Appendix B-1

Fitch Outlook Report dated August 2022 entitled "U.S. Not-for-Profit Hospitals Health Systems Outlook 2023"

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U.S. Not-For-Profit Hospitals and Health Systems Outlook 2023

Protracted Labor Expense Growth Driving Weaker Margins

Fitch's Sector Outlook: Deteriorating

Fitch expects that core credit drivers for the sector will remain challenged for 2023 as highlighted by our mid-year sector outlook revision to Deteriorating in August 2022. The sector is seeing labor pressures and generationally elevated inflation, compressing margins for virtually all providers. These macro headwinds, specifically the labor supply, became highly pronounced in a very short period of time, with sector pressure further compounded by investment losses in 2022.

The largest single expense for healthcare providers is labor (salary, wages and benefits) typically at 50% or higher, followed by supplies, which, when including pharmaceuticals, are typically at 25% or higher. Consequently, 75% or more of a providers' expenses are currently under intense expense pressure, and operating metrics are down significantly in 2022 for most providers, with 2023 not expected to show a rapid operational recovery for most.

For providers that suffered significant operational losses in 2022, Fitch believes that break-even on a month-to-month basis should return sometime in 2023, with gradual improvement from there. Others who suffered only modest losses may return to profitability on a month-to-month basis by late 2022 or early 2023. A select few health systems continue to enjoy strong operating margins (excluding one-time supplemental support), which is a mark of distinction in the current sector landscape.

While liquidity has provided a significant rating cushion for years, and should allow most providers to weather the current environment, asset price corrections are reducing unrestricted liquidity levels from sector highs seen in 2021. As a result, deteriorating operating conditions will be felt more acutely in 2023.

Fitch is not calling for downgrades across the entire sector, but does predict a period in which downgrades and negative outlooks outpace upgrades and positive outlooks. The larger pool of providers, generally the unrated universe, which are typically smaller and often rural providers, have fared far worse than the rated universe, and Fitch believes this will remain the case in 2023.

Fitch expects a more manageable endemic period in which Covid-19 cases and hospitalizations are generally disconnected. This will allow most providers to continue servicing elective procedures and a much-reduced volume of Covid-19 inpatients simultaneously, even with possible heightened winter "surge" periods. The pronounced spread of the Omicron variant in late 2021 and early 2022, however, highlights the ongoing uncertainty of the coronavirus and the challenge facing hospitals to respond should an unknown variant or lineage emerge.

Kevin Holloran, Senior Director

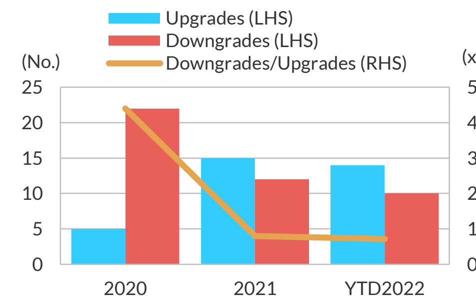
"Over the last three years, not-for-profit hospitals and health systems have endured multiple disruptions caused first by the coronavirus pandemic, and now by labor shortages, intense wage pressure, and generationally elevated inflation. Volumes have generally rebounded from early pandemic lows, but expense inflation remains pronounced, particularly for labor. Even as inflation is expected to attenuate eventually, labor expenses appear to have been reset at a permanently higher level. Remedying this will take all of 2023, and likely beyond."

Core Credit Drivers: Hospitals

	Revenues			Expenditures				Financial Profile		
	Personal income/ affordability	Real-estate values	Demand/ volumes	Labor costs	Labor availability	Non-labor operating costs	Capital input costs	Leverage	Cost of debt	Financial reserves & liquidity
Hospitals	N.A.	N.A.	↔	↘	↘	↘	↘	↘	↘	↔

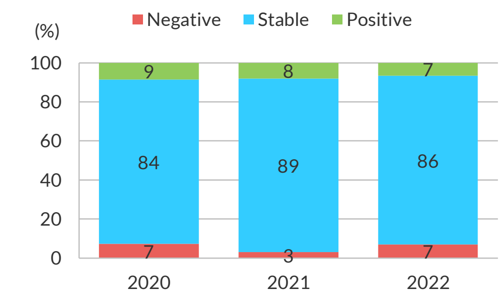
Note: N.A. not a material driver of credit quality in sector; ↑ Improving. high relevance. ↗ Improving: moderate relevance. ↔ Neutral. ↘ Deteriorating: moderate relevance. ↓ Deteriorating: high relevance.
Source: Fitch Ratings

Hopitals — Rating Changes



Note: YTD through 11/10/22.
Source: Fitch Ratings.

