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What to Watch in Healthcare

Issuance Increases, But Financial Performance and Ratings are Likely to Stay Volatile

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Healthcare is essential to all Americans and highly important to the economy. But a granular, issuer-specific approach to selecting investments in the sector is crucial, particularly because financial stress across the industry has forced administrators to re-think their operating assumptions and business models. Financial performance and bond ratings are likely to remain volatile and inconsistent as the sector emerges from a range of post-pandemic issues.

First-quarter bond sales by hospitals and health systems nearly tripled from their 2023 pace, totaling more than $7.2 billion. But investors shouldn't misinterpret the surge as an "all clear" signal for healthcare credits: Financial performance and bond ratings are likely to remain volatile and inconsistent as the sector emerges from a range of post-pandemic issues.

Ultimately, healthcare is essential to all Americans and highly important to the economy. In addition, federal and state policy has traditionally been supportive, especially in times of crisis. As a result, the sector, while operating under a perennial cloud of doubt, has always shown resilience. But a granular, issuer-specific approach to selecting investments in the sector is crucial, particularly because the financial stress across the industry, especially post-COVID, has forced administrators to re-think their operating assumptions and business models.

Investors need to be able to distinguish between financial stress caused by near-term operating disruptions and longer-term competitive challenges, and should also be on the lookout for transformative transactions like mergers or joint ventures that could have a long-term impact on credit strength.

The Post-Pandemic Period and Nascent Recovery

Fiscal 2022 through early fiscal 2023 was one of the worst periods for healthcare providers financially since the passage of the Balanced Budget Act of 1997. The causes were varied and included many factors tied to the country's emergence from the pandemic, such as rising labor costs and limited staff availability, supply chain shortages, and increasing pharmaceutical costs. Operating issues were then compounded by weak investment performance and dwindling COVID support payments, as well as the need to repay previously supplied COVID cash advances. Rating agency downgrades over the past year exceeded upgrades in the sector, reflecting the negative impacts on both income statements and balance sheets, and we also observed a rise in technical defaults.

While the challenges have been immense, the sector is showing clear progress across a wide array of metrics. Operating margins have improved, and balance sheets are generally stabilizing. Higher wages for nurses have helped hospitals attract and retain permanent staff, leading to sharp reductions in contract labor and lower total labor costs. At the same time, supply chain issues have been resolved as they have for many portions of the economy as a whole. Nonfinancial metrics, most notably inpatient volumes, have started to trend positively, and outpatient volumes continue to grow. Anecdotal reports also indicate emergency room volumes are up as people are finally comfortable returning to hospitals.

Many management teams say it will take two to three years to recover to more sustainable margins in line with pre-pandemic performance, and this will require effective execution of formal "turn-around" and operating-improvement plans. A multiyear recovery is consistent with the sector's history of needing time to mend following sharp downturns, as the shock and magnitude of the most recent one was too significant to recover quickly.

Longer Term Risks Reemerge

As the near-term causes of financial weakness subside and partial recovery is evident, longer-term challenges are re-emerging. These include concerns about an adequate labor supply (particularly for front-line caregivers), rising pharmaceutical prices, and changes to the Medicaid program. The sector is also consistently impacted by the emergence of new types of competition, natural evolution in the practice of medicine, and the aging U.S. population, which continues to drive weakening payor mixes for many providers.

Labor issues are moving from a short-term cost and availability issue to a longer-term labor supply issue. Many providers addressed pandemic-era labor issues by sharply increasing the use of very expensive contract labor. When this proved unsustainable, providers increased salaries and benefits and were able to reduce the use of contract labor. As the pandemic slowed, many issues surrounding staff 'burnout' also eased, which helped staff retention.

Physician subsidiaries of hospitals and health systems continue to weigh down operations, as providers have had to pay large and often growing subsidies to attract both line physicians and key physician leaders. Recruitment bonuses and routine subsidies are the norm as the physician labor market continues to make recruitment increasingly difficult and expensive.

The costs of pharmaceuticals continue to outpace inflation. While federal policy to negotiate drug prices for Medicare should help, potential savings are not scheduled to begin until 2026.

The end of the pandemic also brought with it the end of expanded Medicaid eligibility, which meant the loss of health insurance for many patients. However, this is partially offset by record growth in ACA marketplace enrollments. In addition, the robust job growth in the country and the need for employers to compete aggressively for talent helps expand the availability of commercial insurance, which, in turn, should help the sector at least slow the growth in government payors.

The fundamental practice of medicine also continues to evolve, which, while often good for patient outcomes, presents its own risks to providers: Declining hospitalization rates and increasing use of outpatient and therapeutic drug therapy options can reduce inpatient utilization and overall margins.

Competitive Landscape Continues to Evolve

Hospitals and health systems also face new forms of competition outside the traditional hospital structure. The more competitive environment reflects the significant growth in ambulatory care over multiple decades – itself a significant positive – and includes pharmacy chains, urgent care centers, tech companies, and physician consolidators.

Lastly, as the U.S. population ages, Medicare enrollment continues to grow. As the payor mix shifts to Medicare from commercial carriers, profitability is depressed, because commercial insurance remains far more profitable for providers than any other payor source.

And consolidation among insurers is stressing those profits as well. Federal and state regulators are focusing their attention on provider consolidation, yet in many markets, insurers have a higher degree of leverage, as the number of insurance companies is much smaller than the number of providers. This leads to unbalanced market forces that often result in hospitals and health systems receiving annual reimbursement increases that are well below the growth of expenses. While not new, we would expect continued and growing friction over rates.

The increased scrutiny of mergers and acquisitions is an ongoing concern. While tighter examination has halted several mergers recently and over the past decade, usually in an attempt to maintain competition for patients, smaller providers have historically found it difficult to get the same level of rate increases that larger systems are able to obtain from commercial insurance companies, preventing a truly even playing field.

Conclusion

Our assessment of the healthcare sector suggests that the sector retains its historical resiliency, but that the recovery, while broadly evident, remains case-by-case. Hospitals and health systems with robust enterprise profiles and experienced management teams will continue to have the underlying strength to work through their challenges, and are likely to become acquirers over the next few years: Providers that are unable to sufficiently recover over the next few years will be forced to consider mergers, acquisitions and joint ventures, which might not have been contemplated in the past. We believe this will occur despite continuing scrutiny from federal and state officials, as mergers and acquisitions remain an important strategy to help manage costs, improve reimbursement, and strengthen service offerings as well as overall market presence. While the pandemic was an unprecedented event in modern times, the broader challenges facing healthcare are not. Industry consolidation, governmental support, and sector essentiality all play an important role in supporting the long-term health of the sector.

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