Novant Health, NC
Update following upgrade to Aa3; outlook stable

Summary
Novant Health (Aa3 stable) will benefit from its strong market share in demographically favorable and growing markets. The organization will continue to pursue a disciplined approach to capital spending, which combined with a track record of stable and predictable cash flow, will allow the organization to maintain a strong balance sheet position. We expect changing market dynamics in Winston-Salem, the organization's second largest market, will present challenges toward the end of fiscal 2019 and in 2020, but that ultimately, Novant Health will maintain its market share and performance in that market.

Exhibit 1
Strong cash flow will enable Novant Health to continue building cash; debt repayment in 2016 materially reduced leverage and cash on hand has rebounded

Credit strengths
» Novant Health’s location in favorable, growing markets will enable steady growth for the foreseeable future
» Expectation that strong operating results will continue over the near term, driven by steady volume growth and stable market positions in primary service areas
» Disciplined approach to capital spending allows the organization to maintain balance sheet strength
» Frozen defined benefit pension that is essentially fully funded; the plan’s liability is small relative to Novant Health’s size

Source: Moody’s Investors Service
New York, June 05, 2019 -- Moody's Investors Service has assigned an Aa3 to Novant Health's (NC) proposed Health Care Facilities Revenue Bonds (Novant Health Obligated Group) Series 2019A. Bonds will be issued by the North Carolina Medical Care Commission and are expected to be issued in a par amount of $293 million with a final maturity of 2052. We have also affirmed our Aa3 on approximately $1.3 billion of rated debt and the VMIG 1 short term rating on the Series 2004A and 2004B bonds. The outlook is stable.

RATINGS RATIONALE

Assignment and affirmation of the Aa3 rating reflects our expectation that Novant Health will continue to generate strong cash flow margins while maintaining good balance sheet metrics and debt service coverage. Novant Health's operations are located in favorable markets that benefit from projections of above average population growth, which will enable consistent growth without meaningful market share changes. Over the near term, Novant Health faces several reimbursement challenges, including a proposal to significantly reduce reimbursement under the State Health Plan to all providers in the state and a transition to Medicaid managed care that will likely result in lower utilization. An ongoing challenge is that Novant Health will continue to face competitive local markets with well capitalized competitors including a changing market dynamic in Winston-Salem, the organization's second largest market. We expect Novant Health to pursue acquisitions, joint ventures, or other similar deals over the next several years, which we will evaluate on a case by case basis.

Affirmation of the short term VMIG 1 ratings reflects the bank facilities used to support the tender features of the affected debt.

RATING OUTLOOK

The stable outlook reflects our expectation that Novant Health will continue generating favorable cash flow margins and that acquisitions or growth opportunities will not materially change the organization's leverage position.

FACTORS THAT COULD LEAD TO AN UPGRADE

- Material and sustained expansion of margins and cash flow
- Material growth in balance sheet reserves
- Expectations that acquisitions are unlikely over the near term
- For the short term ratings (VMIG 1), not applicable

FACTORS THAT COULD LEAD TO A DOWNGRADE

- Material weakening of operating performance and cash flow
- Material additional debt absent growth in cash flow
- Materially dilutive merger or acquisition
- For the short term ratings (VMIG 1), a downgrade of the bank providing short term liquidity

LEGAL SECURITY

Novant Health's bonded debt is an unsecured obligation from the Obligated Group that includes the two flagship hospitals, Forsyth Medical Center and Presbyterian Medical Center, in addition to the parent company. Management has designated restricted affiliates, who with the Obligated Group represent the Combined Group. Sizable restricted members include Brunswick Medical Center, Medical Park Hospital, Thomasville
Medical Center, Matthews Medical Center, and Prince William Medical Center. Rowan Regional Medical Center and MedQuest are not part of the Combined Group.

There is a rate covenant of 1.2x, measured at year end based on actual debt service and a liquidity covenant of 75 days, measured semi-annually.

USE OF PROCEEDS

Bond proceeds will be used to finance a portion of certain capital projects, repay the Taxable Bank Loan and pay the costs of issuance.

PROFILE

Novant Health operates 15 medical centers in North Carolina and Virginia, including several regional referral centers throughout. The system employs over 1,600 physicians and maintains numerous physician offices and outpatient centers. The system is headquartered in Winston-Salem, NC.

METHODOLOGY

The principal methodology used in the long-term ratings was Not-For-Profit Healthcare published in December 2018. The principal methodology used in the short-term ratings was Variable Rate Instruments Supported by Conditional Liquidity Facilities published in March 2017. Please see the Rating Methodologies page on www.moodys.com for a copy of these methodologies.

