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RATING ACTION COMMENTARY

Fitch Rates Sutter Health (CA)'s Series 2023 Bonds 'A+'; Upgrades Existing Ratings; Outlook Stable

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Fitch Ratings - San Francisco - 24 Apr 2023: Fitch Ratings has assigned an 'A+' rating to approximately $750 million taxable series 2023 revenue bonds to be issued by Sutter Health, CA (Sutter). Concurrently, Fitch has upgraded the Issuer Default Rating (IDR) and ratings on all other outstanding revenue bonds issued by or on behalf of Sutter to 'A+' from 'A'.

The Rating Outlook is Stable.

RATING ACTIONS

ENTITY / DEBT	RATING		PRIOR
Sutter Health (CA)	LT IDR Upgrade	A+ Rating Outlook Stable	A Rating Outlook Stable

Sutter Health (CA) /General Revenues/1 LT	LT	A+ Rating Outlook Stable	Upgrade	A Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

The taxable series 2023 bond proceeds will be used to for general corporate purposes. Bond proceeds will initially go onto Sutter's balance sheet as unrestricted reserves before being spent down over time. The bonds are expected to price in May or early June 2023.

SECURITY

The bonds are secured by a gross receivables pledge of the obligated group (OG).

ANALYTICAL CONCLUSION

Over the past several years, Sutter has implemented and executed upon a number of strategies to centralize key business functions and enhance top-line revenue, while managing its expense base by focusing on obtaining system efficiencies, that have led to reduced costs. The results have been successful, and in part provide much of the rating upgrade rationale to 'A+', as the system has now had two consecutive years of strong operating performance with yoy improvement. In fiscal 2022 (Dec. 31; audited), Sutter generated $278 million in income from operations (7.5% operating EBITDA margin), which was improved from the prior year's gain of $199 million, which is particularly impressive given the considerable macro labor and inflationary challenges faced by the sector. Fitch views favorably management's ability to grow the system's care delivery system in Northern California, which in part is observed by positive volume trends that either meet and/or exceed pre-pandemic levels.

Fitch believes Sutter is past the historical operational and structural challenges that affected the organization negatively in 2019 and 2020, which included the finalization of California Nurses Association (CNA) and SEIU collective bargaining contract renewals and a favorable resolution from a federal antitrust lawsuit (Sidibe v. Sutter Health), among other things.

Additionally, Sutter Health's balance sheet has improved over the past several fiscal years with absolute unrestricted cash and investments totaling more than $7.4 billion at FYE 2022, which has shown improvement over the past five fiscal years from 2018's $5.6 billion. Sutter's liquidity metrics in 2022 equated to approximately 197 days cash on hand and 148% cash to long-term debt, which provides the organization with sufficient financial flexibility at the 'A+' rating level.

The Stable Outlook reflects Fitch's view that the system's broad delivery of care network will remain in strong demand in its markets and that cash flow will be maintained, if not improved, in the 7% to 8.5% operating EBITDA range for the medium term.

KEY RATING DRIVERS

Revenue Defensibility: 'bbb'

Strong Presence in Competitive Northern California Market

Sutter Health benefits from a strong position as a leading provider of a wide array of healthcare services in the competitive, but demographically favorable markets in Northern California (i.e., Silicon Valley, San Francisco, and Sacramento). Sutter's combined Medi-Cal (Medicaid) and self-pay consistently measures in the 22%-23% range, below the 25% threshold for a midrange assessment.

Fitch believes Sutter benefits from both revenue and geographic diversification as each of Sutter's core markets maintain differentiating characteristics that can provide economic support and/or insulation from any acute adverse event in one specific market. Additionally, Sutter operates its own health plan, Sutter Health Plus, which has approximately 100,000 members.

Operating Risk: 'a'

Positive 2022 Performance with Continued Efficiency Expected

Operating performance in FY 2022 improved from the prior year as Sutter produced strong absolute operating EBITDA of more than $1.1 billion (7.5% margin). This marks the second consecutive year the system has posted operating EBITDA performance above $1 billion, which Fitch views favorably and as a primary contributor supporting the operating risk assessment improvement to 'a' from 'bbb'. The operating improvement is particularly noteworthy given the considerable macro labor and inflationary challenges faced by the sector.

