

## Charlotte-Mecklenburg Hospital Authority, North Carolina; Joint Criteria; System

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### Table Of Contents

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Rationale

Outlook

Operations: Strong Market Share, Volume Growth

Solid Balance Sheet, Improving Profitability

Debt Derivative Profile: Low Credit Risk

Related Criteria And Research

# Charlotte-Mecklenburg Hospital Authority, North Carolina; Joint Criteria; System

Credit Profile		
US\$150. mil hosp rev bnds ser 2011A due 01/15/2042		
<i>Long Term Rating</i>	AA-/Stable	New
Charlotte Mecklenburg Hospital Authority		
<i>Long Term Rating</i>	AA-/Stable	Affirmed

## Rationale

Standard & Poor's Ratings Services has assigned its 'AA-' long-term rating to the series 2011A fixed-rate revenue bonds to be issued for the Charlotte-Mecklenburg Hospital Authority, N.C. Standard & Poor's has also affirmed its 'AA-' long-term rating and underlying ratings (SPUR) on the authority's previously issued bonds. The authority does business as Carolinas HealthCare System (CHS).

The series 2005B bonds are supported by a letter of credit (LOC) from US Bank (AAA/A-1+). The long-term component of the rating is based on the application of joint criteria reflecting the rating on US Bank N.A. (AA-/A-1+) and the 'AA-' SPUR on CHS. The short-term component of the rating reflects the 'A-1+' short-term rating on US Bank. The LOC supporting the series 2005B bonds expires Feb. 17, 2016.

The series 2005C and 2005D bonds are supported by an LOC from US Bank. (AAA/A-1+). The long-term component of the rating is based on the application of joint criteria reflecting the rating on US Bank (AA-/A-1+) and the 'AA-' SPUR on CHS. The short-term component of the rating reflects the 'A-1+' short-term rating on US Bank. The LOC supporting the series 2005C and 2005D bonds expires on Feb. 17, 2016.

Supporting the series 2007B and 2007C bonds, which carry a dual rating of 'AA-/A-1+', are standby bond purchase agreements (SBPA) from JPMorganChase Bank N.A. The long-term component of the rating reflects the 'AA-' long-term rating on CHS, and the short-term component of the rating reflects the 'A-1+' short-term rating on JPMorganChase Bank. The SBPAs supporting the series 2007B and 2007C bonds expire on May 4, 2015.

The series 2007D, 2007E, 2007F, and 2007G bonds are insured by Assured Guaranty Municipal Corp., formerly known as Financial Security Assurance Inc. (AA+). In addition, the 2007D, 2007E, 2007F bonds are supported by Dexia Credit Local liquidity facilities, while the series 2007G bonds are supported by a Bank of America LOC. The 'A-1' short-term rating on the series 2007D, 2007E, and 2007F bonds reflects liquidity support provided by Dexia Credit Local. The liquidity facilities supporting the series 2007D, 2007E, and 2007F bonds expire on Sept. 18, 2017.

The series 2007G variable-rate demand bonds, rated 'AAA/A-1', are supported by a letter of credit (LOC) provided by Bank of America (A/A-1). The long-term component of the rating is based on insurance from Assured Guaranty Municipal Corp. (AA+), and the application of joint criteria between Bank of America (A+/A-1) and the 'AA-' SPUR on CHS. The short-term component of the rating reflects the 'A-1' short-term rating on Bank of America. The LOC expires on Jan. 1, 2016.

The series 2007H variable-rate demand bonds are supported by an LOC provided by Wells Fargo Bank, and are rated 'AAA/A-1+'. The long-term component of the rating is based on the application of joint criteria reflecting the rating on Wells Fargo Bank (AA/A-1+) and the 'AA-' SPUR on CHS. The short-term component of the rating reflects the 'A-1+' short-term rating on Wells Fargo Bank. The LOC supporting the series 2007H bonds expires on June 20, 2016.

The overall financial profile has improved to healthy levels consistent with the 'AA-' rating, fully recovering from margin compression during 2008 and 2009. Operating results improved in 2010 to 2007 levels due to continued volume and revenue growth and cost controls, particularly labor, benefits, and supplies expenses. We expect the pro forma balance sheet to remain consistent with the overall rating upon issuance of the series 2011A bonds, though certain pro forma balance sheet ratios will be compressed in the near term while the organization absorbs the additional debt.

