# Perspectives on Capital Markets & Building Investor Confidence

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# Agenda

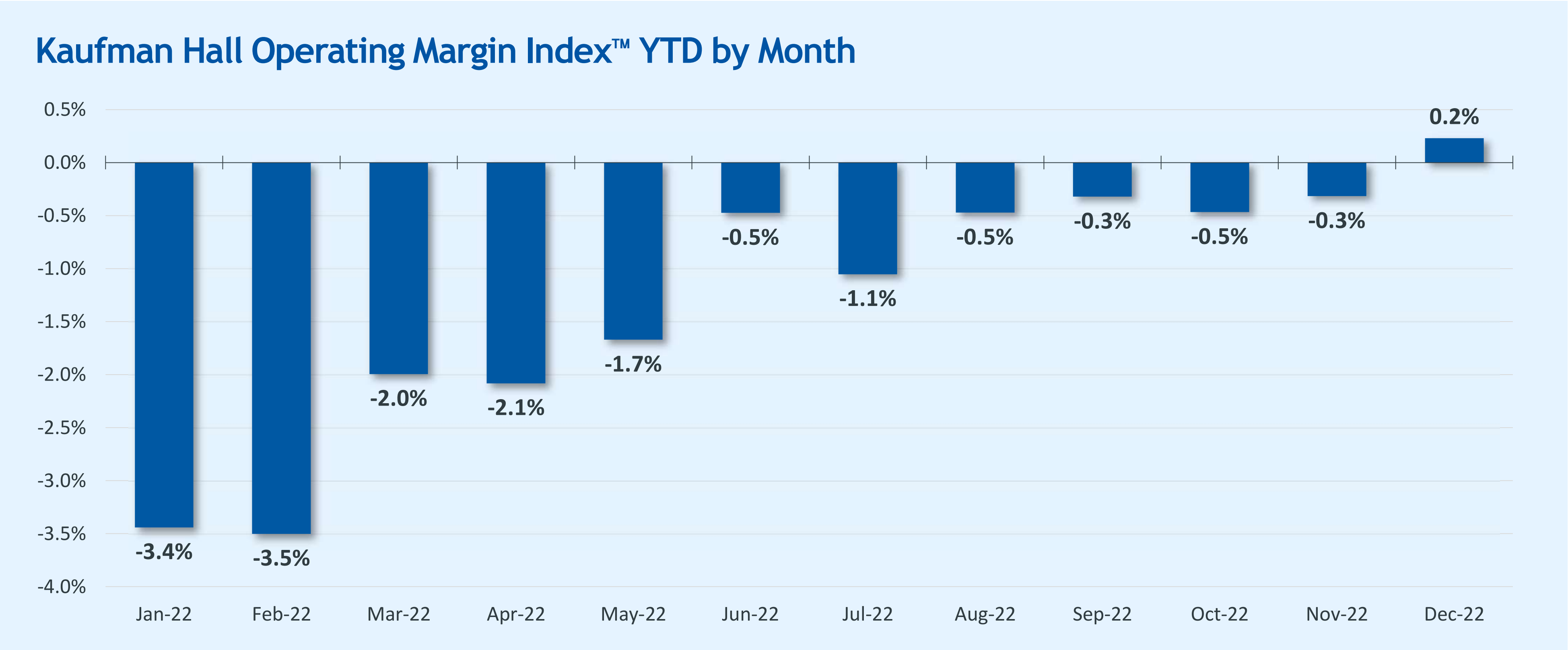
- State of the Industry
- Credit Ratings and Covenants
- The Business Case for Governance

# State of the Industry

# Where are We in the Stages of the Pandemic?

| Crisis | Stabilization | Normalization |
|---|---|---|
| **Largely a monetary event.** | **Largely a credit event as we adjust to the outcomes of the crisis stage.** | **What does financial performance look like in a normal future state?** |
| **CHARACTERIZED BY:** | **CHARACTERIZED THUS FAR BY:** | **TO BE CHARACTERIZED BY:** |
| • Major stimulus spending (approx. $5 trillion)<br>• Accommodative Federal Reserve monetary policy<br>• Heavy focus on clinical and operational performance | • Staffing shortages and surging inflation (including wages and supplies)<br>• Tightening monetary policy and rising interest rates, which is driving market volatility<br>• Renewed focus, and concern, on financial performance | • Stable workforce environment<br>• Stable interest rate environment<br>• Return to steady financial performance and capital spending |

# Has Financial Performance Turned a Corner?




* Note: The Kaufman Hall Hospital Operating Margin and Operating EBITDA Margin Indices are comprised of the national median of our dataset adjusted for allocations to hospitals from corporate, physician, and other entities.

