HIGHLAND

MID-YEAR WAKE-UP CALL

Market Moves, Medicaid Risks, and What to Do Next

Just a few short years ago, hospitals and health systems were navigating what many considered the most turbulent environment in healthcare's modern era. While signs of stabilization have emerged, the first half of 2025 underscored that the industry is far from out of the woods. Reimbursement uncertainty, capital market constraints, and persistent margin compression continue to challenge even the most sophisticated operators.

At the same time, market behavior has defied expectations. Equity indices have set new highs, fueled by narrow leadership and renewed risk appetite, while hedge funds have consistently upheld their purpose of limiting downside risk. Yet beneath the surface, uncertainty remains. Healthcare organizations are facing challenging questions about now only the market, but also about their own risk tolerance and strategic footing.

In this edition of Highland Associates' Healthcare Quarterly, we distill insights from the Healthcare Treasurer's Roundtable and Barclays Healthcare Conference, interpret Moody's evolving sector outlook, and outline how Highland can help clients manage complexity with clarity.

MARKET RECAP

H1 2025 – Volatility Meets Validation

Markets entered 2025 with cautious optimism and exited the first half with renewed conviction. Equity volatility in Q1 (driven largely by policy announcements and geopolitical risk) gave way to strength in Q2, with major indices notching new highs. Valuations currently remain rich – U.S. equities continue to price in uninterrupted earnings growth and stable inflation. A deviation from that narrative, however, could challenge performance.

Hedge funds, at the average, were meaningful contributors during the 1Q25 when markets experienced bouts of volatility. At the Healthcare Treasurer's Roundtable, multiple CIOs cited hedge fund allocations as a key source of stability during recent swings.

> "International equities finally staged a comeback, outperforming domestic markets for the first time in several quarters"

Another noteworthy shift: international equities finally staged a comeback, outperforming domestic markets for the first time in several quarters. This reversal reinforced the value of geographic diversification, especially amid shifting currency dynamics and divergent central bank policies.

Private equity was less encouraging. Limited deal flow and extended exit timelines have delayed distributions, forcing many institutions to reassess liquidity assumptions and adjust their pacing models.

WHAT WE HEARD

Healthcare Treasurer's Roundtable

Key highlights from the March 2025 Healthcare Roundtable include:

- **Reevaluating Risk Profiles:** Margin pressure is prompting organizations to reexamine how much risk their investment portfolios can support, and how best to calibrate it.
- **Finance-Operations Convergence:** Treasury functions are no longer siloed. Finance and operations teams are working in lockstep to align cash flow needs with capital strategy.
- **Portfolio Income vs. Mission Support:** In many systems, investment income now outpaces operating margins. Boards are navigating the difficult tradeoff between de-risking and subsidizing clinical operations.
- **Heightened Credit Caution:** Investors are concerned about thin spreads and are questioning whether they're being adequately compensated for credit risk.
- **ESG and Innovation:** Once a strategic focus, ESG and venture innovation are now taking a back seat as systems focus on stability and seek to avoid political backlash.

MAY 2025

Barclays Healthcare Conference

Highlights from the Barclays Healthcare Conference echoed the Roundtable, with added emphasis on:

- **Resurgence of Value-Based Care:** Health systems are revisiting risk-based models - not as innovation, but as necessity. The prospect of aligning payer and provider economics has gained urgency as traditional reimbursement models falter.
- **Constrained Access to Capital:** With elevated risk premiums, issuing new debt has become more expensive. Some systems are delaying or scaling back capital plans.
- **Margin Pressure Among Leaders:** Even best-in-class providers are struggling. One marquee institution reported a decline from historical margins of 6-8% to just 1.7%.

RESURGENCE OF

Value-Based Care

ELEVATED RISK PREMIUMS

Constrained Access to Capital

PROVIDERS ARE STRUGGLING

Margin Pressure Among Leaders

INDUSTRY TRENDS

Medicaid Reforms Signal Credit Headwinds

Moody's June 2025 sector report paints a sobering picture for nonprofit hospitals: proposed federal Medicaid reforms could materially weaken financial performance as soon as 2026.

Among the most consequential proposals:

- **Moratorium on Provider Taxes and State-Directed Payments:** A cap on new or increased provider taxes would limit states' ability to leverage these mechanisms for federal matching funds. This shift threatens key supplemental revenue streams that have, in many states, bolstered Medicaid reimbursement closer to commercial rates. For example, in California, these programs contribute 200-400 basis points of operating cash flow margin—accounting for up to 50% of median operating cash flow at some institutions.
- **Tighter Medicaid Eligibility and Work Requirements:** New federal rules would introduce work requirements for Medicaid recipients, with implementation deadlines set for 2026. While exemptions apply to certain populations, many enrollees may lose coverage due to administrative hurdles, even if they remain eligible. Moody's highlights Arkansas as a cautionary example: a similar policy there led to thousands of procedural disenrollments and a 7-percent rise in the uninsured rate among adults aged 30-49.
- **Operating Margin Sensitivity:** If enacted, these changes could reduce median hospital operating cash flow margins by 1 to 1.5 percentage points. The impact could be more acute in states with high Medicaid penetration or systems that rely heavily on supplemental payments. With Medicaid representing roughly 15% of system revenue on average, even marginal cuts carry outsized risk.

The proposed reforms land at a vulnerable time. Health systems continue to battle persistent labor costs, inflationary pressure on supplies and pharmaceuticals, and lagging cash flow recovery. Additional strains on Medicaid reimbursement could tip already fragile margins further into negative territory – particularly for rural, safety-net, and mission-driven providers.

So, What Does This Mean for You?

Healthcare executives navigating today's market should keep the following priorities top of mind:

- **Reassess Portfolio Risk:** Given margin volatility, now is the time to revisit whether your current asset mix still aligns with your system's operating realities and board expectations.
- **Revisit Liquidity Planning:** Delayed private equity distributions and uncertain Medicaid funding make a clear understanding of short- and mid-term liquidity needs more critical than ever.
- **Reconsider Diversification:** With international equities outperforming and hedge funds proving effective shock absorbers, diversification is once again delivering real value.
- **Monitor Capital Access:** Rising credit spreads and constrained bond market appetite may affect upcoming debt issuance – consider alternative financing or delaying capital projects.
- **Rethink Strategic Alignment:** The reemergence of value-based care and margin pressure are forcing systems to evaluate how investment strategy can better support long-term mission delivery.

Our Recommended Approach

Highland continues to work closely with healthcare clients to ensure their investment strategy supports both immediate and long-term needs. Our approach emphasizes:

Enterprise Risk Modeling

Tailored frameworks to evaluate the portfolio's role within broader institutional risk tolerance.

Liquidity Planning

Elevated focus on understanding expected cash needs and liquidity profiles, particularly critical in today's strained operating environment.

Asset Allocation Adjustments

Strategic realignments that enhance resilience and flexibility.

Implementation Discipline

Incorporating hedge funds, global equities, and credit alternatives to help manage volatility and diversify risk.

While uncertainty persists, Highland remains committed to equipping healthcare organizations with the insight and tools they need to navigate complexity with confidence and remain mission-aligned through all market cycles.

HIGHLAND

Looking Ahead

As the second half of 2025 unfolds, healthcare leaders will continue balancing immediate financial pressures with long-term strategic priorities.

At Highland, we believe clarity in uncertain times is not just possible, but essential.

Whether it's recalibrating risk, rethinking liquidity, or realigning portfolios to support mission delivery, our team remains focused on helping clients make decisions with discipline and confidence.