FitchRatings

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Credit Journal

Healthcare

Welcome to **Credit Journal** – a curated compilation of Fitch Ratings' in-depth research and commentary. This edition takes a deep dive into the healthcare and pharma industry. At Fitch, our expert analysts collaborate across our corporates, public finance and financial institutions teams to provide global, integrated analysis and commentary.

We hope this issue, as well as future ones, serve as reliable resources and help you make more informed investment decisions. We welcome comments for future issues, including suggestions for topical or credit-specific research.

For our latest insights, please visit **fitchratings.com**

Welcome

I'm pleased to share our in-depth, cross-sector healthcare commentary and analysis in this latest edition of **Fitch Ratings' Credit Journal**.

Healthcare is a complex global industry that is constantly innovating and evolving in response to competing factors and pressures. With the global pandemic reshaping the economic and healthcare landscape this year, it takes a wide range of analytical and industry expertise to develop a thorough understanding of the key credit issues facing this multi-faceted sector.

With a combined 85+ years of sector experience among our senior healthcare analysts and public ratings work performed on over 300 companies, Fitch is a leading voice in healthcare credit. Our analysts actively contribute to credit discussions, providing transparency during uncertain and volatile times. Meanwhile, our research deals with a wide range of sector and issuer themes, from industry innovation and regulatory risk, to pressures on life plan communities and not-for-profit hospitals, to profitability and legislation exposure in the insurance sector. This issue of Credit Journal includes a variety of insightful, industry-leading research and commentary that discusses these themes and others.

One cannot talk meaningfully about healthcare in 2020 and beyond without discussing COVID-19. Our analysis covers how healthcare corporates, not-for-profits, and insurers have fared under the increased pressures caused by the pandemic. In this issue, Megan Neuburger, Managing Director, North America Corporate Ratings, and Kevin Holloran, Senior Director, U.S. Public Finance Ratings, discuss the risks and opportunities for healthcare corporates and not-for-profit hospitals, as well as what may lie ahead.

Enjoy your reading!

Brett Hemsley
Global Analytical Head for Fitch Ratings

Sector Research

Corporates

Not-for-Profit

Insurance

Corporates

Healthcare Issuers' Credit Profiles Resilient

U.S. Healthcare companies will be less affected by the coronavirus pandemic and its influence on U.S. consumers' behavior than other corporate sectors as demand is less economically sensitive and is not often discretionary. However, certain industry segments are more exposed than others. Because of the idiosyncratic nature of business models and the varying degrees of exposure to the consumer, companies will exhibit very different top-line growth trajectories during and following the coronavirus-related business disruption.

Healthcare service providers are experiencing the worst of the coronavirus pandemic-related business disruption. Fitch expects that companies will be able to adapt operations to mitigate these effects through initiatives like telehealth. Doctors use telehealth to consult with and monitor patients remotely. Such efforts will help minimize the effects of localized outbreaks of the virus on patient volumes before a vaccine or highly effective treatments are available. The longer-term effect of the economic disruption caused by the pandemic on healthcare consumers is less certain.

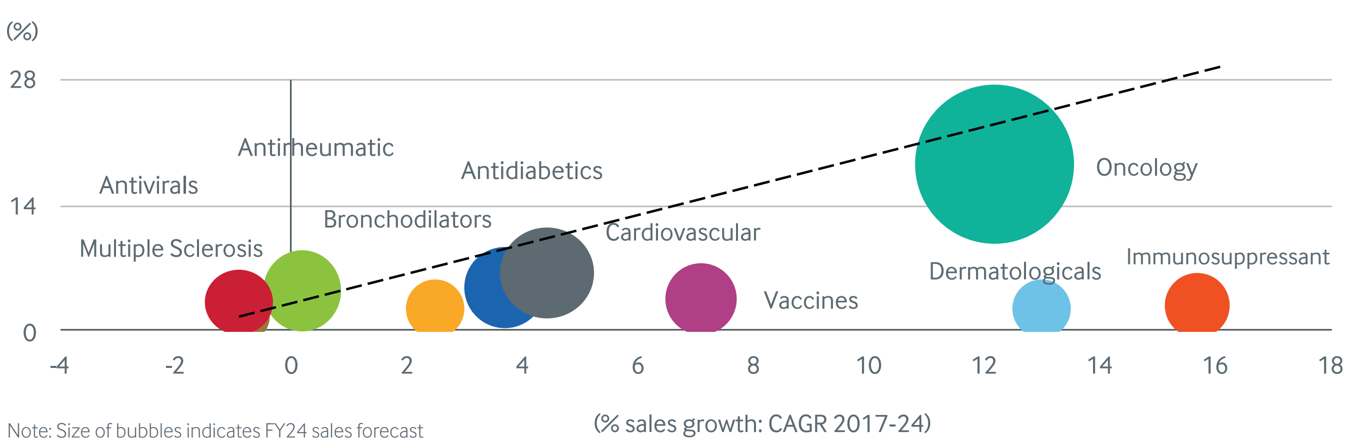
The sector has historically been fairly resilient but not immune to the effects of economic recessions. Healthcare providers typically experience lower operating margins during and immediately following recessions due to treating greater numbers of uninsured patients and patients with less profitable government-sponsored health insurance. Fitch expects operating margins for healthcare providers will rebound sharply in 2021 following a 2020 trough that reflects the peak pandemic business disruption, but they will remain below the 2019 level. We do not expect a full recovery of 2019 EBITDA levels until 2022 for most healthcare service providers in the U.S.

Innovation Key for Global Big Pharma & Biotech

Fitch views innovation as a key factor underpinning the long-term growth prospects of the global big pharma & biotech industry. New treatments should drive sales growth despite a high percentage of sales at risk across key industry participants as established blockbuster treatments come off patent and increasingly face generic or biosimilar competition.

