

## OU Medicine Inc., Oklahoma Oklahoma Development Finance Authority; Hospital

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# OU Medicine Inc., Oklahoma Oklahoma Development Finance Authority; Hospital

## Credit Profile

### Oklahoma Dev Fin Auth, Oklahoma

OU Medicine, Inc., Oklahoma

Oklahoma Dev Fin Auth (OU Medicine, Inc.) hlth sys rev bnds

*Long Term Rating*

BB+/Stable

Current

## Rationale

S&P Global Ratings' long-term rating on the Oklahoma Development Finance Authority's series 2018B tax-exempt fixed-rate bonds and series 2018C taxable fixed-rate bonds is 'BB+'. Our underlying rating (SPUR) on the insured maturities of the authority's series 2018B and 2018C bonds is also 'BB+'. All bonds were issued for OU Medicine Inc. (OUMI).

The outlook on all ratings, where applicable, is stable.

### Credit overview

The rating reflects our view of OUMI's strong position as the region's academic health system, including the state's only Level 1 trauma center and comprehensive children's hospital, covering a large service area with referrals from across the state, albeit operating within a competitive market. We believe OUMI's business position, along with management's actions and CARES Act grant support, have all contributed to stable operating results despite the COVID-19 pandemic. In addition, we expect relative stability in OUMI's balance sheet over the outlook period as spending on its new patient tower cools following its partial opening in late 2020, which should be completed by the end of fiscal 2021 and bring 144 new beds online. Though unrestricted liquidity remains lighter and capital allocation is now shifting to the launch of a new Epic IT system over the next couple of years, we do not expect major cash declines, aside from temporary accounts receivable volatility after launch.

OUMI is currently under a letter of intent with the University of Oklahoma (OU) and the University Hospitals Authority and Trust (UHAT) to merge OU Physicians, the school's faculty practice group, into OUMI from the University of Oklahoma Health Sciences Center (OUHSC). OUMI and OU Physicians are already deep clinical partners, but the merger would allow for more streamlined governance and greater clinical and financial integration. We understand the terms of the merger call for a neutral effect on days' cash on hand as OU will bring offsetting cash into OUMI; this would have a favorable effect on OUMI's reserves to debt and leverage. The practice group is break-even to slightly negative and is expected to pressure existing OUMI margin projections, all else constant. Definitive agreements and deal closure could move quickly, possibly occurring by July 1, 2021, pending final board approvals. We believe this merger can be absorbed at the current rating and will likely position OUMI for greater long-term success. That said, we will fully incorporate this merger and the ensuing integration into subsequent reviews once the deal is final and pro

forma financials can be shared. The new academic health system will be branded as OU Health.

OUMI's weaker financial profile continues to reflect very high debt levels following its spinout from the for-profit HCA Healthcare in 2018. In addition, cash has declined from a high-point at the conclusion of fiscal 2020, given the return of about \$36 million in CARES Act grants, a \$22 million interest payment on subordinate debt, and OUMI's cash contribution to the new tower's completion. We expect days' cash on hand to hold near current levels, possibly aided by improved operating earnings over the coming years as volumes continue to rebound from COVID-19, supported by the added capacity of the new tower, as well as Oklahoma's expansion of Medicaid, which is anticipated to have a materially positive effect on OUMI, given its safety net role and unique relationship with the state.

The OUMI rating is limited by its low unrestricted reserves, which, pursuant to our criteria, generally caps the rating at no higher than 'BB+' as a result of unrestricted reserves to long-term debt being less than 25%.

The 'BB+' rating further reflects our view of OUMI's:

- Highly leveraged balance sheet, with 85% debt to capitalization and 16% unrestricted reserves to long-term debt with debt burden of over 5%, with slower principal amortization structured over the coming years to support cash growth;
- Light unrestricted reserves of 60 days' cash on hand as of March 31, 2021 (excluding \$100.9 million in Medicare advance payments), with limited cushion above covenants and slower growth expected, given heavy IT investment and subordinate debt service payments triggered as cash grows;
- Integration risk related to the OU Physicians merger, though we believe the long-standing partnership should help mitigate any major disruptions;
- Thin debt service coverage at just above 1.6x in interim fiscal 2021, coupled with slightly negative operating results inclusive of \$26.3 million in CARES Act grants; and
- Highly competitive local market, including INTEGRIS Health and other multistate systems.

