S&P Global
Ratings

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Ballad Health, Tennessee; Joint Criteria; System

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Credit Profile		
US$514.215 mil rev bnds (Ballad Health) ser 2018A dtd 05/15/2018 due 07/01/2045		
Long Term Rating	A-/Stable	New

Rationale

S&P Global Ratings assigned its 'A-' long-term rating to Ballad Health, Tenn.'s $514 million series 2018A.

The 2018 bond proceeds are expected to refinance debt issued by both Wellmont Health System (Wellmont) and Mountain States Health Alliance (MSHA). The two systems will be unified under a new amended and restated Master Trust Indenture (MTI). The obligated group will consist of Ballad Health, MSHA, Wellmont, and the majority of the hospitals, excluding Johnston Memorial.

Pending the refinancing, S&P Global Ratings is taking the following rating actions on Wellmont's and MSHA's debt:

- We raised the rating on the Health and Educational Facilities Board of the City of Johnson City, Tenn.'s series 2016A, 2010A, 2009A, 2000C, and 2012A bonds, issued for MSHA, to 'A-' from 'BBB+'.
- We raised the rating on the Industrial Development Authority of Smyth County's 2009B and 2010B bonds, issued for MSHA, to 'A-' from 'BBB+'.
- We raised the rating on the Industrial Development Authority of Washington County's series 2009C bonds, issued for MSHA, to 'A-' from 'BBB+
- We raised the rating on the Health and Education Facilities Board of the County of Sullivan, Tenn.'s series 2011 and 2006C bonds, issued for Wellmont Health, to 'A-' from 'BBB+'.
- We raised the rating on MSHA's series 2000D taxable debt to 'A-' from 'BBB+'.
- We raised the rating the Health and Educational Facilities Board of the City of Johnson City's series 2011B bonds to 'AA/A-1' from 'AA-/A-1' based on the application of joint criteria where the long-term component of the rating is based jointly on our rating on Ballad Health and the letter of credit (LOC) provider PNC Bank, N.A. and the short-term rating is based solely on our short-term rating on the LOC provider. We raised the underlying rating (SPUR) on the same series to 'A-' from 'BBB+'. Proceeds from the 2018B bonds (to be issued at a later date) are expected to refinance these bonds.
- We raised the rating on the Health and Educational Facilities Board of the City of Johnson City's series 2011A and 2007B bonds to 'AA/A-1' from 'AA-/A-1' based on the application of joint criteria where the long-term component of the rating is based jointly on our rating on Ballad Health and LOC provider U.S. Bank, N.A. and the short-term rating is based solely on our short-term rating on the LOC provider. We raised the SPUR on these same bonds to 'A-' from 'BBB+'. Proceeds from the series 2018A and 2018D bonds are expected to refinance these. While we have not been asked to rate the 2018D bonds, we have factored them into our analysis.

The outlook on all ratings is stable.

The upgrades reflect our view of the unification under the restated MTI and that the new obligated group will issue debt as a single organization for the first time, with the result that all legacy MSHA and Wellmont debt will carry the same rating as that on Ballad Health.

Ballad Health, in its current corporate structure, was formed on Feb. 1, 2018, following a full asset merger between Wellmont and MSHA. The two health systems applied for a certificate of public advantage (COPA) under the Tennessee Hospital Cooperation Act of 1993 amended in 2015, and a similar document known as the cooperative agreement (CA) in Virginia as authorized by Virginia law passed in 2015. The act provides "state-action" immunity from federal antitrust laws under Supreme Court doctrine originating from the Parker v. Brown decision (317 U.S. 341 (1943). This doctrine applies to non-state actors if a two-pronged requirement is met: (1) there must be a clearly articulated policy to displace competition, and (2) there must be active supervision by the state of the policy or activity. Both the COPA and cooperative agreement were issued by the states under clearly articulated policy passed by the legislature and signed by the governors with a series of contingencies aimed at improving the overall health of the population, expanding access points, and supporting health research and medical education. Both states will monitor the system and the fulfillment of COPA and CA conditions on an ongoing basis.

The resulting organization has robust size and scale, which we believe can be translated into financial metrics that remain, as they are now on a pro forma basis, consistent with a 'A-' system rating. Furthermore, we believe that the contiguous geography now present in the combined system and the adoption of the common clinical platform will benefit the organization as the health care industry continues to move toward population health management. In our opinion, the first phase of the merger went smoothly; the entire board and management team were in place at closing, including a dedicated senior vice president who is overseeing integration and savings initiatives. Although the new system is fairly decentralized from an operating standpoint, over the next year it will consolidate the enterprise resource system (including HR and Finance) and shift to a single electronic health record in the next 18-24 months.

