

Rating Update: Moody's upgrades El Camino Hospital's (CA) revenue bond rating to A1 from A2; Outlook remains stable

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Upgrade affects \$186.9 million of rated revenue bonds outstanding

SANTA CLARA COUNTY FINANCING AUTHORITY, CA
Hospitals & Health Service Providers
CA

Opinion

NEW YORK, February 22, 2013 --Moody's Investors Service has upgraded to A1 from A2 El Camino Hospital's (ECH) bond rating affecting \$186.9 million of outstanding fixed and variable rate demand revenue bonds issued by Santa Clara County Financing Authority, CA (see RATED DEBT section at the conclusion of this report). The outlook remains stable.

The El Camino Hospital District's (the "District") Series 2006 general obligation bonds (\$142.2 million outstanding) are rated Aa1 and are secured by the District's voter-approved unlimited property tax pledge. Bondholders of the general obligation bonds do not have any recourse to the hospital for payments under the bonds. Tax revenues and payments related to the general obligation bonds have been excluded from this analysis. A complete list of the District's debt is included at the end of this report.

SUMMARY RATING RATIONALE

The rating upgrade to A1 and maintenance of the stable outlook is based on ECH's fundamental strengths as a large, high-end tertiary provider with operations in a wealthy and demographically strong service area in Silicon Valley. Over the past two and half years, ECH's balance sheet and operating performance and relative metrics have notably rebounded since tempering in FY 2010. ECH's balance sheet continues to strengthen with growth in unrestricted liquidity and with a relatively low revenue bond direct debt position. Operating performance through six months of FY 2013 is on track for another year of improved and very strong operating profitability and cash flow generation that can be attributed to good volume and revenue growth. Additionally, following a couple of years of instability and turnover in key management positions and under a newly developed and reenergized board, a permanent senior leadership team, and an engaged medical staff, ECH has outlined a renewed strategy focused on the triple aim of quality, service, and affordability with a focus on continuum of care, physician partnerships and other innovative business and community alliances. We expect ECH to continue to produce strong operating cash flow given its favorable market presence and location and its continued focus on operating efficiencies, in order to support future capital plans, maintain solid liquidity and leverage measures and offset any future reimbursement declines and competitive pressures.

STRENGTHS

*Sizable, high-end tertiary community hospital (operating revenue base of \$664 million in FY 2012) with two campuses (flagship campus in Mountain View and Los Gatos campus) located in affluent and desirable service areas of Silicon Valley; ECH's Mountain View campus maintains a stable and leading inpatient market share of 41% and the Los Gatos campus maintains 10% market share in its primary service area (according to management provided data)

*FY 2013 is on track for another year of strong profitability and operating cash flow generation and double-digit cash flow margins; ECH reported an exceptionally strong 11.7% operating margin and 19.4% operating cash flow margin through six months of FY 2013; ECH's financial performance notably improved since the downturn in FY 2010 driven by strong volume growth at both its campuses related to service expansions and additions, performance improvement initiatives, expense growth commensurate with revenue growth, and favorable payer commercial payer contracts

*Steady growth in unrestricted cash and investments to \$490 million as of December 31, 2012, equating to

excellent 303 days cash on hand, 249% cash-to-debt, 214% cash-to-comprehensive debt, and cash-to-demand debt over nine times; ECH has a conservative asset allocation and highly liquid investments

*Maintenance of solid debt measures to service a low debt load (measured by debt-to-revenues of 29.7%) with Moody's adjusted maximum annual debt service (MADS) coverage of 6.8 times and a favorably low 1.5 times adjusted debt-to-cash flow in FY 2012 compared to 7.0 and 1.8 times, respectively, in FY 2011

*Conservative debt structure with largely (75%) fixed rate debt, modest and manageable amount of interest rate swap exposure and operating leases outstanding; operates an active cash balance defined benefit pension plan which had a funded status of 88.3% on a projected benefit obligation basis at FYE 2012; management is continuing to evaluate several sizable capital projects over the next 2-3 years and expects to finalize plans and funding sources over the next 12 to 24 months.

*All ECH facilities in Mountain View and Los Gatos subject to mandated state seismic regulations are 95% compliant until 2030. The final 5% will be 2030 compliant upon completion of minor voluntary upgrades in accordance with approved extensions by January 1, 2015.

