HIGHLAND

# NAVIGATING THE HEALTHCARE LANDSCAPE IN 2018

Last year, Highland identified 10 critical areas that we believed not-for-profit (NFP) healthcare investors should reevaluate, given the complex and rapidly evolving nature of the healthcare industry. We correctly anticipated a shifting operating environment in which healthcare systems would face mounting operational pressures as political uncertainty, escalating expenses, and demographic headwinds compress margins. Another robust year for investment markets helped keep balance sheets strong and in some cases mitigate the impacts of operational strains.

2018 is shaping up to be another demanding year from an operational standpoint, while investment markets will likely struggle to reproduce the gains witnessed in 2017. The confluence of these two factors means NFP healthcare investors should not sit idly by and let the events of prior years influence their investment strategy for 2018. That said, we have once again outlined 10 key areas NFP investors should closely monitor in the coming year.

Not-for-profit (NFP) healthcare providers comprise a distinct class of institutional investors. Nowhere is that more apparent than within their operating portfolios. For NFP healthcare investors, operating assets have multiple investment objectives and are charged with the distinctive goal of delivering quality healthcare within their communities. These portfolios serve 3 fundamental purposes:

- Primary funding source for future capital expenditures
- Access to capital through public finance debt markets
- Complement operating strategy

### 1. REASSESS INVESTMENT PORTFOLIOS AMID UNCERTAIN OPERATING AND FINANCIAL BACKDROP.

Most NFP healthcare organizations will likely face another year of operational pressures in 2018. In fact, both Moody's and Fitch recently revised their outlooks to negative (from stable) given the sector dynamics listed earlier. Many healthcare systems will likely need investment portfolios to continue to enhance balance sheets and contribute to the bottom line. The decision of whether to increase or decrease the risk profile of the investment portfolio is unique to each organization and requires a dynamic view of the portfolio's role and how it relates to the organization and its mission. A clear understanding of the impact that portfolio decisions may have on the financial health of each organization is paramount.

### 2. CRAFT YOUR STORY FOR THE RATING AGENCIES.

Rating agencies such as Moody's and Fitch have begun to de-emphasize investment portfolio liquidity during the ratings process. While it still plays an important role, both firms are more focused on each investor's story—that is, the portfolio's role and how it fits within the context of the entire organization. This is increasingly important as investors allocate more to nontraditional investments given lower return expectations for their traditional counterparts. Read more in our paper entitled, "**The Rating Agencies are Listening: What's Your Story?**"

### 3. REVIEW DEFINED BENEFIT PLAN RISKS.

Unfunded pension liabilities can present a meaningful risk to NFP healthcare organizations' balance sheets. Rising PBGC premiums also represent an added expense for underfunded plans. Rating agencies have also begun to closely scrutinize the impacts these may have on an issuer's financial picture. For example, both Moody's and Fitch adjust certain debt ratios to include unfunded pension liabilities. For governmental plans (GASB) that use higher discount rates, Moody's now modifies the rate to more closely match corporate peers. This can result in a much higher obligation, potentially straining certain debt metrics. For organizations that have issued debt to fund pension liabilities, this can be negative for the hospital's credit, per Moody's.

### 4. CREATE A PLAN TO MANAGE PENSION RISKS.

While employee buyouts and debt issuance are strategies many healthcare organizations have recently implemented to address pension risks, they are short-term fixes and fail to address the long-term relationship between assets and liabilities. Although liability-driven investing (LDI) is currently the topic du jour in the defined benefit space, most NFP healthcare organizations are not in a position to fully immunize pension plans. For A-rated NFP healthcare systems, the median funded status was just 74% (per Moody's) versus 84% for their corporate counterparts . NFP investors would do well to establish a framework to de-risk their pension plans as funded status improves. Additionally, "Glidepath" strategies are typically viewed in a favorable light by rating agencies.

