Fitch Downgrades UPMC's (PA) Ratings to 'A'; Rates Expected 2020A&B Bonds 'A'; Outlook Stable

Fitch Ratings - New York - 24 March 2020:

Fitch Ratings has assigned an 'A' rating to the following series of bonds expected to be issued on behalf of UPMC (PA):

--$533,975,000 Pennsylvania Economic Development Financing Authority, UPMC revenue bonds, series 2020A;

--$212,925,000 Maryland Health and Higher Educational Facilities Authority revenue bonds, UPMC Western Maryland Issue, Series 2020B.

In addition, Fitch has downgraded UPMC's Issuer Default Rating (IDR) and revenue bond ratings on UPMC's outstanding parity debt issued by UPMC and through the Pennsylvania Higher Educational Facilities Authority, Allegheny County Hospital Development Authority, University of Pittsburgh Medical Center, Monroeville Finance Authority, Lycoming County Authority, and Pennsylvania Economic Development Financing Authority to 'A' from 'A+'.

The Rating Outlook is Stable.

The series 2020A and 2020B bonds are expected to be issued as fixed-rate, tax-exempt or taxable bonds and sold via negotiation the week of April 6, 2020. Proceeds from the 2020A bonds may be used for working capital, capital expenditures, refunding certain outstanding bonds and pay costs of issuance. The proceeds from the series 2020B bonds will be used to refinance a bridge loan related to the early 2020 acquisition of Western Maryland Health System (WMHS) and pay costs of issuance. The bonds will have an April 2050 final maturity. Additionally, UPMC has executed or is planning to enter into four additional financing arrangements before April 15: a new line of credit and three private placement agreements that will provide a combination of working capital funds, capital projects and proceeds to refinance certain outstanding bonds. UPMC has also drawn $500 million under its existing line of credit for working capital.

SECURITY

The bonds are secured by a gross revenue pledge of the obligated group (OG). The series 2020A and 2020B bonds will constitute parity debt under UPMC's 2007 master trust indenture (MTI). The

Insurance Division, which is not in the OG, accounts for over 55% of system operating revenues (before eliminations).

ANALYTICAL CONCLUSION

The rating downgrade to 'A' from 'A+' is based on UPMC's plan to increase its long-term debt by $1.2 billion in addition to borrowing $1 billion in short-term capital in 2020. The interim financings will be fully drawn during 2020 and are intended to help address any additional working capital needs during the current coronavirus outbreak but will be paid back before the end of the audit year.

The long-term incremental debt pressures UPMC's financial profile, which already reflected cash to adjusted debt of 91% at YE 2019. UPMC has demonstrated considerable growth in recent years, pursuing strategic investments to position the organization as an essential, innovative provider on both the clinical and health plan side. This growth has come at a cost however with strategic investments that have outpaced UPMC's weaker cash flow over the past two years. As a result, unrestricted cash remained stable at $5 billion in fiscal 2019, despite higher investment valuations at YE 2019 compared to YE 2018. UPMC's low cash position for an organization of its size has left it vulnerable to the current decline in investment valuations, and combined with the additional debt load, results in a credit profile that is no longer consistent with the 'A+' rating.

With the new 10-year agreement between Highmark and UPMC that was settled in June, Fitch expected fiscal 2020 to be a year of increased margins for UPMC, which would ultimately improve the balance sheet. The operating recovery will have to wait while UPMC, like many other providers, address the short-term disruptions from the coronavirus pandemic on both the clinical side as well as the possibility of increased insurance claims at its health plan. Furthermore, UPMC will need to pay back the $1 billion in working capital loans by year-end, and there is uncertainty as to how much of those funds will have been used during the year, which may require the system to use some of its unrestricted cash and investments to pay the loans.

UPMC has generated weak operating EBITDA margin averaging approximately 4.6% over the past five years, but the operating risk driver is assessed by Fitch at 'bbb' based on its view that the system's sizable health plan and the strategic importance of this plan in solidifying market share is accretive to UPMC's overall operating model. While the financial profile for UPMC suggests a lower rating, Fitch believes that UPMC's integrated delivery model with its aligned physician base, extensive health plan, and sizeable delivery network, will continue to significantly shift the market in Western Pennsylvania in UPMC's favor and supports a higher rating.

The recent coronavirus pandemic and related worldwide government containment measures, has created an uncertain environment for the entire healthcare system in the near term. While UPMC's financial performance through the most recently available data has not indicated any impairment, material changes in revenue and cost profiles will occur across the sector, and will likely worsen in the coming weeks and months as economic activity suffers and government restrictions remain in place or expand. Fitch's ratings are forward-looking in nature, and Fitch will monitor developments in the sector as a result of the virus outbreak as it relates to severity and duration, and incorporate revised expectations for future performance and assessment of key risks.

KEY RATING DRIVERS

Revenue Defensibility:: 'bbb'

Leading Market Position Enhanced by Insurance Plans

UPMC's main credit strength continues to be its strong and leading market share of the western Pennsylvania market with an estimated 59% share in Allegheny County, which is home to approximately 1.2 million residents. UPMC's leading market share remains strong at 43% share of the 29 counties in western Pennsylvania including Allegheny County. Additionally, Fitch views UPMC's revenue diversification, which includes the insurance division generating more than half of system revenues before eliminations or 48% of unconsolidated revenues, as a credit positive. The insurance plans are a source of stable revenue for the system while solidifying UPMC's healthcare presence in the state.

