S&P Global
Ratings

Research

Charlotte-Mecklenburg Hospital Authority, North Carolina; CP; Joint Criteria; System

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Credit Profile		
US$365.125 mil hlth care rfdg rev bnds ser 2016A dtd 10/12/2016 due 01/15/2047		
Long Term Rating	AA-/Stable	New
Charlotte-Mecklenburg Hosp Auth		
Long Term Rating	AA-/Stable	Affirmed

Rationale

S&P Global Ratings assigned its 'AA-' long-term rating to Charlotte-Mecklenburg Hospital Authority (the authority), N.C.'s $365.1 million series 2016A tax-exempt refunding revenue bonds.

S&P Global also affirmed its 'AA-' long-term ratings and underlying ratings (SPURs) on the authority's outstanding bonds, and affirmed its 'A-1+' short-term rating on the authority's series 2015B taxable health care commercial paper (CP) revenue bonds program. The authority, directly and through its affiliates, does business as Carolinas HealthCare System (CHS or the system). The outlook is stable.

The 'A-1+ short-term rating reflects our opinion of CHS' general credit strengths and liquidity support. CHS has identified about $534.5 million of investment assets as of Aug. 31, 2016, to guarantee the full and timely purchase price of the CP program for which CHS has arranged to provide self-liquidity. The assets invested in highly rated money market funds, treasuries, agencies and investment-grade debt provides sufficient coverage in the event of a failed remarketing. Management has established clear and detailed procedures to ensure the ongoing maintenance of sufficient asset coverage and to meet liquidity demands on a timely basis. S&P Global will monitor the liquidity and sufficiency of assets pledged by Charlotte-Mecklenburg Hospital Authority on a monthly basis.

Three letters of credit (LOCs; 'AAA/A-1+') from U.S. Bank N.A. support the series 2005B, 2005C, and 2005D bonds. We based the long-term rating component on the application of joint criteria, which reflects the rating on U.S. Bank ('AA-/A-1+') and the 'AA-' SPUR on CHS. The short-term rating component reflects the A-1+' short-term rating on U.S. Bank. The LOCs supporting the series 2005B, 2005C, and 2005D bonds expire July 1, 2018.

Supporting the series 2007B and 2007C bonds, which we rate 'AA-/A-1' are standby bond purchase agreements (SBPA) from JPMorgan Chase Bank N.A. The long-term rating component reflects the 'AA-' long-term rating on CHS, and the short-term rating component reflects the 'A-1' short-term rating on JPMorgan Chase Bank. The SBPAs supporting the series 2007B and 2007C bonds expire May 4, 2017.

An LOC from TD Bank supports the 2007E bonds, which we rate 'AAA/A-1+'. We based the long-term rating component on insurance from Assured Guaranty Municipal Corp. and the application of joint criteria between TD Bank and the 'AA-' SPUR on CHS. The short-term rating component reflects the 'A-1+' short-term rating on TD Bank. The LOC expires on May 30, 2018.

An LOC provided by Wells Fargo Bank supports the series 2007H variable-rate demand bonds, which we rated 'AAA/A-1+'. We based the long-term rating component on the application of joint criteria reflecting the rating on Wells Fargo Bank (AA-/A-1+) and the 'AA-' SPUR on CHS. The short-term rating component reflects the 'A-1+' short-term rating on Wells Fargo Bank. The LOC supporting the series 2007H bonds expires June 18, 2019.

In 2013, the series 2007D, 2007F, and 2007G bonds were restructured from variable-rate demand bonds supported by LOCs or SBPA to variable-rate direct purchase agreements with SunTrust Bank, PNC Bank, and Bank of America, respectively, following a mandatory tender and mode change. Upon the mode change into direct purchase agreements, S&P Global Ratings no longer rates the series 2007D, 2007F, and 2007G bonds, but factors the new structure into its analysis.

