2019 Median Ratios for Not-for-Profit Children's Hospitals

Special Report

Fiscal 2018 Median Ratios: Stabilized Profitability; Improved Leverage; Potential for Operational Stress Remains

The children's hospital sector appears to have stabilized as profitability and leverage medians (using audited 2018 data) were generally on par with the 2017 medians, even in the midst of increased capital spending.

Fitch Ratings' stand-alone children's hospitals' strong 'AA–' median rating continues to reflect their credit profile characterized by robust liquidity, solid operating EBITDA margins, unique market positions, strong philanthropic support and specialized clinical services relative to the general acute care hospitals in Fitch's broader rating portfolio.

Operating Analysis: The median operating margin grew to a strong 5.6% in fiscal 2018, up from 4.5% in the prior year. This marks a turn-around from two consecutive years of deterioration after reaching a high of 6.8% in fiscal 2015. Expense-control initiatives, along with geographic and market share growth, contributed to the operational improvements. Although the median operating margin increased, the median operating EBITDA and EBITDA margins of 11.6% and 14.5% in fiscal 2018 were in line with the 2017 medians of 11.9% and 14.5%, respectively.

Improved Leverage Metrics: Operating stability in fiscal 2018 produced improved liquidity metrics. Fitch's cash to adjusted debt metric, which is similar to but more encompassing than cash to debt, increased to 233.1% from 225.9%. Days cash on hand (DCOH) was virtually unchanged at 334.7 days relative to the 2017 median of 334.8 days. Although some providers are in the midst of large inpatient projects, stronger leverage metrics generally reflect a recent spending pattern of funding projects through cash flow and investments in smaller, more numerous outpatient projects.

Capital Spending Increased: Median capital expenditures as a percentage of depreciation expense grew to 161.1% in fiscal 2018 from 145.9% in fiscal 2017. Increased spending is the result of moderate expansion projects focused primarily on ambulatory and service-line growth, combined with a few large-scale expansion projects currently under way.

High Medicaid Exposure: Children's hospitals' high exposure to Medicaid and supplemental funding and inherent vulnerability to governmental funding cuts remain ongoing credit concerns, especially given potential cuts to Medicaid Disproportionate Share Hospital (DSH) funding starting Oct. 1, 2019. Children's hospitals have historically been insulated from the impact of any decreases to Medicaid and supplemental reimbursement, largely mitigating this credit concern. Fitch expects this to continue, given the strong political and public-policy support for the specialized pediatric services provided.

Solid Market Platform: Fitch believes stand-alone children's hospitals exhibit strong brand identification with highly specialized tertiary and quaternary services, which bolsters and solidifies their market positions and will continue to support higher revenue defensibility compared to their stand-alone acute care counterparts. Children's hospitals continue to extend their service-area reach through alignment and service agreements with acute care providers, making them key partners in the development of networks in an increasingly consumer-driven healthcare market.

Related Research

2018 Median Ratios for Nonprofit Hospitals and Healthcare Systems (September 2018)

Fitch 2019 Outlook: U.S. Not-for-Profit Hospital and Health Systems (Acute Care Sector) (December 2018)

Analysts

Richard Park
+1 212 908-0289
richard.park@fitchratings.com

Melanie Her
+1 415 732-3729
melanie.her@fitchratings.com

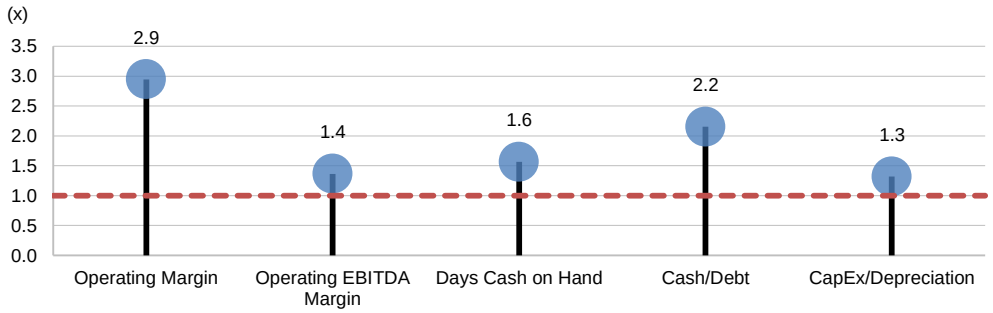
Matthew Shapiro
+1 212 908-0823
matthew.shapiro@fitchratings.com

