Not-For-Profit Health Care Outlook 2016

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Not-For-Profit Outlook: Stable

Easing negative pressures & sector's prolonged positive response to these pressures are now driving credit stability, which we believe will result in balanced upgrades versus downgrades for 2016 & into 2017.

- ACA: Medicaid expansion and management countermeasures, which took a prolonged effort & many years to implement, are driving margin stability
- Balance sheets remain a key credit strength for the sector
- M&A activity has been generally positive
  - Opportunistic M&A will continue
  - Strategic M&A now more likely to be driven by enterprise rather than financial considerations
- Improved performance where observed is usually due to:
  - Medicaid expansion; improved volumes; improved payor mix; and favorable M&A experience
- Broad market confusion over mixed incentives & variable pace of change as sector begins movement to value orientation

Not-For-Profit Outlook: Stable

Easing negative pressures & sector's prolonged positive response to these pressures are now driving credit stability, which we believe will result in balanced upgrades versus downgrades for 2016 & into 2017.

- Negative pressures remain broad based, though less than a few years ago
- Weaker performance where observed due to:
  - Poor IT installations; weaker patient volumes; weak investment markets; cost of absorbing physician practices
- A credit gap remains
  - Large provider vs. small providers (i.e. size and scale issues)
  - Strong market position vs. weak market position (i.e. payor leverage)
  - Population health management capacity & ability to take & manage risk is emergent differentiator
- The strongest hospitals and health systems are likely to just hold existing margin and reserve levels, while weaker providers will likely continue to see operating margin and cash flow erosion and eventually balance sheet pressure

Three Major Themes

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

Evolution of ACA-Driven Expansion

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ACA-Driven Expansion

- Payor mix shifts
  - Significant shift to Medicaid from uninsured depending on location/prior business mix
- Incremental contribution to profitability as material reduction in uninsured although uninsured burden remains
- Disproportionate share reductions in 2017 will hurt margins for some
- Expansion has had a positive impact on admissions/ adjusted admissions
  - Near-term favorable impacts as 20 million plus access care via ACA, although we are now seeing broader use rate/inpatient admissions level off and expect declines to re-emerge over time
  - Boosting public exchange enrollment in areas where managed care is being utilized (e.g. Arkansas)
  - Credit quality improved in 2015 for NFP organizations in expansion states vs. non-expansion states as upgrades exceeded downgrades in those states due to improved financial profiles & utilization growth

1 ACA Driven Expansion   2 Market Driven Reform   3 M&A

Market-Driven Reform

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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

- **Growth of high deductible plans and consequences**
  - Currently 30-40 million Americans have high deductible plans excluding exchanges, up from about 5 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

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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 & personnel & ways to access care becoming essential including e-visits, phone & photo consults
- Greater consumer 'skin in the game' drives price consciousness, & value orientation, as individuals more involved in decision making

Competition

- Heightened competition within and across the sectors & 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

1 ACA Driven Expansion

2 Market Driven Reform

3 M&A

Mergers & Acquisitions

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Mergers and Acquisitions

- **M&A activity remains at a steady pace:**
  - Large: Ascension acquisition of Wheaton Franciscan (Wisconsin); Mountain States and Wellmont Health (TN)
  - Smaller more opportunistic M&A continues largely unabated
- **Why:**
  - Organizations seeking both size and scale, 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 (hopefully positively impacting them) – part of a widen the funnel strategy;
  - Expanding a geographic “footprint” for longer-term transition to population health management
- **New observations:**
  - In some markets few unaffiliated partners remain;
  - Next set of mergers likely to run into legal barriers;
  - Have seen new push back from regulators
- **Growth in affiliation strategies in lieu of full M&A:**
  - Joint ventures/joint operating agreements;
  - Clinical networks – often first step to something more permanent;
  - Management contracts – also often first step to something more permanent;
  - Easier to dismantle if it does not ‘test well’ than a full asset merger

