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CREDIT OPINION
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Sutter Health, CA

Update to credit analysis

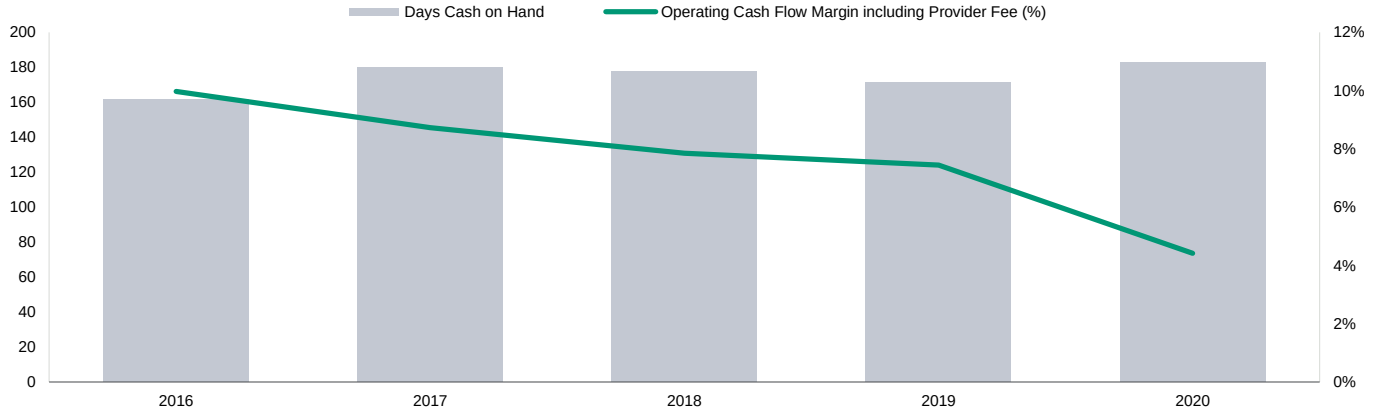
Summary

Sutter Health's (A1 negative) negative outlook reflects our expectation that the system will continue to face formidable headwinds which will sustain pressure on operations, and limit short term operating cashflow growth. Following weak operating results through much of 2020 and through the first quarter of 2021, operations are likely to remain modest through the rest of 2021, improving slowly over time. Challenges to operations include: an expensive cost structure driven by high wage rates; a difficult payer environment with only modest increases expected; and significant competition in most markets. Sutter is currently undertaking a comprehensive organizational improvement plan and intends to review all components of the organization with urgency.

Sutter faces a number of other challenges at this time. Nursing union contracts are expiring this summer, and negotiations may be challenging. Also, Sutter Health expects to finalize its settlement of the UFCW lawsuit this summer (which would result in an already accrued cash payment of $575 million, and the requirement to adhere to certain restrictions around payer contracting in the future, which may limit flexibility) and is involved in other litigation, including a second antitrust class-action lawsuit pending in federal court, which may entail additional costs. Other organizational challenges include: liquidity that remains below the medians for the rating category, despite recent short-term improvement (due to CMS advance funds, among other factors); and debt measures which remain comparably modest.

Favorably, Sutter will continue to benefit from a number of well-established strengths which continue to support the A1 rating. These include: Sutter's strong presence in northern California; its favorable size; its good market position in each of its markets; its strong and diversified clinical offerings located across the entire care continuum; its conservative asset-liability structure (including a large pension plan that has historically been well funded); and its integrated nature.

Exhibit 1
Operating results weakened in 2020, but balance sheet measures remained stable



Based on audited financial statements for Sutter Health, for fiscal years ended December 31; California State provider fee included in calculations; expenses in 2019 reduced by $644 million relating to lawsuit settlement and other one-time items; unrestricted cash and investments in 2020 exclude $999 million of CMS Accelerated and Advanced Funds, $209 million of deferred FICA payments, and $400 million related to a draw on a line of credit
Source: Moody's Investors Service

Credit strengths

» Sutter will continue to benefit from its contiguous footprint and strong presence in Northern California; Sutter has over $13 billion of operating revenues, operates 29 acute care facilities, and partners with over 2,500 physicians contracted through medical foundations.

