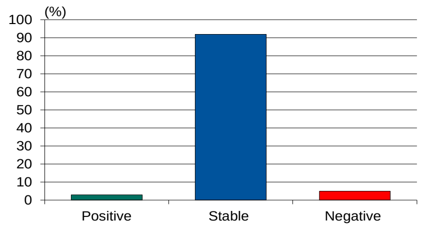
2013 Outlook: Nonprofit Hospitals and Healthcare Systems

Outlook Report

Rating Outlook
STABLE

Hospital Rating Outlooks



Related Research

Capital Expenditure Trends Among Nonprofit Hospitals (May 2012)

2012 Median Ratios for Nonprofit Hospitals and Healthcare Systems (August 2012)

2012 Outlook: Nonprofit Hospitals and Healthcare Systems (December 2011)

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Rating Outlook: Stable

Fitch Ratings' outlook for rating actions for nonprofit hospitals and healthcare systems in 2013 is stable despite the continued and mounting operating pressures in the industry. The stable rating outlook largely reflects management's initiatives in the changing landscape that should result in another year of stable operating performance.

However, Fitch believes that there is a greater amount of uncertainty beyond 2013 as opportunities for further cost cutting wane and as a wave of expected reimbursement reductions are realized under the full implementation of the Patient Protection and Affordable Care Act (PPACA) beginning in 2014. In addition, there is risk of further reimbursement reductions given the acknowledgement in Washington for the need for entitlement reform, which places a target on the Medicare and Medicaid programs.

2013 Financial Performance to Remain Stable: Fitch expects financial performance to remain stable as management teams continue to focus on operating efficiency initiatives and as reimbursement levels have generally remained stable with continued modest managed care rate increases and a higher Medicare market basket increase for fiscal 2013 than originally expected.

Reform Measures Under Way: Providers have been preparing for the changing landscape from a fee-for-service environment to one that is focused on quality and cost. The financial impact to the sector is uncertain upon the full implementation of PPACA as the reduced growth in spending for Medicare and Medicaid is expected to be mitigated by the expanded coverage for the uninsured through the creation of health insurance exchanges and expansion of Medicaid eligibility.

Potential Sequestration Cuts: The hospital industry is facing an automatic 2% reduction in Medicare reimbursement beginning in January 2013 if Congress and the administration fail to reach an agreement to avoid the fiscal cliff. Although any reimbursement reduction is viewed negatively, Fitch believes hospitals should be able to absorb the impact of the reduction since many use conservative assumptions surrounding governmental reimbursement in their budgeting process. However, lower-rated credits are expected be affected to a greater degree than higher-rated credits.

Widening Credit Gap: A widening credit gap is a trend that Fitch has observed for several years, which is being accelerated by the changing operating environment and consolidation activity. Fitch believes negative rating actions will continue to be concentrated in the lower end of the rating scale.

What Could Change the Outlook

Unexpected Reimbursement Reductions: Larger than expected reimbursement reductions would fundamentally affect the sector's operating environment and would likely lead to an erosion in profitability and therefore a revision in the rating outlook to negative.

Key Issues

Greater Degree of Uncertainty Beyond 2013

Fitch believes that management teams have had to deal with numerous operating challenges since the economic downturn, including depressed volume and a deteriorating payor mix. However, operating profitability has remained stable through this time, which is expected to continue in 2013 due to management's initiatives to preserve profitability, including a focus on labor productivity, supply chain and revenue cycle management, better documentation and coding, and classification of observation patients. Those who have been able to invest in information technology have been able to leverage those investments to improve quality and operating efficiency.

In addition, profitability has been stable due to modest reimbursement levels, which is also expected to continue in 2013. Managed care rate increases have remained stable in the 4%–5% range across the nation, and the net Medicare market basket increase for fiscal 2013 of 2.3% was higher than the original expectation of 0.9%.

Fitch believes 2013 is likely to be the last year of stable performance, as scarcer expense-reduction opportunities and looming reimbursement reductions threaten operating performance.

Fitch believes that the next level of cost reduction within the industry will need to be realized from a change in the care delivery operating model through integrating clinical operations, implementing standardized protocols, coordinating care, and managing population healthcare, which will be more difficult to accomplish.

Full Implementation of PPACA

With the presidential elections over and the planned implementation of PPACA, there remains a great deal of uncertainty regarding the portion of the law that should be beneficial to providers, including expanded coverage for the uninsured through health insurance exchanges as well as the expansion of Medicaid.

The creation of health insurance exchanges seems to be behind schedule, as they are expected to be operational by Oct. 1, 2013. States were granted another extension by the federal government regarding the option a state has to create its own exchange or rely on the federal government to operate the exchange.

Half of the increased coverage of the uninsured population is supposed to be through the expansion of Medicaid, but this is now in question given that a state can opt out of the Medicaid expansion. Six states have already said they would opt out, including Texas and Florida, which both have a higher percentage of uninsured compared to the national average.

