HIGHLAND

NAVIGATING THE HEALTHCARE LANDSCAPE IN 2019

As predicted, 2018 was another demanding year for not-for-profit (NFP) healthcare investors. It is likely that most NFP healthcare systems will show another year of declining profitability as the sector endures its ongoing struggles with reimbursement pressures, the transition to value payments, and swelling expenses. Investment market volatility also crept back into markets during the fourth quarter, which will only put further pressure on margins. Highland expects market volatility to continue in 2019, alongside the sector's ongoing operational pressures. For NFP healthcare organizations to endure, they should focus on the key areas outlined below in order to best position themselves to succeed in 2019 and moving forward.

1. *Continued Eyes on M&A Activity*

Mergers and acquisitions in the NFP healthcare space remained robust during 2018, and many expect that trend to continue into 2019. Many large healthcare systems realize the need to create scale and the technical synergies that can result from mergers. Meanwhile, smaller organizations often seek the technology, capital, and expertise of a larger integrated system. Rating agencies typically view mergers and acquisitions in a positive light as one-third of S&P's total upgrades during 2018 were attributable to mergers. While the pace of M&A activity will likely remain healthy, there is growing criticism that these transactions reduce competition and increase healthcare prices for individuals. This has led federal and state regulators to scrutinize proposed transactions more closely. Future M&A activity may come with certain stipulations, and organizations will likely have to justify the benefits of consolidation.

2. *Monitor the Political Environment - Federal*

While the administration's efforts to repeal the Affordable Care Act were ultimately unsuccessful, many believe the Trump administration will remain committed to gradual changes to the law. The elimination of the individual mandate penalty and efforts to allow non-ACA-compliant plans on healthcare

TRANSFORMING PORTFOLIOS. ADVANCING MISSIONS.

Highland Associates, Inc. is an independent institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for institutions. We serve a national client base of investors including not-for-profit healthcare organizations, foundations, endowments, defined benefit plans, defined contribution plans, and high-net worth individuals. Please visit the website at www.highlandassoc.com to learn more.

HIGHLAND ASSOCIATES

2545 HIGHLAND AVENUE SOUTH
SUITE 200
BIRMINGHAM, ALABAMA 35205
P. 1-800-405-7729 / (205) 933-8664
F. (205) 933-7688

7733 FORSYTH BLVD., SUITE 1103
ST. LOUIS, MO 63105
P. (314) 296-6171

exchanges are recent examples. A Texas federal judge's ruling that the ACA is unconstitutional is unlikely to have an immediate impact on NFP organizations, and while it is unlikely to be upheld, it brings the law back to the forefront of political discussion and bears monitoring. Finally, "Medicare for All" continues to be a focal point for Democratic candidates in the 2020 election. Each potential change would represent a significant transformation and potential risk for the sector. On the positive side, in late 2018, a U.S. federal district court ruled against cuts that reduced Medicare reimbursements to hospitals under the 340B drug pricing program. According to Moody's, this program can account for as much as 25% of an NFP hospital's operating cash flow.

3. *Monitor the Political Environment - State*

While NFP healthcare investors should pay close attention to developments at the federal level, matters at the individual state level shouldn't be ignored. Recent developments include a proposal for a public health insurance option in Colorado. While it is unclear what the ultimate impact of such a change would entail for Colorado hospitals, it is likely that reimbursements under a government option would be lower than those of commercially available insurance plans. Meanwhile, North Carolina, Montana, and Oregon have begun to use Medicare reimbursement rates to adjust how much their state employee health plans pay hospitals. Additionally, approving Medicaid work requirements to qualify for benefits are being proposed in some states, which would likely increase the level of bad debts for hospitals in these states. On the other hand, Medicaid expansion in a number of states would likely be positive for organizations that operate in those states (Virginia is a recent example). The numerous bills in states across the country illustrate that political risk is not confined to the federal level.

4. *Revisit Portfolio Allocations*

Operational pressures will likely continue into 2019 as NFP healthcare organizations contend with slowing revenue growth and expense pressure. This has resulted in a growing reliance on investment income and philanthropy to bolster financials. This reliance is a growing trend that rating agencies are watching closely. According to our 2018 survey of NFP healthcare systems, operational pressures have yet to result in changes in investment portfolio asset allocation for most organizations. Many organizations are also contending with large capital needs as they replace aging infrastructure and make large-scale technological investments. For those organizations where the portfolio could be a potential source of funds, a large equity drawdown alongside withdrawals could cause a significant decrease in days cash on hand. With market volatility and uncertainty likely to remain elevated in 2019, NFP healthcare organizations should revisit their asset allocation so that operating investment portfolios work for them and not against them. Alternatively, many systems with historically conservative investment portfolios have emerged with stronger balance sheets and are in a position to take on a measured increase in risk.

