

## Health Care

### Ratings pressure in the first half could ease in the second

January 9, 2024

This report does not constitute a rating action.



#### What's changed?

**Deterioration at the low end continues.** The low speculative-grade rated end of universe will see further deterioration into at least the first half of 2024.

**Demand normalized, labor improving.** Almost all companies saw demand normalize in 1H23. Inflationary and labor costs also moderated, though labor remains a longer-term challenge.

**Services remain vulnerable.** The labor-intensive, lower-margin, heavily sponsor-owned health care providers at the lower end of the ratings spectrum remain vulnerable to downgrades.

#### What are the key assumptions for 2024?

**Demand a limited concern.** Patient and procedure volumes should remain steady, with revenue growth in most sectors projected at mid- to upper-single digits.

**EBITDA margins steadily improve.** With costs stabilizing and demand normalizing, we project EBITDA margins will continue to slightly improve in 2024.

**More M&A.** Mergers and acquisitions (M&A) have already returned to pharma, and we're expecting M&A volumes in services to resume.

#### What are the key risks around the baseline?

**Inflationary/labor pressures persist.** Improved in 2023, but the worst may not be over.

**Reimbursement pressures.** The reimbursement environment has been relatively benign. However, with health care costs increasing, payors may get tougher on reimbursement.

**No Surprise Act remains a surprise.** Problematic implementation of No Surprise Act has had a negative impact on free cash flow generation, which could have negative ratings consequences.