### 5. FOCUS ON THE FUNDAMENTALS. BEWARE OF FOMO.

As equity prices around the world continue to reach new heights, some investors are wondering why they should invest in anything other than stocks. This is a perfectly natural emotional response and a perfectly predictable one, as well. However, decades (if not centuries) of market data tell us that these emotional biases work against us far more than they work for us. In "**More Than a Feeling: Why Diversification Still Matters**", we examine the sources of investors' emotional decision-making and advocate instead for an objective, data-driven framework that prioritizes diversification.

### 6. DEFINED CONTRIBUTION-EDUCATION AND FINANCIAL WELLNESS ARE TAKING CENTER STAGE.

Plan fees have been a hot topic for defined contribution plans for several years. The focus on fees drove plan sponsors to review and lower expenses to a point where expenses are now starting to stabilize. With overall fees beginning to moderate, plan sponsors should now focus their time on understanding their plan participants' needs. This needs-based approach allows plan sponsors to deliver more effective solutions. These may include targeted participant education, financial wellness programs, or potentially adding voluntary benefits such as critical illness or life insurance policies, identity theft protection, or even short-term disability. This shift is important for plan sponsors, as many participants want employers to take a more active role in ensuring employees' financial wellness.

### 7. GAIN A NEW PERSPECTIVE ON PRIVATE INVESTMENTS.

Evaluation of private (or opportunistic) investments requires an approach different from that of traditional investments. In "**Private Equity Investments: What You See is Not Always What you Get**", we discuss how existing measurement tools such as Internal Rate of Return (IRR) or Multiple of Capital(x) do not translate effectively from private to public markets, as neither measures how long it takes for the return to be generated. This may lead to the wrong conclusion when evaluating the opportunity costs of such investments. Utilizing a Time-Weighted Equivalent (TWE) calculation can provide an apples to apples comparison of private versus public investments. As private investments should command a return premium over public markets, a 10% TWE is Highland's threshold for investment. Due to the sizable amount of capital flowing into larger mainstream private deals, a niche focus with an emphasis on smaller deals will likely be necessary to generate the 10% TWE hurdle.

### 8. VIEW THE WORLD IN 3-D.

We believe we are approaching a turning point in how investors allocate capital going forward. It will be important to dig through broad markets to find value, as certain areas of the market will benefit more than others. With newly enacted tax reform, some of the more capital-intensive companies stand to gain the most from lower taxes. On the other hand, highly indebted companies will be hurt by a lower tax benefit from expensing debt and higher funding costs from increasing LIBOR. As we move further into the business cycle, investors will be more discerning toward company balance sheets and how management apportions capital. By conducting our own analysis and looking at the fundamentals to understand the true drivers, we can recognize what is going to drive the market moving forward. This attitude drives our **3-D** approach to **Decode** and **Deconstruct** to **Deliver Value**. Investors must dissect broad markets and find these opportunities to achieve the returns needed to meet their objectives.

### 9. ANTICIPATE ROBUST M&A ACTIVITY.

Rising costs along with lower reimbursement rates and revenue growth are driving NFP healthcare systems to find ways to gain an upper hand in this challenging environment. This has led to a proliferation in merger and acquisition (M&A) activity as organizations seek to gain negotiating leverage and reduce costs through scale. Both Fitch and Moody's expect M&A activity to increase in 2018. NFP healthcare organizations should pay close attention to the potential impacts an acquisition could have on the organization's debt rating. For instance, acquiring weaker systems that may be financially dilutive or engaging in deals with high execution risk can be viewed as credit negative by the rating agencies. Rating agencies will typically view M&A activity in a positive light when accretive for the acquirer, or when an acquired hospital's financial obligations are assumed by a stronger organization.

### 10. EVALUATE THE UBIQUITY OF ESG.

Investors are implementing Environmental, Social, and Governance (ESG) criteria into their decision-making frameworks now more than ever. For NFP healthcare investors, ESG can help to better align investment portfolios with their core mission. What began years ago as simple exclusions of sin stocks has evolved into a critical aspect of active portfolio management. In an upcoming *Insight*, we will discuss how money managers are using environment, social, and governance factors to augment their fundamental research and, in many cases, improve their returns.