

## OUTLOOK

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## Not-for-Profit and Public Healthcare - US 2017 Outlook - Volume and Revenue Growth Drive Stability, But Operating Pressures Persist

Our stable outlook indicates our expectations for the fundamental credit conditions driving the not-for-profit and public healthcare sector over the next 12-18 months.

The US not-for-profit and public healthcare outlook is stable based on projections of 0%-1% operating cash flow growth over the next 12-18 months. Solid patient volume and revenue growth drive albeit slower operating cash flow growth, and will offset pressures from rising drug costs, pension liabilities and employment expenses. Technological and operational investments, necessary to keep pace with changing regulations and population health trends, will continue to pressure the sector. We see mixed results for the sector from any change in federal policy regarding Medicaid expansion and the Affordable Care Act without a well-defined replacement policy, with much near-term uncertainty.

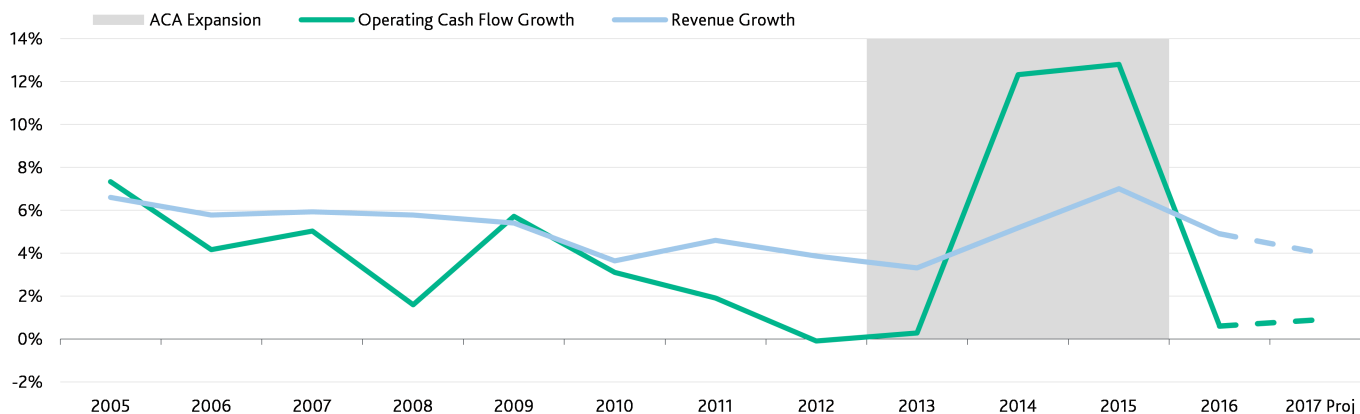
- » **We expect operating cash flow will grow 0%-1% over the next 12-18 months.** Operating cash flow growth is moderating but remains positive after two years of extraordinary growth associated with Medicaid expansion under the Affordable Care Act.
- » **Patient volume growth is stable at about 1%.** Utilization will be more modest in 2017 as the uninsured population stabilizes, but revenue growth will remain favorable with hospitals pursuing outpatient growth strategies.
- » **Expenses are on the rise, compressing margins.** Soaring pharmaceutical costs, employment growth and rising pension pressures are driving thinner bottom lines.
- » **Bad debt is rising as expected.** Hospitals in non-Medicaid expansion states will see continued growth in bad debt as exchange enrollment likely contracts. In Medicaid expansion states, strong declines in bad debt will moderate because the benefits of expansion have largely been realized. High deductibles and rising co-pays will also drive bad debt.
- » **What could change the outlook.** We would consider changing the outlook to positive if we expected sustained operating cash flow growth above 4% over a 12-18 month period, after accounting for healthcare inflation. We would consider changing the outlook to negative if we expected weakening business conditions leading to flat or negative operating cash flow, after inflation. Any major regulatory changes or disruption of current policy could pressure the outlook.

