26 FEB 2024

Fitch Rates CommonSpirit's Taxable, CA and CO 2024A Bonds 'A-'; Outlook Stable

Fitch Ratings - Austin - 26 Feb 2024: Fitch Ratings has assigned a 'A-' long-term rating to the following series of bonds:

--$246,170,000 California Health Facilities Financing Authority Revenue Bonds (CommonSpirit Health) series 2024A;

--$780,705,000 Colorado Health Facilities Authority revenue bonds (CommonSpirit Health) series 2024A;

--$1,763,485,000 CommonSpirit Health taxable bonds series 2024.

In addition, Fitch has affirmed CommonSpirit Health's Issuer Default Rating (IDR) at 'A-' and approximately $16.6 billion of debt issued by CommonSpirit Health or on its behalf (by various issuers) at 'A-'. The ratings include legacy debt issued by Dignity Health and Catholic Health Initiatives (CHI).

The Rating Outlook is Stable.

Bond proceeds will predominantly be used to refund approximately $1.0 billion of previously issued debt (CommonSpirit 2019 taxable bonds and Dignity Health 2014A taxable bonds); refinance approximately $1.3 billion of various loans, including a Citi term loan and a portion of a Wells Fargo term loan used to fund the Steward Acquisition and a PNC term loan; and portions of commercial paper and the bank syndicated line of credit.

Additional new money bond proceeds (approximately $455 million not including premium amounts), is reimbursement for prior capex in Arizona, California, Colorado and Nebraska. Fitch has also affirmed the Short-Term rating on CHI bonds backed by the system's self-liquidity at 'F1', including on the series 2004C variable rate demand bonds and Catholic Health Initiatives' CP notes. The 'F1' short-term rating correlates to the 'A-' long-term rating and to a higher implied short-term rating given the issuer's revenue defensibility assessment and a liquidity ratio that exceeds 1.75x.

After an operationally challenging FY22, CommonSpirit continued to realize synergies and work on improving profitability through improved efficiencies, reductions in external contract labor and productivity initiatives. Despite meaningful progress, realizing just over their initial $2.0 billion goal, CommonSpirit, like many healthcare systems, encountered ongoing operational challenges in FY23. These included reduced acuity levels, stubbornly persistent labor issues and high levels of inflation, as well as a slightly unfavorable shift in payor mix. While CommonSpirit realized its merger-driven operational goals, lingering challenges continued to affect operations negatively to the same degree in FY23.

The system experienced total operational losses of $1.40 billion incurred in audited FY23 (audited results through June 30, 2023) following operating losses of $1.30 billion in FY22, resulting in an operating margin loss of 4.1% and an operating EBITDA margin of just 1.8%. As a result of operational challenges in FY23, the planned return to a better-than-breakeven operating margin on an annual basis will likely not occur until FY26. Fitch does, however, view this is a delay to, not a rejection of, CommonSpirit's multiyear journey to operational profitability and balance sheet accretion.

Fitch believes that CommonSpirit is still positioned to build on prior gains and has made demonstrable progress toward its longer-term financial goals, particularly in light of second-quarter 2023 results (unaudited six-month results through Dec. 31, 2023) that show an operating margin loss of just 0.3% and an operating EBITDA margin of 5.6%. (Year-to-date results include a one-time $234 million positive adjustment for 340(b) program settlement.) Operational improvement was driven by prior labor and non-labor gains that have held consistent year-to-date, along with a notable uptick in volume growth, with a 5.9% same-store increase in adjusted admissions compared to the same period last year. Building upon these recent improvements in general accordance with management's articulated timing will be a key component for maintaining the current rating and Outlook.

While operating results have not been as robust as expected, Fitch expects that over the longer term CommonSpirit will generate a consistent operating EBITDA margin of around 7% with a positive operating margin achieved by no later than FY26. For the immediate term, Fitch expects operating EBITDA margins of roughly 5% to 6% over the next one to two years given current industry headwinds, but also acknowledging CommonSpirit's more recent progress.

Capital spending is expected to fluctuate with operational performance but should remain at or above annual deprecation levels and continue to support CommonSpirit's long-term mission as the sector continues to shift to more outpatient access points. Even just a breakeven operating income margin would result in an operating EBITDA margin of approximately 6.5% and operating EBITDA cash-flow of approximately $2.5 billion. While some current financial metrics indicate a lower rating category than 'A-', Fitch believes CommonSpirit's substantial size, diversity and national scale suggest strength beyond the face value of these metrics.

SECURITY

The bonds are a joint and several obligations under CommonSpirit's Master Trust Indenture (MTI) and secured by a gross revenue pledge of the obligated group (OG).

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. The system has a combined payor mix in FY23, consisting of 23.8% of gross revenues derived from combined Medicaid and self-pay, which is factored into the midrange revenue defensibility. CommonSpirit has not experienced a significant shift in payor mix, but like most in the sector, will likely seek rate increases from commercial payors, given the trend line of rising staffing and overall costs to the system.

CommonSpirit has a number of sizable markets that individually generate over $2 billion in net revenue annually, including Northern California, Southern California, the Southwest, the Pacific Northwest, the Southeast, Colorado, Midwest and Texas.

CommonSpirit garners a leading or a near-leading market share in many of its key markets, most of which are competitive with strong regional providers. The system has focused on growth and expansion in Colorado, Arizona and the Pacific Northwest in recent years and remains focused on stabilizing its Texas operations, with multiple options available to achieve that goal.

