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Ratings

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California Health Facilities Financing Authority
Stanford Health Care; Hospital

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California Health Facilities Financing Authority Stanford Health Care; Hospital

Credit Profile		
Stanford Hlth Care rev bnds ser 2018 due 08/15/2048		
Long Term Rating	AA-/Stable	Current
California Hlth Facs Fincg Auth, California		
Stanford Hlth Care, California		
Series 2012C		
Long Term Rating	AA-/A-1+/Stable	Current

Rationale

S&P Global Ratings' rating on California Health Facilities Financing Authority's fixed-rate revenue bonds, issued for Stanford Health Care (SHC; f/k/a Stanford Hospitals and Clinics) is 'AA-'. Our rating on the series 2018 taxable revenue bonds issued directly by SHC is also 'AA-'. In addition, our dual rating on the authority's variable-rate series 2008B and 2012C revenue bonds, issued by the authority for SHC is 'AA-/A-1+'. We based our 'A-1+' short-term rating component on our view of SHC's own liquidity and related procedures for handling any potential tenders. The outlook on all bonds is stable.

Our rating reflects our assessment of SHC's very strong enterprise and financial profiles. The enterprise profile reflects SHC's favorable tertiary focused business mix, exceptionally high case mix index, overall market share growth and brand strength as one of the region's two academic medical centers in a generally competitive market. The overall financial operating profile has improved in each of the last two fiscal years and in the early portion of fiscal 2019 with strong operating margin, cash flow and coverage of maximum annual debt service (MADS). These strengths are tempered by debt levels that, while manageable, are elevated for the rating and reflective of SHC's near completion of a major new facility on its main campus in Palo Alto, Calif. Operations are complemented by generally sound reserve levels on a days' cash on hand basis. However unrestricted reserves as a percentage of debt is only adequate for the rating as compared with relevant medians. Stanford Health's rating risk is tempered by strong cash flow and the benefits of opening its new major hospital addition in the fourth quarter of 2019.

These factors are aided by enterprise strengths, including SHC's close relationship to Stanford University and its sister organization the Lucille Packard Children's Hospital; a large, widely regarded and well distributed academic and medical faculty; solid research funding; and a comprehensive service mix, including numerous tertiary and quaternary services, combined with stable inpatient volumes, growing equivalent inpatient admissions, and a growing ambulatory presence throughout the Bay Area. The rating also reflects the 2015 acquisition of ValleyCare Health System in neighboring Alameda County. We believe ValleyCare is a strategically sound acquisition that helps extend SHC's brand into the east bay region of the larger metropolitan area despite growing losses at this facility through fiscal 2018.

The rating also reflects the very near completion of a major new hospital construction project now scheduled to be

completed by April 2019 with an opening roughly in the fourth quarter 2019 after formal commissioning, acceptance by regulatory authorities, and staff training. The final construction costs are forecast by management to come in at roughly 8%-10% over initial estimates due largely to management changes in the project's scope over the construction period, and some delays related to labor availability in the highly competitive construction market in the greater San Francisco Bay area.

In addition, the major construction on the campus has not hurt current patient flow and volumes as project staging on the campus has been successfully managed. In fact, getting more patients on campus is a key priority as hospital occupancy at the flagship campus is high at roughly 90%. Other credit strengths supporting the rating and stable outlook are a solid fundraising program that supports both the project and SHC's overall balance sheet, payor mix, and SHC's location in the economically vibrant Silicon Valley centered in Palo Alto.

The long-term rating reflects our opinion of SHC's:

- Sound enterprise position as a premier academic medical center in the affluent Silicon Valley region highlighted by continued sound patient volumes with strong growth in equivalent inpatient admissions, and a comprehensive tertiary and quaternary mix of services as reflected in a very high Medicare case mix index;
- Solidly improving operations for a number of years, demonstrating solid revenue growth and operating margins, combined with sharply improved results in the first quarter of the current fiscal year, generating strong cash flow, and MADS coverage given higher than average debt level;
- Stable and solid liquidity on a days' cash-on-hand basis but weak for the rating as measured by unrestricted reserves to debt as operations have been instrumental in supporting the high capital expenditures; and
- A sound strategy of trying to expand its overall footprint through significant outpatient expansion, physician recruitment, combined with a needed hospital expansion on the main campus to position SHC well for growth including the ability to accept many transfers it cannot accept now due to space constraints.

