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Weakening Consumer Hurts the Hospitals

We continue to believe we are in the early stages of a consumer-led recession similar to that experienced in the early 1990s. While many of the victims of such a recession are obvious, others may be less so. One group that we believe flies below the radar screen and may be more at-risk than investors currently believe is the hospital group.

In its simplest form, the drivers for hospital profitability are two-fold:

1. **Utilization:** A hospital is like a factory. They have high fixed costs (building, staff, equipment) and relatively low variable costs. If the beds are full, fixed costs are absorbed by the large patient population. If the beds are empty, the hospital must eat a greater portion of these costs.
2. **Ability to Collect:** Generalizing, insurance companies pay their bills, patients don't. According to Standard & Poor's, hospitals collect roughly \$0.99 of every dollar when billing an insurance company, but only \$0.08-\$0.10 of every dollar in a self-pay situation.

There are several cyclical and secular issues that, in our opinion, will negatively affect hospital profitability.

1. **Utilization:** Hospitals are experiencing a long-term secular downturn in utilizations. Better drugs and medical devices are keeping potential patients out of the hospital, while managed care companies are becoming more restrictive on their stays. Additionally, the outpatient alternative is growing and being encouraged by cost sensitive insurance companies and entrepreneurial physicians. We believe this is a trend that will continue for the foreseeable future and possibly accelerate in bad economic times.
2. **Ability to Collect:** Fewer companies are offering health insurance and rising unemployment places more Americans in the uninsured category. The number of uninsured is now approaching 16% of the population and growing every year. Even those with insurance are being forced to shoulder an increasing portion of the costs through higher co-pays and re-classification of some procedures to elective. The drastic difference between collectability from insurance companies and self-payers underscores the economic sensitivity of hospitals.

We are not only expecting hospitals to experience pressure on their two main profitability drivers, we are also anticipating additional pressures from other sources including:

- **Operating Expenses:** The largest expense for any hospital is staffing, and the shortages in nurses and doctors has not abated. A tighter labor pool means hospitals are increasingly forced to pay-up to meet necessary staffing levels. Other operating costs like energy for heating and cooling and food costs should continue to pinch profit margins and unlike hotels or airlines, hospitals have yet to adopt surcharges to help defray the rising costs.
- **Regulatory:** Rising healthcare costs remain a front-burner issue among the Presidential hopefuls. While we can't predict who will ultimately be in office and what programs they will be able to implement, we do believe that the regulatory backdrop will become increasingly cloudy in the coming months and quarters. When uncertainty rises, investors typically demand a higher margin of safety in their investments and are unwilling to pay higher valuations.

Bottom Line: Like many of the consumer discretionary stocks, we believe the hospitals are in a bad spot. Profits are likely to be pinched by a top-line that is softening from a weakening consumer whose uninsured ranks are growing every day and an expense base that is not declining. Some view healthcare as a safe harbor during recessionary times - we would not agree with extending that viewpoint to the hospital group.

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