Opportunities and Challenges for Not-for-Profit Healthcare Institutions

J.P. Morgan Endowments & Foundations Group

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IN BRIEF

Not-for-profit healthcare organizations face significant market and industry pressures while seeking to deliver outcomes for shareholders, employees, and beneficiaries. In the second quarter of 2015, J.P. Morgan hosted a session with healthcare professionals and market specialists where we identified key themes and challenges in the not-for-profit healthcare sector. When making key asset allocation decisions, healthcare investors must carefully consider these market and economic factors:

- The current low-return climate is forcing institutions to seek return-generating opportunities.
- To address increasing industry pressures, healthcare organizations are considering new growth strategies, revenue diversification, and building their cash reserves.
- Many healthcare organizations are evaluating their retirement plans in order to balance organizational needs while meeting employee retirement needs.
- In order to ensure that organizations are appropriately navigating the continuously evolving healthcare landscape, active partnerships with industry experts are critical.

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MARKET OUTLOOK

In a global market defined by uncertainty and increasing volatility, healthcare organizations must consider certain key factors when diversifying and preserving returns. As interest rates are a timely focus, it seems likely that the Fed will increase the Federal Funds rate once by the end of 2015. In addition, we expect an increase in inflation as demand in the economy and wage growth both increase over time.

Given the ongoing fluctuation of global geopolitical and macroeconomic factors, healthcare investors must discern within and across asset classes to find appropriate return-generating opportunities. Fixed income is not cheap at the moment, but certain areas remain attractive. In particular, the economy appears to be in the middle of a growth cycle and is not yet overheating, thereby making high yield debt or similar proxies (i.e., direct lending, credit) appealing due to the ability of companies to repay interest within a strong credit market. In addition, **unconstrained fixed income, low volatility, low Beta, or return-enhancing hedge funds, real assets, and credit strategies can enable organizations to diversify portfolio holdings.**

The equity markets also offer opportunities to source alpha in a lower-return environment. Following the recent market pullback, we expect lower than average returns in the U.S. going forward with higher volatility. Therefore, pockets of opportunity in emerging markets

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in the long term as well as an expected resurgence in Europe can enable investors to protect against domestic overvaluation.

Overall, beta has generated the bulk of returns in the cycle thus far, but **future growth will come from alpha**. To source this alpha, organizations could consider seeking out high active share strategies, prioritizing tracking error over passive exposures. Additionally, less liquid strategies such as hedge funds and a variety of private market investments can enable investors to access incremental return.

INCREASING INDUSTRY PRESSURES

Healthcare organizations face significant pressures in today's climate—they need to assess how to grow, capitalize on economies of scale, and establish relevance in the market.

Three core themes have emerged within the current not-for-profit healthcare environment:

- Partnerships and acquisitions are changing the competitive landscape
- Ongoing diversification of strategy and revenue
- "War chests" are being built for strategic initiatives and anticipated revenue pressures

Growth through acquisition

Many healthcare organizations have evolved their strategy towards inorganic growth through acquisition and strategic partnerships. Due to a relatively uncertain revenue environment, healthcare organizations have continued to face pressures on their balance sheets. Driving factors include the impact of the Affordable Care Act, heightened competition for patients, increased spending on IT, and the shift to ambulatory strategies (i.e., health services delivered in non-hospital settings).

In response to these revenue pressures, many healthcare entities are considering mergers and acquisitions to bolster growth. Firms continue to rely on access to capital markets to improve market share and fund new revenue-generating initiatives. For instance, healthcare organizations based in Chicago clearly exhibit this trend with increased consolidation among peers (mergers of Adventist and Alexian, Northshore and Advocate, and Northwestern and Cadence).

Revenue diversification

Healthcare organizations have recently engaged in diversification efforts to drive increased revenue and broaden sources of revenue. Companies are focused on expanding consumer touch points, broadening scalable ancillary businesses, looking to investments for steady cash flow, and maintaining access to capital markets. As a result, there have been greater points of collaboration between for profit and not-for-profit institutions, with heightened bilateral dialogue regarding potential deals and best practices.

This diversification extends to financial management, as many healthcare organizations have learned valuable lessons from the financial crisis. Companies have increasingly diversified their banking relationships, specifically in regards to their debt issuance and letters of credit. They have also increased their "war chest" and further segmented liquidity.