The rating also includes a negative holistic adjustment on Ballad Health that reflects the risks associated with integration of two sizeable health systems coupled with the complexities associated with the COPA and cooperative agreement.

The rating reflects our assessment of Ballad Health's:

- Excellent business position, with an overwhelming market share at 77% in its primary service area with generally favorable demographics;
- Strong historical financial performance on a pro forma basis with very healthy EBIDA and operating margins;
- Generally solid balance-sheet metrics with strong liquidity and continued moderation of leverage metrics; and
- Management team with proven turnaround and integration skills.

In our view, partially offsetting rating factors include our assessment of Ballad Health's:

- Weak operating results through the first seven months of fiscal 2018 ended Jan. 31, with the system reporting an operating loss;
- Challenged payor mix with a heavy reliance on governmental payors;
- Challenges associated with integration and realizing the benefits and cost savings initiatives over time; and

- Ability to comply with terms of the COPA and CA and the high number of performance metrics.

Outlook

The stable outlook reflects the system's dominant market position, coupled with a favorable financial profile and generally stable business volumes. The outlook also reflects our expectation that the system will retain its financial strength and business position while it implements COPA guidelines. Additional debt is not expected and therefore not factored into the rating.

Upside scenario

While we do not anticipate it during the two-year outlook period, a higher rating is possible if Ballad Health successfully integrates the two health systems as planned while staying in compliance with COPA guidelines, sustains strong cash flow, improves unrestricted reserves to levels commensurate with a higher rating, and does not issue additional debt, as debt metrics are slightly elevated for the rating level.

Downside scenario

We could revise the outlook to negative if there were significant unfavorable changes in the financial profile. These could include: an increase in debt; future cash flow and balance-sheet metrics decreasing due to operating pressure, driving down margins and liquidity below projected levels; and investment market declines pressuring unrestricted reserves. We will also continue to assess the impact of any issues related to operating under the COPA.

Enterprise Profile: Strong

Organizational overview and business position

Ballad Health is now a 2,506-bed acute care regional health system that serves 29 counties in northeast Tennessee, southwest Virginia, southeastern Kentucky, and western North Carolina. The region is home to several large employers including Eastman Chemical, KVAT Food City, Strongwell, and East Tennessee State University. Local economic fundamentals are mixed, with some population growth expected; however, per capita personal incomes are below state and national levels and employment growth is expected to be less than half of U.S. national rates over the next five years.

Ballad Health garners an overwhelming 77% market share of its 21-county primary service area that includes more than 1 million residents. The system captures a very healthy 66% from its secondary market. Competition is limited to a number of smaller hospitals mainly located in counties within the service area surrounding the Tri-Cities region of Kingsport, Johnson City, and Bristol, Tenn. The system's primary competitors providing comparable tertiary services are located in areas within the four states it operates in, but outside of the service area.

Ballad Health also consists of the region's only children's hospital, a range of outpatient facilities, and ancillary services, including a home health agency, a hospice, and other activities such as the ownership and management of medical office buildings. In fiscal 2017, it had approximately 91,300 inpatient admissions, 2 million outpatient visits, and 442,000 emergency department visits. As part of its physician-integration efforts, it employs more than 800 providers through various physician entities, which we understand management is working to consolidate into one centrally managed entity.

The Certificate of Public Advantage

After a merger was first announced in April 2015, Wellmont and MSHA started the lengthy application process for COPA approval from state officials in Tennessee and filed a similar application with the Southwest Virginia Health Authority. Shortly thereafter, the two health systems entered a formal review phase by regulators in Tennessee and Virginia and in fall 2017, after close examination of the proposed integration, the states granted approval for the two entities to combine under the corporate umbrella of Ballad Health.

The Hospital Cooperation Act provides immunity from Tennessee antitrust laws and is intended to provide "state-action" immunity from federal antitrust laws for cooperative agreements among two or more hospitals following a merger. A state may issue a COPA if it can determine that the benefits of a cooperative agreement outweigh the potential disadvantages of reduced competition resulting from a merger. Typically, a COPA includes contingencies to assure the business activities the hospitals engage in are in accordance with the Hospital Cooperation Act and its purpose of limiting health-care costs.

