Are Hospital Munis on the Mend?

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Notes from the Municipal Bond Desk

Brad Bode

Sr. Municipal Credit Analyst

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Finding value in the municipal bond (muni) market often involves investing in out-of-benchmark sectors, such as the hospital sector. Although riskier than some other sectors, many active managers, including American Century Investments, have favored investments in hospital bonds given their attractive yields and heterogenous characteristics. However, the sector is facing unprecedented challenges amid the COVID-19 pandemic. Brad Bode, senior municipal credit analyst, explains the virus's effect on the sector and assesses the current health of hospital munis.

How severely did the pandemic hurt hospital revenues?

In mid-March, the rapid spread of the COVID-19 virus forced many hospitals to cancel elective procedures to make room for potential coronavirus patients. As a result, revenue at many hospitals declined 30% to 60% over a two-month period. To partially offset this rapid and steep decline and shore up liquidity, the federal government provided stimulus funds through Coronavirus Aid, Relief and Economic Security (CARES) Act grants and accelerated Medicare payments (the latter of which hospitals must pay back beginning in the second half of the year).

Only a portion of the federal stimulus hospitals have received to date was recognized as revenue on income statements through June 30, 2020. Other stimulus funds will appear as revenue on third- and fourth-quarter income statements. Therefore, we expect many hospitals to suffer significant operating losses through the first half of 2020, with improvements in the second half of the year.

With the number of coronavirus hospitalizations slowing, are operations returning to normal?

Hospitals began ramping up elective procedures again in May. By the end of July, volume at many hospitals had returned to near pre-COVID levels. Nevertheless, the resumption of elective procedures doesn't mean the hospital sector's challenges have ended. Hospitals have been resilient to past crises, federal regulatory changes and recessions, but the COVID-19 pandemic has presented extraordinary challenges. Longer-term economic pressures stemming from the pandemic may affect hospitals and consumers for several years.

Some expenses, such as costs for additional cleaning crews and time lost to patient staging/distancing, will continue to weigh on hospitals in the near term. Additionally, because hospitals must stock up on supplies to deal with COVID-19, their expenses for personal protective equipment (PPE) also have increased. Most hospital management teams have been diligent about reducing expenses where they can, but none were prepared for these significant additional costs.

We believe they have learned lessons to use if or when a COVID-19 spike occurs again. They also adapted to the stay-at-home protocol by implementing initiatives such as telehealth. Hospitals likely will continue to use telehealth services to help minimize the effects of localized COVID-19 outbreaks until a vaccine or effective treatment options are available.

Are hospitals' financial ills improving?

Hospitals typically experience lower operating margins during and immediately following recessions, as people lose jobs and insurance. We expect hospitals' operating margins to rebound sharply in fiscal 2021, but we don't believe operating margins will recover to 2019 levels until 2022 or later. That's because it will take time for some patients to feel comfortable going to a hospital again and for those who have lost their jobs to find work (and insurance) again.

What does this mean for hospital munis?

We believe hospitals with higher credit ratings have enough financial cushion to absorb the disruptions caused by the pandemic, including lower revenues and higher expenses. Lower-rated and smaller, single-site hospitals that typically have lower liquidity levels and higher debt levels are more vulnerable. But even these hospitals have dodged severe liquidity crises thanks to federal stimulus funds and quick executive action on expenses.

We don't expect widespread ratings downgrades as a result of the pandemic, but lower-quality hospitals are more vulnerable. Hospitals with AA credit ratings are typically large national or regional systems that have considerable scale and size and typically have strong liquidity. The sector's A-rated category is more evenly distributed among small, medium and large hospitals. The BBB rating category typically contains small- and medium-sized hospitals. Hospitals with below-investment-grade credit ratings are typically small hospitals and often include facilities with fewer than 100 beds or critical access hospitals with 25 or fewer beds.

Are you still finding attractive investments in the sector?

Periods of market disruption often lead to opportunities for active investors. Recently, our bottom-up research process has identified such opportunities among high-quality new issuers that we believe are attractively priced. Market disruptions also provide a chance to review existing portfolio holdings to help ensure the munis we continue to own remain well positioned to weather current challenges.

Glossary

Credit ratings. Credit ratings are measurements of quality assigned by a Credit Rating Agency to issuers of certain types of debt obligations as well as the debt instruments themselves. Securities and issuers rated AAA to BBB are considered/perceived "investment-grade"; those rated below BBB are considered/perceived non-investment-grade or more speculative.

Income Statement. A financial statement that indicates how profitable a business was over a specific reporting period.

Investment-grade. Typically used in reference to fixed income securities that possess relatively high credit quality and have credit ratings in the upper ranges of those provided by credit rating services. Using Standard & Poor's ratings as the benchmark, investment-grade securities are those rated from AAA at the highest end to BBB- at the lowest. To earn these ratings, securities, in the judgment of the rating agency, are projected to have relatively low default risk.

Liquidity. The amount of easy-to-access capital (cash) available to a company.

Municipal securities (munis). Debt securities typically issued by or on behalf of U.S. state and local governments, their agencies or authorities to raise money for a variety of public purposes, including financing for state and local governments as well as financing for specific projects and public facilities. In addition to their specific set of issuers, the defining characteristic of munis is their tax status. The interest income earned on most munis is exempt from federal income taxes. Interest payments are also generally exempt from state taxes if the bond owner resides within the state that issued the security. The same rule applies to local taxes. The two main types of munis are general obligation bonds (GOs) and revenue bonds. Revenue bonds are secured by the charges tied to the use of the facilities financed by the bonds.

Operating margin. Determines the profitability of a business by measuring how much the company earns from sales-related activity, after accounting for production costs (raw materials, wages) but before paying interest and taxes.

Revenue. The total amount of income generated by the sale of goods or services.

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The letter ratings indicate that credit worthiness of the underlying bonds in the portfolio and generally range from AAA (highest) to D (lowest).

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American Century Investments ®

4500 Main Street
Kansas City, MO 64111
1-866-628-8826

330 Madison Avenue
New York, NY 10017
1-866-628-8826

1665 Charleston Road
Mountain View, CA 94043
1-866-628-8826

2121 Rosecrans Avenue
El Segundo, CA 90245
1-866-628-8826

2 Ice House Street
Central, Hong Kong
+852 3405 2600

12 Henrietta Street
London, WC2E 8LH
+44 20 7024 7080

1 Farrer Place
Sydney, NSW 2000
+61 2 8823 3403

Taunusanlage 8
60329 Frankfurt, Germany
+49 69 8088 5501