



Rising labor and debt servicing costs set to worsen credit outlook of the US healthcare sector

by [Raghav Mathur](#)

- **NUS-CRI Agg PD suggests that rising borrowing costs and increasing debt servicing burden may worsen the credit risk of the US Healthcare sector**
- **Breakdown of NUS-CRI Forward PD into sub-industries suggests that healthcare services and facilities providers are most at risk over the next six months due to rising labor costs, which have a relatively muted impact on large pharmaceutical companies and medical devices providers**

As US inflation shows signs of cooling, and as the job market remains tight, global markets are betting that the economy is heading for a soft landing in the latter part of 2023, due in part to the Federal Reserve (Fed) [tapering](#) its hiking cycle. This has led to the yields on [risky](#) corporate bonds dropping since the beginning of this year. Despite this market rally, one sector that still seems to be facing an uphill battle is the US healthcare sector. As seen in Figure 1a, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for US-domiciled publicly listed healthcare companies (US Healthcare sector) has been steadily increasing over the past six months, in line with rising borrowing and labor costs that could pressure the sector's margins and repayment ability. The NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD¹) in Figure 1b also suggests that the sector's short-term aggregate credit outlook is likely to worsen close to BB+ upper bound when referenced to PDiR2.0, possibly due to rising borrowing costs that heighten the sector's debt burden and worsen its refinancing capabilities, as well as a potential slowdown in earnings due to increased clinical and non-clinical labor costs.

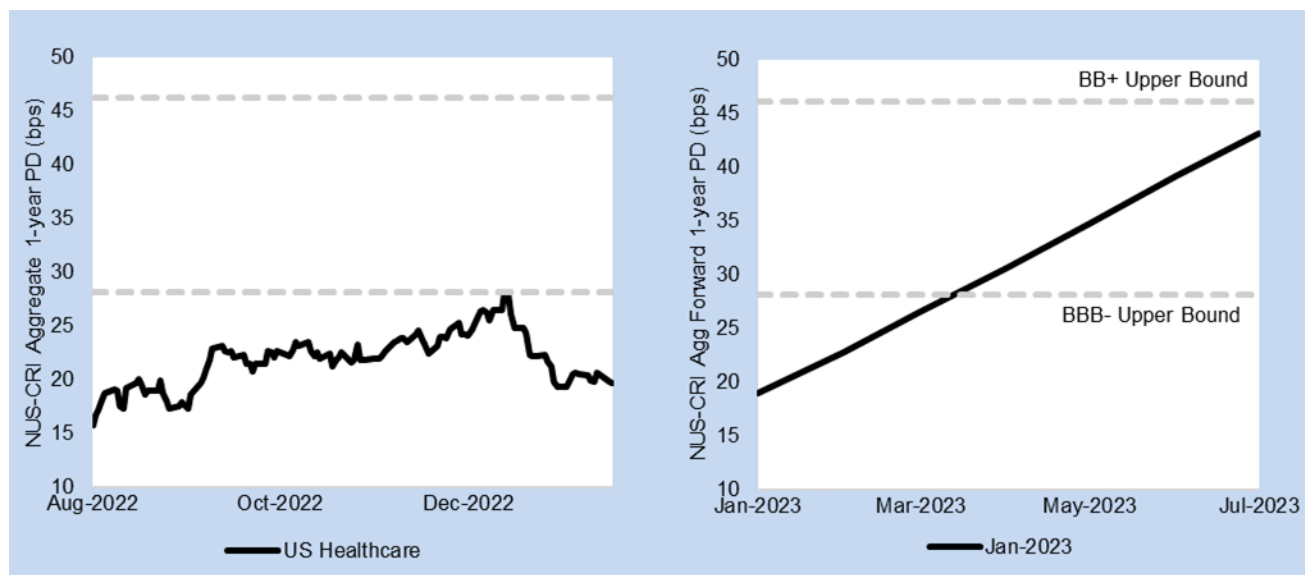


Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for the US healthcare sector with reference to PDiR2.0² bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for the US healthcare sector as of Jan-2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

