CAPITAL PLANNING AND ALLOCATION

How healthcare finance executives are changing their approach
According to the American College of Healthcare Executives’ annual survey, “financial challenges” ranked as the top concern for healthcare CEO’s heading into 2015.¹ This is indicative of the complex operating environment facing the healthcare sector as many struggle to fulfill their mission of providing high-quality, cost-effective patient care within the current economic and regulatory framework.

Net patient revenue has never been harder to predict as long-term uncertainty still exists for coverage, payment models and changing patient volume/behavior. As operating margins continue to be pressured and many experience operating deficits, healthcare providers must find ways to remain competitive while at the same time controlling expenses.

The need to compete in a new landscape focused on quality of care and value-based payment models has put increasing demands on scarce capital resources. Growing competition has intensified the need to invest in real assets and initiatives that support expansion of services and organizational growth. This often includes making difficult decisions related to significant investments in new technologies, equipment, staff and facilities. These are all critical to growing the cash flow necessary to not just survive, but thrive in the new healthcare landscape.

Recognizing this dynamic, senior healthcare finance professionals are changing their approach to capital planning and capital allocation, making these processes much more dynamic. While this historically may have been a static, annual process, many providers are implementing strategies for regularly reviewing capital requirements and how the organization's existing assets are being deployed and invested for maximum returns.

A changing landscape requires a changing approach

In this new landscape, finance executives need to balance having the required amount of available liquidity without sacrificing an opportunity for potential investment returns. Having an efficient cash and asset management strategy is a critical component in the management team’s ability to do so. Here are three considerations for how operating cash and longer term investable assets are allocated to address the specific needs of the organization:

1. **Create a set policy for reallocating assets above the minimum threshold for working capital**
   Most healthcare organizations set aside cash to be used for day-to-day operations such as payroll and purchasing. Changes to payment models have increased the desire and the need to keep more cash on hand, and most management teams have identified targeted minimum levels of operating cash necessary to support ongoing operations. That said, many of these same organizations may not have a construct in place to regularly (or systematically) transfer excess cash over and above identified core cash targets into longer term pools designed to maximize growth and return opportunities. Setting target levels of core cash, combined with a process for automatically moving excess amounts into longer term pools, ensures those assets are working fully to support long-term balance sheet and organizational growth.

2. Establish a policy for how much of short-term capital expenditures will be funded in advance

Some healthcare providers have short-term pools as part of their broader investment account structure. They use these pools to set aside resources to fund known near-term capital expenditures, provide additional cushion for unexpected liquidity requirements and/or support variable rate debt programs (e.g., self-liquidity and letter of credit-backed) within their capital structure. The purpose of a short-term pool is to provide incremental yield above cash with a lower risk profile and volatility than that of a longer term pool. As with the working capital account, a minimum funding threshold for this account should be identified and parameters should be developed to periodically set aside cash needed for identified near-term expenditures versus waiting until the time when these expenses are incurred. Management teams should understand all of the potential risks and the trade-offs in each scenario. Once that policy is determined, a minimum threshold should be set and a process should be established for reallocating investable assets over and above minimum thresholds into longer term pools with allocations supporting greater potential returns.

3. Develop a well-diversified long-term investment strategy reflecting organizational goals, risk tolerance and financial objectives

The organization’s Investment Committee, staff and leadership team should work together to develop the Investment Policy Statement (IPS) by identifying the unique objectives of the portfolio and determining the impact on the entire organization. Once goals are known, a process to identify, quantify and prioritize risk exposures can and should be undertaken. One way to implement such a process includes using financial modeling tools to simulate a range of capital market scenarios and economic environments to analyze the effects that these scenarios have on the portfolio. This analysis should be thorough in that it provides a view into how changes in spending, inflation, capital expenditures, liquidity needs, projected operation budgets, debt policies, asset allocation or market scenarios can affect the organization’s short- and long-term financial objectives. Once these broader enterprise risks are identified, and where possible, quantified, the organization then should be in a better position to design an asset allocation strategy. Some common factors to evaluate when deciding on allocation include current and future debt profile and sensitivities related to financial covenants, existing rating agency opinions and concerns, and the suitability of portfolios based on the projected operations and capital structure of the organization. In addition, the allocation should consider the organization’s tolerances for standard healthcare financial benchmarks, such as days cash on hand, debt to capitalization and unrestricted cash to debt. Finally, there should be an ongoing process for monitoring the progress and success of the portfolio against several metrics, such as the impact on credit ratings, cash/debt ratio, days cash on hand and debt/capital ratios, as well as compliance with the IPS.

