Healthcare Quarterly

FIRST QUARTER 2022

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Highland Healthcare Quarterly

From an operating perspective, 2021 represented a marked improvement from 2020 – a year when revenues and margins plummeted to levels never seen in the healthcare industry. Although the COVID-19 pandemic continues into its third year, most healthcare organizations have learned to better navigate the uncertainty associated with the virus.

Author:
Mike Thomas, CFA *Head of Healthcare Analytics*

That said, the industry is far from "back to normal." Revenues remain well below and expenses remain well above those of pre-pandemic levels. 2022 is likely to be another difficult year for hospital performance as sector headwinds continue to pressure the industry.

TRENDS

Operating Trends

- According to Kaufman Hall, the median hospital operating margin for 2021 was 2.5%, versus (-0.9%) for 2020 (Link to Report). When including federal aid, the operating margin was 4.0% for 2021. Volumes and revenues were significantly higher in 2021 when compared to 2020 – a year where nonessential services were shut down across the industry, causing these metrics to plummet. On the flip side, expenses continue to increase and are outpacing the growth of revenues for most hospitals. Hospitals have been hit particularly hard on the labor front as staff shortages are driving up wages and costs, particularly for skilled nurses. To meet staffing needs, most healthcare organizations are having to rely on contract labor, where wages are exponentially higher. To combat this shortage, a number of large healthcare organizations are creating their own internal staffing agencies to mimic the agency/travel services in the market to deploy nurses/staff to hospitals located in COVID hotspots. Additionally, many are investing in "care at home" models to utilize labor more efficiently. Finally, the shift to lower cost outpatient settings will likely continue after accelerating during the pandemic. While positive on the expense front, these are lower margin strategies and will limit revenue growth when compared to inpatient admissions.

Below, you can see the dramatic increase in expenses (per Kaufman Hall) for 2021 when compared to 2019:

- Total Expense per Adjusted Discharge was up 20.1%
- Labor Expense per Adjusted Discharge was up 19.1%
- Non-Labor Expense per Adjusted Discharge was up 19.9%

The Omicron variant has forced many health systems to once again suspend nonurgent, elective procedures. This is likely to impact operating performance initially in 2022. Growing volumes associated with the virus were compounded by staff infected with the virus. At many systems, anywhere from 10%–20% of staff were out sick. With healthcare staffing already tight, many organizations were forced to limit capacity and volumes. While Omicron will eventually wane, future variants could have a similar impact on the healthcare system.

What the Rating Agencies Are Saying

Moody's

- Moody's has a negative outlook for the sector in 2022 and is a bit more pessimistic than the other rating agencies.
- Moody's is especially negative due to sector headwinds impacting operating performance. This includes expense growth likely continuing to outpace revenue growth, leading to deteriorating margins. Staffing shortages will be the main driver of higher expenses.
- Further straining hospitals are headwinds that have been in place for a long time – i.e., changing demographics that will continue to push more volumes toward Medicare, as well as regulatory risks (Medicare sequestration, 340B changes, and antitrust changes that could slow down M&A activity).

Fitch

- Fitch has a neutral outlook for the not-for-profit healthcare sector in 2022.
- Fitch shares many of the same concerns as Moody's, particularly on the expense front. They expect margins to reflect the difficulty in keeping revenues on pace with higher operating expenses, which are complicated by inflationary/wage pressures.
- While operational pressures will continue to persist in 2022, strong balance sheets and liquidity across the sector should provide cushion throughout the year. Fitch does not anticipate any significant deterioration of rated hospitals' financial positions to trigger ratings downgrades.

S&P

- S&P's outlook mostly mirrors Fitch's. They have a stable outlook as strong balance sheets and effective management should help healthcare organizations manage near-term challenges associated with COVID-19.
- Organizations with strong balance sheets are less likely to experience a negative credit rating. These organizations are better equipped to handle near-term operational pressures. Weaker credits may continue to struggle in this environment.
- Per S&P, it's likely the industry incorporates changes tied to data and technology more quickly over the next few years. This will likely further the credit gap as smaller organizations without the balance sheet and scale lack resources to support these investments.

Trends and What We're Watching

***Liquidity* —** Hospitals still remain flush with liquidity. Per Moody's, absolute unrestricted cash and investments grew 29.7% (in 2020) over the prior

year after averaging 7.5% across the previous three years. With investment markets moving higher in 2021, it's likely growth will remain substantial. It should be noted that much of this growth is attributable to Medicare advance payments that left hospitals with substantial cash levels.

These payments are currently being recouped by the government. Starting in April 2021, funds began to be recouped at a rate of 25% of submitted Medicare bills. This rate will increase to 50% starting on March 1, 2022. On September 1, 2022, any unpaid loans will be immediately due and payable. This could cut into liquidity for some organizations, particularly those with weak balance sheets prior to the pandemic. Ongoing operational pressures associated with Omicron could compound these issues. Recently, the American Hospital Association asked Congress to suspend the recoupment of these payments. We are monitoring any changes here as this could provide more balance sheet flexibility.

With liquidity flush, healthcare organizations should evaluate near-term cash needs and look for opportunities to earn excess returns. With short-term rates moving higher, hospitals can earn additional yield above and beyond money markets by moving a portion of excess cash to short-duration strategies. Additionally, healthcare organizations should strongly consider moving excess liquidity (above and beyond short-term needs, if available) to longer-term investment pools to increase overall returns.

Inflation — Inflation continues to impact NFP hospitals on multiple fronts. First of all, inflation, which is currently running at 7.5% - its highest rate since 1982, has reduced real returns on the investment portfolio(s). For organizations with heavy investments in cash and fixed income, the impact is even more pronounced. Secondly, as we have written about before, healthcare organizations must contend with inflation and its impact on operations. In last year's healthcare *Insight*, we anticipated continued inflationary pressures for healthcare organizations given staffing shortages (particularly on the nursing front) and ongoing wage pressures. There seems to be little hope of these pressures letting up. While overall healthcare inflation (as measured by the medical care component of CPI) has been relatively tame since March 2020, the most recent monthly increase in January was the highest in over two years.

We have long advocated for a dedicated allocation to inflation-sensitive assets. Those clients have been rewarded as real assets posted some of the best returns within our clients' portfolios. With inflationary pressures likely to continue on both fronts, healthcare organizations would be well served to reassess their asset allocation to ensure they are protected from inflationary risks.

Regulatory — Mandatory cuts to Medicare, known as sequestration, were avoided when President Biden signed a bill halting 2% mandatory cuts to Medicare spending. A 4% statutory pay-as-you-go sequester was also halted. This was a significant risk to healthcare organizations, particularly those with a large government payor base. Risks remain with several drug pricing programs potentially credit negative for 340B-eligible hospitals. Vaccine mandates for healthcare workers could cause healthcare organizations to lose a significant percentage of employees, which could force hospitals to rely more on contract labor.

The COVID-19 pandemic has forced many healthcare organizations to consider further consolidation and/or strategic partnerships. This has provided a lifeline to struggling systems while strengthening larger ones. President Biden's focus on antitrust laws will likely force more scrutiny of potential mergers in the healthcare industry. These actions would be negative for smaller struggling systems while also slowing the growth of larger healthcare organizations.

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HIGHLAND ASSOCIATES

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

- BIRMINGHAM
- ST LOUIS
- NASHVILLE
- PENSACOLA

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