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Sutter Health, California California Health Facilities Financing Authority; System

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California Hlth Facs Fin Auth (Sutter Health System)		
Long Term Rating	A/Stable	Current

Rationale

Sutter Health, Calif.'s taxable bonds and the California Health Facilities Financing Authority's tax-exempt bonds issued for Sutter Health are rated 'A'. The outlook is stable.

Credit overview

The 'A' rating reflects our view of Sutter's sizable and integrated presence in the large and populated Northern California market with Sutter's extensive inpatient and outpatient facilities throughout the greater San Francisco and East Bay region, Sacramento and the surrounding area, and the Central Valley of California. Medical staff, many of whom are associated 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 incorporates a healthy balance sheet, which provides flexibility as Sutter continues to improve and sustain stronger operating margins, with good success in 2021, but with ongoing headwinds that call for it to maintain discipline for its significant annual improvement plan to reach targets of 8% EBIDA over the long term. Specifically, the operating environment includes industry-related inflationary pressures and labor shortages and higher expenses, as well as the more regional circumstances of higher cost of living in parts of Sutter's service area and an active collective bargaining environment which could cause short-term and potentially medium-term expense pressures. 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 it to continue to make ongoing capital investments over time.

Finally, the rating incorporates a positive holistic adjustment that reflects the system's solid balance-sheet ratios relative to medians and incorporates Sutter Health's meaningful market position and improved operating results in fiscal 2021.

While operating performance improved to positive 0.6% margins in 2021 from a negative 3.3% margin in 2020, there was still support from provider relief funds, though much less than was received in fiscal 2020. We believe Sutter should be able achieve stronger cash flow with a disciplined multiyear annual improvement plan, but the post-pandemic recovery and the broader operating environment highlighted above, could complicate the multiyear effort.

The board is selecting a permanent CEO following Sarah Krevans' retirement in January 2022, but the team has moved forward on its three-year strategic plan. That plan focuses on growth and being a unified system with consistent experience and affordable care for its communities while ensuring that Sutter is on a stronger financial footing. In concert with the operating improvement targets, the strategy calls for lowering the total cost of care while investing in its various assets to help patients access affordable and patient friendly care and serving the growing demand of patient needs. We believe combined, these initiatives should ensure Sutter's financially sound position and provide a good foundation to pivot to the next set of strategies. In addition, Sutter continues to manage through various regulatory and legal scrutiny with a couple of inquiries and lawsuits finalized or settled in recent years, although they remain a modest risk as some cases and investigations remain open.

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

- Diverse revenue base of more than $14.2 billion with solid business position across a broad region with 29 acute-care campus facilities in the system, a large physician base (with many associated through Sutter's two medical foundations), a small health plan, and extensive outpatient services;
- Healthy unrestricted reserves with days' cash on hand over 200;
- Debt levels that are consistent with the rating, including leverage at 30% and unrestricted reserves to long-term debt at a stronger 1.6x;
- Historically good maximum annual debt service (MADS) coverage of over 3x with 2021 exceptionally strong due to solid investment income returns and one-time gains on sales; and
- Conservative fiscal policies, including a fixed-rate debt portfolio with no swaps outstanding or direct-purchase borrowings, combined with a pension plan that was well funded (98%) as of Dec. 31, 2021.

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

- Performance that has improved from fiscal years 2020 and 2019, but is light at under 1% margin;
- Need for continued operating improvement in a more challenging environment that are both industry-wide and specific to Sutter's markets;
- Performance that is reliant on special funding including disproportionate share (DSH) and quality assurance fee funds; 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 with ongoing investments in care delivery. The stable outlook also reflects our view of Sutter's sustained focus on a performance improvement plans. Finally, no significantly large capital projects are underway, and this should help maintain reserves.

Environmental, social, and governance

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 IT to help support patients and operations during such events, thereby minimizing disruption to its overall operations. It has also long invested in strategic capital projects to meet state-mandated seismic building codes with more likely to be needed to meet certain 2030 targets.

We considered the recent legal cases and investigations in our governance assessment, but overall we view Sutter's governance risk factors as consistent with those of the industry. We view its social risk as being in line with those of industry peers, with some strengths but also some challenges. While its large and broad service area supports ample demand for services, the higher cost of living and related labor costs, along with a more active collective bargaining environment offset some of those strengths. Sutter's approximately 25% union staff could cause operating and financial challenges in case of issues with future labor contracts. One of the larger groups, CNA, is still without a contract and has recently called for one-day strikes, causing some short-term financial effects as management brings in temporary labor to support patient needs. Finally, COVID-19 has also 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, therapies, and immunity from various surges have begun moderate the effects of COVID-19 cases, we still view there to be some ongoing uncertainty.