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Comparative Statistics

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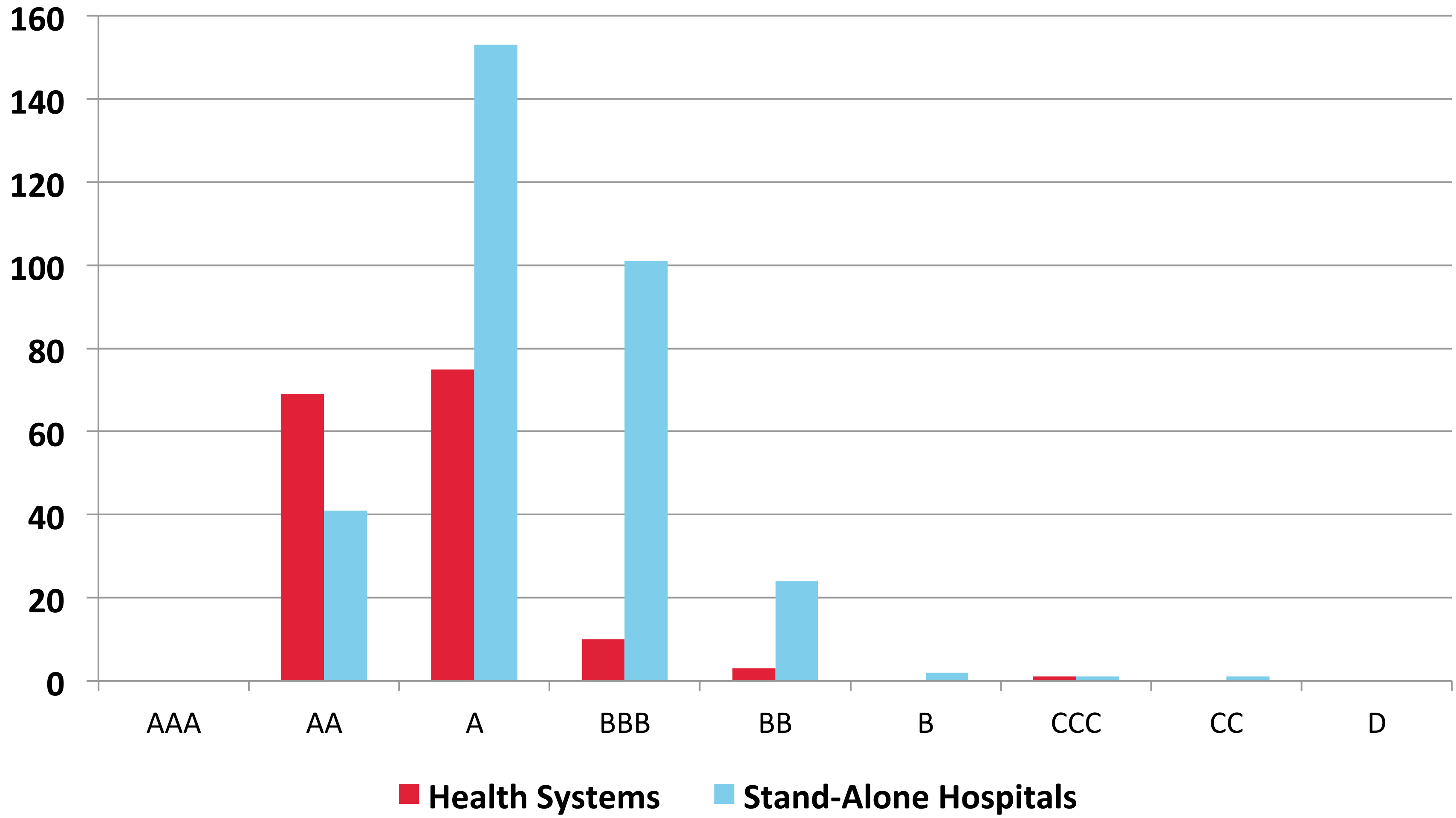
Not For Profit Health Care Rating Distribution



*Ratings as of 6/1/2016. Sample size: 158 health systems, 323 stand-alone hospitals.
Source: S&P Global Ratings

