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Ratings

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California Health Facilities Financing Authority
Sutter Health; System

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Aamna Shah, San Francisco,

Rating Action

S&P Global Ratings lowered its long-term rating to 'A' from 'A+' on Sutter Health, Calif.'s series 2018A and 2020A taxable fixed-rate revenue bonds and on the California Health Facilities Financing Authority's series 2016B, 2017A, and 2018A tax-exempt fixed-rate bonds issued for Sutter. The outlook is stable.

Gross receivables of the Sutter obligated group secure the rated bonds outstanding.

Credit overview

The rating action reflects our view of Sutter's weakened performance in 2020, largely as a result of COVID-19 but also a result of Sutter's underlying operating structure that will likely take a couple of years to fully address with a sizeable and multiyear turnaround. This turnaround is potentially complicated by the post-pandemic environment and Sutter's broader operating environment in Northern California .

The 'A' rating reflects our view of Sutter's sizable and integrated presence in the large and populated Northern California market with most of Sutter's extensive inpatient and outpatient facilities located throughout the greater San Francisco and East Bay region, Sacramento and the surrounding area, and the Central Valley of California. Medical staffs, many of whom are aligned with Sutter through its extensive foundation model structure as well as its focus on various modes of care delivery such as telehealth and virtual visits, complement Sutter's facilities. The Northern California market economics and demographics are mixed, as reflected by a payer mix that is net 40% governmental.

The rating also reflects our view of Sutter's good average annual debt service coverage (despite operating losses) and moderate debt with stable pro forma cash on hand (which includes the payment for the $575 million settlement for a class action lawsuit). The debt structure is conservative at all fixed rate, but recent taxable issuances include several large bullet payments over the life of the bonds (three over the next 10 years). Sutter has no new money debt plans until operations stabilize, with just a few larger capital projects that are manageable in size. However, the competitive market will likely require Sutter to continue to make investments.

Finally, the rating incorporates a positive holistic adjustment that reflects the system's solid balance sheet ratios relative to medians and incorporates our view that reduced operating losses should allow Sutter Health to generate debt service coverage that is consistent with rating medians.

Operating performance had weakened prior to fiscal 2020, and we incorporated the expectation for some ongoing lighter performance, but the steeper declines coupled with a large and likely multiyear turnaround effort are embedded in the 'A' rating. Sutter's financial operations suffered as a result of the COVID-19 pandemic, but also remain susceptible to the dynamics of operating in Northern California. While margins improved and losses decreased in the second half of the fiscal year, Sutter still generated sizable operating losses of around $400 million (negative 3% margin), which incorporates about $800 million of grant funds from the Coronavirus Aid, Relief, and Economic Security (CARES) Act. Management has a break-even budget for 2021 but that could be a challenge to meet if volumes remain soft and certain operational improvements aren't realized. Management implemented a voluntary separation program, and another staffing adjustment that should help recurring operations for 2021, but the team is also looking at much more significant and broader initiatives along with volume recovery to improve performance in the coming years.

The Sutter team is committed to making additional operational improvements to support the health system's long-term financial strength although detailed plans are still being formulated. At the same time, management and the board are formally reviewing Sutter's strategic focus and expect more details over the next year. Sutter's new chief financial officer (CFO), Brian Dean (previously at Memorial Hermann in Texas), who has also taken on strategy and has led turnarounds in the past, is playing a key role in both the operating and strategic reviews. Although we believe Sutter should be able to stem the losses and achieve stronger cash flow, we believe the post-pandemic recovery and the broader operating environment (including higher costs of living, legal scrutiny, upcoming payer contract negotiations, and collective bargaining activity) could complicate the multiyear effort.

The 'A' rating reflects our view of Sutter's:

- Diverse revenue base of more than $13.2 billion with solid business position across a broad region with 29 acute care campus facilities in the system, a large physician base (with many aligned through Sutter's two medical foundations), a small health plan, and other outpatient services;
- Growth in unrestricted reserves over the past few years that has kept cash on hand stable, and on a pro forma basis, was 170 days at fiscal year-end Dec. 31, 2020 (and excluding all external liquidity support);
- Historically good maximum annual debt service (MADS) coverage of more than 3x (fiscal 2020 coverage was lower at 2.6x) and with better historically average annual debt service coverage of 4x to 5x; and
- Conservative fiscal policies, including a fixed-rate debt portfolio with no swaps outstanding or direct purchase

borrowings, combined with a pension plan that remains well funded (90%) as of Dec. 31, 2020, and a low average age of plant, reflecting consistent historical capital investment.