We view oncology as a key medium-term growth driver for the industry, as new science and high unmet medical needs are enabling firms to bring meaningful breakthroughs in this area at relatively high prices. The late-stage oncology pipeline is full and broad in terms of tumor types and treatment combinations; we believe the latter part of the year will deliver a clearer picture of

Selected Therapeutic Areas in 2024 Market Share & Sales Evolution
Worldwide Market Share 2024 (%)



Note: Size of bubbles indicates FY24 sales forecast
Source: Fitch Ratings and EvaluatePharma

the fast-moving competitive landscape as the science becomes better understood.

For Corporate Healthcare Issuers, Regulatory, M&A, and Product Liability Risk Are Most Common Concerns

Regulatory change, strategic M&A, and exposure to contingent liabilities rank among the most prevalent types of event risk influencing the credit profiles of U.S. Corporate Healthcare issuers. Risk of regulatory change is a perennial concern for healthcare companies. The greatest regulatory change risk, Fitch believes, is at companies most directly exposed to threats to pricing power, profitability and cash flow.

Event risk related to strategic M&A that is large enough to be considered transformational to the balance sheet, operating profile, or both, is generally low to moderate for the industry. A variety of factors limit the propensity for very large M&A, including decent organic growth prospects, currently stretched balance sheets as companies digest recent transactions and, in some cases, poor performance of recent acquisitions.

Contingent liabilities are a risk for healthcare issuers, partly because the nature of these companies' business models introduces a certain degree of product liability risk, given the potential of medical products

and services to influence patient health and safety. Companies with high exposure to contingent liability event risk are primarily those most directly exposed to the opioid epidemic, which has the potential to influence sales and profitability and could result in significant financial outflows for legal awards and settlements.

Manageable Pressure on Profitability for U.S. Healthcare and Pharmaceuticals

Fitch's outlook for the U.S. Healthcare and Pharmaceutical sector is stable even considering headwinds presented by the coronavirus pandemic. Demand drivers for healthcare products and services remain intact globally and most companies have proven adept at managing pressures on profitability that increased over the last several years. We do not foresee a precipitous loss of pricing power for any segment of healthcare in the near term, but note that when these situations do arise they can develop rapidly and outpace management's efforts to preserve financial flexibility. A recent example is the accelerated price erosion in the U.S. generic pharmaceutical market in 2017–2018.

Fitch has seen persistent deterioration in credit quality over the last five years, particularly among the IG-rated group of healthcare and pharmaceutical issuers. Most downgrades have resulted from companies taking advantage of the historically low cost of debt to fund M&A and payments to shareholders. As more issuers have migrated down the IG rating scale, this opportunistic debt-financing activity has tapered, with the ratio of downgrades to upgrades peaking at 4:1 in 2017, and dropping to 1.3:1 in 2019.

Fitch does not believe healthcare companies are highly vulnerable to disruption by industry outsiders, partly because of the industry's complex economic structure and its regulated nature. Profits are shielded since dramatic reform depends upon policy solutions that have proven to be out of reach in a divided U.S. political environment. In addition, disruption by outside players typically relies on upending incumbents with relatively

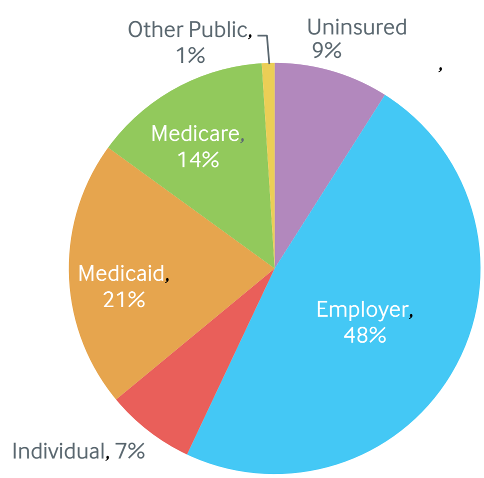
weak value propositions. Healthcare industry profits are under secular pressure because of funding constraints and growing consumerism aided by technology. This is a result of social and political priorities, rather than the value proposition of the industry, which Fitch generally thinks is strong.

Business as Usual for U.S. Healthcare Despite Election Year Noise

The debate about how to address rising healthcare costs is not new to this election cycle, but the backdrop has evolved. According to data from the Kaiser Family Foundation, during the 2008 presidential election, less than 10% of Americans with commercial insurance had a plan with an annual deductible greater than $2,000. By 2016, this number had risen to about one-quarter of covered workers and it continued to increase to nearly 30% in 2019. Americans are unsurprisingly more conscious than ever of the financial burden of healthcare. At the same time, regulatory and industry-driven innovations to advance price transparency and other methods to enable consumers to shop for healthcare have been materializing slowly. Regardless of these consumer-friendly developments, much of the demand for healthcare products and services will remain fairly price inelastic due to the often urgent nature of non-discretionary care.

Over the last several decades the healthcare industry's pricing power has proven resilient to regulatory reforms. The Affordable Care Act was the most sweeping piece of healthcare policy implemented since the start of the

U.S. Insurance Coverage



Source: Kaiser State Health Facts

Medicare and Medicaid programs in the late 1960s, and in the decade since its start the ACA has done little to affect companies' profitability.

While there has been much focus on sweeping policy proposals, legislation does not need to achieve wholesale reform of the U.S. healthcare system to have important implications for profitability. Legislative proposals addressing drug pricing and surprising billing stalled late in 2019. However, legislative proposals scuttled late in a presidential term often drive policy decisions during the next administration, depending on the balance of power after the election.

