North Carolina Medical Care Commission
Novant Health Inc.; System

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North Carolina Medical Care Commission Novant Health Inc.; System

Credit Profile		
Series 2013C		
Long Term Rating	AA-/Stable	Upgraded
North Carolina Med Care Comm, North Carolina Novant Hlth, Inc., North Carolina		
Series 2004A		
Long Term Rating	AA-/A-1/Stable	Upgraded
Series 2004B		
Long Term Rating	AA-/A-1/Stable	Upgraded
Series 2009A, 2010A, 2013A		
Long Term Rating	AA-/Stable	Upgraded
Prince William Cnty Indl Dev Auth, Virginia Novant Hlth, Inc., North Carolina		
Series 2013B		
Long Term Rating	AA-/Stable	Upgraded

Rationale

S&P Global Ratings raised its long-term rating to 'AA-' from 'A+' on various issuers' series 2009A, 2010A, 2013A, 2013B, and 2013C revenue bonds issued for Novant Health, N.C. We also raised our dual rating on the system's series 2004A and 2004B variable rate demand bonds to 'AA-/A-1' from 'A+/A-1', whereby the long-term component of the ratings reflects our credit rating on Novant Health and the short-term component reflects a standby purchase agreement (SBPA) from JPMorgan Chase Bank N.A. that expires on Jan. 31, 2021. The outlook is stable.

The upgrade reflects Novant Health's sustained and favorable financial profile trends, namely consistent healthy operating performance and a falling debt load. When coupled with the system's enterprise profile strengths, we believe Novant Health's overall credit profile is more commensurate with the 'AA' category. At last review, we had sustained our positive outlook at the lower rating due in part to Novant Health's uncertain growth plans, as the system was considering various options for future affiliations, including merger and acquisition opportunities, as well as joint venture and clinical partnerships. While the system is still considering future affiliations and has ambitious growth plans across and beyond its existing service areas, we believe Novant Health has the financial profile cushion for the higher rating and note that no partnership plans are imminent.

We will evaluate any future affiliations as they occur and understand that leadership has stringent criteria that must be met when considering new partners. Novant Health has not announced any new merger or acquisition opportunities but we have been aware of its desire to grow the size of the organization for several years.

Novant Health surpassed its operating budget in 2018 and generated over 6x maximum annual debt service (MADS) coverage for the third straight year (as calculated by S&P Global Ratings). Moreover, Novant Health has made a concerted effort to deleverage over the past several years, with leverage falling to 27% in 2018 from over 50% in 2010. Unrestricted reserves now surpass 200% of long-term debt as the system prepares to enter a phase of higher capital spending of up to $400 million annually through 2023. Though actual spending levels are dependent on adequate operating cash flow generation, we expect slower reserve growth over the coming years as Novant Health continues to expand its system footprint through greenfield construction projects and investment at its market flagship campuses: the 734-staffed-bed Novant Health Forsyth Medical Center (Winston-Salem) and the 480-staffed-bed Novant Health Presbyterian Medical Center (Charlotte).

The rating further reflects our view of Novant Health's solid enterprise profile, highlighted by stable market share in its various service areas and steady patient volumes across its 15 hospitals in North Carolina and Virginia. The rating also reflects Novant Health's healthy financial profile, including solid operating and cash flow margins that we believe support the system's spending plans. We expect Novant Health will achieve its budget for fiscal 2019 and its credit profile will remain stable.

We anticipate Novant Health will issue up to $350 million in bonds over the coming months. The bonds are expected to reimburse the system for prior capital spending and replenish the balance sheet. However, we also expect Novant Health to use $250 million of cash to retire its series 2009A bonds when due in November 2019. Moreover, the system is expected to pay off its line of credit, which has about $100 million drawn through March 2019 related to prior capital spending. Though we believe there will be some fluctuation in cash and debt metrics through the end of fiscal 2019, we expect a normalized balance sheet by the end of the year with total debt levels lower than fiscal 2018. Management currently has no other debt plans outside the expected 2019 issuance, which we believe leaves the system with sizable debt capacity.

The rating reflects Novant Health's following credit strengths:

- Sound enterprise profile with good financial and business dispersion across North Carolina and Virginia, with a presence in distinct markets with favorable demographics, combined with stable volume trends and a large employed physician base;
- Healthy operations and cash flow with all markets exceeding budget in 2018 with a consolidated 4.8% operating margin on about $5 billion in total operating revenue;
- Balance sheet that has improved dramatically in recent years and is expected to remain stable over the outlook period; and
- Manageable liabilities with contingent debt just 23% of total debt and the system's defined-benefit pension plan expected to be terminated during fiscal 2019 after several years of being fully funded.

