

RatingsDirect®

Mountain States Health Alliance, Tennessee; Joint Criteria; System

Primary Credit Analyst:

Karl Propst, Dallas (1) 214-871-1427; karl.propst@standardandpoors.com

Secondary Contact:

Stephen Infranco, New York (1) 212-438-2025; stephen.infranco@standardandpoors.com

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<i>Long Term Rating</i>	BBB+/Stable	Affirmed
Mountain States Health Alliance, Series 2000D		
<i>Unenhanced Rating</i>	BBB+(SPUR)/Stable	Affirmed
The Hlth & Educl Facs Brd of the City of Johnson City, Tennessee		
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<i>Unenhanced Rating</i>	BBB+(SPUR)/Stable	Affirmed
Series 2010 A&B, 2006A and 2009A		
<i>Long Term Rating</i>	BBB+/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services has affirmed its 'BBB+' long-term rating and underlying rating (SPUR) on rated obligations from various issuers for Mountain States Health Alliance (MSHA), Tenn. At the same time, Standard & Poor's affirmed its 'BBB+' issuer credit rating on MSHA. The outlook on all ratings is stable.

The 'BBB+' ratings reflect our view of MSHA's strong business position, and solid level of unrestricted reserves and corresponding days' cash on hand. The system's just adequate maximum annual debt service (MADS) coverage for the rating level, and improving, but still high, leverage remaining from the past capital spending and acquisition activity partially offset these strengths, in our opinion.

In April 2015, MSHA and the six-hospital Wellmont Health System announced their intent to merge. We believe the merger could create both operating and financial synergies. In addition, we believe that MSHA's operational and financial trends have demonstrated improvement over the past few years and, if sustained, would support a favorable rating action. Once we have more information on the financial profile of the combined organization and on the success of the process of integration of the two systems, we will reassess our ratings on the bonds. (For more information on Wellmont, see the report published Feb. 4, 2015, on RatingsDirect.)

More specifically, the 'BBB+' ratings reflect our view of MSHA's:

- Excellent business position, with solid demographics, a robust market share relative to that of its competition, and a broad range of services;
- Strong management and governance, which the system's favorable performance record since its creation in 1998 reflects;
- Continued strong financial performance, with solid EBITDA margins, a 13th consecutive year of operating

profitability in fiscal 2015, and solid liquidity for the rating based on days' cash on hand; and

- Moderated capital spending in recent years and lower planned capital spending, which will likely support further growth in unrestricted liquidity and a reduction in leverage.

Despite MSHA's strong business position and consistent operating profitability, system leverage is elevated and remains an offsetting credit factor, in our opinion. The system has a debt-to-capital ratio of approximately 57% and a debt burden of about 6% of revenue. One of management's goals is to continue to reducing leverage. We believe this, along with successful merger integration, remain keys to a higher rating.

The 'BBB+' ratings also incorporate our view of MSHA's group credit profile and the obligated group's core status. Accordingly, we rate the bonds at the same level as the group credit profile. Our determination of the group status of MSHA's obligated group is core, because the obligated group contains the majority of system assets and accounts for most of its revenues and income.

Bonds that are not otherwise secured by letters of credit (LOCs) are secured by MSHA's gross revenues or are jointly secured by gross revenues and an irrevocable direct-pay LOC. Various debt issues supported by irrevocable direct-pay LOCs for which there is no SPUR (including series 2013A and 2013B) are based solely on the long-term and short-term ratings of the LOC provider. While we are not affirming those ratings, we have factored the debt amounts into our analysis of MSHA's overall leverage and debt service capacity.

We are affirming the ratings on bonds, including series 2007B1, 2011A, and 2011B, whose ratings we base on the low correlation joint support of both MSHA and the LOC provider. For those bonds, MSHA and the LOC provider are each individually fully responsible for their repayment.

As of the interim period ended Sept. 30, 2015 (unaudited), MSHA had about \$1.0 billion of long-term debt, notes, and capital lease obligations. Debt is split between approximately 60% fixed- and 40% variable-rate obligations. We understand that MSHA has no plans to issue a material amount of debt during the next few years, because management expects to fund its modest capital needs with cash flow and reserves. Also, management and the board have approved a plan to accelerate debt repayment in addition to scheduled debt amortization, which we view favorably because MSHA's sizable debt and accompanying high leverage remains the system's most significant credit risk, in our opinion.

