S&P Global
Ratings

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University of Pittsburgh Medical Center, Pennsylvania; System

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Rating Action

S&P Global Ratings lowered its tax-exempt long-term rating and underlying rating (SPUR) to 'A' from 'A+' on various issuers' bonds issued for the University of Pittsburgh Medical Center (UPMC), Pa. We also lowered our rating on UPMC's taxable bonds to 'A' from 'A+'. Additionally, we lowered our long-term rating to 'A' from 'A+' on various issuers' revenue bonds originally issued for Pinnacle Health System and Hanover Hospital. The ratings and outlooks on UPMC Pinnacle and Hanover are on parity with the rating on UPMC because UPMC assumed responsibility for their debt. The outlook on all ratings is stable.

UPMC had a 2020 issuance planned to secure $1 billion of additional debt for capital projects, $550 million for various refinancings, and $210 million to repay a bridge loan used to defease debt after the acquisition of Western Maryland Healthcare System. In light of the COVID-19 pandemic and unpredictable health system needs over the next several months, management has obtained, or is in the process of obtaining, a line of credit and several bank loans totaling $2 billion and plans to place all proceeds on the balance sheet for potential working capital and other needs during this time. Ultimately, management has committed to keeping debt outstanding at $5.5 billion, or approximately $1.2 billion above debt levels at December 31, 2019. This review and rating action assume that once the health care environment around COVID-19 stabilizes, UPMC will be able to accomplish the refinancing, return debt levels to $5.5 billion, and begin to finance the capital project contemplated under the originally proposed $1 billion new debt issuance. Our calculation of debt coverage does not include payments on the incremental $1 billion line of credit and bank loan, as we assume those funds will not be part of UPMC's long-term debt structure. If the situation changes, we will reassess debt levels and debt service coverage (DSC) ratios.

The downgrade reflects thin margins that have not met expectations for the past two years coupled with the unexpected additional debt issuance of $1 billion that strains the balance sheet and DSC. While UPMC's absolute amount of unrestricted reserves continues to increase, the growth has been tempered by high capital spending and has not kept pace with rising costs or debt. Because of these factors, we no longer view UPMC's financial profile as being in line with an 'A+' rating.

However, the 'A' rating is supported by UPMC's very strong business position, resulting from strategic benefits associated with its integrated delivery and financing system (IDFS); increased geographic and revenue diversity, including from the late-2017 eight-hospital UPMC Pinnacle acquisition and recent expansion into Maryland; participation in statewide insurance contracts; solid growth at the health plan with insurance enrollment revenue actually in excess of net patient service revenue for the first time in fiscal 2019 on a consolidated basis; and a new 10-year contract with Highmark, Inc. that allows Highmark's insurance members to access UPMC providers and hospitals.

The rating also incorporates a one-notch positive adjustment reflecting UPMC's size, scale, and growth trajectory that we believe is more consistent with an 'A' rating, even in light of just-adequate financial metrics.

The stable outlook reflects UPMC's robust enterprise characteristics and growth opportunities that provide a cushion for adequate financial performance and any short term operational and financial disruption from COVID-19. Maintenance of the rating during the two years covered by our outlook period assumes approximately break-even earnings, steady cash flow, and returning long term debt balances to approximately $5.5 billion. We expect the current financial, spending, and pricing pressures associated with many of UPMC's strategic initiatives as well as the extremely competitive environment for both providers and health plans in Western and Central Pennsylvania, to continue for several years. As a result, margins and other financial metrics will likely remain weaker than those of similar systems during the two-year outlook period.

The rating reflects our assessment of UPMC's:

- Large geographic footprint and leading market presence in many of the regions served;
- Extremely low average age of plant from robust capital spending, which is expected to continue;
- Increasingly diverse and rapid growth from both the health plan and provider network, with volume increases likely from its new Highmark contract;
- Continued opportunities for growth-related system synergies and cost improvements;
- Extremely well-funded defined-benefit pension plan; and
- Benefits of operating an integrated delivery and financing system.

In our view, partially offsetting rating factors include UPMC's:

- Significant pro forma debt resulting in moderately high debt levels;
- Thin unrestricted reserves relative to both heightened debt levels and operating expenses;
- Below-median margins, cash flow, and DSC;
- Significant routine and strategic capital spending, although there may be some temporary delays, including the planned or underway construction of three specialty hospitals; and

- Highly competitive Pennsylvania service areas.