Kevin Holloran
+1 512 813-5700
kevin.holloran@fitchratings.com

Overview

Most, if not all, hospital and healthcare systems provide medical care to children and infants within their clinical settings. And while many adult-focused acute care providers have created specialized pediatric departments or hospitals in their existing acute care setting, stand-alone children's hospitals are unique in the larger U.S. healthcare system from a financial, operational, societal and political perspective. The unique credit profile of stand-alone children's hospitals is reflected in a strong median rating of 'AA–'. The higher median rating for children's hospitals, compared to adult providers, demonstrates this subsector's robust liquidity, solid operating profitability, unique market positions, strong philanthropic support and highly specialized clinical services. The chart below demonstrates just how strong stand-alone children's hospitals are as a multiple of their adult counterparties. For example, days cash on hand is generally 1.6x greater at a children's hospital versus an adult provider.

Children's NFP Hospitals versus Adult NFP Hospitals



Source: Fitch Ratings, Fitch Solutions.

Children's hospitals' specialized service mix and high acuity of care generally translate into a leading pediatric market share. Children's hospitals are typically located in major population centers and provide complex tertiary and quaternary care to a regional pediatric population with a larger-than-average service area. Some markets can, and do, have large enough population bases to support multiple children's facilities, and in those cases, market shares tend to be less dominant.

Additionally, children's hospitals typically have strong academic affiliations with local medical schools and are able to recruit and retain the limited supply of certain pediatric subspecialists, and Fitch has seen increased competition with regard to physician recruitment in recent years. Fitch believes the academic affiliations further strengthen their essential market roles through increased patient demand and physician alignment, as well as through their specialized academic teaching and research capabilities.

The primary credit risk for children's hospitals is their elevated exposure to Medicaid relative to general acute care hospitals (approximately 50% of gross revenue from Medicaid in Fitch's rated portfolio of children's hospitals, compared with approximately 15% in its general hospital portfolio). The high exposure to Medicaid makes children's hospitals potentially vulnerable to state and federal budget cuts. Still, children's hospitals maintain very strong societal, political and philanthropic support in providing critical services to the pediatric population, which has historically protected them from Medicaid funding reductions.

Related Criteria

U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria (May 2019)

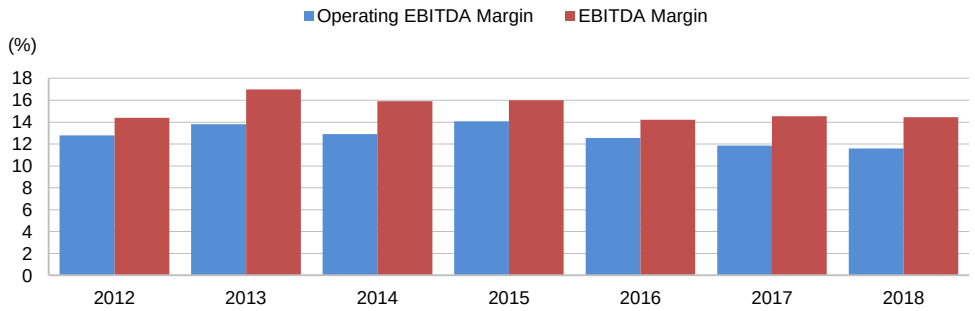
Profitability and Operational Ratios

Profitability in the children's hospital sector remained significantly favorable in fiscal 2018, compared to Fitch's adult provider medians. Median operating and operating EBITDA margins for stand-alone

children's hospitals of 5.6% and 11.6%, respectively, in fiscal 2018 well exceeded the respective acute care hospital and health system medians of 1.9% and 8.5% (fiscal 2017).

Median operating margin improved to 5.6% in fiscal 2018 from 4.5% in the prior year but still remained slightly below operating margins achieved of 6.8% and 6.1% in fiscal 2015 and 2016. It is likely that increased capital spending that occurred over the past few years, combined with project completion, along with associated startup expenses and related depreciation increases, played a role in some softening of this median compared to prior years. Fiscal 2018's median EBITDA margin of 14.5% was unchanged compared to the prior year, despite some investment market volatility during the end of 2018.