In addition to its debt obligations, MSHA has \$590 million of swaps with Bank of America N.A. as the counterparty. The swaps' estimated fair value on Nov. 24, 2015 was a negative \$610,000. Combined, these swaps generated \$4.7 million of positive annual cash flow in 2015.

Outlook

The stable outlook reflects our view of MSHA's sound business position, favorable record of integrating acquired facilities, and improvement in debt ratios, which we expect will continue given modest capital spending needs, although we continue to believe the system's high debt burden remains a rating constraint.

Upside scenario

Although we view MSHA's trends favorably, and, if sustained, could lead to a positive rating action, we would expect to do so once the system's MADS coverage and leverage metrics reach levels more consistent with 'A' category medians. We will also expect the system's business position to remain strong -- with stable-to-improving patient volumes and by sustained robust cash flow. Successful integration of the merger with Wellmont could also support a favorable rating action.

Downside scenario

Although we don't expect it, if balance-sheet metrics weaken, coverage declines, or operating margins decline and stay at or below 1.0%, we could consider a negative rating action.

Enterprise Profile

Since its formation in 1998, MSHA has tripled its asset base and more than tripled annual net patient revenues to \$2.1 billion and \$1.1 billion, respectively. Today, it owns and operates 13 acute-care facilities led by the flagship Johnson City Medical Center, a 548-licensed-bed tertiary regional provider. The system's hospital facilities include 1,669 licensed beds (1,305 acute care beds). MSHA also consists of a range of outpatient facilities and ancillary services, including a home health agency, a hospice, and other activities such as the ownership and management of medical office buildings. In fiscal 2015, it combined inpatient admissions of slightly more than 62,000, 1.8 million outpatient visits, 257,000 emergency department visits, and 94,000 urgent care facility visits. As part of its physician integration efforts, it employs 400 physicians through various physician entities, including Mountain States Medical Group.

Merger

In April 2015 MSHA and Wellmont announced that they had signed a letter of intent to merge. We understand that there is no financial consideration being exchanged to complete the agreement. The merger requires the approval of regulatory authorities in Tennessee and Virginia and compliance with the terms and conditions of a Certificate of Public Advantage to ensure that the new system will sustain adequate public health, clinical quality, patient access, and cost benefits to the communities served. The merged entity will share equal governance through board representation from both MSHA and Wellmont, six members from each system. In addition, two individuals will join the board as independent members from the region served. The management team will include executives from both MSHA and Wellmont. We expect the merger to close early fall 2016.

MSHA management

In January 2014, Alan Levine became President and CEO of MSHA. Mr. Levine joined MSHA from Health Management Associates, where he served as group president. Marvin Eichorn is MSHA's COO after having previously served as the MSHA's CFO for 16 years. Lynn Krutak is MSHA's CFO, previously serving as corporate CFO and CFO for MSHA's Blue Ridge Medical Management Corp.

Since the system's creation, MSHA's management and governance have evolved effectively, in our view. A strong central leadership team focuses on maximizing the system's potential as a whole and broadening access to managed-care contracts for all of the facilities while centralizing the negotiations at the system level. It has also centralized other functions such as billing and collections, purchasing, and laboratory services. We believe the

leadership structure works well for the organization. In addition, we believe MSHA's capable 13-member board provides sound governance. We expect the post-merger leadership and governance to sustain these positive characteristics.

Market position

The system's core service area encompasses 13 counties in Tennessee and Virginia, where MSHA continues to have a dominant market share. Currently, fewer than 30% of the system's patients originate from its original home county of Washington County, Tenn. In the broader 29-county service area, the system's has a 42% share, while Wellmont, which historically was MSHA's main competitor, holds about a 25% share. There is no significant third player. The system's market share is strong in the core Washington County market, and Wellmont dominates in adjacent Sullivan County. However, over the past several years, the two's service areas have increasingly overlapped. We believe service area market characteristics remain favorable in terms of population growth.

Financial Profile

In our view, MSHA generated solid operating performance in fiscal 2015, with patient volume growth and continuing improvement in the expense base largely through labor and supply cost management efforts. A sizable provision for bad debts, however, continued to offset patient revenues. Like almost all other acute care providers, MSHA continues to incur sizable costs to transform its processes to succeed in the changing health care landscape and under the Affordable Care Act. In addition, reimbursement from both governmental and commercial sources remains under pressure, but in our view, the system's leadership is capably managing these challenges.

