Sisters of Charity of Leavenworth Health System

Update to credit analysis

Summary
Sisters of Charity of Leavenworth Health System (SCL Health, Aa3 stable) will continue to deliver very strong operating performance, balance sheet measures will remain strong, and debt measures will continue to improve. Capital spending is expected to remain at manageable levels, and cashflow is expected to continue to grow, allowing for debt measures to continue to improve to levels more commensurate with the Aa rating category. Other ongoing strengths include: good market position; locations in favorable markets; and adherence to a centralized management model that allows for standardization and coordination across the system. Challenges include high leverage (though improved), material competition in certain markets, high exposure to a single state (Colorado operations make up 70% of operating revenues), and a somewhat challenging payer mix.

The VMIG 1 short term rating on debt supported by SCL Health’s self-liquidity is a function of SCL Health’s ample liquidity coverage, and the presence of appropriate operational procedures in support of the administrative aspects of the program.

The VMIG 1 short term rating on debt supported by standby bond purchase agreements reflects the agreements with - and the credit quality of – the corresponding banks.

Exhibit 1
Debt refunding further improves debt service coverage; balance sheet remains strong

Based on audited financial statements for Sisters of Charity of Leavenworth Health System, Inc., for fiscal years ended December 31; investment returns normalized at 6% prior in 2014, and at 5% in 2015 and beyond; net gain from joint ventures reclassified as non-operating income, net loss from disposal of assets excluded

Source: Moody’s Investors Service
Credit strengths

» SCL Health will continue to benefit from its sizable footprint, consisting of eight hospitals in two states with $2.7 billion in annual revenues

» SCL Health’s favorable market position in each of its markets will continue to help drive stable utilization

» SCL Health will likely continue to look to optimize its operating portfolio; most recent divestiture was St. Francis Health Center in Topeka Kansas in November 2017; currently, SCL Health is looking to partner with Providence St. Joseph Health in Montana

» Operating performance is expected to remain favorable; operating cashflow margin averaged 12.6% over the last five years

» Liquidity is expected to remain strong; days cash on hand measured 329 days as of June 30, 2019 (unaudited)

» SCL Health will continue to benefit from strong management and good disclosure practices; recent turnover of certain positions has been smooth, with strong continuity

Credit challenges

» Despite improvement, debt measures are expected to remain somewhat modest for the rating category; proforma cash to debt measured 154% as of FYE 2018

» SCL Health’s somewhat unfavorable payer mix will continue to be a challenge; in fiscal 2018, Medicaid was 16% of gross revenues, and Medicare was at 45%

» SCL Health remains highly concentrated in Colorado, with over 70% of operating revenues derived from the state and with over 50% concentrated in the Denver metropolitan region

» SCL Health will continue to have relatively high exposure to Kaiser Permanente as a payer and as a source of volumes; Kaiser was responsible for approximately 22% of net patient revenues in fiscal 2018

» SCL Health’s Master Trust Indenture uses a Restricted Affiliate model, which we view as weaker than an Obligated Group structure; this will remain a relative weakness despite expected springing changes to the indenture

Rating outlook

The stable outlook reflects the expectation that balance sheet measures will remain strong and that margins will remain favorable, delivering sufficient coverage of debt service requirements.

Factors that could lead to an upgrade

» System growth along with further cashflow diversification

» Significant improvement of debt measures while maintaining strong balance sheet and operating measures

» Short Term Self Liquidity: not applicable

» Short Term SBPA: not applicable

Factors that could lead to a downgrade

» Deterioration of operating performance

» Additional debt without the commensurate increase of cashflow and cash

» Short Term Self Liquidity: decline in coverage levels or in organization’s ability to manage the program
MOODY'S INVESTORS SERVICE

U.S. PUBLIC FINANCE

» Short Term SBPA: Moody’s downgrades the short-term CR Assessment of the Bank or the long-term rating of the bonds

