What Investors Want to Know

Coronavirus/COVID-19: USPF Healthcare

Kevin Holloran, Senior Director

"The scale of the coronavirus pandemic is unprecedented. Severe disruptions to operations and longer-term economic pressures could affect provider and consumer decisions for years to come. With this outbreak, hospitals will likely end up at peak capacity or beyond for an undetermined amount of time. While the immediate effects of the outbreak will be challenging but manageable for higher rated hospital credits, medium- and longer-term risks will weigh on the sector, particularly if the outbreak continues throughout 2020 and macroeconomic conditions deteriorate for a prolonged period. Lower-rated hospitals with light liquidity levels that do take a significant financial loss over the next few months will be more limited in their ability to respond to any future operational issues, particularly in light of significant declines in unrestricted liquidity levels with recent market activity."

Margaret Johnson, Director

"We view LPCs as among the USPF sectors most exposed to the effects of the coronavirus. The most severe pressure could come from escalated operating costs due to labor and supply shortages. We are paying particularly close attention to lower-rated credits undergoing expansion projects, given the likely macroeconomic impact the outbreak and related containment measures will have on the financial position of prospective residents and prevailing real estate values if home buying activity remains slow for a protracted period."

Related Research

Coronavirus-Related Market Fallout Tests U.S. Not-For-Profit Hospital Reserves (Gauging Issuer Investment Portfolio Performance and Implications) March 2020

Fitch Rtgs: Coronavirus Pressure Builds for NFP Hospitals, Health Systems (March 2020)

Fitch Ratings Updates 2020 Sector Outlooks to Reflect Coronavirus Impact (March 2020)

Fitch Rtgs: Coronavirus Pressures Lower-Rated Life Plan Communities (March 2020)

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On March 25, Fitch Ratings held a webinar discussing the novel coronavirus and COVID-19, the disease it causes, in the U.S. and its potential impact on two key aspects of the U.S. healthcare system: acute hospitals and health systems, and life plan communities (LPCs).

After a short presentation, participants were invited to submit questions electronically. We received 60 questions, many of which were similar. We worked to answer most questions, and now we believe it helpful to provide market participants with written answers to all the questions submitted, including those addressed during the call. We combined duplicative questions where appropriate.

Coronavirus/COVID-19

The coronavirus is an unpreceded worldwide event that, mercifully, has not been experienced before in this sector. However, Fitch rating analysts have past experience with smaller infectious disease outbreaks (e.g. SARS or bird flu) and more localized credit events that impacted credit performance in material ways (e.g. natural disasters, network disputes or employee strikes). While neither compares to the depth and breadth of the COVID-19 outbreak, they provide a surrogate look to severe but plausible outcomes for the sector.

Limited Initial Rating Impact

Fitch does not anticipate widespread initial rating impact to either acute providers or LPCs. Fitch expects a deep economic contraction centered on second-quarter 2020, with a massive rise in unemployment. Fitch assumes containment measures can be unwound in the second half of 2020, allowing for recovery, although with so much depending on the progress of the virus, there is a large degree of uncertainty.

Our baseline scenarios anticipate that U.S. GDP will shrink by around 3% in 2020 (although this could be subject to revision), which is a deeper contraction than in 2009. In the event the virus is contained during the second half of 2020, Fitch believes real GDP growth will resume in 2021, but remain below the 2019 level for most of the year.

Feedback Encouraged

Fitch appreciates the attention from the market evidenced by the number of participants in the webinar (over 300) and the extensive and detailed questions they posed. We encourage future questions and actual issuer responses to the unique challenges of the outbreak.

U.S. Not-For-Profit Hospital and Health Systems

Is construction still occurring at hospitals or is it still planned? Is construction being delayed or stopped?