Partly offsetting the above weaknesses, in our view, are OUMI's;

- Solid business position, with around 18% market share and a close relationship with the state and OUHSC as the primary academic health system in Oklahoma;
- Resilient operating performance with fiscal 2020 finishing well above expectations at last review and interim 2021 results close to budget entering the final quarter; operations remain reliant on supplemental funds from the state, although we view these funds as less vulnerable to changes given their incorporation into legislation;
- Expected financial benefit from the state's expansion of Medicaid coverage that is set to take effect in OUMI's fiscal 2022;
- Historically solid demand, particularly for tertiary and quaternary services, as reflected by improving volumes and high occupancy heading into COVID-19; we believe some upside exists with the onboarding of new bed capacity; and
- Conservative financial profile with no contingent debt or defined-benefit pension plan exposure; all unrestricted reserves are currently held in cash or cash equivalents.

The stable outlook reflects our view that OUMI has weathered the COVID-19 pandemic well, despite softer volumes and the acceleration of construction on its major tower project. We anticipate financial stability and possible upside over the outlook period as capital spending becomes more routine following fiscal 2022 and added Medicaid reimbursement fosters materially stronger operating results. Moreover, while the financial profile is weaker in many respects, we believe OUMI's position in the state and the unique services it provides lend stability to the credit profile and we consider OUMI's enterprise profile to be indicative of an investment-grade rating.

### **Environmental, social, and governance risk factors**

While we view social risk as in line with that of sector peers, we believe OUMI, like other hospitals, is exposed to heightened risks related to COVID-19. The core mission of health care facilities is to protect the health and safety of communities, which is further evidenced by responsibilities to serve the demand of patients ill with COVID-19, as well as maintain adequate capacity and supplies for all patients. We believe this exposes OUMI and its peers to additional social risks that continue to present financial pressure, albeit with continued normalization expected over the outlook period. We believe environmental risks are in line with our views of the industry as a whole.

We view governance risks as in line with our views of sector peers, but we note the unique joint operating agreement structure between University Hospitals Trust (UHT), a component of the University Hospitals Authority, and OUMI. Both University Hospitals Trust and the authority (collectively referred to as UHAT) are component units of the state, while OUMI is a separate 501(c)(3) whose sole member is UHT. To date, the structure has not weakened the hospital, and in fact, has led to closer relationships with OUHSC as well as the state in terms of meeting the health care needs of the region. In addition, we generally view self-perpetuating boards as best practice, with negative consideration given to an appointed structure, as is the case with OUMI. That said, we believe this governance structure is effective for OUMI. The pending OU Physicians merger is not expected to change OUMI's governance structure, which includes five members appointed by OU, five by UHAT, and five from the community.

For additional information on governance and OUMI's spinout from HCA Healthcare, see our full analysis on OUMI, published Feb. 15, 2018, on RatingsDirect.

## **Stable Outlook**

### **Downside scenario**

We could consider a negative outlook or lower rating if operations or days' cash on hand weakens from current levels, failing to remain in line with management's expectations. In addition, failure to maintain coverage at current levels could also be a consideration for a lower rating. Although unlikely, any additional debt could also pressure the rating.

### **Upside scenario**

While we don't expect to do so over the outlook period, we could consider raising the rating if OUMI is able to improve key debt-related ratios, specifically, unrestricted reserves to long-term debt, while generating operating performance consistently positive with coverage over 2.0x. In addition, we expect OUMI to maintain its healthy business position as the premier academic health system for the region and successfully integrate OU Physicians.

