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The Financial Impact of COVID-19 on California Hospitals

KaufmanHall

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About Kaufman Hall

For more than 30 years, Kaufman Hall has been providing organizations in Healthcare, Higher Education, and Financial Institutions with independent, objective insight and financially-centered software tools that support decision making and enable the development and execution of sustainable strategies and goals.

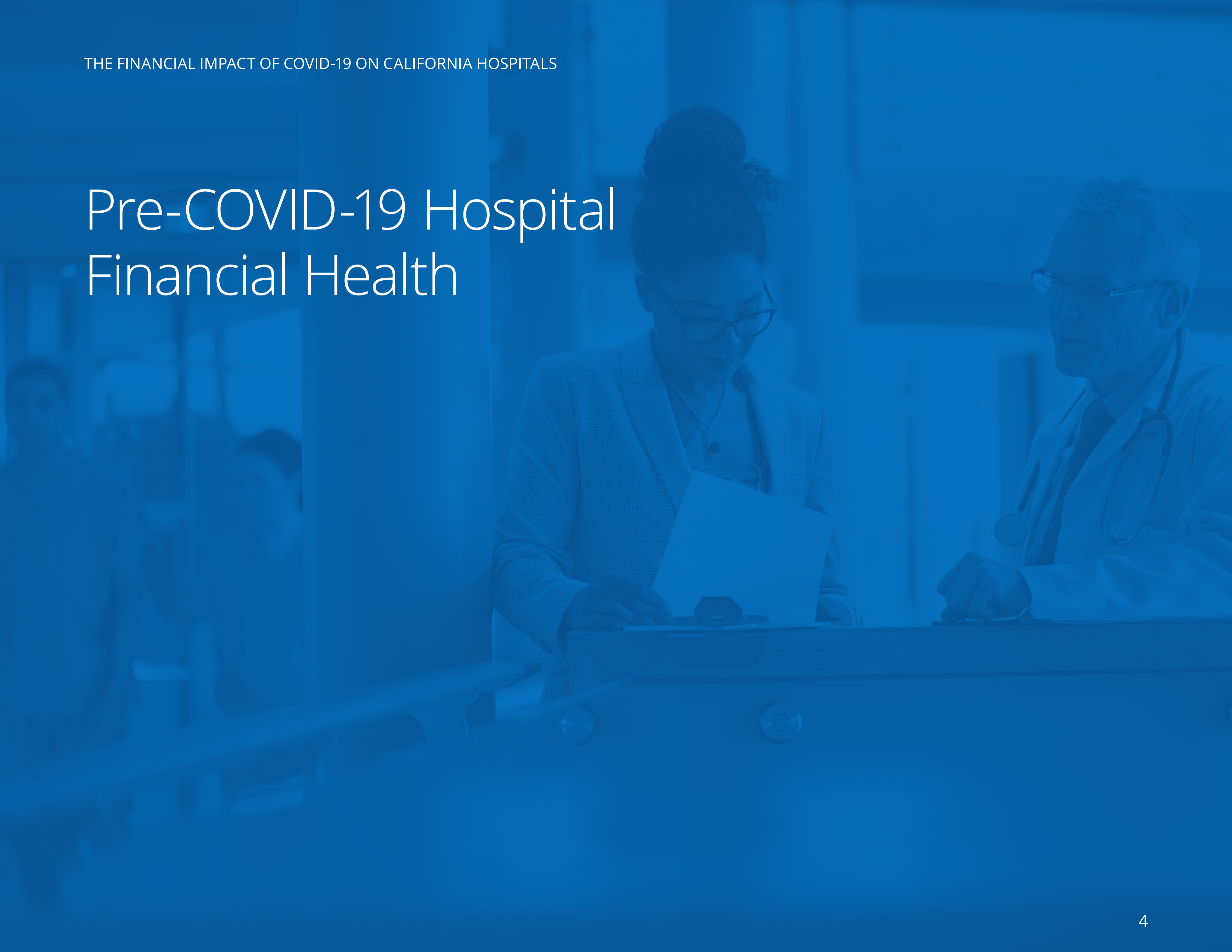
Kaufman Hall currently provides consulting services and software to 80 of the 100 largest health systems in the United States.