Operating EBITDA Margin/EBITDA Margin



Source: Fitch Ratings, Fitch Solutions.

Children's hospitals provide specialized care that is built to serve the distinct needs of the children and families they serve. Favorable clinical outcomes and strong reputations result in families often traveling locally, domestically and internationally to receive the best care from pediatric subspecialists who can only be seen at major children's hospitals. This combination of high quality and strong reputation, as indicated by a recent ranking report from U.S. News, is generally linked to higher net patient revenue generation as the best-ranked children's hospitals tend to have the ability to produce stronger volumes.

The sector's year-over-year median total revenue growth improved slightly in fiscal 2018, with total operating revenues of $1.25 billion, up from $1.09 billion in fiscal 2017. The change from fiscal 2017 can be attributed in part to the small sample size, continued ambulatory growth and the specific timing of provider fee revenues (namely in California, where five of 22 median hospitals operate).

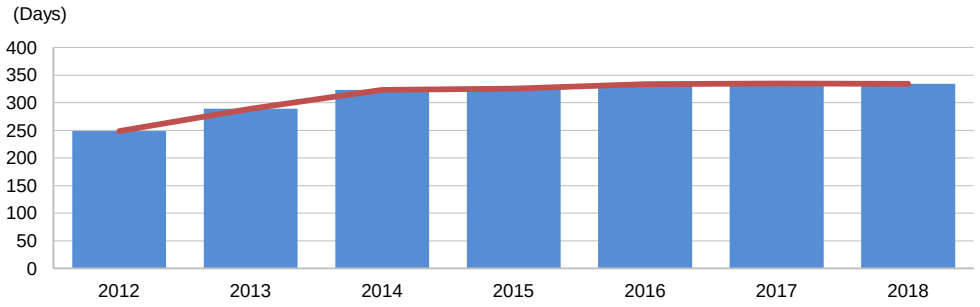
Expense-control and market share/geographic growth initiatives remain a common theme among stand-alone children's hospitals. Fitch believes this strategy has been a key element in their consistent year-over-year median strength. Fitch expects children's hospitals to continue to pursue strategic footprint-expansion through affiliations, partnerships and organic growth initiatives.

Robust Liquidity

Liquidity positions of many children's hospitals remain a key credit strength, providing flexibility and substantial financial cushion to offset the risk associated with elevated exposure to Medicaid reimbursement, a typical payor mix of children's hospitals. Robust philanthropic support, consistently strong EBITDA margins and favorable investment returns have contributed to the maintenance of liquidity levels for children's hospitals with metrics well exceeding medians relative to Fitch's portfolio of general acute care hospitals.

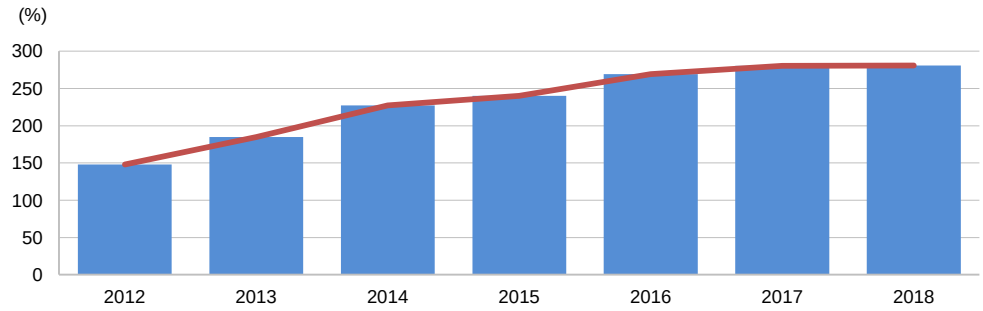
Median DCOH and median cash to debt metrics held steady at 334.7 days and 280.8%, respectively, in fiscal 2018. Children's hospitals' liquidity medians remain ahead of Fitch's general acute care hospitals (DCOH of 205.7 days and cash to debt of 159.8%).

Days Cash on Hand



Source: Fitch Ratings, Fitch Solutions.

Cash to Debt



Source: Fitch Ratings, Fitch Solutions.

