Evangelical Lutheran Good Samaritan Society, South Dakota

Revenue Bonds

New Issue Report

Ratings

New Issue

$205,605,000 Colorado Health Facilities Authority Health Facility Revenue and Revenue Refunding Bonds, Series 2015	A–

Outstanding Debt

$63,675,000 Colorado Health Facilities Authority Health Facility Revenue Bonds, Series 2013	NR
$168,250,000 Colorado Health Facilities Authority Health Facility Revenue Bonds, Series 2012	NR
$55,750,000 Fixed-Rate Direct Placement Bonds, Series 2011	NR
$23,830,000 Colorado Health Facilities Authority Variable-Rate Demand Bonds, Series 2007	NR
$85,445,000 Colorado Health Facilities Authority Health Facility Revenue Bonds, Series 2006[a]	NR
$55,195,000 Colorado Health Facilities Authority Health Facility Revenue Bonds, Series 2005[a]	NR
$24,000,000 Colorado Health Facilities Authority Health Facility Revenue Bonds, Series 2004A[a]	NR
$13,520,000 Minnesota Agricultural and Economic Development Board Variable-Rate Demand Revenue Bonds, Series 1996	NR
$1,800,000 Oregon Facilities Authority Variable-Rate Demand Bonds, Series 1995A	NR

[a]To be refunded (in whole or part) with 2015 debt issuance. NR – Not rated.

Rating Outlook

Stable

Related Research

Fitch Rates Evangelical Lutheran Good Samaritan Society Series 2015 Revs at 'A–'; Outlook Stable (June 2015)

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New Issue Details

Sale Information: $205,605,000 Colorado Health Facilities Authority Health Facility Revenue and Revenue Refunding Bonds, Series 2015, sold the week of July 6 via negotiation.

Security: A pledge of gross revenues of the obligated group (OG) and a debt service reserve fund.

Purpose: To fund and reimburse for various capital expenditures, to refund the outstanding series 2004A bonds, to partially refund the series 2005 and series 2006 bonds, to fund a debt service reserve and to pay costs of issuance.

Final Maturity: Dec. 1, 2026.

Key Rating Drivers

Scale and Geographic Diversity: The 'A–' rating reflects the Evangelical Lutheran Good Samaritan Society's (ELGSS) large revenue base and wide geographic diversity, which serve to moderate the corporation's overall operating volatility and reimbursement risk related to Medicaid payors. Further, Fitch Ratings views positively the strategic direction implemented by management and the board. Initiatives to improve operating efficiencies and drive strategic growth are gaining traction and will strengthen operating performance and further diversify ELGSS' revenue base.

Manageable Debt Burden: With the series 2015 issuance, ELGSS is expected to maintain coverage of maximum annual debt service (MADS) at or above 2.5x, which is commensurate with the 'A' rating category. Revenue-only coverage has averaged a solid 2.4x since 2011, well ahead of Fitch's 1.2x 'A' rating category median, and has since improved to 3.2x coverage in the three-month interim period ended March 31, 2015. ELGSS' capital structure is very conservative, with a 97% fixed rate and 86% committed pro forma structure, and no swaps.

Improving Profitability: As a result of successful strategic efforts, ELGSS has produced improved operating profitability through the three-month interim period that Fitch believes will be sustained through 2015. ELGSS produced an 8.2% net operating margin (NOM) through the interim period, an improvement over NOM of 7.0% and 7.8% in 2014 and 2013, respectively, reflecting successful expense controls and the substantial completion of a systemwide IT system (which suppressed results in 2014 and 2013).

Rating Sensitivities

Steady Profitability: The rating will require ELGSS to maintain its NOM in line with 'A' rating category median levels, which should support sufficient levels of debt service coverage near 2.5x, and 2.0x by revenue only. Negative rating pressure is possible should ELGSS not sustain improvements needed to preserve liquidity and support its capital plans, which are sizable (near $110 million annually). Upward movement in the rating would reflect continued improvement in operating profitability resulting in stronger coverage and meaningful liquidity growth.

