CommonSpirit Health

Update to credit analysis

Summary

CommonSpirit Health (Baa1 stable) will continue to benefit from certain strengths, including: exceptional size and good diversification across 21 states; good concentration within certain markets; high acuity service offerings and a broad delivery platform in most markets; improved management structure; and good liquidity for the rating category, bolstered in part by $2.6 billion of advance funds from CMS. Much progress has been made in consolidating the two legacy organizations (Catholic Health Initiatives, and Dignity Health, which merged on February 1, 2019) including reverting to a single CEO model, and we expect additional efficiencies and synergies to be garnered, particularly in certain underperforming markets. Operating performance showed improvement through February, however results for full year 2020 (ended June 30) were modest largely due to COVID-19. We expect CommonSpirit to continue to face operational headwinds in 2021. We also expect liquidity to drop over the next year, due to the challenging operating environment, and the partial payback of funds. The current debt offering will improve debt structure, and slightly decrease peak debt service. Nevertheless, debt measures will remain modest for the rating category. Our long-term expectation is that the organization will continue to optimize its operating portfolio and strategy, and will gradually improve measures across all categories over time.

The most immediate social risk under our ESG framework is the impact of COVID-19, which resulted in short-term volume and revenue losses earlier in the year. Results in 2020 were weaker in large part due to pressures relating to COVID-19 and we expect margins in 2021 to remain below our original expectations due to increased operational challenges. There remains a high degree of uncertainty around the potential longer-term impact of COVID-19, the state of the economy, and their continued impact on CommonSpirit.

Affirmation of the VMIG2 and P-2 short-term ratings on debt that is backed by CommonSpirit’s own liquidity is a function of sufficient liquidity headroom at those levels, and the continuation of good treasury management practices.
Profitability remains modest; liquidity receives a boost from short term borrowings

2016-2019 based on consolidated pro-forma of CHI and Dignity Health combined, ended June 30; the California State Provider Fee is normalized; benefit from Scripps Health is excluded; non-cash related restructuring expenditures excluded; swap cashflow expense added to interest expense; $121 million gain from US Healthworks excluded in 2018; 2020 includes short term borrowings, including $2.6 billion from CMS
Source: Moody’s Investors Service

Credit strengths

» CommonSpirit will continue to benefit from cashflow diversification and economies of scale derived from its very large size (nearly $30 billion of revenues in fiscal 2020) and significant presence in 21 states

» Strong brand and regional focus help support competitive position

» Strong security structure for the bonds, and improved debt structure, provide certain bond holder protections

» Continued access to the California State provider fee program (over 35% of CommonSpirit’s revenues are derived from California) will continue to provide needed and material operating support

» Management structure has improved, including reverting to a single CEO, and we expect further progress on streamlining and integration will be made in the year ahead

» A good start has been made on CommonSpirit’s goal of achieving $2 billion in synergistic benefit, with more progress to be made in 2021

» Liquidity has temporarily improved due to short term borrowings, including a $2.6 billion loan from the Medicare Advance and Accelerated Payment Program

Credit challenges

» Execution risk remains as the organization continues to integrate

» While improvements may be made, certain markets will likely continue to significantly underperform in 2021, including Arkansas and Texas

» Overall, margins will likely remain modest in 2021 as the organization continues to emerge from COVID-19 and faces increased operating pressures

» Debt measures will remain modest for the rating category

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Pension liability has significantly increased, measuring $5.2 billion at fiscal year end (FYE) 2020; this may increase further in the year ahead, and pressures comprehensive debt.

CommonSpirit will continue to face significant competition in most markets; labor unions are active and aggressive in certain markets.

Rating outlook
The stable outlook reflects our expectation that operating and debt measures will remain modest over the intermediate term, despite anticipated improvements.

