Sisters of Charity of Leavenworth Health Sys.

Update to credit analysis

Summary

It is our expectation that Sisters of Charity of Leavenworth Health System (SCL Health, Aa3 stable) will continue to deliver very strong operating results over the long term, that balance sheet measures will remain favorable, and that debt measures will continue to improve over the next two years. Despite pressures relating to COVID-19, results in 2020 remained very favorable (fiscal year ended (FYE) December 31), and results through six months of 2021 continue to be very strong. This general level of performance is expected to be maintained going forward. Liquidity is also expected to remain a strength, with days cash on hand reaching an all-time high as of June 30, 2021 (even excluding Medicare’s Accelerated and Advance Payment Program funds and deferred payroll tax), and is expected to remain favorable despite elevated capital spending over the next several years. Other strengths include: diversification across three markets, all with certain favorable characteristics; stable and seasoned management; and fairly conservative asset / liability policies.

SCL Health’s biggest challenge currently is its recent announcement to replace the Lutheran Medical Center, which is budgeted to cost $684 million, and will result in elevated capital spending averaging 2.1 times depreciation over the next three years. The project is expected to be completed by the Summer of 2024. In support of the project, SCL Health is considering issuing debt towards the end of the construction period. This would return SCL Health to somewhat elevated leverage metrics, nevertheless at levels that remain better than what they were during most of the last ten years. SCL Health’s improved debt metrics are a significant driver of the rating affirmation. Additional challenges include: ongoing pressures and uncertainty related to COVID-19; high exposure to Kaiser Permanente as a payor and a source of volumes; elevated labor costs; material competition in certain markets; a somewhat challenging payer mix; and concentration in the State of Colorado, which has a history of contemplating legislative measures which could be credit negative to hospital systems.

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 organizational policies in support of the administrative aspects of the program.
Credit strengths

» SCL Health will continue to benefit from its sizable footprint, consisting of eight hospitals in two states with approximately $3 billion in annual revenues

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

» Liquidity is expected to remain very strong

» Operating performance is expected to remain favorable despite pressures related to COVID-19

» SCL Health will continue to benefit from strong management and good disclosure practices

Credit challenges

» The planned replacement of Lutheran Medical Center will elevate capital spending over the next three years (averaging 2.1 times depreciation) and entail construction risk

» Additional debt may be issued in the next two to three years, which may prevent debt measures from further improving

» SCL Health’s somewhat unfavorable payer mix will continue to be a challenge; in fiscal 2020, Medicaid was 17% 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; competition in the Denver market is significant

» 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 18% of net patient revenues in fiscal 2020

» SCL Health’s Master Trust Indenture uses a Restricted Affiliate model, which we view as weaker than an Obligated Group structure

Rating outlook

The stable outlook reflects the expectation that margins will remain favorable over the long term, delivering good coverage of high debt service requirements. We also expect: liquidity levels to remain strong; the Lutheran Medical Center project to be completed on
time and on budget; debt measures to remain favorable compared to historical levels (despite the contemplated increase in debt); and SCL Health’s strategic position to remain strong.

Factors that could lead to an upgrade

» Further improvement of debt measures while maintaining strong balance sheet and operating measures and achieving system growth

» Short term rating: not applicable

Factors that could lead to a downgrade

» Additional debt without the commensurate increase of cashflow and investments

» Greater than expected long-term impact from COVID-19

» Failure to successfully execute the Lutheran Medical Center project

» Weakening of SCL Health’s strategic position or significant complications related to the Kaiser contract

» Short term rating: decline in coverage levels or in organization’s ability to manage the program; downgrade of long-term rating

Key indicators

Sisters of Charity of Leavenworth Health System, KS

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>6M 2021</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Revenue ($'000)</td>
<td>2,635,100</td>
<td>2,721,600</td>
<td>2,844,800</td>
<td>2,880,100</td>
<td>3,092,600</td>
</tr>
<tr>
<td>3 Year Operating Revenue CAGR (%)</td>
<td>3.2</td>
<td>2.3</td>
<td>4.6</td>
<td>3.0</td>
<td>2.4</td>
</tr>
<tr>
<td>Operating Cash Flow Margin (%)</td>
<td>14.1</td>
<td>11.7</td>
<td>13.3</td>
<td>11.4</td>
<td>13.2</td>
</tr>
<tr>
<td>PM: Medicare (%)</td>
<td>44.0</td>
<td>45.0</td>
<td>47.0</td>
<td>45.0</td>
<td>N/A</td>
</tr>
<tr>
<td>PM: Medicaid (%)</td>
<td>18.0</td>
<td>16.0</td>
<td>16.0</td>
<td>17.0</td>
<td>N/A</td>
</tr>
<tr>
<td>Days Cash on Hand</td>
<td>331</td>
<td>302</td>
<td>341</td>
<td>383</td>
<td>397</td>
</tr>
<tr>
<td>Unrestricted Cash and Investments to Total Debt (%)</td>
<td>154.7</td>
<td>153.1</td>
<td>187.3</td>
<td>220.4</td>
<td>244.9</td>
</tr>
<tr>
<td>Total Debt to Cash Flow (x)</td>
<td>3.0</td>
<td>3.1</td>
<td>2.5</td>
<td>2.6</td>
<td>2.2</td>
</tr>
</tbody>
</table>