Risks to the rating include broad industry pressures, a fairly competitive environment and some dependence of investment markets to maintain overall balance reserve growth. Losses at a number of subsidiaries including ValleyCare are manageable currently given overall system performance. Under our criteria for acute care hospital providers, we can adjust the final rating by one notch to reflect peer comparisons and a more holistic view of the credit profile, which we have done to arrive at the current rating of 'AA-'.

Outlook

The stable outlook reflects our view of SHC's enterprise strengths including its ties to Stanford University, and our expectation that the overall financial profile will be maintained at least at levels demonstrated in fiscal 2018. In addition, we expect the opening of the new facilities to go smoothly with increased capacity and growth in patient volume to help offset the higher depreciation expenses.

Upward scenario

We continue to believe SHC's enterprise profile is consistent with a higher rating, and a positive outlook or upgrade would be premised on sustaining overall operating margins and coverage that was demonstrated during the first

quarter of the current fiscal year, combined with substantive improvement in balance sheet metrics over time. In addition, SHC would have to successfully complete the opening of the new facility, as forecast.

Downward scenario

While not expected, we believe a lower rating or negative outlook would be premised on reductions in overall cash flow and MADS coverage falling to under 3.5x, combined with moderate reductions in unrestricted reserves to debt from current modest levels.

Enterprise Profile – Very Strong

Market position

SHC is centered in Palo Alto, with one additional facility in Alameda County and a wide regional ambulatory care network. The flagship hospital is on Stanford University's campus. SHC is a controlled and wholly owned subsidiary of Stanford University and is adjacent to the Stanford University School of Medicine (SOM). Approximately two-thirds of the medical staff are members of the SOM faculty and account for roughly 90% of SHC's total admissions. SHC's flagship facility is an academic medical center and provides many tertiary and quaternary services as reflected in its Medicare case mix index of 2.47 for the first quarter of fiscal 2019. SHC has a significant outpatient presence, including a large 360,000-square-foot outpatient facility in Redwood City and, during the first quarter of fiscal 2019, a total of 60% of gross revenues came from outpatient business. Other new facilities and expansions include a South Bay cancer center, a women's cancer center, and a major new outpatient facility in Emeryville near Oakland and Berkeley as well as a variety of outpatient centers in and around the entire San Francisco Bay Area. On May 18, 2015, SHC became the sole member of a small health system known as ValleyCare Health System in Alameda County. In general, ValleyCare's overall financial effect on SHC is currently dilutive as it lost roughly $41 million in fiscal 2018, although it helps expand SHC's catchment area into the East Bay. ValleyCare is not currently a member of the obligated group. Management reports further mergers are not likely.

Stanford University and its other wholly owned hospital subsidiary, the Lucille Salter Packard Children's Hospital (a/k/a Stanford Children's Health), are separately rated, as the university does not guaranty SHC's debt, although numerous ties exist. The SOM employs the medical faculty, but SHC reimburses the school and university. While considerable funds flow to and from the university, these funds are for services rendered or received. In addition, SHC transferred $98.2 million in fiscal 2018 and $69.4 million in fiscal 2017 to Stanford University to support the SOM's academic mission and related initiatives, including faculty recruitment, the academic community and the school's physical plant. A portion of this funding relates to overall operating performance of SHC. The university provides other types of support to the hospital, including managing some of SHC's investments; inclusion, at times, in the university's broader fundraising program; and as co-joint-venture partners in certain physician-related and imaging businesses. The SOM faculty also conducts significant third-party funded research annually and many faculty members are on the hospital staff.

