FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Adventist Health's (CA) IDR and Long-Term Debt Ratings at 'A+'; Outlook Stable

Mon 14 Sep, 2020 - 5:44 PM ET

Fitch Ratings - Austin - 14 Sep 2020: Fitch Ratings affirms Adventist Health's (CA) 'A+' Long-Term Issuer Default Rating (IDR) and 'A+' long-term ratings on the following series of bonds:

--$751,850,000 Adventist Health System/West Taxable series 2019 bonds;

--$52,535,000 The Hospital Facilities Authority of Multnomah County, OR's series 2019A bonds;

--$245,545,000 California Statewide Communities Development Authority, CA's series 2018A;

--$251,675,000 California Health Facilities Financing Authority, CA's series 2016A;

--$169,400,000 California Statewide Communities Development Authority, CA's series 2015A

--$50,000,000 Adventist Health System/West Taxable series 2013 bonds;

--$258,400,000 California Health Facilities Financing Authority, CA's series 2013A;

--$98,300,000 California Health Facilities Financing Authority, CA's series 2011A bonds;

--$30,000,000 California Health Facilities Financing Authority, CA's series 2009B (LOC U.S. Bank);

--$42,055,000 California Statewide Communities Development Authority, CA's tax-exempt series 2007A bonds.

The Outlook is Stable.

SECURITY

Gross revenue pledge of the obligated group.

ANALYTICAL CONCLUSION

The 'A+' IDR reflects Fitch's view of Adventist's position as the leading acute care provider in multiple growing markets, supporting midrange revenue defensibility, despite a comparatively higher level of Medicaid and self-pay volume. The 'A+' rating also reflects Adventist's historically solid operating income levels, a gradually improving balance sheet, and recent affiliation and expansion activity.

The coronavirus pandemic and related government containment measures has created an uncertain and negative environment for the entire healthcare system. While Adventist's financial performance through the most recently available data (unaudited six-month results through June 30, 2020) has shown limited impairment, material changes in revenue and cost profiles have occurred since, and are likely to continue to manifest themselves in the coming weeks and months. With a prior easing of restrictions on elective surgeries, Adventist has demonstrated that top-line revenues rebounded, with a quick initial uptick in volumes from previously postponed elective procedures.

Fitch believes that Adventist will improve upon their most recent operating results to regain margins more closely aligned to historic levels, such that Adventist generates operating EBITDA margins of approximately 9%, with continued cost controls that support their expected growth and capital allotments, resulting in a strong operating risk assessment. The rating also reflects Fitch's expectations that Adventist's leverage profile will continue to improve over the near to long term, continuing to support an 'A' category rating.

Fitch's ratings are forward-looking in nature, and Fitch will monitor developments in the sector as a result of the virus outbreak as it relates to severity and duration, and incorporate revised expectations for future performance and assessment of key risks.

KEY RATING DRIVERS

Revenue Defensibility: 'bbb'

Leading Market Positions; Growing Size and Scale

Adventist's revenue defensibility is midrange, with solid market positions in multiple states and markets, all of which exhibit strong population growth characteristics. While Adventist has a comparatively constrained payor mix, with over 30% of their payor mix coming from Medicaid (MediCal), this is somewhat mitigated due to California provider-fee funding delivered through the state. California provider fees have shown a general uptick over the last several years, further mitigating revenue risk and supporting midrange revenue defensibility. Notwithstanding the provider-fee funding, the high level of Medicaid remains an inherent credit challenge and requires continued focus on operating efficiencies, which Adventist has successfully managed for many years.

Operating Risk: 'a'

Stronger Operating Margins Expected to Return

Fitch expects Adventist to continue to demonstrate strong cost management as it continues to grow in size and scale over the next several years, toward its goal to be a $6 billion healthcare provider by 2022. Fitch expects that long-term financial results will show an approximate 9% operating EBITDA margin, given Adventist's historical growth rates.

However, the more recent softness in operating income levels, the impact of the Feather River Fire, the pandemic and other disruptions necessitates a need to ramp up profitability in the near term. Adventist has historically exercised its ability to flex spending up or down based on financial performance.

