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The Road to Rating Recovery: Moody's Profiles Recent Rating Upgrades of Non- Investment Grade Hospitals

Summary Opinion

Over the past two years, Moody's has upgraded the ratings on several highly distressed not-for-profit hospitals or has changed the negative outlooks on these credits to either stable or positive. What makes these rating and outlook changes notable is that they not only show improved financial performance and debt coverage measures – as would any rating upgrade suggest – but are upgrades on hospitals whose ratings fell precipitously down Moody's rating scale to below investment grade due to severe financial problems. The financial problems were so pronounced that in certain cases we believed the organization may have been facing payment default or contemplating bankruptcy. This *Special Comment* seeks to identify the common as well as unique factors behind several of these rating upgrades, some of which have occurred quite rapidly, as the changes within the organizations have been swift and far-reaching. Other upgrades have taken longer as the efforts to turn around financial performance and increase liquidity have proven to be very challenging. We note, however, that with the exception of one organization, the hospital ratings profiled in this piece remain below investment grade and are not without elevated risk to investors, but nonetheless appear to be on the road to rating recovery.

The hospitals or health care systems highlighted in this report are:

- CareGroup, Inc. (Boston, MA)
- The Cooper Health System (Camden, NJ)
- East Texas Regional Medical Center Healthcare System (Tyler, TX)
- Hillcrest HealthCare System (Tulsa, OK)
- Mount Sinai Medical Center (Miami Beach, FL)
- PorterCare Adventist Health System (Denver, CO)
- Tampa General Hospital (Tampa, FL)

The rating histories of each organization are presented in Chart #1.

A QUICK LOOK AT THEIR DOWNFALL:

Before we can examine the factors behind these credits' rating upgrades, it is important to identify briefly some of the key themes behind their financial difficulties and subsequent rating downgrades. (These themes will be expanded upon in an upcoming *Special Comment*.) All of the credits highlighted in this publication carried investment grade ratings prior to their financial and operational difficulties which we believe indicates that they could indeed return to investment grade status.

Some of the common causes for the downgrades include:

1. Precipitous decline in liquidity usually indicated by less than, say, 30 days cash on hand.

Factors behind the decline in liquidity often include:

- Capital spending in excess of cash flow
 - Restatement of audited financial statements that reduces cash balances
 - Poor business decisions or investments that did not generate the returns anticipated by management
 - Inadequate attention paid to revenue cycle management
2. Severe declines in earnings which lead to very thin or inadequate debt coverage indicators, often resulting in a rate covenant or other debt covenant violations of an overly-leveraged organization.

Factors behind the decline in cash flow are numerous and have included:

- Departure of key physicians or volumes to competing facilities
- Integration difficulties following a merger or acquisition
- Unfavorable managed care contracts, especially in the financial performance of capitated contracts

OUT OF THE TRAUMA BAY AND INTO THE ICU: AN EXAMINATION OF THE SUBSEQUENT RATING UPGRADES OR REMOVAL OF A NEGATIVE OUTLOOK

In these distressed situations, the subsequent improvement in financial performance reflects a host of strategies that have been implemented to improve financial performance as quickly as possible. In fact, we contend that in some cases, the rating can be upgraded as rapidly as it was downgraded because the turnaround actions are usually very swift and far-reaching. In other instances, the growth in cash takes a longer period of time to accomplish as new fiscal and spending disciplines must be introduced into the organization.

Some of the common themes behind the upgrades include:

1. Stabilization and Subsequent Growth in Liquidity
2. Significant Economic Events that Can Quickly Improve A Hospital's Fiscal Profile
3. Improvement and Sustainability of Earnings
4. Replacement of Prior Management

STABILIZATION AND SUBSEQUENT GROWTH IN LIQUIDITY: FROM VERY WEAK TO MORE ACCEPTABLE LEVELS

We believe that the growth in liquidity is a key factor for a rating upgrade for most of these distressed credits. In many instances, a severe drop in liquidity was the primary reason for the rating downgrade with cash falling to dangerously low levels, usually, say, below 30 days on hand. The thin level of liquidity fosters concerns of the hospital's ability to make its next debt service payment, much less monthly payroll and vendor payments. For many of these credits, the growth in liquidity to more acceptable levels (exceeding 30 days cash on hand) reflects material improvements in cash flow typically through receivables and revenue cycle management. This dynamic was the primary factor behind the multi-year turnaround for **East Texas Regional Medical Center Healthcare System (TX)** and most recent upgrade to Ba2 from Ba3. East Texas's liquidity sharply dropped in 1998 to 11 days cash on hand following the under-reserving of receivables and contractual allowances and subsequent restatement of the audited financial statements that decreased cash balances. With a new focus on receivable management and disciplined capital spending, days cash improved to 23 days at the time of its May 2002 upgrade to Ba3 from B2 and to 47 days at the time of its most recent upgrade, July 2003, to Ba2 from Ba3. We believe its financial momentum also warranted a change in the rating outlook to positive from stable.