Partly offsetting the above strengths, in our view, are Sutter's:

- Heightened operating losses in 2020 on top of already light operations with dependence on special revenue, including disproportionate share payments and net provider tax revenue;
- Need for significant operational improvement, which lingering strains from the pandemic and a more difficult operating environment could complicate; and
- Location in a competitive market that includes Kaiser Permanente, Stanford Health, CommonSpirit (Dignity Health), and the University of California, San Francisco.

The stable outlook reflects our view of Sutter's stable and healthy unrestricted reserves coupled with an overall solid enterprise profile in Northern and Central California and a comprehensive physician and outpatient strategy. The stable outlook reflects our view of Sutter's focus on a comprehensive turnaround plan that has risks but that could help lower operating losses, albeit over a couple of years. Finally, no significantly large capital projects are underway, and this should help preserve reserves.

Environmental, social, and governance factors

We view Sutter's overall environmental risks as elevated relative to those of industry peers given its location in markets that are historically prone to earthquakes and wildfires, particularly in recent years. In our view, Sutter has demonstrated an ability to use its diversity of facilities to execute facility plans to manage environmental challenges effectively. Northern California has been home to many wildfires, and Sutter has been able to use its facilities, network of physicians, and information technology to help support patients and operations during such events, thereby minimizing disruption to its overall operations. Moreover, Sutter has long invested in strategic capital projects to meet state-mandated seismic building codes, including several recent projects that required significant cash outlay. We note that Sutter has managed the high capital spending diligently by successfully opening the facilities while maintaining financial health. We considered the recent class action legal case as well as various other ongoing legal cases in our governance assessment, but overall we view Sutter's governance risk factors as consistent with those of the industry. We view Sutter's social risk as lower than that of industry peers, given its large and broad service area. That said, COVID-19 has exposed Sutter and other health care providers to additional social risks related to Sutter's mission of protecting the health and safety of communities. While vaccinations have begun to moderate COVID-19 cases in the region, should financial pressure related to costs for caring for COVID-19 patients or revenue as individuals' forgoing care for safety reasons overly affect performance, that could affect the credit. Finally, Sutter' 25% union staff could cause operating and financial challenges in case of issues with future labor contracts. A majority of the unions will have negotiations this year, and we will monitor progress on those contracts.

Stable Outlook

Downside scenario

We could consider a lower rating or a revised outlook if Sutter isn't able to make progress on reducing operating losses or if pro forma unrestricted reserves decline (after adjusting for the payment for the $575 million legal settlement in 2019) or key balance sheet ratios decline materially. While management has no plans to issue additional debt until operations have stabilized, a large issuance without meaningful improvement to cash flow could also affect the rating.

Upside scenario

If Sutter is able to demonstrate a path to sustained positive margins with coverage at levels consistent with a higher rating and while incrementally improving its overall balance sheet, we could consider a higher rating.

Credit Opinion

Enterprise Profile: Very Strong

Regional presence is broad with good diversity and solid alignment with physicians

Sutter maintains a solid presence primarily in Northern and Central California, as reflected by its 29 acute care facilities in a very broad service area encompassing San Francisco and the greater San Francisco Peninsula, Oakland, the East Bay, Sacramento and the surrounding area, and the Central Valley region and its large annual admissions base of more than 187,000 historically. Despite historical volume growth, particularly in hospitals in Roseville, Los Banos, and Modesto, and our expectation of volume recovery in 2021, some demographic shifts in the Bay Area resulting from the pandemic could slow that process. Foundation visits were also strong at more than 9.4 million visits in 2019 but declined to 8.4 million in 2020 as a result of pandemic. Overall capitated membership at Sutter's medical foundations and aligned independent practice associations grew incrementally to 304,980 as of Dec. 31, 2020. Separately, Sutter has some presence with health plan offerings to expand affordable access with the largest plan (Sutter Health Plus) accounting for 97,000 lives of the total 100,000 or so that Sutter has in all its health plans. Sutter's payer mix has some exposure to governmental funding and could be a credit risk in case of broader cuts to programs within Medicare and Medicaid. In addition, Sutter has increased its reliance on the provider fee and disproportionate share funds as operating performance has weakened, and we view this as an increased risk as well.

