S&P Global
Ratings

Research

Charlotte-Mecklenburg Hospital Authority, North Carolina; CP; Joint Criteria; System

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Credit Profile		
Charlotte-Mecklenburg Hosp Auth		
Long Term Rating	AA-/Stable	Affirmed

Rationale

S&P Global Ratings affirmed its 'AA-' long-term ratings and underlying ratings (SPURs) on Charlotte-Mecklenburg Hospital Authority, N.C.'s bonds outstanding. We also affirmed our 'A-1+' short-term rating on the authority's series 2015B taxable health care commercial paper (CP) program, our 'AA-/A-1' long-term rating on its 2007B and 2007C bonds, and our 'AAA/A-1+' rating on its 2007E bonds. The authority, directly and through its affiliates, does business as Carolinas HealthCare System (CHS). The outlook, where applicable, is stable.

Supporting the series 2007B and 2007C bonds, which we rate 'AA-/A-1', are standby bond purchase agreements (SBPA) from JPMorgan Chase Bank N.A. The long-term rating component reflects the 'AA-' long-term rating on CHS, and the short-term rating component reflects the 'A-1' short-term rating on JPMorgan Chase Bank. The SBPAs supporting the series 2007B and 2007C bonds expire in 2021.

A letter of credit (LOC) from TD Bank supports the 2007E bonds, which we rate 'AAA/A-1+'. We based the long-term rating component on insurance from Assured Guaranty Municipal Corp. and the application of joint criteria between TD Bank and the 'AA-' SPUR on CHS. The short-term rating component reflects the 'A-1+' short-term rating on TD Bank. The LOC expires in 2020.

CHS uses self-liquidity to support its CP program, with our 'A-1+' short-term rating reflecting our opinion of its general credit strengths supporting this program. CHS also maintains several forms of direct purchase bank debt across multiple banks. We do not rate these transactions but we do assess potential debt acceleration risk for CHS associated with various defaults and remedies inherent to these documents.

The 'AA-' rating on CHS reflects its healthy enterprise profile, highlighted by year-over-year volume growth; favorable service area economic fundamentals, with considerable geographic reach across the state of North Carolina; and dominant market share in its core market. Its financial profile is also sufficient for the rating level, with financial performance metrics in line with our expectations, as well as slightly favorable liquidity and debt metrics compared with our medians for the rating level. We expect the enterprise profile to remain strong, and anticipate continued solid operating results and balance sheet growth through the two-year outlook period. CHS has no debt plans through that timeframe and is currently evaluating its master capital framework. We expect more information from management in our 2018 review.

The 'AA-' rating is based on CHS' following credit strengths:

- Balance sheet cushion, with overall unrestricted reserve and debt metrics favorable to our expectations for the rating level;
- Maintenance of a significant business position within North and South Carolina as the largest health care provider;
- Robust demographic characteristics in its primary service locations; and
- Depth of knowledge within the management team, with no break in aptitude during recent management transition.

The 'AA-' also rating reflects CHS' following credit weaknesses:

- Significant reliance on supplemental funds from state and federal funding sources, totaling $228 million in operating revenue in fiscal 2016 and $238 million in fiscal 2015. Management doesn't expect any major reduction in funding at this time--however, we believe this is a factor outside of management's control that could be a future credit risk, with some uncertainty about future supplemental funding from state and federal sources;
- Slight downturn in financial performance through the first quarter of fiscal 2017 (interim period ended March 31, 2017), which management attributes to a timing issue with a higher expense typically paid within that period; and
- Continued exposure to underlying variable-rate debt and contingent liabilities.

A gross revenue pledge of the obligated group secures all bonds, including the commercial paper program, which comprises the entire CHS organization including the primary enterprise and one component unit, the Carolinas HealthCare Foundation. All ratios cited in this report refer to the obligated group, unless otherwise noted. Our rating reflects our view of the authority's group credit profile and the obligated group's "core" status. Accordingly, the rating matches our assessment of the group credit profile.

