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INVESTORS SERVICE

OUTLOOK
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Not-for-Profit and Public Healthcare – US

# 2024 Outlook - Revised to stable as financial recovery gains momentum

TABLE OF CONTENTS



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## Summary


The outlook for the not-for-profit healthcare sector has been revised to stable from negative as expense growth decelerates, especially labor costs. At the same time, a modest rebound in patient volumes and higher reimbursement rates in many cases will lift revenue. These factors signal that a financial recovery will increasingly take hold in 2024, marked by an uptick in cash flow margins. While some government initiatives pose risks, increased state financial backing and Federal Emergency Management Agency (FEMA) funds will aid some healthcare providers' financial turnaround.

» **Operating cash flow and margins will improve.** Median operating cash flow (OCF) growth will be about 10%-20% in 2024, while the median OCF margin (our measure of profitability) will edge up to about 7% from 6% in 2023. Still, the median OCF margin will trail a pre-pandemic 8%-9% and fall below 3% for about a third of providers we rate.

» **Revenue growth will slightly top expense growth, calling for strict expense management to maintain a path to recovery.** Higher reimbursement rates from insurers for some providers and modest patient volume growth will propel a revenue increase. Yet, growth in labor costs, while slower, will remain a challenge.

» **Liquidity will remain healthy despite using cash for capital investment.** Though many hospitals will increase capital investments after deferrals during the pandemic, most will maintain solid days cash on hand. Still, liquidity will remain vulnerable to investment volatility.

» **Covenant headroom will improve for most issuers, but a significant portion will continue to face difficulties avoiding violations.** Headroom above debt covenant levels will increase as OCF strengthens. Yet the risk of covenant breaches will remain high for some providers facing fundamental challenges such as weak cash positions.

» **Federal and state policies offer opportunities and risks.** Many states are using Medicaid directed payments to help some hospitals, while FEMA grants will continue to provide one-time revenue bumps. However, Medicaid disenrollment and potential minimum nurse-to-patient staff ratios will remain among policy hurdles.

» **What could change the outlook**. The outlook could move to positive if the median OCF margin is above 8%, likely driven by significantly slower expense growth and better reimbursement prospects. A substantial rise in labor or supply costs or a disruption in volume recovery could lead to a negative outlook.

### Outlook definition

The stable outlook reflects our view of credit fundamentals in the US not-for-profit healthcare sector over the next 12 months. Sector outlooks are distinct from rating outlooks, which, in addition to sector dynamics, also reflect issuers' specific characteristics and actions.

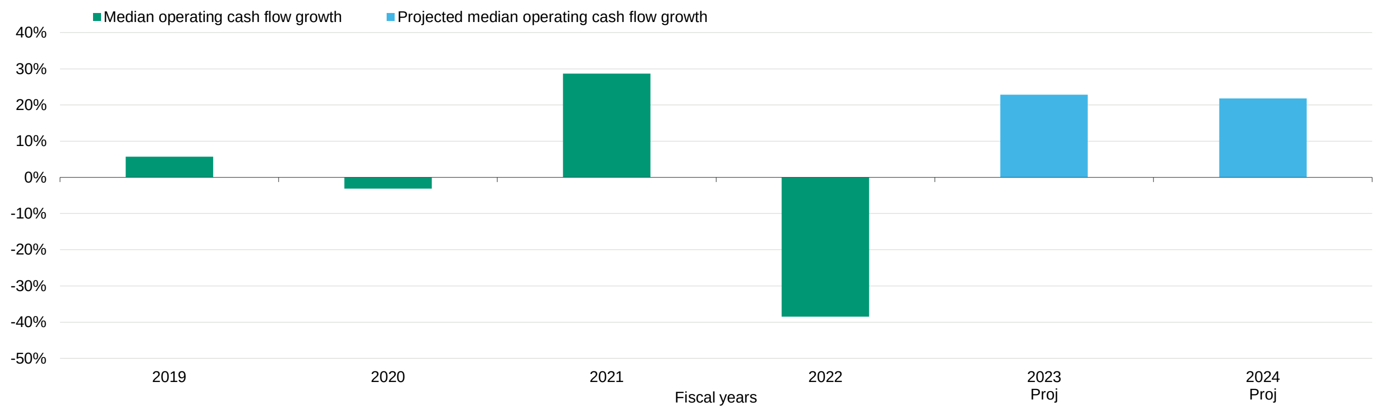
A sector outlook does not represent a sum of upgrades, downgrades or ratings under review, or an average of rating outlooks.

