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OUR WEBINAR RECAP

Intersection of Innovation and Investing Recap

Highland Associates recently hosted a virtual two-day healthcare-focused webinar entitled “Intersection of Innovation and Investing.” We hosted six sessions where our speakers highlighted the challenges and opportunities for healthcare organizations in what has certainly been a demanding environment over the past 18 months.

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 and defined contribution plans. Please visit the website at www.highlandassoc.com to learn more.

Our speakers provided fascinating insights into topics that ranged from economic growth and inflation, Washington, D.C. policy, to financing and M&A trends. For more detail on these timely topics, please see a summary below highlighting our conference discussions.

SESSION ONE

U.S. Economic Overview and Update

RICHARD MOODY, *CHIEF ECONOMIST, REGIONS FINANCIAL*
HOST – ALAN MCKNIGHT, *CHIEF INVESTMENT OFFICER, REGIONS FINANCIAL*

- Richard estimates real GDP growth of 5.5% in 2021, 4.6% in 2022, and 2.9% in 2023. Estimates for Q3 2021 growth have come down considerably from what were once lofty expectations. The August spike in COVID cases alongside ongoing supply chain and logistics bottlenecks remain a meaningful drag on growth (and a source of inflation pressures). Richard noted that this growth has been pushed into 2022, which is higher than previously forecast. Growth in 2023 and 2024 will look a lot like the growth levels pre-pandemic (~2% real GDP growth).
- There has been a growing imbalance between the supply side and demand side of the economy, which has resulted in higher prices across virtually every segment of the market. As a result, measures of inflation, whether on the wholesale or retail level, have been significantly elevated over the past few months. Despite Federal Reserve assurances that inflation would prove to be transitory, it is becoming more evident that higher inflation is likely to be with us longer that initially anticipated.
- Labor markets continue to heal—while the U.S. lost more than 22 million jobs in March and April of 2020, the economy has added back almost 17 million jobs. More recently, the pace of job growth has become more uneven. This is in part

a reflection of rising COVID cases in August and early September, but the more pressing issue is that firms have been unable to find workers to hire. Richard noted that as of August, the U.S. had almost 11 million open unfilled jobs, while the ratio of unemployed persons per job opening has fallen to 0.7. Around three million people are no longer in the workforce and have dropped out for a variety of reasons. One is enhanced unemployment benefits, which expired in early September. Another is lower female participation, associated with homeschooling and lack of childcare services. We should see female participation rise once these constraints begin to relax. One area that is likely to continue to challenge the labor market is the exit of older workers as they begin to retire.

- Interest rates remain depressed even in the face of higher inflation. For now, it seems market participants are buying the Fed story that inflation pressures are transitory. The danger is that the longer inflation persists, inflation expectations could adjust upward, leading to a significant increase in interest rates. Richard expects the Fed to begin tapering asset purchases in December and is likely to raise rates in the fourth quarter of 2022. Much has been made about the latest Federal Reserve "Dot Plot," but Richard cautioned against reading too much into this, as the Dot Plot is less of a forecast and more of a lens into the general direction of interest rates. Longer-term, it is likely that the Fed Funds rate will stay low relative to prior tightening cycles.

SESSION TWO

Financing, M&A, and Strategy – How NFP Healthcare Systems Are Positioning for Growth

TERRY SHIREY, *PRESIDENT, PONDER & CO.*
ALYSSA ZELLNER, *ASSOCIATE, PONDER & CO.*
HOST – MIKE MAULDIN, *SVP HEALTHCARE, REGIONS FINANCIAL*

- When assessing the NFP healthcare landscape, Terry noted that there are common themes across the three major rating agencies (Moody's, S&P, and Fitch). The biggest and most consistently referenced is liquidity and the strength that gives hospitals to weather future storms and unexpected events. Second is staff shortages and the associated increase in labor costs, particularly on the nursing front. On the COVID front, the Delta variant has intensified concerns, but the rating agencies have figured out that it's very market specific—for instance, what's happening in East Tennessee is likely different from what's happening in San Francisco. Finally, the industry continues to face demographic headwinds as an aging population continues to shift patients toward Medicare.

