FITCH AFFIRMS STANFORD HEALTH CARE (CA) REVS AT 'AA'; OUTLOOK STABLE

Fitch Ratings-Chicago-28 March 2019: Fitch Ratings has assigned an Issuer Default Rating (IDR) of 'AA' to Stanford Health Care (fka Stanford Hospitals and Clinics, SHC). Fitch has also affirmed the 'AA' rating on SHC's outstanding bonds and the 'AA'/'F1+' rating on bonds that are supported by SHC's self-liquidity, as listed at the end of this release.

The Rating Outlook is Stable.

SECURITY

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

ANALYTICAL CONCLUSION

The 'AA' rating is driven by Stanford Health Care's (SHC, f.k.a. Stanford Hospital and Clinics) strong financial profile assessment in the context of the system's mid-range revenue defensibility and strong operating risk profile assessments. The rating reflects SHC's capital-related ratios that are strong through-the-cycle in Fitch's rating case, broad reach for high-acuity services, largely favorable service area characteristics, and very close relationship with Stanford University (rated AAA). Fitch expects that SHC's operating EBITDA margin will improve and capital needs remain modest in the coming years as the system continues to stabilize after opening its new main facility during calendar 2019. Strong credit characteristics are balanced by a high degree of competition in the greater San Francisco and Central Valley region, as well as expected increased operating costs associated with the new facility. The 'F1+' rating reflects SHC's long-term credit quality, together with its ability to cover the maximum potential liquidity demands presented by its CP and weekly variable rate demand (VRDB) programs by at least 1.25x from its available liquid resources, including cash and highly liquid, highly rated investments.

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: 'a'; Near-term margin compression will improve beyond fiscal 2020

SHC has a strong operating risk profile. Some margin compression is expected - and typical - when the new facility opens in fall 2019, but performance will remain consistent for the rating and is expected to recover within a few years. Further, future capital needs are modest given the brand new main facility that will provide additional inpatient capacity.

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 outer years through a stress rating case.

Total debt of $1.9 billion is manageable against SHC's $2.9 billion in unrestricted liquidity, and with a 97% 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 $116 million in fiscal 2018, which translated to a $581 million debt equivalent (5x multiple).

Asymmetric Additional Risk Considerations

There are no asymmetric risk factors associated with SHC's rating. Following some deliberate structure reorganization, the system has a stable long-term management team and an aligned strategic planning process with its system counterparts. Substantially all senior leadership (save for the CMO) was new in 2016 and 2017. No additional turnover is planned or expected.

RATING SENSITIVITIES

CONTINUED SOLID FINANCIAL PERFORMANCE: Stanford Health Care's financial profile is solid and is expected to remain in line with 'AA' category medians. This should allow SHC to successfully complete its new main hospital, which will continue to enhance SHC's prominence in the industry. Weaker financial performance or significant additional borrowing could place pressure on the rating.

CREDIT PROFILE

Stanford Health Care (SHC, fka Stanford Hospital and Clinics) is a principal teaching affiliate of the Stanford University's School of Medicine. SHC, together with Lucile Salter Packard Children's Hospital, 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 currently operates a 613 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 and a majority of the clinics are 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 Medicaid and Self-Pay revenues (approximately 10%). SHC's 'single-signature' 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 approximately50% 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 UCSF in San Francisco.

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 it's 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 averaged near 10% between fiscal 2015 and fiscal 2018 (operating expenses include SHC's services purchased from the University and the School of Medicine under its Funds Flow Agreement). EBITDA margins average near 10.5%, which is consistent with other similarly structured peers at the 'AA' rating. SHC's margins will likely decline in fiscal 2019 due largely to increased expenses associated with the opening of the new hospital (depreciation, transition costs, etc.). Despite the softer margins on the horizon, Fitch expects SHC to maintain solid operating EBITDA at or above 9% in-line with historical performance. SHC also transferred $98 million in 2018 to the university, in support of the School of Medicine's academic mission.

A key driver for SHC's cash flow generation going forward is expected to be volume growth. SHC has operated at capacity in its existing facility, but will increase its operated beds to about 600 (versus the 477 operated currently) and allow for volume growth and better efficiencies. Further, cost control initiatives continue, and SHC's FTE's per adjusted occupied bed have fallen consistently since FYE 2016.

In addition, a very strong fundraising foundation is expected to generate solid philanthropic support and alleviate costs going forward. SHC reported it has collected approximately 75% of its $700 million goal for the new hospital.

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 is expected to come in slightly over budget ($2 billion). SHC expects to take occupancy in November 2019, following substantial completion in April 2019.

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. SHC's current net adjusted debt-to-adjusted EBITDA is -0.5x and cash-to-adjusted debt 113%. 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 through the stress and cash-to-adjusted debt remains above 100% throughout and reaches 170% by year five.

Total debt outstanding at fiscal 2018 year-end was about $1.9 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. SHC has several fixed payor swaps outstanding on a total notional amount of $576 million, with a current mark to market value of negative $176 million as of Nov. 30, 2018. SHC is currently posting approximately $3 million in collateral.

The affirmation of the 'F1+' short-term ratings are supported by the adequacy of SHC's highly liquid resources available to fund any un-remarketed puts on the $228.2 million series 2012C, 2008B1, and 2008B-2 VRDBs. The VRDBs are in weekly, CP, and Windows mode. Based on Fitch's rating criteria related to self-liquidity, SHC's position of eligible cash and investments available exceeds Fitch's 1.25x requirement to cover the maximum tender exposure on any given

date. SHC has liquidation procedures in place detailing the process by which internal funds would be liquidated to meet the tender obligations.

Outstanding debt affirmed at 'AA':
--$500 million Stanford Health Care taxable bonds, series 2018
--$454.2 million California Health Facilities Financing Authority (CA) (Stanford Health Care) refunding revenue bonds series 2017A;
--$100,000,000 California Health Facilities Financing Authority (CA) (Stanford Health Care) revenue bonds series 2015A;
--$375.4 million California Health Facilities Financing Authority (CA) (Stanford Hospital and Clinics) refunding revenue bonds series 2012A&B;
--$19.3 million California Health Facilities Financing Authority (CA) (Stanford Hospital and Clinics) refunding revenue bonds series 2010A&B;
--$5.9 million California Health Facilities Financing Authority (CA) (Stanford Hospital and Clinics) hospital revenue bonds series 2008A - 1-3.

Outstanding debt affirmed at 'AA/F1+':
--$60,000,000 California Health Facilities Financing Authority (CA) (Stanford Hospital and Clinics) variable rate revenue bonds series 2012C;
--$168,200,000 California Health Facilities Financing Authority (CA) (Stanford Hospital and Clinics) hospital revenue bonds series 2008B-1, 2008B-2 subseries 1 and 2008B-2 subseries 2.

Contact:

Primary Analyst
Emily Wadhwani
Director
+1-312-368-3347
Fitch Ratings, Inc.
70 West Madison Street
Chicago, IL 60602

Secondary Analyst
Kevin Holloran
Senior Director
+1-512-813-5700

Committee Chairperson
Joanne Ferrigan
Senior Director
+1-212-908-0723

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email: sandro.scenga@thefitchgroup.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
Rating Criteria for Public-Sector, Revenue-Supported Debt (pub. 26 Feb 2018)
https://www.fitchratings.com/site/re/10020113

U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria (pub. 04 Feb 2019)
https://www.fitchratings.com/site/re/10060276
U.S. Public Finance Short-Term Debt Rating Criteria (pub. 01 Nov 2017)
https://www.fitchratings.com/site/re/905637