HFMA Lone Star Chapter

Signs of Life; Margins to Remain Pressured

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January 26th, 2024

> The last several years have proven very challenging for most of the sector, which is now facing the ongoing ‘labor-demic’ with significant staff shortages, intense wage pressure and heightened inflation. While staffing issues have started to attenuate, salary and wage expenses appear to have been reset at a new, higher level for many — directly impacting operating margins over the near term. This year (2023) was a turning point for many to the positive, particularly on a month-to-month basis; however, 2024 will remain challenging and will be yet another make or break year for a sizable portion of the sector.

Kevin Holloran; 2024 USNFP Hospital and Health System 2024 Outlook

Rating Distribution Remains Relatively Unchanged
By the way, this is my happy slide

Core Credit Drivers are Moderating; But Still Under Duress

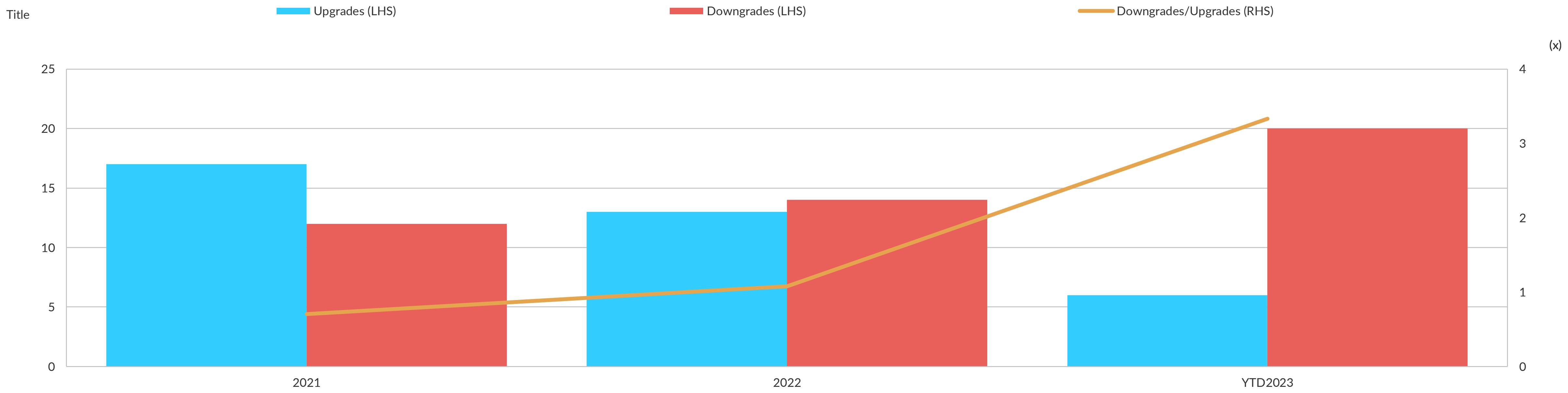
Core Credit Drivers: Hospitals

	Revenues			Expenditures				Financial Profile		
Sub-Sectors	Personal Income/ Affordability	Real-Estate Values	Demand/ Volumes	Labor Costs	Labor Availability	Non-Labor Operating Costs	Capital Input Costs	Leverage	Cost of Debt	Financial Reserves & Liquidity
Hospitals	N.A.	N.A.	↗	↘	↘	↘	↔	↔	↘	↔

↑ Improving – High relevance. ↗ Improving – Moderate relevance. ↔ Neutral. ↘ Deteriorating – Moderate relevance.
↓ Deteriorating – High relevance. N.A. – Not a material driver of credit quality in the sector.
Source: Fitch Ratings