» The healthy condition of Sutter's physical plant will remain a credit positive; having completed a large-scale, 20-year, seismic preparedness project, current projected capital spend is modest.

» Sutter's conservative asset-liability policy will remain a strength, consisting of all fixed rate debt, no swaps, and a historically well-funded pension program.

» It is anticipated that the California State provider fee program will continue to provide needed and very material ongoing operating support.

Credit challenges

» Operating results in 2021 are expected to remain modest, due to ongoing pressures related to COVID-19 and other operating challenges.

» Despite the current pull back on additional debt, debt measure remain modest compared to medians and peers.

» Liquidity is favorably stable (even excluding short term borrowings), but remains below medians and peers.

» Sutter will continue to face material competition in most major markets from large and financially solid healthcare systems.

» Sutter currently faces a heightened level of instability, including: the pending settlement of one lawsuit; ongoing litigation in another law suit; persistent under performance in a number of markets; and expiring nursing union contracts.

Rating outlook

The negative outlook reflects modest operating results year-to-date, and the expectation that results will remain challenged through at least the end of year. Challenges include significant operating losses at some of the facilities, expiring union contracts, and pending lawsuits. Failure to demonstrate traction to the improvement plan could result in a downgrade.

Factors that could lead to an upgrade

» Significantly improved debt and balance sheet measures

» Sustained, improved, operating measures

Factors that could lead to a downgrade

» Additional dilution of balance sheet and debt measures beyond expectations

» Inability to show traction to plan during 2021

» Inability to show material improvement in 2022

» Significant disruption due to labor action

» An additional unfavorable lawsuit result

Key indicators

Sutter Health, CA

	2016	2017	2018	2019	2020
Operating Revenue ($'000)	11,310,000	11,623,000	12,120,000	12,725,000	12,737,000
3 Year Operating Revenue CAGR (%)	7.0	5.9	4.5	4.0	3.1
Operating Cash Flow Margin (%)	8.5	5.6	6.0	0.7	3.3
Operating Cash Flow Margin including Provider Fee (%)	10.0	8.7	7.9	7.4	4.4
PM: Medicare (%)	44.0	42.0	43.0	44.0	43.0
PM: Medicaid (%)	23.0	19.0	19.0	18.0	19.0
Days Cash on Hand	162	180	178	171	183
Unrestricted Cash and Investments to Total Debt (%)	117.7	142.1	128.2	136.0	143.0
Total Debt to Cash Flow including Provider Fee (x)	2.8	2.8	3.4	3.4	4.9

Based on audited financial statements for Sutter Health, for fiscal years ended December 31; California State provider fee excluded from calculations unless indicated otherwise; investment returns normalized at 5%; expenses in 2019 reduced by $644 million relating to lawsuit settlement and other one-time items; unrestricted cash and investments in 2020 exclude $999 million of CMS Accelerated and Advanced Funds, $209 million of deferred FICA payments, and $400 million related to a draw on a line of credit - inclusive of those items, days cash on hand measures 235 days and cash to debt equals 164%
Source: Moody's Investors Service

Profile

Sutter Health is the parent of affiliates that make up a large, not-for-profit health system centered in Northern California. The system operates 29 acute care facilities, operates a small health plan, runs a large number of out-patient facilities, and manages two medical foundations that contract with medical groups organized as professional corporations that account for the services of over 2,500 physicians. In fiscal 2020, Sutter Health produced over $13 billion in revenues, and generated nearly 175,000 admissions.

Detailed credit considerations

Market position: large, integrated, geographically focused delivery system; heightened risks in current year

Sutter will continue to benefit from its well-established business strategy, which consists of providing a full spectrum of services within its northern California footprint. Sutter's contiguous footprint enables numerous operating efficiencies, and Sutter has successfully lowered certain costs over the last several years, and has streamlined system-wide operations. Sutter has a favorable clinical reputation, and the vast majority of its 29 hospitals are substantial in size, and provide high acuity services. Additionally, Sutter is well integrated with its physician networks, and it has a substantial clinic presence throughout its footprint. Sutter's retail strategy is currently focused on operating store-front retail clinics, and 25 of these are currently in operation. Other investments include the development of a number of surgery centers, the expansion of the Sutter Health Plus network (consisting of more than 90,000 members as of FYE 2020), and a new partnership with Stanford Health to establish a large comprehensive cancer center in the east bay. Sutter is open to enhancing its various relationships in an effort to better serve its target populations.