As seen from the Agg PD in Figure 1a, the US healthcare sector's aggregate credit risk has been steadily increasing over the past six months, rising from around 15bps to near the BBB- upper bound of 28bps by the

¹ The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

² The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

end of last year³. One of the primary causes of concern, which may potentially drive the increasing term structure of the Forward PD in figure 1b, is the sector's increasing debt burden. The sector has been on a debt binge since 2020 (See Figure 2a). The onset of the pandemic saw a [boom](#) in the volume of new M&A activity in the sector funded through leveraged loans. These are typically [floating-rate](#) loans, which are bound to significantly increase the servicing burden for healthcare companies, especially at a time when borrowing costs have steadily increased. As seen in Figure 2b, the index yield-to-maturity of the Bloomberg investment-grade and high-yield healthcare companies in the United States has risen by close to 2.5 and 3.9 percentage points since the beginning of last year. A rising servicing burden could act as a signal of the potential increase in default risk that the sector faces. As per NUS-CRI's calculation, the predicted distribution of defaults in the sector over a six-month horizon has become more [right-skewed](#) compared to pre-pandemic levels.

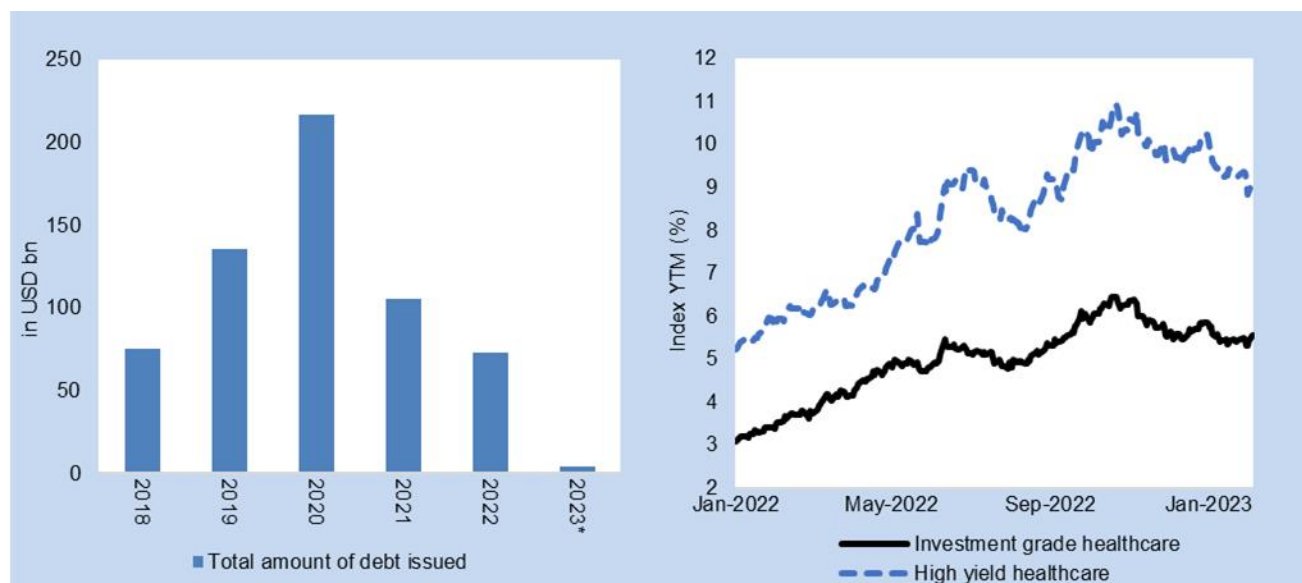


Figure 2a (LHS): Total amount of debt issued by US healthcare providers in USD bn. Figure 2b (RHS): Index yield to maturity of the Bloomberg investment-grade and high-yield US healthcare total return index. *2023 data is YTD as of 31st Jan, 2023. Source: Bloomberg

