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U.S. Not-For-Profit Health Care Sector Moves Toward Stability, But Its Long-Term Outlook Is Uncertain

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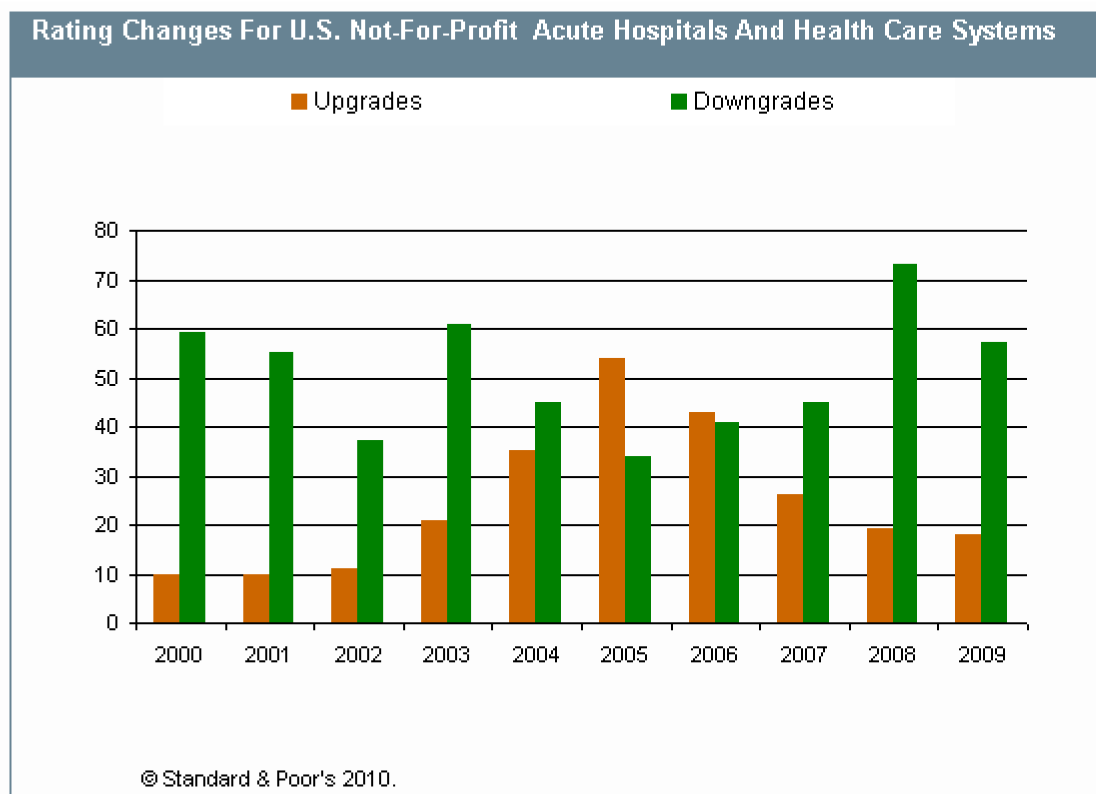
U.S. Not-For-Profit Health Care Sector Moves Toward Stability, But Its Long-Term Outlook Is Uncertain

Standard & Poor's Ratings Services believes that the U.S. not-for-profit health care sector has begun to stabilize after a very difficult period. While the recession has contributed to many rating downgrades and weaker median financial ratios, based on current financial results, we think the sector is showing signs of stabilization, which has contributed to more positive rating actions recently. While we believe many questions remain about the longer-term health of the sector, including significant uncertainties about the future of health care reform in the wake of the recent failure to pass major health care legislation, in our view, the sector's financial and operating performance is rebounding from last year's weakest moments. However, current stabilization for our rated providers is at levels generally below prior peaks.

Based on this evidence, we believe that our ratings and outlooks will likely stabilize in 2010, although many questions remain for 2011 and beyond. In our view, credit stabilization began in the 2009 fourth quarter and has continued through early 2010 with an increase in upgrades and favorable outlook revisions to stable from negative or to positive in some cases. Downgrades exceeded upgrades by a large margin in 2009 (see chart 1), however we expect that the ratio is likely to be much closer to one to one this year as we believe that further improvement is on the horizon for many providers and that steps taken by some providers in early to mid-2009 to preserve capital and improve operations are paying off.

Chart 1



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Stability Is Tempered By Challenges

While we see improvement for many providers, we also are concerned that 2010 could be the eye of the storm and that it may be a respite before the next phase of the storm. In our opinion, the health care sector remains beset by long-term problems that appear intractable, such as weakening payor mixes, cost escalation, and growing levels of uninsured and underinsured, all of which are compounded by a still-fragile economy and high unemployment. Although we expect credit rating changes will be more balanced this year based on recent financial and operating data, we also think that the many challenges in this environment could intensify at any time and tilt what we see as the sector's emerging but fragile stability back toward last year's negative outlook.

Prospects For Health Care Reform This Year Are Slim

Despite the vigorous debate about health care reform legislation last year, we think it's realistic to assume that comprehensive reform will not pass this year. Yet, many of the forces behind the health reform effort remain in place, such as the rising cost of insurance premiums, a decline in employer-based insurance coverage, and a growing population of uninsured and underinsured people. Thus, we believe hospitals and health systems will continue to confront a host of operating and capital pressures, all of which make for a tough operating environment.

Last year, we viewed the pressures facing providers as acute because of the recession and the related issues of declining inpatient volumes and revenue, weakening payor mixes, and sharp investment-market losses. This year, however, we view the pressures as more incremental in nature as the sector confronts pent-up demand for capital spending, higher capital costs, pension funding needs, and growing physician subsidies amid a continued tight revenue environment. On a positive note, we believe many management and governance teams have well-entrenched business models and cost-cutting programs to address this difficult operating environment, although to the extent that spending cuts have been implemented, we think that further cuts will likely be harder to find.

While leaders in Washington are trying to determine the next steps in the health care reform debate, many providers and financial advisers are now looking to the federal Centers for Medicare and Medicaid (CMS) to act more unilaterally to control costs and implement pilot programs aimed at reforming payment incentives to ensure better quality at a lower cost or simply to stabilize unit cost. While these initiatives may have the potential to be significant over the longer term, we think any CMS initiatives are likely to have limited, if any, credit impact this year. However, we do see many hospitals continuing to prepare for some type of reform by lowering costs and boosting quality where possible, integrating physicians through the growing use of employment contracts and joint ventures, and continuing to implement more robust information technology systems.

States Face Struggle To Fund Medicaid

In our view, one of the most serious issues is the financial health of states and their ability to fund Medicaid at what we consider to be adequate levels. Under the federal stimulus legislation, large one-time funding support for Medicaid is scheduled to sunset at the end of 2010. As states begin budgeting for the fiscal 2011 year -- which starts on July 1, 2010, for many – we expect rising demand for Medicaid services will likely be met with reduced funding ability. How individual states respond, either with reduced eligibility or reduced payments or both, we expect that providers are likely to be squeezed financially. While reductions in Medicaid funding may be good for states and

their financial profiles, we believe it is potentially detrimental to health care providers. One narrower concern is a willingness on the part of states to lower what can loosely be called "safety net funding," often in the form of reductions in special bad debt and charity care pools. We believe that providers who are dependent on these types of funds could find their ratings at risk as historic assumptions about the willingness of states to maintain funding levels may no longer be correct. This may lead to significant reductions in funding and what we believe could be long-term fiscal damage to some providers. Moreover, in our view, Medicaid reductions are likely to also hurt long-term care providers, which in turn may create difficulties in the acute care discharge process, leading to longer lengths of stay and higher costs. While this is likely to emerge as an issue in 2010, we expect it will be a more serious issue next year.

A Shift Toward More Fixed-Rate Debt

Since late 2007, many not-for-profit providers have found it more difficult than in preceding years to access credit markets. The decline of the auction-rate market that began in late 2007 and accelerated in early 2008 caused many providers to refinance or convert auction-rate bonds to other short-term instruments, including short-term self-liquidity or term modes as well as many forms of bank liquidity. While these efforts addressed the immediate problem of failed auctions for these securities, we believe they contributed to a new set of issues as increased bank renewal risk and the lack of permanent capital coincided with what we considered to be an exceptionally sharp decline in unrestricted cash and investments at many providers and a period during which no or very few primary health care transactions were being marketed.

Through 2008 and 2009, many banks tightened credit standards and even when they were willing to extend credit, the financing was often in a smaller amount, at a higher price, and for a shorter period. Moreover, after bank downgrades in the past two years, the number of highly rated banks dwindled and credit became more expensive. As a result, we saw many providers begin to tilt their debt mixes back to a more traditional fixed-rate portfolio. While this reduced bank renewal risk and pressure on liquidity balances, it raised the cost of capital. This has become another incremental pressure on health care costs. Conversely, with increased fixed-rate debt, many credits have significantly reduced or limited the volatility associated with variable-rate debt, which we believe is likely to result in more-stable financial profiles.

The Impact Of Weak Investment Performance On Ratings

Weak investment performance was an important factor in many rating actions we took in 2009, although as we discussed in our report, “The Impact Of Investment Market Declines On U.S. Not-For-Profit Health Care Provider Ratings” (published April 27, 2009, on RatingsDirect), most actions were also attributable to what we considered to be other significant operating pressures. These pressures, which included operating margin compression, weak revenue growth, volume declines, and increased competition from outpatient ventures, often physician owned, all contributed to the large number of downgrades.

One aspect of the large investment losses suffered by many providers was significantly reduced coverage of maximum annual debt service. From an accounting perspective, investment losses were both realized and unrealized and, in some cases, providers took other-than-temporary loss adjustments, which further weakened coverage. As a result, debt service coverage was what we considered to be extremely volatile in 2008 and 2009 compared with prior years. This volatility was compounded by the fact that Standard & Poor's excludes unrealized gains and losses

from its coverage calculation. In many cases, this moves the effective loss or gain, as measured on the balance sheet, from one income statement period to another when calculating debt service coverage. While our view of reduced coverage has been a factor in many rating changes, especially if operating weakness was a concern of ours, we typically have been able to see beyond the debt service coverage factor in situations where the only reason for weak coverage was investment losses.

Improved Operations Bolster Results

As we look to this year, we are encouraged to find that many providers' financial results and balance sheets have rebounded, even exceeding prior peaks in a few cases or holding steady in some cases. We saw many providers respond to weak investment markets and recessionary volume and payor mix pressures by reducing expenditures, curtailing capital spending, and by making what we consider conservative adjustments in debt and investment portfolios. Many of these changes, including the shift to what we consider more-conservative investment policies or fixed-rate debt instruments, are in our view likely to reduce volatility and enhance long-term financial stability. For many, we believe the cost-cutting initiatives were stronger than the underlying weakness in revenues and the result was improved operating margins. In many cases, we believe improved operations helped providers limit declines in liquidity and fund balances relative to the industry trend. In many cases, this contributed to higher ratings or improved outlooks.

Despite improved results from a year ago, many providers are still performing well below peak levels demonstrated a few years ago – and therefore likely have a lower ability to handle unforeseen issues. This has led to negative outlooks or lower ratings. Right now, these two trends -- improved performance and results that are well below historic peaks -- appear to be in balance, which we believe is a significant positive for the sector compared with the outlook a year ago.

Higher-Rated Providers Also Felt The Recession's Impact

In contrast to prior years, a number of highly rated providers were downgraded in 2009. The downgrades affected providers in the 'AA' category, many of which saw the ratings on their bond issues drop to the 'A' category. In many ways, the larger liquidity levels enjoyed by the higher-rated credits meant that for a comparably balanced portfolio, these credits had a greater proportion of investment losses than many smaller, lower-rated credits. However, as investment markets rebounded, debt issuance increased and many larger issuers saw their cash and investment balance rebound more quickly than the smaller providers. In addition, we saw the underlying operating strength of larger systems begin to reassert itself. During 2010, we believe the higher-rated credits will see a greater proportion of upgrades and positive outlook revisions as we believe their size as well as their geographical, financial and service line dispersion, combined with what we generally consider to be strong management teams, will allow them to more easily manage through the incremental pressures affecting the whole sector. We think this expected trend likely will be similar to the emergence of a credit quality gap between higher-rated and lower-rated providers several years ago.