#### Contacts

**Arthur Wong**

Toronto  
+1 416 507 2561  
arthur.wong  
@spglobal.com

**Nicolas Baudouin**

Paris  
+33 1 4420-6672  
nicolas.baudouin  
@spglobal.com

**David A. Kaplan**

New York  
+1 212 438 5649  
david.a.kaplan  
@spglobal.com

**Tulip Lim**

New York  
+1 212 438 4061  
tulip.lim  
@spglobal.com

**David Peknay**

New York  
+1 212 438 7852  
david.peknay  
@spglobal.com

**Ryan Gilmore**

New York  
+1 212 438 2411  
ryan.gilmore  
@spglobal.com

**Matthew Todd**

New York  
+1 212 438 2309  
matthew.todd  
@spglobal.com

**Scott Zari**

Chicago  
+1 212 438 2411  
scott.zari@spglobal.com

**Shannan Murphy**

Boston  
+1 617 530 8337  
shannan.murphy  
@spglobal.com

# Ratings Trends: Health Care

Chart 1  
Ratings distribution by region

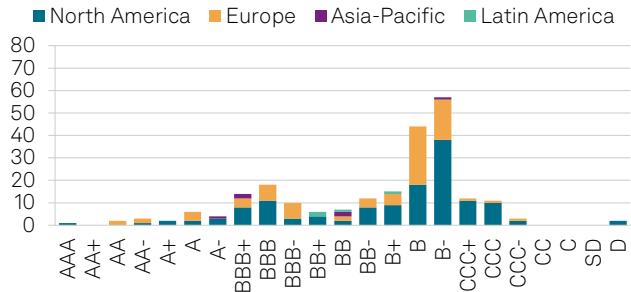


Chart 2  
Ratings distribution by subsector

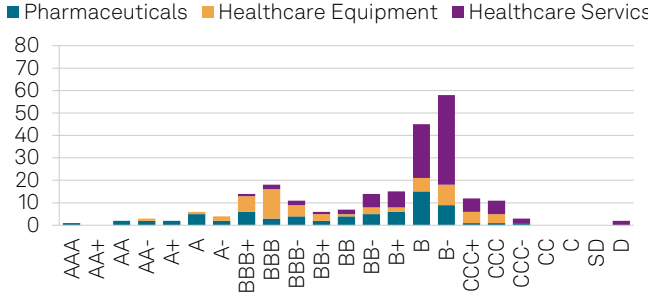


Chart 3  
Ratings outlooks

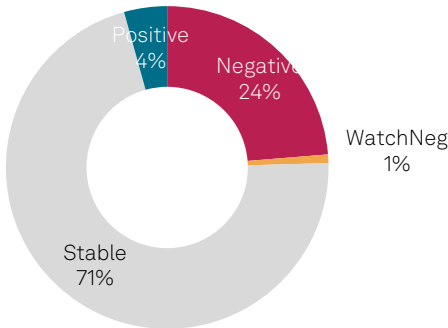


Chart 4  
Ratings outlooks by subsector

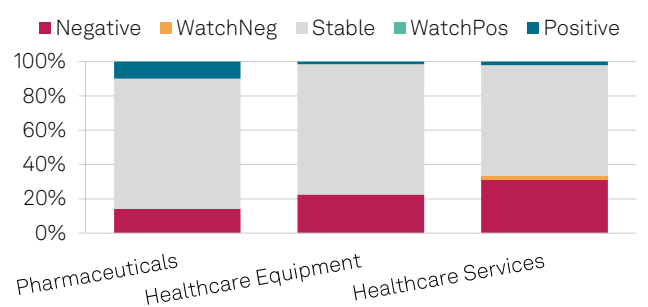


Chart 5  
Ratings outlook net bias

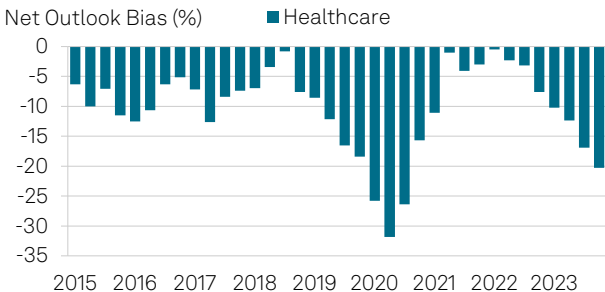
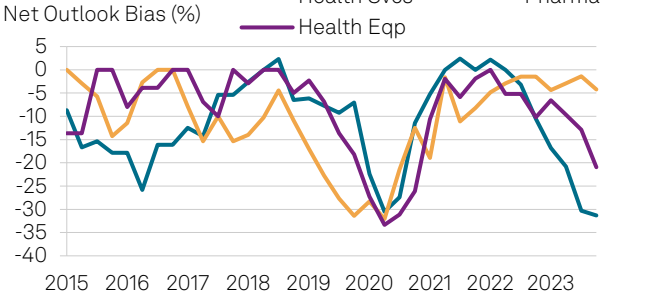


Chart 6  
Ratings net outlook bias by subsector



Source: S&P Global Ratings. Ratings data measured at quarter-end.

# Industry Outlook

## Ratings trends and outlook

Our overall ratings outlook remains stable for the pharmaceutical and medical device and life science products subsectors of the health care industry. However, the outlook for the much larger health care services subsector remains negative and will likely remain so into the first half of 2024.

**Health care services ratings continue to deteriorate, despite improving conditions.** The health care ratings universe has seen more ratings deterioration in 2023 and we believe the deterioration will persist into at least the first half of 2024. The deterioration is largely contained in the very low-end of the speculative-grade ratings universe, which is populated mainly by sponsor-owned health care services companies. These highly leveraged companies are struggling to generate adequate sustained free cash flows given the inflationary environment, particularly on labor, as well as the high interest rate environment. The ongoing disruptions caused by the No Surprise Act and Medicaid redetermination process have also been detrimental to free cash flows.

While health care demand remains solid and the labor situation has improved, with EBITDA margins for most companies being flat to up versus the prior year, they remain below pre-pandemic levels and are unlikely to return to those levels through 2024, as labor costs will remain a challenge and cash flows will remain weighed down by elevated interest expense. Thus, we maintain a negative outlook for the health care services subsector.