- On the debt side, NFP hospitals have been very active over the past two years given persistently low rates. According to Terry, based on a recently completed analysis for a healthcare system in Texas, when looking at hospitals in the state with revenue over $1 billion, all but one issued debt within the past two years. Looking at 2021, issuance is down 30% from the prior year, as most hospitals came to market in 2019 and 2020 to take advantage of low rates. Naturally there is less appetite now, even as rates remain low. Municipal bond inflows remain strong, recording positive inflows in every month since April 2020.

- Both tax-exempt and taxable rates have fallen since the spring amid fears of the Delta variant dampening economic growth. Both have risen more recently given concerns over inflation and a more hawkish tone from the Fed. During 2020, taxable rates were actually lower than tax exempt for a period of time, which made taxable issuance very popular. Ponder has seen that reverse in 2021 as tax-exempt rates have significantly outperformed. Lower-rated credits are benefiting the most from falling rates. For instance, BBB spreads have come in significantly over the past year (35 basis points, versus 7 basis points for AA credits). As of the end of September, BBB spreads stood at 3.43%, not significantly higher than AA (3.20%). Ponder had also seen an emergence of sub-3% coupons issued throughout 2020 as investors have become increasingly willing to purchase these securities.

- On the M&A front, the number of announced hospital change-of-control transactions declined in 2020 and into 2021. The COVID pandemic changed the focus for hospital management, while government support money allowed many systems to push off an M&A decision. Ponder believes that in the end, the same pressures on health systems that existed pre-pandemic will return, possibly with more force. As a result, we are likely to see M&A activity pick back up. However, the increasing levels of regulatory scrutiny will require that some proposed mergers demonstrate consumer benefit, as several states are heavily consolidated and competitors continue to draw closer.

SESSION THREE

China Update: Common Concerns, Common Confusion

JAMES DONALD, *MANAGING DIRECTOR AND HEAD OF EMERGING MARKETS, LAZARD ASSET MANAGEMENT*
HOST – WILL WYKLE, *CFA, DIRECTOR, HIGHLAND ASSOCIATES*

- James began with a review of China's maturation, both in terms of economic growth drivers and capital markets development. He specifically noted that, post-financial crisis, investors became concerned with whether Chinese companies could truly be entrepreneurial. Internet-based companies, notably Tencent and Alibaba, have proven their entrepreneurial chops and are now rivaling U.S. leaders like Facebook and Amazon in size and scale. Until late last year, it seemed as though there were no limit to the growth and power potential of Tencent, Alibaba, and other mega-cap Chinese consumer/technology stocks. That changed quickly in late 2020 when Alibaba's spin-off of Ant Financial was abruptly canceled by Chinese authorities at the very last minute. Since then, the government has specifically targeted other industries with onerous restrictions on growth and profitability, including the education and gaming industries. James argued that the introduction of "Common Prosperity" in general, and the associated threat to certain industries, has "essentially changed the whole market environment in China."

- Regarding the impact of these policies on economic growth generally and middle-class growth specifically, James argued that "Common Prosperity" is specifically designed to ensure stability in China by reducing the growing wealth gap. As such, he expects less conspicuous consumption from China's elites and upper middle class, which should hurt luxury brands like LVMH and Gucci. Conversely, the bottom tiers of the middle class should benefit from at least the perception of a level playing field; going further, James noted that new Chinese policy is intentionally designed to bring lower income individuals and families up further and faster than before. All that said, James believes it is entirely plausible that we will see a material downshift in overall consumption in the short-term, but the long-term middle-class growth story remains firmly intact.

- Next, James discussed the Evergrande situation, noting that the property developer's $300B in liabilities could present a systemic risk to the Chinese economy. However, there are an abundance of resources to navigate this crisis, as he noted that Chinese capital markets remain more liquid than ever, while the nation continues to maintain a strong asset and reserve position. More specifically, James notes that holders of Evergrande debt should not expect a significant bailout— "buyer beware," after all. For competing property owners in sound financial shape (of which there are many), Evergrande's struggles could allow them to acquire quality assets at a highly discounted price. James expects that this will be a major development to watch in the coming months.

- Regarding overall growth potential in China, James noted that Chinese growth has slowed recently, and he does not expect China to return to the 8%–10% annual economic growth that the country achieved throughout most of the 21st century. However, he painted this as a positive, noting that asynchronous economic recovery is actually the best thing for the global economy. If we were to have a completely harmonized growth recovery across the world, James believes it would create even stronger and more durable inflationary pressure.

