

RATING ACTION COMMENTARY

Fitch Affirms Advocate Aurora Health (WI) IDR at 'AA'; Outlook Stable

Fri 09 Aug, 2024 - 3:06 PM ET

Fitch Ratings - Chicago - 09 Aug 2024: Fitch Ratings has affirmed Advocate Aurora Health's (AAH) Issuer Default Rating (IDR) at 'AA'. Fitch has also affirmed the outstanding revenue bonds issued directly by AAH or by the Wisconsin Health and Educational Facilities Authority, Illinois Finance Authority, and Illinois Health Facilities Authority on behalf of AAH/Advocate Health Care Network at 'AA'.

The Rating Outlook is Stable.

Fitch has additionally affirmed AAH's short-term rating at 'F1+' on variable rate debt and CP debt supported by AAH's self-liquidity.

RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕			PRIOR ↕
Advocate Aurora Health, Inc. (WI)	LT IDR	AA Rating Outlook Stable	Affirmed	AA Rating Outlook Stable

Advocate Aurora Health, Inc. (WI) /General Revenues/1 LT	LT	AA Rating Outlook Stable	Affirmed	AA Rating Outlook Stable
Advocate Health Care Network (IL) /General Revenues/1 LT	LT	AA Rating Outlook Stable	Affirmed	AA Rating Outlook Stable
Advocate Aurora Health, Inc. (WI) /Self-Liquidity/1 ST	ST	F1+	Affirmed	F1+
Advocate Health Care Network (IL) /Self-Liquidity/1 ST	ST	F1+	Affirmed	F1+

[VIEW ADDITIONAL RATING DETAILS](#)

AAH's 'AA' IDR is based on the system's very strong financial profile in the context of a sound operating profile, leading positions in markets across two states, and good balance sheet metrics. AAH also benefits from the strong financial profile of the combined Advocate Health as evidenced by Atrium Health's (Atrium) 'AA' IDR.

Combined, Advocate treats approximately six million unique patients in more than 1,000 sites of care (including 68 hospitals) across six states in the Southeast (North Carolina, South Carolina, Georgia, and Alabama) and Midwest (Illinois and Wisconsin). The system also benefits from being the primary teaching affiliate of the Wake Forest University (WFU) School of Medicine.

While like most acute care providers in the U.S. Advocate's operating margins were compressed in FY22 due to macro labor and inflationary pressures, Fitch believes the system has the foundation to generate good margins in the long term. Advocate's operating EBITDA margin improved in FY23 (driven by considerable improvement at Atrium). Advocate's (and AAH's) combined capital-related metrics should remain strong in Fitch's forward-looking scenario analysis, even in a stress case.

Advocate Health Joint Operating Agreement (JOA)

AAH is a member of Advocate Health. Advocate is the result of the December 2022 combination of AAH and Atrium. Combined, Advocate Health recorded more than \$31 billion in operating revenue in FY23. While the organizations have not yet combined debt obligations, Advocate Health operates with a common management team and one board and the system is deeply integrated.

Most of the financial ratios in this release reference the combined Advocate Health (unless otherwise noted). For the rest of this release "Advocate Health" and "Advocate" refer to the new combined system. For more information regarding Atrium, please see rating action commentary dated Aug. 9, 2024.

SECURITY

Bonds are unsecured joint and several obligations of the obligated group, which consists of the vast majority of AAH hospitals, the AAH parent, and the Advocate Health Care Network and AAH physician practices.

KEY RATING DRIVERS

Revenue Defensibility - 'bbb'

Broad Reach Across Multiple States; Competition Present in Key Markets

Advocate Health has diversified operations across multiple markets in six states in distinct regions of the U.S. (the Southeast and Midwest). While diversified among many service areas, Advocate hospital operations are centered around Charlotte and Winston-Salem in North Carolina, the Macon area in Georgia, the Chicago area in Illinois, and Milwaukee and Green Bay in Wisconsin. Advocate maintains the market lead in most core service areas, although competition is present in many markets.

AAH is the largest health care system in both Illinois and Wisconsin. While the system is the market share leader in the Chicago, Milwaukee, and Green Bay metro areas, competition is present in each.

Advocate Health operates in varying service area demographic profiles, as expected from a large and geographically diverse health system. The Charlotte metro area and Winston-Salem area enjoy population growth in excess of the national average, and growth in Bibb County (Rome) and Floyd County (Macon) are in-line with the national average.

