



## Fitch Rates Advocate Aurora Health's Taxable CP Program 'F1+'; Affirms IDR and Rev Bond Rating

Fitch Ratings-Chicago-22 February 2019: Fitch Ratings has assigned an 'F1+' short-term rating to Advocate Aurora Health's (AAH) taxable commercial paper (CP) program. Fitch has also affirmed the following ratings for AAH:

- Issuer Default Rating (IDR) at 'AA';
- Revenue bonds issued by the Wisconsin Health and Educational Facilities Authority, Illinois Finance Authority, and Illinois Health Facilities Authority on behalf of AAH as well as taxable fixed-rate bonds issued directly by AAH at 'AA';
- Existing variable rate debt supported by self-liquidity at 'F1+'.

The Rating Outlook is Stable.

The taxable CP program will be supported by AAH's internal liquidity and used initially to refund \$49 million of outstanding series 2008-C-2A variable rate demand obligation (VRDO) bonds that are supported by a standby bond purchase agreement (SBPA). The taxable CP program will also be available for general corporate purposes.

### SECURITY

Bonds are unsecured joint and several obligations of the obligated group. The obligated group consists of the vast majority of AAH hospitals, the Advocate Aurora Health parent, and the Advocate Health Care Network and Aurora Medical Group physician practices.

### ANALYTICAL CONCLUSION

The long-term 'AA' rating on AAH is driven by the system's very strong financial profile assessment, leading market position over a broad and diversified service area covering the population centers of two states (albeit with competition in many key markets), and expectations for maintenance of a strong operating profile. The Stable Outlook reflects Fitch's expectation that AAH will sustain strong capital-related ratios through the cycle in the stressed rating case of Fitch's FAST scenario analysis.

The 'F1+' short-term rating is based on AAH maintaining a long-term rating of at least 'AA-' as well as adequate internal liquidity and written procedures consistent with Fitch's criteria. AAH has "eligible" discounted cash, U.S. Treasuries, municipal bonds, and corporate bonds in excess of the 125% threshold of its maximum self-liquidity funding exposure for assignment of the 'F1+' rating.

## KEY RATING DRIVERS

### Revenue Defensibility: 'bbb'; Largest Health System in Two States

AAH's revenue defensibility is midrange. The system has a broad market reach operating in multiple markets across Illinois and Wisconsin, and is the largest health system in both states.

### Operating Risk: 'a'; Expectation of Strong Operating Margins with Manageable Capital Plans

AAH's operating risk profile is strong. The combined system has a track-record of generating double-digit operating EBITDA margins. Capital spending plans are manageably elevated.

### Financial Profile: 'aa'; Strong Capital-Related Ratios

AAH's financial profile is strong. Continued profitability and strong operating EBITDA margins should lead to maintenance of favorably negative net adjusted debt-to-adjusted EBITDA and strong cash-to-adjusted debt.

### Asymmetric Additional Risk Considerations

There are no asymmetric risk factors identified with AAH's rating.

## RATING SENSITIVITIES

**EXPECTATION OF STRONG MARGINS AND CAPITAL-RELATED RATIOS:** Fitch expects that the combined AAH system will maintain strong operating margins, as Advocate Health Care and Aurora Health Care did separately for years. On a combined basis, AAH's operating EBITDA margin averaged over 11% over the last six years. Fitch expects AAH to sustain an operating EBITDA margin in the 9% range or better in Fitch's FAST base case. Even under the stressed rating case, Fitch expects AAH to maintain strong capital-related ratios through the cycle. Unexpected material integration challenges leading to sustained weakening of operating margins and capital-related ratios could pressure the rating downward.

## CREDIT PROFILE

AAH is the result of the April 2018 merger between Advocate Health Care (IL) and Aurora Health Care (WI). The system includes 25 hospitals, approximately 3,500 employed physicians, and operates roughly 500 outpatient locations and 100 retail clinics in contiguous markets stretching from Bloomington/Normal in central Illinois in the south, through Chicago and Milwaukee, to Green Bay in the north. AAH is the largest healthcare provider in both Illinois and Wisconsin. AAH is utilizing a co-CEO management model. Combined, AAH recorded \$11.5 billion in revenue in 2017 and was on-track to approach \$12 billion in 2018.

### Revenue Defensibility

AAH's payor mix is midrange. Combined Medicaid and self-pay accounted for 18% of 2017 combined gross revenues (18.2% through nine months 2018), and Fitch expects the system will sustain payor mix well in-line with mid-range characteristics (under 25%). Illinois expanded Medicaid

under the Affordable Care Act (ACA). While Wisconsin did not expand Medicaid under the ACA guidelines, the state did expand eligibility in prior years.

AAH's market position is midrange. The system operates 25 hospitals and more than 500 outpatient locations covering multiple markets between central Illinois and north Wisconsin. AAH is the market share leader in both states. Despite the leading position, the system operates in many competitive service areas, notably Chicago (where AAH is the market share leader in a crowded market) and Milwaukee, the population hubs of the combined service area. AAH's largest competitor is Ascension Health (AA+), which also operates multiple facilities in both the Milwaukee and Chicago markets. AAH also has one of the largest and most sophisticated physician integration models in the industry with broad population health management capabilities, including employing approximately 3,500 physicians.

Like most large multi-market health systems, AAH operates in varying service area profiles. The system's service area characteristics are generally stable supporting a midrange assessment. Much of suburban Chicago (e.g., Lake County), suburban Milwaukee, and other markets such as Brown County, WI (Green Bay) demonstrate generally favorable characteristics such as median household income levels in-line with or better than the national average and low poverty rates. Fitch does not expect AAH's payor mix to change materially in the coming years.