The Downgrade to Upgrade Ratio has Clearly Tilted Negative

Hospitals - Rating Changes



Note: [If applicable.]
Source: Fitch Ratings

Analysis of the 2023 Downgrades

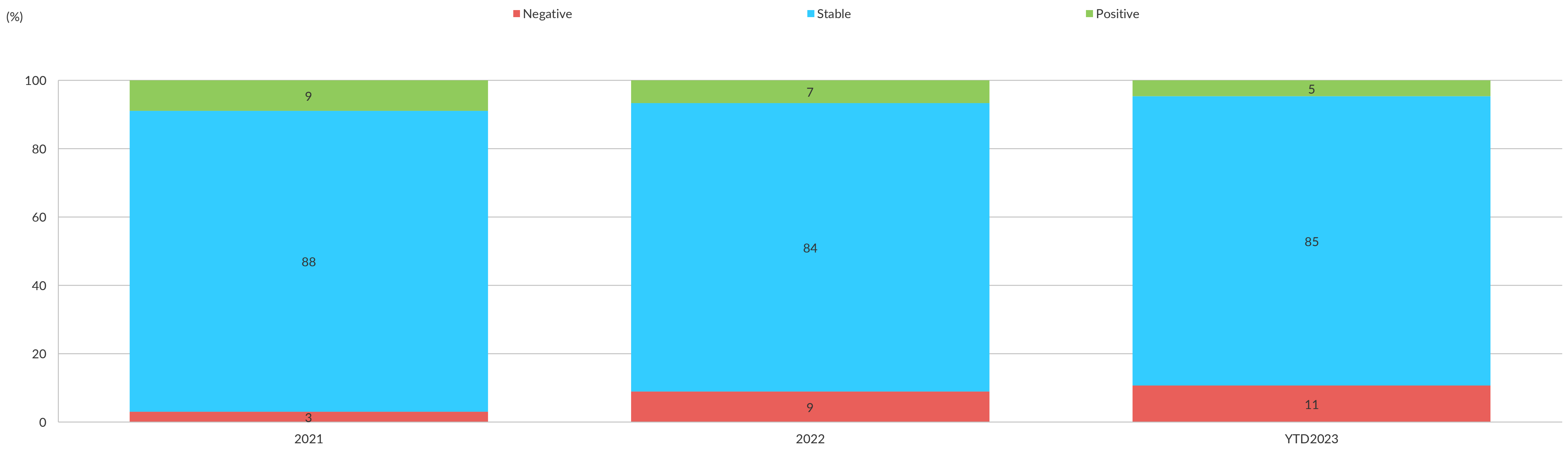
Ended the year with 21 downgrades.

Sample size, 20 downgrades through 11/16/2023

- Interestingly, downgrades concentrated in two states, WA (2) and PA (5); both markets have emerged as challenging states to operate in for a variety of reasons;
- Downgrades averaged 1.3 notches. If you exclude two 3-notch downgrades, the average is 1.1;
- Five downgrades occurred in the BIG range at the time of the downgrade, which is inconsistent with our ratings distribution, but consistent with the assumption that the BIG category carries greater volatility;
- The reasons attributed for the downgrades typically cite "sector-wide" issues such as operational losses and balance sheet diminution; but also very specific issues, such as IT implementation issues; 340b funding; significant capital spending; and aggressive expansion initiatives that simply did not work out as intended;
- Size and scale contributed more to 2023's downgrades that compared to prior year-end lookbacks:
  - Four out of the five multi-notch downgrades occurred in organizations that were under $500 million in revenue;
  - Eight out of the 20 downgrades occurred in organizations that were under $500 million in revenue.

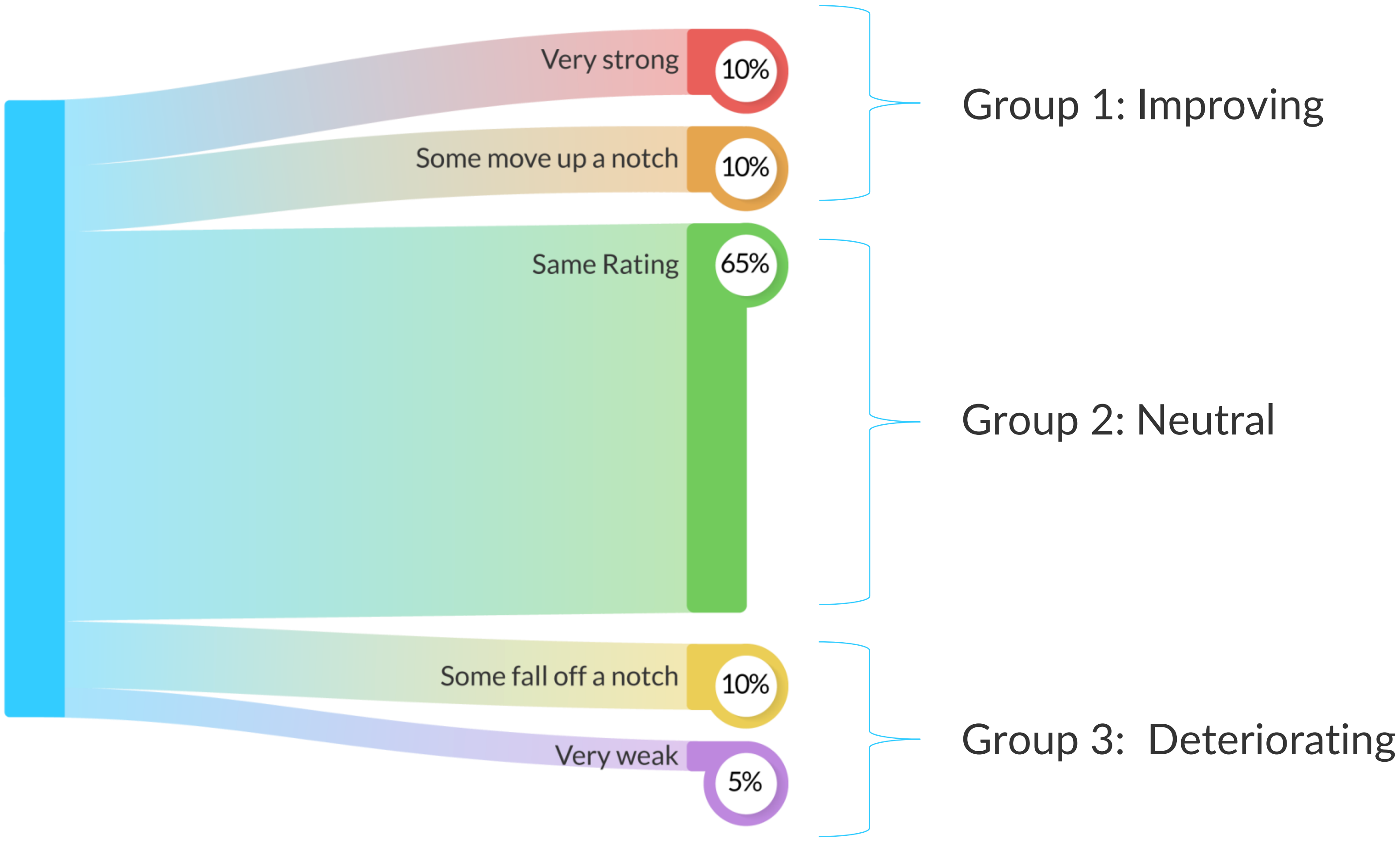
Negative Outlooks to Positive Outlooks Have Also Tilted Negative