The unemployment rates in each of these counties is in line with or below the national average. Much of suburban Chicago (e.g., Lake County), suburban Milwaukee, and other markets such as Brown County, WI (Green Bay) demonstrate generally sound characteristics such as median household income levels in-line with or better than the national average, although population trends tend to be somewhat stagnant.

Combined Advocate Health system Medicaid and self-pay are below Fitch's threshold of 25% of gross revenue for a midrange assessment. North Carolina recently expanded Medicaid per the Affordable Care Act (ACA). North Carolina also recently approved a Medicaid directed payment program, which significantly increases net Medicaid reimbursement rates in the state. Georgia and Wisconsin did not expand Medicaid under the ACA, while Illinois did expand.

Operating Risk - 'a'

Track-Record Sound Operating Results; Macro Pressures Compressed Margins, with Improvement in FY23

Both AAH and Atrium have a track record of sound operating results. Together (per management combination of audited results), the combined Advocate Health would have generated an average operating margin of roughly 3.1% and operating EBITDA margin of about 8.5% in the four years prior to FY22, despite the pandemic (and of course these ratios do not include any potential efficiencies or synergies from the combination).

Like the rest of the sector, Advocate Health was not immune to macro labor and inflationary pressures, as the system recorded an adjusted -0.8% operating margin and 4.3% operating EBITDA margin in FY22 (combination of Atrium and AAH audits, adjusted to move the portion of investment income included in operating revenue to non-operating).

Advocate's adjusted operating margin and operating EBITDA margin improved notably to 1.8% and 6.5%, respectively, in audited FY23 (as of FY23, Advocate Health now completes a combined system audit). Most of the system's improvement in FY23 were driven by gains at Atrium, whose operating EBITDA margin increased to 8.2% in FY23 from 3.9% in FY22 (AAH also improved, but more modestly, to an operating EBITDA margin of 4.9% in FY23 from 4.7% in FY22).

Overall, Advocate benefited in FY23 from strong volume growth, with inpatient admissions up 6.6% in FY23 over FY22, inpatient surgeries up 6.2%, and outpatient surgeries up 5.9%, as well as continued gains in outpatient visits (including gains in each of these areas at AAH). Moreover, the system continues to capture integration synergies.

Management estimates significant synergy benefits over the first three years since the integration, which include: supply chain, pharmacy optimization, revenue cycle, continued reduction in contract labor and nurse vacancy, and IT consolidation. Also, the aforementioned implementation of a Medicaid directed payment program in North Carolina to complement Medicaid expansion in the state, is of particular benefit to Advocate Health Southeast (Atrium). Advocate also received \$238 million in 340b settlement funding in FY23.

Moving forward, Fitch expects Advocate Health to continue to show steady improvement and to record sound profitability and an operating EBITDA margin closer to historical averages. Favorably, Advocate was profitable in the first six-months of FY24 and to-date the system is ahead of prior year and budget. Volume growth continues in interim FY24.

Capital Spending

Advocate Health has maintained a steady pace of capital spending over time (e.g., AAH's capital spending ratio averaged just over 1x between FY19 and FY23, and Atrium's averaged about 1.5x). The combined system's average age of plant measured a sound 11.4 years at FYE 2023. Fitch expects Advocate will continue to reinvest in its plant. Management notes that capital spending is contingent on meeting EBITDA targets, and capex will flex accordingly.

Highlighted ongoing and future projects include a new patient tower in Winston-Salem, a new hospital in Cornelius (NC), the Pearl (a joint venture education and research project in Charlotte with the WFU medical school), a replacement hospital in Sheboygan (WI), a major addition in Chicago, and additional ambulatory access points. Both the legacy Atrium and AAH systems are on the Epic EMR platform, so a major EMR update is not required. Fitch expects that a system of Advocate's scope and reach will access the debt markets on a regular basis.

Financial Profile - 'aa'

Very Strong Capital-Related Ratios Should be Sustained

Advocate Health's financial profile is very strong. Capital-related metrics should remain strong in the forward-looking scenario analysis, including in a stress case.

