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Is your Health System Team Ready for What's Next? A Recession or More Malaise?

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Today's State of Affairs

Coming out of the pandemic, health systems in the US have been dealing with a prolonged period of operational disruption driven by increased labor costs, supply chain issues and soft patient volumes. During this same period, the broader US economy has generally remained resilient in

Key Takeaways:
In this article, we outline some key considerations for health system management teams and boards to prepare for a potential recession, and below are some takeaways that help frame what's crucial to organizational readiness:

- *Diverse Skillsets*: It is critical to have a multidisciplinary team of individuals to address a variety of operational and strategic functions, including treasury management, capital resource allocation and budgeting, technological innovation, operational performance improvement, and risk management.

- *Operational Effectiveness and Scale*: There are a range of affiliation and partnership structures that could be considered to enhance scale and help bridge core competency gaps in terms of innovation and technology. These affiliation strategies also present opportunities for cost saving opportunities without sacrificing alignment. A broadened business platform can lower the cost of capital, absorb unexpected economic downturns, and shrink the overall expense structure.

- *Capital Investment Priorities:* Management teams should finetune a more detailed approach in identifying which capital projects should take precedence over others. As the healthcare landscape shifts away from the inpatient setting, consumer-friendly, higher margin outpatient services are one obvious less capital-intensive place to redirect capital. Proper resource allocation for capital projects will be particularly important as bank debt and bonds remain expensive and hospital credit is perceived as generally riskier by investors.

- *Innovation*: The attention of private equity investors and other disruptors like major retailers pose challenges to health systems. It will be crucial for health systems to direct resources toward innovation and affiliation to remain competitive and put themselves in a better position to withstand any adverse macroeconomic conditions.

the face of inflationary headwinds. Despite efforts by the Fed for a soft landing, many are forecasting a recession, begging the question as to how well-positioned hospitals are to withstand a potential recession while still wrangling with the lingering malaise of post-pandemic financial and operating woes. Below we attempt to outline focus areas that proactive management teams may want to prioritize as we enter the second half of 2023. A perfect storm is upon us: higher cost of current and new debt, diminished appetite by bond investors and banks to remain in the sector, inability to count on consistent investment returns during this volatile period, continuing significant fundamental operating challenges (i.e., labor cost escalation, payor mix deterioration, slow volume growth, etc.), and increased antitrust and regulatory scrutiny. This article explores how hospital system management teams and boards can position their organizations for success, regardless of what the future might hold.

Debt Markets Impact on Capital Spending

The days of easy money are behind us, making capital planning more difficult and cost structures more onerous for health systems. In the wake of the 2008 Great Recession, the Federal Reserve lowered benchmark interest rates to near-zero levels and purchased bonds, mortgages, and other assets to increase the money supply, resulting in a long period of cheap borrowing. However, as evidence that the cure sometimes is more painful than the disease, the US Fed has increased intrabank lending rates and caused the cost of bonds and bank debt to rise, contributing to the more than 200 basis point increase in 10-year treasury yields compared to the most favorable rates in 2020-2021.[1]

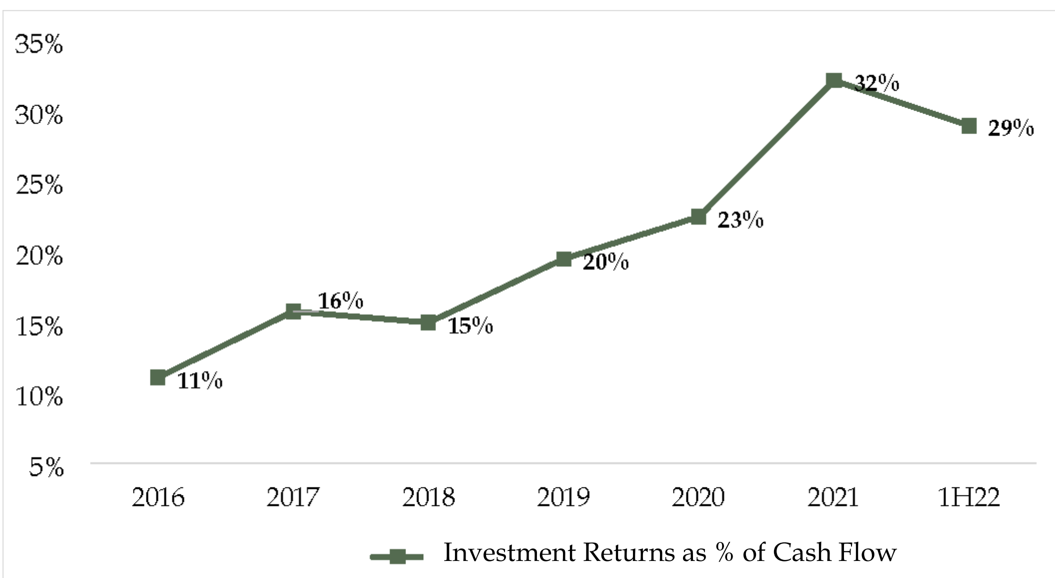
If a recession occurred in the near-term, it is difficult to determine how quickly, if at all, the capital markets could become favorable for health system borrowers again. Most of the distress in 2023 for the $4 trillion municipal bond market will come from hospitals and nursing homes[2], introducing new risk for health system bond buyers who might remain skittish about investing in the sector. Roughly $12 billion in hospital bonds are impaired, which is the most since 2008-2009, and both banks and bondholders are shrinking their holdings as bond values decline due to higher rates.[3] There has also been significant credit degradation across the rating spectrum over the last year. According to S&P Ratings, rating agency downgrades have outpaced upgrades by nearly 3-to-1,[4] making health system credit riskier, and thus more difficult for lenders to seamlessly jump back into the sector. As investors take more of a risk-off approach to the sector, debt profile management will be more challenging for organizations that face variable rate credit renewal risk and have scarcer refinancing opportunities for maturing obligations.