**Defaults to remain elevated in 2024.** Health care is a traditionally defensive industry, in that demand is relatively constant; people get sick in good and bad times, leading to a relative high visibility in terms of demand and sales. However, in 2023 we have seen a record number of defaults in our rated universe, the second straight year of the industry setting such a record. This was partly because of the impact on EBITDA margins of inflationary pressures, particularly on labor, combined with the impact on cash flows from higher interest rates and the disruptions caused by No Surprise Act and Medicaid redeterminations. It was also partly due to the high level of private equity participation in health care, highlighted by the fact that over half of our rated universe is private equity owned and have above-average leverage.

Though health care labor costs have improved, they remain relatively high and a long-term concern given persistent the shortages of health care personnel. Interest rates will also remain elevated over the next year, despite the potential for cuts in the second half of 2024. And efforts to streamline the arbitration process under the No Surprise Act, and hopefully speed up cash collections, as well as the Medicaid redetermination process, will run through the first half of 2024.

Many of our rated companies also face 2025 debt maturities and must refinance in a difficult refinancing environment while still unable to sustain positive free cash flows. Thus, while we do not believe the rate of default in health care will set a record for a third straight year, given the overall improvement in labor and EBITDA margins and No Surprise Billing, it will likely remain elevated.

**Medical devices and products companies outlook is the most stable.** The medical device and products subsector remains the most stable of the health care subsectors. Procedure volumes have fully normalized in the second half of 2023 as procedure backlogs built up during the pandemic was worked through in the first half of 2023. Labor and supply chain issues have largely

stabilized for medical device and product makers, as have freight costs. We project solid mid-single-digit growth of 5%-7% across several medical device categories.

Meanwhile, life science companies have seen some slowdown in demand, due to a combination of a decline in sales COVID-19 related products and tests as well as a slowdown in China. A slowdown in R&D activity amongst the biotech startups has also led to sales pressure. However, we do not have significant concerns regarding the rated life science and research tools companies as they generally maintain conservative balance sheets. We view the sales slowdown as temporary and believe the longer term growth prospects remain intact.

**Pharma sees solid growth prospects as it returns to M&A.** The windfall of COVID-19-related vaccine and treatment sales has dissipated and the best-selling drug in the industry, Humira, has seen biosimilar competition emerge in the U.S., creating a drag on industry sales growth. However, industry growth has held up well and the prospects for the industry looks promising, at least until 2026, when Medicare drug price changes under the Inflation Reduction Act are scheduled to be implemented. We believe the pipelines of many of the rated players are healthy, and expect the GLP-1 diabetes and weight loss drugs, new classes of cancer drugs, and new Alzheimer's treatments to drive sales growth.

M&A has returned after a relatively quiet period, and we continue to view M&A as strategically important for the highly rated Big Pharma and biotech companies. We believe sustained adjusted leverage for this group of companies has permanently shifted higher, to the 1.5-2.5x range, over the past several years, after having been traditionally sub-1.5x on an adjusted basis. Thus, even when many companies, such as Pfizer, saw their leverage decline below our upside triggers, given the relative pause on M&A activity and strong COVID-19 related sales, we did not take positive rating action, given the expectation of future major debt-financed acquisitions. And acquisitions have significantly returned in 2023--including Pfizer's \$43 billion acquisition of Seagen Inc., Merck's \$10.8 billion acquisition of Prometheus Biosciences, Amgen's \$26 billion acquisition of Horizon Therapeutics, Abbvie's acquisition of Cerevel Therapeutics for \$8.7 billion and ImmunoGen for \$10.1 billion--and Bristol-Myers' \$21 billion of acquisitions consisting of Karuna Therapeutics (for \$12.7 billion), RayzeBio (\$3.6 billion), and Mirati (\$3.7 billion). The significant use of financial capacity led to downgrades on Bristol-Myers (downgrades to 'A' from 'A+') and Pfizer (to 'A' from 'A+') and outlook revision to negative from stable on Amgen (BBB+/Negative/A-2).

The implementation of the Medicare drug price change in 2026 clouds the longer term prospects, especially as the regulation gets phased in, though it is too early to speculate on the earnings and ratings impact, given the still evolving price negotiation process, the level of discounts, and ability to retain market shares. We have not reflected the impact in our company projections at this time.