The rating reflects Novant Health's following credit weaknesses:

- Increasing capital spending over the coming years as the system invests in its markets to keep pace with both a growing population and local competition from Atrium Health (Charlotte) and Wake Forest Baptist

(Winston-Salem), though we believe spending plans are manageable;

- Some uncertainty surrounding the magnitude and timing of the system's longer-term growth plans and its next major affiliation, as well as the potential financial impact associated with those relationships;
- Some state level pressures including North Carolina's expected transition to Medicaid managed care and the potential for material cuts to the state employee health plan; and
- Significant annual operating lease obligation ($92 million in 2018) that is about as large as the maximum annual debt service obligation on the system's bonds.

Financial metrics cited in this report are based on Novant Health's consolidated and audited financial statements. As part of this review, S&P Global Ratings has also reviewed unaudited first-quarter numbers ended March 31, 2019.

Outlook

The stable outlook reflects Novant Health's healthy enterprise and financial profile characteristics, which we expect to remain steady through the two-year outlook period. Though some challenges and uncertainties remain, we believe management's track record of executing on strategic plans and responding to industry pressures will continue to support stability for the system.

Upside scenario

Given the recent rating action, we are unlikely to raise the rating over the outlook period. Over the longer-term we could consider a higher rating if Novant Health sustains performance at its current levels, while growing unrestricted liquidity and continuing to pay off debt. The impact of any new affiliates would also need to contribute to the stability of the system's enterprise profile and have an accretive impact on consolidated financial metrics.

Downside scenario

We could consider a negative outlook or lower rating is Novant Health is unable to sustain performance in line with expectations, with profitability metrics falling to a lower baseline. While we recognize that the system is in a growth mode, the rating could become pressured if balance sheet metrics deteriorate materially, whether due to increased spending, a significantly higher debt load, or dilutive partnerships.

Enterprise Profile--Very Strong

Growing organizational footprint

Novant Health was born from a 1997 merger that combined two Winston-Salem and Charlotte health care providers. Since that time, the system has seen immense geographic and financial growth--total assets of $6.5 billion as of Dec. 31, 2018--though these two markets continue to drive Novant Health's consolidated operating performance.

Within the Greater Charlotte market and its primary service area of Mecklenburg County, Novant Health has a growing 36% market share, trailing the larger Atrium Health (60%). We project Mecklenburg County will see about 8% population growth over the next five years, which underpins the significant expansion projects both systems are pursuing in the region. Novant Health opened the 46-bed Novant Health Mint Hill Medical Center in October 2018 and is already reporting strong volumes and ahead-of-budget profitability. The system has also secured real estate in Ballantyne (south Charlotte) to construct a 36-bed inpatient facility by 2023. This would reflect Novant Health's seventh inpatient campus in the region and we note Atrium Health has similar plans in south Charlotte. We expect this region's growth will continue to fuel expansion by market incumbents, as both systems aim to position themselves for future market share capture. The Greater Charlotte market encompassed about $2.4 billion of system net patient revenue in 2018.

About 80 miles north of Charlotte, Novant Health operates five inpatient campuses in its Greater Winston-Salem market and primary service area of Forsyth County. Novant Health is the market leader in the region with 59% of inpatient market share, ahead of Wake Forest Baptist (32%). Growth projections in Forsyth County are lower than in Charlotte, but remain strong with about 5% population growth expected over the coming years. The Greater Winston-Salem market encompassed about $1.7 billion of system net patient revenue in 2018.

Novant Health has been successful in developing, constructing, and operating new and upgraded facilities in recent years and anticipates continued capital investment in its two core markets. In April 2019, Atrium Health and Wake Forest Baptist--Novant Health's primary competitors--announced their intent to affiliate and create a new school of medicine in Charlotte. Negotiations are ongoing and the partnership has not been formally approved by regulators. We will continue to monitor this development over the future, but generally believe any material impact on Novant Health would take some time to be felt.

Novant Health operates three hospitals in northern Virginia under a consolidating joint operating agreement with University of Virginia Health System, as well as one stand-alone 55-staffed-bed hospital in Brunswick County, North Carolina. These two markets generated combined net patient revenue of less than $600 million in fiscal 2018.