For the fiscal year ended June 30, net operating income was \$25.6 million, or a 2.4% margin, on \$1.06 billion in total operating revenues. Results were improved over fiscal 2014 when MSHA generated operating income of \$986,000 (or a 0.1% margin) on slightly less than \$1.0 billion in total operating revenues. For the year, inpatient admissions rose to 62,049 from 57,040, an 8.8% improvement that well exceeded budget.

Net excess income for fiscal 2015 was what we consider solid and improved over fiscal 2014, at \$53.5 million (a 4.9% margin), compared with \$40.4 million (3.9%) the previous year. MSHA's EBITDA margin was 15.2% in fiscal 2015. Coverage, based on MADS of \$67 million, was 2.5x for fiscal 2015, although adjusted for minority interest consistent with MSHA's methodology, coverage would be 2.3x for fiscal 2015.

For the three months ended Sept. 30, 2015, the system had operating income of \$3.1 million and excess income of \$5.7 million (Standard & Poor's-calculated), generating cash flow adequate to support annualized MADS coverage of 2.0x. Interim operating results were consistent with fiscal 2015.

Five-year financial plan

MSHA's five-year forecast calls for inpatient admissions to be flat in fiscal 2016 and decrease modestly until fiscal 2020. The forecast further assumes no Medicaid expansion in Tennessee or Virginia, and factors in additional declines in Medicare reimbursement.

Supported by reduced length of stay and other operating and cost containment initiatives, management expects to sustain at or near \$160 million of annual EBIDA, which is adequate to comfortably support debt service and further

reduce debt. For fiscal 2016, the system is budgeting for operating EBITDA of \$156 million, which would produce a consistent 2.3x MADS.

Balance sheet

MSHA's aggressive acquisition spending ended several years ago, and although we believe that made the system a stronger competitor, it resulted in high leverage, which has been an impediment to a higher rating. As of Sept. 30, 2015, the system's long-term debt to capitalization was 57%, which, due to robust operating cash flow, continues to improve. Management's debt management plan calls for the system to use surplus cash each year to further reduce debt beyond scheduled debt service.

Unrestricted cash and investments totaled \$703 million at Sept. 30, 2015, equal to approximately 256 days' cash, which we view as robust for the rating. Cash to debt is approximately 70%, which, although below the median for the current rating, continues to improve. MSHA continues to comply with all bond covenants.

MSHA's average age of plant is 12 years, which we consider in line with the median, and the system has only what we consider modest capital plans during the next several years. As a result, we believe that MSHA will be able to comfortably maintain robust days' cash and be able to accelerate the reduction of outstanding debt.

Management plans to spend about \$63 million on capital expenditures in fiscal 2016, primarily on IT and other small projects. Spending for fiscal 2016 represents about 91% of budgeted fiscal 2016 depreciation. For fiscal years 2016-2010, we expect capital spending to be moderate, at well less than 100% of depreciation. We expect spending in fiscal years 2017 and 2018 to include the construction of the new \$20 million, 20-bed replacement hospital for Unicoi County, as part of MSHA's 2013 hospital affiliation agreement. Management has no financing plans, because it will fund Unicoi and other projects from operations.

Mountain States Health Alliance -- Selected Financial Statistics			
		--Fiscal year ended June 30)--	
	Three months ended Sept. 30, 2015	2015	2014
Enterprise Profile			
PSA population	1,100,000	N.A.	N.A.
PSA market share (%)	42.4	40.1	39.4
Inpatient admissions*	15,967	62,049	57,040
Emergency visits	66,595	255,857	239,606
Full-time equivalent employees	7,357	7,071	7,014
Based on net/gross revenues	Gross	Gross	Gross
Medicare (%)	50.5	51.0	51.3
Medicaid (%)	14.7	14.0	14.5
Commercial/blues (%)	27.8	27.9	26.8
Financial Profile			
Financial performance			
Net patient revenue (\$000s)	251,631	989,435	924,125
Total operating revenue (\$000s)	270,674	1,059,634	991,206
Total operating expenses (\$000s)	267,523	1,033,995	990,221