Rating History

Rating	Action	Outlook/ Watch	Date
A–	Assigned	Stable	6/9/15

Related Criteria

Revenue-Supported Rating Criteria (June 2014)

Not-for-Profit Continuing Care Retirement Communities Rating Criteria (July 2014)

Credit Profile

ELGSS is currently the largest not-for-profit provider of senior care services in the U.S. Concentrated in the upper Midwest, it operates approximately 217 centers across 24 states, serving approximately 27,000 residents and employing approximately 19,000 staff. Its centers include 165 skilled nursing facilities (SNFs), 35 affordable housing projects and 17 housing facilities that are either leased or managed (not owned) by ELGSS. The system offers Type C contracts, with no life care (Type A). Total reported consolidated revenue was $982.3 million in fiscal 2014 (year ended Dec. 31).

Fitch's analysis reflects the OG. The OG includes the operations of its owned continuing care communities, home care, hospice and the foundation. It excludes the Department of Housing and Urban Development (HUD) and tax credit senior housing communities. As of Dec. 31, 2014, the net operating revenue of the OG constituted approximately 99.2% of the consolidated system net operating revenue, and the OG's assets constituted approximately 92.8% of the system's total consolidated assets.

Governance and Management

Fitch met with management during a site visit in May 2015 and found them to be well versed in healthcare experience and poised to manage an evolving senior care operating environment. ELGSS is currently led by David Horazdovsky, who has led since 2003 after joining ELGSS in 1978. Current CFO Grant Tribble, who joined in December 2014, was previously president of operations and COO at Athens Regional Health System, and was its CFO prior to that.

Further, ELGSS has added several new positions in its efforts to focus on strategic positioning and improvement, including a chief administrative officer, a vice president of operations for rehab-skilled and senior living, a vice president of operations for home and community-based services, a vice president of affordable housing, a chief medical officer, a director of mergers, acquisitions and divestitures, a director of government relations, a director of strategy and project management and a director of national campus services.

Fitch believes the board is efficiently structured and appropriately diverse, with a structure that is consistent with best practices. The board of directors is elected from the ELGSS membership of approximately 342 members, including members of the board who are also church members, staff who are also church members, and other active members. Members elect 15 board members, including six facility administrators and nine who are not employees of ELGSS. Two members must be approved by the Lutheran Church-Missouri Synod. Directors are limited to two consecutive three-year terms, with five elected each year.

Strategic Direction

Overall, ELGSS is working to diversify its revenue and reduce its exposure to skilled nursing and to Medicaid revenues. As such, the total number of system SNF beds has decreased by approximately 26% since 2000, while the number of residential units increased by 45%. In addition, it has begun working with acute care providers across its network to grow its post-acute care census, including by evaluating participation in accountable care organizations across its markets. ELGSS is also growing its home health and other community-based services, and now participates in a home health bundled payment pilot with the Centers for Medicare and Medicaid Services (CMS).

Leadership has also implemented a systemwide expense reduction initiative, focused on reducing overtime, centralizing services like food and supplies and improving productivity, with an overall target of $20 million in savings for 2015 and nearly $16 million in 2016. Of note, management has also indicated a willingness to divest underperforming assets, having divested 17 locations in the past five years for a combined net loss of $4 million. In 2014 ELGSS's 30 lowest performing locations had a combined operating loss of negative $14.3 million (this includes six start-up campuses with a combined loss of $3.6 million), while its top 30 locations had a positive operating margin of $18.5 million.

Operating Profile

Residency Contract

Overall, Fitch views the residency contracts offered as standard for a Type C, and views favorably the requirement of re-occupancy prior to refunding an entrance fee. None of ELGSS' facilities has a life care contract, and therefore it does not guarantee lifetime care for a one-time entrance or endowment fee. The amortizable portion of all entrance fees is amortized to income over the actuarially determined life expectancy of each individual resident at the time of move in. If the resident chooses to move out, the contractually required portion of the entrance fee is paid to the resident moving out after re-leasing the unit.

