HOSPITALS

Rating Agencies Update

Margins under Pressure but Balance Sheets Improve

After one of the best years in recent memory in 2015, the last 18 months have been a challenge for nonprofit hospitals. A tight labor market coupled with lackluster investment returns resulted in a deterioration in excess margin. Consequently, debt service coverage was weaker in 2016. However, balance sheets continue to strengthen, as most hospitals and hospital systems continue to deliver. Readers may recall that 2014 showed improvement for the higher rating categories (A-rated and above), but the lower investment-grade and non-investment grade categories struggled. In 2015, the positive trend continued for the higher rated providers, but the improvement was more widely disbursed. In 2016, the trend reversed as median ratios deteriorated for all rating categories.

Each of the credit rating agencies (CRAs) issue an annual report that summarizes past performance and provides a forecast for the upcoming year. With approximately 95% of the world market share for credit ratings, Fitch Ratings (Fitch), Moody's Investor Service (Moody's), and Standard & Poor's (S&P) reports provide a wealth of information which systems and standalone hospitals can use to make meaningful comparisons to financial benchmarks and emerging trends.

Operating Performance

A common theme in the rating agency reports was the drastic increase in operating expenses and decline in operating margin for all rating categories, despite robust revenue growth. The rating agencies noted that a slowdown in revenue growth was expected in 2016. The first full year of Medicaid expansion through the Affordable Care Act (ACA) occurred in 2015, so there was a degree of pent-up demand, as nearly 20 million more Americans were covered by insurance. One would have expected a slowdown in revenue growth for 2016, but the results were surprisingly mixed.

- The most troubling theme in the rating reports is the sharp rise in expenses, which far outpaced revenue growth. Operating margin declined in every rating category for all three rating agencies. The primary culprit was labor costs. Increased volumes—partly because of the ACA—have driven up the demand for labor, but a lack of supply and wage pressure have caused a rise in labor costs. The shortage of qualified nursing staff is a long-run problem, particularly in some markets. However, the strong economy has exacerbated the issue, as even relatively unskilled labor is hard to attract and retain now. The rating agencies note that hospital management teams continue to try to extract operational efficiencies wherever they can find them; however, the efforts to do so are increasingly difficult.
- While further consolidation in 2016 did help many hospitals and health systems, the rating agencies reported that some of the recent mergers did not yield desired operational improvements. It is noted that increased economies of scale and negotiating power can help with costs and revenue, but difficulty in merging systems and cultures has led to higher costs in some cases.
- Continuing a long-term trend, larger hospitals and health systems have demonstrated greater stability and resiliency, and rating downgrades were concentrated in the smaller organizations. Furthermore, the trend for larger and stronger rated health care organizations is bolstered by the ongoing boom in M&A activities.

The higher labor costs, along with an increase in pharmaceutical expenses, led to a rather dramatic decrease in operating margin across the board. According to Fitch, the median operating margins for 2016 and 2015 were 2.8% and 3.5%, respectively. Operating EBIDA margins demonstrated similar results.

All three CRAs continue to point out that the shift from volume- to value-based care with respect to reimbursement is moving more slowly than expected—and surely more slowly than the Centers for Medicare and Medicaid Services (CMS) desires. Nevertheless, the shift is gradually building momentum. As is the case with operational efficiencies, size and scale benefit providers in an environment where pricing power and geographic reach are vital. Accordingly, Fitch echoed an opinion held by many that the gap between the larger/higher rated credits and smaller (typically lower rated) will continue to widen.

Non-Operating Income and Cash Flow

Compounding the operating cash flow difficulties, investment returns were mixed in 2016. Consequently, overall earnings before interest, depreciation and amortization (EBIDA) margins were down, as non-operating income could not