While we believe that Sutter's primary location in Northern California has positives, as Sutter serves a broad and growing population base that is economically sound, the market also provides challenges as relate to consolidated competition, higher cost of living in parts of its markets, exposure to collective bargaining, and legal scrutiny as shown by recent challenges. Sutter remains competitive with other providers in the area and is one of the larger health care systems in Northern California along with Kaiser and CommonSpirit. Sutter continues to review its footprint, particularly as it reviews its overall strategy in the coming months. Sutter is partnering with Stanford Health Care to jointly provide cancer services in the East Bay and will be further supported by a cancer center that should open in 2024.

Collective bargaining units represent about 25% of Sutter's employees. Sutter has 55 collective bargaining agreements with 14 unions, including the California Nurses Assn. and Service Employees International Union, with a significant percentage up for renewal in 2021, including the two named, which are the largest. Sutter continues to have a complicated relationship with its unions as evident in a history of work stoppages, although no major stoppages have occurred for several years. However, the upcoming negotiations could be complicated given the post-COVID environment and an active union environment.

Generally stable management team with a recent transition in finance leadership

The broader team remains stable, but with Brian Dean's arrival as the CFO in July 2020 the whole team has engaged on a couple of very large and ambitious but needed initiatives for the organization to maintain its solid presence in the market. The operating turnaround is significant, will likely take a couple of years to reach a steady state, and, as outlined above, faces various risks that could slow those efforts. The team has identified broad areas of improvement (including labor productivity and revenue cycle), but is working with consultants to benchmark key expense areas and identify specifics to implement. The team will also have more details on its strategic direction in the coming months and could draw from existing investments in areas such as affordability, partnerships, health plans, digital health, and expanded access. Sutter has also tried to remain in the forefront of the changing dynamics in health care, but we expect that its strategies over time will likely become more focused as it goes through its review.

We believe the turnaround work that Sutter is doing is meaningfully larger and reflects the team's attention to strengthening the organization for the long-term. The team has implemented operating improvements over time and developed efficiencies around the shared services model but the scale of turnaround for the current initiative is likely much larger than what has been pursued in the recent past and will require ongoing discipline and support from the management and board.

Legal cases continue to be an issue for Sutter. Sutter anticipates the court approving its legal settlement with UVCW & Employers Benefit Trust in 2021, and anticipates no modifications to the terms of the settlement or the already accrued settlement expense. While we've factored in this payment and settlement charge, we believe longer-term effects are less obvious and we could see medium- to long-term impact on performance as payer contracts are renewed, although we note that nothing within the settlement specifically indicates that. One of Sutter's larger payer contracts is up for renewal early next year, and we will monitor whether the recent settlement affect those negotiations. Sutter still has other lawsuits and a few investigations and alleged violations under review (e.g., Sidibe vs. Sutter Health and Lab Outreach Program) that remain an unknown risk and that we will monitor, as they could affect financial results and processes.

Table 1

Sutter Health Utilization

	--Fiscal year ended Dec. 31--			
	2020	**2019**	**2018**	**2017**
PSA population	12,449,000	12,500,000	N.A.	12,400,000
PSA market share (%)	N.A.	N.A.	N.A.	N.A.
Inpatient admissions*	174,547	189,341	187,713	193,202
Equivalent inpatient admissions	375,402	426,980	419,703	419,548
Emergency visits	691,054	845,091	844,249	868,837
Inpatient surgeries	N.A.	52,621	52,424	53,285
Outpatient surgeries	69,230	80,626	82,010	79,641
Medicare case mix index	1.62	1.62	1.59	1.54

Table 1

Sutter Health Utilization (cont.)

	--Fiscal year ended Dec. 31--			
	2020	**2019**	**2018**	**2017**
FTE employees	44,406	43,471	42,395	42,340
Active physicians	5,500	5,500	5,500	5,500
Medicare (%)§	28	27	25	24
Medicaid (%)§	14	12	15	16
Commercial/Blues (%)§	56	59	58	58

*Excludes normal newborn, psychiatric, rehabilitation, and long-term care facility admissions. §Based on net revenue. FTE--Full-time equivalent. N.A.--Not available. PSA--Primary service area.

