

Take a Deep Breath

The health care industry was hardly immune to the financial catastrophes that swept the world in 2008. Hospitals watched as their access to capital steadily decreased over the year, punctuated in September by dramatic declines in the stock market and the recent

determination by the National Bureau of Economic Research that the United States has been in a recession since December 2007. As if that wasn't enough, a November American Hospital Association report on the economic crisis found that 31 percent of hospitals experienced a moderate to significant decline in elective procedures between August and November, while 38 percent reported a moderate to significant decline in admissions.

Also in December, Fitch Ratings downgraded its outlook on the U.S. not-for-profit hospital sector to negative after five years with a stable outlook, predicting more ratings downgrades than upgrades over the next 18 months as declining investments, rising bad debt from patients and increasing costs associated with obtaining long-term capital all take their toll on hospital balance sheets. Fitch Ratings last downgraded the sector to a negative outlook in 2002.

"A hospital that's in a deteriorating situation because of a poor competitive situation or ineffective management might have been able to coast two years ago, but the combined nega-

tive effects of what we're seeing might be enough to push a hospital into a new [lower] rating," says Jeff Schaub, senior director of public finance for Fitch Ratings.

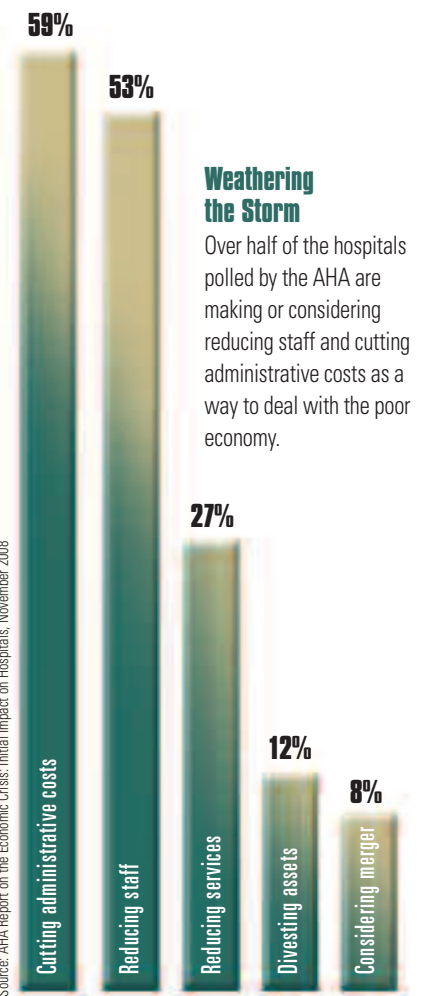
But while hospital CEOs and health care financial analysts predict the gloomy economic times will continue into 2009 and possibly 2010, some hospitals and systems plan to emerge from the recession—whenever it ends—with a leg up on the competition. Institutions in strong financial shape remain relatively well-positioned to borrow for capital expenditures, albeit at higher rates, after a partial thawing of the October credit freeze. And some rural hospitals have felt less of an impact from the national recession.

"We're not suffering as much as the rest of the nation because we don't have large Fortune 500 companies," says Mark Doak, CEO of Davis Health System in Elkins, W.Va.

But for hospitals in hard-hit areas, there are signs of troubling shifts in payer mixes and patient volumes, as their consumer base adjusts to the recession.

Shands Healthcare, an eight-hospital system in Florida, recently closed Shands-Gainesville after it lost \$12 million in 2007 as Medicaid cuts, declines in patients using private insurance and reductions in patient volume took a significant toll on its overall operating margin. CEO Tim Goldfarb says Shands had no choice but to close the ailing hospital.