Fitch also uses net adjusted debt to adjusted EBITDA (NADAE) to evaluate an issuer's leverage relative to cash flow, with a negative value meaning that the issuer holds more cash and investments than the amount of its outstanding debt. Given the sector's robust EBITDA performance and strong liquidity positions, NADAE improved to a favorable negative 3.03x in fiscal 2018 from negative 2.75x in fiscal 2017. The children's hospital sector's NADAE metric remained favorable compared to the adult acute provider median of negative 1.1x (fiscal 2017).

From a criteria standpoint, a majority of children's hospitals' financial profiles were assessed as being within the 'aa' category expectations as characterized by healthy cash and leverage positions. This supports Fitch's expectation that balance sheet positions will remain stable through Fitch's five-year forward-looking analysis.

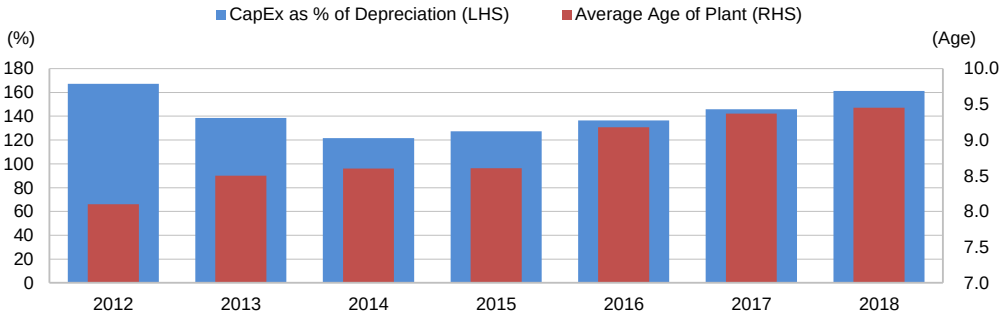
Fitch believes that strong liquidity levels will continue to favorably position children's hospitals given the uncertainties of the healthcare landscape, providing flexibility to adapt to future changes in reimbursement and/or potential healthcare reform.

Capital Spending

The need for high-quality, state-of-the-art services is a capital-intensive endeavor, and capital expenditures as a percentage of the depreciation median totaled approximately 160% for the children's sector in 2018, ahead of the 2017 median of 146% and well ahead of adult providers at approximately 120%. As evidenced by an average age of plant median of nine years

(virtually unchanged in fiscal 2018 versus fiscal 2017), a majority of the children's hospitals within the sample size keep their plants well maintained and up to date.

CapEx/Average Age of Plant



Source: Fitch Ratings, Fitch Solutions.

Fitch assesses capital expenditure requirement needs when reviewing each enterprise. Overall, when viewed through the lens of Fitch's criteria, the combination of solid margins, higher capital spending as a percentage of depreciation and a relatively low average age of plant has resulted in a favorable 'strong' operating risk assessment for the overwhelming majority of Fitch-rated children's hospitals.

Fitch notes that children's hospitals are spending capital on ambulatory care to add outpatient facilities and access points. This is in line with current trends in healthcare strategy that are moving toward patient-centric care, expanding access and addressing population health issues through social determinants of health. These efforts are being made in hopes of making communities healthier and reducing the longer-term cost of providing care. In addition, as the main providers of highly specialized children's healthcare, capital continues to be spent on increasing specialty service lines and research for pediatric health conditions.

Although spending levels remain high, Children's hospitals generally maintain a lower debt load when compared to Fitch's general hospital portfolio. While this is partly a result of solid profitability levels that allow for projects to be funded through cash flow, strong philanthropic support for the sector also enables children's hospitals to execute on capital projects through donations and contributions rather than debt. This results in a lower median debt to capitalization ratio of 20.9% and maximum annual debt service as a percentage of revenue of 1.8%, compared with 2017 general acute care medians of 34.3% and 2.6%.

Potential Reimbursement and Demographic Pressures

According to the Centers for Medicare and Medicaid Services, nearly one-half of the population of children in the U.S. (slightly over 36 million children in 2018) are enrolled in Medicaid. In addition, children's hospitals are a large provider of Medicaid services on a percentage basis, even though they account for a very small portion of the hospitals in the nation. These facts show that the $4 billion in DSH funding cuts, currently scheduled to begin on Oct. 1, 2019, could put negative operating pressure on children's hospitals. Under the Affordable Care Act (ACA), the Secretary of Health and Human Services is required to develop a methodology to implement DSH reductions. The requirements of the methodology are to impose the largest reductions to the states with the lowest percentages of uninsured individuals and not target DSH payment reductions on hospitals with high Medicaid/uncompensated care volumes. CMS has not published a final rule on the DSH payment reductions, but under the general framework described above, the states most vulnerable to DSH reductions would be Massachusetts, Hawaii, District of Columbia, Minnesota

and Vermont, and states least vulnerable to DSH reductions would be Texas, Oklahoma, Alaska, Georgia and Florida.