## Operating cash flow continues to grow, though the pace will slow

Operating cash flow growth has moderated to 0%-1% after two years of extraordinary growth associated with expansion under the Affordable Care Act (see Exhibit 1). Top-line revenue growth is strong, but constrained reimbursement rate increases and rising costs will temper that growth. Operating cash flow growth recently peaked in fiscal 2015 when the sector experienced the one-time positive effects of individuals gaining insurance coverage for the first time and accessing healthcare services. Growth at those levels would be difficult to maintain.

Exhibit 1

### Top-line Revenue Growth is Good, But Expense Pressures Will Compress Operating Cash Flow Growth



Source: Moody's Investors Service

## Patient volumes remain stable, with moderate growth expected through outpatient strategies

With the percentage of the population that is uninsured leveling at around 11% over the last year, growth in healthcare utilization will be more modest in the future. However, the growth will be sufficient to drive continued top-line revenue growth of 3.5%-4.5%.

Inpatient admissions will grow about 1%, reflecting the continued shift toward outpatient services. Hospitals continue to tap into new markets and grow overall volumes by opening urgent care and quick visit locations. Continued physician practice acquisition will also help drive modest patient volume growth. However, these strategies are accompanied by corresponding increases in operating and capital expenses that can pressure operating margins.

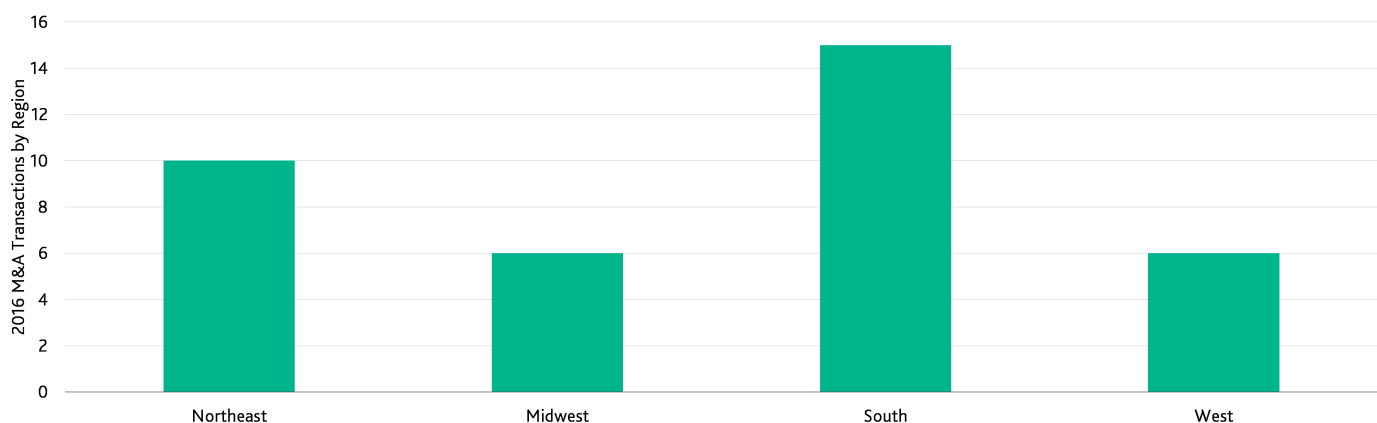
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**Hospital affiliations can drive volume growth and will remain prevalent.** The rapid pace of mergers, acquisitions and strategic partnerships reflects larger systems' general expansion strategies to increase size and scale of the enterprise. The flurry of affiliations is also a response to market pressures, which include increased stress on reimbursements from governmental and commercial payers, and the threat of consolidation among insurance companies (which would have reduced hospitals' pricing power). Per Exhibit 2, [Texas](#) (Aaa stable), [New Jersey](#) (A2 negative) and [Pennsylvania](#) (Aa3 stable) experienced the highest number of new affiliations in calendar 2016 to date. These affiliations were largely the result of large system mergers, expansions into new states and market consolidation. While affiliations are generally credit positive by increasing geographic coverage and accessing economies of scale, they may also include capital commitments, immediate liquidity needs, transitional operating expenses, and the risk of governance and cultural challenges.

