

January 2025

## 2025 Credit and Capital Markets Outlook

**F**or the first time since 2017, all three agencies currently maintain a stable outlook on the not-for-profit healthcare sector after S&P and Fitch revised their outlooks. The reports cited stronger balance sheets through improved cash flow and market returns, with solid revenue and demand illustrating that the industry is stabilizing after rocky post-pandemic years.

While absolute levels of cash have increased, days cash on hand medians are still declining as expense growth has outpaced the growth of cash reserves.

Despite overall industry improvements, the divide between stronger and weaker performers continues to increase. Covenant violations have and are likely to continue to decline as performance stabilizes across the wider spectrum of credits but remain a concern for more challenged regions and lower-rated credits.

Other challenges to the sector include the still-challenged labor market, the continued difficult payer environment and potential policies from the new Trump administration contributing to continued uncertainty.

### Factors Influencing the 2025 Outlook

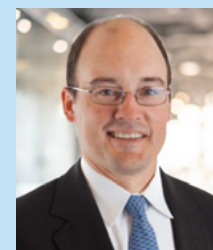
#### Governmental policy challenges

As the agenda of the new Trump administration came into focus, whispers began to circulate around potential spending cuts that would have a direct and adverse impact on healthcare organizations. It will be practically impossible for the new Department of Government Efficiency (DOGE) to cut \$1 trillion from the \$6 trillion budget (\$1.7 trillion discretionary spending in fiscal year 2022 after entitlements, interest and defense<sup>1</sup>) without affecting healthcare. The cost of extending the 2017 Tax Cuts and Jobs Act also will require offsetting spending cuts.

The potential for significant healthcare cuts was confirmed on January 17 when the House Ways and Means Committee released its list of items that could be on the chopping



**Bradley Dills**  
Vice President



**Jeffrey Sahrbeck**  
Managing Director

block to accommodate the extension of the 2017 Tax Cuts and Jobs Act.<sup>2</sup> Notable items contained in the initial list are the elimination of the tax-exempt status of municipal bonds, as well as the possibility of eliminating the not-for-profit status of hospitals and health systems entirely.

The tax-exempt status of not-for-profit healthcare entities is always on the list of possible cuts and every interest group, law firm and lobbyist we have consulted has said the likelihood of passage is very low. The tax-exempt status of municipal bonds is a more serious concern.

It is too early to say how, if enacted, these changes would be implemented, but some possibilities include:

- Preserving the tax exemption of existing municipal bonds while removing the ability to issue tax-exempt municipal debt going forward
- Capping the amount of tax-exempt debt healthcare entities can issue (previously used with colleges)
- The more extreme measure of an immediate removal of the tax-exemption on outstanding debt (the complications that would arise from this are difficult to contemplate and feel so draconian that we believe it would be almost impossible to pass with the constituencies aligned behind it)

While still in the initial stages, this is clearly something to watch as we get further into 2025.

<sup>1</sup> Congressional Budget Office, "[Discretionary Spending in Fiscal Year 2022: An Infographic](#)," March 28, 2023.

<sup>2</sup> Nick Hut, "[GOP Puts Ideas for Major Healthcare Spending Cuts in Writing](#)," HFMA, Jan. 20, 2025.

Despite an aggressive stance by the federal antitrust agencies, merger and acquisition (M&A) activity between hospitals and health systems has been steadily rebounding from pandemic lows.<sup>3</sup> It is too early to say what impact a change in the agencies' leadership might have on future M&A activity.

At the state level, 37 out of the 44 states that can implement supplemental funding mechanisms have done so.

**Length of stay reductions**

Volumes have returned to pre-pandemic levels for the industry as a whole (though disparities exist), powered by pent-up demand, a return to normal and declines in average length of stay; prior reliance on volume growth for margin has been replaced by a doubling-down on operations.

