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outlook for independent community hospitals: uncertain

Today's financially challenging healthcare environment is forcing leaders of many independent community hospitals to ask whether their "stand-alone" can continue to stand alone.

AT A GLANCE

- > Increasing financial pressures in the healthcare marketplace have made it imperative for many independent community hospitals to conduct assessments to determine the viability of continued independence.
- > For organizations initiating such assessments, the decision of whether to affiliate with another organization is as much about *when* to act as it is about whether to seek a partner.
- > Even if all indicators considered point to a need to consolidate, there remains one critical concern in identifying the best partner for a successful combination: whether the two organizations are culturally compatible.

Independent community hospitals have long been the bedrock of the healthcare delivery system. The past 20 years have seen movements toward greater consolidation as changes in payment, technology, and healthcare delivery have had considerable impact on the development of health systems. Notwithstanding the effect of such forces, the community hospital has remained a significant factor in the delivery of health care.

Now that role is under greater pressure than ever before as many community hospitals face a future in which capital is difficult to obtain and competitiveness is harder to maintain. Many small and medium-sized, independent community hospitals already find themselves in an increasingly competitive marketplace with significant financial challenges and resource constraints. In such an environment, it is incumbent on these hospitals to perform internal assessments of whether they can continue to meet the current and future healthcare needs of their service areas as independent organizations.

Indicators and Warning Signs

A stand-alone hospital's assessment of its ability to remain independent should focus fundamentally on six key indicators:

- > Financial position and ability to access capital and make strategic investments
- > Physician "platform"
- > Market presence and position
- > Differentiated clinical service complement
- > Clinical performance
- > Patient access and preference

Ultimately, the decision to affiliate with another organization is as much about *when* to act as it is about whether to seek a partner. Organizations that wait too long risk depleting their value, making it more difficult to find a

partner and negotiate terms in their communities' favor. The ability to assess the indicators and warning signs is crucial to understanding both the need and timing for affiliation.

Financial Position

The clearest indicator of a hospital's inability to remain independent is often financial. If an organization's balance sheet is weak and it cannot access the capital necessary to keep its facility competitive and make strategic investments, it enters a cycle of competitive deterioration that is hard to break.

Balance sheet weakness is usually a product of years of poor or negative operating margins, which in turn are difficult to improve without the ability to invest strategically. If a hospital has been unable to maintain consistent positive operating margins over the past several years, the tightening payment trends forecast for the next several years will make it difficult for the hospital

to generate positive margins in the future, let alone the 3 to 4 percent typically needed to support capital reinvestment.

A hospital's cost position is another financial indicator. Given the focus on cost management over the past decade, most hospitals have found ways to reduce costs in the most obvious places. Consequently, many small and medium-sized independent hospitals are operating at the base of their fixed costs and lack sufficient scale to reduce costs much further. If a hospital's cost per adjusted admission (case mix index [CMI] and wage index [WI] adjusted) is higher than that of its competitors, and it has already implemented the most readily identifiable cost reductions, its ability to compete with larger-scale, low-cost competitors is severely compromised.

Key points to consider. Finance leaders should consider the following points when evaluating this indicator:

Consolidation on the Rise: How We Arrived at This Point

The current drive to consolidate differs from similar trends in the past in several ways.

First, the severity of the 2008 recession in many areas caused the payer mix for community hospitals to shift away from higher paying commercially insured patients to lower paying Medicaid and self-pay patients. As a result, many hospitals experienced a weakening of their financial resources at the very time they needed them most. In addition to the change in payer mix, volumes declined as health care became more of a discretionary spending item for those hard hit by the downturn.

Second, while volumes and payer mix were changing for the worst, demands for additional capital expenditures were increasing. The demand for investment in technology, especially information systems technology, has clearly strained the capacity of many independent hospitals to finance such sizable expenditures. Likewise, the acquisition of physicians requires sizable capital that is increasingly less available for the typical community hospital.

Third, access to the capital necessary to finance such expenditures has also become strained. While current interest rates hover near all-time lows for highly rated borrowers, the benefit to smaller, lower-rated credits has been diminished by wider credit spreads (i.e., the premium bondholders demand for a weaker credit versus a better rated one). Financing is not only more expensive, but also often unavailable in some forms as lenders favor large, better-rated borrowers at the expense of lower-rated community hospitals.

