S&P Health Care: Trends, Overview and Outlook

For-Profit Health Care

Health Care Insurance Ratings

Not-For-Profit Health Care
Speakers

Moderator

• Lucy Patricola, Senior Director, Analytical Manager, For-Profit Health Care

Panelists

• Jennifer Soule, Director, Not-For-Profit Health Care
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• Neal Freedman, Director, Health Care Insurance
• Olaf Toelke, Director, EMEA Health Care
To find a copy of slides, articles, and watch videos the team has produced, please visit:

www.SPRatings.com/healthcare
Agenda

Economic Overview
Discussion of Common Themes
Comparative Statistics
Individual Sector Thoughts
Global Risks

**U.S.**
Uncertain fiscal policy still pressuring growth
Ramifications of Fed tapering process
External shock and potential for contagion (from the Eurozone, China, and EM)

**Latin America**
U.S. economic performance; end of FED’s quantitative easing policy – resulting in capital outflows in Latin America
Commodity prices downward trend
Disappointing growth in Brazil
Increasing funding costs reducing companies’ cashflows
Currency depreciation affecting inflation and consumer sentiment

**Europe**
Insufficient fiscal consolidation undermining sovereign solvency
Potential relapse into recession if EM slow and domestic demand stalls
Political/social uncertainty undermining Eurozone policy consensus
Rising unemployment without effective structural reforms
Capital flight from EM reversing spread tightening in the periphery
Fragmentation in Eurozone banking markets persists

**Asia-Pacific**
Two main macro risks to growth have narrowed:
- China’s growth appears to have stabilized at around 7.5%, and hard landing risk is less likely.
- Financial market stress due to speculation about U.S. Fed’s QE tapering have eased.

China – structural risks remain, particularly in the financial sector.
Japan – consumption tax scheduled to increase in April 2014 could significantly dampen momentum from Abenomics.
Other Asia – export-oriented economies might face significant headwind from any weaker U.S. outlook.
## Standard & Poor’s U.S. Economic Outlook: Sluggish Growth

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014e</th>
<th>2015e</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP Growth</td>
<td>+1.9%</td>
<td>+2.8%</td>
<td>+3.2%</td>
</tr>
<tr>
<td>Residential Construction (% change)</td>
<td>+12.2%</td>
<td>+11.1%</td>
<td>+20.2%</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>7.4%</td>
<td>6.4%</td>
<td>5.8%</td>
</tr>
<tr>
<td>Fed Funds Rate</td>
<td>0.1%</td>
<td>0.1%</td>
<td>0.4%</td>
</tr>
<tr>
<td>Consumer Spending (% change)</td>
<td>+2.0%</td>
<td>+2.7%</td>
<td>+3.1%</td>
</tr>
<tr>
<td>10 yr. T-Note Yield</td>
<td>2.4%</td>
<td>3.0%</td>
<td>3.3%</td>
</tr>
</tbody>
</table>

**Source:** Standard & Poor’s Economic Outlook.  
Note: Forecasts are constructed using the Global Insight Model of the U.S. Economy.  
As of March 24th, 2014.
Conclusion: The U.S. Economy Is Growing Modestly But Risks Remain

The economy continues to heal and is being strengthened by:

- Housing market recovery
- Energy sector boom
- Improved household and corporate balance sheets
- Continued favorable interest rates
- Improving labor market, and thus, consumer sentiment

But challenges and uncertainties remain:

- Unemployment levels still high relative to pre-crisis
- Q.E. tapering process
- Fiscal policy (sequestration)
- Growth challenges overseas
Three Common Themes

We have identified three common themes that are affecting S&P Health care:

1. Declining Utilization
2. Affordable Care Act/Health care Reform
3. Mergers and Acquisitions
Declining Utilization

Unabated downward trend – a negative surprise

Then: due to the economy

Now: due to

• higher deductible plans; and
• the effort to address quality and utilization

Big debate as to why

We are forecasting higher competition in the provider space → leading to sluggish growth rates in the provider space and pressure on financial metrics
Declining Utilization: Not-For-Profit

