

## CREDIT OPINION

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 Rate this Research

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# Stanford Health Care

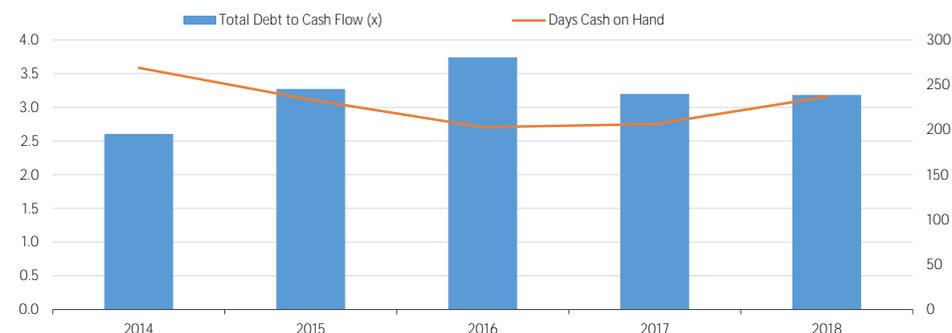
## Update to credit analysis

### Summary

Stanford Health Care (SHC, Aa3 stable) will continue to leverage its strong market position and brand name in order to generate stable margins and growing absolute cash flow. The organization will continue to benefit from multiple strengths including its large size, strong reputation for patient care and research, unique clinical offerings and its ownership by Stanford University (Aaa stable). Material challenges over the near term are related to its move into a new hospital, while managing the potential for operational disruption. Longer term challenges include generating sufficient cash flow to sustain a period of high capital spending that is expected to last several years and modestly depress liquidity metrics, while continuing to grow the organization's network throughout the competitive Bay Area.

Exhibit 1

**Capital spending will reduce days cash on hand over the next two years, but debt to cash flow will improve as the enterprise grows**



Source: Moody's Investors Service

### Credit strengths

- » SHC is a wholly owned subsidiary of Stanford University, which benefits fundraising; SHC has a strong working relationship with the School of Medicine and Children's Hospital
- » Strong brand name and significant demand for patient care services will allow SHC to continue growing volumes at the main campus and satellite locations throughout the Bay Area
- » Revenue growth will remain strong due to favorable contracts, high case mix index, and expected volume growth once the new hospital opens

- » Local service area will continue to be characterized by strong wealth levels and low rates of uninsured

## Credit challenges

- » Capital spending will remain elevated over the next several years, causing liquidity to decline
- » Competitive market throughout the Bay Area with multiple systems pursuing growth and various insurance strategies
- » Financial performance of the community hospitals will continue to depress consolidated margins
- » Liquidity is modest relative to peer institutions given that over half is managed by Stanford Management Company, which requires up to six-months advance notice of withdrawal of substantial funds

## Rating outlook

The stable outlook reflects our expectation that SHC will maintain margins at approximately current levels and that although higher capital spending will reduce liquidity from current levels, days cash on hand will remain strong.

## Factors that could lead to an upgrade

- » Significant growth in cash flow translating into increased liquidity and reduced leverage
- » For the P-1 and VMIG 1 short term ratings: not applicable

## Factors that could lead to a downgrade

- » Material decline in days cash beyond projections
- » Material additional debt issuance
- » For the P-1 and VMIG 1 short term ratings: a material change in coverage levels of assets backing the program

## Key indicators

Exhibit 2

### Stanford Health Care, CA

	2014	2015	2016	2017	2018
Operating Revenue (\$'000)	2,988,780	3,467,020	4,097,665	4,454,401	4,910,546
3 Year Operating Revenue CAGR (%)	13.0	13.3	15.4	14.2	12.3
Operating Cash Flow Margin (%)	12.3	9.7	6.6	8.1	8.9
PM: Medicare (%)	38.0	39.0	39.0	40.4	41.4
PM: Medicaid (%)	11.0	13.0	13.5	13.3	12.7
Days Cash on Hand	269	233	203	206	237
Unrestricted Cash and Investments to Total Debt (%)	155.7	141.8	151.7	152.5	157.9
Total Debt to Cash Flow (x)	2.6	3.3	3.7	3.2	3.2

Transfers to Stanford University as operating expenses; 2016 treats \$36 million of this expense (related to purchase of blood center) as non operating Revenue and expense related to the California Provider Fee reclassified as non-operating

Swap settlement payments reclassified to interest expense

Investment returns normalized at 6% prior to 2015, and at 5% in 2015 and beyond

Source: Moody's Investors Service

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## Profile

Stanford Health Care is an academic medical center that is wholly owned subsidiary of Stanford University. It operates a hospital on the university campus in Palo Alto, one community hospital in the East Bay, and several outpatient centers throughout the Bay Area, in addition to numerous physician offices.