Stable Outlook

Upside scenario

We view Sutter's enterprise profile as consistent with a higher rating and if it is able to demonstrate sustained positive margins with coverage at levels consistent with a higher rating while maintaining or incrementally improving its overall balance sheet, we could consider a higher rating or positive outlook.

Downside scenario

Although unlikely given balance-sheet flexibility and the focus on operating improvement, we could consider a lower rating or a revised outlook if Sutter's operating losses return to levels closer to those in 2020 or if reserves decline materially. While management has no plans to issue additional debt until operations have stabilized and are sustained, a large issuance without meaningful improvement to cash flow could also affect the rating.

Credit Opinion

Enterprise Profile: Very Strong

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

Sutter maintains a solid presence primarily in a broad geographic area of Northern and Central California, as reflected by its 29 acute-care facilities and its large annual admissions base of more than 187,000. Broadly, volumes have not recovered to 2019 levels but are stronger than 2020, with growth in outpatient areas and higher acuity, which has helped revenues. Foundation visits remain sound at 10.2 million visits in 2021. Overall capitated membership at Sutter's medical foundations and associated independent practice associations grew incrementally to around 306,000 as of Dec. 31, 2021, and we see this as a positive for experience managing some risk. Separately, Sutter has some modest presence with health plan offerings to expand affordable access with the largest plan (Sutter Health Plus) accounting for the vast majority of the approximately 100,500 lives in all its health plans.

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. It continues to review its footprint as well as partnerships to grow and provide specific noncore services and more broadly. Sutter does not provide market share, but we believe with the admissions cited above, it has a broad and meaningful presence across the service area. Sutter is partnering with Stanford Health Care to jointly provide cancer services in the East Bay and supported by a new joint cancer center that should open in mid-2025 with 50% support for capital spending at that facility ($350 million total costs). Its 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, we've also noted the challenges in the markets that it operates above.

Collective bargaining units represent about 25% of Sutter's employees. Sutter has 60 collective bargaining agreements with 14 unions, including the California Nurses Assn. (CNA) and Service Employees International Union (SEIU). It negotiated its contract with SEIU in 2021 with key terms in line with current years' trends, but still has an open contract with CNA (over 7,000 nurses) that recently resulted in a one-day strike. Sutter has had a historically complicated relationship with its unions and has periodically had these types of strikes, though the last one before the recent one was many years ago.

Generally stable management team with a recent transition in finance leadership

While the management team remains largely stable, there is a new CFO as of 2020 with the permanent CEO potentially named by mid-2022. As mentioned, the team has initiated its next strategic plan that will help put the organization on stronger financial footing as it relates to operations while continuing to move forward on strategies that build off the current strengths of the enterprise. We note that the recent and ongoing turnaround efforts are significant and required a sustained effort in light of the various risks that could slow those efforts and that have been noted above.

Legal and regulatory scrutiny remains an issue for Sutter. The court approved the $575 million legal settlement with UFCW & Employers Benefit Trust and the California Attorney General in 2021, and there were no modifications to the terms of the settlement or the already accrued settlement expense. We believe longer-term effects may be less obvious and we could see medium- to long-term effects on performance as payer contracts are renewed, although we note that nothing within the settlement specifically indicates that and there was nothing material to note from one of Sutter's larger payer contracts that came up for renewal in 2021. The jury in a federal district court ruled unanimously in favor of Sutter in "Sidibe vs. Sutter Health," but the plaintiff has recently filed a notice of appeal, so that case remains ongoing. We will monitor any changes from the original decision, but view the initial ruling as a favorable sign for Sutter. Finally, Sutter Health and its medical foundations are now under a corporate integrity agreement (CIA) for five years related to alleged coding issues under Medicare Advantage several years ago. Management believes it has addressed any issues at the medical foundations where the alleged issue occurred, but the CIA will provide review of related processes and procedures. A number of other cases and inquiries that we continue to monitor remain ongoing, though none appear to be at the scale of the ones mentioned above.

