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Healthcare and Pharma Credit Rounds: 2Q22

Rating Actions Increasingly Negative

"Global supply chain disruptions and inflationary pressures are challenging some U.S. healthcare companies. Rating actions are issuer specific, despite generally secular headwinds, given differing amounts of headroom."

Britton Costa, CFA, Managing Director

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Inflation Reduction Act Passes

Fitch Ratings considers pharmaceutical drug price elements in the Inflation Reduction Act (IRA) to be credit negative as the act will pressure revenues and margins. This is particularly true for branded manufacturers as the IRA allows Medicare to negotiate the price of high-priced, single-source drugs in 2026, among other provisions.

However, the timing and likelihood of rating actions will depend on the direct effect on individual issuers and their responses, such as altering capital allocation, managing higher leverage on lower EBITDA, or identifying other methods to offset revenue declines elsewhere.

Manifesting Headwinds Drive Negative Actions

The typically economically resilient healthcare sector saw an elevated number of negative rating actions in recent weeks. The catalysts were largely secular, while rating actions are issuer-specific and not secular.

Issuers with limited rating headroom or stretched balance sheets after recent M&A are finding it more challenging to reduce leverage. This is amid market headwinds, such as inflation and supply chain disruption. We revised Community Health Systems, Inc.'s Rating Outlook to Negative as the provider saw precipitous declines in EBITDA due to continued use of expensive temp labor and some volume weakness.

We revised Baxter International Inc.'s and ICU Medical, Inc.'s Rating Outlooks to Negative, as inflationary pressures eroded cost synergies from recent acquisitions the issuers were relying on to delever. These headwinds are also reducing the sector's cash flow conversion as supply chain issues lead to building excess inventory to meet demand and some inventory remains in-progress.

The sourcing of more materials and inputs earlier, and at higher prices than usual are resulting in reduced margins and, in some instances, foregone revenue when issuers were unable to procure enough to meet demand.

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Healthcare Credit Rounds' Sub-Sector Comparison

Sub-Sector	Performance and Expectations Compared with Rating Case Assumptions	Key Themes from the Most Recent Quarter	What Are We Watching?	Legislation and Regulation
Hospitals	**In Line to Below Expectations** Hospital providers delivered revenue and EBITDA growth in 2Q22 in line with, and below, our expectations due to coronavirus-elevated pressures on labor costs and volumes. Labor costs are reflecting staffing shortages driving up full-time employee compensation costs and needs for temporary staffing, entailing outlier-level unit costs. While operating costs in other areas are generally well managed, margins were moderately to materially affected as labor is by far the largest component of the cost structure for providers. However, balance sheets across the group are generally in solid shape and most companies are continuing to generate solid FCF with credit statistics within our rating sensitivities. Managing discharges to avoid elongating length of stay and reducing temporary staffing costs are likely to remain top priorities. The highly-contagious Omicron variant accounted for a greater share of 1Q22 admissions than the 5%–10% that was coronavirus-related in 2021, although with a lower level of severity than the Delta variant. We expect improvement in volumes, patient acuity and payor mix to sustain higher revenue growth in 2H22. Inpatient capacity is still constrained by staffing shortages in certain cases and ambulatory care is outperforming amid the ongoing secular shift in volumes to outpatient settings and more favorable labor conditions. Providers are focusing on improving operations, containing costs and negotiating commercial rate increases commensurate with inflationary trends. These measures are likely to take several quarters, if not longer, to achieve the targeted effects. While fiscal 2023 Medicare inpatient rates were finalized with an improved 4% inflation update, this is clearly below recently-observed levels of cost inflation and commercial rate negotiations are likely to benefit providers only partially until 2024. Finally, we expect capex in 2022 to remain focused on investments in higher-growth outpatient care and higher-acuity inpatient service lines.	Volumes failed to rebound as the Omicron surge receded but are generally trending at or near pre-pandemic levels. Cost optimization efforts provided only a partial offset to coronavirus-driven inflation in labor costs, with notably less pressure on supplies expense, where favorable GPO contracting terms are containing costs. Shareholder-friendly activities returned but hospitals remain disciplined with capital deployment and maintain a commitment to stated leverage policies.	Payor and acuity mix trends. Pressure from staff turnover, wage inflation and temporary staffing. A focus on implementing new, innovative care models and pursuing technology investments to manage capacity and throughput with greater efficiency. Capital deployment and M&A activities, especially in-home health, virtual care, behavioral health and post-acute care. Refinancing activity amid higher volatility in the high-yield debt capital markets.	The three-year extension of enhanced subsidies for health insurance purchased via the ACA exchanges, price transparency requirements, the continuing implementation of the No Surprises Act and the end of the Medicare inpatient-only list also warrant monitoring.