# While Improving, Volumes Remain Below Pre-Pandemic Levels

## Compared to Pre-Pandemic

**Median Volume Percent Change**
**(December 2022 CYTD vs December 2019 CYTD)**

| ADJUSTED DISCHARGES | AVERAGE LENGTH OF STAY | ED VISITS | OPERATING ROOM MINUTES |
|---|---|---|---|
| -4% | 11% | -3% | -2% |

## Compared to Mid-Pandemic

**Median Volume Percent Change**
**(December 2022 CYTD vs December 2021 CYTD)**

| ADJUSTED DISCHARGES | AVERAGE LENGTH OF STAY | ED VISITS | OPERATING ROOM MINUTES |
|---|---|---|---|
| 3% | 0% | 6% | 0% |

Source(s): Kaufman Hall National Hospital Flash Report (January 2022 Report as of December 2022)

# Financial “Twindemic” Hit Both Margins and Cash

## Financial Performance Has Reached All-Time Low

- Intractable labor issues
- Unpredictable volume recovery
- High average length of stay
- Limited relief from payers; end of the CARES Act; sequestration re-starts

## Financial Position Has Sharply Declined

- Use of cash to fund operations
- Investment losses
- Outsized daily operating expenses reduces cash on hand
- Payers slow to pay

***Capital is a hospital’s oxygen and they can no longer afford to hold their breath.***

— Eric Jordahl, Moving Into and Through 2023

# Sustained Headwinds in 2023 Challenge Every Component of the Business Model

***2023 challenge:*** *sustained credit and market headwinds challenge capital formation and resource allocation*


**OPERATING COMPANY HEADWINDS**

- Long-tailed margin pressures drive sustained sector credit pressures
  - Volume, revenue, expense dislocation
  - Escalating and diversified competitive environment

**FINANCE COMPANY HEADWINDS**

- Baseline sector credit headwinds
- Market environment complicates external capital formation: elevated rates and spreads, flat curve; diminished investor appetite

**INVESTMENT COMPANY HEADWINDS**

- Volatility and return headwinds
- Pressure to elevate risk or use investments as a capital source
- Do investments remain “resiliency anchor”?

