Fitch Affirms Sutter Health (CA)'s Long-Term Rating at 'A'; Outlook Stable

Tue 26 Apr, 2022 - 1:15 PM ET

Fitch Ratings - Austin - 26 Apr 2022: Fitch Ratings has affirmed Sutter Health, CA's Long-Term Issuer Default Rating (IDR) and revenue rating at 'A' for outstanding bonds issued by or on behalf of Sutter Health.

The Rating Outlook is Stable.

SECURITY

The bonds are secured by a gross receivables pledge of the obligated group (OG).

ANALYTICAL CONCLUSION

Sutter Health, like many in the sector, saw pandemic-related operating losses in 2020, likely made more challenging operating in the complex and competitive Northern California market. Since that point, Sutter Health has implemented significant strategies and actions to sharply reverse those financial results, which has resulted in profitability in fiscal 2021 (audited YE results through Dec. 31, 2021).

Sutter appears to be well past additional operational and structural challenges that have impacted the organization over the last several years. Recent examples include the finalization of a number of collective bargaining renewal negotiations, successful negotiation
of any potential negative impact from public and legal scrutiny, and a favorable resolution from a federal antitrust lawsuit (Sidibe v. Sutter Health).

Additionally, Sutter Health's balance sheet has materially improved, and now sits at approximately 198 days cash on hand and more importantly, 143% cash to long-term debt, which provides the organization with additional flexibility at the existing rating level.

The Stable Outlook reflects Fitch's view that the system's broad delivery of care network will remain in strong demand in its markets and that cash flow will be maintained in the 7% to 8% operating EBITDA range for the near term, which is adequate to sustain Sutter Health's capital and strategic investments within expectations for the 'A' rating.

**KEY RATING DRIVERS**

**Revenue Defensibility: 'bbb'**

**Key Provider in Competitive Northern California Market**

Fitch assesses Sutter Health's revenue defensibility as midrange based on its position as a leading provider of a wide array of healthcare services in the competitive but demographically favorable markets in Northern California.

**Operating Risk: 'bbb'**

**Recovery in 2021**

Operating EBITDA margins in 2019 (-4.4% operating margin, 2.4% operating EBITDA margin) were thin due to expected higher expenses from construction and staffing of two new San Francisco hospitals, as well as unexpected wildfires and a sizable lawsuit settlement. Better, but still challenged margins in fiscal 2020 were primarily due to the disruptions caused by the pandemic, with a -2.7% operating margin and 4.2% operating EBITDA margin, respectively.

Since then, Sutter Health produced a much improved positive 1.4% operating margin (7.5% operating EBITDA margin) in fiscal 2021. Fitch believes Sutter Health's current operating risk expectations are still appropriately aligned with its 'midrange' assessment given our expectation that operating EBITDA margins are likely to settle around 7% to 8% over the near term. This level should be sufficient to fund Sutter Health's capital needs, but would not allow for significant balance sheet accretion. However, even modest operational
improvements from this level, or some moderation in capital spending would allow Sutter Health to improve unrestricted liquidity, and see positive rating movement.

Financial Profile: 'a'

Debt and Liquidity Metrics Support the 'A' Rating Category

Sutter Health's leverage metrics support the 'a' assessment in Fitch's scenario analysis, despite an applied investment portfolio stress and revenue stress.

Asymmetric Additional Risk Considerations

No asymmetric additional risk considerations were applied in this rating determination.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Maintenance of recent operational recovery with an operating cash flow that is consistently above 7%;

--Sustainable increase in unrestricted cash that yields a stronger cash-to-adjusted debt of over 100% with the Operating Risk driver assessed at strong, or of roughly 160% or higher if the Operating Risk driver is assessed at midrange;

--Ability to fund capital needs primarily from cash flow in future years without significantly depleting cash or materially increasing debt.

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

--Cash flow margins below 7% for a prolonged period of time;

--Significant capital needs that limit capital spending flexibility or exceeds cash flow generation;

--A significant drop, or a steady decline, in cash or material increase in 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.

CREDIT PROFILE

Headquartered in Sacramento, CA, Sutter Health is the parent of a large, integrated healthcare provider with 29 hospitals, two medical foundation organizations, ambulatory surgery centers and specialty centers serving over 3.2 million Californians. The system includes other healthcare related entities, including a modest-sized health plan, Sutter Health Plus (SHP). On a consolidated basis, the Sutter Health system reported over $14.2 billion in total system revenues in 2021.