Two-Year Stable Outlook

Downside scenario

We could consider a lower rating with persistently negative operating margins through the outlook period that fail to generate around 2.5x DSC. Any further weakening of the balance sheet beyond this additional debt issuance could also pressure the rating or outlook, unless there is a commensurate increase in unrestricted reserves. We view UPMC's enterprise profile, with ample geographic diversity and substantial market presence, as a stabilizing rating factor during the outlook period.

Upside scenario

We believe UPMC's enterprise profile could support a higher rating, but given the comparatively weaker financial metrics for the rating level, we consider a positive outlook or higher rating as more likely outside the outlook period if a trend of improved financial performance can be reestablished. This would include DSC of near 4x, 1.5x unrestricted reserves relative to debt, and near 150 days' cash on hand.

Enterprise Profile--Very Strong

Healthy geographic diversification, size, and scale

UPMC has a strong geographic presence throughout the state of Pennsylvania for its health plan, and covers western and central Pennsylvania with its provider network. The system has a track record of successfully integrating and rationalizing new assets into the system, and expansion offers opportunities for regional and clinical consolidation, spreading corporate overhead, and a platform for owned physicians and hospitals to efficiently serve the insurance plan members.

UPMC's three biggest hospitals (UPMC Presbyterian Shadyside, UPMC Pinnacle, and UPMC Magee-Womens Hospital) are located in western and central Pennsylvania. Together, they operate 14 hospitals that account for slightly more than half of the system's net patient service revenue, but only one-quarter of the system's 2019 total operating revenue, which also includes $9.9 billion of insurance enrollment revenue. We view the acquisition of UPMC Pinnacle as being important for UPMC Health Plan's statewide expansion and for shifting the system's attention to a broader region outside western Pennsylvania.

The health plan serves the entire state of Pennsylvania through a variety of non-profit plans. Together, three plans accounted for a majority of UPMC's premium revenue in 2019 and, according to statutory filings, had enrollment of almost 1.1 million at December 2019.

Supporting both organizations are almost 5,000 physicians employed through the University of Pittsburgh faculty practice plan and the largely primary care-employed physicians in Community Medicine, Inc., which together are managed as a single group under UPMC Physician Services.

UPMC recently added two facilities to its organization (Western Maryland Health System in Cumberland, Maryland

and Clane General Hospital in Ireland), closed Lancaster Regional Medical Center in Lancaster, Pa., and is preparing to close UPMC Susquehanna Sunbury in Sunbury, Pa. We do not view these transactions as material to the credit because they are small relative to UPMC's size, scale, and resources. UPMC does not currently have any imminent acquisitions or divestitures, although the system is looking at certain service line and clinical consolidation opportunities. Management indicates that any further additions to the system would be contiguous to existing markets in Pennsylvania.

Pennsylvania markets remain highly competitive

The Pittsburgh market is highly consolidated, with just a few remaining independent providers in the region. Most hospitals and physicians have aligned with either UPMC or Highmark, which offers Blue Cross-branded products and also has a provider division, the Allegheny Health Network (AHN). UPMC remains the largest health care system in terms of care delivery, followed by the AHN hospitals. However, Highmark's health plans have larger enrollment for their full risk products across Pennsylvania and serve a broader three-state region. Aetna is one of the few national insurers to gain a foothold in the Pittsburgh market. To the extent that UPMC's health plans continue to grow outside western Pennsylvania, the local Pittsburgh market dynamics become less critical.

Central Pennsylvania is also a competitive market, with Penn State Health and Geisinger Health both strategically aligned with Highmark and actively expanding services and membership in the same region. UPMC is bringing a suite of specialty services such as oncology, transplant, women's health, and pediatrics to its central Pennsylvania regions in an effort to keep care local and gain both provider and health plan market share.

Long-term contract signed with Highmark

In June, 2019 UPMC and Highmark signed a 10-year contract allowing Highmark health plan members to access UPMC physicians and hospitals at in-network rates within certain Highmark products primarily serving western Pennsylvania. UPMC indicates that the agreement allows Highmark to sell products where members have in network access solely to the AHN network, but not to offer a plan that tiers or offers higher benefits for those seeking care at AHN instead of UPMC.

Because of UPMC's strong reputation, and because some Highmark health plan members have continued to receive care from UPMC during the consent decree, we believe there could be some movement between health plans and some volume movement between the systems over the next year. While this contract provides opportunities for growth, Highmark insured patients currently account for a relatively small 7% of 2019's net patient service revenue, as most Highmark members shifted to AHN providers or to other health plans in advance of the consent decree expiration last year.

