RATING ACTION COMMENTARY

Fitch Affirms Advocate Aurora Health's (IL) IDR at 'AA'; Outlook Stable

Fri 21 Jul, 2023 - 1:01 PM ET

Fitch Ratings - Chicago - 21 Jul 2023: Fitch Ratings has affirmed Advocate Aurora Health's (AAH) Issuer Default Rating (IDR) at 'AA'. Fitch has also affirmed at 'AA' the outstanding revenue bonds issued directly by AAH or by the Wisconsin Health and Educational Facilities Authority or Illinois Finance Authority on behalf of AAH.

The Rating Outlook is Stable.

In addition, Fitch has affirmed AAH's short-term rating at 'F1+' on variable rate debt and CP debt supported by AAH's self-liquidity.

Advocate Health Joint Operating Agreement (JOA)

AAH is now a member of Advocate Health. Advocate Health is the result of the December 2022 combination of AAH and Charlotte, NC-based Atrium Health. The combined Advocate Health system recorded more than $28 billion in operating revenue in FY 2022. While the organizations have not yet combined debt obligations, Advocate Health operates with a common management team and one board and the system is already deeply integrated. Most of the financial ratios in this release reference the combined Advocate Health (unless otherwise noted). For the rest of this release "Advocate Health" and "Advocate" refer to the new combined system, while "AAH" refers to the legacy Advocate Aurora Health.

RATING ACTIONS

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Analytical Conclusion

AAH's 'AA' IDR considers a very strong financial profile in the context of an already sound market position and geographic reach that is enhanced by the recent combination with Atrium and formation of Advocate Health. Combined, Advocate Health treats nearly six million unique patients in more than 1,000 sites of care (including 67 hospitals) across six states in the Midwest (Illinois and Wisconsin) and Southeast (North Carolina, South Carolina, Georgia, and Alabama). The system also benefits from being the primary teaching affiliate of the Wake Forest University School of Medicine. While like most acute care providers in the U.S., Advocate's operating margins were compressed in FY 2022 due to macro trends such as labor pressures and inflation, Fitch believes that the system has the foundation to generate good margins in the long term. Moreover, Advocate's combined capital-related metrics should remain quite strong in Fitch's forward-looking scenario analysis, even in a stress case.

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.

SECURITY

AAH bonds are unsecured joint and several obligations of the obligated group, which consists of the vast majority of AAH hospitals, the AAH parent, and the Advocate Health Care Network and AAH physician practices. Atrium Health and AAH are not yet co-obligated on each other's debt.

KEY RATING DRIVERS

Revenue Defensibility - 'bbb'

Broad Reach Across Multiple Service Areas; Competition Present in Key Markets

Advocate Health has diversified operations across multiple markets in six states in distinct regions of the U.S. (the Midwest and Southeast). While diversified among many service areas, hospital operations are centered around the Chicago area in Illinois, Milwaukee and Green Bay in Wisconsin, Charlotte and Winston-Salem in North Carolina, and the Macon area in Georgia. AAH is the largest health system in both Illinois and Wisconsin, and Advocate maintains the market lead in most core service areas, although competition is present in many 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 3,600 physicians.

Advocate Health operates in varying service area demographic profiles, as expected from a large and geographically diverse health system. 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 sound characteristics such as median household income levels in-line with or better than the national average, although population trends tend to be somewhat stagnant. The Charlotte metro area and Winston-Salem area enjoy generally favorable demographics with strong population growth. Combined Advocate Health system Medicaid and self-pay area below Fitch's threshold of 25% of gross revenue for a midrange assessment. Illinois expanded Medicaid under...
the Affordable Care Act (ACA). While Wisconsin did not expand Medicaid under the ACA, the state did expand eligibility in prior years. North Carolina has legislation pending to expand Medicaid per the ACA.

