Fitch Rates Kaiser Permanente's (CA) Ser 2017 Rev Bonds 'A+' and CP 'F1'; Outlook Stable

Fitch Ratings-Chicago-07 April 2017: Fitch Ratings has assigned 'A+' long-term ratings to the following revenue bonds to be issued by or on behalf of Kaiser Permanente (Kaiser):

--$2.1 billion taxable fixed rate revenue bonds, series 2017A-1 (Green Bonds) and series 2017A-2;
--$0.3 billion taxable floating rate notes, series 2017B;
--$1.5 billion tax-exempt fixed rate revenue bonds issued by the California Health Facilities Financing Authority (CHFFA), series 2017A-1 (Green Bonds) and series 2017A-2;
--$0.5 billion floating rate notes issued by CHFFA, series 2017B, 2017C and 2017D.

Fitch has assigned an 'F1' short-term rating to the following commercial paper (CP):

--$0.985 billion 2017 taxable CP (supported by Kaiser's self-liquidity).

In addition, Fitch has affirmed the 'A+' long-term rating on approximately $7.4 billion of outstanding Kaiser debt issued by CHFFA, California Statewide Communities Development Authority. Further, Fitch affirms the 'F1' short-term ratings on approximately $1.4 billion of tax exempt variable rate demand bonds (VRDBs) and $1.5 billion of tax exempt bonds in a CP mode, and the $2.4 billion of taxable CP issued by Kaiser Foundation Hospitals. The 'F1' short-term rating is based on Kaiser's self-liquidity.

Bond proceeds will be used to reimburse Kaiser for approximately $760 million of prior capital spending, provide $2.2 million of liquidity for general corporate purposes, refund $517 million of FRN, fixed rate, and put bond, refinance $900 million of existing CP debt, and pay the costs of issuance. Pro forma maximum annual debt service (MADS) is $640 million based on a smoothed debt service assuming level debt service over 30 years ($2.2 billion based on a bullet maturity in 2047). The bonds are expected to price via negotiation the week of April 17.

The Rating Outlook is Stable.

SECURITY

Debt service is an unsecured general obligation of Kaiser Foundation Hospitals (KFH). KFH's obligations under the loan agreement are guaranteed by Kaiser Foundation Health Plan, Inc. (KFHP), Kaiser Hospital Asset Management, and Kaiser Health Plan Asset Management, Inc., which along with KFH comprise the Credit Group. The Credit Group represents 96% of system total assets and 84% of system total operating revenues.

KEY RATING DRIVERS

UNIQUE BUSINESS MODEL: Kaiser is a unique, vertically integrated, closed health maintenance organization (HMO). The organization has created a fully integrated healthcare delivery network of primarily owned hospitals and clinics staffed by affiliated physicians who contract exclusively with KFHP.

LEADING POSITION, SIGNIFICANT SCALE: KFHP maintains the largest market share in the California health insurance market. Kaiser is among the largest health insurance and HMOs in Fitch's rated portfolio (including for-profits). Based on revenue, Kaiser is by far the largest nonprofit healthcare system in the U.S.

CONSISTENT AND STABLE PROFITABILITY: Kaiser has a track-record of profitability (2.7% adjusted operating margin in fiscal 2016). The system's adjusted operating EBITDA margin is suppressed (6.5% in fiscal 2016), but very stable and it is common for hospital systems that own large health plans to have more modest operating EBITDA margins. Kaiser's pro forma debt burden and debt coverage ratios are favorable (pro forma MADS burden is 1.0% and MADS coverage is a very strong 8.6x).

STRONG LIQUIDITY: Including cash reimbursement from the 2017 financing, pro forma cash on hand measures a solid 229 days, cushion ratio 59.2x, and cash-to-debt a very robust 363%, all in-line with or better than 'A' medians.