**Ambulatory expansion and partnerships**

Revenue growth has been primarily in the outpatient arena with inpatient relatively flat overall. The most recent Kaufman Hall National Hospital Flash Report data shows that year-to-date inpatient revenue per calendar day has increased 12% since 2021, while outpatient revenue has increased 31%.<sup>4</sup>

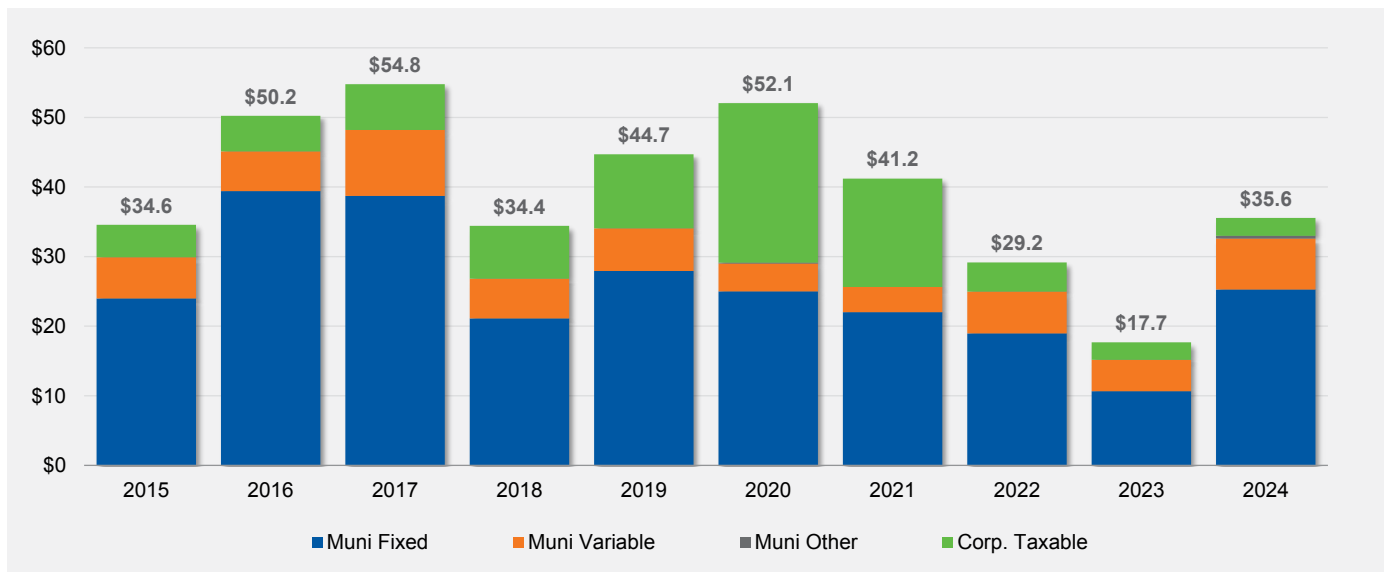
Successful growth strategies have been focused on patient access, primary care, ambulatory and accretive results; divestiture strategies are in place for low-volume, low-margin services or where capital needs outstrip cash flow. Health systems continue a shift away from financing legacy hospital builds to focus more on the ambulatory setting (including medical office buildings, freestanding emergency departments and surgery centers).

Partnerships and joint ventures continue to be a way for health systems to dip their toes into expansion strategies, especially around behavioral health and rehabilitation facilities with experienced service providers.

**Healthcare issuance volume rebounds in 2024, with expectation for continuation in 2025**

After three years of continued declines in healthcare bond market volume, 2024 saw a large rebound (a more than 100% increase year-over-year) and a return to longer-term average supply (Figure 1). That said, healthcare issuance as a percentage of the market still lagged, as the municipal market as a whole saw the highest level of issuance ever, with new money comprising over 86% of total issuance.<sup>5</sup>