CHALLENGES

*A highly competitive marketplace for high end services with the presence of a number of large, prominent health systems including Stanford Hospital and Clinics (rated Aa3/Stable) located nine miles to the north and Kaiser Permanente eleven miles to the south; the Los Gatos campus, located about thirteen miles south of the Mountain View facility, has greater direct competition and competes with three nearby larger hospitals: Good Samaritan Hospital (owned by for-profit HCA) located less than two miles south, O'Conner Hospital (owned by Daughters of Charity Health System) located five miles north, and Santa Clara Valley Hospital, also located to the north; state has no certificate of need law

*Historically has had a high level of dependence on the Palo Alto Medical Foundation (PAMF), a large, multi-specialty physician group that is responsible for about 50% of ECH's admissions; PAMF is affiliated with Sutter Health (rated Aa3/Stable) and captures a significant share of all outpatient services in Mountain View

*A unionized workforce with about 82% of employees represented by collective bargaining organizations including Professional Resource Nurse (PRN), the Service Employees International Union-United Health Workers, West (SEIU-UHW), and the International Union of Operating Engineers, Stationary Engineers, Local 39; while the agreement with SEIU-UHW extends through 2015, agreements with PRN and Local 39 end in 2013

*Measure M, which was passed by the electorate in fall 2012, would cap executive salaries at two times the Governor's salary, is currently under legal appeal by ECH; management has outlined contingency plans in the meantime

DETAILED CREDIT DISCUSSION

LEGAL SECURITY: The bonds are a general obligation of El Camino Hospital and are backed by a security interest in El Camino's gross revenues. The hospital has covenanted not to assume liens in excess of 25% of the value of all its property. El Camino Hospital is the only member of the obligated group and is the dominant economic entity of El Camino Hospital District. This analysis incorporates the financial performance of El Camino Hospital District (the system). The obligated group represents approximately 95% of system assets and 98% of system revenues.

INTEREST RATE DERIVATIVES: ECH has one fixed payer interest rate swap agreement to synthetically fix a portion of the Series 2009A bonds for a notional amount of \$50 million; ECH pays a fixed rate of 3.204% and receives a variable rate based on 56% of LIBOR-BBA plus .23%. The counter-party to the swap is Citibank. As of January 31, 2013, ECH recorded a total net liability of \$8.8 million. No collateral posting is required.

RECENT DEVELOPMENTS/RESULTS

ECH is on track through six months of FY 2013 to post its strongest year to date, attributed to strong volume and revenue growth. Since experiencing some financial decline in FY 2010 (1.6% operating margin and 9.9% operating cash flow margin) which was a departure from a history of stronger operating results (averaging 9.5% operating margin and 16.0% operating cash flow from FY 2005- FY 2009), operating performance returned to historical levels and improved in FY 2011 and FY 2012 with an operating margin of 7.8% and 16.7% operating cash flow margin in FY 2011 and 9.9% and 16.1%, respectively in FY 2012 (bad debt is reclassified as an operating expense in FY 2011 and prior). Through six months of FY 2013, operating performance showed continued improvement with

results exceeding budget and prior year with operating income of \$42.1 million (11.7% margin) and operating cash flow \$70.4 million (19.4% margin) compared to \$28.0 million (8.9% margin) and \$56.7 million (18.0% margin), respectively, through six months of FY 2012. The strong operating results in recent years is attributed to favorable volume growth at both its campuses in Mountain View (new replacement hospital opened in November 2009) and Los Gatos (acquisition and opened in July 2009), favorable commercial payer contracts, and ongoing focus on operating efficiencies and revenue cycle improvements.

Through six months of FY 2013, operating revenue growth improved to 15% exceeding 13% expense growth. Combined inpatient admissions and observation stays were up 7.6%, newborn admissions were up 22.4%, open heart surgeries were up 45%, outpatient surgeries were up 11.7% and ED visits were up 3.9% through six months of FY 2013. ECH's payer mix has remained favorable and stable (45.8% Medicare, 5.1% Medi-Cal, 44.2% Commercial and 5.0% Self Pay and Other through six months of FY 2013). In addition, acuity levels have elevated in recent years (Medicare CMI increased to 1.8 in FY 2012 from 1.5 in FY 2009 and all payer CMI improved to 1.4 in FY 2012). The favorable volume and increased acuity is due to expansion and enhancement of services, further alignment of its medical staff, increase in high acuity surgery cases at both facilities, and improved clinical documentation and coding efforts. Since the purchase and opening of the Los Gatos facility at the beginning of FY 2010, ECH has added and expanded several services at the hospital including a 30-bed inpatient rehabilitation center and men's health program in 2010, an orthopedic pavilion in 2011, and a sleep disorder program in 2012. Additionally, ECH continues to see growth in robotic surgeries, which is one of the largest volume centers in Northern California and its Cancer Center has also seen growth since the purchase of a cyberknife robotic radiosurgery system in 2009. The District also opened a Senior Health Center at the Mountain View campus in 2012.

