FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Ballad Health, TN at 'A'; Outlook Stable

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Fitch Ratings - New York - 25 Apr 2023: Fitch Ratings has affirmed the 'A' Issuer Default Rating (IDR) and revenue bond rating on various series of bonds issued on behalf of Ballad Health, Mountain States Health Alliance (MSHA) and Wellmont Health System (Wellmont).

Fitch also assigned an 'A' rating to the following series of bonds expected to be issued on behalf of Ballad Health:

--$190 million Health and Educational Facilities Board of the City of Johnson, Tennessee Hospital revenue refunding and improvement bonds series 2023A and 2023B.

The Rating Outlook is a Stable.

RATING ACTIONS

ENTITY / DEBT	RATING		PRIOR
Ballad Health (TN)	LT IDR Affirmed	A Rating Outlook Stable	A Rating Outlook Stable

Ballad Health (TN) /General Revenues/1 LT	LT	A Rating Outlook Stable	Affirmed	A Rating Outlook Stable
Mountain States Health Alliance (TN)				
Mountain States Health Alliance (TN) /General Revenues/1 LT	LT	A Rating Outlook Stable	Affirmed	A Rating Outlook Stable
Wellmont Health System (TN)				
Wellmont Health System (TN) /General Revenues/1 LT	LT	A Rating Outlook Stable	Affirmed	A Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

The series 2023A and 2023B bonds will be issued as fixed rate and will be used to refinance approximately $158 million of the outstanding series 2018A bonds and the series 2023B bonds will total $45 million of new money, which will be used to fund capital projects.

SECURITY

Bonds are secured by the gross revenues of the obligated group (OG). The OG is composed of all the Ballad Health hospitals except Johnston Memorial Hospital in Virginia. The OG makes up approximately 84% of Ballad Health's total assets and 89% of its total revenues.

ANALYTICAL CONCLUSION

The affirmation of the 'A' rating reflects Ballad Health's leading inpatient market position as the largest health system in its primary service area, historically solid operating profitability levels and a strong financial profile. Despite significant sector headwinds, Ballad Health has continued to operate at a high level due in part to its long tenured and seasoned management team and the merger of MSHA and Wellmont. The combined entity continues to mature and has resulted in a more streamlined approach to healthcare delivery in the service area, various cost efficiencies and improvements in quality.

While YTD operating performance is softer in 2023, Fitch expects that Ballad will maintain performance that is in line with a strong operating risk assessment over the medium term as it continues to realize synergies related to the merger and implements its economic recovery plan. Leverage metrics are expected to improve incrementally as debt levels will continue to moderate due in part to Ballad's five-year debt reduction plan, which commenced in 2021, and given Ballad has no immediate plans for additional debt beyond the current issuance. Improvement in cash flow and manageable capital plans should also contribute to improved leverage metrics. Fitch expects the financial profile will remain in line with a strong assessment, even in a stressed scenario.

Ballad Health continues to operate under a Certificate of Public Advantage (COPA) in Tennessee and Cooperative Agreement (CA) in Virginia, both issued in 2018, which created a single healthcare system for the region by allowing MSHA and Wellmont to merge.

KEY RATING DRIVERS

Revenue Defensibility: 'bbb'

Regional Healthcare System with Dominant Market Share

The midrange assessment is supported by Ballad Health's commanding 73.8% inpatient market share across a 21-county region in Northeast Tennessee and Southwest Virginia. Demographics in the region are mixed, with much of the region trailing state and national indicators. Fitch expects Ballad Health's payor mix to remain stable through the cycle as Balled continues to expand on community initiatives in the region.

Operating Risk: 'a'

Consistent Performance Despite Mounting Operational Pressure

Ballad Health has produced consistent and solid operational results for the last four years with operating EBITDA and EBITDA margins averaging 10.2% and 11.8%, respectively, which it maintained despite the merger in 2018, an EPIC installation, various waves of coronavirus, macro inflationary pressures and elevated labor pressure.

While performance through the third quarter is lighter than historical levels, Ballad has demonstrated operational resiliency over the last four years and because of that Fitch expects that performance will rebound and will remain in line with a strong operating risk assessment over the medium term. Operating pressures are expected to ease somewhat over the next several months as agency usage and premium pay rates have subsided, which, combined with Ballads economic recovery plan, should contribute to incremental improvement over the five-year forward look.