5. *Don't Ignore Pension Plan Risks*

In 2018's "Navigating the Healthcare Landscape," we recommended NFP investors establish a framework to de-risk their pension plans as funded status improves. 2018 proved to be a perfect example of why healthcare organizations would be well served to address their potential exposure to pension plan risks. Through the first three quarters of the year, most plans saw funded status improve dramatically thanks to both rising discount rates and investment markets. However, those gains quickly vanished during the fourth quarter amid sharp equity market drawdowns and declining interest rates. For investors with a well-established "glidepath" framework, these funded status gains were locked in as exposure to liability hedging assets were increased alongside funded status improvement. With rating agencies scrutinizing pension plans more closely alongside rising PBGC premiums for underfunded plans, plan sponsors should continue developing a framework for reducing pension plan risk.

6. *Focus on the Enterprise*

NFP healthcare organizations are unique in that there are multiple pools of capital, each with different objectives and asset allocations. While we discussed how healthcare organizations should revisit asset allocations with their operating and pension portfolios, it is imperative that this is done from an enterprise-wide perspective. For instance, when stress testing pension plans, the balance sheet impact and potential for cash contributions should be modeled alongside stresses in the operating portfolio (including any other relevant unrestricted assets). This helps integrate all key factors into the decision-making process so that investors can assess the

complete impact on the organization's financial profile. This is particularly important for NFP healthcare organizations that are scrutinized by rating agencies and helps to frame what risks they are exposed to and what the potential rating impacts might be.

7. Evaluate Evolving Capital Needs

As the healthcare industry continues to evolve thanks to operational challenges and new entrants, capital spending needs are also witnessing a transformation. Disruption in the healthcare industry means NFP healthcare systems must attempt to differentiate themselves from nontraditional entrants in the marketplace. New competitors are turning to outpatient settings as a more efficient and cost-effective way to treat patients. This means that the traditional hospital setting of simply putting patients in beds is changing. This will have an impact on capital spending needs for healthcare organizations as future capital needs will likely focus on "downsizing" to smaller, more focused settings. Furthermore, younger patients favor convenience and digital touch settings, such as "Telehealth," which will require significant capital outlays for technology. Finally, cybersecurity will likely be a focus for many healthcare organizations as data breaches become more common and hospitals bear the responsibility of protecting patient data. This means capital spending needs will not be as cut-and-dried as in the past, when an organization's capital spending ratio was closely tied to its average age of plant.

8. Academic Medical Centers (AMCs)

As we have seen in other segments of healthcare, there is no single story to summarize the current state of AMCs. Certain AMCs are highly integrated within a university setting, while others are being spun out on their own as universities seek to distance themselves from the volatility in profits for healthcare vs. universities. The third major trend is the affiliation, integration, or merger of AMCs with other NFP healthcare systems. Relative to traditional NFP healthcare systems, AMCs have held a distinct advantage as leading providers of higher-end services. While AMCs will continue to be a vital source of innovation in healthcare, how their often-higher cost structure coexists with a broader push to lower costs with declining reimbursements bears watching.

IMPORTANT DISCLOSURES: The information provided herein is for informational purposes only. While Highland has tried to provide accurate and timely information, there may be inadvertent technical or factual inaccuracies or typographical errors for which we apologize. The information provided herein does not constitute a solicitation or offer by Highland or its affiliates, to buy or sell any securities or other financial instrument, or to provide investment advice or service. Nothing contained herein should be construed as investment advice or a recommendation to purchase or sell a particular security. Investing involves a high degree of risk, and all investors should carefully consider their investment objective and the suitability of any investments. Past performance is not indicative of future results. Investments are subject to loss.

Author:

J. MICHAEL THOMAS, CFA
DIRECTOR OF
HOSPITAL ANALYTICS

HIGHLAND ASSOCIATES

BIRMINGHAM: 2545 HIGHLAND AVENUE SOUTH
SUITE 200
BIRMINGHAM, ALABAMA 35205
P. 1-800-405-7729 / (205) 933-8664
F. (205) 933-7688

ST. LOUIS: 7733 FORSYTH BLVD., SUITE 1103
ST. LOUIS, MO 63105
P. (314) 296-6171