

April 4, 2019

VIA FEDERAL EXPRESS

Mr. Michael Constantino
Illinois Health Facilities and Services Review Board
525 West Jefferson Street, 2nd Floor
Springfield, IL 62761

Re: Permit Application (Project #19-012)

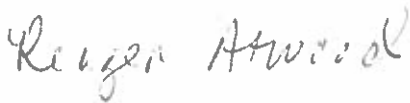
Applicants: Lurie Children's Primary Care and Outpatient Services
Ann & Robert H. Lurie Children's Hospital of Chicago/Children's Hospital
of Chicago Medical Center

Dear Mr. Constantino:

As requested in connection with the above-referenced permit application, enclosed please find the ratings report from S&P Global for Ann & Robert H. Lurie Children's Hospital of Chicago dated March 29, 2019 affirming the hospital's AA- rating.

Please let me know if you have any question or require anything else.

Sincerely,



Reagen Atwood
Associate General Counsel
Ann & Robert H. Lurie Children's Hospital of Chicago
225 E. Chicago Avenue, Box 261
Chicago, IL 60611

Enclosure

cc: Ralph Weber, Consultant

RECEIVED

APR 5 2019

HEALTH FACILITIES &
SERVICES REVIEW BOARD

**Illinois Finance Authority
Ann & Robert H. Lurie Children's
Hospital of Chicago; Hospital**

Primary Credit Analyst:

Allison Bretz, Chicago (1) 303-721-4119; allison.bretz@spglobal.com

Secondary Contact:

Suzie R Desai, Chicago (1) 312-233-7046; suzie.desai@spglobal.com

Table Of Contents

Rationale

Outlook

Enterprise Profile: Very Strong

Financial Profile: Very Strong

Credit Snapshot

Illinois Finance Authority

Ann & Robert H. Lurie Children's Hospital of Chicago; Hospital

Credit Profile

Illinois Finance Authority, Illinois

Ann & Robert H. Lurie Children's Hosp of Chicago, Illinois

Illinois Finance Authority (Ann & Robert H. Lurie Children's Hospital of Chicago)

Long Term Rating

AA-/Stable

Affirmed

Rationale

S&P Global Ratings affirmed its 'AA-' long-term rating on the Illinois Finance Authority's outstanding revenue bonds issued for the Ann & Robert H. Lurie Children's Hospital of Chicago (Lurie Children's). Children's Hospital of Chicago Medical Center is the parent organization for the system, and we refer to the combined system in this report as Lurie Children's. The outlook is stable.

The rating reflects Lurie Children's strong financial performance over the last several years, supported by solid demand for hospital services and management's ongoing focus on expense control. Over the last few months, Lurie Children's completed transactions with two independent physician groups, forming two new legal entities that now employ these physicians. This strategic transaction supports a stronger relationship with these physicians, and further solidifies Lurie Children's position in the competitive Chicago-area market. We note that Lurie Children's operating margin will likely decline in fiscal 2019 with the additional expenses associated with these transactions, but recognize that many of these expenses formerly flowed through the hospital's nonoperating expense line, so the transaction should not materially affect overall cash flow. Lurie Children's also has a strong balance sheet, which should provide some flexibility in the face of any operating challenges. We believe this is critical in light of ongoing state and federal legislative credit risks and an increase in Lurie Children's capital investments. Lurie Children's maintains strong advocacy with key partners, and its management team is engaged in a rigorous planning and budgeting process, both of which help offset some of the downside risk.

The rating further incorporates our view of Lurie Children's strong and stable market share in a very broad service area that incorporates Chicago and the surrounding counties, albeit with ongoing competition from other academic medical centers and larger systems, coupled with a large and growing medical staff. The management team continues to execute on its strategic plan, including investing in research capabilities, expanding access to the larger market, and lowering cost of care while maintaining and improving quality of services. Lurie Children's capital spending will remain somewhat elevated over the next year as it completes its new research facility and continues to add beds at the hospital, but we believe this spending can be sustained at the current rating level.

