FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Episcopal Communities & Services, CA at 'A-'; Stable Outlook

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Fitch Ratings - San Francisco - 17 Dec 2024: Fitch Ratings has affirmed the 'A-' rating on series 2024A&B bonds issued by the California Health Facilities Financing Authority on behalf of Episcopal Communities & Services (ECS). Additionally, Fitch has affirmed ECS's Issuer Default Rating (IDR) at 'A-'.

The Rating Outlook is Stable.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Episcopal Communities & Services (CA)	LT IDR	A- Rating Outlook Stable	Affirmed	A- Rating Outlook Stable
Episcopal Communities & Services (CA) /General Revenues/1 LT	LT	A- Rating Outlook Stable	Affirmed	A- Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

The 'A-' rating affirmation reflects ECS's strong financial profile, inclusive of the organization's large debt issuance from earlier in 2024. ECS is expected to return to sound unrestricted cash to debt levels (after entrance fee bonds are repaid in 2026), and capital-related metrics, as evidenced by Fitch's scenario analysis. Additional positive credit factors include the ECS's strong market position with good and improving demand indicators in each of its markets.

As of audited FYE24 (June 30 FYE), ECS had unrestricted cash-to-adjusted debt of approximately 73% (pre-temporary entrance fee debt paydown) and 2.8x debt service coverage, which incorporates ECS's series 2024A&B debt issued. Operating performance improved in 2024, in part driven by enhanced occupancy across all levels of care, which led to an increase to unrestricted balance sheet reserves (along with good investment returns). Fitch notes that ECS is outperforming its initial financial projections, which anticipated cash to adjusted debt would fall to around 53% following 2024 debt issuance.

The 'A-' rating also considers ECS's midrange operating risk assessment that reflects adequate cost management practices as the organization has faced multiple historical performance headwinds originally stemming from the pandemic and then post-pandemic heightened inflationary-related expenses.

SECURITY

The bonds are secured by a gross revenue pledge of ECS's obligated group.

KEY RATING DRIVERS

Revenue Defensibility - a

Multi-site Communities Located in Strong Markets; Improving Demand

ECS's strong revenue defensibility reflects good and improving ILU occupancy rates with strong market positions poised to lead to further demand growth over the medium term. The organization's three communities are located in strong markets (Los Angeles and Orange counties) with pricing characteristics that are affordable relative to wealth and income levels. Fitch views ECS's overall market position as a primary credit strength.

In 2024, ECS's average ILU occupancy rate improved to a solid 91.8%, up from 90.8% in 2023, and exceeded 94% by fiscal year-end. This demonstrates the occupancy gains management anticipated to boost operations as the organization continues recovering from pandemic-related challenges.

Assisted living (AL) and memory care occupancies also improved in 2024 to approximately 78% and 93%, respectively. This is up from 75.5% and 67%, and has contributed to margin growth. Going forward, management continues to budget for enhanced occupancy across all levels of care that, which support further improved performance.

ECS's three communities in the obligated group include MonteCedro in Altadena, The Canterbury in Palos Verdes and The Covington in Aliso Viejo. Although there are other LPCs nearby, ECS does not compete with them directly as they offer different contract types and price points.

Operating Risk - bbb

Improved Operating Performance

The midrange operating risk assessment reflects ECS's adequate cost management over the past several years, satisfactory capital metrics and good plant investment. Pandemic-related disruptions historically affected operations, but recovery has begun and is expected to continue over the medium term. ECS has largely adjusted to and incorporated post-pandemic expense inflationary pressures, and robust occupancy growth is improving operating performance.

Over the past three fiscal years, ECS's net operating margin adjusted (NOMA) averaged approximately 13.2%. In fiscal 2024, ECS's NOMA was 14.9% and operating ratio was 100.3%, both metrics improved from the prior year. Fitch expects ECS's operating performance to keep improving due to strong demand reflected in higher occupancy and easing inflationary expense pressures.

Capital spending has averaged approximately 107% of depreciation over the past four years, peaking in fiscal 2024 with project construction. Capex, including ILU expansion, is expected to total around $140 million over the next 36 months, funded by debt, equity and operating cash flow. After project completion, Fitch expects capex to taper and no additional debt plans over the medium term. With the 2024 debt issuance, ECS is at its debt capacity for the 'A-' rating.