## Operating cash flow and margins will improve

Median operating cash flow (OCF) will grow about 10%-20% in 2024 as revenues are set to slightly top expenses (see Exhibit 1). Revenue growth drivers include a modest rebound in patient volumes, higher-than-average reimbursement rate increases for some providers, and improvements in revenue-cycle management, including reducing coverage denials by insurance companies. Still, while the expense growth rate is decelerating, high costs will remain a trouble spot.

Exhibit 1

**After plummeting in 2022, operating cash flow growth is rebounding**

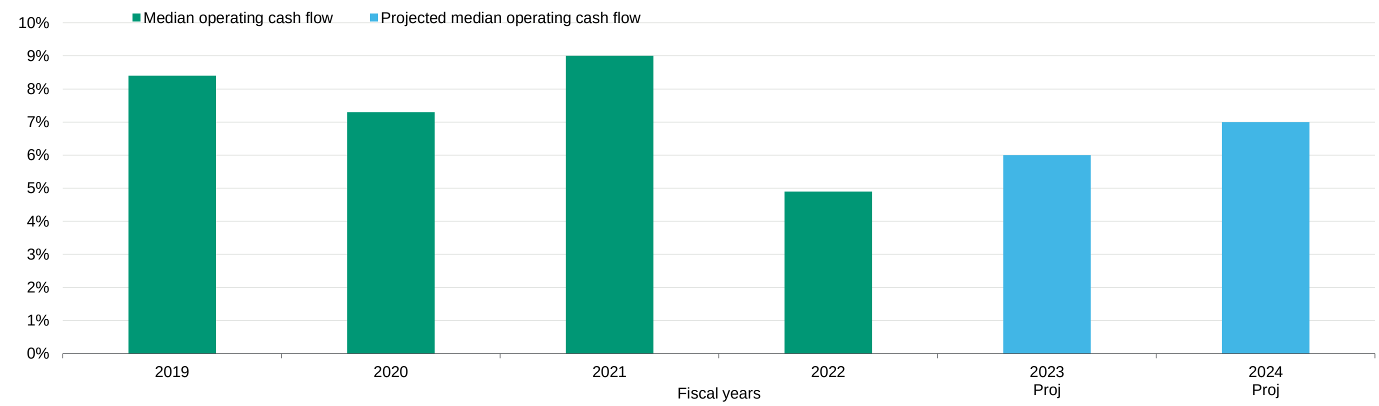



Fiscal years differ by issuer. Approximately a third end June 30, a third September 30 and a third on December 31.
*Source: Moody's Investors Service*

In a sign that the sector's recovery is gaining momentum, the median OCF margin (our measure of profitability) will tick up to 7% in 2024 from 6% in 2023 (see Exhibit 2). The increase will allow many providers to make investments in facilities and programs that can improve their competitive positions while maintaining liquidity.

Exhibit 2

**Growth in operating cash flow margins will allow many hospitals to make needed investments in facilities and programs and maintain liquidity**




Fiscal years differ by issuer. Approximately a third end June 30, a third September 30 and a third on December 31.
*Source: Moody's Investors Service*

