Fitch Rates Adventist, CA's Series 2022 and 2022A Bonds 'A'; Revises Outlook to Negative

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Fitch Ratings - San Francisco - 30 Nov 2022: Fitch Ratings has assigned an 'A' long-term rating to Adventist Health's (Adventist) series 2022 and series 2022A bonds (issued by the California Health Facilities Financing Authority) and affirmed the system's other outstanding debt at 'A'.

Fitch has also affirmed the following ratings for Adventist:

--Long-term Issuer Default Rating (IDR) at 'A';

--Short-term CP note rating at 'F1+' (based on self-liquidity).

The Rating Outlook has been revised to Negative from Stable.
The series 2022(taxable) and series 2022A bonds (tax-exempt) will be used to refinance Adventist's $150 million line of credit balance, refinance $150 million of outstanding CP (total program is currently $350 million), refinance the series 2013 bonds, fund $100 million of new money to support the system, and fund associated costs of issuance. There will be no reserve fund with the 2022 debt issuance. The new money financing portion will go primarily towards the construction, expansion, remodeling, renovation, and/or acquisition of certain health facilities.

SECURITY

The bonds are secured by a gross revenue pledge of the obligated group.

ANALYTICAL CONCLUSION

The Outlook revision to Negative from Stable reflects continued negative operational pressure, which resulted in a negative 6.5% operating margin and negative 1.6% operating EBITDA margin through the nine-months of fiscal 2022 ending Sept. 30, 2022 (unaudited).

Fitch's affirmation of Adventist's long-term rating at 'A' is primarily based on management's sharp focus on improving operations from current levels with an expectation to finish the 12-month year-end with a positive 0.7% operating EBITDA margin. Fitch recognizes that Adventist's recent performance has been affected by a series of unfavorable events including devasting wildfires in certain markets, the novel coronavirus, and now acute labor pressures affecting the entire healthcare industry. Together these factors have created adverse economic conditions for the system.
However, Adventist's credit strengths continue to include leading market positions throughout its three-state hospital footprint; an adequate liquidity position for the rating level; and a reasonable and accretive strategic plan.

Fitch views Adventist's strategic plan to improve operational performance as reasonable and expects it to drive improved results beginning in 4Q22. Over the next two years, Fitch anticipates the system to improve upon the most recent operating results (Sept. 30, 2022) and begin to make the operational journey to reestablish positive margins more closely resembling historical levels. Fitch anticipates fiscal 2023 to produce an operating EBITDA margin north of 3% and then continue to improve, reaching an approximate 6.4% operating EBITDA margin in fiscal 2025.

The rating and Outlook also reflect Fitch's expectations that Adventist's new management team (largely installed in early 2022) will make operational improvements and successfully execute upon its long-term strategy of growing in favorable markets, while closely evaluating underperforming markets. Fitch anticipates the organization's balance sheet resources will be stable at current levels and then improve over the medium to long term, which also supports an 'A' rating.

The 'F1+' short-term rating is applicable within Fitch's criteria and reflects both the linkage to Adventist's current 'A' rating and its strong liquidity levels compared with short-term puttable debt requirements providing sufficient coverage for the notes at just over 4x. Adventist also has a $350 million syndicated line of credit available that can be drawn upon for general corporate purposes.

In an event of an unsuccessful rollover, the dealer will notify Adventist and the Issuing and Paying Agent (IPA) shall request payment for the full amount of the notes due. Adventist shall deliver funds to the IPA on the same day to be applied to the matured notes.

Based on Fitch's rating criteria relative to self-liquidity, Adventist's eligible cash and investments for same-day settlement comfortably exceeds Fitch's requirement to cover the maximum tender exposure on any given date.

**KEY RATING DRIVERS**

**Revenue Defensibility: 'bbb'**

Maintenance of Leading Market Positions; Growing in Accretive Markets
Adventist's revenue defensibility is midrange, with solid positions in multiple markets, all of which exhibit stable-to-favorable population growth trends and socioeconomic characteristics. Adventist is a multistate provider, with system operations in four states and inpatient hospital facilities located in three states: California, Oregon and Hawaii, (with one retirement facility in Washington), although the vast majority of facilities are located in California.

Adventist remains the largest provider in all of their major market regions, with respective market shares ranging from high single digits in highly fragmented (and sizable) markets, such as in Southern California and in certain segments of Northern California, to the highest share reaching approximately 61% in the greater Sacramento area market. It demonstrates good revenue defensibility in California, which is significant given the high financial barrier to entry with construction mandated to be seismically compliant, and therefore more expensive to build.

