Fitch Rates CommonSpirit Health's (CO) Series 2020 and 2020A Bonds 'BBB+'; Outlook Stable

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Fitch Ratings - New York - 08 Oct 2020: Fitch Ratings has assigned a 'BBB+' revenue bond rating to the following anticipated debt issues:

--$1.52 billion CommonSpirit Health Taxable Bonds Series 2020;

--$626 million California Health Facilities Financing Authority Revenue Bonds (CommonSpirit Health) Series 2020A.

Additionally, Fitch has affirmed the 'BBB+' Issuer Default Rating (IDR) on CommonSpirit Health (CO) and the 'BBB+' revenue bond ratings on debt issued by CommonSpirit Health or by various issuing authorities on behalf of CommonSpirit. Fitch has also affirmed the 'F2' short-term rating on bonds backed by the system's self-liquidity, which includes $96.7 million of series 2004C variable rate demand bonds as well as CommonSpirit's commercial paper notes. The 'F2' short-term rating correlates to the 'BBB+' rating and self-liquidity coverage of less than 2.0x.

The Rating Outlook is Stable.
CommonSpirit's upcoming financing offers approximately $1.5 billion in taxable fixed-rate series 2020 bonds and $626 million in fixed-rate, tax-exempt series 2020A bonds that are expected to be issued as fixed rate tax-exempt bonds. The financing includes $600 million in new money proceeds that will be used to reimburse CommonSpirit for prior capital expenditures. The remaining bond proceeds will refund various outstanding debt obligations (including private bank placements) and pay costs of issuance. The bonds are expected to price around October 21. Smoothed maximum annual debt service (MADS) is estimated at $842.7 million.

SECURITY

The bonds will be a joint and several obligation under CommonSpirit's Master Trust Indenture (MTI) and secured by a gross revenue pledge of the obligated group (OG). CHI St. Luke’s Health Baylor College of Medicine Medical Center, which is operated as a joint venture with Baylor College of Medicine, is a Restricted Affiliate under the MTI.

ANALYTICAL CONCLUSION

When CommonSpirit issued its initial financing in 2019, Fitch expressed its expectation that the system would be able to fully realize synergies, execute on difficult decisions and build a sustained track record of improved profitability within three to five years. Despite the substantial set-backs created by pandemic disruptions, Fitch believes that the CommonSpirit Health has begun to build the platforms and delivery system needed to reach those goals. Despite strong improvement in the first two quarters, full fiscal 2020 (ended June 30) results were disappointing as they failed to move CommonSpirit Health along the path of improvement that the system and Fitch originally envisioned, but the system has been working on alignment and standardization to create an effective operating company model that will benefit it in the long-run.

CommonSpirit's initial goals of efficient cost management and synergies need to be successfully implemented to facilitate the next phase of growth that will increase revenue and strengthen market share in key markets. Until that time, Fitch's 'BBB+' ratings reflect CommonSpirit's high leverage position in relation to the system's liquidity position and thin
operating margins. Fitch views CommonSpirit’s weak balance sheet as lacking the flexibility and resilience to support the system’s low margins for a prolonged period of time.

While the combination of midrange revenue defensibility, midrange operating risk, and weak financial profile assessment in Fitch’s scenario analysis initially suggest a lower rating, Fitch’s criteria allow for ratings that fall outside of the suggested rating category outcome when considering all relevant credit factors. Fitch believes that CommonSpirit’s substantial size, diversity and national scale suggest additional credit strength beyond the face value metrics to support achievement of CommonSpirit’s goals.

Given the uncertainty created by the pandemic and Fitch's expectation of a slower economic recovery trajectory in 4Q20, CommonSpirit Health’s operations may experience further volatility than that evidenced in its 2020 audited statements (ended June 30, 2020). Fitch continues to monitor the severity and duration of the coronavirus pandemic and its impact on the sector and the economy, assessing key risks and revising expectations as necessary.

**KEY RATING DRIVERS**

**Revenue Defensibility: 'bbb'**

Extensive Size and Revenue Diversity.

CommonSpirit’s revenue defensibility is supported by its broad revenue composition, ranging across different services and markets. Many of the system’s hospitals are in higher growth markets where they command solid market share. Medicaid represents 21% of gross patient revenues and self-pay represents 3% of gross patient revenues.

**Operating Risk: 'bbb'**

Financial Results Expected to be Tempered in 2021.
CommonSpirit's operating EBITDA for fiscal 2020 was unexpectedly low at 4.7% as a result of the pandemic. CommonSpirit Health reported progress on multiple objectives in the first eight months of the year before the effects of the pandemic derailed results for the last four months of the year. The lingering effects on the economy and consumer behavior are likely to unsettle plans for stronger operating results in fiscal 2021, with Fitch's expectations that the system will not break-even from operations and operating cash flow margin will be below 6%. Fitch believes that with identified financial synergies, CommonSpirit should be able to generate incremental cash flow closer to a 7% operating EBITDA margin as it approaches fiscal 2023.

Financial Profile: 'bb'

Weak Leverage Profile Reflects Limited Resiliency to Economic Cycles.

