Healthcare Finance

Newsletter | May 2020

Taking a Holistic View to Weather the Storm

The severe disruption that is taking place in the healthcare industry is like nothing we have ever seen before. In a time like this, it is logical to try to compare the current environment to an event or period from the past. After all, doing so provides us with lessons to draw on as we work to analyze and make sense of the problems that will continue to impact the space.

Although there is temptation to compare recent events with that of the Great Financial Crisis (GFC) of 2008-2009, what is happening as the result of COVID-19 is perhaps even more severe in terms of its ultimate impact on hospitals, healthcare systems, and other non-profit institutions. In addition to the impact on investment balances, the entire operational structure of healthcare providers has been markedly disrupted. Furthermore, the uncertainty with respect to forthcoming elective procedures is creating difficulty when trying to determine what operating budgets will look like for FY 2021. All of this in turn materially impacts how one thinks about both sides of the balance sheet because of the need to create liquidity to fund a range of potential operational outcomes.

Governance

Recent volatility in the marketplace has institutional investors and their governing bodies concerned about the drawdown of investment balances and the availability of restricted assets to meet budget requirements to support their institutions. COVID-19 has created a greater sense of awareness with regard to the interdependency of revenue and spending at non-profit institutions. Of interest in this discussion are budget tightening and board planning, taking into consideration the increasing importance of the investment portfolio as it relates to the operating needs of the non-profit organization. As a result, a growing number of boards are taking a holistic view, looking beyond investment returns and asset allocation; focusing on the balance sheet, fundraising, other sources of revenue and good governance.

Boards are also outsourcing in the areas of planned giving, investment management and administration, thus creating greater accountability for meeting performance benchmarks and achieving pre-set milestones. Now is also a prudent time for boards to evaluate the effectiveness of policies and internal procedures, including the following:

- Audit
- Conflict of Interest
- Fundraising
- Investment
- Personnel
- Risk Management
- Spending

Asset allocation and spending are integrally linked, yet many institutions don't take spending rate into consideration. In most cases, an operating budget has significant sensitivity to performance derived from asset allocation. The task of determining which spending policy to use and a spending rate that balances out the needs of a non-profit organization is critical. A board should strive to understand the institution's risk profile, e.g. its ability to maintain and grow long-term investments and its ability to provide liquidity and operating support. Stress testing the spending policy can be a worthwhile exercise. A holistic view of assets and liabilities can inform a board with insights about revenues and expenses, balance sheet strength, risk appetite, and help to achieve better risk-adjusted returns and sustainability.

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Asset Allocation

Even under ideal conditions, it can be challenging to generate expected investment returns. However, in the current environment, that task might be downright daunting. In short, making "panic" decisions, or decisions that are not well thought out or vetted can lead to a marked decline in the value of a portfolio. This is not the first bear market, nor last, and throughout history for every decline there has been an eventual recovery. Our view is that there are characteristics that lead to solid performance that have stood the test of time, and that should be employed. They are: discipline, proper diversification, and the willingness and ability to have a long-term investment horizon.

During periods of volatility, participating in, or even missing out on just a few trading days can dramatically impact performance. Using the S&P 500 as a simple proxy, in the past roughly forty years (1980-2019), a "buy and hold" portfolio returned 11.8% annually. If that same hypothetical investor missed the ten worst/down trading days in each decade, the return would have been 18.4%. On the flipside, if an investor missed the ten best days in each decade, their annual return would have been 6.5%.[2]

Practically speaking, a given portfolio should adhere to a well-defined Investment Policy Statement, which recognizes long-term objectives, and which is properly diversified across multiple asset classes, geographies, and sectors, and is also well balanced with public and private investments.

Banking and Liquidity Management

In order to help promote additional liquidity during the coronavirus pandemic, the Federal Reserve (Fed) exercised a rarely used monetary policy tool, as it lowered the reserve requirement from 10% to 0% effective March 26, 2020.[3]

This change reduced banks' needs for deposits. And this, in conjunction with the Fed's lowering of the overnight target rate range (to 0% to 0.25%) is expected to have a significant impact on the earnings credit rate (ECR) and the interest rate paid on bank balances. As healthcare institutions face budgetary uncertainty and expenses, the tendency would be to increase "liquid" cash. Unfortunately however, these bank balances may now generate little to no economic benefit.

Therefore, in this rapidly changing environment, it is critical to review banking relationships, including the rate paid on balances, and compare it to other safe and liquid investment options in order to optimize their short-term earnings.