Table 1

Sutter Health, CA -- Enterprise Statistics

	--Fiscal year ended Dec. 31--			
	2021	**2020**	**2019**	**2018**
PSA population	12,470,000	12,449,000	12,500,000	N.A.
Inpatient admissions	181,836	174,547	189,341	187,713
Equivalent inpatient admissions	407,258	375,402	426,980	419,703
Emergency visits	752,371	691,054	845,091	844,249
Inpatient surgeries	48,724	47,026	52,621	52,424
Outpatient surgeries	77,750	69,230	80,626	82,010
Medicare case mix index	1.8500	1.8100	1.6200	1.5900
FTE employees	42,124	44,406	43,471	42,395
Active physicians	5,500	5,500	5,500	5,500
Based on net/gross revenues	Net	Net	Net	Net
Medicare (%)	31.5	28.0	27.0	25.0
Medicaid (%)	14.1	14.0	12.0	15.0
Commercial/Blues (%)	57.2	56.0	59.0	58.0

N/A--Not applicable. N.A.--Not available. Inpatient admissions exclude normal newborn, psychiatric, rehabilitation, and long-term care facility admissions.

Financial Profile: Adequate

Operating performance improving, but still light and with limited track record

While Sutter had historically generated healthy performance and cash flow, the last several years leading up to COVID-19 had thin performance with break-even gains to small losses. This was followed by a substantial loss in fiscal 2020 after weak performance in 2019. While the recent historic trend was partially a result of a focus on maintaining moderate rate increases to preserve affordability, the system has also been exposed to the environmental challenges of Northern California (such as wildfires), and higher cost of living, and we view the more active approach by management of the last year or two as helpful to maintain long-term financial strength. With a new CFO and a disciplined focus on operating improvement, management was able to improve performance substantially in 2021. This was a result of additional provider relief funds, and good revenue yield through 2021 and early 2022, but also actions by management to reduce labor expenses and focus on productivity. Between attrition and, voluntary and early separations, full-time equivalent (FTE) counts are over 2,000 lower than 2020, which results in annual savings of several hundred million dollars.

Sutter's 2022 budget calls for improved performance, but we note headwinds related to inflation and collective bargaining agreements and whether revenue yield will remain as strong as it has through last year and early 2022. Management continues to have a steady plan to take out a substantial amount of annual expenses to keep up with inflationary costs and expenses to achieve EBIDA targets. Areas of focus for 2022 include revenue cycle, supply chain, pharmacy, corporate services, and clinical care variation improvements. While management was able to successfully negotiate its large SEIU contract last year, the contract with CNA remains open and has resulted in a recent one-day strike. If these challenges continue, we could see hurdles to meeting 2022 targets. We see some short-term flexibility for lighter operating performance given the healthy balance sheet and the team's turnaround efforts at the current rating.

Cash flow was supported by very healthy investment returns and some one-time gains, including the sale of an equity investment in MD Live and some property. Thus, MADS coverage was unusually strong in 2021. 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.

Unrestricted reserves grew with good cash flow and investment results as well as limited capital expenditures

Unrestricted reserves (excluding all external support) have continued to grow at about 12% in 2021 versus 10% in fiscal 2020 with positive cash flow, lower capital expenditures, solid investment returns (including one-time gain on sales identified above), and unrealized gains on investments. This was offset by Sutter's $575 million settlement expense that was accrued in 2019. If cash flow reaches targeted levels, capital expenditures will be at or just above annual depreciation expense, after being lower for the last couple of years due to the pandemic. Management expects to see reserve-related balance-sheet ratios hold or improve. Over time, if performance improves, we could see capital expenditures increase. We consider Sutter's investment asset allocation reasonable for the rating with about 45% fixed income, 25% equities, and 30% alternatives (and less liquid assets).

Near-term capital projects are related primarily to technology investments and clinical expansions in Davis, Roseville, and Santa Rosa, as well as outpatient investments, but likely larger projects (both for seismic and other reasons) could be considered over the next few years once operations stabilize, and the new full-time CEO is in place. The largest project that management will have to make a decision on related to 2030 seismic needs is its Alta Bates Summit Medical Center in Oakland and which it is evaluating among other seismic projects.

Conservative debt structure supports the 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 conservative given the lack of direct-purchase debt and no variable-rate demand bonds, but we note a few 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 $371 million with a commensurate $418 million operating lease right-of-use asset as of Dec. 31, 2021. 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 32%. Sutter has no plans for new-money debt over the next year, and likely not until operations stabilize.