[1] US Department of Treasury, 6/30/23.
[2] Bloomberg News, "Bank of America Sees More Muni-Bond Defaults in 2023 After January Uptick," Feb. 7, 2023.
[3] The Wall Street Journal, "Some Hospitals That Spent Big on Nurses During Pandemic Are Now Short on Cash," July 5, 2023.
[4] S&P Ratings, "U.S. Not-For-Profit Health Care Midyear Update 2023: Out Of Intensive Care And On The Path To Recovery Amid Ongoing Operating Challenges," June 28, 2023.

Because health systems are capital-intensive businesses and they rely heavily on debt as a construction funding source, increased borrowing costs could significantly impact the return on investment necessary to justify strategic and major capital projects while diluting operating income. Health system management teams will need to be more skillful with budgeting and resource allocation as they weigh any potential new construction projects. If management teams refocus their capital plans, they might prioritize investing in less capital-intensive ambulatory facilities that are leased from third party developers or considering joint venture structures that require lower initial capital commitments. Access to capital should also be expected to exacerbate the gap between well-capitalized high performing systems and typically smaller systems that made it through the pandemic but with diminished resources.

Investment Income Reliability

In today's high interest rate environment with volatile equity returns, health systems can no longer rely on investment income to bolster net income and cash flow. A broader economic recession would result in greater uncertainty around investment returns. As a result, without significant management intervention or focus, key lender covenants, including debt service coverage and days cash on hand metrics, are likely to be harder to maintain at traditional investment grade levels, "becoming a hallmark of the late pandemic period."[5] Furthermore, adding to the issue is the increasing reliance by health systems on market returns over time as operating cash flow has diminished:



As shown in the chart above, the percentage of cash flow available to pay bondholders that comes from investment earnings has nearly tripled since 2016. Heightened geopolitical risk largely due to the war in Ukraine and tensions with China, coupled with the S&P index's large concentration

[5] Bloomberg News, Feb. 7, 2023.

in leading social media and streaming company stocks also make portfolio performance even more volatile for health systems. Given the uncertainty around investment earnings, health systems need to be better operationally equipped to deal with new challenges. While the entire hospital sector must deal with this challenge, more diversified, larger systems can withstand investment return risk more than standalone hospitals with lighter liquidity and less resources.

The volatility in potential investment returns from public markets may cause management teams to explore alternative investment vehicles. Other sources of investment returns could take the form of venture or innovation funds like those created by Ascension (St. Louis): Ascension Ventures; Henry Ford Health System (Detroit): Henry Ford Innovations; and Intermountain Healthcare (Salt Lake City): Intermountain Ventures Fund.[6] Following the example of healthcare private equity investors, these in-house funds often seek to deploy capital (often on a much smaller scale) into revenue-generating technologies or businesses which are also strategically important or accretive to the broader health system beyond generating cash. The magnitude of investment in this area is not likely to replace traditional balance sheet investment vehicles for large health systems, but it is another strategy in a more robust portfolio that could help blunt the impact of a more difficult macro and equity investment environment.

Profitability Outlook and Challenges

Health system management teams will need to think of creative operational solutions to help ensure they are ready for an economic downturn. Operating concerns and the unlikelihood of future governmental support are among a wide range of potential profitability challenges, as highlighted below:

- *Job Market Dynamics*: It is uncertain how a recession would impact labor costs for health systems. High labor expenses have weakened hospital margins. Further, the overall job market remains resilient and healthcare workers are exiting the sector, resulting in sticky-to-rising healthcare wages. However, there are signs that agency costs have abated, but higher salaries and premium pay persist.[7] Two feasible but competing outcomes that might occur if a recession happened: (1) Job market loosening could reduce wages, providing some expense relief for health systems; (2) Higher unemployment would negatively impact payor mix by shifting more consumers away from commercial insurance and toward governmental payors. The countervailing impacts on wages and insurance coverage will impact individual health systems and markets differently, but organizations prepared with quick responses will be the ones that benefit. In addition, staffing pools and centralized human resource functions will allow for more effective recruitment efforts, which bigger systems typically have at their disposal. Smaller organizations are more challenged in recruiting staff, particularly if they reside in more rural areas of the country. As mentioned in other areas, a strong joint venture

[6] https://www.beckershospitalreview.com/innovation/22-health-systems-with-investment-arms.html
[7] S&P Ratings, June 28, 2023.

management partner could also help squeeze more efficiency and productivity from the latent workforce, especially in key ancillary service lines like ASCs, imaging centers, urgent care, and home health.