Significant movement from inpatient utilization to shorter observation stays and ambulatory settings

Greater use of pharmacology treatments as substitute for procedures

Shift of health care costs to patients in the form of higher copays, deductibles and coinsurance

Deferred care due in part to growth in high deductible plans

Greater focus on quality and quality metrics leading to reduced utilization
Organic growth: no better than GDP

Ratings incorporate our weaker forward-looking expectations

Affecting all areas except pharmaceuticals

• Providers: hardest hit → 20% of outlooks are negative
• Equipment companies: longer replacement cycles (e.g. beds)
• Product distributors: minimal growth expected in 2014
• Surgery centers: very low single-digit growth and sequential quarterly declines
Declining Utilization: Insurance

Lower than expected utilizations trends have resulted in higher profits due to the favorable impact of prior years’ health care cost estimates.

This situation resulted in greater financial flexibility for the large national insurers and allowed for surplus accumulation at smaller insurers (e.g. limited geography blue plans).
Affordable Care Act

In 2014, we see a growing impact from the Affordable Care Act in the S&P Health care Sectors, although the impact is less pronounced than headlines suggested.

Why?

• We’ve signaled since 2010 that the ACA would not have a big rating impact
• Health care reform is evolving slowly
• Uncertainty about implementation (e.g. healthcare.gov)
• Recent lower than expected utilization has allowed health insurers to strengthen their balance sheets
• Mixed and evolving concerns about narrow networks
Unlike insurance and for-profit, movement to health reform and the Affordable Care Act is contributing to a more negative environment for providers.

Limited direct rating impact to-date, although tighter margins and tighter credit quality… balance sheets remained strong.

“How do we make it on Medicare rates?” Cost containment has helped provider profitability – it is sustainable?

Exchanges could drive weaker commercial reimbursement – to date marginal impact and not as dramatic as originally anticipated.

Contributor to declining utilization as previously discussed (value based purchasing driver).
Affordable Care Act: For-Profit

Beginning to see the “bite”, especially in post-acute

For now, appears to be largely isolated with providers

Contrasts with pharmaceuticals, labs, and devices
Affordable Care Act: Insurance

Minimal impact initially

The large national insurers are taking a deliberate approach to the individual exchanges

Single region blues generally have significant surplus resulting from prior years’ lower than expected medical trends
Health Care Reform

Bending of the price curve starting to become apparent

• Getting sharper: starting to impact ratings and outlooks
• Pace is picking up
• Profitability pressure will continue to grow
• Providers are increasing efficiency

Value-based pricing and price transparency are big drivers but are not yet apparent

At risk: high cost procedures and providers

Does high quality justify the cost?
Health Care Reform: Not-For-Profit

Providers prepared for national health reform by cutting costs, strengthening balance sheets, enhancing infrastructure, and aligning with strategic partners... this continues

Initial focus has been on the insurance mandate

New payment models are not yet broadly applicable or measurable

Uncertainty about pace and depth of impact remains
Price Transparency

- Pharmaceutical and medical device companies
  - Transparency leads to insurers and consumers questioning pricing

- Price transparency is a big exposure that could change the rating landscape
Health Care Reform: Insurance

Insurers and providers are discussing whether to move to a more value-based reimbursement structure.

The integrated care movement has not:

- Had a significant near to intermediate term impact on health insurer ratings;
- Changed the industry’s overall financial profile.
Mergers & Acquisitions

We expect continued M&A activity in the three S&P health care sectors

M&A activity is offsetting some of the negative bias, particularly with providers

The investor market encourages M&A and tolerates higher leverage
Mergers & Acquisitions: Not-For-Profit

Merger and acquisition activity is expected to continue

Like for-profit providers, the need to build scale and increase covered lives in preparation for new reimbursement models

Health plan and hospital mergers and acquisitions

Growth in participation and affiliation strategies in lieu of M&A
Mergers & Acquisitions: For-Profit

The pace of consolidation is increasing
Several large debt-funded acquisitions
Specialty pharma is the most active
Primary reasons: increase scale, shareholder value creation, and profitability pressure due to lower utilization
Market supports higher leverage → bullish sentiment on business risk
Mergers & Acquisitions: Insurance

Pressures to achieve efficiencies will likely create “make or buy” decisions.