Outlook

The stable outlook reflects our assessment of CHS' enterprise strengths and our view that its overall financial profile is commensurate with the 'AA-' rating level. We expect the organization will continue to post solid financial performance metrics and maintain its balance sheet strengths through the outlook period.

Upside scenario

We could revise the outlook to positive within the outlook period if CHS maintains its enterprise strengths, produces financial performance metrics more in-line with a 'AA' rating, and continues to bolster its balance sheet, with no material dilution related to new debt or the use of unrestricted reserves.

Downside scenario

While not expected, we could revise the outlook to negative if CHS experiences a sharp decline in financial operating performance or in the event of a significant dilution of its balance sheet strengths.

Enterprise Profile

Organization

CHS is the larger of two health care systems serving the Charlotte region and offers area residents convenient access to all primary and secondary services, in addition to a broad tertiary and quaternary service mix, including its recognized strength in key specialties such as pediatrics, cardiology, orthopedics, cancer, and neurosciences. Currently, CHS' primary enterprise consists of 11 acute-care hospitals, including more than 3,400 licensed beds. It also maintains a large physician network of more than 1,500 primary and specialty physicians and faculty at Carolinas Medical Center.

CHS' strategy is to broaden its geographic outreach through a network of nonobligated entities, including 22 hospitals and eight related nursing homes. These entities constitute the managed entities, which are not included in the CHS audit. CHS has its direct management expenses reimbursed and also receives management fees from all managed entities, which are included in other revenue. Together, the CHS primary enterprise and the network of nonobligated entities provide approximately 1,000 sites of care.

Utilization

CHS' patient volume has been increasing across most of its facilities in recent years, with continued expansion of its physician network through recruitment and programmatic growth associated with strategic investments. We expect these patterns to continue within the inpatient setting, with some shift to outpatient services following the national trend.

Market position and physician network

CHS' inpatient market share (including all facilities owned or managed) in the service area--consisting of the 34-county region--remained strong at 37%, with the balance shared by Winston-Salem based Novant Health, which includes Novant Health Presbyterian Medical Center, as well as by individual community hospitals that have strong positions in their home counties. CHS has strong market share in key service lines, which we view as an institutional strength. CHS has a 52% market share in its 13-county core market, where competition comes largely from Novant Health Presbyterian Medical Center and its affiliates. CHS' market share has grown since the mid-1990s at the expense of providers in the primary service area. Commercial insurance accounts for about 59% of net revenue. CHS contracts with all substantive commercial insurance companies in the region and has several value-based shared saving arrangements. Large multispecialty and single-specialty medical groups characterize the Charlotte region. CHS' physician network remains a core business strength, in our opinion, with 1,523 community-based and faculty physicians, generating roughly 5 million visits annually. Carolinas Medical Center is one of five academic medical center teaching hospitals designated by North Carolina, with 321 medical residents in 39 programs.

According to demographic data provided by CHS, economic fundamentals within its core service area remain robust with significant population growth and booming economic development. In addition, the unemployment rate in the area has declined significantly in recent years, with the Mecklenburg County unemployment rate lower than that of both the state itself and the U.S.

Management

The CEO of CHS has been with the organization since early 2016, following the retirement of the former CEO, with a seamless transition in leadership. Its chief financial officer is set to retire at the end of calendar 2017 and a search for a replacement is underway. We think that the CHS management team has a depth of knowledge and leadership experience even below the C-suite, which will allow for this leadership change to also have no negative impact on the operations or strategic direction of the organization. The remainder of the management team has been in place for many years, which we believe promotes the organization's stability. Senior management has focused on a strategy of growth, clinical safety, and quality and geographic expansion, which has produced consistent volume and revenue growth for several years.

We note that as of June 2016, CHS has been the subject of a civil antitrust lawsuit filed by the federal government and the State of North Carolina, for alleged violation of the Sherman Act. The duration and final outcome of the lawsuit remains unknown, and as such is not factored into the current rating. We will continue to monitor the lawsuit for its potential effect on CHS' enterprise and financial profiles.

