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CREDIT OPINION
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Ballad Health (TN)

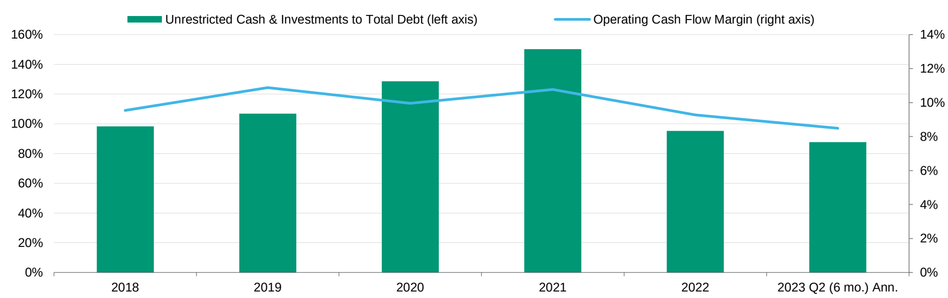
Update to credit analysis

Summary

Ballad Health (A3 stable) will continue to demonstrate its ability to operate effectively under state-imposed regulations following the 2018 merger of two formerly competing and like-sized health systems. We expect Ballad to continue to generate synergies through integration and consolidation while remaining compliant with the rate regulations of the Terms of Certification of the Certificate of Public Advantage (COPA) in Tennessee and Cooperative Agreement (CA) in Virginia. Ballad weathered the first two years of the pandemic with very solid operating cash flow (OCF) margins through fiscal 2022. Fiscal 2023 appears to be back in line with historical margins after a first quarter downturn attributed to volume softness and labor costs. The ability to sustain solid OCF margins will depend on expense management due to limited volume growth opportunities in an aging service area and competitive labor market. Ballad's still favorable, albeit reduced, days cash levels will likely be maintained. The system's elevated financial leverage position, as measured by relatively high debt to cash flow and modest cash-to-debt will remain a credit challenge especially given recent investment losses. Favorably, Ballad's leverage profile benefits from limited pension and operating lease obligations.

Exhibit 1

Solid operating cash flow margins help offset elevated leverage measured by cash to debt



Source: Moody's Investors Service

As of the date of this report this Issuer has declined to participate in the Credit Rating process, and has not provided Moody's with access to its books, records and other internal documents. For more information about Non-Participating Rated Entities, see Moody's Policy for Designating Non-Participating Rated Entities.

Credit strengths

» Dominant inpatient acute care market share in a broad service area will continue to be supported by large scale, wide array of tertiary services and absence of meaningful competition

» Demonstrated ability to operate effectively under the extensive terms of the Certificate of Public Advantage and Cooperative Agreement should continue given demonstrated active supervision and good engagement between Ballad and regulatory oversight agencies

» Favorable, albeit lower, days cash will likely be maintained absent major capital needs in the near term

» Maintenance of solid operating performance will continue to be supported by management's attention to cost reduction initiatives and ongoing merger-related synergies

Credit challenges

» High leverage, as measured by cash to debt and debt to cash flow will likely be sustained especially in light of reduced cash levels

» Relatively low population growth and aging service area will contribute to declining volume trends as seen pre-pandemic, increasing reliance on expense savings

» Rising labor costs and the ability to recruit and retain nurses will be a longer-term challenge

» High exposure to governmental payers will require additional synergies to lower cost of care

Rating outlook

The stable outlook reflects our view that Ballad will continue to see solid operating cash flow margins in fiscal 2023 and beyond. The stable outlook also assumes that Ballad will maintain favorable days cash levels and not see further erosion in cash to debt or a material rise in debt to cash flow.