Factors that could lead to an upgrade
- Material improvement in operating and debt measures
- Continued successful integration of legacy organizations
- Short term rating: Improvement in overall credit quality of borrower; improved coverage levels

Factors that could lead to a downgrade
- Decrease in operating performance
- Dilution of balance sheet measures beyond expectations
- Decline in debt measures
- Sizable acquisition that is dilutive
- Short term rating: Decline in overall credit quality of borrower; further decline in coverage levels

Key indicators

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<tr>
<td>Operating Revenue ($'000)</td>
<td>28,349,759</td>
<td>28,453,105</td>
<td>29,034,328</td>
<td>28,832,600</td>
<td>29,579,000</td>
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<td>3 Year Operating Revenue CAGR (%)</td>
<td>N/A</td>
<td>N/A</td>
<td>2.7</td>
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<td>Operating Cash Flow Margin (%)</td>
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<td>4.5</td>
<td>7.0</td>
<td>5.0</td>
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<tr>
<td>PM: Medicare (%)</td>
<td>40.9</td>
<td>42.3</td>
<td>44.0</td>
<td>44.0</td>
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<td>PM: Medicaid (%)</td>
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<td>16.0</td>
<td>21.0</td>
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<td>21.0</td>
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<td>Days Cash on Hand</td>
<td>153</td>
<td>171</td>
<td>161</td>
<td>152</td>
<td>166</td>
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<td>Unrestricted Cash and Investments to Total Debt (%)</td>
<td>79.3</td>
<td>92.3</td>
<td>88.3</td>
<td>85.9</td>
<td>89.0</td>
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<tr>
<td>Total Debt to Cash Flow (x)</td>
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<td>7.0</td>
<td>5.1</td>
<td>6.6</td>
<td>6.9</td>
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2016-2019 based on consolidated pro-forma of CHI and Dignity Health combined, ended June 30; the California State Provider Fee is normalized; benefit from Scripps Health is excluded; non-cash related restructuring expenditures excluded; swap cashflow expense added to interest expense; investment returns normalized at 5%; $121 million gain from US Healthworks excluded in 2018; $2.6 billion from CMS and $140 million related to deferred employer social security payments excluded from unrestricted cash and investments in 2020

Profile
CommonSpirit is the product of the February 1, 2019 merger of Dignity Health and Catholic Health Initiatives, the latter of which changed its corporate name to CommonSpirit Health. CommonSpirit generated approximately $30 billion of revenues in 2020 and is headquartered in Chicago with significant operations in 21 states. Its largest markets include California, Colorado, Arizona, the Pacific Northwest and Texas.
Detailed credit considerations

Market position: size and scope of integrated system provides good diversification and a degree of overall stability

CommonSpirit will continue to benefit from its large size and good diversification, with significant operations in 21 states. The organization has a regional orientation, and is focused on being a leader in each of its markets, while developing a broad array of service offerings and delivery platforms in order to be competitive across the full spectrum of care delivery. CommonSpirit was formed through the coming together of Dignity Health and Catholic Health Initiatives on February 1, 2019, and favorably, there was no geographic overlap between the two parent organizations. Dignity Health had very significant operations in California, with additional operations in Nevada and Arizona. CHI had operations in four different time zones, with significant operations in the Pacific Northwest, Colorado, Texas, the Midwest, and the Southeast. This portfolio approach will allow the organization to continue to benefit from economies of scale and operational synergies, while also benefiting from revenue diversification, which helps stabilize overall performance metrics.

The focus of the organization in this next year will be the additional streamlining of organizational structure, the optimization of certain markets, and the continued integration of the legacy organizations. Much has already been accomplished on these fronts in the first year, including doing a portfolio review of all of the system’s assets, adjusting regional management where necessary, and reverting to a single system-wide CEO (immediately following the merger, the organization was launched with an "office of the CEO" structure, which included both legacy CEOs). In line with this process, management originally set out to achieve $2 billion in synergistic benefit in the first four years of operation. Management was on its way to achieving its first year goal through February when it encountered pressures relating to the pandemic. Productivity based efforts stalled, while other corporate synergy work continued. Management remains committed to this target, and will be looking to achieve additional progress in the year ahead.

Certain markets continue to present particular challenges, and management will endeavor to make improvements in the next year. One of the most challenging markets continues to be Texas, where CommonSpirit operates 15 hospitals, including Baylor St. Luke’s Medical Center (BSLMC). The Houston area is highly competitive with several larger tertiary systems at the Texas Medical Center. CHI had changed local and divisional management multiple times but had been unable to achieve material improvements. The system has suffered from clinical issues and has needed to reimplement its cardiac program. The road to recovery here is likely still very long. An additional challenging market is Arkansas, which is driving the poor performance in the Southeast region. Management here is focused on improving reimbursement, and making the operations more efficient.