SHC has a large 21-county service area encompassing the broad San Francisco Bay region. Its more centralized market is the nine county area in and around San Francisco Bay where it captures roughly 10% inpatient market share. In its immediate local market of Santa Clara and San Mateo counties, it captures roughly 36% inpatient market share.

Share continues to grow modestly. SHC also has a broad patient draw reflecting its tertiary and quaternary service mix. It is also a level 1 trauma center. SHC also has an advanced EMR and has achieved recognition as one of the few Health Information Management Systems Society (HIMSS) Stage 7 hospitals in the country. In addition, it has received nursing magnet status.

Overall inpatient admissions were up slightly in fiscal 2018 at 33,955 versus 33,563 the prior year, including ValleyCare. Inpatient admissions at ValleyCare declined for the second straight year to 7,051 in fiscal 2018 from 7,621 the prior year and 8,027 in fiscal 2016. Equivalent inpatient admissions, which incorporate outpatient volume, have grown solidly to 111,133 in fiscal 2018 from 109,000 in fiscal 2017 and just over 105,000 the prior year on the strength of outpatient growth. Overall inpatient surgical growth has been strong as University HealthCare Alliance--an affiliated medical group--has expanded significantly and acquired an oncology center two years ago, which is driving improved surgical volume. Management attributes the broad volume trends as driven by additional recruitment of clinical faculty and the opening of many new large outpatient facilities in the primary service area, as well as the ValleyCare acquisition.

Management

Overall, SHC's management team has been stable since our last review after completing a major change in management two to three years ago. The current CEO started in the summer of 2016, with the current chief operating officer and chief financial officer starting in 2017. Other senior members of the management team were also hired. We believe these management changes have proceeded well and has driven SHC to its best year (fiscal year 2018) ever. Management and the Board completed an update to SHC's strategic plan over the past year. The plan essentially confirms SHC's existing strategy to remain an academic medical center with an exceptionally strong academic faculty and the ability to attract high-end tertiary and quaternary business from a large multicounty service area, while also attending to the primary care needs of the local population.

The local strategy incorporates community physicians, increasingly through its University HealthCare Alliance, to augment its faculty locally, and a robust outpatient facility strategy to expand its coverage of the local market, ultimately throughout the entire San Francisco Bay area. Currently management indicated the ValleyCare Health acquisition is not likely to be repeated as the main strategy is to largely a single high-end campus on the inpatient side while expanding its ambulatory care presence across the bay area. We believe the management team will continue to focus on execution and operating performance improvement as demonstrated in fiscal 2018 and in the current year to date.

The heart of the SHC's strategy is the strong quality of care across the system focused on recruitment of strong physician faculty with expansion centered on outpatient sites, while concluding the construction of the new facility at the main campus. The conclusion of the large inpatient construction of the main campus this year is the central initiative to service current and future growth and help attract top-flight faculty. In our view, the high occupancy at the main facility at roughly 88% of staffed beds is a good indicator of further demand for services at SHC. In addition, management reports many transfers are turned away given high occupancy bottlenecks at certain times, which the new facility should alleviate. The new facility will incrementally add 130 single rooms at the new facility, which we believe will be a huge help to the capacity constrained inpatient business on the main campus. Under the updated plan, capital expenditures are expected to remain high as some renovation of vacated space and further outpatient

growth are expected.

ValleyCare will continue to help SHC expand its presence in the East Bay area centered on Alameda County. SHC is also working to expand its presence into population health management with its own health plan and numerous agreements with local technology firms, although to date these efforts remain relatively modest. SHC's close ties to Silicon Valley's high-technology companies have enhanced fundraising, but also helped SHC develop a customer-focused consulting network for subscribing employers and to remain abreast of many key trends in health care, such as virtual health and telemedicine developments. The SOM's dean is working closely with SHC, according to management. The dean, and the CEOs of SHC and the Lucille Packard Children's Hospital sit on the medical center's executive committee.