In the near term, the parts of the PPACA that were enacted for federal fiscal 2013 (effective Oct. 1, 2012) are expected to have a minimal impact on hospitals' performance. These include the reduction in the Medicare market basket of 0.1% (included in a net 2.3% increase for fiscal 2013), value-based purchasing incentives, and reduced payments for preventable readmissions. These dollars at risk remain small for fiscal 2013, but will increase beyond 2013.

Related Criteria

Revenue-Supported Rating Criteria (June 2012)

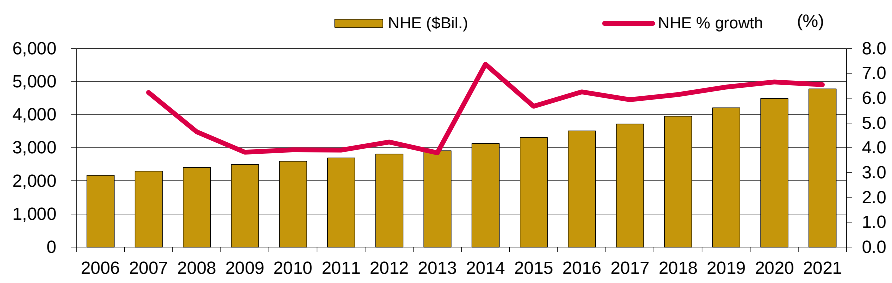
Nonprofit Hospitals and Health Systems Rating Criteria (July 2012)

Looming Reimbursement Reductions

The Medicare and Medicaid programs are targets for reductions given the projected growth in costs. Expected reductions within the PPACA include significant cuts in Medicare and Medicaid disproportionate share funding beginning in federal fiscal 2014.

Along with potential sequestration cuts effective in January 2013, there could also be a significant reduction in Medicare payment rates to physicians. Under a sustainable growth rate (SGR) formula that physician reimbursement is based on, physician payments are slated to be reduced by 26.5% in January 2013 unless Congress defers this cut as it has done every year since 2003. Fitch does not expect this payment reduction to be implemented, but if it is, it would have a significant impact on those providers with a large employed physician base. In addition, the size of the reduction would likely cause other longer-term issues, such as decreased access to physicians for Medicare patients.

U.S. National Health Expenditures



Source: Centers for Medicare and Medicaid Services.

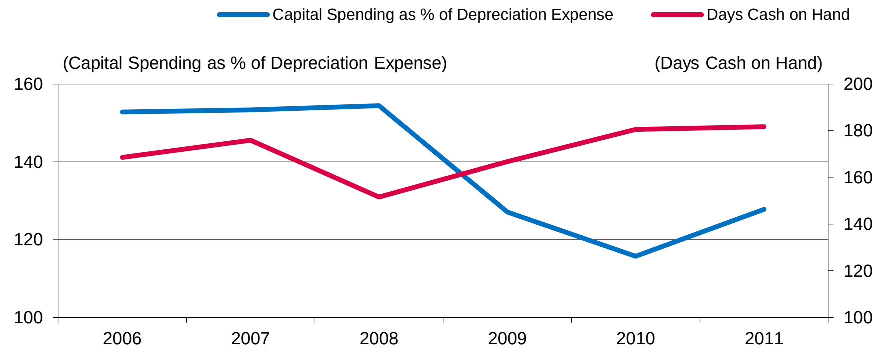
Widening Credit Gap to Continue

Fitch has seen an increase in merger and acquisition activity in 2012 and expects it to continue in 2013 as the changing operating environment has accelerated consolidation activity. Fitch believes this will further widen the performance gap between larger, highly rated hospitals and health systems and lower rated, single-site hospitals. In addition to typical merger and acquisition activity, other forms of partnerships are increasingly being pursued as providers seek partners who will enable them to coordinate care and manage population health, including an accountable care organization structure. These operating models are still relatively new, and the ability to generate savings and improve quality within these models is yet to be seen.

Maintenance of Balance Sheet Strength

Balance sheet strength is a primary credit factor. Fitch believes a strong balance sheet will lend more financial flexibility as providers implement various strategic initiatives to prepare for the new value-based environment. After the financial market collapse in 2008, hospitals have been rebuilding liquidity through solid cash flow and decreased capital spending. However, according to a survey conducted by Fitch, the majority of nonprofit hospitals expect capital spending to either increase or remain at current levels over the next five years. The highest priority capital expenditure area is information technology.

Liquidity Versus Capital Spending



Source: Fitch Ratings Nonprofit Hospitals Overall Median Ratio.

2012 Review

Hospitals have continued to maintain solid operating performance due to their focused efforts on improving operating efficiencies and clinical outcomes and implementing various expense control initiatives to maintain profit margins. Fitch expects the fiscal 2012 median ratios to exhibit another year of solid financial performance as large scale reimbursement reductions are not slated or expected until after 2013. Through Dec. 10, 2012, there have been 199 affirmations, 21 downgrades, and 16 upgrades in Fitch's portfolio in 2012 with 14 of the downgrades in the 'BBB' rating category or below.