System Focus

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Accelerating Health System Performance in Healthcare's New Era

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The Current Healthcare Landscape and Outlook

Two-plus years into the worst healthcare crisis of the past century, there's encouraging news on the horizon. COVID-19 may transition from pandemic to endemic at some point this year, which will bring great relief to an overburdened healthcare system. But by no means does this imply a return to pre-pandemic social, economic, or business patterns—certainly not for healthcare providers. Other headwinds remain, including:

- Tepid volume growth
- The continued shift of volumes out of the health system
- Reimbursement pressure from payers
- Expense escalation at levels above revenue growth
- Personnel shortages
- Loss of supplemental CARES Act funding and advance Medicare funding payback requirements

S&P and Fitch project a stable outlook in 2022 for the U.S. healthcare not-for-profit sector, while Moody's remains negative, largely due to labor costs and personnel shortages. Publicly traded companies may be positioned more favorably due to their assets being generally located in markets with faster growth, as well as greater access to capital. Whether the outlook is stable or negative, one thing most industry experts will agree on is that the business of healthcare will likely be forever changed as providers and payers embrace the types of innovations in care delivery and operations that helped them through the pandemic.

A New Era for Healthcare

Our healthcare system's response to the pandemic has been nothing short of heroic, and because of their pandemic experience, many healthcare providers have evolved into more agile, integrated, dynamic organizations. We often hear that the healthcare sector is settling into a "new normal," but that implies a reasonably stable environment going forward. We believe we have actually begun a new era in healthcare—one that will be characterized by continued challenges from external market forces, market consolidation across every sector of the continuum, and the pervasive use of technology that could revolutionize healthcare delivery, consumer behavior, and purchasing patterns.

This new era requires accelerated change by health systems. Some are well positioned to navigate this new era, but many systems are not. Every health system should have a clear line of sight as to its clinical, operational, and financial priorities over the next 12 months, as well as a longer strategic vision that can anticipate and adapt to various market scenarios.

Merger and acquisition (M&A) activity among hospitals has been brisk for several decades, and the pace is expected to continue, if not accelerate, in the years ahead.

➜ Key Board Considerations

- Engage health system leadership to understand your organization's current financial health and outlook, including areas of risk and vulnerability for both revenue streams and expense structure.
- Ensure your health system has a clear line of sight to its clinical, operational, and financial priorities over the next 12 to 18 months. Key challenges to monitor include decline in inpatient utilization and shift of services to outpatient settings, payer pressure on rate increases, system readiness for risk-based contracts/population health, workforce engagement and retention, alignment with physicians to support growth as well as clinical transformation to reduce costs and improve outcomes, and competitiveness of the system delivery network.
- Understand industry best practices related to system integration and opportunities to drive both business and clinical synergies across the system's delivery network. Create a mechanism to signal warning signs of enterprise performance risk and threats to sustainability, and define market triggers for when to explore system-level partnership options at the "most responsible moment."

As many as two-thirds of health system leaders expect an increase in M&A activity, inclusive of hospital acquisitions/mergers and a significant focus on acquisition of physician groups and ambulatory surgery centers. Many health systems seek growth as a strategy to improve operational cost efficiency and generate margins to fund capital investments and balance sheet liquidity. The American Hospital Association indicates that the percentage of hospitals in health systems has grown from 38 percent in 1990 to 67 percent today.[1] One would think this trend toward building system scale through M&As has resulted in improved performance and value to purchasers. Yes and no.

ECG's Financial and Operational Health Index stratifies U.S. short-term acute care hospitals (excluding critical access hospitals, government, and specialty hospitals) based on the current year and a four-year trend of operational and financial metrics. Our findings (see **Exhibit 1**) suggest that 35 percent of hospitals are marginal/at risk and another 27 percent are technically failing or at high risk of failure, with the latter characterized by negative operating and EBITDA margins on a year-over-year basis. Many of these poor-performing hospitals are part of systems. The top 6 percent (peak performers) enjoy double-digit operating and EBITDA margins, strong cash generation, and the ability to grow revenues much more quickly than expenses.