Chart #2 below tracks the days cash on hand at the time of the initial rating, downgrades and subsequent upgrades or outlook changes. It is important for readers to note, however, that while cash is an important credit factor in many of these rating upgrades, it is not the only credit issue for many of these upgrades. Improving earnings and the ability to sustain these new levels of earnings can be equally as important and is discussed below.

SIGNIFICANT ECONOMIC EVENTS THAT QUICKLY IMPROVE A HOSPITAL'S FISCAL PROFILE

Other, more commonplace events that can quickly improve a credit's liquidity and risk profile include the sale of hard assets to improve liquidity or reduce debt. This strategy was employed by **Hillcrest HealthCare System (OK)**, which sold its 49% interest in a newly constructed hospital in south Tulsa to its joint venture partner. The \$40 million of proceeds were used to pay off a demand note and line of credit (combined \$40 million) that in our opinion represented a significant pressure point facing the organization that already had extremely weak cash resources. While the proceeds from the sale were deployed to reduce debt, as opposed to recapitalizing the balance sheet, we believe that failure to repay these short-term borrowings and possible payment demands by the lenders may have forced the organization into bankruptcy. Thus, rating committee viewed the repayment of these short-term borrowings as a significant economic event that resulted in an unencumbered cash position (via the removal of the lines and notes), warranting a rating upgrade to B2 from B3. We note that this upgrade was four months after the downgrade to B3. Hillcrest was again upgraded the following year to B1 due to improved earnings and maintenance of the cash balances.

IMPROVEMENT AND SUSTAINABILITY OF EARNINGS: DIVING INTO THE NITTY GRITTY OF EVERYDAY OPERATIONS

For most credits whose ratings are upgraded following a period of distress, a demonstrated trend of improved earnings, in addition to cash growth, underscores the rating rationale for an upgrade. Even if the hospital still shows a loss from operations, a steady reduction in that loss which results in improved, positive operating cash flow (operating income plus depreciation and interest expenses) may result in a rating upgrade. Likewise, as important as the trend toward profitability or positive operating cash flow is the sustainability of this trend. It is important for Moody's to see that the improvement is a reflection of improved core operations, versus one-time items such as prior year settlements, advance Medicaid funding or debt forgiveness that may only temporarily improve earnings which could subsequently revert back to their distressed levels.

In many instances, the improvement in earnings is a result of fixing basic operations. These improvements reflect renegotiated managed care contracts (which may have been neglected for several years), price increases, and a material reduction in expenses following a reduction in workforce or divestiture of non-core businesses, such as health maintenance organizations or physician employment strategies. In certain cases, such as **Mount Sinai Medical Center (FL)**, the new management team had to overhaul the organization's central business office to properly bill and collect receivables, as well as *establish* a managed care office to negotiate contracts that had been neglected for several years. Moody's recently changed the rating outlook on Mount Sinai's Ba3 rating to stable from negative after the organization showed material improvement just one year after the implementation of these corrective actions.

In some instances, the upgrade may happen very shortly after the multi-notch downgrade occurs as in the case of the aforementioned East Texas. Following the downgrade to B3 in February 1999, the rating was upgraded a mere 8 months later to B2 following actions and steps taken that improved the financial performance, along with specific, near-term exit strategies to divest system related ventures, such as the HMO operation. In other instances, the turnaround may take more time given the complexities of the hospital or health care system or the reasons behind its rating deterioration. For example, we believe the recent removal of the negative outlook and change to stable on **CareGroup's (MA) Ba1** rating in 2003 was a significant indication of improving results. CareGroup, which reflected the 1998 merger of the prestigious Beth Israel Hospital and New England Deaconess Hospital, had seen its rating downgraded nearly every year following the merger given the system's material integration difficulties and secondary market position in the competitive Boston market. The change in the outlook to stable reflected a reduction in the annual losses through improved contract renegotiations and divesting unprofitable community hospitals and non-core business lines. Additionally, management embarked upon a de-leveraging strategy by monetizing non-core assets and repaying outstanding debt.

