Health Care 2016

Seeking Common Ground

New York

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• For-Profit Health Care
• Not-For-Profit Health Care
• Health Insurance Ratings

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Integrated Sector Review: Outlook and Perspective

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Health Care: Seeking Common Ground

As we move past the sixth anniversary of the Affordable Care Act (ACA) and approach the 2016 elections, our outlook for the U.S. health care sector is generally stable, although key risks persist in the three segments we look at: health insurance companies; for-profit health care services companies (which include hospitals and related subsectors); and not-for-profit health care providers (which include health systems and standalone hospitals).
Health Care Industry Landscape

Service Providers

Not-for-profit hospitals & health systems
- Acute Care Hospitals
- Nursing/Assisted Living
- Home-based Health
- Hospice
- Behavioral Health
- Rehab
- Ambulatory Surgical Centers
- Dialysis Centers

For-profit service providers

Federal & State Governments
- Exchanges
- Privately managed government programs

Employers
- Underwriting
- Administrative & Customer Service
- Marketing

Users (out of pocket)
- Insurance companies

Products

Pharmaceuticals
- Branded
- Specialty Pharmaceuticals
- Generic
- Biotech/Biosimilars

Medical devices
- Cardiovascular
- Orthopedic
- Surgical Equipment
- Monitors
- Infusion
- Medical Supplies/Consumables
- Others

Distributors
- Contract Research & Manufacturing
- Life Science Companies

Laboratory & Diagnostic Services

- Service Providers
- Products
- Distributors

S&P Global Ratings
Agenda

Individual Sector Profiles
- Health Insurance
- For-Profit
- Not-For-Profit

Discussion of Common Themes
- Evolution of ACA Driven Expansion & Exchanges
- Market-Driven Reform
- Mergers & Acquisitions

Comparative Statistics
- Cross-Sector Comparable Information
Sector Profiles
Health Insurance: Stable With Downside Bias

Rating movement expected to derive from company specific factors

Financial fundamentals
- Underpinned by capitalization and liquidity

Business conditions
- Growth supported by sustained employment gains, migration of gov’t sponsored lines, exchanges, access to capital
- Exchange development has been mixed but potential for stability by 2018 remains

Improved risk / opportunity perspective, though concerns and uncertainty persist in connection with ‘exchange market’ stability and political factors
- Insurers mostly absorbing expected strain through implementation phase of ACA
- Near term forward focus on company specific actions and regulatory responsiveness

Sustained margin compression expected for 2016
- Dilutive impact of growth lines, tighter commercial pricing, medical trend uptick, weaker investment returns
- Performance outlook generally at to below ‘target margin’ trend (For-profit > Not-For-Profit)

Impact of M&A activity
- Deal risk creating downside rating pressure - financing, integration
- DOJ related court challenges in Q4
Not-For-Profit: Stable

Stronger operations over past two years is a temporary easing of some negative pressures. Management initiatives and ACA driven expansion, have continued to support credit stability, as we expect balanced upgrades versus downgrades for 2016 and into 2017.

• A combination of the ACA’s Medicaid expansion, exchange launch, and providers positive countermeasures, some of which took multiple years to implement, drove operating margin improvement and credit stability
  • Improved volumes
  • Improved payer mix

• Balance sheet strength continues to remain a key credit strength

• Merger and acquisition activity has been generally positive and is expected to continue

• Broad market confusion remains with mixed incentives, variable pace of change as sector begins movement to value orientation, and expectation of impending changes in the exchange market

• Negative pressures remain broad based though less than a few years ago
Not-For-Profit: Stable (cont.)

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- Weaker performance where observed due to:
  - Poor IT installations; weaker patient volumes (shift to observation/short stay and at times competition); cost of absorbing physician practices; strategic spending

- A credit gap remains, and is perhaps spreading
  - Large provider vs. small providers (i.e. size and scale issues)
  - Strong market position vs. weak market position (i.e. payer leverage)
  - Population health management capacity and ability to manage risk is also emergent differentiator

- The strongest hospitals and health systems are likely to just hold existing margin and reserve levels – we are at the peak; while weaker providers will likely continue to see operating margin and cash flow erosion and eventually balance sheet pressure

- Medicare payer mix swing with the “greying” of America; some expectation of increased uninsured due to expected changes in the exchange market
For-Profit: Stable

We expect credit quality to be stable across all for-profit health services sectors. Downgrades slightly exceed upgrades.

