FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Adventist, CA's 2024 Revs 'BBB+'; Downgrades Outstanding Debt; Outlook Stable

Wed 01 May, 2024 - 2:46 PM ET

Fitch Ratings - San Francisco - 01 May 2024: Fitch Ratings has assigned a 'BBB+' long-term rating to Adventist Health's (Adventist) taxable bonds series 2024 (issued by Adventist Health System) tax-exempt bonds series 2024A (issued by the California Health Facilities Financing Authority), and taxable bonds series 2024B and 2024C (issued by the California Public Finance Authority).

Fitch has also downgraded Adventist's Issuer Default Rating (IDR) to 'BBB+' from 'A' in conjunction with rating the system's series 2024, 2024A, 2024B, and 2024C bonds. The rating downgrade also applies to all of Adventist's outstanding rated debt.

Fitch has also downgraded Adventist's Short-Term CP note rating to 'F1' from 'F1+'. This reflects both the linkage to Adventist's 'BBB+' rating, as well as the organization's strong levels of liquidity to meet any short-term puttable debt requirements. Adventist also has a $400 million syndicated line of credit available that can be drawn upon for general corporate purposes. 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.

The Rating Outlook is Stable.

Proceeds from the series 2024A, B & C bonds will primarily be used to convert the organization's outstanding bridge loan that was originally used to help fund the acquisition of the two new Adventist Health hospitals to long-term debt. Proceeds will also be used to pay off the organization's outstanding line of credit balance, refinance and redeem certain portions of outstanding debt, fund various capital needs throughout the system, and pay for associated costs of issuance.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Adventist Health (CA)	LT IDR	BBB+ Rating Outlook Stable	Downgrade	A Rating Outlook Negative
Adventist Health (CA) /General Revenues/1 LT	LT	BBB+ Rating Outlook Stable	Downgrade	A Rating Outlook Negative
Adventist Health (CA) /General Revenues/1 ST	ST	F1	Downgrade	F1+

VIEW ADDITIONAL RATING DETAILS

The rating downgrade is primarily driven by the sizeable increase in leverage (approximately 31%) the system is taking on, in part to support the acquisition of two new hospitals into the system (Adventist Health Sierra Vista and Adventist Health Twin Cities). Following the transaction, along with the need to create long-term funding capacity at the system, long-term debt is projected to increase by approximately $750 million, which is a significant amount.

Adventist's liquidity and leverage metrics will be negatively impacted (from already lower levels) with projected debt service coverage projected of approximately 1.4x and cash to adjusted to debt of around 60%, which are down from the prior year's approximate 1.9x and 81% cash to adjusted debt position.

Fitch views the rationale behind the strategic acquisition favorably, which should help support the organization's competitive position over the long term. The acquisition should also help drive improved cash flow, as Adventist's new Central Coast market immediately becomes its top financially performing market.

The Outlook revision to Stable reflects demonstrated improved operational performance over the last 12-months with the expectation of continued progress. In fiscal 2023 (Dec. 31;

audited), Adventist recorded an operating income loss of approximately $108 million, which equated to a negative 1.8% operating margin and 3.0% operating EBITDA margin. While still challenged and low, the system's operating performance is much improved from fiscal 2022's larger operating loss of $241 million (negative 4.5% operating margin and 0.3% operating EBITDA margin).

Fitch expects the improved operating performance to continue. Progress has been supported by management's implementing of its operational turnaround plan, which has ultimately reduced costs and streamlined efficiencies. The plan's goal is to reach breakeven performance over the medium term, which Fitch views as attainable.

Adventist's credit strengths include continued leading market positions throughout its three-state hospital footprint, adequate liquidity position for the new rating level, and a reasonable and accretive strategic plan.

SECURITY

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

KEY RATING DRIVERS

Revenue Defensibility - 'bbb'

Maintenance of Leading Market Positions; Growing in Accretive Markets

Adventist's revenue defensibility remains '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). However, 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 lower double digits in highly fragmented (and sizable) markets, such as in Southern California and in certain segments of Northern California. The highest share reaches approximately 65% in the Mendocino County, Northern California market.

The system demonstrates good revenue defensibility in California, which is significant given the system's large provider presence and the high financial barrier to entry, with seismic compliant construction mandates, and therefore more expensive to build.

Adventist's newest market is the Central Coast service area, where the system recently acquired Adventist Health Sierra Vista (162 beds) and Adventist Health Twin Cities (122 beds) for approximately $600 million. The Central Coast market is characterized by a favorable payor mix, good demographic indicators, and solid demand for services. Fitch views this strategic acquisition favorably for the organization, which gives Adventist a solid position in a good market that should be financially beneficial to the system over the near-term.

