Healthcare Finance

Newsletter | September 2019

Rating Agencies Release Not-For-Profit Healthcare Median Reports, See Some Improvements

The three major rating agencies recently released their annual median reports for the not-for-profit hospital sector based on fiscal 2018 data. Moody's released three separate reports: general medians,[i] medians by provider size,[ii] and medians by region.[iii] Standard and Poor's (S&P) released four reports: standalone providers,[iv] systems,[v] children's hospitals,[vi] and speculative grade providers.[vii] Fitch released a single report[viii] covering all hospitals and health systems. Fitch previously released a Children's Hospitals Medians report in July.[ix]

The rating agencies were generally consistent in their findings, noting improving operating margins and relatively stable balance sheet metrics. The following are the key takeaways highlighted by the median reports.

Fitch:

- There was improvement in operating margin for the first time in two years, particularly at the low end of the investment grade spectrum (BBB category), and among AA borrowers.
- Key balance sheet metrics including days cash on hand, cash-to-debt and leverage remain stable.
- Medians are based on 220 rated hospitals.
- Fitch maintains a negative outlook on the sector based on historic pressure on operating performance and challenges inherent to the transition to population health, at-risk contracting, and the entrance of non-traditional competitors. Sector pressure will persist but longer term stability is likely as the sector weathered the great recession, sequestration cuts, and a shifting payor mix.

S&P:

- Overall median operating margins improved in the BBB and AA categories, reversing a multi-year decline that started in 2016.
- Balance sheet medians are generally stable, with standalone unrestricted cash-to-debt declining slightly due to added debt and the investment market downturn in late 2018.
- Expected longer-term rating pressure for standalones is due to reimbursement and expense trends.

continued on next page

PFM'S HEALTHCARE TEAM

Errol Brick
Group Co-Head
bricke@pfm.com
Miami • 786.671.7480

Chris Doyle
Group Co-Head
doylec@pfm.com
Boston • 617.330.6914

Pierre Bogacz
Director
bogaczp@pfm.com
Orlando • 407.406.5780

Brian Carter
Director
carterb@pfm.com
Philadelphia • 215.814.1962

Alford Evans
Director
evansal@pfm.com
Chicago • 312.523.2435

Duncan Brown
Senior Managing Consultant
brownd@pfm.com
Seattle • 206.858.5367

Stephen Murphy
Senior Managing Consultant
murphys@pfm.com
Boston • 617.330.6914

Brenda DeGoias
Senior Analyst
degoiasb@pfm.com
New York • 646.561.0714

- Mergers and acquisitions (M&A) activity continues to grow systems' net patient service revenue as they further consolidate.
- Medians are based on 279 rated standalone hospitals and 142 health systems.
- S&P maintains a stable outlook for the sector based on improving balance sheets, stabilizing operating margins, and M&A activity expected to boost credit quality and increase operating margins as weaker performers are eliminated.

Moody's:

- Margins and debt coverage ratios show signs of stabilizing for first time in three years, driven by expense reductions and revenue cycle improvements, although margins remain well below past levels.
- There is a decline in days cash on hand due to M&A and weaker equity market returns.
- Leverage metrics stabilize due to improvement in revenue available for debt service and decreased leverage.
- Outpatient volume growth continues to outpace inpatient volume growth.
- Liquidity decreased across sizes.
- Capital spending remains below depreciation for smaller providers, while it exceeds depreciation for larger providers.
- South and Midwest regions continue to show robust profitability, while the Northeast continues to show the weakest financial performance and lowest relative liquidity. Stagnant population growth, high costs of living, and a unionized workforce constrain margins.
- Medians are based on 284 rated standalone hospitals and health systems.
- Moody's maintains a negative outlook for the sector based on expected flat or declining operating cash flow, growing expenses, flat or declining inpatient admissions, soft outpatient visit growth, increased Medicaid share of payor mix, and low reimbursement rates increases.

As part of its financial advisory services to not-for-profit healthcare providers, PFM can prepare a comparison of an institution's historical key financial ratios to the rating agencies' median ratios for the institution's rating category and subgroup.

[i] Medians – Revenue growth rate inches ahead of expenses as margins hold steady (Moody's 9/3/2019).

