



## RATING ACTION COMMENTARY

# Fitch Downgrades Sutter Health (CA) to 'A'; Outlook Stable

Mon 10 May, 2021 - 4:40 PM ET

Fitch Ratings - New York - 10 May 2021: Fitch Ratings has downgraded Sutter Health's Long-Term Issuer Default Rating (IDR) and revenue rating to 'A' from 'A+' for outstanding bonds issued by or on behalf of Sutter Health. The Rating Outlook has been revised to Stable from Negative.

## SECURITY

The bonds are secured by a gross revenue pledge of the obligated group (OG). The OG includes the 30 hospitals and other healthcare related entities.

## ANALYTICAL CONCLUSION

Even before the pandemic generated material operating losses in 2020, Sutter Health's softening margins in recent years revealed the challenges of operating in the complex and competitive Northern California market. Fitch believes that management is evaluating significant strategies and actions to sharply reverse recent financial results, but ongoing

pressures may limit Sutter's ability to sustainably recover to operating EBITDA margins much above the 7% level.

Sutter's balance sheet has historically lagged expectations for its rating and Fitch believes that it lacked the resiliency to support the previous 'A+' rating given the expectations for ongoing margin strain from escalating labor costs (a number of collective bargaining units are due for renewal negotiations in 2021), legal expenses and uncertainty from a separate federal antitrust lawsuit that is expected to go to trial this fall (Sidibe v. Sutter Health), possible increased capital expenditures from seismic requirements, certain contracting limitations from the injunctive relief from the UFCW lawsuit that received preliminary approval in March, and possible negative impact from recent public and legal scrutiny.

Despite these pressures, 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 ultimately be 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 Expected to Begin in 2021

Sutter Health's financial results are expected to improve in 2021 after two consecutive years of lower margins. Operating results declined sharply in fiscal 2020 (-2.7% operating margin, 4.2% operating EBITDA margin) primarily due to the disruptions caused by the pandemic.

Operating EBITDA margins in 2018 and 2019 were also thinner due to expected higher expenses from construction and staffing of two San Francisco hospitals, as well as to unexpected wildfires and a sizable lawsuit settlement. Fitch believes Sutter Health's current operating risk expectations are better aligned with the 'bbb' assessment given our expectation that operating EBITDA margin is likely to settle around 7% in the coming years, but most likely not until after 2021.

### **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. Fitch's analysis incorporates the anticipated payment of the UFCW lawsuit settlement in 2021 (preliminary but agreed upon \$575 million).

### **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:

--Significant and sustainable recovery showing a trajectory towards operating cash flow that is consistently above 8%;

--An upgrade may be considered if there is a sustainable increase in unrestricted cash that yields a stronger cash-to-adjusted debt of over 100% with the Operating Risk driver assessed at strong ('a'), or of roughly 160% or higher if the Operating Risk driver is assessed at midrange ('bbb');

--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:

--The 'A' rating would be pressured by cash flow margins below 7% for a prolonged period of time;

--Significant capital needs that limit capital spending flexibility and 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 million Californians. The system

includes other healthcare related entities, including a modest-sized health plan, Sutter Health Plus (SHP). SHP had more than 90,000 members as of the end of 2019. On a consolidated basis, the Sutter Health system reported over \$13 billion in total system revenues in 2020.

## **REVENUE DEFENSIBILITY**

Sutter Health's payor mix has a combined self-pay and Medicaid mix that is around 25%, with Medicaid growth of almost 4% from 2017 to 2020. Medicare has also increased to 45% in 2020 from 42.1% in 2017. The shift to governmental payors has contributed to recent margin compression.

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 and CommonSpirit.

Sutter Health operates in a broad service area that has generally favorable demographics and high population growth areas such as Sacramento, San Francisco and Alameda Counties. Lower Medicare, reflected in 45% of gross revenues, highlights the younger, commercially insured population in parts of this economically diverse market. There have been some temporary residential shifts in the Bay Area market as residents relocated to lower cost of living locations during the pandemic.