Key indicators

Exhibit 2
Sisters of Charity of Leavenworth Health System, KS

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<tbody>
<tr>
<td>Operating Revenue ($’000)</td>
<td>2,395,800</td>
<td>2,539,100</td>
<td>2,483,800</td>
<td>2,635,100</td>
<td>2,721,600</td>
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<tr>
<td>3 Year Operating Revenue CAGR (%)</td>
<td>-2.0</td>
<td>4.9</td>
<td>2.7</td>
<td>3.2</td>
<td>2.3</td>
</tr>
<tr>
<td>Operating Cash Flow Margin (%)</td>
<td>12.0</td>
<td>11.5</td>
<td>13.8</td>
<td>14.1</td>
<td>11.7</td>
</tr>
<tr>
<td>PM: Medicare (%)</td>
<td>44.0</td>
<td>44.0</td>
<td>44.0</td>
<td>44.0</td>
<td>45.0</td>
</tr>
<tr>
<td>PM: Medicaid (%)</td>
<td>13.0</td>
<td>15.0</td>
<td>17.0</td>
<td>18.0</td>
<td>16.0</td>
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<tr>
<td>Days Cash on Hand</td>
<td>316</td>
<td>301</td>
<td>302</td>
<td>331</td>
<td>302</td>
</tr>
<tr>
<td>Unrestricted Cash and Investments to Total Debt (%)</td>
<td>121.0</td>
<td>120.8</td>
<td>131.1</td>
<td>154.7</td>
<td>154.4</td>
</tr>
<tr>
<td>Total Debt to Cash Flow (x)</td>
<td>3.8</td>
<td>4.0</td>
<td>3.3</td>
<td>3.0</td>
<td>3.1</td>
</tr>
</tbody>
</table>

Based on audited financial statements for Sisters of Charity of Leavenworth Health System, Inc., for fiscal years ended December 31; investment returns normalized at 6% prior in 2014, and at 5% in 2015 and beyond; net gain from joint ventures reclassified as non-operating income; net loss from disposal of assets excluded

Source: Moody’s Investors Service

Profile

SCL Health is a Catholic, three-state health system with approximately $2.7 billion of operating revenues. SCL Health’s operations are located primarily in Colorado, and Montana, and include: 90-bed Holy Rosary Healthcare, Miles City, MT; 73-bed St. James Healthcare, Butte, MT; 282-bed St. Vincent Healthcare, Billings, MT; 334-bed St. Mary’s Hospital & Medical Center, Grand Junction, CO; 379-bed Saint Joseph Hospital, Denver, CO; 391-bed Lutheran Medical Center in Wheat Ridge, CO; 185-bed Good Samaritan Medical Center in Lafayette, CO; and 98-bed Platte Valley Medical Center in Brighton, CO (numbers reflect staffed beds). SCL Health also operates three safety-net clinics in Kansas, and other various facilities in its primary markets.

Detailed credit considerations

Market position: multi-market system with favorable operating strategy

SCL Health’s strong market position, and favorable operating strategy, will continue to drive strong performance. Management is active in refining the organization’s approach, and over the past many years, the organization has augmented and rebalanced a number of its operating assets, particularly more recently in the Denver market. In 2014, St. Joseph Health and National Jewish Health (NJH) entered into a joint operating agreement whereby the two hospitals jointly manage all clinical operations and share profits. (SCL Health has a 75% share in the JOA). The partnership has been very profitable to date and contributed significantly to the strong revenue growth posted in 2017 and 2018. In 2015, SCL Health affiliated with Platte Valley Medical Center, an 81-bed community hospital located in the Denver suburb of Brighton. This transaction has also been very successful and is contributing to strong cashflow growth. Conversely, SCL Health’s partnership with Emerus was less successful. Established in 2015, the JV was terminated in 2018, with the Westminster micro hospital shut down on March 1, 2018, and with the two remaining micro hospitals (in Southwest and Northglenn) converted to Community Clinic Emergency Centers in the latter half of the year. SCL Health is looking to further broaden its footprint and presence in the Denver market, and has purchased land in a variety of locations as a preliminary measure.

An additional important strategic partner is Kaiser Permanente, which has contracts with SCL Health’s hospitals in Lafayette and Denver and is responsible for approximately 24% of SCL Health’s total patient volumes. The current contract with Kaiser in Lafayette has expired and is continuing year by year at rates established through the end of 2020, and the contract in Denver extends for an additional three years. SCL Health is currently exploring ways to enhance this relationship. Were Kaiser to terminate or discontinue these contracts, it would likely have a significant impact on SCL Health’s volumes, revenues, and overall profitability.
Overall, SCL Health’s competitive position is favorable, and is expected to remain strong. In Denver (which is responsible for over 50% of revenues), SCL Health competes with a number of other systems, including the for-profit Health One (which is the market leader with over 30% market share); Centura Health (owned by Baa1-rated CommonSpirit Health; with approximately 22% market share), and University of Colorado Health (with 11% market share). SCL Health is essentially tied in second position, with 21% market share. Outside of Denver, SCL Health’s position is particularly strong. In Grand Junction CO, SCL Health has 74% market share, in Billings MT, it has 48% market share, and in its other markets in Montana, it has close to 80% market share. Strong physician relationships (SCL Health employs over 770 physicians, physician assistants, and nurse practitioners) and numerous programs providing care across the delivery spectrum, further undergird SCL Health’s strong strategic position. These will remain important strengths going forward.