Comparison of Select Median Figures and Ratios						
	Fitch 'BBB'			S&P BBB[1]		
	2014	2015	2016	2014	2015	2016
Sample Size	57	58	59	112	97	88
Net Patient Revenue ($000)	433,389	448,099	466,479	174,975	205,988	275,503
Operating Margin (%)	0.6%	1.5%	0.9%	1.3%	2.4%	1.2%
EBITDA Margin (%)	9.2%	9.5%	9.3%	10.8%	10.7%	9.4%
Days Cash on Hand	161.5	161.2	148.8	160.3	158.5	163.6
Cash to Debt	89.5%	90.8%	93.1%	112.2%	115.5%	127.0%
Debt to Capitalization	48.1%	50.2%	50.2%	34.6%	36.0%	34.4%
	Fitch 'A'			S&P A[1]		
	2014	2015	2016	2014	2015	2016
Sample Size	101	107	110	155	137	128
Net Patient Revenue ($000)	591,117	633,705	677,366	408,424	429,850	410,619
Operating Margin (%)	3.6%	3.8%	3.0%	3.3%	3.6%	3.0%
EBITDA Margin (%)	11.0%	12.4%	11.3%	12.9%	13.1%	11.9%
Days Cash on Hand	205.3	215.5	218	261.6	248.6	252.1
Cash to Debt	143.7%	148.6%	150.6%	182.0%	189.9%	200.9%
Debt to Capitalization	36.2%	36.0%	36.5%	29.4%	30.8%	31.4%

1 "U.S. Not-For-Profit Health Care Stand-Alone Hospital Median Financial Ratios" 2015 and 2017 editions

overcome the decline in operating margin. The weaker cash flow margins led to a decline in debt service coverage (DSC). Median MADS (maximum annual debt service) coverage declined from 4.3x in 2015 to 3.9x for the S&P portfolio of health care organizations. All three CRAs did acknowledge that capital spending remains in check and the overall debt burden (debt as a percentage of revenue) improved for the sixth year in a row. In addition, historically low interest rates and high demand for municipal bond debt helped keep interest expense very low for providers in nearly every rating category. The low rates presented an opportunity for many health care systems to refinance existing debt, which lowered debt service and "cleaned up" capital structures, which contained debt that was issued in a less favorable time.

Liquidity and Capital Spending

In spite of operational challenges and less than stellar non-operating cash flow, balance sheet measures improved in nearly all ratings categories. The CRAs noted that hospitals and health systems have controlled capital expenditures in recent years. Continuing a recent trend capital expenditures were above depreciation expense in 2016, but average age of plant increased—indicating investments in shorter lived assets. For the most part, hospitals are shunning large replacement or expansion projects. The capital spending is focused on ambulatory care centers, renovation projects, and IT infrastructure that are keys to population health and meeting consumer demands. The rating agencies observed that days' cash on hand, cash to debt, and other liquidity measures improved in 2016.

Trends and Expectations

The following themes were common to all median reports:

- There are few signs that the expense pressures will abate in the near term, revenue growth will remain slower, and operating margins will be challenged.
- Similar to a common theme in 2014 and 2015 median reports, all three CRAs observed that risk or value based reimbursement programs have been slow to take hold, but the expectation is that these will accelerate at some point. The most efficient providers—who also tend to be the highest rated—stand to benefit most from this trend.
- Another trend carried over from the 2015 median report is continued efficiency initiatives through increasing use of technology and further consolidation/affiliation, especially where larger systems acquire weaker providers that lack the scale to keep up with the pace of change.
- Despite the operating challenges, the rating agencies were largely sanguine with respect to the overall outlook. The ratio of upgrades to downgrades was about 1:1 across all rating categories; although, the outlook for large systems (a separate category for S&P) is brighter than it is for small systems or standalone providers. The revenue and geographic diversity inherent in large scale operations, coupled with an ability to attract top-tier physicians mitigated many of the risks that health care providers face.

All of the factors above portend even more consolidation and affiliation activity. A key question that we see from investors, rating agencies, and creditors is "what is your affiliation plan?" The assumption is that all hospitals will need to affiliate or else face elimination by "narrow networks" or an inability to keep up with the pace of change.

S&P, Moody's, and Fitch all signaled that 2015 was likely to be as good as it gets for the hospital sector. With the full force of increased Medicaid enrollment, operating efficiencies from IT and management initiatives, and greater economies of scale through consolidation and affiliation, most providers enjoyed excellent margins. Unfortunately, pressures from tighter labor markets and slower revenue growth did in fact hinder performance in 2016. That said, operating margins and debt service coverage have remained stable since 2008, and MADS coverage has actually improved since 2010.

Furthermore, prudent capital spending and limited use of leverage—combined with very low costs of capital—have helped improve balance sheets for most rated hospitals. The challenge going forward is to use technology and management skills to harness more operational improvements, while taking advantage of affiliation opportunities to broaden revenue base and diversify risk. The hospitals that can take advantage of a strong market position and/or develop strength through size and efficiency will likely thrive.

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