Not-For-Profit

Coronavirus Pressure Builds for NFP Hospitals, Health Systems

Not-for-profit (NFP) hospitals and health systems, particularly those that are higher rated, should have a sufficient financial cushion to absorb an increase in operating costs and a shift in volumes without meaningfully affecting credit profiles over the short term.

Fitch expects that the coronavirus will delay earnings for most rated credits as elective procedures are temporarily suspended, but these will resume after the crisis abates. Lower rated, typically smaller, single site facilities and credits with comparatively lower liquidity levels are more vulnerable. These credits will be far more constrained as they are unable to sustain declining reimbursement. They will face rising expense pressure due to the influx of coronavirus volumes that will require additional staffing and supplies.

Hospital staffing levels may become a greater concern if a significant number of staff become subject to isolation or furlough. This may reduce hospital capacity and increase costs in the form of agency employment and overtime. All hospitals have protocols in place for viral outbreaks. However, while the healthcare sector has responded extremely well to past crises, the scale of the coronavirus pandemic is unprecedented. Severe disruptions to operations and longer-term economic pressures could affect provider and consumer decisions for years to come.

While the immediate effects of the outbreak will be manageable for higher-rated hospital credits, medium- and longer-term risks will weigh on the sector, particularly if the outbreak continues throughout 2020 and macroeconomic conditions deteriorate for a prolonged period.

U.S. Life Plan Communities With Ample Liquidity Are Best Positioned to Absorb Coronavirus-Related Operating Stress

Most Fitch-rated Life Plan Communities (LPCs) are well positioned to withstand increased operating costs or shifts in census associated with the coronavirus. However, a prolonged economic downturn could lead to deterioration in credit quality. Lower-rated LPCs are more vulnerable to operating pressures and may experience rating downgrades. Most LPC ratings range from the 'BBB' to the 'A' category, with a median rating of 'BBB', although about a quarter of LPCs are rated below investment grade. We expect some Negative rating outlook changes and Rating Watches, and a few rating changes following a full review of our portfolio. Fitch's through-the-cycle ratings gauge whether a credit can sustain the current pressures and maintain financial metrics post-crisis consistent with its current rating.

Most credits had a sufficient financial cushion to weather a period of revenue and expense pressure entering the crisis. Below investment-grade credits have lower liquidity buffers, with a median of 312 days cash on hand, and may come under rating pressure if cost increases persist beyond the next few months. Skilled nursing facility operations are the most susceptible to operating pressure as a result of the coronavirus. The residents are the most vulnerable, the services rely on labor and supplies that could become scarce, and post-acute short-term rehabilitation volumes will also decline.

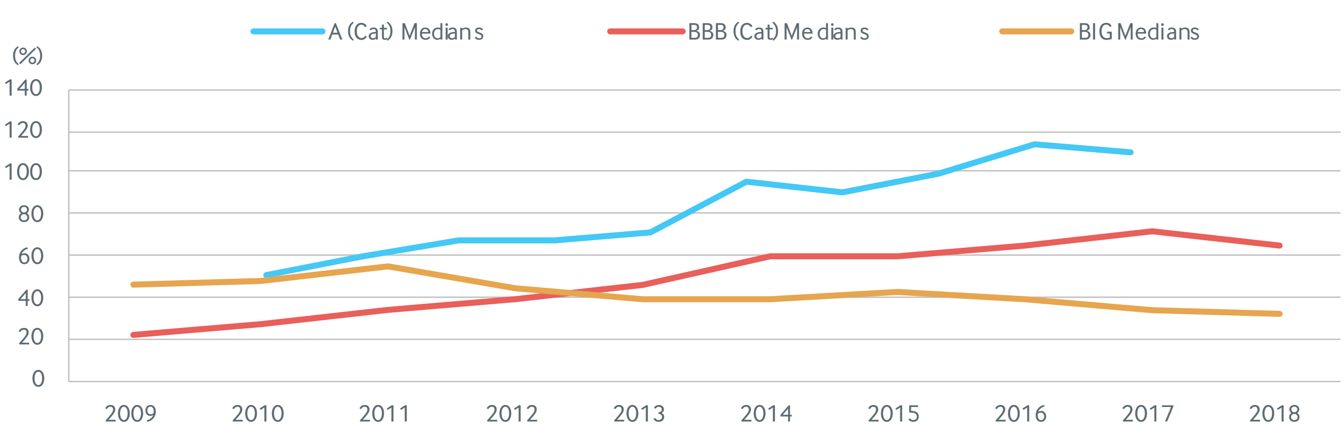
Initial indications are that generally issuers took decisive action in the early weeks of the viral spread to limit the risk of resident exposure.

Fitch has a Negative sector outlook for LPCs. Slower home sales could depress move-in rates as most residents sell their homes to facilitate their move into an LPC. However, assuming gradual economic recovery, we believe there will be a limited effect on medium to longer-term move-in rates as Fitch-rated LPCs have strong referral networks owing to high occupancy.

Limited Initial Rating Impact on USPF Healthcare Due to the Coronavirus

Fitch does not anticipate widespread initial rating impact to acute care providers from the coronavirus pandemic. Fitch's baseline scenarios anticipate that U.S. GDP will shrink significantly in 2020. In the event the virus is contained during the second half of 2020, Fitch believes real GDP growth will resume in 2021, but remain below the 2019 level for most of the year.

Life Plan Communities: Cash/Debt



Source: Fitch Ratings

Sector Research

After a Fitch webinar presentation earlier this year, participants were invited to submit questions electronically. Select questions and responses are as follows.

Have construction/capital expenditure plans changed?

This depends on the issuer's unique situation. Projects that were underway seem to be continuing. Some planned projects have been postponed. Fitch has seen cases of cuts as high as 60% or greater to planned capital spending.

Longer term, do hospitals need more PPE/ventilator type equipment or ICU beds? Will this crisis result in fewer, but stronger hospitals?