## Main assumptions about 2024 and beyond

### 1. Demand for health care remains stable.

There are pockets of softness, depending on specialty and geography, mainly relating to labor availability. However, we believe health care demand has normalized and we project it will continue growing in the mid-single digit area.

### 2. Labor and inflationary costs moderate but remain a challenge.

The labor situation had improved in 2023, but longer term, the specialized needs of the industry make increasing the labor supply challenging.

### 3. Adjusted EBITDA margins and free cash flow generation to improve.

We are projecting flat to moderate improvement in EBITDA margins for 2024 for many companies. However, particularly for the health care service providers, there remains work to be done.

**Margin pressures and cash flows could worsen.** For health care service providers, EBITDA margins improved in 2023 and we project margins and free cash flow generation will improve in 2024, especially toward the second half of the year. Labor pressures have peaked, supply chain pressures have eased, and cost-cutting and efficiency initiatives have taken further hold. The reimbursement environment has been relatively benign, as providers were for the most part able to pass on their inflationary costs through pricing and reimbursement increases.

However, we believe the reimbursement environment may become more difficult in 2024, given rising medical cost ratios at health insurers and increasing health care costs at plan sponsors. Labor remains a long-term concern as well. Should companies' continued efficiency efforts fall short and cost inflation reemerge, EBITDA margins could decline, increasing pressure on cash flows and pushing adjusted leverage to higher, potentially unsustainable, levels.

**Labor remains a top challenge for the health care industry,** especially for health care services subsector, which makes up the majority of our rated corporate universe. The labor situation had improved in 2023 and health care hiring remains strong, leading all industries. However, longer term, the highly trained, specialized needs of the industry makes increasing the labor supply challenging. By some estimates, the nursing shortage may not improve until after 2025 and per the American Medical Association (AMA), the U.S. could be 130,000 doctors short by 2030. Thus, while labor expenses for many service providers grew mid-single digits in 2023 versus roughly 9% in 2022, the worst may not be over.

Despite the full normalization of health care patient and procedure volumes in the first half of 2023 and the expectation of solid mid- to high-single-digit topline growth for the industry, a stabilization of supply chains, and moderating inflationary and labor pressures, the elevated interest rate environment along with legislative developments such as No Surprise Act and Medicaid redetermination have combined to weaken free cash flow generation at many of our rated health care service providers.

**The No Surprises Act led to immense payment backlog.** The implementation of the No Surprises Act in 2022 has wreaked havoc on many health care service providers. The Act sought to protect patients from surprise medical bills that arise when they inadvertently use out-of-network providers by making providers and health insurers negotiate a final amount, which has taken a toll on the cash flows of providers, many of which are highly leveraged sponsored-owned companies that are exposed to labor and interest expense inflation. Per the latest figures available, 489,000 claims were submitted to the arbitration system between April 2022 to July 2023, fourteen times more than originally projected by the U.S. Department of Health and Human

Services (HHS). This led to long delays in payments and contributed to the elevated number of negative rating actions and defaults amongst the lower rated speculative-grade end of the health care ratings universe, such as TeamHealth, Radiology Partners, Envision, and Air Methods. Given the volume of claims and delay in processing, the Centers for Medicare and Medicaid Services (CMS) is working on amending the process, though we believe the impact on companies will likely be felt well into 2024.

### Credit metrics and financial policy

We expect credit metrics for the health care industry to deteriorate in 2024, despite steady demand, easing inflationary and labor pressures, and cost saving and efficiency measures leading to improved adjusted EBITDA margins. We see labor costs as a long-term risk, along with a tougher reimbursement environment, especially as employers seek to lower their health care bill.

The health care industry has been among the most active when it comes to M&A, especially within the pharmaceutical subsector as a pipeline for future products. With the rebound of M&A, we see a deterioration of credit metrics as companies utilize their capacity within the current ratings. We expect this elevated level of M&A to persist in 2024.