- Finally, James noted that private markets in China are "growing dramatically" with "lots of enthusiasm" behind them. He also mentioned that Chinese private markets are more focused on later-stage investments than their counterparts in the U.S. and Europe.

SESSION FOUR

Washington Policy Overview

DAN GRATTAN, *FEDERAL GOVERNMENT AFFAIRS, REGIONS FINANCIAL*
HOST – MICHAEL LYTLE, *CFA, MANAGING DIRECTOR, HIGHLAND ASSOCIATES*

- There are currently two large spending packages being debated in Washington. The first is the hard infrastructure package with a topline number of $1.2 trillion. It includes items such as roads and bridges, power system upgrades, renewable energy, passenger and freight rail upgrades, affordable access to broadband, lead pipe upgrades for drinking water, and airport upgrades. This is a very popular program across the aisle and does not currently include anything for higher taxes.

- The second is the Build Back Better package, which would have to go through the reconciliation process, which means increased spending has to be offset by increased revenue (i.e., taxes), impacting corporations and higher-earning individuals. This started at $3.5 trillion, but many expect the number to be much closer to $1.5–$2 trillion. This bill focuses on healthcare, climate issues, childcare and education, and housing. The expectation is that everything gets trimmed down to meet the lower expected number, but that education and housing get trimmed the most.

- The prospects for both have been impacted not only by partisanship but also by divisions within each party. While we may be at peak partisanship in our country, it is more within the populace than within Congress. There is more collegiality inside the walls of Congress than it appears in public. That said, some of the public posturing by members of Congress gives a different impression, and Congress needs to act on some widely popular programs to avoid encouraging a further divide in the country.

- For the midterm elections, there is a reasonable chance that the House flips and a small chance that the Senate does as well. The elections that are a part of the cycle for the Senate this time around don't have as much opportunity for Republicans, but there is still some chance. Candidate recruitment is kicking into high gear, with both parties looking at vulnerable seats and choosing candidates specifically to win that seat.

- As far as the debt limit, it takes 60 votes to suspend the limit but only 51 to raise it. So suspending would take the cooperation of both parties, and the Republicans are saying to the Democrats, "You have all the tools you need to raise it" since it takes 51 votes, but it would require every Democrat to vote for it and the Vice President to break the tie, essentially handing the

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Republicans the script to blame the Democrats for excessive spending in the midterms. You can easily see how that is uncomfortable for the Democrats. Interestingly enough, President Biden, then Senator Biden, gave a speech on the floor of the Senate nearly 20 years ago telling the Republicans the same thing. And they raised the debt limit on their own. Lastly, this current raise does not even cover the two major packages mentioned previously, so they will have to raise the limit again in early 2022. They reached a short-term deal to raise the limit to fund the government until early December.

- Regarding the Federal Reserve, the recent news of trading patterns by governors and their resignation has caught the eye of critics like Senator Warren. However, a number of other members of the Senate Banking Committee have come out in support of Chairman Powell, noting that a change at this point would be concerning. All is not lost for Powell, but things are certainly interesting.

- Lastly, on the executive order impact for healthcare, particularly mergers, the more important thing to watch is who is running the agency responsible for evaluating the actual deal. Executive orders get the headline, but they really only direct the agencies to pay attention. Mergers that cause job losses or increases in cost are going to be in trouble. Beyond that, the expectation is limited impact on deals.

SESSION FIVE

A Return to Normal or a New Normal? A Discussion on the State of NFP Healthcare with Moody's and Fitch

DANIEL STEINGART, *VICE PRESIDENT, MOODY'S*
OLGA BECK, *SENIOR DIRECTOR, FITCH*
HOST – MIKE THOMAS, *CFA, DIRECTOR, HIGHLAND ASSOCIATES*

- Dan and Olga began by giving an update on the state of the NFP healthcare sector. For Fitch, 2020 was certainly a difficult year for the sector, given the massive revenue hit that impacted hospitals. There was significant variance based on factors such as size, timing of government funding, and revenue diversification. Hospitals such as academic medical centers or those with a large research presence fared better than children's hospitals, which were hit very hard amid lockdowns. Large hospitals certainly had an advantage, as they were able to deploy resources as needed. Olga noted that in 2020, there were only five healthcare upgrades at Fitch, and three of those came pre-pandemic. The year 2021 has been a different story for healthcare systems, as volumes have mostly returned and investment markets have remained strong, giving hospitals substantial levels of liquidity.