Although Moody's did not maintain a public underlying rating on **Tampa General Hospital (FL)** during its difficult financial period following its conversion to a 501c3 organization from public facility in 1997, the organization embarked on significant strategies to improve upon what we perceived to be a weakened credit profile. These strategies included a charge master review and managed care contract renegotiations that translated good volume trends and exclusive services into bottom line results. Moody's initial rating of Baa2 assigned in May 2002 was upgraded less than a year later to Baa1. Likewise, **The Cooper Health System (NJ)** also underwent a review of its pricing and managed care contracts to build revenues, in addition to replacing and rebuilding its cardiology, critical care and orthopedic practices after key specialists departed. Cooper also made a concerted effort to determine where its limited operating cash should be invested programmatically, and which payer contracts needed to be renegotiated for more equitable payment rates. As a result of these efforts and an increase in liquidity, Cooper's rating was upgraded to Ba3 from B1 in 2002 and most recently in August 2003 to Ba2 from Ba3 as earnings, volumes and liquidity continue to show favorable improvement.

REPLACEMENT OF MANAGEMENT

Underlining much of the turnaround efforts is typically a new permanent Chief Financial Officer or Chief Executive Officer, or both, following the dismissal or resignation of the prior management team. Many of the new management teams associated with the credits in this publication brought a new skill set to the organization by focusing on daily operations and instilling financial accountability and capital-spending discipline. Prior management may have not adequately focused on these basic principals because they were overseeing a merger, acquisition or other major strategy. In many cases, an outside turnaround team was brought in by the board of trustees or the bondholders to oversee the turnaround before permanent management was hired.

Whatever the focus is that is warranted, it is apparent to Moody's that any new management team must engage physicians, nurses and non-clinical personnel to affect financial stability. For example, not only did Tampa General Hospital undergo a pricing review and contracting strategy as mentioned earlier, but equally important, new management commenced a media campaign with a reinvigorated medical staff to rebuild the organization's image and relay a unified message to the public that the organization would not be selling to a for-profit company nor relocating. Also, The Cooper Health System's financial management was completely overhauled and re-staffed. Over three years, new leadership was brought in or reassigned to various financial operations including revenue cycle, cash management and cash forecasting. As a result, operating managers were given better and more timely information and better direction on operating priorities.

Conclusion: These Credits Can Get Back to Investment Grade

We believe that in of the credits profiled in this report are very large and important to the economic fiber of their local economies and health care markets. While the road to rating recovery may be on a larger and longer scale given their size, we believe these credits have a critical mass that makes them viable investment grade enterprises. **PorterCare Adventist Health System (CO)** is a good example of a credit whose rating not only returned to investment grade from Ba1 but also exceeded its original rating of Baa (assigned in 1993) with its most recent upgrade to A3 in 2002. The upgrade to A3 reflected many of the strategies outlined above, including significant liquidity growth and a heavy focus on rate and growth strategies which resulted in solid and consistent improvement in earnings.

As significant as the rating upgrades are for these credits, it is important for investors to note that with the exception of PorterCare, these credits are not "out of the woods" as indicated by their still below investment grade ratings. In all of the examples cited, liquidity has improved, but still remains thin as compared to the debt outstanding or the size of the organization (as measure by revenues). Furthermore, new pressures on liquidity, such as underfunded pension plans, as well as ongoing capital needs to remain competitive and keep facilities attractive and modern may limit the ability to improve these low liquidity position in the near-term to levels more commensurate with an investment grade rating. Finally, given the low liquidity, unanticipated changes to earnings, such as Medicaid reductions or union activity can impair the ability to increase cash balances.

Chart 1

Rating Histories***CareGroup, MA**

Jan-98	Initial	A2; stable outlook
Feb-99	Downgrade	Baa1; stable outlook
Mar-00	Downgrade	Baa2; negative outlook
Jan-01	Downgrade	Baa3; stable outlook
Jan-02	Downgrade	Ba1; rating placed on Watchlist for possible downgrade
Apr-02	Confirmation	Ba1; confirmed with a negative outlook
Feb-03	Affirmation	Ba1; outlook revised to stable from negative

The Cooper Health System, NJ

Jan-97	Initial	Baa2; stable outlook
Nov-98	Downgrade	Ba2; negative outlook
Apr-99	Downgrade	B1; stable outlook
Jun-03	Affirmation	B1; positive outlook
Aug-02	Upgrade	Ba3; stable outlook
Aug-03	Upgrade	Ba2; stable outlook

East Texas Regional Medical Center Healthcare System, TX

Feb-93	Initial	Baa
Nov-96	Rating Refinement	Baa3
Feb-99	Downgrade	B3; negative outlook
Dec-99	Upgrade	B2; positive outlook
Jun-02	Upgrade	Ba3; stable outlook
Jul-03	Upgrade	Ba2; positive outlook