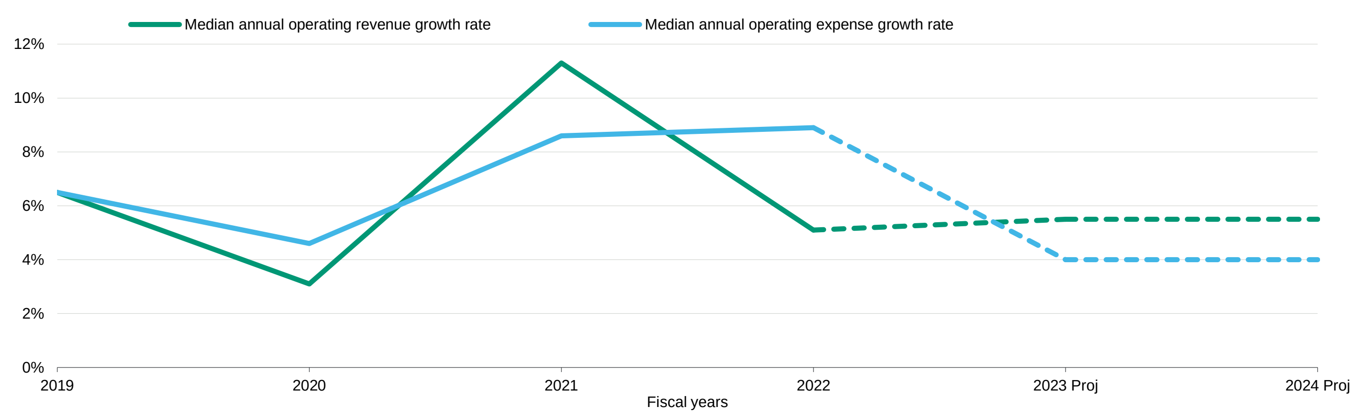
A median OCF margin above 8%, likely driven by slower expense growth, especially for labor, and an improved reimbursement environment could lead to a positive outlook. A large increase in labor or supply costs or disruption in volume recovery trends could lead to the outlook returning to negative.

## Revenue growth will slightly top expense growth, calling for strict expense management to maintain a path to recovery

Higher reimbursement rates negotiated with insurers in some cases and modest patient volume increases will drive median operating revenue growth in the 4%-6% range in 2024 (see Exhibit 3), topping median operating expense growth in the 3%-5% range. While expense growth will slow as labor costs decelerate substantially from a median 9.7% increase in salaries and benefits in 2022 (the last year with complete data), baseline expenses will remain structurally higher. And with the labor market still tight and inflation high, expense growth could pull ahead of revenue without diligent cost controls and efforts to improve operating performance.

Exhibit 3

**Revenue growth will surpass expense growth as labor costs decelerate, though baseline expenses will remain high**




Fiscal years differ by issuer. Approximately a third end June 30, a third September 30 and a third on December 31.
*Source: Moody's Investors Service*

### Cost controls will remain key to financial turnaround

Though reimbursement rate increases from insurers will rise in the mid-single-digit percentage range on average in 2024, they will not fully compensate for the recent expense increases due to inflation. In addition, rate increases will vary widely among providers and boosting margins will require relentless expense management for some hospitals, including efforts to reduce premium pay and increase net hires. Revenue-cycle management will also be critical as costs collecting patient payments remain high, partly because insurers remain aggressive in denying coverage and requiring extensive pre-authorization.

Revenue growth will be constrained by denied reimbursement claims and payment delays, while demand for extensive documentation by private payors will increase hospitals' costs and time needed for revenue collection. Growth in managed care plans like Medicare Advantage, where insurers have a greater denial incentive than plans in which they simply administer payments with no insurance risk, will likely lead to more denials. In turn, we anticipate a rise in lawsuits by hospitals for underpayment and contract violations, leading to more contentious contract renegotiations with insurers and terminations in relationships. High-profile lawsuits and terminations could spur legislative intervention that alters the negotiating landscape.