Operating Risk:: 'bbb'

Weak Operating Margins Offset by Insurance Plans; Elevated Capital Plans

Despite a multi-year trend of low profitability in the health service division, Fitch is assessing a mid-range overall operating risk profile given the accretive health insurance operations and low capital needs that provide a fair amount of spending flexibility.

Financial Profile:: 'bbb'

Leverage Metrics Weaken with the Current Issuance

Fitch expects UPMC's leverage metrics to remain weak for the foreseeable future with the increased debt as well as the possible decrease in cash from operating constraints in 2020, in addition to lower investment valuations. With revenue defensibility and operating risk assessed at mid-range, average cash to adjusted debt of roughly 70% in the outer recovery years of Fitch's scenario analysis and average net adjusted debt to adjusted EBITDA of 1.0x are within the thresholds of a 'bbb' assessment for the financial profile.

Asymmetric Additional Risk Considerations

No asymmetric additional risk considerations were applied in this rating determination.

RATING SENSITIVITIES

The Stable Outlook reflects Fitch's belief that the downgrade to 'A' incorporates the decline in balance sheet strength as well as some of the uncertainty in 2020 results, and that UPMC's longer-term results are aligned with this rating.

Developments That May, Individually or Collectively, Lead to a Negative Rating Action:

--Significant use of unrestricted cash at year end 2020 to pay back the two working capital loans;

--Further margin compression that continues over a period of time;

--High capital or strategic spending that requires significant additional cash or debt commitments.

Developments That May, Individually or Collectively, Lead to a Positive Rating Action:

--Significant sustained improvements to unrestricted liquidity compared to adjusted debt;

--Sustainable improvement in profitability that translates to an increase in liquidity over time.

CREDIT PROFILE

UPMC is the largest healthcare system and the largest non-governmental employer in Pennsylvania, as well as one of the largest integrated healthcare delivery networks in the country. It is also one of the world's leading organ transplant centers. With 40 hospitals and more than 700 clinical locations in the region, along with 4,900 employed physicians and almost 3.5 million covered lives in its network of health insurance plans, UPMC reported total revenues of over $20 billion in fiscal 2019.

Over the last four years, UPMC's revenue base, assets and liabilities have grown quickly with the growth of its health plans as well as the addition of Jameson Hospital, WCA Hospital, Susquehanna Health, PinnacleHealth System, Charles Cole Memorial Hospital, Somerset Hospital and the 2020 acquisition of Western Maryland Health System. The system does not have any other acquisition targets at this time.

Revenue Defensibility

Less than 20% of UPMC's gross patient revenue is represented by Medicaid and self-pay, supporting the 'bbb' assessment for revenue defensibility. Most of UPMC's commercial plan revenue originates from its own UPMC plans, and about 6% originates from Highmark commercial contracts, although that number is expected to grow now that Highmark and UPMC have entered into a new ten-year agreement that keeps most UPMC providers and hospitals in network for Highmark enrollees.

During Fitch's last review, UPMC and Highmark had expected to terminate the consent decree between the two organizations as of July 2019. Consequently, UPMC plans and national insurance plans saw significant growth as many Highmark enrollees switched to these plans to avoid out-of-network charges with UPMC hospitals and physicians. However, with a new agreement in place as of July 2019, Highmark enrollees can keep their plans and access UPMC's network. Therefore, Fitch expects UPMC's plans will not grow significantly in 2021 as they did in prior years, but UPMC benefits from increased volumes of Highmark enrollees at UPMC providers and improved rates from Highmark.

UPMC is the largest medical insurer in Western Pennsylvania with approximately 32% of the insurer market, up from 21% in 2014. All the other insurers account for roughly 31% of the market and Highmark represents 20% of the insurer market.

Market Position

Allegheny County is a competitive market served by two integrated delivery systems; UPMC and the Allegheny Health Network (AHN). AHN is the result of Highmark's affiliation with West Penn Allegheny Health System in 2013. UPMC maintains the clear leading position with a 59% market share.

With recent strategic acquisitions and affiliations, UPMC is well-positioned for a statewide strategic presence. Fitch expects UPMC will continue to grow in size and stature over the next several years as both sides (delivery and insurance) grow. The system continues to enhance its clinical offerings in regional strategies to attract higher acuity business and is developing innovative platforms to better respond and compete in a consumer-centric environment.

UPMC's 29-county service area has a population of approximately four million people. Its home county of Allegheny County has a senior population of almost 20%, which provides a base of higher demand for healthcare services. However, the area's overall population is flat to slightly declining resulting in an absence of organic growth. Median income and poverty levels in the region are in line with those in the rest of the state and the U.S. Fitch expects payor mix to remain stable with Medicaid and self-pay staying well below the 25% threshold for the 'bbb' assessment in the revenue source component of the revenue defensibility driver.