[ii] Medians – Smallest hospitals show margin stability while largest decline (Moody's 9/3/2019).

[iii] Medians – Revenues outpace expenses across all regions, yielding financial stability (Moody's 9/3/2019).

[iv] U.S Not-For-Profit Acute Health Care Stand-Alone Hospital Median Financial Ratios – 2018 vs. 2017 (Standard & Poor's 9/4/2019).

[v] U.S Not-For-Profit Acute Health Care System Median Financial Ratios – 2018 vs. 2017 (Standard & Poor's 9/4/2019).

[vi] U.S. Not-For-Profit Health Care Children's Hospital Median Financial Ratios – 2018 vs. 2017 (Standard & Poor's 9/4/2010).

[vii] U.S. Not-For-Profit Acute Health Care Speculative Grade Median Financial Ratios – 2018 vs. 2017 (Standard & Poor's 9/4/2010).

[viii] 2019 Median Ratios for Nonprofit Hospitals and Healthcare Systems (Fitch, 9/3/2019).

[ix] 2019 Median Ratios for Not-for-Profit Children's Hospitals (Fitch July 2019).

While on the main stage, the trade war continued.

Economic Highlights

- Although domestic economic data remains generally positive, concerns about global growth, geopolitical issues in Europe and the U.S.-China trade war remain center stage.
- President Trump announced, by tweet, another round of tariffs on "the remaining 300 Billion Dollars of goods and products coming from China" into the U.S. A 10% tariff on $112 billion went into effect on September 1, with the balance deferred until December 15 to avoid harming American consumers during the holiday shopping season. Not to be upstaged, China retaliated by halting the purchase of U.S. agricultural goods and imposing a new round of tariffs on $75 billion of U.S. goods. The markets remain on edge for each new tweet, announcement or news event.
- Following the 25 basis point (bps) (0.25%) rate cut at July's Federal Reserve (Fed) meeting, market pundits have called into question central bank independence in the face of blistering White House criticism. Nevertheless, Fed Chair Jerome Powell has set the stage for another "mid-cycle rate adjustment" in September. The European Central Bank and other central banks around the globe have also begun to shift towards a more accommodative posture.
- The U.S. labor market remains strong, but job gains have moderated. The U.S. added 130,000 jobs in August, below expectations, and that figure included 25,000 temporary hirings to prepare for the 2020 census. The unemployment rate remained at 3.7%, while the labor force participation rate rose and wages grew at a decent pace.
- U.S. manufacturing remains in the limelight, with industry surveys showing a notable decrease in business confidence and contraction in orders, exports, production and employment. Although an important indicator, the manufacturing sector today is only responsible for about 8.5% of jobs in the U.S. Manufacturing is among the sectors most sensitive to trade and business cycle turns.
- An 8.4% jump in building permits and a 2.5% rise in existing home sales were positive indicators for the housing market, while a plunge in new home sales, decline in housing starts and weak home price gains disappointed. The expected boost from lower mortgage rates has yet to fully materialize.

Bond Markets

- U.S. Treasury yields plunged in August, posting the sharpest monthly declines since 2015. Thirty-year Treasuries reached record lows, falling below 2% for the first time ever. The inversion of the yield curve grew, with 10-year Treasuries falling below those of two-year Treasuries in a classic early warning sign of recession. Yields on short maturities (less than one year) fell nine to 22 bps, while yields on maturities greater than one year fell 37 to 56 bps.
- As a result, August's bond rally led to strong returns on longer-term Treasury benchmarks compared to their shorter counterparts. For example, the three-month and 12-month U.S. Treasury indices returned 0.21% and 0.38%, respectively. Meanwhile, the two-year, five-year and 10-year indices generated returns of 0.83%, 2.26% and 4.67%, respectively, for the month.
- Although absolute returns were strong across the board in August, diversification generally detracted from performance as most spread sectors did not keep pace with the significant rally in the U.S. Treasury market.

