FitchRatings

Fitch Rates Children's Health System of Texas Revs 'AA'; Outlook Stable

Fitch Ratings-Austin-30 November 2017: Fitch Ratings has assigned a 'AA' rating to the expected issuance of $327.66 million of New Hope Cultural Education Facilities Finance Corporation Hospital Revenue Bonds (Children's Health System of Texas Project) series 2017A and $25.32 million of Children's Health System of Texas (CHST) taxable bonds series 2017A.

Additionally, Fitch has affirmed the 'AA' ratings on $145.7 million series 2012 and $198.3 million of series 2009 bonds issued by the North Central Texas Health Facilities Development Corporation on behalf of CHST.

The Rating Outlook is Stable.

The series 2017A bonds will be used to refund series 2009 and certain 2012 outstanding bonds, to fund hospital facility improvements and to pay costs of issuance. The series 2017A taxable bonds will be used for general corporate purposes.

SECURITY

Bond payments are secured by a pledge of the gross revenues of the obligated group.

KEY RATING DRIVERS

LEADING MARKET POSITION: CHST holds a dominant market share in its service area, with limited competition for high acuity pediatric services. The leading market position is bolstered by CHST's status as the primary pediatric teaching hospital for the University of Texas Southwestern Medical Center at Dallas (UTSW).

SOUND PROFITABILITY: Interim fiscal 2017 operating profitability of 5.1% for the 10-months ending Oct. 31, 2017 represents Fitch's expectation for CHST's ongoing performance and is consistent with Fitch's 4.8% 'AA' category median. These results are improved from fiscal 2016, but lower than the average operating margin of 8.6% realized during fiscal 2011 - 2015, reflecting the expected new normal of lower supplemental funding.

MANAGEABLE DEBT BURDEN: All of CHST's capital related metrics are favorable to Fitch's 'AA' category medians. Pro forma maximum annual debt service (MADs) represents a manageable 1.9% of fiscal 2017 (annualized) revenues and CHST generated 5.6x of coverage by operating EBITDA through October. No additional debt is planned over the next several years.

ROBUST LIQUIDITY: Liquidity metrics are robust with 370 days cash on hand (DCOH), 49x cushion ratio and 421% cash-to-debt at Oct. 31, 2017.

RATING SENSITIVITIES

SOUND OPERATING PERFORMANCE: Fitch expects Children's Health System of Texas to maintain healthy cash flow and coverage based on utilization trends and the organization's commitment to cost containment. However, a main credit concern continues to be CHST's high exposure to change in Medicaid funding.

CREDIT PROFILE

CHST (fka Children's Medical Center of Dallas) operates two pediatric acute care hospitals and a pediatric rehabilitation hospital located in Dallas and Plano. Additional operations include a pediatric research institute, a health maintenance organization, an integrated regional pediatric network with over 340 physicians, a telemedicine network, eight outpatient rehabilitation clinics, 10 specialty centers, two ambulatory surgical centers and a range of community health programs. CHST has provided pediatric services in the Dallas community for over 100 years and is nationally recognized as one of the nation's leading children's hospitals. CHST changed its name from Children's Medical Center of Dallas in 2014 to reflect the system's evolution from a standalone pediatric medical center to a clinically integrated pediatric

health system. Total consolidated operating revenue equaled $1.4 billion in fiscal 2016.

LEADING MARKET POSITION

CHST has a leading market share in high acuity pediatric services in its two primary service areas, Dallas and Plano. The system has developed into the dominant provider of complex, high acuity pediatric services in both service areas. CHST maintained leading market shares of 79% in Dallas and 65% in Plano, well ahead of its nearest competitors.

ACADEMIC AFFILIATION

The leading market position is further enhanced by CHST's status as UTSW's exclusive pediatric teaching hospital and its affiliation with the Texas A&M Baylor College of Dentistry. The academic programs include over 100 pediatric residents, 128 pediatric subspecialty fellows and 22 pediatric dental residents. CHST also has facility agreements with five nursing schools for clinical education of nursing students in the area of pediatric/critical care nursing. Fitch views the academic affiliations favorably as they provide valuable benefits in clinical care, research, and recruitment of nurses and physicians.

SOUND PROFITABILITY

CHST has generated strong profitability associated with solid utilization growth, especially in the northern portion of its service territory. As is typical with children's hospitals, CHST has a high exposure to Medicaid, equal to 63% of gross revenue in fiscal 2016. Additionally, CHST receives significant supplemental government funding.

Thinning fiscal 2016 and 2017 margins reflect reduced levels of supplemental funding. Restoration of fiscal 2017 margins result from ongoing outpatient utilization growth as well as cost savings resulting from CHST's organizational restructuring. Fitch expects CHST to realize profitability consistent with its current 5% operating margin based on utilization trends and an organizational commitment to ongoing cost containment.

MANAGEABLE DEBT BURDEN

CHST's $355 million of total at Oct. 31, 2017 translated to 14.6% of debt to capitalization, favorable to Fitch's 27.9% 'AA' category median. The debt portfolio consists of 100% underlying fixed-rate bonds. The system is not counterparty to any swap agreements.

Series 2017A new money issuance will fund of $50 million of CHST's planned $120 million in capital needs over the next several years. The remainder of capital needs will be funded from cash flow. CHST's 9.6 year average age of plant is consistent with Fitch's 10.3 year 'AA' category median, reflecting a history of healthy capital spending.

Pro forma MADS of about $30 million is equal to 1.9% of fiscal 2017 annualized operating revenue relative to Fitch's 'AA' category median of 2.2%. MADS coverage by EBITDA and operating EBITDA equaled 6.4x and 5.6x, respectively, in the interim period ending Oct. 31, favorable to Fitch's 'AA' category medians of 5.7x and 4.9x.

ROBUST LIQUIDITY

CHST's unrestricted cash and investments of $1.5 billion at Oct. 31 translate to 370 DCOH, reduced from recent highs due to margin compression, but very strong in relation to Fitch's 254 DCOH 'AA' category median. Fitch expects stabilizing margins to protect CHST's current cash position. The robust liquidity metrics provide significant financial flexibility to manage its capital needs.

DISCLOSURE

CHST covenants to provide audited financial statements within 150 days of each fiscal year-end and quarterly unaudited financial statements within 60 days of the first three quarters. Disclosure is provided through the Municipal Securities Rulemaking Board's EMMA website.

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Applicable Criteria

Rating Criteria for Public Sector Revenue-Supported Debt (pub. 05 Jun 2017) (https://www.fitchratings.com/site/re/898969)
U.S. Nonprofit Hospitals and Health Systems Rating Criteria (pub. 09 Jun 2015) (https://www.fitchratings.com/site/re/866807)

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