CommonSpirit's financial profile assessment is consistent with a 'bb' financial profile assessment in the context of the midrange (bbb) operating risk assessment, reflecting limited balance sheet cushion in the current challenging economic environment. Fitch's scenario analysis includes both a margin stress as well as a stress on the system's investment portfolio.

ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS

No asymmetric risk considerations were applied in this rating determination.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to a positive rating action/upgrade:

--Significant and sustainable improved operating cash flow margins of roughly 8% or above;

--An ability to generate higher cash flows that allow for continuous level of capital reinvestment to remain competitive without diminishing cash;
--Improved cash to adjusted debt of roughly 100% while maintaining a solid mid-range operating risk assessment.

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

--If margin compression continues over a prolonged period of time such that operating EBITDA is consistently closer to 6% or less;

--High capital spending that requires significant additional cash or debt commitments;

--Cash-to-adjusted debt that does not increase above 70% and/or growing pension liability that further weakens leverage metrics;

--Further long-term economic decline from the pandemic that brings additional operating challenges for hospital providers in 2021 and beyond.

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/1011579].

CREDIT PROFILE

CommonSpirit was created by the alignment of Dignity Health and Catholic Health Initiatives (CHI) that closed on Feb. 1, 2019, forming the largest not-for-profit and largest Catholic health system in the country. This integrated system operates 137 hospitals and more than 700 care centers across 21 states. The system has combined revenue of approximately $30 billion and 25,000 affiliated physicians and practitioners. In addition to
hospitals, the system offers a wide continuum of care in its individual market divisions that may include micro hospitals, imaging centers, urgent care centers, specialty clinics, virtual care and home health and hospice services. Members of the CommonSpirit OG comprise 88% of the system's revenues and 83% of the system's assets.

REVENUE DEFENSIBILITY

Across its different markets, CommonSpirit has an aggregate proforma payor mix consisting of 24% of gross revenues derived from Medicaid and self-pay, which is factored into the 'bbb' revenue defensibility assessment. Like other systems in the country, CommonSpirit is continuing to experience modest payor mix shifts towards more governmental payors in addition to constrained revenue increases from commercial payors.

CommonSpirit has a number of sizable markets that individually generate over $2 billion in net revenue annually, including Greater Sacramento, Arizona, Southern California (part of the Southwest division), Pacific Northwest, Colorado, Texas and Midwest. Aside from the broad geographic diversity, there is also revenue diversity from a portfolio that provides a wide array of acute and non-acute healthcare services. The system has embarked on a review of its market assets to comprehensively evaluate the long-term potential and contribution of each market. Fitch continues to believe that CommonSpirit should be able to leverage its better performing assets to find a balance between profitability and supporting its mission.

Although CommonSpirit garners a leading or a near leading market share in many of its key markets, most of them are competitive markets with strong regional competitors. To remain competitive, CommonSpirit has to be agile in order to respond in a timely fashion to individual market pressures, while implementing best practices and standards from CommonSpirit's national operating model. Additionally, there may be patient or physician preference towards what is viewed as local providers in the market. The system has focused on growth in Colorado and Arizona in recent years and is still working on stabilizing its Texas operations.

A key measure of CommonHealth's success in implementing its market strategies will be its ability to modestly increase adjusted admissions on a same-facility basis. This volume metric decreased in 2018 and decreased very slightly again in 2019. Due to the volume dislocation from the pandemic, the number decreased in 2020 which prevents a horizontal
trend analysis of the progress made against this goal. Volume has begun to improve in July and August, but still remains almost 5%-8% below monthly averages before the pandemic, which is relatively consistent for the sector at this time.

Fitch believes that CommonSpirit benefits from diverse service area characteristics that offset reliance on any one or two markets. The system operates in high-growth service areas like Houston, Omaha, and markets in Arizona, Colorado, Nevada and Washington. This is offset by areas with less growth and more challenged payor mix such as Southern California where CommonSpirit feels that its presence helps provide healthcare access to otherwise underrepresented communities.

**OPERATING RISK**

With the effects of the pandemic, CommonSpirit's financial metrics did not meet Fitch's expectations in fiscal 2020. The system reported audited results of negative 2.1% operating margin and an operating EBITDA margin of 4.7% for the year, which represents the first full 12-month audit for the combined organization. Fitch had originally expected that the system would generate results closer to 6% operating EBITDA margin by FYE 2020, but those expectations are now delayed by about a year due to the volume weakness and additional costs incurred in responding to the pandemic in 2020. The year-end results include $826 million of the $1.3 billion received to date from the Coronavirus Aid, Relief, and Economic Security (CARES) Act funding. CommonSpirit also deferred approximately $140 million in deferred employer social security payments through June 30, 2020, with additional amounts expected to be deferred in the second half of calendar 2020, that will be paid in December 2021 and in December 2022. Fitch expects continued pressure from the persistent economic weakness and high unemployment figures nationwide, and believes there are significant headwinds for CommonSpirit in fiscal 2021. Nevertheless, Fitch views the system's diverse portfolio, scale and operating model as providing the system with the control and flexibility to make the changes ultimately necessary to generate steady improvements to operating EBITDA margin in the coming years.