Fourth, the industrywide transition from volume-based to value-based payment, driven by funding constraints from all payer groups, requires new levels of operational efficiency and expertise that are difficult for smaller independent hospitals to achieve.

Finally, demographic influences are changing how health care is delivered and forcing community hospitals in directions where size offers clear advantages.

- > Utilization and financial performance trends (Are they stable, deteriorating, or improving?)
- > Cost per adjusted discharge, CMI- and WI-adjusted, compared with that of competitors
- > Credit ratings and credit profile, including operating performance and balance sheet strength (Does the hospital have, and can it maintain, “investment grade” credit ratings to access affordable debt?)
- > Debt capacity and ability to support facility recapitalization needs (e.g., financial capability to replace or substantially modernize a Hill-Burton era facility)

Physician “Platform”

While financial position is the “lagging indicator” of a hospital’s ability to remain independent, the physician platform is one of the key drivers or leading indicators. To continue as stand-alone institutions, hospitals must have a sufficient complement of strategically located, closely aligned, or integrated primary care physicians supported by the appropriate complement of specialists and subspecialists. Moreover, they must be able to successfully recruit and retain physicians. Because many small and medium-sized independent hospitals are located in rural areas or small towns, recruitment can be difficult, especially when the medical community consists of small or solo practices that are unable to recruit for their own needs. A critically massed physician enterprise includes a balanced physician “ecosystem” with a large enough primary care base to support a broad range of core specialists.

Because of the industry’s rapid move to the “value” model, requiring increasing levels of clinical integration among physicians and between physicians and hospitals, the availability of a range of functioning physician alignment vehicles also is an important indicator of an independent hospital’s ability to stand alone. Employment is the physician integration model of choice for most small and medium-sized independent hospitals. Other “tight” integration models are less commonly used.

For example, the comanagement model is limited to a small number of specialty-specific physicians, and the clinical integration model approved by the Federal Trade Commission requires larger scale and more sophistication than is available in most independent community hospitals. Other “loose” models of integration such as management services organizations (MSOs) and standard professional services contracts are helpful, but not sufficient to develop the integrated model of care that will be required to compete in many markets.

Key points to consider. Points that finance leaders should consider when evaluating this indicator include:

- > The presence of a sufficient primary care base and an appropriate complement of specialists to maintain strong market position and address key coverage gaps
- > The ability to recruit physicians, and a strong track record in retaining them
- > The use of tight physician integration models, including employment-based integration

Market Presence/Position

Another key factor to consider is market presence. A stand-alone hospital must have sufficient critical mass to be a “relevant” provider in the market in terms of size, market share, and geographic coverage. How big is big enough? Although there is no single answer on minimum size, a stand-alone hospital is relevant if insurance companies consider it to be a necessary provider for their networks. Otherwise, it risks being excluded from the preferred-provider contracts negotiated by stronger competitors.

A stand-alone hospital’s market share should reflect its position as a provider of choice for the communities it serves. For example, if it is the only hospital in its primary service area, it should have the dominant market share. If it is one of several hospitals in its service area, it should have an equal or greater market share than its competitors.

Beyond total market share, the hospital should have a strong position in the more profitable

surgical and procedural specialties with a strong payer mix. This indicator should be examined closely, as weakness in these areas can be masked by high market shares for chronic medical cases with a less sustainable payer mix. Also, in terms of trends over time, market shares should be steady or improving. Eroding market shares are difficult to recover.

A stand-alone hospital's geographic footprint also reflects the strength of its market position. Does it have a network of primary care coverage available within 15 minutes of the majority of its served population or are all services concentrated on the hospital campus? Are its locations well represented in growing areas?

The alternate view of a stand-alone hospital's market position is the presence and strength of its competitors. Are there other strong local providers that cover the same market with largely the same services? Has the hospital experienced competitive encroachment by regional systems?