Financial Profile

Income statement

CHS has reported stable financial performance metrics since fiscal 2014, with healthy operating margins, EBIDA margins, and maximum annual debt service coverage (MADS) across that timeframe. Management attributes this to effective cost controls, volume and revenue growth, and greater clinical and operating efficiencies. We expect that CHS will achieve its budget for fiscal 2017 with an operating margin at or near 3% by fiscal year-end and that MADS coverage will remain at or near current levels should operating cash flow remain healthy.

Balance sheet

CHS' core strength has been its balance sheet. Favorable investment returns, sound operations, a continued low balance of accounts receivable, coupled with improved revenue-cycle management, have increased cash on an absolute basis. CHS' asset allocation is fairly balanced, in our opinion--and falls within the ranges established by the system's target allocation--with 31% invested in fixed income securities, 63% in equities, and 6% in alternative investments. CHS' unfunded private equity commitments as of March 31, 2017, were, in our view, minimal at $39.9 million.

CHS has identified approximately $770.8 million of cash and fixed income assets as of June 30, 2017, to guarantee the full and timely purchase price of its $200 million CP program, series 2015B-1 and series 2015B-2, for which CHS has arranged to provide self- liquidity. The assets--invested in highly rated money market funds, treasuries, agencies, and investment-grade debt--provide sufficient coverage in the event of a failed remarketing. Management has established clear and detailed procedures to ensure the ongoing maintenance of sufficient asset coverage and to meet liquidity demands on a timely basis. We will continue to monitor the liquidity and sufficiency of assets pledged by CHS on a monthly basis.

Contingent liabilities

CHS maintains approximately $713 million in contingent debt, approximately 39% of its debt profile, including its variable-rate demand bonds and several direct purchase bank agreements spread across PNC Bank, Bank of America, and Wells Fargo. Under the terms of the direct purchase agreements, each bank will hold the bonds for terms ranging from six to 10 years, at which time, unless extended, CHS may remarket the bonds, or if they cannot be remarketed, CHS may repurchase some or all of the bonds. Covenants for the CHS direct purchase agreements include the obligated group's maintenance of 1.1x debt service coverage, at least 75 days' cash on hand, and less than 65% leverage, although not all agreements contain each covenant. In addition, in some agreements a long-term credit rating of less than 'BBB' is considered an event of default. An event of default could occur, if not waived by the banks, should CHS breach any of the aforementioned covenants following a 30-day cure period. In the event of default, the banks have the right to accelerate the bonds, at which time CHS would have 180 days to repurchase some or all of the bonds from the bank, or to remarket the bonds. In our view, CHS' 5.7x unrestricted reserves (liquid in less than 30 days) compared with contingent liability debt as of March 31, 2017, mitigates the risk of acceleration.

CHS maintains a floating to fixed-rate swap on its series 2005B-D issue with Bank of America on an outstanding notional amount of $61.6 million. CHS also maintains several floating to fixed-rate swaps on series 2007B-H bonds with Wells Fargo Bank, Citigroup, and Bank of America for an outstanding notional amount of $713 million. Despite a significant mark-to-market of negative $224 million as of Dec. 31, 2016, CHS has not had to post any collateral related to its swap portfolio, in part because the collateral posting requirement for insured swaps is based on a simultaneous downgrade of both the insurer (Assured Guaranty Municipal Corp.) to 'BBB+' and CHS to 'A'.