Core to CommonSpirit's strategy for operating improvement is the realization of $2 billion in financial synergies which it had expected to accomplish by 2023. Management reported progress on the synergies before February 2020, but with the pandemic disruptions, they may not be fully achieved by 2023. Almost a billion dollars is derived from merger-related savings that reduce redundancies, particularly in support functions, and other efforts such
as standardization of initiatives, and consolidating vendors and re-bidding administrative contracts. The remaining billion dollars in synergies will come from traditional operating improvement efforts such as reducing length of stay, labor productivity, and leveraging best operating practices to lower overall cost of care. Ongoing discipline in identifying operating improvement is needed to offset many of the industry pressures including eroding payor mix, more modest commercial payor increases, and inflation.

CapEx

CommonSpirit's combined size allows it to better allocate cost of capital for technology, which is an important component of the system's strategic plans. On an overall aggregate basis, Fitch believes that the system has manageable routine capital needs. CommonSpirit is planning to reinvest at roughly depreciation levels but is committed to funding capital within EBITDA expectations. Capital needs throughout the markets are required to demonstrate high return on invested capital as cash flow to fund projects is somewhat limited compared to the size of its portfolio assets.

Fitch anticipates that capex may increase in later years once the system is on stronger financial footing and begins to pursue larger growth opportunities. For now, the system is trying to identify the capital needs with the highest return on investment as it focuses on short-term stabilization before larger growth opportunities.

FINANCIAL PROFILE

CommonSpirit's financial profile is assessed as 'bb' with net leverage metrics that are slightly lower than those measured by Fitch at the time of its last review. Cash increased to $13.2 billion as of June 30 (Fitch excludes the $2.6 billion in Medicare accelerated funds from unrestricted cash due to current expectations that the government will begin recouping these funds between March and September 2021) from $11 billion as of March 31, 2019. However, total adjusted debt also increased to $19.4 billion from $16.1 billion during this period due to the addition of long-term debt, short-term borrowings in fiscal 2020 (which helps boost liquidity) and a $2.4 billion debt equivalent in pension liability. The defined pension was funded at 63% as of FYE 2020, compared to a 72% funding status as of FYE 2019. Fitch's adjusted debt figure includes the operating lease liability as reported on the balance sheet as part of total debt and the pension liability below the 80% level as a debt equivalent. Days cash on hand is calculated at 168 days as of June, excluding the
Medicare accelerated funds, although this amount includes approximately $800 million in line of credit debt that was paid after the FYE.

Consequently, Fitch calculates cash to adjusted debt of 68% and net adjusted debt to adjusted EBITDA of 2.7x for FYE 2020. Fitch's criteria for the sector classifies a financial profile with cash-to-adjusted debt of less than 75% and net adjusted debt-to-adjusted EBITDA of greater than 1.0x as below investment grade for a credit with a mid-range revenue defensibility and mid-range operating risk assessment. The thresholds for these leverage metrics increase should CommonSpirit's operating risk driver be assessed as weak in the future if margins do not improve to approximately a 7% operating EBITDA margin.

Fitch's new baseline scenario analysis assumes a margin stress with operating cash flows below 5% for fiscal 2021 and just under 7% for fiscal 2022 in addition to a portfolio sensitivity of -12.8% based on CommonSpirit's asset allocation. The tool assumes stronger margins in 2023 and portfolio investment returns of 4.6% thereafter. The analysis also includes $600 million in new money debt with this issuance and modest capital expenditures below depreciation levels and in line within the cash flow parameters consistent with management's expressed goal of capital spending discipline.

Fitch's forward look scenario incorporating the margin and liquidity stress outlined above results in leverage metrics that stay within the 'bb' assessment until the fifth year of the analysis.

**ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS**

No asymmetric risk considerations were applied in this rating determination.

Management and Governance

The Office of the CEO structure that had been put in place when the system was formed in 2019 was dissolved when Kevin Lofton retired as of June 30, 2020. Lloyd Dean remains as the system's CEO.

Debt Profile

This financing further de-risks the debt portfolio by reducing variable rate debt and bank exposure while generating cash flow savings. Pro forma interest rate mix after the financing will be comprised of 77% fixed rate debt.
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

RATING ACTIONS

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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)
Fitch Rates CommonSpirit Health's (CO) Series 2020 and 2020A Bonds 'BBB+'; Outlook Stable

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

ENDORSEMENT STATUS

Arizona Health Facilities Authority (AZ)  EU Endorsed
California Health Facilities Financing Authority  EU Endorsed
California Statewide Communities Development Authority  EU Endorsed
Catholic Health Initiatives (CO)  EU Endorsed
Chattanooga Health, Educational, & Housing Facility Board (TN)  EU Endorsed
Colorado Health Facilities Authority (CO)  EU Endorsed
CommonSpirit Health (CO)  EU Endorsed
Dignity Health (CA)  EU Endorsed
Kentucky Economic Development Finance Authority (KY)  EU Endorsed
Louisville-Jefferson County Metro Government (KY)  EU Endorsed
Montgomery County (OH)  EU Endorsed
Washington Health Care Facilities Authority (WA)  EU Endorsed

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