High Yield | Leveraged Credit

Taking a shine to acute care hospitals post-pandemic

By: James Croom, CFA | & Stephen C. Concannon, CFA | June 8, 2021

Boston - Earlier in the year, we saw fairly consistent leadership in the high-yield market by some of the more cyclical sectors, led by entertainment & film, air transportation, publishing & printing and energy. One area in particular that has captured our attention is acute care hospitals.

Health care is approximately 9% of the ICE BofA U.S. High Yield Index and continues to be the largest overweight position in our portfolios, although we have reduced it somewhat in 2021. Within the sector, health care facilities is the largest subsector, at a little under 4%, and includes acute care hospitals.

Acute care hospitals well positioned

Acute care hospitals performed well throughout the pandemic and, in our view, the group appears well positioned as economic recovery moves forward. Importantly, before the pandemic hit, many of these hospitals were cutting costs and focusing on more profitable service lines, such as cancer and orthopedics. The pandemic forced acute care hospitals to accelerate their cost reduction efforts — bolstered by government support from the CARES act and other policy measures — and many hospitals expect these savings to continue into 2021. These actions have resulted in hospital balance sheets being in the best shape we have seen in years.

Some of the larger providers that had the best EBITDA[1] margins have already been able to repay all the government funds received in 2020. For the weaker players going into the pandemic, some were able to leverage the strength of the high-yield market and the incremental liquidity to refinance near-term maturities at much more attractive rates. In one case, for example, the hospital system saved almost $200 million in cash interest expense.

We think acute care hospital fundamentals look strong for the balance of 2021 and going into 2022. Current U.S. government health care policies and rising employment levels are positives for a broader patient payer mix — the percentage of patients with government or commercial private health care insurance. In addition, many hospital systems have been investing in alternative sites of care, such as freestanding emergency departments, urgent care centers and ambulatory surgery centers. This started before the pandemic and allows these health systems to capture more patients in their networks.

Further, we think several acute care hospitals are well positioned for ratings agency upgrades, which may result in incremental spread tightening. We believe the ratings agencies are focused on scale, revenue diversity, free-cash-flow generation and capital allocation.

Retail and other more challenging areas

Conversely, we see challenges among some formerly strong performers. We are finding fewer opportunities in the retail space, where we believe robust performance resulted from the unique circumstances created by COVID — and is not likely to be replicated. We think certain subsectors like grocery stores and parts of specialty retailers are likely to see their results and credit profiles revert to what they looked like pre-COVID. If so, we think there could be some spread widening in certain parts of that space.

On the margin, we are also growing more cautious in our views on energy. U.S. producers are exercising more supply discipline and demonstrating more focus on balance sheet sustainability; however, OPEC's supply discipline and future demand curves present risk.

Bottom line: As a result of the pandemic, certain market sectors have seen supersized, perhaps somewhat artificial, gains. In other areas, such as acute care hospitals, there has been cost cutting and restructuring efforts that have created attractive, long-term investment opportunities.

[1] EBITDA stands for earnings before interest, taxes, depreciation and amortization.

ICE BofA U.S. High Yield Index is an unmanaged index of below investment grade U.S. corporate bonds.

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investments is likely to decline.

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