KaufmanHall



2022 Capital Markets Recap & 2023 Outlook Not-for-Profit Healthcare Systems

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Today's Agenda

- 1. Introduction
- 2. 2022 Capital Markets Recap
- 3. Impacts to Not-For Profit Healthcare Systems
- 4. Expectations for 2023
- 5. Questions

What We Do

KaufmanHall

For nearly 40 years, Kaufman Hall has been a trusted partner to our clients.

We use disciplined methods and innovative ideas to help clients achieve their most challenging goals in times of uncertainty and opportunity.

What We Deliver



UNMATCHED EXPERTISE

Founded in 1985, Kaufman Hall created the discipline of strategic-financial planning in healthcare.

We are the #1 healthcare financial advisory firm in treasury and capital markets.

We have advised some of the largest and most complex healthcare mergers and acquisitions.

We have successfully applied our unique approach to performance improvement and merger integration across the country.



DISCIPLINED ANALYSIS

Throughout its history, Kaufman Hall's consulting has been based on a foundation of sound and state of the art analytics.



BROAD EXPERIENCE

Kaufman Hall has been a trusted partner to more than 3,000 **healthcare** and **higher education** organizations.

In the last ten years, Kaufman Hall has advised:

- 675+ healthcare organizations
- **150**+ healthcare strategic partnerships, mergers, and acquisitions
- **40**+ higher education institutions
- 20+ private equity funds and investors



EXTENSIVE REACH

We are headquartered in Chicago, with 460+ professionals. Other offices: Los Angeles, CA & West Palm Beach, FL

*Kaufman Hall was ranked the No. 1 financial advisor in the U.S. in new healthcare debt for both long-term municipal public offerings and private placements for 14 out of the last 18 years according to Thomson Reuters™ Municipal Market Analysis. 2023.

Our *Healthcare* Integrated Advisory Services

For almost 40 years, Kaufman Hall has provided independent, objective insights grounded in sound data and analysis to help clients fulfill their missions, achieve their goals, and tackle their toughest problems.



Strategy

- Enterprise strategy
- Partnership strategy
- · Organizational design and operating strategy
- Integrated strategic financial planning
- Payer-provider strategy and partnerships
- Consumer-centric transformation
- Clinical excellence
- · Business growth
- Private equity assessment

Partnerships, Mergers & Acquisitions

- Sell-side services
- Facilitated partnerships
- **Buy-side** services
- Affiliations and joint ventures

Treasury & Capital Markets

- Credit and capital management
- Treasury operations
- Debt and derivative advisory
- · Strategic resource allocation
- Invested asset strategy
- · Real estate capital markets

Performance Improvement

- Workforce
- Non-labor strategy
- Care transitions
- Revenue cycle process
- Clinical variation
- Merger-integration services
- Delivery network optimization

Financial Planning

- Integrated strategic financial planning
- Capital planning solutions
- Business case and project ROI analysis
- Strategic partnership analytics and synergies analysis

Clinical Documentation Improvement

- Inpatient
- Outpatient
- · Professional fee

Physician Enterprise

- Structure
- Operations
- Alignment
- Partnerships

Real Estate

- Investment sales & institutional monetization
- Sale/leasebacks
- Partnership ownership recapitalization
- · Joint venture capital raising
- Debt capital raising
- Developer/capital selection
- Owned portfolio strategic assessment and valuation



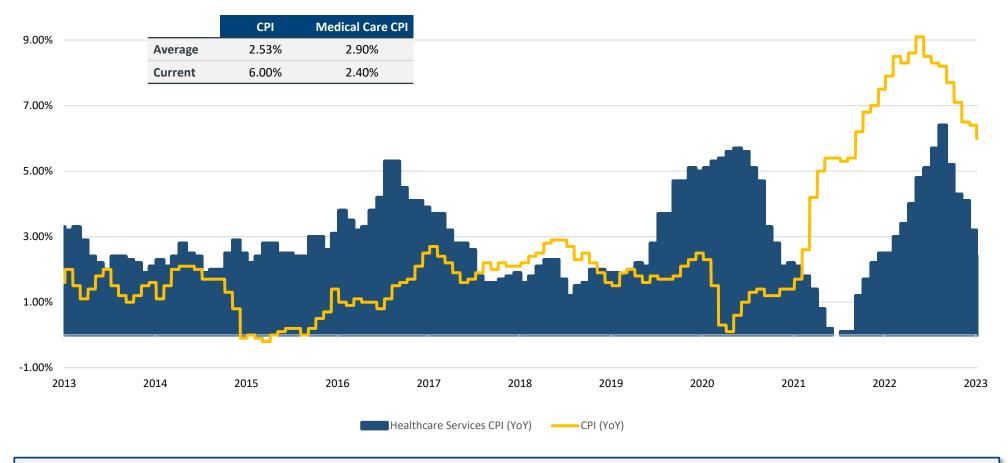
2022 Capital Markets Trends

- 2022 was a challenging year from many perspectives
- Omicron and geopolitical tensions threatened supply chains
- Inflation, Fed tightening and higher interest rates permeated all facets of the markets