At FYE 2023, Advocate Health had nearly \$22 billion of unrestricted cash and investments (approximately \$11.7 billion at AAH) and around \$8.8 billion of debt (\$3.8 billion at AAH) (inclusive of operating leases). Advocate sponsors six private defined benefit (DB) pension plans, each of which is more than 80% funded (Fitch includes as a debt equivalent the portion of a FASB DB pension plan below 80% funded). Atrium also has the CMHA government DB pension, which was approximately 57% funded as of Dec. 31, 2023. Advocate's net adjusted debt (adjusted debt minus unrestricted cash and investments) is favorably negative and cash-to-adjusted debt exceeded 245% at FYE 2023.

Advocate's capital-related ratios should remain strong, even in the stress case of Fitch's forward-looking scenario analysis. In the stress case, Advocate's net adjusted debt-to-adjusted EBITDA is favorably negative in every year and cash-to-adjusted debt does not drop below 210% (and exceeds 275% by year four).

Short-Term Rating

The 'F1+' short-term rating is based on AAH maintaining a long-term rating of at least 'AA-'. AAH (and Advocate) maintains sufficient discounted internal liquid resources and has implemented written procedures to fund any un-remarketed put on the approximately \$1.1 billion of theoretical maximum potential AAH debt supported by self-liquidity. AAH's self-liquidity supported demand debt includes CP and puttable variable rate demand bonds (VRDB) not supported by standby bond purchase agreements (SBPAs) or letters of credit (LOC), which are adequately covered by internal liquidity (per Fitch's standard discounting of assets).

Asymmetric Additional Risk Considerations

There are no asymmetric risk factors affecting Atrium's rating.

Advocate Health's debt is comprised of approximately 55/45 fixed rate/variable rate mix. Variable rate debt includes bank private placements, VRDB, floating rate notes (FRN), and CP. Combined Advocate maximum annual debt service (MADS) is \$458 million, based on smoothing debt service (there are more than \$1 billion in bullets due in FY26). Advocate's MADS coverage based on FY23 results was sound at 7.1x and does not pose an asymmetric risk. The legacy AAH's MADS coverage was 4.6x in FY23.

Advocate had just over 265 days cash on hand at FYE 2023, and therefore days cash does not pose an asymmetric risk.

Since created in December 2022, Advocate Health has operated with a common management team and a single board.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Compression in operating margins, such that the operating EBITDA margin is expected to remain closer to 6% for a sustained period;

--Weaker balance sheet metrics, leading to thinner capital-related ratios, particularly if compounded with a weaker operating risk assessment.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Combined Advocate Health operating EBITDA margin consistently above 10%;

--Considerable growth in unrestricted cash levels leading to superlative cash-to-adjusted debt.

PROFILE

Advocate Health is the result of the December 2022 combination of Atrium and AAH. The combined system operates 68 hospitals and more than 1,000 sites of care. The system has an academic affiliation with Wake Forest University and engages in considerable research efforts and has more than 220 GME programs.

Advocate has acute care operations in six states: North Carolina, South Carolina, Georgia, and Alabama (Advocate Health - Southeast, the legacy Atrium); and Illinois and Wisconsin (Advocate Health - Midwest, the legacy AAH). Core hospital operations are diversified, with particular penetration around Charlotte and Winston-Salem in North Carolina, Macon and Rome in Georgia, Milwaukee and Green Bay in Wisconsin, and the Chicago area in Illinois. Advocate Health treats approximately six million unique patients.

Advocate's total operating revenue measured more than \$31 billion in FY23, making Advocate one of the five largest not-for-profit health systems in the U.S., and is the largest health system in North Carolina, Illinois, and Wisconsin. The system is structured as a JOA. Advocate Health has a common board with 14 members (seven each from Atrium and AAH). While Atrium and AAH are not obligated on each other's respective debt, it is Fitch's belief that management and the board are committed to the combined Advocate Health system and are deeply integrated

AAH consists of 28 hospitals across two states, with particularly focus on operations in Chicagoland, metro Milwaukee, and Green Bay.

Sources of Information

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

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit <https://www.fitchratings.com/topics/esg/products#esg-relevance-scores>.

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APPLICABLE CRITERIA

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

[U.S. Public Sector, Revenue-Supported Entities Rating Criteria \(pub. 12 Jan 2024\) \(including rating assumption sensitivity\)](#)

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)

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Advocate Health and Hospitals Corporation

EU Endorsed, UK Endorsed

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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. For more details on sector-specific best- and worst-case scenario credit ratings, please see [Best- and Worst-Case Measures](#) under the Rating Performance page on Fitch's website.

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