SHC's preliminary capital budget for fiscal years 2019, 2020, and 2021 is large, in our opinion, at $1.8 billion. Fiscal 2019's capital is largely the completion of the hospital construction project, although roughly $1.1 billion is for fiscal 2020 and 2021. The last two years are still tentative. Capital expenditures of this magnitude, if funded from operations as forecast, are likely to keep overall balance sheet reserves stable at levels we consider only adequate for the rating. While no plans for future debt currently exist, an assessment of the broader balance sheet strategy is active and plans for additional debt, if any, should be clearer next year.

Table 1

Stanford Hospital And Clinics, California Enterprise Statistics

	--Three months ended Nov. 30--	--Fiscal year ended Aug. 31--	
	2018	**2018**	**2017**
PSA population	N.A.	N.A.	7,760,000
PSA market share (%)	N.A.	N.A.	10.4
Inpatient admissions	8,856	33,955	33,563
Equivalent inpatient admissions	20,136	74,680	62,755
Emergency visits	26,985	111,133	108,998
Inpatient surgeries	15,434	58,660	56,568
Outpatient surgeries	10,770	41,253	40,244
Medicare case mix index	2.4706	2.4201	2.3903
FTE employees	13,478	11,993	12,966
Active physicians	3,082	3,009	2,785
Based on net/gross revenues	Net	Net	Net
Medicare (%)	22.8	22.8	19.9
Medicaid (%)	6.4	7.3	6.6
Commercial/Blues (%)	67.4	66.3	61.6

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

Financial Profile – Very Strong

Growing equivalent admissions, strong revenue growth, minimal dependence on provider tax and disproportionate share revenues, and strong fundraising are key financial strengths. In addition to its focus on complex care, SHC

boosted overall patient activity by adding outpatient space, renovating and expanding operating rooms, and will be adding additional capacity later this year with the opening of the new acute care facility on the main campus. In the fiscal year ended Aug. 31, 2018, SHC had operating income of $320.7 million (6.5% operating margin). This is a solid improvement over fiscal 2017 operating results of $223.9 million (5.0% margin). Results for the first quarter of fiscal 2019 are much stronger with operating income at $118.6 million (9.1% margin). In general, the improved performance reflects on-going growth in equivalent inpatient admissions, while growing high-end acuity business as measured by a very high Medicare case mix index combined within-going attention to costs. All results are calculated according to S&P Global Rating methodology.

Excess income in fiscal 2018 was strong at $351.8 million (7.1% excess margin), which was incrementally improved from fiscal 2017 results of $314.2 million (6.9% excess margin). The drop reflected lower non-operating income from market performance. During the first quarter, excess income also showed improvement to $129.1 million (9.9% margin). Coverage of maximum annual debt service (MADS) was sound at 5.2x in fiscal 2018 and 4.7x in fiscal 2017. Non-cancellable operating leases have risen over time and reduced lease-adjusted MADs coverage to 4.1x in fiscal 2018, which we consider sound for the rating. Coverage during the first quarter showed continued improvement. S&P Global Ratings historically does not include unrealized gains or losses in its income calculation, and management reports that the change in value of its unrestricted cash and investments managed by Stanford University are unrealized until liquidated. As of Nov. 30, 2018, total cumulative unrealized gains in the SHC portfolio managed by Stanford University were sizable at $638.7 million. As a result, investment income, cash flow, and coverage are a bit understated. These results exclude direct support for the Stanford SOM, which SHC handles as a net asset transfer.

While SHC's balance sheet has improved though Nov. 30, 2018, because of broad investment market performance and solid cash flow, it has generally stabilized on an unrestricted reserve to debt basis even as overall reserves have risen. As of Nov. 30, 2018, SHC had $2.9 billion in unrestricted cash and investments, which, while strong overall, is an only adequate 237 days' cash on hand and 152% of outstanding debt. Both of these metrics are well below comparably rated providers.