The most "consistent" capital markets trend was volatility itself



Healthcare Services CPI Increases vs. Total CPI

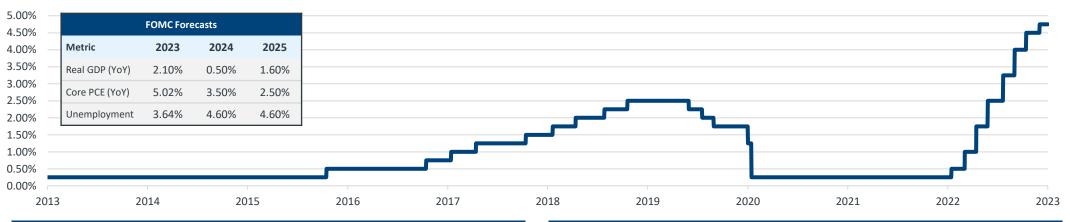


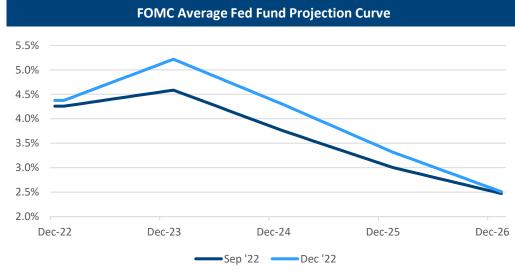
U.S. consumer prices are up 6.00% from a year ago as the cost of medical care moves in tandem with overall inflation.

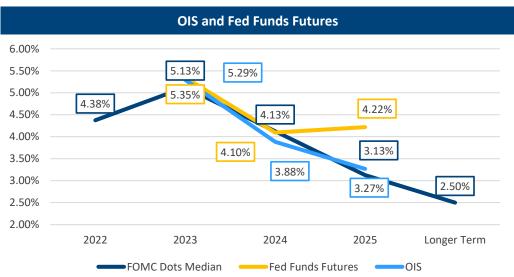
Source: Bloomberg as of March 10, 2023

FOMC Has Been on a Journey with Fed Funds Rate

The Federal Reserve continues to increase their Federal Funds rate to help combat record-high inflation







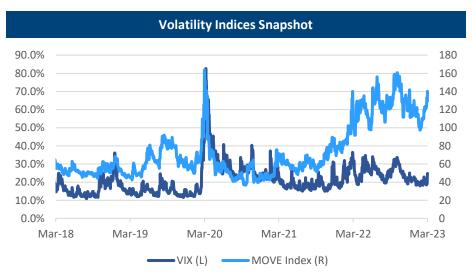
Source: Bloomberg as of March 10, 2023; Federal Open Market Committee as of December 14, 2022

Volatility Has Been Consistent in Bonds and Equities

Benchmark rates increased significantly since 2021 lows and have been volatile in 2023 with Fed policy and key inflation metrics in focus







Source: Bloomberg, Thomson Reuters as of March 10, 2023

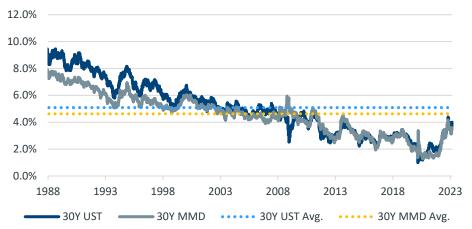
Long-Term Borrowing Costs Increased for Health Systems in 2022



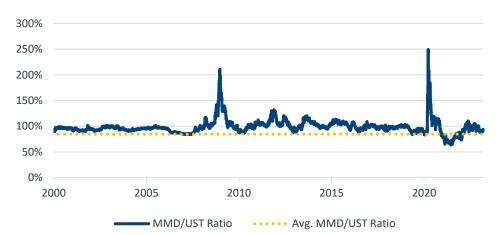
Source: Thomson Reuters, Bloomberg, and Internal Kaufman Hall sources