Fitch expects CommonSpirit to undergo a comprehensive portfolio review, having recently just reorganized into fewer geographical regions. System assets are being evaluated on the long-term potential for a full continuum of care model and the relative contribution of each market. Fitch believes that CommonSpirit will be able to leverage its higher performing assets and find a sustainable balance between profitability and support of its mission. Markets that are deemed to have a limited path to financial sustainability will, in the context of CommonSpirit's mission, necessarily need to be considered for alternate models or partnerships in order to improve operating results, while still honoring community impact. New geographies and new capabilities have been added (e.g., Steward Health Care's Utah care sites) to an already extensive list of pre and post-acute service offerings.

CommonSpirit's leadership team has stated that it must find additional synergies along with any new growth initiatives.

Operating Risk - 'bbb'

Continued Operational Stress in Fiscal 2023; Financial Results Expected to Improve and Stabilize

CommonSpirit experienced the near sector-wide operational challenges associated with FY22, resulting in an operating margin loss of 3.8% and an operating EBITDA margin of 1.9%. As previously mentioned, the system experienced a very similar year operationally in FY23 with an operating margin loss of 4.1% and an operating EBITDA margin of 1.8%.

Even with full realization of $2 billion in financial synergies target implementation by 2023, CommonSpirit will have to continue with additional financial actions in order to improve profitability. It is intensely engaged in labor standardization, organizational design changes and other value capture initiatives in its revenue cycle, supply chain and ancillary services, that Fitch expects to result in meaningful operational improvements in FY24 and FY25 and beyond. Fitch projects that full year FY24 will show an operating loss but positive operating EBITDA margins, even with these initiatives. Operational losses may linger in 2025 but generate a stronger operating EBITDA margin, and Fitch expects that positive operating margins will occur in FY26.

As of the second quarter of fiscal 2024, CommonSpirit saw an improvement in operations, even accounting for one-time operational adjustments, with a YTD operating margin loss of 0.3% and an operating EBITDA margin of 5.6%. Results have been driven by volume growth, incremental lowering of the average length of stay, and productivity (labor) initiatives. Results compare favorably to the same period last year, when CommonSpirit saw an operating margin loss of 2.6% and an operating EBITDA margin of 3.0%.

Capital spending averaged $1.4 billion over the past three fiscal years. Fitch projects it will be approximately $1.6 billion on average over the next five years, with a total spend of approximately $8.2 billion. Lower levels of spending are expected in the earlier years and then ramping up as operations improve.

Financial Profile - 'bbb'

Liquidity Expected to Improve

Unrestricted cash and investments stood at $15.5 billion at FYE23. Long-term debt at FYE23 stood at $20.2 billion inclusive of operating lease liabilities, resulting in cash to debt of 76.5%. Given the nature of the current debt issuance, with the only new money portions of debt issued as reimbursement for prior capital expenditures, pro forma cash to debt does not change materially.

Unrestricted cash, not including any impact from improved operations, should grow in FY24 and into 2025 due to several liquidity infusions including, among other things, FEMA settlements and employee retention credits. The exact amount is still to be determined but should be in the range of $1.5 billion.

CommonSpirit's FY23 pension funding increased and now stands at a total funding level of 84%. Fitch only includes as a debt equivalent the portion of a defined benefit (DB) pension that is below 80% funded. This debt equivalent was as much as $2.4 billion a few years ago. As a result, cash to debt and cash to adjusted debt are the same ratio.

Asymmetric Additional Risk Considerations

No asymmetric risk considerations were applied in this rating determination.

RATING SENSITIVITIES

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

--Should CommonSpirit be unable to adhere to articulated improvement initiatives, or miss key financial milestones in FY24 through 2026, a negative Outlook or a downgrade is possible;

--Similarly, should cash-to-debt levels fail to gradually improve and expected to be sustained above 80%, negative action is likely;

--Higher levels of capital spending that requires significant additional cash or debt commitments without commensurate EBITDA growth.

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

--Sustained operating EBITDA margins of 8% or above;

--Generation of more robust cash flow that allows for a continuous level of capital reinvestment to remain competitive without diminishing cash;

--Sustained cash-to-adjusted debt expectations of 100% while maintaining a midrange (or better) operating risk assessment and while sustaining capex that keeps CommonSpirit competitive.

PROFILE

CommonSpirit is the largest Catholic healthcare system in the U.S. This integrated system currently operates 142 hospitals (with another 20 hospitals operated through unconsolidated joint ventures) and more than 2,250 care sites across 24 states. In FY23 (audited results through June 30, 2023) the system had combined revenue of approximately $34.5 billion, in addition to 25,000 affiliated physicians and practitioners, with more than 6,000 of those providers employed, and 2.6 million attributed people in value-based agreements. 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.

Sources of Information

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 is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
CommonSpirit Health (CO)	LT IDR	A-	Affirmed		A-
• Catholic Health Initiatives (CO) /General Revenues/ 1 LT	LT	A-	Affirmed		A-
• CommonSpirit Health (CO) /General Revenues/ 1 LT	LT	A-	Affirmed		A-

ENTITY/DEBT	RATING			RECOVERY	PRIOR
• Dignity Health (CA) /General Revenues/ 1 LT	LT	A- ⊡	Affirmed		A- ⊡
• Catholic Health Initiatives (CO) /Self-Liquidity/ 1 ST	ST	F1	Affirmed		F1

RATINGS KEY	OUTLOOK	WATCH
POSITIVE	⊕	⬘
NEGATIVE	⊖	⬙
EVOLVING	◈	◆
STABLE	⊡	

Applicable Criteria

U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria (pub.18 Nov 2020) (including rating assumption sensitivity)

U.S. Public Sector, Revenue-Supported Entities Rating Criteria (pub.12 Jan 2024) (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)

Additional Disclosures

Solicitation Status

Endorsement Status

Catholic Health Initiatives (CO)	EU Endorsed, UK Endorsed

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