Revenue Defensibility

Sutter Health's payor mix has a Medicaid (Medi-Cal) percentage that is around 19%, improving slightly to its current level from 22% in 2018. Medicare has also moderated to 43% in 2021 from 45% in 2018. With its Medicaid business, Sutter Health receives supplemental Medi-Cal payments from California’s provider fee program. Sutter Health recorded $257 million in the 2019 fiscal year, $162 million in the 2020 fiscal year, and $186 million in the 2021 fiscal year in net operating income from the hospital fee program.

Sutter Health is a well-recognized provider offering a full range of healthcare services primarily in Northern and Central California. With the move toward integrated delivery models and capitated lives (over 300,000), Sutter Health remains one of the largest systems in this broad market, along with Kaiser Permanente (AA-/Stable) and CommonSpirit (BBB+/Positive).

Sutter Health operates in a broad service area that encompasses generally favorable demographics and high population growth areas such as Sacramento, San Francisco and Alameda Counties. Lower Medicare, reflected in 43% of gross receivables, highlights the younger, commercially insured population in parts of this economically diverse market. There have been some residential shifts in the Bay Area market as residents relocated to lower cost of living locations during the pandemic.

Operating Risk
Sutter Health has had long-term inherent expense pressures from higher capital from state seismic regulation, high cost of living wages, and a sizable number of collective bargaining agreements. Nevertheless, management is continuing to search for opportunities to reduce costs, including recent FTE reductions, service consolidations and possible divestitures of certain non-core assets.

Management is also working on a longer-term forecast for business growth and limiting expenses to support additional growth in the face of inflationary pressures. Fitch expects that Sutter Health's cash flow margins should rebound to a level of around 7% to 8% in the near term. Sutter Health has targeted additional sustained benefit realization to be achieved through 2024, in areas of corporate services, revenue cycle, supply chain and through reduction in clinical variation. Full time equivalent (FTE) reductions have already occurred as a result of Sutter Health's improvement initiatives.

Capex

Sutter Health spent a considerable amount of capital in past years due to state mandated seismic requirements with all major hospital replacements completed. Net capex decreased significantly in 2020 to $428 million (57% of depreciation) and again in 2021 to $368 million (50% of depreciation). Capex are expected to increase to approximately $800 million to $900 million in 2022, which is a more manageable longer-term level for the system, particularly with more robust positive cash flow. Capex are expected to remain in that same range for the next several years, barring any future relief in the 2030 seismic mandates. Regardless of any future seismic relief, Fitch expects fairly high levels of annual capital spending given the competitive nature of this market.

Legal Settlements

Sutter Health settled two consolidated lawsuits in December 2019, one brought by California's Attorney General and the other brought by a class of self-funded payers. The $575 million settlement agreement received court approval and was paid in the third quarter of 2021. Sutter already recorded the expense for the settlement in their 2019 financials.

Sutter Health and several affiliates, including the Palo Alto Medical Foundation, agreed to pay $60 million to resolve claims that they violated the False Claims Act (FCA) by knowingly submitting inaccurate and unsupported information about the health status of individuals enrolled in Medicare Advantage plans.
Most recently, a jury in the U.S. District Court for the Northern California District Court sided in favor of Sutter Health in a $411 million anti-trust lawsuit (Sidibe v. Sutter Health) that alleged Sutter Health used anti-competitive business practices that inflated the cost of health care for patients across Northern California.

Financial Profile

Sutter Health's leverage metrics in 2021 improved due to higher liquidity reserves and is consistent with Fitch's expectations for a credit in the 'A' rating category. Cash-to-adjusted debt was 143% in 2021. Unrestricted cash at YE (excluding $592 million in Medicare accelerated funds and $102 million in deferred payroll taxes) was $7.2 billion. An outstanding $400 million a line of credit was repaid in early 2021.

Sutter Health's adjusted debt figure includes the $479 million operating lease liability reported on the balance sheet for 2021. Sutter Health's defined benefit plans were 98% funded at Dec. 31, 2021, and did not contribute to Fitch's adjusted debt metrics as it exceeded the 80% funding threshold.

Fitch's stress case scenario incorporates Fitch's stress assumptions of a sharp decline in investment portfolio values (-11.7%) and continued margin compression in 2022, returning to operating EBITDA of approximately 6% in the early years of the five-year scenario during a potential operational stress.

The scenario expects capital expenditures to be reduced by approximately 12% in a period of stress, which Fitch views as doable given Sutter Health's capital flexibility. Fitch's scenario is a sensitivity tool to analytically gauge the level of recovery after a plausible stress, and Sutter Health's longer-term leverage metrics currently correspond towards the middle part of the 'a' financial profile assessment given the system's 'midrange' operating risk assessment.

