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What Would You Do?

what should this hospital do about its physicians developing a freestanding endoscopy unit?

The Problem

Like many hospitals, Community Hospital has faced an increasing number of competitive outpatient ventures by its medical staff. The latest salvo is rumored to be a freestanding endoscopy unit. What, if anything, should Community Hospital do about the proposed venture?

The Situation

Community Hospital is a successful, growing, increasingly full-service provider operating in a rapidly developing part of a major metropolitan area. Because of the historically low density of the population, hospitals are spread out in Community's home county; the nearest is 10 miles away. Although there are some freestanding outpatient competitors locally, the competition is really quite modest except for the outpatient ventures of Community's own medical staff.

Community Hospital has been experiencing steady increases in inpatient and outpatient volumes, averaging 2 percent to 7 percent per year, respectively, for the past five years. As a result, market share has gradually increased in its primary service area from about 60 percent to 65 percent in that period. Community's scope of services has expanded in the past five years to encompass invasive cardiovascular services, including open-heart surgery, and a developing cancer center, both of which have fueled volumes and share growth.

Financial performance has been good, but not great, in recent times. Operating margins have fluctuated between 1 percent and 4 percent and total margins have ranged from 3 percent to 7 percent. The hospital's annual operating

revenues were \$125 million in FY06. The balance sheet is also good, but not great. Endowment and reserves total about \$75 million. Long-term debt is approximately \$20 million, and the hospital is likely to go to the debt market for approximately another \$50 million in the next few years to support its continued growth.

The medical staff, which encompasses about 200 physicians, is one of Community Hospital's strengths. For the most part, the physicians are organized in small, single-specialty practices, and few are on the active staff of any other hospital. The gastrointestinal physicians, who are the subject of this challenge, are in two groups, one with three physicians and the other with four.

Community Hospital's board and management have become increasingly troubled by the entrepreneurial ventures of its medical staff. In 2004, about 20 of the surgeons collaborated with a for-profit company to establish a freestanding ambulatory surgery center near the hospital. As a result, outpatient surgery volumes decreased by one-third between FY04 and FY06, with contribution margin dropping by more than \$1 million. The anesthesiologists moved almost their entire nerve block service to the new surgery center, which caused another \$500,000 hit to Community's bottom line. A variety of other outpatient ventures in the past five years (physical therapy by an orthopedic group, full range of cardiac diagnostics by two cardiology groups, and freestanding magnetic resonance imaging, for example) have nearly doubled the annual negative impact on the financial performance of Community Hospital's outpatient services.

STRATEGY CHALLENGE

Now it looks as if the gastroenterologists may be next to move the bulk of their outpatient business to a freestanding facility. Community Hospital's finance staff has reviewed the potential impact on the hospital of such a move.

Clearly, senior management and the board are deeply concerned about a possible doubling of the annual impact on the hospital's margin in the worst-case scenario. Although the move is still speculative and the gastroenterologists have denied they are contemplating relocating their outpatient business to a freestanding facility, the hospital leaders believe they can't wait until such a possibility becomes a "done deal" before acting. So, what are their options?

Alternative Considerations

The board convened a special committee to study the situation, meet with the gastroenterologists, and make a recommendation to the board. The committee reviewed various scenarios involving migration of all or a part of the endoscopy business to a freestanding facility. It examined its existing physician partnerships (cancer center, primary care, managed care contracting) for attributes of physician relationship models that could potentially be applied to this situation. It also conducted an extensive review of other hospitals that have faced similar situations and how they responded.

As a result, the committee identified four broad categories of responses to the gastroenterologists' potential threat:

- > Do nothing (and hope it all blows over or has minimal impact).

- > Aggressively compete (including recruiting new gastroenterologists to the staff).
- > Attempt to thwart the venture (through economic credentialing or other means).
- > Propose and enter into a collaborative outpatient venture with the gastroenterologists.

For each category of response, the committee delineated specific substrategies, pros and cons, and the probability of success. None of the options was a clear-cut best course to pursue, and the committee debates were long and heated before an outcome was reached.

If you were in Community Hospital's position, what would you do?

The Decision

Ultimately, four factors carried the day:

- > *Additional physician entrepreneurial ventures appear inevitable, and Community Hospital needs a clear, consistent strategy to deal with them.*
- > *The quality of the gastroenterologists, their relationships with other medical staff members, and the long-term needs of all parties mitigate against the desirability of competitive strategies.*
- > *The potential negative financial effects of a freestanding endoscopy venture are too significant to ignore.*
- > *A collaborative deal could be structured that could provide incentives for the parties to significantly grow volumes (in their extended service area) and offset somewhat the losses from sharing the financial contributions of existing volume and the additional costs of a new outpatient center.*

Extensive negotiations between Community Hospital and the gastroenterologists ensued before a deal was concluded. In the end, the parties agreed on a 60-40 joint venture. The new endoscopy center is now under construction, with an estimated opening date of April 2008. ●

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POTENTIAL IMPACT OF GASTROENTEROLOGISTS' MOVE TO A FREESTANDING FACILITY

	Outpatient Procedures	Net Insurance Payments	Estimated Contribution Margin
FY04	4,900	3.1M	1.6 M
FY06	6,000	6.9 M	3.5 M
% Change	22%	123%	119%
Projected FY08	7,000	8.0 M	4.0 M
Projected FY10	8,000	8.8 M	4.3 M

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