System Focus

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Staying Ahead of the Disruptors: The Board's Role in Innovation

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Key Board Takeaways

Current health system strategies may not be sufficient to support future growth. Some leading health systems have diversified their sources of revenue by creating innovation centers of their own. Questions for your board to ask leadership include:

- How diversified are our enterprise revenue streams?
- What non-core revenue streams are we aspiring to grow over the next three to five years? How do they enable our mission?
- Have we evaluated build, buy, or partner approaches to innovation, revenue growth, and diversification?
- What governance and leadership accountability structures are in place to oversee and manage major partnerships?
- What is the enterprise communication strategy for non-core business growth strategies and major partnerships?

In 2018, healthcare spend represented $3.6 trillion, or 17.7 percent of the GDP, and is expected to continue climbing given the aging population in the U.S., according to the Centers for Medicare & Medicaid Services (CMS). Private equity firms are seeking to capitalize on this growing sector as medical groups and technology-based start-ups seek capital to support their growth. In addition, large companies such as Walmart and Amazon are more meaningfully entering healthcare delivery to diversify their traditional revenue streams and gain a share of the healthcare spend, while also seeking to solve their own spending trends for their employee health plans. Retailers such as Walmart may be well-positioned to unseat traditional healthcare providers, given the distributed physical footprint they already have and their experience in engaging consumers.

This trend is not new. And in response, health systems have sought to diversify their revenue streams for the last decade as operating margins have remained flat or declined. Yet, while for-profit competitors are salivating at the prospect of healthcare-driven profits, increasing numbers of hospitals are failing to grow their operating margins. In fact, according to Moody's, before the onset of the COVID-19 pandemic in 2019, median operating margins for the hospitals were hovering near a 10-year low of 2.2 percent and well below the 2015 peak of 3.4 percent. For years, hospitals have made more profit through their investments in their investment portfolios than in delivering patient care to their communities.

> *NBC News*: "Private equity firms have jumped into health care with both feet."[1]

1 Gretchen Morgenson and Emmanuelle Saliba, "Private equity firms now control many hospitals, ERs and nursing homes. Is it good for health care?," *NBC News*, May 13, 2020.

CNBC: "Amazon is moving into healthcare, its next big market."[2]

Diversification or Bust?

Understanding current health system strategies alone may not be sufficient to support future growth, some leading health systems have diversified their sources of revenue by creating innovation centers of their own. According to *Modern Healthcare*, more than 70 innovation centers exist today nationally across health systems.[3] These centers are collaborating with start-ups and accelerators to create high-growth companies that leverage the value of the health system and its purchasing power and network while insulating these companies from the bureaucracy that generally characterizes hospital decision making and execution. Yet while these strategies have worked for some and have generated newspaper headlines ($14 billion, Boston-based Partners HealthCare's innovation arm reported $154 million in revenue in fiscal year 2019), these efforts certainly are not a panacea, particularly for smaller systems outside of major metro areas where start-up talent is more difficult to cultivate. Others such as Ascension, Intermountain Healthcare, and Providence are seeking the highest and best use of their capital through development of their own venture capital fund. Yet those efforts remain largely the domain of the largest health systems with enough scale to appropriately manage the financial risk.

Outside of direct investment and financing of new revenue streams, some are taking steps to monetize their assets through partnerships such as Philadelphia-based Jefferson Health's recently announced long-term strategic partnership with Welltower, a real estate investment trust (REIT). In this partnership, Welltower agreed to acquire a stake in certain real estate assets enabling Jefferson to reduce its fixed asset investments and deploy capital to other strategic initiatives. Jefferson is also positioned to leverage Welltower's predictive analytics to guide future real estate investment decisions.

Innovation in Healthcare

For most health systems, routine and replacement capital consume most of the free cash flow, leaving little room to invest in emerging technologies let alone "make bets" on ventures where the return on investment is uncertain. Yet, healthcare delivery continues to evolve—spurred by innovative technology such as digital health and consumer expectations. Demands are changing such that seeing your doctor should be as simple as ordering take-out; non-traditional healthcare entities are finding it easier and easier to grab a foothold in healthcare delivery through the development of focused models and retail-like approaches backed by loads of private and public capital. Therefore, health systems cannot stand still. Systems must find creative ways to drive these new models of care delivery and participate in the value creation. For example, many health systems entered into contracts with third-party companies to provide virtual urgent care as an easy way to enter the market. Given the increased adoption of virtual health, the question now becomes: should health systems continue in this vendor or contracted relationship, create more lasting win-win partnerships with these companies, or build their own capabilities?

What Does Your Growth Portfolio Look Like?

Moving forward, health systems will need to find creative and innovative ways to deploy capital for the highest and best uses, to partner in ways that unlock and monetize their assets and to grow non-core business units. While some systems will be able to create or participate in provider-backed innovation centers to build new capabilities and diversify sources

Barron's: "Walmart could disrupt health care the same way it did retail, analysts say."[4]

2 Christina Farr and Katie Brigham, "Amazon is moving into health care, its next big market," *CNBC*, April 10, 2019.
3 See www.modernhealthcare.com/article/20190119/DATA/500039840.
4 Josh Nathan-Kazis, "Walmart Could Disrupt Health Care the Same Way It Did Retail, Analyst Says," *Barron's*, September 3, 2019.

of revenue, the reality is that most providers do not have the requisite financial scale to manage this level of investment and execution risk. The increasingly competitive paradigm for healthcare delivery suggests a set of imperatives for leadership teams and boards positioning to broaden their revenue streams and manage a sustainable growth portfolio:

- **Commit to partnering:** Fight the urge to own and manage every business or revenue stream. Set up governance structures that enable appropriate oversight without strangling growth.
- **Maintain strategic focus and discipline:** Define what you will do and what you won't. Set appropriate guardrails to keep the leadership team and board focused whenever the newest "shiny metal object" opportunity undoubtedly presents itself.
- **Think outside the healthcare box:** Revenue diversification strategies may require more board education, participation, and alignment. Commit to educating yourself on opportunities that may not fit squarely in with historical hospital-based strategies.
- **Open up your rolodex:** As a board member with ties across the community, be willing to tap into your business contacts to help enable novel partnerships.
- **Prioritize enterprise alignment and communications:** Aligning board and leadership teams around strategic decisions is no longer enough; physicians, care teams, and the front-lines must be bought-in and aligned with new strategies. Effective communication strategies are an imperative.
- **Seek home-grown innovation:** Your employees and teammates on the front lines are some of the best sources of new ideas and innovation. Be creative in how you engage them (e.g., create a contest to reward employees by asking them to submit their best margin-creation ideas).

The for-profit entities entering healthcare delivery are unshackled from the mission-based and community-focused orientation of not-for-profit health systems. They have the benefit of focusing on very specific segments of the community or clinical programs rather than being a comprehensive care provider. Successful health systems will choose to see these entities as competitors or potential collaborators on the path to innovation, growth, and revenue diversification.

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