



findings brief

Corporate Finance and Consolidation in Health Care

An ongoing national debate is taking place on the responsibilities non-profit hospitals have in providing community benefits that justify their special tax-exempt status.^{1,2,3,4} The most familiar of these benefits is charity care, but since 1969, the IRS allows hospitals to qualify if they provide other benefits such as education, health promotion, or research.⁵ While striving to fulfill the community benefit standard, non-profit hospitals face increasing pressure to stay financially viable as the demand for uncompensated care rises with increasing numbers of uninsured.

Non-profit hospitals also face increased competition, lower profit margins, aging facilities, and less profitable patient populations compared to for-profit institutions.⁶ This may prompt some non-profit hospitals to pursue strategies that conflict with their charitable mission. For example, multiple media accounts have revealed questionable billing practices and aggressive collection tactics of the poor and uninsured by both for-profit and non-profit hospitals.^{7,8} The involvement of non-profit hospitals in these activities has generated particular concern within communities.

Researchers at the University of California, Berkeley examined how a forty-hospital, non-profit system, Catholic Healthcare West (CHW), that was experi-

encing major financial losses in 2000 was able to reorganize and reverse those losses, while still preserving its charitable mission. Lessons from this experience provide important insights and considerations for non-profit hospitals attempting to reverse financial losses and demonstrate tangible community benefits.

The research team, led by James C. Robinson, Ph.D., and Sandra Dratler, Ph.D., found that after centralizing financial authority and delegating operational responsibility to local facilities, CHW used measures of market attractiveness, hospital financial performance, and social mission to determine where it should shift investments. CHW's strategy of selective diversification improved its operating performance significantly, resulting in an estimated capital capacity averaging \$600 million annually from 2005-2009.

"CHW must continually balance the strategy of entering profitable markets and exiting unprofitable ones with their religious mission of focusing on communities with large clinical and financial needs," says Robinson. "This imperative pushed the health system beyond the 'no margin, no mission' reality facing every non-profit organization."



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Background

Consolidation of the hospital industry through mergers and acquisitions over the last decade has generated a trend toward rapid growth of large health care systems that reach across multiple regions and states to operate as integrated delivery systems that could address most aspects of an individual's health care needs. At the height of managed care, CHW also took on this strategy and aggressively pursued acquiring physician groups and additional hospital facilities.

Integrated delivery was intended to reduce overall costs and create higher revenues through care coordination. Unfortunately, Robinson's analysis found that the realities of a fragmented healthcare system, inappropriate management structure and inattention to individual performance threatened CHW's financial stability. Like many other hospital chains, the philosophy of "bigger is better" resulted in overexpansion and entry into markets where the system had no comparative advantage. CHW went from an operating gain of \$26 million in 1996 to a loss of more than \$300 million in both 1999 and 2000. The severe losses suffered by CHW prompted the system to reinterpret its markets and services so that investments and divestments reflected new capital investment priorities.

Findings

The researchers explored how a large hospital chain's capital investment strategy can incorporate performance and growth markets, along with the charitable activities of a facility and the economic and health-related needs of the community.

They identified several necessary features that allowed CHW's strategy for a diversified organizational chain to succeed. These core competencies include: 1) the ability to evaluate existing and potential markets, 2) understanding where the internal capabilities of the firm can best be deployed, 3) possessing necessary financial resources for new opportunities, and 4) having self-discipline to exit underperforming markets and services.

They also found CHW's determination in preserving the system's social mission was as important as their market strategy in regaining financial stability. In order to identify mission-related capital investment options, CHW used an analytic approach that quantified the level of each facility's charitable contribution in relation to the economic and health-related needs of its community. This score was then weighed against each facility's financial prospects, which considered performance and market attractiveness. CHW was able to guide investments to areas of high need because they quantified aspects of the system's social mission.

As a result of the new investment strategy, weak facilities in low growth markets received 27 percent of total investments, down from 35 percent in 2000-2004. The largest percentage of capital went to the most profitable facilities on this scale, increasing from 32 percent of total investments to a predicted 46 percent in 2005-2009.

Aside from a handful of major commitments to high ranking charitable institutions, most of the new investments in especially needy communities were small. Robinson's analysis found that, "mission-related investments were made to sustain, but not expand, the system's presence in low-income communities."

Additional details on the study's findings can be obtained from an article, "Corporate Structure and Capital Strategy at Catholic Healthcare West," published in the January/February 1006 *Health Affairs*.⁹

Policy Implications

Discussions of non-profit hospitals' community benefit requirements at the federal level primarily have encouraged non-profit hospitals to self-regulate their contributions to the community. There is a perception that this has not resulted in satisfactory contributions, stimulating some legislators to contend that without voluntary revisions to existing practice, Congress will, "set standards for the industry if it does not do so for itself."¹⁰

Many state and local governments have taken more direct action to clarify the expectations for non-profit hospitals' roles in the community. At least 24 states have considered and/or passed legislation regarding charity care guidelines, transparency in non-profit governance, spending mandates, or withdrawal of tax breaks.¹¹ The legislation covers a range of voluntary guidelines for reporting, statutory definitions of community benefit, and minimum mandates. Texas is one of the only states that explicitly links the community benefit provisions to requirements for tax exemption.¹²

Conclusion

Robinson's analysis of CHW's approach to financial turnaround demonstrates one way a non-profit system can evaluate the financial returns of services, markets, and organizational capabilities, while also considering social needs. The act of quantifying and documenting the capabilities and charitable contributions of a system could help strengthen a non-profit hospital's position in the community and justify their special tax-exempt status.

Robinson's findings illuminate the strengths and challenges of preserving one non-profit hospital system's community benefits as it shifted from an integrated delivery system that tried to coordinate inpatient, outpatient, and ancillary services to a diversified organizational chain structure that determines which services it will provide, based upon the idea that there is inherent profitability or unprofitability in specific activities.

"A charitable mission inevitably is limited by the financial margin, and the social effectiveness of a non-profit organization can be furthered by a strategic approach on how best to lose money as well as how best to earn it," says Robinson. The researchers suggest that CHW's approach is well adapted to industry realities and public pressure for non-profit accountability and the lessons may be applicable to other non-profit hospital systems struggling to balance mission and margin.

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