

## Health Care Special Report

## 2003 Outlook for Nonprofit Nursing Homes

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### ■ Summary

Fitch Ratings' outlook for the nonprofit nursing home sector is negative due to the severe financial pressures expected to weaken the sector over the near and long terms. Fitch believes the sector's most significant challenge in 2003 will be cuts in already inadequate Medicaid reimbursement, with reduced or frozen reimbursement levels likely as states grapple with budgetary shortfalls. Rising labor, benefit, and insurance expenses are also primary concerns.

Nonprofit nursing homes' weak financial profiles have limited their ability to access capital, and consequently, many homes have accrued substantial deferred capital expenditures. In addition, increased scrutiny from governmental regulators regarding the quality of care provided has added pressure on expenses. Non-operating income has virtually dried up, as annual investment returns are at all-time lows. The convergence of these forces in 2003 will continue to worsen the already weak financial condition of nonprofit nursing homes.

On a positive note, nursing facility occupancy has stabilized at around 84% over the past three years, following a precipitous decline begun in the early 1990s. High barriers to entry exist in many states in the form of certificate of need requirements and/or moratoriums on new beds licensure, which have limited bed supply. The sector's improvement depends on improved governmental reimbursement and stability in expenses. Increased demand from the aging baby boomer population is more than 20 years away.

Fitch believes investment-grade ratings are now more difficult for nonprofit nursing homes to attain than in years past. Fitch continues to believe the fundamental credit profile of an investment-grade nonprofit nursing home begins with maintenance of a high census, a competitive market advantage, and favorable payor mix, as well as wise cash management. Fitch expects a decline in credit quality in 2003 and maintains a long-term negative outlook for the sector.

### ■ Credit Positives

- Stabilized occupancy.
- Long-term demand from an increasing elderly population.
- High barriers to entry.

### ■ Credit Negatives

- Likely reduction in Medicaid reimbursement.
- Rising labor and insurance expenses.
- Capital needs.
- Increased scrutiny from governmental regulators.

## ■ Demand

### Occupancy

Skilled nursing facility occupancy has stabilized over the past three years at 83%–84% (data from National Investment Center for the Seniors Housing and Care Industries) after a decade of declining occupancy caused by increased competition from assisted living facilities. In many states with a certificate of need requirement or moratoriums on new beds that limit supply, occupancy remains above the national average.

Fitch believes occupancy should increase in the long term due to the aging baby boomer generation, although the likely benefits are more than 20 years away. Based on the 2000 census, 1.3 million people aged 75 and older are in nursing homes. The 75 and older age group is projected to increase 46.4% from 2020–2030, ensuring the need for nursing care.

### High Barriers to Entry

Most states have certificate of need requirements and/or moratoriums to regulate the supply of nursing home beds, with 20 states having a moratorium on new nursing home beds and 36 states and the District of Columbia requiring nursing homes to receive a certificate of need before building new facilities or adding new beds. Fitch views these limitations as positive for bondholders, as they raise occupancy rates by controlling supply. In addition, Fitch believes new building projects in this sector are few due to the unprofitable nature of the business and a general inability to access capital.

Regardless of high barriers to entry, current national bed supply is plentiful, with approximately 15,000 skilled nursing facilities nationwide (both for profit and nonprofit), compared with approximately 6,000 hospitals nationwide (data from the U.S. General Accounting Office's report "Skilled Nursing Facilities: Medicare Payments Exceed Costs for Most but Not All Facilities"). Fitch expects that the equilibrium between nursing home bed supply and demand will remain out of balance over the near to medium term.

## ■ Revenue Concentration

### Medicaid

Fitch believes the reduction in Medicaid reimbursement is the largest challenge for nursing homes in the near to long term. When assessing the credit quality of a nursing home, revenue mix is paramount. Medicaid payments, which already barely cover the full cost of

care, will strain the financial position of nursing homes even more in the future if cuts are implemented.

Medicaid payors make up the largest component of a home's census, accounting for approximately 60% of its patient days. This high revenue concentration creates an inherent credit risk due to the volatile nature of governmental reimbursement. Due to budget crises in nearly every state, many face the need to cut Medicaid spending.

Nearly 50% of national nonprofit nursing home spending is provided by Medicaid, and approximately 30% of total Medicaid expenditures are for elderly Medicaid enrollees. Medicaid expenditure on a nursing home patient is three times that on an acute care patient due to the longer length of stay. Therefore, many states are examining the reimbursement to nursing homes for potential savings. Medicaid budget cuts being discussed could be in the form of reduced provider reimbursement, tightened eligibility requirements, reduced benefits, and/or increased co-payments.