Medical management and administrative efficiency (e.g. information technology/management) companies will be acquisition targets.

We also expect to continue to see M&A activity based on broadening market segments or products (e.g.: Aetna/Coventry and Cigna/HealthSpring)
Comparative Statistics
S&P Health Care Outlook Distribution

- Health Insurance
- Non Profit
- For Profit

Outlook Categories:
- CreditWatch Negative
- Outlook Negative
- Outlook Stable
- Outlook Positive
- CreditWatch Positive
The majority of outlooks remain stable across all sectors despite health care reform

- Reform is evolving at a slower pace
- One to two year outlooks on ratings
- Good cash flow
- Not-For-Profit providers cutting costs and building cash reserves, allowing for capacity within current ratings
- M&A provides growth for some providers
What is driving the negative bias in FP and NFP (e.g. the providers)?

• Debt-funded M&A in for-profit
• Declining utilization trend and reimbursement pressures
• Growth of risk-sharing arrangements
• Continued pressure on employer cost increases
• Rising out of pocket expenses=discriminating consumers=volume and revenue decline= weaker financial profiles
S&P Health Care Upgrades/Downgrades

*Data as of 12/31/2013
Upgrade/Downgrade Trends

For-profit

- Debt-funded M&A is driving pharmaceutical downgrades
- Declining utilization is impacting providers

Insurance

- Capital perspective: industry in good shape

Not-for-profit

- Clear evidence of broad pressures constraining operating margins, combined with our view that additional cost containment measures will be hard to achieve
S&P Health Care Ratings Distributions

The chart shows the distribution of health care ratings distributions. The categories are AAA, AA, A, BBB, BB, B, CCC, CC, and D. The ratings distributions are color-coded as follows:

- Health Insurance: Blue
- Non Profit: Red
- For Profit: Green

The ratings distribution shows a higher concentration in the AAA and AA categories, with a notable peak in the A category for Non Profit. The ratings for Health Insurance and For Profit are relatively lower and more dispersed across the categories.
Individual Sector Thoughts
Not-For-Profit

Stable outlooks will continue to dominate, although we believe the sector is at a tipping point

- Positive factors are helping to cushion incremental rating pressures, for now
- On-going uncertainty and long-term credit risks for the sector abound
- We believe that the operating environment will be increasingly negative
  - Weaker revenue environment
  - Renewed competition for patients
  - Transition risk issues
  - Cost savings harder to find
  - Capital pressures building again
  - Investment in IT, physicians and integration continue
For-Profit

For 2014 we expect credit quality to be stable to slightly negative

• To date in 2014, we are sharply more negative than corporate ratings

• Shareholder return policies predominate our rating actions

• Credit quality is negatively impacted by higher levels of M&A in the pharmaceutical sector and increasing refinancing at speculative-grade companies
  • Financial policies have been stretched because of M&A
  • Higher debt levels are burdensome for some of the health care services companies
Health Insurance

Stable outlook predominates amongst our rated Health Insurers

• Strong capital adequacy enhances ability to withstand short-term strain
• Strong cash flows support liquidity profile
• Business conditions still favorable
• Increased M&A activity over the last couple of years
• Industry risk is somewhat elevated
• Late ACA rule changes may add short-term earnings volatility
• Government fiscal pressures impact Medicare and Medicaid businesses
EMEA Health Care: Pharma – Stable Outlook on 2014 – Key Rating Drivers

Favorable underlying market conditions (aging, life style)