## Credit Opinion

### Enterprise Profile – Strong

#### **Solid market position and evolving strategy in a competitive but favorable service area**

We view the market as competitive, with OUMI having about 18% market share in its eight-county primary service area and INTEGRIS Health, with several facilities across the service area, having the leading market share at around 26%. OUMI's market share has been steady recently, possibly as a result of occupancy issues that management is addressing with its new tower. Mercy Health and SSM Health, both based in Missouri, have market share below that of OUMI. We expect competition to remain strong in the area and note INTEGRIS Health has updated its strategic plan under a new management team in recent years.

Despite OUMI having a lighter market share than INTEGRIS Health, we view it as having a unique market position as the academic health system for the region, including the state's only Level 1 trauma center and its only comprehensive children's hospital with a pediatric intensive-care unit (PICU). Since 2018 and as a fully independent facility, OUMI has implemented several significant strategic actions to increase its strength in the market, including ongoing IT infrastructure investment, completion of its new patient tower to relieve occupancy issues (opened November 2020), and expansion of the PICU at Oklahoma Children's Hospital (opened July 2019), as well as continued investment in physicians, key service lines, and access points, including multiple urgent-care/emergency department hybrid clinics currently under development. OUMI's key programs include trauma, neurosurgery, cancer, and pediatrics. University of Oklahoma Medical Center (OMC) provides many of the highly acute services in the service area and region, as reflected by the Medicare case mix index of over 2.000 for the past several years.

OUMI is the main partner of separately managed and governed OUHSC, which currently includes OU Physicians, the state's largest physician group with about 900 physicians. OU Physicians is OUMI's main physician partner and accounts for the vast majority of admissions. OUHSC also includes the National Cancer Institute-designated Stephenson Cancer Center, which brings research and clinical trial benefits for both OUHSC and OUMI.

#### **Higher governmental payor mix offset by state support, expected Medicaid expansion**

OUMI's payor mix is modestly concentrated with governmental payors, but this reflects Oklahoma Children's Hospital (Medicaid), as well as its status as an academic health system and safety net provider of essential services. OUMI has not seen payor mix weakening during COVID-19.

Oklahoma voted to expand Medicaid eligibility under the Affordable Care Act and this is expected to take effect July 1, 2021. This is anticipated to materially benefit OUMI by increasing net revenue received for its outsized care of the region's Medicaid population, particularly those with higher acuity and cost. In addition, partly offsetting the high concentration of governmental payor mix is OUMI's receipt of significant supplemental funds from the state, totaling a net \$160 million for fiscal 2020 when also including disproportionate share funds. State funds largely come through a program designated for Level 1 trauma centers called the Teaching Hospital Reimbursement Program (THRP). This program is unique to OUMI within the state, and OUMI does not participate in the state's broader provider tax program (SHOPP). Both net Medicaid revenue and THRP revenue are expected to grow over the coming years, which

we believe would have a strongly supportive effect on OUMI's financial profile. While Oklahoma is also transitioning to Medicaid managed care, we believe the gains from expansion will offset any financial and volume pressures under managed care.

OUMI provides certain essential services to the market that support its payor relationships, but the competitive market and Blue Cross Blue Shield of Oklahoma's (BCBS) large payor position also affect overall commercial payments. BCBS and OU Physicians are currently engaged in a contract dispute, which could put the physician group out of network if an agreement is not reached by June 28, 2021. We will continue to monitor this situation as it develops, and note that while this contract is separate from OUMI's, it does add complexity to the pending merger and integration. As the market is largely fee-for-service on the commercial payor side, we expect no meaningful shifts toward risk- or value-based contracts over the next two years.

**Table 1**

OU Medicine Inc., OK -- Enterprise Statistics			
	--Fiscal year ended June 30--		
	2020	2019	2018*
PSA population	1,486,822	1,481,642	1,378,653
PSA market share (%)	N.A.	17.6	17.3
Inpatient admissions	33,404	34,790	13,834
Equivalent inpatient admissions	53,757	56,565	21,112
Emergency visits	101,970	112,220	44,376
Inpatient surgeries	11,721	12,307	4,864
Outpatient surgeries	17,817	18,082	7,080
Medicare case mix index	2.0200	2.0800	2.0600
FTE employees	4,700	4,619	4,419
Active physicians	905	875	869
Based on net/gross revenues	Gross	Gross	Gross
Medicare (%)	28.5	27.4	26.6
Medicaid (%)	25.5	24.9	27.5
Commercial/Blues (%)	27.4	28.1	27.4

\*Irregular five month period. PSA--Primary service area. FTE--Full-time equivalent. N.A.--Not available. Inpatient admissions exclude normal newborn, psychiatric, rehabilitation, and long-term care facility admissions.