- *Medical Group Inefficiencies / Physician Integration*: Practice losses from employed physicians and the inability to properly integrate physicians into the management of the continuum of care continue to plague hospitals. A recession may accelerate certain trends (e.g., payor mix degradation, shift to value-based reimbursement, care continuum responsibility, staffing and RCM issues), which further exacerbate these inefficiencies and lack of integration especially where reimbursement is tied closely to the ability to control cost and quality across the entire episode of care and population health.

  Physician practices (especially primary care practices) are increasingly managed or affiliated with corporate or strategic entities (as opposed to independent physician groups or hospital-owned groups). Hospitals and health systems are uniquely positioned to capitalize on this trend, if they are able to orchestrate a high level of collaboration with these corporate or strategic entities in order to solve for the inefficiencies and lack of integration on the physician services /coverage. One potential opportunity for capital efficiency could involve moving physicians (especially physician practices that are not profitable) off the health system income statement and into an independent, co-managed practice. It also provides an opportunity to create alignment with a strategic partner in the health system's applicable market, which may pave the way for other joint ventures or care structures that benefit patients in the health system's service area.
- *Future Governmental Support*: If a recession occurs, don't count on Uncle Sam for more checks in the mail. During the pandemic, the US government provided a total of over $5 trillion in COVID-related stimulus, with roughly 10% of that, $482 billion, allocated toward healthcare[8]. The federal government provided direct revenue enhancement and short-term liquidity to health systems through various programs, which hugely benefited hospitals between 2020-2022 as volumes shrunk, and expenses escalated. In addition, the government expanded Medicaid eligibility during the pandemic, which helped support reimbursement to hospitals. However, expanded Medicaid coverage expired in May 2023, resulting in many newly enrolled patients no longer being eligible. Despite robust public assistance during the pandemic, lawmakers' appetite to provide additional support to hospitals appears to be severely impaired (or nonexistent) as federal deficit reduction measures are top of mind for Congressional leaders as demonstrated by the recent passing of the Federal Reduction Act. Organizations with less capital resources and balance sheet strength were disproportionately impacted by the loss of stimulus money. Margins for smaller hospitals were already thin before the pandemic, and profit metrics for many companies did not fully recover once government funding dried up. On the other hand, large systems can tap into liquidity reserves and mitigate losses through diversified service lines to manage these headwinds.

[8] New York Times, "Where $5 Trillion in Pandemic Stimulus Money Went," March 11, 2022.

- *Demand and Volume*: The hospital business is highly subject to consumer utilization patterns. Out-of-pocket healthcare costs continue to be burdensome for many Americans with the proliferation of high-deductible health plans. Over half of adults surveyed by the Kaiser Family Foundation in March 2019 said they had put off seeking medical care in the past year due to costs. This comes despite the US experiencing one of the greatest periods of economic expansion in its history. A recession would cause consumers to further tighten spending and likely delay elective procedures, further straining health systems' operating performance. Increasingly providers will need to look to risk-bearing and value-based payment models to maintain ever-shrinking margins.

Closing Thoughts

Health systems were hit hard because of the pandemic, and the ramifications have not been fully realized. As S&P Ratings notes, "Early 2023 financial results indicate mixed performance as revenues and demand are generally healthy but expenses, both labor and non-labor, remain elevated for many health care providers. Our sector view remains negative."[9]

Although technically the US has not experienced a recession during this period of disruption, the risk of one occurring is concerning. The likelihood of ongoing operational challenges and general economic malaise continuing remains high whether a technical recession occurs. Health systems' balance sheets are weaker, profit margins are thinner, and market returns remain volatile, making operators less capable of weathering a broader macroeconomic shock.

Health systems are thus in a unique position in today's economy. Management teams are dealing with unprecedented levels of financial duress and disruption, but we have yet to see the technical advent of a recession, which will impact the broader US economy in both expected and unexpected ways. Health system management teams need to be nimble and ready for an economic shock that could impose additional strain on their ability to service communities and thrive as leaders of successful enterprises.

Hopefully recent financial challenges caused by the pandemic are a wakeup call or at least solid training ground for a future recession so that management teams are not caught flatfooted. In the end, management teams that have strong boards of trustees, systems, and operating mechanisms in place to weather an economic crisis will be best positioned to grow and succeed.

[9] S&P Ratings, June 28, 2023.

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