In each of the states where Adventist operates, the respective service areas generally exhibit stable population growth characteristics, with pockets of good population growth, high wealth and income levels, but also more rural markets that constrain its overall payor mix. Adventist has a comparatively constrained payor mix, with over 30% of their gross revenues coming from Medicaid (MediCal) and self-pay sources; this is somewhat mitigated due to California provider-fee funding delivered.

The payor mix is also heavily exposed to governmental payors with approximately 75% of system gross payor revenue coming from Medicare and Medicaid. However, Adventist benefits from supplemental reimbursement at its rural facilities, with Adventist operating the largest rural health clinic network in California.

**Operating Risk: 'bbb'**

Large Operating Loss in Fiscal 2022; Significant Improvement Expected in Fiscal 2023

The system's operating risk assessment is midrange with the expectation of adequate cost management opportunities to support improved performance going forward. As of the end of 3Q'22, Adventist recorded a significant $254 million loss from operations, which resulted in a negative 6.5% operating margin and negative 1.6% operating EBITDA margin. This marks the fourth consecutive year the system will record a loss from operations. The fiscal 2022 decline in operating income is largely related to an acute increase in labor expenses, in addition to the carryover effect of prior unfavorable factors that have impacted the system's overall financial.

Fitch believes that Adventist has begun its operational turnaround, which will take place in the fourth quarter in fiscal 2022 and is supported by year-over-year volume increases and focused on curtailing certain expenses. By fiscal year-end (Dec. 31, 2022), management expects to generate a positive 0.7% operating EBITDA margin and observe continual improvement into the next fiscal year, which Fitch views favorably.

Financial Profile: 'a'

Satisfactory Balance Sheet Resources with Limited Debt Capacity

Adventist's unrestricted liquidity position remains satisfactory for the strong 'a' financial profile. Unrestricted cash totaled approximately $2.1 billion through Sept. 30, 2022, which equated to approximately 140 day's cash on hand and 90% cash to debt. Current long-term debt is $2.3 billion; on a proforma basis, long-term debt is expected to increase to approximately $2.4 billion. Fitch believes the system has very limited debt capacity at the current rating level, but Adventist does not anticipate any significant new debt issuances over the near-term.

Asymmetric Additional Risk Considerations

No asymmetric risk considerations affected this rating determination.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--If operating EBITDA margins continue to remain low and at negative levels, coupled with the inability to meet projections close to or near a 3.6% operating EBITDA margin in fiscal 2023;

--If unrestricted liquidity materially declines below current levels, pressuring the key leverage metrics that support the rating;

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

Factors that could, individually or collectively, lead to positive rating action/upgrade:
Given the Negative Outlook and the need to significantly improve operating performance, a higher rating level over the two-year Outlook period would be unexpected and limited to only exceptionally positive impacts to Adventist’s unrestricted liquidity position;

(Longer-term positive rating action will be contingent on Adventist fully achieving and/or exceeding its plan to return operational performance to historical 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 23 hospitals that are located in three states (Hawai‘i, Oregon, and California) with its facilities enjoying the leading market position in the majority of its markets. Adventist has its largest presence throughout California, in the northern, northwest, central and southern regions. The system's total revenue in 2021 (last audited period) was approximately $5.2 billion.

One of Adventist's main credit strengths is the size of its network with total operations spanning four states operating 370 clinics, which account for approximately 2.5 million clinic visits a year. The system's hospital presence is concentrated in California but geographically diversified, with no one facility comprising more than a small portion of system operating revenue. Management's future growth goal is for the system to be a $10 billion organization (in total revenues) by 2030.

Adventist has a new executive leadership team in place led by Kerry Heinrich, President and CEO, who began the role earlier in 2022, and previously served on the system's board for seven years. Additionally, Adventist's CFO John Beaman began his role with the system in January 2022.
Revenue Defensibility

Historically, Adventist has been a major beneficiary of the California provider-fee program, and the net benefit is projected to be approximately $266 million in 2022, which is consistent with the prior year’s amount. If there is revenue impact variability in the amount that’s remitted to Adventist it generally relates to the timing of CMS approval of the various components of the program. Notwithstanding beneficial provider-fee funding, the high level of Medicaid remains an inherent credit challenge and requires continued focus on operating efficiencies, which Adventist is committed to successfully managing.

Adventist has inpatient facilities operating in three states and maintains leading and solid market positions in each of its regions. A majority of the system’s facilities are located in California and have market positions that range from high single digits to above 60% shares, respectively. As part of the system’s long-term strategy to nearly double its size by the end of the decade, management is carefully reviewing performance in all markets and expects to add services in accretive, growing markets while prudently addressing operations in underperforming markets.

