

# managing the margin

...strategies for generating new revenue and controlling costs

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## FEATURED FOCUS

## Divestiture: Defense Strategy or Growth Initiative?

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Divestiture is often seen as a purely defensive move, linked with announcements of strategic repositioning or major restructuring. This perception is reinforced because poor financial performance, either for the organization as a whole or the service or program in question, is frequently cited as a key driver in the decision to divest.

However, divestiture is a relevant strategy for all organizations striving to maintain financial health. As the following case studies show, decisions to divest, when made proactively, can be a valuable tool for achieving sustainable, financially beneficial growth. A divestiture strategy can:

- Focus capital and management resources on an organization's core services and businesses
- Eliminate the need to subsidize financial losses in certain programs
- Provide capital to meet infrastructure requirements and fund future growth initiatives in a health system's strategic plan
- Provide capital to pay down debt and improve the organization's financial position

### Refocus on Core Business

During the 1990s, many health systems pursued the integrated delivery service model, developing or acquiring businesses that enabled them to offer services across the whole continuum of care. These services included home care, nursing homes, skilled nursing facilities, and assisted living communities.

When payment levels changed, organizations reexamined the value of continued investment and many decided to divest. These services represented programs that were peripheral to the delivery of acute care services.

Such is the case with Aurora Health Care, a not-for-profit healthcare organization with sites in more than 75 communities throughout the eastern third of Wisconsin. Aurora operates 13 acute care hospitals and a psychiatric hospital. It also owns 140 pharmacies; offers laboratory, home care, hospice, family, and social services; and employs more than 600 physicians from various specialties as part of its Aurora Medical Group.

Until recently, Aurora's facilities also included senior

housing, skilled nursing care, and nursing homes. When Medicare began paying based on a per patient rate instead of cost, these subacute services lost some of their financial appeal. As a result, in 2004, Aurora sold off its Friendship Living Centers and Valley Manor Nursing Home, deciding that the two senior housing facilities did not represent a core competency for the system.

The sale of Friendship Living Centers and Valley Manor Nursing Home will enable Aurora to focus its resources on medical and other services it provides to seniors, including acute care for the elderly, the Aurora Geriatrics Institute, a regional Parkinson's center, memory assessment and geriatric assessment services, and elder care management. Through the Visiting Nurse Association of Wisconsin, Aurora also offers in-home health monitoring and adult day centers.

The facilities promise to be a better fit for the core business strategies of the purchasers. Friendship Living Centers was sold to The Village at Manor Park, which operates senior housing, assisted care, hospice facilities, and

medical and rehabilitation clinics in greater Milwaukee. The sale included two facilities that will give The Village at Manor Park a physical presence on the northwest side of Milwaukee: Friendship Village, an independent, assisted living and skilled nursing facility; and Freedom Village, an independent living townhouse community.

The other purchaser, Rice Partnership, is a long-term and continuing care provider based in Appleton, Wis. It purchased Aurora's Valley Manor Nursing Home and South Horizons Senior Apartments for \$2.67 million. The facilities are located in Plymouth, Wis., in the same complex as Aurora's Valley View Medical Center. Eventually, Rice plans to buy the medical center as well.

### Minimize Loss

Divestiture can also eliminate the need to subsidize financial losses in certain programs. One common strategy for health systems over the past decade was the employment of physicians to secure a referral base for affiliated specialists and negotiate with managed care plans from a position of strength. More recently, employed physician groups

have served as a mechanism for physician recruitment strategies.

However, as financial losses continued to mount and the spin-off revenue was harder to quantify, many hospitals and systems have chosen to reprivatize these practices. Some also have revised employment contracts to include performance criteria for individual practices with the option to divest if targets are not met. Such was the case with Health First, a healthcare system in Brevard County, Fla., that divested some, but not all, members of its employed physician group.

Health First owns three acute care hospitals, Holmes Regional Medical Center, Cape Canaveral Hospital, and Palm Bay Community Hospital; an HMO offering commercial and Medicare insurance products, Health First Health Plans; and a multi-specialty group of employed physicians, Health First Physicians.

The physician group was formed in late 1995 and grew rapidly. Within two years, the group had expanded to include 60 primary care and specialty physicians. The practices were located in southern Brevard County in the service area of Holmes Regional Medical Center and Palm Bay Community Hospital and in the central portion of the county near Cape Canaveral Hospital. By offering generous contracts, Health First Physicians was successful in acquiring physicians who were key strategic players in the market. But the contracts, which had 15-year terms, provided the healthcare system with no flexibility.

A systemwide strategic planning process led Health First to reexamine its physician strategy and reevaluate whether it should continue to employ physicians that would compete with the private practice physicians on its medical staff. As a result, Health First decided to negotiate buyouts with the physicians in southern Brevard County and focus on the remaining physicians with offices in the central portion of the county. By the end of 1998, Health First had 25 physicians in

14 practices, most in primary care and obstetrics/gynecology.

By 2003, Health First Physicians, like many employed physician groups, was still not meeting financial expectations. The healthcare system initiated a strategic assessment of Health First Physicians prior to the development of a performance improvement plan for the group. As part of the strategic assessment, strategic and operational criteria to evaluate the Health First Physicians were developed. The criteria considered each physician's strategic priority for the system and role in meeting coverage requirements, historical financial performance and other productivity measures, growth potential, and the likelihood of alienation if the physician's practice was divested. Scoring indicated which practices were candi-

dates for divestiture or probation and which should be retained.

Since the conclusion of this assessment, Health First has divested two Health First Physicians practices, and others have been the focus of performance improvement initiatives. Health First Physicians continues to play an integral role in physician recruitment initiatives for the system and has recruited 14 additional physicians to the group since 2003.