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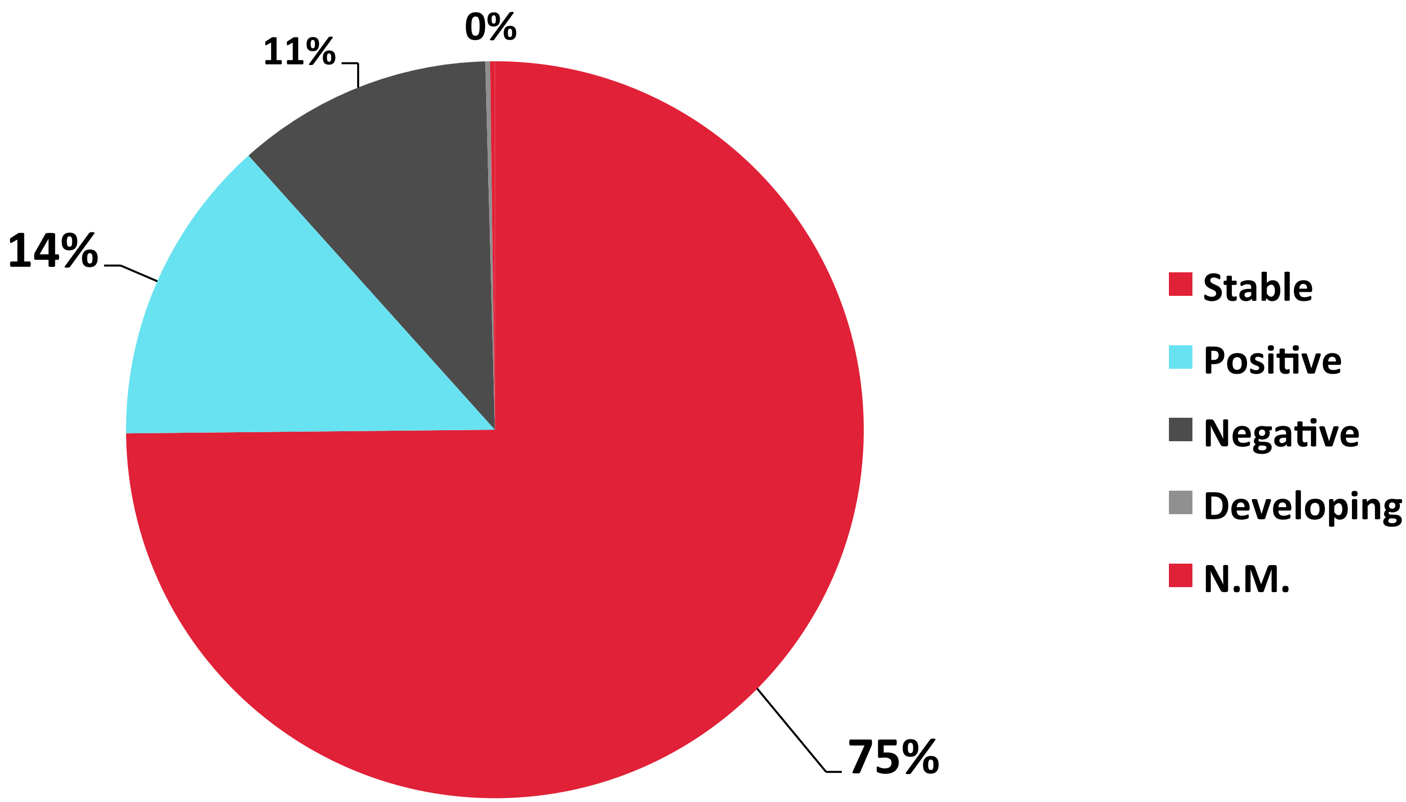