Meanwhile, M&A activity amongst the health care services subsector remains muted, given many companies' current struggles with free cash flow generation and already high leverage levels from past acquisition sprees. However, we believe M&A will return in the near term, given the strategic need for continued consolidation, to gain economies of scale, and to extract higher reimbursement rates from payors, despite the elevated interest rate environment.

The U.S. Federal Trade Commission (FTC) is likely to remain focused on health care M&A, concerned that consolidation in the industry has contributed to the rise in health care costs. The FTC is not only scrutinizing acquisitions by larger players, such as Amgen (on its acquisition of Horizon, ultimately approved) and HCA Healthcare (acquisition of five Utah hospitals in 2022, ultimately canceled), but also by sponsor-owned companies that employ "roll-up" strategies, some of which--like the health care services sector, which remains relatively fragmented, could see consolidation as a path to increase market power in a specialty or geographic region, and a means to extract higher prices/reimbursement from the already consolidated healthcare insurance players that dominate U.S. health care. Greater scrutiny by the FTC could hamper sponsor-owned company's abilities to pursue roll-up strategies as well as their ability to increase prices to justify past acquisitions done at high multiples and de-lever quickly, clear negatives from a credit perspective. We do not believe the increased FTC scrutiny will necessarily lower M&A volumes in the industry, given the strategic need for M&A within the pharmaceuticals and health care provider industries. However, acquisitions may take longer to complete.

## Key risks or opportunities around the baseline

### 1. Margin pressure could worsen.

EBITDA margins improved in 2023 but cost and reimbursement pressure could reverse those trends in 2024, and labor costs remain a long-term challenge.

### 2. Free cash generation fails to improve.

Many health care services companies are still struggling to generate sustained positive free cash flows. While we expect some of the headwinds to start to moderate in mid-2024, if they persist it would lead to further deterioration of credit metrics, liquidity, and credit ratings.

### 3. FTC is a near term wildcard with longer term implications.

M&A transaction volumes will rise across the health care sector. However, the FTC is on high alert in both the pharmaceutical and health care services subsectors.

### 4. Legislative risk remains.

While health care policy has not come up as a major talking point in the upcoming presidential election yet, there's bipartisan support for lowering health care costs and increasing transparency, which could lead to further legislation that would be disruptive to providers, contributing to negative rating actions.

**Margin pressure could worsen.** Companies have largely seen adjusted EBITDA margins improve in 2023. However, companies could see EBITDA margins pressured should labor costs or reimbursement pressures rise. Many health plan sponsors are seeing costs to provide health care coverage to employees growing at an unsustainable double-digit rate, and health insurance companies are facing rising medical cost ratios as health care utilization has increased. This could lead to more difficult discussions on pricing and reimbursement.

While labor costs growth has moderated, health care labor remains a challenge given steadily growing health care demand, health care employee burnout, and the persistent shortage of doctors and nurses, especially in select areas of growing need. The latest jobs data also shows that despite a slowing market, health care continues to drive jobs growth. This will pose a long-term challenge for the sector.

**Free cash generation fails to improve.** Despite cost cutting and efficiency efforts, improving topline demand, and moderating inflationary/labor costs, many health care services companies are still struggling to generate sustained positive free cash flows. The elevated interest rate environment is part of the reason, but legislative developments, such as No Surprise Billing and the Medicaid redetermination process, have also weighed on cash flows. We expect the negative impact from such developments to start to moderate in mid-2024, leading to expected improvement in the second half of 2024. However, if the headwinds continue it could lead to further deterioration of credit metrics, liquidity, and credit ratings.

**Consolidation resumes, and the FTC is watching.** M&A has returned to the industry, especially in the pharmaceutical sector, and we believe transaction volumes in health care services will rise as well. However, the FTC is increasingly scrutinizing M&A in both subsectors to ensure that newly enlarged firms do not wield disproportionate power in setting prices. A number of mergers were delayed--such as Amgen's acquisition of Horizon--and even canceled--such as HCA Healthcare Inc.'s aborted acquisition of five Utah hospitals from Steward Health Care System. The FTC could put the brakes on strategically necessary M&A.

