2023 Median Ratios for Not-for-Profit Children's Hospitals

> Despite significant inflationary pressures on the healthcare industry, Fitch's 2023 medians show that children's hospitals continue to be able to drive positive operating results due to favorable reimbursement for higher acuity services and distinct market positions that provide for more consistent volumes compared to the overall acute care sector.
>
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Median Ratios: Weaker Results

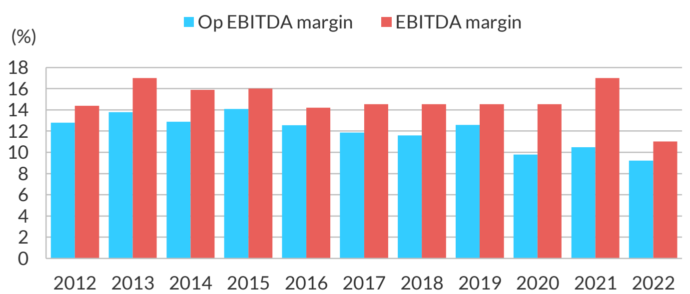
Fitch Ratings' 2023 children's hospital medians (using 2022 audited data) shows operational deterioration and liquidity dilution as a result of inflationary pressures and investment losses. Staffing shortages, labor cost inflation and supply chain disruptions became particularly very pronounced in 2022. Additionally, children's hospitals also faced what many called a 'tridemic' of increased COVID-19, RSV and flu cases in late 2022 that caused providers to experience capacity challenges, a decline in patient acuity and a temporary increase in contract labor utilization.

Despite major challenges in 2022, the stand-alone children's hospitals' median rating remains strong at 'AA–', reflecting children's hospitals' unique credit profile characterized by robust liquidity, solid operating profitability, unique market positions, strong philanthropic support and specialized clinical services relative to the general acute care hospitals in Fitch's broader rating portfolio. The credit strength of this subsector is also seen in not having any downgrades or negative rating signaling (through rating watches or outlooks) of rated credits over the past year.

Cash Flow Contraction

Median cash flow metrics declined to the lowest level seen in the past 10 years. The median operating EBITDA margin was 9.2% compared to the 10.5% level from 2021 and the 12.2% average from fiscal 2013–2021, respectively. Fitch attributes the year-over-year fluctuation to inflated permanent and contract labor and supplies expenses that outpaced revenue growth (median increase of 9.6%). Even with reduced cash flow, median debt service coverage by operating EBITDA remains favorable at 4.6x.

Operating EBITDA/EBITDA Margin



Source: Fitch Ratings

While overall cash flow medians show a modest year-over-year decline, the weakening of results is more pronounced after removing California based children's hospitals, many of which recognized above average provider fee revenue in 2022. After removing California children's hospitals from the 2021/2022 data sets, the median operating EBITDA margin shows a pronounced decline of over 300 basis points to 9.2% in fiscal 2022 from 12.8% in fiscal 2021.

Related Research

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U.S. Not-For-Profit Hospitals and Health Systems Outlook 2023 (December 2022)

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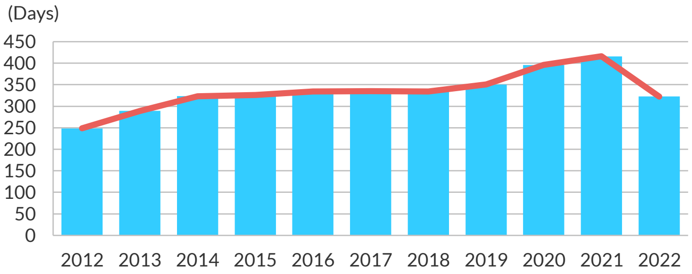
Liquidity Dilution

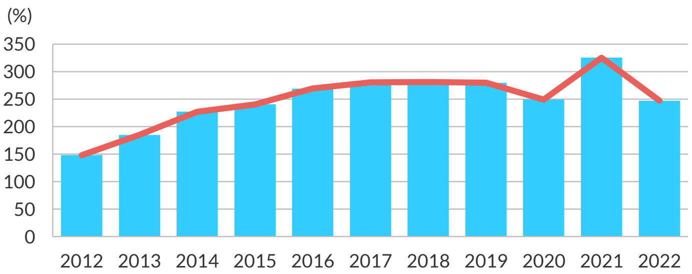
Overall expense growth (median increase of 12.1%) and investment market losses (median loss of 8.1%) drove a significant deterioration of key liquidity metrics (days' cash on hand and cash to debt) compared to the prior year. Median days' cash declined by approximately 93 days (-22%) to 323 from 416 while median cash to debt fell to 247% from 325%. Despite the precipitous drop in days' cash on hand and cash to debt from 2021 all-time highs, levels remain generally in line with pre-pandemic levels. In addition, these metrics remain ahead of the median liquidity metrics of general acute care hospitals, which were also at or near all-time highs in 2021 (days' cash of 260 and cash to debt of 186%).

