Allegheny County Hospital Development Authority, Pennsylvania University of Pittsburgh Medical Center; Hospital; Joint Criteria; System

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Rationale

Standard & Poor's Ratings Services raised to 'A+' from 'BBB+' its long-term and underlying ratings (SPUR) on Blair County Hospital Authority, Pa.'s revenue bonds, series 1998A and 2009, issued for Altoona Regional Health System. The outlook is stable. The upgrade is due to the debt becoming part of University of Pittsburgh Medical Center's master trust indenture, effective July 1, 2013.

Standard & Poor's also affirmed its 'A+' long-term and underlying ratings (SPURs) on various issuers' revenue bonds, issued for University of Pittsburgh Medical Center (UPMC). We also changed our long-term ratings to 'A+' from 'AAA/A-1' on Allegheny County Hospital Development Authority's series 2010B-1 and 2010B-2 revenue bonds, issued for UPMC, due to a remarketing to index mode from variable-rate demand mode, effective July 1, 2013. We also withdrew our SPUR on those bonds. The outlook is stable.

UPMC's operating performance has softened considerably since last year, which management attributes to reimbursement pressure from commercial and government payors. However, due to strong investment income and a gain on the sale of UPMC's equity stake in a company, its excess income remains adequate to support the rating at this time. Management has responded with cost-cutting initiatives that we expect will restore an adequate operating income in fiscal 2014, although the pressures currently reducing margins will remain, and we expect operating profitability to be slim. UPMC's acquisition of Altoona Regional Health System, expected to be effective on July 1, 2013, has a very minor dilutive financial impact on UPMC, and will further enhance UPMC's already-strong business position in western Pennsylvania.

UPMC's competitive environment continues to evolve, and while it remains the dominant provider in western Pennsylvania, we believe the organization faces considerable competitive and financial risk over the next two to three years. Specifically, UPMC's largest hospital competitor, West Penn Allegheny Health System completed its
long-delayed merger with Highmark Inc. Highmark is the largest health insurance plan in the market and is building a provider network in the market, known as Allegheny Health Network, which could change the competitive dynamic on both the provider and insurance fronts. UPMC owns the second-largest health insurance plan in the market and with Highmark building its provider base, the market is evolving toward two large integrated delivery systems, with potentially narrow network choices as they may no longer have contracts with each other.

UPMC has indicated that it does not intend to renew certain hospital and physician insurance contracts with Highmark when they expire on Dec. 31, 2014. UPMC's health plan has historically not contracted with West Penn Allegheny Health System. We continue to believe that the future expiration of the Highmark contract could cause UPMC to lose business because Highmark-insured patients will be forced to use other providers. However, certain individuals and corporations could choose to switch to another health plan if they have strong preference for UPMC's provider network. UPMC's own insurance plan could gain members under that scenario.

More specifically, the 'A+' ratings reflect our assessment of UPMC's:

- Continued market share growth within its large western Pennsylvania service area, supported by acquisitions, ongoing capital investments, a strong reputation, brand-name recognition, several highly visible subsidiary facilities, and comprehensive service offerings, including women's, children's, cancer, rehabilitation, behavioral health, and transplant services;
- Large and diverse footprint in western Pennsylvania, with 21 domestic hospitals including Altoona, a large complement of employed physicians, and a health care plan with 2.1 million covered lives, all of which offset a balance sheet that is weak for the rating level;
- Sound management team, which has kept UPMC very well positioned within its market as the region's dominant provider, demonstrating the ability to divest itself of nonperforming assets when needed, and the development of several nontraditional service lines, including the UPMC Health Plan; and
- Management's demonstrated strong commitment to implementing leading-edge information technology (IT) and financial control systems.

Partially offsetting the preceding credit strengths, in our view, are:

- A large debt load of $3.3 billion, with additional borrowings planned each year through fiscal year 2017 though management does not anticipate the overall debt load will increase because borrowings are expected to largely be offset by the repayment of existing debt;
- A balance sheet that has been strained by declines in investment markets, robust capital spending, and increased debt, leading to certain measures that are below average for the rating, although UPMC's balance sheet has rebounded well from the lows of 2009; and
- Weak local demographics highlighted by a 5% drop in the population in the core service area of Allegheny County since 2000, to 1.2 million in 2012.