- From a ratings perspective, Fitch has upgraded 14 credits in 2021. As in 2020, 2021 has seen a lot of variability in results because of the Delta variant. Areas with lower vaccination rates have been dealing with the possibility of halting nonessential procedures. From Moody's viewpoint, Dan remarked that we are moving from a pandemic stage to an endemic stage as COVID is going to be with us for a long time. Hospitals are evolving and learning to live with COVID on a day-to-day basis and adjusting the way they operate and treat patients.

- Another important theme is how hospitals continue to grapple with expense growth, particularly on the labor front. While a significant driver is on the nursing side, Moody's noted that wage pressures are broad based and even on the low end of the wage scale. On the nursing front, Dan stated that the industry has been squeezed by a couple of factors. One is that there has been an incredible amount of demand for skilled nurses at COVID hotspots around the country. This has led to an extraordinary amount of growth in the travel nurse industry, which carries much higher costs, with wages typically around

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$200–$300 an hour. These costs have grown significantly over the past two years amid much higher demand. Secondly, many nurses have left the industry due to retirement or COVID-related burnout. Moody's has witnessed a growing trend of hospitals investing in technology and education while looking at ways to redesign workflow. Virtual monitoring and virtual care are notable projects that are gaining momentum at many healthcare organizations.

- The pandemic has not led Fitch or Moody's to change their ratings methodology. For Fitch, they believe their ratings criteria should still apply during difficult periods such as 2020. For instance, rating methodology should always focus on important factors such as demand, market, payor mix, and operations. Fitch expects that many of the same challenges that have always faced healthcare will continue going forward.

It is also likely that COVID accelerated the timeline for healthcare organizations to deal with these obstacles. Moody's expressed similar thoughts and observed that its ratings framework accurately reflected the challenges hospitals faced and will continue to face going forward.

- While volumes have generally increased from their mid-2020 lows, the emergency department is one area where volumes are still generally 10%–15% below their pre-pandemic levels. According to Moody's, while those levels may not come back completely, this could lead to higher-acuity volume, which would actually be positive for hospital systems. Fitch noted that many hospitals for years have been pushing to move some of these services to lower-cost settings such as ambulatory centers or urgent care offices, while allowing the hospital to focus on higher-acuity services.

SESSION SIX

Healthcare Trends – Venture Investing

ANYA T. SCHIESS, *GENERAL PARTNER AND COFOUNDER, HEALTHY VENTURES*
HOST – ERIC RALPH, *CFA, MANAGING DIRECTOR, HIGHLAND ASSOCIATES*

- Investors are viewing healthcare as ripe for disruption. The disruption targets include current payors and providers. This perspective is being driven by the low digitization across the healthcare value chain, inefficient and complex processes, and the growing component of customer spending for healthcare.

- Investors have committed record dollar amounts for healthcare efforts. Change and new ideas will get funded. More than $14.6 billion was committed to healthcare venture investing in 2020 and in just the first six months of 2021 has exceeded $14.7 billion. These cash flows are funding new businesses and ideas. Healthcare investors (payors and providers) make up over 10% of the deals.

- On-demand healthcare is a top dollar recipient. This vertical is targeting disintermediation of the providers and payors from patients. New startups are going directly to the consumer without the legacy expenses and infrastructure of current providers and payors. Venture investors are focused on near-term revenue growth and a medium time horizon—the low-hanging fruit—to drive returns.

- The public markets are favoring providers over payors at this time. Based on current valuations, the market is rewarding startups that are providing medical services and taking risk with multiples in the 20–70 times earnings versus traditional payors and payor upstarts in the 3–9 times revenue range.

- Healthcare providers should be thinking about how the competitive dynamic is changing for payors and providers. The trend points toward a blend of the two; an example is Optum, which is the largest owner of physician practices. Providers can ensure the long-term health of their business by thinking about the following points:

- Expanding the customer relationship for non-medical items (social/health)
- Leveraging specialists and creating referral networks with non-traditional (newer) players
- Focusing on high-margin procedures in hospitals and community health in geographic markets
- Move into the provider's/payor's business and offer solutions rather than just services

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