Not-for-Profit Hospitals & Health Systems Market Update

Industry Consulting Team | Q3 2023

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Newsletter Highlights

- Can AI and Automation impact staffing challenges?
- Monthly operating margins from Kaufman Hall continue to show improvement
- Charity care under renewed scrutiny
- Bond market update
- Private Placements as an alternative to fixed rate bonds and bank debt
- The location for care continues to shift away from hospital-based procedures

Can AI & Automation Help with Ongoing Staffing Challenges?

Within the healthcare universe, there have been several promising examples of how the use of artificial intelligence ("AI") might be used to automate administrative tasks such as patient scheduling, insurance claim submission, and analyzing medical records.

Clinical Note Transcription

One particularly interesting application has been testing to transcribe clinical notes, allowing the clinician to focus on the patient without typing notes into an electronic medical record system. When diagnoses or treatments are presented, the AI tool can immediately gather relevant materials that can be provided to the patient for educational purposes.

Insurance Claims

The revenue cycle process currently involves multiple parties including patients, clinicians, medical coders, billing staff, and insurers along with financial intermediaries such as consultants, clearinghouses and banks. One major impediment to a smooth revenue cycle process—at least from the providers perspective—is when a health insurance company refuses to pay a claim.

When a claim is denied, standard practice is to submit an appeal— a process that is both time-consuming and complicated. (Surprisingly, a recent paper by McKinsey & Company notes that as much as 60% of denials may not be appealed at all resulting in the healthcare provider writing off the debt.)

This is an example of where AI could review a hospital's denial history looking for patterns such as certain procedures experiencing higher levels of denial. In cases when the analytics suggest a high rejection rate, the AI tool could facilitate supplementing the claim with additional supporting clinical documentation (demonstrating medical need) and referencing the relevant provider contract documentation confirming contract eligibility.

Nurse Time Management

With respect to automation, another McKinsey report recently analyzed the time management of nurses: how do they break down a typical shift including time spent with patients, time spent on administration, etc.

The data suggested that nurses spend meaningful time on tasks that do not use the full extent of their licensure. For example, nurses reported that they spend close to one hour per day on nutrition and activities of daily living ("ADL") such as assisting patients with bathing, toileting and feeding. Could a portion of those tasks be automated and/or delegated to entry level staff?

In the survey, nurses reported spending up to 15% of their time monitoring, recording & documenting patient vital signs. Automating this task by using technology to upload this data directly into the electronic medical record system is just one simple example of how investments in technology might free up nursing time that could be spent elsewhere on higher-level direct patient care.

Innovation and new technology shows incredible promise to address two of the primary challenges within the healthcare delivery system—too much administrative burden combined with scarce staff resources. Even incremental improvements could provide a meaningful benefit and extend valuable resources.

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Sources: https://www.mckinsey.com/industries/healthcare/our-insights/nursing-in-2023
https://www.mckinsey.com/industries/healthcare/our-insights/setting-the-revenue-cycle-up-for-success-in-automation-and-ai