As Sutter's new management team is now largely in place, led by CEO Warner Thomas (who joined in late 2022), the system has been focused on creating more operational efficiency with certain key business functions more centralized; efficiencies highlighted by items such as driving down contract labor and supply expenses, elevating throughput initiatives that increase revenue, while bringing down average length of stay, and streamlining hiring initiatives to recruit and retain staff, nurses, and physicians.

Fitch views Sutter Health's current operating risk expectations as 'strong', which reflect the expectation for strong cost management and that operating EBITDA margins are likely to range from approximately 7% to 8.5% over the medium term. This level of operating performance and continually generating operating EBITDA above $1 billion annually should be sufficient to fund Sutter Health's sizeable capital needs. Additionally, with positive and strong operational cash flow generation, Fitch would anticipate modest, incremental improvement to certain financial metrics (cash to adjusted debt) over time.

Over the next five fiscal years, Sutter Health expects to spend, well above annual depreciation expense. In recent years, net capex had been relatively low, with a capital spending ratio averaging well below 1x over the last three fiscal years, as the system grappled with various operating pressures.

Financial Profile: 'a'

Debt and Liquidity Metrics Support 'A' Rating Category

Sutter Health's leverage and liquidity metrics continue to support the 'a' assessment in Fitch's scenario analysis, despite an applied investment portfolio stress, operational stress, and incorporation of the 2023 debt.

Sutter's leverage and liquidity metrics continue to be consistent with Fitch's expectations for a credit in the broad 'A' rating category; cash-to-adjusted debt was approximately 148% at FYE 2022.

Sutter Health's adjusted debt figure totaled approximately $5 billion at FYE 2022. The system's defined benefit pension plans were over 100% funded at Dec. 31, 2022, and did not contribute to Fitch's adjusted debt metrics as it exceeded the 80% funding threshold.

Fitch's scenario analysis incorporates Sutter's planned series 2023 taxable debt issuance. In a stress case, Sutter is still able to maintain key financial metrics (cash to adjusted debt and net adjusted debt to adjusted EBITDA) that are consistent with the broad 'A' rating category.

Asymmetric Additional Risk Considerations

There were no asymmetric additional risk considerations applied in this rating determination.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Although unexpected, cash flow margins that are below 6% for a sustained period of time;

--A significant drop, in unrestricted resources that pressure Sutter's liquidity metrics;

--A material increase in long-term debt that's not met with commensurate revenue to support additional debt service.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Positive rating action is unlikely over the Outlook period given the current rating upgrade;

--Further improvement in operating cash flow generation that is consistently near or above a 9% operating EBITDA margin;

--Increase to the system's unrestricted cash position that yields a stronger cash-to-adjusted debt that exceeds 200%.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

CREDIT PROFILE

Headquartered in Sacramento, CA, Sutter Health is the parent of a large, integrated healthcare provider with 27 acute care campuses, two medical foundation organizations, ambulatory surgery centers and specialty centers serving approximately 3.3 million Californians. The system includes other healthcare related entities, including a health plan with approximately 100,000 members, Sutter Health Plus (SHP). On a consolidated basis, the Sutter Health system reported nearly $14.8 billion in total system revenues in fiscal 2022 (Dec. 31 YE; audited).

Revenue Defensibility

Sutter Health's payor mix has a Medicaid (Medi-Cal) percentage that was approximately 22% in 2022, which has been stable over the past five fiscal years at or near the current level. Medicare has also similarly exhibited historical stability for the system at 46% in 2022. With its Medicaid business, Sutter Health receives supplemental Medi-Cal payments from California's provider fee program. In 2022, Sutter recorded $175 million in net operating income from the hospital free program, which is relatively consistent with 2021's $186 million in provider fee net operating income.

Sutter Health is a well-recognized provider offering a full range of healthcare services primarily in Northern and Central California. With the move toward integrated delivery models and capitated lives (over 400,000), Sutter Health remains one of the largest systems in this broad market, along with Kaiser Permanente (AA-/Stable) and CommonSpirit (A-/Stable).

Fitch believes the system does possess both revenue and geographic diversification as each of Sutter's core markets maintain differentiating characteristics that can provide economic support and/or insulation from any acute adverse event in one specific market. Fitch views favorably management's focus on not only maintaining, but growing the system's care delivery presence in each of its markets, which should be accretive financially over time especially with continued drives in efficiency.

