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

Mon 25 Jul, 2022 - 1:47 PM ET

Fitch Ratings - Chicago - 25 Jul 2022: 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, Illinois Finance Authority, and Illinois Health Facilities Authority on behalf of AAH.

The Rating Outlook is Stable.

Fitch has also affirmed AAH's Short-Term Rating at 'F1+' on variable rate debt and CP debt supported by AAH's self-liquidity.

SECURITY

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.

ANALYTICAL CONCLUSION

AAH's 'AA' IDR rating reflects the system's very strong financial profile and leading market position over a broad and diversified service area covering several population centers of
Illinois and Wisconsin. While margins were compressed in Q1 fiscal 2022 and will likely remain below trend in the near term as AAH contends with macro labor and inflationary pressures, the system has a track-record operating success and long-term Fitch believes margins should rebound to metrics consistent with a strong operating risk assessment over time as Fitch believes the system's fundamental operating platform remains strong.

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 is in negotiations to affiliate with Atrium Health. Atrium is headquartered in Charlotte, NC and operates hospitals in North Carolina, South Carolina, Georgia, and Alabama. The proposed affiliation is not factored into the current rating for AAH.

**KEY RATING DRIVERS**

Revenue Defensibility: 'bbb'

Largest Health System in Two States; Competition Present in Key Markets

AAH is the largest health system in both Illinois and Wisconsin, with a broad market reach and operating in multiple markets covering a contiguous service area stretching from northeastern Illinois (Chicago area) through Milwaukee to northeastern Wisconsin. Despite its leading market position, the system operates in many competitive service areas, notably Chicago (where AAH is the market 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 3,600 physicians, and covering nearly three million unique lives.

AAH 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 favorable characteristics such as median household income levels in-line with or better than the national average and low poverty rates. Combined Medicaid and self-pay remain below 20% of gross revenue (19% in fiscal 2021) and Fitch does not expect AAH's payor mix to change materially in the near term. 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.

Operating Risk: 'a'

Track-Record of Strong Operating Results; Macro Trend Compress Margins in Q1 2022

AAH has a track-record of generating strong operating EBITDA margins, averaging 9.1% between fiscals 2017 and 2021 (including 8.9% in 2021). Margins were compressed in Q1 fiscal 2022, with a 0.3% operating margin and 5.0% operating EBITDA margin, as the system faced macro headwinds affecting the entire sector including a surge of omicron COVID-19 cases in January and February, intense labor pressures, and elevated inflation. It is notable that while AAH's margins were compressed in Q1, the system was still profitable for the quarter (which did not include recording CARES Act grants) and many peer health systems suffered deep operating losses.

The weaker margins in Q1 2022 portend compressed operating metrics for full-year 2022 as the aforementioned macro pressures persist for the rest of the year and likely into 2023. Nevertheless, over the long-term, Fitch expects AAH's should rebound to levels consistent with a strong operating assessment.

Capital spending plans are manageable. AAH's capital budget for 2022 is nearly $1.2 billion. If AAH spends at that pace, the capital spending ratio would approach 2x, although the capex is flexible. The highlighted project is the construction of a new patient pavilion at Advocate Illinois Masonic Medical Center in Chicago. Beyond 2022, the capital spending ratio is expected to approximate 1x. AAH expects to issue $250 million of new money debt in 2023.

Financial Profile: 'aa'

Strong Capital-Related Ratios Should be Sustained

AAH's financial profile is very strong. Capital-related ratios should remain strong in the forward-looking scenario analysis, including in a stress case, despite the current macro pressures.

At FYE 2021, AAH had nearly $3.9 billion of direct debt and unrestricted cash and investments exceeded $11.6 billion. AAH's defined benefit pension plans remain well funded, with a funded ratio of 95% at FYE 2021 compared with a projected benefit
obligation of approximately $2.5 billion (because the pension plans are collectively more than 80% funded, Fitch does not include the underfunded status in calculating adjusted debt). Net adjusted debt (adjusted debt minus unrestricted cash and investments) was favorably negative at nearly -$7.8 billion at FYE 2021.

AAH's capital-related ratios should remain consistently strong, even in the stress case of Fitch's forward-looking scenario analysis. Cash-to-adjusted debt was 300% at FYE 2021 and net adjusted debt-to-adjusted EBITDA was favorably negative at approximately -3x. In the stress case of the scenario analysis, net adjusted debt-to-adjusted EBITDA is favorably negative by year two and cash-to-adjusted debt does not drop below 230% (and exceeds 300% 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-remarketed put on the $1.2 billion of theoretical maximum potential debt supported by self-liquidity. AAH's self-liquidity supported demand debt is comprised of its puttable VRDO bonds not supported by standby bond purchase agreements (SBPAs) as well as the $1 billion maximum authorized under the taxable CP program (only $50 million was outstanding as of March 31, 2022).

Asymmetric Additional Risk Considerations

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

Maximum annual debt service (MADS) is approximately $227 million, based on smoothing debt service (actual MADS is just over $820 million, based on a bullet payment in 2050). MADS coverage based on fiscal 2021 results was strong at approximately 11x and does not pose an asymmetric risk. The MTI includes a minimum historical debt service coverage covenant of 1.10x. AAH had approximately 330 days cash on hand at FYE 2021 (excluding Medicare advance payment funds and deferred employer FICA tax), and just over 300 days at unaudited March 31, 2022, and therefore days cash does not pose an asymmetric risk.

RATING SENSITIVITIES

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.
Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Unexpectedly prolonged compression in operating margins, such that the operating EBITDA margin is expected to remain below 7% for a sustained period beyond what Fitch currently expects, 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 an above-mentioned sustained weakening of operating EBITDA margin;

--If the proposed affiliation with Atrium leads to considerably tighter operating margins and/or much weaker balance sheet ratios, AAH’s rating could be pressured.

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.

AAH is the result of the April 2018 merger between Advocate Health Care (IL) (Advocate) and Aurora Health Care (WI) (Aurora). The system includes 24 acute care hospitals and one behavioral health hospital (totaling more than 5,100 staffed beds), approximately 3,600 employed physicians, and operates roughly 500 outpatient locations and 100 retail clinics in contiguous markets stretching from the Chicago metro area north through Milwaukee, to Marinette, WI in the north. AAH is the largest healthcare provider in both Illinois and Wisconsin. AAH recorded more than $14 billion in operating revenue in audited fiscal 2021 (Dec. 31 year-end).

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.

RATING ACTIONS

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VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS
Mark Pascaris  
Director  
Primary Rating Analyst  
+1 312 368 3135  
mark.pascaris@fitchratings.com  
Fitch Ratings, Inc.  
One North Wacker Drive Chicago, IL 60606

Kevin Holloran  
Senior Director  
Secondary Rating Analyst  
+1 512 813 5700  
kevin.holloran@fitchratings.com

Eva Thein  
Senior Director  
Committee Chairperson  
+1 212 908 0674  
eva.thein@fitchratings.com

MEDIA CONTACTS

Sandro Scenga  
New York  
+1 212 908 0278  
sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com

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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. 01 Sep 2021) (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
Solicitation Status
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ENDORSEMENT STATUS

Advocate Health and Hospitals Corporation EU Endorsed, UK Endorsed

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