Debt Management

The most immediate focus for the use of debt during the pandemic revolves around the need for working capital. In March 2020, as hospitals and healthcare systems were mandated by states to implement a moratorium on all elective procedures, the focus was on shoring up liquidity. Many healthcare providers drew on their working capital liquidity lines, while others worked aggressively to put liquidity in place.

What PFM has seen is that the cost of lines of credit increased quickly, and the tenor lines became shorter (lines commonly have tenors of one year or less). During the next several months, PFM feels it is prudent to formulate longer-term strategies to effectively manage working capital liquidity needs. This may take the form of using lines of credit for a period of time, or may require the use of longer-term debt in some instances. Each situation must be customized, and the further ahead an endowment/foundation plans for a multitude of outcomes, the better.

Also, because there will be an increased focus on operational and investment liquidity, debt portfolios should be reviewed for opportunities to improve liquidity risk on existing long-term debt. This is something that happened during the GFC, as institutions moved to more stable liabilities on the balance sheet. Since then, most healthare institutions have erred on the side of caution; maintaining more conservative debt structures. Given the focus on liquidity, there may also be opportunities for entities to de-risk existing exposure to liquidity risk by fixing out pieces of variable rate debt.

2 Bloomberg Data
3 https://www.forbes.com/sites/bobhaber/2020/03/16/the-fed-fires-the-big-one/#293282d66aa8

There will likely be an increase in covenant violations. Each of those circumstances should be approached on a customized basis. However, the most important thing is to get in front of issues sooner rather than later. Institutions would then be able to "stress test" 2020 and 2021 covenants and identify where concerns might be.

Finally, it should also be remembered that during times of financial stress, credit spreads widen. Currently, capital markets are "open" for AA and better credits, but it is less clear where the market is on a day-to-day basis. Meanwhile, the market for "A" rated or lower credits is harder to predict. Although many financings for new capital have been delayed, there will still be financing needs for new capital, refinancing of existing debt, working capital or other reasons. Because the markets are changing quickly, PFM recommends to evaluate a variety of alternatives, and to keep all options open.

Final Thoughts

While other firms may work in limited silos, PFM works across an entire balance sheet, employing a true enterprise view to address the challenges that healthcare institutions face. For a deeper discussion on any of the topics mentioned, please contact the Healthcare team.

Economic Highlights

- The COVID-19 pandemic has upended the U.S. economy. In three months, it has gone from stable growth to a historic plunge with the depth unknown. Even as plans evolve to ease lockdown restrictions, the pandemic is exacting an unprecedented toll on business activity, employment and consumer spending.
- U.S. gross domestic product fell at an annualized rate of 4.8% in the first quarter of 2020, the worst level since the Great Recession, even though the economic impact of the pandemic-induced shutdown was concentrated late in the quarter. The current quarter will be much weaker.
- The U.S. economy lost 20.5 million jobs in April, erasing nearly all the jobs created since the 2008-2009 recession. Unemployment spiked to 14.7%, the highest level since the Great Depression, and is likely still under-reported. Some 6.4 million people left the workforce, pushing the labor force participation rate down to 60.2%, the lowest since 1973. The number of Americans applying for unemployment benefits topped 30 million.
- According to IHS Markit, private sector firms in the U.S. signaled an unprecedented decline in business activity in April. The manufacturing PMI fell to 36.1, while the services PMI sank to 26.7 (a record low), both well below the level of 50 which marks the boundary between expansion and contraction.
- The Federal Reserve (Fed) — after having reduced rates essentially to zero in March — focused on mobilizing its arsenal of emergency lending programs to shore up corporations and stabilize still-fragile markets. At its April meeting, the Federal Open Market Committee acknowledged the hardships the pandemic has caused, noted considerable risks for the U.S. economy over the medium term, and signaled it will maintain current policy until "the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals." Fed Chair Jerome Powell commented that the Fed would use all of its tools to support the economy "forcefully, proactively, and aggressively."
- The Paycheck Protection Program and Health Care Enhancement Act, authorized by the fiscal stimulus bill passed by Congress in April, provides $484 billion in additional funding to replenish key programs under the CARES Act, including the small business loan program which was quickly depleted..