## Detailed credit considerations

### Market position: strong brand and reputation will continue to drive favorable market position

Stanford Health Care (SHC) will continue to maintain an excellent market position as one of two academic medical centers in the Bay Area (the other is the University of California, San Francisco). SHC has a strong reputation for both clinical services and research, which will continue to aid in recruiting faculty and researchers and results in a very high Medicare case mix index of nearly 2.5.

In fall 2019, SHC will open a new flagship hospital in Palo Alto that will increase capacity to about 600 beds from approximately 477 today. We expect patient volume to grow as demand for transfers and admissions currently exceeds capacity. Construction and equipping the new hospital will be about \$200 million over the original budget of \$2.0 billion; the overage will be covered by cash flow.

Over the next several years, we expect SHC to focus on strategies that emphasize the organization's quality and unique capabilities. We expect SHC to continue building out its network of primary and specialty care centers throughout the Bay Area and begin offering new services in tele-health including second opinions for complex cases. We also expect SHC to emphasize various centers of excellence in high demand or relatively complex and highly reimbursed services such as neurology, cardiovascular, or solid organ transplantation. Given the organization's strong reputation and already high demand (many transfer requests are currently denied due in part to capacity constraints), we expect focus on these services to drive growth for the next several years.

### Operating performance, balance sheet, and capital plans: opening of new hospital will suppress margins over the near term; significant growth expected longer term

We expect operating margins in fiscal 2019 to be somewhat below that of fiscal 2018 as SHC incurs a number of one-time costs related to its move into the new hospital. Also suppressing margins in 2019 are higher than normal equity transfers to the university to support a school of medicine capital project. We expect margin improvement in fiscal 2020 with cash flow margins approaching 10%. Through six months fiscal 2019, SHC generated a 10.8% operating cash flow margin, inclusive of transfers to the university, compared to 11.3% in the prior year. Margins will come down by year end as SHC incurs move in costs.

Expense control will be key to achieving margin targets. Although SHC provides a number of highly reimbursed services, it also has a relatively high cost structure compared to community hospitals due to its role as an academic medical center with a large emphasis on research, teaching and high acuity care and we expect the organization will continue pursuing savings. Since joining several years ago, the current management team has emphasized operational discipline and achieving sustainable margins.

We expect capital spending to remain high for the next several years, totaling over \$1 billion in fiscal years 2020 - 2021. Spending will be focused on a variety of growth opportunities including new outpatient capacity.

## LIQUIDITY

We expect liquidity to moderate over the next several years, given SHC's large capital spending plans. Absent additional debt to fund capital projects, liquidity will likely fall to about 200 days cash on hand over the next three years. At the end of February, 2019, SHC had about 225 days cash.

Aside from approximately \$1.3 billion of cash, short term bond funds, and mutual funds, investments are managed in the university's merged pool. SHC can access a portion of the funds with up to six months' notice, but given the more aggressive nature of university investments, SHC's investment profile is more similar to that of a university than a typical hospital. Moreover, liquidity is modest for the rating category and compared to peer institutions (monthly liquidity as a percentage of total cash and investments is currently higher than in recent years, but still low at approximately 50% given the large share of investments not readily accessible by the hospital).

### Debt structure and legal covenants

Strong revenue growth will allow SHC to continue deleveraging. Debt to revenue is currently average at about 35%, but we expect this ratio to improve rapidly over the next several years due to strong revenue growth.

#### DEBT STRUCTURE

Debt structure is approximately 78% fixed rate, 12% self-liquidity, and the balance in direct bank loans.

Self-liquidity supported debt is comprised of \$84 million in weekly VRDB's and \$84 million of VRDB's in a commercial paper mode. There is also \$60 million in Windows mode which requires a six month notice before any put. SHC staggers the rolls of debt in a CP mode and keeps the two tranches at least one months apart. Assets supporting the program are evenly divided among three money market funds.

#### DEBT-RELATED DERIVATIVES

SHC has a very large swap program with approximately \$575 million in notional amount outstanding. The portfolio is diversified across four counterparties (JP Morgan, Wells Fargo, Goldman Sachs, and Morgan Stanley). The mark-to-market value across the entire portfolio was a liability of \$176 million at November 2018. At that date, there was no collateral posted. SHC has been required to post collateral at various points over the last several years which has been manageable given SCH's cash position.

#### PENSIONS AND OPEB

SHC has a small defined benefit plan. The unfunded liability was about \$6.5 million at FYE 2018, significantly down from the prior year after SHC annuitized a portion of the plan. Operating lease exposure is average and the comprehensive debt position (inclusive of the unfunded pension liability and operating lease debt equivalents) is manageable.

### Management and governance

SHC is a wholly owned subsidiary of Stanford University which approves various budgets at SHC and helps manage fundraising efforts. The hospital's senior management team has been in place since 2016 or 2017, depending on the role.

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