Factors that could lead to an upgrade

» Significant improvement in leverage position, including cash to debt and debt to cash flow

» Sustained increase in patient volumes

» Improved days cash

» Maintenance of very solid operating performance

Factors that could lead to a downgrade

» Sustained reduction in operating cash flow margins or rise in debt to cash flow

» Further decline in cash to debt or days cash

» Further meaningful declines in volume that result in lower revenues and operating cash flow

Key indicators

Exhibit 2

Ballad Health (TN)

	2018	2019	2020	2021	2022	2023 Q2 (6 Mo.) Ann.
Operating Revenue ($'000)	2,078,905	2,106,465	2,077,520	2,191,638	2,312,916	2,328,767
3 Year Operating Revenue CAGR (%)	25.2	25.2	24.3	1.8	3.2	N/A
Operating Cash Flow Margin (%)	9.5	10.9	10.0	10.8	9.3	8.5
PM: Medicare (%)	52.9	53.5	53.8	55.2	54.8	55.7
PM: Medicaid (%)	13.6	13.4	14.6	14.4	15.5	15.4
Days Cash on Hand	245	264	321	351	231	210
Unrestricted Cash and Investments to Total Debt (%) - Incl. JMH Promissory Note	98.3	106.9	128.6	150.2	95.3	87.7
Unrestricted Cash and Investments to Total Debt (%) - Excl. JMH Promissory Note	98.3	106.9	128.6	150.2	108.1	99.4
Total Debt to Cash Flow (x) - Incl. JMH Promissory Note	5.0	4.4	4.5	3.8	5.0	5.5
Total Debt to Cash Flow (x) - Excl. JMH Promissory Note	5.0	4.4	4.5	3.8	4.4	4.9

Based on Ballad Health's audited financial statements for fiscal years ended June 30. Investment returns smoothed at 5%.
Fiscal 2020 results include $200 million of Medicare Advance Payments and $11 million in FICA payroll tax deferrals; excluding these amounts, Moody's calculates 280 days cash on hand and 105% cash to total debt. Fiscal 2021 results include $179 million of Medicare Advance Payments and $29 million in FICA payroll tax deferrals; excluding these amounts, Moody's calculates 313 days cash and 120% cash to total debt. Fiscal 2022 results include $53 million of Medicare Advance Payments, and $14 million in FICA payroll tax deferrals; excluding these amounts, Moody's calculates 220 days cash and 91% cash to total debt. Cash to total debt and total debt to cash flow have been presented with and without the $168.6 million collateralized Johnston Memorial Hospital promissory note in fiscal 2022 and 6-month fiscal 2023.
Source: Moody's Investors Service

Profile

Ballad became operational February 1, 2018 as a private 501(c)(3) not-for-profit healthcare organization. The health system ($2.3 billion in fiscal 2022 revenues) is comprised of the service areas two legacy healthcare systems, Mountain States Health Alliance and Wellmont Health System. The health system consists of 21 hospitals and over 3,000 licensed beds, including a children's hospital. Ballad operates under a Certificate of Public Advantage and Cooperative Agreement executed by Tennessee and Virginia, respectively, to regulate the system under state action immunity from federal antitrust law.

Detailed credit considerations

Market position: dominant tertiary provider in broad service area with limited growth opportunities

Ballad will continue to maintain dominant inpatient acute care market share given the absence of other large tertiary providers in the service area. Located primarily in northeastern Tennessee and southwestern Virginia, Ballad enjoys 74% inpatient market share in its broad 21 county service area and 86% share within its primary 17 county service area based on 2021 data. As permitted by the COPA and CA, Ballad has consolidated facilities and services to drive efficiencies and savings. Despite its broad footprint, Ballad will continue to operate in a market with low growth and aging population with somewhat below average economic growth indicators. As a result, we expect that recruiting and retaining clinical talent will also remain a challenge. Exacerbated by a national labor shortage during the pandemic, Ballad reports that it more than tripled its use of contract nurses between 2019 and 2022.

In the past few years, Ballad has taken full ownership of several hospitals that will enable management to fully control facilities but also provide more opportunities for population health initiatives. In November 2021, Ballad became the sole owner of Johnson Memorial Hospital (previously 50.1% owned) and Smyth County Community Hospital (previously 80% owned).