Financial Profile: 'a'

Steady Performance Through the Cycle

Ballad's leverage and liquidity metrics improved year over year until 2022, when unfavorable investment markets, cash outflows related to the non-controlling interest purchases, and to a lesser extent lighter cash flow and capital spending, led to a decline. Despite lower unrestricted liquidity, Ballad's financial profile is still considered solid and is expected to remain in line with strong assessment, even in a stressed scenario.

Asymmetric Additional Risk Considerations

No asymmetrical risk considerations affected the rating determination

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to a negative rating action/downgrade:

--Ballad Health has financial commitments, programmatic goals, and outcome targets that it needs to meet under the COPA. Although not expected, failure to meet these could potentially lead to negative rating pressure;

--A sustained weakening of operating performance with operating EBITDA margin consistently below 7% and 8%;

--Capital spending that exceeds Fitch's current expectations and that includes additional debt.

Factors that could, individually or collectively, lead to a positive rating action/upgrade:

--A significant build up in unrestricted cash and investment levels over time.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

CREDIT PROFILE

Ballad Health, a Tennessee non-profit corporation headquartered in Johnson City, became operational on Feb. 1, 2018, when it became the sole member of MSHA and Wellmont. Ballad operates 21 hospitals, including the area's only children's hospital, a Level I trauma center, post-acute care facilities, outpatient care sites, and physician practices with over 700 providers in Northeast Tennessee and Southwest Virginia. In FY22, Ballad purchased its remaining 49.9% interest in Johnston Memorial Hospital and 20% interest in Smyth County Community Hospital.

Payments for the transactions included $33.6 million in cash at closing for Smyth and $112.4 million of cash for Johnston in addition to a $168.7 million note payable. There is also a note payable related to the 2019 purchase of the remaining interest in Norton Community Hospital (current balance in aggregate of $136.2 million). The notes for Johnston and Norton are fully secured by a pledge of cash and securities with payments to be stretched out over eight years with $26 million in annual payments in 2023 and 2024 and $21.1 million in annual principal payments per year thereafter, all of which are fully paid by the pledged collateral.

Revenue Defensibility

Despite disruptions from the pandemic, Ballad Health's payor mix remains consistent in 2023 as evidenced by self-pay and Medicaid accounting for approximately 20% of gross revenues. Medicare and commercial contracts accounted for approximately 55% and 25% of gross revenue, respectively.

Ballad Health has a dominant 73.8% inpatient market share across a 21-county region and 86% inpatient market share in a smaller 17 county region. The system is centered in the cities of Johnson City, Bristol and Kingsport known collectively as the Tri-Cities. Ballad's three largest hospitals -- Holston Valley Medical Center, Johnson City Medical Center, and Bristol Regional Medical Center -- are located in these three cities and in total have almost half of the system's total licensed beds. Ballad is also home to the region's only children's hospital. Ballad's service area also extends to other parts of Northeast Tennessee and into Southwest Virginia. No other competing health system has more than a 5% inpatient market share in Ballad's primary service area.

Ballad Health's service area characteristics mostly trail state and national indicators. Given the sizable service area, demographics vary across the region. Generally, the larger cities have slightly better demographics than the more rural regions. For example, Johnson City, (AA) with a population of around 71,000, had good population growth of 8% over the last five years and an unemployment rate of 3.3% (2022) which is better than state levels.

However, Wise County, which is also in Ballad Health's service area, has a total population of approximately 36,000, had its population decline by 9% over the last five years. Its unemployment rate and poverty rate are 6.7% and 20%, above state and national figures, respectively. Overall, the five-year demographic trends for the region show relative stability, with population growth flat, income rising very slightly, and unemployment decreasing. These trends should keep Ballad's payor mix stable over the near term.

Operating Risk

Similar to the sector, Ballad Health is experiencing escalating pressure on operating expenses related to staffing shortages and premium pay, supply chain issues and inflation. As such, results through the third quarter of fiscal 2023 ended March 31 are lighter than the prior year and but area ahead of budgeted expectations with Ballad generating a 7.6% and 9.7% operating EBITDA and EBITDA margin, respectively compared with a 9.3% operating EBITDA margin and 13.6% EBITDA margin in 2022. Management does not expect results to worsen materially through the fourth quarter, but is projecting an operating loss for the full fiscal year. Projections do not include the potential for one-time relief funds which include FEMA, TennCare and other relief funding.