While we had expected some balance sheet accretion once the major capital expansion project was completed in 2019, we now expect capital expenditures to remain strong keeping the overall balance sheet generally stable over the near to medium term. In our view, this will limit rating improvement in the near term, and will push future upward rating movement to the sustainability of the exceptionally strong margins shown in the first quarter of the current year and the ability of that performance to improve the balance sheet over time.

We consider overall pro forma leverage above average for the rating at 36% of capitalization. The debt burden is consistent with the rating at 2.1%. SHC's pension is well funded with a very small $6.7 million unfunded pension liability because the plan was frozen in 1997, combined with a $77.5 million postretirement benefit liability at the end of fiscal 2018. Since fiscal 2008, financial management has limited variable-rate risk and diversified counterparty and bank exposure prudently.

SHC's fundraising program remains a credit strength, which includes recent success through a corporate partners program with many widely known Silicon Valley high-technology companies and other substantial donations. As of Nov. 30, 2018, SHC has raised $656 million toward its $700 million for the "New Stanford Hospital," with roughly $521

million in cash received as of that date.

Under SHC's construction plan the new hospital will be substantially complete in the second quarter of 2019 with opening in the fourth quarter of this year. The hospital will be 1.1 million square feet of space, including 456 new beds in private rooms for a total increase of 130 beds, along with clinics, ancillary space, operating and emergency rooms, and medical and administrative offices.

SHC has $403 million of contingent liability debt, including its $228 million of variable-rate debt, a $100 million series 2012D direct-purchase obligation and a $75 million series 2015B direct-purchase obligation. In addition, it has a diverse but sizable swap portfolio with a notional amount of $575 million of floating- to fixed-rate swaps. Certain swap agreements require SHC (or the counterparties) to post collateral, based on then-current ratings, if fair-market value of the swap agreements exceeds a predetermined threshold dollar amount. As of fiscal 2018 year-end, SHC had no collateral posted, while the mark-to-market on the swap portfolio was a liability of $190.6 million. SHC's overall counterparty exposure has been diversified over the past few years and is now divided among four major institutions, with total notional exposure between $103 million and $182 million each.

As of Feb 28, 2019, SHC identified $1.2 billion in fixed-income and money market assets from its various investments to guarantee the full and timely purchase price of $228.2 million in debt outstanding supported by self-liquidity. Liquidity levels are monitored monthly by S&P Global Ratings. The debt supported by self-liquidity consists of $84.1 million series 2008B-1 weekly variable-rate demand bonds (VRDBs) and two tranches of VRDBs in commercial paper (CP) mode of $42.05 million each, designated as series B-2-1 and B-2-2, and $60 million series 2012C issued in a Windows mode, totaling $228.2 million. A range of assets made up of various investments in actively managed diversified portfolios back the debt. The bonds in CP mode are multi-modal and carry a dual rating.

Table 2

Stanford Hospital And Clinics, California Financial Statistics

	--Three months ended Nov. 30--	--Fiscal year ended Aug. 31--		Medians for 'AA-' rated health care system	Medians for 'AA' rated health care system
	2018	**2018**	**2017**	**2017**	**2017**
Financial performance					
Net patient revenue ($000s)	1,236,351	4,677,929	4,234,526	2,403,147	2,959,918
Total operating revenue ($000s)	1,300,227	4,910,546	4,444,369	MNR	MNR
Total operating expenses ($000s)	1,181,636	4,589,887	4,220,519	MNR	MNR
Operating income ($000s)	118,591	320,659	223,850	MNR	MNR
Operating margin (%)	9.12	6.53	5.04	2.60	3.60
Net nonoperating income ($000s)	10,518	31,122	85,275	MNR	MNR
Excess income ($000s)	129,109	351,781	309,125	MNR	MNR
Excess margin (%)	9.85	7.12	6.82	4.50	7.40
Operating EBIDA margin (%)	13.60	10.85	9.50	8.70	10.40
EBIDA margin (%)	14.29	11.41	11.20	10.80	13.50
Net available for debt service ($000s)	187,313	563,957	507,454	337,797	499,394
Maximum annual debt service ($000s)	107,910	107,910	107,910	MNR	MNR

Table 2

Stanford Hospital And Clinics, California Financial Statistics (cont.)