Management intends to spend \$1.6 billion on capital between 2011 and 2015--an amount that reflects a \$491 million reduction from original plans, and, which could be reduced further if management deems it necessary. Funding sources for the capital plan are cash from future operations, philanthropy, future monetization of office space, American Recovery and Reinvestment Act funding, and bond proceeds from the upcoming series 2011A bonds.

In Standard & Poor's view, additional rating factors include:

- Healthy pro forma debt service coverage in 2010;
- Favorable balance sheet, with days' cash on hand as of Dec. 31, 2010, that is consistent with the rating;
- Maintenance of a significant business position within the states of North and South Carolina as the largest health care provider;
- A longstanding relationship with Mecklenburg County (AAA), highlighted by a long and stable history of providing indigent-care funding;
- An experienced management team that has a long record with the organization; and
- Robust population growth with very strong economies in the county and Charlotte, N.C.

Partly offsetting credit factors, in Standard & Poor's view, include:

- CHS's continued exposure to variable-rate debt, though the degree of the exposure has lessened in light of the 2009 debt restructuring; and
- Light pro forma cash-to-debt ratio in 2010.

CHS's adequate unrestricted cash of \$2.2 billion on Dec. 31, 2010, equates to 298% of \$736.7 million of puttable debt in the event of repurchase. However, notwithstanding favorable repayment provisions in the liquidity facilities and LOCs for repurchased bonds, any substantial repurchase of variable-rate debt could limit CHS's ability to spend on future capital needs, given the still large nature of the five-year plan.

Beyond the series 2011A bonds, management does not plan to issue additional debt within the next several years. Management will use the series 2011A bonds to partially fund its capital needs including various capital projects during the next two to three years, during which time it will use operating cash flows to further strengthen the balance sheet. The pro forma debt service calculation is based on CHS's maximum annual debt service (MADS) of \$98.8 million.

In 2007, the Carolinas HealthCare Foundation (the foundation) became a member of CHS's Obligated Group. The foundation has long financially supported CHS, and its board mainly consists of individuals with long-standing ties to CHS. All ratios cited within this report refer to the obligated group that includes CHS's primary enterprise and the foundation.

CHS is the larger of the two health care systems serving the Charlotte region and offers area residents convenient access to all primary and secondary services in addition to a broad tertiary and quaternary service mix, including its recognized strength in key specialties such as pediatrics, cardiology, orthopedics, and neurosciences.

## Outlook

The stable outlook reflects our assessment of CHS's very strong business position and strengthening overall financial profile. We also expect that management will likely sustain operating profitability and maintain overall financial flexibility in light of the capital spending program.

We could consider a positive rating action beyond the next one to two years based on measurable growth in income statement and key balance sheet metrics, such that CHS absorbs the series 2011A bonds and capital plan successfully. Should operating profitability or liquidity decrease to levels not commensurate with the current rating, we could consider a negative outlook or rating change during the next one to two years.

## Operations: Strong Market Share, Volume Growth

CHS's primary enterprise consists of 10 hospitals (one tertiary and quaternary, two tertiary, and three acute-care hospitals with a total of 1,801 licensed beds, one behavioral health facility with 66 licensed beds, and two rehabilitation facilities with 159 licensed beds), two long-term-care facilities with 292 licensed beds, and a large physician network of primary and specialty physicians and faculty at Carolinas Medical Center.

The primary enterprise includes Carolinas Medical Center-Lincoln (formerly Lincoln Health System), beginning in the fourth quarter 2006, and CMC-NorthEast, effective July 1, 2007. CHS has a primary care physician network in 226 locations in 15 counties. CHS's strategy of broadening its geographic outreach is being achieved through a network of nonobligated entities, including 22 hospitals and eight related nursing homes. These entities make up the component units or managed entities. The component units, which are separately included in CHS's audit, are profitable and generate solid debt service coverage of debt and related lease payments.

