4.7%; 9.4%

*Debt to cash flow (x): 15.2 times; 8.2 times

*Days cash on hand: 87 days; 122 days

*Maximum annual debt service (MADS) ($): $8.3 million; $8.3 million

*MADS coverage with reported investment income (x): 1.6 times; 2.3 times

*Moody's-adjusted MADS Coverage with normalized investment income (x): 1.9 times; 2.6 times

*Direct debt ($): $111.7 million; $110.8 million

*Cash to debt (%):55%; 55%

*Comprehensive debt ($): $146.3 million; $139.2 million

*Cash to comprehensive debt (%): 42%; 43%

RATED DEBT (debt outstanding as of December 31, 2012)

Series 2007: $40.7 million, fixed rate

Series 2009: $68.4 million, fixed rate

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RATING 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.moodys.com for a copy of this methodology.

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