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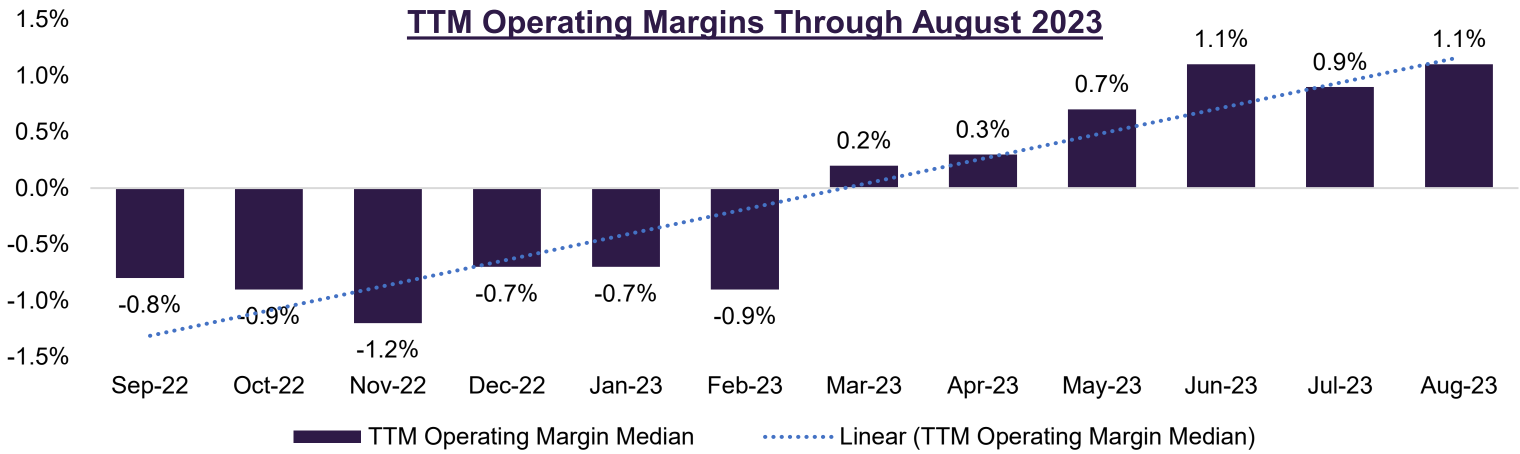
Improved Operating Profitability with Rising Divergence from For-Profit Operators:

Not-for-profit hospital operating profitability has continued to improve as volumes – particularly outpatient volumes– increased during the 8-month period ending 8/31/2023. As noted on the chart below, the median operating margin for the 1,300 names tracked monthly by Kaufman Hall was 1.1% in August 2023 which compares favorably to -0.6% in December 2022 and -0.8% a year ago in September 2022.



Source: Kaufman Hall | National Hospital Flash Report (August 2023)

While operating profitability has improved, the not-for-profit hospital segment (which according to the American Hospital Association's 2023 data represents 58% of acute care hospitals) continues to underperform relative to the large, publicly traded, "for profit" operators.

Based on Q2 financial results for five of the largest "for profit" U.S. hospital operators (HCA, Community Health Systems, Tenant, Universal Healthcare and Select Medical), the median operating margin was 9.6%.

For-profit hospitals operate differently than not-for-profits (different markets, size, service lines, & missions) but the growing divergence between the financial performance of the not-for-profits and for-profits bears watching.

Increasing Pressure on Not-for-Profit Hospitals to Expand Charity Care:

On the topic of the differences between "for profits" and "not for profits", lawmakers around the United States are increasing scrutiny on not-for-profit hospitals regarding the "community benefits" that are expected as a condition of their tax-exempt designation.

More than a dozen states have considered – or have already passed – legislation to better define charity care & community benefit. Currently, while federal laws define what spending qualifies as a community benefit, the existing legislation does not specify how much a hospital needs to spend, with community benefit activities varying greatly by organization.

A 2021 study by Johns Hopkins University found that for every $100 in total spending, not-for-profit hospitals provided only $2.30 in charity care.

In February 2023, a hospital outside of Philadelphia had its nonprofit status revoked after a state court cited "eye-popping" compensation for executives.

"The ruling sent a warning shot to all nonprofit hospitals, highlighting that their state and local exemptions, which are often greater than their federal income tax exemptions, can be challenged by state and local courts," said Ge Bai, a health policy expert at Johns Hopkins.