**Operating Risk - 'a'

**Track-Record of Sound Operating Results; Macro Trends Compressed Margins in 2022**

Both AAH and Atrium have a track record of sound operating results. Together (per management combination of audited results), the combined Advocate Health would have generated an average operating margin of roughly 3.1% and operating EBITDA margin of about 8.5% in the four years prior to FY 2022, despite the pandemic (and of course these ratios do not include any potential efficiencies or synergies from the combination). Like the rest of the sector, Advocate Health was not immune to macro labor and inflationary pressures, as well as a spike in average length of stay (ALOS), in 2022. As a result, the combined system recorded a -0.8% operating margin and 4.3% operating EBITDA margin in FY 2022.

While Advocate Health’s operating metrics were pressured in 2022, Fitch notes that margin compression was in-line with industry trends. Also, these trendline of results for the combined Advocate Health track those of AAH, which recorded an average operating margin of 3.7% and operating EBITDA margin of 8.9% between FY 2018 and FY 2021, which compressed to -0.3% and 4.7%, respectively, in FY 2022.

Moving forward, Fitch expects Advocate Health to show steady improvement and to record solid profitability and an operating EBITDA margin closer to historical averages. Favorably, Advocate was profitable in 1Q FY 2023 with a 0.1% operating margin and the operating EBITDA margin improved to 5.1% (compared to -1.4% and 3.6%, respectively, for 1Q FY 2022) (the legacy AAH’s operating margin improved to 2.5% in 1Q23 from 0.1% in 1Q22). The gain in 1Q23 over the same period 2022 (and over budget) is due to: volume growth in many key areas, including discharges (up 8.5% over 1Q22), observation stays (up nearly 18%), and surgeries (up 9.4%); a decline in ALOS, from 6.02 days to 5.62 days; and recording $36 million of FEMA reimbursement.

Fitch notes that these improvements are only the early stages of management’s expected synergies from the combination. Management has identified significant opportunities over the next three years. Key areas of synergies and efficiencies include: supply chain, pharmacy optimization, revenue cycle, continued reduction in contract labor and nurse vacancy, and IT consolidation. Also, there are potential changes to Medicaid in North Carolina that could yield additional benefits to Advocate.

**Capital Spending**

Advocate Health has maintained a steady pace of capital spending over time (e.g., AAH’s capital spending ratio averaged about 1.1x between FY 2018 and FY 2022, while Atrium’s averaged more than 1.5x between FY 2019 and FY 2022). The combined system’s average age of plant measured a sound 11.4 years at FYE 2022. Fitch expects the Advocate system will continue to reinvest in its plant, and at a manageable pace. The 2023 capex budget is just under $2 billion. Highlighted ongoing and future projects include a replacement hospital in Sheboygan (WI), a new hospital/MOB in Mt. Pleasant, a new patient tower in Winston-Salem (NC), a new hospital in Cornelius (NC), expansion of Greensboro presence, and the Pearl (a joint venture education and research project in Charlotte with the Wake Forest School of Medicine). Both AAH and Atrium are on the Epic EMR platform, so a major EMR update is not required at this point. Fitch expects that a system of Advocate’s scope and reach will access the debt markets on a regular basis.

**Financial Profile - ‘aa’**
Very Strong Capital-Related Ratios Should be Sustained

Advocate Health's financial profile is strong, reflective of the combined balance sheet strength of AAH and Atrium. Capital-related ratios should remain strong in the forward-looking scenario analysis, including in a stress case.

At FYE 2022, combined Advocate Health had approximately $19.6 billion of unrestricted cash and investments (nearly $10.7 billion at AAH) and almost $9.1 billion of debt ($3.9 billion of which was AAH). Collectively, Advocate sponsors six private defined benefit (DB) pension plans, each of which is at least 80% funded (Fitch's threshold for inclusion as a debt equivalent). Atrium also has the Charlotte-Mecklenburg Hospital Authority (CMHA) government DB pension, which is approximately 60% funded. Even including the underfunded CHMA DB plan as a debt equivalent, Advocate Health's net adjusted debt (adjusted debt minus unrestricted cash and investments) is favorably negative and cash-to-adjusted debt exceeds 200%.

