FINANCIAL STRATEGIES FOR WEATHERING THE ECONOMIC DOWNTURN

Leaders Will Need to Focus on Operations, Financing Options and Long-term Plans

BY STEVEN A. LEVIN & KEITH DICKEY

From top, Mr. Levin is director, The Chartis Group, and Mr. Dickey is first vice president, Shattuck Hammond Partners.

Editor's Note: This article is an abridged version of a publication titled "The Impact of the Capital Markets Crisis and Economic Slowdown on Hospitals and Health Systems" and co-authored by The Chartis Group and Shattuck Hammond Partners in fall 2008. The article in its entirety can be found at www.chartis.com or www.shattuckhammond.com.

Given that the U.S. capital markets are experiencing a credit crisis of historic proportions, the market and reimbursement environments or health care providers promise to be extremely challenging during the next several years. Economic pressures will likely cause consolidation, and all providers will need to work aggressively to maintain operating margins, access to capital and, in some cases, viability. As executives in health care already know, lack of investor confidence has caused widespread dislocation in the tax-exempt market, increasing short- and long-term rates. Most new tax-exempt bond issues have been postponed and the municipal bond market remains especially wary of weaker credits.

The increased cost and more limited availability of debt, along with prevailing operational challenges, will require health systems to be much more judicious in making capital investments. No one can predict the severity or duration of the credit crisis. However, we can conclude that access to the capital markets for hospitals and health systems has been altered drastically.

EVALUATING OPERATING PERFORMANCE IMPACT

Here are four areas of concern:

Medicaid reimbursement will remain flat or decline. Medicaid represents the most significant cost in most state budgets, and many states may be unable to balance their budgets without freezing or reducing Medicaid reimbursement during the next several years. Three years of flat Medicaid reimbursement for a typical Moody's A-rated hospital[1] would reduce annual revenue by $4 million in year three, representing a full percentage point of operating margin. In addition, every 1 percent increase in the national unemployment rate translates to 1 million more enrollees in Medicaid and the State Children's Health Insurance Program. A typical hospital may be forced to make up 2 to 3 percentage points of operating margin caused by a shift of patients from commercial insurance to Medicaid.

Utilization will decline and bad debt will rise as employers continue to shift costs to employees and the number of working uninsured increases. Cost shifting and economic uncertainty are causing employees to reduce their use of health services, while increasing bad debt exposure for providers. Although these reductions may be temporary, a downtrend or flat utilization rates could prevail for the next few years. The steepest declines may occur in typically more profitable elective procedures.

Emergency department volumes already growing by an annual average of 2.5 percent during the past decade[2] will continue to rise as more patients avoid routine care and lose access to primary care services. This trend could accelerate as more patients consider emergency rooms as their only source of care. Challenges in collecting payment for these services will significantly increase bad debt profiles for hospitals that carry this burden.

Although inpatient volumes overall have been stable, many large tertiary care hospitals have experienced significant growth, as smaller community hospitals have experienced stable or declining volume. There will be continued redistribution of volume as large tertiary centers expand activity while patients at small, community hospitals delay elective and lower acuity care or seek treatment in lower cost settings.

Outpatient activity currently represents 38 percent of net revenue for a typical hospital, and a disproportionate share of operating income. A major portion of outpatient revenue is derived from ambulatory surgery, cancer treatment and imaging, including elective care that patients may decline or delay in an economic downturn. On Oct. 13, 2008, *USA Today* reported: "One in eight people with advanced cancer turned down recommended care because of the cost, according to a new analysis from Thomson Reuters."

No major changes in the growth of negotiated managed care rates are expected. Although employers will continue to pressure insurers to manage premiums, we expect little or no change in the rate of growth of negotiated rates between hospitals and insurers. Continued consolidation in the insurer market could put greater pressure on provider reimbursement. At the same time, a new wave of provider consolidation could maintain the current negotiating balance between payers and providers in most markets.