- Whenever economic or operational stress strikes a provider, the very first and often the easiest way to preserve capital (liquidity) is to turn the dial down on capital spending. This is not an across the board cut, nor a set percentage for all providers, rather each issuers' unique situation dictates how much capital they can preserve. For example, if you are a provider that recently completed and moved into a new facility, substantial amounts of future capital can be delayed, and Fitch has seen cases as high as a 60% or greater cut to capital spending. On the other hand, if you are a provider that is halfway through a new facility building project, it becomes very problematic to delay that spending/project for more than a brief period of time. Fitch can confirm that many projects that have yet to start are being sidelined for the immediate time being, as energy and dollars are best served focusing on the current COVID-19 outbreak.

Do sole community providers enjoy a position during this crisis that they cannot close? How does that affect Fitch's thinking on a rating?

- Fitch does not support the statement that sole community providers are any safer in terms of suffering operating losses, and ultimately rating stress, in regard to the COVID-19 outbreak. They are in fact, very likely to be on Fitch's shorter list of credits considered more at risk (smaller, single site, lighter levels of liquidity). While it may (or may not) be true that a sole community provider is unlikely to go out of business, as local business or local government might step in and bail out their only hospital in some sort of intervention, it does not mean that the hospital will not suffer operational losses and sharp decline in liquidity such that bondholders could miss a payment or have a re-structuring, which is a form of selective default. The hospital may remain open, but bondholders won't necessarily get paid on time, or in full.

Longer term, do we need to encourage hospitals to maintain higher inventory levels of PPE/ventilator type equipment or ICU beds? Will this COVID-19 crisis result in fewer, but stronger hospitals?

- Fitch believes that the COVID-19 outbreak will result in several longer term ramifications. One is that minimal levels of certain types of equipment and beds will become a requirement for "the next outbreak". Another is that some of the unprecedented levels of cooperation between non-partner providers will result in a mini-wave of merger and acquisition activity post COVID-19, although this could occur in the form of a joint venture, loose partnership or a joint operating agreement versus an outright merger.

Do you anticipate highly rated credits to run into debt service coverage issues for this fiscal year?

- Yes. All credits, highly or lower rated, will likely have debt service coverage issues during calendar 2020. The combination of lower revenues and heighted expenses, combined with recent market losses, should result in significantly lower coverage ratios for most of our rated universe. Similar to the 2008/2009 financial crisis, Fitch expects that these will be "technical" debt service violations and not payment defaults, and it is our expectation that waivers will likely be issued by bondholders. Technical defaults will be viewed in the longer-term context, while actual payment defaults would be considered a default according to our rating definitions, regardless of the duration of the payment delay.

Regarding elective surgeries, do you have a sense of the margin impact or percentage of revenues that will be affected?

- This will vary among hospitals and the volumes they typically serve in their facilities. For example, Women's and Children's hospitals predominantly do births, which are not elective; nor should specialty oncology (cancer) hospitals see volume declines — again, these are not elective. Many, but not all, safety net hospitals will also not see a significant impact as they see high levels of births and emergency room (not elective) types of surgical procedures. As you look around the sector, community hospitals currently see less reliance on elective procedures, and the financial impact to them will be less than to a high-end tertiary/quaternary facility that serves a mix of patients skewed towards more surgical (elective) versus medical. Fitch has seen ranges estimated (at the higher end) of a 400 to 600 basis point swing in operating margins for calendar 2020. Ultimately it depends on how long the moratorium on elective procedures lasts that will determine the final margin impact.

Do you have information on how the federal stimulus money will be distributed to hospitals? Is this enough and does this change Fitch's viewpoint?