The continued operating improvements have been led by a re-energized board, a new permanent senior management team, and an engaged medical staff. According to management, since the arrival of the new CEO, ECH has restructured its governance and management structures, expanded the hospital board and committees with 24 new community leaders and members and with a new senior leadership team in place, the cultural of the organization has positively transformed over the past two years. After several years of instability within its senior management team beginning with the retirement of its long-standing CFO of 30 years in 2010, departure of its CEO of five years in 2011 and a couple of interim CFOs, ECH filled permanent senior management positions beginning with a new CEO appointed in October 2011, a new CFO appointed in May 2012, and new COO role created and filled in November 2012. There have been several other new members that have joined the management team. ECH has also restructured its governance structure with the expansion of the hospital board to nine members from six with the addition of three new community members, as well as expanded its committees to include 21 new committee members with a wide range of expertise and experience in the areas of finance, compensation, compliance, governance and quality. Also, two of the five District board members were newly elected members in the November 2012 elections. Re-elected in November 2012 was the incumbent board chairman, who was previously elected to the board in 2007.

Under new governance and leadership, ECH also has redefined its strategy which is focused on the triple aim of quality, service and affordability and providing continuum level of care and improving care coordination in the community by stronger alignment with physicians, other providers (including skill nursing facilities and home health/hospice), and payers in the community and also fostering innovative business and community alliances. ECH has received several recognitions for innovation, quality and patient experience in recent years including the prestigious Magnet designation for nursing care (awarded for the second time in 2010) and the distinguished hospital clinical excellence award by HealthGrades in 2013. Recently, the ECH also launched LEAN process improvement initiative called PacT, patient centered transformation, to develop a culture of continuous improvement through LEAN principles. The hospital is focused on operational efficiencies and integration across both campuses, continued service line development and reduction in clinical variation to improve quality, and the alignment of organizational goals and financial metrics with its mission and strategic investments.

ECH's unrestricted cash and investments have steadily grown to a peak \$490.2 million as of December 31, 2012, equating to an excellent 303 days cash on hand (A1 median is 216) and 249% cash-to-direct debt (A1 median is 147%) from \$454 million at FYE 2012 (June 30) (302 days and 230.3% cash-to-direct debt). Cash-to-comprehensive debt improved to 214.3% (A1 median is 117%) from 198.4% at FYE 2012 (comprehensive debt includes the debt equivalent of operating leases and unfunded pension liability). ECH has a manageable amount of operating leases outstanding. It operates an active cash balance defined benefit pension (DB) plan and defined contribution plan (403(b) plan). The funded status of the DB plan was 88.3% based on a projected benefit obligation basis. Additionally, ECH has a conservative investment allocation with current asset allocation of 85% fixed income and cash and 15% equities with good diversification among fund managers. Investments are highly

liquid with all investments able to be liquidated within one month.

Due to improved operating cash flow generation and a modest debt load (measured by debt-to-operating revenues of 29.7% (A1 median of 36.6%), ECH's debt measures remain solid at the A1 rating category with Moody's adjusted maximum annual debt service coverage of 6.8 times (A1 median is 5.1) and adjusted debt-to-cash flow of 1.5 times (A1 median is 3.1) in FY 2012 compared to 7.0 times and 1.8 times, respectively, in FY 2011.

Total capital spending over the past two years has averaged little less than one time depreciation expense following five years of higher spending (averaging little over four times depreciation expense, ranging between \$73 million-\$278 million). Capital spending in FY 2012 was \$29.1 million up from \$14.5 million in FY 2011. ECH estimates capital spending of \$36 million by the end of FY 2013 of which \$22 million has been spent to date. ECH has identified several capital projects which management is currently evaluating. Some projects identified include replacement of a behavioral medicine building, expansion of the women's health center, upgrades to its data center, continued renovations at its Los Gatos campus and possible replacement of the facility, and upgrades to its electronic medical record system. A number of these projects would be sizable. Management expects to finalize near term capital projects and funding sources over the next 12-24 months.