In a National Association of State Budget Officers' survey, several states (including Maine, Illinois, Indiana, Iowa, and Virginia) reported they would reduce or freeze rate reimbursements for nursing homes in 2002 and 2003. Ohio has proposed freezing reimbursement rates to nursing homes for this year's budget, and California is contemplating a 15% cut in Medicaid payments to nursing homes. Pennsylvania is revising income eligibility requirements to tighten admissions.

Until Medicaid payments cover fixed costs, nursing homes will need to keep tight control on expenses and attract more favorable payors to enhance revenue.

### Medicare

Fitch views Medicare reimbursement favorably, as Medicare is generally a profitable payor for most nursing homes; however, reimbursement declines are possible in the near term.

On average, 10% of a home's residents are Medicare payors. Since Medicare reimbursement was revised to a prospective payment system from a cost-based methodology, many nonprofit nursing homes have suffered financially. In response, Congress enacted temporary payment increases under four changes (two of the changes expired Oct. 1, 2002, and the other two are expected to remain in place through

2003). As these increased payments are temporary, Fitch expects a reduction in Medicare reimbursement in 2004 and after. The American Association of Homes and Services for the Aging reports a potential 4.5% decline in Medicare reimbursement to nursing homes in 2004.

Although Medicare accounts for a small percentage of a home's census, Fitch believes any additional reimbursement cuts could severely affect nonprofit nursing homes' financial profiles, as many providers offset unprofitable Medicaid reimbursement with profitable Medicare reimbursement.

## Other Payors

Fitch views commercial insurance for long-term care positively; however, the growth of private long-term care insurance is relatively small. Long-term care insurance for nursing home services is still not enough of an industry factor to materially affect credit ratings.

## Reduced Investment Returns

The majority of Fitch's nonprofit nursing home credits are generally dependent on an endowment; the financial ratios of these credits have suffered due to reduced investment returns in the past three years. Aggressive asset allocations yielded negative investment returns for most credits, and investment income in 2002 was less than in the previous two years. Due to negative investment returns, Fitch's nursing home credits experienced drastic reductions in debt service coverage ratios and liquidity levels. Fitch believes prudent cash management is important, as the reliance on volatile investment earnings is unpredictable.

## ■ Expense Pressures

### Labor

Fitch believes labor expenses will continue to increase at a rate higher than inflation. Nursing homes are struggling to attract and retain personnel. Rising labor expenses associated with the nationwide nursing shortage have challenged the entire health care industry, but Fitch believes this problem is more severe in the nursing home sector given that nursing homes offer lower pay and a less favorable work environment than other health-related institutions. Turnover rates remain extremely high in this sector, especially for aides (certified nursing assistants [CNAs] and licensed practical nurses [LPNs]), which generally provide most of the patient care.

Lower skilled workers (such as housekeepers and dietary aides) compose a large percentage of a nursing home's work force and also have been difficult to attract and retain. Fitch believes the rising unemployment rate in the U.S. should relieve some of this pressure. However, filling registered nurse (RN) and aide vacancies and retaining skilled employees remains a long-term problem. Labor expenses are also pressured by executive management salaries, as executive directors of nursing homes generally make less than their counterparts at other health care facilities.

Other factors affecting rising labor expenses include state-mandated staffing ratios and increased scrutiny from governmental regulators. In 2001, nonprofit nursing homes had an average 0.9 RN hours per patient day and 2.37 aide hours per patient day (data from the 2001 *Nursing Home Statistical Yearbook*). To date, 37 states have implemented minimum staffing requirements. Increased scrutiny from governmental regulators has brought a level of transparency to the sector. All nursing home survey results are now available on the internet with comparisons to state and national averages.

### Insurance

Nursing home liability coverage premiums typically increased 50% per year over the past three years nationally. Insurance premiums continue to rise due to the level of attention brought to nursing home fraud and abuse cases, high jury awards, the reduced investment returns of insurance companies, and the withdrawal of major insurance carriers.

Professional liability costs vary significantly by state. General liability and professional liability rates used to range from \$50-\$100 a bed, but have increased dramatically in some states, including Florida and Texas and states with no limits on awards for pain and suffering. Insurance premiums have soared to \$5,000 a bed in Florida and \$2,500 in Texas. Some nonprofit providers have been operating without insurance, although none of these are Fitch-rated credits. In addition, skyrocketing insurance premiums have been the cause of several recent for-profit divestitures in Florida.