Introduction

The COVID-19 crisis has caused significant financial harm to California hospitals, as it has on hospitals across the country. Kaufman, Hall & Associates LLC has been analyzing the impact of COVID-19 nationally. To understand the dimension of this harm in California, the California Hospital Association asked us to quantify the known impact as of May 2020, and to forecast the probable financial effects through the remainder of 2020 and into 2021.

This report has two sections:

- ***Pre-COVID-19 Hospital Financial Health:*** Key metrics that measure the financial performance of hospitals, and hospitals' overall health pre-COVID-19
- ***Financial Effects of COVID-19:*** Findings of current and projected impacts of COVID-19 on net revenues and patient volumes, along with a discussion of possible long-term effects of the crisis on California hospitals



Pre-COVID-19 Hospital Financial Health

Margins were thin before COVID-19

For hospitals and health systems, positive financial margins – or the extent to which total revenues exceed total expenses – allow them to invest in new facilities, treatments, and technologies to better care for patients, and build reserves to meet unexpected expenses or revenue shortfalls.

Pre-COVID-19

Compared with other industries, healthcare margins are very thin. Even before COVID-19, nearly 40% of California hospitals had negative margins.

General COVID-19 impact

The dramatic slowdown of non-emergency services due to the COVID-19 pandemic, and the resulting dramatically reduced margins that damage hospitals' financial strength, are expected to present unprecedented challenges to hospitals' abilities to serve their communities and remain financially viable.

41% TO 60%

Percentage of U.S. hospitals expected to have a negative profit margin by 2025 (pre-COVID-19 projection)

Source: Congressional Budget Office, 2016

Revenue growth was declining before COVID-19

Pre-COVID-19

As a percentage of revenue, outpatient care has been growing over the past three-plus decades, in 2018 constituting almost half of hospital revenues.

However, downward payment pressure, flat inpatient volumes, and the beginning of a decline in outpatient volume suggest that revenue growth will slow. Moody's forecasts that hospital median annual operating revenue growth rates will fall from 7% in 2015 to 4% in 2019.

Payments from government programs such as Medicare and Medi-Cal are usually less than the cost of providing healthcare services. Via Medi-Cal, California already has the most Medicaid enrollees of any state. Hospitals and health systems rely on higher payments from commercial health insurance plans and employer-sponsored plans to cover these payment shortfalls. Over the next 10 years, the number of Medicare enrollees is expected to grow by more than 16 million, putting further pressure on hospital revenue.

General COVID-19 impact

The virtual stoppage of non-COVID-19, non-emergency care has led to a significant decline in inpatient, outpatient, and emergency department revenues at a time when revenues and margins already were under pressure.

In addition, the economic impact of COVID-19 will result in higher numbers of uninsured patients and Medi-Cal beneficiaries, leading to decreased revenues. California is now anticipating a $54 billion budget deficit resulting from COVID-19's economic impacts, which could lead to cuts in Medi-Cal spending.

FROM 7% TO 4%

Forecasted median operating revenue growth rates, 2015-2019

Source: Moody's

16.4 MILLION

Projected growth in the number of Medicare beneficiaries from 2018 to 2028.

Source: Centers for Medicare & Medicaid Services

Revenues were barely keeping pace with expenses before COVID-19

Hospitals and health system expenses fall into two broad categories – operating expenses (including labor and non-labor costs) and capital expenditures (for equipment, facilities, and information technology).