	--Three months ended Nov. 30--	--Fiscal year ended Aug. 31--		Medians for 'AA-' rated health care system	Medians for 'AA' rated health care system
	2018	2018	2017	2017	2017
Maximum annual debt service coverage (x)	6.94	5.23	4.70	4.80	6.50
Operating lease-adjusted coverage (x)	4.12	3.03	2.94	3.50	4.60
Liquidity and financial flexibility					
Unrestricted reserves ($000s)	2,942,280	2,954,190	2,284,878	1,813,269	3,055,984
Unrestricted days' cash on hand	236.8	244.3	205.1	243.20	341.80
Unrestricted reserves/total long-term debt (%)	152.3	152.3	161.2	187.70	259.90
Unrestricted reserves/contingent liabilities (%)	729.7	732.7	566.7	509.10	758.20
Average age of plant (years)	8.8	9.3	9.5	9.70	10.30
Capital expenditures/depreciation and amortization (%)	164.8	268.6	410.9	131.40	154.60
Debt and liabilities					
Total long-term debt ($000s)	1,931,562	1,940,167	1,417,729	MNR	MNR
Long-term debt/capitalization (%)	36.4	37.0	32.9	29.20	23.30
Contingent liabilities ($000s)	403,200	403,200	403,200	MNR	MNR
Contingent liabilities/total long-term debt (%)	20.9	20.8	28.4	39.60	44.10
Debt burden (%)	2.06	2.18	2.38	2.20	1.90
Defined-benefit plan funded status (%)	N.A.	96.45	78.90	81.30	86.10

N/A--Not applicable. N.A.--Not available. MNR--Median not reported.

This report does not constitute a rating action.

Credit Snapshot

- Security Pledge: The bonds are secured by the gross revenues of the of obligated group, which includes the main hospital located on the campus of Stanford University in Palo Alto, Calif., along with numerous outpatient physician clinics in the greater San Francisco region. Non-obligated subsidiaries of SHC include ValleyCare Medical Center, an insurance captive, joint ventures with Stanford University, and an outpatient oncology center with Emanuel Medical Center. The University HealthCare Alliance (UHA) is a physician medical foundation, with just under 300 affiliated physicians, is also outside of the obligated group.
- Group Rating Methodology: The current rating is based on our view of SHC's group credit profile (i.e., the consolidated audit for the system as a whole) and the obligated group's core status within the system. The obligated group is considered 'core' to SHC as it includes the flagship acute care hospital and the vast bulk of the system's revenues and assets, and thus, is rated at the same level as the group as a whole.
- Organization description: SHC is an academic medical center closely tied to the Stanford University School of

Medicine. SHC's sole corporate member is Stanford University and its board elects all of SHC's Board of Directors. SHC's main campus includes a 477 staffed acute care bed hospital located directly adjacent to Stanford University. In addition, SHC includes ValleyCare Health System, which operates in a number of locations in and around Pleasanton, Calif.

- Rating framework: Under our published criteria (U.S. And Canadian Not-For-Profit Acute Care Health Care Organizations, published on March 19, 2018) SHC is considered a stand-alone acute care provider. The presence of ValleyCare, a medical foundation, and other subsidiaries do not provide enough revenue diversity to consider this a health care system under the criteria.

Ratings Detail (As Of March 29, 2019)		
California Hlth Facs Fincg Auth, California		
Stanford Hlth Care, California		
Series 2008A-3, 2008A-1		
Long Term Rating	AA-/Stable	Current
Series 2008B-2, 2008B-1		
Long Term Rating	AA-/A-1+/Stable	Current