Service Areas and Competition

Fitch views ELGSS' revenue size and wide geographic diversity, which help to mitigate the risks of high exposure to Medicaid reimbursement and modest historical operating profitability, to be key credit factors supporting the 'A–' rating. There are no other organizations with the geographic reach or economies of scale that ELGSS maintains. While certain markets do face competition from other not-for-profit providers, ELGSS' position as a religious-affiliated and high-quality provider, as well as its reach into other post-acute services, is expected to continue to support its market position and demand.

Of the 168 owned locations, 33 are in Minnesota, 22 are in Nebraska, 21 are in South Dakota and 19 are in Iowa. Management noted that it maintains a leading market position within its largest and most profitable markets, namely Minnesota, Colorado, Nebraska, Iowa and South Dakota. No state accounts for more than 17% of revenue, or more than 22% of cash flows.

Facilities and Capital Plans

The capital budgeting process has evolved in the past few years, with leadership identifying facilities with stronger operating performance and growth potential as targets for capital spending. Capital expenditure requests above $500,000 are evaluated for their potential contribution to the system (using a rate of return calculation), and are defined in conjunction with system operating cash flow levels.

Capital spending is budgeted to be level near $110 million annually through 2017, but will depend on making EBITDA targets. Management maintains its capital spend in line with key targets for operating performance, and has a history of underspending if necessary or if flexibility allows. The 2015 capital budget includes $22 million for new facilities, with the remainder for renovations/additions for existing facilities. ELGSS' average age of plant is somewhat elevated, although Fitch notes this is concentrated in rural facilities: 45 locations in towns with populations smaller than 10,000 have an average age of plant of 19 years.

ELGSS is also developing its use of technology. It moved to implement a centralized electronic medical record (EMR) and IT system platform in 2013, completing that process in March 2015. Now, the system has centralized and consolidated accounting, billing and purchasing functions, and ELGSS is partnering with Mayo Clinic and IBM to leverage its health data and improve functionality.

Operational Effectiveness

Occupancy

Overall, occupancy has been relatively steady, although it declined 1.1% (across all units) in 2014 due in part to population declines in rural areas, reductions in admissions in acute care and more acute care discharges to home health or other community-based services. While ELGSS is focusing heavily on obtaining affiliation agreements and reducing rehospitalizations to make it an attractive partner, it is likely that SNF occupancy will remain pressured. Fitch notes that occupancy in residential living was very steady at 85% in 2014, and that the number of clients and visits in home and community-based services has grown significantly since 2010, by 68% and 30%, respectively.

Occupancy

(Audited Years Ended Dec. 31)

	2011	2012	2013	2014	Three Mos. Ended 3/31/15[a]
Independent Living					
ILU Available Units	7,128	7,360	7,347	7,300	7,283
Occupancy (%)	84.5	82.9	84.0	85.0	85.9
Skilled Nursing					
SNF Available Beds	11,745	11,308	11,137	10,754	10,708
Occupancy (%)	86.2	86.3	78.3	78.0	77.3

[a]Unaudited. ILU – Independent living unit. SNF – Skilled nursing facility.
Source: Evangelical Lutheran Good Samaritan Society and Fitch.

Payor Mix

A relatively high exposure to Medicaid presents some credit concern. Approximately 37.5% of 2014 net revenues was derived from Medicaid, making ELGSS susceptible to reimbursement pressure as well as limiting its ability to grow via rate increases. Still, Fitch notes that ELGSS has successfully shifted significantly away from Medicaid and toward private and Medicare since 2000, and will continue efforts to maintain that trend via targeted service expansion and contraction. Further, ELGSS' broad revenue base and geographic reach mute its exposure to any one Medicaid program or payor arrangement.

