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Hospitals Strut in a Lurching Market

By REED ABELSON

In a stock market starved for good news, Triad Hospitals has had something to celebrate. Last week, the company announced another quarter of strong results, ahead of Wall Street's estimates. Its shares have gained 33 percent so far this year, compared with a decline of 25 percent for the broader market.

Rising admissions, higher prices and a recovery from cuts in federal reimbursement in the 1990's have helped for-profit hospital companies like Triad to prosper. Earnings are surging, and there is little to suggest a reversal anytime soon, according to analysts and professional investors.

The stocks definitely have a swagger. Shares of five of the eight public companies have had gains this year. The other three have easily outperformed the overall market. HCA, the largest in terms of beds, and Tenet Healthcare, at No. 2, are both up about 20 percent. Triad, at No. 3, has led the group in stock gains.

"We're probably right in the middle of a swing," said James D. Shelton, the chief executive of Triad, about the for-profit industry.

Some investment professionals say they remain confident that hospital companies will continue to deliver strong results, with annual earnings increasing 15 percent or more for the next year or so. "I think as long as they maintain their high growth of earnings, relative to the market, there is still opportunity present," said Dr. Kris Jenner, who manages the T. Rowe Price Health Sciences fund, which owns shares in HCA, Tenet and Triad. But he cautioned that the stocks were unlikely to perform as well as they did in the last year and a half.

Valuations are still attractive, agreed Michael Yellen, who manages the AIM Global Health Care fund. "I don't think it's too late on a long-term basis because the market is beginning to realize that these are good businesses," Mr. Yellen said.

While the stocks have made significant gains, on average, A. J. Rice, an analyst at Merrill Lynch, expects earnings to grow rapidly. The stocks "are in the midst of a fundamental bull run," he said.

While Triad Hospitals, for example, is trading at a price-to-earnings ratio of 31.2, Wall Street analysts estimate its five-year annual earnings growth rate at 25 percent. That compares with a P/E of 31.1 for the Standard & Poor's-500 stock index and a much slower growth rate, of only 8 percent.

The industry's fundamentals are strong. After years of dire predictions about empty beds, many hospitals closed wings or shut down operations altogether. In recent years, however, admissions have climbed because baby boomers are aging and because managed-care companies are less adamant about keeping people out of hospitals. That has prompted a flurry of construction.

Moreover, hospitals have charged more for services as they have come to dominate some markets. Tenet, which also beat Wall Street estimates when it reported earnings last month, had a 13 percent increase in revenue per admission for the quarter. The revenue increase reflected the company's ability to charge higher prices as well as its treatment of sicker patients, it said.

Pricing trends should remain in the hospitals' favor, according to Michael T. Smith, an analyst at the Strong Funds, which has invested in several hospital stocks, like Triad and Community Health Systems. Because insurers can get rate increases, "they really don't need to be aggressive in pushing back the hospitals," he said. And while government financing for Medicare and Medicaid is a constant concern, Mr. Smith and others say significant cuts are unlikely.

The companies are also benefiting from the precarious financial situation of many nonprofit competitors. If the federal government or the states cut funds, many of these hospitals will go out of business, according to Mr. Shelton of Triad. "We have some artificial walls of protection," he said.

Most of the for-profits are also taking market share away from struggling nonprofit hospitals or deciding to acquire ones that they can turn around. They follow a simple strategy, according to Sheryl R. Skolnick, a managing director at Fulcrum Global Partners, which provides research to large investors. "You buy it, you fix it, you grow it, and you do it again," she said.

The exception is HCA, formed by the 1994 combination of Columbia Healthcare and HCA-Hospital Corporation of America. HCA, which is based in Nashville and has roughly 40,000 beds, spent the last few years largely trying to shed hospitals; it made only a few scattered purchases. Triad, in Dallas, and LifePoint Hospitals, in Brentwood, Tenn., were spun off from HCA in 1999. HCA paid $745 million in May 2000 to settle charges that it had defrauded Medicare.

The biggest companies — HCA, Tenet, Triad and Universal Health Services — tend to focus on the largest markets. Of the two leaders, Ms. Skolnick prefers Tenet, based in Santa Barbara, Calif., because of its ability to get cold, hard cash by collecting from patients when they are admitted, enforcing its contracts and making sure that the bills it sends out are paid. Tenet converts about 82 percent of its operating earnings into cash flow, versus just 66 percent for HCA.

Other companies have the advantage of being able to focus on small markets, where the hospitals they operate face little if any competition. "The business model itself is incredibly attractive," Mr. Yellen said.

Health Management Associates, in business since 1977, pioneered the concept of expanding in small markets in the mid-1980's, when it bought a hospital in Sebring, Fla., and one in Mooresville, N.C. The company, based in Naples, Fla., had nearly $2 billion in revenue last year and operates about 40 hospitals. Mr. Yellen said the company had turned around poor performers. "Execution is the name of the game," he said.

But Ms. Skolnick regards Health Management's size as a disadvantage because it must make eight or 10 acquisitions a year to have much impact on its financial results. "They have to run very hard to stay in place," she said.

She said a company like Province Healthcare, based in Brentwood, was more attractive. With just 20 hospitals, Province can grow more quickly. She is also impressed by its improving cash flow, which she estimates will increase to $61 million this year from $38 million last year. "This is a company that is figuring it out," she said.

Another company that is focusing on small markets is Community Health, also based in Brentwood. Forstmann Little, the buyout firm, owns almost half of its shares.

Although many investors still favor companies that focus on rural or small markets, the distinctions between the groups have narrowed in recent years, according to Mr. Rice, the Merrill Lynch analyst.

Management styles of these companies are similar, he said, because some were spun off from HCA and have executives who spent time there or in Humana's former hospital group. "They have very similar approaches to the market," he said.

With the vast majority of the industry still composed of nonprofits, the for-profit companies manage to stay out of one another's way, although they compete for acquisitions. "There's very little overlap among these companies," Mr. Smith said.

The industry's biggest risk may be that it will do too well, reaping ever larger profits in a time when government policy makers are already worried about rising health care costs. "That would lead the pendulum to swing back in the other direction," said Dr. Jenner at T. Rowe Price.