Insurance membership rising

UPMC's multi-year strategic efforts in advance of the consent decree expiration have resulted in insurance membership growth, development of a broader provider network, and expanded Medicare and Medicaid coverage, including a new statewide Medicaid managed-care contract for Community HealthChoices (CHC). CHC has contributed to enrollment growth, adding almost 71,000 members since the program began in 2018, with more expected as the program rolls out to all five regions in 2020. Total enrollment across all UPMC's health plans rose about 5%, from 3.4 million at the end of 2018 to 3.6 million at the end of 2019.

Management estimates that approximately 40% of the clinical services are provided to health plan membership by UPMC hospitals and physicians. Because of this substantial overlap and the financial dynamics within an IDFS, we do not consider certain soft volume trends--such as declining inpatient admissions and surgeries, or emergency department visits--to be a concern, as long as overall revenue growth for the IDFS continues.

Search underway for new CFO

UPMC's chief financial officer retired in December 2018. UPMC has installed an interim CFO and a national search is underway for a replacement, with expectations that the position could be filled by this summer. Given the depth of the executive team, we do not consider this to be a risk.

Table 1

University of Pittsburgh Medical Center--Enterprise Statistics

	--Fiscal year ended Dec. 31--		
	2019	**2018**	**2017**
Inpatient admissions	260,452	267,545	208,311
Equivalent inpatient admissions	531,966	532,591	464,423
Emergency visits	1,127,622	1,136,776	839,135
Inpatient surgeries	84,700	88,289	69,922
Outpatient surgeries	175,260	171,434	131,990
Medicare case mix index	1.8000	1.7700	1.7600
FTE employees	75,452	63,742	60,177
Active physicians	7,790	7,482	5,791
Based on net/gross revenues	Net	Net	Net
Medicare (%)	35.5	36.2	35.6
Medicaid (%)	13.5	14.5	14.5
Commercial/Blues (%)	45.5	45.0	45.7

Inpatient admissions exclude normal newborn, psychiatric, rehabilitation, and long-term care facility admissions.

Financial Profile--Adequate

Operating losses and below-budget performance in 2018 and 2019

UPMC missed its operating income targets and posted small operating losses in both 2018 and 2019, as calculated by S&P Global Ratings, excluding contributions and investment earnings. On top of more routine cost and revenue pressures, management attributes the weaker earnings to changes in pension accounting; growth initiatives, particularly in central Pennsylvania, including building out a physician network; pricing strategies for its health plans; and startup losses on the CHC program. In 2019, both the health plan and provider network posted thin margins, although as an IDFS it is less meaningful to distinguish between provider and insurance results, because plan pricing and provider payment strategies can negatively influence individual earnings while being accretive overall.

With thin returns from operations, UPMC relies on nonoperating revenue to reach around 2.5x to 3x DSC annually. We calculate debt service based on a schedule that amortizes bullet payments because we believe that UPMC has the market access and internal resources to retire these obligations as they mature, although management typically refinances the debt before bullet payments are due. Supporting robust nonoperating revenue is UPMC's almost $5.5 billion of unrestricted reserves that typically produce meaningful investment returns.

Our calculation of nonoperating revenue also includes UPMC's growing innovation and development activities in UPMC Enterprises. While we classify these activities within nonoperating revenue, some components could be considered operating, although it is difficult to make a specific distinction. While this treatment is favorable to UPMC's operating metrics now because the net impact is negative, we temper the benefits by continuing to remove any large one-time gains associated with these investments. UPMC has announced that it will invest $1 billion into Enterprise efforts over the next five years, largely focused on digital solutions, including building data and consumer-driven capabilities that will benefit UPMC, and translational sciences for commercializing UPMC and University of Pittsburgh developed research. While this figure is large, it represents a moderate increase over support totaling $136 million in 2019 and $133 million in 2020. We do not view this as a meaningful shift in the credit's financial profile.

Improvement budgeted for fiscal year 2020

The 2020 budget expects operating income of $250 million and EBIDA of $945 million. This includes continued efficiency savings of $200 million and the benefit of recently implemented or received rate increases, offset by expense pressures. Given the significant strategic investments being made, particularly on the provider side, along with likely revenue and expense pressures associated with COVID-19, we believe meeting this budget could be challenging. In our view, system leadership and governance remain committed to opportunistic expansion and strategic investments even if earnings fall short of targets and we have factored this into our rating analysis. If UPMC meets its 2020 budget, S&P Global Ratings' expects to report another small operating loss because we exclude contributions and investment earnings from operating income, but include interest expense.

In 2019, UPMC provided $398 million to the University of Pittsburgh for physician services and support of the joint research and academic missions at University of Pittsburgh and UPMC. We expect this support to continue at slightly higher levels each year.