Exhibit 1: ECG's Financial and Operational Health Index of U.S. Hospitals

HOSPITAL PERFORMANCE TIER	# HOSPITALS	% HOSPITALS
Peak	180	6.2%
Steady	909	31.3%
Marginal/At Risk	1,024	35.2%
High Risk for Failure	795	27.3%
	2,908	**100.0%**

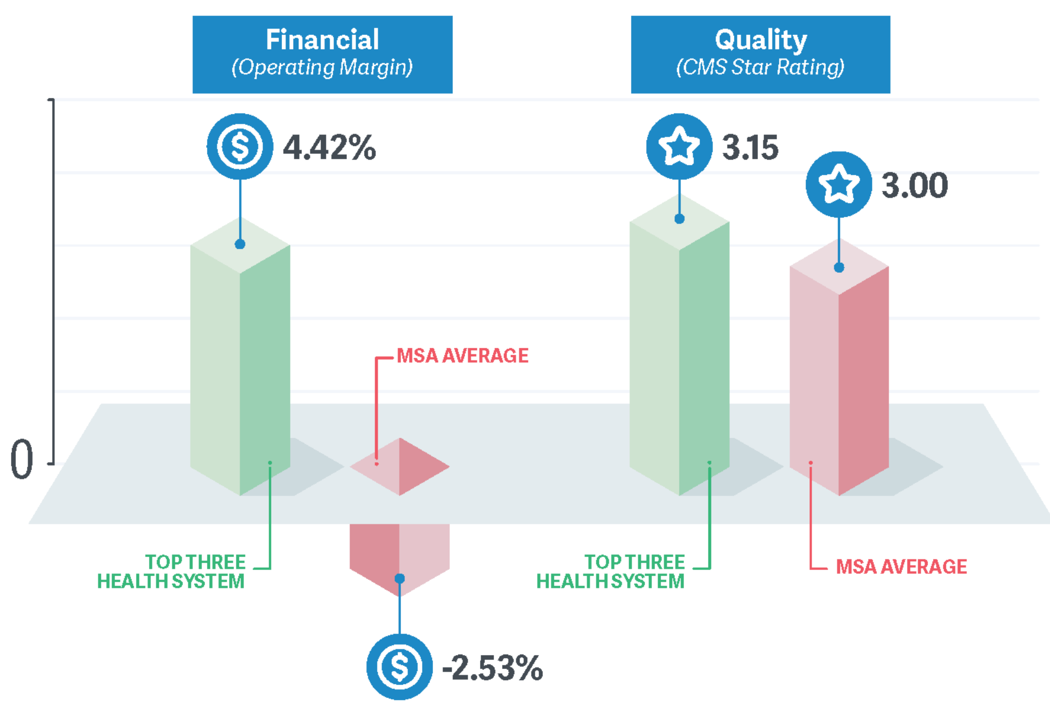
1 AHA, "Fast Facts on U.S. Hospitals, 2021."

The next 31 percent are steady performers and also perform well on these metrics, though at a level below the top tier.

Our findings are not dissimilar from other studies over the years. Further, many studies have documented that the growth in number and/or scale of systems has not necessarily driven improvements in quality or lowered costs to purchasers. We do find, however, that systems significantly outperform the market in terms of financial performance. The largest 50 metropolitan statistical areas (MSAs) in the United States account for approximately half of the nation's population. In studying these MSAs, as illustrated in **Exhibit 2**, the largest three health systems in each MSA substantially exceed the median financial performance of all health systems in the MSA and perform somewhat better on quality.

