Not-for-Profit Hospitals & Health Systems Market Update

Industry Consulting Team | Q1 2023

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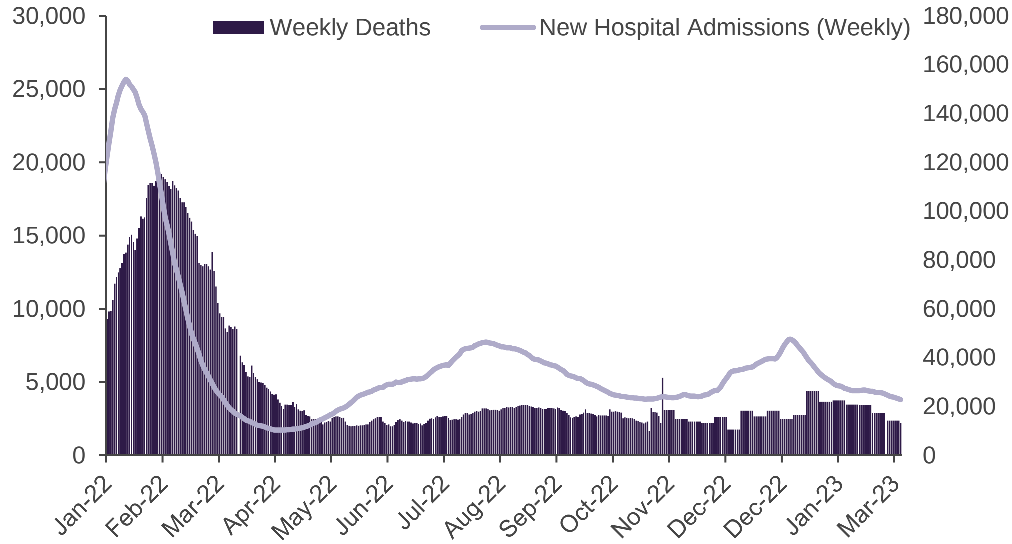
Newsletter Highlights

- COVID hospitalizations declining, end of the State of Emergency
- Not all health sectors growing at the same rate
- Patient Volumes have yet to return to pre-pandemic levels
- Workforce challenges persist but hiring has picked up
- Profitability remains elusive as margins remain negative

COVID Update

- Based on current COVID-19 trends, the Federal Government recently declared that the Public Health Emergency for COVID-19 will end on ***May 11, 2023***. The chart below highlights the declining severity of the pandemic over the past 12 months. The dark purple bars represent deaths from COVID while the light purple line shows COVID-related hospital admissions.



Sources: Centers for Disease Control and Prevention, Our World in Data

- The end of the State of Emergency (which was declared in January 2020 and renewed 13 times) will have an impact on not-for-profit hospitals & health systems including:
  - Special waivers for Medicaid eligibility requirements that have been in place will come to an end and *as many as 18 million people could be dropped from Medicaid* when the emergency ends, though some will likely qualify for other government programs or employer-sponsored health insurance.
  - Hospitals will no longer receive a 20% premium payment for Medicare COVID patients.
  - Current benefits relating to vaccines, testing and treatment will technically shift to individuals and their health insurers. It is expected that Medicaid, Medicare and most commercial plans will continue to cover COVID vaccines and tests ordered by a physician, but some treatments and at-home testing may no longer be fully covered.
  - The retail price of vaccines could increase from the current government rate and treatment drugs (such as Paxlovid) will no longer be free, becoming the financial responsibility of the patient and/or their insurer.