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Healthcare REITs	**In Line** Performance in 2Q22 was in line with expectations as REITs and/or tenants continued to report steady occupancy growth. Omicron has not directly or meaningfully altered the recovery curve for senior housing and skilled nursing. However, skilled nursing's recovery is increasingly influenced by the labor market and underlying demand. Medical office buildings and life science buildings continue to exhibit stable occupancy rates and remain attractive due to long-term secular demand of outpatient services.	Operator rent deferrals and/or non-payments were in line with our expectations as occupancy rates increased and property-level operating costs (labor and non-labor) moderated. Labor shortages continue to affect new admission rates in SNFs, as the facilities have government-manded staffing requirements. Senior housing pricing power is strong driven by a combination of improved occupancy and accelerating rent growth. The slowdown in new senior housing inventory growth, acting as a tailwind, is further supporting occupancy growth.	The extent to which staffing shortages, new variants, and vaccination mandates limit the recovery of the SNF sector, both in terms of magnitude and timing. Whether there will be an increase in permanent rent cuts and/or operators deferring or not paying rent payments due to operational difficulties and how will affected REITs offset increases in leverage. The extent to which senior housing rent growth, both asking and in place, will accelerate in order to offset higher but normalizing labor costs. How much of an effect will laboratory real estate demand and rent growth be affected by soft fundraising and valuations.	How much of an effect the final Medicare SNF rate increase of 2.7% on Oct. 1, 2022, will have on SNF rental non-payments. When the U.S. Department of Health and Human Services will give its 60-day notice prior to terminating the Public Health Emergency and its subsequent effect on SNF occupancy recovery. Whether plans to improve oversight and quality controls at SNFs announced by the Biden administration in 1Q22 have a meaningful effect on margins and the ability to meet rent payments.
Generic Pharma	**In Line** Generic revenue in 2Q22 continued to slide downward, relative to expectations, primarily due to the strengthening U.S. dollar but showed growth in local currency terms. Volumes remain stable in the face of persistent price pressure caused by competition offset by new product sales and volumes on existing products. Our overall performance expectations for YE 2022 were adjusted lower to reflect the above headwinds but will depend heavily on the timing of approvals and launches.	Macroeconomic headwinds acceleration, increased inflation, higher interest rates and a stronger U.S. dollar. Generic price deflation assumptions remain stable in the mid-single digits. Sales volumes in 2022 continue to accelerate, relative to 2021, due to less disruption from the pandemic and higher launch activity. Biosimilar therapies appear to be accelerating according to a recent report by Amgen. This will continue to be a key area of focus due to sluggish generic sales. Supply discontinuities appear to be modest.	Growth in revenue from new product launches, especially involving complex generics and biosimilars. Management of R&D, SG&A expenses and persistent FX headwinds on revenue. Speed to market and the effects of the U.S. FDA approval process on planned new launches. Manufacturing scale, R&D capabilities and development expertise appear key to biosimilar launches. Supply chain stability and script growth. On a global level how coronavirus variants present challenges for patient access to healthcare, which may affect script volumes.	Expectations are for modest effects on drug prices resulting from the Inflation Reduction Act. Over the long term, a new approach for Medicare negotiation of drug prices may be credit negative. Whether inflation dampens generic price deflation. Whether new drug price legislation affects the strategy of planned generics and biosimilars. Effects of a new U.S. "book minimum tax" and excise tax on share repurchases affect capital allocation plans, if at all.