Better performance is not only associated with health system size—there is also a correlation between market leaders' performance and the market concentration where those systems operate. Of the top 50 MSAs across the United States, 20 of

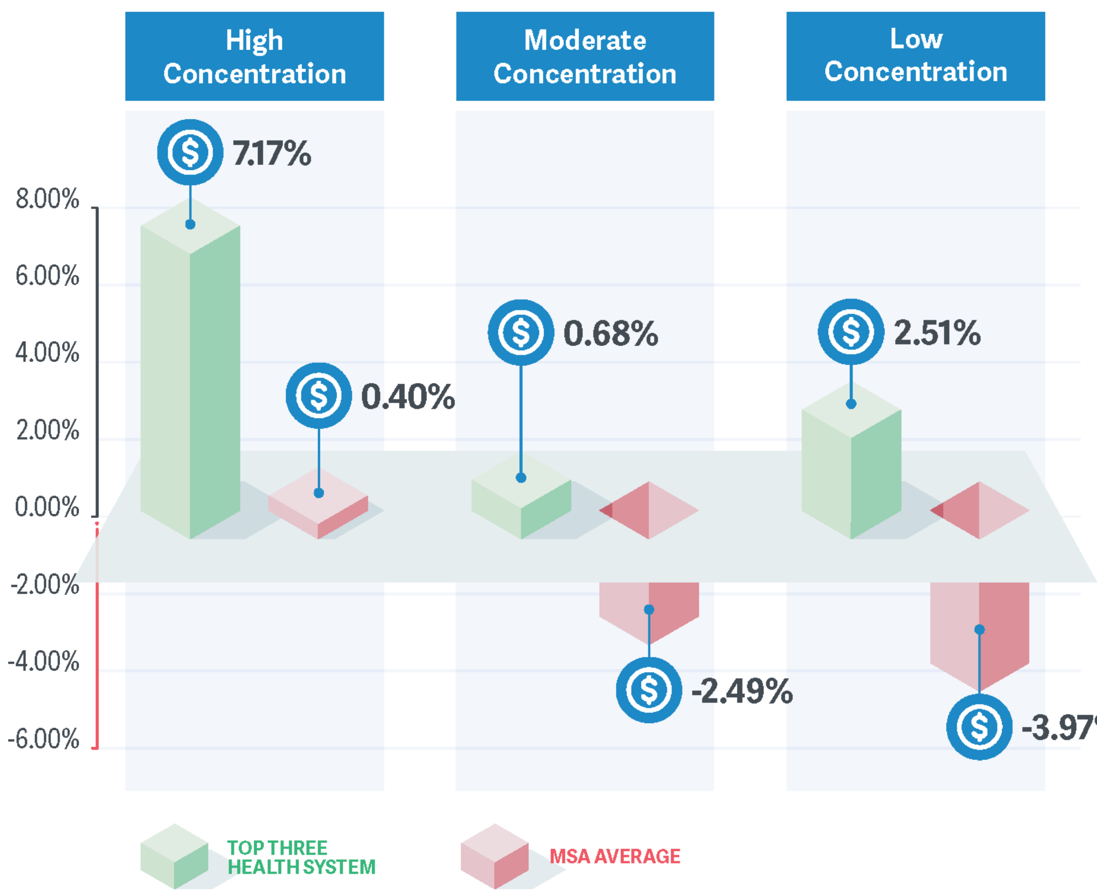
Exhibit 2: Largest Three Health Systems' Median Performance versus MSA Median Performance (Top 50 MSAs)



them (40 percent) are considered to have a high market concentration of hospitals, 21 (42 percent) have a moderate concentration, and nine (18 percent) have a low concentration.

As shown in **Exhibit 3**, the median operating margin of the top three health systems in highly concentrated MSAs is over 7 percent, compared to a median operating margin of less than 0 percent across all market participants in MSAs of moderate and low concentration. Based on these results, one could infer that performance is optimized by large health systems in highly concentrated markets. Furthermore, the top three highest-performing health systems in the best-performing MSAs typically have a combined market share of greater than 80 percent; this is the case in 17 of the 20 highly concentrated MSAs.