Management's initiatives to enhance operating profitability following soft results in fiscal 2013 were successful, producing a solid margin and debt service coverage in fiscal 2015 through the first half of fiscal 2016 ended June 30. Margins, coverage, and balance sheet metrics have remained healthy compared with 'AA-' medians, in our opinion. The overall balance sheet remained healthy for the rating, driven by strong operating cash flow. CHS' strong enterprise profile, highlighted by increasing market share and considerable geographic reach, continue to support the rating. We expect the enterprise profile to remain strong, and anticipate continued solid operating results and balance sheet growth during the next year or two.

Management has committed to spend approximately $1.8 billion on capital between 2016 and 2020. CHS spent 0.9x depreciation expense in 2015, down from a previous average of 1.7x between 2012-2014, which also helped balance sheet growth. Management indicates that CHS plans to keep annual spending near fiscal 2015 levels in the next year or two, given the higher spending in recent years.

In our view, additional positive rating factors include:

- Favorable balance sheet, with 266 days' cash on hand as of June 30, 2016, that is healthy for the rating;
- Maintenance of a significant business position within North and South Carolina as the largest health care provider;
- Robust population growth, with very strong economies in the county and Charlotte; and
- An experienced management team that has a long record with the organization.

Partly offsetting credit factors include:

- Continued exposure to underlying variable-rate debt and contingent liabilities, though the degree of the exposure has lessened in light of the 2009 restructuring; and
- Solid excess margin in fiscal 2015, though nonoperating revenue has been dampened by realized investment losses through the first half of fiscal 2016 ended June 30.

Management plans to use the series 2016A bonds to refund series 2007A and series 2008A bonds, and pay costs of issuance. A gross revenue pledge of the obligated group secures all bonds including the commercial paper revenue bonds, which includes CHS' primary enterprise and one component unit, the Carolinas HealthCare Foundation. All ratios cited in this report refer to the obligated group, unless otherwise noted. Our rating reflects our view of the authority's group credit profile and the obligated group's core status. Accordingly, the rating is at the level of the group credit profile.

Outlook

The stable outlook reflects our assessment of management's successful restoration of profitability in 2014 continuing in 2015, and our expectation that solid margins will continue during the next one to two years, consistent with relevant medians. In addition, the stable outlook reflects our opinion of CHS's healthy balance sheet metrics and our expectation that the balance sheet will strengthen further during the next one to two years.

Upside scenario

We could revise the outlook to positive during the next two years if CHS sustains financial metrics at a level commensurate with a higher rating, and produces substantial growth in unrestricted reserves compared with debt and days' cash on hand.

Downside scenario

Given the recent improvement in the financial profile, we do not expect to lower the rating in the next one to two years, but we could revise the outlook to negative if the operating margin decreases to a negative level or if balance sheet metrics decline sharply.

Enterprise Profile

Organization

CHS is the larger of two health care systems serving the Charlotte region and offers area residents convenient access to all primary and secondary services, in addition to a broad tertiary and quaternary service mix, including its recognized strength in key specialties such as pediatrics, cardiology, orthopedics, cancer, and neurosciences. Currently, CHS' primary enterprise consists of 3,418 beds including the following: 11 acute-care hospitals (one tertiary and quaternary, three tertiary, and seven acute-care hospitals with a total of 2,475 licensed beds); two behavioral health facilities with 132 licensed beds; four rehabilitation facilities with 179 licensed beds; five long-term care facilities with 582 licensed beds; three hospices with 50 licensed beds; and a large physician network of 1,457 primary and specialty physicians and faculty at Carolinas Medical Center as well as home health services.

CHS' strategy is to broaden its geographic outreach through a network of nonobligated entities, including 22 hospitals and eight related nursing homes. These entities make up the managed entities, which are not included in the CHS audit. CHS has its direct management expenses reimbursed and also receives management fees from all managed entities, which are included in other revenue.