## **OPERATING RISK**

Sutter Health is anticipating improvement following the sharp margin decline in fiscal 2020, which was primarily due to the revenue loss and higher expenses during the pandemic. This amount was partially offset by almost \$800 million in federal stimulus funds, but even with CARES funding, Fitch calculates operating EBITDA of 4.2%. This follows a 2.4% operating EBITDA margin in fiscal 2019.

Sutter Health has 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 rationalizing costs to support the growth. Fitch expects that ultimately Sutter Health's cash flow margins should rebound to a level of around 7%, most likely after 2021.

### UFCW Legal Settlement

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 has now received preliminary court approval and is expected to be paid in the third quarter of 2021. Sutter already recorded the expense for the settlement in the 2019 financials. The settlement also provides for injunctive relief in the form of certain contracting requirements and certain limitations on out-of-network rates and charge master increases.

### Capital Expenditures

Sutter Health spent a considerable amount of capital in past years due to state mandated seismic requirements with all major hospital replacements completed. Net capital expenditures decreased significantly in 2020 to \$428 million (57% of depreciation) and is expected to increase again to approximately \$600 million in 2021, which is a manageable level for the system. Capital expenditures may increase further in a few years when the system will need to address 2030 seismic requirements at some of its hospitals, assuming there is no future relief in the seismic mandate. However, Sutter Health is re-evaluating its future delivery of care needs to determine the appropriate level and use of capital expenditures going forward. Fitch expects higher capital spending after 2022 given the competitive nature of this market.

## FINANCIAL PROFILE

Sutter Health's leverage metrics in 2020 improved slightly 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 123% in 2020. Unrestricted cash at YE (excluding \$999 million in Medicare accelerated funds and \$209 million in deferred payroll taxes) was \$6.8 billion but this includes \$575 million that is expected to be paid for the legal settlement later in 2021 and \$400 million from a line of credit that was repaid in early 2021. Excluding these additional funds, unrestricted cash would be relatively stable with the \$6.0 billion at YE 2019.

Sutter Health's adjusted debt figure includes the \$577 million operating lease liability reported on the balance sheet for 2020. Sutter Health's defined benefit plans were 90% funded at Dec. 31, 2020, 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 (-13.3%) and continued margin compression in 2021, returning to operating EBITDA of just above 7% in the later years of the five-year scenario. The scenario includes the expected payment of the UFCW lawsuit settlement in 2021. 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 correspond to the lower end of the 'a' financial profile assessment given the system's 'bbb' operating risk assessment.

## **ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS**

No asymmetric additional risk considerations were applied in this rating. Debt outstanding is primarily composed of fixed rate debt. Sutter Health tapped into a \$400 million line of credit in April 2020 that was repaid and terminated in the first quarter of 2021. The system has access to a new \$900 million line that is not currently drawn.

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](http://www.fitchratings.com/esg)

## RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Sutter Health (CA)	LT IDR	A Rating Outlook Stable	Downgrade	A+ Rating Outlook Negative
● Sutter Health (CA) /General Revenues/1 LT	LT	A Rating Outlook Stable	Downgrade	A+ Rating Outlook Negative

[VIEW ADDITIONAL RATING DETAILS](#)

## FITCH RATINGS ANALYSTS

### Olga Beck

Senior Director

Primary Rating Analyst

+1 212 908 0772

Fitch Ratings, Inc.

Hearst Tower 300 W. 57th Street New York, NY 10019

### Kevin Holloran

Senior Director

Secondary Rating Analyst

+1 512 813 5700

**Margaret Johnson, CFA**

Director

Committee Chairperson

+1 212 908 0545

**MEDIA CONTACTS****Sandro Scenga**

New York

+1 212 908 0278

sandro.scenga@thefitchgroup.com

Additional information is available on [www.fitchratings.com](http://www.fitchratings.com)**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 \(pub. 23 Feb 2021\)](#) (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), v1.3.2 ([1](#))

**ADDITIONAL DISCLOSURES**

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[Endorsement Policy](#)

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Sutter Health (CA)

EU Endorsed, UK Endorsed

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