The system will likely see ongoing constraints on volume, particularly inpatient trends, which were declining pre-pandemic. Although second quarter 2023 volume trends appear to be ahead of the prior year period, a full recovery to pre-pandemic levels will prove challenging.

Ballad will likely continue to operate effectively under the COPA and CA. After being suspended during the public health emergency, all provisions of the COPA and CA were reinstated on June 30, 2022. COPA and CA stipulations include: 1) a ceiling on rate growth for fixed rate increases, but which allows unlimited value-based and quality incentives based on negotiations with commercial payers, 2) inability to directly contest third party CONs, 3) employ no more than 35% of physicians by service line compared to the overall market only in non-rural markets of Kingsport, Johnson City and Bristol. In addition, Ballad, as required, is investing in various population health initiatives, access and service offerings and graduate medical education and research. The 10-year financial commitment averages $30 million per year through 2028 although the timing of these amounts were modified during the pandemic. Salaries between the two systems must also reach an equilibrium over ten years, or by 2028, per the COPA and CA terms.

Operating performance, balance sheet and capital plans: solid operating margins will be driven by expense savings; still favorable days cash although leverage remains high

Having operated at very solid operating cash flow (OCF) margins amid the pandemic, improvements seen in Q2 2023 performance (9.9% for the quarter and 8.5% YTD) will likely result in solid margins in fiscal 2023. Second quarter OCF margins showed improvement over Q1 2023 as volume trends improved. While CARES grants contributed to fiscal 2020 and 2021 performance, management also instituted cost savings measures and realized merger-related synergies (totaling about $200 million in the first three years). Ongoing expense management and additional synergies will be important to sustaining solid OCF margins.

Growth in patient volume will remain uncertain over the long term, a key credit challenge. Unrelated to the pandemic, declines are partly due to sector-wide care shifts to outpatient and other lower cost settings. However, a portion of the decline is also due to a declining population. Additionally, the aging population will continue to shift Ballad's payer mix more to Medicare. Highlighting the shift away from inpatient care, outpatient Medicare revenues represented about 30.7% of gross revenues in fiscal 2021. Medicare Advantage business is growing at the expense of traditional Medicare, representing about 35% compared to 20.7% of gross revenues, respectively; while this could provide an opportunity for value based care, it also increases exposure to commercial insurers.

Despite additional COPA funding requirements for enhancing health care services in the service area discussed above, Ballad's capital expenditures remain manageable.

Liquidity

Ballad will likely maintain still favorable days cash measures, albeit lower than in prior years. Excluding Medicare advances and FICA deferrals, days cash on hand declined to about 220 in fiscal 2022 from about 313 days in fiscal 2021, in part because of investment losses as well the purchase of remaining ownership of Johnson Memorial and Smyth County (upfront payment of $112 million).

Ballad and Highlands Physicians, Inc settled the legacy Wellmont litigation related to a contractual dispute that did not involve current management. This settlement was fully accrued for by fiscal year end 2022.

Debt structure and legal covenants: leverage will remain relatively high

Financial leverage (even after excluding collateralized promissory notes, see below) will remain relatively high following management's decision to forgo additional debt repayment above normal debt service payments. Moody's considers debt metrics both with and without this collateralized debt. Excluding collateralized debt, debt-to-revenue and debt-to-cash flow as of fiscal year end 2022 of about 54% and 4.5 times, respectively, are both high for the rating category. Cash to debt is also below average as of fiscal 2022 at about 102.7% (excluding Medicare advances and FICA deferrals).

Legal security

All debt issued under Ballad, Mountain States Health Alliance and Wellmont Health System is parity and secured by a gross revenue pledge of the obligated group; the only Ballad hospital that is not part of the obligated group is Johnson Memorial. A mortgage remains in place for all bondholders until the Municipal Bond Insurance Association (MBIA) permits its release or the MBIA debt is refunded or repaid.