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 by California's provider-fee funding. The overall payor mix remains heavily exposed to governmental payors, with approximately 76% of system gross payor revenue coming from Medicare and Medicaid. However, Adventist also benefits from supplemental reimbursement at its rural facilities, with Adventist operating the largest rural health clinic network in California.

Operating Risk - 'bbb'

Improved, but Challenged Performance in Fiscal 2023; Expected Operational Progress with Robust Capex Plan

The system's operating risk assessment remains 'Midrange' with the expectation of adequate cost management opportunities to continue supporting improved operating performance. In fiscal 2023 (Dec. 31), Adventist recorded an operating loss of approximately $108 million, which is significantly improved from the prior period's $241 million operating loss in fiscal 2022.

Fiscal 2023's improved operating performance translated into a better 3.0% operating EBITDA margin (up from 0.3%), and is in line with management's projections. Fitch anticipates operational performance to continue to track positively and reach between 6%-7% over the next 24-months, which should be attainable.

The observed operational improvements are largely related to the system's implemented operational turnaround plans, which have included reductions to various expenses by reducing contract labor and other workforce positions, capitalizing on group purchasing opportunities for additional savings, and reducing enterprise services expenses. Additionally, top-line revenue growth has been supported by positive payor contract rate increases, revenue cycle and throughput improvements, along with enhanced volumes.

Fitch anticipates Adventist will continue to reinvest in itself and grow in size and scale over the next several years. The system has a longer-term goal of becoming a $10 billion healthcare company by 2030 by building more provider sites, organic growth in existing sites, expanding into newer geographic locations and through additional affiliations. Adventist continues to robustly invest in its facilities across the system and is expected to spend around $1.2 billion over the next four years.

Financial Profile - 'bb'

Weakened Financial Profile; Little Cushion for Negative Downside

Fitch views Adventist's financial profile assessment as 'Weak' and consistent for the 'bb' assessment. Unrestricted cash and investments totaled approximately $2.1 billion in fiscal 2023 (Dec. 31; audited), which equated to approximately 132 day's cash on hand (DCOH) and 80.7% cash to adjusted debt. After incorporating the series 2024 debt issuance, Fitch anticipates DCOH and cash to adjusted debt to be around 120 days and 60%, respectively, which is a primary trigger for the rating downgrade.

Despite the rating downgrade and lower rating level, Fitch believes the system's debt capacity is somewhat limited. Fitch does not anticipate any significant new debt issuances over the near term without commensurate increases in revenue sources to support additional associated leverage expenses.

Through Fitch's base scenario, or Fitch's best estimate of the most likely scenario of financial performance over the next five years, given the agency's expectations for current economic conditions and operational performance, Adventist will see continued improvement in operating performance metrics after the recent period of lower margins. Fitch expects the improvement to continue over the medium to long term, which should help support some growth to Adventist's unrestricted balance sheet resources. However, as capital expenditures are expected to be heavy over the near term, balance sheet resource growth is anticipated to be fairly limited.

Fitch's stress scenario assumes an economic pressure to reflect potential revenue downturn and equity volatility, understanding that the system is already in a period of operational stress. With the applied stress, Fitch's forward-looking analysis shows cash to adjusted debt of around 50% in the out years of the five-year scenario analysis, which is low.

Fitch's forward-looking portfolio sensitivity analysis is based on Adventist's specific asset allocation, with 32.8% in cash and fixed income, 41.1% in domestic and international equities and the remaining portion in hedge funds/alternative investments. If Adventist is not able to meet its long-term budgeted operating performance goals, while maintaining (if not growing) unrestricted balance sheet resources at or near current levels, further negative rating pressure may be warranted.

Asymmetric Additional Risk Considerations

No asymmetric risk considerations were relevant to the rating.

RATING SENSITIVITIES

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

--Although unanticipated, if operating EBITDA margins revert from current progression, which demonstrates a limited ability to meet improved operating performance projections;

--If unrestricted liquidity metrics materially decline from projected pro forma levels such that cash to adjusted debt is below 60% for a sustained period of time;

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

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

--Substantial improvement to Adventist's operating performance; a higher rating level over the two-year Outlook period would be driven primarily by exceptionally positive impacts to Adventist's unrestricted liquidity position most likely stemming from robust cash flow generation;

--Longer-term positive rating action will be contingent on Adventist fully achieving and/or exceeding its plan to return operational performance to historical levels, while improving its liquidity ratios.

PROFILE

Adventist Health has 28 hospitals that are located in three states (Hawaii, 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 2023 (Dec. 31, 2023; audited) was approximately $6 billion.

One of Adventist's main credit strengths is the size of its network with total operations spanning four states operating 442 clinics, which account for approximately 2.7 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) over the longer term.

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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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

Dodd-Frank Rating Information Disclosure Form

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