Strengths in the portfolio include Colorado, Arizona, Central California and the California Central Coast. Kentucky had long been a drag on performance, and in the last year, management successfully closed on the divestiture of its Louisville operations. Operations in the Sacramento region in California, and in the Southwest in general, also showed improvement. Management remains interested in making opportunistic acquisitions in current markets for assets that will be complementary and accretive, and several new relationships are in process. Management has entered into an affiliation agreement with Yavapai Regional Medical Center (A2 stable) in Arizona, which is expected to close in November. Management is also in discussions with Virginia Mason Medical Center (Baa3 negative) in Seattle, and with a multi-site provider for CommonSpirit to acquire a controlling interest in the company. Management has not indicated an interest in another major affiliation at this time, and is focused on making its current operations profitable. CommonSpirit will need to improve performance overall in order for the organization to begin to perform closer to its potential.

Operating performance, balance sheet, and capital plans: modest improvement in operating performance expected in 2021; liquidity has improved temporarily, but will likely decline

Operating results in 2021 are likely to show modest improvements over the somewhat thin margins achieved in 2020. Management was showing improved results through February 2020, but then results declined due to the elimination of elective procedures and the dramatic reduction in revenues related to COVID-19. In response to the pandemic, management implemented resource sharing and cost reduction measures system wide, which succeeded in minimizing some of the losses. Additional significant support came from the CARES Act, with CommonSpirit booking $826 million of funds through June 30, and receiving $1.3 billion in total through September 2020. (Like all health systems, there is risk that CommonSpirit may not be able to recognize all of the grant money received and may have to return a portion to CMS.) Volumes returned in subsequent months, and management reports currently achieving close to normal levels of gross charges. Longer term, management has stated the goal of reaching 8% operating cashflow margins. Other goals include debt to capitalization of 45% or less, MADS coverage of at least 3.5 times, and days cash on hand of at least 150 days. While
it is likely that measures will underperform these goals and remain below the medians for a while, failure to show at least consistent improvement could result in credit pressure.

An additional support to the organization is the California State Provider Fee. With over 35% of net patient revenues generated from the state of California, CommonSpirit is a significant beneficiary of the program, with net receipts totaling approximately $548 million in fiscal 2020, which is equal to 38% of total operating cashflow for the year. The California provider fee program has historically been highly variable with respect to the timing and distribution of funds, which leaves CommonSpirit vulnerable to significant changes in the program. Favorably, the program has been more consistent in recent years, and the amount received has been increasing. We expect this to remain a positive source of support going forward.

**LIQUIDITY**

Unrestricted cash and investments are currently at peak levels, and will likely decline in the year ahead as CommonSpirit begins to repay the Medicare advance funds. Unrestricted cash and investments increased from $11.6 billion at FYE 2019 (equal to 152 days cash on hand on a proforma basis) to $15.8 billion at FYE 2020 (equal to 202 days cash on hand). A major source of additional liquidity was an increase in short term borrowings, including $2.6 billion under Medicare’s Advance and Accelerated Payment Program, $831 million of bank lines, and $140 million from deferred employer social security payments, among other sources. Excluding funds related to Medicare and social security, days cash on hand measures 166 days at FYE 2020. Management expects cash balances to ultimately return to near 150 days cash on hand as advances are repaid. Current asset allocation including long-term investments and cash within the system’s banking and cash management system consists of approximately 29% cash and fixed income, 39% equity, and 32% alternatives.

**CAPITAL SPENDING**

Capital spending was reduced significantly mid year in order to preserve liquidity. Total spending equaled 0.8 times depreciation for the year. Capital spending remains under strict review, and management plans on matching future spending levels to cashflow generation, ensuring the preservation of liquidity.

**Debt Structure and legal covenants: somewhat modest debt measures for the rating category**

The 2020 financing consists of a combination of new money and restructuring. Proforma debt measures will remain somewhat modest for the rating category, with cash to debt at 89% (Baa1 median is 132%), debt to revenue at 49.5% (Baa1 median is 35.9%), debt to cashflow at 6.9 times (Baa1 median is more favorable at 3.5 times), and peak debt service coverage at 2.5 times (Baa1 median is 3.6 times). (Calculations exclude $2.6 billion related to the advance from CMS, and $140 million related to deferred employer social security payments).

**DEBT STRUCTURE**

The 2020 financing will somewhat simplify CommonSpirit’s debt structure, reducing exposure to variable rate and put bonds from 36% to 23%. Peak debt service (on a smoothed basis) will also slightly improve, dropping to $841 million from $853 million (calculated per Moody’s methodology). CommonSpirit’s debt is highly reliant on bullet maturities, and unsmoothed peak debt service is quite high, at $2.1 billion. Nevertheless, CommonSpirit’s $15.8 billion of unrestricted cash and investments more than amply covers the largest bullets, giving the organization flexibility and protection in the event of temporary market disruptions.

**LEGAL SECURITY**

Bonds are secured by a gross revenue pledge and are a joint and several obligation of the obligated group. All proposed and outstanding debt, including debt originally issued by CHI and Dignity Health, is on parity. As part of the 2019 financing, CHI’s COD and Dignity Health’s MTI were consolidated into a new MTI under CommonSpirit Health. Both legacy organizations are part of the obligated group.

Key MTI covenants include a rate covenant of 1.1 times. Less than 1.0 times constitutes an event of default. There are additional requirements in certain bank agreements, including: minimum 75-days cash on hand; maximum debt to capitalization of 65%; and minimum rating of Baa3 or BBB- by at least two rating agencies.

**DEBT-RELATED DERIVATIVES**

CommonSpirit inherited a number of swaps from the two legacy organizations. Current swap obligations have a total notional of $3.1 billion. Swaps include fixed payer swaps, total return swaps, fixed receiver swaps, and basis swaps. Some of the swaps have collateral...
posting requirements, and the total return swaps have possible termination payments. CommonSpirit is currently posting $353 million in collateral. The total current market to market of the portfolio is -$630 million.

PENSIONS AND OPEB
The organization’s pension obligation has increased significantly in the last year and a half. At the time of the last review, prior to the end of the fiscal year, total unfunded pension liability was valued at approximately $2 billion on a proforma basis. At FYE 2019, this increased to $3.5 billion. Now, most recently, at FYE 2020, the unfunded pension liability is at $5.2 billion. This materially adds to CommonSpirit’s already highly leveraged credit position.

ESG considerations

Environmental
With over 35% of CommonSpirit’s revenues concentrated in California, the system is exposed to the state’s environmental risks such as earthquakes, droughts, and fires. Other markets have exposure to hurricanes, winter storms, and extreme heat. Mitigants include good liquidity with over $15 billion of unrestricted cash and investments, market diversification, and diversified revenue streams.

Social
Social risks include high reliance on the California State Provider Fee, which historically has had uneven timing and variable funding levels. Other social risks include potential labor issues, systemic nursing shortages, reliance on temporary labor, and recruitment challenges in certain markets. Social factors also include material exposure to Medicare and Medicaid, and the need to care for the indigent population.

The most significant social consideration currently is the impact of COVID-19. Like other healthcare providers, CommonSpirit suspended elective services system wide beginning in mid-March. Though services have since resumed, volumes remain below pre-COVID levels within certain service lines and in certain markets. CommonSpirit’s good liquidity position along with borrowings from CMS have been a bulwark against cash disruptions, and significant support from the CARES Act has helped offset some of the losses. Nevertheless, margins remain weaker, and the full duration and impact of the pandemic remains unknown.

Governance
CommonSpirit is in the second year of integration following the February 1, 2019 merger, and while much progress had been made in integrating senior management and streamlining the executive management team (including transitioning from an "office of the CEO" structure to one CEO), we believe more progress can be made in integrating the organization as a whole, and implementing best practices across all markets. The board was formed with an equal number of board members from each legacy system, with two additional board members added in 2021. Going forward it will be a self-perpetuating 501-C-3. Disclosure practices are routine.
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