
HIGHLAND

# Healthcare Quarterly

2ND QUARTER 2022

*Transforming Portfolios. Advancing Missions.*

Anyone looking for a relatively benign start to 2022 for the not-for-profit healthcare sector was surely disappointed. The lingering effects of the Omicron surge have left hospitals in a position where they are trying to regain their footing. For many organizations, operations and margins continue to be pressured as hospitals grapple with labor shortages and wage pressures alongside volumes that struggle to return to their pre-pandemic levels. Relentless volatility in stock and bond markets have created a one-two punch for the healthcare industry, still reeling from a generational pandemic whose effects are still being felt.

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OPERATING ENVIRONMENT

## Operating Environment and Implications for Healthcare

- According to Kaufman Hall, U.S. hospitals continued to face headwinds into May. While April marked the fourth straight month of negative margins, margins did improve a bit in May. Still, the median year-to-date operating margin at the end of May was (-0.33%). This compares to a median margin of +2.5% at the end of 2021. While volumes are slowly creeping back to their pre-pandemic levels, hospitals are wrestling with labor costs that have risen 27% since the start of the pandemic. During the winter surge associated with the Omicron variant, worker burnout rates remained high, while staffing was in short supply as employees contracted the virus. According to Forvis, 76% of healthcare workers reported exhaustion and burnout through the pandemic. Use of agency nurses peaked during the winter months as did their rates, while hospitals needed to limit certain services, particularly elective cases, because of staffing shortages. This put further pressure on margins that had already been pummeled by rising expenses.

Many NFP healthcare organizations find themselves in a precarious position halfway through the year. As of the end of June, global stock and U.S. bond markets are down 20% and 10%, respectively, year-to-date, wreaking havoc on most investment portfolios. Bond markets have not played the role of crisis hedge this year, and a traditional 60/40 portfolio is down 16% YTD. While alternative asset classes such as hedge funds and real assets have held up relatively well (and in some cases provided a positive return stream), even investors with diversified portfolios generally find themselves down double digits YTD. Negative margins combined with investment losses mean hospitals are likely to find themselves in the red at the end of the second quarter. This could present covenant challenges for organizations with a June 30 fiscal year-end, especially when looking at debt coverage ratios. Even those with September and December year-ends could face challenges if investment markets and operations fail to rebound. Days cash on hand ratios also bear watching for hospitals with limited liquidity cushion.

NFP hospitals faced a similar environment in March of 2020, as organizations found themselves strained amid a sharp equity market drawdown and operations that were impacted by the shutdown of most elective procedures. However, capital markets recovered rapidly, and government stimulus provided substantial relief for the healthcare industry. This year, equity market volatility has been longer-lived, and it's doubtful markets will recover quickly as the Federal Reserve has made it known that it will remain vigilant in its quest to bring down inflation. Government relief has likely been tapped out, so it will be up to healthcare executives and management teams to remain laser focused on reducing expenses and improving efficiencies.

What does this mean for the investment portfolio? While each healthcare organization has different needs and underlying demands, many are faced with decisions surrounding liquidity and risk tolerance. Some organizations may need to tap the investment portfolio to fill operational shortfalls or to supplement capital spending needs, especially as interest rates continue to rise, making debt issuance less attractive. On the flip side, higher interest rates are making relatively safe segments of the market, such as enhanced cash and short-term fixed income, attractive. For most short-duration mandates, yields are now exceeding 4%, compared to sub 2% at the end of 2021. As a result, some organizations may look to allocate a portion of the investment portfolio to reserves, in the event that funds are potentially needed for the reasons stated above. With higher yields, investors are better compensated to hold dry powder in the event funds are needed for operations, capital spending, or portfolio investment. Conversely, balance sheet stability and lower portfolio returns will not replace aging towers or fund expansions into new growth areas and technologies. Investors will be forced to balance between taking on additional volatility and illiquidity or accepting lower returns and more stability.

