

STRATEGIC

M A N A G E M E N T

Market Memo:

Ambulatory care: What's profitable, what's not

By Alan Zuckerman, FACHE, FAAHC

More patient encounters take place in ambulatory care settings than in any other sector of the health care industry. Ambulatory care covers a wide range of services, ranging from emergency and surgery care at the high end of the intensity spectrum to primary care office visits, screening, and wellness services at the low-intensity end. In between is a broad spectrum of diagnostic and treatment services that are provided in physician offices, clinics, outpatient centers, hospitals, and a variety of other institutional and commercial settings.

Along with the pharmaceutical industry, the ambulatory care sector of health care has been experiencing double-digit growth for many years. Both reimbursement and technology have been the dual drivers of market growth. And if there was a signal event that catapulted ambulatory care into a high-growth mode, it was the initiation of the federal prospective payment system for inpatient care in the early 1980s. This new reimbursement system created strong financial incentives for substituting outpatient services for inpatient care and accelerated an already pronounced trend.

The rapid growth in ambulatory care has benefited traditional and new providers. Hospital and physician groups, the traditional providers of outpatient services, have been challenged to keep up with the tremendous growth in demand for the past 15 years. As a result, a wide variety of new outpatient providers, services and facilities have sprung up to meet the demand. In particular, for-profit niche companies have emerged as major forces in ambulatory care. While Health South, a \$4 billion company that got its start in outpatient rehabilitation, is probably the largest and best-known of the ambulatory care for-profits, there are a number of other large, national players (e.g., Fresenius in dialysis, Concentra in occupational health, etc.) and many medium and small national and regional companies operating in various outpatient niches. In the large and fragmented market for ambulatory care, where no one firm has more than a small share of the total market, the competitive situation is very dynamic and fluid.

Technology moves services to ambulatory care

As one of the two main factors spurring rapid ambulatory care growth, developments in technology have allowed many services to be provided on an ambulatory basis when previously it was only safe and feasible to carry out diagnosis or treatment in an inpatient setting. With the technological developments of the past decade, now most surgery is done in the outpatient setting, upwards of 80% of cancer treatment (close to 90% in some communities) is provided in ambulatory centers, and large proportions of imaging, rehabilitation, diagnostic cardiac catheterization, and other high-tech services are primarily outpatient based.

Some of the more notable technological developments of the past decade affecting ambulatory care include minimally invasive surgery, laser surgery, arthroscopy, upgraded imaging such as MRI and ultrasound, and faster, more precise linear accelerators.

These technologies have, in general, created entirely new demand or facilitated treatment moving from inpatient to outpatient settings. At the same time, improvements in technology primarily applied in inpatient settings have resulted in earlier discharge of inpatients and more of the

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care delivery for many patient conditions being provided in outpatient rather than inpatient settings.

Reimbursement rules make it happen

If technological advances are the main enabler for the provision of services in an outpatient versus inpatient setting, reimbursement is the catalyst to make many of the service delivery changes actually happen. Reimbursement policies of the past 20 years have and largely continue to create strong incentives for outpatient services growth.

The implementation of the federal prospective payment system in 1983 resulted in a large decline in hospital lengths of stay over the next 15 years. Earlier discharge of hospital inpatients generally meant that more care was provided on an outpatient basis. Throughout the past two decades, the federal government and commercial insurers have been diligent about incentivizing providers to move care to lower-cost settings, which has also resulted in many former inpatient procedures no longer being allowable for reimbursement while reimbursement for care on an outpatient basis is acceptable.

The next major payment change after prospective payment was managed care. As managed care grew, especially in the 1990s, additional pressure was applied by managed care payors to deny inpatient care in favor of outpatient care. Even with managed care on the wane today, the residual effects of these policies continue.

Today, providers are adapting to the latest major federal payment change, the ambulatory payment classification system. The system bundles related outpatient encounters by a patient into a single category for reimbursement purposes and has had the effect of lowering payment for ambulatory care services provided by Medicare patients in nearly all instances. This new system is the first significant reimbursement disincentive for ambulatory care and it is still too early to tell what its long-term prospects and impact will be.

Patients prefer ambulatory care

Consumer market research studies have repeatedly demonstrated that, all other things being equal, consumers prefer to receive their health care services on an ambulatory basis. Consumer preference for ambulatory over inpatient care has certainly been an important factor in the growth of ambulatory care.