Financial Profile - a

Improving Financial Profile, Including in a Stress Case

Fitch's strong financial profile assessment reflects ECS's satisfactory, but quickly improving unrestricted balance sheet resources, despite the organization's large 2024 debt incurrence. At FYE24, cash to adjusted debt fell to 73% after issuing approximately $105.5 million of additional debt, while debt service coverage remained adequate at 2.8x. Fitch's initially expected cash to adjusted debt to fall to approximately 53% before recovery, but ECS is outpacing its projected performance goals, which Fitch views favorably.

Fitch's forward-looking base case scenario analysis continues to support the expectation that ECS will be able to maintain leverage metrics in line with the 'A-' rating level over the next several years with cash to adjusted debt and pro forma MADS coverage estimated to be north of 120% and 2.5x, respectively, once the temporary debt is repaid with initial entrance fees.

Management intends to pay off the series 2024A bonds with entrance fees collected as new ILUs are occupied in 2026. Management notes that fill-up is not intended to take place until 2026, and 100% new ILUs (40/40) already have deposits placed. In some cases, prospective residents have already made significant unit upgrade plans, which gives Fitch confidence that ECS will experience strong new unit move-ins and generate sufficient entrance fees to repay the temporary debt.

Even under a stress scenario, which includes the debt issuance from earlier in 2024, Fitch's stress case supports a financial profile that would recover and stabilize over the next few years with leverage metrics that continue to support an 'A' category rating. If management is not able to meet its financial projections, there is limited financial cushion to absorb a material negative economic event, which could negatively pressure the rating.

Asymmetric Additional Risk Considerations

No asymmetric risk considerations are relevant to the rating.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--If ECS experiences difficulty in ILU expansion fill-up over the project period and is unable to continue exhibiting strong demand for services, the resultant operating pressure could cause pro forma MADS and unrestricted balance sheet resources to be behind budget and pressure the rating.

--If core operations weaken such that net operating margin (NOM) adjusted is less than 10% for a sustained period of time.

--Any material deterioration in liquidity levels resulting in a sustained cash to adjusted debt below 110% post series 2024A (entrance fee bonds) pay down.

--Although unexpected, any additional debt incurred that is not met with commensurate revenue and unrestricted balance sheet resource offset.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Any positive rating action at this time is unlikely given the significant amount of new debt ECS incurred earlier in 2024 with the series 2024A&B debt issuance.

--Positive rating action may result over time if operating performance and liquidity levels significantly overperform Fitch's expectations such that leverage metrics with cash to adjusted debt is sustained above 150% post expansion and renovation project completion, including in a stress case.

PROFILE

ECS is headquartered in Altadena, CA and is the sole corporate member of the OG. There are some non-obligated affiliates, which include ECS Management LLC, Creative Housing Services, Twelve Oaks Foundation, and Episcopal Communities & Services Supportive Funds Management.

The ECS communities are The Canterbury (opened in 1983), The Covington (opened in 2004), and MonteCedro (opened in 2015). The Canterbury is located in Rancho Palos Verdes, The Covington is located in Aliso Viejo and MonteCedro is located in Altadena, CA. MonteCedro, Inc joined the ECS OG in November 2022 and merged with ECS effective July 31, 2023.

ECS offers Type B contracts at all three communities, which Fitch views as presenting less actuarial and contract pricing risks. As a part of the campus repositioning projects associated with the 2024 debt issuance, ECS will be providing healthcare services in an enhanced assisted living setting that is not served in a skilled nursing facility (SNF).

Fitch's analysis is based on the OG, which comprised around 97% of total consolidated revenues in fiscal 2024 (OG had total revenues of approximately $75.1 million in fiscal 2024 [audited; June 30 fiscal year end]).

Sources of Information

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

FITCH RATINGS ANALYSTS

Michael Burger
Director
Primary Rating Analyst
+1 415 796 9960
michael.burger@fitchratings.com
Fitch Ratings, Inc.
One Post Street Suite 900 San Francisco, CA 94104

Meggi Carr
Director
Secondary Rating Analyst
+1 212 908 0799
meggi.carr@fitchratings.com

Mark Pascaris
Senior Director
Committee Chairperson
+1 312 368 3135

mark.pascaris@fitchratings.com

MEDIA CONTACTS

Sandro Scenga
New York
+1 212 908 0278
sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

U.S. Public Sector, Revenue-Supported Entities Rating Criteria (pub. 12 Jan 2024) (including rating assumption sensitivity)

U.S. Public Finance Not-for-Profit Life Plan Community Rating Criteria (pub. 19 Aug 2024) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Portfolio Analysis Model (PAM), v2.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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California Health Facilities Financing Authority	EU Endorsed, UK Endorsed

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