Moody's Investors Service

Rating Action: MOODY'S DOWNGRADES WEST PENN ALLEGHENY HEALTH SYSTEM'S (PA) BOND RATING TO Caa1 FROM B2; OUTLOOK REMAINS NEGATIVE

Global Credit Research - 22 Nov 2011

ACTION AFFECTS $737 MILLION OF OUTSTANDING DEBT

New York, November 22, 2011 -- Moody's Investors Service has downgraded the bond rating for West Penn Allegheny Health System (WPAHS) (PA) to Caa1 from B2, affecting $737 million of Series 2007 fixed rate bonds issued through the Allegheny County Hospital Development Authority. The outlook remains negative.

RATINGS RATIONALE

The Caa1 rating and downgrade reflect the severity of the financial status of the system and our belief that, without the financial support of Highmark (Baa2/stable), the system would have been forced to restructure earlier in the year, which without such support, may have resulted in a bond payment default as Moody's has seen in other similar circumstances. While a new affiliation agreement with Highmark has provided significant cash to WPAHS to remain viable, the affiliation may not close until 2013 and, therefore, we are only partly incorporating the benefit of the Highmark affiliation at this time. Without the affiliation agreement and financial support of Highmark, and in the event the agreement is terminated, the rating would be lower.

WPAHS reported a very large $75 million operating loss in fiscal year 2011 (excluding approximately $23 million in a non-recurring positive item included in operating revenue), driven by a significant 15% decline in discharges. Unrestricted cash at fiscal yearend 2011 was only $5 million below the prior fiscal yearend 2010 because of $85 million in several cash infusions; without these payments, cash would have declined by 37%. Continuing a history of management turnover, a new interim management team was recently engaged at WPAHS, but has not yet had time to fully develop revised financial projections. The system's overall strategy in the affiliation with Highmark has changed from one of downsizing to targeted expansion, which creates a high degree of uncertainty and execution and financial risks, although the magnitude of financial risk is difficult to assess at this time without revised financial projections.

CHALLENGES

*Uncertainty related to the viability of a new strategy to expand rather than downsize, given the very recent arrival of a new interim management team and absence of revised financial projections; risks relate to reversing the strategy to regain volumes and investing in recruiting physicians while reducing financial losses

*Very large operating loss in fiscal year 2011 of $75 million (excluding a large non-recurring positive item) and quarterly run rate of over $20 million in operating losses in the latter quarters; revenue declined 3.5% in 2011

*Significant decline in acute discharges of 15% in fiscal year 2011, largely due to the closure and downsizing of services at West Penn Hospital and inability to retain volumes within the system

*Weak unrestricted cash position of 55 days of cash on hand as of fiscal yearend June 30, 2011 (excluding trustee-held project funds), which represented a $5 million decline from fiscal yearend 2010; cash would have declined by $90 million (37%) without $85 million in one-time cash payments (including $50 million from a Highmark unrestricted payment); without further support from Highmark, we expect cash to continue to decline at a fairly rapid rate until operating losses are stemmed

*As of fiscal yearend 2011, underfunded status of pension plan was large at almost $200 million, even though decreasing from $300 million at fiscal yearend 2010; the system made large required pension payments in fiscal year 2011

*Heavy competition from UPMC Health System (Aa3/positive), which is the largest health system in the region and owns a large managed care plan, enabling UPMC to influence health plan membership and volumes

*High leverage relative to operating performance with 51% debt-to-operating revenues and peak debt service coverage under one time in fiscal year 2011 by Moody's calculation

*Challenging demographic service area with declining population trends in the primary service area and an aging patient base

STRENGTHS

*Affiliation agreement with Highmark, executed October 31, 2011, which provides significant financial and management support to the system; as of the execution date, the system received $150 million in unrestricted payments or loans from the insurer

*Favorable debt structure with all fixed rate debt and no interest rate derivatives

*System's prominence as the second largest healthcare system in Pittsburgh with almost 60,000 acute discharges

Outlook

Maintenance of the negative outlook reflects the substantial execution and financial risks as the system reverses strategy, and a weak operating performance and cash position that leave little flexibility to absorb any unexpected challenges, such as continued volume declines.

WHAT COULD MAKE THE RATING GO UP

With a negative outlook, a rating upgrade in the near-term is not likely. Long-term, an upgrade would be considered with significant and sustained improvement in operating cash flow for several years, at least stability in volumes, significant growth in unrestricted cash, stability or growth in medical staff and closing of the Highmark affiliation.

WHAT COULD MAKE THE RATING GO DOWN

Decline in unrestricted cash (excluding project funds), continued large operating losses and volume declines; failure to close the Highmark affiliation

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