

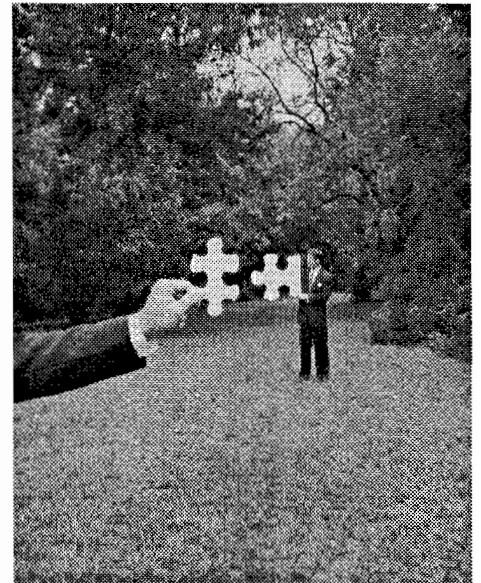
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COVER STORY

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the capital challenge needs versus resources



Effective capital planning within budget requires a disciplined approach grounded in the organization's strategic plan.

AT A GLANCE

To set investment priorities, capital resources should be allocated into at least three funding pools:

- > Routine projects (e.g., replacing equipment and maintaining facilities)
- > Mandated projects (e.g., fulfilling regulatory requirements)
- > Strategic projects (e.g., developing new facilities and service lines)

Hospital facilities are deteriorating. Demand for a broader range of service offerings and increased capacity is mounting. Technological advances are quickly rendering existing technologies and equipment obsolete. Yet for years, capital resources that could be used to address these concerns had to be funneled into initiatives to comply with regulatory and technology-related mandates, such as Y2K and HIPAA.

The challenge is to get an increasing array of such competing yet critical capital demands to fit within a tightening capital budget. Many healthcare providers are finding that their available resources for capital investment are insufficient to cover all of their

capital needs. And the outlook is not good, as future changes in Medicare payment and operating profitability will likely further reduce these resources. The increasing challenge for providers is how to best allocate scarce resources by setting appropriate priorities among competing capital requirements. Each capital investment should be evaluated to determine the degree to which it supports the strategic and mission goals of the organization while also contributing to a revenue stream that feeds the organization's ability to invest in itself.

A disciplined approach to prioritizing and allocating capital investments is critical, not only to avoid expensive mistakes and wasted capital investments, but also to provide a clear rationale for decision making that will reduce the politics often associated with competing demands among stakeholders.

Foundation of Capital Planning

Capital prioritization and budgeting should be based on the organization's strategic plan. The organization's overall vision, key strategies, and priorities, as outlined in the strategic plan, can provide a basis for

ADDITIONAL RESOURCES

Haugh, Richard, "Use a Disciplined Approach to Capital Allocation Process," 2002 (www.gemedicalsystems.com/services/financial/hfs_online/capital_art6.html). This on-line article suggests that the best way to allocate capital in the healthcare industry is to follow a for-profit corporate model.

determining the criteria necessary to evaluate capital investments and allocate available resources.

Strategic plans typically include the goal of strengthening the organization's financial profile and debt-worthiness. This goal, in particular, should be an explicit part of capital planning and setting priorities.

Master facility plan. An important, related capital-planning tool is the organization's master facility plan, which lays out an orderly schedule for renewing, expanding, and reconfiguring the organization's campus (or campuses) and facilities over the short and long term. An effective master facility plan also anticipates life safety code and other regulatory issues that will require remedies. A master facility plan that is well coordinated with the strategic plan results in facilities that have the right size, location, and configuration to best support overall market, service, and program goals.

Potential pitfalls. Without the underpinning of a strategic plan and, ideally, a master facility plan, the capital-budgeting process is subject to several pitfalls. Requests from individual departments and/or physicians can be subject to silo thinking if they are made in ignorance of the organization's overall vision. Moreover, if such requests are considered only in isolation, the squeakiest wheel often wins the competition for administrative support and capital dollars.