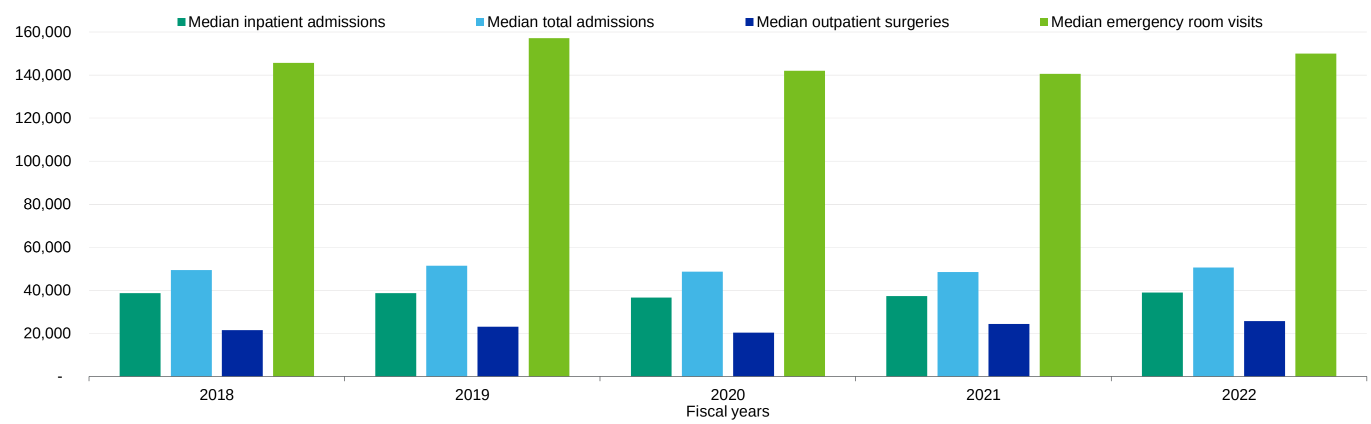
With the end of a pandemic-era provision blocking states from disenrolling Medicaid beneficiaries, the uninsured rate will likely increase and potentially cost hospitals reimbursement funds. However, some states' Medicaid directed payment programs will help offset a revenue loss. The programs enable states to draw down matching federal funds using taxes levied on managed care companies and direct increased payments to providers. New programs in North Carolina, South Carolina and other states will increase some providers revenue by 4%-6%, with most of the increases directly increasing cash flow and augmenting operating margins.

### Volumes will continue to recover, with outpatients leading the way

In 2024, volume recovery will continue as staffing turnover stabilizes, labor productivity strategies are more effective, and the average length of stay (ALOS) is reduced, freeing up inpatient treatment capacity. Total admissions, which include inpatient and observation stays, have already surpassed pre-pandemic levels (see Exhibit 4). However, the composition of volumes may not be favorable for hospitals. Growth in outpatient volumes will lead the recovery, in line with the industry shift of more complex procedures to outpatient settings because of advancements in medicine. Insurers provide hospitals with lower reimbursement for outpatient treatment than inpatient and encourage patients to seek care in outpatient centers. To compensate for lesser revenue, health systems will continue to shift their focus to growing high-margin outpatient service lines in fields such as oncology and orthopedics.

Exhibit 4

**Total admissions and outpatient volumes continue to grow, while inpatient volumes trail pre-pandemic levels**




Total admissions include inpatient admissions and observation stays.
Fiscal years differ by issuer. Approximately a third end June 30, a third September 30 and a third on December 31.
*Source: Moody's Investors Service*

### Expenses will remain high, but grow at more manageable levels

The healthcare sector will continue to grapple with high expenses principally because of a shortage of skilled labor, particularly nurses. However, the growth in expenses will slow as hospitals make greater efforts to recruit and retain full-time nurses (partly through providing expanded benefit packages) to reduce reliance on expensive contract labor. Still, with union activity on the rise nationwide, contract negotiations could become more contentious, resulting in work stoppages and hefty wage increases.

The ALOS will continue to decrease as hospitals aim to secure more post-acute-care beds through long-term contracts and improve discharge processes. However, ALOS is likely to remain at higher than historical levels. Healthcare systems with minimal access to post-acute-care settings will be particularly vulnerable to elevated ALOS, as many patients will need to stay in the hospital until they can be discharged to an appropriate post-acute-care setting. An elevated ALOS will keep labor costs high and may constrain hospital bed capacity, potentially curbing revenue.

Rising drug costs and medical supply inflation will weigh on hospitals. Inflation will also keep interest rates at higher than historical levels, making new borrowings more costly, and reducing some refinancings. Additional COVID-19 surges have the potential to increase costs if leading to staff departures and absences. Further, surges can hurt volumes and revenue if COVID-19 patients take the place of patients requiring more lucrative procedures. Also, cyber risks will necessitate significant spending on preventive measures, while security failures carry potential financial and other costs.