"It was increasingly less financially viable, and we placed that in the context of a terrible

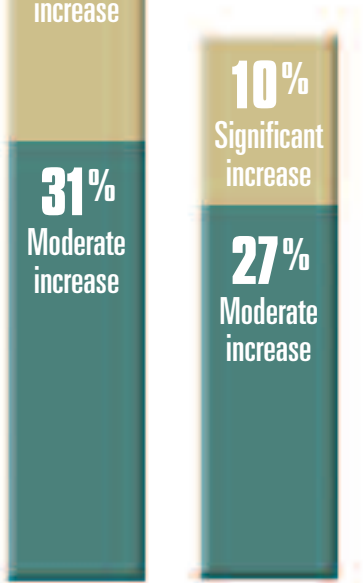


and Brace Yourself...

The economy is going to bruise a lot of hospitals. Some will not survive intact. A few will emerge stronger than ever. Where do you fit in? **BY HAYDN BUSH**

More Uncompensated Care

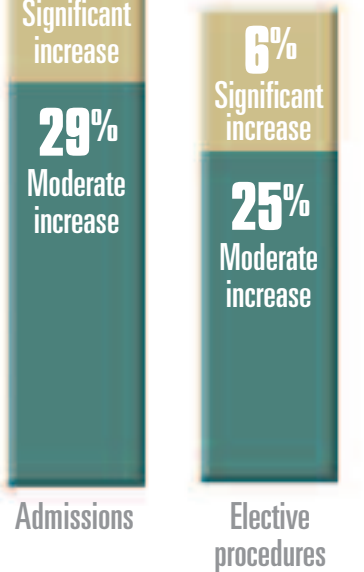
Percent of hospitals reporting a moderate to significant increase in uncompensated care and need for subsidized services in past three months relative to projected levels.



Uncompensated care as percent of total revenue
Community needs for subsidized services

Patient Demand Declines

Percent of hospitals reporting a moderate to significant decline in admissions and elective procedures in past three months relative to projected levels.



Admissions
Elective procedures

Source: AHA Report on the Economic Crisis: Initial Impact on Hospitals, November 2008

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state budget situation," Goldfarb says.

For many hospitals, the next 18 months could be a battle for survival. Meanwhile, high performing hospitals may gain even more of a competitive advantage than before. "You're going to start see a significant structural change to the health care industry in terms of haves and have-nots," predicts Jeffery Seubel, managing director of public finance for Bank of America.

Kenneth Kaufman, managing partner of consulting firm Kaufman, Hall & Associates, says hospitals with significantly lighter balance sheets may have to consider aligning themselves with stronger organizations. The next three to six months will be a critical period, he says.

The AHA has called for several federal interventions to calm the crisis, including expanded COBRA benefits, more Medicare and Medicaid funding and eased access to capital for hospitals.

In the meantime, every hospital and system, regardless of its financial position, is entering 2009 with the prospect of a potentially long and severe downturn. Plans to rein in capital expenditures, scale back construction and other plans and curb labor costs abound. According to the AHA report, 56 percent of hospitals surveyed plan to reconsider or postpone new facilities and renovations, and 45 percent are reconsidering or postponing expenditures on new technology and equipment.

"For 2009, we're very sober in our planning," says Michael Browder, president and CEO of the Tennessee-based hospital chain Essent Healthcare.

Access to Capital Weakens

An early sign of trouble for hospitals looking to borrow money came at the start of 2008, when the market for auction-rate securities began to collapse. The market gave investors the chance to recoup their money by auctioning their bonds to other investors every seven days; hospitals and other borrowers got rates as low as 3.5 percent as recently as 2007. But the bond auctions began failing in February, as investors sought liquidity in the wake of the subprime mortgage crisis. Auction rates soared to 15 percent.

In reaction, hospitals refinanced their debt into variable-rate and 30-year, fixed-rate debt. But the September financial crisis hit the market for variable-rate debt hard, as rates designed to reset over short periods began to fluctuate dramatically. By October, even 30-year, fixed-rate debt was hard to obtain.

At Rush University Medical Center in Chicago, CEO Larry Goodman had planned to borrow roughly \$250 million as part of an ongoing \$950 million campus transformation that includes a replacement hospital, new outpatient centers and a power plant. Goodman says that Rush's operating budget, along with a strong capital campaign, will allow construction to go forward next year. However, the tightening of the credit markets means that Rush, despite an A-minus rating that had allowed it plentiful access to capital in the past, will have to wait for a better climate in which to borrow.

