Fitch Rates Stanford Health Care (CA) New Issue Revs 'AA'; Outlook Stable

Fitch Ratings - Chicago - 09 March 2020:

Fitch Ratings has assigned a 'AA' rating to the following California Health Facilities Financing Authority (CHFFA) revenue bonds issued on behalf of Stanford Health Care (fka Stanford Hospitals and Clinics, SHC):

--$149M CHFFA Series 2020A;
--$146M CHFFA Series 2020B;
--$128M CHFFA Series 2020C;

Fitch has also affirmed the 'AA' Issuer Default Rating (IDR) and bond rating on approximately $1.7 billion of SHC's outstanding revenue bonds, and the 'AA'/'F1+' rating on $228 million in bonds that are supported by SHC's self-liquidity.

The Rating Outlook is Stable.

The Series 2020A, 2020B and 2020C bonds will be issued as tax exempt, used to refund approximately $235 million in outstanding series 2012C, 2012D, and 2015B bonds, and provide $280 million in reimbursement for project expenditures. The series 2020D taxable bonds will be issued as taxable, used to advance refund the series 2012A bonds and provide SHC approximately $150 million in proceeds for general corporate use. The bonds are expected to price the week of March 16.

SECURITY

Debt payments are secured by a pledge of gross revenue of the obligated group.

KEY RATING DRIVERS

Revenue Defensibility: 'bbb'; Solid position in competitive market with favorable demographics

Stanford Health Care has mid-range revenue defensibility, reflecting its solid footing as the only level 1 trauma center between San Francisco and San Jose as well as its position as the primary adult academic teaching hospital for Stanford University.

Operating Risk: 'aa'; Near-term margin compression will improve beyond fiscal 2020
SHC has a strong operating risk profile. Following some expected modest margin compression through the three-month interim period ended Nov. 30, 2019 since the opening of the new inpatient facility at 500 Pasteur in November 2019 (fiscal 2020), performance is expected to recover to historical levels. Future capital needs are modest given the brand new main facility that will provide additional inpatient capacity, though some capital needs remain for renovation of the 300 Pasteur inpatient building.

Financial Profile: 'aa'; SHC's financial profile is very strong, with capital-related ratios that exhibit solid improvement in Fitch's scenario analysis, and remain consistent in later years through a stress rating case.

Total debt of $1.9 billion is manageable against SHC's $3 billion in unrestricted liquidity, and with a 92% funded (actuarial benefit obligation, or ABO basis) defined benefit pension obligation SHC's debt equivalents are limited to its operating leases. Operating lease expense was $123 million in fiscal 2019, which translated to a $613 million debt equivalent (5x multiple).

Asymmetric Additional Risk Considerations

There are no asymmetric risk factors associated with SHC's rating.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action:

--Stanford Health Care (SHC)'s rating could improve over time with strengthened balance sheet and leverage metrics that are more consistent with a higher rating. Indicators of positive rating consideration would include cash and investments approaching 200% of adjusted debt, or net adjusted debt to adjusted EBITDA that is consistently less than (-3x).

Developments That May, Individually or Collectively, Lead to Negative Rating Action:

--Weaker financial performance or significant additional borrowing, which brings cash to adjusted debt below 120% could place pressure on the rating.

CREDIT PROFILE

Stanford Health Care (SHC) is a principal teaching affiliate of the Stanford University's School of Medicine. SHC, together with Lucile Salter Packard Children's Hospital (rated AA-), operates clinical settings through which the School of Medicine educates medical and graduate students, trains residents and clinical fellows, supports faculty and community clinicians and conducts medical and biological sciences research. SHC's close relationship with Stanford University and its School of Medicine generates certain reputational and clinical benefits that are unique in the service area and are important for recruitment. SHC operates a 605 licensed-bed tertiary, quaternary and specialty hospital, and the primary, specialty and sub-specialty clinics in which the medical faculty of the School of Medicine provide clinical services. SHC is also the sole corporate member of 242-bed SHC ValleyCare, located in the East Bay.

The main Stanford hospital is located on the campus of Stanford University adjacent to the School of Medicine in Palo Alto, CA.

Revenue Defensibility
SHC's payor mix is mid-range, with limited exposure to Medi-cal (California Medicaid) and Self-Pay revenues (approximately 10% of gross and 5% of net revenues). SHC's 'single-signature' (single structure is a key element in payor negotiations. Under its Stanford Health Care Alliance structure, more contracts like this are possible with major employers. The SHC Alliance provides a very useful environment for the move to value-based reimbursement.

