Rating Outlook **Stable**

(2015: Stable)

**Sector Outlook Negative**

(2015: Negative)

- Shifting of risk from payors to providers
- Increasing consumerism
- Labor cost pressure

**Rating Outlook Stable:** Fitch Ratings is maintaining its stable rating outlook for the sector, as we expect the vast majority of rating actions and outlooks in 2016 to be affirmations and stable, respectively. The sector’s improving liquidity and leverage positions provide a solid financial cushion to absorb potential operating volatility, thereby allowing for relative stability in overall 2016 rating actions.

**Sector Outlook Negative:** Fitch is maintaining a negative sector outlook reflecting our longer-term view that the sector will be increasingly challenged by growing consumerism, meager rate increases and a shifting of risk from payors (particularly Medicare) to providers through the expansion of value-based/risk-based contracting. The slower than anticipated impacts of ACA have not diminished sector risks, only deferred them. We believe these effects will remain limited beyond 2016, these impacts have not been diminished over the longer term.

**Sustained Performance Expected in 2016:** Fitch expects the sector to preserve historical profitability in 2016, reflecting stable patient volumes and a continued focus on operating efficiencies. Reimbursement levels will continue to be constrained due to increased penalties under the Medicare value-based reimbursement program, meaningful cuts to disproportionate share payments and limited commercial rate increases.

**Size, Scale or Specialization:** Developing and effectively leveraging size and scale will continue to be critical factors driving strategic decisions and capital deployment. Providers lacking relevant market penetration and the platform to properly align the continuum of care will increasingly be challenged. Providers with highly specialized expertise (i.e. children’s hospitals) will be somewhat insulated if able to draw from a broader geographic area and/or embed into larger organizations.

**Mergers and Alignments Remain Brisk:** The level of mergers and acquisitions (M&As), alignments and joint-venture arrangements among hospitals, physicians and non-acute healthcare providers is expected to remain brisk in 2016. 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.

**Operating Agility Remains Key:** Despite the expected overall rating stability, Fitch believes that the pace of change in reimbursement models and patient volumes across states and markets will be increasingly uneven. Providers’ ability to adapt operations to the changing environment will be a driver of credit stability.

**Outlook Sensitivities**

**Pace of Change:** Fitch’s stable rating outlook reflects our belief that the impact on reimbursement from risk-based and value-based reimbursement models remains limited. While a growing percentage of provider revenues from Medicare, Medicaid and commercial payors have a risk-based component, the potential gain or loss under those contracts has been and is expected to remain relatively limited in 2016 and even 2017.
Key Issues

Stable Patient Volumes Expected

Clinical volumes in 2015 were higher than anticipated, primarily reflecting the benefits of increased coverage under the ACA, as well as growth in the Medicare population and a higher level of activity from commercial beneficiaries. Providers in Medicaid expansion states experienced particularly higher clinical volumes with material reductions in charity care and bad debt expense. Clinical volumes from Medicare and commercial payors were also fairly solid with inpatient admissions holding steady year over year and higher levels of outpatient activity.

Inpatient surgical volumes were mostly stable in 2015 after several years of erosion, while outpatient surgical volumes were higher, compared with 2014. Fitch believes the trend reflects not only increased coverage under Medicaid, but also absorption of volume impacts from readmission reductions, Medicare’s ‘two midnight rule’ and the growth in high-deductible health plans over the past few years.

Fitch expects overall stability in clinical volumes in 2016 with a continued shift toward outpatient volumes. Healthcare services delivered in non-acute care settings will also likely rise as providers emphasize management of population health and chronic conditions in the community, as well as coordination of services across the continuum of care (such as rehabilitation, home health and primary care). More effective management of newly enrolled Medicaid populations in 2016 may be reflected in lower ER visits and inpatient admissions.

Continued Pressure on Reimbursement

Providers in Medicaid expansion states realized meaningful reimbursement benefits, resulting in sharp declines in charity care and bad debt. Excluding the benefit of expanded Medicaid coverage, Fitch expects reimbursement levels to continue to be constrained in 2016, reflecting increased penalties under Medicare’s value-based purchasing program, the growth in risk-based reimbursement models and anticipated cuts to Medicare included in the November budget compromise. Additionally, meaningful cuts to disproportionate share funding began on Oct. 1, which is likely to negatively impact providers in those states that have not expanded Medicaid eligibility and serve a large indigent population.