The Affordable Care Act (ACA) initially authorized DSH reductions to begin in 2014, under the assumption that uncompensated care costs would decrease as healthcare coverage increased. Though Medicaid coverage has increased (below coverage levels anticipated under the ACA), Medicaid reimbursements remain weak relative to the cost of providing care, and a reduction in DSH payments would bring profitability pressure. If DSH cuts are not delayed, CMS would reduce payments until 2025, at which point, total reductions would reach $43 billion. In addition to DSH cuts, any potential budget constraints at the state and federal levels have the risk of cutting Medicaid funding overall.

Due to their tertiary and quaternary focus, and generally higher cost structure (compared to general acute care hospitals), stand-alone children's hospitals may be vulnerable to volume erosion as payors and patients become increasingly price sensitive. If not addressed, volume fluctuations have the potential to affect funding for research, innovation and strategic and programmatic expansion. Additionally, the movement toward risk-based contracts by payors is expected to grow around the integrated health systems that have developed in several major metropolitan areas and could pose reimbursement pressure for those not yet structured to manage risk. Fitch believes children's hospitals will continue investing in population health initiatives to increase engagement and effectively manage costs, which, in turn, may help the hospitals prepare for profitability challenges.

Over the longer term, children's hospital volumes may be affected by a combination of increasing competition and national demographic changes. Traditional adult acute care hospitals continue to explore opportunities to become full-service providers across ages and the continuum of care. This likely will include the pursuit of growth in high-acuity and margin service lines that are mainly provided at children's hospitals. Increasing competition may arrive in the midst of declining births as the total number of births in 2017 was 3.85 million and the general fertility rate, as measured by the number of births per 1,000 women aged 15–44, was 60.3. These numbers were well below recent highs set in 2007 of 4.36 million births and a general fertility rate of 69.3.

Fitch believes most stand-alone pediatric facilities will maintain key market roles as the only providers of highly specialized pediatric tertiary and quaternary services in their service area. This should continue to generate support for their mission and philanthropic support for their endeavors, providing some protection from any future reimbursement and funding pressures.

Fundamentally, the strong brand identity associated with children's hospitals is expected to continue to enable the sector's legislative, financial and public support. The strategy among certain pediatric providers to extend their service-area reach through various alignment and service agreements with community hospitals should enhance their position in an increasingly consumer-directed healthcare market by making them a key partner in the coordination of care and management of chronic conditions among a wider pediatric population.

Fitch's medians have historically shown that children's hospitals have strong financial flexibility to weather potential changes in the ever-changing healthcare environment, more so than their general acute care hospital counterparts. This is reflective of the key characteristics emphasized above that make up the unique profiles of children's hospitals. Fitch expects trends in children's hospitals' median ratios to remain relatively constant within the one year outlook despite continued operating pressures and heightened capital spending. Factors that could pose potential stress in Fitch's children's hospitals' medians are changes (repeal and replace) to the ACA, which could have a

significant impact on reimbursement, or a potential recession, which could further pressure profitability ratios.

Methodology

Due to their unique credit profile, Fitch has traditionally excluded children's hospitals in its annual not-for-profit hospital and health system medians report. To provide a benchmark for comparative purposes, Fitch offers this medians report, which is limited to stand-alone children's hospitals.

Fitch identified stand-alone children's hospitals that are not part of a larger hospital or health system. Of those stand-alone children's hospitals, Fitch was able to obtain audited or draft audit financials for 22 providers for the fiscal 2018 operating year. Fitch currently maintains ratings on 15 children's hospitals. Fitch notes the small sample size inherently creates greater volatility in the data, and the small sample size should be considered when reviewing year-over-year changes.