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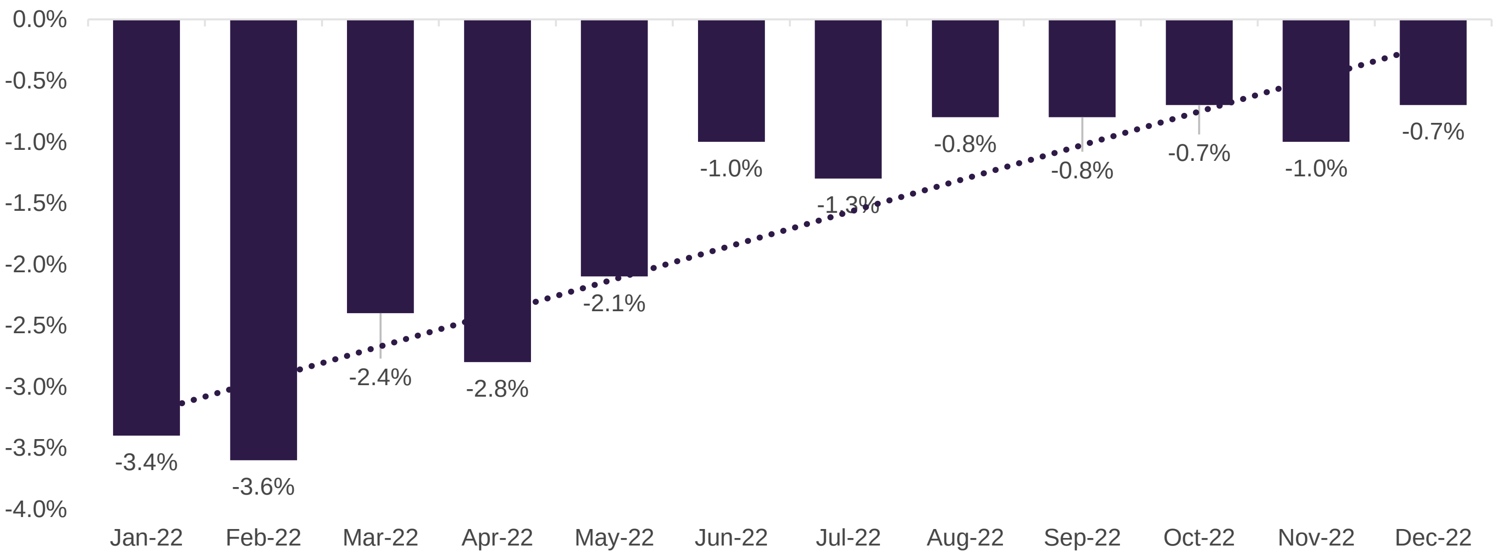
2022 Operating Performance

- There is no "sugar coating" it—2022 was an extremely difficult year for the not-for-profit hospital & health system sector. The pain was felt across the board from the small rural hospital providers to the largest multi-site/multi-state systems. A few recent examples include:
  - The Cleveland Clinic posted an operating loss of $200 million. Revenues increased 4.5% but operating expenses increased nearly 14%, driven by higher wages & benefits. While not impacting the operating margin, the Cleveland Clinic was further hampered by $1 billion in unrealized investment losses.
  - UPMC (40-hospital system in Pittsburgh) reported a modest operating profit of $162 million (a 0.6% operating margin) but, like the Cleveland Clinic, was impacted by $1.1 billion in investment losses.
  - The Mayo Clinic also maintained a positive operating margin for 2022, however operating income declined nearly 60% in 2022 due to a 6% increase in wage & benefit costs, plus a 13% increase in supply & service costs. Investment losses caused a $700 million drop in investment balances.
- Interestingly, the "for-profit" hospitals, particularly Community Health Systems, Tenet, and HCA Healthcare fared better—all maintained positive operating margins for 2022. Intuitively, one might expect that not-for-profits would outperform "for-profits" due to the tax exemption, significant investment portfolios and charitable fundraising. However, for-profits have been quicker to centralize operations to achieve efficiencies and are able to focus on patient populations that include higher percentages of patients with commercial insurance while not-for-profits, being "mission focused" generally deliver care to those in need, regardless of their ability to pay.
- While progress was made on addressing staffing issues, 2022 volumes remained below pre-pandemic levels and more rural markets seem to be suffering more than urban/suburban markets. Average Length of Stay remains above pre-pandemic levels with sicker patients remaining hospitalized for longer, incurring more care at higher costs—with no increase in reimbursement/revenue.

2022 Operating Margins



Source: Kaufman Hall

Sources: 20 health systems reporting losses in 2022 (beckershospitalreview.com)

Mayo Clinic's 2022 profits plummet by more than 50% | Modern Healthcare

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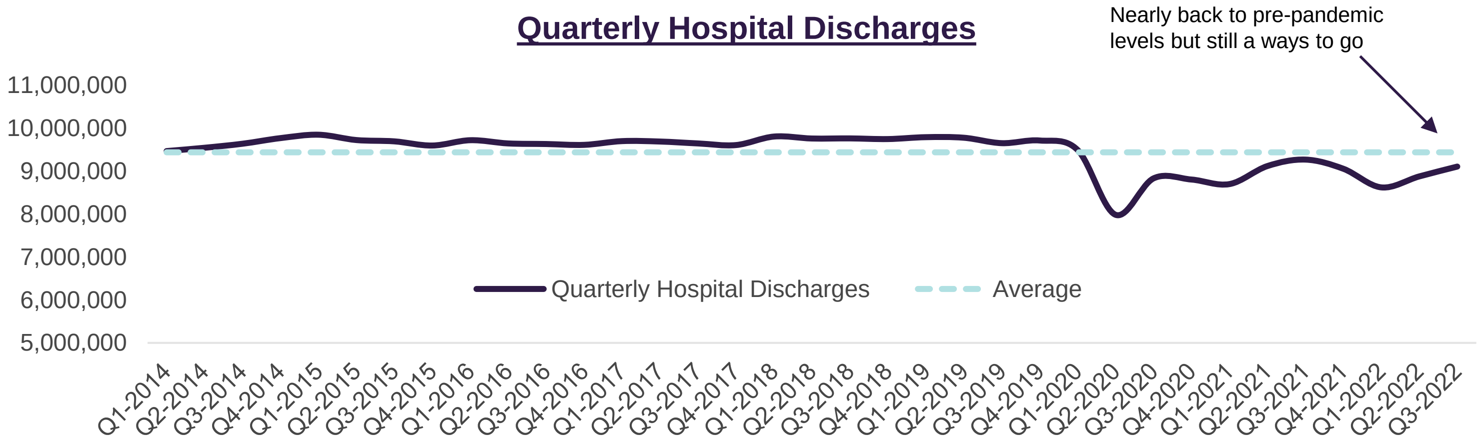
Patient Volumes