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Credit challenges

» We expect Novant Health to pursue acquisitions and other growth opportunities, some of which could result in significant debt issuances

» Well capitalized competitors in each of Novant Health’s markets will continue to present meaningful competition; new services at Wake Forest Baptist will change the market dynamic in Winston-Salem, Novant Health’s second largest market

Rating outlook

Revision of the outlook to stable at the higher rating reflects our expectation that Novant Health will continue generating favorable cash flow margins and that acquisitions or growth opportunities will not materially change the organization’s leverage position.

Factors that could lead to an upgrade

» Material and sustained expansion of margins and cash flow

» Material growth in balance sheet reserves

» Expectations that acquisitions are unlikely over the near term

Factors that could lead to a downgrade

» Material weakening of operating performance and cash flow

» Material additional debt absent growth in cash flow

» Materially dilutive merger or acquisition

» For the short term ratings (VMIG 1), a downgrade of the rating of the bank providing short term liquidity

Key indicators

Exhibit 2
Novant Health, NC

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<thead>
<tr>
<th></th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>Q3 2018 Annualized</th>
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<tr>
<td>Operating Revenue ($'000)</td>
<td>3,787,931</td>
<td>4,128,001</td>
<td>4,340,123</td>
<td>4,595,392</td>
<td>4,830,708</td>
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<tr>
<td>3 Year Operating Revenue CAGR (%)</td>
<td>5.0</td>
<td>6.0</td>
<td>6.5</td>
<td>6.7</td>
<td>5.4</td>
</tr>
<tr>
<td>Operating Cash Flow Margin (%)</td>
<td>12.2</td>
<td>13.8</td>
<td>13.7</td>
<td>10.5</td>
<td>10.8</td>
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<td>PM: Medicare (%)</td>
<td>45.2</td>
<td>45.3</td>
<td>44.9</td>
<td>45.4</td>
<td>46.1</td>
</tr>
<tr>
<td>PM: Medicaid (%)</td>
<td>12.7</td>
<td>12.2</td>
<td>12.2</td>
<td>11.8</td>
<td>11.5</td>
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<tr>
<td>Days Cash on Hand</td>
<td>258</td>
<td>263</td>
<td>242</td>
<td>264</td>
<td>265</td>
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<tr>
<td>Unrestricted Cash and Investments to Total Debt (%)</td>
<td>134.1</td>
<td>141.8</td>
<td>171.7</td>
<td>201.4</td>
<td>216.3</td>
</tr>
<tr>
<td>Total Debt to Cash Flow (x)</td>
<td>3.0</td>
<td>2.7</td>
<td>2.1</td>
<td>2.4</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Based on audits for Novant Health, Inc. and Affiliates for fiscal years ended December 31; 2018 is 9 months, annualized
Investment returns normalized at 6% prior to 2015, and at 5% in 2015 and beyond
Source: Moody’s Investors Service

Profile

Novant Health operates 15 medical centers in North Carolina and Virginia, including several regional referral centers throughout. The system employs over 1,600 physicians and maintains numerous physician offices and outpatient centers. The system is headquartered in Winston-Salem, NC.
Detailed credit considerations

Market position: stable market position, but changing competitive dynamic in Winston-Salem

Novant Health’s location in favorable markets will continue to drive strong financial performance and enterprise growth for the next several years. There has been significant merger and acquisition activity with Novant Health’s markets and among its competitors in recent years and we anticipate that Novant Health will eventually pursue strategic growth opportunities over the next few years, capitalizing on its strong balance sheet and reputation as strong operators. We believe the system will pursue growth opportunities in new markets, which could result in operations in new states; Novant Health currently has acute care facilities, imaging centers and physician offices in North Carolina and Virginia and imaging centers and physician offices in South Carolina.

In the system’s largest market, Charlotte (accounting for about 45% of total revenue), Novant Health maintains a roughly even market share with Atrium Health (Aa3 stable); although there have been slight shifts in market share over the last several years, we do not expect material changes to either system’s competitive positioning. We expect Novant Health to continue pursuing a diversified model in the Charlotte metro area, adding ambulatory access points in growing communities and building larger facilities as necessary.