Specifically, the 'AA-' rating further reflects our view of Lurie Children's:

- Healthy balance sheet, even with some diminution in unrestricted reserves through the first quarter of fiscal 2019;
- Robust maximum annual debt service (MADS) coverage, which has been over 6x for the past several fiscal years as a result of good cash flow;
- Continued good business position as the only freestanding pediatric acute care facility in the state, with a strong relationship with Northwestern University's (AAA/Negative) Feinberg School of Medicine and Northwestern Memorial Hospital (AA+/Stable);
- Stable market share sustained by a growing medical staff and investment in outpatient satellite facilities, coupled with expanding clinical affiliations with general acute care hospitals in the seven-county service area; and
- Very conservative debt structure profile.

Partly offsetting the above strengths, in our view, are Lurie Children's:

- Ongoing competition in the broader service area from other systems and academic medical centers that are continuing to invest in their pediatric services;
- Operating income that is dependent on supplemental funds through the Illinois provider fee program coupled with Medicaid exposure in a state with fiscal challenges; and
- Higher capital spending over the next year related to research and clinical expansion.

Outlook

The stable outlook reflects our view of Lurie Children's continued sound business position, solid cash flow margins, and excellent MADS coverage. We anticipate that Lurie Children's will maintain its sound business position with its affiliate and partner strategy and as its new critical care beds come on line over the next year, supplementing new beds added over the last two years. In addition, we expect that the growing research investment will be managed without significant margin and cash flow compression. While we understand that Lurie Children's operating margins may be somewhat softer over the next two years due to strategic investments, we expect overall cash flow to remain sound, and believe the hospital's strong liquidity provides ample cushion for any operating challenges.

Upside scenario

We could consider a higher rating if unrestricted reserves further strengthen and operating margins remain at or near current levels, sustaining healthy MADS coverage. Additional considerations for a higher rating would include improvement in Lurie Children's market share, successful completion and operationalization of the new research facility, and clarification of any future capital plans.

Downside scenario

While not expected, we could consider a negative outlook or rating action if MADS coverage drops to less than 4.5x on a sustained basis, operating margins weaken materially, or unrestricted reserves decline as a result of capital investments such that they are no longer commensurate with the rating. In addition, and although not anticipated, any diminution in Lurie Children's business position could pressure the rating.

Enterprise Profile: Very Strong

Market position and strategy

Overall pediatric services in the greater Chicago market continue to consolidate, specifically those services oriented toward tertiary and quaternary services. However, we believe Lurie Children's, with a leading market share, depth of services, and a large medical staff, continues to hold a solid position, albeit in a competitive market with several academic medical centers and hospitals and systems increasing their pediatric presence. Lurie Children's remains the only stand-alone acute care pediatric facility in the state, and its market share increased markedly following its relocation to the new hospital. Outpatient market share is also increasing as Lurie Children's overall network of care continues to expand in the region and with its physician base. Over the last year, Lurie Children's opened a new ambulatory surgical center and urgent care center in Northbrook, a Chicago suburb, which has already seen solid patient demand. The organization also expanded its already robust partnership model, through which it provides services at hospitals across Chicago and its suburbs. Lurie Children's recently entered into two new service line partnerships with two additional academic medical centers in the Chicago area.

Lurie Children's market share has remained relatively flat over the last few years, due largely to capacity challenges at the hospital. As it has worked to expand its bed count over the last few years, Lurie Children's has taken some beds offline. In 2017, the average bed count was 276 (down from 288 in previous years), and management notes there were even fewer beds in service for parts of the year. This limited patient volumes, and forced Lurie Children's to divert some referrals to other pediatric providers in the region. The hospital continues to add beds, most recently in February 2019, with 20 new beds coming online to bring the total in operation to 336. An additional 24 beds will open in November 2019.

Management and the board have specific research strategies as areas of focus for the organization, and we believe that, if executed well, this could eventually contribute to strengthening specific clinical services as well as Lurie Children's regional and national reputation. Despite some financial risks related to research, including the capital investment for the additional space, we believe Lurie Children's is taking a measured and controlled approach from an operating investment perspective and with support from philanthropy and external grants. Consistent with Lurie Children's strategic focus in the area of research, the organization has continued to increase its research investment, funded from a variety of sources, including outside grants, philanthropy, and operating cash flow. The new research space brings research near the main hospital campus and is part of a larger research tower being built by Northwestern University. At the start, Lurie Children's portion will have three floors built out for research with the total potential capacity of research space at 165,000 square feet (from 125,000 square feet currently). The relocation to the new building will take place in June 2019.