## Financial Profile – Vulnerable

### Resilient operating performance to be supported by Medicaid reimbursement

Aided by strong performance prior to the pandemic and \$47.8 million in recognized CARES Act grants, OUMI finished fiscal 2020 with a healthy 3.1% operating margin and 2.3x coverage. This is significantly stronger than expected at last review, when the return of volumes following the spring 2020 suspension of non-emergent care was very much uncertain. Through the first three quarters of fiscal 2021, though volumes remain below pre-COVID-19 levels, operations have remained fairly close to management's break-even budget, with a \$4.1 million operating loss through March 31, 2021 (including \$26.3 million in CARES Act grants). No further stimulus funds remain to be recognized, though management continues to pursue all available reimbursement options (including FEMA), given that the system

continues to incur COVID-19-related costs. Interim fiscal 2021 performance was also weakened by the severe winter storm in February 2021, with management estimating a \$5 million hit from lower volumes and higher expenses. We believe year-end performance could improve slightly, supported by continued volume recovery and sustained above-budget patient acuity.

Preliminary fiscal 2022 forecasts, which do not include OU Physicians and are separate from the formally approved operating budget, aim for strong margin growth with results more comparable to fiscal 2020. This includes several assumptions related the effect of Medicaid expansion and volume trends, but in general, we believe management has been conservative and the most recent developments indicate added net THRP and Medicaid funding is greater than expected. The current fiscal 2022 projection includes a \$69 million net benefit from Medicaid expansion, net of a Medicaid managed-care volume reduction offset. While we believe this transition stands to materially improve OUMI's operating baseline, statewide changes to Medicaid programs carry considerable uncertainties and this tempers our expectations until fully implemented. We will more fully assess the effect of this in subsequent reviews, but believe the messaging to date has been quite positive and indicative of OUMI's strong position within the state.

Total OUMI payments to OUHSC were just under \$200 million in fiscal 2020 operating expenses, but this is expected to decline materially should OU Physicians merge into OUMI, though much of these expenses would be incurred by OUMI directly. OU Physicians is expected to add around \$300 million in incremental new revenue to OUMI. In addition to the clinical and governance synergies expected from the merger, other direct financial benefits include greater utilization of hospital-based billing and the 340B program, a review of vendor contracts, and certain staffing efficiencies from standardization and reduced duplication.

OUMI has some moderate flexibility as it relates to timing of payments on its subordinate debt, but we fully incorporate that debt service into our maximum annual debt service (MADS) coverage calculation, which remains light at around 1.6x through interim 2021 (smoothed at 3.5%).

### **Unrestricted reserves fall from fiscal 2020, expected to remain light, but stable**

Unrestricted reserves at OUMI relative to both long-term debt and operating expenses remain light, but are consistent with pre-COVID-19 levels. To date, all CARES Act grants received by OUMI occurred during fiscal 2020, supporting underlying unrestricted reserves of \$341.2 million and over 100 days' cash on hand as of June 30, 2020. Liquidity normalized in interim 2021 for several reasons. Firstly, OUMI returned about \$36 million in CARES Act grants for which management determined OUMI was not eligible. In addition, the cash position triggered a \$22 million interest payment on subordinate debt as days' cash on hand surpassed 85 days. Lastly, OUMI's capital spending related to the new tower increased as expected once bond funds were exhausted. The cost of the new nine-story tower totaled about \$350 million and will add a net 144 beds and 32 operating rooms when fully open by fiscal 2021 year-end.