2017 - 2020 based on audited financial statements for Sisters of Charity of Leavenworth Health System, Inc., for fiscal years ended December 31, 2021 based on six-month unaudited results annualized; investment returns normalized at 5%; 2020 excludes $183.2 million of Medicare’s Accelerated and Advance Payment Program (MAPP) funds and $53.4 million of deferred payroll tax, inclusive of those funds days cash on hand is 417 days and cash to debt is 240%; 6M 2021 excludes $165.6 million of MAPP funds and $53.4 million of deferred payroll tax, inclusive of those funds days cash on hand is 426 days, and cash to debt is 263%

Source: Moody’s Investors Service

Profile

SCL Health is a Catholic, three-state health system with approximately $3.0 billion of annual operating revenues. SCL Health’s operations are located primarily in Colorado, and Montana, and include: 90-bed Holy Rosary Healthcare, Miles City, MT; 67-bed St. James Healthcare, Butte, MT; 201-bed St. Vincent Healthcare, Billings, MT; 310-bed St. Mary’s Hospital & Medical Center, Grand Junction, CO; 374-bed Saint Joseph Hospital, Denver, CO; 379-bed Lutheran Medical Center in Wheat Ridge, CO; 183-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 overall 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 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 (rated Aa3 positive, with 11% market share). SCL Health is in third position, with 18% market share. Nevertheless, SCL Health is located in favorable neighborhoods and its clinical reputation is positive. Outside of Denver, SCL Health’s position is particularly strong. In Grand Junction CO, SCL Health has 69% market share; in Billings MT, it has 49% market share; in Butte MT, it has 79% market share; and in Miles City MT, it has 82% 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.

The system focuses on offering a full array of services and delivery platforms, and has been proactive in creating strategic partnerships. In 2014, St. Joseph Hospital and National Jewish Health (NJH) entered into a joint operating agreement whereby the two hospitals jointly manage all clinical operations and share profits within a specific geography. (SCL Health has a 75% share in the JOA). The partnership has been profitable to date and has significantly contributed to SCL Health’s favorable competitive position within that service area. In 2015, SCL Health affiliated with Platte Valley Medical Center, a 98-bed community hospital located in the Denver suburb of Brighton. This transaction has also been very successful and continues to contribute to strong cashflow. 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 in the Denver metropolitan region is Kaiser Permanente, which has contracts with Good Samaritan Medical Center, St Joseph Hospital, and as of July 15 2020, Lutheran Medical Center. Management considers its relationship with Kaiser’s local leadership to be strong, and expects the partnership to continue to grow. In 2020, Kaiser was responsible for approximately 18% of SCL Health’s net patient revenues. Were the contracts with Kaiser to be discontinued, it would likely have a significant impact on SCL Health’s volumes, revenues, and overall profitability.

Like all health systems in the country, SCL Health was significantly impacted by the pandemic. In the first and second quarters of 2020, the State mandated the restriction of certain procedures for a period of time, which significantly impacted volumes and revenues. For the remainder of 2020 and through the first half of 2021, operations have continued to be impacted by periodic spikes in COVID related volumes, decreased utilization in certain areas, and increased expenses, particularly labor. SCL Health has managed well through the crisis, and has nimbly adjusted to the changing environment. The State of Colorado worked to coordinate the medical response among all health systems, and SCL Health took a leadership role in this process. We believe the resiliency that SCL Health has demonstrated speaks well of management, and is an indicator of continued stability and financial strength going forward.