Financial Profile: Adequate

Operating performance to remain light over the next couple of years

Although fiscal 2020 saw significant challenges primarily as a result of COVID-19 and related population shifts in some of Sutter's markets, other areas affecting performance include historically modest rate increases coupled with the high cost of living in the region and broader industry pressures. The latter effects resulted in thinner margins prior to COVID-19. The region also contends with wildfires, which can sometimes delay patients' elective visits. CARES funding supported income in 2020, as losses would have been closer to $1 billion without it. While the team implemented some staffing changes, including an early separation program, some of those savings (annual savings of $180 million) didn't come through until fiscal 2021. COVID-19 cases also affected early fiscal 2021 results, and although management has a break-even budget for the year, the slow start to the year could affect that. While we recognize that the team is focused on rightsizing operations to generate enough cash flow to make appropriate investments, we also believe that implementation of certain initiatives could take longer given the significant turnaround required and the risks already mentioned above. We see some flexibility for operating softness given the healthy balance sheet and the team's turnaround efforts, but do expect to see progress.

Nonoperating income remained steady in 2020 given the investment market gains but was not able to fully compensate for weaker operating performance, and thus coverage (both MADS and average) was weaker in 2020. Annual debt service is much lower in most years given the bullet structure on the recent taxable issuances. Operating lease-adjusted MADS coverage is also light and reflects some moderate use of leases. However on a historical basis, both coverage calculations are quite solid for the rating.

Despite losses, unrestricted reserves grew as expenditures tapered and markets performed favorably

Unrestricted reserves grew a reasonable 10% in fiscal 2020 with positive cash flow, slower capital expenditures as a result of the pandemic, and unrealized gains on investments. But on a pro forma basis, and including the $575 million settlement expense that was accrued in 2019 and could be paid in 2021 once final approvals are received, pro forma cash on hand drops by about 15 days. We have excluded Sutter's line of credit draw (paid down in February 2021) and the Medicare accelerated and advance payments from our reserve calculation.

Capital expenditures are targeted at around $688 million for 2021 (slightly higher than 2020's spending of $431 million but on par with 2019 spending), but could be reduced if cash flow falls short of expectations. Near-term capital projects are related primarily to technology investments and some clinical expansions in Davis, Roseville, and Santa Rosa, but likely larger projects (both for seismic and other reasons) could be considered after Sutter's comprehensive strategy review.

Sutter has historically invested in its plant at a healthy clip and average age is still good, but has risen modestly to 10.4 years. The team has delivered most projects on time and under budget. Management has also put in place a sophisticated construction project management process that has helped with timing and costs. While Sutter has some 2030 seismic upgrades to address at a few of its facilities, including its Alta Bates Summit Medical Center in Oakland, management is also reviewing its medium- to long-term capital projects as part of its larger strategic review.

We consider Sutter's asset allocation at the end of Dec. 31, 2020, for its unrestricted resources reasonable for the rating at about 33% equities, 49% fixed income (including cash), and 18% alternatives (but this includes the Medicare accelerated and advance payments funds and line of credit draw).

Conservative debt structure supports the credit rating, but there is exposure to several large bullet payments

Debt metrics remain consistent with the rating. We continue to view Sutter's debt structure as relatively conservative given no direct purchase debt and no variable-rate demand bonds, but we do note an increase in large bullet payments, which will slow principal amortization and expose the credit to refinancing risks. The series 2020A and 2018A taxable bonds have six bullet payments with three varying sized bullets due over the next 10 years, including $300 million (2025), $345 million (2028), and $700 million (2030).

Sutter's operating lease liability was $416 million with a commensurate $470 million operating lease right-of-use asset as of Dec. 31, 2020. We have historically incorporated lease risk into lease-adjusted debt service coverage, and we believe this continues to capture risk associated with lease exposure. Including the operating lease liability in our calculation of leverage brings debt as a percentage of capitalization to 36%.

Sutter has no plans for new money debt over the next year, and likely not until operations stabilize.

Sutter's pension funding is improved over recent years at 90% with the overall net unfunded liability at $666 million and a contribution of $325 million in 2020 compared with pension expense of $233 million. Sutter also has a small legacy multi-employer plan liability of $59 million as of 2019. Sutter has no swaps outstanding.

Table 2

Sutter Health Financial Summary					
	--Fiscal year ended Dec. 31--				'A' rated health care system medians
	2020	2019	2018	2017	2019
Financial performance					
Net patient revenue ($000s)	10,532,000	11,407,000	10,957,000	10,828,000	2,811,264
Total operating revenue ($000s)	13,204,381	13,264,963	12,687,865	12,397,268	2,920,867
Total operating expenses ($000s)	13,607,000	13,352,000	12,664,000	12,183,000	MNR
Operating income ($000s)	(402,619)	(87,037)	23,865	214,268	MNR

Table 2

Sutter Health Financial Summary (cont.)