Fitch expects mandated minimal levels of equipment and beds for "the next outbreak". We also expect a mini-wave of merger and acquisition activity post COVID-19 resulting from the unprecedented levels of cooperation between non-partner providers.

Regarding elective surgeries, do you have a sense of the margin impact or percentage of revenues that will be affected?

This will vary among hospitals and the volumes they typically serve in their facilities. Fitch has seen ranges estimated (at the higher end) of a 400 to 600 basis point swing in operating margins for 2020.

Do you have information on how the federal stimulus money will be distributed to hospitals? Is this enough and does this change Fitch's viewpoint?

Fitch believes the sector will still suffer significant operational losses through the first half of calendar 2020 despite the stimulus. The bill rolls out funding primarily in the following ways:

- Coverage for COVID-19 testing, Medicaid and private insurers;
- Elimination of the 2% Medicare sequester;
- Increasing Medicare reimbursement for inpatient COVID-19 cases by 20%;
- Hospitals can request up to a six-month advance lump sum on Medicare payments. Depending on qualification, some could elect to receive 100% of the prior period payments, or 125% if a critical access hospital (CAH);
- Delay reductions in disproportionate share (DSH) payments through 11/30/20.

What are you looking at for "at-risk" hospitals or health systems during this COVID-19 crisis?

Issuers rated 'BBB' and lower, and issuers with relatively high net leverage.

Over the short term, what does Fitch expect in terms of downgrades? What time frame is Fitch considering when evaluating possible rating changes? In other words, how much time will you allow for a financial recovery? What is the sector outlook?

Strong operators with cushion at their rating level going into the COVID-19 outbreak should emerge after the crisis passes with stable ratings. However, we are scanning our portfolio for potential outliers; there is no set timetable for this process.

Fitch put both sectors on Negative Outlook but remains committed to its forward-looking criteria where we try to gauge where the credit rating will be three to five years out.

Insurance

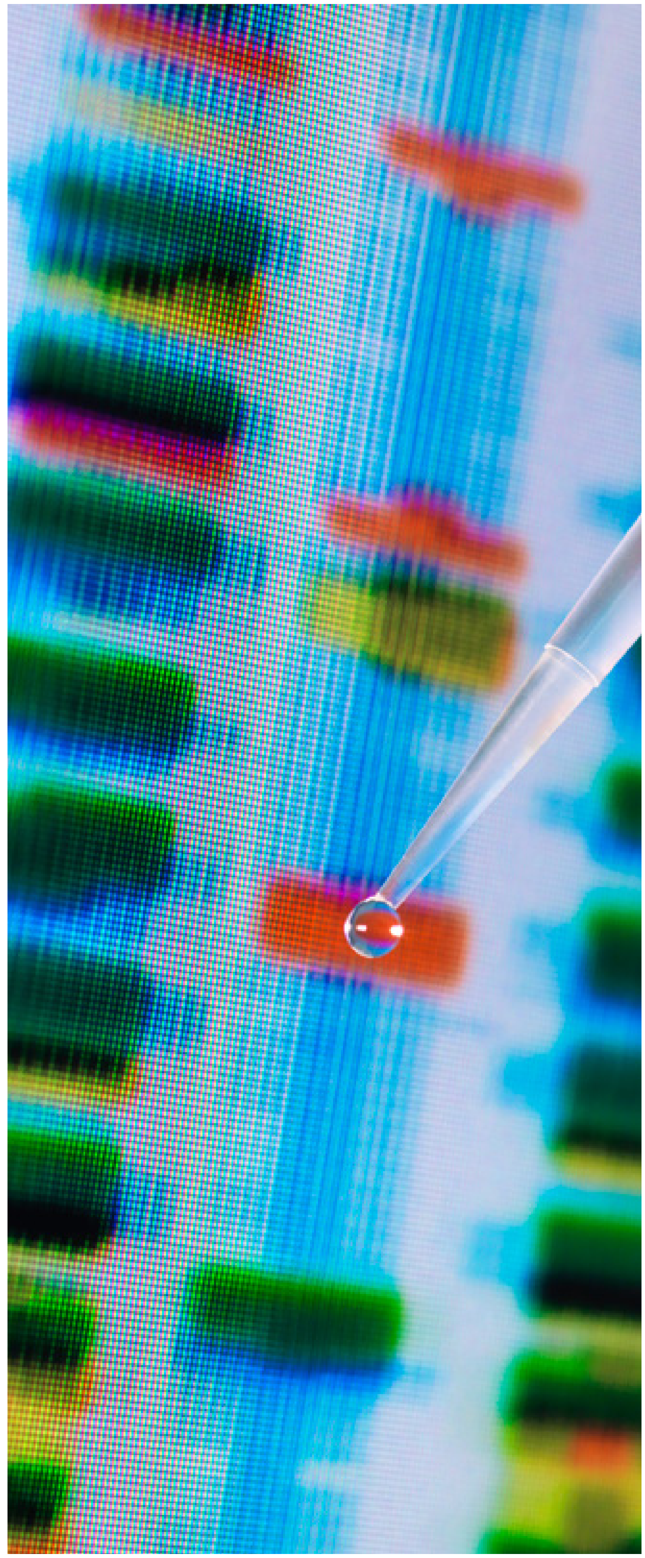
Limited Number of Coronavirus-Related Rating Actions in U.S. Health Insurance Sector

Following the revision of the rating outlook for the U.S. health insurance sector to negative from stable due primarily to increased concerns around the impact of coronavirus pandemic, Fitch reviewed 12 U.S. health insurance companies that it rates on a public and private basis. These represent approximately 80% of the U.S. population whose medical benefits are managed by private health insurers. The rating outcomes are as follows:

- 83% of ratings were affirmed with a Stable Outlook;
- 17% of ratings were affirmed with a Negative Outlook;
- No ratings were downgraded.