Operating performance, balance sheet, and capital plans: favorable operating results and balance sheet measures expected to continue

Operating performance is expected to remain favorable through the remainder of 2021 and into 2022 despite ongoing pressures related to COVID-19. Despite more modest expectations initially, performance measures were favorable in 2020, with operating cashflow margin measuring 11.4% and operating margin equal to 3.6%. Results through six months of 2021 have been even stronger, with operating cashflow margin at 13.2%, and operating margin measuring 6%. Results through the remainder of the year and going forward are expected to benefit from utilization measures that have fully recovered in most areas, continued organizational growth, and ongoing process improvements. SCL Health has experienced an increase in labor turnover rates and in the cost of labor, nevertheless management plans to offset these developments through improved efficiencies and other measures.

An additional benefit has been the receipt of CARES funding, which has been a significant source of additional support. In 2020, SCL Health received and booked $121.8 million of CARES funds, equal to 4.6% of net patient revenue. Through six months of 2021, SCL Health booked another $46 million. SCL Health is not budgeting to receive any additional funds, and margins for the year may moderate from current levels, but nevertheless are expected to remain favorable.

LIQUIDITY

A long-standing credit strength is SCL Health’s favorable liquidity position. SCH Health took a number of actions last year in response to the pandemic to further bolster cash balances, including drawing down a $200 million line of credit (which it repaid before the end of the year), accepting $183.2 million under Medicare’s Advance and Accelerated Payment program, and deferring $53.4 million in payroll tax. Subsequently, unrestricted investment balances hit all-time highs, measuring 417 days at FYE 2020 and 426 days as of June 30, 2021. Importantly, even without the short term advances, liquidity stands at historically high levels, measuring 383 days at
FYE 2020, and 397 days at June 30, 2021. Despite elevated levels of capital spending budgeted over the next three years, liquidity is expected to remain very favorable, constituting a major strength of the organization.

Asset allocation is relatively conservative given the size of the balance sheet. As of December 31, asset allocation consisted of 42% cash and fixed income, 45% equities, and 13% alternatives, including real estate and hedge funds. 87% of investments were available within 30 days.

**CAPITAL PLANS**
Following a period of relatively moderate capital spending, capital spending is expected to increase over the next three years. The largest project is the planned replacement of Lutheran Medical Center, which has a budget of $684 million and is expected to be completed in the Summer of 2024. Total capital spending is expected to average 2.1 times depreciation over the next three years. No other major projects are being contemplated at this time.

**Debt structure and legal covenants: significantly improved debt measures**
SCL Health’s biggest credit challenge historically has been the size of its debt portfolio. Over the last several years, debt measures have improved considerably. In 2020 cash to debt measured 220%, debt to cashflow was at 2.6 times, and peak debt service coverage was 5.9 times - all of which are mostly consistent with the Aa3 medians. (Debt calculations include the $72 million guarantee of a National Jewish Health obligation, and exclude the advance from CMS and deferred payroll tax). In contrast, debt to revenue remains significantly elevated, measuring 43%. SCL Health is contemplating issuing additional debt in the next two or three years, which would likely prevent debt measures from further improving.

**DEBT STRUCTURE**
SCL Health’s debt structure is fairly conservative, consisting of 75% traditional, amortizing, fixed rate bonds. The remainder is split between self-liquidity backed VRDNs (9%), a direct placement (4%), and other miscellaneous debt (12%), including a guarantee of National Jewish Health debt.

**SELF-LIQUIDITY**
SCL Health’s self-liquidity backed variable rate demand bonds (Series 2016 B&D bonds) enjoy good treasury management oversight, access to a large portfolio of diversified investments, and strong coverage from daily and weekly liquidity. Additionally, SCL Health has sufficient procedures in place to support the required administrative aspects of the program in the event 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 obligation. 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. Currently all of the hospitals (as well as some of the other operating entities) are designated as restricted affiliates, with the exception of Platte Valley Medical Center, which SCL Health affiliated with in 2015.

Bond covenants include a debt service coverage requirement of 1.0 times. Failure to comply results in a consultant call-in. Bonds backed by SCL Health’s one bank agreement have certain additional covenants, including a debt to capitalization covenant to not exceed 65%, a debt service coverage requirement of 1.1 times, and a rating covenant that is triggered upon a downgrade to below Baa2 (or BBB) by any rating agency. Failure to pass bank debt covenants would result in an Event of Default. Bank debt currently consists of a $52 million direct placement, equal to 4% of SCL Health’s total debt.

**DEBT-RELATED DERIVATIVES**
SCL Health is counterparty to a relatively small amount of interest rate swaps, consisting of $83.8 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 a defined benefit retirement plan which currently has a funded ratio of 105%. Operating lease liability is equal to $83.9 million. This small amount of indirect debt is an important offset to SCL Health’s historically large amount of direct debt.