Exhibit 2

### Affiliation Activity Spans Across the United States



Sources: Moody's Investors Service, Becker's Hospital Review

### Trump presidency adds uncertainty, but no clear immediate credit impact

During the presidential campaign, President-elect Donald Trump called for repeal of the Affordable Care Act (ACA) and proposed replacing it with a 'market based' alternative that has yet to be outlined in detail. While, in post-election comments, he has suggested keeping certain facets of the ACA in any replacement program, a repeal would be positive for health insurers and pharmaceutical companies. That is notwithstanding the final details and implications of any proposed alternative. However, this policy path would likely create uncertainty in the short run, and an increase in the number of uninsured Americans would be negative for not-for-profit hospitals, healthcare service providers and medical device suppliers. It would also hurt pharmaceutical companies by reducing demand, although they would gain relief from fee, rebate and discount requirements. For US states, the repeal of the ACA would not necessarily reverse increases in Medicaid enrollment nor the associated costs. Trump's plan to convert Medicaid into a block grant would force states to curtail services or pick up more of the costs themselves, a negative.

### Expense pressure is building, contributing to lower margins

Hospitals continue to juggle rising pharmaceutical costs, growing bad debt and additional salary/benefit expenses with growing employment and increased pension costs. Hospitals have been employing more physicians and acquiring physician practices in an effort to manage the transition to population health strategies, such as the introduction of value-based and risk-based models. Employing a greater number of physicians typically leads to lower profitability, and population health strategies require significant technological investment that can also drive down margins. In addition, drug costs continue to rise; high barriers to entry for pharmaceuticals are leading to significant price increases.

Pension costs are a growing expense pressure for private hospitals because the federal government's pension guarantee agency (Pension Benefit Guaranty Corporation, or PBGC) will [progressively increase premiums over the next several years](#). We expect that

pension costs will continue to grow, driven by rising unfunded liabilities due to recent weak investment returns and falling discount rates.

Continued information technology investment to ensure timely insurance and patient billing should improve longer term margins but can require expensive upgrades and system improvements in the near term. Many hospitals view these upgrades and enhancements as necessary preparation to accommodate future changes to reimbursement models, including the evolving focus on population health and value-based payment.

The Centers for Medicare and Medicaid Services (CMS) continues to implement payment model changes. For example, one recent change is the introduction of bundling programs whereby hospitals are responsible for the costs of a patient's procedures and post-discharge care needs over a specific period. The model is designed to incentivize hospitals to improve outcomes and reduce inpatient costs. However, it requires significant near-term technology and tracking investments, which the hospitals will have to run concurrently with the existing fee-for-service care models.