Hopitals — Rating Outlooks



Note: YTD through 11/10/22.
Source: Fitch Ratings.

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Rating Outlook Distribution

As you can see in the accompanying chart, while the vast majority of Rating Outlooks remain Stable (at 86%), there has been another notable year-over-year shift, with Negative Rating Outlooks more than doubling to 7% from 3% the year prior. Positive Rating Outlooks remained about the same at 7% compared to 8% the prior year. The negative shift is not surprising given the financial results posted throughout calendar 2022, but also recognizes concerted efforts by all management teams to reduce operational losses in 2023. While a full recovery in 2023 is not expected, meaningful progress towards break-even is, hence more Negative Rating Outlooks versus downgrades in 2022.

Rating Changes

Despite protracted expense pressure, affirmations have remained the most common rating outcome in 2022, despite the pronounced expense pressures, as credits have relied on balance sheet strength built up over the last several years. Rating actions in 2022 YTD through Nov. 10 indicate that upgrades have only just outpaced downgrades, comparing similarly to 2021's rating results. Looking at these two results, it is initially surprising that 2021 and 2022 would mimic one another, with 2021 being among the stronger years in the sector, compared to 2022, which could go down as one of the worst years ever in the sector. This highlights the general resiliency of the sector and built up financial cushion, but also Fitch's sector approach throughout the coronavirus pandemic to attempt to limit rating changes until a clear instance for rating action presents itself.

What to Watch

- A sector outlook revision to Neutral would require demonstrable improvement in the current amount of labor availability, specifically for nurses, who were in high demand before the pandemic, with the last three years exacerbating the level of need.
- Record levels of cash accumulated through much of 2021 buffered current operating challenges in 2022 (median days' cash on hand reached 260 days in 2021). Recent operational and equity market losses have weakened, but not eliminated, this rating headroom. Equity market stability and a return to year-over-year positive returns would restore and increase rating headroom, signaling a more Neutral sector outlook.
- A change in current regulatory policies limiting mergers and acquisitions in the sector should allow for increased M&A activity, permitting additional consolidation of services, and therefore some expectation of sector stability, particularly among our lower rated universe of credits. The unrated universe of usually financially weaker providers will benefit the most, merging with larger and financially stronger provider hospitals or health systems.
- Local economics will remain an important factor determining hospital credit quality with strong population growth and a favorable payor mix providing more top-line revenue opportunities in certain markets. An unexpected positive change in Medicaid funding (or expansion) may also stimulate additional revenues that would aid in offsetting expense challenges.

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Labor Expenses to Remain Elevated in 2023

Labor expenses will remain high, even if broader inflation cools, for the time being. This is particularly true for nurses, who were in high demand before the pandemic, with Covid-19 only exacerbating departures from this role. The space has long had a worker shortage, with most statistics pointing at a nationwide shortage of approximately 500,000 nurses, which remained generally consistent until Covid-19. This level always required careful use of agency and traveler positions (external) as well as overtime and shift differential (internal) to manage.

During and now post Covid-19, the new nursing shortage, at least short- and near-term need, is estimated anywhere from 1.0 million to 2.0 million. This has required significantly elevated contract labor expenses; increases in the number of contractors used; and increases in standing salary and wage/benefit expenses to retain current employees. The labor supply shortage emerged as the largest single contributor to operational losses in fiscal 2022.

No single effort will remedy this situation quickly; rather, multiple efforts to recruit and retain staffing, along with increasing throughput of nurses through nursing school and into the workforce, novel use of new technology and a reengineering of the hospital operating model will all need to be employed over the next year and well beyond. Fitch's most optimistic rated credits predict at least a year to get back to a break even point on a monthly basis, with less optimistic issuers predicting two years or longer to remedy the staffing shortage. Monthly losses began for most in early 2022, so many providers' efforts are now beginning to be realized. Fitch has seen both month to month profitability for a limited number of providers, along with monthly staff additions exceeding staff losses - two factors that show early efforts are having the intended results. There is, however, significant room for continued improvement and stability, before there is labor stability in the sector.