Stable credit quality already incorporates industry headwinds

- Chronic reimbursement pressure, margins under stress for many
- Notable subsector operating weakness
  - Skilled nursing, long term acute care hospitals
- Relatively modest M&A /consolidation activity. High valuations contribute to lower ratings (despite increased scale and diversification)
- Uninsured level may have declined but struggles with high deductibles problematic
- Dividend-driven refinancing at speculative-grade companies
- Aggressive financial policies tolerated by investors seeking yield: The majority of for-profit healthcare companies have high leverage
- Early upside benefit of Medicaid expansion and exchange enrollment has leveled off. Most utilization growth from outpatient, consistent with national trend.
- Ongoing emergence of new business models
Three Common Themes

We have identified three common themes that are affecting our view of health care:

1. Evolution of ACA-Driven Expansion and Exchanges
2. Market-Driven Reform
3. Mergers & Acquisitions
Evolution of ACA-Driven Expansion and Exchanges
ACA-Driven Expansion: Providers

• As discussed, the initial impact was favorable, particularly in Medicaid expansion states:
  - Significant shift to Medicaid from uninsured depending on location/prior business mix, resulted in incremental contribution to profitability, although uninsured burden remains
  - In 2015, organizations in expansion states vs. non-expansion states saw upgrades far exceed downgrades due to improved financial profiles & utilization growth
  - Expansion has a positive impact on admissions / adjusted admissions, although we are beginning to see this slow down, and as expected, see the re-emergence of more traditional forces pushing inpatient usage rates down

• Going forward, we see emerging negatives:
  - Disproportionate share reductions beginning in 2017 (federal fiscal year 2018) will hurt margins for some
  - Broader use rate/inpatient admissions level off and expect declines to re-emerge over time
  - Expectation of adverse changes in some exchange markets could lead to increased levels of uninsured in those states
ACA-Driven Expansion: Insurance

• ACA exchange challenges persists but rating impact contained by relative size
  - Accounts for less than 10% of industry revenue, mostly unprofitable with certain geographic / company specific exceptions
  - Enrollment growth slowing with risk of near term contraction given need to manage exposure as companies implement counter-measures (pricing, networks, medical management) and dialogue with regulators to address fixes (rates, enrollment controls, grace periods, 3rd party payers, etc.)
  - ‘Blues’, Kaiser, assorted PSPs remain while national players scale-back and Co-Ops continue to fail
  - Fed gov’t has capacity to be responsive though constrained by near term policymaking constraints

• Medicaid growth a positive via expansion and broader MCO use trend
  - MCOs have done quite well on managed Medicaid business in recent years due to enrollment growth, rate increases, lower-than-expected cost trends, reimbursement for industry fees
  - Coincides with broader trend of seeking out private sector for cost containment solutions
  - However, enrollment growth may begin to level off as expansion-resistant states likely to stay that way. In addition, states may seek to reduce rate increases going forward as federal contributions towards Medicaid expansion will start trending down (to 95% in 2017, etc.).

• Medicare advantage (MA) growth expected to sustain as ACA noise subsides
  - MA enrollment at all time high (+18 million, 30% penetration and growing, despite ACA headwind)
  - We expect positive aspects of MA (favorable demographics, high premiums PMPM) to continue to outweigh negatives (year-to-year rate uncertainty, pricing risk, high regulatory / compliance risk)
ACA-Driven Expansion: Key Considerations

• What does the current round of exchange withdrawals portend? How serious a threat is this to the ACA? Is the flight from exchanges truly national or market specific?

• Will commercially insured lives migrate to exchanges? What has been the impact of transitional health plans?