Another common pitfall results from fulfilling clinical capital requests that necessitate a change in location or space; such requests may be justifiable in terms of the added capabilities or capacity, but fail to take into account competing space priorities. Fulfilling a request to install expensive new clinical equipment at a particular site would be ill-advised, for example, if from a strategic standpoint the site could be put to better use for some other purpose. By weighing the request in light of the organization's broader strategic considerations, the organization could avoid unnecessary costs associated with having to undo the installation and move the equipment.

There also is the danger of using up available capital on routine equipment and emergency requests, leaving little funding for investments that have greater strategic importance to the organization's future.

Capital Spending Pool

A key preliminary step in a disciplined capital-planning process is to calculate the total funding available for capital investments for at least the next five years. This step should be updated annually so that adjustments can be made to account for actual performance. The total capital spending pool is the sum of the organization's debt capacity and the funds raised through philanthropy.

Debt capacity. To determine debt capacity, a financial forecast should be prepared incorporating targeted volume, revenue, operating, and depreciation projections for each of the next five years. This forecast should incorporate any improvements to the organization's financial position deemed necessary to achieve the desired level of financial stability and credit worthiness.

For instance, an organization rated BBB that has 98 days of cash on hand, an EBITDA debt-service ratio of 2.5, and debt to capitalization of 45 percent should prepare a forecast that reflects targets of about 160 days on hand, a debt-service ratio of 3.1, and debt to capitalization of less than 40 percent. As a result, the organization will strengthen its balance sheet and earn a higher rating of A, thereby lowering the cost of borrowing in the future.^a The resulting five-year forecast of the organization's financial position can provide a basis for determining the organization's total potential borrowing capacity.

Philanthropic funding. Not-for-profit hospitals and health systems are turning increasingly to fund development programs to augment their borrowing capacity as a capital strategy. These strategies can include general and project-specific fund-raising.

a. Fitch Ratings, *Health Care Special Report: 2002 Median Ratios for Nonprofit Hospitals and Health Care Systems*, August 7, 2002 (www.fitchratings.com). Based on median of sample hospitals in 2001.

The extent of the organization's ability to obtain charitable funds for a project should be factored into capital prioritization.

Capital Allocation

Capital prioritization begins with the allocation of the five-year capital spending pool to different categories of capital spending. At minimum, three categories should be identified:

- > Routine projects (e.g., replacing equipment and maintaining facilities)
- > Mandated projects (e.g., fulfilling regulatory requirements)
- > Strategic projects (e.g., developing new facilities and service lines)

Separating capital spending into categories simplifies the evaluation process by allowing each capital project to be compared with similar projects instead of with all other capital requests.

This approach also helps ensure that priority areas receive adequate funding. Without such an approach, routine capital requests may quickly consume most of the available capital dollars, leaving little funding for more strategic capital investments that would promote long-term growth. This situation can be avoided by reserving some capital funds for more strategically important projects and reducing funds for routine capital items.

Projects involving life safety code and other regulatory mandates jump to the top of the list. They are a cost of doing business, even though they might not score very high based on typical strategic or financial criteria normally used to rank capital projects, such as market or revenue gains.

Organizations also should consider a fourth category of capital spending for mission-related projects. Although one could argue that all capital spending is mission-driven, this category could be reserved for those investments that are considered important to the organization's mission that also have a low or negative projected return on investment or do not meet other priority criteria developed for ranking capital projects. Such projects, for example, might

include renovating the emergency department to accommodate rising volumes of uncompensated care. The relative priority afforded such projects will depend entirely upon the organization's mission.

Strategic capital may involve investments in technology (including information technology), major new service lines, and facilities. Some organizations establish a minimum threshold (e.g., more than \$250,000) for strategic items.

To the extent that the strategic and/or facility plans are still evolving or that the marketplace and projected activity levels are uncertain, some capital funds may be reserved to cover unexpected needs, or as-yet-undefined strategic projects, or reduced debt capacity from unrealized or underestimated market performance.

The balance and budgeting spending levels for each capital funding category should be reviewed and updated each year.