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**Support Capital Needs**

The financial position of a healthcare system also may drive the decision to divest. Profitable services make attractive acquisition targets for niche companies looking to grow. The infusion of cash from the sale of high-performing businesses can provide capital to fund growth initiatives and infrastructure investments across the organization.

One system that used divestiture to help raise capital for growth is Health Alliance of Greater Cincinnati, a not-for-profit system of six hospitals: Christ Hospital, Jewish Hospital, and University Hospital in Cincinnati, Ohio; Fort Hamilton Hospital in Butler County, Ohio, north of Cincinnati; and St. Luke Hospital East and St. Luke Hospital West in northern Kentucky. The system also operates Alliance Primary Care, a group of more than

150 internal medicine, family medicine, and pediatric physicians with practices at more than 30 locations throughout the metropolitan area.

Over the years, a key area of business for Health Alliance has been the Health Alliance Laboratory Services (Alliance Laboratory). Alliance Laboratory provides outreach lab services to physician practices in the Cincinnati area and reference lab testing to Health Alliance hospitals. The comprehensive range of testing services offered includes those in microbiology, immunology, pathology, cytology, and toxicology. Annual revenues associated with the outreach and reference lab testing of Alliance Laboratory have been about \$40 million.

Until early 2004, Alliance Laboratory was the second largest not-for-profit laboratory in the United States. However, in late 2002, Health Alliance announced that it was exploring a range of options related to the sale of its laboratory business. The intent was to select a partner that would also enter into an outsourcing agreement to provide patient clinical lab services at the system's hospitals.

Health Alliance's decision to consider the divestiture of its profitable lab business was made following a review of all business lines to identify opportunities to improve the organization's financial position. The system needed to be able to fund significant capital investments in the near future. The sale of Alliance Laboratory was also expected to have an immediate positive impact on the system's cash position.

In late 2003, Health Alliance announced an agreement with LabOne, a national laboratory testing provider based in the greater Kansas City area that serves physicians, hospitals, health systems, insurance companies, and employers. LabOne's goal is to become the premier diagnostic laboratory provider in the Midwest, and one of its major strategic objectives was to develop a second major laboratory facility. In the spring of 2004, LabOne agreed to build a new laboratory facility in Cincinnati. The \$21 million project is scheduled to be completed in the second quarter of 2005.

In the transaction with Health Alliance, which closed in early January 2004, LabOne purchased the assets of Alliance Laboratory Services for \$38.5 million in cash. Under long-term service agreements signed at the same time, LabOne will also provide reference testing services to Health Alliance hospitals and manage the system's six immediate response labs. Health Alliance will continue to own the immediate response labs.

### **Improve Financial Position**

Restructuring to improve financial position is another common strategy. For-profit healthcare organizations face tremendous pressure to provide a return on investment for shareholders and to meet or exceed the expectations of Wall Street. Perhaps these additional challenges

explain why for-profit organizations are more likely to restructure or divest underperforming hospitals or business units than their not-for-profit peers.

One company that pursued divestiture as a strategy for financial improvement is Tenet Healthcare Corp., which currently owns 69 acute care hospitals in 13 states. In March 2003, Tenet announced plans to sell or consolidate 14 "non-core" hospitals nationwide, including two in the Philadelphia area. The divestitures would allow the company to concentrate on key markets and to raise capital in order to pay down debt. The sales of the Philadelphia hospitals would focus Tenet's resources on the strongest hospitals in the area's network.

Elkins Park Hospital, a 243-bed acute care facility located in suburban Montgomery County, Penn., was sold to Albert Einstein Healthcare Network in November 2003. The purchase price of \$13 million was about one-third of the assessed value for the hospital facility and 30-acre campus, but the financial losses at Elkins Park will no longer impact Tenet's income statement. The acquisition will enable the Albert Einstein Healthcare Network to relocate most of the inpatient beds of its Moss Rehabilitation Hospital, enhancing its inpatient and outpatient facilities and meeting its needs for additional space. Select acute inpatient and

outpatient services will continue to be offered at Elkins Park, expanding the network's ability to serve Montgomery County residents.

Tenet closed Parkview Hospital, a 200-bed facility located in northeast Philadelphia, in September 2003 after efforts to find a buyer for the money-losing hospital were unsuccessful. Subsequently, the company entered into discussions with Cancer Treatment Centers of America (CTCA) in April 2004 and the deal to transfer Parkview Hospital to CTCA closed in September; financial terms were not disclosed. CTCA, which has headquarters in Arlington Heights, Ill., and operates hospitals in suburban Chicago and Tulsa, Okla., integrates conventional cancer treatments with alternative therapies. The acquisition of Parkview is integral to CTCA's East Coast expansion plans and \$44 million in renovations to convert the facility into a 40-bed cancer hospital have already begun in anticipation of an October 2005 opening.

Following a review of the strategic position and capital needs of its remaining hospitals, Tenet announced another restructuring in January 2004 that included plans to divest an additional 27 hospitals.

The hospitals targeted for divestiture require significant future capital investments, are unable to meet financial objectives, or are located in

markets Tenet no longer intended to serve. The decision was intended to improve the company's potential for long-term growth by eliminating the need to divert resources from stronger hospitals to subsidize poor performing ones.

### **A Proactive Pursuit**

As healthcare organizations continue to experience competitive and financial pressures that can impede future growth plans, many could benefit from the proactive pursuit of a divestiture strategy.

The decision to divest is often a difficult one to make. However, the benefits of divestiture, including the elimination of poor performing services, a renewed focus on core businesses, and additional funds for capital investment, can have a significant impact on the financial well-being of tomorrow's hospitals and health systems. ■

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