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Sources: National Hospital Flash Report (kaufmanhall.com)
Becker's Hospital Review
KFF Health News

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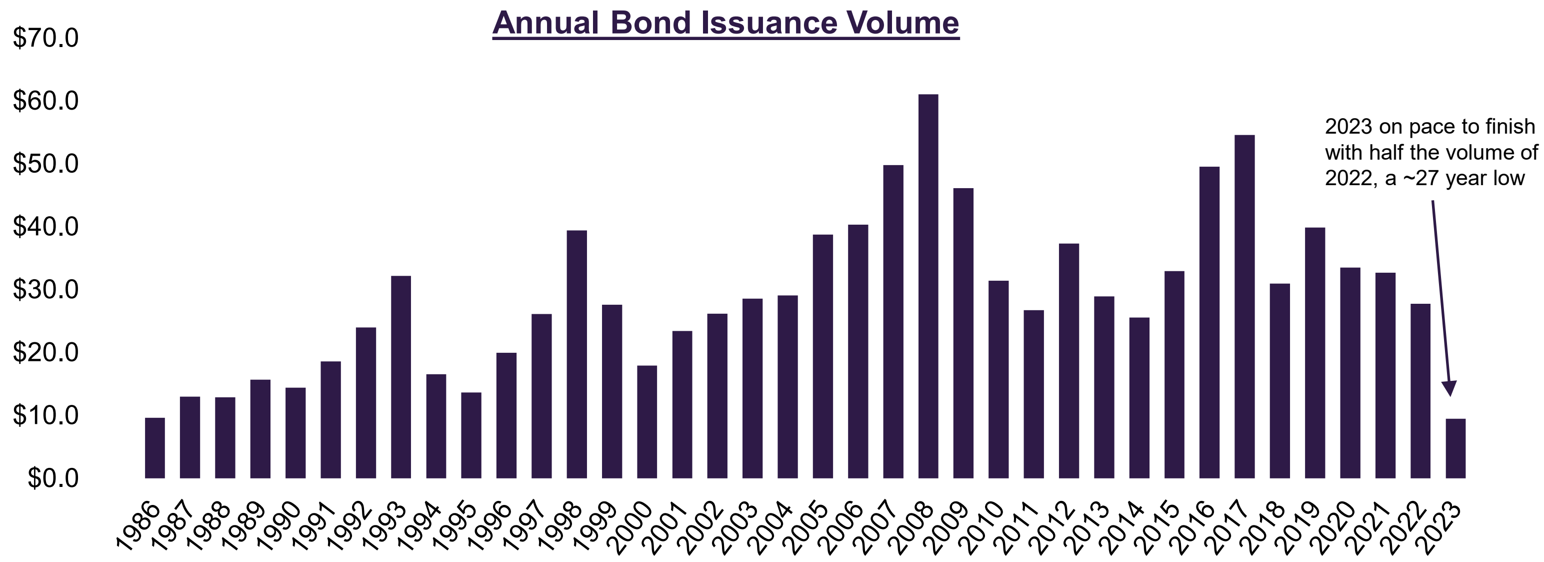
Public Bond Issuance Remains Soft:

As interest rates remain high, public bond issuance has remained soft although transactions continue to be well received within the not-for-profit sector. On an annualized basis, issuance volume is projected to finish the year at roughly half of the volume seen in 2022.



Source: Bloomberg

Private Placement Alternatives:

For not-for-profit hospitals & health systems with "A" ratings or higher, tax-exempt & taxable private placements have re-emerged as an effective financing alternative.

Borrowers can tap into a diverse investor base, including insurance companies and pension funds depending on the specific transaction's characteristics.

Private placement transactions often offer various interest rate and maturity structures to cater to the unique financing needs common in these financings.

This structure serves as an attractive option for hospitals seeking expedited market access while also aiming to limit time consuming public disclosures and preserving limited bank financing capacity.

Advantages:

- Reduced Disclosure Requirements: Private placements typically involve less stringent disclosure and reporting requirements compared to public bond transactions.
- Flexibility in Terms: Private placements offer more flexibility in structuring terms and conditions, often allowing for customization.
- Speed: These transactions often have a faster execution timeline, providing quicker access to capital.

Disadvantages:

- Limited Investor Pool: Private placements have a smaller investor pool which can result in slightly higher borrowing costs due to limited investor competition.
- Less Liquidity: Private placements are less liquid than publicly traded bonds, making it potentially more challenging to sell or trade the bonds – further limiting the potential pool of investors.

