HEALTH CAPITAL Topics
Volume 17
Issue 9
September 2024
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Hospital Operations Finally Rebound Post-COVID

For the first time since the COVID-19 pandemic, hospitals are finally reporting sustained, improved financial and operational performance. To date in 2024, hospitals have seen better margins, increased patient utilization, and a more stabilized workforce. Another result of this improved performance has been an increase in hospital transactional activity. This Health Capital Topics article reviews the hospital sector performance to date, factors driving this improvement, and the impact on hospital transactional activity.

Hospitals were arguably the providers most acutely affected by the COVID-19 global pandemic. In April 2020, for example, hospital operating margins nosedived to -40%.[1] Despite receiving billions of dollars in government funding to offset substantial financial losses during the worst of the pandemic,[2] hospitals continued to suffer for years after, with the worst year for hospitals financially not occurring until 2022. That year, hospitals experienced declines in nearly every financial metric.[3] Although hospitals continue to struggle to return their operations to pre-COVID metrics, recent reports from hospitals suggest that better days may have returned, culminating a 4 ½-year journey back to normal.

Post-pandemic, hospitals have reported continuing (albeit improving) labor shortages, capacity issues, and increasing expenses. While some providers attribute these challenges directly to the pandemic, others consider such headwinds the "new status quo."[4] At the same time, these challenges are partially ameliorated by increases in hospital utilization that have resulted in increased revenues.[5]

Credit rating agency Fitch Ratings predicted that hospitals' operating margins would increase an average of 1.6% in 2024, compared to a growth of only 0.5% to 0.7% in 2023.[6] As of July 2024, hospitals' median operating margin was 4.1%, significantly outperforming expectations.[7] These trends have been confirmed by multiple health systems in their mid-year reports.[8] While operating margins are still below pre-pandemic levels, they are predicted to fully rebound by 2026.[9] Other measures of financial performance are similarly trending better. The median monthly operating index through July 2024 was 3.8%, much higher than the index at the same time in 2023 (1.3%) and 2022 (-0.98%),[10] and hospitals' cash on hand is at 220 days (median), close to pre-pandemic levels.[11]

Despite these encouraging trends, industry analysts note that this growth is not uniform; there is a growing division between the hospitals that are performing well and those that continue to struggle.[12] Up to 40% of hospitals are still operating in the red.[13] The main differences between the "haves" and the "have nots" is largely that the stronger-performing hospitals have embraced the shift to outpatient care, which tends to generate a higher margin.[14]

Operating margin improvements are being driven by stabilization in labor (typically the largest expense for hospitals), increases in patient volume, and decreases in average lengths of stay.

A September 2024 Fitch Ratings report found that hospitals' labor problem has largely stabilized. Wage inflation has "cool[ed] to more sustainable levels," with average wages growing approximately 3% in 2024, compared to 4.2% in 2023 and 8% in 2021-2022.[15] Wages escalated quickly during the pandemic in an effort to reflect the increased hazard of front-line work, meet the changing demand for healthcare services, and counter high turnover rates. To fill those labor gaps, many hospitals were forced to utilize costlier outside labor (e.g., locum tenens).[16] Notably, the demand for healthcare services has remained high over the last couple years due to pent-up demand, i.e., increased utilization from patients who deferred care during the pandemic, which has resulted in a continuing, critical need for healthcare workers. In addition to stabilizing wages, hospital job openings have also decreased, although they are not yet at pre-pandemic levels.[17] Fitch Ratings predicts that healthcare labor, particularly for non-profit hospitals, will return to "some semblance of normal" by the end of 2024.[18]

Patient volume in hospital emergency departments (EDs) grew approximately 4% from 2023 to 2024, back to pre-pandemic levels, which helped to improve operating margins by 21% during that time.[19] Over the next decade, ED utilization is expected to increase another 4%[20] as the Baby Boomers, nearly all of whom have aged into the age 65+ age cohort, will require more healthcare services. While ED utilization increased, the average lengths of stay in hospitals decreased 3% for the year,[21] likely due to reduced patient acuity with the abatement of the pandemic, improved patient throughput across the healthcare delivery system, and the continued shift in care to the outpatient setting. Reducing the length of stay

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has the dual effect of decreasing hospital expenses and improving outcomes (which can result in additional incentives from Medicare).[22]

Improved financial performance across the hospital sector, and particularly among potential hospital acquirers, is driving increased transactional activity.[23] With extra cash on hand due to improved profitability, many transactional advisors predict that the number of hospital deals will increase. There were 20 hospital transactions announced, totaling $12 billion, in the first quarter of 2024 – the highest number since before the pandemic.[24] That activity slowed to only 11 transactions in the second quarter; however, the total number of hospital transactions for the year is expected to be similar to 2023's total of 65 announced deals.[25] For context, hospital transactional activity hit its peak in 2017, with 117 announced transactions; that level of activity is not expected to return, due not just to pandemic-related financial struggles, but also to increased regulatory oversight and enforcement of hospital transactions.[26] Nevertheless, industry analysts expect increased acquisitions of community hospitals by academic medical centers and transactional activity from large health systems selling off less-profitable hospitals or – in the case of Steward Health – all of its 33 hospitals as part of its Chapter 11 bankruptcy case.[27]

On September 18, 2024, the Federal Reserve cut interest rates by 0.5%, the first rate reduction in four years.[28] The federal funds rate now stands at approximately 4.9%, down from an over two-decade high, and is expected to see additional cuts over the next couple of years.[29] This cut will likely have a significant effect on hospitals and their operations. For example, decreasing borrowing costs may further stimulate hospital transactional activity, as hospitals will have access to more capital that could be utilized to expand their facilities or acquire other providers. Lower interest rates can also positively impact hospital valuations. Lower interest rates may be particularly helpful for hospitals that have seen their expenses continue to increase, up an average of 8% from 2023.[30] As interest rates are anticipated to decrease further in the coming months, this may be just what the doctor ordered to bring hospitals back to level footing and the "new normal" in healthcare delivery.

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