Source: Kaufman Hall *Credit and Capital Markets Outlook for 2023*

# Credit Ratings and Covenants

# All Rating Agencies Maintain Negative Outlooks on the Sector

Moody's

*Outlook: Negative*

S&P Global

*Outlook: Negative*

FitchRatings

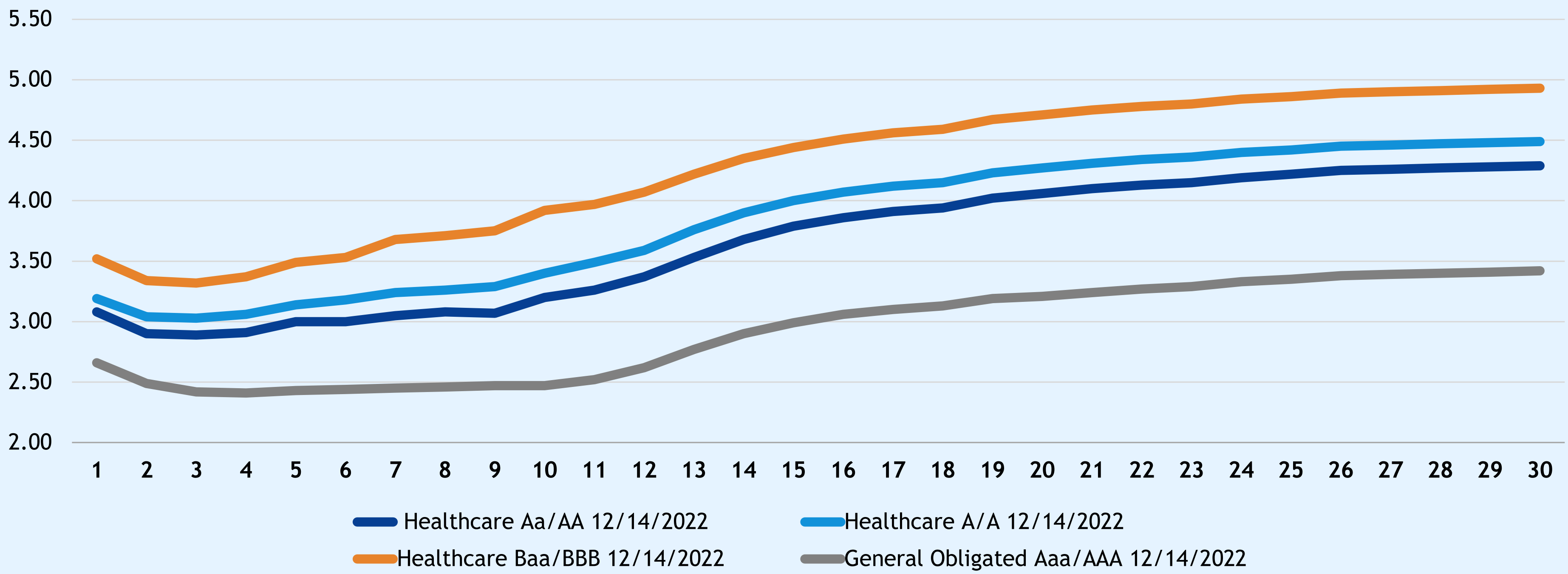
*Outlook: Deteriorating*

- The sector continues to experience **severe labor shortages** and will be the largest driver of operating challenges
- Operating performance will continue to be pressured in 2023, as expense growth will likely outpace revenue growth; performance will have a longer runway to pre-pandemic margins
- Revenue gains will be limited by lingering pandemic strains, inability to meet demand because of labor constraints, deteriorating payer mix and the continued shift of care to low-cost settings
- **Unpredictable volumes** will make budgeting and forecasting increasingly difficult
- Liquidity will decline as market turbulence continues, cash flow is weak and capital spending increases following some delay during the pandemic
- Organizations with strong balance sheets are less likely to experience a negative rating or outlook action; weaker credits may continue to struggle
- Barring significant regulatory pushback, M&A activity will continue as providers seek size and scale to achieve stability and part
- Partnership opportunities for efficiencies and strategic investments are likely to evolve
- Significant shifts in care delivery models are occurring, with disruptors seeking to gain a speed-to-market advantage
- The credit quality gap may continue to widen between stronger and weaker providers
- Legislative, regulatory and judicial activity will continue to add risk to the sector including price and drug scrutiny and the **end of the Public Health Emergency**

Source: Moody's, S&P, and Fitch sector outlook reports; KH Webinars.

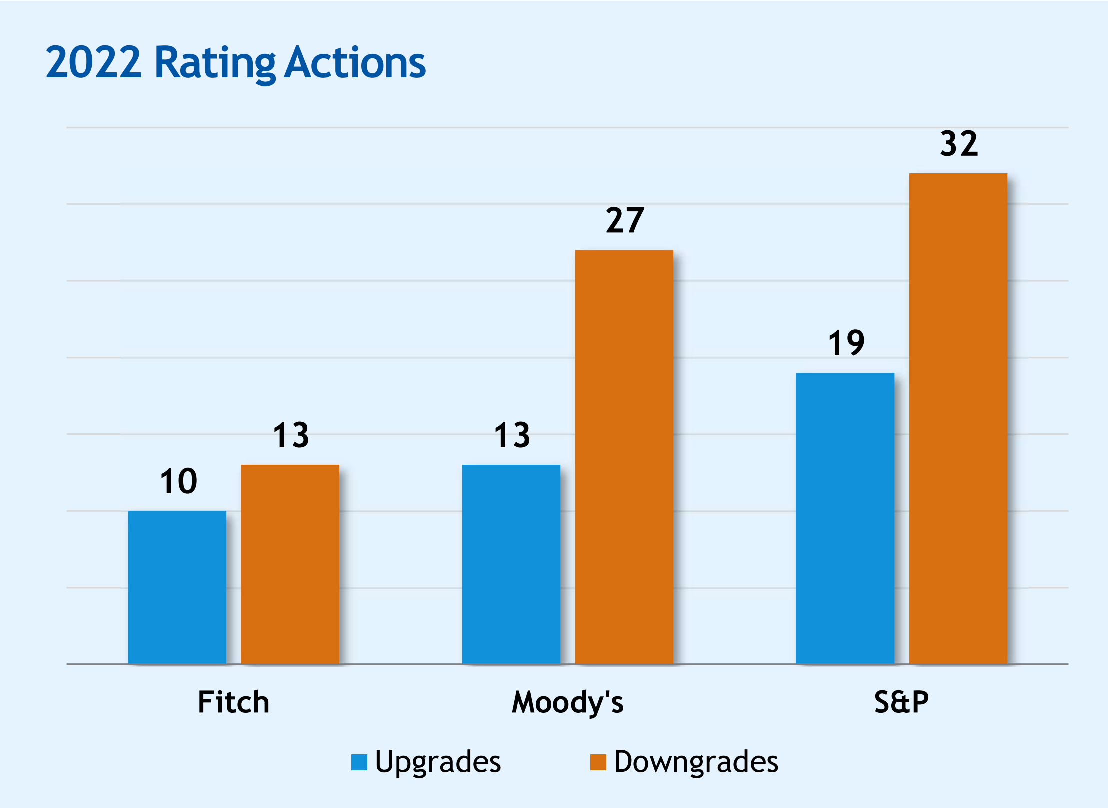
# Ratings are a Key Component in the Cost of Capital