Due to the challenging operating environment, management has developed an economic recovery plan designed to drive revenue growth and expense reduction. The plan includes a focus on service lines, physician alignment, growth of key services, stabilization of labor expense and other key initiatives. Despite the recent decline in operating profitability and the several near-to-medium term operating challenges, Fitch expects that Ballad should be able to gradually return to margins that are more consistent with historical results once the economic recovery plan being implemented is fully realized. The system continues to benefit from the merger, which has afforded cost and efficiency opportunities that were not present pre-merger. Although Ballad continues to develop their budget expectations for FY

2024, management believes some improvement in operating performance can be achieved barring a further deepening of the current labor and expense pressure.

Capital spending was reduced during the pandemic to preserve liquidity; however, management expects to resume a normal capital planning cycle in FY 2024, with spending targeted at 100% of depreciation. There are no major capital projects planned with the exception of a $40 million expansion of the Niswonger Children's Hospital, which is expected to largely be funded through philanthropy. Fitch expects that capital outlays will include mostly routine spend and will be aligned with Ballad's long-term strategies. Average age of plant is slightly elevated at 15 years. Over the past five years a significant portion of capital spend was related to information technology, as the health system has worked to build out its EPIC platform and its ERP (Enterprise resource planning) system.

Financial Profile

Ballad Health reported cash and unrestricted investments of $1.3 billion at June 30, 2022, down from $1.7 billion in the prior year (excluding $53.1 million and $200 million of Medicare advance payments, respectively), translating into 102% of cash to adjusted debt, a decline from 131% at 2021 YE.

Fitch has excluded the balance on the notes for Johnston Memorial Hospital and Norton Community Hospital, as these are fully secured by pledge of investments not included in unrestricted reserves; debt service on the notes are paid entirely from the pledged funds. Ballad Health does not have a defined benefit pension plan and its operating lease expenses are reflected as a liability on its balance sheet. Through the end of the third quarter, ended March 31, liquidity metrics are stable with Ballad maintaining a cash to adjusted debt ratio slightly above YE 2022 at 104%.

Fitch's forward-looking base scenario assumes a period of slightly lower profitably in the early years of the forward look based on management's forecast and the current debt issuance, which is fully offset by Ballad's debt reduction program. The base case also assumes that capital spending will be equal to depreciation. Fitch's base case shows Ballad with NADAE and cash-to-adjusted debt that is in line with the 'a' assessment with some flexibility, should managements plan not materialize.

Fitch's forward-looking stress scenario analysis assumes an economic/operational stress (reflected as potential equity/operational volatility) in year one and two followed by a recovery and then growth in years three through five. The scenario reflects operating EBITDA margins of around 6% to 8% with a portfolio sensitivity under a market dislocation of 15.2%, reflecting Ballad's current portfolio asset allocation through the five-year cycle. The stress scenario also assumes that management would pull back on capital in years one and two. Even after applied stress on operations and the investment portfolio, Fitch's scenario analysis indicated cash to adjusted debt and NADAE would continue to remain strong and support rating stability at the 'A' rating category.

Asymmetric Additional Risk Considerations

No asymmetric additional risk considerations affected this rating determination.

Ballad had approximately $1.27 billion in long term debt as of March 31, 2023. Its pro forma debt structure includes approximately 54% fixed and 46% variable rate debt. Ballad Health's swap portfolio includes two basis swaps and two total return swaps. Bank of America, NA, is the counterparty of all the swaps. Total notional amount is approximately $363.7 million. The collateral posting threshold is $22 million and the mark-to-market as of March 24, 2023 was below that at negative $8.9 million.

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

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This 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. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

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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)

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 01 Sep 2021) (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

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Johnson City Health & Educational Facilities Board (TN)	EU Endorsed, UK Endorsed
Johnson City Health & Educational Facilities Board (TN)	EU Endorsed, UK Endorsed
Sullivan County Health, Education & Housing Facilities Board (TN)	EU Endorsed, UK Endorsed

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