The limited number of negative rating actions reflects, in part, a concentration of Fitch's ratings toward larger, national health insurance carriers, whose profit margins are generally robust and whose capital buffers are generally strong. Additionally, the vast majority of health insurers rated by Fitch carry very low exposure to unaffiliated equity investments and below-investment-grade bonds, making these companies less exposed to the very high levels of capital markets volatility caused by concerns around the pandemic and its ultimate impact on the economy.

Primary credit concerns for U.S. health insurers involve the considerable level of uncertainty around how the pandemic will ultimately run its course in terms of longevity, mutation or a potential second wave of infections, as well as how severely the associated economic impact will reduce premium revenue due to higher unemployment. An additional area of uncertainty involves adverse health consequences and related higher claims cost associated with delayed treatment, diagnostic procedures, and preventive care due to state government restrictions, hospital surge preparation and patient choice.



Sector Research

U.S. Health Insurer Medical Loss Ratios Will be Elevated in 2020 Following Strong 2019

Although there is currently a high level of uncertainty around many aspects of COVID-19, Fitch expects the U.S. health insurance sector to report moderately elevated medical loss ratios (MLR) in 2020 as a result of associated medical claims. 2019 was a strong year for health insurers, but 2020 could be more challenging given the unforeseen nature of the new coronavirus.

Profitability was generally stable in 2019, with EBITDA margin remaining level at 7.6%. While the collective reported medical loss ratio for the eight largest publicly traded insurers increased to 83.9% in 2019 from 82.2% in 2018, most of this increase was driven by the suspension of the health insurer fee (HIF) in 2019. In fact, most of the volatility in the MLR over the past four years can be attributed to the suspension and reintroduction of the HIF. Fitch believes that the increase in reported MLRs in 2020 related to COVID-19 will be at least partially offset by the reintroduction of the HIF in 2020. In terms of the effect from the coronavirus, medical loss ratios should begin to stabilize in 2021 as clinical information builds and morbidity is incorporated into premium rates.

Given information currently available, Fitch expects the effect on overall operating performance of rated health insurers to be moderately adverse and generally limited to 2020, with higher impact on carriers with higher proportional exposure to Medicare Advantage business due to the focused enrollment period for MA and concentration of COVID-19 symptoms among the elderly.

Negative Rating Outlook for U.S. Health Insurance Industry Due to COVID-19

The rating outlook for the U.S. health insurance industry is presently Negative due to expectations for an adverse effect on industry fundamentals related to COVID-19 (previously it was Stable). Heightened claims costs associated with COVID-19 testing and treatments, including hospitalizations, will likely drive a weakening of profitability and debt service metrics. The Negative rating outlook is mainly driven by the extremely wide range of expert estimates with respect to the eventual infection rate, which creates significant uncertainty in Fitch's ability to forecast 2020 earnings levels for U.S. health insurers.

In addition to the direct effect of heightened claims costs, reported earnings for health insurers may also be pressured by lower premium income due to adverse employment conditions driven by a significant economic downturn, as well as investment earnings reflecting declines in interest rates.

Despite pressure on profitability in 2020, the effect of COVID-19 should not cause excessive stress for most of the health insurers in Fitch's ratings coverage, which is skewed toward larger national carriers, as profit margins among these companies are otherwise robust and most have good capital buffers. Additionally, the vast majority of health insurers rated by Fitch carry very low exposure to unaffiliated equity investments and below investment grade bonds. This exposes these companies less to the very high levels of capital markets volatility caused by COVID-19 concerns and its ultimate impact on the economy.

Fitch believes health insurers most exposed to higher levels of stress would include smaller insurers with a very high proportion of non-administrative-services only business for which premium rates are already contractually locked for the year, and those that have a high exposure to risk in their investment portfolio. Health insurers with this profile make up a very small portion of Fitch's ratings coverage.

U.S. Life, Health Insurers See Most Risk Amid Coronavirus Fallout

North American insurers face key vulnerabilities and potentially unforeseen downside risks amid the fallout from the coronavirus pandemic, including outsized investment exposure with market volatility exacerbating potential issuer defaults, increased mortality risk and elevated claims. The U.S. life insurance sector is most exposed to capital market volatility, with the industry's stable rating outlook going into 2020 vulnerable to slowing economic growth, macroeconomic uncertainty tied to global trade and monetary policy, and late cycle credit market conditions. The review of Fitch's ratings on U.S. life insurers in light of the coronavirus pandemic has focused on companies' exposure to three primary risks: asset risk; mortality risk; and market-sensitive businesses such as variable annuities, with death and living benefit guarantees.

Health insurance has many moving parts and significant uncertainty. This reflects the lack of clarity around the true infection rate due to the low level of effective testing, the potential for a secondary wave of infections, the amount of deferred care and the timeline for its return to the healthcare system, potential increase in the severity of the illness due to deferred diagnostic procedures, and the loss and shift of enrollment due to the economic fallout.

Health insurers, while facing higher-than-anticipated acute care claims, have lower interest rate and investment risk and may temporarily benefit from the pandemic. Healthcare providers and insurers have seen a substantial reduction in high-cost elective procedures, diagnostic procedures, emergency visits and routine care due to state mandates regarding hospital capacity utilization and anxiety among healthcare consumers. As the lockdown in the U.S. expanded, claims related to strokes and heart attacks declined significantly, which may suggest that people who should have sought medical treatment did not and that additional complications may result in subsequent months.

Property and Casualty (P&C) insurers, while facing lower risk from the pandemic, will see earnings pressure from claims losses in several segments and lower investment income. Reinsurers generally mirror the risk trends of non-life companies with several large global insurers likely to absorb significant claims losses from these events.

