HIGHLAND

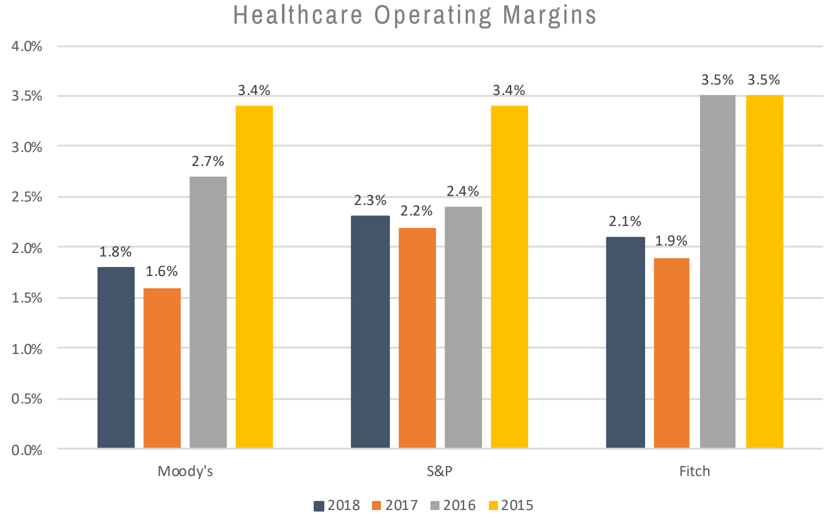
2018 NOT-FOR-PROFIT HEALTHCARE MEDIANS SHOW SIGNS OF IMPROVEMENT

This month, each of the three major credit rating agencies (Moody's, S&P, and Fitch) released their annual not-for-profit (NFP) healthcare system median reports for 2018. These reports revealed a surprising turnaround from an operational standpoint when compared to 2017. Whereas 2017 operating margins declined broadly across all three rating agencies, 2018 data revealed a slight uptick in margins as cost-cutting strategies, along with the shift to lower-cost settings, proved advantageous. These improvements notwithstanding, ongoing industry pressures remain for healthcare organizations as both Moody's and Fitch have maintained their negative sector outlook. Below we have provided a brief overview of the key takeaways, along with our own observations.

Operations

On an operational basis, 2018 median data showed broad-based operating margin improvement when compared to 2017. When examining all rating levels in aggregate (AA, A, BBB, etc.), operating margins showed an uptick for all three rating agencies (see Figure 1). Moody's notes that 2018 was the first time in three years that operating revenue growth outpaced expense growth.

Figure 1



Source: Highland Associates, Moody's, S&P, and Fitch

TRANSFORMING PORTFOLIOS. ADVANCING MISSIONS.

Highland Associates, Inc. is an 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.

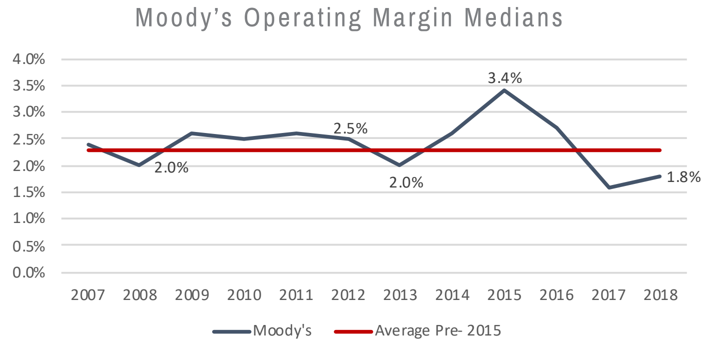
HIGHLAND ASSOCIATES
2545 HIGHLAND AVENUE SOUTH
SUITE 200
BIRMINGHAM, AL 35205
P. 1-800-405-7729 / (205) 933-8664
F. (205) 933-7688

ST LOUIS:
8182 MARYLAND AVENUE,
12TH FLOOR
ST. LOUIS, MO 63105
P. (314) 615-3501

Lower rated credits (BBB and BB) realized the greatest improvement, which is a welcome change for this area of the NFP healthcare market. Lower rated credits witnessed a higher level of deterioration in margins during the 2016-2017 period, as many significant technological investments (particularly electronic medical records) caused their results to lag their higher rated peers.