SHC's key markets are San Mateo and Santa Clara counties, which account for approximately 50% of its inpatient admissions. However, its geographic reach as the only level 1 trauma facility located between San Francisco and San Jose expands its reach further from Napa, south to Monterey, and east to the Central Valley. As indicated by a very high case mix index (CMI) of 2.5, SHC's role as a tertiary and quaternary provider anchors its key role in the region. The nearest 'same-service' competitor is University of California San Francisco Medical Center in San Francisco, and SHC continues to grow its ambulatory and physician network in its market.

SHC's service area economy is favorable. Palo Alto benefits from the strong economic characteristics within the broader region. Population trends in San Mateo County and the greater region are favorable, and unemployment and income levels are favorable against state and national averages. The median household income level in Palo Alto is particularly strong within a greater region with favorable economic characteristics. Unemployment levels have remained solidly below state and national averages.

Fitch rates the city and county of San Francisco 'AA+' (Issuer Default Rating [IDR] and GO). The city is the economic and cultural center of the nine-county San Francisco Bay area, and its economic profile benefits from good wealth levels; per capita personal income is almost twice the national average and market value per capita is over $250,000.

Operating Risk

SHC's operating cost flexibility is strong. The system's operating EBITDA margin has averaged over 10% between fiscal 2017 and fiscal 2019 (operating expenses include SHC's services purchased from the University and the School of Medicine under its Funds Flow Agreement). EBITDA margins average above 11%, which is consistent with other similarly structured peers at the 'AA' rating. Operating EBITDA did weaken to 7.5% in the three-month interim period ended Nov. 30, 2019 (coinciding with the new hospital's open in November 2019), but is expected to recover and be maintained at or above 9% in-line with historical performance.

A key driver for SHC's cash flow generation going forward is expected to be volume growth, with some evidence of that already. Ambulatory revenue grew significantly in fiscal 2019 over prior year, to now 61% of net patient revenue (an 11% increase) across the system. Surgical cases increased about 3%, and outpatient clinic visits increased as well (just over 7%). The number of operated beds is 549, and SHC's efficiency, quality and cost control initiatives have continued to yield results.

Now under new leadership, Stanford's ValleyCare hospital improved its performance in fiscal 2019, generating strongly positive Operating EBITDA (following negative cash flow in 2018). Better results were produced by a combination of improved volume and payor mix characteristics and operational improvements, which should be sustainable. SHC reported it has collected approximately 75% of its $700 million goal for the new hospital as of November 2019.

Capital needs are modest, and SHC's average age of plant will decline in fiscal 2020 once it finishes its capital outlay and moves into the new facility. Future needs are focused on renewal at the existing facility, and will be funded with a combination of internal funds and philanthropy. The new hospital was completed at an estimated final cost of $2.2 billion.

Financial Profile
Per Fitch's scenario analysis, SHC's capital-related ratios remain consistent with the broad 'AA' rating category through year five of the stress case scenario, and inclusive of the current transaction. SHC's current net adjusted debt-to-adjusted EBITDA is -0.6x and cash-to-adjusted debt is 119%. Through the cycle in the stress case scenario (which assumes a modest recession in year one followed by a modest recovery and then stability), net adjusted debt-to-adjusted EBITDA is favorable and cash-to-adjusted debt remains above 100% throughout and reaches 160% by year five.

Total debt outstanding as of Nov. 30 2019 was about $1.8 billion. SHC's debt is approximately 78% underlying fixed-rate and 22% underlying variable-rate in various modes (e.g. CP mode, Windows mode, weekly, etc.). The variable-rate exposure includes variable-rate demand bonds (VRDBs) supported by self-liquidity and direct purchase. This series 2020 transaction will bring total debt to approximately $2.2 billion, with less than 8% in variable rate mode. SHC has several fixed payor swaps outstanding on a total notional amount of $575 million, with a current mark to market value of negative $281 million as of Nov. 30, 2019, at which point SHC was posting approximately $19 million in collateral.

The affirmation of the 'F1+' short-term ratings are supported by the strength of SHC's credit profile, and its highly liquid resources available to fund any un-remarketed puts on the today outstanding $228.2 million series 2012C, 2008B1 and 2008B-2 VRDBs. The VRDBs are in weekly, CP, and Windows mode. SHC has liquidation procedures in place detailing the process by which internal funds would be liquidated to meet any tender obligations.

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Applicable Criteria

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 07 Nov 2019)
U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria (pub. 27 Nov 2019)

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