System Focus

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Leveraging Balance Sheet Strength to Promote Long-Term Sustainability

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In an environment where the pressure to improve financial performance only grows, many health systems fail to examine and engage the full potential range of opportunities that balance sheet resources can contribute to the organization's long-term sustainability. Any organization's balance sheet serves three purposes: 1) as a shock absorber, 2) as a financing mechanism, and 3) as a profit center. This article considers each purpose and provides key takeaways to ensure the health system's viability through improving balance sheet performance.

Shock Absorber

Operating as a healthcare provider is a very difficult business model with few factors within the organization's control. In such an environment, balance sheet strength has long been noted as an essential determinant of credit strength by rating agencies. Simply put, cash buys you time to fix your problems. But keeping a strong balance sheet takes real effort.

Health system leadership—both the management team and the board—need to understand the risks embedded across the organization so that the shock absorber function is properly integrated into the broader organization's processes. In football, if a player is out of position, the results can be problematic (sacks, interceptions, touchdowns). In healthcare finance, the implications can be very expensive (short-term decision making, lost opportunities, etc.). Periodically repositioning the balance sheet to protect the organization and accommodate risk-taking maneuvers (such as large capital investment cycles or merger and acquisition pursuits) requires effort, interconnectedness, and analytics. Creating necessary connections across the organization becomes essential to ensuring that the balance sheet is properly positioned to serve in its role as shock absorber.

Financing Mechanism

The range of financing activities that reside on the balance sheet spans from daily working capital needs on one end of the spectrum to long-term debt instruments and joint venture holdings on the other. Across every category (receivables, equipment, IT needs, real estate, etc.), the organization is routinely extending credit terms or utilizing them. With billions of dollars invested in these cycles, the opportunity to improve balance sheet efficiency can be substantial. Take, for example, the desire to hoard cash under the umbrella concept of working capital. It may feel good to have 30 days cash on hand in working capital, but for-profit hospitals can operate with about six days cash on hand. Some efforts to wring excess cash out of the working capital process can allow the organization to deploy excess cash in a more effective manner.

Many organizations feel the need to own all their real estate and purchase all their equipment. Does your organization consistently evaluate return on assets (ROA) and other key balance sheet metrics? That would seem only fair, given that we operate in an industry that has historically had very low margins and very high capital investment needs. Adding rigor to balance sheet management becomes an imperative in the current operating environment.

Profit Center

As a rule of thumb, Kaufman Hall has found that cash flow from operations constitutes approximately 80 percent of an organization's earnings before interest and depreciation (EBIDA) or free cash flow. The remaining 20 percent comes from investment income generated from investible assets. This analysis has been conducted over long periods of time and generally holds up regardless of rating category, revenue size, or asset base. Naturally, there are exceptions to this, whereby periodic market drawdowns can limit investment income for a period of time. More recently, significant sector operating losses boosted investment income's contribution to more than 100 percent of cash flow generated in some cases. But as a whole, operations generate 80 percent and investments generate 20 percent. So, the question becomes: can you think of another service line within the organization that is singularly responsible for such a large portion of the organization's cash flow?

Key Board Takeaways

- Elevate the role of the balance sheet by enhancing interconnectedness within the organization; consider how key strategic initiatives may affect the balance sheet.
- Challenge the organization to revisit old notions about the need to own everything (real estate, equipment, etc.).
- Ask hard questions about whether every aspect of the balance sheet is yielding what it can. Is ROA part of the organization's thinking?
- Measure and incentivize balance sheet performance by including investment income as a KPI for management compensation.
- Equip the organization with sufficient resources to drive balance sheet performance.

Implications

Consider the amount of time, effort, resources, technology, and governance dedicated to how the health system's operations perform. Now consider the amount of each of these that are dedicated to generating investment income. Take, for example, the notion that executive compensation arrangements regularly utilize operating margin as a key performance indicator (KPI). Mathematically, this excludes investment income from the equation. As an adage in management theory, people will often do exactly what you pay them to do. By expanding the aperture to include investment income in the equation, it would incentivize management to think more deeply about whether the balance sheet is performing as well as it can.

Equip balance sheet management with the resources—the people, processes, and technology—necessary to effectively drive its performance. While operations contribute 80 percent of cash flow generation, the reality is that almost all of the organization's personnel are devoted to operations. Better investment in balance sheet performance stands to yield improvements in performance and ultimately sustainability.

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Analytics can go a long way toward strengthening an organization's understanding of the opportunities to improve balance sheet performance. How do decision points across the balance sheet landscape affect each other? How are they informed by the organization's strategy, planning efforts, goals, and objectives? How does enterprise risk management connect with balance sheet positioning? Better analytics will allow the organization to be nimble with its needs.

Generating cash flow from investments is like a good stew. Invested assets are the essential ingredient or, in culinary terms, the base. But understand that other facets of the balance sheet are instrumental to the process. The amount of leverage an organization carries, the amount of liquidity tied up in working capital, and the decision to lease equipment versus buying it also contribute to the result. A myriad of decisions impact the organization's balance sheet strength and therefore the organization's long-term sustainability.

TGI thanks Robert Turner, Managing Director and Leader of the Treasury & Capital Markets practice at Kaufman Hall, a Vizient company, for contributing this article. He can be reached at rturner@kaufmanhall.com.