"We had always planned to go into the marketplace in October, but there was not much of a marketplace in October," Goodman says.

Since the height of the turmoil in the fall of 2008, when few long-term debt deals were completed, analysts say highly rated institutions are beginning to find opportunities to issue fixed-rate and even variable-rate debt, though at significantly higher rates than before. The AHA economic report found that its hospitals paid 15 percent more on interest on borrowed funds in the third quarter of 2008 compared with the same time frame in 2007.

"More highly rated hospital systems, like the AAs, are finding increasing access to capital," Schaub says. "It's more expensive than it used to be, but AA-rated hospital bond issuances are getting done."

Investment Declines Hit Pension Funds

Like most investors, hospitals saw a significant decline in their investment portfolios last year. The 557 hospitals participating in the AHA's economic survey reported a net loss of \$831.5 million in nonoperating revenue in the third quarter of 2008, after reporting gains of \$396.1 million in the third quarter of 2007.

"In the nonprofit world, most of these folks have reasonably substantial portfolios," says Fred Hessler, an AHA board member and managing director of Citigroup's Health Care Group. "Those have been really impacted with the declines in the market."

The Carle Foundation Hospital in Urbana, Ill., experienced a 35 percent to 40 percent decline in its investment income in 2008, says Rob Tonkinson, chief financial officer. The hospital can no longer rely on using investment income to bolster operating revenue, he says.

For hospitals with defined benefit pension plans, declining investment income can be even

more devastating, forcing them to make up shortfalls in pension funds with operating revenues. In November, the AHA reported that of the roughly 60 percent of hospitals with defined benefit pension plans, 31 percent anticipated they would need to increase pension funding.

"Our pension expenses will go up dramatically this year because of the drop in market value," says Connie Howes, CEO of Women & Infants Hospital in Providence, R.I. "That cost, even though it might be a rolling average, stays with you for a long time."

The Larger Recession

Hospitals are also beginning to feel the impact of the broader recession, as patient volumes drop, payer mix changes and they brace for potential drops in fundraising. Richard Clarke, president and CEO of the Healthcare Financial Management Association, says hospital executives are telling him that volumes for profitable surgical procedures like hip and knee replacements have fallen, while volume for more immediate, and less profitable, medical services has remained steady.

Nick Vitale, senior vice president of financial operations for Beaumont Hospitals, had been budgeting for the three-hospital system in southeastern Michigan to turn a \$3.7 million profit in 2008, a projection that was on track through June. During the next three months, the payer mix shifted from commercial insur-

ance to Medicare by roughly 1.5 percent. Each 1 percent shift in payer mix costs the hospital \$11 million over the course of a year, Vitale says.

The dramatic declines forced Beaumont to reduce pay throughout the organization and install a hiring freeze, with the goal of ultimately reducing the number of full-time employees by 500. Beaumont was also forced in November to stop work on a planned facility in Royal Oak, Mich., that broke ground in September, fencing off the site for the foreseeable future, and had to delay plans at another location for a new emergency department.

"We're essentially deferring anything we can to later in 2009 or perhaps 2010," he says. "We plan on continuing on all of these projects, just not on the same timeline."

At Women & Infants Hospital, Howes reports that the number of self-pay patients nearly doubled this year from 2007. With a payer mix that includes about a third of patients on Medicaid, she is anxiously watching whether the Centers for Medicare & Medicaid Services approves a waiver that could allow the state to save up to \$67 million in expenditures in 2009 but could also reduce restrictions on how Medicaid dollars are distributed to hospitals.

"With such a large Medicaid population that we serve, our ability to pay for services gets called into question," Howes says.