Building a war chest

Healthcare companies have been steadily building their war chests for strategic initiatives and anticipated revenue pressures. Due to the fact that both long-term and short-term interest rates remain very low, organizations have used this as an opportunity to shore up their balance sheets and create a cash reserve. Furthermore, the decrease in charity care (i.e., health care provided for free or reduced prices)—near term—has strengthened the balance sheets of healthcare organizations, though reimbursement rates remain a concern.

As of the Spring Healthcare Investors Roundtable, Standard and Poor's maintained a negative view on the not-for-profit healthcare industry overall and associated credit quality due to perceived continued downward revenue pressure and uncertainty related to ongoing industry changes. As of September 1, 2015, S&P has improved their outlook for the Not-for-profit Healthcare to Stable. The improved outlook reflects their view of a stable to improved financial environment. In particular:

- Operating margins and debt service coverage ratios improved overall
- Growing unrestricted investment pools across a broad spectrum of systems
- Steady to improving debt metrics

On August 27, 2015, Moody's also changed its outlook for NFP Healthcare from Negative to Stable for the first time since 2008.

KEY CONSIDERATIONS FOR RETIREMENT PLANS

As not-for-profit healthcare organizations try to balance organizational needs with meeting employee retirement needs, the dynamic between Defined Benefit (DB) and Defined Contribution (DC) strategies is increasingly important.

Despite the waning prevalence of DB plans, plan sponsors must continue to balance several core implementation elements. An AiCIO Pension Survey polled participants across the corporate pension landscape and found that in the past three years, 41% of open plans froze or closed to new entrants. Supporting this trend in the not-for-profit healthcare space, a recent survey of Catholic healthcare organizations showed that only 44% have an open DB plan—down from 70% in 2011. Nevertheless, the concerns regarding the effectiveness of DB plans have moved beyond just long duration—they focus more holistically on glidepath management, return management, funding volatility management and hedge ratio. **Plans are not just looking at DB from one perspective** (e.g., liability side or hedge side), **but instead are focusing on the overall implementation.**

Some organizations have opted to close/freeze the traditional DB plan while offering a Cash Balance Plan. The move to Cash Balance Plans eliminates longevity risk and allows for greater cash flow predictability. Cash Balance Plans still have funding level volatility, but with meaningfully shorter liability duration (8–9 years vs. 11–12 years), there can be less impact on the balance sheet.

With more Plans closing and/or freezing the DB, there is a greater industry focus on DC. **Organizations are transferring a greater portion of retirement risk to their employees, but also recognize the need to help employees with a varied knowledge base.**

Compared to corporations, healthcare organizations use DC plans as a tool to attract and retain employees. **Many healthcare organizations are considering "supercharging" DC plans with the goal of providing access to institutional quality investment solutions.** Unlike in corporate America, many healthcare DC Plans are 403b (non ERISA). Though not required, these organizations are following the trend of transforming a traditional 403b (supplemental savings account) to a 401k light design, incorporating best practices while not providing the required reporting to the Department of Labor.

There are a number of tools being evaluated and broadly implemented—ranging from plan design (re-enrollment, auto-enroll, auto-escalate), investments (TDF default options, focused core menu), communication, and education (effective rollout campaigns and messaging). As HR groups seek ways to increase engagement with the workforce, many are turning to their DC Plans as a way of achieving that mission. An effective communication strategy is imperative to a successful rollout and satisfaction; one large multinational industrials company recently did a plan re-enrollment involving 19 intentional communication touch points, resulting in zero calls to HR and a clear understanding of the plan by employees.

Despite this, many organizations tend to underutilize retirement partners when looking to communicate and understand the behaviors of their employees. Ultimately, organizations must present all employees with the latest and best financial opportunities in order to do the right thing for their workforce.

CONCLUSION

Intelligently sourcing investment opportunities in a volatile market is a continued source of focus for not-for-profit healthcare organizations. Downward revenue pressures have driven growth through acquisition, required revenue diversification, and a focus on growing "war chests" to enable healthcare organizations to remain nimble and effective. Additionally, close attention to retirement plan design, investment options, communication and education is imperative to balance organizational needs with employee retirement needs. Partnering with organizations that understand the unique pressures of the industry can help not-for-profit organizations take advantage of opportunities in today's increasingly complex environment.

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