- While the CARES Act, just passed by Congress will undoubtedly help offset losses associated with the COVID-19 outbreak, it is Fitch's opinion that it will not completely make them whole, and that the sector will still suffer significant operational losses through the first half of calendar 2020.
- The bill rolls out funding primarily in the following ways:
  - Coverage for COVID-19 testing, Medicaid and private insurers;
  - Elimination of the 2% Medicare sequester;
  - Increasing Medicare reimbursement for inpatient COVID-19 cases by 20%;
  - Hospitals can request up to 6 month advance lump sum on Medicare payments. Depending on qualification some could elect to receive 100% of the prior period payments, or 125% if a critical access hospital (CAH);
  - Delay reductions in disproportionate share (DSH) payments through 11/30/20.
- The exact dollar amount or timeline on when the funding will be available is still a guess. This logic does appear to allocate funding to those most directly hit, but does not aid those that are indirectly hit (e.g. pediatric providers are reporting revenue losses due to delayed elective

procedures even though they may never have COVID-19 patients in their facility).

What are you looking at for "at-risk" hospitals or health systems during this COVID-19 crisis?

- Generally, Fitch has two sub-sets of the rated portfolio that we consider more at-risk than other parts of the portfolio. The first set is largely lower rated: 'BBB' and lower; smaller (often stand-alone facilities) issuers; less than $400 million to $500 million in net patient revenue, with lighter liquidity and less than 100 days' cash on hand; and in areas that either have a high percentage of 65 and over population or that are in hard hit areas. A second subset would be issuers that are under currently relatively high levels of net leverage for their rating level pre-COVID-19 outbreak. Often issuers that issue (or absorb) significant amounts of debt are expected to "grow into" a rating very quickly in order to improve leverage (cash to adjusted debt) ratios, and a crisis like COVID-19 will undoubtedly set these providers on a delayed path to sustained improvements.

Cross-Sector Questions

Over the short term, what does Fitch expect in terms of downgrades? What time frame is Fitch considering when evaluating possible rating changes, in other words, how much time will you allow for a financial recovery? What is our sector outlook?

- It is Fitch's belief that credits that were strong operators and stable with ample cushion at their current rating level from a balance sheet perspective going into the COVID-19 outbreak, should emerge the same after the crisis passes with stable ratings. That being said, there are some credits we believe may be more at risk than their numbers initially suggest. We are scanning our portfolio for these now; there is no set timetable for this process. Fitch is trying to communicate to the market as quickly as possible during this extremely fluid situation.
- Fitch recently put both sectors on Negative Outlook but remains committed to its forward-looking criteria where we are ultimately trying to gauge where the credit rating will be three to five years out. Hence, there is time allotted for a financial recovery given Fitch's opinion of the economic impact in calendar 2020 and expectation of recovery thereafter.

What is the best way for a rated hospital or LPCs to communicate with Fitch at this time?

- Any way they can and that they feel comfortable. Fitch is obviously a proponent of transparency, so public EMMA disclosures are always our first preference as it is completely public to the bondholder community. Barring that, and acknowledging how busy providers must be at this moment, emails and phone calls are certainly welcome. We understand there is a lot of issuer sensitivity about verbalizing something you may be held to down the line, and to the potential of downward rating pressure. Our ultimate responsibility, however, is to the bondholder, and to giving them the absolutely best independent read on the current situation that we can, which may include rating pressure for some of our issuers during this COVID-19 outbreak. In the absence of timely or detailed communication from issuers, Fitch will make the necessary assumptions to take timely rating actions based on our scenario analysis, sector expertise and knowledge of issuers from pervious interactions and public disclosure.

U.S. Not-For-Profit Life Plan Communities (LPCs)

What are the potential pressure points for LPCs from COVID-19?

- Operating cost escalation is the most significant near-term pressure, as the LPC sector is already exposed to margin volatility due to labor shortages pre-dating the outbreak. Below-investment grade (BIG) credits and issuers with high exposure to skilled nursing facility (SNF) operations, in particular, could come under rating pressure if revenue declines and cost increases persist beyond the next few months. Credits that are currently undergoing expansions, particularly those that are already rated BIG and in areas heavily affected by the outbreak, may come under the most pressure, including challenges in filling units especially if home sales remain slowed for a protracted period. While equity market exposure is mixed across Fitch's rated LPC portfolio, equity market volatility could affect LPC credits in two ways — by reducing liquidity cushions and affecting prospective residents' financial condition, which could additionally pressure unit turnover and fill.