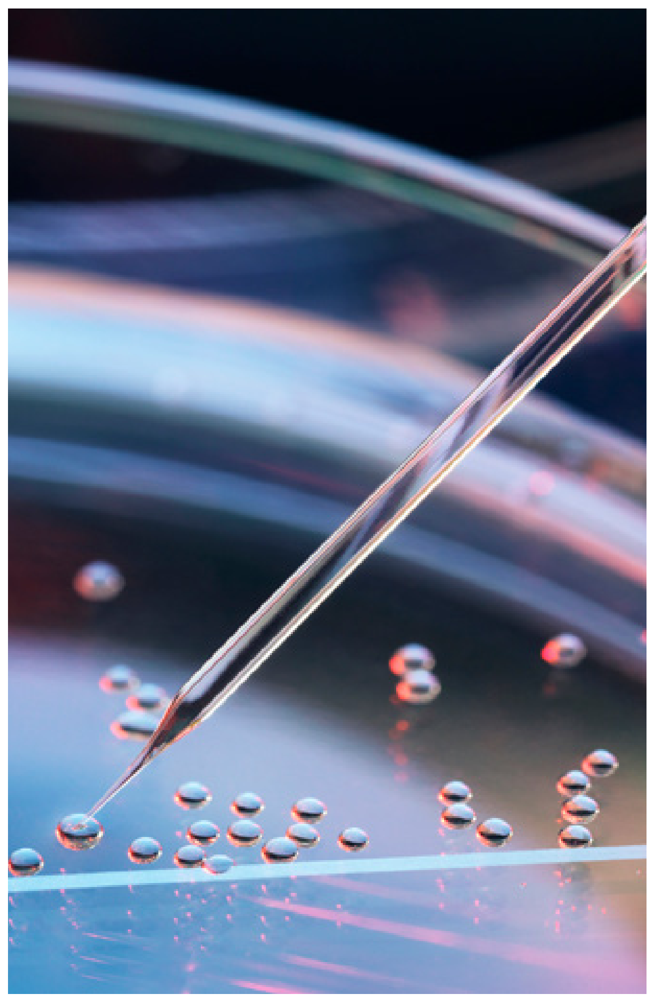
Ratings actions have been less severe relative to those during the global financial crisis thus far, when investment-grade securities fell into non-investment-grade territory or suffered deep defaults. Insurance companies are managing better due to improved liquidity and higher capitalization, with more conservatively positioned investments and covered debt maturities.

U.S. Healthcare Industry Not Warming to Single-Payer Structure

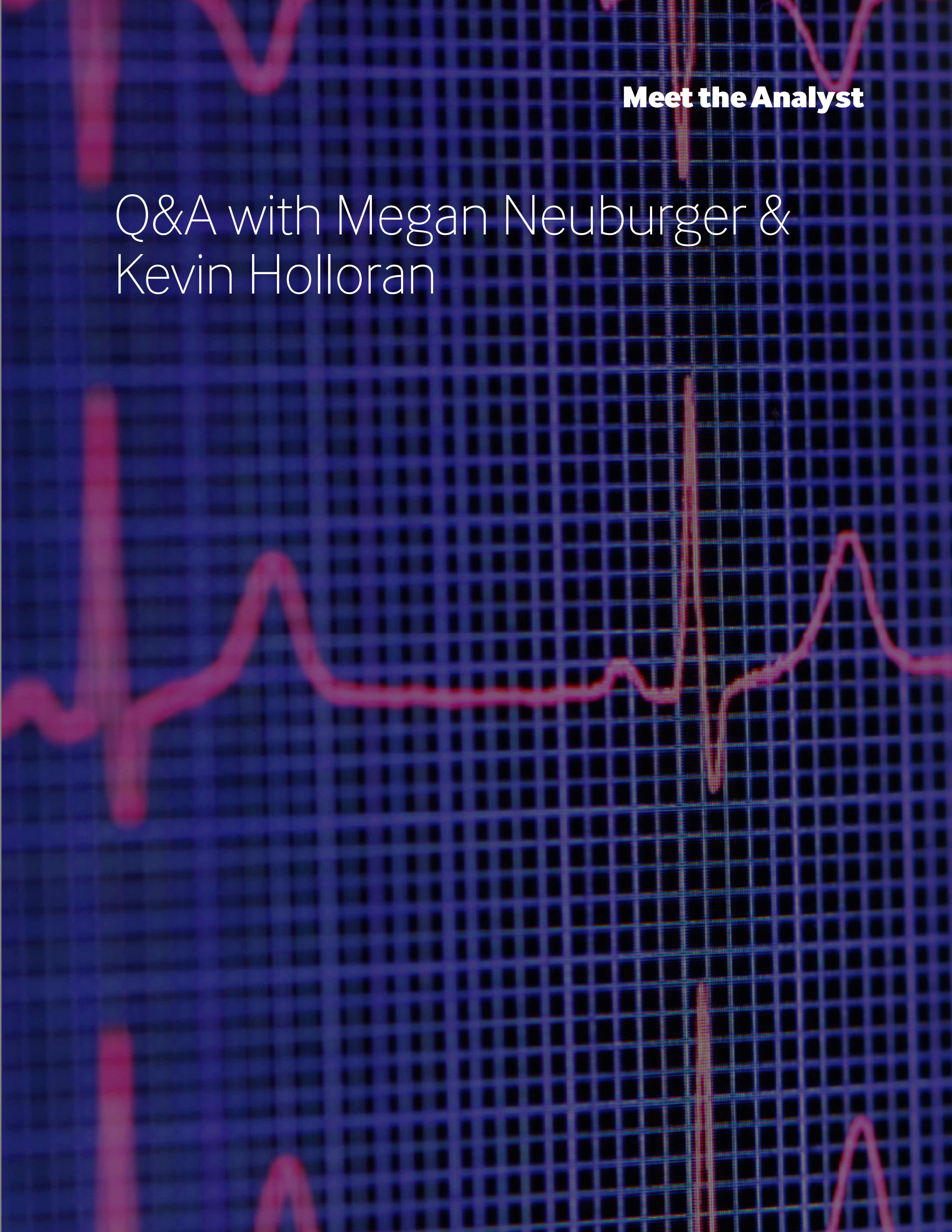
While the potential for a U.S. single-payer system such as Medicare-For-All is an increasing focus, major players in the health system, including physicians, health insurers, hospitals and pharmaceutical companies, are generally not seen as advocates for change. Transition to a single-payer system or other material structural changes are not high priorities for the industry, as the value proposition for these players lies in the ability to attract and deliver services at market prices not subject to price controls.

