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System Focus

The Operating Results Imperative: Accurate Insight into Rural Affiliate Performance

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Today, many health systems are confronting poor or subpar operating results. Leaders of these health systems must have a clear understanding of the operational performance and value provided by key health system components to improve performance. However, rural affiliates within health systems are often evaluated on incomplete or incorrect information. For example, generally accepted accounting principles (GAAP) financials do not accurately capture system benefits derived from the optimal allocation of home office costs to critical access hospital affiliates. As with underlying operating performance, understanding whether the system and rural affiliates have optimized these value levers is critical. The locus of subpar operating performance, if not correctly identified and addressed, will erode an organization's strategic position and its strategic options while elevating its strategic risk.

If performance improvement decisions and priorities are made with incomplete data or without an understanding of the available value levers for rural affiliates, future operating results will be compromised. While occasional and non-recurring deferred investment will not pose an immediate strategic risk in most cases, over time, the cumulative effect of incorrect attribution of value creation and related under-investment can pose a considerable barrier to success and sustainability for both rural affiliates and their parent health systems.

Example: Evaluating Investment in a Rural Affiliate

Recently, Stroudwater spoke with a highly regarded health system that elected not to pursue an opportunity with a cash-flow-positive critical access hospital despite a strong case for accretive financial performance and an existing

referral partner from the critical access hospital. The system listed the following concerns:

- System financials were weakened due to the COVID-19 pandemic.
- Agency staffing at the system level is compressing system margins.
- The system cannot recruit enough providers to their major hubs, let alone a rural affiliate.
- The system does not have models set up that are effectively utilizing advanced practice providers in their current rural affiliates (such as in the ER).
- The system's own investment needs preclude taking on additional capital investment from new affiliates.
- The system board would not approve such a move given the challenges at the system.

The challenging operating environment and subsequent subpar operating results diminished the capacity of the system to take on this strategic investment. In this case, the operating results at the system level precluded the opportunity to make a strategic investment in a rural affiliate. This rural affiliate would have been accretive to system performance due to enhanced referrals, home office cost allocation, rural health clinics (RHCs), 340B, and its aligned primary care base. Ensuring that these value levers are optimized within existing affiliation relationships is essential. In prior years, management shared that its board might have approved the opportunity due to its strategic value but given current operating results and investment needs in the system, this affiliation is not feasible at this time.

Common Mistakes

The most common mistakes we see when it comes to evaluating strategic options at the health system level include:

- **Too little lead time**. Not being proactive enough when addressing operating performance issues or assessing changes in the strategic risk profile of an organization can create constraints that impair strategic initiatives. It takes time to improve operating results. The bigger the performance gap, the more time that is required. A minimum of 18 months of performance improvement is needed to provide a sound basis for evaluating strategic options (for divesting or partnering). When insufficient time is available and decisions are made based on incomplete information (see #2 below), poor decisions that destroy value can follow.

- **Failing to evaluate the performance of rural affiliates comprehensively and accurately.** The accretive value of rural affiliates is often not adequately captured in GAAP financials. Underlying operating performance is key, but so is optimizing the value levers available to systems with significant rural operations.

Optimal financial performance for the system may require allocating additional costs to critical access hospital affiliates so additional revenue can be realized from cost-based payment. These moves can create an inaccurate picture of the rural affiliate's value to the system if contributions of the affiliate to the system (such as allocating home office costs, the resulting enhanced cost-based payments, and the value of incremental referrals) are not part of the analysis. Systems that make budgeting, capital allocation, and performance evaluations without including adjustments for system benefits derived from rural affiliates will be allocating resources and evaluating performance with an inaccurate picture of the system benefits that rural affiliates provide.

Rural Affiliate Value Drivers

Systems must evaluate their rural affiliates including the following value drivers, among others:

- **The value of downstream referrals.** While each referral has variable costs associated with it, those variable costs are a small fraction of fully loaded costs and are in the majority of cases covered by incremental revenue, resulting in positive contributions toward fixed costs and financial benefits for the system.
- **The value of allocating costs to rural affiliates that receive cost-based payment.** Doing this optimizes system performance but will dilute operating results at cost-based affiliates. It is important to account for this when budgeting, allocating capital, or evaluating performance.
- **The value of a primary care base with a positive cash flow.** With the average practice subsidy per primary care physician above $175,000 each and the subsidy per advanced practice professional of $100,000 each, having a rural affiliate that can sustain a primary care referral on a cash-flow-positive basis is a huge benefit for the system parent.

➜ Key Board Takeaways

- When was the last time you evaluated your rural affiliates?
- Does your organization understand:
  - » The true value of downstream referrals from your rural affiliates?
  - » The true value of allocating costs to rural affiliates that receive cost-based payment?
  - » The true value of a primary care base with a positive cash flow?
- Systems that make decisions without considering system benefits derived from rural affiliates will be allocating resources and evaluating performance with an inaccurate picture of the system benefits that rural affiliates provide.

Accurately Evaluating Rural Affiliate Performance and Value Is Key

Given the importance of operating results and the challenge of being proactive and holistically evaluating the performance of rural affiliates, what is best practice for system boards and senior leaders?

In addition to focusing on core rural affiliate operating performance, understanding the value derived from rural affiliates beyond GAAP financials is essential (i.e., home office allocation, referrals, 340B, swing beds, RHCs, etc.). In the current environment, these value drivers cannot be an excuse for subpar performance; rather, they provide an additional potential opportunity for performance improvement and a critical component to understanding how rural affiliates contribute to the overall system operating results.

With an accurate tally of value creation for the system, leaders can more precisely evaluate performance and focus resources accordingly to address performance improvement needs and future investment. Quantifying and improving both core affiliate performance and the results derived from rural affiliate value drivers are essential to address deteriorating margins due to staffing and supply cost escalation. Tackling performance improvement requires time and management focus. Creating clear accountabilities, prioritizing initiatives, and setting timelines for results are essential. However, the first priority is to make sure that decision-makers have a clear and true picture of the value being created by each component of the healthcare system.

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