Key points to consider. Finance leaders should consider the following key points when evaluating this indicator:

- > Size and scale, especially compared with competitors (Are competitors significantly larger?)
- > Geographic footprint—number and coverage of locations (Are outpatient services easily accessible to important submarkets?)
- > Degree of market overlap with other hospitals (Is the hospital a sole-community provider or does it have nearby competitors?)
- > Encroachment of regional systems into the primary service area
- > Managed care contracting position (Is the hospital a “locked out” or low-tier provider versus a preferred provider or participant in exclusive contracts?)

Differentiated Clinical Service Complement

In markets where there are direct local competitors or strong regional referral centers, it is important for a stand-alone hospital to maintain unique capabilities for clinical services, equipment, or facilities. For example, is it the only

hospital in the area with an accredited stroke center, trauma center, or Level III NICU? Is it distinguished as the premier women's center or the only one offering the latest treatments in oncology?

Key points to consider. When evaluating this indicator, finance leaders should examine their organizations' service areas to identify:

- > Programs or services unique in the service area, such as stroke programs, trauma centers, or robotics capabilities
- > Highly differentiated programs based on reputation and preference (Are there programs that consumers highly prefer over the competitors?)
- > The breadth and depth of combined programs or services not matched by competitors (Is the hospital unique in its ability to provide comprehensive medical care to the community?)

Clinical Performance

Stand-alone hospitals must demonstrate high quality and patient satisfaction through measurable indicators to be able to remain independent. Even as quality and patient satisfaction scores are becoming increasingly important to payment, the transparency of these indicators is making them a visible competitive factor.

Key points to consider. Finance leaders should consider these when evaluating this indicator:

- > Quality and patient satisfaction scores—especially compared with those of competitors
- > National recognition and awards (e.g., 100 Top Hospitals, HealthGrades Excellence Awards, and Nursing Magnet Program)
- > Ability to attract and retain high-quality clinical staff (Are the best staff getting “poached” by competitors? Can the hospital fill critical clinical positions with limited use of contract staff?)

Patient Access and Preference

Some factors that affect a hospital's ability to remain independent are largely out of its control. The growth and payer mix of its core service area population is one of those factors. If a hospital serves an area with a stagnant or declining population and a poor payer mix without access to

“avenues of growth,” its ability to remain independent is compromised.

Key points to consider. Following are points that finance leaders should consider when evaluating this indicator:

- > Service area demographics (population size, growth, and payer mix)
- > Access to “avenues of growth” in the service area (e.g., ability to compete along the major highway outside of town rather than just the old downtown area)
- > Current market share by service line or submarket, and recent trends (Are we losing market share or gaining? Is our market share strong in profitable services, growing communities, commercial payers?)

Although access to favorable demographics may be out the hospital’s control, the level of community support and preference is often the result of the hospital’s image in the community. If a hospital is not the preferred choice among its community’s residents, its ability to remain independent will be challenged.

What to Look for in a Prospective Partner

After a hospital has thoroughly reviewed its current operations and future needs and concluded that it should begin seeking a suitable partner, it should determine what characteristics would be best to look for in a partner. To make that determination, it must first determine its goals for the partnership. Typically, through affiliation, stand-alone hospitals seek to improve their financial strength, clinical performance, and market competitiveness. As shown in the exhibit at right, having such clear goals can help determine desirable partner attributes.

In most instances, capital access and willingness to support capital needs are key determinants in assessing the suitability of a partner. Typically, the best way to ascertain whether a prospective partner possesses these characteristics is to consider the degree to which it exhibits the following criteria:

- > High credit rating

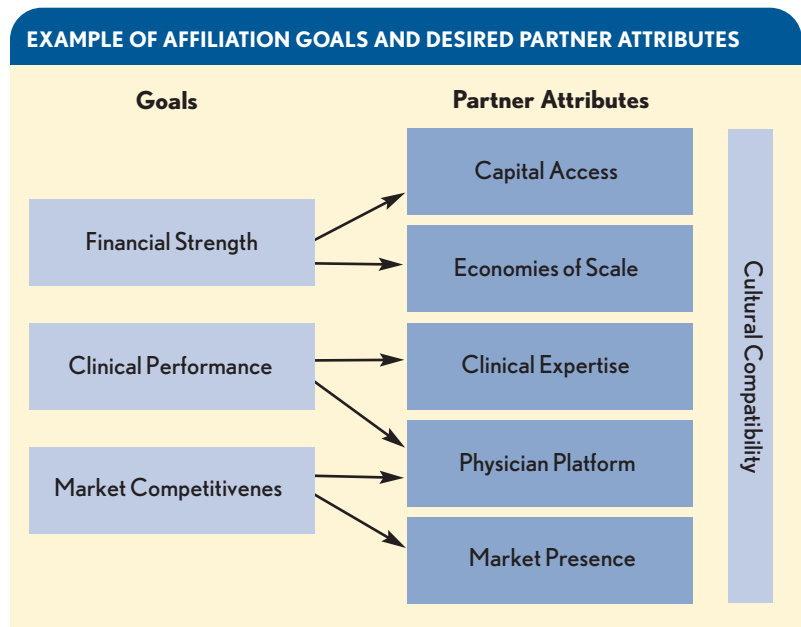
- > Solid operating metrics focused on operating cash flow, days cash on hand, and debt to capitalization
- > Access to capital at attractive rates
- > Access to credit and equity
- > Willingness to support and invest

Another attribute supporting financial strength is economies of scale. In a partnership, size does matter, and a potential partner should have sufficient presence to allow any new costs the consolidation will bring to be spread over a wider base. The prospective partner also should have made substantial investments in electronic health record technology, on both an inpatient and outpatient basis, that can be readily applied in the hospital.

To support clinical performance, a prospective partner should have demonstrated clinical expertise that can enhance the capabilities of the community hospital coupled with established treatment protocols that can serve to ensure more consistent and cost effective outcomes. Likewise, a partner should have addressed the critical issue of physician integration and will have established an infrastructure for physician integration/practice management.

In addition to supporting clinical performance, a strong physician platform supports market

Through affiliation, the hospital seeks to improve its financial strength, clinical performance, and market competitiveness, by affiliating with a partner that can deliver five key attributes and that is culturally compatible.



competitiveness. Other partner attributes that contribute to market competitiveness include reputation and market presence. For example, does the potential partner have a regional, statewide, or even national reputation as major referral center? Does it have a strong brand presence in the local community? Does it have a broad market “footprint” with system-branded community hospitals, ambulatory centers, and physician offices? Does it have an integrated health plan with strong market presence?

Finally, there is the matter of cultural compatibility—whether the mission and values of the prospective partner are compatible or at variance with those of the community hospital. No matter how strong a potential partner may be, if the values and culture of the prospective partnership are not aligned, the potential for a successful integration of the organizations is significantly diminished. It is relatively easy to discern the attributes of a prospective partner or to gain a sense of the benefits a combination may bring. What is more challenging is realistically assessing what benefits the community hospital brings to the relationship and whether its service to community values will remain uncompromised by its incorporation into a larger organization serving multiple constituencies.

Next Steps for Success

Having undergone an internal assessment of its future, and an external assessment of the potential partners in the market, how does a community hospital ultimately decide whether to align itself with a partner or remain independent? For many hospitals, this choice is relatively straightforward. They recognize that they do not have the financial wherewithal to remain independent and align themselves with a partner that they have determined offers the greatest promise of long-term survival. This is certainly a solution to one problem facing community hospitals, but it only takes into account part of the analysis.

The critical considerations in a stand-alone hospital’s decision to remain independent or

consolidate given current marketplace challenges are the questions of how the role of community healthcare provider will be enlarged or diminished by a consolidation and how the prospective partner’s values mesh with the independent hospital.

To answer these questions, the hospital should have a clear sense of the various constituencies it serves: its employees, its medical staff, and its patients. It should be able to see how the consolidation would enhance its ability to meet the community’s needs, as opposed to merely preserving the status quo for a few more years.

Can the consolidation be accomplished without losing all aspects of community control? Will the values of the combined organization be aligned with those of the community?

To be successful, a consolidation must bring value to both parties of the transaction. On the one hand, the community hospital should be mindful of the limitations it brings to the transaction just as the prospective partner should be mindful of the value the community hospital offers its market. Although financial considerations are often the impetus for hospital consolidations, it often is the intangible considerations that determine whether these consolidations are successful. ●

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