CREDO WEALTH

A healthy outlook

HCA Healthcare, the largest “for-profit” hospital owner in the United States, presents an interesting case of a stock which could be a symbol of the times, encapsulating the rollercoaster of expectations investors have been through since the start of the year.

Even after the first reported death in the United States from COVID-19, there was still substantial debate between analysts as to what the impact of an outbreak in the US may look like for hospital providers such as HCA. Some supposed that it might be similar to a bad flu season, where hospitals actually see a benefit from increased volumes. Others were more pessimistic, predicting some delays in elective procedures and increased costs associated with shortages of medical supplies. Few predicted that western countries were on the verge of imposing full-scale lockdowns, as seen in China, and just how disruptive the virus would be on every aspect of life.

Days later, the call came from the American College of Surgeons for hospitals to “thoughtfully consider” the postponement of procedures. However, expectations for the ultimate number of procedures that would be postponed remained minimal. It is indicative of just how fast events unfolded that, in less than a week, channel checks showed that visits to the Emergency Room were down c.30%, outpatient surgical volumes and procedures were down over 50% and even inpatient surgical volumes were down between 30% and 50%. This, combined with the widely held assumption that hospital costs are almost wholly fixed, looked devastating for 2020 earnings. The stock cratered, falling almost 50% in under a month, significantly worse than the c.30% fall in the S&P 500 Index.

The hospital sector has historically been considered relatively defensive. Whilst consumers tend to cut back on discretionary expenditure during economic downturns, hospital procedures tend not to be as impacted. The relative stability of the sector disguises the fragility of the economic positions of many of the operators. Over 80% of the sector are “not-for-profit” operators with many running at around breakeven and around 1/3rd of hospitals in the US are considered to be struggling financially. Even in normal times, it would not be considered a favourable outcome if 30% of the hospitals in the country were to go bankrupt, let alone during a global pandemic.

Sure enough, in the face of a collapse in elective procedures and thus revenue, alongside an increase in costs associated with new safety protocols, the government stepped in to support the sector. This support came in the form of $100bn for healthcare providers. The $100bn covered healthcare related expenses or lost revenues that are directly attributable to COVID-19 and a boost to the Medicare rate paid for COVID-19 cases. It also included broad-based increases to reimbursement levels paid for government funded healthcare programs.

As the US began to start re-opening, reports of sequential improvements in hospital revenues started to come in. One of the reasons that hospitals are usually considered defensive is that many medical procedures simply cannot be postponed indefinitely. Evidence of pent-up demand started to emerge as medical claims recovered during May and June. Although utilisation would likely still be below pre-COVID-19 levels, we believed that the stimulus package provided a floor to earnings. With the stock still trading at a significant discount, we believed that the risk / reward looked attractive and increased our position in the fund in May and again in June.

Then, in July, HCA reported second quarter earnings which came in at over double that of consensus estimates. Although the company significantly benefitted from the stimulus bill, the most significant factor was the greater than expected ability to cut costs. The stock rallied. As cases across the US and in particular in Florida and Texas (where c.50% of HCA's capacity is located) started to fall through August and into September, the stock price continued to rise.

The dramatic changes in outlook for HCA over the past few months are typical of those seen by many stocks. Although the situation appears to have stabilised somewhat in recent weeks, as we head into the elections in the US, we may start to see increased volatility in expectations once again. Despite being a more moderate candidate than Sanders or Warren, a Biden presidency is widely seen as carrying more risk for the hospital sector than a Trump re-election. However, as we have seen, perception of risk often presents opportunities.

Biden broadly supports expansion of the Affordable Care Act and overall insurance coverage. He has publicly supported lowering the age for Medicare Eligibility to 60 from 65. Lowering the age limit may result in a negative impact on revenue mix, with many of these patients previously covered by private insurance and with government rates less than those paid by private insurance. Still, there may also be a positive impact from the increase in the number of insured people, reducing bad debtors. Ultimately, we believe that with many hospitals operating on razor thin margins, if the mix effect does turn out to be substantially negative, Medicare rates will increase to prevent widespread closures. Medicare rates are set nationally and so an increase in rates would benefit all players. This, we believe provides a floor to HCA's earnings and gives us comfort going into the election period.

However, if we have been reminded of anything during this period of volatility, it is of the opportunities presented for attractive returns, when expectations are low and reality happens to turn out better.

Important notice