We expect days' cash on hand to hold steady near 60 days over the coming year, with some noise possible given an assumed temporary increase of accounts receivable by up to ten days following launch of the new revenue cycle IT system, expected to be some time over the coming two years. Over the longer-term, we expect some cash growth, but generally do not anticipate unrestricted reserves growing robustly given the onset of principal payments on senior debt and OUMI's all cash investment allocation, though the latter is a critical risk management tool given the system's lighter liquidity. We expect fiscal 2022 spending as a percentage of depreciation expense to fall from current levels,

and further normalize in fiscal 2023 as OMUI begins a more routine capital spending baseline that should aid the balance sheet. Following the launch of its Epic IT system, which will include both revenue cycle and electronic medical records, OUMI will sunset the last of its transitional agreements with HCA Healthcare, which we view as a significant achievement.

Although UHAT has no obligation for any debt or liabilities at OUMI or any of the capital spending, we view OUMI's relationship with UHAT as positive and supportive. UHAT has supported certain projects important to OUHSC and OUMI, in addition to lending \$40 million of subordinate debt. UHAT also works with the state to generate state and federal funds related to the THRP program to support OUHSC and OUMI's overall mission. THRP funds are typically paid semi-annually in January and July, which can cause some volatility in unrestricted reserves.

### High debt burden remains credit risk

OUMI maintains a significantly leveraged balance sheet, with a total of \$1.375 billion of long-term debt as of March 31, 2021, including \$175 million of subordinate debt. We believe that debt-related metrics will continue their gradual improvement, but expect material movement to take several years, as principal payments do not begin for senior tax-exempt debt until fiscal 2023, with taxable sinking fund redemptions beginning in fiscal 2027. We also believe the accounting treatment related to the acquisition financing of assets by OUMI, as well as UHAT holding Oklahoma Children's Hospital's capital assets on its balance sheet, also contribute to OUMI's very high leverage. OU Physicians will not bring any new debt into OUMI, but rather is expected to have a slightly favorable effect on leverage by increasing unrestricted net assets.

The debt structure is conservative, in our view, but the \$251 million series 2018C taxable bonds consist of bullet payments in fiscal years 2027, 2028, 2029, and 2031 that will likely be refinanced and considered contingent by S&P Global Ratings once their maturity is within five years. The terms of the subordinate debt interest and principal payments are what we consider flexible, with principal and interest only due when operating liquidity surpasses certain thresholds (85 days' cash on hand for interest, 125 days for principal), but the debt is due in December 2032 regardless of underlying liquidity.

**Table 2**

OU Medicine Inc., OK -- Financial Statistics					
	--Nine months ended March 31--	--Fiscal year ended June 30--			Medians for 'Speculative Grade' rated stand-alone hospitals
	2021	2020	2019	2018*	2019
<b>Financial performance</b>					
Net patient revenue (\$000s)	995,838	1,237,012	1,204,736	442,433	144,883
Total operating revenue (\$000s)	1,049,858	1,298,147	1,213,946	444,939	177,971
Total operating expenses (\$000s)	1,053,988	1,258,000	1,203,122	422,117	MNR
Operating income (\$000s)	(4,130)	40,147	10,824	22,822	MNR
Operating margin (%)	(0.39)	3.09	0.89	5.13	0.80
Net nonoperating income (\$000s)	241	6,705	10,612	2,442	MNR
Excess income (\$000s)	(3,889)	46,852	21,436	25,264	MNR
Excess margin (%)	(0.37)	3.59	1.75	5.65	1.50
Operating EBIDA margin (%)	8.11	11.67	9.95	14.08	7.00