Utilization

Patient volumes have been increasing through the first six months of 2016 ended June 30, stemming from growth at Carolinas Medical Center, Carolinas HealthCare System Pineville, continued expansion of CHS' physician network through recruitment, and programmatic growth associated with recent strategic investments. All of the aforementioned have contributed to greater downstream admissions and outpatient volume and market share growth. We expect volume growth to continue through the rest of 2016. Overall combined group acute-care inpatient admissions increased to 128,311 in 2015 from 123,876 in 2014. Surgery volume for the acute-care facilities increased to 95,390 in

2015 from 92,613 in 2014.

Market position and physician network

CHS' inpatient market share (including all facilities owned or managed) in the service area—consisting of the 34-county region—remained strong at 37%, with the balance shared by Winston-Salem based Novant Health, which includes Novant Health Presbyterian Medical Center, as well as by individual community hospitals that have strong positions in their home counties. CHS has strong market share in key service lines, which we view as an institutional strength. CHS has a 52% market share in its 13-county core market, where competition comes largely from the 597-licensed bed Novant Health Presbyterian Medical Center and its affiliates. CHS' market share has grown since the mid-1990s at the expense of providers in the primary service area. Commercial insurance accounts for about 58% of net revenue. CHS contracts with all substantive commercial insurance companies in the region and has several value-based shared saving arrangements. CHS competitors have experienced some inpatient payor-mix erosion because CHS' Medicaid and uncompensated care market share has decreased in recent years.

Large multispecialty and single-specialty medical groups characterize the Charlotte region. CHS' physician network remains a core business strength, in our opinion, with 1,457 community-based and faculty physicians, generating roughly 5 million visits annually. Carolinas Medical Center is one of five academic medical center teaching hospitals designated by North Carolina, with 320 medical residents in 36 programs.

Population growth in the county and metropolitan region remains healthy, with a regional growth rate of more than 2% annually, which management projects to continue through at least the next five years.

Management

The system's CEO retired in 2016 after serving nearly 35 years at the system, and 13 years as CEO. The system appointed a new CEO in early 2016. At the end of 2016, the executive vice president of the regional group and the chief administrative officer will leave CHS to retire and pursue other opportunities, respectively. CHS will hire replacements for both roles and we expect smooth transitions. The remainder of the management team has been in place for many years, which we believe promotes the organization's stability. Senior management has focused on a strategy of growth, clinical safety and quality, geographic expansion, and programmatic growth, which produced consistent volume and revenue growth through 2012. After a temporary slowdown in volume and revenue growth in 2013 and through the 2014 first quarter, management accelerated its clinical transformation across the system to reduce waste, enhance revenue, and restore cash flow levels. The remediation efforts, along with healthy volume growth restored operating profitability to historically solid levels for fiscal 2014, which continue through the first half of fiscal 2016 ended June 30.

In our view, CHS' approach to debt the past few years has moderated, with modest debt issuances following a fairly aggressive 2007 issuance that doubled its long-term debt load as it brought Carolinas HealthCare System Northeast into the organization. Though the income statement has absorbed the additional debt effectively at the current rating, the balance sheet has taken a longer time to regain its former strength due to the size of the debt load and investment market turmoil during the economic recession. We expect that the recent transformation efforts and growth strategies will continue to strengthen the balance sheet during the next few years.

We note that as of June 2016, CHS has been the subject of a civil antitrust lawsuit filed by the federal government and the State of North Carolina, for alleged violation of the Sherman Act. The duration and final outcome of the lawsuit remains unknown, and as such is not factored into the current rating. We will continue to monitor the lawsuit for its potential effect on CHS' enterprise and financial profiles.