Long-Term Rates in Broad Context – Not So Bad

With recent increases, benchmark rates approach historic averages



30-year Muni ratios are trading near historical averages

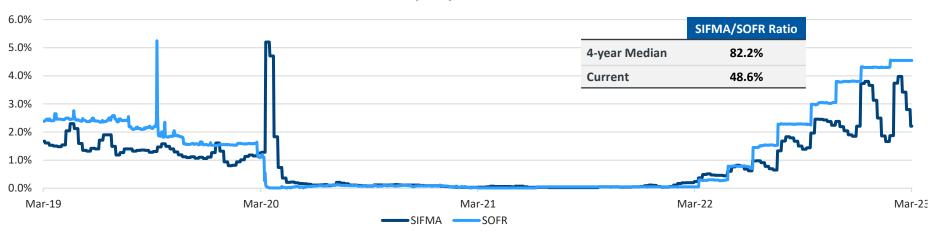


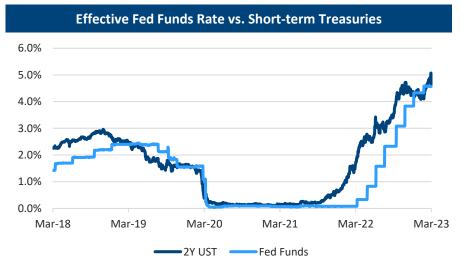
	MMD			UST			Ratios		Spreads	
	5Y	10Y	30Y	5Y	10Y	30Y	10Y	30Y	30Y – 5Y MMD	30Y – 5Y UST
Current	2.59%	2.51%	3.48%	3.96%	3.70%	3.71%	67.9%	93.9%	0.89%	-0.26%
YTD Change	0.07%	-0.12%	-0.10%	-0.04%	-0.18%	-0.26%	0.0 pts	3.6 pts	-0.17%	-0.22%
10-year Average	1.29%	1.91%	2.71%	1.72%	2.18%	2.76%	89.9%	98.2%	1.42%	1.04%
Average Since 1987	3.13%	3.78%	4.64%	4.09%	4.59%	5.08%	85.5%	93.7%	1.51%	1.00%
% Time Higher Since 1987	58.1%	71.5%	72.5%	49.4%	60.2%	68.6%	98.1%	46.7%	87.8%	97.9%

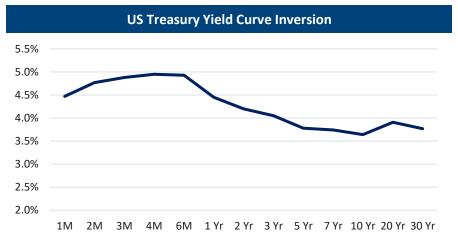
Source: Bloomberg, Thomson Reuters as of March 10, 2023

Fed Action Impacts to Short-Term Markets

Short-term benchmark rates have risen with Federal Reserve policy actions







Source: Bloomberg, Thomson Reuters as of March 10, 2023

Silicon Valley Bank: Wrong Risks at the Wrong Time

Overview

- Silicon Valley Bank, a darling of start-ups, tech and VC investors, and the 16th largest bank by deposits, was seized by regulators last week and placed into FDIC receivership
- The second largest bank failure in US history
- Caused by a confluence of events primarily a mismanaged liability portfolio and a social media-driven run on deposits
- Given average size of deposits for each client, ~83% of deposits were uninsured; highly correlated and connected clientele

What Happened?

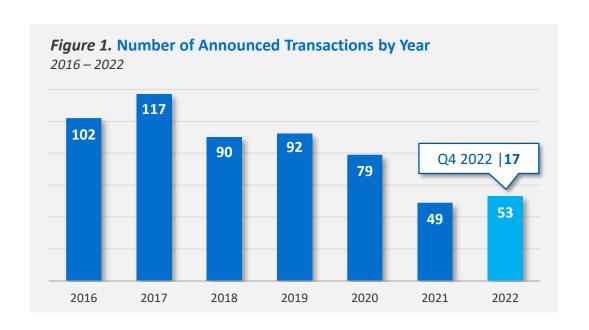
- Easy money since 2020 led to excess deposits and investment as SVB locked in low long term investment rates in its debt portfolio
- Inflation and Fed tightening led to large paper losses in this portfolio (rates rise, bond prices fall)
- Higher rates drew deposits away and SVB attempted to sell Held to Maturity bonds, realizing these large losses (\$15B)
- Simultaneously, concentration of depositors in VC was problematic as the IPO market slows and outflows were needed to sustain start-ups
- Untenable situation becomes public knowledge triggering bank run
- Bank liquidity is inadequate to meet withdrawals leading to bank failure