ESG considerations

Environmental
Extreme weather in the mountain states region can have a seasonal impact on volumes. Otherwise, environmental considerations are not a significant driver of the rating.

Social
The most significant social consideration presently is the nation-wide nursing and skilled labor shortage, which is increasing costs, stressing access, and increasing the organization’s reliance on temporary labor. Other social factors include material exposure to Medicare and Medicaid, and the need to care for the indigent population. Additionally, COVID-19 continues to be a factor, and could have additional impact on utilization, margins, service offerings, and organizational moral. The ongoing duration and impact of the pandemic remains unknown.

Governance
Following a period of heightened turnover, the senior management team has been very stable, with little turnover among senior management in the last two years. Historically, succession planning has been smooth, well communicated, and well organized, with operational practices and strategy remaining consistent, and effective. The current management team is strong, and enjoys a deep bench. Disclosure and planning practices follow best practices.
MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements. Credit ratings do not address any other risk, including but not limited to: Liquidity Risk, Market Value Risk, or Price Volatility. Credit ratings, non-credit assessments ("Assessments"), and other opinions included in Moody's publications are not statements of current or historical fact. Moody's publications may also include quantitative model-based estimates of credit risk and related opinions or commentary published by Moody's Analytics, Inc. and/or its affiliates. Moody's credit ratings, assessments, other opinions and publications do not constitute or provide investment or financial advice, and Moody's credit ratings, assessments, other opinions and publications are not and do not provide recommendations to purchase, sell, or hold particular securities. Moody's credit ratings, assessments, other opinions and publications do not comment on the suitability of an investment for any particular investor. Moody's issues its credit ratings, assessments and other opinions and publishes its publications with the expectation and understanding that each investor will, with due care, make its own study and evaluation of each security that is under consideration for purchase, holding, or sale.

Moody's credit ratings, assessments, other opinions, and publications are not intended for use by retail investors and it would be reckless and inappropriate for retail investors to use Moody's credit ratings, assessments, other opinions or publications when making an investment decision. If in doubt you should contact your financial or other professional adviser. All information contained herein is protected by law, including but not limited to, copyright law, and none of such information may be copied or otherwise reproduced, repackaged, further transmitted, transferred, disseminated, redistributed or resold, or stored for subsequent use for any such purpose, in whole or in part, in any form or manner or by any means whatsoever, by any person without Moody's prior written consent.

Moody's credit ratings, assessments, other opinions and publications are not intended for use by any person as a benchmark as that term is defined for regulatory purposes and must not be used in any way that could result in them being considered a benchmark. All information contained herein is obtained by Moody's from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. Moody's adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources Moody's considers to be reliable, when appropriate, independent third-party sources. However, Moody's is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing its Publications. To the extent permitted by law, Moody's and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use such information, even if Moody's or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by Moody's.

To the extent permitted by law, Moody's and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, Moody's or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

No warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any credit rating, assessment, other opinion or information is given or made by Moody's in any form or manner whatsoever.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc. for credit ratings opinions and services rendered by it fees ranging from JPY125,000 to approximately JPY550,000,000.

MJKK or MSFJ (as applicable) hereby disclose that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MJKK or MSFJ (as applicable) have, prior to assignment of any credit rating, agreed to pay to MJKK or MSFJ (as applicable) for credit ratings opinions and services rendered by it fees ranging from JPY125,000 to approximately JPY550,000,000.

MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.

© 2021 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S CREDIT RATINGS AFFILIATES ARE THEIR CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND MATERIALS, PRODUCTS, SERVICES AND INFORMATION PUBLISHED BY MOODY'S (COLLECTIVELY, "PUBLICATIONS") MAY INCLUDE SUCH CURRENT OPINIONS. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT OR IMPAIRMENT. SEE APPLICABLE MOODY'S RATING SYMBOLS AND DEFINITIONS PUBLICATION FOR INFORMATION ON THE TYPES OF CONTRACTUAL FINANCIAL OBLIGATIONS ADDRESSED BY MOODY'S CREDIT RATINGS. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS, NON-CREDIT ASSESSMENTS ("ASSESSMENTS"), AND OTHER OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. AND/OR ITS AFFILIATES. MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS AND PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS AND PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS AND PUBLICATIONS DO NOT COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS, ASSESSMENTS AND OTHER OPINIONS AND PUBLISHES ITS PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS, AND PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS AND INAPPROPRIATE FOR RETAIL INVESTORS TO USE MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS OR PUBLICATIONS WHEN MAKING AN INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER.