2015 Outlook: U.S. Nonprofit Hospitals and Healthcare Systems

Outlook Report

Rating Outlook

**STABLE**

**2014: STABLE**

Rating Outlooks

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Sector Outlook

**NEGATIVE**

**2014: NEGATIVE**

- Volume and revenue growth challenges
- Uncertain impact of healthcare reform
- Management competence is key

Related Research

Other Outlooks

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Other Research

The Affordable Care Act: Early Impacts (September 2014)
Seeking Value: Direct Contracting Strategies (May 2014)

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Rating Outlook Stable: Fitch is maintaining its stable rating outlook for the sector, as we expect the vast majority of rating actions and outlooks in 2015 to be affirmations and stable, respectively, reflecting the ability of hospital and health systems rated by Fitch to maintain adequate profitability, despite continued pressure on reimbursement, softening inpatient volumes and ongoing challenges to the validity and legality of key provisions of the ACA.

Pressure on Profitability Continues: The key drivers that have pressured sector profitability in 2013 and 2014 are expected to further challenge providers in 2015. The continued proliferation of high deductible health plans (HDHPs), reduced readmission rates and Medicare’s “two midnight rule” are likely to pressure inpatient volumes and profitability.

However, Fitch expects the impact to inpatient volumes to be less pronounced in 2015, compared with 2013 and 2014. Additionally, states choosing to participate in the Medicaid expansion in 2015 would help to mitigate reimbursement pressure from Medicare and commercial payors.

Uncertainty over ACA Implementation: The mid-term elections resulting in Republican control of both the House of Representatives and the Senate is likely to further raise the level of uncertainty about continued implementation of key provisions of the ACA. Fitch believes Republican vows to repeal or de-fund key parts of the ACA will hamper the sector’s ability to adapt and plan. Furthermore, the Supreme Court’s decision to grant certiorari to “King vs. Burwell” could effectively invalidate insurance coverage purchased through federally operated state exchanges in 2015.

Management to Navigate Changing Environment: As stated in last year’s outlook report, Fitch believes hospital and health system financial performance will continue to be more highly impacted by management’s ability and willingness to proactively control expenses, generate improved clinical efficiencies and quickly flex staffing to changes in patient volumes.

Mergers and Alignments Remain Brisk: The level of mergers and acquisitions (M&As) and alignments among hospitals and healthcare providers is expected to remain brisk in 2015. The benefit of size and scale to reduce per-unit shared service costs, create clinical efficiencies and gain access to larger patient populations will continue to drive consolidation in the acute care space.

Outlook Sensitivities

Pace of Change: Fitch’s negative sector outlook reflects the high level of uncertainty faced by healthcare management teams as they attempt to navigate the changing care delivery/reimbursement model and the political and legal uncertainties of further implementation of the ACA.

As a result, Fitch expects a higher level of year-over-year performance volatility among its rated entities, compared with prior years.

However, the sector’s improving liquidity and moderating leverage provide a strong financial cushion to offset the expected increase in year-over-year performance volatility, thereby allowing for relative stability in overall 2015 rating actions.
Key Issues

Continued Pressure on Patient Volumes

Many of the key factors that pressured hospital utilization, particularly inpatient admissions and surgeries, in 2013 and 2014 remain in place for 2015. Fitch believes that the combination of Medicare’s value-based payment reforms, the continued shift from inpatient settings to outpatient settings and the further migration toward HDHPs will continue to pressure inpatient volumes. Additionally, implementation of the “two midnight rule” by Medicare has caused a shift in classification of certain inpatient stays to outpatient or observation stays with a corresponding decrease in reimbursement. Provider emphasis on population health management, better management of chronic conditions in the community and enhancing coordination of care across the continuum of care (such as rehabilitation, home health and primary care) will lead to more healthcare services delivered in non-acute care settings. Additionally, continued advancement in surgical technology and procedures will contribute to a further shift in traditional inpatient procedures to be delivered in less costly outpatient settings.

Fitch suspects that the erosion in inpatient admissions and surgical volumes may be less pronounced in 2015, compared with 2014 and 2013, as the market may have reached a better state of equilibrium with the movement toward observation stays flattening and an expectation that certain care or procedures, which may have been delayed in prior years, will need to be addressed in 2015 and beyond. Moreover, Fitch expects that the increased coverage through Medicaid expansion and enrollment through public exchanges will likely result in a higher level of overall medical utilization and consumption in 2015.

Reimbursement Challenges

Fitch expects revenue growth will continue to be constrained by modest volume growth, increasing reimbursement penalties under Medicare’s value-based purchasing models, the extension of sequestration cuts to Medicare and increasing bad debt related to higher patient co-pays and deductibles. Fitch believes that observation stays may plateau in 2015 after significant increases in 2013 and 2014. The continued shift of patient care from inpatient to outpatient settings will lead to lower levels of reimbursement and possibly erode profitability over the longer term.

Managed care contract negotiations are likely to be increasingly antagonistic as insurers push back against the growing consolidation and alignment among providers and limit rate increases to the low single digits. Fitch expects that insurers and employers are more likely to tie increased reimbursement to improvements in clinical quality and outcomes. Additionally, the requirement of providers to post prices of certain high-use DRG codes is likely to create friction with payors and accelerate the shift toward greater consumerism and price-sensitivity among patients.

The planned implementation of ICD-10 coding in October 2015 is a looming concern. Potential interruptions to the revenue cycle may cause considerable negative impacts, particularly among lower-rated providers with weaker liquidity positions to absorb delayed reimbursement. Correspondingly, ICD-10 readiness from both governmental and commercial payors will also play a critical role in managing revenue cycles.

Continued Uncertainty Related to Healthcare Reform

Two key provisions of the ACA became effective in 2014 — the individual mandate and expanded Medicaid eligibility. Despite the troubled roll out of the federal health insurance exchange at year-end 2013 and the decision of 22 states not to participate in the Medicaid coverage expansion,
almost 7.0 million individuals gained insurance coverage in 2014. Estimates for increased coverage through both Medicaid and the state and federal health insurance exchanges range from 2.5 million to nearly 7.0 million more people in 2015. Additionally, Fitch expects that more Republican-controlled states will look for ways to participate in expanded Medicaid coverage in 2015, using market-based managed care approaches that may require a waiver from CMS.

Results of the November 2014 mid-term elections with the Republicans gaining control of both the House of Representatives and the Senate are likely to raise the level of uncertainty about continued implementation of key provisions of the ACA. While Republican attempts to repeal or de-fund key parts of the legislation are likely to meet a presidential veto, they will further complicate execution of health-system strategies related to the ACA. Congress’ likely repeal of the 2.3% tax on medical devices will have to be offset by reduced spending elsewhere to maintain budget neutrality.

A more immediate concern is the Supreme Court’s decision to grant certiorari to King vs. Burwell, which challenges the legality of subsidies provided to individuals who enroll in insurance through federally run state insurance exchanges. A ruling against the federally created state exchanges would further financially challenge hospital and health systems, particularly in states that did not expand Medicaid and were promised greater insurance coverage from the exchanges and Medicaid expansion to offset the reimbursement reductions being implemented under Medicare.

Management Is Key

The hospital sector has navigated many challenging environments in recent years, but the upcoming years will represent a true transition as the core model of healthcare delivery and reimbursement is undergoing a fundamental redesign. With a multitude of changes that require strategic navigation, Fitch believes management’s strategy, oversight and decision-making capabilities will more highly influence financial performance. The rise of price transparency and growing consumerism among patients and employers will force providers to transition from a wholesale to a retail business model.

Fitch expects patient volumes to continue to be erratic on a month-to-month and quarter-to-quarter basis. Thus, the ability of management to quickly flex staffing, contain costs and manage operating expenses will be increasingly important in maintaining margins. Moreover, management’s ability to maximize current and future reimbursement opportunities by implementing and leveraging IT platforms, delivering the highest quality patient care, building out its continuum of care and aligning with its physicians will be critical. Fitch has observed continued vigilance in expense containment and a focus on operating efficiencies to preserve profitability, with breaking even on Medicare rates a typically cited objective.

Fitch also recognizes that many significant financial and operational initiatives have already been implemented as the industry navigated through the economic downturn and began preparing for implementation of the ACA. Key actions have included terminating and/or freezing defined benefit plans and improvements to labor productivity (through attrition, layoffs and flexible staffing), revenue cycle, supply chain management and shared service efficiencies. Given the number of efficiencies already implemented and benefits realized, management will need to find opportunities for further expense savings, which will likely require a clinical care redesign and rationalization of certain clinical services, which can take longer to implement.

Consolidation, Integration and Alignment Strategies

Fitch expects M&A activity will continue to be robust as hospitals seek partners to fulfill varying needs, including improving economies of scale, expanding and deepening their
market presence or bolstering service offerings across the continuum of care. The ultimate goal is to leverage their collective size in contract negotiations, the supply chain, clinical programs and data mining to achieve cost efficiencies and build a network to prepare for population health management. While physician alignment and employment have been very strong over the past few years, Fitch believes the pace will slow from recent levels. Physician alignment activity in 2015 is likely to focus on development and alignment of primary care networks.

While traditional M&A activity continues, a variety of alternative alignment strategies have emerged, which aim to generate the benefits of size and scale in such areas as the supply chain, managed care contracting and clinical best practices while maintaining organizational independence. Provider development of insurance plan skills and capabilities (either organically or through joint ventures) is also likely to continue in 2015 and beyond.

2014 Review

In 2014, median operating profitability across all rating categories declined for the first time in over six years, reflecting a material softening of inpatient volumes. Median liquidity metrics further strengthened due to lower but still solid cash flow generation and good investment returns, while leverage metrics moderated slightly, reflecting lower capital spending. Fitch expects median ratios for the 2014 operating year to show stable operating profitability, compared with 2013, and further improvement in liquidity and leverage metrics. Through Dec. 8, 2014, there were 147 affirmations, 17 downgrades and 24 upgrades in Fitch's portfolio. In addition, there were 16 positive outlook changes and 10 negative outlook changes over the same period.