Non-operating income will be under pressure due to shortfalls in philanthropy and weaker investment returns. In 2007, the typical Moody's A-rated health system experienced 3 percentage points of non-operating income primarily derived from philanthropy and investment earnings on endowments and other reserves.[3] Most health systems have already seen a steep decline in investment income during the past year. One client, a strong AA-rated hospital in the Midwest, experienced a total excess margin decline of roughly 20 percent in fiscal year 2008 due entirely to reductions in non-operating income. Philanthropic support for not-for-profit health systems could conceivably decline by as much as 15 to 20 percent during the next few years, posing challenges to facility development and often to capital needs and, in the case of a few specialty hospitals, even to basic operations.

While these trends clearly reflect the negative pressures on the industry, in some circumstances they may also support rapid structural and operational transformations that will allow a stronger and more competitive industry to emerge within several years.

Assessing Strategic Responses

The impact and significance of the credit crisis and a deep and prolonged economic downturn will differ dramatically for individual hospitals and health systems. In each case, an accurate and unbiased assessment of the likely impact is critical. The available strategies can be divided into the following three groups:

Develop a strategy for market consolidation The constrained capital environment and concomitant economic pressures will result in a wave of hospital consolidations across many markets.

Before market developments eliminate certain options, every hospital and health system should determine whether they can best strengthen their operations as a potential buyer or seller, or whether they should work to maintain the status quo and improve efficiencies based on current assets. Several fundamental assessments are essential to inform and define this strategy:

- **Assess acquisition opportunities.** Strong players may have opportunities to acquire competitors and other assets in their markets, in many cases without much advance warning. All hospitals should be prepared to move quickly to take advantage of merger or acquisition opportunities while continuing to make strategic investments that position their health systems as local market leaders.
- **Consider sale or affiliation opportunities.** Organizations with weak balance sheets or challenges in operating performance may need to evaluate a sale or affiliation with another health system to access capital, build leverage with payers, and take advantage of other benefits. While this may seem to be a disadvantageous time to consider a sale of assets, value could decline further without access to capital for investments in equipment, facilities and programs. Boards may need to take action as a result of their fiduciary responsibility to preserve an organization's mission before a weakened competitive or financial position makes recovery impossible.
- **Evaluate assets/line of business performance to determine if ownership is required.** All health systems should evaluate the performance of their assets and determine whether non-core assets should be retained or monetized. Some health systems have sold on-campus and off-campus medical office buildings, long-term care facilities and other assets to independent operators while retaining ground leases to control the strategic use of these assets. Despite the current credit crunch, the value of these types of assets appears to be holding steady. Similarly,

hospitals and other businesses that do not represent core assets should also be assessed to determine if they can be used more effectively by other organizations. The potential sale of these assets could provide additional capital to invest in core operations.

■ **Evaluate physician network strategies.** Although practice acquisition and employment are important strategic investments for health systems, they rarely make money as a stand-alone business. In a period of limited access to capital, health systems will need to determine whether this strategic investment is critical to future success and should remain a priority. In most cases, health systems are likely to determine that a well-managed physician network is a worthwhile investment of scarce capital, especially if Medicare moves to bundled reimbursement for hospital and physician services. On a case-by-case basis it will be necessary to assess the relative capital requirements and risk/benefit profiles in practice acquisitions versus other investments.

Manage the Balance Sheet. Aggressive management of the balance sheet and adherence to a rigorous capital allocation methodology can help improve operating performance and access to capital. Approaches that hospitals and health systems can use include:

■ **Preserve cash.** Organizations should consider cash conservation strategies such as managing both revenue cycle and payables, which can provide a one-time boost to liquidity. Some health systems are using third-party developers to finance projects and conserve their own cash. Although the presence of outside partners can introduce additional management challenges, the opportunity to retain capital for more important investments will often outweigh these challenges.

■ **Actively manage relationships with rating agencies, banks and investors.** In difficult credit environments, agencies are likely to be more cautious in their ratings, making it increasingly important to take all available steps to achieve the best rating possible. Maintaining a strong relationship with one or more commercial banks is critical. Where feasible, health systems should push to increase the capacity on their lines of credit. Similarly, managing relationships with investors can help improve access to capital. Managing investor relationships is new to most health systems (and their CFOs), which historically have managed rating agency relationships on an as-needed basis. This strategy represents an important new opportunity and responsibility that most health systems should consider.