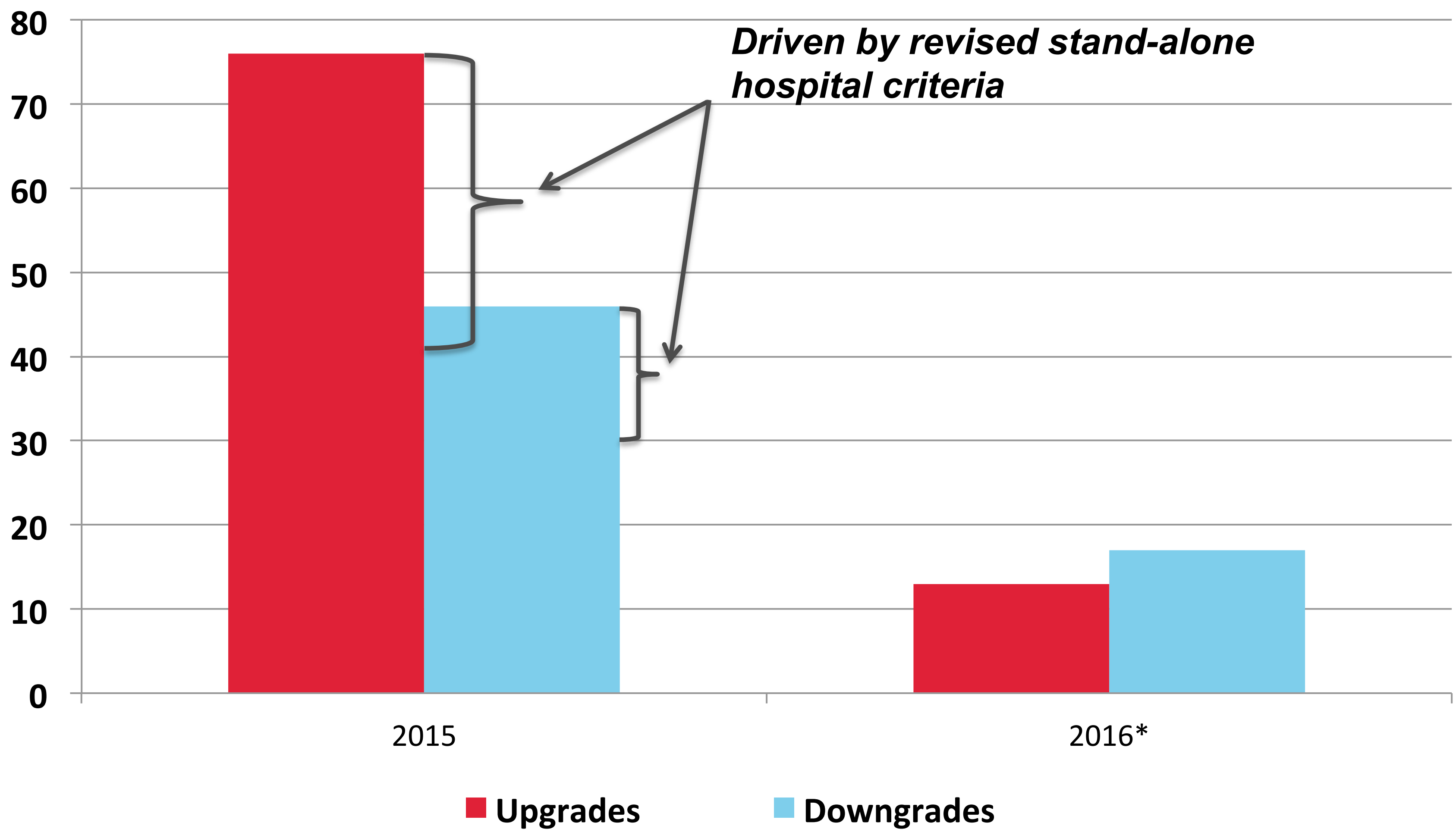
Not For Profit Health Care Outlook Distribution



