HIGHLAND

INSIGHT

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NOT-FOR-PROFIT HEALTHCARE – BUSINESS AS USUAL OR A NEW NORMAL?

The COVID-19 crisis was a one-two punch for the not-for-profit healthcare sector. Instability in capital markets wreaked havoc on healthcare balance sheets, particularly investment portfolios and overall liquidity. On the operational front, after being forced to forgo elective procedures, healthcare organizations faced revenue declines never before seen, even in the most severe economic recessions of the past. The hit was significant in March and April of this year, as most hospitals witnessed revenue declines anywhere from 25%–50%. To make matters worse, most healthcare organizations were forced to contend with a substantial increase in expenses associated with PP&E needs and higher labor costs. Federal stimulus through the CARES Act provided much needed relief to the sector but was not enough to overcome the vast shortfall in revenues. According to Kaufman Hall, operating margins for healthcare organizations declined by 35% in April without CARES funding. With the funding, hospitals still saw operating margins decline by 13%.

Where Hospitals Are Today

Eight months have passed since the COVID-19 pandemic began ravaging the healthcare sector. While the pandemic has yet to pass, most hospitals find themselves in a much more favorable position today. Beginning in May, most states relaxed restrictions on elective procedures as new cases of the virus began to decline in most areas. This has led to a substantial increase in volumes, largely resulting from pent-up demand for hospital services. Despite this increase, volumes are still 70%–90% of their pre-COVID levels per Standard & Poor's. Operating margins at the end of September, while improved, are still 7.9% below their 2019 levels when excluding CARES funds . The recovery has also been uneven and has varied depending on region, infection rates, and amount of stimulus received from the government. While some hospitals have seen inpatient admissions return to prior

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levels, emergency room visits continue to struggle; those visits are still down 16% year-to-date according to a recent Kaufman Hall report. It remains to be seen just how long it will take before the sector fully recovers to its pre-COVID levels.

Investment markets, particularly in the U.S., have recovered from their March lows and are actually positive year-to-date. Combined with federal stimulus through the CARES Act and the Medicare Advance Payment Program, many hospitals find themselves flush with liquidity. Further bolstering balance sheets, the federal government recently announced that hospitals would be given more time to repay their Medicare advanced payments. This is in stark contrast to March, when healthcare organizations were rushing to evaluate liquidity needs to ensure there were sufficient levels to potentially subsidize operational shortfalls. However, this is not true for all hospitals, particularly those in rural areas, where hospitals were already cash-strapped and struggling with challenging demographics. Patients in rural areas are typically older, sicker, and struggle financially, which means margins for rural hospitals are typically much lower than their larger counterparts. The current pandemic is likely to further widen the gap between the strong and the weak. This has been reflected in the level of credit downgrades, with the BBB and below sectors witnessing more downward movement per S&P and Moody's.

A New Normal?

As we move into 2021, the key question for healthcare leaders is whether the current environment is only temporary or represents a new normal for the healthcare industry. In our view, the COVID-19 pandemic has served to accelerate shifts that began over the past decade. Much like the pandemic's influence on technology amid the shift to work-from-home settings and the continued movement away from brick-and-mortar retail, healthcare is also witnessing an acceleration of longer-term trends. These include the following:

- **The expansion of telehealth services and other digital platforms.** It is likely that telemedicine will continue to play a large role even after the pandemic ends.

  While telehealth presents an opportunity to reduce costs and increase efficiencies, the reimbursement landscape remains uncertain as COVID-19–related benefits are set to expire in 2021. Larger healthcare systems that have made significant investments in technology and have the scale for implementation will likely use these services as a competitive advantage.

- **The continued shift to outpatient care.** Even before the current pandemic, outpatient settings were gaining favor among both patients and payors. These settings typically offer more convenience and efficiency and are more cost effective. This trend has been accelerating throughout the pandemic and will likely continue thereafter. The impact to the sector will be credit negative according to Moody's, as many hospitals will likely lose volume to ambulatory surgery centers (ASCs). Acute hospitals with a significant outpatient presence in their local market will be better positioned than those without such facilities. Even for those hospitals, outpatient procedures typically offer lower reimbursements due to their lower cost structure, which will pose headwinds for the sector.

- **Reimbursement shifts show no signs of slowing.** Because of the changing demographic landscape within the U.S., payor mix has gradually shifted toward government plans, in particular Medicare. This trend has always presented challenges due to the lower reimbursement levels of government plans. The current economic environment is likely to add further pressure on reimbursements. As individuals become unemployed and lose their commercial coverage, they will likely shift to Medicaid or lose insurance altogether. This will likely further pressure already thin margins in 2021.

Healthcare organizations are likely to continue to face headwinds entering 2021. The United States is in the midst of its third wave of the pandemic, and new rates of infections are breaking records daily. Although there is promising news on the vaccine front,

the first doses are likely to go to high-risk groups and healthcare workers. It may be spring before vaccines are widely available to the general public. Until then, hospitals are likely to see an increased number of COVID-19 patients, potentially forcing some hospitals to suspend certain procedures to ensure adequate capacity. One bright spot is that the number of deaths along with average length of stay have both declined significantly as more effective treatments have become readily available.

From an investment standpoint, as was the case in March, hospitals should be mindful of potential liquidity needs and how those requirements fit within the context of their entire organization. The government's decision to extend the payback period for Medicaid advance funds should provide most healthcare organizations with ample liquidity to meet any potential needs that arise over the next 3–6 months. We are currently working with numerous healthcare organizations to effectively evaluate liquidity needs and the potential to add additional yield. With rates on the short end of the yield curve anchored near zero, balances held at money market funds are likely yielding anywhere from 10–15 basis points. Moving out slightly on the curve (6 months – 1 year) has the potential to add approximately 40-50 basis points in additional yield. This additional return could prove valuable in what is shaping up to be an uncertain operating environment.

[1] *Kaufman Hall October National Hospital Flash Report.*

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