What service line of an LPC is most susceptible to operating pressure?

- Fitch views SNF operations as most susceptible to operating pressure as a result of coronavirus. SNF's typically house the residents who are most vulnerable to viral outbreak. It is also the service line most reliant on the labor and supplies that could experience shortages as a result of the coronavirus. Post-acute short-term rehabilitation volumes will also be under pressure as hospitals continue deferring elective procedures.
- ILUs could also come under pressure if home sales remain slowed for a protracted period, as this could hamper turnover of vacated existing units and the fill of new expansion units. Real estate market downturn could also put downward pressure on unit prices

Does your level of concern vary depending on a community's contract type?

- Generally speaking, a predominantly rental or type-C (fee for service) contract mix suggests a higher ability to pass through operating cost increases to the resident base in the form of monthly service fee increases. However, LPC's with predominantly type-A (lifecare) contracts typically have higher liquidity cushions to mitigate the risk of their contract structure. In Fitch's view, any LPC, regardless of contract type, has the potential to be exposed to operating pressure as a result of coronavirus and Fitch does not

anticipate taking rating action based solely on a community's contract type.

What provisions are made for LPCs in the stimulus bill?

- LPCs do not appear to be receiving direct subsidies from the CARES stimulus bill. They will likely benefit most from indirect subsidies, such as enhanced Medicare and Medicaid reimbursement, provisions for child care for healthcare workers and the Paycheck Protection Program.

Can states mandate that LPCs admit COVID-19 patients if hospitals no longer have capacity?

- Fitch believes it is unlikely that SNF beds will be used as an alternative to admission to an acute care hospital. SNFs provide post-acute care services and are not equipped to treat acute care patients with active symptoms of COVID-19. They also house the individuals that are most vulnerable to viral outbreak, rendering the issue of pressing them into treating active patients highly politically sensitive.
- However, in an effort to free up acute care hospital beds to care for patients displaying active symptoms of COVID-19, certain state boards of health have issued directives that SNF's are not permitted to deny admission or re-admission of residents previously hospitalized for any reason due to suspected COVID-19. Once a patient is deemed medically stabilized and discharged from a hospital, SNFs must allow them to convalesce in their facilities. This is to allow acute care hospitals to free up their beds and other resources to treat new active cases of COVID-19.
- In some cases, SNFs are also prohibited from requiring a hospitalized resident who is determined to be medically stable to be tested for COVID-19 prior to admission or readmission. In practice, we believe SNF operators will address these directives by immediately quarantining all patients admitted to them from an acute care hospital while the coronavirus outbreak is still ongoing.

Is construction still occurring at LPCs or still planned? Are residents still moving in?

- Similar to hospitals, many planned projects at LPCs that have yet to begin construction are either being put to the side for the time being, or delayed due to market conditions. Issuers who already had capital projects underway when the outbreak hit seem to be continuing with construction.
- We have the most concern about LPCs that have completed construction and are looking to fill expansions, as the disruption caused by the COVID-19 outbreak could hamper move-ins for a number of reasons (slowed home sale activity, change in financial or health status). We have heard anecdotal evidence from some issuers that move-ins and inquiries are still occurring, albeit at a slower pace.

What are the longer-term implications of coronavirus for LPCs?

- It remains to be seen whether freed up labor capacity in the hospitality and food service industries will ultimately be of benefit to LPCs in terms of lowering turnover and filling vacancies on their staff. There is also debate around whether this situation will accelerate increases in minimum wages in states that have not yet enacted such legislation. Fitch believes LPCs could potentially benefit over the longer-term from higher demand for the product more broadly, as this crisis could offer an opportunity for them to prove their value in keeping residents safe and generally healthy and cared for during this pandemic. We strongly emphasize, however, that the data needed to evaluate all of these hypotheticals is very fluid and inconclusive at this point in time.