Medical staff

Lurie Children's large active physician base of over 1,300, including approximately 714 employed pediatric care and pediatric subspecialty physicians, helps support the hospital with its breadth and depth of specialties and Lurie Children's larger research and educational mission. Lurie Children's has also increased the number of its employed primary care physicians with the purchase of a large primary care group in fiscal 2016. More recently, Lurie Children's completed transactions with two independent specialty physician groups, forming two new legal entities which now

employ these physicians. On Jan. 1, 2019, Lurie Children's formed the two new entities: Lurie Children's Surgical Foundation, which employs over 70 surgeons on the hospital's medical and dental staff, and Lurie Children's Pediatric Anesthesiologist Associates, which employs all of the anesthesiologists on the medical and dental staff—currently 34 physicians in total. The full employment of these physicians allows for tighter clinical and financial alignment, and supports future physician recruitment.

Lurie Children's relationship with Northwestern University (where almost all of the employed physicians are on the pediatric faculty at the Feinberg School of Medicine) and growing affiliation strategy with general acute care hospitals continue to enhance and broaden its research position as well as its position as an academic medical center with access points in the broader service area. The main hospital facility in Chicago consists entirely of private rooms that are now more than 60% intensive care beds, reflecting the complexity of services it provides.

Management and the board are taking actions to best position the organization for potential state Medicaid changes as well as for potential insurance-driven changes to hospital payments. To that end, Lurie Children's operates a clinically integrated network that is working with its care coordination entity along with independent physician groups in the area. With its breadth and depth of services as well as its incorporation of some risk-based contracts, management believes that it is taking the appropriate steps to gain experience and succeed under a reimbursement methodology that is likely to evolve toward payments based on quality care at lower costs. We view this as important given the competitive market where other providers are making inroads into pediatric care.

Management

Most of Lurie Children's senior management team has been stable during the past several years. We view the overall management team and governance as capable with a strong track record in challenging times (including weathering the changing economic environment as Lurie Children's began building its replacement hospital several years ago). In addition, management has surpassed or met its budget for the past 22 years, which we also view as representative of good planning and good management of risk. Management also has a history of surpassing many of its long-range financial goals. In addition to research and fundraising, management has focused on growing the larger network and is working to ensure appropriate capacity at the main hospital. Management continues its focus on positioning the organization for a potentially lower reimbursement environment and in managing some risk for its different patient populations, as that shift is likely to come about over the next several years from payers and the state through the managed Medicaid program. We also view this as an important area of focus given the competition in the market and if, over time, competitors are able to show they can manage certain pediatric care at lower costs. Finally, we believe that management and the board have done an excellent job of advocating for the organization both in the state and nationally, and we view this ongoing focus as important in maintaining reimbursement levels for the hospital.

Table 1

Ann & Robert H. Lurie Children's Hospital, Illinois Enterprise Statistics				
	--Three months ended Nov. 30--	--Fiscal year ended Aug. 31--		
	2018	2018	2017	2016
PSA population	N.A.	1,000,000	1,000,000	1,000,000
PSA market share (%)	N.A.	28.8	29.1	28.1
Inpatient admissions	2,584	11,282	11,990	12,428

Table 1

Ann & Robert H. Lurie Children's Hospital, Illinois Enterprise Statistics (cont.)

	--Three months ended Nov. 30--	--Fiscal year ended Aug. 31--		
	2018	2018	2017	2016
Equivalent inpatient admissions	4,240	18,852	19,748	20,381
Emergency visits	14,957	63,675	62,931	62,228
Inpatient surgeries	1,135	4,779	4,815	5,046
Outpatient surgeries	3,791	15,869	14,840	14,129
Medicare case mix index	N.A.	N.A.	N.A.	1.6000
FTE employees	5,245	4,881	4,480	4,480
Active physicians	1,385	1,359	1,336	1,295
Based on net/gross revenues	Net	Net	Net	Net
Medicare (%)	0.4	0.5	0.3	0.3
Medicaid (%)	32.8	31.3	31.2	30.3
Commercial/Blues (%)	61.9	64.2	64.6	65.5

N.A.—Not available. Inpatient admissions exclude normal newborn, psychiatric, rehabilitation, and long-term care facility admissions.