Carolinas HealthCare System, N.C. Selected Financial Statistics

	--Three months ended March 31--	--Fiscal year ended Dec. 31--			Medians for 'AA-' rated healthcare systems
	2017	2016	2015	2014	2015
Financial Profile					
Financial performance					
Net patient revenue ($000s)	1,327,572	5,136,830	4,948,438	4,615,482	2,360,641
Total operating revenue ($000s)	1,463,159	5,632,437	5,437,192	5,032,600	MNR
Total operating expenses ($000s)	1,447,391	5,447,084	5,154,024	4,872,061	MNR
Operating income ($000s)	15,768	185,353	283,168	160,539	MNR
Operating margin (%)	1.08	3.29	5.21	3.19	3.50
Net non-operating income ($000s)	2,356	39,086	147,935	142,541	MNR
Excess income ($000s)	18,124	224,439	431,103	303,080	MNR
Excess margin (%)	1.24	3.96	7.72	5.86	6.40
Operating EBIDA margin (%)	7.84	10.21	11.85	10.07	10.40
EBIDA margin (%)	7.99	10.83	14.18	12.55	12.70
Net available for debt service ($000s)	117,057	614,226	792,075	649,439	399,750
Maximum annual debt service ($000s)	113,384	113,384	113,384	113,384	MNR
Maximum annual debt service coverage (x)	4.13	5.42	6.99	5.73	5.80
Operating lease-adjusted coverage (x)	2.98	3.80	4.93	4.12	4.10
Liquidity and financial flexibility					
Unrestricted reserves ($000s)	4,017,353	3,915,127	3,513,113	3,290,934	1,920,207
Unrestricted days' cash on hand	268.0	277.6	262.8	260.5	258.20
Unrestricted reserves/total long-term debt (%)	222.8	213.0	189.4	174.0	180.90
Unrestricted reserves/contingent liabilities (%)	568.2	549.0	492.0	458.5	568.70
Average age of plant (years)	8.1	8.4	8.2	7.8	10.00
Capital expenditures/depreciation and amortization (%)	93.0	100.4	91.0	139.1	124.20
Debt and liabilities					
Total long-term debt ($000s)	1,803,285	1,838,134	1,855,245	1,891,155	MNR
Long-term debt/capitalization (%)	27.1	29.6	32.2	31.3	31.40

Carolinas HealthCare System, N.C. Selected Financial Statistics (cont.)	--Three months ended March 31--	--Fiscal year ended Dec. 31--			Medians for 'AA-' rated healthcare systems
	2017	2016	2015	2014	2015
Contingent liabilities ($000s)	706,985	713,105	714,005	717,780	MNR
Contingent liabilities/total long-term debt (%)	39.2	38.8	38.5	38.0	31.80
Debt burden (%)	1.93	2.00	2.03	2.19	2.30
Defined benefit plan funded status (%)	N.A.	62.91	67.20	68.95	76.30

N.A.--Not available. MNR--Median not reported.

Related Research

- Glossary: Not-For-Profit Health Care Ratios, Oct. 26, 2011
- U.S. Not-For-Profit Health Care Sector 2017 Outlook: Stable, Yet A Pen Stroke Away From Unprecedented Change, Jan. 10, 2017
- U.S. Not-For-Profit Health Care System Median Financial Ratios -- 2015 vs. 2014, Sept. 21, 2016
- Health Care Providers And Insurers Pursue Value Initiatives Despite Reform Uncertainties, May 9, 2013
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013
- Alternative Financing: Disclosure Is Critical To Credit Analysis In Public Finance, Feb. 18, 2014
- Health Care Organizations See Integration And Greater Transparency As Prescriptions For Success, May 19, 2014
- U.S. Not-For-Profit Acute Health Care Ratios Are Calm On The Surface But Turbulent Underneath, Sept. 21, 2016
- The U.S. Health Care Sector Outlook Is Stable, Though Industry Pressures Persist, Sept. 27, 2016
- Medicaid's Status As An Open-Ended Entitlement Is On Life Support Following The Election, Nov. 17, 2016

Ratings Detail (As Of August 7, 2017)		
Charlotte-Mecklenburg Hosp Auth taxable hlth care comm pap rev bnds ser 2015B-1&2		
Short Term Rating	A-1+	Affirmed
Charlotte-Mecklenburg Hosp Auth JOINTCRIT		
Long Term Rating	AAA/A-1+	Affirmed
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
Charlotte Mecklenburg Hosp Auth Series 2007C		
Long Term Rating	AA-/A-1/Stable	Affirmed
Charlotte-Mecklenburg Hosp Auth Series 2007B		
Long Term Rating	AA-/A-1/Stable	Affirmed

Many issues are enhanced by bond insurance.