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Branded Pharma	**In Line** Organic performance in 2Q22 was generally in line with expectations. Progress on pipelines continue. A low- to mid-single-digit negative FX effect on revenue was somewhat beneficial to outside the U.S. costs. Pricing pressure was mitigated by increases in usage.	Increased utilization persists. Pipeline products continued to advance. M&A continued to be targeted. Pricing remained relatively constrained. Inflationary and supply-chain issues modest. Low- to mid-single-digit negative FX-related revenue effects. Geopolitical conflicts not significantly affecting operations, including R&D.	The incidence and trend of any additional coronavirus variants. How Medicare applies the Inflation Reduction Act, particularly regarding how it chooses the drugs for which it will negotiate prices. Level of consistency in R&D efforts.	Which drugs and pharmaceutical firms will be affected by the Inflation Reduction Act and how will the biopharmaceutical industry and commercial payers respond. What will negotiation entail. Will there be a benefit from increased usage from limiting out-of-pocket expenses that mitigate the pricing pressure from the Inflation Reduction Act.
Distributors	**In Line** Performance in 2Q22 remained resilient in pharmaceutical segments, while the medical segments continued to underperform due to supply chain cost headwinds. Our expectation for the medical segments was lowered to reflect persistent inflationary headwinds but varies by issuer to reflect mitigating strategies.	Macroeconomic headwind acceleration, increased inflation, higher interest rates and a stronger U.S. dollar. Medical segments reflecting strains within global supply chains and hospital staffing constraints influencing the level of procedures resulting in reduced hospital demand. Funded debt declined significantly over the past two years and is expected to stabilize over the near term. The resolution of opioid litigation resulted in a shift in capital deployment back to share purchases and selective M&A activity. Pharma sales growth continues to be driven by specialty drugs and by specialty drug services, despite declines in coronavirus treatments offset by branded to generic conversions. The medical segment continues to experience headwinds from supply chain inflationary pressure, offset by tailwinds driven by increased patient visits, elective procedures, and contributions from ancillary supplies. Distributors with manufacturing capabilities are better able to navigate current inflationary cost pressures compared with those lacking such capabilities. Demand for personal protective equipment shows signs of slowing down.	The depth and duration of inflationary trends, pricing strategies and customer behavior. Effects of declining vaccine volumes in 2022. The durability of testing demand. Whether generic drug deflation will remain in line with expectations set at the start of 2022. Growth in launches and distribution of biosimilars. Capital allocation decisions following the resolution of large opioid litigation settlements.	A derivative of those faced by branded and generic pharmaceuticals.

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Medical Devices	**In Line** Performance in 2Q22 was generally in line with expectations. Products relying heavily on electronic component inputs were most adversely disrupted. The negative FX effect on revenue was partially offset by price increases.	Elective procedures recovery was strong across the globe, especially outside of the U.S. Continued semiconductor and other input material shortages. Backorder caused by shortages of raw materials or components could translate into permanent revenue loss. Manufacturers with secondary suppliers are better managing supply chain pressures. Continued hospital staffing challenges affecting implementation of new equipment. Accelerated price increases to partially offset macroeconomic headwinds. Balance sheets remain healthy amid headwinds. Balancing working capital management versus business development.	Change in macroeconomic headwinds. Threats of recession and industry's ability to withstand it. Management of supply chain pressures. Elective procedures backlog recovery at or above normalized levels. Slowdown of hospital capital spending. Further lockdowns in China.	Generally stable.
Diagnostics	**In Line** Performance in 2Q22 was in line with expectations. Continued increases in demand for core diagnostics and life science products helped weather the fall from coronavirus testing revenue declining meaningfully in 2Q22.	Strong demand in core diagnostics and life sciences enabling products. Companies with larger exposures in instruments are more adversely affected by supply chain issues and slowed laboratory capital spending. Accelerated price increases to partially offset macroeconomic headwinds, which are generally managed with internal initiatives and price increases. Balance sheets remain strong. Financial flexibility continues to provide moderate runway for deal activity in 2022–2023. Further shifting focus away from cyclical business segments.	Mindfulness of credit metrics as companies continue to look to backfill growth with M&A. Change in macroeconomic headwinds. Durability of organic growth in base business. Sustainability of margin levels as pandemic-related product revenue declines in 2022. Slowdown of laboratory capital spending. Further lockdowns in China.	Generally stable.