However, the expected impact on margins resulting from the shift to value-based/risk-based contracts has yet to materialize. Fitch believes this reflects both the structure of contracts (mostly limited to upside-only payments) and a relatively small percentage of payments “at risk”. The movement to risk-based contracts is likely to pick up speed over the next 36 months, driven by the larger, integrated health systems that have developed in several major metropolitan areas.

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. Growth of narrow or “tiered network” products offered through the health insurance exchanges and employer plans will likely disproportionately challenge smaller stand-alone providers located in metropolitan service areas. The continued migration toward high-deductible health plans will drive increased consumerism and price sensitivity among patients, forcing greater price competition for certain services, such as imaging, lab and certain high-use DRG codes.

The continued roll-out of new IT platforms and upgrades has presented an added hurdle, although the majority of providers’ revenue cycles recovered without a prolonged impact on accounts receivables or major write-offs. Fitch took negative rating action in 2015 on a limited number of providers reporting material write-offs, typically within 12-24 months of implementation. While initial
reports from providers have been encouraging, the implementation of ICD-10 coding in October 2015 exposes providers to potential volatility in the revenue cycle. Related financial risks are particularly high for providers lacking strong controls, as well as for lower-rated providers with weaker liquidity positions to absorb delayed reimbursement. Correspondingly, both governmental and commercial payors’ ability to process claims in a timely manner will also play a critical role in managing revenue cycles.

**Consolidation, Integration and Alignment Strategies**

Fitch expects continued robust M&A activity as hospitals seek partners to improve economies of scale, expand their market presence or bolster service offerings across the continuum of care. Developing an individual plan identifying the unique operating footprint of each organization is critical, as strategies will depend on the provider’s size, scale, market penetration and reputation. Failure to recognize the appropriate strategy could lead to unnecessary investments and delays in preparing for reimbursement changes, the combination of which could materially impact financial performance.

The ultimate goal for most providers remains joining a network that can leverage its collective size to achieve financial benefits. Focus is on cost efficiencies via contract negotiations, the supply chain, clinical programs and data mining, as well as building a network to prepare for population health management. While traditional M&A activity resulting in full asset mergers will continue, Fitch believes alternative alignment strategies will become more prevalent in order to preserve financial independence. To date, a number of structures have been executed under joint-venture or joint-operating agreements between providers of varying sizes that typically share operating revenues but keep assets and liabilities separate. Provider development of insurance plan skills and capabilities (either organically or through M&A or other partnerships) is also likely to further accelerate in 2016 and beyond.

The pace of physician alignment and employment will likely slow from very strong levels over the past few years, as most physicians have consolidated. Future employment growth will likely be driven by recent graduates, with further alignment activity focused on clinical integration by developing and aligning primary care networks.

**Operating Agility Remains Key**

The next five to seven years will represent an even greater transition for the hospital sector as financial incentives accelerate in redesigning and implementing the core model of healthcare delivery and reimbursement. 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.

Operating agility remains key to stabilizing financial performance while navigating a multitude of strategic changes and patient volume fluctuations. Fitch has observed continued vigilance in expense containment, judicious capital spending and a focus on operating efficiencies to preserve profitability, with breaking even on Medicare rates a typically cited objective. While expense pressures should remain manageable in 2016, labor cost pressures could begin to escalate in the coming year as the economy continues to improve.

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, as well as improvements to labor productivity (through attrition, layoffs and flexible staffing), the revenue cycle, supply chain management and shared service efficiencies. Given the number of efficiencies already implemented and benefits realized, opportunities for further expense savings will
likely require a clinical care redesign and rationalization of certain clinical services, which can take longer to implement.

2015 Review

For 2015, rating actions reflect sound operating profitability driven by solid clinical volumes from Medicaid, Medicare and commercial payors, effective expense control and modest capital spending. Sector liquidity continues to benefit from solid cash flow generation, lower but still-positive investment returns and modest capital spending. Fitch expects median ratios for the 2015 operating year to show stable operating profitability versus 2014, with continued improvement in liquidity and leverage metrics.

Through Nov 25, 2015, there were 169 affirmations, nine downgrades and 30 upgrades in Fitch’s portfolio. In addition, there were 21 positive outlooks and seven negative outlooks through the same period.