Financial Profile: Very Strong

Financial performance

Lurie Children's continues to perform at a solid level and finished fiscal 2018 (fiscal year end Aug. 31, 2018) ahead of budget, with a slight improvement on operating performance from fiscal 2017. Lurie Children's continues to focus on expense management, and achieved an estimated \$8.2 million in savings in 2018, part of a multiyear campaign that has, to date, achieved over \$100 million in sustainable savings across the organization. In addition, continued growth of services in the outpatient and clinic areas has helped strengthen demand for the higher-end care. While inpatient volumes were down somewhat in fiscal 2018, this was mitigated by provision of higher-acuity services.

Lurie Children's continues to benefit from provider fee payments from the state with approximately \$43.7 million received in fiscal 2018. A redesigned program was approved on July 1, 2018, although we understand further changes are possible over the next year. We believe this program is critical for Lurie Children's. Cuts or even elimination of certain programs linked to the federal government including S-CHIP (a state and federal program to expand insurance to certain qualifying children) and 340b could also affect Lurie Children's financial results, but decreases have also been factored into the budget and into forecasts for planning for these types of risks.

Management is projecting softer operating margins for Lurie Children's in fiscal 2019 and fiscal 2020. Fiscal 2019 is the first year the hospital will bear the operating expenses associated with its two newly employed physician groups, which will add about \$20 million annually to the operating expense base. However, much of the expense associated with these two groups previously flowed through nonoperating expenses, so the total budgeted impact on cash flow is only about \$4 million. Management is also projecting softer operating margins in 2020, reflecting Lurie Children's new hematology-oncology beds that will come online. The softer projected margins in 2020 reflect the additional fixed costs of operating the new beds as volumes ramp up to full productivity. While we recognize these investments may create some expense pressure over the next few years, we expect operating margins and overall cash flow to remain

broadly in line with rating expectations, especially given Lurie Children's excellent history of successful strategic execution.

Liquidity and financial flexibility

Lurie Children's capital spending has increased over the last few years following the lighter years of spending after the hospital opening. We expect capital spending to be higher through fiscal 2019 as the hospital continues its capacity buildout and completes work on the new research facility. These projects, along with the new ambulatory center in Northbrook (\$17.8 million total cost) have been primarily funded from cash flow. The capital budget for fiscal 2019 is \$153.7 million.

Through the first quarter of fiscal 2019 (ended Nov. 30, 2018), Lurie Children's unrestricted reserves have declined somewhat from prior peaks. While capital spending has put some pressure on the balance sheet, the decline is also due in part to weak investment markets in the last quarter of 2018. Lurie Children's has also experienced an increase in its Medicaid accounts receivable, with over \$110 million outstanding as of Nov. 30, 2018, including more than \$75 million outstanding for over 90 days. We understand that the state of Illinois is behind in its Medicaid payments to all providers, and Lurie Children's is more heavily affected given its high concentration of Medicaid payors. Management reports that this continues to be an issue, with over \$130 million in Medicaid accounts receivable outstanding as of Jan. 31, 2019.

Lurie Children's has had a strong history of successful fundraising, and this continues into fiscal 2018 with its new "Campaign for Every Child"--a comprehensive campaign with a focus on advancing Lurie Children's research agenda. The campaign has a goal of raising \$500 million by 2023.

Debt profile

Overall, Lurie Children's debt levels are decreasing incrementally as debt amortizes, albeit with a more modest principal amortization schedule through the next several years, and unrestricted net assets continue to grow. We also view the structure as conservative, with no debt-related contingent liquidity risks (including no direct placement debt and no swaps) and no large bullets or tenders. Lurie Children's has a frozen defined benefit cash balance pension plan, and funding improved to 97.6% at fiscal year-end 2018 due to investment results and an improving discount rate. We also believe that as the defined benefit plan is frozen, the plan should continue to gradually yield additional expense savings.

While management has outlined some possible additional capital spending during the next few years beyond the projects described above, Lurie Children's anticipates no additional new-money debt over the two-year outlook period to fund those plans.