It is likely that ongoing demographic shifts in the largely rural markets ELGSS services will pressure the level of SNF private pay residents, limiting the system's ability to increase

Skilled Nursing Payor Mix

(%, Audited Years Ended Dec. 31)

	2011	2012	2013	2014	Three Mos. Ended 3/31/15[a]
Medicare	20	18.9	19.5	19.1	20.7
Medicaid	41.6	39.2	37.7	37.5	35.5
Private	38.4	41.9	42.8	43.4	43.8
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

[a]Unaudited.
Source: Evangelical Lutheran Good Samaritan Society and Fitch.

revenues by raising rates. Thus, ELGSS' efforts to expand home and community-based services as well as increase residential units (both largely private pay) will be key.

Regulatory Environment

Medicare reimbursement for skilled nursing services is likely to remain flat, and could be pressured as an indirect result of ongoing efforts to reimburse on quality and cost versus volume/census under the Patient Protection and Affordable Care Act. Still, only eight of the 24 states in which ELGSS operates are not expanding Medicaid. Of those eight, only South Dakota generates a meaningful amount of revenue to the system, at 9% in 2014. ELGSS notes that in several states, such as New Mexico, managed Medicaid reimbursement is fairly favorable.

New Issue Debt Details

The $205.6 million in series 2015 bonds will be issued under and pursuant to the terms of the Second Amended and Restated Master Trust Indenture, dated as of Oct. 1, 2013, as supplemented and amended from time to time, including by the Thirty-Fourth Supplement to the Master Trust Indenture, dated as of June 1, 2015. The bonds will be payable via a loan agreement dated June 1, 2015, secured by the gross revenues of the OG. The series 2015 bonds will not be secured by a mortgage. As of Dec. 31, 2014, ELGSS had outstanding mortgages on seven facilities to secure eight debt instruments totaling approximately $1.8 million in aggregate principal amount outstanding. Members of the OG have covenanted not to create any new mortgages on OG property.

The series 2015 bonds are expected to be issued as fixed-rate term bonds, subject to optional redemption. Approximately $78 million in outstanding debt is expected to be refinanced with bond proceeds, including a portion of an $80.9 million line of credit draw. Debt service is level, with MADS estimated at $37.1 million (previously $33.5 million). Debt service is level through maturity.

As of 2014 the OG had approximately $581 million in long-term debt, including current maturities. As of March 31, 2015 the OG had approximately $598 million in long-term debt, which includes the $80.9 million line of credit. Fitch notes that the line of credit is renewed and repaid annually, a practice that is likely to continue. The debt mix is conservative at 87% fixed, and will remain so with approximately 93% fixed.

ELGSS also has approximately $41.3 million in variable-rate demand bonds, which are secured by letters of credit (LOCs) with US Bank. The next line of credit expiration is Nov. 27, 2018. Upon a draw, the LOC will convert to a term loan at bank rate, with quarterly payments over 36 months following a 366-day grace period. This term loan may be prepaid. Fitch notes that ELGSS has no swaps.

Legal Review

Key covenants include:

- Rate covenant: 115% of MADS, tested annually. Consultant call-in, no event of default unless below 100% (even if below 115% for consecutive tests).
- Liquidity covenant: 90 days cash on hand (DCOH), tested semiannually with consultant call-in. Not an event of default unless below 75 DCOH.
- Additional debt: Limited to a debt-to-capitalization ratio below 60%, or pro forma coverage of at least 125%.

- Limitations on OG entry/exit.
- Limitations on sale, lease or disposition of assets: No more than 7.5% of aggregate unrestricted liquidity and no more than 5% unless MADS coverage is above 115%.
- Event of default: Failure to perform financial covenant, with 30-day grace period that can be extended so long as action is taken within that 30 days. Requires request from 50% (not the standard 25%) of bondholders to pursue remedy.
- Remedy: Acceleration, with cross-default on all parity debt.