Debt structure

Ballad's debt structure does carry some risk with about 47% variable rate and 53% fixed rate. The system has about $183 million in collateralized debt; about $168.6 million in promissory notes was added in November 2021 when Ballad acquired the minority interest of Johnson Memorial and Smyth County. These notes are fully collateralized and debt service is paid by an irrevocably pledged escrow that is held by a third party. The escrow is reflected in Ballad's financial statements sheet as an investment whose use is restricted.

Headroom to covenants will be adequate. The Master Trust Indenture provides for an annual debt service coverage test of 1.1x which would trigger a consultant call-in or an event of default if the rate falls below 1.0x for two consecutive years. There is no MTI liquidity covenant, however, MBIA requires a 110 days cash on hand liquidity covenant that will remain in place until MBIA-insured debt is refinanced or repaid. Swap payments continue to be on parity with bonds. In addition, the bank covenants are more restrictive than the MTI covenants as follows: debt service coverage test of 1.15x and 75 days cash on hand liquidity test.

Debt-related derivatives

Ballad will have some exposure to derivative risk with four interest rate swaps with a total notional amount of about $370 million. Bank of America is the counterparty on all, providing some concentration risk.

Pensions and OPEB

Ballad's low indirect debt will continue to be favorable as there is no defined benefit pension exposure and limited use of leases. Leases added about $28 million of indirect debt in fiscal 2022.

ESG considerations

Ballad Health (TN)'s ESG Credit Impact Score is Moderately Negative CIS-3

Exhibit 3

ESG Credit Impact Score

CIS-3

Moderately Negative

For an issuer scored CIS-3 (Moderately Negative), its ESG attributes are overall considered as having a limited impact on the current rating, with greater potential for future negative impact over time. The negative influence of the overall ESG attributes on the rating is more pronounced compared to an issuer scored CIS-2.

Source: Moody's Investors Service

Ballad's **CIS-3** reflects moderate exposure to ESG considerations. The system has very high exposure to governmental payers and operates under state-imposed regulations. However, this is mitigated by its strong market share within a broad service area. The presence of unrestricted cash also helps mitigate ESG risk.

Exhibit 4

ESG Issuer Profile Scores

ENVIRONMENTAL	SOCIAL	GOVERNANCE
E-2	S-3	G-2
Neutral-to-Low	**Moderately Negative**	**Neutral-to-Low**

Source: Moody's Investors Service

Environmental

Credit exposure to environmental risk is neutral-to-low (**E-2**), in line with sector norms. Ballad's two largest hospitals are located in Kingsport and Johnson City, TN. While these locations have higher exposure to heat stress and/or extreme rainfall, these risks have had a minimal impact. Beyond these two facilities, Ballad has another 19 hospitals serving a broad 17 county primary service area in northeastern Tennessee and southwestern Virginia, further reducing risk.

Social

Ballad's overall social risk is moderate (**S-3**) in line with the sector. Demographic and societal trends (4) present the highest risk, reflecting industry-wide exposure to governmental payers as well as challenges the system will continue to face as it operates under state-imposed regulations, following its 2018 merger. Relatively low population growth and an aging population base increases exposure to softer volume trends and governmental reimbursement. In addition, Ballad faces moderate risk (3) from human capital trends, reflecting sector-wide labor challenges. However, Ballad's neutral-to-low score (2) in customer relations compares favorably to the sector, reflecting its position as a large rural system, with strong market share, serving a broad service area.

Governance

Credit exposure to governance considerations is neutral-to-low (**G-2**), in line with the sector average. While the organization is subject to increased regulation and oversight per the COPA and CA (discussed above), a tenured management continues to demonstrate its ability to effectively operate within the limits of regulation as well as document value created by the merger for the service area through required disclosures. Management is governed by Ballad's 11-member Board of Directors which has full reserve powers. The Board is reflective of the community (8 from Tennessee and 3 from Virginia) and has diverse competencies. Management participation on the board is limited to one, with that person serving as the Chair, President and CEO.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

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