SIZEABLE PENSION OBLIGATIONS: Kaiser's defined benefit pension plan obligations are considerable. Combined at fiscal year-end 2016, the pensions were 46% funded relative to a projected benefit obligation (PBO) of $25.3 billion. Management has worked in recent years to restructure pensions to limit liabilities.

INSURANCE FINANCIAL STRENGTH RATING OF 'A+': Fitch currently has an Insurer Financial Strength (IFS) rating of 'A+' on the following: Kaiser Foundation Health Plan, Inc.; Kaiser Foundation Health Plan of the Northwest; Kaiser Foundation Health Plan of Georgia, Inc.; Kaiser Foundation Health Plan of the Mid-Atlantic States, Inc.; Kaiser Foundation Health Plan of Colorado; and Kaiser Permanente Insurance Company.

RATING SENSITIVITIES

Membership Growth and Improved Financial Profile: Fitch believes Kaiser's vertically integrated, fully aligned model is well positioned for the transition to a value based healthcare environment. Upward movement in the rating could occur if there is measured and sustained improvement in profitability and/or continued liquidity strengthening. Diversification of membership and revenues from markets outside of California and/or material reduction in defined benefit pension plan obligations without dilution of financial profile also could lead to upward rating movement.

CREDIT PROFILE

KFHP along with KFH and the Permanente Medical Group (PMG) constitute a unique, vertically integrated, closed HMO that together conducts business under the trade name Kaiser Permanente (Kaiser). The organization has created a fully integrated healthcare delivery network of primarily KFH-owned hospitals and clinics staffed by PMG's physicians who contract exclusively with KFHP. On a combined basis, Kaiser's total adjusted revenues in fiscal 2016 (Dec. 31 year end; audited) were $64.1 billion.

LEADING POSITION, SIGNIFICANT SCALE

Based on premium revenues, KFHP maintains the largest market share in the California health insurance and managed care market. Using other metrics such as revenues, capital, and annual earnings as guides, Kaiser is among the largest health insurance and managed care organizations in Fitch's rated portfolio (including for-profits). Based on revenue, Kaiser is by far the largest nonprofit healthcare system in the U.S.

Kaiser is diversified and operates in multiple regions across the country, including the west coast (California, Hawaii, Oregon, and Washington), central mountains (Colorado), southeast (Georgia), and mid-Atlantic (Maryland, Virginia, and D.C.). With the January 2017 acquisition of Group Health Cooperative in Washington State, Kaiser is up to 11.7 million members and growing. Despite this geographic diversification, however, over 70% of Kaiser's members are located in California.

CONSISTENT AND STABLE PROFITABILITY, GOOD DEBT COVERAGE

Kaiser has a track-record of profitability and very stable operating EBITDA margins. In fiscal 2016, Kaiser's adjusted operating margin measured 2.7% and operating EBITDA margin measured 6.5% (adjusted to remove the portion of investment income included in operating revenue and associated expense from operating expense). Kaiser's operating results are very stable, as the operating EBITDA margin ranged between 6.5% and 6.9% since fiscal 2012.

Kaiser's operating EBITDA margin is modest ('A' median is 10.3%). It is common for hospital systems that own large health plans, however, to have more modest operating EBITDA margins.

Kaiser's pro forma debt burden and debt ratios are favorable. Including the 2017 financing, total pro forma debt outstanding is $10.4 billion. Based on fiscal 2016 results, pro forma MADS burden is a low 1.0% ('A' median is 2.7%), assuming smoothed MADS of $640 million. Actual MADS is $2.2 billion, based on a bullet payment due in 2047. MADS coverage is a very strong 8.6x based on smoothed MADS and 2.5x based on actual MADS ('A' median is 4.5x). Pro forma debt-to-EBITDA is a favorably low 1.9x (A median is 2.9x). The system does not have additional new money debt plans beyond the 2017 financings through 2019.