## Higher Ratings Drive Lower Cost




Source: Refinitiv TM3

# Downgrades Exceeded Upgrades in 2022




## Key Takeaways

- Downgrades occurred on all types of hospitals:
  - urban, rural, suburban
  - non-teaching and academics
  - small and large organizations
- Several multi-notch downgrades (2 or more notches)
- Upgrades reflected improved performance, mergers with higher-rated organizations
- Overwhelming majority of ratings were affirmed

Source: Fitch Ratings, Moody's Investors Service, S&P Global

# Rating Agencies Are Focused on Three Important Items in 2023

## Labor

### What are your strategies to recruit and retain employees?

- Vacancy and turnover rates before, during and after the pandemic
- Trend of contract labor and the impact on performance
- Strategies to rebuilding the pipeline of healthcare workers

## Public Health Emergency

### How will you adjust to Medicaid disenrollment and lower funding?

- Expectations for decline in Medicaid enrollment, rise in self-pay and bad debt
- Additional FMAP funding of 6.2 percentage points will be phased out by the end of the year
- Other add-on payments to lapse

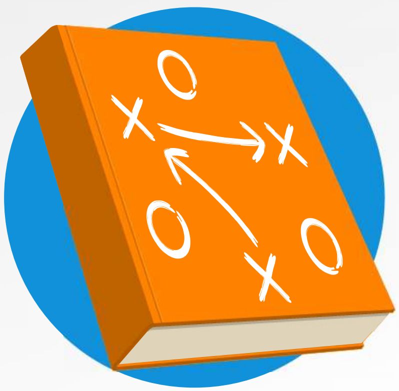
## Margins/Liquidity

### How will you stabilize financial performance and fund capital?

- Return to stable, durable financial performance and capital spending practices
- Increase in absolute and relative cash measures including days cash on hand
- Ability to meet covenants with adequate headroom

# Long-Term Sustainability is The Real Story

1. Understand key financial covenants in the MTI and credit agreements and whether the MTI and/or credit agreements need amendment or waivers
2. Develop detailed Performance Improvement plans that identify:
   - Key drivers causing the potential breach
   - Near- and long-term strategies and tactics to improve financial performance
   - The organization’s plan to execute, measure, and monitor its performance improvement plans
3. Integrate Performance Improvement plans with financial planning
4. Measure, monitor, and communicate results proactively
5. Communicate with rating agencies, investors, stakeholders



# Managing Credit and Covenants

Communication with rating agencies, investors, and banks is important if a breach is likely

A downgrade is not necessarily automatic if there is a breach, but narrows the bandwidth of rating tolerance

Analysts will want to understand:

1. The drivers causing the breach;
2. How are you proactively managing the breach; and
3. Near-term and long-term strategies to improve financial performance and preclude future violations

