



MOODY'S WEBINAR NOTES:

COVID-19 AND NOT-FOR-PROFIT HEALTHCARE RATINGS

On April 30, 2020, Moody's hosted a webinar titled "COVID-19 and Not-for-Profit Healthcare Ratings." The webinar was hosted as an opportunity for participants to gain a better understanding of how Moody's is managing ratings during the COVID-19 crisis. There were a number of topics discussed on the call, and we have provided a high-level summary to help healthcare organizations understand how Moody's is approaching credit ratings through the current pandemic.

How Moody's Is Managing Ratings Through Turbulent Times

Moody's is identifying for deep review those credits that are most at risk. If analysts are taking a healthcare organization to the rating committee, Moody's will request the issuer send in updated information. At the current time, they are not performing broad market surveys or blanket information requests. Moody's anticipates a return to growth in the second half of the year given the magnitude of government support, and they are integrating federal assistance into their analysis of individual issuers. They are taking a thoughtful, measured, and balanced approach as they rate through the cycle. While the government is providing support in the short term, repayment and other arrangements will inform the longer-term view. The Federal response and trajectory of the pandemic are key credit factors.

Moody's noted that spreads between downgrades and upgrades were highest in 2008. Spreads started to narrow as the sector recovered alongside passage of the Affordable Care Act and expansions in Medicaid. However, downgrades began to increase in 2017 as expense pressures narrowed margins and impacted many systems. As expected, Moody's is seeing very few upgrades and more downgrades this year, with most of the downgrades in March. Of note, many of these downgrades weren't related



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, ALABAMA 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

to the COVID-19 pandemic. Difficult IT installations and a material increase in debt for many systems drove ratings activity. Additionally, many hospitals were dealing with volume declines not related to the current pandemic.

Notes on Short-term Debt Markets

Moody's saw a significant increase in risks in short-term debt markets. Self-liquidity borrowers were most at risk. Those issues have subsided, but Moody's is continuing to monitor the risks. Lisa Goldstein, Associate Managing Director for Public Finance, noted that the increase in rates was mostly manageable. The most notable difference between March's market upheaval and the Global Financial Crisis is the health of banks and availability of bank liquidity. Many healthcare organizations were able to draw on or increase lines of credit. The Federal Reserve was also quick to provide liquidity to market. Some states launched programs that were designed specifically for healthcare borrowers. Ohio, for instance, implemented a liquidity stabilization program called the Variable Rate Demand Obligation (VRDO) Stabilization Program to purchase short-term healthcare debt. Many Ohio issuers such as Cleveland Clinic, Bon Secours Mercy Health, and Summa Health took advantage of this program.

Sector Outlook

In March, Moody's changed its outlook for the not-for-profit healthcare sector to negative. The suspension of elective procedures drove this change as most healthcare organizations are witnessing revenue declines of 25%-40%. Meanwhile, COVID-19 prep is driving up expenses. As discussed earlier, even before March, Moody's saw trends that contributed to the negative outlook.

Given these challenges, hospitals are seeking near-term liquidity relief. The most meaningful liquidity injection has come from the federal government. This relief is being driven by the Medicare Accelerated Payment Program. However, in its current state, this is only considered a loan.

Moody's notes that there is growing support to turn this into a grant, which would certainly boost revenues and cash flow. Unfortunately, the Centers for Medicare & Medicaid Services (CMS) recently suspended applications, so hospitals that were early to take advantage will be in better overall shape.

Overview of Federal Stimulus

Dan Steingart, Vice President and Senior Credit Officer for Public Finance, provided an overview of the Coronavirus Aid, Relief, and Economic Security (CARES) Act. As it currently stands, there is still \$105 billion to be distributed for hospitals (based on a second round of an additional \$75 billion in funding). At this time there is still uncertainty surrounding when or what the distribution methodology will be, although a portion will go to hospitals with a significant level of uninsured patients. According to Moody's, this will not fully compensate providers for lost revenue.

Moody's estimates that the Medicare Accelerated Payment Program will provide 5%-10% of annual revenues. Repayment of funds starts in four months and occurs through a holdback of Medicare revenues. Moody's believes that once hospitals start repaying these proceeds, it will cause cash flow stress later this year unless CMS changes the payment terms. At the state level, most states also provided much-needed relief, such as advancing Medicaid payments that are normally paid later in the year. This is also likely to cause cash flow issues, as hospitals will not receive these payments during the latter part of 2020.

On the subject of reopening and reactivation of services, Moody's expects the pace to accelerate over the coming weeks. The pace will likely be very uneven depending on state and local guidelines. Hospitals will need to demonstrate that they have sufficient levels of PPE, blood, and other supplies. Another key factor will be rapid testing results to ensure hospitals are safe. At the moment, there are substantial unknowns surrounding patient willingness to return to hospital settings. If patients are slow to return to hospitals, it could be some time before revenues return to their pre-crisis levels.

Notes on Technical Defaults

Moody's expects a rise in technical defaults this year due to covenant breaches. Initially, Moody's was concerned with days cash on hand covenants given the substantial drop in investment markets during March. These concerns have diminished given the recent recovery in portfolio values. At the moment, Moody's is more concerned with debt covenant breaches. Some have asked how Moody's will incorporate technical defaults. The rating agency doesn't expect to downgrade all issuers that face technical defaults. They will examine why it is occurring – is it temporary or ongoing? Ratings analysts will look at how resilient an organization is.

According to Moody's, many Master Trust Indentures (MTIs) could contain possible "outs" to avoid default. Currently, the suspension of elective procedures could be covered under "government or industry regulations." These are obviously subject to legal review but could represent a way out of technical defaults for many hospitals. Some MTIs also have language for certain events covered under acts of God. These "outs" could be helpful for a number of healthcare organizations. Bank documents and covenants, however, are usually more restrictive and don't have the same provisions as MTIs. If there are bank covenants in place, Moody's will want to understand the conversations hospitals are having with banks surrounding potential amendments or waivers.

Conclusion

Highland will continue to monitor rating agency communications amid the ongoing COVID-19 pandemic. Incorporating rating agency criteria and their current thinking into the asset allocation process has been a cornerstone of our enterprise-risk framework throughout our history. Any change in rating methodology from any of the major rating agencies will be implemented into our framework so we can make thoughtful and accurate recommendations to clients.

*FOR INSTITUTIONAL USE ONLY

Authors:



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: ST LOUIS:

8182 MARYLAND AVENUE,
 12TH FLOOR

ST. LOUIS, MO 63105

P. (314) 615-3501

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.

PUB0000013