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STRATEGY CHALLENGE

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What Would You Do?

is this system's smaller hospital a keeper?

The Problem

Suburban System has two hospitals: a medium-sized, vibrant one in the western suburbs of a major metro area, and a smaller one about 20 miles further west in a semirural but rapidly growing area. The smaller hospital's capital needs have been deferred for many years and are now great. However, the system does not have the capital capacity to keep the larger hospital vibrant and make the required investments in the smaller hospital. What should the system do with the smaller hospital?

The Situation

Suburban System is well-located on the western edge of a major metropolitan area. Suburban's flagship, the merger of two small hospitals 15 years ago, is a modern, thriving, community hospital situated in a growing, affluent market. The flagship is a 200-bed hospital that has generated consistently healthy operating margins of about 5 percent annually. Its volumes have grown with the community: Admissions are up 22 percent in the past five years, emergency department visits are up 27 percent, surgery volumes have risen 25 percent, and nearly all other volume indicators are similarly positive. To continue to meet the needs of the community, the flagship is facing major capital expenditures over the next five to 10 years, estimated to be a minimum of $50 million and possibly as high as $80 million, apart from routine capital needs.

While the flagship hospital has prospered, the smaller hospital has languished. The smaller hospital is located about 20 miles further west in a rural area, and there are no hospitals between it and Suburban's flagship facilities. The rural hospital has 100 beds, runs an average census of 70, and has experienced minimal growth in the past five years, ranging from 0 percent to 5 percent in key areas. Operating margins have hovered between 0 percent and minus 2 percent for the past five years. The hospital's physical plant is functionally obsolete, it is located in a historic village on a very small site, and its technology is barely adequate. By any measure, a total renewal or replacement of this hospital will be required if it is to continue. The hospital has struggled in recent years operationally as well, facing difficulties attracting new physicians as older physicians are retiring; staffing has been an ongoing challenge.

However, the area that the rural hospital serves is beginning to develop rapidly, partly due to continued suburbanization as the metropolitan area pushes west, and because the local military base has been identified as a hub for the military under federal base consolidation plans. Competitors are undertaking initiatives to exploit this development. Another, larger rural hospital, about 15 miles further west, is in the midst of a major facility expansion and upgrade, and all of Suburban's flagship's competitors have ambulatory initiatives for the rapid growth area planned or under way.

Because this is a certificate-of-need state, competitors' options are somewhat limited, and the franchise that Suburban has is of greater value than it would be in a deregulated environment.

Capital needs for Suburban's rural hospital for the next five to 10 years range from $70 million to $100 million, depending on how Suburban approaches this situation. While Suburban's financial performance has been good, its debt-to-capitalization ratio is already 68 percent and additional debt capacity is limited. Although

OPTIONS BEING CONSIDERED FOR SUBURBAN SYSTEM'S RURAL HOSPITAL

Option		Considerations
Divest – Close		> Close hospital services; maintain medical office space and basic services for local physicians.
	Pros	> Advantages include elimination of (historically) marginal business, ability to focus on flagship, and less strain on medical staff covering both sites.
	Cons	> Disadvantages include loss of market share, community backlash, likely financial losses as patients leave before hospital can close, increased costs to expand capacity at flagship for some redirected rural hospital volume, and smaller base to spread flagship's overhead costs.
Divest – Sell	Pros	> In addition to those listed above, advantages include potential net gain in financial position with sale, and fewer expansion requirements at Suburban than with continued rural hospital operations.
	Cons	> In addition to those listed above, disadvantages include even greater loss of market share with new, active competitor nearby.
Maintain		> Continue to manage costs and selectively grow existing services, minimizing capital investments required. > Recruit physicians to replace existing ones as needed and to meet community need.
	Pros	> Advantages include least political risk and management attention.
	Cons	> Disadvantages include aging physical plant likely to result in continued erosion of competitive position and failure to attract new population to the area; moderate capital investment required; and small size, leaving rural hospital vulnerable to market and cost pressures.
Grow – Current Site		> More aggressively recruit physicians and selectively add programs/centers of excellence. > Develop interim investment strategy even if rural hospital is relocated eventually.
	Pros	> Advantages include stronger growth in market and financial position.
	Cons	> Disadvantages include additional management effort and capital investment required; also, existing site may not support capacity or image required.
Grow – New Site		> Aggressively recruit physicians and expand programs to become more full service longer term.
	Pros	> In addition to the above, advantages include new location, offering greater visibility and access.
	Cons	> Disadvantages include high level of capital investment required to replace hospital, longer timeframe to completion, greater management effort, and need to manage/reuse existing site.

growth, philanthropy, and operational improvements can help raise capital capacity, it is impossible to see how both hospitals' capital needs can be met concurrently.

Suburban's board is divided about how to proceed, and discussions have been in gridlock for 24 months. How can progress be made?

Alternative Considerations

Staff were directed to thoroughly review all recent previous studies on this situation (of which there were eight, directly or indirectly related) and distill them into a series of options for leadership consideration. Carrying out the required capital investment at the flagship hospital was taken to be a given. Therefore, the focus was on the rural hospital. Staff identified three general options—divest, maintain, or grow—and then suboptions within two of the three general categories. A summary of staff's analysis appears in the table.

Although staff's distillation and analysis were helpful, the board was still divided about how to proceed. Clearly, the desire to grow the rural hospital was strong, but the financial realities were equally stark. An ad hoc committee was appointed to develop a recommendation. What should that recommendation be?

The Decision

The committee came to the conclusion early in its deliberations that the maintenance strategy was not working now and was wholly unsatisfactory going forward. Although its preference is to grow the rural hospital, desirably on a new site close by a major interstate highway, this approach is feasible only if "angels" can be found to support the large capital investment required. The committee asked to be given six months to explore private and public options in this regard, up to and including obtaining a capital partner to assist in carrying out the necessary development. If, after six months, the committee is no further along or out of options to pursue, a sale is recommended as the next best alternative. ●

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