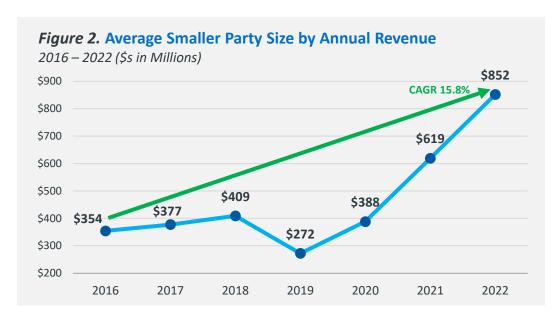


Outcome:

- SVB seized by FDIC on Friday night, placed into receivership
- Sunday night FDIC announces all deposits are secured and will be backed by FDIC insurance program
- Shareholders, bondholders, executives not secured
- Fed creates new Bank Term Funding Program offering loans to banks under easier terms than typical to support liquidity
 - Bank collateral valued at par for Fed loans even if collateral is valued at less than par

Total Transactions Remain Below Pre-Pandemic Levels But Size of Transactions Reach Record Highs

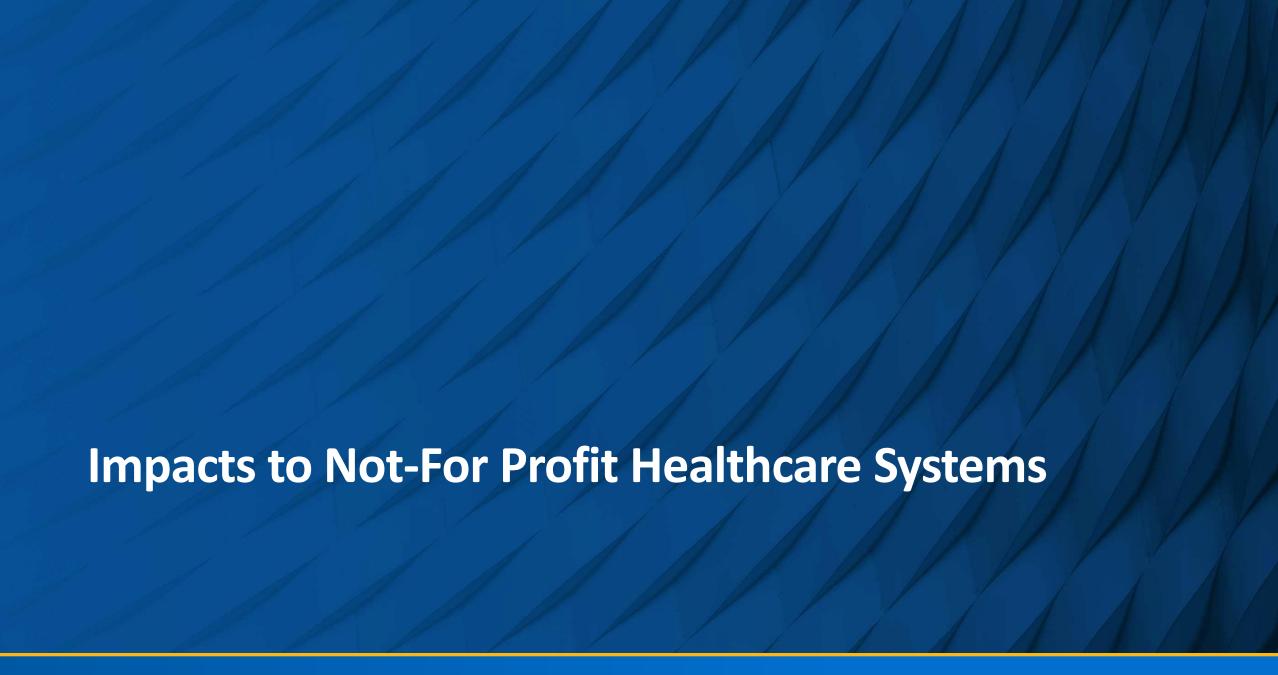




OBSERVATIONS

- As noted above, the 53 total announced transactions for 2022 moved up from 2021's recent historic low of 49 announced transactions (Figure 1).
- The high percentage of mega mergers and other significant transactions over the course of 2022 resulted in an historically high average smaller party size by annual revenue of \$852 million (Figure 2), more than \$200 million higher than last year's historic high of \$619 million. The compound annual growth rate (CAGR) of the average smaller party size over the past 6 years approached 16%.