CHS has its direct management expenses reimbursed and receives a network development fee of 7%-11% of cash flow from these component units. The primary enterprise received roughly \$6.1 million in network development fees last year from the component units, which is treated as a net assets transfer and is not added back into CHS's income or debt service coverage. CHS guarantees about \$2.9 million of annual operating lease payments for the component units. As these entities are all solidly self-supporting, the guaranteed lease payments are not factored into debt service coverage.

Overall primary enterprise acute-care inpatient discharges increased to 95,089 in 2010 from 91,978 in 2009 and adjusted discharges increased to 201,555 from 194,262 during the same period. The increase stems from growth at Carolinas Medical Center, programmatic growth associated with recent capital investments (such as Levine Children's Hospital), and continued growth of CHS's physician network, which has contributed to greater

downstream admissions and outpatient volume. Surgery volume for the acute-care facilities increased to 69,520 cases in 2010 from 68,994 in 2009.

CHS's market share (including all facilities owned, leased, or managed) in the service area--consisting of the 31-county region--remained strong at 38% in 2010, with the balance shared by Charlotte-based Presbyterian Hospital and its affiliates, as well as by individual community hospitals that have strong positions in their home counties. CHS has strong market share in key service lines. Competition comes largely from the 531-licensed bed Presbyterian Hospital and its two community hospitals, which have a market share of 31.5% in Mecklenburg County compared with CHS's 58%. Presbyterian is part of the Novant Health System (A+), which includes Forsyth Memorial Hospital, based in Winston-Salem. CHS's market share has grown since the mid-1990s at the expense of Presbyterian, although more recently Presbyterian's and CHS's market share in the urban core have clearly stabilized at current levels. Managed-care accounts for approximately 41% of revenue and CHS contracts with all substantive managed-care payors in the region. There has been some payor-mix erosion recently by CHS competitors, as CHS's Medicaid and uncompensated-care market share has decreased in recent years, with a slight increase occurring in 2010.

Large multispecialty and single specialty medical groups characterize the Charlotte region. CHS's physician network remains a core business strength in our opinion with 1,400 community-based and faculty physicians, generating approximately 3.9 million visits annually. Carolinas Medical Center is one of five academic medical center teaching hospitals designated by the State of North Carolina, with approximately 262 medical residents in 13 specialties.

CHS's long-term relationship with its local county government remains strong. Mecklenburg County (AAA) is committed to funding the operating deficits of Carolinas Medical Center's outpatient indigent-care clinics, as well as other indigent care provided to Mecklenburg County residents. This commitment, which currently amounts to approximately \$16 million annually, has been in place for a long time. In addition, CHS contractually operates the county's public health department, and various outreach services, which are reimbursed generally on a cost basis. The county also provides funding for CMC's comprehensive inpatient and outpatient behavioral health programs. Population growth in the county and the metropolitan region remains healthy, with a regional growth rate of more than 2% annually, which is projected to continue through at least the next five years.

## **Solid Balance Sheet, Improving Profitability**

Profitability for the obligated group has improved gradually since 2008, rebounding to pre-recession levels due to volume and revenue growth, as well as continued expense controls. CHS's cost-control program is highlighted by sharply controlled labor, pharmacy and supplies expenses that increased just marginally over the past few years, compared with a national average annual percentage increase in the low teens. Pension expense was increased by weakened investment returns in 2008 that were not completely offset by favorable returns in 2009 and 2010. We view the increasing profitability as a source of stability at the current rating, and a key factor in CHS's ability to absorb the series 2011A debt. Operating income increased to \$107.6 million (3.0% margin) in 2010 from \$74.7 million (a 2.3% margin) in 2009. Management expects to earn \$68.4 million from operations in 2011.

Excess income also rebounded in 2010, increasing to \$182.5 million (a 5.0% margin) from \$54.9 million (a 1.7% margin) in 2009 due to favorable realized investment returns and increased operating cash flow. Excess (net) income excludes \$135.5 million in 2010 and \$295.0 million of unrealized gains in 2009. Pro forma debt service coverage was healthy for the rating at 4.2x in 2010, compared with a light 3.0x in 2009.

