Not-for-profits prosper

Moody's annual review shows more upgrades, profit

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How good a year was 2005 for not-for-profit hospitals? Market conditions were so favorable to the sector that any hospital that performed poorly financially should probably do some serious soul-searching about the future.

Not-for-profit hospitals across the board achieved their best year ever with the highest level of profitability and liquidity since 2001, according to Moody's Investors Service, which planned to release its annual median report this week. The median operating margin for the 395 organizations that submitted their audited financial statements for fiscal 2005 was 2.8%, up from 2% in fiscal 2004. In 2005, 82% of providers reported operating profits, compared with 79% in 2004 and 48% in 2000.

The feat was in large part accomplished by keeping expense growth at bay at 8.5% so that revenue grew faster than expenses, "which is really a testament to management working on the expense side," said Pamela Federbusch, a senior vice president at Moody's.

Meanwhile, Standard & Poor's last week reported that both stand-alone hospitals and healthcare systems showed broad improvement in key financial measures across most rating categories. Similarly, Fitch Ratings reported last month that profitability ratios for both not-for profit hospitals and healthcare systems were at their highest level since 1998. Operating margins rose to 2.8% in 2005 from 2.1% in 2004. Total margins rose even more for the third consecutive year: to 4.8% from 3.7%, according to Fitch.

For Moody's, the annual report validated preliminary data released in March, but did not change Moody's median rating of A3 with a stable outlook (March 20, p. 4). Moody's attributed the improvement in operating performance over the past two years to managements' cost-control measures, a continued focus on revenue enhancement strategies and plans for volume growth.

Other factors included a strong national economy, favorable Medicare reimbursement, and management's success at targeting profitable clinical services.

If there is a downside to the report, it's that utilization appears to be softening, although no one can explain why, Federbusch said. On the outpatient side, volumes are arguably down because of competition, but it is difficult to determine whether a flattening of inpatient admissions marks a trend or an anomaly, she said.

Nevertheless, "Given how accommodating the healthcare environment was in 2005, those hospitals that performed poorly during this period are likely to fare considerably worse during more difficult times in the future," Federbusch said in the report.

Hospitals "that couldn't make it this year" should seriously consider why they were not able to take advantage of the favorable conditions, she said.

Waiting for a shoe to drop after the positive momentum shown now for two years running, S&P wondered in its report "how long can the industry sustain the favorable levels of operating performance and balance sheet growth?"

Departing somewhat from Moody's, S&P attributed this year's improvement to continued revenue growth, strong outpatient demand, inpatient growth in many if not all markets and "solid, although more restrained, rate increases from commercial payers" as well as favorable investment returns.

There was balance sheet improvement, although that was "moderated" by capital spending that "remains robust" at the higher rating levels -- a reflection of the ongoing gap in credit quality, S&P said.

S&P based its report on the 2005 audited financial statements of 89% of the 465 rated stand-alone hospitals and on the 2005 audited financial statements from 135 systems.

Although there are "a whole host of smaller incremental issues" of concern to the sector, the favorable performance of recent years is continuing longer than anyone expected, said Martin Arrick, a managing director with S&P. "There is no catastrophic shock coming until at least the (next presidential) election," he said.

Arrick noted that at the same time that the financial performance of not-for-profit hospitals has been positive, credit trends have also turned positive this year and last.

For the first six months of 2006, S&P raised 24 ratings and lowered 20. More important, the sector reflected stability: 83% of the 265 rating actions during the period were affirmations, S&P noted. Upgrades have outpaced downgrades this year at Fitch, with 12 healthcare providers receiving upgrades year-to-date while only eight were downgraded. Fitch affirmed 63 ratings during that period.

The picture was different at Moody's, which upgraded 16 not-for-profit debt obligators in the first half of 2006, representing $8.2 billion in debt, and downgraded 24, representing $3.7 billion in debt. There were 156 affirmations. In 2005, Moody's upgraded 46 providers, downgraded 42 and affirmed 343.