Exhibit 3: Top Three Health System Median Operating Margin versus MSA Median Operating Margin (Top 50 MSAs)



We can derive several important observations from these findings:

1. Strong financial performance, at least for the top systems in MSAs, is a reflection of the fact that with scale comes the opportunity to drive significant business efficiencies across the system, and most systems have spent a great deal of energy in pursuit of this aim through the creation of centralized and shared services.
2. Many large systems are also characterized by large integrated physician enterprise organizations, and this helps secure and drive growth and market share in clinical services.
3. While most health systems have invested significantly in information technology and many in building the infrastructure to support value-based care and population health, they have not focused as much on clinical service standardization or service rationalization as they have on business operations.
4. Regional market dynamics play a large role in financial and quality performance for all systems operating in a market—indeed, healthcare is very much local.

Looking ahead, we believe that many markets will continue to consolidate, and industry trends will demand better performance across the board; the delineation between market leaders and laggards will become more pronounced. Boards must give thoughtful consideration to how their health systems will drive value in this environment—for their organizations and key stakeholders, consumers and patients, purchasers, and their communities overall.

Accelerating System Performance

In both the current and future environment, table stakes for all health systems will be the ability to execute across four key imperatives:

- Optimize revenue and cost structure

➜ Key Questions for Boards

- To what degree is your market concentrated, and what is the strategic position of your health system?
- How does your health system perform on key financial and quality metrics?
- How advanced is your health system in terms of integration and rationalization?

- Redesign the delivery network for high performance
- Advance physician alignment and integration
- Perform well under risk-based and population health contracts

A key measure of success for health systems is consumer engagement and perception. It isn't enough to have top-box patient satisfaction, which is ultimately a retrospective measure for encounters against experience expectations. Health systems need to establish a prospective value proposition such that consumers and purchasers, as well as physicians and employees, wouldn't consider any other provider as their top choice.

To achieve economic sustainability and market essentiality, health systems must integrate and rationalize to enhance clinical care, optimize operations, and lower costs, ultimately focusing on the improvement of every aspect of patient care and business operations. While the benefits for patients and providers can be significant, reaching this future state (as denoted in **Exhibit 4**) isn't easy.

Health systems across the country are at different stages on their integration and rationalization journey, as shown in **Exhibit 5** (on the following page). Most health systems are in the mature stage. At the advanced stage of integration and rationalization, systems are high functioning and highly integrated across their