Source: Kaufman Hall Proprietary Transaction Database



Financial "Twindemic" Hits 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 hospitals can no longer afford to hold their breath.

— Eric Jordahl, Moving Into and Through 2023

Healthcare System Stress Across Operations and the Balance Sheet

Operating Entity

Industry-wide stressed operating margins Coupled with a continuing elevated risk state

Key Drivers:

- Continued labor challenges
- Elevated contract labor rates
- Uneven volume recovery and persistent length of stay issues



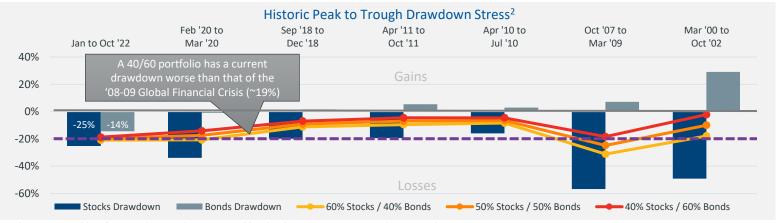
Source: February 2023 Kaufman Hall National Hospital Flash Report

Investment Entity

Many organizations are not benefiting from a 'fortress balance sheet'

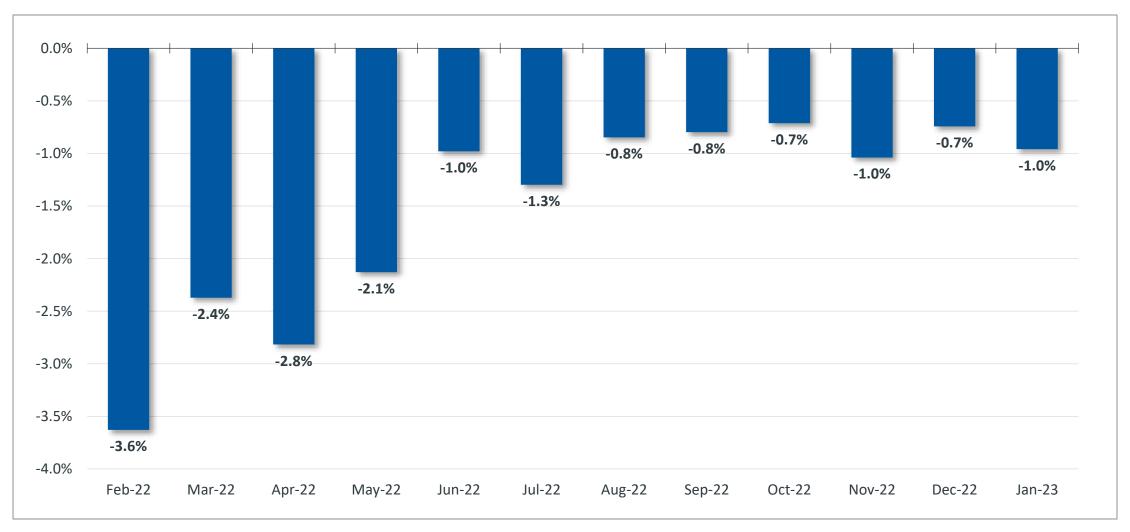
Key Drivers:

- Drivers of stagflation resulted in shock to both stocks and bonds
- Reliance on investment income, external funding and credit profile contributions are being exposed and tested