Kaiser has 11 fixed payor swaps in place with a total notional amount of approximately $1.2 billion. Swap counterparties include JPMorgan, Merrill Lynch, and Goldman Sachs. The net termination value of the swaps was a negative $251 million to Kaiser at fiscal year-end 2016. None of Kaiser's swaps have collateral posting requirements at the current rating level, although some agreements would require collateral should Kaiser's long-term rating drop below 'A-'.

SIZEABLE PENSION OBLIGATIONS

Kaiser's defined benefit pension plan obligations are considerable, which views as a credit concern. At fiscal year-end 2016, the pensions were 46% funded relative to a PBO of $25.3 billion. This $13.6 billion underfunded status is 30% greater than the value of Kaiser's pro forma total direct debt outstanding. Management has worked in recent years to restructure pensions to limit liabilities.

STRONG LIQUIDITY

Kaiser's liquidity ratios are strong. Including cash reimbursement from the 2017 financing, pro forma cash on hand is 229 days ('A' median is 216 days), cushion ratio is a very strong 59.2x ('A' median is 19.4x), and cash-to-debt a very robust 363% ('A' median is 149%). Even if Kaiser's operating leases and sizeable defined benefit pension plan obligations are included as debt, pro forma cash-to-debt is still a sound 137%.

PROGRAMMATIC CAPITAL SPENDING

Kaiser has a well-developed approach to systematic capital spend planning. Between 2016 and 2025, the system's board has approved $41 billion of capital. All California hospitals are seismically compliant and Kaiser has a fully-developed electronic medical record (EMR) system, both of which Fitch views favorably. Highlighted projects in the coming years include a new medical center in San Diego (to open April 2017), a 50-bed expansion in Irvine, patient tower replacements/upgrades in San Jose, Sacramento and South San Francisco, and a number of 23-hour stay facilities. Kaiser is also starting a medical school in southern California; while this represents an important strategic development for the system, capital requirements to start up the school are minimal. The school is expected to accommodate 48 graduates once fully ramped up.

MULTIPLE RATING CRITERIA USED

Recognizing Kaiser's unique business model, Fitch's ratings on Kaiser draws from Fitch's nonprofit hospital and U.S. health insurance and managed care criteria. The ratings place a heavier emphasis on the hospital criteria since Kaiser's hospital operations represent the majority of the organization's earnings and assets. Nevertheless, the magnitude of Kaiser's insurance operations and attendant actuarial risk remain a credit concern.

SHORT-TERM RATING

The 'F1' short-term rating reflects the sufficiency of Kaiser's internal liquid resources (composed of cash, liquid investments, and dedicated bank credit facilities) available to fund any failed re-marketing puts on a maximum potential of $5.3 billion of CP and VRDB bonds supported by the system's self-liquidity.

Based on Fitch's rating criteria related to self-liquidity, Kaiser's position of eligible cash and investments available exceeds Fitch's 1.25x requirement to cover the maximum tender exposure on any given date. Kaiser has liquidation procedures in place detailing the process by which internal funds would be liquidated to meet the tender obligations. Moreover, the CP maturity dates have been staggered to manage potential put exposure at any one time.

DISCLOSURE

Kaiser covenants to provide audited financial statements to bondholders within six months of the close of each fiscal year, as well as quarterly unaudited financial statements no later than 60 days after each quarter. Disclosure to

Fitch has been excellent and includes quarterly earnings calls and subsequent distribution of detailed financial statements.

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Applicable Criteria

Insurance Rating Methodology (pub. 15 Sep 2016) (https://www.fitchratings.com/site/re/887191)
Rating U.S. Public Finance Short-Term Debt (pub. 08 Feb 2017) (https://www.fitchratings.com/site/re/893974)
Revenue-Supported Rating Criteria (pub. 16 Jun 2014) (https://www.fitchratings.com/site/re/750012)
U.S. Nonprofit Hospitals and Health Systems Rating Criteria (pub. 09 Jun 2015) (https://www.fitchratings.com/site/re/866807)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1021947&cft=0)
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