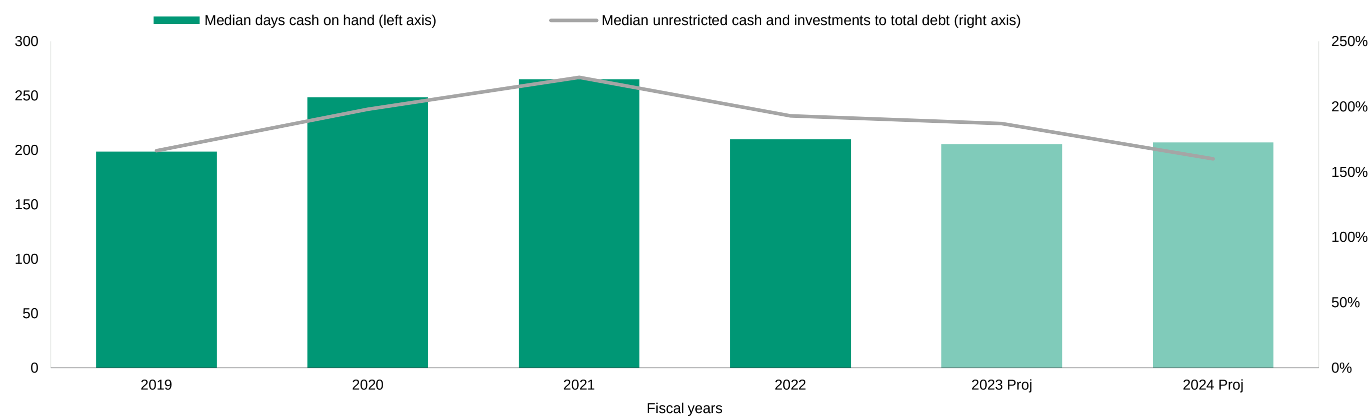
In response to these challenges, management teams will likely expedite initiatives that redesign workflow, better leverage IT and increase use of telemedicine and other technologies to streamline operations. Generative AI also stands to reduce some of health systems' record-keeping difficulties, long a pain point. Hospitals will also seek to reduce costs through partnerships with physician management groups and organizations specializing in revenue-cycle management, IT, care management, the patient experience and other areas.

## Liquidity will remain healthy despite using cash to fund capital investments

The sector's strong liquidity will continue in 2024 (see Exhibit 5) even though many hospitals will boost capital investments after deferrals during the pandemic. Hospitals will mainly use cash to fund the investments as opposed to issuing more debt. Despite using cash for capital investments, days cash on hand will grow, though not to previous heights, partly due to the repayment of accelerated Medicare payments.

Health systems will remain vulnerable to investment market volatility, particularly those with a heavy exposure to the equity markets. The median percentage of unrestricted cash and investments held in equities in 2022 was approximately 32%, accounting for the significant investment losses hospitals suffered then. While market returns have been better in 2023, the sector will remain subject to volatility risk.

Exhibit 5
**Liquidity will remain strong even with capital investments**




Fiscal years differ by issuer. Approximately a third end June 30, a third September 30 and a third on December 31. Projections do not take into account investment returns.
*Source: Moody's Investors Service*

## Covenant headroom will improve for most issuers, but a significant portion will continue to face difficulties avoiding violations

The headroom needed to avoid violations of covenants that require a minimum debt service coverage level or amount of days cash on hand will improve on balance in 2024, partly because of stronger operating cash flow. However, the pace of recovery from recent financial stress will differ across the sector with many issuers still at risk of covenant breaches. This group includes many health systems with substantial fundamental challenges such as high labor costs, weaker cash cushions, outsized operating losses or already-low covenant headroom.

Management teams have taken a variety of steps to mitigate the chances of a covenant violation, including liquidating investments to boost debt service coverage or drawing on lines of credit to temporarily increase cash. Additionally, hospitals can retire or refinance unfavorable debt agreements or request that bondholders enter into a forbearance agreement or provide a waiver. The current interest-rate environment, however, makes refunding to get out of an unfavorable debt agreement more expensive.

## Federal and state policies offer opportunities and risks

Some government policies stand to curb health systems' financial performance. For example, Medicare reimbursement levels are not keeping up with inflation and the end of a pandemic-era provision preventing states from Medicaid disenrollment has the potential to cost hospitals reimbursement funds.

However, some states' Medicaid directed payment programs will increase Medicaid managed care reimbursement and sometimes provide funding for indigent care, helping offset a revenue loss. Also, FEMA continues to provide one-time grants for previously incurred COVID-19-related costs, though the timing of the payments is uncertain and subject to delays as FEMA also needs funds to provide assistance in the wake of natural disasters.