**Legislative risks could increase.** We are entering a U.S. Presidential election year. While health care policy has not come up as a major talking point yet, there remains a high level of bipartisan

support for health care legislation that seeks to lower costs and increase transparency. Legislation like the well-meaning No Surprise Act, to protect patients from surprise billings, have had a disruptive effect on providers, contributing to negative rating actions.

## Related Research

- [Research Update: Bristol-Myers Squibb Co. Downgraded To 'A' On Plans For \\$21 Billion Of Debt-Financed Acquisitions; Outlook Stable](#), Dec. 27, 2023
- [Merck & Co. Inc.](#), Dec. 22, 2023
- [Research Update: McKesson Corp.'s Leverage Has Declined; 'BBB+' Rating And Stable Outlook Affirmed](#), Dec. 18, 2023
- [Hologic Inc.](#), Dec. 15, 2023
- [Research Update: LifePoint Health Inc. Outlook Revised To Stable From Negative On Steadily Improving Performance. Ratings Affirmed](#), Dec. 14, 2023
- [Research Update: Pfizer Inc. Downgraded To 'A' From 'A+' On Proposed Seagen Inc. Acquisition](#), Dec. 13, 2023
- [Research Update: ADMI Corp. Outlook Revised To Stable From Negative On Maturity Extension And Solid Liquidity; 'B-' Rating Affirmed](#), Dec. 12, 2023
- [Johnson & Johnson](#), Dec. 11, 2023
- [Medtronic PLC](#), Dec. 6, 2023
- [Thermo Fisher Scientific Inc.](#), Dec. 5, 2023
- [Tear Sheet: Eli Lilly & Co.](#), Dec. 4, 2023

# Industry Forecasts: Health Care

Chart 7  
Revenue growth (local currency)

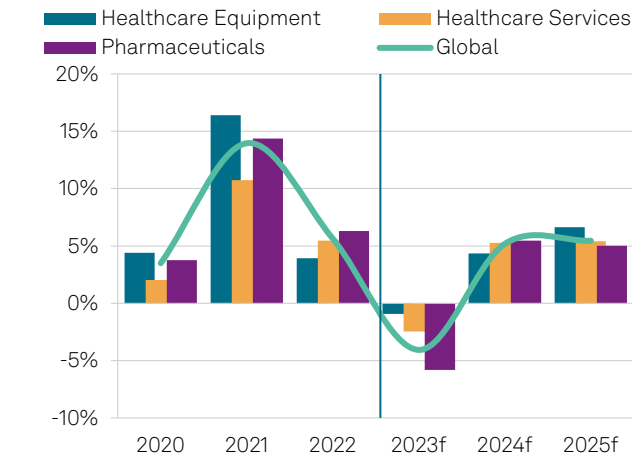


Chart 8  
EBITDA margin (adjusted)

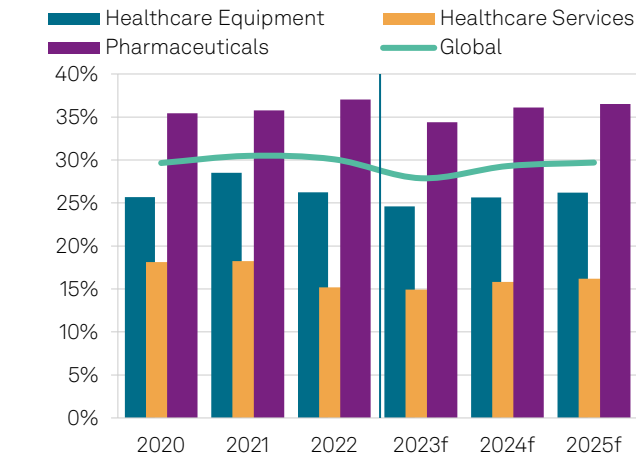


Chart 9  
Debt / EBITDA (median, adjusted)