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Sources: Bond Buyer Data accessed August 2023 - Bloomberg

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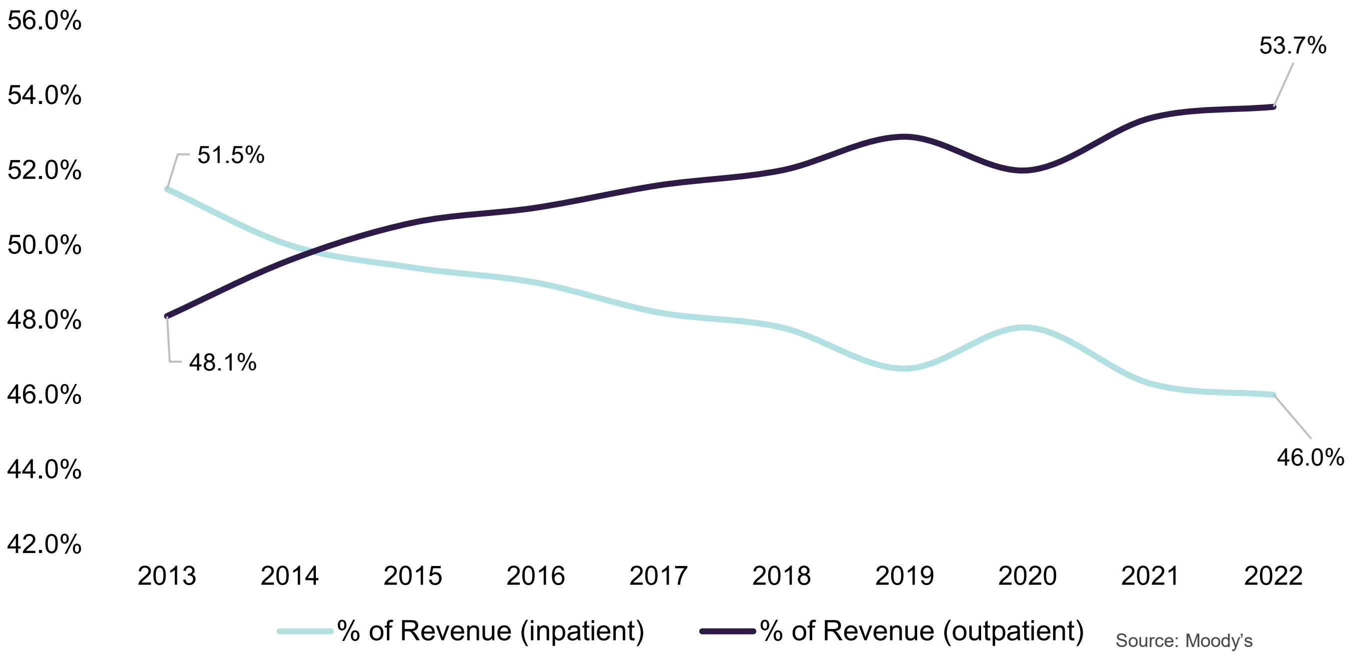
Where Care is Being Provided Continues to Shift:

Over the past 10 years, there has been a significant shift in healthcare services from hospital-based inpatient settings to outpatient/ambulatory settings. This move is due to a number of factors including advances in medical technology, efforts on the part of Payors to incentivize the use of lower cost settings and the preferences of patients to receive care in more convenient, safer and less disruptive settings.

One example – as noted in a study by the Kaiser Family Foundation – found that the average cost of a hip replacement surgery in an outpatient setting was $23,000 compared to $36,000 for an inpatient procedure.

As noted in the graph below – using data recently updated by Moody's – the mix between inpatient & outpatient services (as a % of total revenue) has flipped over the past 10 years. In 2013, 52% of hospital revenue came from inpatient services and by 2022 that figure decreased to 46% of revenue. As medical technology continues to advance, we can expect to see even more procedures being performed in outpatient settings.