The Portland, OR market has recently exhibited some population growth and favorable unemployment and poverty levels, while Hawaii and California state-wide generally have flat population trends. In California and Hawai‘i, unemployment levels are at and/or near state and national averages. As a rural provider in California, service area characteristics are somewhat distinct than from major population centers in the state and are reflected in the system’s payor mix.

Operating Risk

Now that the system and economy are recovering from the pandemic coupled with a new management team in place, the system is evaluating all markets and focused on an improvement plan that should yield more than $400 million in revenue enhancements and cost savings opportunities over the next 24-months.

Revenue enhancements are anticipated to come in part from positive negotiations related third party payor contracts, improved payor mix and patient volumes, a transformation of the system’s revenue cycle management structure, and improvements in collections to reduce receivables, are among other initiatives. Cost savings will come principally from labor and productivity with reduced contract labor and an emphasis on recruiting new RNs and retaining RNs. Enterprise services savings are expected to include certain fixed cost reductions and insourcing of vendor contracts.
The system is expecting positive developments regarding outstanding settlement claims that should benefit its financial performance and that Fitch has factored into this analysis. Volumes have been trending positively (emergency department visits, outpatient surgeries, outpatient visits) for the system since 2021, which should continue to bolster revenues and contribute to future positive performance as expenses are managed prudently.

Fitch anticipates Adventist will continue to reinvest in itself and grow in size and scale over the next several years, toward a longer-term goal to be a $10 billion healthcare company by 2030. This will be accomplished by further building provider sites, with organic growth in existing sites, newer geographic locations and through additional affiliations. Adventist has maintained a competitive average age of plant at 12.9 years with capital expenditures as a percentage of depreciation expense averaging approximately 88% over the past four fiscal years (FY2018-FY2021).

Future capital spending is anticipated to be a minimum of $200 million per year going forward and ramp up to $264 million in fiscal 2025, which excludes the new money series 2022A bonds. The additional capex represents a return to more normal capital investment for the system as the thesis of returning to historical operating performance becomes true.

**Financial Profile**

Through Fitch's base scenario, or Fitch's best estimate of the most likely scenario of financial performance over the next five years given our expectations for current economic conditions and operational performance, Fitch expects that Adventist will see gradual improvement in key metrics after the recent period of lower margins. Fitch expects gradual improvement to continue over the medium to long term, given the expectation of operational improvement, which should lead to balance sheet accretion. With the somewhat heightened capital spending over the next several years, cash to adjusted debt improves to between 110% and 120% by the outer years of the five-year scenario.

Fitch's stress scenario assumes an economic stress to reflect potential equity volatility understanding that the system is already in a period of acute operational stress. Despite the stress, Fitch's forward-looking analysis shows cash to adjusted debt at approximately 95% within three years but expects improvement similar to the base scenario in the outer years of the five-year scenario analysis. Fitch's forward-looking portfolio sensitivity analysis is based on Adventist's specific asset allocation, with 42.8% in cash and fixed income, 34% in domestic and international equities and the remaining portion in hedge funds/alternative investments.
Fitch expects Adventist's financial and leverage profile to remain consistent with 'A' category metrics as it begins to recover from recent operational stresses and generates additional unrestricted liquidity to support planned capital spending. Key balance sheet and leverage metrics could improve further if actual capital spending or borrowing is lower than expected or if operations ramp up faster than anticipated.

**Asymmetric Additional Risk Considerations**

Adventist has good disclosure practices and provides a detailed MD&A along with audited materials. It does not have any unusual legal restrictions or operate under any unusual regulatory pressures. Adventist's debt and asset allocation are somewhat conservative for the sector, and it does not have a defined benefit plan liability. Neither days' cash on hand nor debt service coverage constitute an asymmetric risk.

Adventist's debt service coverage ratio 12-months through Sept. 30, 2022 (unaudited) is expected to be approximately 1.1x on a system-wide basis (MTI coverage is expected to be 1.5x), which is slightly above the 1.0x covenant threshold. Although close, management does not expect to trip this threshold. If Adventist were to violate this covenant threshold, which would be the first year of doing so, a consultant call-in would be required. This does not pose an asymmetric risk to the organization as the covenant requires two-consecutive years of violation before becoming a hard default.

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**

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of ‘3’. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg)

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APPLICABLE CRITERIA
U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria (pub. 18 Nov 2020)
(including rating assumption sensitivity)
Public Sector, Revenue-Supported Entities Rating Criteria (pub. 01 Sep 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

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

Portfolio Analysis Model (PAM), v2.0.0 (1)

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