Did you know?

Hospitals invest, on average, 10 cents more in a given year for every additional dollar returned by investment securities in the previous year. This impact is magnified to 23 to 28 cents for every dollar when we consider capital expenditures over two years following the return on financial investments.2

The Journal of Finance
AUGUST 2015

Case study: Healthcare system reworks its account structure to support spending need and long-term growth

**Important information:** This case study describes the attributes of a specific client that SEI has determined is comparable based on objective criteria, including organizational goals, asset size and industry sector. Any discussion of specific asset allocations is intended to help clients understand SEI’s customized investment approach, and should not be regarded as a recommendation. Information concerning SEI’s recommendations over the last year is available on request.

Take for an example, a not-for-profit, multifacility healthcare system that recently went through a comprehensive analysis of how it wanted to allocate its broader pools of investable assets. The system recently had their AA-rating affirmed and their outlook revised from “Stable” to “Positive.” The rating agency’s observations included consistently solid operating performance and balance sheet improvement. Their financial profile compared favorably to rating agency medians and peers, with operational cash flow and unrestricted liquidity (both relative and absolute) being particular strengths.

In early 2015, the system issued $248 million in taxable municipal bonds to take advantage of the favorable rate environment, with the expectation of spending all or a portion of the proceeds on identified strategic capital projects. The bond issuance resulted in incrementally higher financial leverage (as measured by the Long-term Debt/Cap' ratio) and a lower Cash/Long-term Debt ratio, but did not materially impact the system’s overall financial profile. The system directed $83 million of the proceeds into their Long-term Reserves portfolio and held the remaining $165 million in a money market account. The issuance also led to an analysis of how those assets would be invested, as well as a review of their broader allocation strategies within their various investment pools. Previous analyses had resulted in the system setting up the following investment account structure:

<table>
<thead>
<tr>
<th>Account</th>
<th>Assets</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating cash, including:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Core cash (24 days cash)</td>
<td>$85 million</td>
<td>6%</td>
</tr>
<tr>
<td>• Uninvested bond proceeds</td>
<td>$165 million</td>
<td>11%</td>
</tr>
<tr>
<td>Short-term reserves</td>
<td>$107 million</td>
<td>7%</td>
</tr>
<tr>
<td>Long-term reserves</td>
<td>$1.1 billion</td>
<td>76%</td>
</tr>
<tr>
<td><strong>Unrestricted cash and investments</strong></td>
<td><strong>$1.47 billion</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

To support both strategic and routine capital expenditures, the system knew it would need to withdraw funds over the upcoming 24- to 36-month period. In addition, the system’s five-year balance sheet plans called for spending 85% of annual Earnings Before Interest, Depreciation and Amortization (EBIDA) on routine capital expenditures. The system also needed to consider that as a result of planned routine and strategic expenditures during 2016 and 2017, spending during these two years may be greater than the above described policy.

After reviewing the needs of the organization and the current allocation strategies, the increased need for capital over the next two years became a focal point for the analysis, which weighed the benefits and considerations of funding these known expenditures in advance. Stochastic modeling was done to view a variety of asset allocation options, which included setting aside all or a portion of the
targeted capital commitments in the short-term reserves pool. The system was able to gain additional information by stress-testing the different options against various market scenarios, such as a rise in inflation or how a meaningful market decline on the investment balances would affect their broader financial profile. Ultimately, their goal was to balance a potential risk and return profile, and based on the resulting analysis, the following changes were recommended to appropriately align funding targets for each account with identified capital requirements.