#### Operating Risk

AAH's operating cost flexibility is strong. Combining Advocate's and Aurora's financial statements, over the last six years (through nine months fiscal 2018) the combined system's operating EBITDA margin averaged over 11% (including 10.1% in fiscal 2017 and 9.7% through nine months fiscal 2018).

Looking forward, Fitch expects that AAH's operating EBITDA margin may be somewhat compressed as the system merges functions and executes strategies. Nevertheless, we assume in the base case of Fitch's FAST scenario analysis that AAH will sustain an operating EBITDA margin in the 9% range -- if not better -- in the coming years.

Fitch expects AAH's capital expenditure requirements to be only elevated in the coming years. The system has approximately \$1.3 billion of capital spending plans in 2019 (translating to a capital spending ratio of more than 2.2x). Capital spending is expected to remain high in 2020 with a capital spending ratio of approximately 2x. After 2020, the capital spending ratio is expected to moderate to the 1.3x-1.4x range. AAH's capital spending is focused on continued ambulatory development. Fitch believes the system's capital plans are flexible, and management would have the ability to downsize/defer projects if needed. While AAH does not currently have new money debt plans, Fitch expects a system of AAH's scope and scale will access the capital markets from time-to-time.

#### Financial Profile

AAH has approximately \$3 billion of debt outstanding. Unrestricted cash and investments measured nearly \$7.9 billion at Sept. 30, 2018 (unaudited).

AAH's debt equivalents are manageable, measuring roughly \$705 million at fiscal year-end 2017. Combined, AAH has three defined benefit pension plans, two of which are frozen. The three plans combined were only \$67 million underfunded at year-end 2017 relative to a projected benefit

obligation of just over \$2.6 billion, translating to a funded status of 97%. Because the pension plan is more than 80% funded, Fitch does not include the underfunded status in calculating adjusted debt. Operating lease expenses totaled \$141 million in fiscal 2017, translating to a debt equivalent of \$705 million (based on 5x lease expense). Consequently, AAH's adjusted debt (direct debt plus underfunded defined benefit pension plan below 80% funded plus operating leases) measures \$3.7 billion. Net adjusted debt (adjusted debt minus unrestricted cash and investments) is negative at \$4.2 billion, and Fitch expects it to remain favorably negative, including through the cycle in the rating case over the next five years.

Per Fitch's FAST scenario analysis, AAH's capital-related ratios should be consistent with the broad 'AA' category, including in the stressed rating case. Based on combined fiscal 2017 results, AAH's net adjusted debt-to-adjusted EBITDA measures nearly negative 3x and cash-to-adjusted debt is over 200%. In the rating case (which assumes a modest recession in year one followed by a recovery and then stability), net adjusted debt-to-adjusted EBITDA remains below negative 1x through the cycle and cash-to-adjusted debt does not fall below 150% and measures nearly 200% by year five.

The 'F1+' short-term rating is based on AAH maintaining a long-term rating of at least 'AA-' and is consistent with Fitch's "U.S. Public Finance Short-Term Debt Rating Criteria." AAH maintains sufficient discounted internal liquid resources (composed of cash, U.S. Treasuries, municipal bonds, and corporate bonds) and has implemented written procedures to fund any un-remarketed put on the \$545 million of maximum potential pro forma debt supported by self-liquidity. AAH's self-liquidity supported demand debt is comprised of \$70 million of series 2011B VRDO bonds in Windows mode (due seven months after a put) as well as the \$475 million maximum authorized under the expected taxable CP program (management notes that initially AAH will only draw \$50 million of the CP). Based on Fitch's rating criteria related to U.S. Public Finance Short-Term Debt, AAH had "eligible" cash, U.S. Treasuries, municipal bonds and corporate bonds in excess of the 125% threshold of its maximum self-liquidity funding exposure for assignment of the 'F1+' rating. Using Fitch's Criteria, coverage of self-liquidity debt measures 2.6x. Management notes further that the CP program is structured that only \$50 million of CP can be called within a seven day period. AAH also has \$275 million of bank lines of credit available.

#### Asymmetric Additional Risk Considerations

There are no asymmetric risk factors associated with AAH's rating.

The senior management team is deep and is comprised of members of both the legacy Advocate and Aurora systems. The combined system currently is utilizing a co-CEO model. AAH's chief medical officer retired in late 2018. The system does not have any additional near-term senior management retirements planned.

AAH will have approximately \$3 billion of debt outstanding. The initial \$50 million draw on the CP program will refund the series 2008-C-2A bonds that are supported by an SBPA. AAH's pro forma variable rate debt is comprised of the planned taxable CP, mandatory tender bonds, floating-rate notes, Windows, direct loans, and VRDO bonds. The VRDO bonds are supported by standby bond purchase agreements (SBPA) that expire in August 2020 and August 2021, respectively. Maximum annual debt service (MADS) is \$191 million. Based on nine months fiscal 2018 results (unaudited, as of Sept. 30, 2018), MADS coverage is 7.5x and does not pose an asymmetric risk. The MTI includes

a minimum historical debt service coverage covenant of 1.10x.

AAH has fixed payor swaps with Wells Fargo Bank and PNC Bank. The notional amount of the swaps outstanding is roughly \$325 million and they will mature in November 2038. The swaps had a net termination value of negative \$74 million to AAH at Dec. 31, 2017 and negative \$57 million at Sept. 30, 2018.

AAH had over 260 days cash on hand at Sept. 30, 2018, and cash on hand does not pose an asymmetric risk.

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Applicable Criteria

Fitch Internal Liquidity Worksheet (pub. 15 Feb 2019)

Rating Criteria for Public-Sector, Revenue-Supported Debt (pub. 26 Feb 2018)

U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria (pub. 04 Feb 2019)

U.S. Public Finance Short-Term Debt Rating Criteria (pub. 01 Nov 2017)

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