Pre-COVID-19

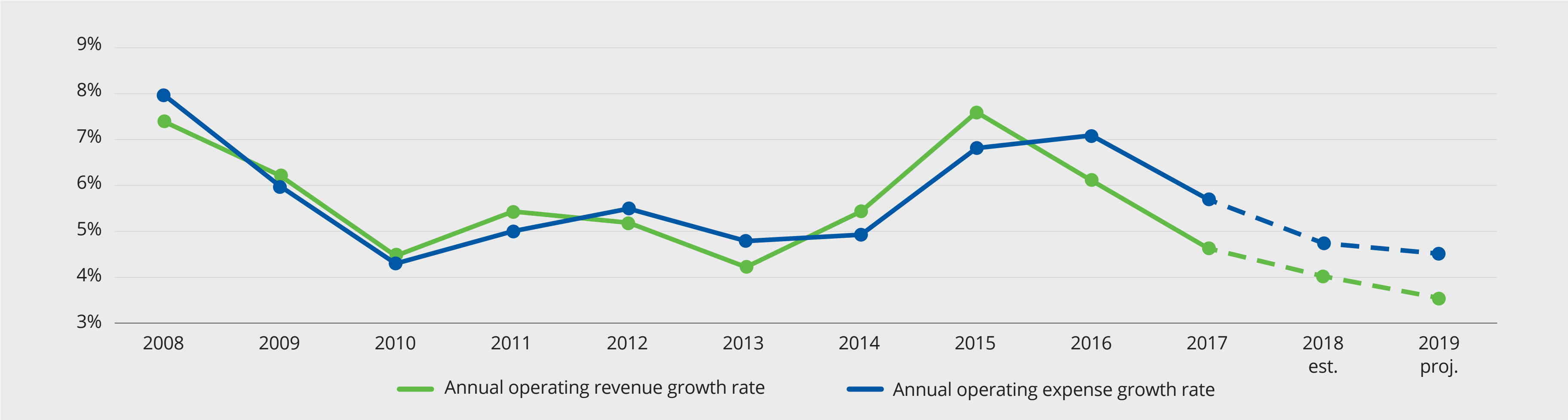
Despite years of effort, revenues were barely keeping pace with expenses as hospitals deal with major needs, including particularly high-cost information systems and developing more outpatient facilities and services.

California hospitals also face the costs of complying with Senate Bill (SB) 1953, which requires retrofitting or replacing buildings by 2030 to make sure they remain fully operational following a seismic event. Those costs are estimated at $34 billion to $143 billion by the RAND Corporation.

General COVID-19 impact

With loss of revenue, hospitals will be challenged to significantly change their expense structure, including reducing labor and supply costs and reducing capital spending.

Expense Growth Compared with Revenue Growth



Historical figures based on Moody's 2017 and 2012 medians. "est." indicates Moody's estimate based on preliminary information; "proj." indicates Moody's projection. Source: *Moody's Investors Service*.

Rating agency outlooks were stable before COVID-19

Many hospitals issue bonds to fund major capital expenditures. Their ability to access bond markets and the amount they must pay to service their debt depends in large part on the rating they receive from credit rating agencies (including Fitch Ratings, Moody's Investors Service, and S&P Global), with lower bond ratings resulting in higher interest rates.

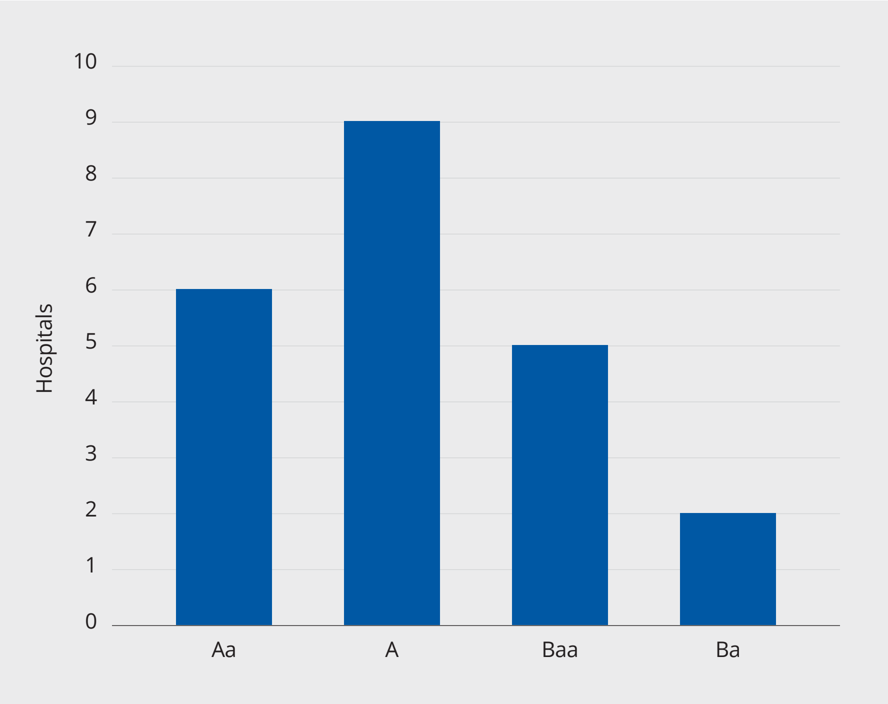
Pre-COVID-19

Prior to COVID-19, the ratings agencies all held a stable outlook for the sector.