CHS's core strength, from a credit perspective, is its balance sheet, which has rebounded due to favorable investment returns, sound operations, a continued low balance of accounts receivable, and improved revenue cycle management. Unrestricted cash reached its peak of \$2.2 billion as of Dec. 31, 2010 (243 days' cash on hand) compared with \$1.9 billion (236 days' cash on hand). Pro forma cash to debt was, in our opinion, light for the rating at 134% due to the series 2011A bonds, while we considered leverage moderate for the rating at 35% as Dec. 31, 2010.

## Debt Derivative Profile: Low Credit Risk

In 2006, CHS entered into a floating-to-fixed rate swap on the series 2005B-D bonds (uninsured) with Bank of America N.A. (A) for an initial notional amount of \$93.9 million. In 2007, CHS entered into several floating-to-fixed rate swaps on the series 2007B-H bonds (insured) and series 2007L bonds (uninsured) with Wells Fargo Bank (AA), Citigroup (A), and Bank of America for a total initial notional amount of \$709.1 million. The swap on the series 2007L bonds (notional amount of \$49 million) was terminated by CHS in 2009. Current total notional amount stands at \$736.7 million as of Dec. 31, 2010. Despite a significant mark to market of negative \$120.8 million as of Dec. 31, 2010, CHS has not had to post any collateral related to its swap portfolio, as the collateral posting requirement for insured swaps is based on a simultaneous downgrade of both the insurers (Assured Guaranty Municipal Corp or Ambac) to 'BBB+' and CHS to 'A'.

CHS has been assigned a Standard & Poor's Debt Derivative Profile (DDP) overall score of '2.0' on a scale of '1' to '4', with '1' representing the lowest risk and '4', the highest.

The overall score of '2.0' reflects Standard & Poor's view that CHS's swap portfolio reflects a low credit risk at this time due to:

- Good economic viability of the portfolio over stressful economic cycles;
- Minimal counterparty risk due to the moderate 'A' rating on Bank of America, the 'A' rating on Citigroup, and the strong 'AA' rating on Wells Fargo Bank;
- Limited termination risk given the spread between the current rating on CHS and no requirement of collateral posting unless an insurer default occurs; and
- Excellent management practices that include a written swap policy and periodic monitoring and valuations of the portfolio.

## Related Criteria And Research

- USPF Criteria: Not-For-Profit Health Care, June 14, 2007
- USPF Criteria: Bank Liquidity Facilities, June 22, 2007
- USPF Criteria: Standby Bond Purchase Agreement Automatic Termination Events, April 11, 2008
- USPF Criteria: Municipal Applications For Joint Support Criteria, June 25, 2007
- USPF Criteria: Debt Derivative Profile Scores, March 27, 2006

Ratings Detail (As Of April 27, 2011)		
Charlotte-Mecklenburg Hospital Authority hosp VRDB ser 2005B		
Long Term Rating	AAA/A-1+	Affirmed
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed

<b>Ratings Detail (As Of April 27, 2011) (cont.)</b>		
Charlotte-Mecklenburg Hospital Authority hosp VRDB ser 2005C		
<i>Long Term Rating</i>	AAA/A-1+	Affirmed
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Charlotte-Mecklenburg Hospital Authority hosp VRDB ser 2005D		
<i>Long Term Rating</i>	AAA/A-1+	Affirmed
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Charlotte-Mecklenburg Hospital Authority hosp VRDO ser 2007H		
<i>Long Term Rating</i>	AAA/A-1+	Affirmed
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Charlotte-Mecklenburg Hospital Authority (MBIA) (National) (SEC MKT)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
<b>Charlotte-Mecklenburg Hospital Authority VRDB ser 2007B</b>		
<i>Long Term Rating</i>	AA-/A-1+/Stable	Affirmed
<b>Charlotte-Mecklenburg Hospital Authority VRDB ser 2007C</b>		
<i>Long Term Rating</i>	AA-/A-1+/Stable	Affirmed
<b>Charlotte-Mecklenburg Hospital Authority VRDB ser 2007D,E,F</b>		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
<i>Long Term Rating</i>	AA+/A-1/Stable	Affirmed
<b>Charlotte-Mecklenburg Hosp Auth</b>		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
<i>Long Term Rating</i>	AAA/A-1	Affirmed
Many issues are enhanced by bond insurance.		

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