Positioning Your Health System for a New Future

By Dave Morlock, Cain Brothers

We are in the midst of an interesting time for the healthcare industry. For several years, health systems have been experiencing a slow and steady shift in the key basic business model including:

- Care moving from the inpatient setting to the outpatient and home settings
- An increase of government paid business as a percentage of the payer mix
- A shift from traditional Medicare to Medicare Advantage
- Public and private equity investment in care delivery

These changes have led to downward pressure on revenues and cash flows, and what feels like a never-ending cycle of budget cuts every year.

More recently, the pandemic was a catalyzing moment for the industry. It forced us to deal with significant upward pressure on expenses driven by inflation, supply chain issues, rising interest rates, organized labor momentum, burnout, and relative labor force contraction.

From a business model perspective, this all suggests that we are reaching (or have reached) a tipping point.

The interesting element in all of this is the significant bifurcation of health systems during this turmoil. Almost half of all hospitals are losing money. Another quarter are making money, but not enough to keep up with capital expenditure needs. This manifests itself in layoffs, bond rating downgrades, large multi-market systems selling off hospitals, and one of the largest health system bankruptcies in history.

On the other hand, a quarter of hospitals are doing very well financially. The performance of some large health systems has soared in the last year, despite hundreds of other hospitals that are at risk of closure. Many large health systems with scale, regional density, and strong strategic direction are thriving. This includes academic health systems, too. These large systems are building balance sheets that give them a margin of error, as well as the opportunity to pursue acquisitions, growth strategies, and invest in the ambulatory and value-based care spaces.

Conversely, smaller systems often have weakened balance sheets with virtually no margin for error or ability to weather additional head winds beyond their control. This means that they are not positioned to invest heavily in new strategic directions.

Steps for Senior Leadership and the Board

In our advisory work around the country, we are continually asked by boards and CEOs "What should we do?" While there is not a one-size-fits-all path, it is important to take the following steps to position your health system for the future:

- Invest in ambulatory care with lower cost settings (let go of your reliance on the hospital outpatient department).
- Invest in physicians and physician relationships.
- Invest in technology that supports managing risk, value-based care, consumerism, and supporting physicians.
- Invest in "economies of capability" rather than just economies of scale.
- Seek M&A and joint venture opportunities that support growth in the ambulatory care space.
- Have significant insight into the actual cost of the various services that your organization provides.
- Tap alternate sources of capital that go beyond the traditional sources of capital.

All of these elements require access to capital and scale. Your health system must be a relevant participant in a relevant market. You also need density in your region, and that region must be large enough to support the necessary scaled growth to facilitate these investments. Regions are now measured statewide and across state lines. It is no longer enough to be a dominant player in a mid-sized town and the surrounding county. Regions are getting bigger.

An exception to this approach exists if your health system is located in one of the fastest-growing large metro areas in the country. In that case, sheer volume growth will permit you to ride the old fee-for-service business model a bit longer. But even then, that strategy's success will be measured in years rather than decades.

The underlying business model of health systems has been changing for years, and the change is accelerating. Very large health systems with broad regional density are positioned well for the changes. But smaller health systems are at risk of not being able to invest in the necessary elements to ensure future success. Seeking alternate capital, M&A opportunities, and partnerships is a must in order to survive well into the future.

››› KEY BOARD TAKEAWAYS

- Which side of the bifurcation is your health system on—strong long-term survivor or struggling to get by?
- Does your organization have the scale, regional density, and strong strategic direction to survive?
- Does your health system have any margin of error if additional headwinds emerge?
- What necessary investments is the organization making in ambulatory care, physicians, technology, joint ventures, and M&A to position for the future?
- What are the sources of capital that leadership is willing to tap?

> *For health systems located in the fastest-growing large metro areas, sheer volume growth will permit you to ride the old fee-for-service business model a bit longer. But that strategy's success will be measured in years rather than decades.*

TGI thanks Dave Morlock, Managing Director, Head of Health Systems Group, Cain Brothers, for contributing this article. He can be reached at dmorlock@cainbrothers.com.