Some Negative Industry Trends Are Likely To Continue

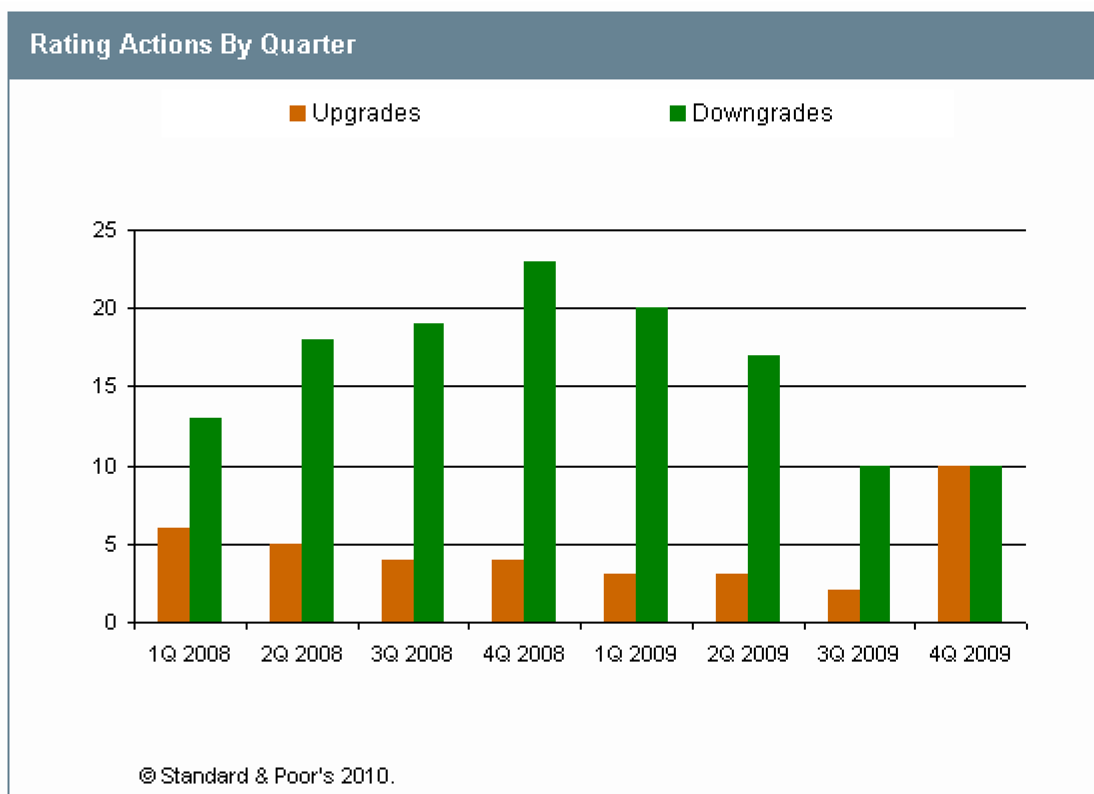
The sharp downward trend of ratings that occurred in the first nine months of 2009 reflected our view of the impact of the recession and poor investment-market performance, although our assessment of specific factors and

circumstances contributed to individual rating actions. These pressures came on top of concerns that had already emerged in the sector prior to the recession and stock-market downturn. In our 2008 sector outlook, we noted softer operating results and other trends that were already evident to us, such as weaker revenues, slower growth in inpatient volumes, rising costs of capital, higher bad debt and charity care costs, and rising physician subsidies. We believe these operating pressures will likely continue to be significant rating factors, even as acute recessionary forces subside. However, we view these factors as generally incremental in nature and affecting overall credit quality over longer periods of time.