Children's Hospitals Long-Term Ratings

Hospital	Rating	Rating Outlook
Children's Hospital & Medical Center (NE)	AA–	Stable
Children's Hospital Medical Center of Akron (OH)	AA–	Stable
Children's Hospital of Orange County (CA)	AA–	Stable
Children's Hospitals and Clinics of Minnesota (MN)	AA	Stable
Children's Medical Center of Dallas (TX)	AA	Stable
Children's National Medical Center (DC)	A+	Stable
East Tennessee Children's Hospital (TN)	A	Stable
Lucile Salter Packard Children's Hospital at Stanford (CA)	AA–	Stable
Lurie Children's Hospital (IL)	AA	Stable
Nationwide Children's Hospital (OH)	AA	Stable
Nicklaus Children's Hospital (FL)	A+	Stable
Phoenix Children's Hospital (AZ)	A+	Stable
Rady Children's Hospital and Health Center (CA)	AA	Stable
Seattle Children's Hospital (WA)	AA	Stable
Texas Childrens Hospital and Affiliated Entities (TX)	AA	Stable
Arkansas Children's Hospital (AR)	NR	—
Children's Hospital Boston (MA)	NR	—
Children's Hospital Central California (CA)	NR	—
Children's Hospital Los Angeles (CA)	NR	—
Children's Mercy Hospitals & Clinics (MO)	NR	—
Cincinnati Children's Hospital Medical Center (OH)	NR	—
Cook Children's Health Care System (TX)	NR	—

NR – Not rated by Fitch.
Source: Fitch Ratings, Fitch Solutions.

Children's Hospital Medians

(Fiscal Years)	2012	2013	2014	2015	2016	2017	2018	General Hospital and Health System Medians (Fiscal 2017)[a]
Sample Size	22	21	20	20	20	21	22	232
Total Operating Revenues ($ Mil.)	805.2	866.1	920.4	1,071.7	1,101.3	1,093.0	1,245.0	802.2
Days Cash on Hand	248.7	289.1	323.5	325.8	334.1	334.8	334.7	213.9
Days in Accounts Receivable	52.1	50.2	54.6	51.3	54.9	59.4	60.7	47.0
Cushion Ratio (x)	21.7	27.3	32.2	33.4	35.2	44.6	42.8	20.9
Days in Current Liabilities	63.0	65.6	68.6	66.4	62.1	64.9	74.0	61.7
Cash to Debt (%)	148.0	184.9	227.1	240.2	269.2	280.4	280.8	159.0
Cash to Adjusted Debt (%)	—	—	—	—	—	225.9	233.1	130.4
Operating Margin (%)	6.1	6.7	4.9	6.8	6.1	4.5	5.6	1.9
Operating EBITDA Margin (%)	12.8	13.8	12.9	14.1	12.6	11.9	11.6	8.5
Excess Margin (%)	8.0	9.5	8.2	9.4	7.1	8.0	8.8	4.2
EBITDA Margin (%)	14.4	17.0	15.9	16.0	14.2	14.5	14.5	10.3
Net Adjusted Debt to Adjusted EBITDA (%)	—	—	—	—	—	(2.8)	(3.0)	(1.1)
Personnel Costs as % of Total Operating Revenue	52.4	54.1	54.8	53.0	56.4	54.5	54.5	54.9
EBITDA Debt Service Coverage (x)	6.4	7.2	6.9	7.8	6.5	6.7	8.3	3.8
Operating EBITDA Debt Service Coverage (x)	5.5	6.0	5.0	6.5	5.2	5.0	6.1	3.2
Maximum Annual Debt Service as % of Revenues	2.4	2.7	2.5	2.2	2.1	2.1	1.8	2.6
Debt to EBITDA (x)	2.8	2.4	2.0	2.0	2.2	2.5	2.0	3.3
Debt to Capitalization (%)	27.9	27.2	24.6	24.4	21.9	22.0	20.9	34.3
Average Age of Plant (Years)	8.1	8.5	8.6	8.6	9.2	9.4	9.5	11.2
Capital Expenditures as % of Depreciation Expense	167.1	138.4	121.5	127.3	136.5	145.9	161.1	121.4

[a]Fitch's 2018 Median Ratios for Not-For-Profit Hospitals and Healthcare Systems. N.A. – Not available. EBITDA – Earnings before interest, taxes, depreciation and amortization.
Source: Fitch Ratings, Fitch Solutions.