19 MAR 2024

Fitch Affirms UPMC's (PA) Bond Rating and IDR at 'A'; Outlook Revised to Stable from Positive

Fitch Ratings - New York - 19 Mar 2024: Fitch Ratings has affirmed UPMC's Issuer Default Rating (IDR) and revenue bond rating on the outstanding series of bonds issued by various issuing authorities in Pennsylvania and Maryland on behalf of UPMC (PA) at 'A':

The Rating Outlook has been revised to Stable from Positive.

The affirmation of the rating and IDR at 'A' is based on UPMC's leading market share position in its core markets of Western Pennsylvania. The rating also reflects UPMC's significant level of revenue diversity across several markets in Pennsylvania and adjoining western New York and north-western Maryland.

The rating is further supported by UPMC's large insurance division, which accounted for 55% of the consolidated system operating revenues in fiscal 2023 (year-end December 31). This provides a certain level of revenue predictability. Additionally, the ratings reflect the system's balance sheet metrics, which were maintained despite weaker operating performance over the last two fiscal years.

The Outlook revision to Stable is based on challenging FY23 results. The system fell materially short of its budgeted performance, which was expected to reverse the operating loss in the prior year. The consolidated system ended FY23 with an operating loss of $651 million, equal to an operating EBITDA margin of 0.9% (Fitch includes the $242 million of academic support and interest expense in operating income). The loss was partially driven by a loss at the hospital division, and was exacerbated by materially lower, though positive, operating income at the insurance division.

Management, with a new CFO appointed in September 2023, is focused on turning operations back to a positive territory. They forecast an operating EBITDA margin of 3.6% for the current fiscal year, with the expectation that a level similar to the budgeted operating results can, and will be maintained over the longer term.

In October 2023, UPMC executed an affiliation agreement with Washington Health System (WHS), located in Washington, PA, approximately 28 miles southwest of Pittsburgh. The transaction is in the later stages of FTC review, with resolution anticipated later this summer. UPMC and WHS collaborate on several services and the affiliation apparently has solid community support.

While UPMC's operating EBITDA margins have historically been lower than the 'bbb' midrange' operating risk assessment, Fitch views the presence of the large UPMC health plan, which tends to dampen profitability, as a positive offsetting credit factor. This provides a strategic advantage, and acts as a natural hedge to revenue volatility.

SECURITY

The bonds are secured by a gross revenue pledge of the obligated group (OG) and constitute parity debt under UPMC's 2007 master trust indenture. The Insurance Division, which is not in the OG, but owned by the corporate parent, accounted for approximately 55% of fiscal 2023 system operating revenues (before eliminations).

KEY RATING DRIVERS

Revenue Defensibility - bbb

Leading Market Position Enhanced by Large Insurance Division

UPMC's leading market share in Allegheny County and the western Pennsylvania market remains a significant credit strength. Fitch views UPMC's revenue diversification and integrated delivery model, large aligned physician base, extensive health plan division and sizeable geographically distributed delivery network with a 40 hospital and extensive ambulatory network with 800 clinical locations, as a material credit differentiator.

UPMC reported market share of 43% in the 29 counties of western PA, 26% in central PA and strong, 57% in Allegheny County itself. In each case there was a slight decline of between 1% to 2%, but still leading versus the prior year. Allegheny County is a competitive market served by two integrated delivery systems, UPMC and the Allegheny Health Network (AHN; Highmark's affiliation with West Penn Allegheny Health System).

The small decline in UPMC's respective market shares was due to AHN opening a 160-bed hospital in 2021, and several micro hospitals. However, UPMC maintains the clear leading position and has a larger share of the high acuity market, particularly in neurology, cardiology and orthopedics.

UPMC Presbyterian is also a leading provider of solid organ transplantation in the U.S.

Fitch views the approximately 55% of UPMC's gross revenues generated by its health plan division favorably. The UPMC Health Plan's market share has grown yoy over the last decade, increasing to 27% recently from 17% in 2013, compared to Highmark, with 21%. Highmark's market share has consistently declined over the same period.

Favorably, less than 19% of UPMC's gross patient revenue were represented by Medicaid and self-pay in fiscal 2023, supporting the 'bbb' assessment for revenue defensibility. The recent completion of the UPMC Vision and Rehabilitation Tower and the 636-bed patient tower under construction in Pittsburgh are expected to be accretive to market share.

Pennsylvania's population increased by 1.2% over the last five years, as has Allegheny County's (1.1%), but has an older profile than that of the U.S., with median income and poverty relatively in line with those of the U.S.

Operating Risk - bbb

Recent Weak Operating Margins Expected to be Reversed Starting in 2024

In the two years of the system failing to meet its operating budget, FY23 was particularly weak. It ended with an operating loss of $651 million, translating to an operating EBITDA margin of 0.9%, lagging management's expectation of operating EBITDA margin in the 3% range). Fitch now includes the academic and research support ($247.3 million in FY23, $242 million in FY22) as part of the operating expenses, consistent with how this expense is treated in Fitch's hospital sector; UPMC reports this expense as non-operating.

The loss in FY23 was mostly due to continued industry inflationary pressures, particularly labor costs, which could not be alleviated given UPMC's very robust utilization, combined with the insurance division's increasing expense ratio. The costs per discharge across the UPMC hospital division was reported at about 30% higher than the pre-pandemic level. This was further exacerbated by a still elevated length of stay, partially due to shortages in post-acute capacity.