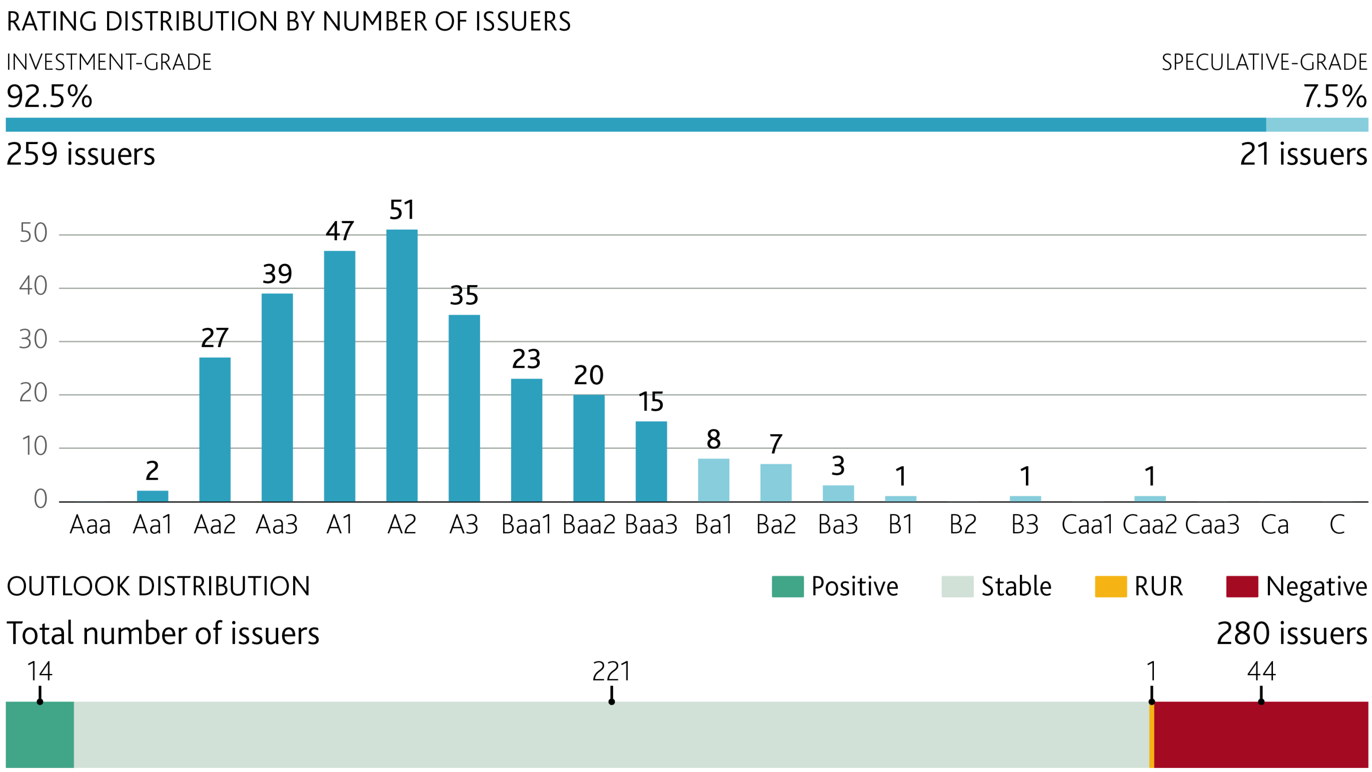
The 340B program, which allows some hospitals to purchase drugs at a discount, will continue to face scrutiny, with limits on usage of contract pharmacies possibly hurting eligible hospitals through operating income losses. However, some health systems may benefit from a one-time payout from prior-year 340B reimbursement true-ups in 2024.

The rate of consolidation among health systems may slow due to increased scrutiny of mergers by federal and state governments, potentially depriving distressed systems of exit strategies and slowing the growth of larger systems active in the M&A space.

Additionally, potential requirements for nurse-to-patient staff ratios could increase labor costs and exacerbate staffing shortages, especially at post-acute-care facilities.

## Appendix

Exhibit 6
**Distribution of ratings and outlooks of US not-for-profit healthcare providers**
As of October 27, 2023




*Source: Moody's Investors Service*

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