Hospitals - Rating Outlooks

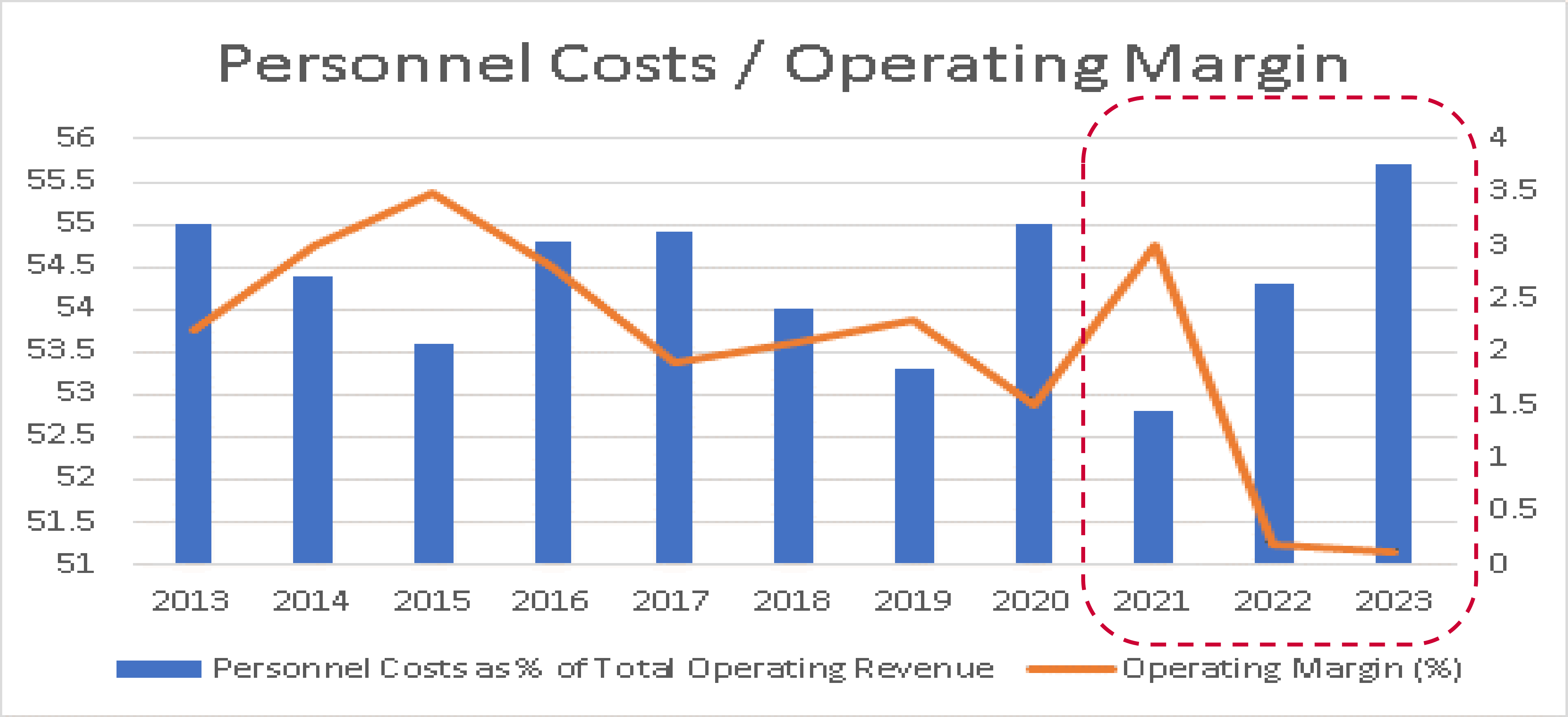


Note: [If applicable.]
Source: Fitch Ratings

Credit Quality is Trifurcating

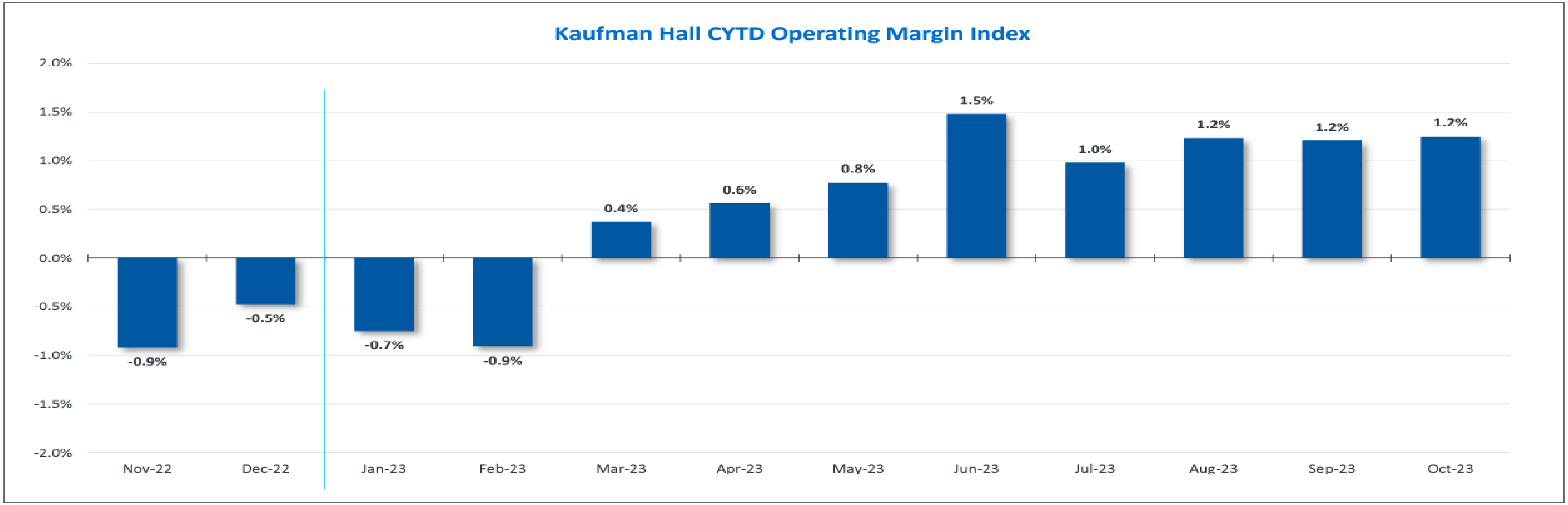


The Single Largest Determinant to Operating Success, by far, is Personnel Costs



Looking at this Slide, There are Signs of Life in the Sector

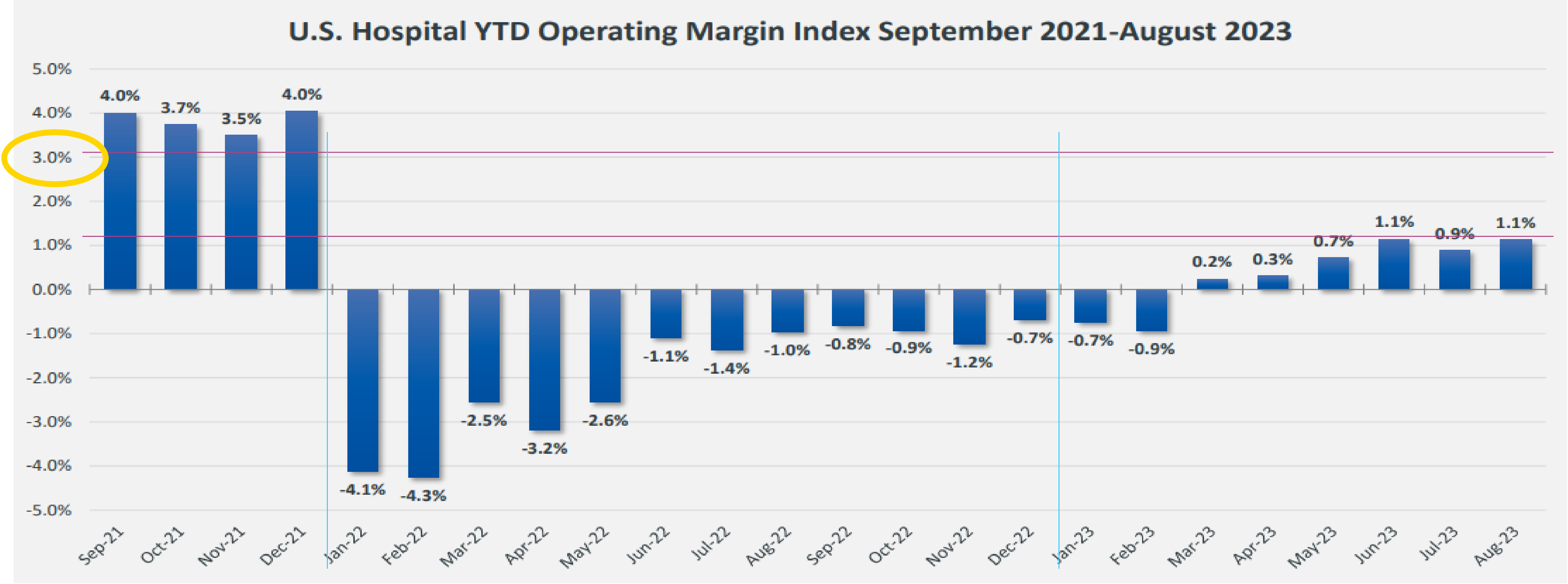
November at 2%



Kaufman Hall, National Hospital Flash Report (November 2023)

** Note: The Kaufman Hall Hospital Operating Margin and Operating EBITDA Margin Indices are comprised of the national median of our dataset adjusted for allocations to hospitals from corporate, physician, and other entities.*

Looking at this Slide; it is Clear we Have More Work Ahead of Us



* Note: The Kaufman Hall Hospital Operating Margin and Operating Margin Index is composed of the national median of our dataset adjusted for allocations to hospitals from corporate, physician, and other entities.