Although use of agency staffing has gradually declined along with the nursing hourly rate, and with nursing turnover having plateaued at half of the 20% high point, labor costs remain high and continue to strain operating results. Membership in the health plan declined in FY23 by 3.9%, partially due to the disenrollment following the rollback of Covid period Medicaid expansion. Combined with higher medical expense ratios, these factors drove lower profitability in the health plan. However, management reports that the most recent January 2024 enrollment was very successful and ahead of expectations.

Fitch believes that UPMC's strong market position, revenue diversification and scale provide the system with the opportunity to better manage its own revenues and expenses within its integrated network. Management is further refocusing the operating improvement plan with specific short- and long-term targets. These are related to workforce recruitment to reduce agency use, stabilizing the medical expense ratio, particularly in the Medicare Advantage product (e.g. utilization management), and expanding the lower cost ambulatory access points. Efforts also include improving accessibility to both primary and specialty care.

Additionally, there are permanently ongoing efforts, such as supply costs management and evaluating real estate needs. Ongoing efforts also include improving productivity through work standardization, optimizing service lines, particularly those focused on UPMC's centers of excellence, and increasing care access both on outpatient side through more responsive appointment scheduling.

However, UPMC must reduce average length of stay (ALOS), which spiked during the pandemic, to create needed inpatient capacity. The expectation is to generate $800 million run-rate margin improvement. Additionally, the FY24 budget is based on achieving 3.6% operating EBITDA margin, which management views as achievable.

Fitch assesses UPMC's operating risk profile as midrange, despite metrics that are lower mostly because of its operating cash flow margin that tends to be lower than that of provider-only systems. This is due to the lack of depreciation expense related to the health plans. Further, Fitch incorporates in the midrange operating risk assessment the typically accretive health insurance operations and UPMC's manageable capital capex relative to depreciation expense.

Capex

UPMC's capital investments averaged 117% of depreciation over the last five years, with an average age of plant at 11 years at 2023 FYE. Based on FY23 results, management scaled back last year to about $744 million. However, going forward Fitch assumes that the system will return to spending about $1 billion, equal to approximately 1.3x depreciation expense, a level Fitch projects will maintained for the next several years.

Of the two major projects, which were partially funded with the proceeds of the series 2023 bond issuance, the $510 million nine-story UPMC Vision and Rehabilitation Tower at UPMC Mercy was completed in the Fall 2023 and the construction of the 17-story, 636-bed, $1.5 billion patient tower at UPMC Presbyterian is underway and expected to be completed in Fall 2026. There are no other major projects planned currently, though the system will continue to invest in ambulatory touchpoints.

Financial Profile - a

Liquidity and Leverage Metrics Lower but Generally Maintained

UPMC's leverage and liquidity metrics were improving until FY22. The initially unfavorable investment environment, combined with weaker operating performance over the last two years, as well as the large new money issuance in FY23, caused cash-to-adjusted debt to decline to 110% and days cash on hand hovering at 109 days. Unrestricted cash and investments were reported at $8.2 billion at FYE23, an increase over the prior year, but still lower than the $8.6 billion in FY21.

UPMC's liquidity has always been low vis-a-vis the system's debt position due to the large insurance division. UPMC's net adjusted debt to adjusted EBITDA (NADAE) was a still favourably negative 1.0x. Fitch does not include any adjustments to debt, as UPMC's defined benefit pension plan is funded at 94%, meeting Fitch's 80% threshold.

Fitch's forward-looking stressed scenario assumes a portfolio stress of -10.6% based on UPMC's relatively conservative asset allocation and applies standard revenue stress in the initial two years of the stressed case. Fitch assumes a gradual improvement in operating EBITDA margins and leverage in the outer years of the stressed scenario. Additionally, Fitch assumes annual capex spending at about $1 billion and new money debt issuance only to the extent that it is offset by debt amortization, and not intended to increase the overall debt position. No issuance is planned in FY24.

Asymmetric Additional Risk Considerations

There are no asymmetric risk considerations factored into this rating analysis.

RATING SENSITIVITIES

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

--Further margin compression, failing to return the system to operating EBITDA margins of near 3% over the two year period.

--High capital spending that requires significant additional cash or debt commitments such that cash-to-adjusted debt falls below 100%.

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

--Sustained improvement in unrestricted cash-to-adjusted debt at a levels maintained at better than 120%.

--Meeting Fitch's expectation for operating EBITDA margins sustained at the minimum 3% range.

PROFILE

With 40 hospitals, over 800 clinical locations in the region, and over 5,000 employed physicians and close to 4.3 million covered lives in its network of health insurance plans, UPMC is the largest health care system and non-governmental employer in Pennsylvania. UPMC is one of the largest integrated health care delivery networks in the country. It is also one of the world's leading organ transplant centers. UPMC reported total revenues of over $27.7 billion in fiscal 2023 (year-end December 31). UPMC's international division owns or operates or plans to operate as partnership or joint ventures facilities in Ireland, Italy, Kazakhstan, China, and Croatia.

Following the retirement of the prior CFO, Frederick Hargett was appointed to the position in September 2023. He served most recently in that capacity at Novant Health (NC).

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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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
UPMC Health System (PA)	LT IDR	A	Affirmed		A
• UPMC Health System (PA) /General Revenues/ 1 LT	LT	A	Affirmed		A

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

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)

Additional Disclosures

Solicitation Status

Endorsement Status

UPMC Health System (PA)	EU Endorsed, UK Endorsed

DISCLAIMER & DISCLOSURES

historical default rates in a central repository in accordance with Articles 11(2) of Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 and The Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019 respectively.

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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

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