Inpatient vs Outpatient Revenues from 2013 - 2022



Source: Moody's

In addition to lower costs, outpatient procedures also offer other advantages including:

- **Convenience**: Outpatient procedures can be performed in more convenient settings, such as doctors' offices, surgery centers and ambulatory care centers. This can be especially beneficial for patients who live in rural areas or who have difficulty traveling.
- **Less Disruption**: Outpatient procedures typically require less time away from work/school/family than equivalent inpatient procedures.
- **Faster Recovery**: Outpatient patients often recover from their procedures at home, which can be more comfortable, less costly and less disruptive than recovering in a hospital.

Article continues on the next page . . .

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Sources: Moody's: Sept 2023: Not-for-Profit and Public Healthcare – US Medians

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Location of Care Continued . . .

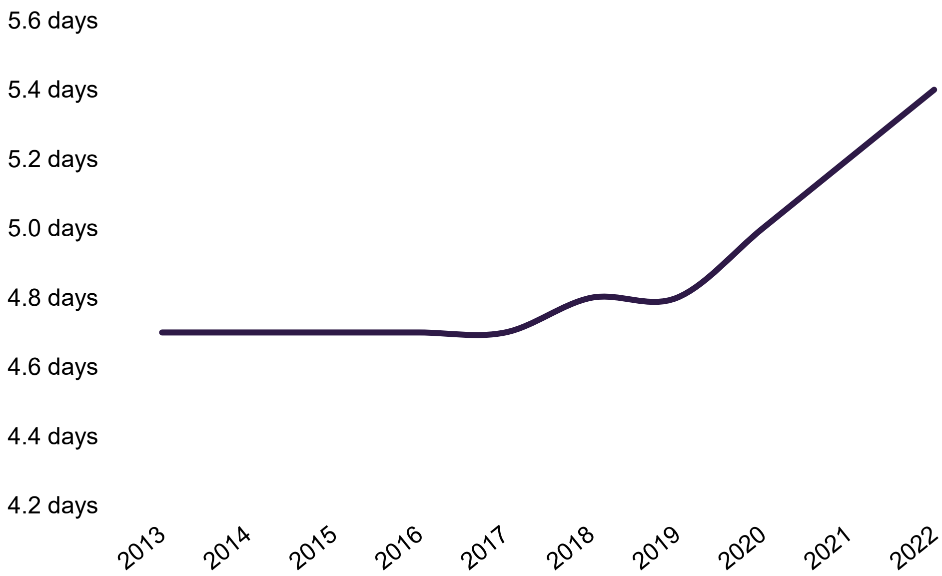
This shift presents a dilemma that has major implications for hospitals. Outpatient procedures generate lower revenue – revenue which often is shared with partners such as physician practices and surgery center owners.

In many cases, hospitals lose out altogether from this revenue since these procedures may be performed at unaffiliated surgery centers owned by competitors or private-equity backed partnerships with physicians.

With these procedures shifting, hospitals have been left with inpatients who are generally sicker and who require longer hospital stays. This can be seen on the chart below – also using Moody's data – indicating the Average Length of Stay has increased 15%, to 5.4 days, since 2013.

Depending on the patient's diagnosis and condition, the hospital is often undercompensated for longer-stay patients. This dynamic has been exacerbated due to downstream challenges within the skilled nursing sector which – due to staffing issues – is often unable to accept patients who would otherwise be discharged from the hospital.

Average Length of Stay (days)



Source: Moody's

Not-for-Profit Hospital & Health System Short-Term Outlook:

- Scarcity of labor and the resulting capacity challenges are expected to continue into 2024.
- Continued operating challenges will likely result in additional (limited) covenant defaults, particularly for smaller organizations.
- Investment earnings will remain challenged as the Fed's "higher for longer" interest rate strategy increases the possibility of a recession.
- The cessation of COVID-19 relief funding along with scrutiny on how stimulus funds were spent remain top of mind concerns
- Cyber threats continue to challenge and invade clinical operations and financial assets.

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Sources: Moody's: Sept 2023: Not-for-Profit and Public Healthcare – US Medians