The US Bank direct placement debt does not have additional covenants. However, the four LOCs have an additional rating covenant threshold of 'BBB–', which is a termination event.

Financial Profile

Financial Reporting

ELGSS will covenant to provide audited financial statements within 150 days of fiscal year end and quarterly financial statements within 60 days of each quarter end for both the OG and consolidated system to the municipal securities rulemaking board's EMMA system. Failure to disclose is not an event of default.

Liquidity and Treasury

ELGSS maintains relatively moderate targets of 34% fixed income, 25% cash and 41% equities. Systematic rebalancing occurs quarterly, and board review occurs no less than annually. ELGSS has a defined contribution pension plan for substantially all its employees, so there is no ERISA funding level credit concern. It pays 3.25% of salaries into the plan, with an additional 3.75% of salaries for managerial employees.

While light for the 'A' rating category, ELGSS' liquidity metrics are consistent with those of Fitch's system median levels, and have consistently improved over time. As of March 31, 2015, ELGSS had $426.9 million in unrestricted cash and investments, equal to 172.7 DCOH and 11.5x pro forma cushion ratio, versus Fitch's CCRC system medians of 331.4 DCOH and 6.7x cushion ratio. ELGSS had approximately 17.0x cash to putable debt at March 31, 2015.

Pro forma, ELGSS will maintain a sufficient 11.5x cushion ratio, and liquidity is expected to remain consistent with revenue/expense growth, with DCOH between 160 and 175 through 2017.

Operating Profitability

2014 was hampered by some operating challenges, namely softer occupancy and some significant EMR expenses related to training and implementation (administrative expenses increased 4.2%). This has rolled off in 2015, as evidenced by stronger profitability and ongoing growth in targeted areas, such as home health (revenue increased 82% since 2011).

Capital Related

ELGSS' pro forma debt burden remains manageable, with only minimal increase in par and debt service requirements, the elimination of putable debt and modest extension in average life. Capital needs could require additional debt should they remain as budgeted, although management has indicated a likelihood of flexing outlays to minimize the impact on the system financial profile, as well as focusing capital on projects with solid return on investment. No additional debt plans were disclosed to Fitch.

Financial Summary

($000, Audited Years Ended Dec. 31)

	2011	2012	2013	2014	Three Mos. Ended 3/31/15[a]
Balance Sheet Data					
Unrestricted Cash and Investments	377,198	412,245	441,745	432,234	426,865
Restricted Cash and Investments	1,410	6,622	10,498	3,161	0
Trustee-Held Cash and Investments	37,024	94,983	98,172	40,960	43,728
Net Accounts Receivable	75,904	86,977	84,286	83,465	77,667
Property, Plant and Equipment, Net	860,436	901,207	920,854	944,471	956,870
Total Assets	1,471,974	1,577,631	1,646,854	1,596,216	1,639,451
Current Liabilities	187,466	149,104	225,522	157,868	199,658
Total Debt (Including Current Portion)	481,304	589,363	621,562	580,839	597,555
Deferred Revenue from Nonrefundable Entrance Fees	16,108	16,914	17,621	17,775	18,206
Refundable Entrance Fees	71,154	75,761	80,993	87,297	93,737
Unrestricted Net Assets	686,121	715,014	717,998	714,322	775,054
Income Statement Data					
Resident Service Revenue	910,784	914,473	920,149	929,270	232,781
Amortization of Advance Fees	3,564	3,564	3,491	3,278	835
Interest and Dividends	9,074	7,487	7,360	6,543	3,980
Net Assets Released from Restrictions for Operations	3,594	5,796	4,885	3,077	823
Other Operating Revenue	27,017	32,436	34,979	41,729	6,794
Total Operating Revenue	954,033	963,756	970,864	983,897	245,213
Salaries, Wages, Fees and Benefits	845,256	862,458	881,002	903,250	220,002
Depreciation and Amortization	61,340	64,207	65,926	66,809	16,683
Interest Expense	19,343	20,978	20,263	21,762	5,569
Total Expenses	925,939	947,643	967,191	991,821	242,254
Operating Income	28,094	16,113	3,673	(7,924)	2,959
Realized Gains on Investments	16,051	7,778	13,146	4,559	3,943
Other Non-Operating Revenue	(6,768)	(11,630)	(18,706)	(10,858)	856
Total Non-Operating Revenue	16,054	7,778	13,154	(6,299)	4,799
Excess Income	44,148	23,891	16,827	(14,223)	7,758
Net Operating Income	92,545	84,451	74,126	67,749	19,573
Adjusted Net Operating Income	96,805	95,783	82,765	77,387	23,168
Unrealized Gains/(Losses) on Investments	(11,746)	16,098	7,888	13,306	2,028
Pro Forma Maximum Annual Debt Service (MADS)	36,987	36,987	36,987	36,987	36,987
Actual Annual Debt Service (AADS)	34,829	34,867	31,249	32,537	N.A.
Cash Flow Data					
Entrance Fees Received – Turnover Units	15,255	20,390	18,577	21,086	6,046
Entrance Fees Refunded	10,995	9,058	9,938	11,448	2,451
Net Entrance Fees Received – Turnover Units	4,260	11,332	8,639	9,638	3,595
CCRC Net Available	125,527	116,844	108,164	80,708	32,770
CCRC Net Available – Revenue Only	121,267	105,512	99,525	71,070	29,175
Net Capital Expenditures	90,550	77,225	102,448	102,715	20,700