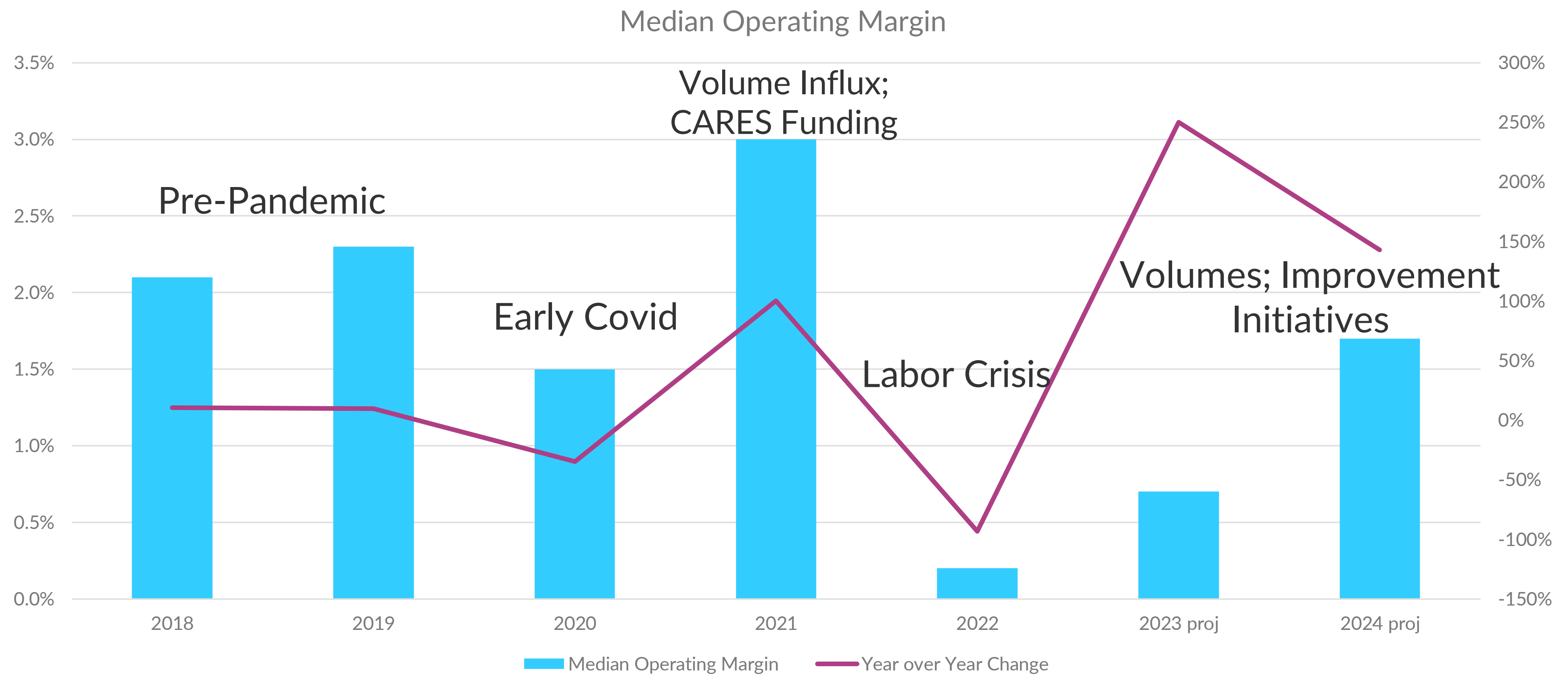
What to Watch

- A sector outlook reassessment would likely require significant improvement in labor productivity, given the current scarcity of available labor industry-wide, and for clinical positions in particular, which historically have been in high demand, but short supply. Gains in labor productivity will likely be achieved only through redesigned labor processes, possibly (probably) through technology and artificial intelligence advancements. Recent years have seen enhanced R&R efforts, emerging as one of, if not the, single most meaningful differentiator of operational success.
- A sector outlook revision to neutral would necessitate more widespread sector wide improvement to operating income, particularly in the wake of a very challenging 2022 (with an essentially break-even median operating margin) and an equally challenging 2023 expected.
- Equity market stability and a return to materially positive returns, could restore and increase rating headroom, in turn signaling a higher likelihood of a sector outlook revision as greater credit stability is amassed.