Municipal Bond Market

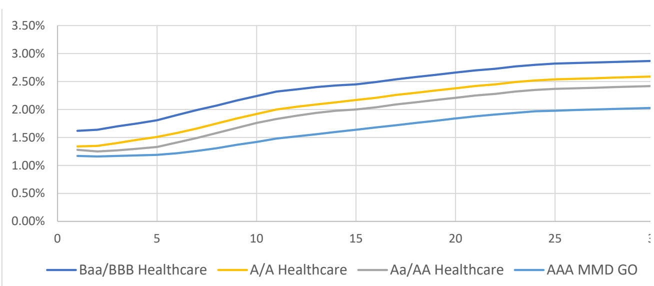
- Municipal new issuance increased in August by 13.6% to $38.75 billion from $34.1 billion the same month last year. Year-to-date municipal new issuance is up 5.3% to $239.9 billion for 2019 from $227.8 billion during the same period last year, according to Municipal Market Monitor (TM3) data.
- August experienced positive bond flows throughout the month and ended with net inflows totaling $8.79 billion, following July's net inflows of $10.14 billion, according to Investment Company Institute (ICI) data.
- The Municipal Market Data (MMD) Index saw declining rates across the yield curve in August. The 1-year rate dropped 6 bps to 1.01%, while the 3-year rate dropped 6 bps to 1.02%. The 5-year rate declined 8 bps to 1.03%, while the 10-year rate decreased 30 bps to 1.22%. On the long end, the 30-year rate dropped 40 bps to 1.84%, according to TM3 data.
- The 10-year MMD Single-A General Obligation (GO) Index credit spread decreased by 3 bps to 28 bps and the Double-A GO Index credit spread remained unchanged at 12 bps, according to TM3 data.
- In August, Municipal-to-Treasury ratios experienced increasing rates across the yield curve. The 2-year ratio rose to 66.7% from 56.4% in July, and the 5-year ratio increased to 73.9% from 60.0%. The intermediate-term ratio rose to 72.7% from 66.3% and the 10-year ratio rose to 81.2% from 75.2%. The 30-year ratio grew to 93.7% from 88.7%, according to TM3 data.
- The Municipal curve steepened in August with the AAA MMD 2-year/10-year slope falling to 21 bps from 45 bps in July, and the AAA MMD 2-year/30-year slope decreasing to 83 bps from July's 117 bps.

FIXED-RATE MARKET			
Maturity	AAA MMD	US Treasury	Muni Swap Rate
5-Year	1.19%	1.65%	1.06%
10-year	1.26%	1.72%	1.13%
20-year	1.42%	1.79%	1.24%
30-year	2.03%	2.22%	1.54%

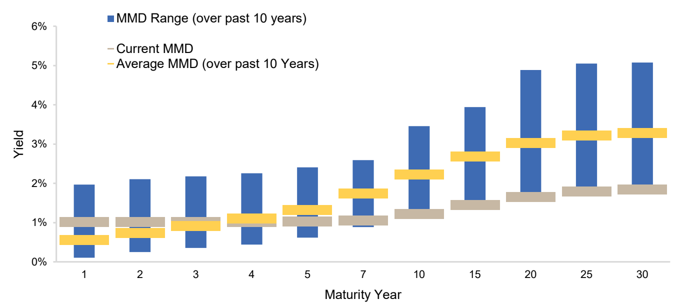
VARIABLE RATE MARKET		
Maturity	Current	1-Month Change
SIFMA Index	1.31%	-1 bps
1-Month LIBOR	2.04%	-16 bps
3-Month LIBOR	2.13%	-3 bps
SOFR	2.15%	-1 bps

HEALTHCARE 30Y SPREADS	
Category	Spread to MMD
AAA Level	21 bps
AA Level	39 bps
A Level	56 bps
BBB Level	84 bps