General COVID-19 impact

In March 2020, all three rating agencies changed their sector outlook to negative in response to the impacts of COVID-19, a signal that hospitals' bond ratings may be at risk of reclassification. Most vulnerable are the hospitals in the lower rating categories, but all hospitals could find themselves facing higher interest rates to access necessary capital for everything from facility maintenance to information technology. The chart at right shows the distribution of California hospitals among the various ratings categories as of May (hospitals and health systems rated by Moody's only).

California Rating Distribution – Moody's



Source: Moody's Municipal Financial Ratio Analysis as of May 20, 2020

Financial Impacts of COVID-19 on California Hospitals

Overview

On March 4, 2020, Governor Gavin Newsom declared a State of Emergency in California due to the pandemic. To prepare for a surge in potential COVID-19 patients and to preserve limited resources, including personal protective equipment, for their care, hospitals across California cancelled most elective and non-emergency services.

The actions taken by California hospitals were necessary to address a public health emergency and comply with Gov. Newsom's executive order. But the impacts have been severe, including:

- 35% decline in hospitalizations and 62% decline in emergency department visits in April 2020, as compared to typical monthly volumes
- A likely net loss of $14.6 billion through the end of December 2020

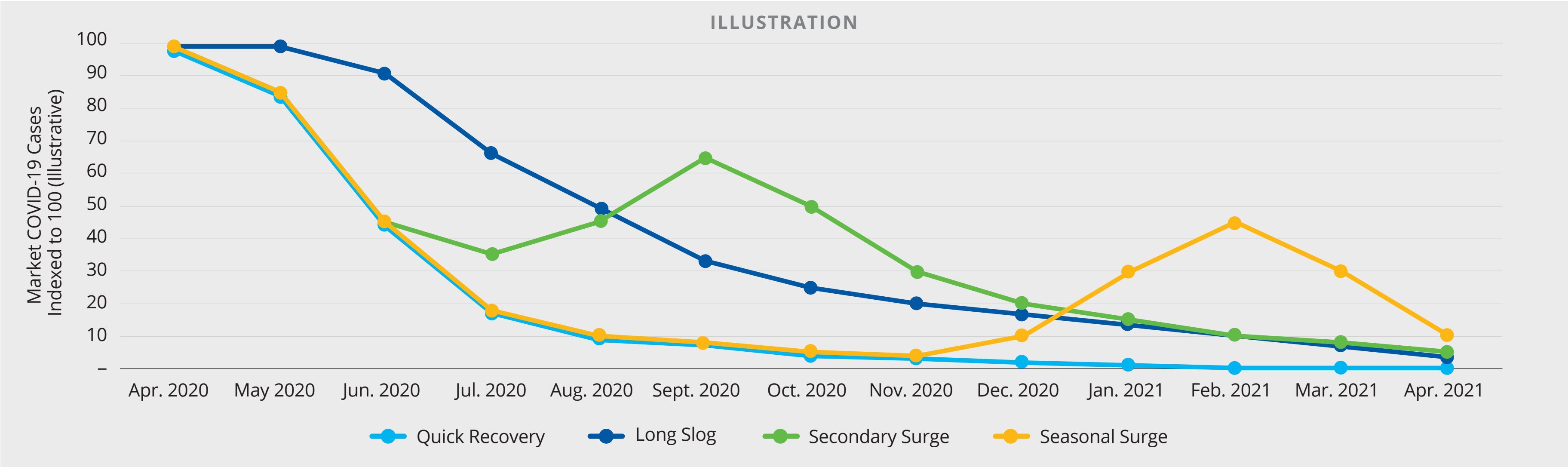
Federal assistance covers only a portion of this lost revenue. Even with this assistance factored in, hospitals face $11.2 billion in lost revenue by year-end.

