

## CREDIT OPINION

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# Cooper Health System (The), NJ

## Update to credit analysis

### Summary

Cooper Health System (Cooper; Baa1 Stable) will improve operating performance in the near term. Following challenged performance in fiscal 2017, largely driven by electronic medical record challenges, Cooper is expected to return to healthier margins in fiscal 2018. Operating improvement will be driven by growth strategies and expense control initiatives. Continued growth of its centers of excellence and significant partnerships with providers such as MD Anderson Cancer Center will solidify Cooper as an essential provider of services for Southern New Jersey in the near term. Additionally, the system's favorable leverage position, adequate headroom to financial covenants and continued growth of liquidity will provide cushion as the system works to improve operating results. Although less reliant on state charity subsidies the system's high reliance on governmental payors and other supplemental funding exposes the system to State funding challenges in the future. These expected improvements will be pressured by the system's high reliance on governmental payors, operations in a highly competitive market, and variable supplemental funding payments.

### Credit strengths

- » Large revenue base with \$1.3bn in operating revenue
- » Essential New Jersey based provider of tertiary services as well as the safety net hospital for Camden County
- » Adequate multi-year revenue growth as a result of several strategic partnerships
- » Favorable leverage metrics with 165% cash to debt and 2.5x debt to cash flow projected in FY 2018

### Credit challenges

- » High reliance on governmental payors (40.1% Medicare and 27.7% Medicaid)
- » Although improved, unfavorable liquidity metrics compared to peers
- » Significant reduction in operating performance in FY 2017 (0% operating margin and 5.2% operating cash flow margin)
- » Challenging competitive landscape with other large academic providers

### Rating outlook

The stable outlook reflects our view that many of the challenges experienced in fiscal 2017 that drove a significant decline in operating performance are one time and that improved

financial performance through six months fiscal 2018 will be maintained. Challenges as the result of the system's electronic medical record installation and letter of intent to acquire the Lourdes hospital system are largely behind the system. Additionally, the stable outlook reflects our view that the system will continue to maintain its market position in a highly competitive market while continuing to grow liquidity metrics.

### Factors that could lead to an upgrade

- » Ability to improve and sustain operating margins
- » Continued liquidity growth more in line with medians
- » Further geographic reach resulting in improved payor mix
- » Reduction in reliance on supplemental funding, while maintaining margins

### Factors that could lead to a downgrade

- » Inability to achieve projected operating performance
- » Increase in debt without a commensurate increase in cash or cash flow
- » Reduction in market share as a resulting in a decline in utilization
- » Inability to sustain current liquidity metrics

### Key indicators

Exhibit 1

#### Cooper Health System, NJ

	2013	2014	2015	2016	2017
Operating Revenue (\$'000)	874,925	950,394	1,056,848	1,172,908	1,197,439
3 Year Operating Revenue CAGR (%)	5.6	6.7	8.5	10.3	8.0
Operating Cash Flow Margin (%)	7.2	10.2	10.4	9.4	5.2
PM: Medicare (%)	39.7	38.5	40.2	40.2	40.1
PM: Medicaid (%)	19.7	23.1	27.7	27.5	27.7
Days Cash on Hand	120	151	135	142	147
Unrestricted Cash and Investments to Total Debt (%)	80.0	116.4	117.0	128.8	146.5
Total Debt to Cash Flow (x)	4.1	2.5	2.4	2.4	3.6

Based on audited financial statements for Cooper Health System, NJ for fiscal year ended December 31

Investment returns normalized at 6% prior to FY 2015 and 5% in FY 2015 and beyond.

Source: Moody's Investors Service

### Profile

The Cooper Health System is comprised of Cooper University Hospital, a network of more than 100 outpatient offices, surgical and urgent care centers. Cooper also has partnerships with Rowan University (A2 rating), through the Cooper Medical School of Rowan University and MD Anderson through the MD Anderson Cancer Center at Cooper.

### Detailed credit considerations

#### Market Position: essential provider of tertiary services balanced by broader competitive landscape

In the near term we expect overall market share to remain stable. Stability of market share is driven by the system's strong brand equity as an essential provider of tertiary services in the southern New Jersey market. Additionally, continued efforts to build brand

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equity through key partnerships with nationally recognized providers like MD Anderson will provide market stability. The system serves as the primary teaching site for Cooper Medical School of Rowan University and state certificate of need will provide further stability in the future. These strengths will be offset by strong southern New Jersey and Philadelphia regional local systems and large academic medical center competition.

Challenges related to the system's high reliance on governmental payors (40% Medicare and 28% Medicaid) are expected to continue, as Camden is one of the state's poorest cities. This could be offset by Cooper's focus on strategic partnerships and growth in surrounding suburban communities. Favorable tax incentives attracting more businesses to the area will be offset in the longer term by lagging demographic trends due to weak single-family housing gains (Moody's Analytics). A continued focus on generating additional revenue streams and decreasing the reliance on supplemental funding, which can be variable, will provide further stability. The State's continued focus on revitalizing the Camden area will provide longer term demographic stability. Part of the improvement in operating performance in the second half of 2018 and in 2019 will be driven by favorable increases in supplemental funding.