Advocate's capital-related ratios should remain strong, even in the stress case of Fitch's forward-looking scenario analysis. In the stress case, net adjusted debt-to-adjusted EBITDA is favorably negative in every year and cash-to-adjusted debt does not drop below 195% (and exceeds 250% by year four).

The 'F1+' short-term rating is based on AAH maintaining a long-term rating of at least 'AA-'. AAH maintains sufficient discounted internal liquid resources and has implemented written procedures to fund any un-reremarketed put on the approximately $1.1 billion of theoretical maximum potential debt supported by self-liquidity. AAH's self-liquidity supported demand debt includes puttable variable rate demand bonds (VRDB) not supported by standby bond purchase agreements (SBPAs) as well as the $1 billion maximum authorized under the taxable CP program.

Asymmetric Additional Risk Considerations

There are no asymmetric risk considerations affecting the rating.

Advocate Health's debt is comprised of approximately 50% variable rate and 50% fixed rate. Variable rate debt includes bank private placements, VRDB, floating rate notes (FRN), and CP. Combined Advocate Health maximum annual debt service (MADS) is $472 million, based on smoothing debt service. Advocate's MADS coverage based on FY 2022 results was sound at 4.4x (despite the softer cash flow generation) and does not pose an asymmetric risk. The legacy AAH's MADS coverage was 4.7x in FY 2022. AAH's MTI includes a minimum historical debt service coverage covenant of 1.10x.

The combined Advocate Health had just over 260 days cash on hand at FYE 2022 (AAH was nearly 280 days and Atrium just over 245 days), and therefore days cash does not pose an asymmetric risk.

RATING SENSITIVITIES

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

--Compression in operating margins, such that the operating EBITDA margin is expected to remain closer to 6% for a sustained period, which would lead to an operating risk profile more consistent with a midrange assessment;

--Weaker balance sheet metrics, leading to thinner capital-related ratios in the long term, particularly if compounded with a weaker operating risk assessment.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade
--Sustained improvement in operating EBITDA margin consistently above 10%;

--Considerable growth in unrestricted cash levels leading to superlative cash-to-adjusted debt.

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.

PROFILE

Advocate Health is the result of the December 2022 combination of AAH and Atrium. The combined system operates 67 hospitals and more than 1,000 sites of care. Advocate has acute care operations in six states: Illinois and Wisconsin (making up Advocate Health - Midwest, the legacy AAH); and North Carolina, South Carolina, Georgia, and Alabama (Advocate Health - Southeast, the legacy Atrium). Core hospital operations are diversified, with particular penetration around Milwaukee and Green Bay in Wisconsin, the Chicago area in Illinois, and Charlotte and Winston-Salem in North Carolina. Advocate Health treated nearly six million unique patients in 2022. Combined total operating revenue measured more than $28 billion in FY 2022, making Advocate one of the five largest not-for-profit health systems in the U.S.

Advocate Health is the largest health system in Illinois, Wisconsin, and North Carolina. The system is co-headquartered in Charlotte and Chicago until January 2024, after which Charlotte will be the HQ. The system is structured as a JOA, currently operating with co-CEOs: Eugene Woods (the CEO of the legacy Atrium) and Jim Skogsbergh (the CEO of the legacy AAH; Mr. Skogsbergh plans to retire in 2024). Advocate Health has a common board with 20 members (10 each from AAH and Atrium). While AAH and Atrium are not obligated on each other's respective debt, it is Fitch's belief that management and the board are committed to the combined Advocate Health system and are already deeply integrated.

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

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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APPLICABLE CRITERIA
U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria (pub. 18 Nov 2020) (including rating assumption sensitivity)
Public Sector, Revenue-Supported Entities Rating Criteria (pub. 27 Apr 2023) (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)

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ENDORSEMENT STATUS

Advocate Health and Hospitals Corporation

EU Endorsed, UK Endorsed

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