[a]Unaudited. N.A. – Not available. CCRC – Continuing care retirement community. Note: Fitch may have reclassified certain financial statement items for analytical purposes. Numbers may not add due to rounding.
Source: Evangelical Lutheran Good Samaritan Society and Fitch.

Financial Ratios

($000, Audited Years Ended Dec. 31)

	2011	2012	2013	2014	Three Mos. Ended 3/31/15[a]
Liquidity Ratios					
Days Cash on Hand	159.2	170.3	178.9	170.6	172.7
Cash/Debt (%)	78.4	70.0	71.1	74.4	71.4
Cushion Ratio (x)	10.2	11.2	11.9	11.7	11.5
Profitability and Operational Ratios (%)					
Operating Ratio	91.0	92.0	93.2	94.3	92.3
Operating Margin	2.9	1.7	0.4	(0.8)	1.2
Net Operating Margin	9.9	8.9	7.8	7.0	8.2
Net Operating Margin – Adjusted	10.3	10.0	8.6	7.9	9.5
Excess Margin	4.6	2.5	1.7	(1.5)	3.1
Capital-Related Ratios					
MADS Coverage (x)	3.4	3.2	2.9	2.2	3.5
MADS Coverage – Revenue Only (x)	3.3	2.9	2.7	1.9	3.2
AADS Coverage (x)	3.6	3.4	3.5	2.5	N.A.
MADS/Revenue (%)	3.8	3.8	3.8	3.8	3.7
Capital Expenditures/Depreciation (%)	149.3	120.4	157.0	159.1	124.1
Debt/Net Available (x)	3.8	5.0	5.8	7.2	4.6
Adjusted Debt/Capitalization (%)	40.7	44.6	45.8	44.2	43.0
Average Age of Plant (Years)	14.1	14.1	14.2	14.6	14.8

[a]Unaudited. N.A. – Not available. Note: Fitch may have reclassified certain financial statement items for analytical purposes.
Source: Evangelical Lutheran Good Samaritan Society and Fitch.

Stable Outlook

ELGSS is expected to further focus on diversifying its revenue mix by expanding its home and community-based health services, while also divesting some underperforming facilities and rigorously implementing expense reduction and efficiency initiatives Fitch believes ELGSS has significant opportunity to further benefit from its size and scale, having only recently begun to centralize administrative functions and services and implementing a systemwide IT and health record infrastructure.