Fitch expects insurance premium increases to continue to rise, with no relief until states pass legislation that limits lawsuits and establishes meaningful caps on settlements.

## ■ Capital Needs

Fitch believes capital investment in a nursing home's plant is crucial for maintaining a competitive advantage and attracting private-pay patients. Many facilities have deferred capital needs or new projects due to weak financial positions and inability to access capital. Many facilities do not have excess cash flow to cosmetically enhance physical plants to meet consumer design preferences. Fitch believes this is a credit weakness, especially for those nursing homes in competitive markets. Consumers are demanding private rooms and better amenities. Due to the current financial situation, several facilities even have deferred expansion projects for more profitable service lines, such as independent living units. As the influx of revenue from aging baby boomers is more than 20 years away, Fitch believes nursing home facilities will continue to deteriorate under the current system.

## ■ Issuance Volume

The deferral of capital projects is demonstrated by the sharp drop in nursing home bond issuance. Nonprofit nursing home bond issuance volume fell dramatically to \$508.7 million in 2002 from \$2.3 billion in 1998, a 78% decline (*see chart below*). Nonprofit nursing home bond volume composed only 1.9% of total health care bond issuance in 2002, with nearly all nursing home issuance being speculative grade. This is a decrease from 7.1% of total health care bond issuance in 1997. Fitch expects the nonprofit

nursing home sector's volume in 2003 to approximate 2002 levels.

## ■ Fitch's Nursing Home Portfolio

The vast majority of nonprofit nursing home credits are below investment grade. Fitch is rarely asked to rate initial below-investment-grade nonprofit health care credits; however, in an effort to better serve the investor community, Fitch produces nonrated descriptive reports for such credits. In addition, Fitch welcomes any opportunity to rate below-investment-grade credits, as the default rate of a 'B' rated credit is two times that of a 'BB' rated one.

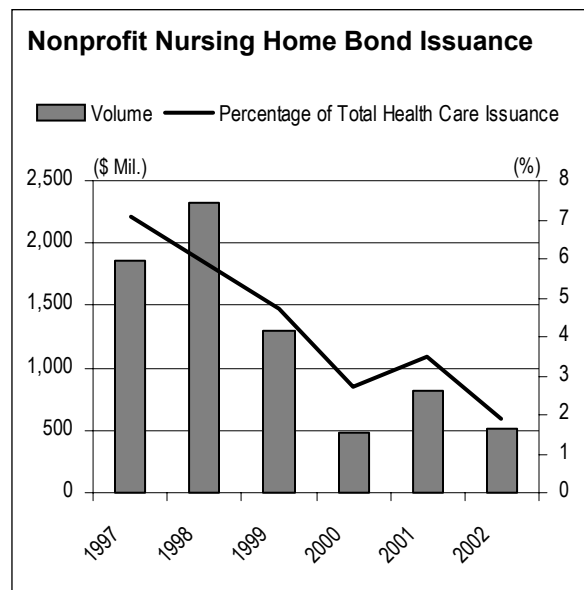
Fitch rates only seven freestanding nonprofit nursing homes, all of which are investment grade. Fitch has received requests to look at only a handful of nonprofit nursing home credits over the past three years and rated only one of these credits in 2002. Fitch downgraded one nursing home credit in the past year, and more downgrades are expected for 2003.

## ■ Outlook

Fitch's outlook for nonprofit nursing homes is much more negative than its outlook for hospitals or continuing care retirement communities. Industry pressures are more exacerbated in this sector than in other health care sectors due to the high reliance on Medicaid payors and limited revenue streams of most nursing homes. Fitch believes little room for revenue enhancement exists while expenses continue to rise at a pace higher than inflation.

Fitch believes nonprofit nursing home credit profiles will continue to weaken in the near to long term due to industry pressures. Demand from aging baby boomers may save nursing homes, but this demand is more than 20 years away.

The sector's improvement depends on several key factors. High occupancy is crucial to a nursing home's success; it can be achieved through offering high-quality care in a superior facility and through securing referral sources through hospitals and religious organizations. Nonprofit facilities will need to attract a more favorable payor mix, preferably private-pay patients, to offset the heavy reliance on inadequate Medicaid reimbursement to improve the sector's credit metrics. Expense control is paramount due to little revenue stream flexibility but is especially challenging in the current environment with escalating labor and insurance costs.



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