The Local Agency Formation Commission (LAFCO) for Santa Clara County conducted a service review and audit regarding proper use of taxpayer funds related to the Los Gatos hospital acquisition, which is outside the District boundaries. LAFCO is a state mandated local agency set up to oversee the boundaries of cities and special districts. The commission's final report, completed in August 2012, found there was no inappropriate use of taxpayer funds and made recommendations regarding increased transparency. At the request of LAFCO, management notes the District has made a concerted effort to improve governance, transparency and public accountability within the organization. A final report to LAFCO is expected in April 2013. In addition, Measure M, which was passed by the voters in fall 2012, which would cap executive salary and compensation packages at two times the Governor's salary, is currently under appeal by ECH. In the meantime, management has outlined contingency plans.

Outlook

The stable rating outlook reflects ECH's favorable market position in a strong demographic service area, steady growth in unrestricted liquidity, and continued strong and improved operating results through six months of FY 2013 due to strong volume and revenue growth. Furthermore, under a reenergized and newly developed board and senior leadership team, ECH has a renewed strategy to focus on the triple aim of quality, service and affordability. We expect given the system's strong market presence, favorable location, and focus on achieving operating efficiencies, ECH will continue to produce good operating cash flow in order sustain solid debt coverage and liquidity metrics, support future capital expenditures and offset any future operating volatility and reimbursement declines and new competitive pressures.

WHAT COULD MAKE THE RATING GO UP

Sustained growth in volumes contributing to favorable revenue growth; continued improvement and ability to sustain improved operating and cash flow performance for multiple years; growth in absolute liquidity; strengthening of debt coverage and liquidity measures

WHAT COULD MAKE THE RATING GO DOWN

Decline in volumes and revenues; prolonged decline in operating performance resulting in lower debt coverage levels; decline in liquidity; increase in debt without commensurate increase in operating cash flow generation and unrestricted cash growth; new competitive pressures and loss of market share

KEY INDICATORS

Assumptions & Adjustments:

- Based on financial statements for El Camino Hospital District
- First number reflects audit year ended June 30, 2011
- Second number reflects audit year ended June 30, 2012
- Investment returns normalized at 6% unless otherwise noted

-Comprehensive debt includes direct debt, operating leases (using multiple method), and unfunded pension liability, if applicable

-Bad debt is reclassified as operating expense in FY 2011; Bad debt is deducted from revenues in FY 2012

-GO bonds and related interest expense are excluded from all ratios

Inpatient admissions: 18,915; 22,593

Observation stays: 4,885; 4,839

Medicare % of gross revenues: 47.3%; 47.2%

Medicaid % of gross revenues: 5.3%; 5.4%

Total operating revenues (\$): \$659.8 million; \$664.3 million

Revenue growth rate (%) (3 year CAGR): 12.9%; 10.7%

Operating margin (%): 7.8%; 9.9%

Operating cash flow margin (%): 16.7%; 16.1%

Debt-to-cash flow (x): 1.8; 1.5x

Days cash on hand: 239 days; 302 days

Maximum annual debt service (MADS) (\$) \$17.9 million; \$17.9 million

MADS coverage with reported investment income (x): 7.1x; 6.3x

Moody's-adjusted MADS Coverage with normalized investment income (x): 7.0x; 6.8x

Direct debt (\$):\$205.5 million; \$197.0 million

Cash-to-direct debt (%): 178.1%; 230.3%

Comprehensive debt: \$230.0million; \$228.7 million

Cash-to-comprehensive debt (%): 159.3%; 198.4%

Monthly cash-to-demand debt (%): 732.0%; 908.0%

RATED DEBT (debt outstanding as of June 30, 2012)

Rated Revenue Bonds

-Series 2008 fixed rate revenue bonds (\$136.9 million outstanding), insured by AMBAC; A1 unenhanced rating

-Series 2009A variable rate demand revenue bonds (\$50 million outstanding), rated Aa1/VMIG 1 based on joint support analysis of Aa3-rated Wells Fargo Bank Letter of Credit (expires April 6, 2017) and El Camino Hospital, A1 underlying rating

Rated General Obligations Bonds

-Series 2006 fixed rate general obligation bonds (\$142.3 million outstanding), rated Aa1

CONTACT

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PRINCIPAL 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.moody.com for a copy of this methodology.

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