Note: Stable has fallen to 75% from 78% as of Dec. 31, 2015. Positive rose to 14% from 11%. Negative held at 11%.

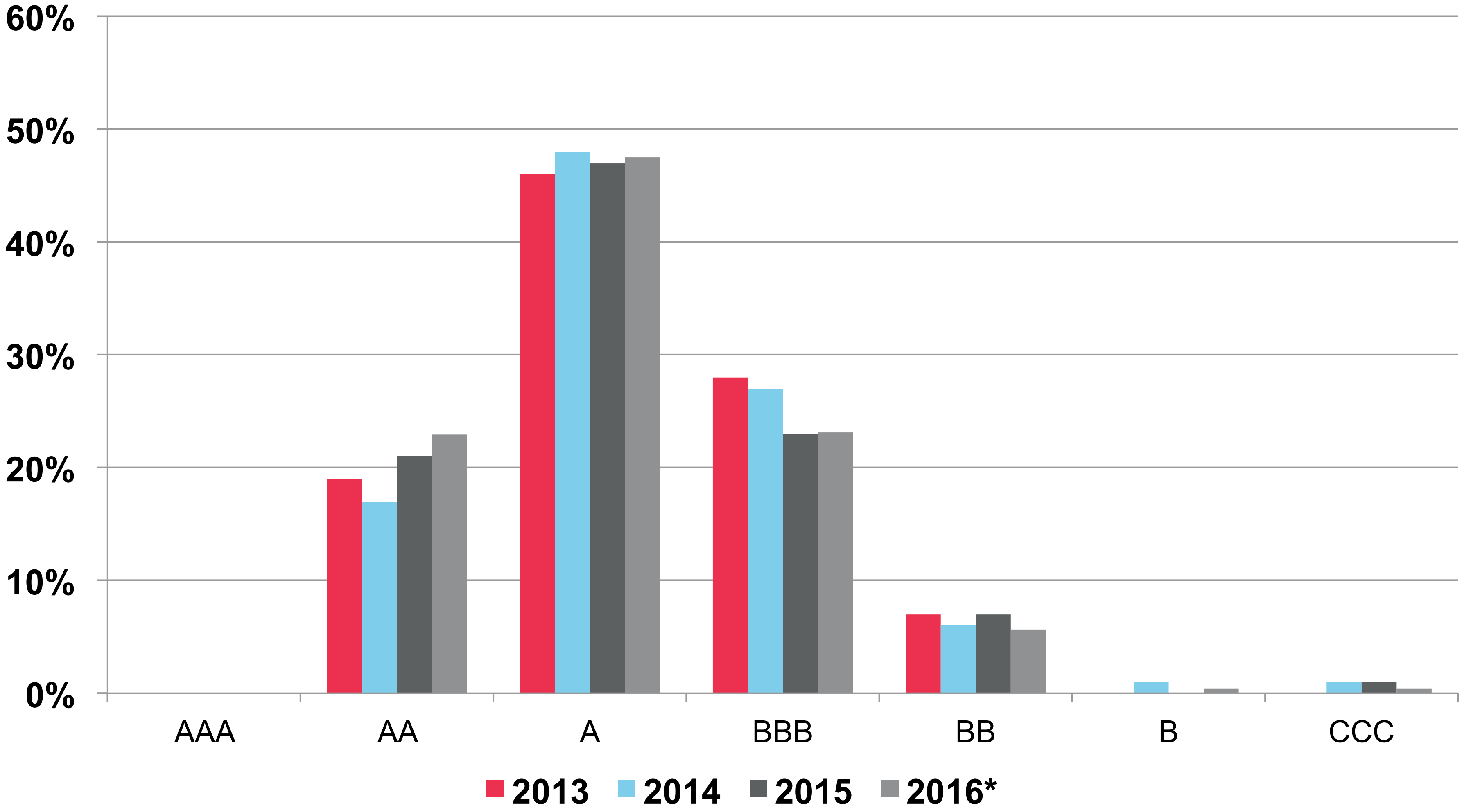
*Outlooks as of 6/1/2016. Sample size: 158 health systems, 323 stand-alone hospitals. Includes one developing outlook (Lawrence + Memorial Hospital) and one CreditWatch Negative (Presence Health).
Source: S&P Global Ratings

Not For Profit Health Care Rating Actions



*Rating actions through 6/1/2016. Includes health systems and stand-alone hospitals. 2015 include 35 upgrades and 16 downgrades driven by the implementation of revised stand-alone hospital criteria
Source: S&P Global Ratings

Not For Profit Health Care Rating Distribution Trend



*Ratings as of 12/31/2013, 12/31/2014, 12/31/2015, and 6/1/2016. Includes health systems and stand-alone hospitals.
Source: S&P Global Ratings

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Conclusions

The majority of outlooks remain stable across the sector despite health care reform.

- Good cash flow, particularly for strong providers
- Brief improvement in utilization trends and reimbursement, although not expected to continue over time
- Rising out of pocket expenses
  - Discriminating consumers
  - Volume and revenue decline
  - Weaker financial profiles
- Providers cutting costs and building cash reserves, allowing for capacity within current ratings
- M&A provides growth for some providers
- Growth of risk-sharing arrangements
- Reform has been slow to evolve but may be accelerating

Thank you

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