Headroom to the covenant(s) is an important financial metric for rating agencies

# Scenario Planning Can Support the Sustainability Path

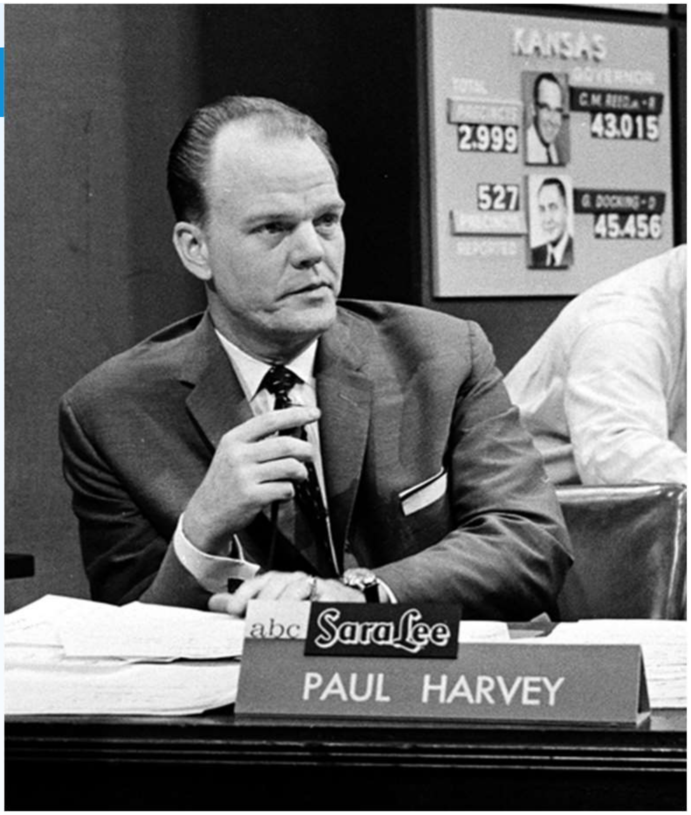
1. What is required to reach a sustainable operating path? What are key associated assumptions and factors driving uncertainty?
2. How do we stress-test our financial trajectory and strategy in light of changing market conditions?
3. How do we ensure the resiliency of our organization by pivoting our decision-making? What mitigation levers are available?

| Approach | | | |
|---|---|---|---|
| **Approach** | Quantify the long-range financial trajectory | Stress-test the results and identify key drivers, risks, and opportunities | Monitor actual performance and market developments and communicate transparently |

# How You Tell The "Rest of the Story" Is Equally Important

**Today's presentations follow a new roadmap:**

1. Focus the discussion on **recent financial challenges**
2. Discuss **immediate levers** pulled to stabilize performance and **meet covenants**
3. Include **long-term financial plan** for durable improvement
4. Outline **demands on finite liquidity** (short-term, near term, strategic and routine)
5. Explain **Governance** over the financial plan



# The Important of Cash…Yesterday, Today and Tomorrow

- Cash buys an organization time when unforeseen events occur
- Strong liquidity allows a health system to access cash quickly when needed
- Serves as a key metric for maintain high credit ratings
- Serves as a financial cushion when debt increases
- Serves as a source of capital when debt capacity is limited