Pipelines improving

Patent cliff is over

Emerging Markets – initially tempered, but too big to ignore

No macro-economic dependence
EMEA Health Care: Pharma – Downside

Favorable underlying market conditions (aging, life style)

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No macro-economic dependence
<table>
<thead>
<tr>
<th>Month</th>
<th>Company</th>
<th>Rating Action</th>
<th>CCR Change</th>
<th>Key Driver</th>
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</thead>
<tbody>
<tr>
<td>January</td>
<td>Sharp Healthcare</td>
<td>Upgrade</td>
<td>AA-/Stable/-</td>
<td>Solid financial profile in-line with ‘AA-’ medians; reform readiness</td>
</tr>
<tr>
<td>February</td>
<td>Actavis plc</td>
<td>Downgrade</td>
<td>BBB-/Stable</td>
<td>Forest Laboratories acquisition</td>
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<td></td>
<td>Mallinckrodt plc</td>
<td>Downgrade</td>
<td>BB-/Stable</td>
<td>Cadence acquisition</td>
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<tr>
<td></td>
<td>Nordian Mutual Insurance Co.</td>
<td>Downgrade</td>
<td>BBB+/CreditWatch Negative</td>
<td>Removed as lead contractor for Maryland Health Insurance Exchange</td>
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<tr>
<td>March</td>
<td>Baxter International Inc.</td>
<td>Downgrade/Watch Negative</td>
<td>A-/CW Negative/A-2</td>
<td>Spin-Off Announcement</td>
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<tr>
<td></td>
<td>McKesson Corp.</td>
<td>Downgrade</td>
<td>BBB+/Stable/A-2</td>
<td>Weaker future earnings</td>
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<td></td>
<td>Highmark Inc.</td>
<td>Downgrade</td>
<td>A-/Stable</td>
<td>Improved financial performance</td>
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<td></td>
<td>UC Health</td>
<td>Upgrade</td>
<td>A-/Stable/-</td>
<td></td>
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<tr>
<td>April</td>
<td>Allergan Inc.</td>
<td>CreditWatch Negative</td>
<td>A+/CreditWatch Negative/A-1+</td>
<td>Potential hostile takeover by Valeant</td>
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<tr>
<td></td>
<td>Zimmer Holdings Inc.</td>
<td>CreditWatch Negative</td>
<td>A-/CreditWatch Negative/--</td>
<td>Acquisition of Biomet Inc.</td>
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<tr>
<td></td>
<td>SSM Healthcare</td>
<td>Downgrade</td>
<td>A+/Stable/-</td>
<td>Lighter financial profile following debt issuance</td>
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* Data as of April 2014
## EMEA Health Care: Coverage Positioning

<table>
<thead>
<tr>
<th>Business Risk Profile</th>
<th>Financial Risk Profile</th>
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<tbody>
<tr>
<td></td>
<td>Minimal</td>
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<tr>
<td><strong>Excellent</strong></td>
<td>Roche (AA)</td>
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<tr>
<td><strong>Strong</strong></td>
<td>Novo Nordisk (AA-)</td>
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<tr>
<td><strong>Satisfactory</strong></td>
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<tr>
<td><strong>Fair</strong></td>
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<tr>
<td><strong>Weak</strong></td>
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<tr>
<td><strong>Vulnerable</strong></td>
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Not-For-Profit Ratings Distribution

Combined System and Standalone
For-Profit Ratings Distributions

Corporate Ratings (excludes Financial Institutions and Insurance Ratings)
Local Currency Long Term Issuer Credit Ratings
Core data provided by the Global Ratings & Regulatory Reporting Group. Data as of 12/31/2013
Health Insurance Ratings Distributions

* Health Insurance Ratings
* Core data provided by the Global Ratings & Regulatory Reporting Group. Data as of 12/31/2013

December 2011  December 2012  December 2013
Current Ratings

- Sector ratings greatly dominated by stable outlooks
- We expect these to continue in 2014