• Exchanges have not had material impact on provider pricing but concerns remain as exchanges continue to evolve and mature

• Exchanges are driving emerging narrow / tiered network arrangements

• Employer sponsored insurance growth appears tied to economic recovery – will declines in employer based insurance reappear? If so, when?

• Cadillac tax pushed to 2020 could water down incentives for more price conscious insurance options
Market-Driven Reform
Market-Driven Reform – Part 1

• **Value orientation emerging slowly**
  - Broad provider recognition of need to prepare value orientation continuum, yet movement is slow. Insurers seeking to offer risk exposure to willing and capable providers.
  - Wide range of value arrangements: p4p, bundled payments, shared risk and full capitation
  - CMS role in accelerating change remains important
  - We expect long-period of pluralistic models; one size does not fit all providers or markets

• **Growth of high deductible plans and consequences on-going**
  - Currently 40 - 45 million Americans have high deductible plans excluding exchanges, up from about 5 - 10 million ten years ago
  - For providers re-emergence of old bad debt problems as vast increase in retail collections
  - These plans contribute to emerging pricing sensitivity although still limited
    - Important in some “cash based” corners of the market and when purchasing insurance
    - Price sensitivity also contributing to on-going cost cutting
  - Consumerism, high deductible plans and exchanges driving greater use of narrow networks
Market-Driven Reform – Part 2

Consumerism
• Consumers ‘empowered’ and are more involved in wide variety of decisions about their own care – Can your system provide that?
• Broader non-traditional distribution channels and personnel, and ways to access care becoming essential including e-visits, phone and photo consults
• Greater consumer ‘skin in the game’ drives price consciousness, and value orientation, as individuals more involved in decision making

Competition
• Heightened competition within and across the sectors and new forms of cooperation
• Continued industry consolidation for providers and re-emerging consolidation for insurers
• Competition for covered lives, changing access points, cross selling opportunities
• Insurers and provider strategies overlapping creating alignment, cross sector collaboration, but also more direct competition as ‘integrated delivery systems’
• Physician employment model evolving in generational shift
Market-Driven Reform – Part 3

Strategic Responses

• Prolonged and intentional merger and acquisition agenda as providers seek size, scale, skills and surroundings

• Virtual arrangements and other forms of collaboration

• Increased interest in provider sponsored health plan development, often “bought” not “made”

• Increased spend, very often significant, in information technology to better link clinical practices (physicians included) with financial costs and outcomes results – tied to broad quality improvement goals

• Goal of tying cost savings and quality together still elusive, but seen as necessary for population health management

• Private sector innovation both in non-traditional partners, but also in what is often labeled ‘disruptive technologies’ such as mobile medicine
M&A Case Studies
M&A Case Studies: Insurance

- **UNH/Catamaran** – UNH probably done with major MCO M&A, focus on Optum
  - Optum now contributes ~40% of UNH operating earnings
  - Recent deals (Catamaran, Helios, Medexpress) focused on PBMs / clinical services
- **Mega deals** (ANTM/CI, AET/HUM) meant to position combined entities more in line with UNH on paper, but integration could take time
  - ANTM/CI deal is about commercial business, Medicare Advantage, international and specialty
  - AET/HUM deal is mostly about Medicare Advantage, healthcare services
- **DOJ blocked deals in July citing anti-competitive concerns**
  - AET/HUM had completed funded and was 90% through 20 state approvals needed
  - ANTM/CI is the more complex transaction (Blues affiliation, ESRX lawsuit, etc.) and moving slower
- **Both deals to be challenged in court with interim settlements possible but unlikely**
  - AET / HUM issues seem more focused (to address via MA business line divestitures - tentative deals with Molina)
  - An important consideration for both is how the marketplace is defined, anti-competitive remedies
- **If terminated we expect both to pursue deal making at a lower level.**
  - In connection with underlying sector trend
  - Ongoing intent to strengthen product line value and diversity, expand scope, enhance scale
M&A Case Studies: For-Profit