Days Cash on Hand



Source: Fitch Ratings

Cash to Debt



Source: Fitch Ratings

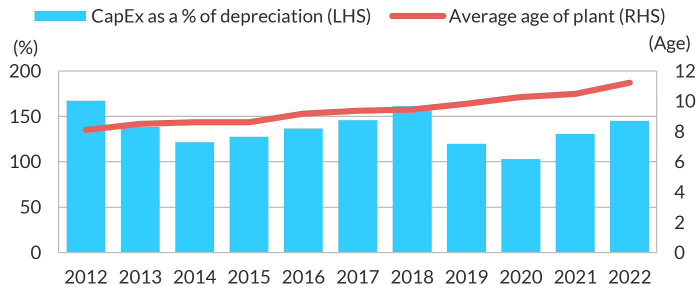
Fitch still believes that the favorable liquidity positions of children's hospitals remain a key credit strength, providing flexibility and substantial financial cushion to manage through operating challenges and offset the risk associated with elevated exposure to Medicaid reimbursement, by far the single biggest payor for most children's hospitals.

Children's hospitals generally maintain a lower debt load when compared to Fitch's general hospital portfolio. While partly a result of solid profitability levels that allow to fund projects 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 21.9% and maximum annual debt service as a percentage of revenue of 1.8% compared to the fiscal 2021 general acute care medians of 31.7% and 2.2%.

High Capital Spending

The need for high-quality, state-of-the-art services is a capital-intensive endeavor resulting in a median capital spending ratio (capital expenditures as a percentage of depreciation) for children's hospitals that is consistently above depreciation. The median capital spending ratio increased to 145% in 2022 from 131% in 2021. Although the capital spending ratio increased year over year, the median average age of plant rose to 11.2 years for 2022 from 10.5 years for 2021.

CapEx/Average Age of Plant



Source: Fitch Ratings

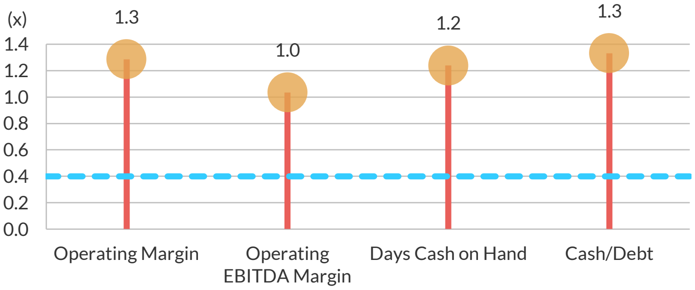
The combination of high capital spending and increased average age of plant is indicative of ongoing capital projects financed by new money debt issuances from the past few years. Fitch expects capital spending as a percentage of depreciation expense to remain high in 2023 as many large inpatient growth projects remain in process. Given the current realities of higher interest rates and construction costs, capital spending may eventually slow and shift to focus on more cost-effective ambulatory care investments that provide additional access points and relieve capacity for higher acuity cases at main locations.

Summary

Most, if not all, hospital and healthcare systems provide medical care to children and infants within their clinical settings. While many adult-focused acute care providers have created specialized pediatric departments or hospitals in their existing acute care setting, standalone 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 standalone children's hospitals is reflected in a strong median rating of 'AA–' compared to the 'A+' median rating of Fitch's overall not-for-profit hospitals and healthcare systems.

The chart below shows just how strong standalone children's hospitals are as a multiple of their adult counterparts, even when comparing against the deceptively strong fiscal 2021 medians of Fitch's not-for-profit hospitals and healthcare systems that were supported by stimulus funding and bullish investment markets. For example, the fiscal 2022 median days cash on hand of children's hospitals remains 1.2x greater than the fiscal 2021 median days cash on hand of Fitch's not-for-profit hospitals and healthcare systems.

Children's NFP Hospitals Versus Adult NFP Hospitals



Source: Fitch Ratings

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; in those cases, market shares are less dominant.

Children's hospitals often have strong academic affiliations with local medical schools and are able to recruit and retain the limited number of certain pediatric subspecialists. Fitch has seen increased competition regarding physician recruitment in recent years. Fitch believes academic affiliations further strengthen children's hospitals' 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 remains 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 to approximately 18% in its general hospital portfolio). The high exposure to Medicaid makes children's hospitals 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 generally protected them from Medicaid funding reductions.

Final Thoughts

Operating strategies focused on productivity improvements, service line enhancements and expense reduction, primarily through lower external labor utilization and the recruitment and retention of permanent staff, should help stabilize operating performance over the next few years. Over the longer term, the sector will continue to face multiple challenges, including pediatric mental health, which was elevated because of the COVID-19 pandemic. Fitch expects direct investments into behavioral health to increase, but a variety of strategies beyond cash flow/bond funded inpatient care will likely to be utilized given the low Medicaid reimbursement rates for behavioral health services. These include capital projects supported by philanthropy, federal or state support, capacity growth through partnerships as well as the integration and coordination of care in inpatient, outpatient and school-based settings.

In addition, children's hospitals will have to be prepared for the downstream effects of declining births in the nation. The total number of births in 2021 was 3.66 million and the general birth rate, as measured by the number of births per 1,000 women aged 15–44, was 56.3. These figures highlight that the U.S. births remain in a longer term downward trend since recent highs set in 2007 of 4.36 million births and a general birth rate of 69.3.