Exhibit 4: Moving from the Current State to the Ideal Future State

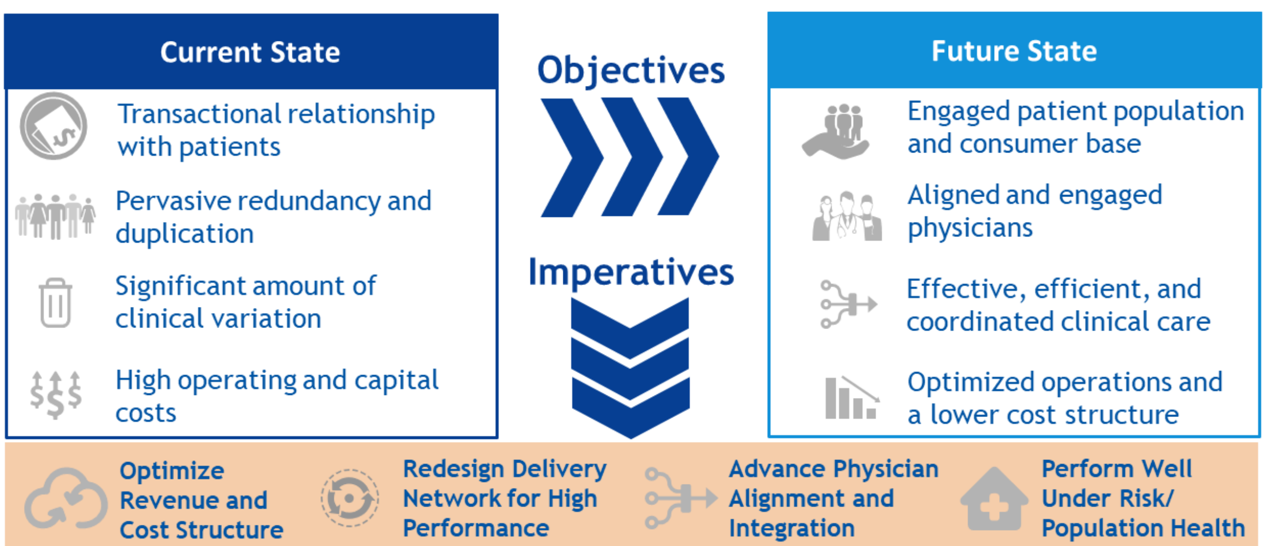
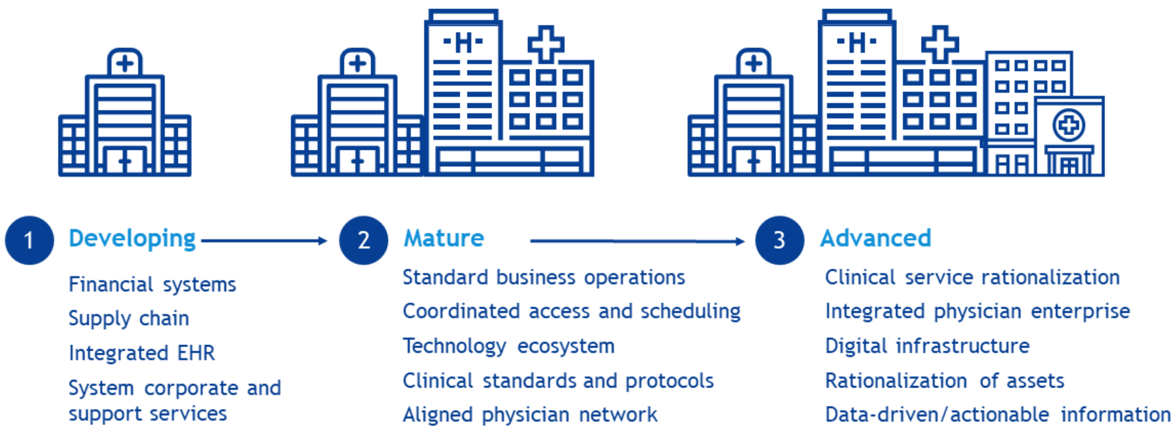


Exhibit 5: Essential Considerations by Integration/Rationalization Stage



business operations, have a high-performing integrated physician enterprise, have rationalized their care delivery platform to eliminate unnecessary duplication of services, have eliminated underperforming assets, and have invested in a facilities and technology infrastructure that supports business and clinical transformation.

Implications

High-performing health systems are strategic, agile, and change-oriented. Their leaders see data as an asset and use it to inform action. The time, effort, and leadership commitment required for a health system to achieve gains in clinical, operational, technological, and financial integration and/or rationalization are significant, and the cultural and political challenges are real. Organizations that have embarked on these initiatives realize both measurable and qualitative benefits in four key areas:

1. Patient experience:
    - Improved care coordination
    - Streamlined scheduling and access to services
    - Consistent service standards
2. Clinical outcomes:
    - Increased care effectiveness
    - More evidence-based protocols and pathways
    - Less clinical variation

3. Physician engagement:
    - Collaborative development of solutions
    - Data insight into outcomes and costs
    - Increased effectiveness due to automated processes and operational efficiencies
4. Financial:
    - Optimized, more consistent operations
    - Less redundancy and waste
    - Lower cost structure, both per unit costs and total cost of care
    - Increased ability to manage risk

Realizing the benefits of system integration and rationalization requires a journey, not one-time initiatives, so ongoing leadership commitment is a prerequisite, while physician alignment and engagement are essential. As markets continue to consolidate, and industry pressures continue to challenge healthcare providers, health systems must act with a sense of urgency to position their organizations for a sustainable future—and one in which they can thrive.

The Governance Institute thanks Andrew Bachrodt, M.B.A., Principal, Senior Strategy Advisor, ECG Management Consultants, for contributing this article. He can be reached at akbachrodt@ecgmc.com.