Hillcrest HealthCare System, OK

Feb-99	Initial	Baa2; positive outlook
Oct-99	Affirmation	Baa2; negative outlook
Jul-00	Downgrade	Ba1; negative outlook
Dec-00	Downgrade	B3; negative outlook
Mar-01	Upgrade	B2; stable outlook
Dec-02	Upgrade	B1; stable outlook

Mount Sinai Medical Center, FL

Apr-01	Initial	Baa3; positive outlook
Nov-01	Affirmation	Baa3; positive outlook removed
Aug-03	Downgrade	Ba3; rating placed on Watchlist for possible downgrade
Aug-02	Confirmation	Ba3 confirmed; negative outlook assigned
May-03	Affirmation	Ba3; outlook revised to stable from negative

PorterCare Adventist Health System, CO

May-93	Initial	Baa
Nov-96	Rating Refinement	Baa2
May-99	Downgrade	Baa3; on Watchlist for possible downgrade
Nov-99	Downgrade	Ba1; on Watchlist for possible downgrade
Feb-01	Upgrade	Baa2; positive outlook
Jun-02	Upgrade	A3; stable outlook
Jun-03	Affirmation	A3; positive outlook

Tampa General Hospital, FL

Jun-02	Initial	Baa2; positive outlook
Apr-03	Upgrade	Baa1; stable outlook

* For presentation purposes, we have eliminated certain Watchlist actions unless applicable.

Chart 2

Days Cash on Hand Trend of Selected Credits Over Recent Rating History **

	Rating Action	Days Cash on Hand	Notes
CareGroup, MA			
Jan-98	A2	155	
Feb-99	Baa1	143	Cash expected to decline to 90 days with cash defeasance of bonds
Mar-00	Baa2	117	
Jan-01	Baa3	108	
Jan-02	Ba1	84	
Apr-02	Ba1	84	
Feb-03	Ba1	88	
The Cooper Health System, NJ			
Feb-97	Baa2	23	Cash expected to increase to 38 days with reimbursement from bond proceeds
Jan-98	Ba2	N/A	Cash represented \$12.3 MM line of credit borrowing
Apr-99	B1	N/A	Cash represented \$16.0 MM line of credit borrowing
Aug-00	B1	7	Lines of credit repaid; cash unencumbered
Jun-01	B1	15	
Aug-02	Ba3	27	
Aug-03	Ba2	28	
East Texas Regional Medical Center Healthcare System, TX			
Mar-93	Baa	13	Cash expected to increase to 40 days with reimbursement from bond proceeds
Nov-96	Baa3	N/A	Rating Refinement
Feb-99	B3	11	
Dec-99	B2	16	
Jun-02	Ba3	35/57	Days cash on the right reflects the inclusion of the Special Reserve Fund (SRF).
Jul-03	Ba2	47/66	While the SRF cannot be used for capital, its does reflect cash set aside for bondholders and is akin to a debt service reserve fund.
Hillcrest HealthCare System, OK			
Feb-99	Baa2	71*	* Expected cash position with reimbursement
Jul-00	Ba1	40	
Dec-00	B3	27	Cash reflected line of credit and demand note borrowings
Mar-01	B2	22	Upgrade reflected sale of assets which paid off lines demand notes
Dec-02	B1	29	
Mount Sinai Medical Center, FL			
Apr-01	Baa3	87	Cash includes unrestricted foundation funds; foundation guarantees the outstanding bonds
Nov-01	Baa3	N/A	
Aug-03	Ba3	47	
Aug-02	Ba3	70	
May-03	Ba3	63	
PorterCare Adventist Health System, CO			
May-93	Baa	46	Cash expected to increase to 111 days cash with reimbursement from bond proceeds
Nov-96	Baa2	N/A	Rating Refinement
May-99	Baa3	51	
Nov-99	Ba1	35	
Feb-01	Baa2	117	
Jun-02	A3	212	
** In most cases, days cash on hand reflects most recent interim financial statements as opposed to most recent audited financial statements. For presentation purposes, we have eliminated certain Watchlist and outlook actions unless applicable.			

Related Research

Industry Outlook:

[Not-For-Profit Healthcare: 2003 Healthcare Outlook and Medians, August 2003, # 78919](#)

Special Comments:

[Drug-Coated Stents Challenge Profitability Of Hospital Cardiology Programs, July 2003, # 78802](#)

[Moody's Second Quarter 2003 Healthcare Update: Heavy Downgrade Activity Suggests Industry Outlook Moving Towards Negative, July 2003, # 78713](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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