Asymmetric Additional Risk Considerations

No asymmetric additional risk considerations were applied in this rating. Debt outstanding is composed of fixed rate debt. The system has access to a $900 million line of credit that is not currently drawn. Maximum annual debt service is calculated at $301.6 million, and does not pose an asymmetric risk, nor does Sutter Health's asset allocation, which is considered standard for the sector, with a mix of fixed income instruments, followed by a fairly equal split of equities and alternatives and other investments.

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

<table>
<thead>
<tr>
<th>ENTITY / DEBT</th>
<th>RATING</th>
<th>PRIOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sutter Health (CA)</td>
<td>LT IDR</td>
<td>A Rating Outlook Stable</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Affirmed</td>
</tr>
<tr>
<td>Sutter Health (CA)</td>
<td>LT</td>
<td>A Rating Outlook Stable</td>
</tr>
<tr>
<td>/General Revenues/1</td>
<td></td>
<td>Affirmed</td>
</tr>
<tr>
<td>LT</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

FITCH RATINGS ANALYSTS

Kevin Holloran
Senior Director
Primary Rating Analyst
+1 512 813 5700
kevin.holloran@fitchratings.com
Fitch Ratings, Inc.
2600 Via Fortuna, Suite 330 Austin, TX 78746

Melanie Her
Director
Secondary Rating Analyst  
+1 415 732 5629  
melanie.her@fitchratings.com

Joanne Ferrigan  
Senior Director  
Committee Chairperson  
+1 212 908 0723  
joanne.ferrigan@fitchratings.com

MEDIA CONTACTS

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

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

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), v1.3.3 (1)
ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

ENDORSEMENT STATUS

Sutter Health (CA) EU Endorsed, UK Endorsed

DISCLAIMER & DISCLOSURES

All Fitch Ratings (Fitch) credit ratings are subject to certain limitations and disclaimers. Please read these limitations and disclaimers by following this link: https://www.fitchratings.com/understandingcreditratings. In addition, the following details Fitch's rating definitions for each rating scale and rating categories, including definitions relating to default. Published ratings, criteria, and methodologies are available from this site at all times. Fitch's code of conduct, confidentiality, conflicts of interest, affiliate firewall, compliance, and other relevant policies and procedures are also available from the Code of Conduct section of this site. Directors and shareholders' relevant interests are available at https://www.fitchratings.com/site/regulatory. Fitch may have provided another permissible or ancillary service to the rated entity or its related third parties. Details of permissible or ancillary service(s) for which the lead analyst is based in an ESMA- or FCA-registered Fitch Ratings company (or branch of such a company) can be found on the entity summary page for this issuer on the Fitch Ratings website.

In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the
availability of independent and competent third-party verification sources with respect to
the particular security or in the particular jurisdiction of the issuer, and a variety of other
factors. Users of Fitch’s ratings and reports should understand that neither an enhanced
factual investigation nor any third-party verification can ensure that all of the information
Fitch relies on in connection with a rating or a report will be accurate and complete.
Ultimately, the issuer and its advisers are responsible for the accuracy of the information
they provide to Fitch and to the market in offering documents and other reports. In issuing
its ratings and its reports, Fitch must rely on the work of experts, including independent
auditors with respect to financial statements and attorneys with respect to legal and tax
matters. Further, ratings and forecasts of financial and other information are inherently
forward-looking and embody assumptions and predictions about future events that by their
nature cannot be verified as facts. As a result, despite any verification of current facts, ratings
and forecasts can be affected by future events or conditions that were not anticipated at the
time a rating or forecast was issued or affirmed.

The information in this report is provided “as is” without any representation or warranty of
any kind, and Fitch does not represent or warrant that the report or any of its contents will
meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to
the creditworthiness of a security. This opinion and reports made by Fitch are based on
established criteria and methodologies that Fitch is continuously evaluating and updating.
Therefore, ratings and reports are the collective work product of Fitch and no individual, or
group of individuals, is solely responsible for a rating or a report. The rating does not address
the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned.
Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared
authorship. Individuals identified in a Fitch report were involved in, but are not solely
responsible for, the opinions stated therein. The individuals are named for contact purposes
only. A report providing a Fitch rating is neither a prospectus nor a substitute for the
information assembled, verified and presented to investors by the issuer and its agents in
connection with the sale of the securities. Ratings may be changed or withdrawn at any time
for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any
sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not
comment on the adequacy of market price, the suitability of any security for a particular
investor, or the tax-exempt nature or taxability of payments made in respect to any security.
Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for
rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable
currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued
by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a
single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the
applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001.

Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the “NRSRO”). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the “non-NRSROs”) and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

Copyright © 2022 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved.

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch’s international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch’s
approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

US Public Finance Healthcare and Pharma North America United States