GPO – Group purchasing organization. ACA – Affordable Care Act. SNF – Skilled nursing facilities. SG&A – Selling, general and administrative. FDA – Food and Drug Administration.
Source: Fitch Ratings.

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What We Are Watching for in North American Healthcare and Pharma: Familiar Topics at the Forefront

North American Healthcare and Pharma

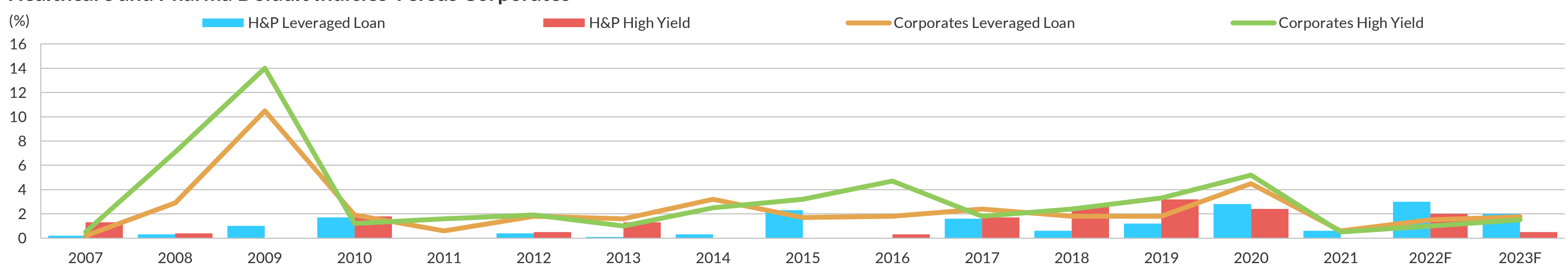
- **Operating Fundamentals**
  - Inflation (MT)
  - Durable Demand (LT)
  - Cyber Incident Risk and Governance (LT)
- **Capital Allocation**
  - Strategic M&A (LT) & Portfolio Culling (MT)
  - Resolution of Contingent Liabilities (e.g. Opioid Litigation)
- **Legislation & Regulation**
  - Drug Pricing (LT)
  - Antitrust Enforcement (MT)
  - Corporate Taxes (LT)

ST – Short term. MT – Medium term. LT – Long term.
Source: Fitch Ratings.

Default Insights: Healthcare and Pharma to Increase in 2022

Additional information on our insights and expectations for Leveraged Loan and High-Yield defaults, including methodology, can be found in our most recent published reports.

Healthcare and Pharma Default Indicies Versus Corporates



H&P – Healthcare and Pharma. F – Forecast.
Source: Fitch U.S. High Yield Default Index, Fitch U.S. Leveraged Loan Default Index, Refinitiv LPC, Bloomberg.

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Issuers with Non-Stable Outlooks