## What the Rating Agencies Are Saying

### *Moody's*

- In an in-depth report, Moody's noted that the delivery of care will continue to shift to less costly locations such as outpatient or in-home settings. Healthcare has been trending this way, but the COVID-19 pandemic accelerated this trend. While fewer patients sought care in traditional hospital settings during the pandemic, this impact on how consumers access healthcare will likely persist. This means fewer emergency room visits and the continued use of telehealth. According to Moody's, outpatient revenue has exceeded inpatient revenue annually since 2016 and is likely to continue. Additionally, the shift to value-based care among governmental and commercial issuers will move care away from more expensive settings. These are headwinds that will continue to constrain hospital revenue growth and margins. Hospitals with higher-acuity care, such as academic medical centers, will be better positioned to offset these trends.
- In the most recent Healthcare Quarterly, Moody's noted that the NFP healthcare sector will face numerous regulatory and legislative challenges over the next year. These include the return of Medicare sequestration, which began on April 1 with a 1% cut. The full 2% reduction is scheduled to return on July 1. On top of that, hospitals will receive less COVID-19 relief funds in 2022, which will make it difficult to

*[1]* Stock markets defined as the MSCI ACWI and bond markets defined as the Barclays Aggregate Bond Index*
*[2]* 60% MSCI ACWI /40% Barclays Aggregate Bond Index*

offset sequestration cuts. These cuts come as the sector faces inflationary pressures on labor and supplies and as volumes are still recovering from this year's COVID surge. Furthermore, the environment for M&A activity in healthcare has cooled significantly with the Biden administration taking a closer look at hospital consolidation. Other regulatory bodies will also continue to scrutinize certain hospital systems for state and federal antitrust violations. This could potentially hinder key strategic proposals for some NFP healthcare systems as they look for ways to create scale and grow revenues. Finally, healthcare systems that participate in the federal 340B Program could be challenged by legislative proposals to allow the Centers for Medicare & Medicaid Services (CMS) to place limits on drug pricing. This can be a significant source of income for many NFP healthcare systems. It should be noted that the U.S. Supreme court recently overturned a $1.6 billion 340B payment cut by CMS, a positive move for NFP hospitals.

- Moody's also noted that despite operational pressures in 2022 alongside volatile capital markets, NFP healthcare systems will likely maintain credit quality. NFP healthcare organizations built up sizable cash cushions coming into 2022, thanks to favorable investment markets and the receipt of federal relief funds from the CARES Act. Additionally, many organizations reduced capital spending throughout the pandemic. Median days cash on hand at the end of 2021 (based on preliminary medians) was 265 days, compared to 199 in 2019. When stressing these cash balances based on 20%-35% equity market drawdowns and excluding Medicare advances, estimated median cash balances remained above 2019 levels, per Moody's analysis. Moody's did note that organizations with weaker cash reserves and minimal covenant cushions would be more susceptible to ratings downgrades.

## Citigroup NFP Healthcare Conference Recap

- Highland had the pleasure of attending the 2022 Citigroup NFP Healthcare Conference. This year's conference was the first in-person gathering since 2019. While the conference typically highlights each organization's strategy for growth alongside financial results, this year's meeting instead focused on the larger, innovative, and more transformational changes and pivots that healthcare organizations and their leaders are making. Many of the organizations present are actively working to "disrupt" the traditional healthcare delivery model through innovation and technology – changing the way that healthcare is delivered and the value proposition that comes with it. Several of these transformations have been ongoing for years, though accelerated by the COVID-19 pandemic. There is a heightened sense of urgency in healthcare to transform and innovate or become irrelevant. Below is a summary of key topics and our takeaways from presenting healthcare systems.

## Addressing Health Inequities and Social Determinants of Health

- ***Norton Healthcare***

  To address health inequities, Norton Healthcare established the Institute of Health Equity to ensure access to primary care for everyone in Louisville. West Louisville is known for having less favorable health outcomes than the eastern part of the city. For example, the average life expectancy of an individual residing in West Louisville is 69–71 years, while in the eastern part of the city it ranges from 78–82 years. It has been more than 150 years since a hospital was built in West Louisville. To address the lack of access to care, Norton is building a $70 million hospital on the new "Opportunity Campus," which is set to open in 2024. The organization is also investing an additional $20 million over 5 years to address underserved areas of the community.