The COPA in Tennessee and the cooperative agreement in Virginia allowed Wellmont and MSHA to merge, with the states setting forth guidelines and actively supervising the new health system. As part of the agreement, Ballad Health has made enforceable monetary and non-monetary commitments. Monetary commitments include but are not limited to investments in rural health services, behavioral health, population health management, and expanding health research and graduate education, while non-monetary commitments include developing a three-year rolling capital plan, established by the system but which does not need state approval, establishing a systemwide physician-led clinical council aimed at improving quality, and reducing variation and sharing best practices. The COPA also includes certain protections for employees and specifically states that all hospitals currently operated by Ballad Health remain open as healthcare institutions for at least five years and which facilities may be repurposed at the request of the system and with concurrence of the states and that the system is required to maintain essential healthcare services in counties that it operates in. Furthermore, it must maintain Johnson City Medical Center, Holston Valley Medical Center, and Bristol Regional Medical Center as full-service tertiary facilities.

Ballad Health will be required to submit in-depth annual and quarterly reports to the Department of Health. We understand a dedicated COPA compliance officer (already appointed by Ballad Health) will work within the health system to ensure it is in compliance with the terms of the agreement and will investigate complaints -- similar in nature to a health system compliance officer. Furthermore, a COPA monitor, who is independent from the health system, will be put in place and will continually monitor the public advantage of Ballad Health and compliance requirements. If noncompliance is determined, the Department of Health can issue fines ranging from $10,000 to $1 million for breaching terms and commitments.

While every merger has its own set of challenges, the creation of Ballad Health is unique, given the regulatory oversight, and it could be more difficult for the system to implement certain strategies due to onerous guidelines and approval processes set forth in the COPA. However, we believe there are many benefits, such as the ability to expand the scope of services by providing more efficient and quality care and meaningful cost savings, among other things.

Management

The full senior leadership team is in place and includes members of both organizations as well as newly hired executives from outside Ballad Health. In our opinion, Ballad Health has an experienced management team that has taken a proactive and purposeful approach to the merger that includes developing a strong strategic vision, setting explicit financial and non-financial goals, aligning executive and functional leadership, integrating cultures, and leveraging integration best practices. The COPA process took considerable time and demanded substantial efforts by management, which we believe is a testament to the wherewithal of the management team and its ability to execute the planned integration.

Financial Performance: Strong

Historically steady operating performance

In the past few years, Ballad Health's pro forma financial results have remained relatively steady, in part due to healthy revenue growth and management's operational improvements through better documentation, expense management, increased productivity, and lower length-of-stay. In 2017 and 2018, the system also benefited from increased revenue associated with the acquisitions of Takoma Regional Medical Center and Laughlin Memorial Hospital.

We believe that the combination of the two organizations will present future opportunities for cost reductions over and above what either could achieve alone. The forecast has integration expense savings of about $41 million annually compounding to about $158 million by 2023. In the earlier years, these savings are somewhat offset by certain expense commitments, including those related to salaries and wages, and changing to a common IT platform.

With strong operating performance and cash flow and accretive nonoperating revenue, net income margins have generally been consistent and exceeded median levels. Based on the pro forma debt service schedule, debt service coverage is what we consider healthy for the rating.

Year to date for the seven months June 30, 2017 through Jan. 31, 2018, Ballad Health's pro forma operating income is down significantly from the previous year's. Management reports that the decline is due to non-recurring costs related to the regulatory process preceding the merger, increased expenses related to the use of contract labor, higher nursing wages, higher-than-expected health benefit costs, and the continued industry shift toward outpatient visits. Management is targeting a $12 million gain from operations for full year fiscal 2018, which is below historical performance but would be a healthy turnaround based on current performance.

Based on the track record, particularly at MSHA, we believe the forecast operating margins in 2019 and 2020 are achievable; however, in the three years following, management is budgeting for an average operating margin of 6.7%, which we believe could be challenging in the changing industry landscape. Health systems typically don't see the benefits from integration until after the first two years, so should management successfully execute its plan, higher margins are possible. However, as with any acquisition, events can arise that could cause some variance to plan, and any material shifts would be a concern.

Ballad derives the majority of its operating income from its acute care hospitals, with the Tri-Cities facilities accounting for 66% of revenues. Systemwide, the hospitals are generally positive from an operating income standpoint, though

Holston Valley Medical Center, which from a volume standpoint, is the second largest facility under Ballad Health, has been the most dilutive to the overall financial performance. Management indicates that Holston Valley has struggled recently due to expenses pressures and the loss of the 340B program. Improvement in financial performance at Holston Valley is a key focus of management over the next several months.