Unrestricted reserves expected to be flat

UPMC's unrestricted reserves relative to operating expenses and debt is a credit weakness that is not expected to change materially, given significant capital plans, limited earnings, and management's desire to reinvest in the organization. While absolute unrestricted reserves continue to rise the days' cash on hand metric has been diluted by new acquisitions and health plan growth. Although we anticipate that UPMC will have increased reserves on its balance sheet this year, we have not factored those into our analysis as they are specifically being held for COVID-19 related needs and future capital spending. Included in unrestricted reserves is $1.3 billion of risk-based capital that is statutorily required by regulators.

UPMC expects to spend $1 billion on capital annually through the forecast period which equates to about 1.5x annual depreciation expense. The organization still has $1.3 billion of acquisition-related capital commitments, with over half of those funds targeted for UPMC Pinnacle and the substantial investments UPMC is making to build its provider capabilities in central Pennsylvania. Management also has plans to construct two new specialty hospitals on the campuses of UPMC Shadyside (for oncology) and UPMC Presbyterian (for heart and transplant). UPMC is currently working on the enabling projects and expects to phase these two large projects over the next eight years or so.

Construction on the planned third specialty hospital, with a budget of $400 million, is currently underway. UPMC's average age of plant is quite young and will likely remain low because of UPMC's healthy capital spending plans, which provide management with some spending flexibility, if necessary. At the time of the last review, management indicated that debt would remain at $4.3 billion, but management has increased the baseline to $5.5 billion because of the new contract with Highmark and opportunistic financing as a result of low interest rates. The UPMC board has a goal of keeping a $500 million differential between unrestricted reserves and debt.

Conservative debt profile and well-funded pension

At the end of fiscal 2019, about one-quarter of UPMC's debt is variable-rate or direct-purchase, which we consider conservative for an organization this size. This contingent liability debt is not a credit issue because UPMC is well in compliance with all covenants, has ample coverage of contingent liability debt by unrestricted reserves, and has proven access to the debt markets in the event it needs to repay a loan. Final documents for the new bank loans are not available yet. As of Dec. 31, 2019, UPMC had $139 million notional outstanding for four interest swap agreements, with no collateral posted.

The funded status of UPMC's defined-benefit pension plans is well above median level at 100.9% on Dec. 31, 2019. The plans' projected benefit obligation of $2.485 billion compares with $2.507 billion fair value of plan assets for an overfunding of $22 million.

At Dec. 31, 2019, UPMC has booked a long-term $1 billion operating lease liability and a commensurate $1.1 billion operating lease right of use assets. Including the operating lease liability into our calculation of leverage, without the new borrowing, brings debt as a percent of capitalization to 42%. While the audit presentation resulting from the new accounting guidelines provides more clarity on the actual value of the lease liability, the actual lease obligations incurred by UPMC have not changed, and this is therefore not a credit factor.

Table 2

University of Pittsburgh Medical Center--Financial Statistics

	--Fiscal year ended Dec. 31--			Medians for 'A' rated health care system
	2019	2018	2017	2018
Financial performance				
Net patient revenue ($000s)	9,100,868	8,822,997	7,164,626	2,696,397
Insurance enrollment revenue ($000s)	9,862,977	8,491,686	7,273,331	MNR
Total operating revenue ($000s)	20,560,005	18,744,049	15,594,095	MNR
Total operating expenses ($000s)	20,734,187	18,846,183	15,528,700	MNR
Operating income ($000s)	(174,182)	(102,134)	65,395	MNR
Operating margin (%)	(0.85)	(0.54)	0.42	2.10
Net nonoperating income ($000s)	259,863	314,306	274,425	MNR
Excess income ($000s)	85,681	212,172	339,820	MNR
Excess margin (%)	0.41	1.11	2.14	3.30
Operating EBIDA margin (%)	2.99	3.65	4.81	7.60
EBIDA margin (%)	4.20	5.24	6.45	8.60
Net available for debt service ($000s)	875,416	999,342	1,024,274	273,620

Table 2

University of Pittsburgh Medical Center--Financial Statistics (cont.)