Table 2

OU Medicine Inc., OK -- Financial Statistics (cont.)					
	--Nine months ended March 31--	--Fiscal year ended June 30--		Medians for 'Speculative Grade' rated stand-alone hospitals	
	2021	2020	2019	2018*	2019
EBIDA margin (%)	8.13	12.12	10.73	14.55	7.90
Net available for debt service (\$000s)	85,333	158,154	131,403	65,109	14,193
Maximum annual debt service (\$000s)	70,250	70,250	70,250	70,250	MNR
Maximum annual debt service coverage (x)	1.62	2.25	1.87	2.22	2.60
Operating lease-adjusted coverage (x)	1.44	1.95	1.66	1.97	2.20
<b>Liquidity and financial flexibility</b>					
Unrestricted reserves (\$000s)	222,393	341,162	215,332	186,498	38,943
Unrestricted days' cash on hand	60.1	102.9	67.8	70.1	89.40
Unrestricted reserves/total long-term debt (%)	16.2	24.8	15.7	13.6	76.90
Unrestricted reserves/contingent liabilities (%)	N/A	N/A	N/A	N/A	405.20
Average age of plant (years)	2.8	2.3	1.4	0.4	13.60
Capital expenditures/depreciation and amortization (%)	307.6	427.1	264.6	275.8	66.20
<b>Debt and liabilities</b>					
Total long-term debt (\$000s)	1,375,300	1,375,454	1,375,660	1,375,676	MNR
Long-term debt/capitalization (%)	84.9	85.3	87.9	88.6	50.80
Contingent liabilities (\$000s)	0	0	0	0	MNR
Contingent liabilities/total long-term debt (%)	0.0	0.0	0.0	0.0	9.80
Debt burden (%)	5.02	5.38	5.74	6.54	3.50
Defined-benefit plan funded status (%)	N/A	N/A	N/A	N/A	68.30
<b>Miscellaneous</b>					
Medicare advance payments (\$000s)¶	100,859	100,859	N/A	N/A	MNR
Short-term borrowings (\$000s)¶	N/A	N/A	N/A	N/A	MNR
CARES Act grants recognized (\$000s)	26,291	47,804	N/A	N/A	MNR
Total net special funding (\$000s)	130,728	160,265	160,886	65,601	MNR

\*Irregular five-month period. ¶Excluded from unrestricted reserves, long-term debt, and contingent liabilities. N/A--Not applicable.  
MNR--Median not reported.

## Credit Snapshot

- **Security:** The unrestricted receivables of OUMI (the obligated group) secure the bonds along with a mortgage on certain assets. The unrated \$175 million of subordinate debt is not issued under the master trust indenture, and principal and interest payments are made when certain financial metrics and ratios are achieved.
- **Group rating methodology:** OUMI accounts for the vast majority of assets and revenue of the system, and, accordingly, we consider them core to the group credit profile.
- **Key covenants:** OUMI must maintain at least 45 days' cash on hand and attain annual debt service coverage on senior debt of 1.1x. We expect OUMI to remain in compliance with all financial covenants.
- **Organizational profile:** OUMI owns and operates University of Oklahoma Medical Center, a 421-staffed bed academic medical center in Oklahoma City, along with Edmond Medical Center, about 15 miles north of OUMC with 66 staffed beds. OUMI also leases and operates the 334-staffed-bed Oklahoma Children's Hospital and owns and operates clinics, imaging, and other health-related services across the service area, including a 40% joint-venture rehabilitation hospital. OUMC and Oklahoma Children's Hospital are on the same campus as the OUHSC, the state's main health sciences education and research facility. University Hospitals Trust, a public entity that, together with another public entity, University Hospitals Authority, is known as UHAT, remains OUMI's sole corporate member, but is not obligated for OUMI's debt.

## Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

## Ratings Detail (As Of May 5, 2021)

### Oklahoma Dev Fin Auth, Oklahoma

OU Medicine, Inc., Oklahoma

Oklahoma Dev Fin Auth (OU Medicine, Inc.) Hosp

<i>Long Term Rating</i>	BB+/Stable	Current
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Oklahoma Dev Fin Auth (OU Medicine, Inc.) Hosp (AGM)

<i>Unenhanced Rating</i>	BB+(SPUR)/Stable	Current
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Oklahoma Dev Fin Auth (OU Medicine, Inc.) Hosp (AGM)

<i>Unenhanced Rating</i>	BB+(SPUR)/Stable	Current
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Oklahoma Dev Fin Auth (OU Medicine, Inc.) Hosp (AGM)

<i>Unenhanced Rating</i>	BB+(SPUR)/Stable	Current
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Many issues are enhanced by bond insurance.

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