■ **Restructure long-term debt.** The optimal strategies in restructuring long-term debt will be unique to each organization. Health systems that have not already converted or refinanced existing auction rate securities will need to do so, though the range of options has narrowed considerably.

■ **Monitor all aspects of the balance sheet.** Monitoring aspects of the balance sheet, including but not limited to long-term debt, can help to identify opportunities and potential risks. For instance, the changing interest rate environment can have a potentially significant impact on the valuation of unfunded pension liabilities. On the asset side, health systems should revisit investment policy and reconsider whether assets used to hedge certain liabilities are still adequate.

■ **Establish/update your strategic capital plan.** Every organization should have a well-developed and up-to-date capital plan that harmonizes strategic objectives and financial performance with the prevailing conditions and opportunities in the capital markets. A capital plan should establish a methodology for investment and financing decisions and provide a set of guidelines for overall capital structure and financial risk. It should include target credit quality benchmarks for profitability, liquidity and leverage as well as an overall target credit rating. Ultimately, the capital plan should be a roadmap for financing the organization's strategic plan.

Strengthen Operating Performance. Although many health systems have been aggressive in managing operating performance, most still have substantial

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The Chartis Group is an advisory services firm that provides management consulting and applied research to leading health care organizations. The firm is comprised of senior health care professionals and consultants with knowledge of health care economics, markets and organizational dynamics. The Chartis Group has offices in Boston, Chicago, New York and San Francisco.

and achievable opportunities to reduce costs, improve outcomes and service and increase revenues. For example:

■ **Improve throughput to increase capacity and revenue.** Many clients have been able to increase effective capacity via increased throughput efficiencies by 5 to 12 percent, resulting in significant increases in volumes and revenues. Economic pressures combined with a greater degree of integration between hospitals and physicians could set the stage for more sophisticated solutions such as demand management to improve throughput even further. Operational throughput improvement can also delay and reduce the capital needed for expanded capacity.

■ **Fine tune growth strategies and other strategic investments.** Most hospitals and health systems are attempting to expand a few key service lines and, in some cases, to extend their geographic reach. It will be critical to focus on those few programs that are most likely to succeed and provide a rapid and significant return. Some attractive long-term investments might need to be deferred until more promising near-term investments succeed in producing additional capital. Similarly, investments in new equipment and facilities will need to achieve higher and more certain returns. Within this framework, aligning physicians, boards and executives in support of an organization's investment priorities is a significant and critical undertaking.

■ **Rationalize programs and operations.** Many health systems have integrated back office functions including IT, accounting and revenue cycle management. For most health systems, further integration opportunities remain as options in the following areas:

Although unpopular in the past, some health systems are now evaluating opportunities to rationalize services with high fixed costs, such as maternity, pediatrics and oncology, to gain economies of scale and improve quality.

Real estate management and facility operations functions have historically been under the control of local or regional management. Based on increasingly stringent regulatory requirements, IT-enabled management solutions and higher cost of capital, growing support for central control of these functions to improve performance exists.

Improved management strategies and discipline in staffing decisions, combined with aggressive identification and application of best practices, could yield operating cost reductions of up to 5 percent annually.

Moving Forward

In light of the severe contraction of credit in the capital markets and the prospects for continued economic instability, the future is likely to present an unparalleled mix of challenges and opportunities for executives, physicians and boards of not-for-profit health systems. Organizations that take proactive steps and are positioned to act quickly are more likely to emerge from this period with expanded scale, improved market strength and broader capabilities. Succeeding in this environment will require a clear and accurate assessment of where the market is headed, a willingness to take risks and act quickly, and a continued focus on an organization's core mission and long-term business strategy. ■

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NOTES

1. National Health Statistics Reports, "National Hospital Ambulatory Medical Care Survey: 2006 Emergency Department Summary," No. 7, Aug. 6. 2008, www.cdc.gov.
2. American Hospital Association, "2007 Chartbook: Trends Affecting Hospitals and Health Systems, April 2007," www.aha.org.
3. Jane Haderlein, "Unleashing the Untapped Potential of Hospital Philanthropy," *Health Affairs* 25, no. 2 (2006).