Moody's

Rating Action: Moody's revises Palomar Health's (CA) outlook to negative; affirms Baa3 revenue bond rating

13 Jun 2023

New York, June 13, 2023 -- Moody's Investors Service has affirmed Palomar Health's (CA) Baa3 revenue bond rating. The outlook has been revised to negative from stable. Palomar Health (Palomar) has approximately $709 million of debt outstanding.

Moody's also rates Palomar's general obligation bonds, which currently are rated A1 stable. The general obligation bonds are secured by the district's voter-approved unlimited property tax pledge and general obligation bondholders do not have any recourse to the hospital for payments under the bonds. Tax revenues, payments, and principal related to the general obligation bonds have been excluded from this analysis.

RATING RATIONALE

Affirmation of Palomar's Baa3 rating is anchored by its favorable market position and its strategic growth initiatives which will continue to translate into good demand trends and revenue growth. As a district hospital Palomar will remain the beneficiary of strong community support in the way of unrestricted tax revenue which support operations. Although the district's debt burden from its revenue backed debt is elevated, debt structure risks are limited. Management has implemented an extensive performance improvement plan with a focus on growing medical services, consolidating duplicative services, optimizing revenue cycle and reducing agency staff costs. These initiatives are expected to drive growth in operating cash flow and cash beginning in 2023. That said, operating performance, through March 31, 2023 has moderated due to increased labor expense and a delay in the consolidation and expansion of NICU beds at PMC- Escondido as well as a delay in the reconversion of a number of beds to medical. The decline in operating performance as well as a delay in the intergovernmental transfer funds receivables stressed cash on hand (42 days) and cash to debt (16%) to historical lows through March 31, 2023. Liquidity will improve by year-end, June 30, but will remain below 2022 levels; and growth is expected in 2024. Ongoing challenges include: very high leverage; still modest liquidity; high level of losses at the medical foundation; significant competition within its broader service area; and thin headroom to the debt service coverage covenant and days cash on hand.

RATING OUTLOOK

The negative outlook reflects increased hurdles to restoring operating cash flow and consequently cash to debt and days cash on hand to stronger levels and demonstrating a path to ongoing growth given the setbacks experienced in 2023. The outlook also incorporates elevated risks in clearing financial covenants, particularly days cash on hand.

FACTORS THAT COULD LEAD TO AN UPGRADE OF THE RATINGS

- Material reduction in revenue backed debt burden and strengthening of absolute and relative liquidity

- Significant improvement in operating performance and days cash on hand

FACTORS THAT COULD LEAD TO A DOWNGRADE OF THE RATINGS

- Failure to improve cash levels and demonstrate a path to ongoing growth
- A violation of debt covenant requirements
- Inability to improve operating performance
- Issuance of incremental debt

LEGAL SECURITY

Revenue bonds are secured by a pledge of gross revenues of the obligated group members whom are jointly and severally liable. The obligated group includes Palomar Health and Arch Health Partners, Inc. (d/b/a Palomar Health Medical Group). Financial covenants include maintenance of debt service coverage (below 1.15x consultant call-in; below 1.0x event of default), measured annually. Palomar also has to meet a cash on hand test (below 65 days consultant call-in; below 50 days event of default), measured annually, under its agreement with Assured Guaranty. A remedy under the MTI and the agreement with Assured Guaranty is acceleration; the MTI includes cross default provisions.

Although we expect clearance to financial covenants, headroom will be very tight at June 30, 2023. Through March 31, 2023, the system reported a debt service coverage ratio of 1.22x and cash on hand of 41.6 days. While we expect that in the event the organization is unable to clear its days cash on hand test it will be able to execute a waiver with the insurer there is no guaranty.

PROFILE

Palomar Health is the largest public health care district in the State of California, with over $900 million of revenues reported for fiscal 2022, and generating over 23,000 admissions. The district operates acute care facilities in the towns of Escondido and Poway, and captures 44.5% of the market share within the district.

METHODOLOGY

The principal methodology used in these ratings was Not-For-Profit Healthcare published in December 2018 and available at https://ratings.moodys.com/rmc-documents/70886. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For further specification of Moody’s key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody’s Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

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