Recent Rating Actions Reflect Stabilization

In our view, credit quality in the not-for-profit health care sector, as reflected by downgrade to upgrade activity, began to show signs of stabilizing in the last quarter of 2009 as many organizations emerged from the difficulties of the past two years. We are beginning to see what we consider a solid jump in the number of upgrades for the first time since the last quarter of 2007. While downgrades exceeded upgrades by a ratio of 3.2:1 in 2009, the fourth quarter highlighted what we consider a strong rebound with a downgrade to upgrade ratio of 1:1 (see chart 2), compared with 6:1 for the first three quarters of the year. While we may still see downgrades outpace upgrades in 2010, we expect that the gap will narrow appreciably from the wide ratios of downgrades to upgrades in 2009 and 2008. January 2010 saw five upgrades and only one downgrade, although we do not expect that ratio to be sustained over the year.

Chart 2



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We believe that a further indication of the positive momentum was seen in the number of positive and negative outlook actions in the fourth quarter (see chart 3). The ratio of positive outlook changes to negative changes (with no accompanying rating change) was 2:1 for bonds of acute care providers, compared with 1:1 in the third quarter and 1:5 in the first half. Positive and negative outlook revisions also include a return to a stable outlook from either negative or positive, respectively. Most of the positive outlook revisions reflected what we consider to be improvements in operations and liquidity. Also, we think it is important to note that the ratings on the issues of 422 providers were affirmed. This amounts to 85% of the acute care providers whose bond ratings were reviewed last year (see chart 4). In total, we reviewed the ratings (individual issues or issuer credit ratings) on 500 hospitals and health care systems, of which many were reviewed multiple times.

During the fourth quarter, we downgraded the ratings (issues or issuer credit ratings) on 10 organizations and upgraded 10, compared with 10 downgrades and two upgrades in the third quarter. Of the 10 downgrades in the fourth quarter, 80% ended with low investment-grade ('BBB+ to 'BBB-') or speculative-grade ratings (below 'BBB-'). The remaining 20% were in the high-to-medium investment-grade category ('A-' or above). Of the 10 upgrades, 70% were in the high-to-medium investment grade category, with the remaining 30% in the low investment-grade category.