Todd Nelson, vice president and chief financial officer at Grinnell (Iowa) Regional Medical

Center, worries his organization will have a difficult time competing with nearby critical access hospitals that are compensated for Medicare above cost. Grinnell is a "tweener hospital"—which means it's too big to qualify for CMS' critical access program but too small to participate in the urban/rural referral program. It loses 33 cents on the dollar for each Medicare and Medicaid patient, Nelson says. With the recession taking its toll, the hospital has to rely on capital freezes and reduction of its workforce through attrition.

"There's a huge payment disparity between hospitals like us and the hospital 25 miles away that has shrunk to fit the critical access model," Nelson says.

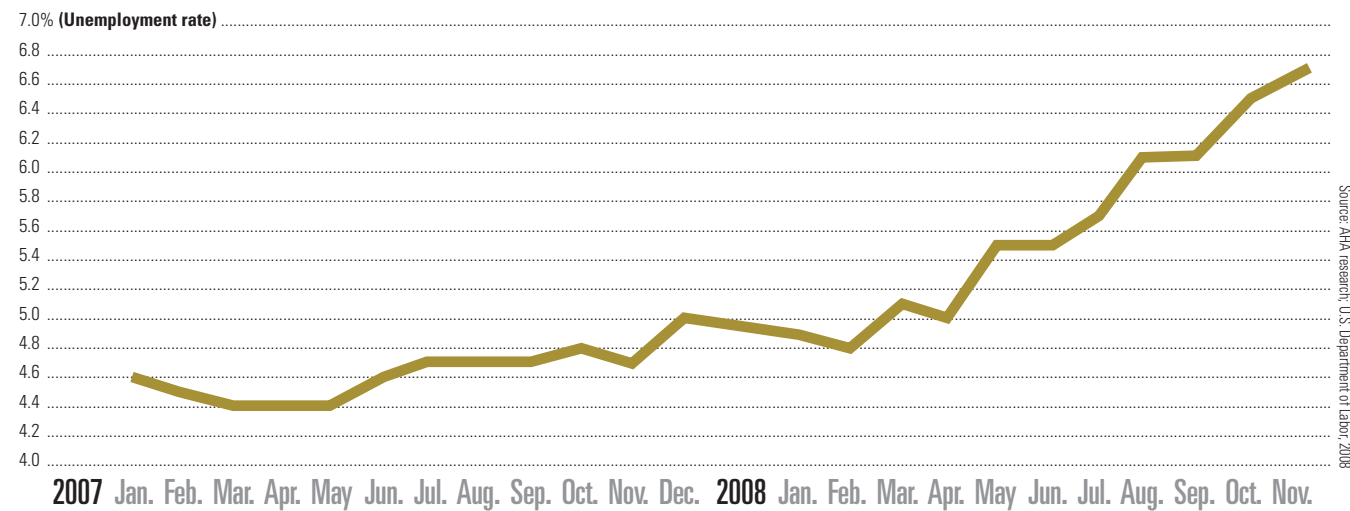
Rich Morrison, regional vice president of Florida Hospital in Orlando, has noticed the impact of the recession on fundraising. While no big donors have pulled back, Morrison says donations in the amount of \$50 to \$200 are "drying up." "Smaller donors are holding on [the their money]," Morrison says. "It's uncertainty. Some folks don't know if they're going to have a job next year."

Bright Spots

Not every hospital has horror stories to tell from the current recession. Kathy Hoefl, CEO of Ashley (N.D.) Medical Center, says her 26-bed, critical access hospital has actually seen an increase in patient volume since June 2008, thanks to a

Unemployment Soars, With Dangerous Consequences

According to the AHA, every 1 percent increase in unemployment corresponds with a loss of employer-sponsored coverage for an estimated 2.5 million employees and dependents. Over the last 24 months, an estimated 5 million Americans lost their employer-sponsored health plans.



Source: AHA research; U.S. Department of Labor, 2008

COVER relatively strong state economy predicated on booming agriculture and energy industries.

"There's been a tsunami coming in from east and west, but as of right now, North Dakota hasn't been directly hit," Hoeft says.

