



## Fitch Rates Advocate Aurora Health's (IL, WI) Series 2019 'AA'; 'AA' IDR Affirmed; Outlook Stable

Fitch Ratings-Chicago-30 October 2019: Fitch Ratings has assigned a 'AA' Long-Term rating to Advocate Aurora Health's (AAH) approximately \$366 million of series 2019 taxable fixed rate revenue bonds. The series 2019 bonds are to be issued directly by AAH. In addition, Fitch has affirmed the following:

- AAH's Issuer Default Rating (IDR) at 'AA';
- Outstanding 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'.

AAH has variable rate debt and commercial paper (CP) debt supported by self-liquidity, which has a Short-Term rating of 'F1+'.

The Rating Outlook is Stable.

Bond proceeds will be used to refund all or portions of AAH's Series 2011A-2, Series 2012, Series 2013A, and Series 2014 fixed rate revenue bonds, and pay the costs of issuance. The bonds are not expected to be supported by a debt service reserve fund (DSRF). The series 2019 taxable bonds are expected to price the week of November 4.

### 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

AAH's Long-Term 'AA' rating 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 Rating Outlook reflects Fitch's expectation that AAH will continue to sustain strong-capital related ratios through Fitch's forward-looking scenario analysis, even under a stress case scenario.

## 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 the major population centers of Illinois and Wisconsin. AAH is the largest health system in both states. Fitch expects the system's payor mix to remain easily under the 25% threshold for a midrange assessment.

### 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 manageable. While the operating EBITDA margin may soften a bit to the 9% range, AAH has sufficient operating flexibility.

### 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 AAH will continue to generate strong operating margins, as Advocate Health Care and Aurora Health Care did separately for years, and are currently doing as a combined system. AAH's combined operating EBITDA margin averaged better than 11% over the last five fiscal years. Fitch expects AAH to sustain an operating EBITDA margin in the 9% range, and possibly better. AAH is expected to maintain strong capital-related ratios through the cycle, including in a stress case in Fitch's forward-looking scenario analysis. Unexpected operational challenges leading to sustained weakening of operating margins and notably thinner capital-related ratios could pressure the rating.

## CREDIT PROFILE

AAH is the result of the April 2018 merger between Advocate Health Care (IL) (Advocate) and Aurora Health Care (WI) (Aurora). The system includes 26 acute care hospitals and one behavioral health hospital (totaling more than 6,600 licensed beds), approximately 3,700 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 Marinette, WI in the north. AAH is the largest healthcare provider in both Illinois and Wisconsin. Combined, AAH recorded more than \$9 billion in operating revenue in the audited nine-month fiscal 2018 period (as of Dec. 31, 2018), which translates to over \$12 billion annualized.

## Revenue Defensibility

AAH's payor mix is midrange. Combined Medicaid and self-pay accounted for 17% of gross revenues in 2018 (16.5% through six months 2019), well in line with a midrange revenue source characteristic (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 27 hospitals and more than 500 outpatient locations in multiple markets covering a contiguous service area stretching from central Illinois and to northern 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, and nearly three million unique lives touched.

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 overall operating risk profile is strong, driven by strong operating cost flexibility and manageable capital spending. Combining Advocate's and Aurora's financial statements, over the last five years (including the nine-months audited period ended Dec. 31, 2018) the operating EBITDA margin averaged 11.6%. The operating EBITDA margin measured a somewhat softer 9.7% in audited fiscal 2018 as the system continues to integrate. The operating EBITDA margin measured 10.1% through six-months unaudited fiscal 2019. These operating margins do not include nonrecurring operating expenses (e.g., early retirement incentive plans, one-time Epic EMR upgrade/installation costs, and other one-time merger costs).

Management notes that AAH exceeded its revenue growth and operating margin targets in fiscal 2018, as the system is on track to achieve savings through the integration process. In interim fiscal 2019, while inpatient admissions are down, AAH has benefited from volume gains in other key areas such as surgeries, observation stays, and total outpatient visits.