Liquidity and financial flexibility

Ballad Health's balance sheet improved incrementally between 2015 and Jan. 31, 2018, and is generally in line with median levels, with unrestricted cash and investments of $1.3 billion (244 days' cash on hand and 1x pro forma long-term debt). Ballad Health expects cash to remain relatively flat over the next few years in part because of its debt reduction strategy (through cash flow), which includes a voluntary debt reduction of $385 million starting in fiscal 2021 and extending through fiscal 2023; a debt reduction of over 44% in the next five years. The system's current average age of plant is just over 13, which is slightly above medians, and the system has only modest, in our opinion, capital plans during the next several years. As a result, we believe that Ballad will be able to comfortably maintain robust days' cash and be able to accelerate the reduction of debt outstanding.

Management is integrating the legacy investment portfolios, which should be complete within the next 12 months. As of Jan. 31, management reports that approximately 43% of the combined system's assets are invested in cash, cash equivalents, and fixed income. We believe there is sufficient liquidity in the portfolio to cover the amount of direct-purchase and variable-rate debt that is expected to be outstanding with $ 1.3 billion of available cash compared to about $345 million of pro forma contingent liability debt.

Debt and contingent liabilities

Ballad Health's pro forma debt of $1.3 billion is structured with 54% fixed-rate bonds and just 46% of debt either variable rate or direct purchase. The contingent liability debt, which comprises less than 30% of total debt, is spread equally between two banks with staggered expiration dates, which we view favorably. The direct purchase debt includes covenants that are outside of the MTI, including 1.15x debt service coverage and 75 days' cash on hand. The 2018B variable-rate debt is expected to be backed by a letter of credit with U.S. Bank. While we have not been asked to rate the bank placement debt and the series 2018B debt has not been finalized, we have factored them both into our analysis. Ballad Health is also party to five basis swaps and two total return swaps (TRS). We understand that approximately $134 million of the TRS swaps will be terminated in conjunction with the planned financing. Total notional amount on all swaps is equal to approximately $821 million. The mark to market on the MSHA legacy swaps was negative $12 million as of March 15. If the mark to market were to exceed $18 million, Ballad Health would be required to post collateral.

The system's debt levels are moderately elevated, with debt as a percent of capitalization and debt burden above median levels. Ballad Health has no future debt plans during the outlook period, and management remains focused on deleveraging the balance sheet over the next five years with a goal of reducing long-term debt by $385 million over and above the normal principal amortization.

Management is budgeting for mostly routine capital expenditures and has no plans for any major projects, with the exception of replacing the electronic health record system for MSHA. We understand that this is a $150 million investment and will be funded through cash flow. In addition, as part of the COPA agreement, management has committed to invest $308 million over the next 10 years in pediatric, behavioral, rural health services, graduate and medical education, and population health. Commitments begin in year one and scale up to $36 million annually by year five.

Wellmont has a defined-benefit plan, which is frozen and is well funded, with assets totaling 95% of its benefit obligation at the end of fiscal 2017.

Ballad Health -- Selected Financial Statistics				
		--Fiscal year ended June 30--		--Medians--
	Seven months interim ended Jan. 31, 2018	**2017**	**2016**	**Healthcare system A- 2016**
Enterprise profile				
Inpatient admissions	55,690	91,274	86,358	MNR
Equivalent inpatient admissions	131,261	211,125	199,380	MNR
Emergency visits	267,561	442,025	443,292	MNR
Inpatient surgeries	12,644	20,297	20,058	MNR
Outpatient surgeries	30,483	50,068	50,466	MNR
Medicare case mix index	1.6410	1.6300	1.6350	MNR
FTE employees	14,701	13,495	13,474	MNR
Based on net/gross revenues	Net	Net	Net	MNR
Medicare %	52.4	52.3	52.0	MNR
Medicaid %	13.9	14.0	13.8	MNR
Commercial/Blues %	27.7	27.8	28.1	MNR
Financial profile				
Financial performance				
Net patient revenue ($000s)	1,195,732	1,913,760	1,815,976	2,004,428
Total operating revenue ($000s)	1,225,717	1,973,440	1,886,041	MNR
Total operating expenses ($000s)	1,228,564	1,918,556	1,832,709	MNR
Operating income ($000s)	(2,847)	54,884	53,332	MNR
Operating margin (%)	(0.23)	2.78	2.83	2.30
Net nonoperating income ($000s)	29,885	49,889	15,697	MNR
Excess income ($000s)	27,038	104,773	69,029	MNR
Excess margin (%)	2.15	5.18	3.63	2.90
Operating EBIDA margin (%)	9.19	12.34	12.83	9.40
EBIDA margin (%)	11.35	14.50	13.55	9.50
Net available for debt service ($000s)	142,548	293,436	257,656	183,923
Maximum annual debt service ($000s)	85,339	85,339	85,339	MNR
Maximum annual debt service coverage (x)	2.86	3.44	3.02	3.40
Operating lease-adjusted coverage (x)	2.40	2.87	2.59	2.70
Liquidity and financial flexibility				
Unrestricted reserves ($000s)	1,315,668	1,304,993	1,193,391	809,463
Unrestricted days' cash on hand	244.1	266.2	255.1	148.50
Unrestricted reserves/total long-term debt (%)	100.5	96.4	84.7	103.90

