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Responding to the Crisis: Perspectives from Hospitals and Healthcare Systems

Since the beginning of the COVID-19 pandemic and sell-off in the equity markets, the Pavilion nonprofit Healthcare team has been in continuous dialogue with our clients to assess operational, financial and capital risk exposures as they navigate through this unprecedented crisis. We have drawn from a wide variety of healthcare systems ranging from large to small, higher credit quality to lower investment grade, with urban, suburban and rural service areas. We thought it would be instructive to offer our observations and the current thinking and actions of our clients[1]—your peers—as you consider a course of action. Additionally, we sought the perspective of healthcare rating agencies and credit banks.

[1] Hospitals and healthcare system opinions throughout this paper referred to are those of current Mercer Investments LLC clients. It is not known whether they approve or disapprove of the investment services provided by Mercer.

Operations

As a result of the healthcare business environment in the pre-COVID 19 period, coupled with the direct impact of the pandemic, some hospitals and healthcare systems have estimated that Net Patient Revenue will drop up to 40 percent over the next several months.[2] The delay in elective and non-elective procedures has been the major driver of lower revenue (with the additional risk that patients will opt not to return for elective procedures despite the end of the restrictions). Several healthcare systems' estimates suggest that a timeframe to recover lost Net Patient Revenue will be approximately two years.[3] Expenses incurred due to staffing shortages, the increased cost to source and purchase protective personal equipment (PPE) and the high level of acuity for hospitals directly impacted by the coronavirus have created a spike in expenses. Systematic furloughs of essential and non-essential employees have reduced healthcare systems' payrolls, but have put a high level of strain on remaining employees. Management teams also have implemented salary reductions. One bright spot for healthcare providers has been subsidiary insurance/payor businesses, which have seen much lower utilization, thereby enhancing liquidity and helping to preserve leverage ratios.

Balance Sheet

Hospitals and healthcare systems have responded with aggressive borrowing measures on existing lines of credit, as well as new lines, in an attempt to mitigate the impact of the operational downturn. Most borrowers have opted to fully fund lines of credit without concern about increased leverage ratios. Also, there was some anxiety of being subject to "material adverse event" risk language in credit agreements, which could have prevented borrowers from drawing on their lines. Credit banks have opted to offer credit to existing clients only and have turned away new, prospective healthcare borrowers even with attractive credit profiles. One bank told us that they were receiving over $1 billion in credit requests *per day* in March. The demand for credit in such a short period of time was unprecedented. Going forward, there is an expectation that hospitals and healthcare systems will require additional capital infusions.

The Coronavirus Aid, Relief, and Economic Security (CARES) Act made available $100 billion to hospitals and healthcare systems for lost electives and costs associated with COVID-19 readiness (e.g., PPE, additional medical equipment such as ventilators). Our review of recent fund payments and Medicare accelerated payments suggest that the average of the sum of the two payments equates to roughly one month of expenses for a typical system. Medicare's accelerated advance payment program enhanced liquidity, but repayment of the funds starts four months from the funding date.

At the current time, we are not observing wholesale changes to the investment policies for operating asset pools as hospitals and healthcare systems seek to avoid forced liquidations of investments with depressed valuations. Our suggestion is that hospitals and healthcare systems revisit their assumptions and stress test their enterprise risk modeling to account for drawdown of the investment portfolio(s) and impact on days cash on hand (DCOH), covenants, credit rating, etc. (Please see here for more insight from Pavilion on this topic.)

[2] Based on conversations with Pavilion healthcare clients, March-April 2020.

[3] Services to be provided by Mercer Investments LLC using the business name of Pavilion, a Mercer Practice. Mercer Investments LLC is one of several associated legal entities that provide investments services to clients as part of a global investment advisory and investment management business (collectively referred to as "Mercer"). Mercer Investments LLC is registered to do business as "Mercer Investment Advisers LLC" in the following states: Arizona, California, Florida, Illinois, Kentucky, New Jersey, North Carolina, Oklahoma, Pennsylvania, Texas and West Virginia; as "Mercer Investments LLC (Delaware)" in Georgia; as "Mercer Investments LLC of Delaware" in Louisiana; and "Mercer Investments LLC, a limited liability company of Delaware" in Oregon. Throughout this document, unless otherwise stated, references to Pavilion are references to Mercer and the investment services that Mercer would provide.