<table>
<thead>
<tr>
<th>Account</th>
<th>Previous</th>
<th>Recommended</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating cash, including:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Core cash</td>
<td>$85 million</td>
<td>$70 million</td>
</tr>
<tr>
<td>• Uninvested bond proceeds</td>
<td>$165 million</td>
<td>$0</td>
</tr>
<tr>
<td>Short-term reserves</td>
<td>$107 million</td>
<td>$196 million</td>
</tr>
<tr>
<td>Long-term reserves</td>
<td>$1.1 billion</td>
<td>$1.2 billion</td>
</tr>
<tr>
<td>Unrestricted cash and investments total</td>
<td>$1.47 billion</td>
<td>$1.47 billion</td>
</tr>
</tbody>
</table>

The above changes reflect a decrease in the size of the operating cash pool by $15 million, reducing days of operating cash on hand from 24 days to 20 days, which was management's identified target for core operating cash. This was offset by an increase in the allocation to the Short-term Reserves pool, which focuses on capital preservation and the minimization of drawdown risk. The analysis helped determine how much was needed in the Short-term Reserves pool by establishing the following objectives for the pool:

1. To offset the decrease in operating cash, a minimum threshold for fiscal year 2016 of 10 days of cash on hand would be set aside as an incremental liquidity cushion over and above its target for operating cash ($35 million).

2. Providing a reserve for 50% of the estimated potential impact to cash flow associated with ICD-10 implementation ($36 million).

3. Prefunding approximately 50% of known strategic capital commitments over the next 24 months ($125 million).

The Operating Cash and Short-term Reserves pools, were constructed to support the specific liquidity and capital needs for the system, and all remaining assets were directed to the Long-term Reserves pool. Based on SEI Capital Market Assumptions (CMA’s), the then current allocation of the Long-term Reserves had an annual expected return of 7.1% with a one-year risk-of-loss of -11.2%.

Concurrent with the funding decisions for each of the pools, and in effort to improve the potential risk and return profile of the broader portfolio, the system increased return enhancing allocations, increased inflation hedging strategies and added new asset classes in the Long-term Reserves pool. Based on SEI CMA’s, the new allocation for the Long-term Reserves portfolio carries a higher expected annual return of 7.4% with a lower one-year risk-of-loss of -11.0%.
Conclusion

The post-ACA world has brought with it a new landscape that requires a paradigm shift in every aspect of healthcare finance, including how healthcare organizations allocate and invest capital. Finance executives and management teams need to find ways to leverage assets to improve profitability and strengthen the balance sheet. This can be accomplished with a thorough and customized process designed to create multiple pools of investments built to support short- and long-term needs. By establishing and continuing to monitor the organization’s risk tolerance, thresholds can be created to allow access to “waterfall” out of short-term holdings and be deployed to more return-seeking investments. This multi-tiered account structure should remain dynamic and constantly monitored to make sure the organization remains within its established risk tolerance. The end result should be a more strategic and efficient process for leveraging the organization’s assets to support growth.

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The asset class assumptions are aggregated into a diversified portfolio, so that each portfolio can then be simulated through time using a Monte Carlo simulation approach. This approach enables us to develop scenarios across a wide variety of market environments so that we can educate our clients with regard to the potential impact of market variability over time. Ultimately, the value of these assumptions is not in their accuracy as point estimates, but in their ability to capture relevant relationships and changes in those relationships as a function of economic and market influences.

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We believe our approach enables our clients to make more informed decisions related to the selection of their investment strategies.

For more information on how SIMC develops capital market assumptions, please refer to the SEI paper entitled “Executive Summary: Developing Capital Market Assumptions for Asset Allocation Modeling.” If you would like further information on the actual assumptions utilized, you may request them from your SEI representative.
About the author

Craig Standen serves as the Healthcare Director for the Advice team within SEI's Institutional Group. In his role, he is responsible for implementing our healthcare solution, which integrates multiple asset pools, including operating, foundation, endowment and pension plan assets, into one holistic investment strategy.

An expert in healthcare finance and a frequent speaker at industry events, Craig has more than 17 years of experience in the healthcare sector. Prior to joining SEI, Craig was a senior relationship banker at Ziegler Investment Banking, providing healthcare clients with debt capital markets access, strategic advisory services and balance sheet solutions.

Craig holds a Bachelor of Arts in economics from Cornell University and a Master of Business Administration degree with a finance concentration from the Weatherhead School of Management at Case Western Reserve University. He maintains his FINRA Series 7 and Series 66 licenses.

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