	--Fiscal year ended Dec. 31--			Medians for 'A' rated health care system
	2019	**2018**	**2017**	**2018**
Maximum annual debt service ($000s)	389,372	389,372	389,372	MNR
Maximum annual debt service coverage (x)	2.25	2.57	2.63	3.50
Operating lease-adjusted coverage (x)	1.80	2.04	2.15	2.70
Liquidity and financial flexibility				
Unrestricted reserves ($000s)	5,500,050	5,483,772	5,806,983	1,441,898
Unrestricted days' cash on hand	99.9	109.8	141.4	175.80
Unrestricted reserves/total long-term debt (%)	130.0	129.2	128.8	136.60
Unrestricted reserves/contingent liabilities (%)	503.6	378.7	403.0	555.20
Average age of plant (years)	9.2	8.7	9.5	12.10
Capital expenditures/depreciation and amortization (%)	146.6	138.9	126.0	128.60
Debt and liabilities				
Total long-term debt ($000s)	4,231,077	4,245,409	4,508,413	MNR
Long-term debt/capitalization (%)	37.2	38.9	39.6	40.20
Contingent liabilities ($000s)	1,092,066	1,447,991	1,441,005	MNR
Contingent liabilities/total long-term debt (%)	25.8	34.1	32.0	24.90
Debt burden (%)	1.87	2.04	2.45	2.50
Defined-benefit plan funded status (%)	100.90	94.92	103.02	77.00
Pro forma ratios				
Unrestricted reserves ($000s)	5,500,050	N/A	N/A	MNR
Total long-term debt ($000s)	5,451,077	N/A	N/A	MNR
Unrestricted days' cash on hand	99.9	N/A	N/A	MNR
Unrestricted reserves/total long-term debt (%)	101.1	N/A	N/A	MNR
Long-term debt/capitalization (%)	43.2	N/A	N/A	MNR

N/A--Not applicable. MNR--Median not reported. Pro forma debt includes $1.2 billion of debt expected to be on UPMC's balance sheet at year-end for capital projects and to repay a bridge loan used to defease Western Maryland Health System's debt upon its acquisition by UPMC.

Credit Snapshot

- Security pledge: Securing the bonds are gross revenues from UPMC (the parent company), UPMC Presbyterian Shadyside, Magee-Womens Hospital of UPMC, UPMC Passavant, and UPMC St. Margaret. However, our analysis covers all of UPMC, including non-obligated entities, the largest of which is the insurance division. While the insurance revenues are not technically obligated on the debt, UPMC's board and management operate all assets as an integrated financial delivery system, and so the rating assumes that these revenues would be available to bondholders, if necessary.
- Group rating methodology: Core.
- Organization description: UPMC's system consists of 40 domestic hospitals, about 4,900 employed faculty and community physicians, various insurance and related products with 3.6 million enrollees, international operations, over 700 outpatient sites, and a growing emphasis on entrepreneurial business development.

Ratings Detail (As Of March 19, 2020)

Allegheny Cnty Hosp Dev Auth, Pennsylvania		
Univ of Pittsburgh Med Ctr, Pennsylvania		
Allegheny Cnty Hosp Dev Auth (University of Pittsburgh Medical Center) hosp rev bnds		
Long Term Rating	A/Stable	Downgraded
Unenhanced Rating	NR(SPUR)	
Allegheny Cnty Hosp Dev Auth (University Pittsburgh Medical Center) (MBIA) (National)		
Unenhanced Rating	A(SPUR)/Stable	Downgraded
Dauphin Cnty Gen Auth, Pennsylvania		
UPMC Pinnacle, Pennsylvania		
Dauphin Cnty Gen Auth (Pinnacle Health System)		
Long Term Rating	A/Stable	Downgraded
Dauphin Cnty Hosp Auth, Pennsylvania		
UPMC Pinnacle, Pennsylvania		
Dauphin Cnty Hosp Auth (Pinnacle Hlth Sys) hlth sys rev bnds (Pinnacle Hlth Sys)		
Long Term Rating	A/Stable	Downgraded
General Auth of Southcentral Pennsylvania, Pennsylvania		
UPMC Pinnacle Hanover, Pennsylvania		
Southcentral Pennsylvania General Auth (Hanover Hosp)		
Long Term Rating	A/Stable	Downgraded
Monroeville Fin Auth, Pennsylvania		
Univ of Pittsburgh Med Ctr, Pennsylvania		
Monroeville Financing Authority (Univ of Pittsburgh Med Ctr) rev bnds		
Long Term Rating	A/Stable	Downgraded
Pennsylvania Econ Dev Fing Auth, Pennsylvania		
Univ of Pittsburgh Med Ctr, Pennsylvania		
Pennsylvania Econ Dev Fing Auth (Univ of Pittsburgh Med Ctr) SYS		
Long Term Rating	A/Stable	Downgraded

Ratings Detail (As Of March 19, 2020) (cont.)		
Pennsylvania Hgr Educl Facs Auth, Pennsylvania		
Univ of Pittsburgh Med Ctr, Pennsylvania		
Pennsylvania Hgr Ed Fac Auth (University of Pittsburgh Medical Center)		
Long Term Rating	A/Stable	Downgraded

Many issues are enhanced by bond insurance.