Considering Capital Requests

Healthcare organizations also should develop and implement a clear process for submitting capital requests, along with justification forms. A justification form should:

- > Describe the project or equipment
- > Evaluate the need relative to the organization's overall goals and market dynamics
- > Assess financial feasibility, including costs, potential volumes and revenues, and return on investment
- > Identify key stakeholder support (e.g., physicians or employees)
- > Evaluate impact on quality of care
- > Identify alternatives and reasons for rejecting them
- > Identify implementation requirements and time frame

Each capital request should be reviewed and assigned to the appropriate capital budget category. The merits of each project should then be evaluated using strategic, market, financial, operational, and other stakeholder criteria. These criteria should be assigned weights reflecting their relative importance

EVALUATING CAPITAL PROJECTS: A CASE EXAMPLE

To illustrate the application of a disciplined process for comparing capital requests, consider the case of a large U.S. multihospital health system, which we will call ABC Health System.

When evaluating capital requests, ABC places the greatest emphasis on financial benefits. This emphasis is reflected in the relative maximum scores for weighted criteria in each area of benefit.

ABC HEALTH SYSTEM CAPITAL PROJECT SCORING CRITERIA AND WEIGHTS

| Benefit Area | Criteria | Sample Weights/Scoring |
|--|------------------------------------|---|
| Strategic/Market Maximum score: 5 with six goals | Fit with key strategic goals | 0.5 point for each strategic goal met |
| | Support of clinical priorities | 1 point if yes, 0 if no |
| | Effect on market position | 1 if market share gain, -1 if market share loss, 0 if no change |
| Financial/Operational Maximum score: 8 if no capital cost | Revenue potential | 2 points for positive revenue impact |
| | Achievability of operating savings | 2 points if yes, 0 if no |
| | Capacity to increase productivity | 2 points if yes, 0 if no |
| | Return on investment | 2 if >10%, 0 if 0-10%, -2 if <0% |
| | Level of investment | 0.5 for every \$X million in costs |
| Stakeholder/ Community Impact Maximum score: 4 | Effect on quality of care | 1 for improvement, 0 for no change |
| | Effect on patient satisfaction | -1, 0, or 1 depending on level of improvement (negative to positive) |
| | Level of medical staff support | -1, 0, or 1 depending on level of support (negative to positive) |
| | Increases employee satisfaction | -1, 0, or 1 depending on amount of change (negative to positive) |

ABC was faced with evaluating four initiatives that it had identified as strategic/mission-related: developing a new cancer center, reconfiguring a day-surgery recovery area, consolidating two ICUs into one unit, and expanding an existing women's health center.

ABC HEALTH SYSTEM CAPITAL PROJECT SCORES

| Criteria | New Cancer Center | Day Surgery Reconfiguration | ICU Consolidation | Women's Center Expansion |
|---------------------------------------|-------------------------|--------------------------------|----------------------|-----------------------------|
| Strategic/Market | | | | |
| Meets strategic goals* | 3.0 | 2.0 | 1.5 | 1.0 |
| Supports clinical priorities | 1.0 | 1.0 | 1.0 | - |
| Expands/enhances market position | 1.0 | - | - | 1.0 |
| Strategic/Market Score | <u>5.0</u> | <u>3.0</u> | <u>2.5</u> | <u>2.0</u> |
| Financial/Operational | | | | |
| Revenue potential | 2.0 | 2.0 | - | 2.0 |
| Achieves operating savings | - | - | 2.0 | - |
| Increases productivity | - | - | 2.0 | - |
| Return on investment | 2.0 | - | - | (1.0) |
| Level of investment† | (1.0) | (0.5) | (1.0) | (0.5) |
| Financial/Operational Score | <u>3.0</u> | <u>1.5</u> | <u>3.0</u> | <u>0.5</u> |
| Stakeholder/Community Impact | | | | |
| Enhances quality of care | 1.0 | 1.0 | 1.0 | 1.0 |
| Improves patient satisfaction | 0.5 | 0.5 | - | 0.5 |
| Supported by medical staff | 1.0 | 1.0 | - | 0.5 |
| Increases employee satisfaction | - | 0.5 | - | - |
| Stakeholder/Community Score | <u>2.5</u> | <u>3.0</u> | <u>1.0</u> | <u>2.0</u> |
| Total Capital Evaluation Score | <u>10.5</u> | <u>7.5</u> | <u>6.5</u> | <u>4.5</u> |

* Out of six goals

† (0.5) for each \$5 million

ABC's approach to scoring the capital requests illustrates how weighted criteria allow objective evaluation of a capital project, resulting in a score that reflects the overall impact of the project to the organization. The expansion of the women's health center scored lowest due to a poor financial return and lack of consistency with strategy goals, while the cancer center scored highest because it was better aligned with ABC's strategic and clinical priorities and was likely to produce a more significant financial return.