Bond Markets

- After extreme market volatility in March, the fixed income markets gradually moved back toward more normal conditions. Movements in U.S. Treasury yields were relatively tame. Short-term yields inched higher off briefly negative yields, fueled in part by the massive increase in short-term Treasury borrowings to fund the CARES Act, while long-term yields moved lower by three to five basis points. The federal deficit — expected to total $3.7 trillion this fiscal year — barely made headlines.
- Treasury benchmark returns for April were generally muted. The 3-month and 2-year U.S. Treasury indices returned just 0.01% and 0.03%, respectively. The 5-year and 10-year indices returned 0.18% and 0.70%, respectively.
- Corporate bond and other non-government sectors produced strong returns, as the Fed's lending and liquidity support programs helped push yield spreads sharply lower. For example, the 1-5 year index of investment-grade corporate bonds had excess returns over Treasuries of 2.97% in April. Compared to March, where the return on this index lagged the Treasury benchmark by 5.83%, this was strong evidence of the effectiveness of the central bank's actions.

Municipal Bond Market

- Municipal new issuance decreased in April by 6.6% to $26.1 billion from $28.0 billion the same month last year. Year-to-date municipal new issuance is up 10.8% to $119.0 billion for 2020 from $107.3 billion during the same period last year, according to the Municipal Market Monitor (TM3) data.

- April experienced negative bond fund flows throughout the month and ended with net outflows totaling $4.16 billion, following March's net outflows of $44.5 billion, according to Investment Company Institute (ICI) data.

- The Municipal Market Data (MMD) Index experienced falling rates on the short-end, with the 1-year rate dropping 24 basis points (bps) to 0.81% and 3-year rate falling 10 bps to 0.97%. Meanwhile, the 5-year rate remained unchanged at 1.09%. Rates increased on the long-end, with the 10-year rate rising 13 bps to 1.37% and the 30-year rate jumping by 29 bps to 2.28%, according to Municipal Market Monitor (TM3) data.

- The 10-year MMD Single-A General Obligation (GO) Index credit spread increased 7 bps to 36 bps and the Double-A GO Index credit spread rose by 2 bps to 15 bps, according to TM3 data.

- Municipal-to-Treasury ratios increased in April. The 2-year ratio increased to 484.0% from 481.8% in March, and the 5-year ratio rose to 318.7% from 297.0%. The intermediate-term ratio grew to 243.6% from 213.5%, while the 10-year ratio rose to 235.5% from 196.5% in March. The 30-year ratio increased to 179.5% from 150.2%, according to TM3 data.

- The Municipal curve steepened in April with the AAA MMD 2- through 10-year slope rising to 55 bps, and the slope between the AAA MMD 2- through 30-year increasing to 137 bps from March's 93 bps.

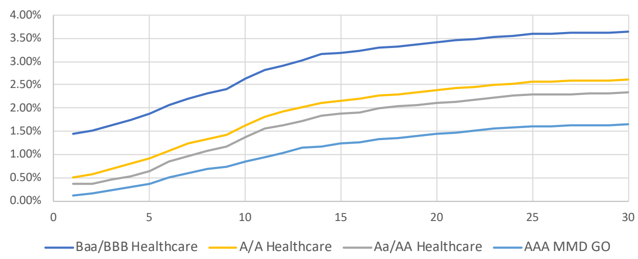
FIXED-RATE MARKET			
Maturity	AAA MMD	U.S. Treasury	Muni Swap Rate
5-Year	0.38%	0.35%	0.32%
7-year	0.61%	0.53%	0.45%
10-year	0.84%	0.69%	0.62%
30-year	1.65%	1.43%	0.98%

VARIABLE RATE MARKET		
Maturity	Current	1-Month Change
SIFMA	0.16%	-5 bps
1M LIBOR	0.17%	-27 bps
3M LIBOR	0.40%	-49 bps
SOFR	0.04%	1 bps

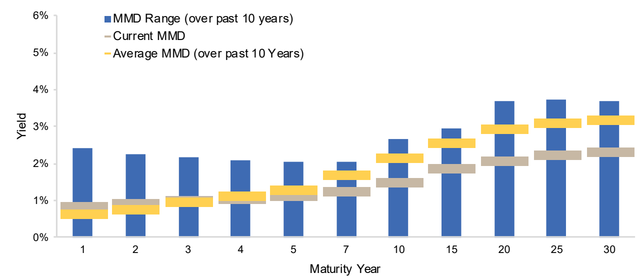
HEALTHCARE 30Y SPREADS	
Category	Spread to MMD
AAA Level	47 bps
AA Level	68 bps
A Level	96 bps
BBB Level	199 bps