In Montana, SCL Health is contemplating further strengthening its competitive position through a potential partnership with Providence St. Joseph Health System (Aa3 stable), which operates hospitals in Missoula and Polson. A letter of intent was signed on May 9, 2019. The proposal is to create a joint operating company (similar to SCL Health’s agreement with NJH) whereby SCL Health and Providence would co-manage all of their Montana based clinical operations and share profits. The transaction may close early next year. Also in Montana, SCL Health has entered into an agreement with the Billings Clinic and Kindred Healthcare to jointly construct, own and operate a freestanding 34-bed inpatient rehabilitation hospital in Billings, Montana. SCL Health contributed the operations and assets of its existing inpatient rehabilitation program at St. Vincent, and the Billings Clinic and Kindred contributed cash. The hospital opened on August 6. While there are risks to the execution of these partnerships, SCL Health has a favorable track record of using partnerships to favorably grow volumes and cashflow, and we believe there is material potential upside to these projects.

**Operating performance, balance sheet, and capital plans: consistently strong operating margins; strong liquidity; modest capital spending**

Profitability is expected to remain strong, despite certain operational headwinds. Operating pressures include: reduced reimbursement in the Denver market; strategic pricing initiatives in Grand Junction and Montana; reduced reimbursement under the 340B program; payer mix shifts in western Colorado; reductions to the provider fee programs in Montana in 2018; and overall labor and contracting pressures. Nevertheless, despite a drop in margins in fiscal 2018, overall results remained favorable, with operating cashflow margin dropping to 11.7% from 14.1%, and with operating margin declining to 3.7% from 5.9%.

Results through six months of fiscal 2019 show significant improvement, with operating cashflow margin jumping to 14.5%, from 12.1% for the same period the prior year. Part of the improvement is due to a number of one-time items, including a catch-up payment under the Montana provider fee program, and an accounting adjustment due to a change in retirement plans. Nevertheless, without these items, profitability would still be strong, with the operating cashflow margin measuring 13.3%. Going forward, management expects to keep operating cashflow margins within the 11%-12% range. This high level of profitability is the result of a number of initiatives, including a more centralized approach to operations, greater uniformity with respect to supply contracts, improved revenue cycle management, improved efficiencies, and a willingness to optimize the portfolio of operating assets. Despite strong performance, management continues to look for additional opportunities to improve performance, including recently hiring consultants, and completing a new five-year plan. We view management’s ability to achieve and maintain strong operating performance year over year as a significant credit positive.

**LIQUIDITY**

A long-standing credit strength is SCL Health’s favorable liquidity position. As of June 30, 2019, unrestricted cash and investments totaled $2.2 billion, equal to a very favorable 329 days cash on hand. Asset allocation consists of 39% of cash and fixed income, 44% equities, and 17% alternatives, including real estate and hedge funds. 85% of investments can be made available within 30 days.

**CAPITAL PLANS**

Following high levels of capital spending which lasted over a decade, capital spending has been moderate since 2015, and has averaged 1.3 times depreciation over the last three years. It is expected that over the next several years capital spending will remain at approximately this level, enabling SCL Health to focus on further digesting its elevated debt load.