Also, the hospital has traditionally relied on strong relationships with two local banks for access to capital, which enables her to continue to finance capital projects, Hoeft says.

Essent Healthcare's Browder is also optimistic. Despite a drop in 2008 inpatient admissions and a 6 percent jump in bad debt, elective procedures have not yet declined, and the for-profit system's regional diversification—with five hospitals spread between Texas and New England—has helped keep it on firmer financial ground than competitors, Browder says. In addition, Essent recently invested heavily in infrastructure, completing three major building projects. That means it won't need to borrow large amounts of capital anytime soon.

Even certain hospitals in hard-hit regions offer some encouraging news. Nancy Schlichting, CEO of Henry Ford Health System in Michigan, says a series of layoffs at the start of the decade increased her resolve to avoid that situation again. When the local economy worsened in 2007, the system began taking proactive measures, including a closer look at whether certain vacant positions need to be filled and standardization of supply chain costs, among other things. Henry Ford plans to open a new hospital in Oakland County, Mich., in March.

"We're still growing," Schlichting says. "We're not growing at the rate we were, but we're not seeing declines."

Despite the recession, Rush University is closing in on a \$300 million fundraising goal after a strong summer of donations. "July through September was one of the best quarters we've ever had," Goodman says.

A potential bright spot for hospitals in the middle of already-financed construction projects may be the impact of the recession on commodities prices. Dennis Smith, a facilities management and construction consultant for B.E. Smith, says global prices for commodities like steel and cement mix have been dropping after several years of increases. "The worldwide recession caused a slowdown," Smith says. "This is a beneficial piece of that."



Turmoil in the stock market has turned investment gains into losses. 2008 third quarter nonoperating revenues were down \$831.5 million.

Consolidation Could Increase

Michael Maloney, head of the Healthcare Group for J.P. Morgan, forecasts a wave of consolidation in the next 18 months, as lower-rated institutions suffer from reduced access to credit. Large, multistate systems that can withstand regional economic crises on the strength of their diversity will emerge in the best shape to pick up new hospitals and continue to grow.

"It's going to be the market leaders," Maloney says. "Those hospitals or systems that are No. 1 or No. 2 in their markets are likely to be the survivors and pick off one-offs or stand-alone hospitals."

Mark Grube, a partner at Kaufman Hall, says smaller hospitals will have to decide whether

to continue operating independently or to align their facilities with organizations that have the capital to invest in information technology and competitive physician compensation.

"Regional providers rationalize capital spending with systemwide service line planning and can support investment in IT," Grube says. "These are drivers in consolidation."

Kenneth Kaufman adds that strong systems will have to look carefully for opportunities to grow in the new climate.

"Organizations in a position to add new facilities will want to acquire organizations that don't dilute their financial position," he says. "The second criteria is finding the organizations that offer the right clinical program and physician match in order to achieve market share and synergies."

2009 and Beyond

Shands Healthcare's Goldfarb is among those who hope that their institutions will emerge from the current crisis in better competitive shape than before. Despite having to implement a capital freeze in 2008, Goldfarb notes that his AA-rated system still hopes to open a new medical campus down the street from the Gainesville facility that was closed in 2008, and has no plans to change his long-term outlook.

The financial crisis even had a small upside for Shands Healthcare, which was able to buy back some of its outstanding debt in October for 70 cents on the dollar from an investor looking for short-term liquidity.

"I believe the financial markets will stabilize," Goldfarb says. "The economy will come back. If you have that optimistic outlook, there's a tendency to position the organization to grow."

Back in Michigan, though, where the fate of the auto industry remains precarious, Beaumont Hospital's Vitale entered the new year by preparing for the worst. Vitale, who notes that his system was AA-rated by major rating agencies for years before recently slipping to two A-plus ratings and one A rating, is making a series of different projections for the next year, depending on how the current crisis plays out.

"As we put together our budget, we're looking at base scenarios," Vitale says. "We're also putting together a lower scenario and a disaster case." ●