Four scenarios describe possible paths for COVID-19

Kaufman Hall has developed four scenarios that describe how hospital volumes and revenues might recover as the number of COVID-19 cases decline:

- ***Quick recovery.*** The most optimistic scenario, which assumes that COVID-19 cases decline sharply through summer and fall to near zero by spring 2021.
- ***Long slog.*** The most pessimistic scenario, which assumes a surge extending through May, then a slow decline, with cases persisting into spring 2021.
- ***Secondary surge.*** A peak in April would be followed by smaller peak in fall, then a relatively steady decline into spring 2021.
- ***Seasonal surge.*** A relatively sharp decline in cases after April would be followed by another peak next winter at roughly the same time as the original outbreak, with the expectation that COVID-19 would reoccur seasonally.

These scenarios were used to inform the ranges of financial impact of California's hospitals.

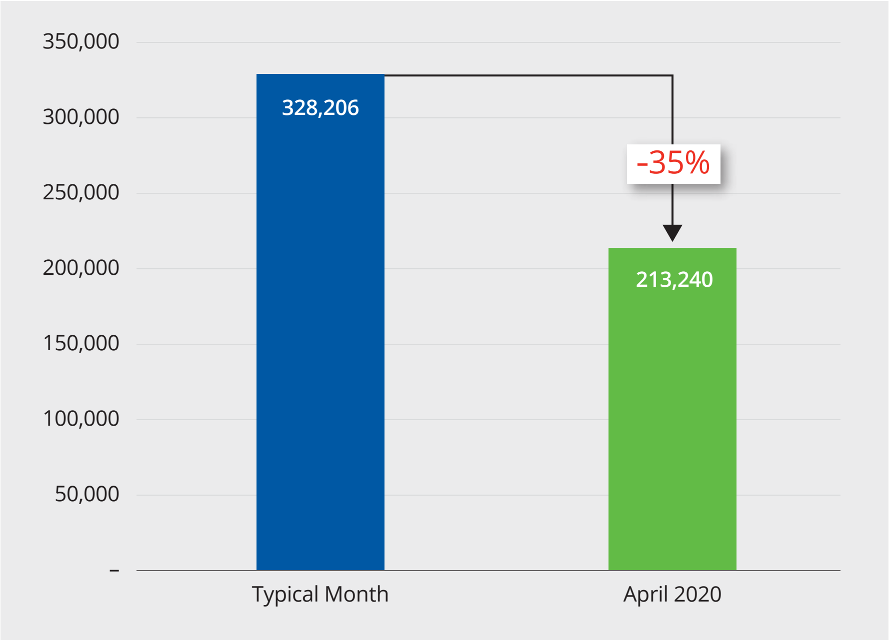


In April, California saw inpatient volumes decline by 35% and ED visits dropped 62%

California hospitals have seen dramatic declines in inpatient and emergency department volume since the pandemic began. These have been largely responsible for the staggering revenue losses. In April, inpatient volume fell 35% from a typical month, and ED visits plummeting 62% from usual levels.