**Figure 1: Healthcare Issuance More Than Doubled in 2024 (\$s in Billions)**



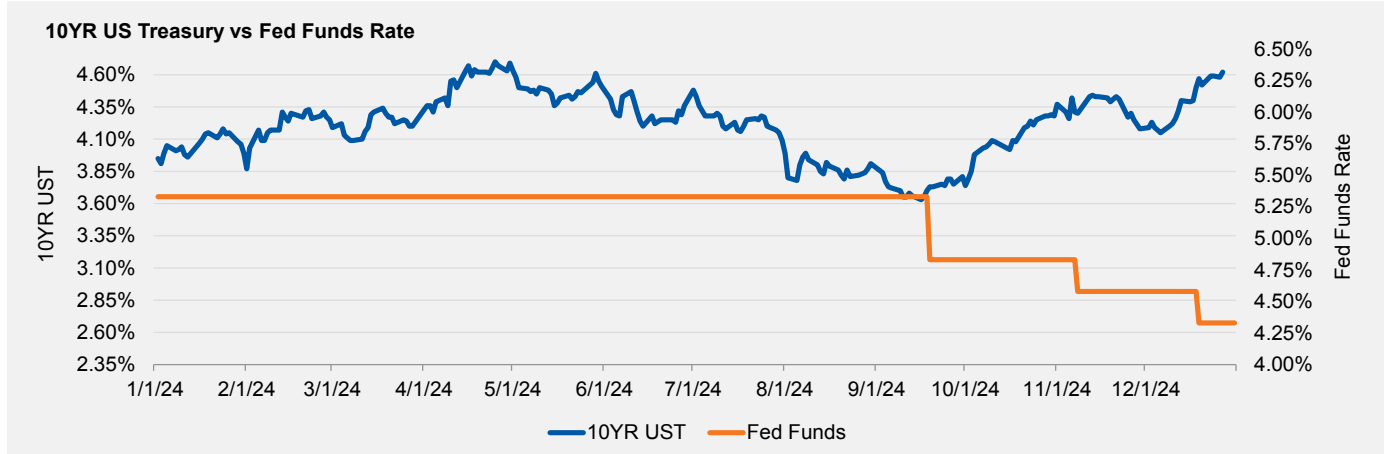
Source: Refinitiv, Bond Buyer

<sup>3</sup> Kaufman Hall, "Hospital and Health System M&A in Review: Despite Industry Stabilization, Numbers Reveal Ongoing Distress in 2024," Jan. 9, 2025.

<sup>4</sup> Kaufman Hall, "National Hospital Flash Report: November 2024 Metrics," Jan. 9, 2025.

<sup>5</sup> LSEG Data & Analytics, "United States Municipals Review: Full Year 2024"

**Figure 2: Fed Cuts Did Not Result in Lower Rates**



Source: Bloomberg, Refinitiv

Specific to healthcare, new issuance proceeds were primarily utilized for renovation and expansion of existing facilities and growth opportunities—especially around ambulatory expansion.

2025 is already off to hot start, with nearly \$3 billion of healthcare supply expected in January, including over \$1 billion for Orlando Health’s financing of certain acquisitions including five hospitals in Alabama.

**Fed approaching 2025 with caution**

A variation of a question we receive throughout the year is, “What is going to happen to interest rates?”, which we are always cautious to opine on. As it turns out, even the market is bad at answering this question.

Coming into 2024, the market consensus was for six 25 basis point rate cuts; instead, we saw four. The first Fed cut since 2019 took place in September when the Fed cut 50 basis points. At that time, the market expected five 25 basis point cuts in 2025, but as of late January 2025, the market only expects one additional 25 basis point cut in 2025.

Although some may have expected long-term rates to decline as the Fed began its cutting cycle, the opposite has taken place (Figure 2). Through year-end 2024, we saw a 100 basis point reduction in the Fed Funds Rate, while 10-year Treasury rates increased approximately 100 basis points, something that has not occurred in the last several rate-cutting cycles. Perhaps this is due to cutting

rates into strengthening financial numbers in addition to potential inflationary Trump policies, including tariffs, deportations and tax cuts.

These factors likely point to higher for longer, or at a minimum, range-bound long-term interest rates in 2025.

**Conversion of bank products to SIFMA**

SIFMA has returned to its historic average of SOFR (and its predecessor, LIBOR) over the past 24 months, averaging 66% of SOFR (Figure 3). With most bank products indexed to 79-82% of SOFR, this has created 50-70 basis points of opportunity for health systems to switch to SIFMA-based products at current interest rate levels. These products include variable rate demand notes, commercial paper, total return structures, and securities lending agreements.

**Figure 3: Historical SIFMA-to-SOFR Ratio**

	1M TSOFR	SIFMA	Difference	Ratio
Current (1/1/2025)	4.33%	2.72%	161 bps	63%
1-year Average	5.11%	3.35%	176 bps	66%
2-year Average	5.09%	3.34%	175 bps	66%
5-year Average	2.49%	1.70%	79 bps	68%
30-Year Average	2.63%	1.79%	84 bps	68%

Source: Bloomberg

Further strengthening a potential switch to SIFMA is the reemergence of a potential decrease to the corporate tax rate under the new Trump administration. If corporate tax rates are reduced further, that will be passed through to health systems with bank products indexed to SOFR (e.g., going from 21% to 15% could increase rates approximately 25 basis points in the current market).