	--Fiscal year ended Dec. 31--				'A' rated health care system medians
	2020	**2019**	**2018**	**2017**	**2019**
Operating margin (%)	(3.05)	(0.66)	0.19	1.73	1.80
Net nonoperating income ($000s)	298,619	285,037	286,135	364,151	MNR
Excess income ($000s)	(104,000)	198,000	310,000	578,419	MNR
Excess margin (%)	(0.77)	1.46	2.39	4.53	3.50
Operating EBIDA margin (%)	3.80	6.09	6.46	7.86	8.00
EBIDA margin (%)	5.93	8.07	8.52	10.49	9.00
Net available for debt service ($000s)	801,000	1,093,000	1,106,000	1,338,419	285,841
MADS ($000s)	301,623	301,623	301,623	301,623	MNR
MADS coverage (x)	2.66	3.62	3.67	4.44	3.70
Operating-lease-adjusted coverage (x)	2.03	2.64	2.69	3.26	3.10
Average annual debt service ($000s)	247,812	247,812	247,812	247,812	MNR
Average annual debt service coverage (x)	3.23	4.41	4.46	5.40	3.70
Average operating lease-adjusted coverage (x)	2.28	2.97	3.03	3.69	3.10
Liquidity and financial flexibility					
Unrestricted reserves ($000s)	6,624,972	5,998,633	5,599,756	5,465,618	1,462,285
Unrestricted days' cash on hand	188.0	173.6	170.6	173.1	160.6
Unrestricted reserves/total long-term debt (%)	144.0	132.7	121.0	137.6	136.1
Unrestricted reserves/contingent liabilities (%)	2,208.32	5,998.6	2,799.9	2,732.8	531.6
Average age of plant (years)	10.4	9.6	9.6	9.5	11.8
Capital expenditures/depreciation and amortization (%)	57.7	89.7	135.7	141.1	134.6
Debt and liabilities					
Total long-term debt ($000s)	4,601,000	4,520,000	4,626,000	3,972,000	MNR
Long-term debt/capitalization (%)	34.2	33.9	34.9	30.4	38.8
Contingent liabilities ($000s)	300,000	100,000	200,000	200,000	MNR
Contingent liabilities/total long-term debt (%)	6.5	2.2	4.3	5.0	25.70
Debt burden (%)	2.25	2.24	2.34	2.38	2.30
Defined benefit plan funded status (%)	89.51	88.11	86.93	92.01	75.90
Pro forma ratios - excluding $575 mil. settlement					
Unrestricted reserves ($000s)	6,049,972	N/A	N/A	N/A	MNR
Total long-term debt ($000s)	4,601,000	N/A	N/A	N/A	MNR
Unrestricted days' cash on hand	172.8	N/A	N/A	N/A	MNR
Unrestricted reserves/total long-term debt (%)	131.5	N/A	N/A	N/A	MNR
Long-term debt/capitalization (%)	34.2	N/A	N/A	N/A	MNR
Miscellaneous					
Medicare advance payments ($000s)*	999,000	N/A	N/A	N/A	MNR
Short-term borrowings ($000s)*	400,000	0	0	0	MNR
CARES Act ($000s)	812,000	N/A	N/A	N/A	MNR
Risk-based capital ratio (%)	N/A	N/A	N/A	N/A	MNR

Table 2

Sutter Health Financial Summary (cont.)

	--Fiscal year ended Dec. 31--				'A' rated health care system medians
	2020	**2019**	**2018**	**2017**	**2019**
Total net special funding ($000s)	235,324	308,077	351,192	516,579	MNR

*Excluded from unrestricted reserves, long-term debt, and contingent liabilities. CARES--Coronavirus Aid, Rewcovery, and Economic Security. N/A--Not applicable. MADS--Maximum annual debt service. MNR--Median not reported.

Credit Snapshot

- Security: Gross receivables of the Sutter obligated group secure the bonds outstanding.
- Group rating methodology: The long-term rating is based on our view of Sutter's group credit profile (the system as a whole) and the obligated group's core status to the system. The obligated group constituted approximately 94% of overall system net assets, 98% of operating revenue, and roughly all operating profits in fiscal 2019. Accordingly, the bonds are rated at the same level as the group credit profile.
- Credit profile: Sutter has a broad presence primarily in Northern California with 29 acute care campus facilities, a freestanding chemical dependency facility, two medical foundations, and more than 275 related medical foundation facilities and clinics. Sutter also has home care and is party to a number of joint ventures and accepts capitated risk for a small percentage of its patients.

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020