Sutter's pension funding improved over recent years to 98% with the overall net unfunded liability at a much lower $106 million (relative to 2020). It also has other postretirement employee benefits liability of $26 million and a small legacy multiple-employer plan.

Sutter has no swaps outstanding or direct-purchase debt.

Table 2

Sutter Health, CA -- Financial Statistics					
	--Fiscal year ended Dec. 31--				Medians for 'A' rated healthcare system
	2021	2020	2019	2018	2020
Financial performance					
Net patient revenue ($000s)	12,133,000	10,527,000	11,407,000	10,957,000	2,687,606
Total operating revenue ($000s)	14,186,384	13,178,381	13,264,963	12,687,865	3,065,105
Total operating expenses ($000s)	14,109,000	13,607,000	13,352,000	12,664,000	MNR
Operating income ($000s)	77,384	(428,619)	(87,037)	23,865	MNR
Operating margin (%)	0.55	(3.25)	(0.66)	0.19	0.70
Net nonoperating income ($000s)	769,616	324,619	285,037	286,135	MNR
Excess income ($000s)	847,000	(104,000)	198,000	310,000	MNR
Excess margin (%)	5.66	(0.77)	1.46	2.39	2.30
Operating EBIDA margin (%)	6.70	3.61	6.09	6.46	6.60
EBIDA margin (%)	11.50	5.93	8.07	8.52	8.00
Net available for debt service ($000s)	1,720,000	801,000	1,093,000	1,106,000	253,176
Maximum annual debt service ($000s)	301,623	301,623	301,623	301,623	MNR
Maximum annual debt service coverage (x)	5.70	2.66	3.62	3.67	3.60
Operating lease-adjusted coverage (x)	3.84	2.03	2.64	2.69	2.80
Liquidity and financial flexibility					
Unrestricted reserves ($000s)	7,428,517	6,624,972	5,998,633	5,599,756	1,653,752
Unrestricted days' cash on hand	202.7	188.0	173.6	170.6	177.60
Unrestricted reserves/total long-term debt (%)	163.0	144.0	132.7	121.0	143.60
Unrestricted reserves/contingent liabilities (%)	2,476.2	2,208.3	5,998.6	2,799.9	580.20
Average age of plant (years)	11.2	10.4	9.6	9.6	11.60
Capital expenditures/depreciation and amortization (%)	51.4	57.7	89.7	135.7	117.30
Debt and liabilities					
Total long-term debt ($000s)	4,556,000	4,601,000	4,520,000	4,626,000	MNR
Long-term debt/capitalization (%)	29.7	34.2	33.9	34.9	39.50
Contingent liabilities ($000s)	300,000	300,000	100,000	200,000	MNR
Contingent liabilities/total long-term debt (%)	6.6	6.5	2.2	4.3	26.40
Debt burden (%)	1.99	2.23	2.23	2.32	2.40

Table 2

Sutter Health, CA -- Financial Statistics (cont.)

	--Fiscal year ended Dec. 31--				Medians for 'A' rated healthcare system
	2021	2020	2019	2018	2020
Defined-benefit plan funded status (%)	98.30	89.51	88.11	86.93	73.10
Miscellaneous					
Medicare advance payments ($000s)*	592,122	999,000	N/A	N/A	MNR
Short-term borrowings ($000s)*	0	399,940	0	0	MNR
COVID related stimulus recognized ($000s)	80,000	791,000	N/A	N/A	MNR
Supplemental Funding ($000s)	260,086	235,324	308,077	351,192	MNR

*Excluded from unrestricted reserves, long-term debt, and contingent liabilities. N/A--Not applicable. N.A.--Not available. 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 constitutes the majority of the assets and revenues of Sutter. 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 free-standing chemical dependency facility, two medical foundations, and more than 275 related medical foundation facilities and clinics. It also has home care and is party to a number of joint ventures and accepts capitated risk for a small percentage of its patients.

Ratings Detail (As Of May 4, 2022)

Sutter Hlth SYSTEM		
Long Term Rating	A/Stable	Current
Sutter Hlth SYSTEM		
Long Term Rating	A/Stable	Current
California Statewide Communities Dev Auth, California		
Sutter Hlth, California		
California Statewide Communities Dev Auth (Sutter Hlth) rev rfdg bnds		
Long Term Rating	A/Stable	Current