## How Hospitals Should Respond

### *Return to strategic long-term planning*

Health systems are returning to long-term strategic planning, albeit with a new economic reality of leaner financial performance for the foreseeable future.<sup>6</sup>

The last several years have seen health systems focus on income statement improvement (through growth and expense management) and it is now time to shift to the balance sheet (both cash and debt).

Commit to a strategic, operating and capital decision model that is aligned with a deliberately developed value proposition. Health systems need to focus on expanding and improving access for patients in existing markets.

A sense of urgency is critical. Use a sound financial plan to place guardrails around the strategic decision-making process and avoid a focus on “wish list” items. Playing offense is the new defensive strategy, which includes securing buy-in that “going faster” is likely to be a key competitive advantage.

### *Emergence of alternative capitalization strategies*

**Energy as a Service**—As hospitals look for alternative ways to reinvest in aging facilities, Energy as a Service (EaaS) partnerships present an attractive solution.

With the first tax-exempt publicly financed partnership taking place in 2024 for Adventist Health, the cat is out of the bag on a structure that had previously been financed on a private basis.

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**EaaS partnerships** allow health systems to transfer certain operational risk to a service partner in return for an upfront consideration for the right to jointly use and operate certain of the health system’s energy assets, without the outright sale to the partner.

**Synthetic Leases**—This is the newest in vogue product being pitched by real estate firms and developers. Synthetic leases allow for lower cost of capital, with the ability to structure on a tax-exempt basis (with some added complexities) and lower balance sheet liability impact compared to traditional leases or debt issuance.

**Real Estate Monetization**—Another capitalization strategy being utilized by health systems is the monetization of existing real estate. While the primary focus has been on extracting value from non-core assets (e.g., parking garages) to reinvest elsewhere across the system, some health systems are taking a wider view of what may be possible in the market.

### *Free cash flow generation*

After back-to-back impressive years of investment market returns, market analysts have tried to temper expectations for 2025.

Healthcare systems should be wary of what has actually driven balance sheet growth (i.e., investment market returns vs. operating performance). For some, as free cash flow has been driven by market gains, opposed to operational improvements, it may be time to take stock of the investment portfolio and ensure risks are aligned with operational and strategic plans.

<sup>6</sup> Vizient and Kaufman Hall, “2025 Trends Report: Strategy Is (Finally) Back in the Driver’s Seat.”

### **Capitalization analysis**

It might be time to give up the ghost on protecting a health system's bond rating and balance sheet at all costs.

Health systems have historically viewed credit ratings as an indicator of overall success and boards can be wary about letting a rating fall. But not all downgrades are equal. Taking a debt downgrade to be stronger financially in the future is fine. Weak performance downgrades are bad. Investments and *strategic* growth are good stories to tell, but growth for growth's sake may no longer be the top priority.

### **Avoid reliance on expansion of direct payment programs**

Many states have increased direct provider payment programs (DPPs); this has perhaps created an investment opportunity for health systems given the newfound capital. However, rating analysts are becoming particularly wary on margin improvements being entirely driven by DPP expansion.<sup>7</sup>

While strategic and capital planning for the future should incorporate these funds, given the annual award process

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and possibility of timing variances year to year, health systems should avoid committing to capital plans or operating frameworks that are expected to be facilitated through DPPs.

While signs of stabilization are good news for an industry that has experienced numerous challenges to operating and financial performance in recent years, new uncertainties cloud the horizon in 2025. A disciplined focus on strategy and building financial strength will help provide a buffer for any shocks that lie ahead.

**For more information, contact Bradley Dills ([bdills@kaufmanhall.com](mailto:bdills@kaufmanhall.com)) or Jeffrey Sahrbeck ([jsahrbeck@kaufmanhall.com](mailto:jsahrbeck@kaufmanhall.com)).**

<sup>7</sup> Kaufman Hall, "[Rating Agency Update: Supplemental Funding Programs, Cybersecurity, and Industry Outlooks](#)," Dec. 17, 2024.