Financial Profile

Income statement

Management reports that the rebound in profitability in 2014 resulted from effective cost controls, volume and revenue growth, and greater clinical and operating efficiencies. We expect that full fiscal 2016 results will be comparable with those of 2015, and through the first six months of 2016 ended June 30, totaled $143 million (a 5.1% margin). Excess income of $136 million for the first half of 2016 ended June 30, 2016, excludes $62 million of unrealized investment gains. Pro forma debt service coverage was consistent with the rating at 5.8x through June 30, 2016, compared with 7.0x in 2015. We expect that coverage will remain at or near 2015 levels should operating cash flow remain healthy.

The pro forma debt burden was light at 2% of operating revenue in the first half of fiscal 2016 ended June 30. We expect that coverage will remain at or near current levels should operating cash flow remain healthy.

Balance sheet

CHS' core strength has been its balance sheet. From 2009 through June 30, 2016, favorable investment returns, sound operations, a continued low balance of accounts receivable, and improved revenue-cycle management have increased cash on an absolute basis. Unrestricted reserves increased to a strong $3.7 billion (266 days' cash on hand) as of June 30, 2016, compared with $3.5 billion (263 days' cash on hand) as of Dec. 31, 2015, due to favorable investment returns and operating cash flow. In addition, CHS contributed a large amount, $92.4 million, to its pension plan in 2015, compared with $79.1 million, in 2014. Cash-to-debt was consistent with the rating, and much improved from the previous year at 201% as of June 30, 2016; leverage was also in line with the rating at 29% on June 30, 2016.

CHS' asset allocation is fairly balanced, in our opinion, at 11% cash, 23% fixed income, 60% equities, and 7% alternative investments. CHS' unfunded private equity commitments as of June 30, 2016, were, in our view, minimal at $42.8 million.

Contingent liabilities

In May 2013, CHS entered into three direct purchase agreements with SunTrust Bank, PNC Bank, and Banc of America Public Capital Group, respectively, in an initial aggregate amount of $238 million to restructure the series 2007D, 2007F, and 2007G bonds by changing the mode from SBPA- and LOC-supported to variable rate with a seven-year term for the series 2007G bonds and 10-year terms for the 2007D and 2007F bond series. Under the terms of the agreement, each bank will hold the bonds for either seven or 10 years, at which time, unless extended, CHS may remarket the bonds, or if they cannot be remarketed, CHS may repurchase some or all of the bonds. Covenants for the CHS direct purchase agreements include the obligated group's maintenance of 1.1x DSC, at least 75 days' cash on hand, and less than 65% leverage, although not all agreements contain each covenant. An event of default could occur, if not waived by the banks, should CHS breach any of the aforementioned covenants following a 30-day cure period. In the event of default, the banks have the right to accelerate the bonds, at which time CHS would have 180 days to repurchase some or all of the bonds from the bank, or to remarket the bonds. In our view, CHS' 5.1x unrestricted reserves compared with contingent liability debt as of June 30, 2016, mitigates the risk of acceleration.

In 2006, CHS entered into a floating to fixed-rate swap on the series 2005B-D (uninsured) with Bank of America for an initial notional amount of $93.9 million. In 2007, CHS entered into several floating to fixed-rate swaps on series 2007B-H bonds (insured) and series 2007L bonds (uninsured) with Wells Fargo Bank, Citigroup, and Bank of America for a total initial notional amount of $709.1 million. The swap on the series 2007L bonds was terminated in 2009. The current total notional amount was $714 million as of Dec. 31, 2015. Despite a significant mark-to-market of negative $262 million as of Dec. 31, 2015, CHS has not had to post any collateral related to its swap portfolio, in part because the collateral posting requirement for insured swaps is based on a simultaneous downgrade of both the insurer (Assured Guaranty Municipal Corp.) to 'BBB+' and CHS to 'A'.