Looking forward, Fitch expects AAH's operating EBITDA margin will be maintained at least in the 9% range, which is consistent with a strong assessment. The system continues to merge functions and execute on strategic initiatives.

Fitch expects AAH's capital expenditure requirements to be only elevated in the coming years. The system's average age of plant measured a healthy 9.5 years at FYE 2018 (AA median is 10.6 years). AAH's capital spending ratio averaged approximately 140% of annual depreciation over the last six years (including six-months fiscal 2019).

Over the next five years (including 2019) AAH is expected to spend approximately \$3.5 billion in capital, which is a capital spending ratio of approximately 120%. With this pace of capital spending, AAH's average age of plant should not increase much if at all. Capex plans remain focused on continued ambulatory development. In addition, the system has been working to convert Advocate legacy assets to Epic EMR; the Advocate physicians were on Epic as of spring 2019, and the first two Advocate hospitals were on Epic in fall 2019. Fitch believes the system's capital plans are flexible, and management would have the ability to downsize/defer projects if needed. Management is considering a comparatively modest debt issuance in the next year or two; moreover, Fitch expects a system of AAH's scope and scale to access the capital markets from time-to-time.

#### Financial Profile

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.

AAH has approximately \$3 billion of pro forma debt outstanding. Unrestricted cash and investments measured just over \$7.5 billion at FYE 2018 and just over \$8 billion at unaudited June 30, 2019.

AAH's debt equivalents are manageable. Combined, AAH has three defined benefit (DB) pension plans, two of which are frozen. The three plans combined were only approximately \$150 million underfunded compared to a projected benefit obligation (PBO) of just under \$2.5 billion at FYE 2018, translating to a funded status of 94%. Because the pension plan is more than 80% funded, Fitch does not include the underfunded status in calculating adjusted debt. The system plans to freeze the third DB pension plan (the Advocate plan) as of Dec. 31, 2019. Operating lease expenses totaled roughly \$95 million in the nine months fiscal 2018 audit period. AAH adjusted debt (direct debt plus underfunded defined benefit pension plan below 80% funded plus operating leases) measured approximately \$3.5 billion at FYE 2018. Net adjusted debt (adjusted debt minus unrestricted cash and investments) is negative at roughly \$4 billion, and Fitch expects it to remain favorably negative, including through a potential stress cycle in the Fitch's forward-looking scenario analysis over the next five years.

Per Fitch's forward-looking scenario analysis, AAH's capital-related ratios should be consistent with the broad 'AA' category, including in the stress case scenario. Based on fiscal 2018 results, AAH's net adjusted debt-to-adjusted EBITDA measures better than negative 2x and cash-to-adjusted debt exceeds 200%. In the stress case (which assumes a modest recession in year one followed by a recovery and then stability), net adjusted debt-to-adjusted EBITDA remains favorably negative in every year through the cycle and cash-to-adjusted debt does not fall below 150% and exceeds 200% by year five.

#### 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. After initially utilizing a co-CEO model, the former CEO of Advocate is now serving as CEO of the combined system. The system does not have near-term senior management changes planned, although AAH has a robust succession planning process in place.

Including the refinancing, AAH will have approximately \$3 billion of pro forma debt outstanding. The system has a CP program in place and other variable rate debt supported by internal liquidity. The maximum theoretical self-liquidity supported debt outstanding is \$545 million. AAH's variable rate debt is comprised of 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 2021 and January 2024, respectively. Pro-forma maximum annual debt service (MADS) is \$200 million. Based on six months fiscal 2019 results (unaudited, as of June 30, 2019), pro-forma MADS coverage is very strong at 14x and does not pose an asymmetric risk. The MTI includes a minimum historical debt service coverage covenant of 1.10x.

AAH had nearly 250 days cash on hand at FYE 2018 and more than 260 days at June 30, 2019. Days cash does not pose an asymmetric risk.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

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Applicable Criteria

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 28 May 2019)

Short-Term Ratings Criteria (pub. 02 May 2019)

U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria (pub. 28 May 2019)

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

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