Ballad Health -- Selected Financial Statistics (cont.)				
		--Fiscal year ended June 30--		--Medians--
	Seven months interim ended Jan. 31, 2018	2017	2016	Healthcare system A- 2016
Unrestricted reserves/contingent liabilities (%)	380.9	377.8	181.6	459.10
Average age of plant (years)	13.2	13.7	12.8	11.10
Capital expenditures/depreciation and amortization (%)	67.4	N/A	70.8	150.40
Debt and liabilities				
Total long-term debt ($000s)	1,309,160	1,353,310	1,409,304	MNR
Long-term debt/capitalization (%)	44.2	46.2	51.3	48.10
Contingent liabilities ($000s)	345,430	345,430	657,283	MNR
Contingent liabilities/total long-term debt (%)	26.4	25.5	46.6	22.20
Debt burden (%)	3.96	4.22	4.49	2.40
Defined benefit plan funded status (%)	N.A.	94.2	71.96	77.90

N.A.--Not available. MNR--Median not reported. Inpatient admissions exclude normal newborn, psychiatric, rehabilitation, and long-term care facility admissions.

Credit Snapshot

- Security pledge: Securing the bonds is a gross revenue pledge of the obligated group, which includes the parent Ballad Health, MSHA, Wellmont, and a majority of the hospital facilities.
- Organization description: Ballad Health was formed Feb. 1, and operates 19 hospitals in Tennessee, Virginia, Kentucky, and North Carolina. In addition, Ballad operates at multiple non-acute care sites throughout the service area, providing ambulatory surgery, diagnostic and testing, among other things.
- Financial reporting: We based information in this report for fiscal years 2016 and 2017 and year-to-date 2018 on an internal compilation provided by Ballad Health management.

Ratings Detail (As Of April 25, 2018)

Mountain States Health Alliance (MBIA) (National)		
Unenhanced Rating	A-(SPUR)/Stable	Upgraded
Mountain States Health Alliance ICR		
Long Term Rating	A-/Stable	Upgraded
Smyth Cnty Indl Dev Auth, Virginia		
Mountain States Hlth Alliance, Tennessee		
Smyth Cnty Indl Dev Auth (Mountain States Health Alliance)		
Long Term Rating	A-/Stable	Upgraded
Sullivan Cnty Hlth Ed & Hsg Fac Brd, Tennessee		
Wellmont Hlth Sys, Tennessee		
Ser 2006C		

Ratings Detail (As Of April 25, 2018) (cont.)		
Long Term Rating	A-/Stable	Upgraded
Ser 2011		
Long Term Rating	A-/Stable	Upgraded
The Hlth & Educl Facs Brd of the City of Johnson City, Tennessee		
Mountain States Hlth Alliance, Tennessee		
Johnson City Hlth & Ed Fac Brd (Mountain States Health Alliance) (MBIA) (National)		
Unenhanced Rating	A-(SPUR)/Stable	Upgraded
Johnson City Hlth & Ed Fac Brd (Mountain States Health Alliance), Series 2007B-1		
Unenhanced Rating	A-(SPUR)/Stable	Upgraded
Long Term Rating	AA/A-1+	Upgraded
Series 2010 A&B, 2006A and 2009A		
Long Term Rating	A-/Stable	Upgraded
Series 2011A		
Unenhanced Rating	A-(SPUR)/Stable	Upgraded
Long Term Rating	AA/A-1+	Upgraded
Series 2011B		
Unenhanced Rating	A-(SPUR)/Stable	Upgraded
Long Term Rating	AA/A-1	Upgraded
Series 2012A		
Long Term Rating	A-/Stable	Upgraded
Washington Cnty Indl Dev Auth, Virginia		
Mountain States Hlth Alliance, Tennessee		
Ser 2009 C		
Long Term Rating	A-/Stable	Upgraded

Many issues are enhanced by bond insurance.