**Debt structure and legal covenants: Somewhat modest debt measures for the rating category, but improving**

SCL Health’s biggest credit challenge will continue to be the size of its debt portfolio, however certain debt measures have been improving, and will further improve upon the issuance of the Series 2019 refunding bonds. The Series 2019A (CO) and the Series 2019A (MT) fixed rate revenue refunding bonds will refund the vast majority of the Series 2010 A&B (CO, KS, MT) fixed rate revenue bonds.
The Series 2019 B&C (CO) self-liquidity backed variable rate demand bonds will refund the Series 2016 A&C self-liquidity backed variable rate demand bonds. Also at this time, the Series 2016B&D VRDBs are converting from weekly mode to daily mode. The net result is that peak debt service will materially decline, and total debt outstanding will stay approximately the same (inclusive of the expected addition of certain guarantees, discussed below). Proforma debt measures remain weaker than the medians for the rating category, but represent and improvement over the past, and are expected to continue to improve as SCL Health’s balance sheet and cash flow continue to grow. Based on fiscal 2018 results, proforma Moody’s-adjusted peak debt service coverage is 5.4 times (Aa3 median is 6.0 times), debt to revenue is 48.9% (Aa3 median is 30.7%), cash to debt is 154% (Aa3 median is 207%), and debt to cashflow is 3.1 times (Aa3 median is more favorable at 2.3 times).

DEBT STRUCTURE
SCL Health’s proforma debt consists of approximately 21% demand debt (including private placements, SBPA-backed debt, and self-liquidity backed VRDNs), and includes approximately $95 million of guarantees, including $9 million for the Rehabilitation Hospital of Montana (entered into earlier this month), and an expected $77 million relating to a new outpatient center to be constructed on the National Jewish Health (NJH) campus. (The NJH guarantee is expected to be entered into during the fourth quarter of 2019, and will likely not be effective for an additional 18 months, at the time of occupancy).

SCL Health’s self-liquidity backed variable rate demand bonds (Series 2016 A&C, to be replaced by the Series 2019 B&C bonds) enjoy good treasury management over-site, access to a large portfolio of diversified investments, and strong coverage from daily and weekly liquidity. SCL Health has adequate liquidity and procedures in place to support the tender feature of the self-liquidity backed variable rate demand debt in the case of a failed remarketing. Moody’s monitors the program on a monthly basis, and will continue to publish certain data relating to the program quarterly.

LEGAL SECURITY
SCL Health utilizes the restricted affiliate legal structure for its debt, which we view as weaker than a joint and several obligations. Under this structure, the parent corporation, which is not a revenue generating entity, is the only legally obligated entity for payment on the bonds. As the sole corporate member of each hospital the Corporate Parent directly holds legal title to essentially all real and personal property of all member hospitals. SCL Health also operates a centralized investment program through which custody and control of most cash and investments is handled directly by the Corporation. SCL Health relies on its ability to appoint and remove with or without cause the local CEOs and hospital boards and the special powers it has under each hospital’s articles of incorporation and by-laws, to cause cash to be up-streamed to the parent in order to service its debt.

Since 2013, four hospitals have been removed as restricted affiliates, namely: Providence Medical Center (Kansas City, KS), Saint John Hospital (Leavenworth, Kansas) Saint John’s Hospital and Health Center (Santa Monica, CA), and, most recently, St. Francis Health Center (Topeka, Kansas, on November 1, 2017), all of which are no longer part of SCL Health. In 2015, SCL Health affiliated with Platte Valley Medical Center (PVMC), however PVMC has not yet been designated a restricted affiliate. All of the remaining hospitals, as well as some of the other operating entities, are designated as restricted affiliates.

Bond covenants are standard and include a debt service coverage requirement of 1.1 times. Bonds backed by bank agreements have certain additional covenants, including a debt to capitalization covenant to not exceed 65%, and a rating covenant that is triggered upon a downgrade to below Baa2 (or BBB) by any rating agency.

DEBT-RELATED DERIVATIVES
SCL Health is counterparty to a relatively small amount of interest rate swaps, consisting of $98 million of fixed payer swaps, equal to 7% of total direct debt. There are no collateral posting requirements.

PENSIONS AND OPEB
Favorably, SCL Health has a relatively small amount of indirect debt. The organization maintains one defined benefit retirement plan which is generally well-funded, and at FYE 2018 had a small unfunded liability of $4.8 million, equal to a funded ratio of 98%. The debt equivalent of operating leases currently equals $116 million. The small amount of indirect debt is an important counter balance to SCL Health’s high direct debt load.
Management and Governance
Starting in 2017, the organization began to undergo some turnover. The CEO left the organization to pursue other opportunities, and after a nation-wide search, the CFO was appointed as the new permanent CEO. In early 2018 a new CFO was hired, and the newly created position of chief clinical officer was filled. Other recent changes include planned retirements of the CIO, CNO, and COO, and their orderly replacement. Overall, management turnover has been smooth, well communicated, and well organized, and operational practices remain consistent, and successful.