Unfavorably, Sutter is currently facing a number of lawsuits which may have a financial impact, and could limit future contracting flexibility. First, it appears the UFCW lawsuit may finally be concluded this summer. Sutter has entered into a settlement with the plaintiffs whereby Sutter would pay $575 million and adhere to certain contracting requirements and other injunctive relief provisions. The settlement payment was booked as an expense in Sutter's Q3 2019 financials, and funds are currently included within unrestricted cash and investments. If the court grants final approval, which could happen this Summer, Sutter would make the settlement payment and begin abiding by the terms of the injunctive relief agreement, including its contracting terms. Secondly, Sutter is involved in a second, class action lawsuit pending in federal court, in which Sutter is being accused of antitrust violations by a different class of plaintiffs. The case is expected to go to trial in the Fall. Sutter denies any wrongdoing and plans to vigorously defend itself.

Perhaps of a more systemic nature, Sutter has a number of assets which are chronically underperforming, and appear to be on a negative trajectory. In response, Sutter has engaged two different consulting firms to address different aspects of their current situation, in an effort to put the organization on a more profitable footing. Sutter believes fundamental changes may be required, and is looking on wide ranging solutions. In conjunction with this, a major voluntary reduction in force was implemented earlier this year consisting of 800 FTE's, and management has already begun to make certain programmatic changes, including closing the specialty hospital in Menlo Park, closing the NICU at Sutter Delta, and closing labor and delivery at Sutter Solano. We believe that management's willingness to reevaluate all aspects of its business plan is a positive development, and reflects favorably on management's current direction. We expect more changes to come.

Other ongoing challenges include material competition in all of Sutter markets, and certain disadvantages in the operating environment. Competitors include Kaiser Permanente, Dignity Health (part of CommonSpirit Health) and various regional systems. Additionally, operating exclusively in California exposes Sutter to certain California-specific challenges, including: unfunded operating mandates such as required minimum nurse staffing levels; high managed care penetration; high construction costs; seismic retrofit requirements; and low state reimbursement for Medi-Cal. An additional challenge in California is organized labor, which historically has taken a somewhat aggressive stance towards Sutter at different times over the years. Sutter's nursing contracts are scheduled to expire this Summer, and negotiations may be challenging. This is an additional risk factor driving the negative outlook.

Operating performance, balance sheet, and capital plans: operations expected to remain modest in 2021 following sharp declines in 2020; liquidity remains stable

We expect operating results to remain challenged in 2021, following sharp declines in 2020. Operating cashflow margin dropped to 4.4% in 2020 from 7.4% in 2019 (inclusive of provider fee, and adjusting for one-time items in 2019). The pandemic was a major driver of the decline, though management believes there are also certain systemic operating imbalances driving the weaker results. An additional driver in fiscal 2020 was a reduction in provider fee from the prior year, which dropped to $162 million in 2020 from $257 million in 2019. Results were saved from being weaker than they were by very significant CARES act funding, which totaled $791 million for the year (equal to 6% of revenues, which is high). Operating cashflow for fiscal 2021 is budgeted to significantly improve, but results through the first three months are tracking to a lower level, and total results for the year are likely to remain modest. Our expectation is that management will be able to show some improvement, and make progress on its overall improvement plan. More significant improvements are expected in 2022.

LIQUIDITY

Liquidity has benefited from recent short term support, including $999 million from Medicare's Advance and Accelerated Payment Program, $400 million drawn on a line of credit (which was paid back in February) and $209 million of deferred FICA payments. Inclusive of these funds, days cash on hand measured 235 days at FYE 2020. Even excluding these funds, however, liquidity remains favorably consistent with prior levels, measuring 183 days cash on hand at FYE 2020, compared to 176 days at FYE 2019. Net liquidity is expected to drop further by the end of year due to the expected settlement of the UFCW lawsuit, but still remain within recent historical ranges, equal to approximately 167 days cash on hand (excluding any additional funds). Management has targeted 150 days as a floor on liquidity.