Despite significant operating challenges, standalone pediatric facilities remain well positioned through their key market roles as the only providers of highly specialized pediatric tertiary and quaternary services in their respective service area. Fitch's medians show 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, which is reflective of the key characteristics emphasized above that make up the unique profiles of children's hospitals.

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 standalone children's hospitals.

Fitch identified standalone children's hospitals apart from a larger hospital or health system. Of those standalone children's hospitals, Fitch obtained audited financials for 24 providers for the fiscal 2022 operating year. Fitch currently maintains ratings on 17 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 Hospital Medians

(Fiscal years)	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2021 (no CA)	2022 (no CA)	General Hospital and Health System medians (Fiscal 2021)[a]
Sample Size	21	20	20	20	21	22	22	22	23	24	18	19	219
Total Operating Revenues ($ Mil.)	866.1	920.4	1,071.7	1,101.3	1,093.0	1,245.0	1,332.8	1,330.1	1,336.9	1,460.7	1,456.7	1,536.9	1,160.2
Days Cash on Hand	289.1	323.5	325.8	334.1	334.8	334.7	350.4	396.1	416.0	322.7	431.7	331.1	260.3
Days in Accounts Receivable	50.2	54.6	51.3	54.9	59.4	60.7	60.1	56.5	66.1	64.1	64.5	63.5	47.2
Cushion Ratio (x)	27.3	32.2	33.4	35.2	44.6	42.8	44.6	43.2	54.3	48.6	56.8	49.7	29.7
Days in Current Liabilities	65.6	68.6	66.4	62.1	64.9	74.0	75.7	85.7	85.8	71.1	71.8	64.5	89.4
Cash to Debt (%)	184.9	227.1	240.2	269.2	280.4	280.8	279.5	249.1	325.3	247.2	325.6	261.8	185.5
Cash to Adjusted Debt (%)	—	—	—	—	225.9	233.1	240.9	229.6	305.6	223.7	311.5	214.9	180.1
Operating Margin (%)	6.7	4.9	6.8	6.1	4.5	5.6	7.0	3.8	3.6	3.9	6.6	3.6	3.0
Op EBITDA Margin (%)	13.8	12.9	14.1	12.6	11.9	11.6	12.6	9.8	10.5	9.2	12.8	9.2	8.9
Excess Margin (%)	9.5	8.2	9.4	7.1	8.0	8.8	9.5	7.5	10.9	5.8	12.5	5.8	6.6
EBITDA Margin (%)	17.0	15.9	16.0	14.2	14.5	14.5	15.4	13.0	17.0	11.0	17.8	11.2	12.4
Net Adjusted Debt to Adjusted EBITDA (%)	—	—	—	—	-2.8	-3.0	-3.6	-3.7	-3.9	-2.9	-3.7	-2.6	-2.1
Personnel Costs as % of Total Operating Revenue	54.1	54.8	53.0	56.4	54.5	54.5	55.3	55.8	55.5	55.2	55.7	56.6	52.8
EBITDA Debt Service Coverage (x)	7.2	6.9	7.8	6.5	6.7	8.3	7.6	6.8	7.4	6.0	11.1	6.0	5.7
OP EBITDA Debt Service Coverage (x)	6.0	5.0	6.5	5.2	5.0	6.1	6.6	4.5	4.9	4.6	5.2	4.4	3.8
Maximum Annual Debt Service as % of Revenues	2.7	2.5	2.2	2.1	2.1	1.8	1.8	1.9	1.8	1.8	1.6	1.6	2.2
Debt to EBITDA (x)	2.4	2.0	2.0	2.2	2.5	2.0	2.1	2.8	2.6	3.3	1.9	3.4	2.7
Debt to Capitalization (%)	27.2	24.6	24.4	21.9	22.0	20.9	19.4	22.6	22.0	21.9	20.5	21.8	31.7
Average Age of Plant (Years)	8.5	8.6	8.6	9.2	9.4	9.5	9.8	10.3	10.5	11.2	10.1	10.9	11.9
Capital Expenditures as % of Depreciation Expense	138.4	121.5	127.3	136.5	145.9	161.1	119.8	102.8	130.6	145.0	133.7	149.8	100.4

[a]Fitch's special report “2022 Median Ratios: Not-for-Profit Hospitals and Healthcare Systems”
Source: Fitch Ratings

List of Rated Credits — Children's Hospitals

(As of July 10, 2023)	Rating	Rating Outlook
Children's Health System of Texas (TX)	AA	Stable
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 National Medical Center (DC)	A+	Stable
Connecticut Children's Medical Center (CT)	A+	Stable
Dayton Children's Hospital (OH)	AA–	Stable
East Tennessee Children's Hospital (TN)	A	Positive
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+	Positive
Phoenix Children's Hospital (AZ)	AA–	Stable
Rady Children's Hospital and Health Center (CA)	AA	Stable
Seattle Children's Hospital (WA)	AA	Stable
Texas Children's 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