Breaking down the sector's credit risk outlook by sub-industries, as seen in Figure 3 below, credit risk is set to rise in companies that provide healthcare services and facilities. This may be due to the rising pressure felt on these companies' margins due to inflation-linked and shortage-driven increases in labor costs. Clinical and non-clinical labor costs for healthcare providers are expected to rise by about [76% and 22%](#) respectively in 2023 compared to 2022. The increase in costs, which are likely going to pressure the sector's bottom line, may affect its ability to meet rising repayment obligations as cash flows could remain subdued and access to the public markets for fresh rounds of funding could remain muted. This is especially likely for distressed healthcare companies that are more likely to refinance their obligations by [tapping](#) into the public bond market to raise funds. Large pharmaceutical companies and those companies that provide healthcare devices/supplies are relatively [immune](#) to this headwind, given that labor costs are a smaller percentage of their total costs, therefore, potentially not having a significant impact on their gross margins and credit risk profile.

³ The rally in global markets at the beginning of 2023 could have subsequently reduced the sector's Agg PD, possibly leading to a lower PD measure seen in Jan-2023.

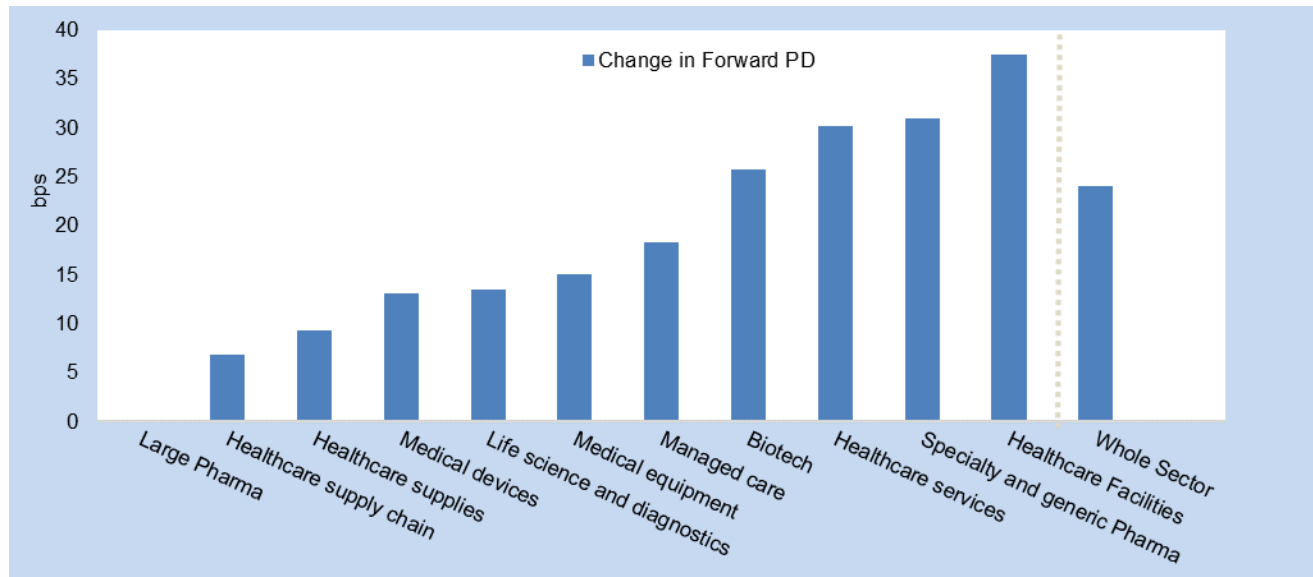


Figure 3: Change in NUS-CRI Forward PD for the US healthcare sub-industries over the next six months. *Source: NUS-CRI*

The potential upcoming burdens faced by the US healthcare sector are due in part to the borrowing-fueled expansion strategies utilized by industry players, especially those companies in the sector that are controlled by private equity firms. Though their increased leverage has not caused a substantial increase in their credit risk yet, weakening earning prospects and increasing repayment pressure are going to pose significant headwinds to the credit risk profile of the sector moving forward, as suggested by the increasing term structure of the Forward PD shown in Figure 1b.