As of FYE 2020, investment allocation had somewhat shifted due to the high amount of short term borrowing, with 49% allocated to cash and fixed income, 33% to equities, and 18% to alternatives. 72% of all unrestricted cash and investments can be liquidated within 30 days.

CAPITAL INVESTMENT

Sutter has successfully completed a 20-year master facilities plan entailing the seismic upgrade of many of its most significant medical centers. In 2019 capital spending dropped to 0.9 times depreciation, and in 2020, it dropped further to 0.6 times in order to preserve liquidity in the face of the pandemic. While certain specific projects continue, the overall rate of capital spend is expected to remain modest until such time when management can address its operating challenges.

Debt structure and legal covenants: debt measures remain modest for the rating category

A historic challenge for the organization is its relatively high debt load. Debt was expected to increase in 2020. Favorably, total debt remained stable. Nevertheless, debt measures for 2020 remained weaker than A1 medians, with cash to debt at 143% (A1 median is 209%), peak debt service coverage equal to 3.1 times (A1 median is 5.8 times), and debt to cashflow at 4.8 times (A1 median is more favorable at 2.5 times). (Calculations assume the paydown of the $400 million line of credit, and exclude from cash $999 million of CMS Accelerated and Advanced Funds, $209 million of deferred FICA payments, and $400 million related to the line of credit).

DEBT STRUCTURE

Sutter's debt structure is favorably conservative consisting of all fixed rate debt, and no swaps. The organization has taken on more market access risk in recent years with the issuance of a number of taxable bullet maturities, with $300 million coming due in 2025, $350 million coming due in 2028, and $700 million coming due in 2030 (among other longer dated bullets). Nevertheless, we believe the absence of material exposure to interest rate volatility, put risk, bank renewal risk, or swap mark-to-market risk, are important mitigants to Sutter's relatively high leverage.

LEGAL SECURITY

A new MTI was implemented concurrent with the 2020 bond transaction. Under the new MTI, bonds are secured by a gross receivables pledge. All members of the Obligated Group are jointly and severally liable with respect to the payment of each obligation secured under the MTI. Financial covenants of the MTI and Sutter's credit facility include a debt service coverage requirement of over 1.1 times, and a days cash on hand requirement of over 70 days. In 2020, Sutter posted sufficient headroom on all of its covenants.

DEBT-RELATED DERIVATIVES

None

PENSIONS AND OPEB

Sutter has historically had the practice of keeping its defined-benefit pension program well funded. At FYE 2020, the program had a funded ratio of 90%. Other indirect debt includes operating lease liabilities, which under the new accounting treatment were equal to $523 million at FYE. Overall, Sutter's relatively low amount of indirect debt is an important mitigant to its high level of direct debt.

ESG considerations

Environmental

All of Sutter's hospitals and facilities have significant exposure to earthquake risk. California hospitals are required to meet high and increasing seismic building requirements. Sutter is compliant with requirements up until 2030 at all of its major facilities, but will be required to invest in further upgrades at certain facilities to be in compliance with regulations that come into effect in 2030. Other environmental risks include potential wildfires, and the attendant risk of power cut offs. Mitigants include geographic diversification

within their foot print, a certain level of balance sheet strength, and other resources that come from the organization's size, structure, and importance.

Social

The most significant social consideration currently is the ongoing impact of COVID-19. Like other healthcare providers, Sutter Health suspended elective procedures system-wide for a period of time starting in Spring 2020, which negatively impacted revenue and cashflow for the year. Though all services were resumed, volumes remained below pre-COVID levels within certain service lines through the remainder of the year, and remain below historical levels through Q1 2021. Additionally, while Sutter Health was the beneficiary of significant CARES Act funds, the support was still not sufficient to offset all of the loses. The full duration and impact of the pandemic remains unknown.

Other social considerations include the service area's high cost of living, strong unions, high cost for construction, challenging payer mix, high managed care penetration, and various unfunded mandates from the state. Favorably, the system benefits from California's provider fee program, support from which has been significant for the past many years.

Governance

Sutter's CFO of five years retired in 2020, and the new CFO, which came from outside the organization, has been in place now for almost a year. The remainder of the senior management team has been stable, and the organization enjoys a deep bench. Disclosure practices are standard.

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