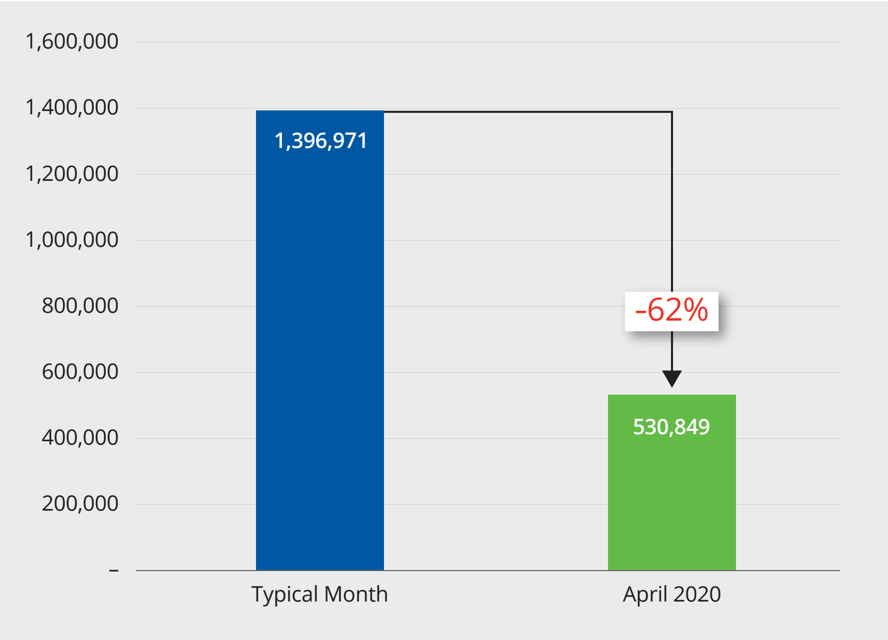
Discharge Volumes

% Reduction Compared to Typical Month



ED Visits

% Reduction Compared to Typical Month



Source: Statistics from California Office of Statewide Health Planning and Development (OSHPD) Hospital Annual Financial Disclosure Report FY17-18 scaled to 2020 assuming 3% YoY growth; % Reduction provided from CHA member survey

Hospitals may experience net losses of $14.6 billion through December, and $16.7 billion through April 2021

The revenue loss from COVID-19 for California hospitals is devastating, presenting a financial shock never before felt and likely reshaping the future healthcare landscape. In just March and April, California hospitals lost an estimated $6.3 billion.

The range of possible revenue losses reflects different scenarios for the virus. The "low case" line generally assumes a quick recovery across all California communities and hospitals.

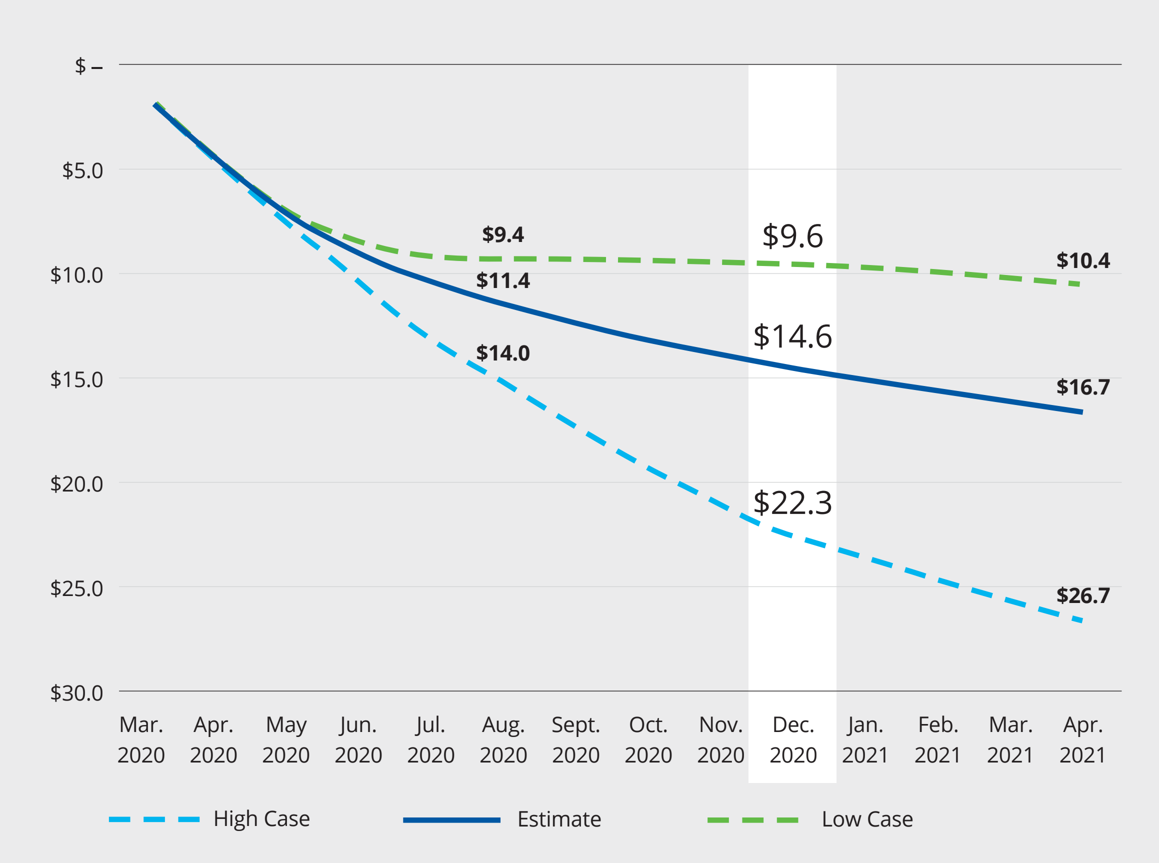
The "high case" line generally assumes a long slog across all California communities and hospitals.