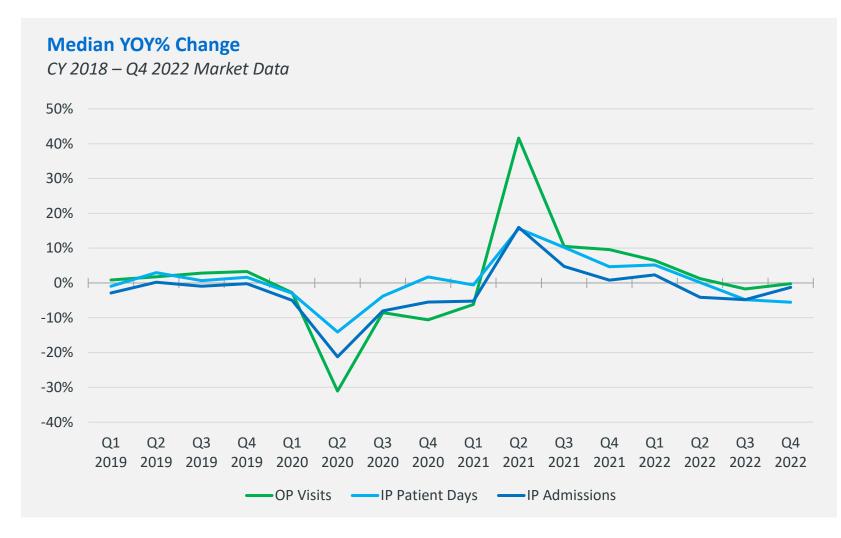
Stocks represented by S&P500 index; Bonds represented by Blomberg US Aggregate Total Return Index.

Kaufman Hall Operating Margin Index™ YTD by Month



^{*} 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.

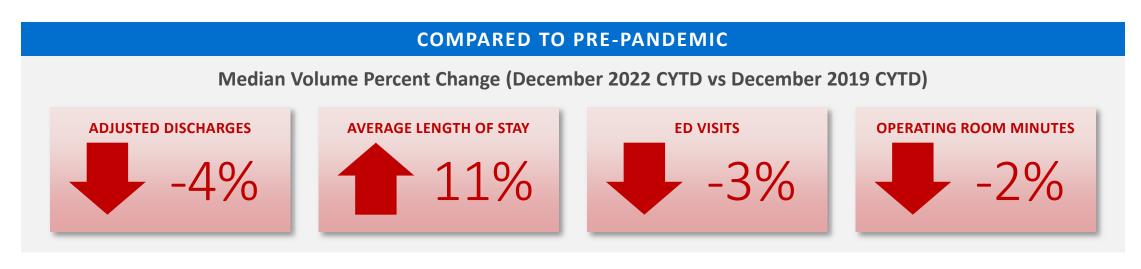
Volume Trends Support Thin Revenue Growth

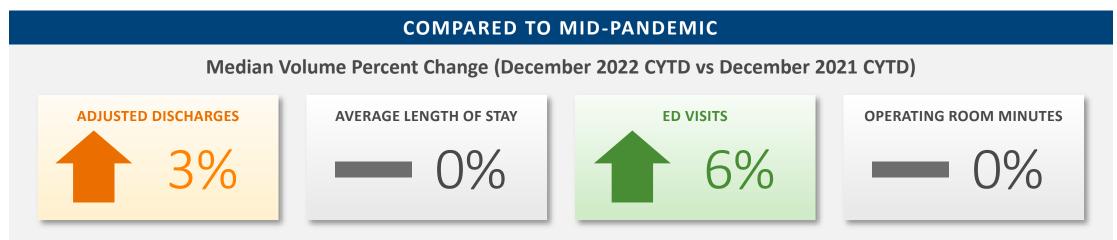


- Volumes overall have been extremely variable relative to pre-COVID levels
- Outpatient visits and admissions show slight increase in Q4 2022
- Patient days show small decrease during Q4 2022
- Length of stay has increased when compared to pre-covid levels driving patient days moderately higher relative to admissions

Source(s): KHA National Flash Report

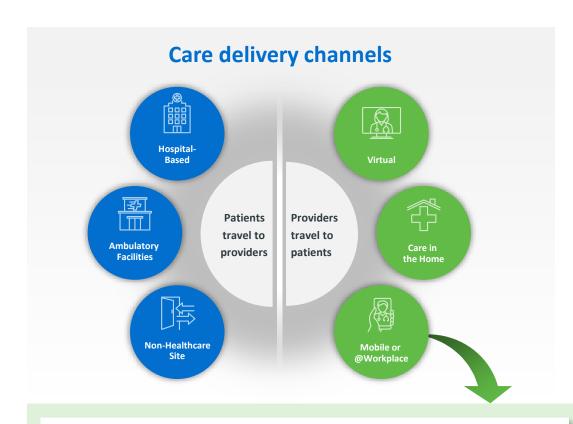
While Improving, Volumes Remain Below Pre-Pandemic Levels **Accelerating Losses with Increasing Costs**

