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Buy-Side Perspectives on Not-for-Profit Healthcare

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We assembled a panel of investors in not-for-profit healthcare at Kaufman Hall's 2022 Healthcare Leadership Conference to get their perspectives on major issues facing the sector today, including weak financial performance and the threat of breached covenants, best practices for disclosure and transparency with investors, and the growing influence of environmental, social, and governance (ESG) concerns on investment decisions.

Financial performance and the threat of breached covenants

Investors are well aware of the financial challenges many health systems are facing in 2022. The good news is that investors are not inclined, at this point, to seek acceleration in the event covenants are tripped. They do not want to own a hospital; they want to get their investment back and are willing to go through a turnaround with the health system if needed. But they also understand that covenants give them a seat at the table with the issuer or borrower, and they will use that seat to ensure that their investment is protected.

In the event of a likely breach, investors are willing to consider a one-time waiver of a compliance obligation, but they will require an explanation of why specific line items are up or down and how the waiver might alter the fundamental credit profile for that period. They also want to know which other lenders are involved and what other covenants might be tripped; a catalog of covenants across an organization's loan and debt obligations that can be shared with investors is helpful. Depending on specific circumstances, investors may be more interested in a forbearance than a waiver if the situation indicates the likelihood of continued deterioration in financial performance.

Amendment is also an option, but it is a more complicated internal approval process than a waiver. Waivers can often be processed in several days, but amendments will take substantially longer and will require the involvement of counsel.

If a consultant call-in is required, investors will want to know who the consultant is, how the management and board have reacted to the consultant's report, and how they plan to implement the report's recommendations. Investors do care about which consulting firm is used and they expect a substantive turnaround plan. Some investors will also want to the see the final consultant report to understand what the specific problems are and what levers are available to fix them.

Disclosure and transparency

Investors do not like surprises and would prefer too much over too little disclosure. Good disclosure is also key to investors being able to trade in the secondary market, which is particularly important in the current market environment where fund outflows are the norm. But it is important to note that investors can only trade in the secondary market based on publicly available information. Investors do not want to hear "we gave the information to the rating agencies" as an excuse for not providing it directly to the investors after it has been publicly released.

Two specific suggestions for sharing information with the investor community are:

- Including a robust management discussion and analysis (MD&A) in each quarterly report with an emphasis on real-time issues. Investors will be particularly interested in knowing whether these issues are industry-wide or credit-specific.
- Scheduling an investor call after information has been publicly released to allow investors to ask questions. This will go a long way toward building goodwill with the investor community and will help with secondary market liquidity. Investor calls also ensure the equitable distribution of information to the investor community.

Kaufman Hall noted that borrowers need to be careful about making comments regarding future performance, and they also should take care to avoid disclosing details on payer contract negotiations and labor issues. Borrowers should consult with legal counsel, auditors, and financial advisors with respect to creating an effective investor communication strategy.

Overall, the investors on our panel gave credit to the healthcare sector versus other industries for good quarterly reporting practices.

Environmental, social, and governance (ESG) considerations

Our panelists all noted growing interest in ESG issues, but their perspectives varied, based largely on whether their organizations offered impact funds or funds that are otherwise incorporating ESG considerations (e.g., carbon footprint, diversity, etc.).

At a basic level, ESG reporting provides information on risks facing borrowers—for healthcare organizations, often environmental risks such as flooding, storms, seismic events, or wildfires. For firms offering ESG-related funds, they are interested in ensuring that the borrower's commitment to ESG is real, not cosmetic. To this end, they will look for sustainability reports or evidence of a commitment to ESG that is backed by specific metrics. Bonds that are marketed as sustainability bonds may have ESG "covenants" that trigger higher coupon payments if metrics are not achieved. The not-for-profit mission of many health systems makes them an attractive option for ESG investors, but investors will want to know if the borrower is acting responsibly in its community.

Although the rating agencies are now issuing ESG scores or commentary on rated credits, most investors do their own analysis of ESG. Information from the rating agencies is a component of their analysis, but not determinative.

Impacts of a low-issuance market

Municipal market outflow has been a trend in 2022, as has a lower rate of debt issuance by not-for-profit health systems. Lower issuance is giving investors more time to focus on other opportunities, including private placements, joint venture structures, credit tenant leases, and off-balance-sheet financing. It is also directing some investors more toward the secondary market for investment opportunities.

In conclusion: In this for the long haul

Investors are long-term capital partners, and they want to be treated fairly. They understand that the current situation presents a variety of challenges, and they are willing to work with borrowers to get through this. They also acknowledge that there are few quick fixes at this point, so the process will take time. To that end, they are asking for better communication and opportunities to ask questions.

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