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Building Resiliency: The Imperative for Not-for-Profit Health Systems

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This article is the first in a series on resiliency through our regular collaboration with Kaufman Hall.

In business, resiliency measures a company's ability to weather each of the three stages of dislocation: the shock of initial crisis, the fight for stabilization, and the transition to normalization. For not-for-profit hospitals and health systems, the COVID-19 pandemic represents an unprecedented assault on the core business model. The industry successfully responded to the first wave but looking forward, potentially sustained shifts in volumes, the costs of changes in care delivery, and uncertainties around the fiscal health of employers, state governments, and consumers all suggest the potential for additional albeit less violent disruption; we are out of the crisis stage, but normalization is not yet in sight.

Given the prospect of a prolonged fight for stabilization, the focus of governance and management over the coming months and years must be the pursuit of resiliency. What this means in practice will depend on such factors as the composition and strength of an organization's resources as well as the business model disruptions and other risks it anticipates. But for every organization, creating resiliency requires establishing a framework to assemble, organize, and then guide the coordinated deployment of *all* available resources.

The Resiliency Foundation

Resiliency starts with an understanding of where an organization sits on a challenged-stable-thriving continuum. The COVID-19 pandemic and the operational challenges it generates have highlighted a fundamental tenet: balance sheet is the resiliency anchor. Organizations on the challenged part of the continuum—those that are confronting the greatest performance and credit pressure—generally have balance sheet resources

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that are too small to offset operating vulnerabilities. Conversely, organizations at the thriving end of the continuum typically entered the crisis armed with material balance sheet resources.

But balance sheet heft is not the only determinant of continuum positioning; scale, operations, and strategy are also contributing factors. The critical differentiator is whether a resiliency framework is in place. Pure scale of resources might define a resiliency starting point, but how those resources are organized and deployed defines the more important end point.

Building Resiliency

Enterprise resiliency is the byproduct of the subsidiary components (described as "companies" below) that make up every not-for-profit healthcare company:

→ Key Board Takeaways

- The extreme disruptions of the past year and the likelihood of ongoing volatility make a focus on resiliency an imperative for not-for-profit health systems.
- Resiliency allows organizations to absorb the initial shocks of disruption and then bear the financial burden of adaptation until a new, more stable platform is achieved.
- The foundation for resiliency is a framework that combines vertical and horizontal management perspectives across the operating, finance, and investment functions of the organization.
- These combined perspectives help management and governance achieve a balance between a vertical focus on optimizing financial returns and a horizontal focus on optimizing enterprise stability; the critical transition is to manage the enterprise as a consolidated portfolio of financial assets, each of which carries risk and return possibilities that need to be integrated and coordinated.
- An understanding of the organization's "embedded resiliency" also helps management and governance define a narrative for the organization's path forward, enhancing credit stability and helping leadership test the risk-return-resiliency impact of operating, financing, and strategic initiatives.

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- *The operating company*, which grows and manages the portfolio of clinical and strategic initiatives that drive cash flow and define the charitable mission of the organization
- *The finance company*, which leverages operating company and investment company resources to secure the liquidity and capital (internal and external) needed to fund the operating company
- *The investment company*, which warehouses and deploys accumulated liquidity resources to support credit, drive return, fund capital, stabilize risk, or respond to any combination of a range of sometimes competing and shifting priorities

Each of these companies has a distinct "enterprise resiliency" profile, meaning that it either contributes to or makes use of the cumulative resources available. Typically, the operating company uses resiliency because of the risk it carries in core operations

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and key strategic initiatives. The finance company can vary significantly, depending on how right-sized liquidity positions are and how much risk is embedded in the debt instruments used to secure external capital. The investment company is a different (and incredibly important) animal because its resources are the most flexible. Although gyrating invested asset allocation is a bad idea, invested asset allocation can be adjusted relatively faster than a debt portfolio or a portfolio of operating and strategic initiatives. This relative flexibility makes investment company resources best suited to play the role of corporate stabilizer.

These companies come together in a "resiliency hub" where two powerful things occur. First, claims inherent in the organization's operating-strategic-liability model can be matched against resources to offer a baseline enterprise resiliency profile. Second, the investment company can be transformed into a resiliency engine by deploying its resources to, first, hedge operating and finance company exposures (i.e., stabilize the enterprise against business model or strategic disruption), and second, pursue independent return.

We call this process "strategic resource allocation", and its power rests in integrating vertical management (which runs the operating company, finance company, or investment company as independent units) and horizontal management (which focuses on building and running the integrated resiliency hub). Merging these perspectives establishes a multi-dimensional and interlocking foundation that allows the organization to better respond to business model dislocation, no matter whether it is positive (such as acceleration from an aggressive growth strategy) or negative (such as COVID-19). This is how long-term resiliency gets built.

What a Focus on Resiliency Means

The blending of vertical and horizontal management in a resiliency hub has important implications for the management and governance of not-for-profit health systems over the coming years.

In basic terms, vertical management focuses on optimizing financial returns, whereas horizontal management focuses on optimizing stability. Both perspectives are essential to success and longevity, but they do not always align. Where the two perspectives come into tension, leadership must do the work to find the right balance point between high performance and sustainability (i.e., resiliency). The first critical transition is viewing operating, finance, and investment activities as a single portfolio that is comprised of discrete units (asset classes or business lines) that contribute their

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own risk and return characteristics. The second critical transition is to a framework that supports the management of that portfolio of corporate activities on an enterprise basis.

As an example, consider a business line assessment focused on whether to maintain, expand, exit, or restructure the current operating portfolio. A vertical analysis might emphasize return performance and whether the committed resources could generate a better outcome if deployed in some other way. A horizontal analysis might focus on whether the business line in question adds to or detracts from enterprise stability. Leadership must balance these perspectives, which may result in the intentional acceptance of sub-optimal returns from a business line or asset class as the price of enhanced stability across the total portfolio.

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A strategic resource allocation framework that brings operations, liabilities, and invested assets under a single, integrated management umbrella provides the foundation for resiliency-focused management and governance. It is the best mechanism to understand the relationship between risks and the resources (the challenged-to-thriving continuum starting point) *and* to actively manage the rolling prioritization between deploying resources to hedge risk or pursue returns (resiliency positioning).

An ancillary but important consideration is the correlation between resiliency and credit. High resiliency will not in and of itself produce a high credit rating, but it is essential to rating stability and is typically a critical ingredient in creating credit upside. Understanding embedded resiliency helps leadership shape the narrative around the organization's forward credit trajectory, especially when pressures emerge from operating volatility, strategic commitments, or both.

A great deal of uncertainty clouds the view out to the next five-year horizon. It is possible—perhaps likely—that over this time period being a great operator will produce better results than being a great strategist. It is also possible that disruption or other forces will drive the need for new strategies or growth channels that might

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unlock the gate to higher returns, enhanced resiliency, or both. In every scenario, healthcare organizations are incredibly complex portfolios of financial activities, and a framework that actively integrates vertical and horizontal perspectives offers the best foundation for balancing risk, resources, and return over the long term. This is what resiliency is about and health systems should be actively building that foundation now.

The Governance Institute thanks Eric Jordahl, Managing Director and Leader of the Treasury and Capital Markets Practice, Kaufman, Hall & Associates, LLC, for contributing this article. He can be reached at ejordahl@kaufmanhall.com.

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