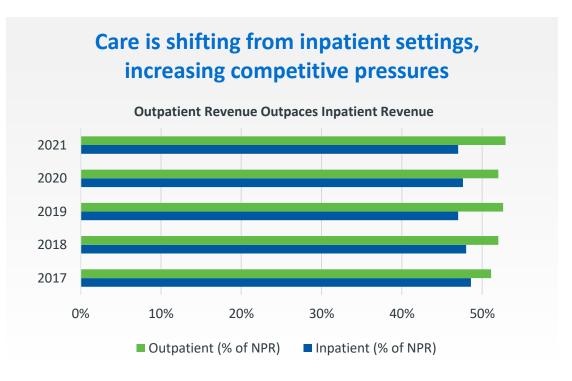




Source(s): Kaufman Hall National Hospital Flash Report (January 2022 Report as of December 2022)

A New Form of Ambulatory Care has Arrived...





- **BENEFITS** 1. Deliver care in setting with dramatically lower fixed costs and overhead
 - 2. Increase patient satisfaction through comfort and convenience
 - 3. Provide alternative revenue streams

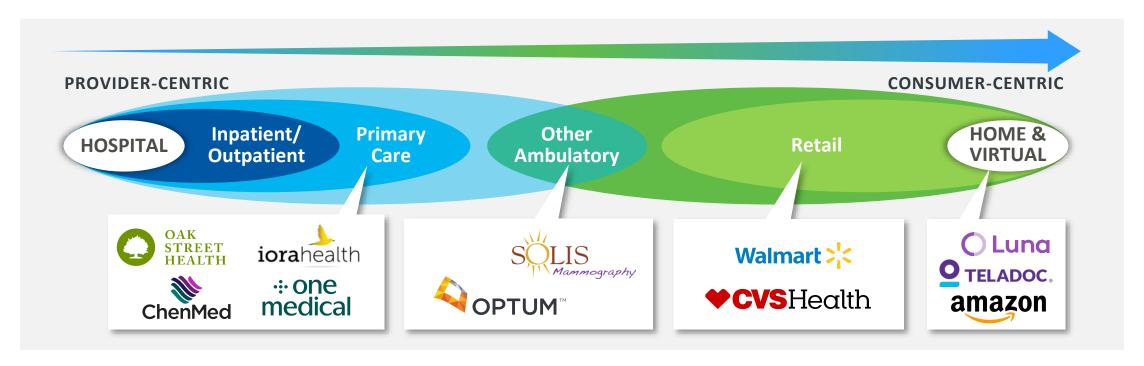
RISKS

- 1. Unclear economic model, particularly in terms of revenue
- 2. Unclear risk implications
- 3. Potential increase in staffing needs

Source: Moody's Investors Service 2021 Not-for-Profit Hospital Medians

As Have the Disruptors..."The Doctor Will Zoom You Now"

- Well-capitalized to pursue aggressive growth strategies
- Hyper-focused on select market segment(s) and have tailored their value proposition accordingly
- · View strategic partnerships with existing players as worthwhile to increase visibility, market share, and financial resources, though not necessary to survive
- Leverage technology and non-traditional business models, though not entirely novel



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All Rating Agencies Maintain Negative Outlooks on the Sector