Table 2

Ann & Robert H. Lurie Children's Hospital, Illinois Financial Statistics					
	--Three months ended Nov. 30--	--Fiscal year ended Aug. 31--			Medians for 'AA-' rated stand-alone hospital
	2018	2018	2017	2016	2017
Financial performance					
Net patient revenue (\$000s)	254,117	953,206	867,181	793,934	752,834

Table 2

Ann & Robert H. Lurie Children's Hospital, Illinois Financial Statistics (cont.)

	--Three months ended Nov. 30--	--Fiscal year ended Aug. 31--			Medians for 'AA-' rated stand-alone hospital
	2018	2018	2017	2016	2017
Total operating revenue (\$000s)	286,801	1,083,203	986,794	911,233	MNR
Total operating expenses (\$000s)	272,537	1,029,945	947,584	872,093	MNR
Operating income (\$000s)	14,264	53,258	39,210	39,140	MNR
Operating margin (%)	4.97	4.92	3.97	4.30	3.40
Net nonoperating income (\$000s)	12,480	45,723	69,212	39,220	MNR
Excess income (\$000s)	26,744	98,981	108,422	78,360	MNR
Excess margin (%)	8.94	8.77	10.27	8.24	7.20
Operating EBIDA margin (%)	12.57	12.80	13.15	14.21	9.70
EBIDA margin (%)	16.22	16.33	18.85	17.75	13.30
Net available for debt service (\$000s)	48,540	184,348	199,023	168,665	106,063
Maximum annual debt service (\$000s)	23,752	23,752	23,752	23,752	MNR
Maximum annual debt service coverage (x)	8.17	7.76	8.38	7.10	6.20
Operating lease-adjusted coverage (x)	5.27	4.68	5.64	5.00	4.70
Liquidity and financial flexibility					
Unrestricted reserves (\$000s)	843,838	950,063	901,153	786,157	743,676
Unrestricted days' cash on hand	302.1	360.2	374.3	356.9	349.00
Unrestricted reserves/total long-term debt (%)	233.1	262.3	255.3	219.9	277.50
Unrestricted reserves/contingent liabilities (%)	N/A	N/A	N/A	N/A	647.40
Average age of plant (years)	7.6	8.2	7.0	6.1	10.30
Capital expenditures/depreciation and amortization (%)	233.9	237.0	145.8	75.6	178.20
Debt and liabilities					
Total long-term debt (\$000s)	362,028	362,206	352,933	357,449	MNR
Long-term debt/capitalization (%)	18.8	18.6	19.3	21.1	19.50
Contingent liabilities (\$000s)	N/A	N/A	N/A	N/A	MNR
Contingent liabilities/total long-term debt (%)	N/A	N/A	N/A	N/A	42.10
Debt burden (%)	1.98	2.10	2.25	2.50	2.10
Defined-benefit plan funded status (%)	N.A.	97.57	94.23	82.66	84.70

N/A--Not applicable. N.A.--Not available. MNR--Median not reported.

Credit Snapshot

- **Credit profile:** Lurie Children's is a 336-bed children's hospital located in downtown Chicago. The obligated group consists of Lurie Children's and the Ann & Robert H. Lurie Children's Hospital of Chicago Foundation (the foundation). Entities outside of the obligated group include Stanley Manne Children's Research Institute (renamed from Ann & Robert H. Lurie Children's Hospital of Chicago Research Center as a result of a philanthropic commitment); Pediatric Faculty Foundation Inc., an employed medical group of mostly pediatric and pediatric subspecialty physicians; Lurie Children's Medical Group LLC (formerly Children's Memorial Medical Group), an employed group of physicians for dentistry, pathology, psychiatry, and medical imaging; Lurie Children's Primary Care LLC, an organization that employs community primary care physicians in three locations; Lurie Children's Surgical Foundation, which employs over 70 surgeons; Lurie Children's Pediatric Anesthesiologist Associates, which employs 34 anesthesiologists on the medical/dental staff; Almost Home Kids, an entity that provides transitional and respite care for children with medical complexity outside of the acute care setting; Children's Hospital of Chicago Medical Center (parent); Lurie Children's Health Partners Care Coordination, an organization to coordinate and provide health care for medically complex children; and CMMC Insurance Co. Ltd., an offshore insurance captive.
- **Security pledge:** The bonds are secured by gross receipts of the obligated group
- **Group rating methodology:** Core

Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw or suspend such acknowledgment at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.