Source: TM3 as of 5/26/2020

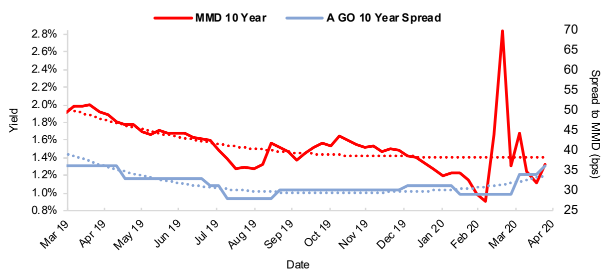
Healthcare Yield Curve



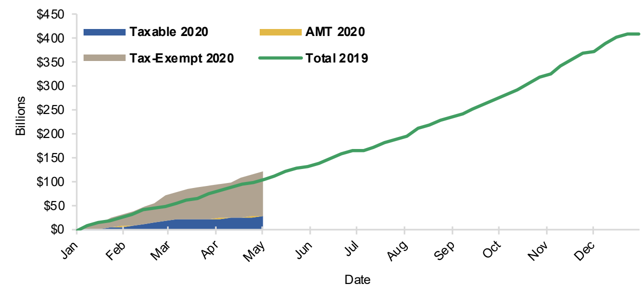
MMD Rates Over Time



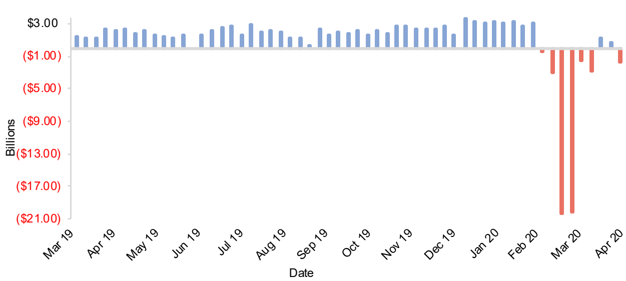
Rate and Spread Movement



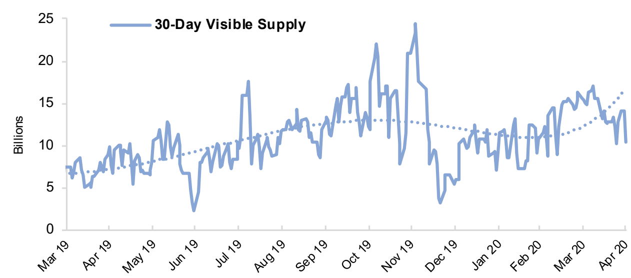
Cumulative Issuance



Weekly Mutual Fund Inflows (Outflows)



30-Day Visible Municipal Supply



Mergers and Acquisitions

- "With no state help forthcoming, 4 South Side hospitals call off merger (Chicago Sun-Times, May 26, 2020)."
- "Eisenreich, Hudson Regional reach deal for hospital, but will CarePoint Health go along with plan?" (NJ.com, May 21, 2020).
- "IRA Capital buys fully leased Medical Office Building" (CoStar Group, May 13, 2020).
- "Coronavirus causes hiccup in timeline for UMass Memorial acquisition of Harrington Hospital" (masslive.com, May 13, 2020).
- "Saint Luke's takeover pushed back" (Iola Register, April 27, 2020).

SELECTED HEALTHCARE ISSUANCES

Borrower	Tax Status	Par Amount	Ratings	Dated Date	Final Maturity	Coupon	Spread	Senior Manager
Baptist Memorial Healthcare	Tax -Exempt	$181,240	NR/BBB+/NR	5/21/2020	2044	5.00%	210 bps	BofA Securities
Baptist Memorial Healthcare	Tax-Exempt	$91,730	NR/BBB+/NR	5/21/2020	2044	5.00%	200 bps	BofA Securities
Children's Hospital and Medical Center	Tax-Exempt	$99,325	A1/NR/NR	5/13/2020	2053	5.00%	124 bps	Piper Sandler
Banner Health	Taxable	$605,954	NR/AA-/AA-	5/7/2020	2050	3.18%	186 bps	Morgan Stanley
Virginia Hospital Center	Tax -Exempt	$273,970	NR/A+/NR	5/6/2020	2050	3.75%	181 bps	JP Morgan
TriHealth Inc	Tax-Exempt	$137,460	NR/A+/NR	5/6/2020	2050	4.00%	193 bps	BofA Securities
University Health System	Tax -Exempt	$72,805	NR/BBB/NR	5/5/2020	2040	5.00%	204 bps	Morgan Stanley

Sources: Bloomberg, Refinitiv and ICI. Unless otherwise noted, all data is presented as of April 30, 2020.