Moody's

Outlook: Negative

S&P Global

Outlook: Negative

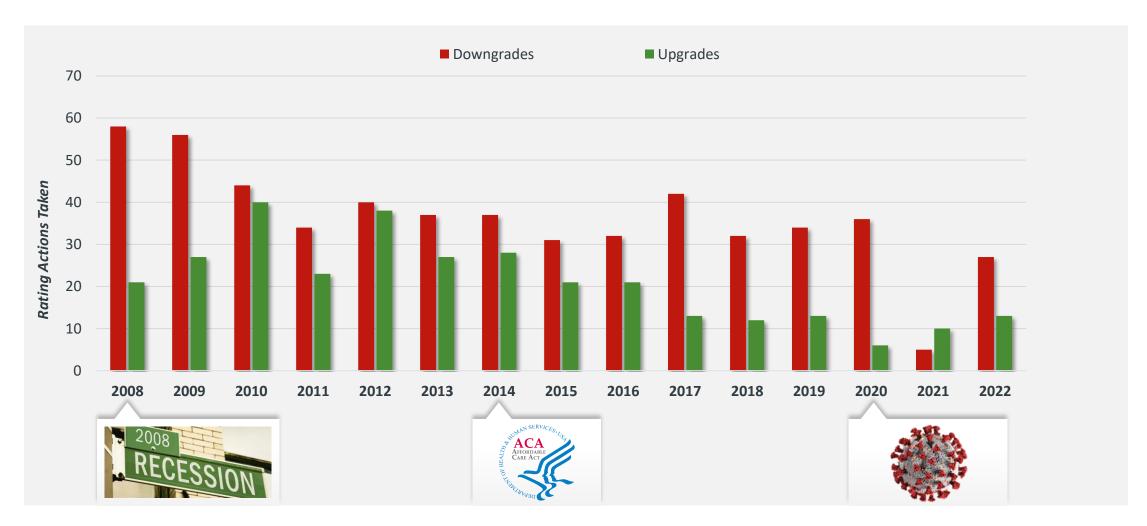
FitchRatings

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

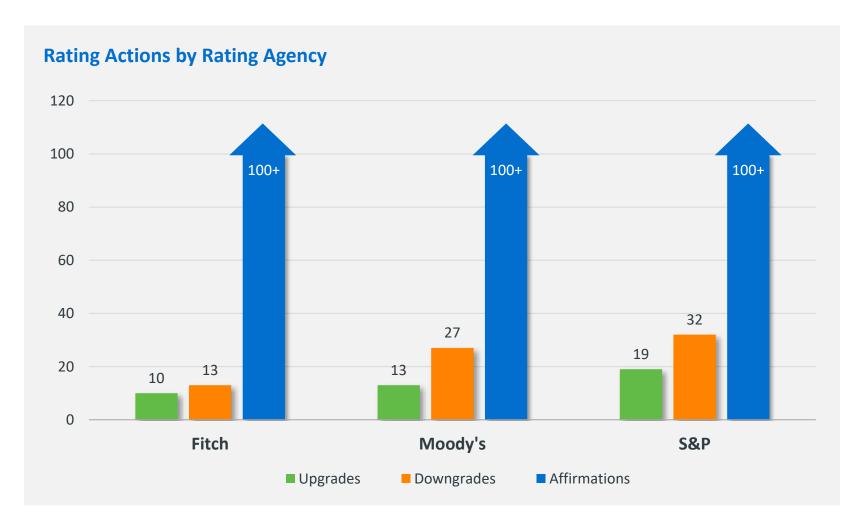
Source: Moody's, S&P, and Fitch sector outlook reports; KH Webinars

Economic Cycles and Rising Expense Drive Rating Downgrades *Moody's Rating Actions*



Source: Moody's Investors Service

Affirmations Remain the Majority of the Actions in 2022 Downgrades Exceed Upgrades



KEY TAKEAWAYS

- Downgrades occurred on all types of hospitals
- Several multi-notch downgrades by Moody's and S&P (2 or more notches), typically low rated organizations
- Upgrades reflected improved performance; others reflected mergers with higherrated organizations

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



Where are We in the Stages of the Pandemic?

Crisis

Largely a monetary event.

CHARACTERIZED BY:

- Major stimulus spending (approx. \$5 trillion)
- Accommodative Federal Reserve monetary policy
- Heavy focus on clinical and operational performance

Stabilization

Largely a credit event as we adjust to the outcomes of the crisis stage.

CHARACTERIZED THUS FAR BY:

- Staffing shortages and surging inflation (including wages and supplies)
- Tightening monetary policy and rising interest rates, which is driving market volatility
- Renewed focus, and concern, on financial performance

Normalization

What does financial performance look like in a normal future state?

TO BE CHARACTERIZED BY:

- Stable workforce environment
- Stable interest rate environment
- Return to steady financial performance and capital spending

Healthcare Industry Challenges Remain Numerous and Persistent

Unprecedented Margin Pressure and Cash Erosion in 2022

- Staggering financial losses continue through 2023
- Covenant violations will be inevitable for many
- A return to pre-pandemic financial performance unlikely
- Labor costs are the single most important challenge
- Wage inflation is now a permanent part of the expense structure
- Liquidity is declining given markets losses and Medicare repayments
- Bailout resources are depleted (CARES Act/CMS funds)
- Higher interest rate environment moderating over time
- Challenges in debt markets

Management teams must act with unprecedented urgency to stabilize performance and create sustainable enterprises

Sustained Headwinds in 2023 Challenge Every Component of the Business Model

2023 challenge:

sustained credit and market headwinds challenge capital formation and resource allocation

FINANCE COMPANY HEADWINDS

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

Operating Company Resiliency Chestment Ombany Finance Hub

OPERATING COMPANY HEADWINDS

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

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





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