Issuer	IDR	Outlook	Key Downgrade Trigger	Key Upgrade Trigger
Bausch Health Companies Inc. (BHC)	C	N.A.	Following the exchange offer's outcome, Fitch anticipates downgrading the rating to 'RD' or Rating Default.	Fitch will reassess BHC's capital structure, liquidity and risk profile based on the outcome of the exchange offer to determine the IDR, secured and unsecured ratings.
Bausch + Lomb Corporation (BL)	B+	RWE	Evidence of factors relating to ringfencing and access and control leading Fitch to rate BL on a consolidated basis with BHC, or one notch rather than two notches. A downgrade of BHC.	Fitch viewing BHC on a standalone basis. An upgrade of BHC.
Baxter International	BBB	Negative	Gross leverage durably above 3.0x without the prospect for timely deleveraging. FCF/total debt durably below 10%.	Gross leverage durably below 2.5x. FCF/total debt durably above 15%.
Boston Scientific Corporation	BBB	Positive	Gross leverage above 3.0x. FCF/debt below 10%. Acquisitions without the prospect of timely debt repayment.	Gross leverage below 2.5x. FCF/debt at or above 15%.
Community Health Systems	B–	Negative	Gross leverage sustaining above 8.0x. Neutral to negative CFO after capex/total debt.	Gross leverage sustaining below 7.0x. CFO after capex/total debt above 2.5%.
Elanco Animal Health Incorporated	BB	Negative	Significant progress on reducing gross leverage through debt reduction and execution on the integration of two recent acquisitions could lead to a revision in the Outlook to Stable. Gross leverage sustaining above 4.5x and/or continued erosion in antibiotic demand without sufficient offsets could lead to a downgrade.	Successful execution of growth and productivity initiatives. Gross leverage sustaining below 3.5x. FCF/gross debt sustaining above 10%. Continued improvements in the issuer's scale and relative competitive position.
ICU Medical	BB	Negative	Fitch's expectation of significant effects from inflation and supply chain issues and/or declining growth prospects leading to EBITDA and FCF margins sustained below 18% and 6%, respectively. Gross leverage above 4.0x. CFO–capex/total debt sustained below 10%.	Fitch's expectation of modest effects from inflation and supply chain issues and/or significant synergies realized from Smiths Medical leading to EBITDA and FCF margins sustained above 23% and 8%, respectively. Gross leverage below 3.0x. CFO–capex/total debt sustained above 15%.
Jazz Pharmaceuticals, Inc.	BB–	Positive	Loss of Oxybate revenue without offsetting growth in other products. A large debt-funded transaction or large investments in IP and R&D causing total debt/EBITDA to be sustained above 4.5x and CFO–capex/total debt with equity credit less than 5%.	Expectations of revenue CAGR over the forecast period of 12% or higher including royalties for Xyrem. Total debt/EBITDA sustained below 4.0x and CFO–capex/total debt with equity credit greater than 10%.
Mozart Holdings, L.P.	B+	Negative	Expectation of sustaining gross debt/EBITDA, including secured mortgage debt at, or above, 6.0x by fiscal year-end 2023. FCF is not used principally for debt reduction. The total revenue growth rate declines to low-to-mid-single digits as a result of customer turnover and price concessions. Expectation of EBITDA margins falling below 10% and FCF/debt remaining consistently below 5%.	Expectation of sustaining gross debt/EBITDA, including secured mortgage debt at, or below, 5.0x by fiscal year-end 2023. FCF of about $750 million a year to $1.0 billion a year is applied to the reduction of debt over the next three years. Operational strength demonstrated by customer retention and market share growth leading to increasing CFO. Expectation of EBITDA margins remaining above 13%. FCF/debt remains consistently above 10%.
P&L Development, LLC	CCC+	N.A.	Further pressure on the credit profile stemming from operational stress, leading to increasing leverage without the prospect of a timely turnaround. Operating stress that leads to stressed liquidity. A persistently negative operational trend that would significantly strain FCF, making it difficult to execute on core operating and business development activities.	Continued advancing revenue supported by some core product categories, recently launched products and new product development. Improving margins through cost control, higher growth in newer products and pricing leading to sustainably neutral to positive FCF. Gross leverage, measured as total debt/EBITDA, to remain durably at or below 7.0x.
Team Health Holdings, Inc.	CCC+	Positive	FFO fixed-charge coverage below 1.0x. FCF deficit requiring incremental debt funding. Continued deterioration in margins. An expectation the company will violate the debt agreement financial maintenance covenant and be unable to secure relief from lenders. An expectation the company will not be able to refinance the revolving credit facility due in 2022 or secure alternative sources of liquidity.	Expectation leverage will be sustained below 8.0x. FFO fixed-charge coverage of at least 1.5x. Profit margin stabilization. At least break-even FCF.

IDR – Issuer Default Rating. RWE – Rating Watch Evolving. CFO – Cash flow from operations. IP – Intellectual property. N.A. – Not applicable.
Source: Fitch Ratings.

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