Thus far, single-payer systems have done little to increase efficiency, access or transparency, or to resolve challenges of the current system-related overutilization and quality. Questions also remain as to potential system structure. As seen in the U.K. and Canada, countries with single-payer systems often have a secondary market for purchasing coverage extending beyond basic care.

Another impediment to meaningful restructuring of the U.S. system is that the vast majority of the population consuming the largest percentage of services remains reluctant to support material structural change that may threaten current healthcare options. They would prefer to maintain the status quo because they presumably understand the system – from both an accessibility and affordability perspective. For real change to occur, Congress and key constituents (employers, physicians hospitals) need to determine whether it is possible to set value, accessibility and affordability as equal priorities and how each will be evaluated and rewarded.



Q&A with Megan Neuburger & Kevin Holloran



Meet the Analyst

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North America
Managing Director

Kevin Holloran
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Senior Director
Not-For-Profit Hospitals

Megan Neuburger & Kevin Holloran

Q. Much has changed in 2020 so far due to the ongoing pandemic. At a high level, how have credits in your sectors been impacted?

Megan Neuburger

A. The majority of U.S. Corporate Healthcare issuers have not experienced a significant disruption to operations due to the coronavirus pandemic. Manufacturers of pharmaceuticals and medical devices, drug distributors and pharmacy benefit managers all saw a manageable impact on profits and cash flows in the first half of the year, due to the loss of elective patient volumes and the associated dampening of demand for their products. Supply chain disruption was initially a concern as the pandemic spread globally, but business logistics proved resilient.

Providers of healthcare services experienced the greatest effects from the pandemic-related business disruption as non-critical patients put off hospital and physician visits. In most areas of the country, this loss of elective patient demand was not supplanted by COVID-19 patients as the anticipated surge of the virus has not materialized. This is good news for the healthcare industry, as the system did not become overwhelmed by the demands of caring for COVID-19 patients.

Kevin Holloran

A. The COVID-19 pandemic quickly moved from initial rating concerns over "what will a hospital full of COVID patients" look like from a credit perspective, to one of "what does an empty hospital" look like from a credit perspective. The revenue dislocation due to the cessation of non-emergent (elective) procedures and surgeries was significant across the industry. Credits have, generally speaking, not been notably affected due to rapid management response to mitigate revenue declines, combined with sizeable, though not fully complete, government stimulus.

Fitch has said from the very beginning that our most significant initial concerns from a credit perspective were those organizations that were lower rated and with comparatively lighter unrestricted liquidity levels. Even then, government stimulus has assuaged many of our initial liquidity concerns. Our belief is that our higher rated credits that are secure at their current rating level should be able to absorb the short-term operating pressures experienced during the first and second quarters of 2020 due to the COVID-19 pandemic.

Q. What are the risks and opportunities that you see in healthcare for the second half of the year?

Megan Neuburger

A. A return of elective patients and recapturing volumes of services lost during the business disruption in the first half will be an opportunity in the second half of 2020. Even if sporadic outbreaks of the virus require the intermittent shuttering of non-essential services, we think industry management teams will employ lessons learned during the peak of the pandemic to minimize the effects of business disruption on their operations through the use of services like telehealth.

Demand for COVID-19 related products is another important opportunity for U.S. Corporate Healthcare issuers, particularly manufacturers of potential treatments, vaccines and diagnostic tests. The ultimate contribution to profits is uncertain, but we think that

COVID-19 related demand could be a significant tailwind to the topline for the sector later in 2020 and into 2021.

Kevin Holloran

A. Assuming no significant "second surge," the second half of the year is all about re-activation of non-emergent (elective) procedures and surgeries. Most of our rated credits indicate that there is a discernable backlog of patients and procedures that have purposefully been delayed during the first half of 2020, and there is an expectation that volumes will see an immediate uptick as issuers "work their lists." After that, our issuers are projecting slower levels of month-over-month growth, and volumes gradually either resume to their pre-COVID levels or very close to it by year end.

There is some assumption that a second round of government stimulus will be disbursed to providers, more accurately this go-around versus the first round, which was geared more toward a speedy delivery to providers. In addition, the repayment of all the advanced payments from Medicare will begin the second half of the year, and elective volume resumption will have to be balanced more effectively than historically to make up this differential.

Q. What about 2021 and beyond? Do we ever get back to normal?

Kevin Holloran

A. In a word, no. There is a reasonable assumption that some volumes will be permanently lost, either due to resolution of symptoms or to a newly introduced "fear of the hospital." There are also very likely going to be added expenses and lost productivity due to COVID-19 – for example, additional cleaning crews and the logistical time lost to patient staging/distancing and to all the time gowning and de-gowning.

Our longer term credit concerns centered on the changes that the pandemic may generate on a more national scale—not on the temporary disruptions that we're seeing in 2020. The high number of unemployment claims filed over the past several months signal considerable strain on the economy, which may ultimately result in people losing employer-based insurance coverage.

