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healthcare financial management

STRATEGY CHALLENGE

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What Would You Do?

affiliate, merge, or stay independent?

The Problem

Metro Mercy Hospital (MMH) has been in a downward spiral, resulting in losses in the past few years and a tenuous cash position. Although a new CEO has recently been hired and a turnaround begun, the board is unclear as to whether the hospital can and should remain independent now and in the future. What should the board do?

The Situation

MMH is a Catholic-sponsored, freestanding, 200-bed hospital with annual operating revenues of $125 million, located in the western end of a city in a large metropolitan area. The hospital is a relatively undifferentiated, general acute care hospital with the typical range of medical, surgical, ob/gyn, and pediatric services. The hospital does not provide any tertiary or even near tertiary services. It has a very busy emergency department and a network of owned physician practices in the area it serves; these practices provide mainly primary care services and constitute a significant portion of the primary care medical staff of the hospital.

MMH is located in a rapidly changing community. The population it has historically served, primarily second- and third-generation Italian- and Polish-Americans, has moved to the suburbs and/or aged. These groups have been replaced by African-Americans, and more recently Hispanics, particularly immigrants from Mexico. Although the service area population was expected to decrease from 1990 to 2000, Census Bureau data indicate that the population—especially Hispanic—actually grew. Recent estimates suggest continued slow growth and transformation of service area demographics.

MMH faces very stiff competition due in part to the number of competitors in and around its service area and the general overbeddedness in the region. Its main competitors include St. Luke's Hospital, the 600-bed flagship of a very successful multihospital system, located a few miles west of MMH in an affluent suburban area; a nationally recognized teaching hospital located within five miles of MMH; a number of other tertiary teaching hospitals located in and around the downtown area of the city; and one large for-profit community hospital and two large system-affiliated community hospitals all located within three to five miles of MMH.

MMH has experienced downward trends in utilization and financial performance since 2004. In 2006, the hospital had an operating loss of $10.9 million (total loss of $10.6 million) after an operating loss of $10 million (total loss of $10.2 million) in 2005. The financial situation led to the resignation of the previous CEO and an interim management arrangement for about 12 months until a new CEO was named and began work early in 2007. The board was also reorganized and a new lay board chair and other board members with strong business skills were added in 2006-07.

The CEO's first priority was to restore the organization to financial health. By fall 2007,

METRO MERCY HOSPITAL BALANCE SHEET

	June 30 2006	2005
Assets		
Current assets:		
Cash and cash equivalents	$ -- --	$2,111,000
Patient accounts receivable*	25,749,000	25,580,000
Inventory of drugs and supplies—at cost	1,939,000	1,919,000
Due from primary third-party payers	2,362,000	1,412,000
Prepaid expenses and other current assets	3,319,000	4,351,000
Total current assets	**33,369,000**	**35,372,000**
Assets limited as to use:		
Internally designated (capital improvements)	5,769,000	19,116,000
Externally designated (debt agreements)	2,821,000	2,747,000
Externally designated (self-insurance program)	3,494,000	3,548,000
	12,084,000	**25,411,000**
Other investments	225,000	225,000
Deferred bond issuance costs, less amortization	571,000	597,000
Land, buildings, and equipment, net	50,788,000	53,662,000
	$97,037,000	**$115,268,000**
Liabilities and net assets		
Current liabilities:		
Accounts payable	$8,039,000	$6,534,000
Accrued salaries and other expenses	6,316,000	8,410,000
Accrued interest	555,000	539,000
Due to primary third-party payers	508,000	736,000
Note payable		2,500,000
Current maturities of long-term debt	863,000	1,076,000
	16,281,000	**19,795,000**
Noncurrent liabilities:		
Long-term debt, less current maturities	24,411,000	25,832,000
Reserve for professional liability claims	4,278,000	4,231,000
Accrued pension and postretirement benefits	3,025,000	3,171,000
	31,714,000	**33,234,000**
Net assets:		
Unrestricted	48,818,000	62,037,000
Temporarily restricted	225,000	202,000
	49,042,000	**62,239,000**
	$97,037,000	**$115,268,000**

* Less allowances for uncollectible accounts.

operating losses had been trimmed substantially (to $6 million total, but $3 million run rate by year end) and the organization was on target to be at breakeven on a monthly basis by the end of FY08.

As the turnaround proceeds, the new CEO and board leadership believe it is imperative that the hospital develop a new strategic plan. Although much of the financial improvement that is occurring is a result of internal operating changes and managed care contract revisions, and leadership believes that tighter operations and financial management can bring the hospital to breakeven, the hospital needs to make significant improvements on the market and revenue side if it is to become truly viable. Therefore, while management continues its operational changes, a strategic planning effort needs to commence to help position MMH for long-term success. A key question to be answered in the strategic planning process is whether MMH should remain

SWOT ANALYSIS

Strengths

- Catholic base, caring organization
- Strong history
- Neighborhood growth, economic revitalization
- Several younger, well-trained, entrepreneurial physicians on staff
- Primary care base

Weaknesses

- Limited response to neighborhood diversity
- Declining volumes, weak market position
- Aging medical staff
- Medical staff-hospital relations
- Poor financial performance
- Large proportion of admissions through the emergency department (few patients are choosing MMH)

Opportunities

- Differentiation through Catholic identity
- Community outreach
- Medical staff development
- Program development/enhancement in key service lines
- Partnerships (other Catholic hospitals, physicians, niche players)
- Niche programs (occupational medicine, wound care, pain management, sleep lab)
- Prevention and health promotion

Threats

- Continued erosion of volumes and market share
- Significant number of providers in the market
- Inability to compete as a stand-alone provider
- Payer mix
- "Outsiders" skimming business from local hospitals
- Medical staff

OPTIONS BEING CONSIDERED FOR METRO MERCY HOSPITAL

	Freestanding	Affiliate	Merge
Pros	> Proud tradition > Growing, Catholic area > Good book of business	> Attractive to two to three organizations > Strong clinical/management complementarity > Transitional step to merger	> Would provide support needed to thrive > Potential Catholic and non-Catholic options > Likely anyway in three to five years
Cons	> Weak cash position > Capital needs > Formidable competition	> Does not address capital needs > Hard to get/keep partners' attention > Probably not long-term solution	> Better deal possible if stabilized > Wrenching decision for sponsor > Potential loss of community focus

freestanding, affiliate, or join a system. Given the above, how should MMH's board proceed?

The Decision

The board asked management to prepare detailed financial pro formas and cash flow projections for the next three to five years, including a best case, worse case, and likely case. In the likely scenario, management's projections showed a modest operating surplus, reaching 1 percent to 2 percent by year two and continuing throughout the projection period. Best case resulted in a 3 percent to 4 percent margin toward the latter part of the forecast period, and worst case indicated a modest 1 percent to 3 percent operating losses, but cash neutral operations throughout the period.

As a result, the board directed management to continue the organization's turnaround and develop a three- to five-year strategic plan, including, as a major component, an affiliation with one of the three potential candidates identified as interested hospitals and health systems with whom MMH could form both clinical and operational support relationships. ●

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