Charlotte Mecklenburg Hospital Authority d/b/a Carolinas HealthCare System Financial Statistics

	--Six months ended June 30--	--Fiscal year ended Dec. 31--		Medians for 'AA-' rated health care systems	Medians for 'AA' rated health care systems
	2016	2015	2014	2015	2015
Financial performance					
Net patient revenue ($000s)	2,577,250	4,948,438	4,615,482	2,360,641	2,231,303
Total operating revenue ($000s)	2,819,563	5,437,192	5,032,600	MNR	MNR
Total operating expenses ($000s)	2,676,981	5,154,024	4,872,061	MNR	MNR
Operating income ($000s)	142,582	283,168	160,539	MNR	MNR
Operating margin (%)	5.06	5.21	3.19	3.50	4.90
Net non-operating income ($000s)	(6,964)	147,935	142,541	MNR	MNR
Excess income ($000s)	135,618	431,103	303,080	MNR	MNR
Excess margin (%)	4.82	7.72	5.86	6.40	7.20
Operating EBIDA margin (%)	11.91	11.85	10.07	10.40	10.60
EBIDA margin (%)	11.69	14.18	12.55	12.70	13.30
Net available for debt service ($000s)	328,720	792,075	649,439	399,750	484,149
Pro forma Maximum annual debt service ($000s)	113,219	113,219	113,219	MNR	MNR
Pro forma Maximum annual debt service coverage (x)	5.81	7.00	5.74	5.80	6.50
Pro forma Operating lease-adjusted coverage (x)	4.15	4.94	4.12	4.10	4.70
Liquidity and financial flexibility					
Unrestricted reserves ($000s)	3,660,850	3,513,113	3,290,934	1,920,207	2,464,462
Unrestricted days' cash on hand	264.5	262.8	260.5	258.20	292.90
Unrestricted reserves/long-term debt (%)	200.8	189.4	174.0	180.90	250.80
Unrestricted reserves/contingent liabilities (%)	513.4	492.0	458.5	568.70	582.20
Average age of plant (years)	8.0	8.2	7.8	10.00	9.80
Capital expenditures/depreciation and amortization (%)	86.7	91.0	139.1	124.20	139.80

Charlotte Mecklenburg Hospital Authority d/b/a Carolinas HealthCare System Financial Statistics (cont.)

	--Six months ended June 30--	--Fiscal year ended Dec. 31--		Medians for 'AA-' rated health care systems	Medians for 'AA' rated health care systems
	2016	2015	2014	2015	2015
Debt and liabilities					
Long-term debt ($000s)	1,822,772	1,855,245	1,891,155	MNR	MNR
Long-term debt/capitalization (%)	29.3	32.2	31.3	31.40	25.50
Contingent liabilities ($000s)	713,105	714,005	717,780	MNR	MNR
Contingent liabilities/long-term debt (%)	39.1	38.5	38.0	31.80	45.50
Debt burden (%)	2.01	2.03	2.19	2.30	1.80
Defined-benefit plan funded status (%)	N.A.	67.20	68.95	76.30	82.00

N.A.--not available. N/A--not applicable.

Ratings Detail (As Of September 26, 2016)

Charlotte-Mecklenburg Hospital Authority (AGM)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
Charlotte-Mecklenburg Hosp Auth taxable hlth care comm pap rev bnds ser 2015B-1&2		
Short Term Rating	A-1+	Affirmed
Charlotte-Mecklenburg Hosp Auth JOINTCRIT		
Long Term Rating	AAA/A-1+	Affirmed
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
Charlotte Mecklenburg Hosp Auth		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
Long Term Rating	AAA/A-1+	Affirmed
Charlotte Mecklenburg Hosp Auth Series 2007C		
Long Term Rating	AA-/A-1/Stable	Affirmed
Charlotte Mecklenburg Hosp Auth Series 2007H		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
Long Term Rating	AAA/A-1+	Affirmed
Charlotte-Mecklenburg Hosp Auth		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
Long Term Rating	AAA/A-1+	Affirmed
Charlotte-Mecklenburg Hosp Auth Series 2007B		
Long Term Rating	AA-/A-1/Stable	Affirmed

Many issues are enhanced by bond insurance.