Retirement Plans

As healthcare plan sponsors assess defined benefit liabilities, consideration must be given to the impact of the crisis on demographic and workforce assumptions, as well as the short- and long-term effects on longevity. Pavilion recommends that plan sponsors reconfirm investment "glide path" liability hedge interest rate and market impacts. Relief could come in the form of deferring contributions. Market dislocations could be good opportunities for plan sponsors to capitalize on purchasing long US Treasuries for liquidity needs and rebalancing while maintaining long corporate credit for more attractive valuations. (For more on this topic, see this recent paper.)

Some defined contribution plan sponsors have moved quickly to reduce 403(b) match and suspend auto-enrollment and profit sharing programs, as discussed in more detail here. To alleviate the financial burden on some employees, healthcare systems have allowed partial, in-service withdrawals as well as increasing the participant loan maximum amount to $100,000 in conjunction with the CARES Act. Delegating some fiduciary responsibilities to third parties in an Outsourced Chief Investment Officer (OCIO) governance model could be economically beneficial and offer plan sponsors increased operational leverage in plan benefit administration.

Capital Expenditures

Capital programs at larger, well-capitalized systems in some cases have not been cut for fear of competitive disadvantage post-COVID 19. Conversely, smaller healthcare systems are cutting capex to preserve capital, and deferring some capital projects to a later date. Some exceptions to the rule are essential investments in technology, such as telemedicine, as systems prepare for the post-pandemic environment.

Hospital and healthcare systems are developing plans to help ensure that, post-crisis, actions can be taken to restore human resources and to sustain capital levels sufficient for preventing prolonged service disruptions. The expectation is that it will be a slow transition back to capacity. M&A opportunities will be available at potentially more attractive valuations.

Credit Rating Agencies

A recent conversation with the healthcare credit rating agencies[4] yielded some interesting perspectives. One of the key themes we heard was "don't try to paint a picture that is not realistic." Rating agencies understand that this will be one of the worst quarters in history.

Ratings agencies do not "rate credits to the bottom or from the top," so do not expect to be penalized unfairly versus peers. Liquidity is of paramount importance, followed by operating discipline. Additionally, carefully look at bond and credit covenants; June fiscal year-ends are of special emphasis. Debt service covenant calculations could be ameliorated by efficiently realizing gains without disruption to the portfolios. Credit discussions will revolve around what can you control now in terms of expense reduction and plans for return to normalcy. The CARES Act is viewed favorably, but it is a modest positive considering the size of the nonprofit healthcare sector. The rating agencies are hopeful for continued credit support from government.

[4] Standard and Poors, Moody's and Fitch credit analysts at Kaufman Hall Not-for-profit Healthcare Webinar, April 2020.

Portfolio Considerations and Opportunities

While each system has different considerations and liquidity requirements in light of the crisis, our general feeling is that the market sell-off could present opportunities akin to the Global Financial Crisis. We suggest:

1. Look for opportunities to upgrade portfolios across asset classes through access to previously capacity-constrained managers. Pavilion expects to see many managers open up to new capital. We are already seeing early signs of this in equities and hedge funds and anticipate the same in private markets.
2. First opportunities likely will appear across the credit sector. Exposure can be through liquid strategies, hedge funds and private debt.

- Be mindful of increasing risk too much across the portfolio if looking at exposure across multiple asset classes. Also, consider where you are taking capital and the purpose of the allocation (investment grade vs. high yield).
- While transaction activity likely will slow over the short-term, real estate and private equity teams continue to anticipate strong managers coming to market this year and are looking for opportunities for new strategies to upgrade the portfolios. While it is still early, specific strategies and vehicles likely will emerge to take advantage of dislocations.

Final Thoughts

The experience of hospitals and healthcare systems has varied widely during the pandemic. The paramount concern for our client organizations initially was to generate adequate liquidity to fund operations. Unfortunately, extreme volatility events like the pandemic reinforce the best practice of consistent, enterprise risk management exercises. While no economic model could have accounted for a drop in Net Patient Revenue due to the suspension of non-elective procedures, our philosophy towards healthcare operating portfolios prepared our consulting team to help clients tactically navigate the current environment. Moving forward over the next several months, clients are concerned whether a second pandemic "wave" is reflected in market valuations and what path a recovery might take. We are urging our clients to remain vigilant in regard to liquidity requirements, to surveil credit positions carefully and to manage the operating assets in synchronization with the operating model. For those hospitals and healthcare systems in sufficient liquidity positions, attractive valuations may begin to appear across asset classes.

Contact us

At Pavilion's dedicated Healthcare practice, we focus on your investment strategy so you can focus on your mission. We welcome feedback and dialogue with you and your organization as we navigate through the current crisis. Please reach out to your Pavilion (or Mercer) consultant or to any of our colleagues listed below.

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