As ambulatory care services are used far more frequently than inpatient services and are nearly always lower-intensity services, consumer selection of ambulatory care providers versus inpatient providers is based on different factors or at least different weights of the same factors. Frequency of use and lower intensity translate into need for closer, more convenient locations as well as higher levels of customer service and amenities in most cases.

Ambulatory patients have more choices, are mobile, and will select providers who offer convenience and comfort. While technical quality is important, in most cases quality differentials among providers are assumed to be minor and since most ambulatory treatment is lower intensity, technical quality is not as important anyway.

Patient preferences have helped to transition many ambulatory services out of large, complex hospital campuses and into the community. In many metropolitan areas, ambulatory care centers are as convenient as frequently used commercial retail establishments. And, as part of the movement to deinstitutionalize ambulatory care to respond to patient preferences, many newer ambulatory care centers resemble shopping malls and upscale hotels.

What's profitable, what's not

The most profitable ambulatory care segments, in general, have the following characteristics:

- **Very rapidly growing demands.** Rapid growth often characterizes new niches, new technologies or modalities, and vastly improved capabilities in existing technologies or modalities. In such segments, demand may outstrip capacity and often results in very high rates of capacity utilization and thus lower fixed costs per unit and, generally, higher margins. For many years this trend characterized MRI, as many machines were being operated 10 to 12 or more hours per day, six days per week. At some point, supply usually catches up with demand and profitability declines.
- **High-tech and high-intensity services.** The most favorable reimbursement is usually offered for high-tech and high intensity services, in the former case as a "risk" (of capital) premium and in the latter as an incentive to move care away from higher-cost inpatient settings. Also, the high capital costs or complexity of care provided generally act as barriers to entry and limit competition, which also increases profitability. As services become more commonplace and profitability is recognized, additional providers enter the market and profitability declines.
- **Barriers to entry.** Barriers limit competition and generally raise profitability. Typical barriers encountered in health care are capital costs, regulations (especially certificate of need and licensing), and availability of specialized personnel and skills. One of the best examples of the power of barriers to raise profitability in health care (but not ambulatory care) in recent times is the case of open-heart surgery, which was enormously profitable until surgeons and support staff became more available and regulatory barriers were reduced.

- **Favorable payer mix.** Probably the most obvious of the expected characteristics of profitable segments is a favorable payer mix. For example, some payers reimburse at more favorable rates, more self-payment (i.e., cash, credit card) is available, or the market has only a small percentage of poorly reimbursing payers (typically Medicaid and other public programs). For-profit niche firms have exhibited a keen awareness of this aspect of ambulatory care, and the most successful national firms have their services concentrated in markets that have better than average payor characteristics. Also, the recent interest in alternative or complementary medicine by traditional providers is largely driven by the favorable payer characteristics of these services.

Single-specialty surgery centers are winners

Based on the assumptions noted above, what are some of the ambulatory care services that are among the most profitable today (however, those which are highly profitable today might not be in as short a period as a year) and what's looming on the horizon for 2002 to 2003?

Today's winners include single-specialty surgery centers, alternative and complementary medicine, medical fitness centers, and emergency department stroke centers (if "spin-off" benefits are considered for stroke centers). Four emerging areas in 2001 that are likely to be hot at least through this year include digital mammography, ultra-fast CT, PET scanning, and whole-body diagnostics.

Harder to forecast are the entirely new areas. Given developments in the industry, areas to watch in 2002 to 2003 may be angioplasty or other therapeutic cardiovascular procedures, new laser and minimally invasive surgical procedures, new or improved imaging modalities, and increasing application of commercial retail concepts in the outpatient setting.

Forecasting the future is perilous and prone to high error rates. Nonetheless, many of the trends in the characteristics of the ambulatory care market are known and described in this article and can be used to develop well-used and financially rewarding services. While it may be hard to hit a home run in every ambulatory care at-bat, there are tremendous opportunities to have a high batting average with frequent singles and doubles in the expanding ambulatory care arena. ■

Alan M. Zuckerman, FACHE, FAAHC, is director of Health Strategies & Solutions Inc., 1429 Walnut Street, Suite 200, Philadelphia, PA 19102. Call 215 636-3500; e-mail azuckerman@hss-inc.com.

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