Mountain States Health Alliance -- Selected Financial Statistics (cont.)			
Operating income (\$000s)	3,151	25,639	986
Operating margin (%)	1.16	2.42	0.10
Net non-operating income (\$000s)	2,584	27,881	39,424
Excess income (\$000s)	5,735	53,520	40,409
Excess margin (%)	2.10	4.92	3.92
Operating EBIDA margin (%)	11.47	13.03	11.76
EBIDA margin (%)	12.31	15.26	15.13
Net available for debt service (\$000s)	33,626	165,983	155,980
Maximum annual debt service (\$000s)	67,288	67,288	67,288
Maximum annual debt service coverage (x)	2.00	2.47	2.32
Operating lease-adjusted coverage (x)	2.00	2.32	2.18
Liquidity and financial flexibility			
Unrestricted reserves (\$000s)	703,178	721,785	646,460
Unrestricted days' cash on hand	256.0	272.9	256.7
Unrestricted reserves/total long-term debt (%)	69.7	70.0	60.1
Unrestricted reserves/contingent liabilities (%)	154.8	158.9	137.6
Average age of plant (years)	12.3	11.9	10.6
Capital expenditures/depreciation and amortization (%)	N.A.	64.8	90.5
Debt and liabilities			
Total long-term debt (\$000s)	1,008,805	1,031,661	1,075,069
Long-term debt/capitalization (%)	56.9	57.1	59.9
Contingent liabilities (\$000s)	454,185	454,185	469,773
Contingent liabilities/total long-term debt (%)	45.0	44.0	43.7
Debt burden (%)	6.16	6.18	6.53

*Inpatient admissions exclude newborns, psychiatric, and rehabilitation admissions. N.A.--Not available.

Related Criteria And Research

Related Criteria

- USPF Criteria: Not-For-Profit Health Care, June 14, 2007
- Criteria: Methodology And Assumptions: Approach To Evaluating Letter Of Credit-Supported Debt, Feb. 20, 2015
- USPF Criteria: Municipal Applications For Joint Support Criteria, June 25, 2007
- Criteria: Joint Support Criteria Update, April 22, 2009
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Methodology: Industry Risk, Nov. 20, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013

Related Research

- Glossary: Not-For-Profit Health Care Ratios, Oct. 26, 2011
- U.S. Not-For-Profit Health Care Sector Outlook Revised To Stable From Negative, Though Uncertainties Persist, Sept. 9, 2015
- U.S. Not-For-Profit Health Care System Median Ratios Likely To Remain Stable Through 2016 Despite Industry

Pressures, Sept. 1, 2015

- Health Care Providers And Insurers Pursue Value Initiatives Despite Reform Uncertainties, May 9, 2013
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013
- Alternative Financing: Disclosure Is Critical To Credit Analysis In Public Finance, Feb. 18, 2014
- Health Care Organizations See Integration And Greater Transparency As Prescriptions For Success, May 19, 2014
- The Growing And Evolving Role Of Provider-Sponsored Health Plans In U.S. Health Care, June 8, 2015

Ratings Detail (As Of January 13, 2016)

Smyth Cnty Indl Dev Auth, Virginia

Mountain States Hlth Alliance, Tennessee

Seies 2010 B and Series 2009B

Long Term Rating BBB+/Stable Affirmed

The Hlth & Educl Facs Brd of the City of Johnson City, Tennessee

Mountain States Hlth Alliance, Tennessee

Johnson City Hlth & Ed Fac Brd (Mountain States Health Alliance), Series 2007B-1

Unenhanced Rating BBB+(SPUR)/Stable Affirmed

Long Term Rating AAA/A-1+ Affirmed

Series 2011A

Unenhanced Rating BBB+(SPUR)/Stable Affirmed

Long Term Rating AAA/A-1+ Affirmed

Series 2011B

Unenhanced Rating BBB+(SPUR)/Stable Affirmed

Long Term Rating AA+/A-1 Affirmed

Series 2012A

Long Term Rating BBB+/Stable Affirmed

Washington Cnty Indl Dev Auth, Virginia

Mountain States Hlth Alliance, Tennessee

Ser 2009 C

Long Term Rating BBB+/Stable Affirmed

Many issues are enhanced by bond insurance.

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