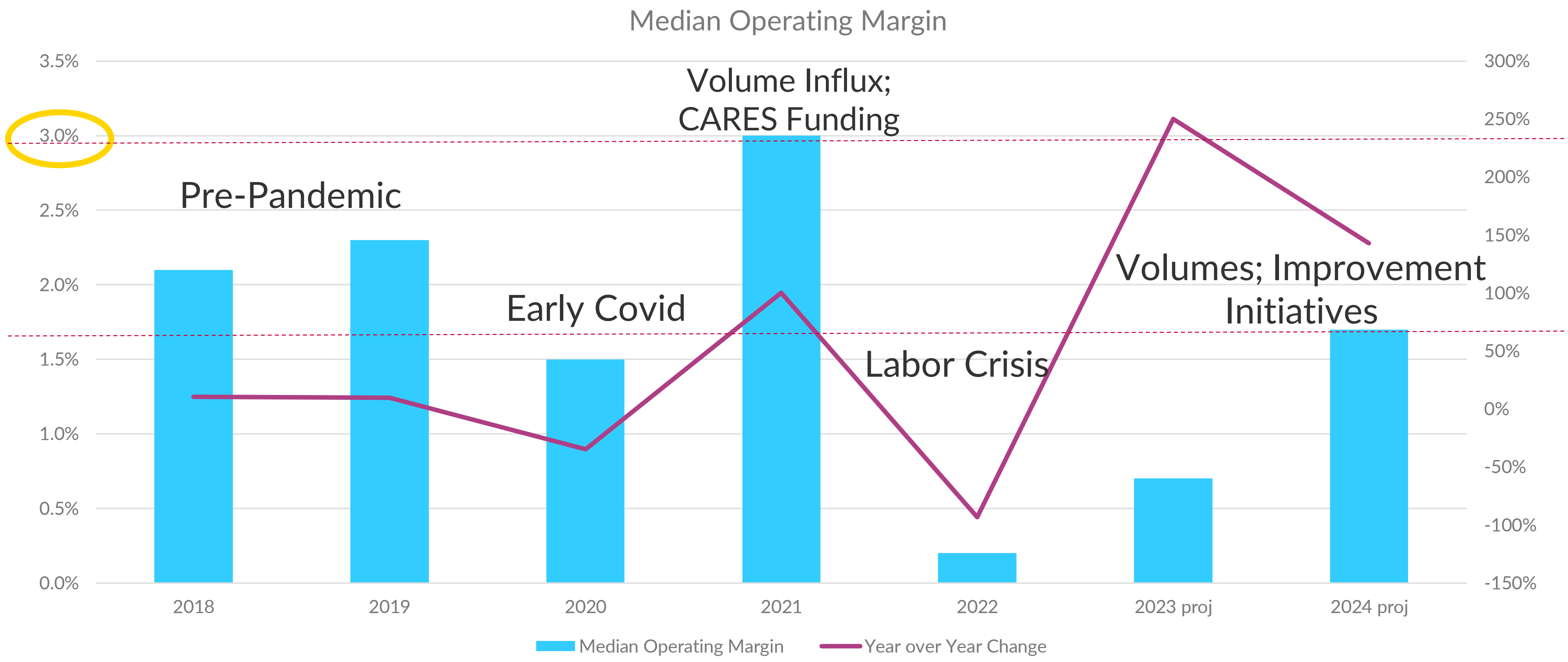
What Keeps me up at Night

- Though not expected to be a widespread event, a second year of debt service covenants violations are of particular concern this year. Second year violations, which would occur in calendar 2024 as late fiscal 2023 and early 2024 audits are finalized, may intensify the potential for bondholders to declare an event of default and perhaps accelerate bond repayment.
- A slow, but perhaps inexorable, unfavorable shift in payor mix as the population continues to age. Arithmetically we have seen this scenario developing for a long time, with lower birth rates coinciding with longer lifespans. Of particular concern is the year 2030, during which the final members of the "Baby Boomer" generation will reach age 65. This will potentially pose the scenario of a smaller workforce serving a larger population in need of heightened care.
- Local unfavorable demographics, that providers who are located in those areas, simply will not be able to positively influence or overcome.

