

# FitchRatings

## FITCH RATES HOSPITAL SISTERS SERVICES, INC. (IL) SERIES 2012 REVS 'AA-' AND 'AA-/ F1+'

Fitch Ratings-Chicago-30 August 2012: Fitch Ratings has assigned 'AA-' ratings to the following revenue bonds issued on behalf of Hospital Sisters Services, Inc. (HSSI):

- \$63 million Wisconsin Health and Educational Facilities Authority, series 2012B;
- \$36.1 million Illinois Finance Authority, series 2012C;
- \$77.5 million Wisconsin Health and Educational Facilities Authority, series 2012D\*;
- \$41.7 million Wisconsin Health and Educational Facilities Authority, series 2012E\*;
- \$50.7 million Illinois Finance Authority, series 2012F\*;
- \$50.7 million Illinois Finance Authority, series 2012G\*;

\*Underlying rating. The bonds are expected to be supported by an irrevocable direct pay letter of credit issued by the Bank of Montreal, N.A.

In addition, Fitch Ratings has assigned 'AA-/ F1+' ratings to the following variable-rate demand revenue bonds issued on behalf of HSSI. The 'F1+' is based on the sufficiency of the self-liquidity provided by HSSI:

- \$66.2 million Illinois Finance Authority, series 2012H;
- \$89.9 million Illinois Finance Authority, series 2012I;
- \$14.2 million Wisconsin Health and Educational Facilities Authority, series 2012J.

In addition, Fitch affirms the 'AA-' and 'F1+' ratings on approximately \$529 million of bonds outstanding currently rated by Fitch.

The series 2012 bonds are expected to price the week of Sept. 10 via negotiation. Proceeds from the series 2012 bonds and a \$121.8 million private placement will be used to refund approximately \$456 million of outstanding bonds (listed at the end of the rating action commentary), fund certain capital projects at St John's Hospital and St Joseph's Hospital (\$160 million) and pay costs of issuance. Total outstanding debt after this issuance is approximately \$684.0 million.

The Rating Outlook is Stable.

SECURITY: Joint and severable liability of each member of the obligated group

### KEY RATING DRIVERS

**STRONG LIQUIDITY POSITION:** HSSI's robust liquidity position provides a strong financial cushion which mitigates the system's depressed operating profitability and the risks associated with its variable-rate debt exposure.

**SOLID DEBT SERVICE COVERAGE:** HSSI's light debt burden (pro-forma maximum annual debt service (MADS) equaled a modest 1.7% of fiscal 2011 revenues) results in very solid historical coverage of pro forma MADS by EBITDA of 5.6x and 5.5x in fiscal 2011 and 2010, respectively. However, given HSSI's strong balance sheet and poor operating performance, solid EBITDA generation has been dependent on investment returns.

**DEPRESSED OPERATING PERFORMANCE:** Operating profitability has been materially depressed over the last two years reflecting the impact of reduced inpatient volumes and the system's continued investment in its physician alignment strategies. Operating EBITDA margin declined to 4.2% in fiscal 2011 from 7.2% in fiscal 2010. However, Fitch expects operating margins to improve to at least breakeven by fiscal 2014.

**CHALLENGING SERVICE AREAS:** HSSI's location in mid-sized markets with stagnant growth, the concentration of system revenue at St. John's (the flagship hospital in Springfield), and its reliance on its five Wisconsin hospitals to cover losses at its Illinois facilities continue to be credit concerns.

**AMPLE INTERNAL LIQUIDITY:** HSSI maintains ample cash and investments which can be liquidated to fund any failed remarketing on approximately \$170.5 million variable-rate demand bonds exceeding Fitch's criteria for assignment of an 'F1+' short-term rating.

#### WHAT COULD TRIGGER A RATING ACTION

**CONTINUED WEAK OPERATING PERFORMANCE:** The failure to meet projected operating performance improvement targets would likely result in negative rating pressure.

#### CREDIT PROFILE

The 'AA-' rating reflects the benefits of HSSI's robust balance sheet, light debt burden and solid debt service coverage which mitigate the recent deterioration in operating profitability. HSSI's strong liquidity position provides a strong financial cushion against the recent decline in operating profitability and is considered a primary credit strength. At May 31, 2012, HSSI's unrestricted cash and investments totaled \$1.44 billion, which translates into 294 days cash on hand (DCOH), a 42.4x cushion ratio (based on pro forma MADS) and cash-to-long-term debt of 260%; all of which well exceed Fitch's respective 2012 'AA' category medians of 241.1, 24.1x and 169.4%.