Financial Profile: 'a'

Significant Stability through the Cycle

Adventist's financial and leverage profile should remain consistent with Fitch's 'A' category expectations, as Adventist begins to improve upon their most recent operational stress, and generates additional unrestricted liquidity to support their planned capital spending levels. Fitch believes that Adventist's key leverage metrics will remain stable for the next several years, as anticipated. Key balance sheet and leverage metrics could improve further if actual capital spending or borrowing is lower than expected, or operations ramp up faster than anticipated.

ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS

No asymmetric risk considerations affected this rating determination.

RATING SENSITIVITIES

Fitch expects that Adventist will improve its financial results over the near term, such that operating performance is more commensurate with their longer-term operating profile. Operational improvements closer to more historic levels should contribute to continued gradual balance sheet accretion over time.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

--Given the current environment of uncertainty due to the pandemic, the exact depth and breadth of which remains unknown, higher rating activity over the two-year outlook would be limited to only exceptionally positive impacts to Adventist's unrestricted liquidity position.

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

--If operations falter for a more extended period of time, with operating EBITDA results below 7%, unrestricted liquidity could decline below current levels, pressuring the key leverage metrics that support the rating. Fitch does not expect more than a one- to two-year ramp up for a return to margins that are more in line with the current strong operating assessment;

--Any unanticipated borrowings without a commensurate improvement in current levels of unrestricted cash and investments; Adventist has limited debt capacity at the current rating;

--Adventist's rating is susceptible to any sudden negative change in operations, such as significant drops in provider tax funding, which would have a negative effect on the system's future unrestricted cash and investments levels.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

CREDIT PROFILE

Adventist has 22 hospitals organized throughout California, in the northern, northwest, central and southern regions. Adventist's facilities have the leading market share in the majority of its markets. Total revenue in 2019 was $4.5 billion.

One of Adventist's main credit strengths is the size of its network, with 22 hospitals and over 290 clinics concentrated in California but geographically diversified, with no one facility comprising more than a small portion of system operating revenue. Management continues to actively pursue additional partnerships and acquisitions and has reached an initial $4 billion in total revenue goal in 2017, with a future growth goal of $6 billion over the relatively near term; further growth beyond that point is expected.

REVENUE DEFENSIBILITY

Adventist has a challenging payor mix, with Medicaid accounting for just over 30% of their gross payor mix, and another few percentage points typically classified as self-pay. While the payor mix is heavily exposed to governmental payors (approximately 75% are Medicare and Medicaid), Adventist benefits from supplemental reimbursement at its rural facilities, with Adventist operating the largest rural health clinic network in California.

In addition, Adventist has been a major beneficiary of the California provider-fee program, and the net benefit is now projected to be approximately $259 million in 2020. Amounts compare similarly to $244 million for 2019 and $245 million in 2018. Any variability in the amount generally relates to the timing of CMS approval of the various components of the program, and historically it is not uncommon to see funding lag one year to pick up in the next year, as funds are shifted from year to year. The program's long-term viability is no longer viewed as a credit concern, although variability in timing can be problematic for individual issuers.

Adventist is a multistate provider, with inpatient facilities in three states: California, Oregon and Hawaii, (with one retirement center in Washington) although the vast majority of facilities are located in California. Currently operating 22 hospitals and total revenues of just over $4.5 billion (in fiscal 2019), Adventist is committed to its long-term goal to be a $6.0 billion organization, with further continued deliberate growth beyond that particular marker.

Adventist defines multiple operating markets, with market shares ranging from low double digits in highly fragmented (and sizeable markets) such as Los Angeles, but still leading the market, with highs over 60% for specific markets. Adventist remains the largest provider in all of their major markets, demonstrating good revenue defensibility in California, which is significant given the high financial barrier to entry with new construction mandated to be seismically compliant, and therefore more expensive to build.

While Adventist operates in four different states, the bulk of their operations are located in California. California has positive population growth characteristics, with pockets of very high wealth and income levels, but also more rural markets that constrain Adventist's overall payor mix. The Portland, OR market is characterized by rapid population growth (double the national average) and favorable unemployment and poverty levels, while Hawaii has exceptional unemployment and poverty levels compared to national averages.

Strategic Affiliations

Adventist continues to expand its delivery network, with several notable additions and separations from its portfolio, along with multiple developing partnerships that should, in Fitch's opinion, benefit Adventist over the longer term.