The likely "estimate line" applies the weighting of scenarios across California communities and hospitals, as described on page 11.

Net revenue loss shows actual and projected declines in revenue from a typical month, adjusted for reductions in expenses. The impact of federal assistance is shown on the following page.

Estimated net losses for California hospitals due to COVID-19

$ in Billions (Cumulative)



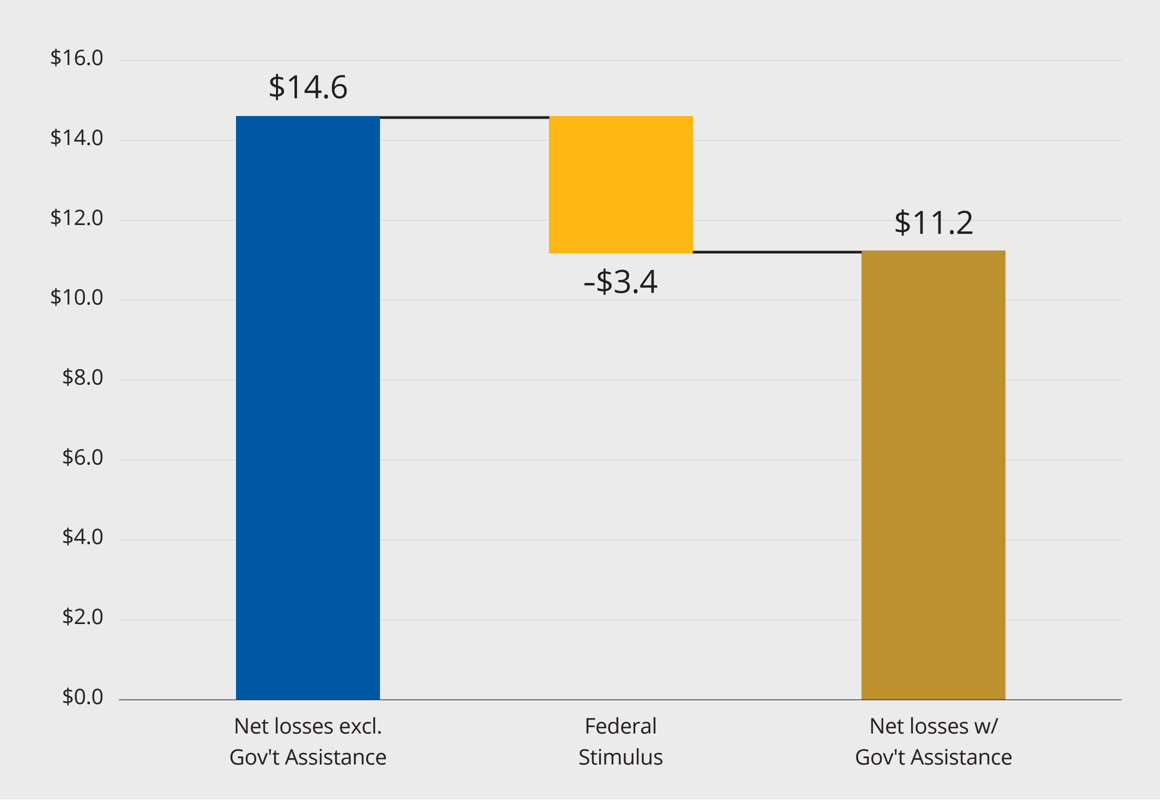
Even with government assistance, California hospitals are estimated to lose $11.2 billion in revenue through December

Even with federal stimulus funds, California hospitals still face $11.2 billion in lost net revenue by the end of 2020.