### **Operating Performance, Balance Sheet and Capital Plans: performance improvement will be driven by strong revenue growth**

We expect system operations will continue to stabilize in the near term. Following a significant downturn in operating performance in FY 2017, 0% operating margin and 5.2% operating cash flow margin operating performance began to stabilize in FY 2018. We expect the system will be able to achieve a 7.3% operating cash flow margin in FY 2018 with a longer term target between 8-9% over a five year period. Challenges related to the system's electronic medical record installation in FY 2017 have largely been resolved and not expected to impair performance in the near term. Additionally, continued strengthening of key service lines, outpatient growth strategies, and strong brand equity will drive increased patient volume translating to top line revenue growth. The system has identified strategic initiatives that are expected to bolster operating performance in the longer term. Key initiatives include improvement in managed care contracts, expense control measures, and continue to capitalize on key partnerships such as the MD Anderson relationship. We expect the system will continue to generate strong volume growth and continue to grow transfer volume. Favorable increases in supplemental funding provide further operating stability in the near term.

### **LIQUIDITY**

Liquidity is expected to remain flat in the near term. The system's days cash on hand is expected to remain between 130-145 days over the next five years. Continued strategic investment in the organization and rebuilding of the operating performance will result in minimal liquidity growth. Additionally, the system will continue to rebuild cash following initial investments in the Lourdes acquisition that did not come to fruition. A continued improvement in accounts receivable following the electronic medical record installation will help stabilize liquidity.

### **Debt Structure and Legal Covenants**

Debt metrics are expected to remain favorable in the coming years with no planned new money borrowings and anticipated capital spending in line with depreciation. As of FYE 2017 leverage metrics were favorable to peers with 26.4% debt to revenue, 147% cash to debt and 3.6 times debt to cash flow. With the system's large electronic medical record install behind them budgeted capital spend over the next two years is expected to be \$128 million.

### **DEBT STRUCTURE**

With no planned new money borrowings we expect the system's debt profile to remain consistent over the next several years. As of FYE 2017, the system had \$316 million of debt outstanding. Total outstanding debt is comprised of 80% fixed rate and 20% variable rate. Cooper's variable rate demand bonds (Series 2008A) are enhanced with a letter of credit from TD Bank, with an expiration date of October 18, 2018. We expect the system will extend the letter of credit with TD bank. The system has a sizeable lease program with a debt equivalent of \$109 million (based on FY 2017 rental expense). Total comprehensive debt (including leases and pension) was \$445.4 million as of FYE 2017.

### **LEGAL SECURITY**

Bonds are secured by the gross receipts of the obligated group and a mortgage pledge on One Cooper Plaza (the main hospital campus). The obligated group represents 99% of the system revenues and does not include the foundation, collection services, properties and medical service groups.

As of FYE 2017 Cooper had sufficient headroom to meet financial covenants. The Series 2002 bonds require a debt service coverage ratio equivalent of at least 1.10 times. Under the Master trust indenture financial covenants are a 1.25 times debt service coverage covenant and minimum 60 days cash on hand. Debt service coverage as of FYE 2017 was 3.7 times and days cash on hand was 147 days.

#### **DEBT-RELATED DERIVATIVES**

Given the system's rating and collateral posting requirements on outstanding swaps we expect the collateral posting position to remain minimal in the near term. Cooper has two swap agreements in place associated with the series 2008A bonds. The counterparties are Goldman Sachs and Morgan Stanley. Cooper pays a fixed rate of 2.428% and 2.577%, respectively and receives three-months Libor. Collateral is required if the mark-to-market falls below \$4 million on the Goldman Sach's swap and \$2.5 million on the Morgan Stanley swap. As of FYE 2017 Cooper was required to post \$0.6 million of collateral.

#### **PENSIONS AND OPEB**

Given the system's several strategies to de-risk the pension plan we expect the systems indirect debt pension burden to remain flat in the near term. Cooper froze the system's defined benefit plan in 2001 and in 2015 began offering lump sum distributions for vested, terminated employees. As of FYE 2017 Cooper reported an underfunded liability of \$19.6 million or 88% funded.

#### **Management and Governance**

The system's recent succession planning announcements of key roles will provide management stability in the near term. Cooper recently reorganized their senior leadership structure appointing two co-presidents to report directly to the chief executive officer (CEO). This revised structure adds strengthened leadership to an already strong and tenured management team. Additionally, the system recently hired a seasoned chief financial officer (CFO) following the departure of the previous individual. The board, comprised of 21 members, remains stable with no anticipated changes in the near term

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