Also factored into the rating is our expectation that UPMC will issue new-money debt of approximately $130 million later in 2013, potentially in conjunction with several refunding transactions. We consider the debt plan very modest and unlikely to change our view of UPMC's credit.

UPMC has all but $360 million of its $3.3 billion long-term debt secured under UPMC's master trust indentures by a revenue pledge of the obligated group. The numbers in this report refer to UPMC as a whole. UPMC reduced risk in its
debt portfolio over the last three years through the refunding or remarketing of several issues, resulting in more fixed-rate debt, less demand debt, and far fewer swaps. Subsequent to the remarketing of the 2010B-1 and 2010B-2 bonds, UPMC will have only $20 million of variable-rate demand bonds backed by letters of credit. As of March 31, 2013, UPMC had $226 million of interest-rate swaps, down significantly from more than $1 billion prior to the 2010 restructuring.

Outlook

The stable outlook reflects UPMC’s record of effectively addressing operating challenges, which should result in a return to a modest positive operating income in fiscal 2014. However, we believe that the forces causing margin pressure, including a challenging reimbursement environment, will continue, and that operating performance will continue to be thin compared with comparably rated organizations. In our opinion, regional demographics, overall high debt levels, and only moderate debt service coverage, particularly when including operating leases, remain credit risks. Failure to restore modest positive operating income or an unexpected decline in balance sheet strength could result in a lower rating. Although it is beyond the outlook period, the Highmark contract expiration could also cause downward rating pressure if it results in a diminished financial or business position.

We believe that a higher rating will be unlikely until the Dec. 31, 2014, termination of the Highmark contract and a subsequent demonstration that the termination hasn't been detrimental to UPMC's financial or business position, which we believe should be apparent by 2015. Subsequent to that, we could raise the ratings if the income statement and balance sheet metrics continue to improve, including a combination of operating margins consistently greater than 2.5%, improvement in days' cash on hand to the 150 to 170 range, operating lease-adjusted coverage consistently at 3x or greater, and improvement in unrestricted reserves to long-term debt to above 125% even as the organization issues new debt.

Enterprise Profile

Market share and demographics

UPMC is a large integrated health care system operating in southwestern Pennsylvania. Its headquarters is in Pittsburgh, and the majority of its operations are in Allegheny County, although it has 21 domestic hospital facilities and more than 400 clinical locations throughout the region and overseas. Its acute-care market share has grown steadily due to mergers and better admissions trends than its competitors, although overall market-wide volume trends are weak. UPMC's market share is 60% of Allegheny County, 40% of the 10-county region, and 37% of the broad 29-county western Pennsylvania market. Management estimates that UPMC's market share will grow to 40% in the broad service area resulting from the merger with Altoona Hospital. Despite the market share growth, population continues to fall and overall market-wide admissions are dropping due to population loss and the shift to observation status for certain low-acuity cases. UPMC's acute-care inpatient admissions were flat at 139,907 through the nine months ended March 31, 2013, despite opening a new hospital (UPMC-East in Monroeville) on July 1, 2012. On a same-store basis, admissions were down 2.8% in the year-to-date period. Management believes that some of the same-store decline was a shift from existing UPMC hospitals that are near capacity to the new facility.
The greater Pittsburgh market is fairly consolidated, with UPMC by far the largest health care system, followed by Allegheny Health Network, which has less than half of UPMC's admissions. There are only a few remaining single-site hospitals and small systems in the region. Overall market-wide admissions have been flat or decreasing for the past several years, in part because of the market's weak demographics, characterized by a declining population in many counties in the region, including the core Allegheny County, where Pittsburgh is located. UPMC's volumes, while relatively flat, have generally outpaced the market as a whole during the past several years, resulting in UPMC's continued market share growth.

Service range and high-end care
UPMC's overall profile includes a solid presence in high-level tertiary care, including transplants, as well as rehabilitation, psychiatric, long-term care, and senior-living business lines. Along with its premier services, UPMC has made some large investments in state-of-the-art facilities, including a new children's hospital in 2009, a large patient tower project at its UPMC Passavant campus, and a new 156-bed hospital east of Pittsburgh in Monroeville (UPMC East) that opened in July 2012. UPMC's robust capital spending on facilities and IT have resulted in what we consider a young average age of plant of 8.9 years as of June 30, 2012.

UPMC's core hospital business is augmented by a large health care plan that has grown in the past few years to 2.1 million members, in various product lines, as of March 31, 2013. The plan has consistently demonstrated overall revenue growth and profitability as has UPMC's insurance division as a whole.

Management and governance
Senior management is stable and demonstrates many characteristics that we believe are best practices, such as compliance with Sarbanes-Oxley's provisions, including the internal controls recommendations, fully consolidated monthly financial statements, and extensive quarterly disclosure. We also recognize management's successful efforts since 2010 to reduce the risk in its debt portfolio by shifting away from bonds with optional put features toward fixed- and floating-rate note structures, and reducing exposure to swaps significantly.

UPMC's governance structure is adequate, in our view, with a moderately large 24-member parent board in full control of all subsidiaries. The university appoints one-third of board members and the member hospital boards appoints another third, although the parent board ultimately has full control of the subsidiary boards. We would consider governance to be stronger if the board were slightly smaller and it were fully self-perpetuating with no outside appointees.

Financial Profile
Change in accounting for bad debt
In accordance with the publication of our article, "New Bad Debt Accounting Rules Will Alter Some U.S. Not-for-Profit Health Care Ratios But Won't Affect Ratings", on Jan. 19, 2012, we recorded UPMC's 2012 audit and 2013 interims including the adoption of Financial Accounting Standards Board 2011-07, but not in prior periods. The new accounting treatment means that UPMC's fiscal 2012 and subsequent financial statistics are not directly comparable to the results for 2011 and prior years. In addition, to facilitate comparison to our median financial ratios, we recalculated our 2011 median ratios as if 2011-07 had been adopted by all of our rated hospitals in 2011. (See the article "How U.S.
Not-for-Profit Health Providers' Financial Ratios Will Change Under The New Bad Debt Accounting Rules*, published Oct. 10, 2012, for more details.) For an explanation of how each financial measure is affected by the change in accounting for bad debt, including the direction and size of the change, please see the above articles.

**Income statement**

UPMC's operating performance weakened considerably in the nine months of fiscal 2013 through March 31 to an operating loss of $19 million, compared with a year-earlier gain of $179 million. Management attributed the swing to reimbursement pressure from government and commercial payors, limited same-store volume growth, and certain nonrecurring revenue sources that boosted performance in fiscal 2012. Operating income for the full fiscal year 2012 included $23 million from the Medicare "rural floor" settlement and $66 million of "meaningful use" funding for implementation of electronic medical records. The meaningful use amount for 2012 was approximately twice the amount UPMC will record for fiscal 2013. UPMC continues to benefit from a provider tax in Pennsylvania that became effective July 1, 2010, and has a three-year term. UPMC recorded $52 million of net revenue related to the program in fiscal 2012 and $57 million in fiscal 2011 and will record approximately $42 million in fiscal 2013. Pennsylvania officials are currently pursuing an extension of the program, which will require federal approval.

Although operating income is down considerably, UPMC's nonoperating income was strong through March 31 due to a $52 million gain on the sale of a company in which UPMC had an equity stake, and higher-than-usual realized gains on investments. UPMC's excess margin of 3.7% in the same period is very close to the year-earlier period's 3.8% despite the large negative swing in operating income. Coverage of the $292 million debt service was actually slightly higher in the year-to-date period at 3.2x compared with 3x a year earlier. We consider UPMC's debt service coverage low for the rating level (Standard & Poor's debt service calculations differ from UPMC's indenture calculations).

Management provides a comprehensive debt service schedule that includes obligated and nonobligated group debt and debt service on UPMC Beacon in Ireland, which is consolidated with UPMC because of its majority stake. In calculating debt service coverage, there are two years with debt service higher than $292 million due to bullet maturities coming due. We believe that UPMC has the market access and internal resources to retire those obligations as they mature, and therefore we focus on coverage of the $292 million. We believe that maximum annual debt service will be slightly above $300 million when UPMC executes its fall 2013 financing plans, which we believe is immaterial to the rating. When adjusting for operating leases, UPMC's coverage falls to 2.4x in fiscal 2012, which we consider adequate, but low, for the rating.

Management has initiated a number of cost-saving and revenue-boosting initiatives that it projects will improve operating income by approximately $150 million in fiscal 2014 even as it absorbs federal rate reductions mandated under the Affordable Care Act and additional costs in investments in physician integration. If it meets plan, we would still consider operating income thin, but adequate, for the rating.

Altoona Health System will merge into UPMC on July 1, 2013. Altoona's operating revenue of $481 million in fiscal 2012 is approximately 5% of UPMC's $9.6 billion operating revenue. Altoona's operating margin was negative 1.1% in fiscal 2012 compared with a positive 2% for UPMC. On a pro forma basis, without the benefit of any potential operating improvements as a result of the merger, UPMC's operating margin would be diluted by 0.2 percentage point to 1.8%. We calculate no impact on UPMC's debt service coverage from the merger.
Balance sheet

UPMC's balance sheet remains weaker than average for the rating level, including above-average leverage and below-average unrestricted reserves. However, most measures have been stable or improving in the past few years, despite the dilutive effect of acquisitions, including Hamot Health Foundation. Debt to capital has decreased to 44.4% as of March 31, 2013, from 53.3% as of June 30, 2010, due to a very strong $1.4 billion increase in unrestricted net assets. We calculate that Altoona will have no impact on UPMC's debt to capital ratio. Unrestricted reserves have risen by $1 billion since the end of fiscal 2010, to $3.6 billion at March 31, 2013. The increase, coupled with limited new-debt issuance, has resulted in an improvement in the unrestricted reserves to long-term debt ratio to 114% from 88% over the same period. However, due to growth in the business base, days' cash on hand has treaded water, ending at 138 as of March 31, 2013, compared with 126 at the end of fiscal 2010. Using the prior bad debt accounting method to put the days' cash figures on comparable footing, days' cash was 135 at March 31, 2013, compared with 126 at the end of fiscal 2010. We estimate that the merger with Altoona will reduce UPMC's days' cash by two days, with no impact on unrestricted reserves to long-term debt.

UPMC's defined-benefit pension plan was adequately funded in fiscal year 2012 at 80.6%, compared with 86.4% in the previous year. The primary reason for the decline was a drop in the discount rate used to calculate the projected benefit obligation to 4.32% from 5.35%. Standard & Poor's defines the funded status as the market value of plan assets divided by the projected benefit obligation.

UPMC's age of plant is below average compared with similarly rated organizations and in particular in comparison with its local competitors. Age of plant was 8.9 years at June 20, 2012, and should remain low due to capital investment, including the opening of UPMC-East hospital at the beginning of fiscal 2013. Altoona's age of plant is higher than UPMC's at 11.1 years, but because it is only 5% of UPMC's size, it will have an immaterial impact on age of plant of the merged organization.

Debt structure and derivatives

UPMC has three interest-rate swaps, one interest-rate cap, and four equity index swaps. The interest-rate swaps include one floating-to-fixed swap with a notional amount of $128 million and two basis swaps with a very modest $98 million total notional. In 2010, UPMC terminated 10 swaps, reducing its overall exposure to interest-rate derivatives to the current $226 million from more than $1 billion. While counterparty diversification declined because of the terminations, the largest remaining counterparty is highly rated Goldman Sachs Mitsui Marine Derivative Products L.P.

Over the last few years, UPMC has reduced its exposure to puttable debt with bank liquidity facilities significantly. As of June 30, 2013, UPMC has only $19.1 million of variable-rate demand debt backed by letters of credit. The rest of its debt is fixed rate or index floating-rate debt. Approximately 21% of UPMC's debt ($673 million) is variable rate, of which $555 million is held directly by banks (including the 2010B-1 and 2010B-2, which is expected to be purchased by a bank on July 1, 2013). Taking into account the floating-to-fixed-rate swap, UPMC's net variable-rate exposure is low, in our view, at 17%.
### University of Pittsburgh Medical Center, PA -- Selected Financial Statistics

#### Nine months ended March 31, 2013*  |  2012*  |  2011  |  2010  |  Health care system 'A+' 2011
---|---|---|---|---
**Financial Performance**
Net patient revenue ($000s) | 3,870,574 | 5,257,955 | 5,045,466 | 4,424,252 | 1,124,515 | MNR
Total operating revenue ($000s) | 7,513,869 | 9,596,122 | 8,975,547 | 8,026,454 | MNR | MNR
Total operating expenses ($000s) | 7,533,190 | 9,405,940 | 8,717,536 | 7,940,487 | MNR | MNR
Operating Income ($000s) | (19,321) | 190,182 | 258,011 | 85,967 | MNR | MNR
Operating margin (%) | -0.3 | 2.0 | 2.9 | 1.1 | 3.1 | MNR
Net non-operating income ($000s) | 308,086 | 170,084 | 224,217 | 115,703 | MNR | MNR
Excess Income ($000s) | 288,765 | 360,266 | 482,228 | 201,670 | MNR | MNR
Excess margin (%) | 3.7 | 3.7 | 5.2 | 2.5 | 5.8 | MNR
Operating EBIDA margin (%) | 5.2 | 7.4 | 8.6 | 7.4 | 11.2 | MNR
EBIDA margin (%) | 9.0 | 9.0 | 10.9 | 8.7 | 13.3 | MNR
Net available for debt service ($000s) | 701,492 | 875,392 | 999,282 | 711,472 | 153,491 | MNR
Maximum annual debt service ($000s) | 291,685 | 291,685 | 291,685 | 291,685 | MNR | MNR
Maximum annual debt service coverage (x) | 3.2 | 3.0 | 3.4 | 2.4 | 4.1 | MNR
Operating lease-adjusted coverage (x) | N.A. | 2.4 | 2.8 | 2.1 | 3.1 | MNR

#### Liquidity and Financial Flexibility
Unrestricted reserves ($000s) | 3,630,125 | 3,319,047 | 3,337,009 | 2,608,379 | 616,754 | MNR
Unrestricted days' cash on hand | 137.7 | 134.4 | 146.3 | 126.1 | 191.2 | MNR
Unrestricted reserves/total long-term debt (%) | 113.8 | 109.9 | 108.2 | 87.5 | 115.3 | MNR
Average age of plant (years) | N.A. | 8.9 | 8.4 | 7.6 | 10.1 | MNR
Capital expenditures/Depreciation and amortization (%) | 117.4 | 149.3 | 110.6 | 91.1 | 122.8 | MNR

#### Debt and Liabilities
Total long-term debt ($000s) | 3,190,829 | 3,020,264 | 3,082,925 | 2,979,790 | MNR | MNR
Long-term debt/capitalization (%) | 44.4 | 45.6 | 46.9 | 53.3 | 39.5 | MNR
Contingent liabilities ($000s) | N.A. | 290,457 | 293,260 | 265,300 | MNR | MNR
Contingent liabilities/total long-term debt (%) | N.A. | 9.6 | 9.5 | 8.9 | MNR | MNR
Debt burden (%) | 2.8 | 3.0 | 3.2 | 3.6 | 3.0 | MNR
Defined benefit plan funded status (%) | N.A. | 80.6 | 86.8 | 70.3 | 78.3 | MNR


### Related Criteria And Research
- USPF Criteria: Not-For-Profit Health Care, June 14, 2007
- Criteria: Methodology And Assumptions: Approach To Evaluating Letter Of Credit-Supported Debt, July 6, 2009
- Criteria: Joint Support Criteria Update, April 22, 2009
### Ratings Detail (As Of June 28, 2013)

#### Series 2011B

**Allegheny Cnty Hosp Dev Auth, Pennsylvania**
Univ of Pittsburgh Med Ctr, Pennsylvania

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#### series 2010B

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#### Series 1997B & 1998B

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#### Erie Cnty Hosp Auth, Pennsylvania
Univ of Pittsburgh Med Ctr, Pennsylvania

#### Series 2006 & 2007A

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#### Series 2008

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#### Monroeville Fin Auth, Pennsylvania
Univ of Pittsburgh Med Ctr, Pennsylvania

#### Ser 2012

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#### Pennsylvania Hgr Ed Fac Auth, Pennsylvania
Univ of Pittsburgh Med Ctr, Pennsylvania

#### Series 2010E

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Many issues are enhanced by bond insurance.