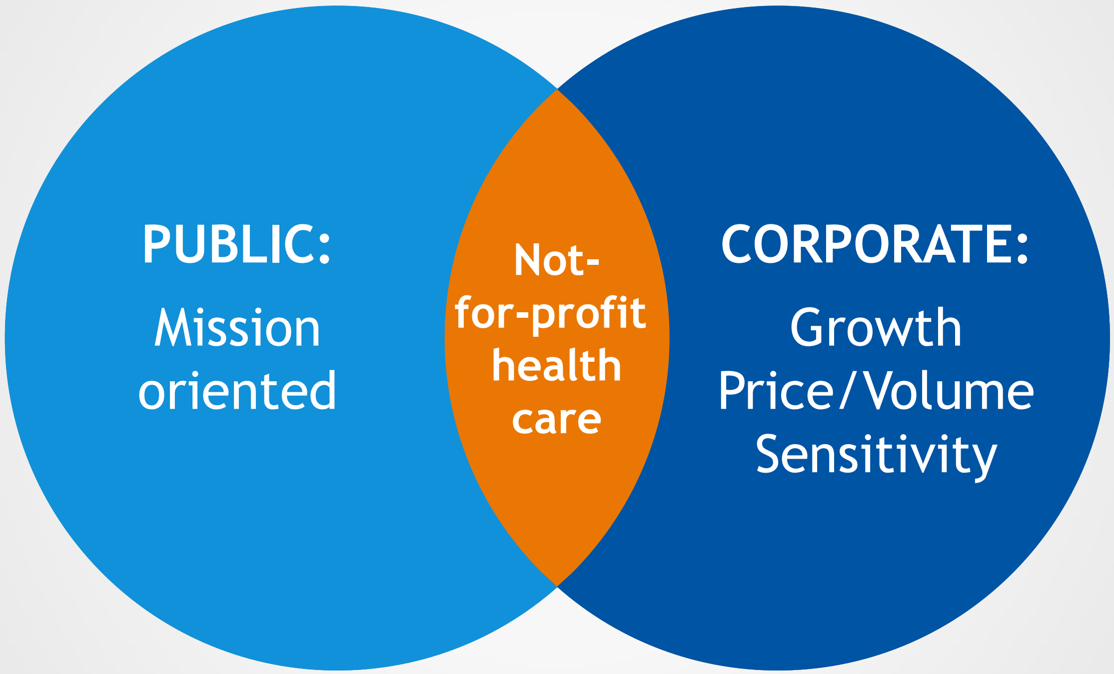
# Hope Doesn't Pay Debt Service…or Does It?

- Impact investing takes community benefit to the next level with loans (not grants) to organizations who address social needs.
- A small return ensures that the funds can be re-invested into new projects.
- Shorter-term gains include social benefits that the projects address (such as affordable housing); longer-term gains can improve healthcare access and appropriate use of hospital facilities.
- Investors and rating agencies will focus on size of allocation relative to unrestricted cash, pace and structure of investments and reporting guidelines.

***UMASS Memorial Health Care's Anchor Mission focuses impact investments on affordable housing and community health services.***

# The Business Case for Governance

# Not-for-Profit Hospitals Maintain Public and Corporate Characteristics



# Five Attributes of Governance Is Critical In Not-for-Profit Healthcare

1. A highly centralized governance model
2. Systematic board monitoring of capital spending
3. Careful, deliberate oversight of organizational growth strategies
4. Agility, manageable size, and high functioning committee structure
5. Continuous effort to stay well informed on state, local, and federal healthcare policies

# What Can Not-for-Profit Healthcare Learn from FTX? A Lot!

## Five Key Lessons, Thus Far…

1. Transparency and disclosure build trust with investors
2. Understand the risks of new-fangled products
3. Adhere to the principles of corporate accounting
4. If it's too good to be true, it usually is
5. Critical thinking, not group think, is imperative

> "Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here…this situation is unprecedented."
>
> *— John J. Ray III, CEO, FTX*

# Can Your Trustees Answer the Following Five Questions?

1. What was the **biggest challenge** your organization faced?

2. What are the **biggest risks now facing your organization** and how will you address them?

3. How does the board **monitor financial performance**?

4. What **financial targets** has the board set for the organization?

5. How does the board **remain educated** on healthcare policy and reimbursement structures?

# Think Differently. Lead Differently.

## Not-for-profit hospitals' long-standing adherence to two principles may no longer be relevant:

### 1 "WE DO IT BEST."

- Can partners aid in delivering the best outcomes to patients?
- Focus on what you do well and where improvements can be made by utilizing the expertise of others

### 2 "WE MUST DO IT ALL."

- Reimbursement structures do not fund "it all"
- Is it time to rethink what a provider must be for their community?
- What are non-core assets or services that utilize resources but without a commensurate return?

# In Defense of Not-for-Profit Healthcare

- The job of America's health systems is to deliver exceptional and equitable healthcare while confronting the pandemic and broad problems of social and economic justice
- Addressing these challenges will require a new level of health system ideas, aggressiveness, ambition, and imagination

*"Hospitals and healthcare workers are simply looking for the public's support and validation in the face of extreme economic and organizational headwinds."*

**— Ken Kaufman, In Defense of Not-for-Profit Healthcare**

**Qualifications, Assumptions and Limiting Conditions (v.12.08.06):**