Credit News

Strong investor demand boosts overseas bond markets

Feb 01. 2023 is witnessing a strong recovery in some corners of the global bond market as debt issuances in Europe and emerging markets surge. Cumulatively, in Jan-2023, emerging market governments have issued bonds worth USD 61bn and European governments have issued USD 75bn of bonds. Investment grade firms have also created a new record by issuing debt at the fastest pace since 2011. The rebound in bond markets is attributable to higher interest rates, moderating inflation and resilience shown by economies in the face of tightening. ([WSJ](#))

Europe's bond recovery falls at first hurdle after ECB high

Feb 05. A strong US jobs reports quickly erased gains in Europe's bond market as traders revised expectations related to the interest rate hiking cycle. ECB raised its policy rate by 50bps last week and indicated that one more such raise could be expected in March. Although headline inflation has eased, core inflation (excluding food and energy) still remains strong and may prolong the interest rate hiking cycle longer than anticipated. ([Bloomberg](#))

Adani crisis ignites Indian contagion fears, credit warnings

Feb 04. As the Adani crisis continues to worsen, fears that the troubles of the conglomerate may have a negative spillover effect on the Indian economy, have increased. The crisis has also led to discussions in both houses of the Indian parliament as policymakers call for an inquiry into Adani Group's companies. As per Reuters, the Indian ministry of corporate affairs has also begun an investigation into the financial statements and regulatory submissions of the group. If the crisis continues to intensify, solvency of the group may come into question as the stock price decline may restrict the group's financing channels. Lenders to the Adani group have been asked to submit details of their exposure to the central bank. However, the RBI has stressed that any major negative impact on the country's banking system remains a remote possibility due to its resilient and stable nature. ([Reuters](#))

Distressed debt funds eye Gulf region opportunities

Jan 31. Distressed debt investors have increased their focus on opportunities in the Gulf region. Banks in the Gulf region may be required to increase provisions as corporates face economic turmoil in addition to climbing interest rates and a stronger US dollar. Local banks are now more open to the idea of selling debt to improve the health of balance sheets, thus, creating opportunities for distressed debt investors. ([Reuters](#))

Pakistan is on the brink

Feb 06. Creditors of Pakistan in the west and China are faced with tremendous default risk given Pakistan's current complicated situation. Pakistan's foreign exchange reserves could only meet about three weeks of imports with total public debt amounting to 79% of its GDP. Should Pakistan default, it will be in a situation worse than Sri Lanka because of its tenfold population, nuclear capabilities and an unstable political environment. The creditors, along with IMF, need to bring Pakistan into debt-restructuring negotiations to avoid another sovereign default. China, as the biggest bilateral creditor of Pakistan, is bound to agree to settle with multilateral institutions and take haircuts on repayments. ([FT](#))

The world's biggest bond fund has a new boss ([FT](#))

Renewed U.S. junk bond rally ignites hope for more stuck buyout debt ([Reuters](#))

Gilts surge after BoE decision, investors wary on longer term ([Reuters](#))

Regulatory Updates

Yen slides after Amamiya said to be approached as BOJ governor

Feb 06. The Japanese yen fell around 1% to 132.5 per dollar right after the news that Masayoshi Amamiya would be the new governor of BOJ who is likely to maintain the current ultra-easy monetary policy. Investors may need to adjust their expectations that a hawkish governor would change the policy and stabilize the yields and currency. As the US dollar appreciates on strong employment data, the Japanese yen is faced with further downward pressure. ([Bloomberg](#))

ECB plan for next big hike makes Lagarde last hawk standing

Feb 03. Though the US and the UK have slowed down the rate hikes, the ECB shows a resolution to tame inflation and promised to raise interest rates by another 0.5% in March, with more hike expectations in the future. Given the fact that inflation remains high in the Eurozone and the economy performs better than expected, the ECB officials' decision seems to make sense, especially after they have learned a lesson from the experiences of aborted tightening in 2008 and 2011. ([Bloomberg](#))

Stocks and bonds soar as investors bet that rates are close to peak ([FT](#))

India's central bank widely seen delivering final 25 bps hike ([Reuters](#))

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