## Transforming How Care Is Delivered

***Ochsner Health***

- Ochsner Health is one of many healthcare organizations that have begun the transition to value-based care. Under a value-based arrangement, reimbursements are tied to improving healthcare outcomes relative to the cost of care.

As a result, hospitals have an incentive to provide care in the most cost-effective setting. To jump-start the transition to value-based care, Ochsner started the Ochsner Health Network in 2017. Today there are nearly half a million people covered by valued-based agreements, up 227% since 2017.

Further disrupting how healthcare is delivered, Ochsner is leveraging digital medicine solutions to transform the care of chronic diseases. According to Ochsner, chronic illnesses such as diabetes are responsible for over 80% of all healthcare costs in our country. Remote monitoring of blood pressure and blood glucose gives the organization's digital medicine team the ability to monitor participants' data to make the best treatment decisions. Clinical and financial outcomes have improved as nearly 80% of members achieved their blood pressure and A1C goals after 6 months. Emergency room visits and hospital admissions among hypertension enrolled members are down 45% and 38%, respectively.

### ▲ *Hartford HealthCare*

Like Ochsner Health, Hartford HealthCare has embraced the move to value-based care. Through "purposeful disruption," the organization is driven to move care to the lowest-cost setting. This means fewer procedures performed in the traditional hospital inpatient setting or emergency room, and more within ambulatory surgery centers (ASCs) or other outpatient facilities. Hartford noted that in 2016, only 6% of all surgeries and procedures were performed in these settings. Today, nearly 40% are performed outside of the typical hospital venue. The pandemic has also driven the shift away from the emergency department and to lower-cost urgent-care centers. In 2021, there were nearly half a million urgent care visits within the Hartford organization, compared to only 45,000 in 2017. Given the industry's evolution to a value-based system, it's unlikely that these trends will reverse. Healthcare organizations will need to transform their strategy for delivering care if that process hasn't already begun.

## Healthcare With No Borders

▲ We heard from two large healthcare systems that either recently closed a merger (Intermountain Healthcare /SCL Health) or had announced plans to merge (Advocate Aurora/Atrium Health) prior to the conference. While each deal is unique, the overwhelming message was that as healthcare continues to evolve, NFP healthcare systems will need to innovate and adapt to thrive in a new environment. For Intermountain Healthcare, growth across new geographies and the shift to value-based care was a major reason for the SCL merger. Acquisitions were nothing new for Intermountain, playing a substantial role for its strategic growth initiatives over the past decade. Intermountain viewed SCL Health as one of the premier outcome-based healthcare systems in the nation, making the merger a perfect fit. The goal is to change the way healthcare is delivered – to a system where consumers can understand what they're getting and at an affordable price.

Advocate Aurora and Atrium Health announced their plans to merge only a couple of weeks before the conference. Like Intermountain, both organizations had prior experience with mergers and acquisitions. The goal for both organizations is ultimately to redefine how, when, and where healthcare is delivered. To quote both presenters: "The challenges in healthcare are not local. They are national, and a larger footprint is needed to solve larger problems." As the delivery of care continues to evolve to a process where technology and data play a larger role, size and scale will be crucial. Also, geographic headquarters will become irrelevant. Atrium Health noted that nearly 80% of its ambulatory healthcare services are already virtual, meaning that a patient in Macon, Georgia, can receive direction and treatment from someone in Charlotte, North Carolina. Additionally, size, scale, and growth will play a role in disrupting the root causes of inequality in healthcare across the nation.

*Sources: Moody's Investor Services Sector Comment 16 June 2022 Not for Profit and Public Healthcare – US; Moody's Investor Services Sector Comment 20 April 2022 Not for Profit and Public Healthcare – US; Moody's Investor Services Sector Comment 15 March 2022 Not for Profit and Public Healthcare – US; Kaufman Hall- National Hospital Flash Report June 2022.*

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