On April 1, 2018 Adventist closed on a definitive agreement with Rideout Health for a member substitution and master note substitution. Rideout has become a member of the Adventist Obligated group. On Aug. 1, 2018, Adventist entered into a relationship with Tulare Local Healthcare District to lease Tulare Regional Medical Center to Adventist (affirmed by the bankruptcy court), and change of ownership was granted March 15, 2019, initiating a 30-year lease for the 108-bed acute care hospital and other facilities. Delano Regional Medical Center joined Adventist Health in December 2019 through a membership transfer. The Tulare and Delano affiliations continue Adventist's continuum of care along California's Highway 101 corridor. Additionally, Adventist has established a lease with the newly renamed Adventist Health Mendocino Coast on July 1, 2020, and Adventist signed a management agreement with Dameron Hospital in December 2019.

Outside of California, Adventist and Oregon Health & Science University entered into a joint operating agreement (JOA) to share clinical practices and a bottom line in the Portland market, with Adventist contributing their Portland facility to the larger JOA.

OPERATING RISK

Operating Cost Flexibility

Adventist had very strong operating EBITDA and EBITDA margins, until seeing slightly weaker operations in fiscal 2018, with an 8% operating EBITDA margin. This weakness continued into fiscal 2019, with an operating EBITDA margin of 3.6%.

Management cites multiple reasons, some of which are one-time in nature, for the operational softness, and formed appropriate mitigation strategies as a result. Reasons for the earlier softer operations include statewide healthcare volume declines with its commensurate impact on operations; The Paradise (Camp Fire) hospital closing, which resulted in a multifaceted financial impact that included business disruption and lost volumes, physical loss of facilities, and costs associated after the fire, as when Adventist kept employees on the payroll for four additional months and assisted in relocation of other employees; and newly absorbed shared services expense. Lastly, there were operational challenges ultimately associated with a prior outsourcing of Adventist's revenue cycle operations to Cerner. Adventist canceled their contract with Cerner and established a new relationship with Huron Consulting. Adventist is now realizing additional cash collections and efficiencies through this new arrangement.

Management identified ways to further improve operations, which include performance improvement initiatives in the main areas of labor productivity, premium pay and benefits, supply chain expense savings, clinical documentation, and reductions in length of stay. Adventist estimates potential cost savings opportunities of approximately $100 million in these areas combined, and they also expect some additional cash acceleration, which should boost its liquidity reserves.

Fitch anticipates that margins will be affected by the disruption from the coronavirus pandemic, which resulted in both the temporary loss of elective surgeries and procedures as well as elevating costs at Adventist, primarily in the form of supplies and future "surge" preparedness. Fitch expects that Adventist will show cumulative gains through the remainder of calendar 2020, the results of early expense mitigation efforts, stimulus funding and relatively early return of non-emergent volumes. The financial market uncertainty will continue to factor into the overall liquidity profile for Adventist, but only mildly, as Adventist's asset allocation remains very conservatively tilted towards cash and fixed income.

Through the first six months of fiscal 2020, operating EBITDA totaled 5.3%. Fitch expects Adventist's operating EBITDA margin will improve to approximately 6% by YE 2020 and gradually increase thereafter. Fitch expects that Adventist will return to its more historical operational trajectory, gradually growing in size and scale and producing consistent operating EBITDA margins in the 9% range over the next several years, after a one- to two-year ramp up in operating income levels.

Capex

Adventist has maintained a competitive average age of plant at 11.7 years (as of Adventist's last full audit in 2019). Adventist's capital spending has been consistently stable and averaged 115% for the last four fiscal years. Future capital spending is based on an operational construct, which sets initial spending limits based on financial performance. Capital spending is initially modeled at approximately 80%-110% of operating EBITDA, which generally totals in the high-$400 million range. This level of capital spending is significantly above Adventist's historical levels of about $200 million a year, and is considered by Fitch as a higher range for possible capital spending, with actual amounts likely to be far less. It is these lower amounts, approximately $250 million a year on average, that Fitch uses in its forward-looking scenario analysis.

No additional operating considerations were factored into the rating determination.