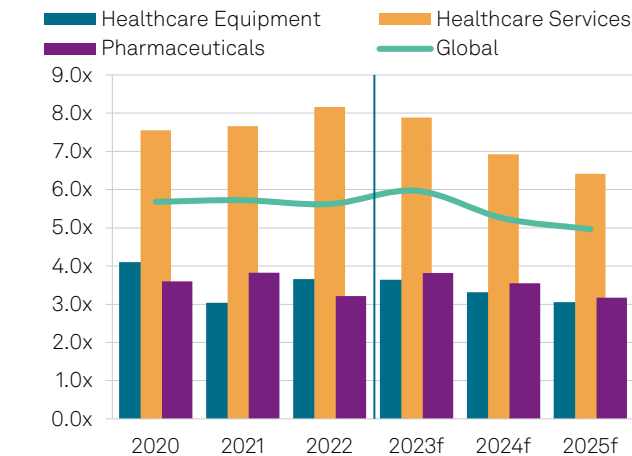
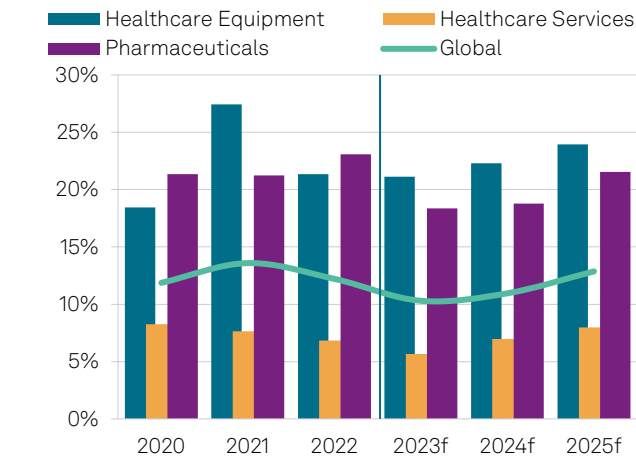


Chart 10  
FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = forecast.  
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