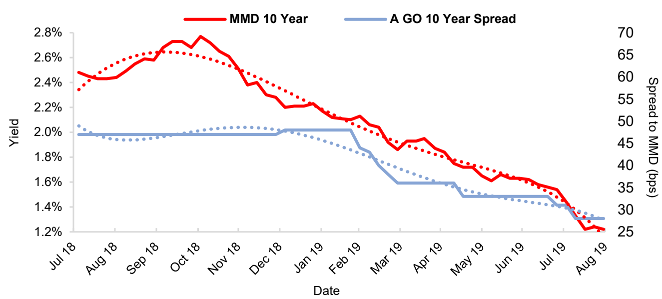
Healthcare Yield Curve



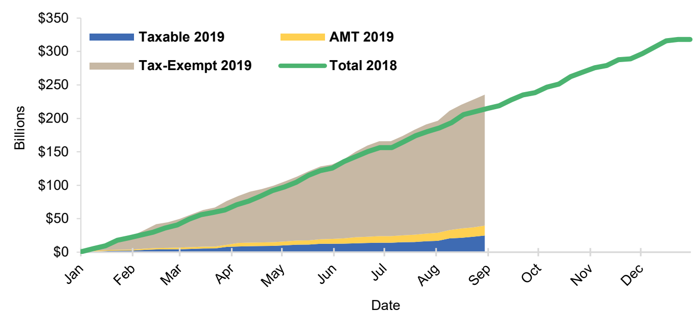
MMD Rates Over Time



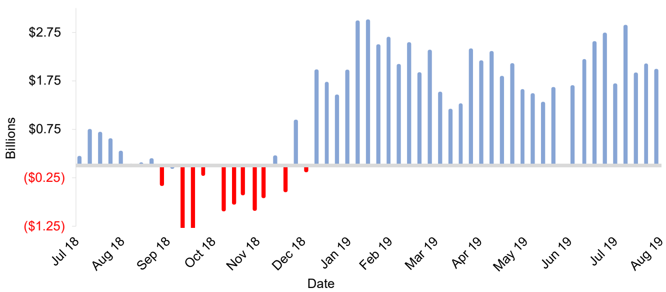
Rate and Spread Movement



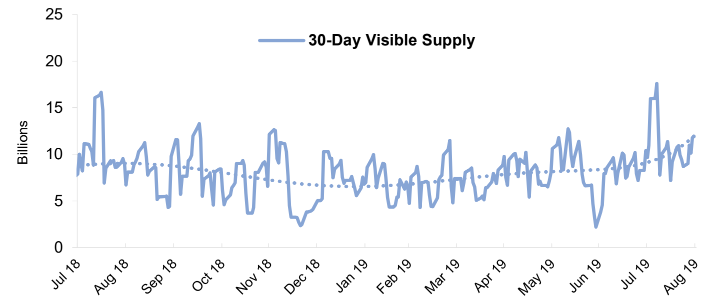
2019 Cumulative Issuance



Weekly Mutual Fund Inflows (Outflows)



30-Day Visible Municipal Supply



Mergers and Acquisitions

- Children's National and HSC Health Care System received regulatory approval to integrate (Washington Business Journal, September 6, 2019).
- Community Health Systems sold two Florida hospitals to AdventHealth (Nashville Ledger, September 12, 2019).
- Quorum Health will divest Watsonville Community Hospital in California (Yahoo Finance, August 30, 2019).
- Northside Hospital and Gwinnett Health System are on the cusp of finalizing their merger (MJDOnline, August 21, 2019).
- Ascension to acquire Allegan healthcare Group in Michigan effective September 1 (St. Louis Business Journal, August 29, 2019).

SELECTED HEALTHCARE ISSUANCES								
Borrower	Tax Status	Par Amount	Ratings	Dated Date	Final Maturity	Coupon	Spread	Senior Manager
Commonspirit Health	Tax-Exempt	$1,207,725	Baa1/BBB+/BBB+	8/8/2019	2049	4.00%	114 bps	Citi
Nuvance Health	Tax-Exempt	$340,110	A3/A-/NR	8/13/2019	2049	4.00%	80 bps	BAML
Premier Health Partners	Tax-Exempt	$288,205	Baa1/NR/A	8/14/2019	2045	4.00%	98 bps	Barclays
SCL Health System	Tax-Exempt	$400,725	Aa3/AA-/AA-	8/20/2019	2039	4.00%	58 bps	Morgan Stanley
St Lukes University Health Network	Tax-Exempt	$103,855	A3/A-/NR	8/22/2019	2050	4.00%	98 bps	BAML
SCL Health System	Tax-Exempt	$98,070	Aa3/AA-/AA-	9/5/2019	2040	4.00%	69 bps	Morgan Stanley

Sources: Bloomberg, Refinitiv and ICI. Unless otherwise noted, all data is presented as of August 13, 2019.