Strong patient volumes and medical staff

Management notes growing volume across most of its service lines and acute care facilities, which it partially attributes to its favorable low-cost, high-quality status with local payors, as well as population growth in specific geographies. Occupancy across the system was elevated at 87% in fiscal 2018, which management cites as the cause for some of its capital spending currently underway. Though we expect overall system volumes to remain strong, we expect some targeted pressure in obstetrics within the Greater Winston-Salem market as Wake Forest Baptist begins to offer labor and delivery services at its flagship North Carolina Baptist Hospital campus later in 2019. This follows decades of Wake Forest Baptist utilizing Novant Health Forsyth Medical Center for such services.

Novant Health's medical staff includes close to 2,500 active physicians, about 1,600 of which are employed under Novant Health Medical Group. These physicians are highly credentialed in their respective specialties.

The system's medical staff and patient mix help support a healthy payor mix with about 60% of net patient revenue coming from commercial payors. Though just 8.3% of 2018 net revenue came from Medicaid, Novant Health does have exposure to North Carolina's transition to Medicaid managed care slated for later in 2019. As part of the transition, Novant Health was a participant in a statewide provider-sponsored health plan that responded to the state's request for proposal--along with other providers such as Atrium Health and Wake Forest Baptist. This entity was not awarded a statewide contract and it has appealed this ruling.

Stable and proven system leadership

Novant Health's current management team is stable and well-tenured. We favorably view the team's track record of executing on major capital projects, such as the launch of its Mint Hill campus, as well as longer-term system-wide initiatives, such as integrating facilities under one brand and operating model, rolling out its holistic Epic information technology (IT) system, and continuing to prepare Novant Health for more value-based reimbursement by positioning the system as a low-cost, high-quality provider and investing in population health capabilities. The current management team has demonstrated discipline when considering potential partners--such as University of Virginia Health System in 2016 and GoHealth Urgent Care in 2018--and has also been willing to divest from dilutive or non-core assets--such as MedQuest's Georgia-based operations and the 83-bed Franklin Medical Center in 2015.

Though, like other systems across North Carolina and the nation, Novant Health will likely experience continued industry challenges over the coming years, we believe management's focus on cost containment and continuous operating improvement should allow for sustained operating cash flow. We anticipate leadership will execute on its strategic plans and continue to manage Novant Health's position within competitive healthcare markets.

The system is governed by a 16-member board of trustees, including two non-voting members from Novant Health's Charlotte and Winston-Salem regional boards, as well as the system's CEO who serves as a voting ex-officio member. All reserve powers rest with the parent board, which is self-perpetuating aside from one seat being appointed by the Forsyth County Board of Commissioners. Board membership changes are based on routine turnover.

Table 1

Novant Health And Affiliates, North Carolina Enterprise Statistics

	--Fiscal year ended Dec. 31--			
	2018	**2017**	**2016**	**2015**
Inpatient admissions	130,474	126,326	122,662	119,512
Equivalent inpatient admissions	282,005	271,958	259,497	244,776
Emergency visits	544,825	538,911	539,085	515,659
Inpatient surgeries	32,093	30,585	30,138	28,659
Outpatient surgeries	108,550	103,368	102,474	94,891
Medicare case mix index	1.7139	1.7086	1.6987	1.6500
FTE employees	25,543	24,225	22,723	21,264
Active physicians	2,437	2,301	2,223	2,121
Based on net/gross revenues*	Net	Net	Net	Net
Medicare (%)	29.4	28.7	30.5	31.0
Medicaid (%)	8.3	9.4	5.4	5.3
Commercial/Blues (%)	59.0	58.9	60.2	60.5

*Fiscal 2017 and 2018 net payor mix calculation reflects the adoption of ASC 606. Inpatient admissions exclude normal newborn, psychiatric, rehabilitation, and long-term care facility admissions.

Financial Profile--Very Strong

Healthy financial performance sustained in 2018

Novant Health's operating and cash flow margins have been favorable in recent years and in excess of our medians for the rating level. The system finished with a 4.8% operating margin in fiscal 2018, ahead of the budgeted 3%--all system markets hit their respective budgets in 2018. The fiscal 2019 operating budget aims for 4% margin and through 2023 management believes that operating and operating EBIDA margins will remain consistent. We believe this is achievable given Novant Health's history of robust performance and management's focus on revenue growth and cost containment. The system's capital plans over the coming years are partly contingent on meeting these targets.