Upon closing of the series 2012 financing, HSSI's debt burden remains light as reflected by pro forma MADS equating to 1.7% of fiscal 2011 total revenues and pro forma debt to capitalization (at May 31, 2012) of 27.0%. Thus, historical coverage of pro forma MADS by EBITDA of, respectively, 5.5x and 5.6x in fiscal 2010 and 2011, exceeds the 'AA' median of 4.8x despite the system's depressed operating profitability. However, coverage by operating EBITDA at 2.4x in fiscal 2011 and 4.0x in fiscal 2010 reflects HSSI's reliance on investment income.

In fiscal 2011 (June 30 year-end), HSSI reported a \$44.8 million loss from operations (-2.2% operating margin) reflecting softer inpatient volumes and on-going investments in its physician alignment strategy. While overall patient encounters increased, inpatient admissions declined 3.0% in fiscal 2011 while total surgical volumes declined 4.4%. However, through the 11 months ended May 31, 2012 (interim period), inpatient admissions and surgeries have stabilized compared to the prior year period. Operating performance in the interim period improved with a negative 0.1% operating margin (\$2.8 million operating loss); however, the improvement was due, in part, to some one-time settlement payments. The fiscal 2013 budget projects a \$12.4 million operating loss with breakeven operating performance achieved in fiscal 2014. HSSI also benefits from approximately \$20 million of supplemental Medicaid funding annually through the Illinois hospital assessment program.

The total number of employed and aligned physician has grown by 101 since the end of fiscal 2010. Currently the system employs a total 542 physicians and mid-level providers. Along with the acquisition of established physician practices, HSSI has many newly recruited physicians, which has had a negative impact on profitability. Further growth in the employed physician group is expected to be limited going forward as management is focused on improving volumes and efficiency.

Many of HSSI's hospitals are located in mid-sized markets with little projected population growth and marginal demographics. The continued operating losses reported at St. John's-Springfield, which accounted for about 22% of total system revenues in fiscal 2011, have been an on-going credit concern. St. John's operating loss in 2011 increased to \$34.4 million in 2011 from \$10.9 million in the prior year and in excess of a \$25 million budgeted loss. Proceeds from the series 2012 financing will be used to execute on management's planned rebuild of the surgical suites and remodel of four patient floors, which should improve surgical volumes and financial performance at St. John's upon completion. Fitch believes improved financial performance at St. John's is critical to

the overall operating success of the system. Historically, HSSI's more profitable Wisconsin operations have offset the weaker performance of the Illinois facilities. Fitch expects to see improved operating balance across the system as capital improvements and physician alignment strategies take hold.

The 'F1+' short-term rating reflects the sufficiency of HSSI's highly liquid cash and investments available to fund any failed remarketings puts on approximately \$170.5 million of series 2012 variable-rate demand bonds. At July 31, 2012, after assigning appropriate discounts based on underlying ratings and maturity of its holdings, HSSI had eligible cash and fixed income investments available to fund any un-remarketed puts well in excess of the required threshold of 1.25x to achieve the 'F1+' short-term rating. The system has a written procedures letter outlining the liquidation procedures in place to ensure timely funding and provides Fitch monthly investment reports which are used to monitor its cash and investment position available for self-liquidity.

The Stable Outlook reflects the system's significant balance sheet strength and the strategies in place to create sustained operating improvements, including a physician alignment strategy. Fitch is tolerant of the recent decline in operating profitability, as the system's low leverage position allows for solid debt service coverage. However, failure to reach break-even or positive operating margins by fiscal 2014 or a deterioration in liquidity and leverage metrics would likely result in negative rating action.

HSSI is composed of 13 inpatient hospitals, with eight facilities in Illinois and five facilities in Wisconsin. In fiscal 2011, the system had 2,069 beds in operation and total revenue of \$1.99 billion. HSSI covenants to provide bondholders with audited annual information within 120 days of fiscal year-end and unaudited quarterly statements within 45 days of quarter-end to the national recognized municipal securities information repositories and through Digital Assurance Certification, L.L.C. The content of HSSI's disclosure to-date has been excellent and includes a balance sheet, income statement, cash flow statement, utilization statistics, and management discussion and analysis.

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Additional information is available at '[www.fitchratings.com](http://www.fitchratings.com)'. The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

Applicable Criteria and Related Research:  
--'Revenue-Supported Rating Criteria' (June 12, 2012);

--'Nonprofit Hospitals and Health Systems Rating Criteria' (July 23, 2012);  
--'Criteria for Assigning Short-Term Ratings Based on Internal Liquidity' (June 15, 2012).

Applicable Criteria and Related Research:

Criteria for Assigning Short-Term Ratings Based on Internal Liquidity

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=681822](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=681822)

Nonprofit Hospitals and Health Systems Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=683418](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=683418)

Revenue-Supported Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=681015](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=681015)

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