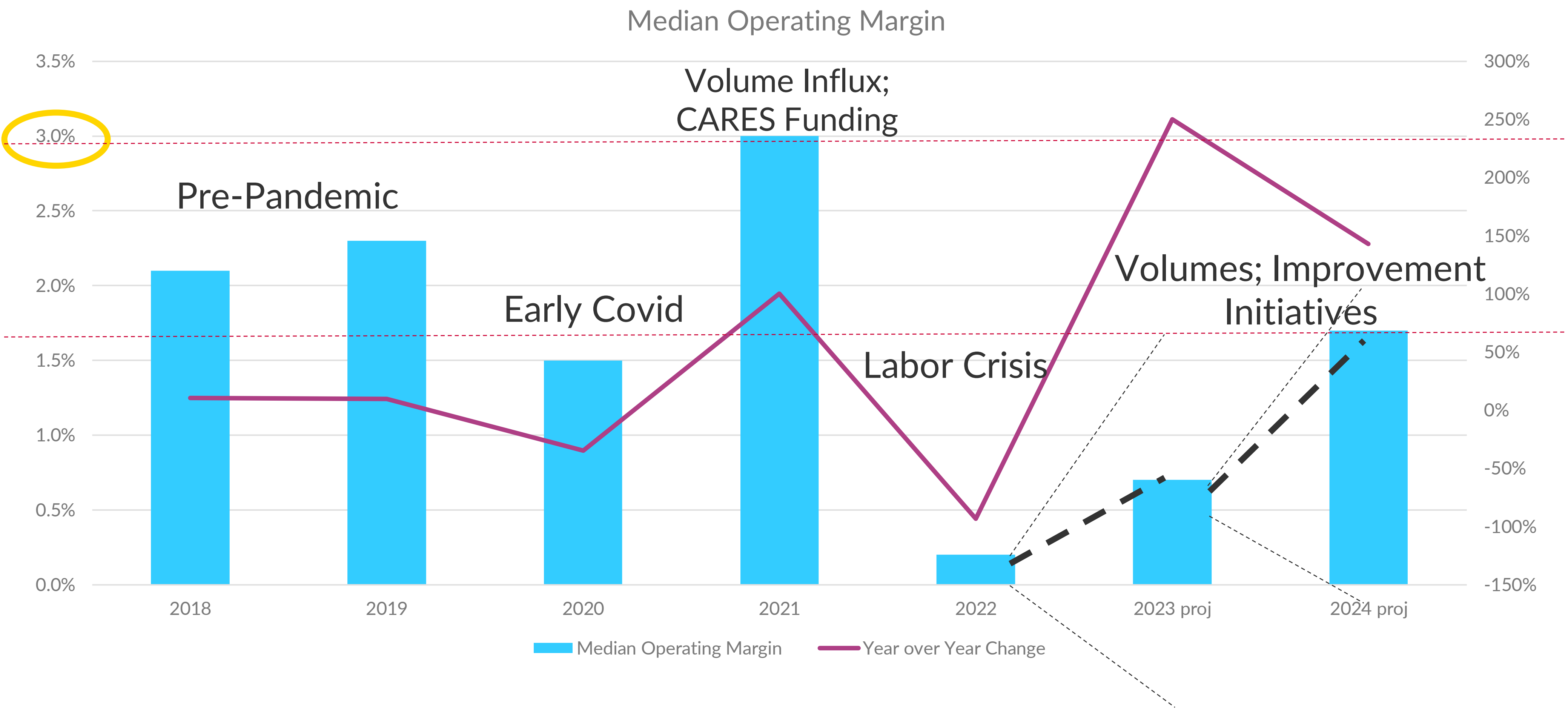
Median Operating Margin to Gradually Improve