Operating Risk

UPMC's revenue grew significantly in 2019, but expense growth outpaced revenue growth resulting in extremely low operating EBITDA margin of 3.2%, continuing to slip from 4.1% in 2018 and 5.0% in 2017. Although management maintains a culture of cost accountability and productivity, there were additional expense inflation and physician and clinical investments that were not offset by low growth rates for same store health services. As in prior years, a portion of the revenue growth in 2019 is derived from new plan enrollees and hospital acquisitions.

Fitch continues to believe that UPMC's strong market position and scale provides the system the opportunity to better manage its own rates and expenses within its integrated network in the long run. Nevertheless, Fitch expects disruption to UPMC's margins on both the clinical and health plan side in 2020, with significantly lower margins than the already constrained results for 2019. Taking the longer view, Fitch expects UPMC to generate operating EBITDA margins that are closer to 4.5%-5% within a couple of years. In the meantime, UPMC is focusing on further improvements from eliminating variation throughout its care settings, site utilization and maximizing regional hubs, consolidating support structure and administration as well as optimizing medical claims; all of which are ongoing efforts.

UPMC expects to continue to grow the UPMC Enterprises division that focuses on two broad areas: digital solutions and translational sciences to develop and commercialize new research and therapies. UPMC publicly announced earlier this year that it expected to commit $1 billion in the development of new drugs and diagnostics by 2024. Fitch expects that the coronavirus disruption may slow down the investments in translational science in 2020 but digital growth may grow in importance with behavioral changes that may originate as a result of the current outbreak.

UPMC increased its capital spending in 2018 and 2019 to an average of approximately $900 million annually (1.4x depreciation). Originally, UPMC expected capital spending to be around $1 billion in 2020, but Fitch expects that amount will be slightly less than originally planned given some of the challenges in 2020. Capital spending in 2020 will be partly funded from $232 million in series 2017D project funds remaining at the end of 2019. UPMC's routine capital for construction and IT now hovers around $400 million annually with another $370 million in capital commitments related to recent acquisitions. The rest is earmarked for major strategic projects, including the new nine-story UPMC Vision and Rehabilitation Tower at UPMC Mercy, part of UPMC's $2 billion investment in specialty care. UPMC has flexibility in capital spending with low capital needs and a healthy average age of plant of 9.2 years as of the end of 2019.

As of this time, there are no plans to increase debt beyond the $1.2 billion in long-term debt from this financing.

Financial Profile

UPMC's liquidity had always been low compared to the system's debt position, but liquidity dropped even further in 2018 due to weak cash flow, higher capital spending and investment losses as of Dec. 31 of that year. Fitch had expected cash to increase slightly in 2019 with increased investment returns in 2019 and an expectation that cash flow would be higher to support UPMC's strategic investments. However, cash remained stable in 2019 as strategic investments and operating costs outpaced revenue for the year. As a result, days cash on hand (DCOH) decreased to 92 days in 2019 from 102 days in 2018 and 132 days in 2017. Fitch has historically factored into its analysis the fact that UPMC's insurance division, which generates almost 50% of the consolidated system operating revenues/expenses, essentially reduces DCOH due to the medical claims flowing through their expense base.

Fitch's stress scenario assumes an 11.6% drop in valuation for UPMC's investments in year 1 (2020) and an additional 2% decrease in year 2 before returning to investment returns of approximately 5.6% thereafter. Currently, there is a fair amount of uncertainty in the financial markets, but Fitch's scenario tool provides a sense of magnitude if UPMC's profitability decreases in 2020 and valuation decreases by approximately 11.6% before beginning to recover in a couple of years. Assuming that both the $1 billion in working capital loans are paid back by the end of fiscal 2020, and that a Fitch-estimated $300 million of UPMC's cash is used to pay back the loans, UPMC's cash to adjusted debt might approach 71% in the recovery years. Additionally, net adjusted debt to adjusted EBITDA may be (unfavorably) positive at 1.0x, with both leverage metrics measuring lower at point-in-time values during the stress years. These results also assume that capital expenditures average around $800 million in each of the next three years (2020-2022). No assumptions are made at this time for the possibility of federal or state funding to help hospitals responding to the current outbreak.

While these values are in line with a 'bbb' assessment for financial profile, Fitch believes that UPMC's highly integrated model, revenue diversification, nationally recognized brand, and essentiality in the state of Pennsylvania, warrants a higher rating.

Asymmetric Additional Risk Considerations

No asymmetric additional risk considerations were applied in this rating determination.

Fitch's adjusted debt number for UPMC includes the operating lease liability that appears in the system's audited balance sheet as of 2019. Therefore, Fitch calculates UPMC's adjusted debt at year-end to be $5.6 billion. UPMC is party to four swaps (two basis swaps and two floating to fixed rate) with total notional amounts of $139.3 million.

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

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RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
UPMC Health System (PA)	LT IDR A Downgrade		A+
UPMC Health System (PA) /General Revenues/1 LT	LT A Downgrade		A+

Additional information is available on www.fitchratings.com

Applicable Criteria

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 07 Nov 2019)
U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria (pub. 27 Nov 2019)

Additional Disclosures

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