Moody's
INVESTORS SERVICE

Rating Update: MOODY'S DOWNGRADES BOND RATING FOR LAKEWOOD HOSPITAL ASSOCIATION (OH) TO Baa2 FROM A3; NEGATIVE OUTLOOK MAINTAINED

Global Credit Research - 29 Jul 2011

RATING ACTION AFFECTS $13 MILLION OF OUTSTANDING DEBT

Lakewood (City of) OH
Health Care-Hospital
OH

Opinion

NEW YORK, Jul 29, 2011 -- Moody's Investors Service has downgraded the bond rating for Lakewood Hospital Association (OH) (Lakewood) to Baa2 from A3. The negative rating outlook is maintained at the lower rating level. The rating action affects $13 million of Series 2003A bonds issued through the City of Lakewood, Ohio.

SUMMARY RATINGS RATIONALE:

The rating downgrade is based on continued significant declines in admissions, large and escalating operating losses (and negative operating cashflow), and significant decreases in unrestricted cash. Although the hospital has taken steps to restructure its operations, including closing certain services, progress is slower and less than anticipated and the hospital has been missing budgets. The extent of the challenges, including volume losses and continued increases in charity care and Medicaid, suggest the hospital's long-term viability is threatened without more significant strategies to restructure the operations.

Lakewood's fundamental credit profile - moderate size and limited service array in a competitive Cleveland-area market, challenging demographics, and physician turnover - suggests a rating level several notches below the current Baa2 rating. However, Lakewood's rating heavily incorporates what we believe is a very strong and integrated relationship with the Cleveland Clinic Health System (CCHS) (rated Aa2), as discussed below, which is the sole corporate member of Lakewood. Additionally, the lease agreement under which CCHS leases Lakewood includes a provision whereby if Lakewood Hospital's cash-to-debt (including bonds only) falls below one time, CCHS is required to transfer funds to Lakewood to meet that requirement.

The negative rating outlook is driven by challenges to reversing volume losses and improving operating performance and the likelihood that cash will continue to decline. In the absence of a more significant reduction of operating losses and stability of volumes, a further rating downgrade within the next year is possible.

CHALLENGES

*Several years of large operating losses ($15 million, -10.4%, in fiscal year 2010) and moderate or no revenue growth; improvement initiatives have been slow and the hospital has missed budget; continued volume declines and the absence of more substantial restructuring initiatives will threaten the long-term viability of the hospital

*Location in a very competitive service area and increased physician turnover has contributed to several years of large admissions declines (cumulative 29% between 2006 and 2010)

*Significant erosion of cash position as a result of negative cashflow with unrestricted cash and investments declining to $49 million as of June 30, 2011 from $66 million at fiscal yearend 2009

*Challenging demographics resulting in high Medicare (50% of gross revenues) and high Medicaid and self-pay (combined 24%)

*Relatively high dependency on a large physician group for admissions

STRENGTHS

*Strategic and financial benefits derived from Lakewood's status as a part of Aa2-rated Cleveland Clinic Health System (CCHS), which is the sole corporate member of Lakewood (the City of Lakewood owns the real assets of the hospital); additionally, an independent foundation holds approximately $23 million in investments, some of which may be available for capital

*Low debt level (19% debt-to-revenue) and adequate liquidity of 120 days as of June 30, 2011, which, despite declines, provides an ample 189% coverage of total debt

*Debt structure is low risk with all fixed rate debt and no swaps

*Provision in lease which requires CCHS to ensure that Lakewood maintain 1:1 cash to debt

DETAILED CREDIT DISCUSSION

LEGAL SECURITY: The hospital is owned by the City of Lakewood and the bonds are secured through a long-term lease by gross revenues of the hospital; indenture contains adequate additional indebtedness tests.

INTEREST RATE DERIVATIVES: None

RECENT DEVELOPMENTS/RESULTS

Lakewood's current rating would be several notches lower without the financial and strategic benefits from its relationship with CCHS. Lakewood Hospital is owned by the City of Lakewood, Ohio and has debt that is solely secured by revenues at Lakewood. In 1997, CCHS entered into a management agreement and long-term lease with Lakewood under which CCHS, as the sole corporate member of the hospital, operates Lakewood as it does all of its other subsidiaries. Importantly, the lease requires Lakewood to maintain a cash-to-debt ratio of 1:1 on a fiscal year basis; if Lakewood falls below this measure, CCHS is required to transfer funds to Lakewood to meet that requirement. Debt includes only bonds and excludes Lakewood's lease payments to the City of Lakewood (unless a lease payment is missed in the measurement year). As of December 31, 2010, cash-to-debt (including bonds only) was 352%.

Over the last several years, we believe the degree of integration between Lakewood and CCHS has continued (in line with CCHS's overall strategy to more fully integrate all of its regional hospitals), providing greater management oversight and expertise and strategic direction. Lakewood is fully incorporated into the financial and strategic planning of CCHS and virtually all support services are consolidated with CCHS including managed care contracting, purchasing (including insurance), investment management and strategic planning. Senior management of Lakewood has been combined with the management of Fairview Hospital (a subsidiary of CCHS) to form one management team that reports to CCHS' regional management team. Certain services at Lakewood are managed by CCHS Vice Presidents who are responsible for that service line across the region. Lakewood's board has heavy community representation (including members of the Lakewood City Council and City Mayor) and most service eliminations are required to be approved by the Lakewood City Council.

Significant admissions declines continue due to the local economy and population declines in northwest Cleveland, competition, physician turnover, the transfer of certain services to other CCHS hospitals, and the closure of some services at Lakewood. Admissions declined 10% in fiscal year 2010, following a 10% decline in 2009. Through six months of fiscal year 2011, admissions are down 5%. Some risk is inherent in Lakewood's high dependency on a large physician group for over 30% of revenue.

Lakewood's operating loss in fiscal year 2010 escalated from 2009 and missed budget due largely to volume declines and increasing self-pay. In fiscal year 2010, Lakewood reported a $15.0 million operating loss (-10.4%), compared with a $9.7 million (-6.8%) operating loss in fiscal year 2009. Operating cashflow in 2010 was a negative $6.7 million (-4.6%), compared with a negative $1.4 million (-1.0%) in 2009. Through six months of fiscal year 2011, the hospital had an operating loss of $4.1 million (-5.6%), compared with a loss of $5.9 million (-8.0%) in the prior year period; operating cashflow was breakeven. Although the hospital has implemented workforce reductions and has other initiatives to cut costs and enhance revenue, the full year loss is expected to be sizable and the hospital will likely need to consider a more major restructuring of the operations to remain viable.

Lakewood's unrestricted cash position has declined significantly and will likely continue to decline based on current operating performance. As of June 30, 2011, unrestricted cash was $49 million (120 days cash on hand), compared with $54 million at December 31, 2010 and $66 million at December 31, 2009. Lakewood's cash is invested with CCHS, which provides investment expertise, but potentially more volatility because of the exposure to equities and alternative investments. An independent foundation exists with approximately $23 million of investments that could be used to support the hospital; while some of these assets are restricted, the Foundation has indicated in the past its commitment to support certain capital projects at the hospital with foundation assets and has provided about $1.5 million to date for projects. Lakewood participates in CCHS's pension plan, which was frozen as of December 31, 2009.

Outlook

The negative rating outlook is driven by challenges to reversing volume losses and improving operating performance and the likelihood that cash will continue to decline. In the absence of a more significant reduction of operating losses and stability of volumes, a further rating downgrade within the next year is possible.

WHAT COULD CAUSE THE RATING TO GO UP

With a negative outlook, a rating upgrade in the short-term is not likely. Over the longer-term, an upgrade would be considered with significant improvement in margins and reduction in debt and notable growth in admissions to better position Lakewood in a competitive market.

WHAT COULD CAUSE THE RATING TO GO DOWN

Further significant volume declines, inability to achieve improvement in operating performance, further decline in cash, increase in debt without commensurate increase in cashflow; change in relationship with CCHS.

KEY INDICATORS

Assumptions & Adjustments:

-Based on financial statements for Lakewood Hospital Association

-First number reflects audit year ended December 31, 2009

-Second number reflects audit year ended December 31, 2010

-Investment returns smoothed at 6% unless otherwise noted

*Inpatient admissions: 10,216; 9,188

*Total operating revenues: $142.9 million; $144.4 million

*Moody's-adjusted net revenue available for debt service: $2.5 million; -$3.3 million

*Total debt outstanding: $31 million; $27 million

*Maximum annual debt service (MADS): $6.3 million; $6.3 million (including lease payments to City of Lakewood and large final maturity payment in 2015)

*MADS coverage based on reported investment income: negative; negative

*Moody's-adjusted MADS coverage: 0.4 times; negative

*Debt-to-cash flow: 30.7 times; -5.6 times

*Days cash on hand: 165 days; 130 days

*Cash-to-debt: 215%; 200%

*Operating margin: -6.8%; -10.4%

*Operating cash flow margin: -1.0%; -4.6%

RATED DEBT (as of June 30, 2011)

-Series 2003 fixed rate ($13.1 million): Baa2

CONTACT

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PRINCIPAL METROLOGY USED

The principal methodology used in this rating was Not-for-Profit Hospitals and Health Systems published in January 2008. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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