Additional Key Sector Issues

- Providers may violate debt service coverage covenants in 2022 and potentially in 2023. Financial covenants traditionally have "consultant call in" provisions that can last two years. Given the first-year grace period, 2023 is the year we could see defaults, particularly if non-operating losses continue due to investment market uncertainty. If waivers are not granted, there could be acceleration on some credits; conversely, if the investment market stabilizes and rebounds, year two covenant breaches may be much more limited.
- Variant uncertainty: Currently the best thinking is that the coronavirus has, or will, become very similar to non-seasonal influenza, requiring yearly (perhaps more) vaccine shots to provide protection against serious illness. Current dominant variants are very transmissible, but generally have not contributed to excessive hospitalizations. If the virus and its subsequent lineages continue to weaken, providers may face even fewer cases and fewer operational disruptions. Conversely, if a highly transmissible and deadly variant emerges, this could result in significant disruption to inpatient volumes and staffing availability at hospitals, particularly if vaccination rates moderate. Such an event would reduce revenues and increase expenses similar to what was experienced by many in the first several months of 2022 when the Omicron surge hit its peak.

Liquidity Levels Falling from All Time Highs

Equity markets appreciated significantly for much of 2021, as the Dow exceeded 36,000 at year-end. This helped providers reach all-time highs in liquidity with the median days' cash on hand reaching 260 days in 2021. Markets have been volatile in 2022, with the Dow slipping below 30,000 in the middle of June 2022 and again in late September (equity market recovered through October). The cash accumulated through much of 2021, and in prior years, has allowed health systems to weather the current macroeconomic labor and inflationary challenges, at least over the short term. Providers with particularly robust balance sheets should expect rating stability as liquidity continues to support credit strength in an environment where the financial strength of providers is assaulted on many fronts. Contrarily, health systems with comparatively thin balance sheets for the rating category are more likely to face negative rating pressure in the current environment.

Hospitals continue to reinvest in capital assets. Many providers took a pause on key capex during the early days of the pandemic in an effort to preserve liquidity. Still cooled, the pace of capital spending for the sector is just above annual depreciation expense at 100.4% in our 2021 medians, compared to fairly stable 117% prior to Covid-19. Capital plans for most of Fitch's rated hospital systems are focused on outpatient and technology with less focus on traditional inpatient beds.

Merger & Acquisition Activity — Temporarily Slowed

Given sector operational challenges, both collaboration among providers and outright necessity may lead to increased M&A activity in the future, but regulators are expected to resist this effort for the time being. It remains to be seen if the current regulatory and legislative environment will continue to limit M&A activity for health systems operating in the same market, or if cross-market mergers will become the new norm. The current merger between Advocate Aurora Health and Atrium Health is by far the most intriguing. While such mergers appear more palatable to regulators, operational synergies may be limited to clinical and back office areas. Longer term goals for Advocate Aurora Health and Atrium Health, however, may not be focused on cost-savings, but rather remedying long-standing flaws in the healthcare system writ large, such as access, and healthcare disparities based on ethnicity and socioeconomic status.

Location, Location, Location

Local economics has emerged, and will likely continue, as an even more important factor in determining hospital credit quality. Service areas with strong population growth and more favorable payor mixes are providing added top-line revenue opportunities, and helping to balance expense challenges. In terms of labor availability, robust population growth affords access to a larger workforce, which appears to be alleviating some more immediate staffing needs, though this by no means solves the labor shortage completely. In addition to labor, generous population growth is also simply providing more access to additional patients, helping to return volume to pre-pandemic levels, or in some cases exceeding it. While a favorable demographic service area, particularly in population growth, is helping, providers can also expect to see elevated capital spending needs in these markets in order to meet the growing population/patient base. Since the immediate pressure point for providers surrounds issues of revenues and expenses, Fitch believes that the pros to be gained in a high growth market outweigh the longer-term cons of a high growth market in the form of elevated capital spending.

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Outlooks and Related Research

2023 Outlooks
Global Economic Outlook (June 2022)
Fitch Ratings 2022 Mid-Year Outlook: U.S. Not-For-Profit Hospitals and Health Systems
U.S. Not-for-Profit Hospitals and Health Systems Face Mounting Operating Stress
Fitch Wire: Staffing Shortage Has Long Term Effects
Fitch Wire: Relentless Cyber Attacks to Pressure NFP Hospitals' Operations
Fitch Wire: Surge in Coronavirus Infections Pressure NFP Hospital Margins

Analysts

Kevin Holloran
+1 512-813-5700
kevin.holloran@fitchratings.com

Mark Pascaris
+1 312-368-3135
mark.pascaris@fitchratings.com

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