

15 NOV 2021

Fitch Revises CommonSpirit Health's (CO) Outlook to Positive from Stable; Affirms 'BBB+' Rating

Fitch Ratings - New York - 15 Nov 2021: Fitch Ratings has revised the Rating Outlook to Positive from Stable for CommonSpirit Health (CO) and affirmed the 'BBB+' Issuer Default Rating and revenue rating 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 CP notes. The 'F2' Short-Term rating correlates to the 'BBB+' rating and self-liquidity coverage of less than 2.0x.

SECURITY

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

ANALYTICAL CONCLUSION

Fitch's analytic focus since CommonSpirit's initial financing in 2019 has been concentrated on tracking the system's ability to deliver on its plans to realize synergies and build a sustained track record of improved profitability within three to five years. Fitch believes that fiscal 2021 (ended June 30) demonstrates the system's first discernable progress towards its financial goals with an operating margin of 2.8% and operating EBITDA margin of 8.7%, in addition to a material improvement in unrestricted cash to \$17.7 billion as of FYE 2021 compared to \$12.8 billion as of FYE 2020.

Despite our belief that the system has been successfully working on system alignment, portfolio optimization and standardization to create an effective operating model, Fitch recognizes that the results in 2021 are not sustainable in the short to mid-term. Fitch does not anticipate that CommonSpirit will generate consistent operating EBITDA of 8% or above for at least another three to four years. Fitch's forward look factors expectations of operating EBITDA in a band of roughly 6.5% to 7.5% over the next four years.

Although unrestricted cash and investments have materially improved, primarily as a result of strong investment returns and proceeds from sale of investments, the system remains highly leveraged, and will remain so for a number of years, as highlighted by a financial profile that is assessed at the 'bbb' level. However, 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 credit strength beyond the face value metrics in supporting achievement of CommonSpirit's goals.

Fitch continues to believe that given CommonSpirit's revenue and geographic diversity, an upgrade may be possible even if profitability and balance sheet metrics lag the medians for the 'A' rating category.

CommonSpirit's overall financial profile has improved since the system's initial 2019 rating, which supports today's Outlook revision and signals rating momentum towards an 'A-' rating. Nevertheless, the system will need to continue to make progress on efficient cost management, revenue growth in key markets, and synergies to prevent cash deterioration while funding its long-term strategy initiatives given its moderate operating cash flow level.

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, competitive markets where they command solid market share. Aside from the broad geographic diversity, there is also revenue diversity from a portfolio that includes a wide array of acute and non-acute health care services. The system has focused on growth in Colorado, Arizona and Pacific Northwest in recent years and is still working on stabilizing its Texas operations, which Fitch believes may take another couple of years.

Medicaid represents 21% of gross patient revenues and self-pay represents 3% of gross patient revenues. The payer mix has been stable at these levels and no significant changes are expected in the coming years.

Operating Risk: 'bbb'

Financial Results Improved in FY 2021

CommonSpirit's operating EBITDA margin improved significantly in FY 2021 to 8.7% following a low 4.7% margin in FY 2020, a year which was heavily affected by the pandemic's disruption. (Fitch reclassifies contributions from operating to non-operating income). FY 2021 benefited from \$690 million recognized in CARES Act funding (\$826 million was previously recognized in FY 2020), a one-time gain on sale of joint venture share (\$523 million), the consolidation of Yavapai Regional Medical Center and Virginia Mason Health System, and from improved volumes through a mix of COVID and non-COVID patients. Operating EBITDA measures at 5.0% excluding CARES funding and the gain on sale.

Fitch expects continued pressure from labor and supply costs in fiscal 2022 for CommonSpirit and throughout the health care sector. Nevertheless, Fitch believes that with ongoing realization of financial synergies, CommonSpirit should be able to generate incremental cash flow closer to a 7% operating EBITDA margin in fiscal 2023. Full realization of the \$2 billion in financial synergies originally targeted by 2023 is only slightly behind schedule given the pandemic's disruption to supply chains and other initiatives.

CommonSpirit's combined size allows it to better allocate cost of capital for technology, which continues to be an important component of the system's strategic plans. With higher liquidity reserves and improving cash flow, the system is likely to increase capital spending in the coming years to above depreciation levels but is still committed to funding capital within EBITDA expectations.