Overall patient volumes have decreased compared to pre-pandemic levels. Some of the decline is attributable to lingering fears of COVID, but volumes are mostly suffering due to labor shortages, the continuing shift of patients to high deductible plans, and the continued transition of care from hospital-based care to ambulatory/outpatient care. While volumes are trending up from the lows seen at the beginning of the pandemic, they have not yet reached pre-pandemic levels.



Workforce

By far, the most cited issue by hospital executives continues to be "workforce". Hospitals have been responding in a myriad of ways including increasing wages, adding benefits, adding flexibility, outsourcing, training, etc. Hospital employment—as tracked by the U.S. Bureau of Labor Statistics—has been increasing and has now returned to pre-pandemic levels.

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Sources: [How has healthcare utilization changed since the pandemic? - Peterson-KFF Health System Tracker]

[U.S Bureau of Labor Statistics]

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M&A Update

- The previously discussed challenges facing the not-for-profit hospital & health system sector are driving some organizations to consider affiliating or partnering with other organizations. These affiliations range from a full affiliation where one organization assumes full control over another to smaller clinical affiliations where organizations may compete for certain services and collaborate for others such as pediatric care.
- One might think of two hospitals or systems coming together as a "horizontal" affiliation. Another trend—which we have seen for some time--are "vertical" affiliations where hospitals affiliate with physician practices, primary care entities, urgent care, labs, ambulatory surgery centers and/or health insurance companies. These vertical affiliations help hospitals and health systems to broaden their continuum of care and prevent "leakage" of patients to competitors.
- In many cases, the rationale for a horizontal affiliation is to increase the "NewCo" organization's negotiating leverage with health insurers and, where possible, to combine service lines and to reduce costs by eliminating redundant overhead functions. However, in 2022 the industry saw what is being referred to as "cross market" transactions where health systems join forces with little to no market overlap.
- According to the consultants at Kaufman Hall, there are a couple of reasons why these types of affiliations are attractive:
  1 - Less Regulatory Risk: Since combining cross mark market organizations are not direct competitors, they stand a higher likelihood of regulatory approval.
  2 - Geographic Diversity: Geographic risks are spread out over a wider service area.
- It is widely anticipated that 2023 will see additional combinations as Management Teams and Boards take stock of their organization's competitive position and determine whether it makes sense to find a partner or to continue to go it alone.

Transaction Highlight: Hospital Joint Ventures

- Historically, the Emergency Department ("ED") has been considered the "front door" of the hospital and the source for admissions. While the ED brought in patients & filled beds, the ED also spent a considerable number of resources addressing "non-emergency" health needs.
- To address this, markets have seen the development of free standing "urgent care" centers. These centers treat minor health issues such as colds, flu, strep throat, minor burns, insect stings/bites, non-life-threatening allergic reactions, basic sprain & fracture care, lacerations, laboratory testing, x-ray and vaccinations.
- Urgent care facilities are often located in the community, away from the hospital campus, frequently in retail areas such as strip centers or shopping malls.
- A large not-for-profit health system client recently sought to expand & accelerate its urgent care strategy. Initially, the health system had taken a "go it alone" strategy and developed a handful of locations in its service area. However, this "build out" was expensive and time consuming.
- The health system entered into a joint venture with a private-equity backed "for profit" development & management company specializing in urgent care to more than double the number of locations. The health system would provide the clinicians to staff the centers, and the management company would run the centers, hire the non-clinical staff, procure & develop the locations, provide the medical equipment and coordinate billing & collections.
- Truist provided a taxable variable rate loan to help capitalize the joint venture. The loan was structured so funds can be drawn "as needed" over the next year with repayment commencing thereafter.

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Sources: [2022 M&A in Review: Regaining Momentum | Kaufman Hall]