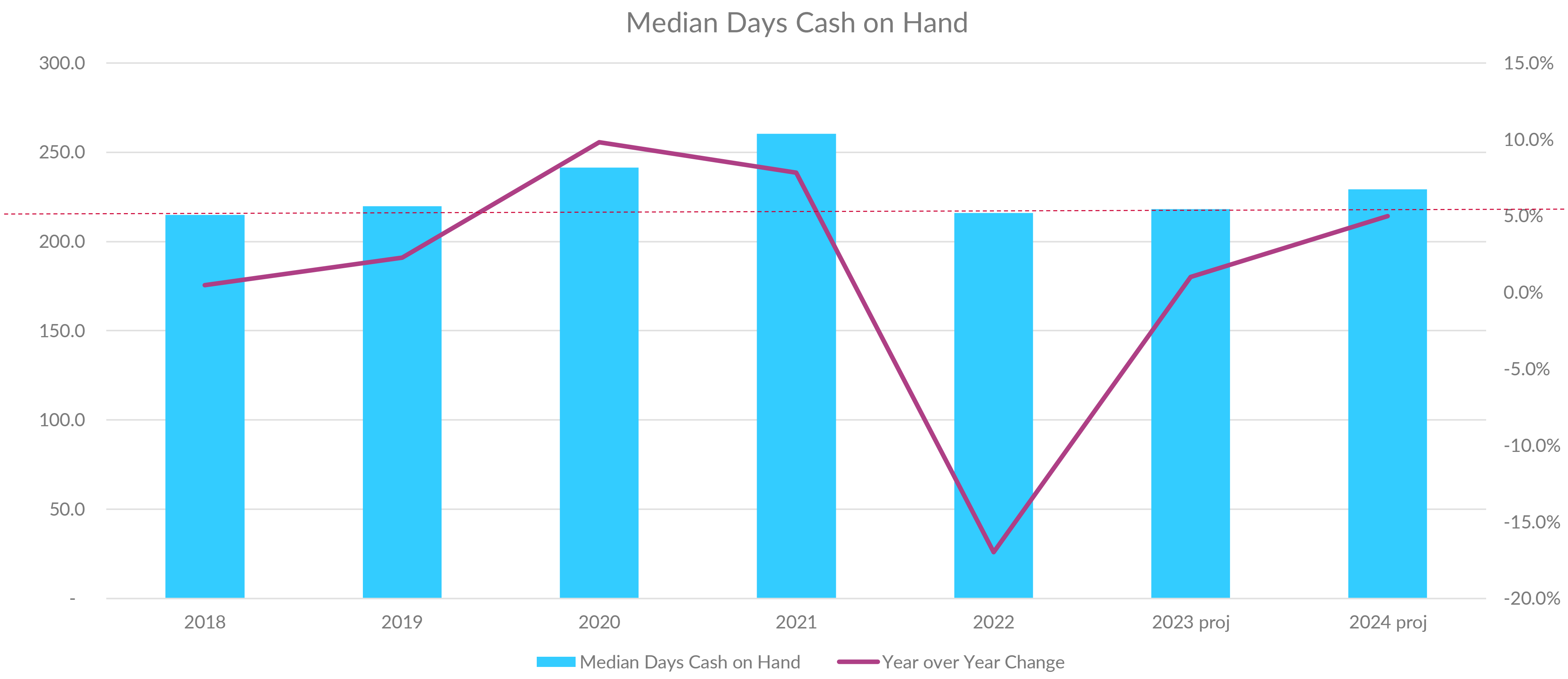
Median Operating Margin to Gradually Improve, but will not Exceed Pre-pandemic Levels in 2024



Median Operating Margin to Gradually Improve, but will not Exceed Pre-pandemic Levels in 2024; Trifurcation Still Expected



Despite Market Rebounds and an Increase in Operating Margin, a Larger Expense Base Will Keep Liquidity Improvement to a Minimum Over the Next Two Years; but Consistent with Pre-pandemic Levels



Key Takeaways: Remaining Stress

The Relationship Between Revenues and Expenses Remains a Structural Problem for the Sector.

Revenues are largely fixed.

Expenses are highly variable.

- Approximately 75% of a provider's revenues are fixed, with set payments from Medicare and Medicaid and Self-Pay.
  - Increasing revenues is only possible by increasing volumes, which is difficult under even the best of circumstances.
- Approximately 75% of a provider's expenses, consisting of salary/wage/benefit expense (50% -60%) and supplies/drugs (25%) have been under extreme duress.
- We cannot easily grow our way out of financial difficulties – diversification and essentiality will be key
- <u>The major issue we see isn't volumes, it's reimbursement levels and balancing expenses</u>
- <u>We have seen a tilt towards more medical v/s surgical volume</u>

Transformational change is needed, but transformational change isn't easy, or quick to implement

Key Takeaways: Green Shoots

There are "green shoots" of positivity in the sector.

- We anticipate a slight uptick in operating results in 2023 (as it comes to a close) and again in 2024
- Balance sheet strength, while down from peaks, is expected to remain at, or above current levels. Current levels are commensurate with pre-pandemic levels and convey overall credit strength to the sector.
- Many issuers have bypassed significant stress on operations for the last two years, indicating it can be done.
- On labor:
  - Data indicates that new hires are outpacing "leavers";
  - The number and per unit cost of contract labor is coming down;
  - Overall, the labor force is beginning to settle down
- Another year of uncertainty is predicted, but now rests at one year of uncertainty, compared to two years as of last year's sector outlook
- The much hoped for break-even on a month to month basis is occurring; although one has to acknowledge that it could be "green mirage", and that we may never regain pre-pandemic operating margins.
- Management continues to work on and develop new models of care delivery in an attempt to manage expense growth in line with top-line revenues.

Thank You for Your Valuable Time Today

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