FINANCIAL PROFILE

Adventist's unrestricted liquidity position consistently improved over the last several years. Cash/adjusted debt as calculated by Fitch (which includes 5x operating leases, but no pension liability, as Adventist has a defined contribution plan), improved to approximately 86% as of fiscal YE 2019. Fitch expects gradual improvement to continue over the medium to long term, given the expectation of cash flow generation contributing to additional balance sheet accretion, and consistent but balanced capital spending over the next several years.

Through Fitch's baseline scenario, or Fitch's best estimate of the most likely scenario of financial performance over the next five years given the pandemic, Fitch expects that Adventist will see gradual improvement in key metrics after a brief period of lower than historic margins. Fitch's baseline scenario assumes both a significant economic stress to reflect potential equity volatility and a business cycle stress to reflect the impact of the pandemic in year one, followed by a recovery, with growth and stability in years three through five. Despite the stress, Fitch's forward-looking analysis shows cash/adjusted debt at 100% within three years, and over 110% in the outer years.

Fitch's forward-looking analysis reflects both an issuer-specific revenue stress and a portfolio sensitivity analysis based on Adventist's asset allocation for the current fiscal year, and is consistent with Fitch's current expectations for economic contraction. With so much depending on the progress of the pandemic, there is a large degree of uncertainty around the scenarios. Fitch's scenarios anticipate that the U.S. GDP contracts sharply in 2020, deeper than in 2009. In the event of the virus being contained during the second half of 2020, Fitch assumes that real GDP growth will generally recover in 2021.

No additional financial considerations were factored into the rating determination.

ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS

No asymmetric risk considerations were identified.

Adventist's management team has been generally consistent for the last several years. The only changes of note are at the senior leadership level, with the turnover of the Chief Financial Officer (CFO). Todd Hofheins assumed the role as Adventist's new CFO, effective Aug. 31, 2020. Hofheins is veteran CFO, having previously served with Providence Health (WA) and Health Partners (MN).

New additions to the senior management team include Joyce Newmyer as Chief Culture Officer (Newmyer currently is president of Adventist's services in Oregon), Alex Bryan as Chief Mission Officer, and Jason Wells as Chief Consumer and Innovation Officer (Wells is president of Adventist's three hospitals and services in Mendocino County, CA). These three strategic appointments are part of a larger vision to transition from a hospital, provider-based organization, and transform into a health company focused on both the individual and the community.

Adventist has good disclosure practices and provides a detailed MD&A along with audited materials.

Adventist does not have any unusual legal restrictions or operate under any unusual regulatory pressures. Adventist's debt and asset allocation are considered somewhat conservative for the sector. Adventist does not have a defined benefit plan liability. Neither days' cash on hand nor debt service coverage constitute an asymmetric risk.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Adventist Health (CA)	LT IDR	A+ Rating Outlook Stable	Affirmed	A+ Rating Outlook Stable
• Adventist Health (CA) /General Revenues/1 LT	LT	A+ Rating Outlook Stable	Affirmed	A+ Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Kevin Holloran
Senior Director
Primary Rating Analyst
+1 512 813 5700
Fitch Ratings, Inc.
111 Congress Avenue Suite 2010 Austin 78701

Melanie Her
Director
Secondary Rating Analyst
+1 415 732 5629

Olga Beck
Senior Director
Committee Chairperson
+1 212 908 0772

MEDIA CONTACTS

Sandro Scenga
New York
+1 212 908 0278
sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria (pub. 27 Nov 2019) (including rating assumption sensitivity)

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Not-For-Profit Hospitals - Fitch Analytical Stress Test Model, v1.4.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Adventist Health System/West (CA)	EU Endorsed
California Health Facilities Financing Authority	EU Endorsed
California Statewide Communities Development Authority	EU Endorsed
Multnomah County Hospital Facilities Authority (OR)	EU Endorsed

DISCLAIMER

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS. IN ADDITION, THE FOLLOWING HTTPS://WWW.FITCHRATINGS.COM/RATING-DEFINITIONS-DOCUMENT DETAILS FITCH'S RATING DEFINITIONS FOR EACH RATING SCALE AND RATING CATEGORIES, INCLUDING DEFINITIONS RELATING TO DEFAULT. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY. FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH RATINGS WEBSITE.

READ LESS

COPYRIGHT

underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third- party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant to the terms of the EU Regulation with respect to credit rating agencies, can be found on the EU Regulatory Disclosures page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

US Public Finance   Healthcare and Pharma   North America   United States

---