## Cash, Debt, And Returns: Sector

Chart 11

### Cash flow and primary uses

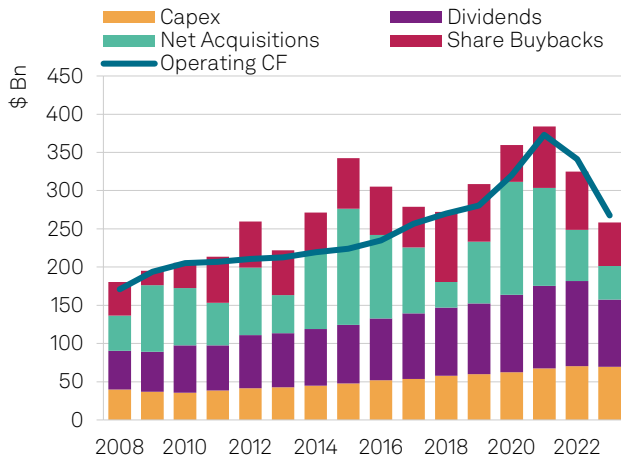


Chart 12

### Return on capital employed

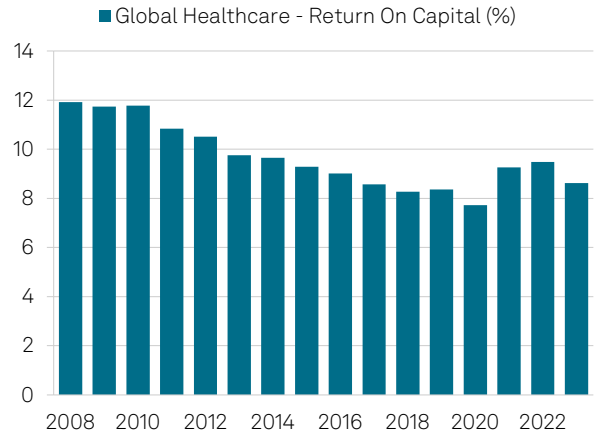


Chart 13

### Fixed- versus variable-rate exposure

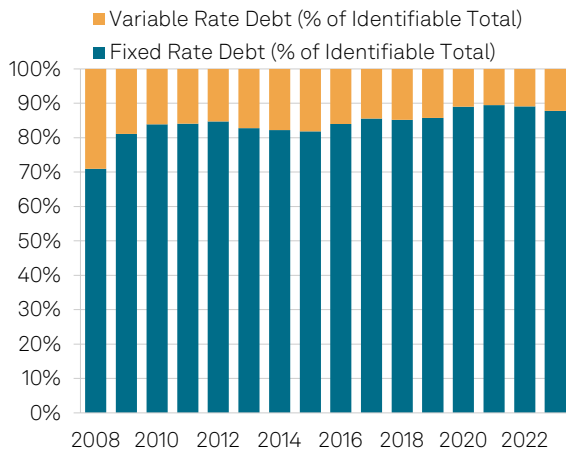


Chart 14

### Long-term debt term structure

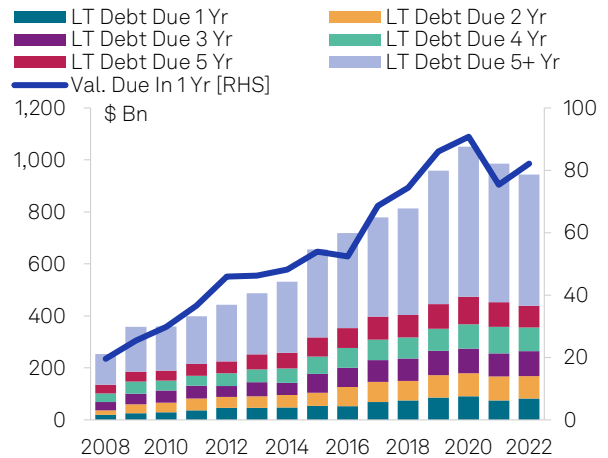


Chart 15

### Cash and equivalents / Total assets

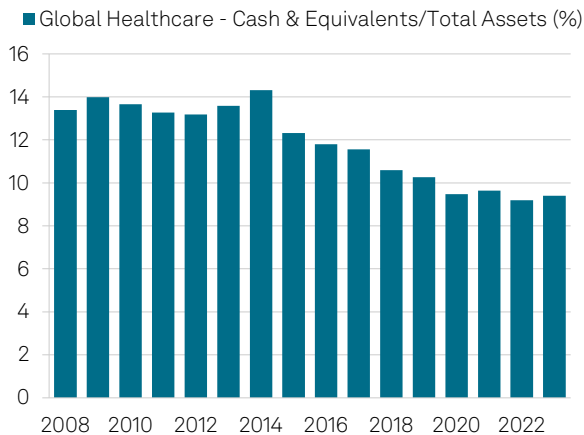
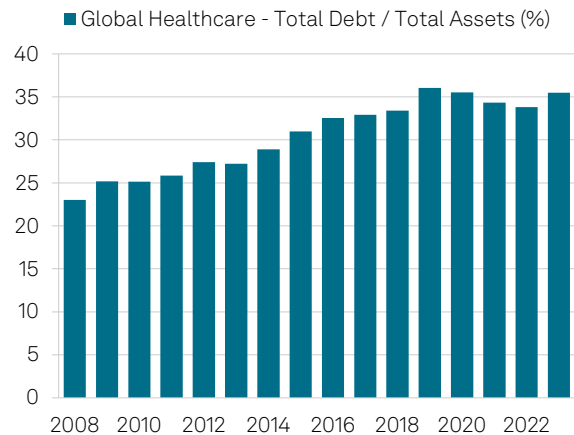


Chart 16

### Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2023) figures use the last 12 months' data.

Copyright 2024 © by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, [www.spglobal.com/ratings](http://www.spglobal.com/ratings) (free of charge) and [www.ratingsdirect.com](http://www.ratingsdirect.com) (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at [www.spglobal.com/ratings/usratingsfees](http://www.spglobal.com/ratings/usratingsfees).

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.