The competitive dynamic in the system’s second largest market, Winston-Salem (accounting for nearly 40% of revenue), has changed somewhat over the last several years as the primary competitor there (Wake Forest Baptist, A2 stable) has adopted a more competitive position and submitted a certificate of need application to offer newborn delivery services. It has also sought to establish a more regional presence through its acquisition of a large physician group (Cornerstone) and community hospital (High Point Regional). Currently, Novant Health is the only provider performing newborn delivery services in Winston Salem (WFB does performs a small number of high risk deliveries each year) and WFB’s participation in this market will negatively impact Novant Health’s patient volumes and market share. WFB will not likely start its program until the second half of 2019 so we expect greater impact in 2020. We anticipate that WFB will continue to adopt a more competitive position in Winston-Salem, but that its regional strategy will not impact Novant Health’s strategic positioning in the broader market. Nevertheless, Novant Health maintains leading market share, which we do not expect to change, and generates strong margins in Winston-Salem.

In Novant Health’s northern Virginia market (which accounts for just 8% of revenue), we do not anticipate material changes. Several years ago, Novant Health partnered with the University of Virginia to create a joint operating model for the region, with each parent system contributing hospitals and other assets. We believe growth opportunities here are limited given that this is a competitive market, with hospitals owned by several large and well capitalized competitors. Nonetheless we expect Novant Health to continue operating profitably here, leveraging its expertise in managing community hospitals.

Operating performance, balance sheet, and capital plans: strong margins and good liquidity expected to be maintained

We expect Novant Health’s operating performance to remain stable over the next 12 – 18 months. Full year results for fiscal 2018 will be in line with performance through the third quarter, with an operating cash flow margin in excess of 11%. We expect population growth and generally favorable economic trends in Novant Health’s key markets will allow for stable financial performance. The system has already completed a major electronic medical record conversion (with minimal impact to financial performance or liquidity) and has not announced any major strategic changes that we believe would impact its ability to generate favorable operating margins.

A medium-term challenge is that beginning in 2019, North Carolina will transition to a Medicaid managed care program. This will introduce some financial risk as it will require providers to negotiate Medicaid reimbursement rates. We expect the managed care companies to pursue strategies to lower per capita spending and the overall growth of spending on their covered populations. Novant Health has less Medicaid exposure than other providers but will nevertheless be affected by the changes. North Carolina recently awarded five managed care companies with contracts for the state Medicaid managed care program. Novant Health, along with eleven other not-for-profit North Carolina system and Presbyterian Health Services NM (Aa3 stable), formed a managed care company that applied to participate in North Carolina’s Medicaid plan. Their bid was not one of the plans that was awarded by the state.

Another potential challenge over the near term is pressure by the North Carolina Treasurer to have the state’s health plan reduce payment rates to providers. Such a move would affect all North Carolina hospitals, but to date, payment rates have not changed.
Capital spending over the next several years will average about 1.25x – 1.4x depreciation expense; Novant Health should be able to fund this level of spending from cash flow. The largest project is a master facility plan at the Winston-Salem campus, followed by an oncology building at the Presbyterian Medical Center in Charlotte.

LIQUIDITY
Novant Health has a strong liquidity position with well over 200 days cash on hand and over 200% cash to debt. Novant Health has a large investment portfolio that is managed internally by the Novant Health Asset Management LLC. The portfolio is broadly diversified across a variety of asset classes and sectors. Approximately 77% of the portfolio is liquid within a month.

Debt structure and legal covenants
Novant Health has reduced debt balances in recent years and currently has a modest amount of debt outstanding with debt to revenue of about 30%. The organization may incur additional debt over the near term, to reimburse itself for prior capital spend, but we do not expect material changes to its leverage profile absent a material acquisition. Novant Health has historically accessed both the tax-exempt and taxable markets for funding.

DEBT STRUCTURE
Debt structure is approximately 77% underlying fixed rate, with the balance in variable rate demand bonds (VRDB’s) or capital leases. After taking into account swaps, about 6% of debt is floating rate and exposed to rising interest rates.

Two series of VRDB’s (about 10% of outstanding debt) are backed by standby bond purchase agreements expiring in January 2021 (Series 2004A and 2004B).

Three series of debt (about 8% of outstanding debt) are directly placed with banks with expirations in December 2024 (Series 2008A, 2008B, 2008C).

DEBT-RELATED DERIVATIVES
Novant Health has three fixed payor swaps with three different counterparties. The aggregate notional is approximately $245 million. No collateral posting is required at a rating of A3 or higher.

PENSIONS AND OPEB
Novant Health sponsors three defined benefit pension plans; the plans are nearly fully funded in aggregate.

Management and governance
The senior C-suite management team is very tenured; Novant Health’s CEO, CFO and COO have worked together for the last 15 years.
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