Capital spending averaged \$1.4 billion over the past two fiscal years, but is expected to be above \$2.0 billion in each of the next five years, including approximately \$800 million still to be spent at the McNair campus of Baylor St. Luke's Medical Center. The higher capital spending assumptions are incorporated in Fitch's forward look analysis.

Financial Profile: 'bbb'

Improved Leverage Profile With Higher Liquidity

CommonSpirit's financial profile assessment is now assessed at a higher 'bbb' level from the prior 'bb' assessment, reflecting improved balance sheet cushion. Primarily through exceptionally high investment returns for the year, unrestricted cash and investments improved to \$17.7 billion as of FYE 2021, excluding \$2.5 billion in Medicare accelerated funds and \$416 million in deferred payroll taxes that will be paid in December 2021 and December 2022. Days cash on hand improved to 211 days in FY 2021 from 163 days as of FYE 2020. Unrestricted cash measured \$16.8 billion as of 1Q Sept. 30, 2021.

Total adjusted debt also improved in fiscal 2021 with higher pension funding at 77% as of FYE compared to 63% in the prior year, reducing this debt equivalent to \$429 million from \$2.4 billion. Fitch includes the operating lease liability as reported on the balance sheet as part of total debt. With higher liquidity and lower adjusted debt for the year, cash-to-adjusted debt materially improved to 98.6% from 65.8%.

Fitch's forward-look scenario analysis includes both a margin stress as well as a stress on the system's investment portfolio. Fitch's analysis focuses on the recovery years after the stress, which in CommonSpirit's case indicates that the system's leverage metrics remain within the 'bbb' assessment with cash-to-adjusted debt of roughly 80% and net adjusted debt to adjusted EBITDA below 1.0x.

Asymmetric Additional Risk Considerations

No asymmetric risk considerations were applied in this rating determination.

CommonSpirit's CEO, Lloyd Dean, has announced his intention to retire in the summer of 2022 and the board has begun a search for his replacement.

RATING SENSITIVITIES

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

- Sustainable improved operating cash flow margins of close to 7% or above;
- An ability to generate higher cash flows that allow for continuous level of capital reinvestment to remain competitive without diminishing cash;
- Sustained cash-to-adjusted debt expectations 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:

- Margin compression 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 without commensurate EBITDA growth;
- Cash-to-adjusted debt that decreases to 80% and/or growing pension liability that significantly weakens leverage metrics may result in an Outlook revision to Stable at the 'BBB+' rating;

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

CommonSpirit was created by the alignment of Dignity Health and 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 140 hospitals and more than 1,500 care centers across 21 states. The system has combined revenue of approximately \$33 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.

Asymmetric Additional Risk Considerations

No asymmetric risk considerations were applied in this rating determination.

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

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Rating Actions

ENTITY/DEBT	RATING		RECOVERY	PRIOR
CommonSpirit Health (CO)	LT IDR	BBB+ 	Affirmed	BBB+ 
<ul style="list-style-type: none"> Catholic Health Initiatives (CO) /General Revenues/1 LT 	LT	BBB+ 	Affirmed	BBB+ 
<ul style="list-style-type: none"> CommonSpirit Health (CO) /General Revenues/1 LT 	LT	BBB+ 	Affirmed	BBB+ 
<ul style="list-style-type: none"> Dignity Health (CA) /General Revenues/1 LT 	LT	BBB+ 	Affirmed	BBB+ 

ENTITY/DEBT	RATING		RECOVERY	PRIOR
<ul style="list-style-type: none"> Catholic Health Initiatives (CO) /Self-Liquidity/1 ST 	ST	F2	Affirmed	F2

RATINGS KEY OUTLOOK WATCH

POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

[Public Sector, Revenue-Supported Entities Rating Criteria \(pub.01 Sep 2021\) \(including rating assumption sensitivity\)](#)

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

Applicable Models

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

Portfolio Analysis Model (PAM), v1.3.2 [\(1\)](#)

Additional Disclosures

Solicitation Status

Endorsement Status

Catholic Health Initiatives (CO) EU Endorsed, UK Endorsed

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