- M&A activity (non pharma) has slowed, but we expect activity to pick up. Impact of rising antitrust efforts?
- One potentially large situation may be brewing: (Community Health Systems)
- Asset sales have been more prominent this year (CYH, THC, ACHC)
- We expect providers to pursue mergers consistent with an integrated delivery strategy.
- Similar to not-for-profits, organizations seeking both size and scale, as well as diversity or expertise in different services
- Interestingly, most active subsector of late has been medical devices
- Large nursing home companies have been reorganizing (HCR, Drumm)
- We expect more joint venture and partnerships between NFP/FP
M&A Case Studies: Not-For-Profit

• **M&A activity remains at a steady pace:**
  - Smaller more opportunistic M&A will continue largely unabated - particularly in decentralized markets
  - Larger mergers will also continue, albeit at a smaller pace, and will need to demonstrate the value proposition/benefit of the merger

• **Why merge:**
  - Organizations continue to seek size and scale (traditional cost savings and market heft), as well as diversity or expertise in different services (e.g., health plan, physician management);
  - Non-overlapping markets provided for cost savings without negatively impacting volumes – part of a widen the funnel strategy;
  - Expanding a geographic “footprint” for longer-term transition to population health management

• **New observations:**
  - Have seen new push back from regulators, particularly in previously consolidated markets and/or where the participants cannot demonstrate the value proposition of the merger.
  - In some markets few unaffiliated partners remain, resulting in the next set of mergers with a higher likelihood to run into legal barriers;
  - “Healthy and strong merging with healthy and strong”

• **Growth in affiliation strategies in lieu of full M&A and “non-traditionals”:**
  - Joint ventures/joint operating agreements; clinical networks – often first step to something more permanent; management contracts – also often first step to something more permanent;
  - Affiliations with payers (THR/Aetna); urgent care/emergent care centers; “disruptive technology”
Comparative Statistics
Health Care Rating Distribution – August 2016

Source: S&P Global Ratings
Health Care Outlook Distribution - August 2016

Outlook Distribution at Aug-2016

Source: S&P Global Ratings
Health Care August YTD 2016 Upgrades/Downgrades

Rating Activity at Aug-2016

- Not For Profit: 25 Upgrades, 10 Downgrades
- For Profit: 15 Upgrades, 5 Downgrades
- Insurance: 2 Upgrades, 3 Downgrades

Source: S&P Global Ratings
Health Care Rating Distribution

S.G.—speculative grade; ratings as of 12/31/2013, 12/31/2014, 12/31/2015. Includes Not for Profit, For Profit and Insurance Health Care

Source: S&P Global Ratings

S&P Global Ratings
For Profit Health Care Rating Distribution

Corporate ratings (excludes financial institutions and insurance ratings); local currency long term issuer credit ratings; ratings as of 12/31/2013, 12/31/2014, 12/31/2015

Source: S&P Global Ratings
Not For Profit Health Care Rating Distribution

Includes health systems and stand-alone hospitals; ratings as of 12/31/2013, 12/31/2014, 12/31/2015.
Source: S&P Global Ratings
Insurance Health Care Rating Distribution

Ratings as of 12/31/2013, 12/31/2014, 12/31/2015
Source: S&P Global Ratings
Outlook Distribution Trend

Outlooks remain stable across all sectors amidst health care reform.

- Market based reform has been slow to evolve but we see growing acknowledgement of the need to shift perspective and plan for change
- One to two year outlooks on ratings
- Good cash flow particularly for the strong providers
- Not-for-profit providers cutting costs and building cash reserves, allowing for capacity within current ratings
- M&A provides growth for some providers
- Downside bias for health insurers in connection with deal activity and earnings volatility / compression
Outlook Distribution Trend (cont’d)

More recent trends

• For profits: aggressive financial policy, desire for acquisition opportunities, and increasing operating pressure driving a small bias towards negative outlooks

• Election cycle 2016 and related ACA implications

• Brief improvement in utilization trends and reimbursement, although not expected to continue over time

• 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
Thank you

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