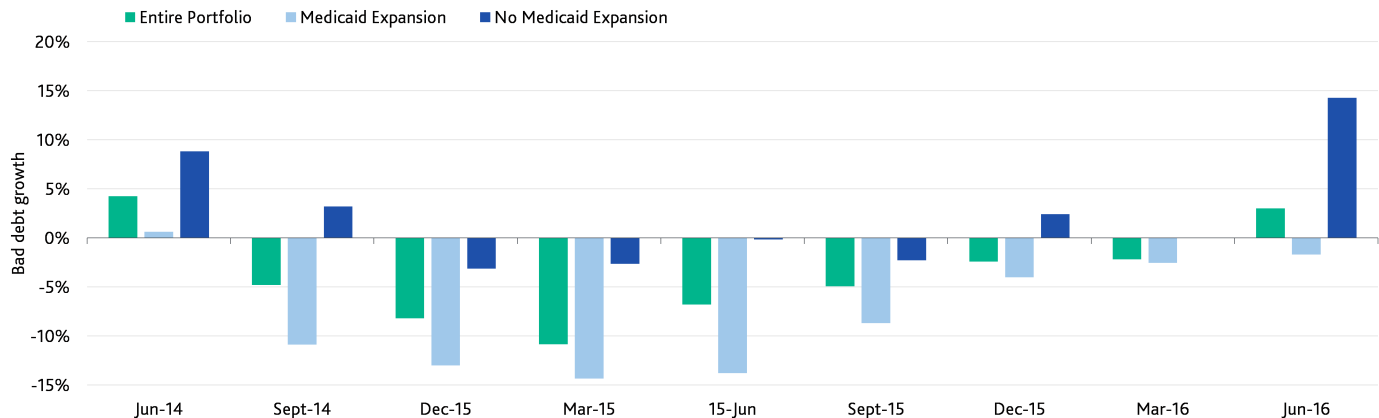
As management teams are becoming more adept at controlling costs and managing risks around population health, some hospitals, typically larger systems, are creating their own insurance companies or purchasing insurance companies in order to manage risk and gain market share. This can create operating volatility and enterprise risk as management expands beyond its core capabilities.

### Bad debt rising as expected

Healthcare exchange disruption and the increased exodus of insurers will contribute to higher bad debt and healthcare costs (see Exhibit 3). After falling for several years as more patients gained insurance, bad debt is again on the rise, particularly in non-Medicaid expansion states. Rising co-pays and high deductibles for employer health plans are also driving increased costs and bad debt, regardless of whether a state expanded Medicaid.

Exhibit 3

#### Bad Debt on the Rise as Initial Benefits of ACA Expansion Abate



Source: Moody's Investors Service

Insurance premiums have increased significantly for plans sold on the public exchanges due to the large losses that insurers have incurred in this market. A variety of reasons are driving these losses, including rule changes that removed a number of healthier individuals from the risk pool and the non-payment of risk-corridor funds owed to insurers (these payments were intended to protect insurers from excessive losses in the first three years of the exchange's operation). These losses have resulted in the large national insurers exiting a number of markets and the closure of many money losing non-profit insurance co-ops.

## What could change the outlook

Our outlook could change to positive if the operating environment improves, allowing for above-average growth in operating cash flow that would likely involve an easing of regulatory pressure or a significant positive shift in projected reimbursement rates. We would consider changing the outlook to positive if we expected sustained operating cash flow growth above 4% over a 12-18 month period, after accounting for healthcare inflation.

We would consider changing the outlook to negative if we expected weakening business conditions leading to flat or negative operating cash flow, after inflation. Other factors that would contribute to a negative outlook include: major changes to Medicare or Medicaid reimbursement, a significant increase in the uninsured rate, or changes to federal policy that disrupt the healthcare market.

### US for-profit hospital outlook is stable

The outlook for the [US for-profit hospital industry is stable](#), reflecting an expectation that same facility EBITDA growth will remain stable at 2.5%-3% over the next 12-18 months. EBITDA growth will be lower than the last few years because hospitals are constrained by weak inpatient volume trends, relatively modest increases in reimbursement rates and rising costs.

## Moody's Related Research

### Sector in depths:

[Trump's Election Victory to Shift Ground on Trade, Financial Regulation, Healthcare, November 2016](#)

[Affiliations to Continue at Healthy Pace, Increasing Scale and Bolstering Finances, October 2016](#)

[Hospitals Increasingly Issuing Debt to Fund Pensions, October 2016](#)

[Quality-Based Reimbursement Will Increasingly Impact Financial Performance, September 2016](#)

### Outlook:

[US For-Profit Hospitals: Outpatient Volumes Drive Stable Outlook as Costs and Bad Debt Continue to Rise, August 2016](#)

### Median Reports:

[Not-for-Profit and Public Healthcare - US Medians - Growing Revenue and Demand Support Strong Margins, Contraction Ahead September 2016](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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