The system recognized a combined $93.6 million in net supplemental funding in 2018, including $69 million from the state's Medicaid Gap Assessment Program. The stability of these funds is uncertain as the state transitions to Medicaid managed care. Moreover, state policymakers are aiming to remove upwards of $300 million from the state employee annual healthcare costs, likely with a direct impact to Novant Health. Providers across the state are seeking a bilateral solution to the state's rising health care costs, but have been asked to commit to new lower rates by summer 2019. Though the ultimate and long-term impacts of these changes are unknown at the current time, in general we believe they are but two of the many industry challenges Novant Health's leadership will continue to address over the coming years.

Stable unrestricted liquidity expected

Novant Health maintains approximately $3.0 billion in unrestricted cash reserves. Though fiscal year-end 2018 reserves fell to $2.87 billion, this includes a $327 million unrealized loss on investments stemming from the late 2018 equity market correction--this has been seen by systems across the sector. Novant Health's balance sheet, in our opinion, is healthy at the current rating level, highlighted by cash on hand consistently above 200 days' and an unrestricted reserves to total long-term debt ratio that has improved considerably. Contributing to this improvement was Novant Health's use of cash in 2016 to repay a $100 million taxable bullet payment and to call $250 million of series 2006 term bonds at par. We think Novant Health's balance sheet provides a cushion for regulatory uncertainties and future growth opportunities, as they arise.

Novant Health's favorable financial results in recent years have allowed for increased capital spending concurrent with its debt pay down. Total capital expenditures grew to $390 million in 2018, from $286 million 2017. We expected spending to remain consistent with fiscal 2018 levels over the coming years. We expect funds will continue to be allocated towards the high-growth Greater Charlotte market, including $164 million for a heart and vascular institute and cancer center at Presbyterian Medical Center and $130 million for the new campus in Ballantyne. In Winston-Salem, Novant Health is commencing a nearly $300 million master facility plan at its flagship Forsyth Medical Center campus. We believe these projects are manageable at the rating and expect relative stability in days' cash on hand over the near term. Novant Health generated $636 million in cash flow in fiscal 2018.

As of Dec. 31, 2018, Novant Health's investments were allocated to 35% cash and fixed income securities, 40% to equities and the remaining to alternative and other investments. Management reports that approximately 34% of the portfolio is accessible daily and about 69% is liquid within seven days.

Much improved debt position; expected series 2019 issuance

Novant Health's overall debt position has substantially improved over the past decade, as management has made a concerted effort to deleverage and build capacity for strategic initiatives and unforeseen opportunities. Leverage (as measured by long-term debt to capitalization) has been halved from 2010 through March 2019 (25.8%).

We calculate MADS based on debt service for its bullet maturities that have been amortized via the straight-line method over 30 years--we do not anticipate a material change in smoothed MADS following the 2019 issuance. Coverage and debt burden weaken considerably when factoring the system's heavy use of operating leases--operating lease expenses was $92 million in fiscal year 2018.

As mentioned, we anticipate Novant Health will issue up to $350 million in fixed-rate bonds over the coming months. The bonds are expected to reimburse the system for prior capital spending and replenish the balance sheet. However, we also expect Novant Health to use $250 million of cash to retire its series 2009A bonds when due in November 2019. Moreover, the system is expected to pay off its line of credit, which has about $100 million drawn through March 2019 ($80.5 million through December 2018). Though we believe there will be some fluctuation in cash and debt metrics through the end of fiscal 2019, we expect a normalized balance sheet by the end of the year with total debt levels lower than fiscal 2018. Management currently has no other debt plans outside the expected 2019 issuance, which we believe leaves the system with sizable debt capacity.

Novant Health currently operates three defined-benefit pension plans with a combined funded status of 94.7% as of Dec. 31, 2018 (about $15 million net shortfall). In February 2018, the Novant Health board announced it would terminate all three pension plans. We expect the pay out of lump sums and annuities to be fully settled by the end of fiscal 2019, at which time no pension liability will be recognized on the balance sheet and we view this de-risking favorably.

Manageable contingent liabilities

As of Dec. 31, 2018, Novant Health's contingent liability debt totaled $324 million (23% of long-term debt) and included the series 2004A and 2004B variable-rate demand bonds, the directly placed series 2008A (Wells Fargo), 2008B (Bank of America), and 2008C (Bank of America) bonds with acceleration features tied to termination events, and other various short-term borrowings.