Chart 3

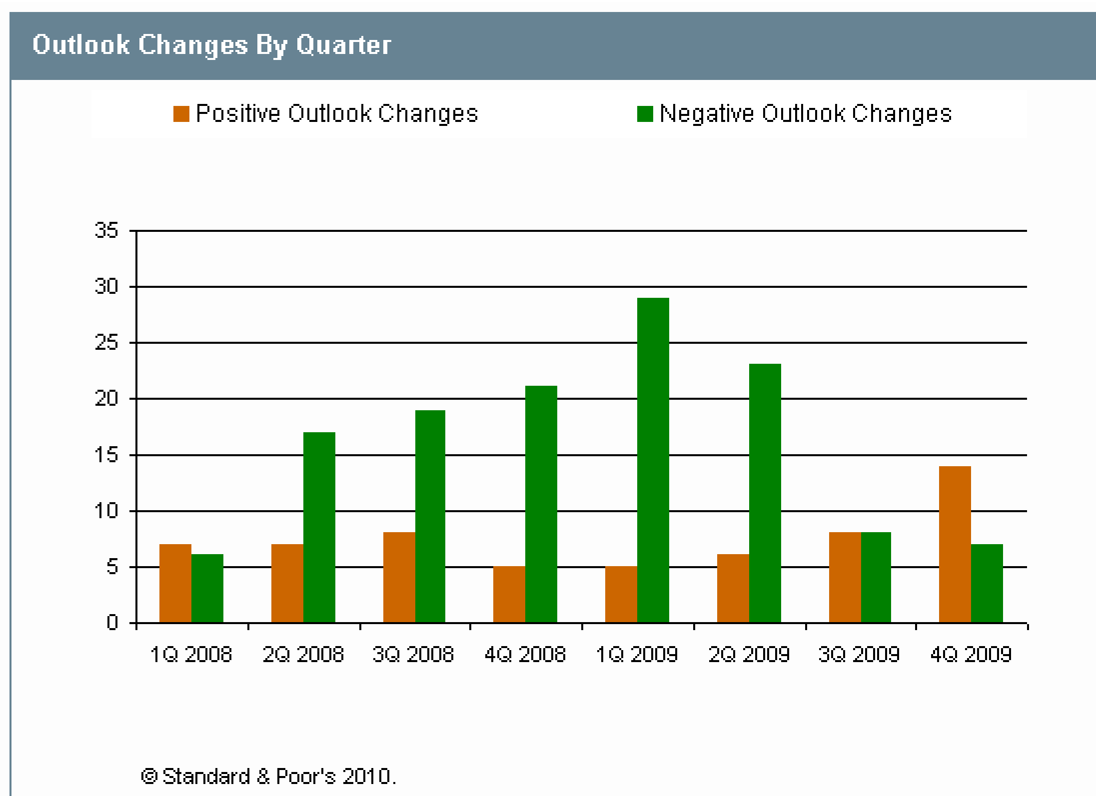
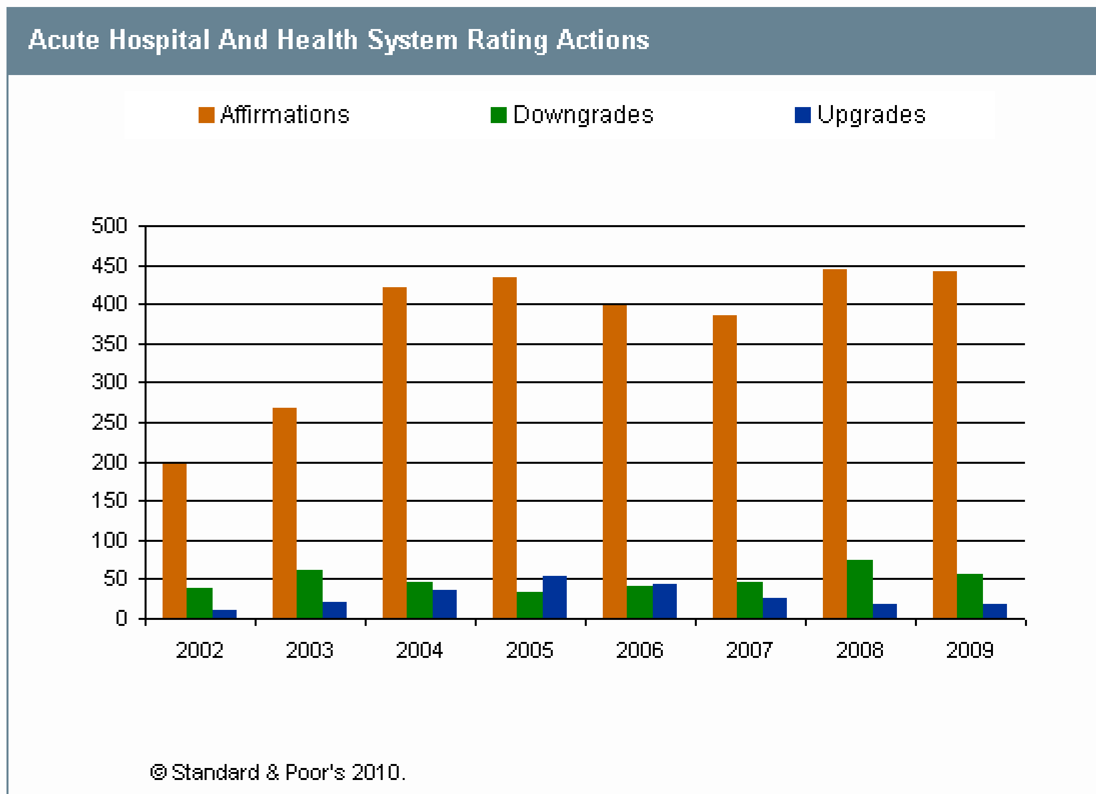


Chart 4



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