Sutter Health operates in a broad service area that largely encompasses Northern California with areas that generally possess favorable demographics and solid population growth. In total, Sutter served approximately 3.3 million patients in 2022 across its geographic reach (total approximate population of 12.5 million), which includes the system's Central Valley, East Bay, Sacramento, San Francisco, and Silicon Valley markets.

Sutter's stable Medicare payor position, reflected in 46% of gross receivables, highlights the somewhat younger, commercially insured population in parts of this wide and economically diverse market. There have been some residential shifts in the Bay Area market as residents relocated to lower cost of living locations during the pandemic, which is a trend that continues.

Operating Risk

Over the past few years, Sutter Health has been working at implementing its recovery plan, which has been successful and helped support fiscal 2022's strong operating performance. Additionally, management has aligned key priorities with newer strategy to move to a more community-based market system that is able to holistically drive efficiencies.

Sutter has had long-term inherent expense pressures from higher capital from state seismic regulation, high cost of living wages, and a large number of collective bargaining agreements, which is expected to remain for the foreseeable future. Thus, management continually needs to identify opportunities to reduce costs (i.e., supply chain, corporate services, workforce effectiveness, and pharmacy) while exploring avenues to expand revenues streams including through market growth, revenue cycle, and other revenue opportunities.

Over the next five fiscal years, Sutter Health expects to spend well above annual depreciation. Historically, net capex was relatively low for the system at $365 million in 2022 (53% of depreciation), $368 million in 2021 (50% of depreciation), and $428 million in 2020 (57% of depreciation) as the system grappled with various operating pressures including the pandemic. Incorporating the series 2023 debt issuance, capex is expected to increase beginning in 2023 with approximately $858 million and then be around $1 billion annually until 2027, which is more appropriate, but manageable given the previous years of decreased investment in plant, competition in the market place, and California's pending 2030 seismic requirements.

Financial Profile

In 2022, Sutter's leverage metrics demonstrated consistency from the prior year, which is characterized by solid liquidity reserves compared against a stable long-term debt position. The system's leverage and liquidity metrics continue to be consistent with Fitch's expectations for a credit in the 'A' rating category. Specifically, cash-to-adjusted debt was approximately 148% in 2022, slightly ahead of 2021's approximate 143% position. Unrestricted cash and investments totaled a strong $7.4 billion for the year-end, which has exhibited good growth over the past five years when Sutter had approximately $5.6 billion in unrestricted cash and investments.

Sutter Health's adjusted debt figure totaled approximately $5 billion in 2022, which is consistent with 2021's amount. Sutter Health's defined benefit plans were over 100% funded at Dec. 31, 2022, and did not contribute to Fitch's adjusted debt metrics as it exceeded the 80% funding threshold.

Fitch's stress case scenario incorporates Sutter's planned series 2023 taxable debt issuance and Fitch's stress assumptions of a sharp decline in investment portfolio values (-13.5%) with margin compression in the initial years. Despite the assumed pressures, Sutter's operating EBITDA performance returns to above 6% in the out years of the five-year scenario during a potential operational stress. With the implied balance sheet and operational stress, Sutter is able to maintain key financial metrics (cash to adjusted debt and net adjusted debt to adjusted EBITDA) that are consistent with the 'A' rating category.

The scenario expects capex to be reduced by approximately 25% in a period of stress, which Fitch views as manageable given Sutter Health's capital flexibility. Fitch's scenario is a sensitivity tool to analytically gauge the level of recovery after a plausible stress, and Sutter Health's demonstrates sufficient financial viability towards to the out years of the scenario.

Asymmetric Additional Risk Considerations

No asymmetric additional risk considerations were applied in this rating. Debt outstanding is composed of entirely fixed rate debt. The system has access to a $900 million line of credit that is not currently drawn. Maximum annual debt service is calculated at approximately $311 million, and does not pose an asymmetric risk, nor does Sutter Health's asset allocation, which is considered standard for the sector, with a mix of fixed income instruments, followed by a fairly equal split of equities and alternatives and other investments.

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

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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APPLICABLE CRITERIA

U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria (pub. 18 Nov 2020) (including rating assumption sensitivity)

Public Sector, Revenue-Supported Entities Rating Criteria – Effective from September 1, 2021 to April 27, 2023 (pub. 01 Sep 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Portfolio Analysis Model (PAM), v2.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Sutter Health (CA)	EU Endorsed, UK Endorsed

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