Connecticut Health & Educational Facilities Authority Masonicare; Long Term Care

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**Credit Profile**

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**Rationale**

Standard & Poor's Ratings Services revised the outlook to positive from stable on its 'BBB' issuer credit rating (ICR) and affirmed its rating on Masonicare, Conn.'s overall credit profile. The outlook revision reflects our assessment of the organization's dramatically improved financial operating performance in recent years, increased balance of liquidity, and solid and stable business position.

Historically, Masonicare reported significant operating losses, which management strategically offset with investment earnings, reporting adequate excess revenues sufficient to cover debt service and, in our opinion, to justify its bond ratings. In 2007, Standard & Poor's lowered its rating on Masonicare to 'BBB+' from 'A-', and in March 2009, Standard & Poor's lowered its rating to 'BBB' from 'BBB+'. We lowered the ratings because of various factors, including Masonicare's heavy capital spending plans prior to 2008, continued operating losses that were no longer offset by investment earnings, an elevated debt position that we believed carried inherent acceleration risk, and liquidity ratios that declined to levels well outside of our medians. Since 2009, management has implemented significant cost-containment initiatives and has adjusted its services to further meet the demands of its residents/patients and to generate new revenue for the organization. In addition, we believe Masonicare's liquidity has rebounded significantly, although not back to its pre-2008 level. Masonicare expects to achieve breakeven financial operating results at the end of fiscal 2011 (September year-end), which we consider a marked turnaround from its peak operating loss in the past five years of $17 million in fiscal 2007.

Factors supporting the rating, in our assessment, include Masonicare's:

- Change in philosophy to generate breakeven, and ultimately profitable, financial operating results with a departure from its reliance on investment earnings; and
- Dominant market share, strong service demand, and healthy occupancy.

In our opinion, partially offsetting credit considerations include:

- Slower-than-budgeted revenue growth for interim fiscal 2011 (ended June 30); and
- Masonicare's aggressive debt profile, which remains exposed to remarketing and acceleration risk, as well as significant collateral posting requirements. Management has taken steps in recent years to mitigate some of its exposure in this area and indicates it may restructure its debt in the coming years to a more conservative mix of fixed and variable interest debt.
Masonicare is the largest nonprofit organization caring for the elderly in Connecticut. It operates four basic business lines:

- The Masonicare Health Center, which consists of 382 long-term skilled nursing beds, 93 independent-living units, 86 residential-care-home beds, and 59 chronic-disease beds;
- Masonicare at Ashlar Village, with 360 independent-living units and 136 assisted-living units;
- Masonicare at Newtown, with 154 skilled-nursing beds and 55 assisted-living units; and
- Masonicare Home Health and Hospice, which offers a full line of home health care and therapies statewide.

The obligated group for Masonicare's bonds includes:

- Masonicare, the parent organization;
- Masonicare Health Center;
- The Masonic Charity Foundation;
- Masonicare at Ashlar Village;
- Masonicare at Newtown; and
- Masonicare Home Health and Hospice.

The obligated group accounts for almost 100% of Masonicare's total assets and 98% of the system's operating revenues. Masonicare is party to a swap agreement with Merrill Lynch Capital Services Inc. (A/Negative) that provides a synthetic fixed rate on approximately 70% of its bonds outstanding, all of which Masonicare originally issued at a variable rate.

Standard & Poor's assigned Masonicare's swap portfolio a Debt Derivative Profile (DDP) overall score of '2.5' on a four-point scale, with '1' representing the lowest risk and '4' the highest risk. The '2.5' score reflects our view that Masonicare's overall swap portfolio currently presents a low-to-moderate credit risk.

Outlook

The positive outlook reflects our view of Masonicare's significantly improved financial operating results in recent years and its solid business position. We could consider a higher rating over time if the organization meets its revenue projections in fiscal 2012, achieves the breakeven operating performance targeted by management for fiscal 2011 and 2012, and sustains its occupancy levels. We would also give favorable consideration to a more conservative debt profile; however, stronger financial operating results and liquidity accretion could offset this credit factor. We may return to a stable outlook if Masonicare's financial operating performance starts to decline. We could also give negative consideration to a significant decline in liquidity and a large debt issuance.

Financial Operations: Reduced Losses; Revenue Challenges

Masonicare reported improved financial operating performance from fiscal 2009 through its interim fiscal 2011 results, with a significant reduction in its operating losses despite lower-than-budgeted revenues. Masonicare's audits in fiscal 2009 and 2010 reflected operating losses of $11 million and $1.5 million, respectively, excluding investment earnings and contributions. Through the first nine months of fiscal 2011, Masonicare reported an operating surplus of $801,000 (0.6% margin). We view this progress favorably compared with the organization's peak operating losses over the past five years that ranged from $15 million to $17 million. Management attributes
the improvement to various cost-containment initiatives and revenue enhancements, some of which were recommended by an outside consultant. Looking ahead, management is specifically targeting revenue growth, with an eye toward expanded home health services and increased occupancy and volume statistics throughout the organization. Management conservatively estimates breakeven operations by the end of fiscal 2011 and targets the same in fiscal 2012.

Excess revenues over expenses through the interim period were $11.6 million, which resulted in coverage of maximum annual debt service -- adjusted to include entrance fees -- of a strong 3.8x, higher than the 3.3x we calculated for fiscal 2010. Our calculation of debt service coverage (DSC) varies from management's calculation in that we view the financial profile of the entire system, not just the obligated group.

Balance Sheet Reflects Improved Liquidity And Debt Profile Risk

Masonicare reported significant growth in liquidity over the interim period of fiscal 2011, with a balance of $92 million in unrestricted cash -- or 213 days' cash on hand -- which remains below our medians for the rating. In 2007, Masonicare's unrestricted cash balance was $108 million, with 266 days' cash on hand. We also calculated cash to total long-term debt for the interim period of fiscal 2011 at an adequate 85%. In 2009, Masonicare's management team and its board agreed to redesignate approximately $20 million of donor-restricted contributions to unrestricted funds to improve liquidity metrics. Management continues to hold these funds in its balance of unrestricted funds as a cushion.

We continue to view Masonicare's investment allocation as aggressive (as of June 30, 2011), with approximately 59% of its portfolio invested in equities, 28% invested in alternatives, and 13% invested in fixed income and cash. Management indicates that by Sept. 30, 2011, one of its hedge funds will be redeemed, which will slightly adjust its investment mix to a more conservative position. Management indicates that, following this restructuring, approximately 79% of its funds will be liquid within a few days, 14% will be semi-liquid, and 7% illiquid.

Currently, all of Masonicare's long-term debt is held in a variable-rate mode, with letters of credit (LOCs) provided by Wells Fargo Bank (AA/Negative). We believe a major remarketing issue or an LOC renewal problem -- LOC support expires Oct. 31, 2012 -- would present significant strain on the organization's balance sheet, with cash as a percentage of long-term debt at about 85% through the interim period. Additionally, we consider the lack of credit diversity, with just one credit provider and with both LOCs scheduled to expire at the same time, a negative credit consideration. Management indicates it is focused on these risks and intends to move to a more conservative approach over the coming year. Management highlights that it has no major capital projects planned at this time -- and no long-term debt plans -- and that it would only consider expansion if the projected return on the investment met specific standards.

In addition, while we realize Masonicare's swap agreements mitigate its exposure to fluctuations in variable interest rates, with approximately 70% of its debt synthetically fixed via these contracts, the agreements have also exposed the organization to significant collateral posting requirements in recent years. Management indicates approximately $5.5 million of its cash is currently posted as collateral.
Overall High Occupancy Rates

We consider Masonicare's occupancy high at 90%-100% for most of its affiliates, with the exception of occupancy at Masonicare at Ashlar Village, where the occupancy rate for assisted-living units was only 78% through the interim period. Management indicates the lower occupancy level reflects a recent higher turnover rate associated with deaths and transfers within Masonicare's continuum of care. Management also indicates it is experiencing a busy application process period that should result in filling these vacancies.

Debt Derivative Profile: '2.5' -- A Low-To-Moderate Credit Risk

Masonicare is party to a single swap agreement with Merrill Lynch that provides a synthetically fixed rate on approximately 70% of Masonicare's total $108.4 million of bonds outstanding. Under the 2007 swap agreement, Masonicare pays a synthetically fixed rate of approximately 3.76% and receives 67% of LIBOR in return.

Management's most recent collateral agreement indicates a maximum collateral posting requirement of $5.5 million, unless the value of the swap is negative by more than $15.5 million. In 2009, under its former agreement, Masonicare's collateral posting peaked at $19 million. We view Masonicare's reduced collateral exposure favorably.

Masonicare's swap agreement currently presents a low-to-moderate credit risk, as indicated by Standard & Poor's DDP score of '2.5'.

The DDP score of '2.5' reflects our assessment of the swap's:

• Moderate-to-high degree of termination risk due to the thin trigger spread between the 'BBB' rating on Masonicare's debt and the termination and collateral triggers of the 'BB+' level;
• Moderate counterparty risk due to the moderate 'A' rating on Merrill Lynch, down from 'AA-' when the swap agreement was originally completed;
• Moderate credit risk associated with the economic viability of the swap portfolio over stressful economic cycles; and
• Minimal credit risk associated with management practices, with formal debt and swap management plans in place.

Related Criteria And Research

• USPF Criteria: Senior Living, June 18, 2007
• USPF Criteria: Bank Liquidity Facilities, June 22, 2007
• USPF Criteria: Debt Derivative Profile Scores, March 27, 2006
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