These figures do not include Medicare advanced payments, as these require repayment to the federal government.

Net Losses & Government Assistance Impact California Hospitals

$ Billions cumulative through Dec, 2020



Note: Did not include Medicare Advanced Payments as these require repayment to the federal government

Scenarios will vary across communities and hospitals

COVID-19 has not affected all communities and all hospitals to the same degree. In particular, small and medium-sized hospitals are less likely to have the cash reserves needed to withstand financial shocks, in comparison to larger hospitals and health systems.

The chart describes three types of California communities and hospitals and assumptions for how COVID-19 could affect them, including the likely speed of resuming a full range of services. These assumptions influenced our weighting in the estimates of overall COVID-19 financial impact.

Community Size	Weighting of COVID-19 Impact
Small, rural community (Hospitals with <100 beds)	Heavier weighting toward quick recovery and secondary surge scenarios given potential COVID-19 case volumes and speed of "reopening" in these markets
Moderately sized community (Hospitals with 100–299 beds)	Even distribution of probabilities given significant variation in COVID-19 impact in these mid-sized communities and community hospitals; speed to reopen also highly variable
Large, urban community (Hospitals with 300+ beds, academic medical centers and others of many sizes)	Heavier weighting toward long slog and secondary surge scenarios, given potential likelihood of experiencing long-term COVID-19 case volumes and a potential lag in return to normalcy as a result

COVID-19 is likely to lead to long-term changes to hospital financial stability and care delivery in California hospitals

The financial burdens on California hospitals resulting from COVID-19 have already been significant. As the data in this report suggest, they are likely to grow. Potential long-term impacts of this crisis include:

- ***Permanent reductions in volume.*** In a recent national survey, 1 in 10 individuals do not plan to reschedule an elective procedure that was delayed or skipped because of COVID-19. 24% of Americans said they would wait a year or longer before scheduling an elective procedure in a hospital, and 5% said "never again."*
- ***Workforce reductions.*** To the extent hospital and emergency department volumes fail to return to pre-COVID-19 levels, hospitals will have no choice but to significantly change their cost structures, including reducing their workforce, in order to adjust to new volume and revenue levels.
- ***Risk of hospital closures.*** The closure of hospitals in the state already raised concerns about capacity to deal with a potential surge in COVID-19 patients. Hospitals that have been financially challenged may not be able to survive the impacts of the COVID-19 crisis. For rural communities, potential closures may cause significant challenges around access to care.
- ***Heightened public appreciation for hospitals.*** On a positive note, recent survey data indicate that 85% of Americans have a favorable opinion of hospitals. 60% believe hospitals require more funding, based on what was included in the first federal stimulus package.*
- ***Financial fallout from difficult decisions.*** Many hospitals have been forced to make difficult decisions with long-term financial implications, including tripping bond covenants, selling investments during a challenging market and borrowing money at increased interest rates.

* Source: Jarrard Inc. and Public Opinion Strategies: *Coronavirus National Online Survey*, April 2020

Appendix: Notes and assumptions on methodology

1. How much hospital revenue has been lost due to COVID-19?

- Based on Kaufman Hall's National Hospital Flash Report data, the impact of COVID-19 on revenues has been felt in a relatively consistent way across similarly-sized hospitals, including in California. The impact has ranged between 32% and 35%, largely excluding the impact of federal assistance.
- We have chosen to model revenue losses based on the size and related complexity of institutions. Given the current uncertainty around COVID-19 recovery, we view this as a reasonable method to extrapolate probable scenarios of recovery from the pandemic and the resulting revenue impact to California hospitals.

2. To calculate net losses, how will expenses move in response to the pandemic?

- Kaufman Hall has seen a broad range of expense changes due to differing responses around labor, COVID-19 case volumes, etc. with a national median expense reduction of 10%.

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