A decrease in employer-based coverage, coming at a time when we are still dealing with ongoing attempts to dismantle the ACA, would cause significant pressure for hospitals if the result is a higher number of uninsured patients. Providers have already seen payor mix erosion with higher Medicare representation and may see an increase in Medicaid recipients and possible cuts to Medicaid rates as states struggle to balance their budgets. At the same time, the pandemic has further exposed the issues of healthcare disparity. Attempts to enhance efforts on social determinants, whether voluntarily or in response to future government actions on this issue, would expand healthcare's mission of improving the wellbeing of their communities, but would come at the expense of higher margins.

Q. Will U.S. Corporate Healthcare issuers change their approach to capital deployment as a result of the pandemic?

Megan Neuburger

A. Under Fitch's baseline scenarios for the coronavirus pandemic, we do not expect to see much change in the financial policies or investment spending of U.S. Corporate Healthcare issuers. Temporary cuts in dividends, share repurchases and capital expenditures are helping to preserve liquidity and maintain balance sheets appropriate for current ratings levels. Strategic M&A is likely to take a brief hiatus due to the logistical issues of creating tie-ups during the pandemic, as well as the upcoming November 2020 U.S. elections. However, the longer-term impetus for all sizes of strategic healthcare industry combinations remains intact as companies look to build scale to preserve pricing power.

Global Focus

Coronavirus May Test Global Pharma's Economic Model

Size and Scale Factor into Hospital Ratings

Coronavirus May Test Global Pharma's Economic Model

The coronavirus pandemic could test the economic model of the pharmaceutical sector if it leads to weaker patent protection. A balanced response, such as tiered pricing and greater collaboration between pharma companies, will be required to develop a sustainable commercial model for COVID-19 medicines. COVID-19 treatments and the associated approach to pricing could bring changes to the economic model of the sector. We expect scarcity of any drugs relative to vast global demand for such treatments will add a new dimension to the three traditional components of drug pricing—clinical value, system value and return on research and development (R&D).

The sector needs to develop a sustainable commercial model that balances scarcity and affordability for COVID-19 treatments. Drug pricing will be in focus again, but this time on a very large scale. There is demand from healthcare systems around the world, but their affordability criteria are very different, highlighting the importance of production volumes, costs and access to COVID-19 drugs.

The main factors for COVID-19 treatments will be value to healthcare systems and affordability. Quicker patient recoveries save costs for healthcare systems, which indicate a significant pricing potential, but could reduce affordability. There is also a danger that richer healthcare systems could outbid each other to gain access to a drug, restricting access for developing economies. This could tempt regulators to weaken patent protection to allow wider production and faster and cheaper access to a drug. Such action could be detrimental to the industry by weakening its economic model, which incentivizes R&D by offering protected returns during the term of patents.

Size and Scale Factor into Hospital Ratings

Fitch believes that size and scale remain important factors in the rating process. Even when the median metrics are similar, larger entities have advantages resulting in greater financial stability. However, Fitch does not exclude smaller credits from high-investment grade ratings when their metrics merit an upgrade.

Reasons for consolidation vary. Scale can improve negotiating power with payors and decrease administrative expenses. Many hospitals are pursuing

Drug Pricing Under Value-Based Healthcare Principles

Balance between reimbursing innovation and delivering value to patients

Pricing Components	Impact
Clinical Value	Efficacy of the drug and value for patient Clinical approvals
System Impact	Affordability and value delivered to the wider healthcare system Commercial access
Return to Business	Risk and innovation premium for business (including cost of failure) Economic incentive to foster R&D

Source: Fitch Ratings

Global Focus

population health management, customer experience improvement strategies and technological innovation through mergers.

Profitability has been on a decline. The transition phase from volume- to value-based reimbursement has challenged many providers. Providers have spent considerable resources to support value-based risk contracting, which have negatively impacted margins.

Innovative hospitals explore techniques to achieve a seamless patient experience, which is shifting how they spend their capital. Hospitals are also facing investment decisions on next-gen technology, precision medicine and genomics. Recent consolidation activity is heavily based on the belief that scale is needed to support innovation in healthcare. Combining balance sheet resources allows for more effective investments in these transformative initiatives and reduces risk.

Larger systems typically may have higher ratings than smaller hospitals, even when the median metrics are similar. Fitch's qualitative and analytical assessment incorporates larger systems' advantages in managing financial obligations. Parsing out small, medium and large credits into equally sized pools (from our entire portfolio), there is a direct relationship between size/scale and rating; 65% of 'AA' rated credits are large systems. The 'A' category is more evenly distributed with 40%, 35% and 25% described as small, medium and large, and in the 'BBB' category, 92% are small- or medium-sized.

While the median data indicate size and scale do not generate stronger financial results for larger providers, increased size and scale can absolutely enhance a credit's stability at most measurable data points as reflected in our ratings.

Company News

Most Transparent Ratings Agency, Environmental Finance

We are pleased to announce that we have been named 'Most Transparent Ratings Agency' in the 2020 Environmental Finance Sustainable Investment Awards. These awards are published by Environmental Finance, a subscription service reporting on sustainable investment, green finance, and the people and companies active in environmental markets. This is the second year in a row that Fitch has won this award.

The winners are decided by an independent panel of 10 or more institutional investors, reflecting the market's stamp of approval on Fitch's ESG Relevance Scores, which provide robust analysis of the influence of ESG factors on credit ratings.

Fitch Bohua Receives Approval to Rate China Onshore Issuers and Bonds

Fitch (China) Bohua Credit Ratings Ltd. has received approval from the People's Bank of China (PBOC) and the National Association of Financial Market Institutional Investors (NAFMII) to rate financial institutions (including banks, non-bank financial institutions and insurers) and their securities, and structured finance bonds in China's interbank market.

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