While margins remain well below their 2015 highs, it appears that the sharp decrease over the past three years has subsided (See Figure 2). Based on 2018 data, the industry has stabilized and could be approaching levels in line with historical norms. Prior to 2015's peak, operating margins as measured by Moody's averaged 2.3%. The sharp increase in margins from 2013-2015 was associated with the implementation of the Affordable Care Act (ACA) along with Medicaid expansion in many states. This increase in volume along with a notable shift in payor mix (from self-pay to Medicaid) helped bolster margins, particularly for AA and A rated credits. As these effects began to fade, escalating expenses and continued demographic shifts caused margins to deteriorate significantly in 2016 and 2017. It appears that management's renewed commitment to reduce expenses, along with the shift to lower-cost settings, has begun to pay off.

Figure 2

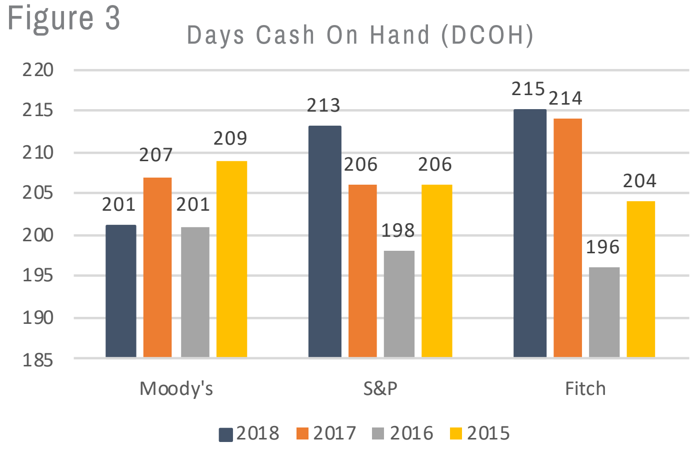


Source: Highland Associates and Moody's

Liquidity and Capital Spending

Balance sheet metrics such as days cash on hand (DCOH) remained broadly stable, although the Moody's median declines slightly (Figure 3). Weaker investment returns likely caused a slight decline for those with a 12/31/18 year-end, as higher rated organizations that typically have larger allocations to equities saw more pronounced declines in DCOH than their lower rated peers, which often have more conservative investment portfolios.

Figure 3



Source: Highland Associates and Moody's

Despite weaker market returns, DCOH remained relatively stable for most organizations due to a variety of factors: management's commitment to expense management, enhanced revenue collection strategies, and a reduction in capital spending.

All three rating agencies showed a divergence in capital spending, with little to no change with AA rated credits, while lower rated organizations (A and BBB) reduced capital spending in 2018. This likely reflects the sector's shift toward smaller outpatient settings rather than traditional large-scale brick-and-mortar projects.

Conclusion

The multiyear decline in operating margins reversed in 2018, and it appears the NFP healthcare sector has begun to stabilize. Nevertheless, the NFP healthcare industry will continue to face the same headwinds as before. This includes ongoing demographic shifts that will only continue to put pressure on margins due to the growth of Medicare enrollees, which reimburse far less than commercial payors. According to the National Bureau of Economic Research, an estimated 10,000 people turn 65 years of age each day. The shift to outpatient services combined with the transition to population health strategies will also weigh on operations. NFP healthcare providers must also contend with non-traditional entrants that are working to transform how care is delivered. Examples include Walmart, Amazon, and Apple, who are in the process of winning over consumers in the primary care and pharmacy space. Potential regulatory changes will only add further uncertainty. In this environment it will be imperative that operating assets work to complement organizational strategy and provide stability to results. For NFP healthcare organizations to fully meet their mission in the future, designing an investment program that incorporates investment assets into the entire organization will be crucial.

Author:

J. MICHAEL THOMAS, CFA

DIRECTOR OF HOSPITAL ANALYTICS

HIGHLAND ASSOCIATES

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

ST. LOUIS: 8182 MARYLAND AVENUE
12TH FLOOR
ST. LOUIS, MO 63105
P. (314) 615-3501