Novant Health is a party to three swaps, including Merrill Lynch Capital Services ($135 million), Goldman Sachs Mitsui Marine Derivative Products ($27 million), and Sun Trust Bank ($75 million). The mark-to-market valuation as of Dec. 31, 2018, was negative $37 million, although there is no collateral posting requirement as long as the rating on Novant Health remains 'A-' or higher. The swaps provide Novant Health a debt structure that is almost entirely fixed-rate or synthetically fixed.

We consider event risk related to Novant Health's contingent liabilities minimal due to a variety of counterparties, strong level of liquid reserves, limited collateral posting requirements for swaps, and headroom above covenant triggers in direct purchase documents.

Table 2

Novant Health And Affiliates, North Carolina Financial Statistics

	--Fiscal year ended Dec. 31--				Medians for 'AA-' rated health care systems
	2018	2017	2016	2015*	2017
Financial performance					
Net patient revenue ($000s)	4,697,425	4,319,314	4,104,458	3,865,285	2,403,147
Total operating revenue ($000s)	4,969,977	4,594,001	4,338,509	4,082,393	MNR
Total operating expenses ($000s)	4,733,563	4,410,867	4,046,846	3,822,208	MNR
Operating income ($000s)	236,414	183,134	291,663	260,185	MNR
Operating margin (%)	4.76	3.99	6.72	6.37	2.60
Net nonoperating income ($000s)	149,650	134,207	79,282	50,445	MNR
Excess income ($000s)	386,064	317,341	370,945	310,630	MNR
Excess margin (%)	7.54	6.71	8.40	7.52	4.50
Operating EBIDA margin (%)	11.19	10.73	14.15	13.77	8.70
EBIDA margin (%)	13.79	13.26	15.69	14.82	10.80
Net available for debt service ($000s)	706,016	627,021	693,165	612,684	337,797
Maximum annual debt service ($000s)	104,590	104,590	104,590	104,590	MNR
Maximum annual debt service coverage (x)	6.75	6.00	6.63	5.86	4.80
Operating lease-adjusted coverage (x)	4.06	3.61	4.02	3.69	3.50
Liquidity and financial flexibility					
Unrestricted reserves ($000s)	2,870,982	3,023,453	2,535,995	2,626,774	1,813,269
Unrestricted days' cash on hand	233.7	264.6	243.2	265.7	243.20
Unrestricted reserves/total long-term debt (%)	200.0	205.9	175.3	153.0	187.70
Unrestricted reserves/contingent liabilities (%)	885.6	793.4	638.9	633.2	509.10
Average age of plant (years)	12.3	11.9	11.1	11.8	9.70
Capital expenditures/depreciation and amortization (%)	156.6	118.8	119.9	106.7	131.40
Debt and liabilities					
Total long-term debt ($000s)	1,435,253	1,468,543	1,446,255	1,716,860	MNR
Long-term debt/capitalization (%)	26.6	27.6	29.9	37.7	29.20
Contingent liabilities ($000s)	324,168	381,084	396,927	414,825	MNR
Contingent liabilities/total long-term debt (%)	22.6	25.9	27.4	24.2	39.60
Debt burden (%)	2.04	2.21	2.37	2.53	2.20
Defined-benefit plan funded status (%)	94.70	100.43	100.72	91.47	81.30
Miscellaneous					
Total net special funding ($000s)	93,614	112,738	85,679	85,405	MNR

*Fiscal 2015 performance metrics do not incorporate ASU 2017-07. MNR--Median not reported.

Credit Snapshot

- Security pledge: Securing the bonds is a general obligation pledge of the members of the obligated group composed of Novant Health Inc., Forsyth Medical Center, and Presbyterian Medical Center.
- Group rating methodology: The obligated group is 'core' to the group credit profile.
- Combined group: The master indenture creates a combined group that includes members of the obligated group and restricted affiliates with the latter entities not directly obligated for debt repayment. However, the obligated group covenants require the restricted affiliates to provide funds to the obligated group to pay its obligations through a commitment agreement. Most of the system's hospitals are restricted affiliates. Together, the combined group accounted for 87% of fiscal 2018 total operating revenue and 85% of total assets. In fiscal 2018, the obligated group accounted for 86% and 63% of the combined group's total assets and operating revenue, respectively. We anticipate Mint Hill Medical Center will be added to the combined group concurrent with the issuance of the series 2019 bonds.
- Organization description: Winston-Salem based Novant Health is one of North Carolina's largest health care systems, owning and operating 15 medical centers and approximately 500 outpatient locations.