After each project was scored, ABC added them to a list of all strategic/mission-related projects proposed for the coming fiscal year, ranked from highest to lowest by score. All projects then were evaluated in terms of the associated capital cost and the budget for strategic/ mission-related capital spending. ABC had budgeted \$75 million for

strategic initiatives. Although the cost of the four projects described previously was well below this amount, ABC determined that, taken together with the other projects under consideration, there was insufficient funding available for the women's health center project, given its relatively low ranking.

Although ABC initially rejected the women's project because of its relatively poor financial return, the project was not completely dismissed, because it offered a way to increase access, patient satisfaction, and volumes. ABC reconsidered the project to include more modest renovations of \$2 million, thereby reducing the level of investment required and boosting the project's ROI and priority ranking. The next year, the project was approved for funding.

CAPITAL ALLOCATION FOR ABC HEALTH SYSTEM, FY2000

| Project | Priority Score | Project Cost (millions) | Cumulative Project Cost (millions) | |
|---------------------------------------|----------------|-------------------------|------------------------------------|---------------|
| Orthopedic Institute | 14.0 | \$22.5 | \$22.5 | |
| Information System Development-Year 1 | 12.0 | \$10.0 | \$32.5 | |
| MRI | 11.0 | \$2.0 | \$34.5 | |
| New Women's Center | 11.0 | \$2.6 | \$37.1 | |
| New Cancer Center | 10.5 | \$8.0 | \$45.1 | |
| Cardiac Cath Expansion | 9.0 | \$10.0 | \$55.1 | |
| Day Surgery Reconfiguration | 7.5 | \$4.0 | \$59.1 | |
| OB Unit Renovation at Hospital A | 7.0 | \$0.8 | \$59.9 | |
| ICU Consolidation | 6.5 | \$7.0 | \$66.9 | |
| OB Unit Renovation at Hospital B | 6.0 | \$7.5 | \$74.4 | Funding Level |
| Women's Center Expansion | 4.5 | \$5.0 | \$79.4 | |
| Women's Pavilion at Medical Center | 4.5 | \$45.0 | \$124.4 | |
| Radiology Renovation at Hospital C | 0.5 | \$4.5 | \$128.9 | |
| OP Mental Health Expansion | (1.0) | \$1.5 | \$130.4 | |

The four capital requests were added to the list of all capital requests submitted for the fiscal year that were categorized as strategic.

to the organization, as well as the extent to which they can be practically achieved, thereby allowing capital planners to emphasize certain goals over other ones. Criteria weight values should be established at the outset of the capital-budgeting cycle, and should not be changed within a budget cycle. They should, however, be reviewed each year between budget cycles to reflect changes in overall emphasis or priority.

To evaluate a capital project, an appropriate number of points should be assigned to the project for each criterion. The points for all criteria then should be added to determine the project's total score. As

shown in the sidebar on these pages, the added weights for all criteria will indicate the project's relative value to the organization.

Some organizations may place the greatest emphasis on stakeholder and community-impact benefit, whereas other organizations may place more emphasis on financial returns. This relative emphasis is reflected in the maximum number of points possible in each benefit area.

After each capital request is scored individually, all requests within a given funding pool should be ranked by score, highest to lowest. The prioritized

list of projects also can be reviewed as a group to determine whether funding should simply be allocated to the capital projects with the highest scores, or whether high-ranked projects that involve significant capital costs should be replaced with several lower ranked, less expensive projects. Another avenue to explore is whether a capital partner or philanthropic resource can be identified for some higher ranked projects, freeing capital for other needs.

The projects that are not funded can be dropped, revised, and resubmitted at a later time.

Communicate the Process

Successful capital allocation depends on clear communication throughout the organization of the criteria used for capital budgeting and prioritization.

This approach should be an integral part of both planning and financial processes. Such integration will ensure that all of the organization's investment decisions reflect the organization's strategic and financial objectives, and thus will help the organization fulfill its mission and optimize its return on investment. ■

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