HIGHLAND

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"Not Out of the Woods Yet"

Just a few short years ago, hospitals and health systems weathered what many have called one of the worst years ever in healthcare – 2022. While providers have seen improvement in operating margins and expense growth, the turnaround effort remains incomplete. Higher labor and supply expenses are the new normal, and patient volumes, while off their lows, have not returned to pre-pandemic levels. However, the light at the end of the tunnel is coming into focus. Recently, in a bid of faith, Fitch Ratings moved their outlook for the nonprofit hospital sector to "neutral" from "deteriorating."[1] While "neutral" does not elicit much enthusiasm, it is cause for optimism. Fitch projects operating margins and cash flow to continue to improve and sees balance sheets offering ample liquidity following recent equity market performance. On balance, the operating environment is much improved from only a short time ago. Nonetheless, changes are afoot. What follow are a few things Highland is watching as we move into 2025.

Republican Sweep

With control of both the White House and Congress, Republicans will have substantial influence over U.S. healthcare in the coming years. Hospitals and health systems should consider the potential impact of the following policy decisions:

1. Affordable Care Act (ACA) subsidy expiration. ACA subsidies are set to expire at the end of 2025.[2] The subsidies lower the cost of health insurance premiums for people who buy insurance through the ACA marketplace. The Trump administration is not expected to extend the subsidies. Essentially, premiums would increase, and enrollment would drop, leading to a larger uninsured population.

2. Trade and immigration policy. Just as supply and labor expense growth appeared to be stabilizing, tariffs and a hard line on immigration could put upward pressure on supply cost and labor expenses for hospitals and health systems. Economists are largely hopeful that the threat of tariffs is just a negotiating tactic from our incoming president, but odds are high that tariffs will be applied early and often in the new administration.

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3. Medicaid program cuts. Medicaid financing is expected to be reduced under the new administration. Strategies to reduce Medicaid spending may include the adoption of a block grant program and a reduction in federal matching dollars. Providers should prepare for reduced Medicaid payments going forward.

4. Medicare Advantage (MA). Medicare enrollment has been quickly moving to MA from traditional Medicare. In fact, more than half of Medicare enrollees are now in MA plans.[2] Look for the administration to continue to push for MA adoption, which pushes Medicare toward privatization.[2] MA has traditionally been a lower-margin business for providers, leading some to refuse to contract with MA plans. In light of the continued transition, we encourage hospitals and health systems to reevaluate their MA business.

Portfolio Diversification

1. Public equity markets have provided a major boost to nonprofit hospital's liquidity profiles and balance sheets in recent years. In both 2023 and 2024, the S&P 500 posted returns of more than 23%. Portfolios have benefited greatly from the rally, but, if history serves as a guide, equity returns should be muted going forward. In fact, many notable asset management firms have dropped their expected return on domestic equity to approximately 5%, a far cry from recent past. While Highland Associates is not quite as pessimistic, we have dropped our projections for global equity returns from 7.5% to 7% year over year. In summation, with equity multiples toward the higher end of their historical range, broadening the sources of risk within the portfolio may make sense moving into 2025.

2. Fixed income is more attractively priced, but risks remain. Compared to starting yields in years past, current rates (U.S. 10-year Treasury at 4.60% at the time of this writing) offer an attractive premium. While corporate spreads are noticeably tight, investment-grade corporate debt and treasuries offer both income and increased potential as equity diversifiers compared with pre-pandemic yields. On the other hand, recent economic data has pointed to a strong underlying economy and persistent inflationary pressure. Of course, tariffs and immigration policy could exacerbate inflationary pressure in the system. If the Federal Reserve indeed pauses their interest rate cuts or is forced to hike, interest rates would likely rise meaningfully. All else equal, allocators might consider upgrading the quality and weight of their fixed-income portfolio – yields are relatively high, and the need for insurance in an equity drawdown is paramount.

3. Secondaries. We would encourage allocators to consider looking to the secondaries market to fulfill their private asset portfolio. Secondaries offer immediate exposure – no J curve – and a chance to judge the underlying portfolio of assets. In addition, managers and allocators have both been willing to part ways with private investments at considerable discounts to NAV to rebalance and raise cash. We believe the secondary market will continue to mature and become a bigger part of the conversation moving forward.

4. Hedge funds. 2024 was a strong year for hedge funds. The asset class posted double-digit returns during the year.[3] While that pales in comparison with equities, we believe hedge funds are positioned well on a go-forward basis due to higher interest rates. Higher rates are generally associated with higher volatility in the market. Hedge funds tend to thrive in volatile environments as prices are more likely to diverge. Also, short proceeds can be invested at higher rates. With the need to diversify sources of risk within the portfolio, hedge funds should get a look.

Operations

1. Providers are dealing with a shifting payer mix, as the share of Medicaid and Medicare enrollment grew from 43% in 2019 to 45% in 2023.[4] All else equal, this should drive net patient revenue lower compared to years past.

2. Patient demand has not rebounded to pre-pandemic levels. Low volume continues to be a headwind and has caused a renewed focus on customer acquisition

and retention. Providers have been considering altering their product and service lineup to meet specific market conditions and competitive landscapes.

3. Digital platform investment. Patients are increasingly comfortable with receiving healthcare from the comfort of their home through digital means. Digital platforms can include patient portal tools that help consumers schedule appointments, view test results, access health records, and receive provider communications, but they can also support apps that connect consumers with monitoring devices, symptom triage tools, and virtual visit services.[5]

4. Cybersecurity measures. The transition to a digital environment has opened healthcare organizations to cyberattacks. Enhancing cybersecurity measures is important not only for mitigating risks and protecting brand reputation but also for safeguarding financial and brand stability.[5]

1 "Nonprofit hospital outlook improves, but headwinds remain, Fitch Ratings says" – Chief Healthcare Executive

2 "The Health Care Credit Beat: Republican Red Wave a Net Negative For Health Care" – S&P Global

3 "Hedge funds score double-digit returns in 2024" – Reuters

4 "What to expect in US healthcare in 2025 and beyond" – McKinsey & Company

5 "2025 US health care outlook" – Deloitte Insights

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